






# Across The Sea

Sailing through across the sea, knowledge and conscience as the key.  
Patience and hope remaining the guide. To reach the horizon of light



# PART 3

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

*Throughout 2011, Bank Indonesia policy aimed to maintain macroeconomic and financial system stability amidst the dynamics of the global economy. On the monetary side, the policy aimed to strategically control inflation in accordance with inflation targets. This is done through a mixture of interest rate and exchange rate policies that were supplemented by macroprudential policy targeted at managing foreign capital flows and excess liquidity. The monetary and macroprudential policy mix was supported by communication strategy to manage inflation expectations, improve the effectiveness of monetary policy transmission, and reduce the uncertainty of market participants. On the banking side, the policy mix focused on raising resilience and strengthening supervision functions in the midst of efforts to promote the role of banking intermediation in the economy. Achievement of a stable financial system was supported by payment system and currency distribution policies that aimed at improving efficiency and security, strengthening payment system infrastructure and fulfilling public needs. Bank Indonesia continues to strengthen its coordination with the Government both at central and regional levels, to support the achievement of high economic growth and help maintain macroeconomic and financial system stability.*

*The implementation of monetary and macroprudential policy mix was adjusted in accordance with the dynamic challenges of the domestic economy. During the first semester of 2011, the domestic economy was challenged by rising inflation and an inrush of capital flows, including portfolio investments in domestic financial assets. In response to these conditions, Bank Indonesia raised the BI rate reinforced by policies that ensured added room for rupiah to strengthen further, in order to dampen inflationary pressures*

*arising from imported inflation. On top of the large current account surplus, the capital inflows amplified foreign exchange reserves, thus providing a sufficient cushion against the risk of reversals (self insurance). Entering the third quarter of 2011, worsening global economic uncertainty resulted in capital flows reversing out of emerging markets, including Indonesia. The pressures on the financial market including exchange rates became heighten. Facing these pressures, Bank Indonesia intervened in foreign exchange markets by using the previously accumulated reserves to stabilize the rupiah. Efforts to stabilize the rupiah exchange rate were accompanied by the purchase of government bonds in the secondary market by Bank Indonesia, both bilaterally or through auction. These steps directly addressed the pressures on the rupiah from the sell-off of government bonds by foreign investors. The government bonds purchases also in line with Bank Indonesia's efforts to use government bonds as a monetary instrument and to avoid a liquidity crunch in the rupiah money market as a result of foreign exchange intervention. Furthermore, in line with the confidence that inflationary pressures will remain low and anticipating the potential impact from an global economic slowdown on the domestic economy, in the fourth quarter of 2011 Bank Indonesia implemented an accommodative and countercyclical monetary policy by lowering the BI rate.*

*These interest rate and exchange rate policies were strengthened by macroprudential policies in order to effectively manage capital flows and banking liquidity, supported by a communication strategy to improve the effectiveness of monetary policy. To mitigate the impact of high, short-term capital inflows fluctuations on the domestic financial system stability, Bank Indonesia strengthened the capital flows management*



policies that has been pursued since 2010. These policies namely increasing foreign currency reserve requirements, lengthening minimum holding period of Bank Indonesia Certificates (SBI) to a minimum of 6 months, and limiting the daily balance of bank's short-term external borrowing. Moreover, to strengthen the structural basis of foreign currency supplies on domestic foreign exchange market towards rupiah stabilization, exporters and debtors are required to receive export proceeds and withdraw their foreign borrowing, respectively through domestic banks. In the meantime, to strengthen the macroprudential policies with regard to liquidity management that were implemented in 2010 such as higher rupiah reserves requirement, in 2011 Bank Indonesia implemented several new policies. The policies are lengthening the maturity profile of monetary instruments and reducing the supply of SBI issued on the primary market. These macroprudential policies were supported by continuous communication strategies aimed at guiding public expectations of the future course of the economy, thus increasing the effectiveness of monetary policy and providing certainty to market participants. The macroeconomy and financial system stability was further supported by the implementation of banking policies aimed at increasing banking resilience and strengthening supervision, as well as promoting banking intermediation. The policy of increasing banking resilience is an effort to support banks' growth, competitiveness, and ability to absorb risk while strengthening good governance. This policy of strengthening banking supervision and promoting the banking intermediation function was implemented among others by improving public access to banks and improving the quality of credit to productive sector.

Efforts to strengthen the financial system stability were also supported by policies regarding payment

systems and currency distribution. Payment system policies were directed at increasing efficiency and security, and strengthening payment infrastructure and interconnections with other systems infrastructure. Meanwhile, currency distribution policy aimed at fulfilling the demand for currency by providing sufficient quantities in appropriate denominations, in a timely manner and good condition for circulation.

Bank Indonesia and the Government coordinated their policies ever more closely with regard to inflation control, achievement of macroeconomic stability, and the promotion and improvement of economic growth quality. Bank Indonesia and the Government primarily coordinated their policies in managing inflation at the central and regional level by strengthening and expanding the TPI (Inflation Control Team) and TPID (Inflation Control Regional Team). On the Government side, prudent fiscal policy has been able to preserve the fiscal sustainability and still able to drive the economic growth through the provision of stimulus in the midst of an increasing subsidy burden. These growing subsidies are primarily intended to support food security and energy resilience, thus supporting price stability. The government's contribution in supporting the domestic economy can be seen from the higher absorption of state expenditure and the significant increase in capital expenditure. Supporting this fiscal policy are various sectoral policies in the industrial, trade and agricultural sectors that are geared towards driving and improving the quality of economic growth. Efforts to expand the capacity of the economy include, among others, the preparation of infrastructure and the improvement of the investment climate, whereas job creation and poverty reduction have been achieved through the provision of assistance and social protection of the poor.





# Chapter VII

## MONETARY AND MACROPRUDENTIAL POLICY





# MONETARY AND MACROPRUDENTIAL POLICY



*Bank Indonesia's monetary policy is aimed to keep inflation in line with inflation targets to support macroeconomic and financial system stability and create a climate conducive to high economic growth. The monetary policy was implemented through interest rate and exchange rate policies, supported by macroprudential policies to manage liquidity and capital flows in accordance with the state of the economy. In addition, Bank Indonesia also implemented a communication strategy to anchor public expectations on the future course of the economy. It is expected that this communication strategy will improve the efficacy of monetary policy and give greater certainty to all market participants. Subsequently, to anticipate the impact of global economic uncertainty and to build a stronger financial system, Bank Indonesia has established crisis management protocols (CMP) with regard to exchange rates and banking. At the moment, Bank Indonesia's CMP is being integrated into national CMP in coordination with the Government. Overall, the combination of monetary and macroprudential policy has successfully maintained macroeconomic and financial system stability in the midst of rising global uncertainty.*



## 7.1 MONETARY POLICY

Throughout 2011, the objective of monetary policy was managing inflation in line with inflation target to support macroeconomic and financial system stability in the midst of highly volatile capital flows. In the first semester of 2011, monetary policy focused on curbing the increased inflation pressures stemming from food supply disruptions and high food prices by managing inflation expectations, capital flows, and excess liquidity. Subsequently, in the second semester of 2011, taking into account the subside inflationary pressures and the potential for a slowdown in domestic economy growth due to rising global economic uncertainty, Bank Indonesia implemented a more accommodative monetary policy strategy.

### INTEREST RATE POLICY

At the beginning of 2011, monetary policy was marked by the decision to keep the BI Rate at 6.5%, in a continuation of Bank Indonesia's 2010 stance on monetary policy. This level of BI Rate was deemed to be consistent with achieving inflation targets while still being conducive to maintain the stability of the financial system and promote banking intermediation.

In February 2011, the BI Rate increased by 25 bps to 6.75% as anticipatory measure to control inflation expectations which at the time tended to increase. This increase in inflation expectations was mainly driven by high volatile food inflation, aside from an increased

in global commodity prices and government policies planning for strategic commodities. Interest rate policy was supported by a strengthened rupiah exchange rate policy to address inflationary pressures from global commodity prices increases (imported inflation), and macroprudential policies to manage liquidity and capital flows.

BI Rate was held steady at 6.75% until the third quarter of 2011 envisaged the continued risk of inflationary pressures while maintaining macroeconomic stability. By allowing the rupiah exchange rate to strengthen, it was considered that this policy would be able to dampen inflationary pressures, especially those stemming from imported inflation. As an aside, it was deemed that the subsequent response of an interest rate increase would attract an increase in capital inflows, specifically short-term, thus increasing the complexity of monetary policy in managing Indonesia's economic performance.

Entering the fourth quarter of 2011, the BI Rate lowered by 25 bps to 6.5% on the consideration that inflation at the end of 2011 and 2012 would fall below 5%, or still within the inflation target range.<sup>1</sup> Another consideration was to anticipate the impact of the global economic and financial slowdown on the Indonesian economy. Subsequently, given that inflationary pressures ahead will continue to decrease, the BI Rate was brought down by 50 bps to 6.0% in November 2011. This policy was also implemented to mitigate the impact of the worsening global economy on the Indonesian economy.

Apart from adjusting the BI Rate, Bank Indonesia also decided to adjust the interest rate corridor, in order to stimulate the interbank money market in the midst of excess liquidity. The interest rate corridor was adjusted by changing the bottom limit, namely the overnight (ON) deposit facilities rate whereas the upper limit, namely the ON lending facilities rate, remained unchanged. As such, the ON lending facilities rate stayed at BI Rate + 100 bps, whereas the ON deposit facility rate was adjusted downwards from BI Rate – 100 bps to BI Rate – 150 bps. Given that the BI Rate stood at 6.0% (as of December 2011), the ON lending facilities rate therefore stood at 7.0%, and the ON deposit facility rate was 4.5%.

1 The inflation target for 2011 was 5%±1%, while for 2012 is 4.5%±1%.

## EXCHANGE RATE POLICY

The strategy of exchange rate policy during 2011 has supported the efforts to control inflation as well as achieve macroeconomic and financial system stability. The rupiah appreciated in the first half of 2011, then depreciated in the second half of 2011 in line with deteriorating global financial and economic conditions. Overall, the implementation of exchange rates policy has successfully maintained exchange rate stability in the midst of highly volatile capital flows. The relative stability of the rupiah was preserved, as reflected in the volatility of the rupiah throughout 2011 which increased just slightly to 0.38% compared with 0.35% in 2010 despite strong downwards pressures at the end of the third quarter of 2011. The rupiah's strong resilience in the midst of a growing global economic crisis was also reflected by the average Rupiah exchange rate, which strengthened 3.56% to Rp8,768 per US dollar compared with the average in 2010 of Rp9,080 per US dollar.

During the first half of 2011, Bank Indonesia gave the rupiah added headroom for appreciation in line with the inrush of capital inflows. In the midst of escalating inflation expectations, it was deemed that a strengthening rupiah could dampen inflationary pressures especially those stemming from high global commodity prices. The rupiah was given room to appreciate but on a measured scale relative to other regional currencies, so as not to interfere with the competitiveness of domestic products on the global market. The implementation of this policy, supported by a surplus in balance of payments both in the current account as well as in the capital and financial accounts, has resulted in an accumulation of foreign reserves. The increase in foreign reserves serve as a cushion for self insurance against the risk of capital reversals, thus adding to the resilience of the Indonesian economy.

Entering the second half of 2011, Bank Indonesia took steps to stabilize the exchange rate in response to mounted pressures on the rupiah depreciation. The shocks in global financial market drove investors to relocate their investments from emerging market assets to safe havens. As a result, the pressure on rupiah built up due to capital outflows mainly from government bonds (SBN) and stocks. In response, Bank Indonesia stabilized the rupiah by intervening in foreign exchange markets, through the uses of previously accumulated reserves. This measures also accompanied by purchasing government bonds in the secondary market.

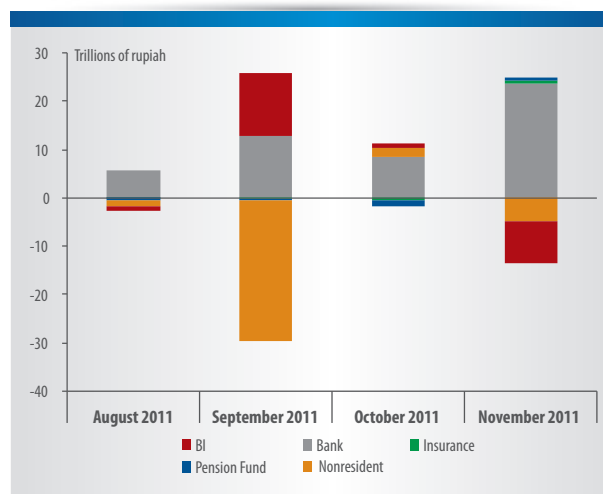


Chart 7.1 Changes in Government Bonds Ownership

Besides addressing the redemption of government bonds by foreign investors as a source of heightened pressure on the rupiah, this move is also intended to preserve the rupiah liquidity which had contracted due to foreign exchange intervention, and to promote the use of government bonds as a monetary instruments (Chart 7.1).

## 7.2 MACROPRUDENTIAL POLICY

Considering that monetary and financial system stability are closely linked, policies in both areas must be carefully synchronized and coordinated. The stability of the financial system greatly determines the efficacy of monetary policy in influencing economic activities and inflation control through various monetary transmission channels, whether interest rates, credit, money supply, exchange rates, or inflation expectations. Conversely, monetary policy response influences interest rate, exchange rates, asset prices risks, as well as inflation risks in an effort to maintain the financial system stability. The link between financial system and macroeconomic stability has become increasingly important given the enormity of economic and global uncertainties which can at any time threaten the stability of Indonesia's macroeconomy and financial system. Consequently, the close linkage between monetary and financial system stability is an ongoing consideration in Bank Indonesia's formulation of monetary and banking policies, particularly with regard to macroprudential policies.

In particular, to strengthen macroeconomic and financial system stability, Bank Indonesia

macroprudential policy focuses on three areas. First, controlling liquidity in the economy, especially banking liquidity. Second, managing capital flows. Thirdly, improving the function of banking intermediation. The formulation of these macroprudential policies is always synchronized with monetary policy in order to remain consistent with the course of macroeconomic development. In this way, the financial system stability can be maintained to support monetary stability and sustain economic growth. The monetary and macroprudential policy mix is supported by a communication strategy which is expected to improve the effectiveness of monetary policy, as well as to provide certainty to market participants and to guide public expectations with regard to the future course of the economy. Moreover, Bank Indonesia has set up Crisis Management Protocol (CMP) as an orderly and integrated mechanism and framework in preventing and managing crises, specifically exchange rate and banking crises, in order to support macroeconomic and financial system stability.

## EXCESS LIQUIDITY MANAGEMENT POLICY

Excess liquidity becomes a challenge for the efficacy of monetary policy in affecting the economy. In general, excess liquidity can be measured by the amount of liquidity that has not yet been channeled to the real sector and therefore placed in Bank Indonesia monetary instruments. The main sources of excess liquidity are capital inflows, government fiscal expansion, and liquidity accumulation from the previous period (Chart 7.2). This excess liquidity reflects the real sector's low absorption capacity and

undeveloped financial markets in providing alternative instruments as source of economic financing. Therefore, in addition to monetary management, the excess liquidity management policy must be accompanied by various policies to promote banking intermediation, to expand the economy capacity, and to foster financial deepening.

In the short term, higher excess liquidity contributed to increased in monetary operation positions. In 2011, the average daily position of monetary operations rose to Rp462.9 trillion compared with Rp371.7 trillion in 2010.

With limited capacity from the real sector to absorb additional liquidity and undeveloped financial markets amid the rush of capital inflows, Bank Indonesia established a macroprudential policy in managing banking liquidity that is consistent with efforts to stabilize financial markets and the economy as a whole. This policy, among others, involved lengthening the maturity profile of monetary instruments and reducing the supply of Bank Indonesia Certificate (SBI) on the primary market. These policies are a continuation from the liquidity management policy that Bank Indonesia has adopted in 2010, among others the primary raising rupiah reserve requirement to 8% of deposits.

### Lengthening the Maturity Profiles of Monetary Instrument

Lengthening the maturity profile of monetary instruments was one of Bank Indonesia's efforts to guide banking liquidity management into longer term perspective. This policy was expected to ameliorate the

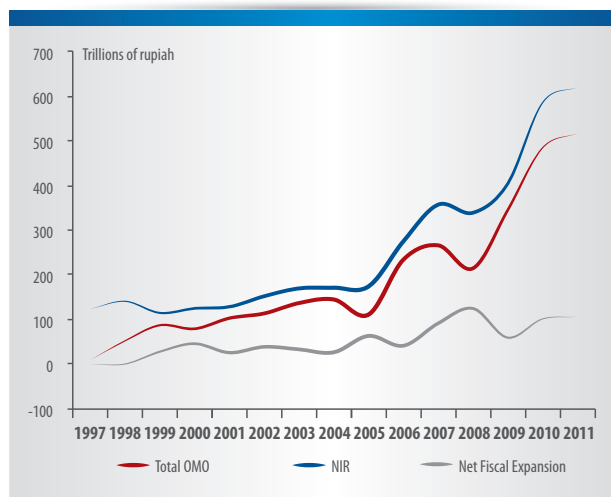


Chart 7.2 Source of Excess Liquidity

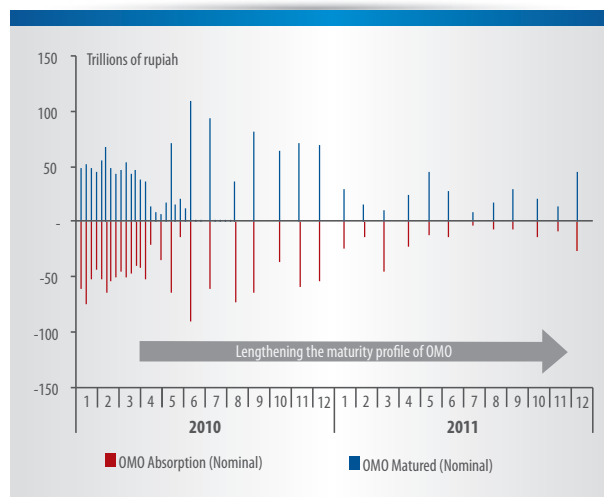


Chart 7.3 The Frequency of Maturity and Absorption of Monetary Instrument

imperfect term structure of interest rates resulted from the high proportion of monetary instruments with very short tenor and frequent maturity dates (Chart 7.3).

Lengthening the maturity profile for SBI issued in 2011 is the continuation of a similar policy that was implemented in March 2010. In general, this policy is implemented in two ways, namely by reducing the frequency of SBI auctions from a weekly to a monthly basis, and gradually non-activated the issuance of 1, 3 and 6 month, leaving only 9 month SBI. The policy aims to reduce the matured SBI as a source of bank liquidity. Moreover, banks are expected to be able to manage their liquidity by lengthening their liquidity management horizon.

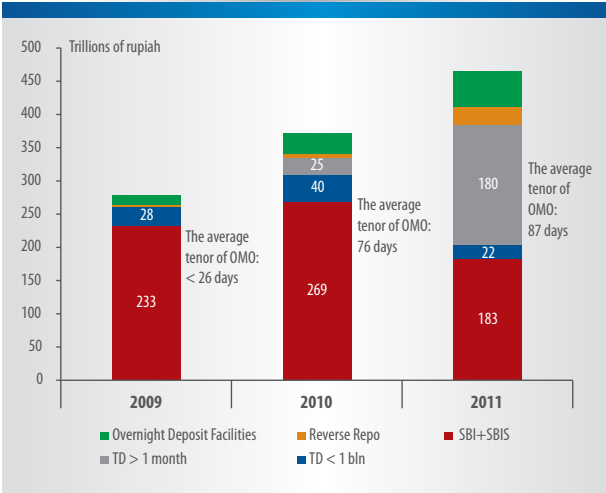
This policy of lengthening maturity profiles was also applied to other monetary instruments, including the auction of Term Deposits (TD) and Reverse Repos of government bonds (RR-SBN) at tenors of over 2 months. However, Bank Indonesia still execute the short-tenor (less than 1 month) auctions to mop up liquidity that longer-tenor instruments cannot absorb. The policy of lengthening the lock up period of excess liquidity in monetary instruments is expected to have a positive impact on financial deepening, through an increase in interbank transactions and an alleviation in the interbank money market segmentation. This will strengthen monetary management towards achieving inflation targets.

Evaluation of lengthening maturity profiles policy showed that the average tenor of monetary instruments has shifted to longer tenor (Chart 7.4).

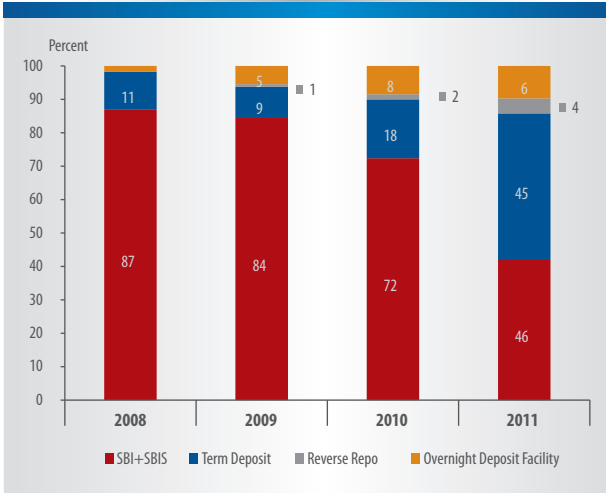
In 2009, the average remaining term of all monetary instruments was 18.23 days given weekly auctions of SBI and a majority SBI issuance was one month. In parallel with the implementation of macroprudential policy to manage excess liquidity, the average tenor of monetary instruments increased from 76 days in 2010 to 87 days in 2011.

**Reducing the supply of SBI on the Primary Market**

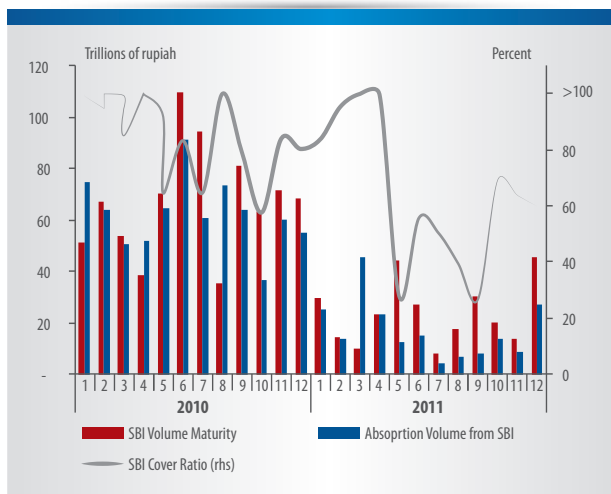
The lengthening maturity profile policy had been able to control the additional liquidity resulting from the maturation of monetary instruments. That policy had been complemented by a policy of reducing the supply of SBI on the Primary Market. SBI was the only monetary instrument are available to absorb excess liquidity that could be purchased by parties other than banks, including non-residents. Meanwhile, the increase supply of SBI on the secondary market had the potential to disrupt liquidity management and price stability. In addition to strengthening monetary management, reducing the supply of SBI issued on the primary market was intended to dampen the potentially negative effects from a large and sudden reversal of foreign capital from SBI. The policy also aimed to increase the role of other monetary instruments in absorbing excess liquidity. This was reflected in the increasing share of term deposit (TD) and reverse repo government bonds (RR-SBN) on monetary operation (Chart 7.5). In this case, the increase use of RR-SBN on monetary operations was also made possible by more purchases of government bonds by Bank Indonesia on the secondary market, especially in the second half of 2011.



**Chart 7.4 The Nominal Daily Average Tenor of Monetary Instrument**



**Chart 7.5 Monetary Instrument Composition**



**Chart 7.6 SBI Auction Profile in 2010-2011**

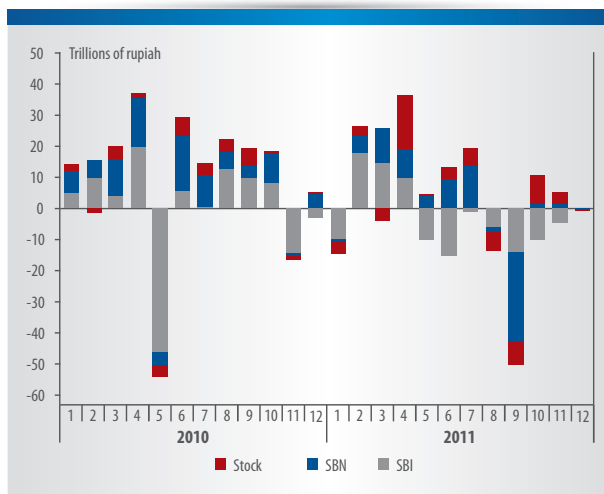
The SBI issuance was reduced gradually as reflected in indicative targets and the winners of each SBI auction. Throughout 2011, SBI auction winners' bid to cover ratio showed a declining trend (Chart 7.6). Excess liquidity that was not absorbed by SBI auction will shift to term deposits or RR-SBN, whose maturity profiles were also lengthened to support the strategy of lengthening maturity profiles of monetary instruments.

TD and RR-SBN are monetary instruments with the same function as SBI, that is to absorb excess liquidity in the market. However, compared to SBI, TD can only be purchased by domestic banks and are nontradable, and therefore its absorption of liquidity is more permanent in accordance with the longer tenor of TD. These characteristics are the primary consideration in replacing SBI with TD in order to absorb excess liquidity.

Meanwhile, monetary operations that use RR-SBN will encourage financial deepening in the SBN market. The use of SBN as the underlying instruments of RR is also consistent with the steps that Bank Indonesia has been taking to gradually replace SBI with SBN as a monetary instrument.

## CAPITAL FLOWS MANAGEMENT POLICY

Amid global economic uncertainty, foreign capital continued to flow into Indonesia although relatively smaller compared with 2010. Immense capital inflows took place in the first half of 2011, then reversed course along with the worsening economic crisis in Europe and the weakening American economy. Strong economic fundamentals and attractive returns were the factors attracting capital inflows (Chart 7.7).



**Chart 7.7 Capital Flows Portfolio**

These capital inflows need to be managed properly for the benefit of the economy. Various efforts need to be taken to encourage longer term capital inflow such as of foreign direct investment (FDI), both through accelerated investment programs as well as infrastructure and financial market deepening. At the same time, short-term capital inflows must be managed due to their vulnerability to large and sudden reversals, which can generate shocks to the exchange rate and financial system stability. Based on these considerations, aside from coordination with the government to encourage longer term capital inflows, Bank Indonesia continued to strengthen the macroprudential policies that were taken in 2010 to manage short-term capital inflows. These policies included higher foreign currency reserves requirement, minimum holding periods for SBI, and limitation on banks' short-term external borrowing. Moreover, Bank Indonesia also issued a regulation on the Exports Proceeds and Foreign Debt Withdrawals which became effective in early 2012.

### Foreign Currency Reserves Requirement

Foreign currency reserves requirement were raised to anticipate increased need for foreign currency in the case of mounted pressure from large or simultaneous capital outflows. Overall, the increase in foreign currency liquid instruments that banks were required to keep in Bank Indonesia would strengthen the financial system stability. In addition, higher foreign currency reserves requirement could also augment the supply of liquid domestic foreign currency, thus helping to stabilize the exchange rate and monetary stability.

Throughout 2011, foreign currency reserve requirement ratio were raised in stages<sup>2</sup>, from 1% to 5% in March 2011 and then to 8% in June 2011 relative to foreign currency deposits held by banks. The gradual increase of foreign currency reserves requirement was intended to provide sufficient time for banks to adjust their foreign currency liquidity management.

It was deemed that the increases in foreign currency reserve requirements had not been a burden for banks. The increase in foreign currency reserves requirement from 1% to 8% was implemented at a time when the foreign exchange market began to see an abundance of funds due to, among other factors, massive capital inflows on top of high excess liquidity in rupiah denominated. Therefore, this policy was expected to have minimal impact on the cost of funds and would not disrupt banking intermediation. In addition, the 1% level of foreign exchange reserves was the lowest in the region, raising concerns that it would be insufficient to serve as a buffer in case of turmoil in the economy.

#### Minimum Holding Period for Bank Indonesia Certificates (SBI)

The policy of six month holding period for SBI which was implemented on May 13, 2011, was a reinforcement from minimum one month holding period for SBI that was applied on July 7, 2010. Evaluation of the one month minimum holding period for SBI showed that foreign investors' interest towards SBI remained high due to the relatively high yields and the liquidity of SBI in the secondary market, amidst a limited choice of financial instruments in Indonesia. With longer holding period, the volume of SBI in the secondary market would be reduced as investors will only be able to buy SBI with maturities of more than six months. Thus, this policy was expected to reduce the potential for capital reversal that could destabilize the monetary and financial system (Chart 7.8). The limited usage of SBI as monetary instruments was also expected to encourage non-SBI instruments, such as RR-SBN in the money market.

The minimum six month holding period required buyers in both primary and secondary markets to hold SBI for at least six months (182 days). During that period, the owners of SBI may not sell them whether in an



Chart 7.8 Foreign Ownership in SBI and Rupiah Exchange Rate

outright or repo transaction to another party, except to Bank Indonesia. This policy applied to both resident and non-resident holders of SBI and was intended to promote longer term ownership and transactions in the secondary market. As such, this policy was still consistent with the free foreign exchange system adopted by Indonesia. In line with the implementation of minimum six month holding period for SBI, outstanding and share of non-resident ownership had trended downwards (Chart 7.9). This meant that foreign investors would only buy SBI with tenors of more than six months, so the majority of SBI would be held by banks and domestic investors, especially as SBI in the primary market could only be purchased by the banks. In addition, foreign ownership of SBI was declining due to the limited supply of SBI in line with Bank Indonesia

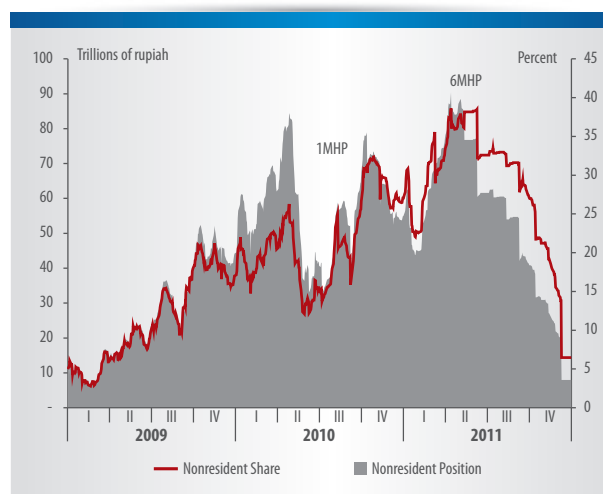


Chart 7.9 Share and Position of Resident Ownership of SBI

<sup>2</sup> Bank Indonesia Regulation No. 13/10/PBI/2011 dated February 9, 2011 concerning Amendment to Bank Indonesia Regulation Number 12/19/PBI/2010 concerning Statutory Reserves of Commercial Banks in the Bank Indonesia in Rupiah and Foreign Currency.

measures to lengthen maturity profiles and encourage the uses of monetary instruments other than SBI.

The six month holding period had increasingly restricted non-resident's flexibility to conduct transactions with regard to the SBI in their possession. Consequently, SBI that were purchased on the secondary market were automatically held to maturity and were generally carried out by the investors for investment purposes rather than speculation. This reduced the adverse impact of abrupt capital reversals from SBI, as reflected by the limited capital outflows stemming from SBI when the domestic financial markets came under pressure in September 2011.

### Banks' Short Term External Borrowing Policy

Limit on daily balance of banks' short-term external borrowing was addressed to strengthen the resilience of the banking system and also an integral part of Bank Indonesia's capital flow management<sup>3</sup>. This policy was a normalization of previous policies<sup>4</sup>. One of the sources for massive capital inflows was through increases in bank's short-term external borrowing, including checking accounts (vostro) and other short-term external financing instruments. In terms of assets, domestically, an increase in external borrowing created more foreign currency liquidity, but from the liabilities side it also raised foreign currency liabilities and increased banks' exposure to the risk of external shocks. It was increasingly important to control such risks, given the short-term and often fluctuative nature of these short-term borrowing. Given these considerations, the limitations were an effort to:

- (1) apply macroprudential principles towards the management of banks' short-term external borrowing;
- (2) encourage banks' longer term external borrowing;
- and (3) support the achievement of macroeconomic and financial system stability.

At the beginning of its implementation, in the event that the daily balance of banks' short term external borrowing had exceeded 30%, banks cannot add up the balance. Banks must lower its balance at most 30% in three months since the effective date of the

3 Bank Indonesia Regulation Number 13/7/PBI/2011 dated January 28, 2011 on the Second Amendment to Bank Indonesia Regulation Number 7/1/PBI/2005 Concerning Foreign Loans by Bank.

4 Restrictions on banks' daily positions of short term foreign loans of 30% (thirty percent) of bank capital were lifted on October 14, 2008 as a policy response to the tight supply of domestic foreign exchange and banking liquidity crunch stemming from the global crisis.

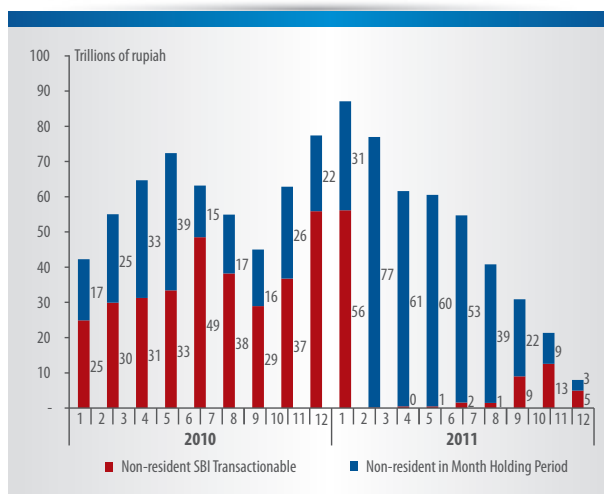


Chart 7.10 Nonresident SBI Available To Sell

regulation. Subsequently, all banks were required to maintain a daily balance of banks' short term external borrowing at the maximum of 30% of bank capital. Banks in violation of this regulation should be subject of a financial penalty of 1% (one one-hundredth) per year for the excess each day.

### Export Proceeds and Foreign Debt Withdrawals through Domestic Banks

Bank Indonesia<sup>5</sup> regulations requiring the receipt of export proceeds and foreign debt withdrawals through domestic foreign exchange banks were aimed at strengthening the structure of foreign currency supply to support macroeconomic stability. This policy was based on the consideration that thus far, the equilibrium of domestic foreign exchange market was dependent on foreign currency supplies sourced from capital inflows, including short-term portfolios. At the same time, the majority of export proceeds and foreign debt withdrawals continued to be received and kept in foreign banks. As a result, the supplies of foreign currency on the domestic market as well as the rupiah exchange rate were vulnerable to the fluctuations of inflows from these foreign portfolios. The rupiah tended to strengthen strongly when immense capital inflows took place, and conversely weaken sharply when there was a capital reversal. In addition, whereas a portion of export proceeds and foreign debt withdrawals continued to be kept overseas, foreign currency funding for the domestic economy was not available optimally.

5 Bank Indonesia Regulation No.13/20/PBI/2011 on Receipt Export Proceeds and Foreign Debt Withdrawal effective January 2, 2012.

The policy of foreign exchange flows came into effect on January 2, 2012. It required that the export proceeds should be received by domestic foreign exchange banks, at the latest six months after the Export Declaration Form (PEB) date. Meanwhile, all foreign debt withdrawals must be withdrawn by debtors through domestic foreign exchange banks. These obligations applied to foreign debt cash proceeds that were sourced from: foreign debt based on non-revolving loan agreements which were not used for refinancing; the difference in refinancing facilities for old debts; and foreign debts based on debt securities in the form of bonds, medium term notes (MTN), floating rate notes (FRN), promissory notes (PN) and commercial paper (CP). Exports and/or debtors who do not fulfill these requirements are liable to administrative sanctions and the suspension of export services in cooperation with the relevant customer authorities.

With such policies, it is expected that the foreign currency from export proceeds and foreign debt withdrawals can strengthen foreign currency supply to be more permanent and stable for the domestic economy, compared with funds coming from portfolio inflows. These additional supply will increase the sustainability of foreign currency supply in domestic market, thus supporting the rupiah exchange rate stability as well as raising the supply of foreign currency funds to finance the national economy. This policy was expected to increase domestic banks' activities related to handling exporters' and businesses' foreign exchange needs with regard to trade, loans, investment as well as the management of foreign funds. In addition, this policy also aimed to enhance the quality of statistics on export, import, foreign debt, balance of payment, and monitoring of foreign currency flow. More accurate export and import data would also provide support for tax and customs policy.

These regulations on export proceeds and foreign debt withdrawals were still in line with the free foreign exchange system which was adopted by Indonesia in accordance with Law No. 24/1999 on Foreign Exchange Flows and Exchange Rate Systems, which states that all residents were free to hold and use foreign currency. This policy did not require exports and debtors to deposit their export proceeds and foreign debt withdrawals in domestic banks and/or convert them into rupiah.

## PROMOTING THE FUNCTION OF BANKING INTERMEDIATION

The banking intermediation function played an important role in strengthening the effectiveness of monetary policy as well as the role and resilience of the banking industry in domestic economy (Chart 7.11). Bank Indonesia had implemented various policies focusing on both the source as well as the uses of banking funds. Regarding the sources of funds, the funds accumulation was done through broadening the depositors' base and improving public access to banking system. In terms of uses of funds, this was done through improving the transparency between banks and the public by publishing prime lending rate, providing incentives for banks who extended credit, and improving credit quality.

### Loan-to-Deposit Ratio (LDR) based reserve requirement

LDR based reserve requirement policy was intended to increase bank lending in accordance with economic cycles, while still preserving the prudential principles. Thus far, there was a tendency for some banks with large funds to place funds in various financial assets, including in Bank Indonesia monetary instruments, rather than channel the funds as credit thus resulting in a low LDR. Meanwhile, there were also a number of banks who aggressively channel the funds without the ability to mobilize sufficient funds, hence resulting in a high LDR. At the same time, banks had a tendency to provide excessive credit as economic activity increases and conversely, tighten too much during economic slowdowns (pro-cyclical).

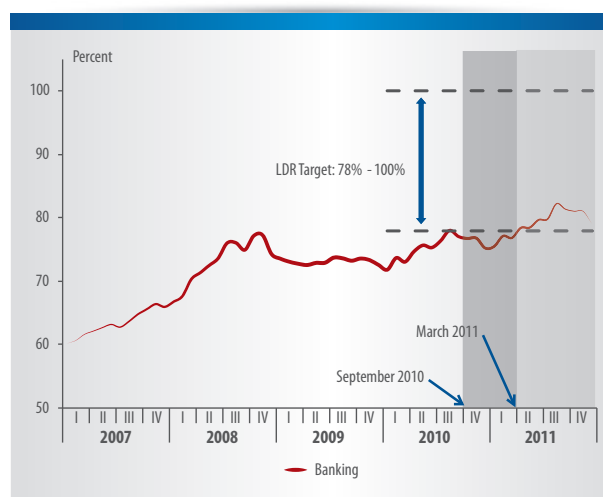


Chart 7.11 Banking Intermediation Function

With these considerations in mind, in March 2011 Bank Indonesia began to reinforce LDR based reserve requirements<sup>6</sup>. This policy was adopted as an incentive mechanism to encourage bank lending within the optimal LDR range with reference to prudential principles. Under this policy, the primary reserve requirements for rupiah were established at 8% of deposits and secondary reserve requirements at 2.5%, with a certain percentage of LDR based reserves requirement in line with the LDR level of the bank.

Banks with LDR between 78%-100% would be given incentives and therefore were not required to increase their reserves requirements. Banks were only permitted to achieve LDR levels of over 100% if supported by adequate level of capital which comply with the capital adequacy ratio (CAR) of 14%. Conversely, banks with LDR levels below 78% or over 100% that did not fulfill CAR requirements were required to raise their reserve requirements as a disincentive for sub-optimal credit channeling. Additional reserve requirements were calculated by multiplying the difference between the actual LDR and the LDR target, deposits in rupiah, and certain disincentive parameters.

### Enhancing transparency and credit quality

Bank Indonesia policy to enhance transparency and credit quality had been carried out through mandatory publication of prime lending rates and coordination with the Government to channel banking credits. Bank Indonesia mandated banks to publish Prime Lending Rates<sup>7</sup> starting March 31, 2011 through bulletin boards in each bank office as well as on the homepages of bank websites, newspapers, and in quarterly financial reports. The aim of this policy was to improve transparency regarding the characteristics of bank products including their benefits, costs and risks. Accordingly, customers could acquire clarity, good corporate governance was simultaneously improved, and healthy competition was encouraged through better market discipline. Meanwhile, to encourage the intermediation function in certain sectors, Bank Indonesia worked together with a number of government institutions such as the Ministry of Fisheries and Maritime Affairs, the Ministry of

Manpower and Transmigration and the Ministry of Small and Medium Enterprise. This effort was aimed to synergize each institution's programs while bridging the gap between banks and businessess. It was expected that more optimal and better quality of credit funding will ensure through these efforts.

## 7.3 MONETARY POLICY COMMUNICATION

The implementation of monetary and macroprudential policy mix had been supplemented by a focused and continuous communications strategy to guide the expectations of economic participants. Intense monetary policy communication had become more important as domestic economic activity surrounded by increased economic and global financial uncertainty. Economic participants and the public continually needed to be given adequate information regarding the development and prospects of the domestic economy, including the impact of economic and global financial uncertainty and Bank Indonesia's considerations and policy direction. Intensive communication regarding monetary policy played an important role in convincing market participants that the stability of the monetary and financial system will be maintained. The communication strategy was making monetary policy more effective in shaping public expectations regarding the future course of the economy, including Bank Indonesia's efforts to control inflation and to stabilize the rupiah exchange rates.

Various steps had been taken by Bank Indonesia to strengthen monetary policy communication strategy. Each monetary policy decision taken by Bank Indonesia in its monthly Board of Governors meeting was immediately broadcast afterwards through press releases or press conferences. The contents of the press releases were supplemented by publications to clarify the considerations behind the policy response taken, and to address the direction of economic development and Bank Indonesia's policy response. Similar steps were also implemented for every new policy taken by Bank Indonesia. The monetary policy communication strategy was also strengthened through routine discussions with economic observers and market participants as well as direct explanations to domestic and foreign investors through teleconferences. In addition, the monthly Monetary Policy Review and the quarterly Monetary Policy Report publications were available on the Bank Indonesia website as well in print form, supplemented by the up-to-date issues to shape

6 Bank Indonesia Regulation Number No.12/19/PBI/2010 dated October 4, 2010 on Statutory Reserves of Commercial Banks in Bank Indonesia in Rupiah and Foreign Currency.

7 SE No.13/5/DPNP dated February 8, 2011 concerning the transparency of prime lending rate. More detailed information can be found in the Financial Stability Review, March 2011.

public expectations. Other efforts included the website publication of the Bank Indonesia Board of Governors' speeches at various events as well as the publication of articles in mass media to expand public comprehension of Bank Indonesia policies.

## 7.4 CRISIS MANAGEMENT PROTOCOL

Bank Indonesia had developed and implemented Crisis Management Protocol (CMP)<sup>8</sup> as experiences had shown that the Indonesian economy cannot fully avoid the possibility of risks happening during a crisis. While policies had been taken to strengthen the resilience of the domestic economy, various events may pose pressures and vulnerabilities from both domestic sources (such as fuel policies or bank failures) as well as from external sources (such as the sudden reversal of foreign capital in large quantities). Since the 2008 global crisis, external sources of vulnerabilities had become increasingly large and uncertain. Experience in the second half of 2011 showed how the worsening global economy created spill over effects in the form of relatively large capital reversals, resulting in pressures on a weakening rupiah and risks of monetary and financial system instability. Moreover, frequently these risks could not be accurately predicted beforehand. Therefore, the appropriate measures were constantly prepared by identifying the sources of these vulnerabilities as well as developing mechanisms to prevent and manage crises.

Basically, CMP was an integrated and standardized framework and mechanism for crisis prevention and management. Within it were set forth the indicators of vulnerability that may lead to a crisis, the conditions of pressure, mechanisms for decision-making and related organizations. On the nation wide, CMP was divided into divisions in accordance with the area where the crisis takes place. In this regard, Bank Indonesia was focuses on CMP that was related to exchange rate and banking crises that fall within Bank Indonesia's authority. Meanwhile, the Government had developed CMP related to financial market crises, fiscal crises, and non-bank financial institution crises. Bank Indonesia and the Government also coordinate closely to synchronize the CMP that each was responsible for.

Close coordination between institutions/agencies was needed to develop a coordinated and integrated

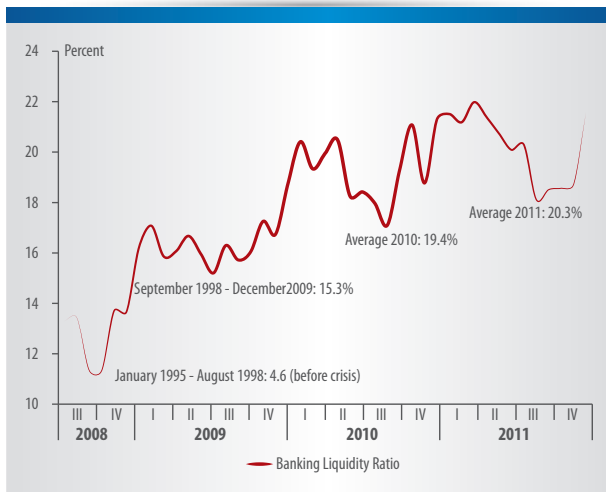
National CMP. Several coordination protocols related to the financial sector had been laid forth in the Law regarding the Financial Services Authority through the Coordination Forum for Financial System Stability, whose members were the Ministry of Finance, Bank Indonesia, the Financial Services Authority, and the Deposit Insurance Institution. However, other CMP areas had not been coordinated and integrated into National CMP, including decision-making mechanisms and the necessary funding. One step that can be taken was to integrate National CMP into the Financial Sector Safety Net framework that the Government is presently preparing. The Financial Sector Safety Net Regulations provide a legal basis for coordination between authorities/institutions in the financial sector. Considering that the Financial Safety Net Regulatory was not finished yet, Bank Indonesia, the Ministry of Finance and the Deposit Insurance Institution had signed a memorandum of agreement that will serve as a reference for crisis prevention and coordination mechanisms within each institution's area of authority.

## 7.5 EVALUATION OF MONETARY POLICY IMPLEMENTATION

The mix of monetary and macroprudential policy that was implemented by Bank Indonesia in 2010 and strengthened in 2011 aimed to make monetary policy more effective in influencing economic activities and controlling inflation. Indonesian experience suggested that during times of enormous excess liquidity and high capital inflows, monetary policy implementation became increasingly complex. Monetary policy that relied solely on the interest rates channel did not always work effectively. Under conditions of high excess liquidity, a substantial increase in interest rates would attract more capital inflows, the cause of the excess liquidity in the first place. The effectiveness of monetary policy through interest rate channel could be strengthened through a combination of monetary and macroprudential policy, that was also expected to improve the effectiveness of the other channels whether credit, money supply, exchange rates, or inflation expectations.

Excess liquidity in Indonesia was considered high and tended upwards. In addition to excess liquidity accumulation from the previous period, the supply of liquidity was driven by huge capital inflows and

<sup>8</sup> More complete information can be found in Box 7.1 Bank Indonesia Crisis Management Protocol.



**Chart 7.12 Banking Excess Liquidity Ratio**

fiscal expansion. As an example, the average ratio of Indonesian banking liquidity during the first two years after the global crisis (2008-2009) was around 15% of deposits, then rose to 19% in 2010 and 20% in 2011 (Chart 7.12). Meanwhile, high economic growth in 2011 was still unable to optimally absorb this excess liquidity. The base money, a proxy for liquidity demand, rose during 2011 from Rp518 trillion to Rp613 trillion. This liquidity supply, which was larger than demand, has amplified excess liquidity in the Indonesian banking system.

Under excess liquidity condition, monetary operation strategy focused on optimizing long term liquidity management. Related to this, Bank Indonesia took several steps to strengthen the implementation of monetary operations. The issuance of monetary instruments was directed towards longer tenors, whereas the supply of short term monetary instruments was increasingly reduced.

Efforts to absorb liquidity through monetary operations had resulted in a buildup of open market operations position. During 2011, open market operations rose by Rp19 trillion to Rp505 trillion compared with the end of 2010. The majority of liquidity was absorbed through Term Deposits, which reached Rp172.6 trillion at the end of 2010 and continued to rise until the middle of the year before falling to Rp154.4 trillion at the end of 2011. Meanwhile, the position of 9-month SBI fell to Rp123.2 trillion from Rp203.1 trillion at year-end 2010.

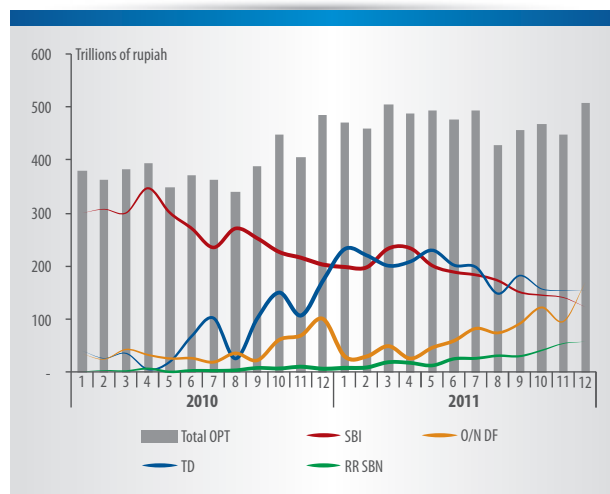
The dominant use of SBI in monetary operations decreased in line with efforts to promote other monetary instruments as well as deepening the

financial market. On average, the share of SBI as a percentage of monetary operations dropped to 38% compared with 71% at the end of 2010. This was in line with Bank Indonesia's steps to promote the role of term deposits and RR-SBN as monetary instruments (Chart 7.13).

The role of term deposits as a monetary instrument continued to grow. Compared with 2010, the average proportion of term deposits in monetary operations rose to 40% from 18%. The adjustment of term deposit characteristics<sup>9</sup> attracted banks to allocate their liquidity in this instruments. In line with the increasing use of Term Deposits and the strategy of lengthening the maturity profile of monetary instruments, the tenor of Term Deposits used in monetary operations also lengthened. Throughout the first semester of 2011, the majority of Term Deposits used (around 93%) had tenors of less than 6 months. However, by the end of 2011, the tenor of most Term Deposits used in monetary operations (about 60%) had lengthened to 6 months.

The use of RR-SBN in monetary operations also increased, though still relatively limited. The frequency of RR-SBN increased since the second half of 2011, in parallel with Bank Indonesia's purchases of government bonds in the secondary market to stabilize the Rupiah exchange rate. The proportion of RR-SBN in monetary operations increased to 6% compared with

<sup>9</sup> One of the adjustment was the ability to redeem Term Deposits to Bank Indonesia prior to maturity. This adjustment went into effect in May 2011.



**Chart 7.13 Monetary Instrument Composition**

1% in 2010. Such rising use was expected to drive financial deepening, in line with an increasing role of government bonds.

The proportion of monetary instruments with longer tenors had increased in line with policies to optimize liquidity management (Chart 7.14). The average proportion of banking liquidity placed in instruments with tenors of greater than 6 months increased to 53% compared with just 20% in 2010. Efforts to promote liquidity management through longer tenor monetary instruments became more difficult in the second half of 2011. As uncertainty surrounding the global economy built up and credit growth tended to increase, the growing need for precautionary motive drove banks to place their liquidity in short term monetary instruments. Overnight deposit facilities at Bank Indonesia as an instrument to meet short term banking liquidity needs rose to Rp170 trillion compared with Rp101.3 trillion at the end of 2010.

Overnight interbank rates declined as large amounts of banking liquidity flowed into short term instruments. Throughout the first half of 2011 this rates fluctuated around the BI rate before moves toward the level of deposit facility rate in the second semester of 2011. Overall, the overnight interbank rate in 2011 declined around 39 bps to 5.65% (Chart 7.15). The overnight interbank rate continued to be in line with the accommodative monetary policies that were implemented by Bank Indonesia around the second half of 2011, and therefore was expected to drive interest rates decreased and encouraged banking credit growth as a stimulus for the domestic economy.

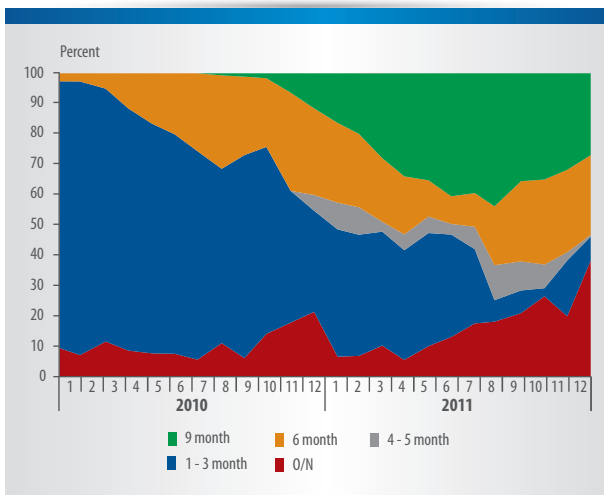


Chart 7.14 Monetary Composition by Maturity

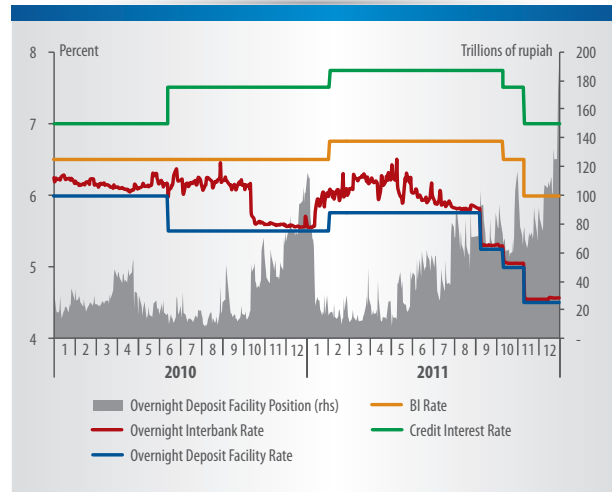


Chart 7.15 Overnight Interbank Rates and Monetary Instrument

Money market conditions were also relatively stable. Following the decrease in Overnight interbank rates, the difference between the highest and lowest rates was slight and fairly stable. Overall the average difference between the highest and lowest Overnight Interbank Rates in 2011 was recorded at 0.22%, approximately the same as the previous year at 0.25%. Money market stability was greatly influenced by the amount of excess liquidity among banks. When the money market came under pressure in September 2011 due to negative global sentiments, the spread increased temporarily to 0.55% but then dropped again. Overall, average monthly difference between the highest and lowest rates in September was relatively controlled at 0.12% compared with 0.16% in August 2011 (Chart 7.16).

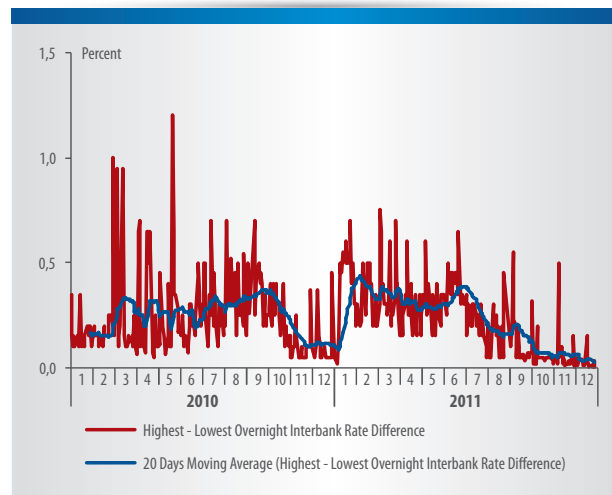


Chart 7.16 Max-Min Deviation of Overnight Interbank Rates

In line with the decline in overnight interbank rates, interbank rates for longer tenors also decreased. The decline in interest rates was bigger for longer tenor instruments compared with overnight rates (Chart 7.17).

Average interbank rates during 2011 rose compared with 2010, in the midst of Bank Indonesia's efforts to encourage money market transactions by widening the interest rate corridor. In 2011, the average Interbank money market transaction volume was Rp11 trillion or slightly higher than the 2010 average of Rp9.5 trillion (Chart 7.18). The large amount of excess liquidity implied that the increases in the interbank money market volume were relatively limited.

Banking interest rates showed a declining trend. In line with lower BI rates, deposit and credit rates also recorded a decrease. Over the course of 2011, deposits rate fell 48 bps to 6.35% while credit rate fell 43 bps to 12.78% (Chart 7.19).

Besides being influenced by lower BI Rates, there were indications that the drop in credit rate also influenced by mandatory regulations regarding Prime Lending Rates transparency which were implemented by Bank Indonesia since the beginning of 2011. Working Capital Credit rates, Investment Credit, and Consumer Credit fell by 67 bps, 24 bps and 38 bps respectively compared with positions at the end of 2010 to reach 12.16%, 12.04% and 14.15% (Chart 7.20). Given these developments, the average difference between credit and deposits rate in 2011 narrowed to 6.25% compared with 6.85% in 2010. However, this spread was still

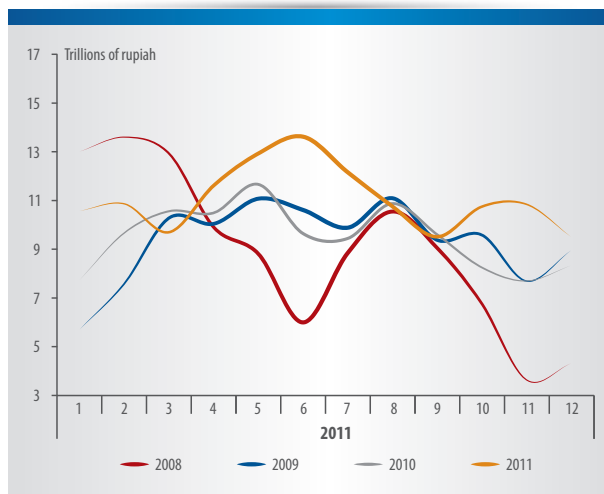


Chart 7.18 Interbank Market Volume

considered high, reflecting a lack of improvement in banking performance, and decreasing the effectiveness of monetary policy transmission.

Deposits and credits posed higher growth compared with 2010. The deposits growth in 2011 relatively stable at 19.0% compared with 2010 growth of 18.5%. Among others, the growth of deposits was influenced by financial inclusion policy aimed at expanding public access to banking in the midst of lower deposits rates. Meanwhile, in line with lower credits rates and rising economic activity, the growth of credit (excluding channelling) in 2011 rose to 24.9% compared with 22.1% in 2010 (Chart 7.21). The increase in credit growth was also driven by the implementation of LDR-based reserve requirement policies. As such, the combination of lowered interest rates and macroprudential policies were able to strengthen

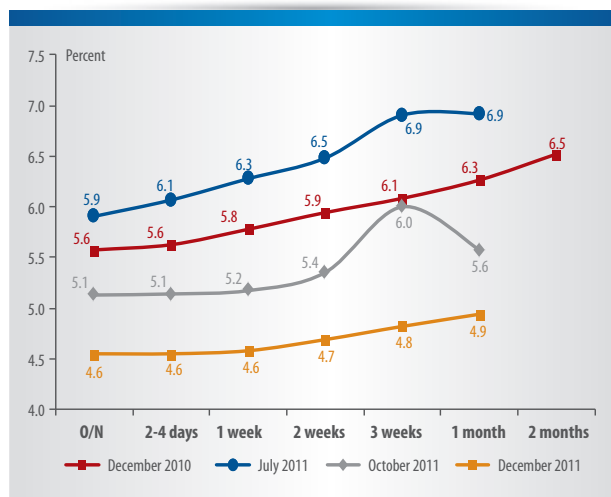


Chart 7.17 Overnight Interbank Rates Structure

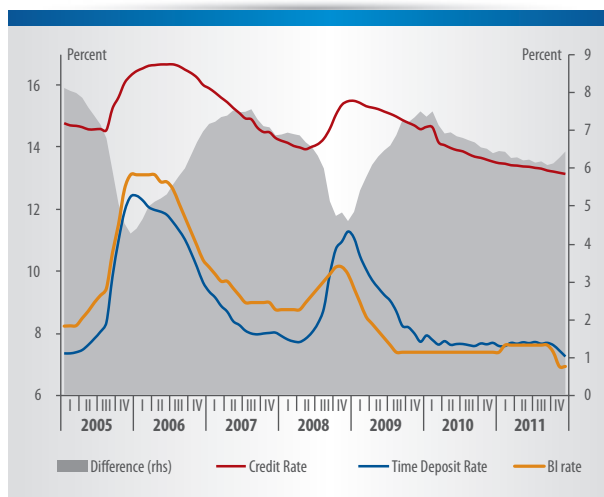
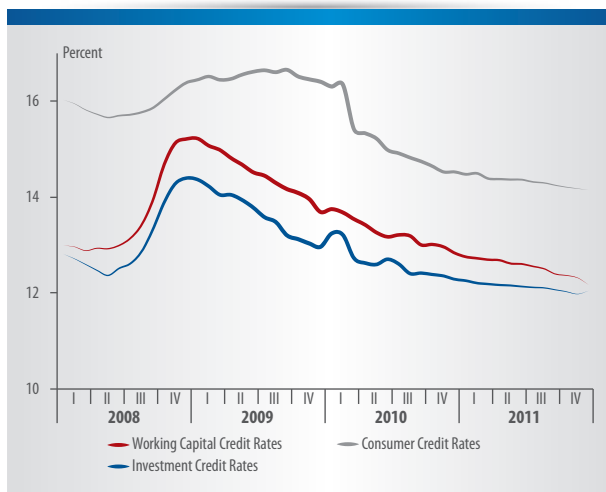


Chart 7.19 Banking Interest Rate

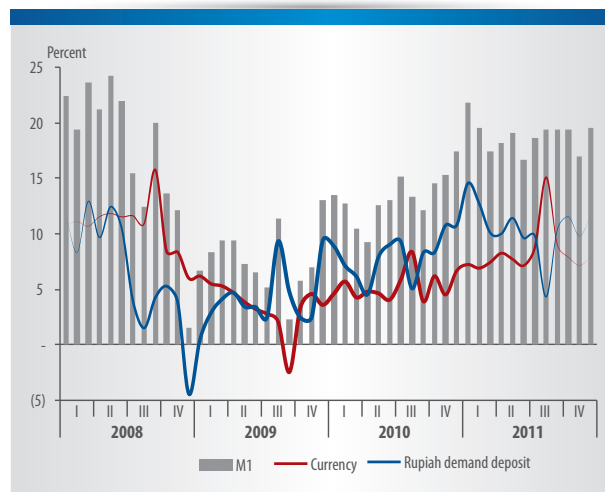


**Chart 7.20 Credit Rate by Type**

monetary policy transmission using banking loans as a channel.

The liquidity in the economy increased as reflected in higher growth of M1. In 2011, M1 grew by 19.4% compared to 2010 growth of 17.4% (Chart 7.22). The M1 growth was fuelled by increasing demand for currency circulation and mobilization of rupiah giro by banks related to credit expansion as economic activity grew.

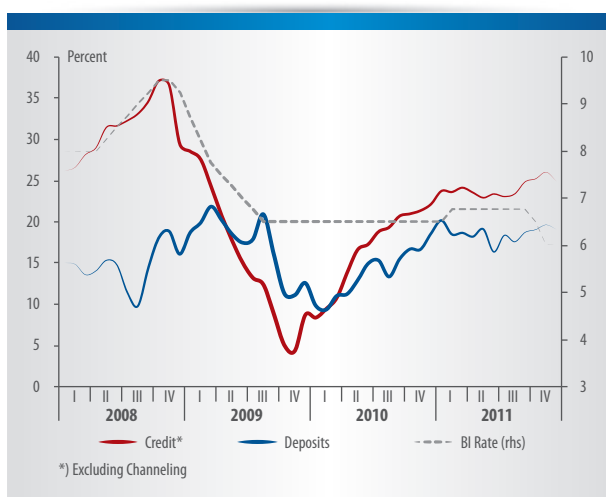
In parallel with M1, M2 growth also saw a slight increase to 16.4% compared with 15.4% at the end of 2010. In terms of factors affecting, M2 was primarily driven by high credit growth (Chart 7.23). In the first half of 2011, the M2 growth was driven by credit growth increases and strong capital inflows. However, in the second half of 2011, the contribution of capital



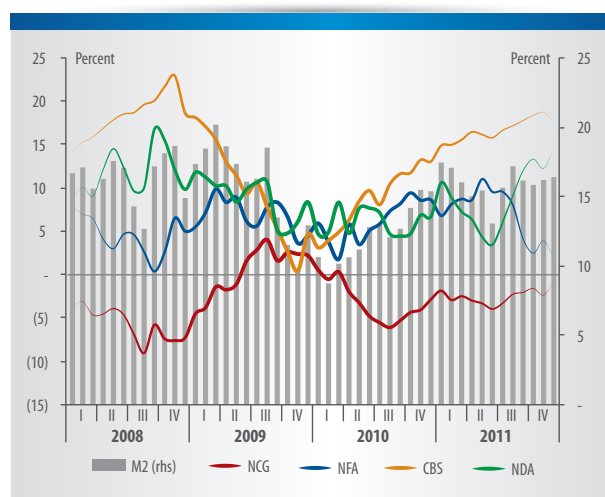
**Chart 7.22 M1 Growth**

flows lowered as global economic uncertainty drove capital outflows. The increase in M1 and M2 growth showed that monetary policy transmission through money supply was effective in influencing the economy. However, large excess liquidity limited the creation of M1 and M2 despite fairly high credit growth (Chart 7.24).

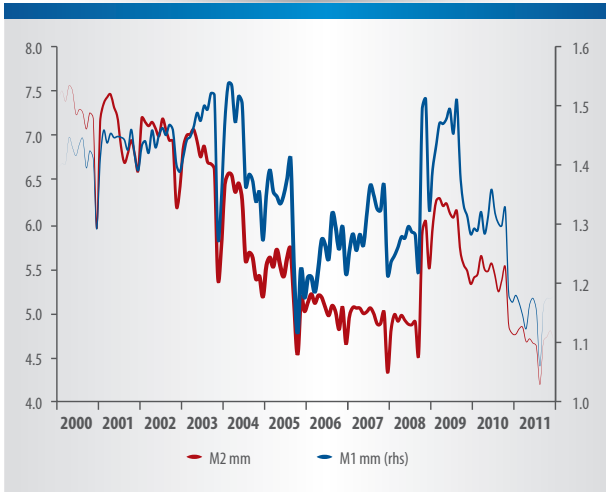
The efficacy of monetary policy transmission through money supply channel was also supported by the velocity of M1 and M2, which showed a rising trend (Chart 7.25). These developments were further supported by an increasingly efficient (fast) system of non-cash payments, and were moreover influenced by rising incomes amidst the middle class.



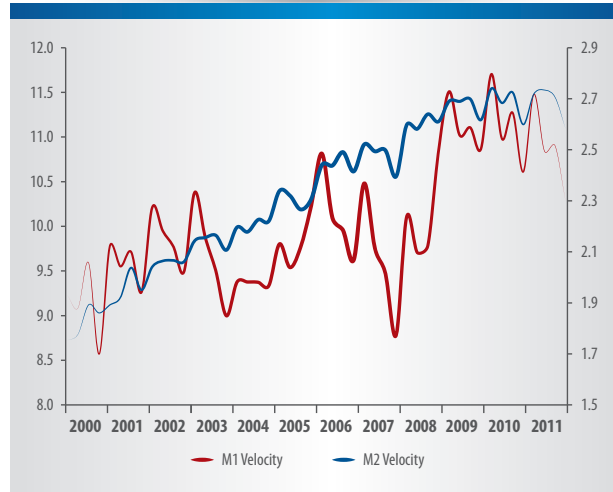
**Chart 7.21 Deposit Rates, Credit Rates, BI Rate**



**Chart 7.23 M2 Growth and Affecting Factors**



**Chart 7.24 M1 and M2 Money Multiplier (mm)**



**Chart 7.25 M1 and M2 Velocity**

The experience from prior crises both in Indonesia as well as in other countries had demonstrated that handling crisis gave rise to extremely high economic and social costs and required considerable recovery time. Experience had also shown that the Indonesian economy cannot be totally free from crises risks. While various policies had been taken in order to strengthen domestic economy resilience, rising economic and global financial uncertainty due to the crisis in the United States and Europe had created vulnerabilities, such as the large capital reversals that took place in the second half of 2011. Moreover, often such risks could not be foreseen or anticipated. Therefore, the appropriate steps were to continually increase awareness by identifying sources of vulnerability and establishing a mechanism for crisis prevention and handling.

With this in mind, Bank Indonesia had put together standardized and integrated Crisis Management Protocol (CMP) frameworks and mechanisms in order to prevent and handle exchange rate and banking crises, as set forth in the Bank Indonesia Board of Governors Regulations. In general, Bank Indonesia CMP aimed to strengthen monetary and financial system stability towards supporting macroeconomic stability. In addition, CMP was also intended to ensure that decision making is done in timely and effective manner, and to ensure that all crisis prevention and management actions and policy had a legal basis.

Bank Indonesia CMP was part of a larger national Crisis Management Protocol that is being developed. In this regard, Bank Indonesia focused on CMP related to exchange rate and banking crises. Meanwhile, the Government had developed CMP that is related to financial market crises, fiscal crises, and non-bank financial institution crises. Eventually, certain parts of these CMP needed to be integrated and coordinated closely with the National CMP in order to comprehensively prevent and handle economic crises.

Among the Government's initiatives was the preparation of Financial Safety Net Act as a legal basis for measures taken for the prevention and management of crises on a national basis. Considering that the Financial Safety Net Act was still in process, in order to maintain the financial system stability, in July 2010 the relevant authorities/institutions in the financial sector comprised of Bank Indonesia, the Ministry of Finance, and the Deposit Insurance Institution agreed to a memorandum of agreement. Among others, this memorandum of agreement mandated that each institution must develop mutually supportive CMP in order to prevent and manage financial sector crises.

Bank Indonesia CMP regulations are based on several principles, namely good corporate governance, the prioritization of crisis management prevention, as well as effective coordination and communication. The principle of good governance involved several aspects: (i) responsibility, namely that crisis prevention and management policies were implemented in line with the responsibilities and authority of Bank Indonesia and in accordance with the duties and authorities of each work unit; (ii) accountability, that was policy responses can be accounted for. The principle of prioritizing crisis prevention and management was intended to expedite the decision-making process during crises, while still promoting governance. Meanwhile, the principles of coordination were based on the consideration that Bank Indonesia CMP is part of National CMP. The principle of effective communication was intended to restore public confidence and to support economic recovery from crisis conditions.

In the context of harmonization with National CMP, overall Bank Indonesian CMP consisted of three major aspects, namely internal working mechanisms, office mechanisms, and surveillance indicators. Internal working mechanisms set out

the responsibilities of each work unit in a crisis prevention and management framework. Office mechanisms functioned as an inter-protocol secretariat and liaison at national level, while surveillance indicators were the trigger mechanisms in the internal Bank Indonesia decision-making process, producing policies which were implemented and coordinated together with the Government.

In terms of surveillance activities, risk identification was carried out together with assessments and formulation of degree of pressure. Various quantitative indicators of macroeconomic, monetary, financial and banking risks in the global as well as domestic economic environment were identified, that might give rise to pressures on the Rupiah exchange rate and the banking system. These surveillance indicators aimed at creating a snapshot of vulnerabilities and factors that might catalyze a crisis, but were not tools to predict timing or the type of crises. Based on these surveillance results, an appropriate policy response would be decided upon.

In the case that surveillance indicators indicated abnormal conditions, namely Alert, Ready, and Crisis, Bank Indonesia had the authority to respond by implementing crisis prevention policy internally. In addition, Bank Indonesia would inform the Government, related institutions, and/or the Coordination Forum for Financial System Stability and formulate policy recommendations that required intra-institutional or national coordination.

To a large extent, the success of CMP implementation was determined by effective coordination between authorities. Such coordination was needed to support the synchronization and harmonization of policies as well as collective action that was effective, transparent and accountable, and is supported by adequate and accurate information. Such supporting information was provided through the exchange of data and information regarding macro and microeconomic indicators as well as other information needed by each authority to carry out its task.

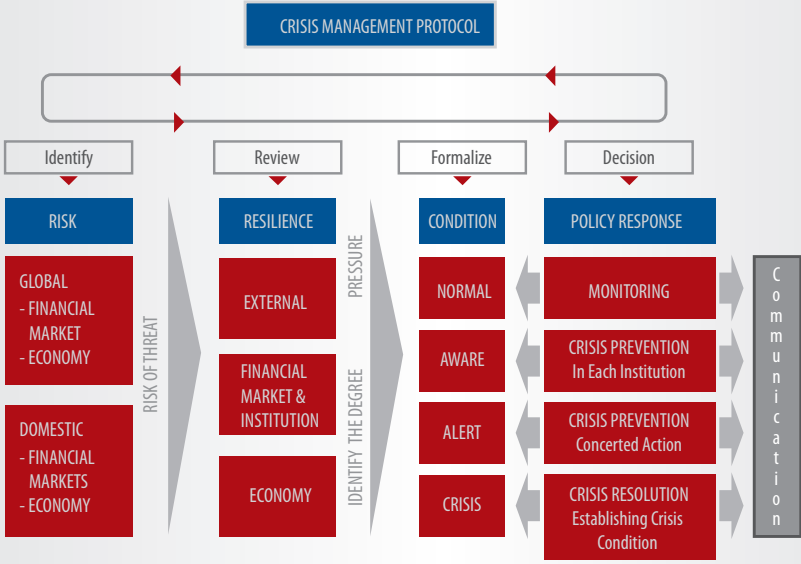


Diagram 1. Crisis Management Protocol







# Chapter VIII

## FINANCIAL SYSTEM POLICY AND PERFORMANCE

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# FINANCIAL SYSTEM POLICY AND PERFORMANCE



Along with monetary and macroprudential policy, Bank Indonesia also issued several policies to optimise the banking sector's contribution to the national economy, in particular by enhancing the intermediation function, bolstering banking resilience and strengthening the bank supervision function. In addition, Bank Indonesia continued to promote financial inclusion through a number of policies, including those relating to Micro Small and Medium Enterprises (MSME), in order to expand public access to the financial system. Meanwhile, policies governing capital market and non-bank financial institutions continued to emphasise the achievement of a competitive, transparent, stable and credible financial industry that adheres to international standards. This panoply of policy introduced by Bank Indonesia and the Government had successfully maintained financial system stability during the reporting period.

Well-maintained financial system stability, coupled with solid macroeconomic fundamentals and sound issuers, supported favourable financial market performance that ultimately preserved the financial system's optimal role in the economy. The favorable financial system performance was reflected by improved indicators of the banking industry, finance companies, pension funds and insurance.

Better banking sector performance, which continued to dominate the financial system, was accompanied by relatively low credit risk, adequate capital and high profitability. Despite price corrections and mounting volatility on the stock market and bond market in the middle of semester II 2011, the financial market showed its resilience to widespread uncertainty risk in the global economy. This was demonstrated among others, by the rapid rate of recovery compared to other countries in the region. Consequently, the domestic stock exchange rebounded to become one of the strongest bourses in the region. Ultimately, financial system resilience in dampening external shocks led to a well-preserved financial sector to support the real sector through the intermediary function and a well-maintained finance companies' activity on the capital market. This also support fiscal financing through the issuance of SBN.



## 8.1 BANKING POLICY AND PERFORMANCE

### POLICY TO STRENGTHEN BANK RESILIENCE

The resilience of the financial system, particularly the banks, in 2011 was supported by the implementation of several policies as well as amendments to banking regulations by Bank Indonesia.<sup>1</sup> One focus of banking policy in order to support price stability and financial system stability was to enhance bank resilience in the face of tougher competition. This was done by transparent management that referred to good governance principles. To this end, Bank Indonesia had issued policy on Fit and Proper Tests.<sup>2</sup> The policy revealed in detail the parties that obliged to conduct fit and proper tests, the requirements and administrative documents, a simplification of fit and proper tests from 10 to 4 phases as well as the imposition of sanctions period. As part of its efforts to enhance bank resilience, Bank Indonesia amended the calculation for risk-weighted assets. These policy guidelines related to the calculation of risk-weighted assets using the standardised approach<sup>3</sup> and were intended to enhance the resilience of the national banking industry in facing crisis and international

1 Refer to Financial Stability Review No. 16 – March 2011 and No. 17 – September 2011.

2 The Bank Indonesia regulation regarding Fit and Proper Tests was issued on 29th December 2010 and complemented by Bank Indonesia Circular No. 13/8/DPNP on 28th March 2011.

3 Bank Indonesia Circular Letter No.13/6/DPNP, dated 18th February 2011.

competition. By adjusting this calculation, the capital adequacy ratio increasingly reflected the risks faced by the banks and was congruent with international standards.

In line with policy to strengthen the banking industry, Bank Indonesia also issued an array of policies to boost the efficacy of banks' supervision function by expanding the function of the early warning system.<sup>4</sup> The policy was aimed at improving the effectiveness of bank soundness assessments through the application of consolidated surveillance using risk based supervision in line with changes in banks' business complexity and risk profile. Furthermore, the policy was introduced to enable identification of troubled banks at early stage and to apply a more effective follow-up supervision. Through this regulation, banks (including foreign bank branches) were obliged to conduct self-assessments on their respective level of soundness using Risk-Based Bank Ratings/RBBR both individually and consolidated. The factors used to assess the level of bank soundness include the risk profile, good corporate governance, earnings and capital.

To enhance banks' effectiveness, BI also altered some regulations regarding the supervision status of a bank as well as follow-up supervision.<sup>5</sup> The aim of these regulations were to accelerate the settlement of bank problems, to maintain public trust and to create financial system stability. In this context, Bank Indonesia imposed a time limit on each level of bank supervision status and demanded genuine efforts from executives and controlling shareholders to resolve outstanding issues at their banks. Sanctions were imposed on any banks failing to meet their deadlines or those that do not show signs of improvement.

Furthermore, Bank Indonesia adjusted the monthly reports submitted by commercial banks (LBBU)<sup>6</sup> to enhance the supervision function through the acquisition of more complete bank information and data. This regulation was introduced to: (i) expedite the delivery time of several reports in the LBBU, thereby maximising the usefulness of other reports

4 Bank Indonesia Regulation No.13/1/PBI/2011, dated 5th January 2011 regarding The Assessment of Commercial Bank Soundness, effective from 1st January 2012.

5 Bank Indonesia Regulation No.13/3/PBI/2011, dated 17th January 2011 to Determine Bank Status and Follow-up Supervision, effective from 17th April 2011.

6 Bank Indonesia Regulation No.13/19/PBI/2011, dated 22nd September 2011, which amends PBI No.8/12/PBI/2006 on the Periodic Reports of Commercial Banks.

that have also been improved in their delivery times; (ii) add new reports namely report on the calculation of risk-weighted assets for credit risk using the standard approach and report on the prime lending rate; and (iii) align a number of regulations in the LBBU with other reporting procedures.

Bank Indonesia improved regulations relating to implementation of the compliance function,<sup>7</sup> to support the establishment of a compliance culture in the national banking industry. Regulatory amendments involved the compliance function of commercial banks which covering the organisation setting, tasks and responsibilities of those parties implementing the compliance function at commercial bank. This compliance function was part of the risk-management framework. The amendments also strived to create a culture of compliance in the national banking industry. This regulation was effective from September 1, 2011 2011.

## **POLICY TO BROADEN PUBLIC ACCESS TO THE FINANCIAL SYSTEM**

The policy to broaden public access to the financial system, known as financial inclusion, was aimed at expanding public access to the most basic financial services. This policy was expected to support financial stability as the basis for solid economic development. In terms of macroeconomic view, this activity was expected to catalyse a more sustainable and widespread economic growth, as well as providing welfare benefits. The strategic targets of this program, among others, included increasing public understanding of banking services, providing infrastructure and a network to facilitate public access to banking services as well as providing a legal platform to ensure the successful implementation of financial inclusion.

Impediments of public access to financial services stemmed from both the supply and demand sides. On the supply side, the problems consisted of the limited coverage of banking sector in terms of existing branches and staff availability, as well as limited banking product that suitable with the public needs and information gaps. In this context, banks' coverage was heavily influenced by infrastructure condition and the business potential at the local area. Information

gaps between banks and MSMEs was another problem on the supply side. Banks required information about MSMEs and their feasibility. Meanwhile, problems on the demand side related more closely to the level of education and access to information on financial products and services. In addition, the banks' commitments to their customers were formally controlled by strict legal requirements. However, not all strata of society met the formal legal requirements, hence the poor still had no access to adequate credit.

## **Financial Inclusion Policy**

There are five strategies pursued by Bank Indonesia in the context of financial inclusion. The first strategy was to enhance public understanding regarding the concept of financial inclusion. This was achieved through educational programs consisting of, among others: i) improving public understanding of the benefits and uses of financial products; ii) customer protection concerning the customer's rights and legal protection when engaged with a financial institution; and iii) financial management. The second strategy was to enhance public capacity and competence when seeking financial services. This policy covered: i) providing training and technical assistance; ii) applying an innovative guarantee system; iii) promoting credit suitable with the community's needs; and iv) identifying potential customers.

The third strategy was pursued through the publication of policies and regulations that expand public access to banks and by providing incentives for the banks to open up access to the public. To this end, the programs included: i) licensing for non-formal/micro financial institutions as well as banking agents; ii) imposing conditions on the opening of new branches; iii) determining the regulations for linkage programs; iv) reviewing the regulations on capital requirements, risk management and customer protection; v) reviewing the regulations on the mechanism for channelling grant funds through the banking sector; and vi) formulating regulations to improve governance and management quality of financial institutions.

The fourth strategy was to raise the awareness and understanding of financial institutions regarding the presence of potential unbanked community by facilitating intermediation activity. This was achieved by: i) facilitating an intermediation forum between financial institutions and productive elements of the poor; and ii) empowering micro financial institutions by boosting cooperation between banks and micro

<sup>7</sup> Bank Indonesia Regulation No.13/2/PBI/2011, dated 12th January 2011 on Compliance Function Implementation at Commercial Banks.

financial institutions. This was bolstered further by the fifth strategy, through expanding the coverage of financial institutions in the community. In this respect, a number of strategies were introduced namely i) banking agent, which is a partnership program between financial institutions and non-financial institutions; ii) phone banking, which uses communication technology when using financial services; and iii) mobile banking, which reaches out communities in remote areas by utilizing mobile banks.

Other endeavours to further encourage bank intermediation was by expanding public access to financial institutions services. In this context, Bank Indonesia launched the Gerakan Indonesia Menabung (National Savings Movement) campaign to develop saving culture as early as possible, to provide low-cost savings products and to empower public to plan their finances. Additionally, Bank Indonesia and the Government had compiled a blueprint for the National Financial Inclusion Strategy as a joint effort to implement financial inclusion policy. The blueprint was designed to broaden financial access to the public at large.

### Financial Inclusion Policy for MSME

Bank Indonesia took a range of efforts, which was expected to further encourage micro, small and medium enterprises (MSME) to play a greater role in the national economy and enhance the role of the wider community. To this end, Bank Indonesia introduced a full range of policy measures to broaden MSME access to the banking sector. The policy measures introduced by Bank Indonesia included the establishment of regional credit guarantee institutions (PPKD) and the formation of Apex Banks.

Bank Indonesia encouraged the establishment of PPKD to overcome problems associated with collateral. The emergence of PPKD denoted the active role played by the government as regulator and Bank Indonesia as central bank. The government played its role as regulator in the establishment and supervision of PPKD and facilitating the acceleration of the formation of new PPKD as well as preparing MSME to interact with PPKD. As the central bank, Bank Indonesia encouraged banks to enhance their intermediation function by extending credit while adhering to the prudential banking principles.

PPKD was expected to resolve the problem of collateral by micro, medium and small enterprises (MSME) in

obtaining access to banks. From the perspective of MSME, the problems that emerge relate to limited collateral, insufficient value of collateral and meeting the legal requirements associated with collateral. From the banks' standpoint, collateral was necessary to mitigate credit risk. Accordingly, PPKD had been established in each province in order to bridge this gap. The presence of PPKD was expected to increase the allocation of productive bank loans and minimise the constraints to MSME access to bank services.

Meanwhile, Bank Indonesia encouraged the establishment of apex banks as an umbrella agency for rural banks to extend the outreach of commercial banks in channeling credit to MSME. On one hand, the advantages of rural banks included their accessibility to the wider community, their understanding of local culture as well as their flexibility in transacting with unbankable elements of society. On the other hand, capital and human resources remained weak at rural banks. Therefore, the presence of apex rural banks was expected to strengthen capital at rural banks while enhancing the quality of human capital. Apex rural banks were also expected to overcome the limitations faced by rural banks in terms of optimising their role and contribution through a synergy in providing technical and financial assistance to member rural banks. This inter-business approach was aimed to expanding MSME access to the banking sector by bridging the gap between the prudential aspects set by the banks and MSME that were feasible but remain unbanked.

## BANKING SECTOR PERFORMANCE

### Commercial Banks

Amid escalating global economic shocks, primarily attributable to the debt crises in the euro area and the slowdown in the US recovery, the banking sector maintained positive performance accompanied by a continuously improving intermediation function. This was made possible by the array of policies issued as well as improved good governance in the banking industry on the back of a conducive domestic economy. Despite experiencing a decline of total number from 122 at yearend 2010 to 120 in 2011 as a result of mergers and self-liquidation, total assets of commercial banks grew by 21.4% to Rp3,652.0 trillion, which exceeded that posted in 2010. The increase in total assets was supported by the growing number of branches serving the public from 13,837 at yearend 2010 to 14,797 at the end of the reporting year.

In general, commercial bank assets were still dominated by deposits, accounting for a 76% share of total assets and representing an increase of 19.0% over the previous year, which surpassed the growth recorded in 2010. The growth in deposits occurred in all components, with the largest increase contributed by savings, followed by checking accounts and term deposits, which grew in the range of 15% to 22.5% (Chart 8.1). Consequently, term deposits, the most expensive source of funds compared to the two other components, continued to dominate private funds held at banks with a 45.4% share of total deposits. Accumulating deposits was the primary source of funds for banks in channeling credit.

Credit channeling remained as the primary placement of bank funds compared to other placements like securities or interbank placements. This is demonstrated by the share of credit that reached 60.2% of total commercial bank assets, up from the previous year of 2010 when the share was recorded at 58.7% (Chart 8.2). Throughout 2011, commercial bank loans experienced 24.5% growth, which exceeded that posted in 2010 at 22.8%. Meanwhile, the portion of bank placements in securities declined and consequently increased the contribution of credit in financing economic development. At year end 2011, the share of credit to GDP reached around 30%, which represent a significant increase over the position in 2010 at 27%.

In addition to a conducive domestic economy, rapid credit growth at commercial banks was also associated with the new regulation on reserve requirement that linked to the loan-to-deposit ratio. This policy was

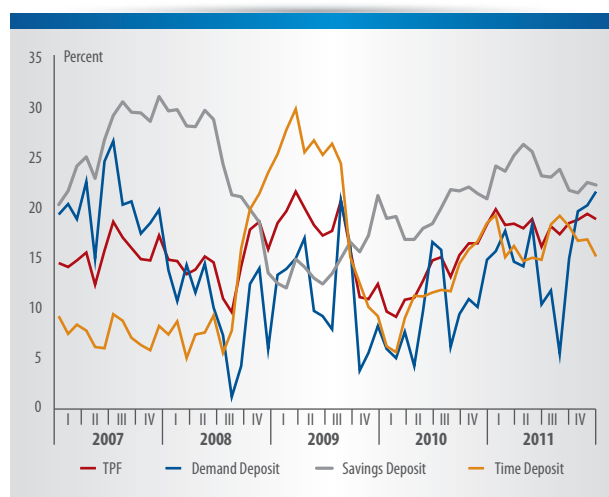


Chart 8.1 Deposits Growth

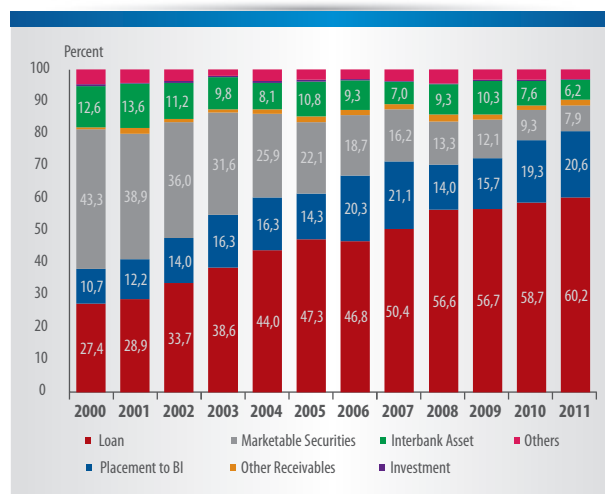
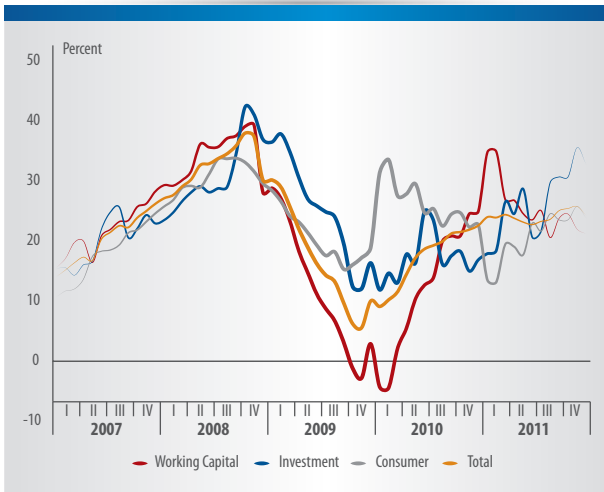


Chart 8.2 Asset Composition

issued by Bank Indonesia in September 2010 and becoming effective in March 2011. According to this policy, the loan-to-deposit ratio was set within a range that was deemed capable of driving the intermediary function while still conforming to the prudential principle. The lower limit of the LDR target was set at 78% and the upper limit at 100%. At the end of 2010, commercial bank LDR was 75.5%, however, subsequent improvements brought it in line with the minimum level determined by the new regulation, achieving 79% at the end of 2011.

The increase in credit was not merely in terms of quantity but also quality. Bank credit growth in 2011 was dominated by productive credit, in particular investment credit that posted 33.2% growth. In comparison, consumption credit chartered growth of 24.1% (Chart 8.3). As a result of this development, investment credit together with working capital credit grew by 21.4%, thereby dominating bank credit with a 70% share. Growth in credit to productive sectors was linked to improvements in domestic economic conditions, which helped improve performance in the business community. By sector, most credit growth in 2011 stemmed from the mining sector, which accounted for 43%, followed by other productive sectors like utilities (electricity, water and gas), transportation and communications as well as agriculture with growth of 34.4%, 26.7% and 26.0% respectively.

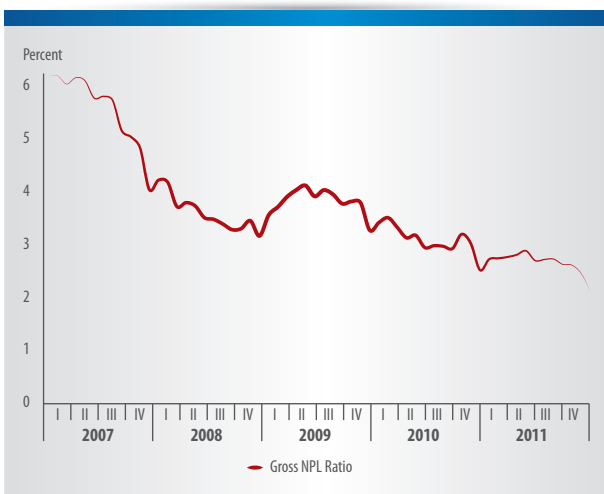
Amid robust credit growth, the banking sector successfully managed the quality of its credit, as reflected by the gross non-performing loans ratio that remained below 3% at 2.2%, which representing its lowest value since 2000 (Chart 8.4). Despite an increase



**Chart 8.3 Credit Growth**

in the nominal amount of non-performing loans in 2011, the banking sector maintained adequate reserves to anticipate possible losses. Notwithstanding, anticipative measures through monitoring activity are still required as early as possible to prevent any further propagation of disruptions that could undermine bank performance in the future

With support from rapid credit growth, which was the main source of income, the banking sector successfully maintained a high level of profitability. Banks managed to generate profit Rp75.0 trillion in 2011, higher than that posted in the same period of 2010. Return on Assets (ROA) was recorded at 3.0%. The main source of bank profitability stemmed from interest income, as evidenced by the bank Net Interest Margin (NIM) of 5.9%, which is higher than the position posted at yearend 2010 of 5.7% (Chart 8.5). Approximately



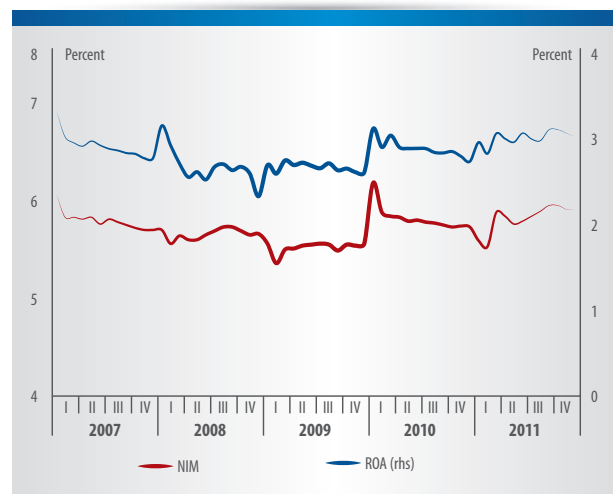
**Chart 8.4 Gross NPL Ratio**

82.4% of bank interest income originated from interest income.

Against this propitious backdrop, the banking sector managed to maintain its capital at an adequate level. Furthermore, solid bank profitability was able to preserve the Capital Adequacy Ratio (CAR) at level of 16.1%, which was slightly below the level reported in 2010 (17.2%). This was in line with aggressive credit allocation. Despite the slight decrease, the level of CAR in 2011 was still higher than the minimum requirement of 8%. On the other hand, bank efficiency remained an issue, among others reflected by the BOPO ratio that remained around 85.4%. This ratio, was relatively high compared to the level of 70% in neighbouring countries like Malaysia, Singapore and Thailand. Nevertheless, the BOPO ratio did experience a slight decline compared to its position at yearend 2010 amounting to 86.1% (Table 8.1)t.

#### Rural Banks (BPR)

Despite their limited number, rural banks played an expanding role in supporting the national economy, which was bolstered by improved performance during the reporting period. The expanding role of rural banks in the economy was demonstrated by the growing coverage area for rural bank services, increasing business scale of rural banks as well as the well functioning intermediation process. Meanwhile, rural banks performance also improved in congruence with the rentability aspect of rural banking industry that was quite promising as well as improvement in efficiency. This was represented by a number of banking indicators like ROA (Return on Assets), Return On Equity



**Chart 8.5 ROA and NIM**

**Table 8.1 Commercial Bank Main Indicators**

Main Indicators (December)	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Assets	1,099.7	1,112.2	1,213.5	1,272.1	1,469.8	1,693.9	1,986.5	2,310.6	2,534.1	3,008.9	3,652.0
Third Party Funds	797.4	835.8	888.6	963.1	1,127.9	1,287.1	1,510.8	1,753.3	1,973.0	2,338.8	2,784.1
Credits	316.1	371.1	440.5	559.5	695.6	792.3	1,002.0	1,307.7	1,437.9	1,765.8	2,199.1
Capital Adequacy Ratio (%) <sup>1</sup>	19.9	22.4	19.4	19.4	19.3	21.3	19.3	16.8	17.4	17.2	16.1
Gross Non Performing Loans (%) <sup>2</sup>	12.2	7.5	6.8	4.5	7.6	6.1	4.1	3.2	3.3	2.6	2.2
Return on Assets (%) <sup>1</sup>	1.5	2.0	2.6	3.5	2.6	2.6	2.8	2.3	2.6	2.9	3.0
Net Interest Margin (%)	3.6	4.1	4.6	6.4	5.6	5.8	5.7	5.7	5.6	5.7	5.9
Operations Expenses To Operations Income (%) <sup>2</sup>	98.4	94.8	88.1	76.6	89.5	87.0	84.1	88.6	86.6	86.1	85.4
LDR (%)	39.6	44.4	49.6	58.1	61.7	61.6	66.3	74.6	72.9	75.5	79.0
Total Bank	145	141	138	134	131	130	130	124	121	122	120

1) Not included Sharia Bank (since April 2010)

2) Not included credit from channelling

(ROE) and BOPO. This satisfactory performance was also due to the series of Bank Indonesia policies issued for rural banks. Improved rural bank performance was supported by wider coverage for rural bank services. Institutionally, the number of rural banks was currently 1,669, consisting of 1,388 private rural banks, 247 regional rural banks and 34 cooperative rural banks. The broader service coverage was supported by increasing number of rural bank branches, up 12.41% from 1,088 branches in December 2010 to 1,223 in December 2011. Despite the increase in coverage area, the total number of rural banks declined by 37 compared to the previous year as a result of license revocations, mergers and consolidation.

Broader coverage area, in turn, helped accelerate growth of rural bank business scale. In this context, BPR asset growth reached 21.99%; up from Rp45.7 trillion to Rp55.8 trillion. Growth in assets also followed by improved performance in terms of funding and financing. Deposits accumulated by rural banks grew by 22% with a nominal value amounted Rp38.2 trillion. Meanwhile, rural banks posted 21.44% credit growth with a nominal value of Rp41 trillion.

The improved performance of rural banks was accompanied by a sound intermediation function. Solid credit and deposit growth helped to maintain the loan-to-deposit ratio of rural banks at a level of 78.54%, which was slightly down compared to the previous year at 79.02%. The quality of credit also improved, with net NPL declining from 4.25% in the preceding year to 3.67% (Table 8.2)

The year of 2011 witnessed improved efficiency in the rural banking industry as well as rentability. The return on assets was recorded at 3.32%, meanwhile, ROE was 29.46%. Rural banks significantly boosted their levels of efficiency in 2011. The BOPO efficiency improved to a level of 79.47% in 2011 compared to 80.97% in the previous period.

#### Islamic Banks

Although still limited, the role of Islamic banks in supporting the national economy continued to expand and was accompanied by increasingly impressive performance. A greater role for Islamic banks in the economy was evidenced by the growing spread of service coverage area, larger business scale and the well functioning intermediation process. Additionally, Islamic bank performance also improved in line with promising rentability as well as easing credit risk. These achievements were possible due to the series of policies introduced by Bank Indonesia for the Islamic banking industry through the iBcampaign.

Islamic banks recorded significant asset growth, among others, buoyed by growth in the office network. Overall, the Islamic banking office network increased from 1,477 branches to 1,737, with office channelling stable at 1,277 (Table 8.3). Expansion of the office network has dramatically increased the number of Islamic bank account holders from 6.92 million accounts to 9.58 million. Furthermore, office network expansion had also raised the business volume of Islamic banks, especially Islamic Commercial Banks (BUS) and Islamic

Business Units (UUS). Total assets as of December 2011 had risen sharply by 49.17% to Rp145.47 trillion, representing the strongest growth posted in the past three years. The share of Islamic banks in the national banking industry was around 4.19% in 2011. Solid asset growth was linked to growth in deposits on the liabilities side and financing growth on the assets side. Meanwhile, the accumulation of deposits increased by 51.79% and the allocation of private funds through financing increased by 50.56% (Table 8.4).

Deposits increased remarkably from Rp76.04 trillion in 2010 to Rp115.41 trillion in 2011. Despite a slight decline at the beginning of the year as a consequence of the January Effect, deposits rallied and rebounded

later in the year. The structure of deposit accounts at Islamic banks was dominated by term deposits with a share totalling Rp70.81 trillion (61.4%) followed by savings accounting for Rp32.60 trillion (28.3%) and demand deposits with Rp12.0 trillion (10.4%) (Table 8.5).

Term deposits were the most appealing Islamic banking product to the public, among others due to the high yields offered. Based on the performance of each type of product, term deposits and savings accounts were the most stable, experiencing a steady increase throughout 2011. Term deposits recorded the most impressive growth figures at around 61.66% from the position in the preceding year at Rp44.07 trillion to

**Table 8.2 Rural Credit Bank Main Indicators**

Indicators (as December)	2010	2011	Growth	
			Deviation	%
Total Rural Credit Bank	1,706	1,669	-37	-2.17
- Corporation	1,384	1,388	4	0.29
- Regional Corporation	288	247	-41	-14.24
- Cooperation	34	34	0	0.00
Total Office	3,910	4,172	262	6.70
- Head Office	1,706	1,669	-37	2.17
- Branch Office	1,088	1,223	135	12.41
- Cash Office	1,116	128	164	14.70
Asset (billions of rupiah)	45,742	55,799	10,056	21.99
Third Party Funds (billions of rupiah)	31,311	38,209	6,897	22.03
- Savings Deposit (billions of rupiah)	9,856	12,035	2,178	22.10
- Time Deposit (billions of rupiah)	21,455	26,174	4,719	22.00
Interbank Assets	4,738	642	1,681	35.49
Interbank Liabilities	10,032	12,434	2,401	23.94
Credits (billions of rupiah)	33,844	41,099	7,255	21.44
Current Profit/Loss (billions of rupiah)	1,446	1,852	405	28.04
Third Party Funds Accounts	8,217,082	8,976,558	759,476	9.24
Savings Deposits Accounts	7,804,000	8,551,718	747,718	9.58
Time Deposits Accounts	413,802	42,484	11,758	2.85
Credits Accounts	3,242,360	3,361,507	119,147	3.67
CAR (%)	30.01	28.68	-1.33	-4.43
LDR (%)	79.02	78.54	-0.48	-0.61
Earning Assets Quality (%)	4.13	3.58	-0.55	-13.32
ROA (%)	3.16	3.32	0.16	5.06
ROE (%)	26.71	29.46	2.75	10.30
Operations Expenses To Operations Income (%)	80.97	79.47	-1.5	-1.85
Gross NPL (%)	6.12	5.22	-0.9	-14.71
Net NPL (%)	4.25	3.67	-0.58	-13.65

**Table 8.3 Sharia Bank Office Network**

Bank Category	2009	2010	2011	Growth
Sharia Commercial Bank (BUS)	6	11	11	0
Sharia Business Unit Operations (UUS)	25	23	24	1
Total BUS and UUS	1,001	1,477	1,737	260
Total Sharia Services	1,929	1,277	1,277	0

Rp70.81 trillion. In addition, savings products also grew expansively by 42.32%. This led to iB savings products reaching Rp32.60 trillion from Rp22.91 trillion in the previous year. On the other hand, the position of demand deposits tended to fluctuate. In spite of a slight decline, demand deposits grew by 32.59% in 2011 compared to previous year. The yield on term deposits fluctuated between 7.24% and 9.11% (equivalent rate), while the yield on savings accounts remained around 2.91% and demand deposits at 1.47% (equivalent rate). The most popular deposit product was the one-month term deposit.

The Islamic banking sector showed commitment to support the real sector through various forms of financing. To this end, the Islamic bank intermediation function, indicated by the Finance-to-Deposit Ratio (FDR), remained relatively high at 88.94%. Therefore, growth in fund accumulation could be offset by growth in financing allocation to the real sector through profit sharing (*Mudharabah* and *Musarakah*), receivables (*Murabahah*, *Istisna* and *Qardh*), and other forms of financing (*Ijarah*). This growth in financing represented an allocation of around 72.81% (Rp102.65 trillion) of all financing extended by Islamic banks. Placements held at Bank Indonesia as well as the securities owned respectively accounted for 10.74% (Rp19.24 trillion) and 4.18% (Rp5.90 trillion) (Table 8.6). The portfolio of Islamic banks held at Bank Indonesia increased significantly, by 65.53%, while receivables (*Murabahah*) continued to dominate financing allocation amounting to Rp56.36 trillion or 54.91%, followed by *Musarakah* financing at Rp18.96 trillion (18.47%) and receivables (*Qardh*) at Rp12.94 trillion (12.60%). The allocation of receivables (*Qardh*) experienced the most significant

growth at around 173.57%, which was dominated by gold *Qardh* (fiduciary).

The improved performance of Islamic bank, among others reflected by the solid level of earnings, and supported by an increase in the quality of fund allocation. ROA and ROE indicated sound earnings at 1.79% and 15.73% respectively. The increase in total financing, coupled with better performance, helped reduce the BOPO efficiency ratio to 78.41% from 80.54% in the preceding year. Greater fund allocation together with higher quality of Islamic bank financing led to a decline in gross non-performing finance (NPF) from 3.02% to 2.52%. This had led to strong profits and cost efficiency, thus maintaining earnings. Ultimately this can enhance profit accumulation and consequently strengthen capital. The capital of Islamic banks was maintained within a range that deemed adequate to absorb potential losses. The capital adequacy ratio of Islamic commercial banks in December 2011 was 16.63%.

These achievements were due to a good synergy between Bank Indonesia and industry players. Bank Indonesia provided support in the form of expediting the licensing process while maintaining analysis quality pursuant to prevailing regulations. Consequently, Bank Indonesia's efforts to expedite the licensing process, to apply fit and proper tests, mergers or acquisitions, to open up the office network and to approve Islamic banking products were tangible in the Islamic banking industry. Such measures were further bolstered by a variety of joint efforts between the regulator and the Islamic banking industry through various export activities, advertising as well as reports in the mass

**Table 8.4 Assets, Third Party Funds and Sharia Commercial Bank and Sharia Unit Business Operations Financing**

Trillions of rupiah

	2010	2011	Growth	
			Nominal	(%)
Assets	97.52	145.47	47.95	49.17
Third Party Funds	76.04	115.41	39.38	51.79
Financing	66.18	102.66	34.47	50.56

**Table 8.5 Third Party Funds Sharia Commercial Bank and Sharia Unit Business Operations**

Trillions of rupiah

Third Party Funds	2010		2011		Growth	
	Nominal	Share (%)	Nominal	Share (%)	Nominal	(%)
Total Third Party Funds	76.0	100	115.4	100	39.4	51.8
Savings Deposit	22.9	30.1	32.6	28.2	9.7	42.3
- <i>Wadiah</i>	3.3		5.4		2.1	61.6
- <i>Mudharabah</i>	19.6		27.2		7.6	39.0
Time Deposit	44.1	58.0	70.8	61.4	22.8	60.7
Demand Deposit ( <i>Wadiah</i> )	9.1	11.9	12.0	10.4	2.9	32.6

media, including the iB campaign for financing and lending.

### Islamic Rural Banks (BPRS)

The performance of Islamic rural banks (BPRS) continued to improve, consequently increasing the contribution of Islamic banks to the national economy. In the reporting year, the number of Islamic rural banks increased by five, thereby bringing the total to 155 in December 2011. The assets of BPRS grew by Rp782 billion or 28.54% from Rp2.74 trillion to Rp3.52 trillion during the period reported, with financing accounted for 76.01% of total assets. On the funding side, savings products increased by 30.52%, while term deposits grew by 30.74%. Therefore, as a whole, the accumulation of private funds increased by 30.65% to Rp2.09 trillion. Accordingly, the structure of BPRS

funding remained dominated by term deposits with a 58.96% share. This development was supported by the iB campaign. The campaign, which was followed by most BPRS contributed to the fund accumulation.

In terms of financing, *Murabahah* contracts continued to dominate Islamic commercial banks and Islamic business units. BPRS financing had expanded over the past year from Rp2.0 trillion to Rp2.68 trillion; an increase of 33.19%. *Murabahah* financing contracts amounted to Rp2.15 trillion, and remained the primary contributor with a share of 80.51%. This achievement was also facilitated by greater BPRS service coverage area and supporting policies.

The increase in BPRS assets was complemented by improved performance and well-maintained intermediation function. Performance indicators

**Table 8.6 Fund Disbursement Sharia Commercial Bank and Sharia Unit Business Operations**

Trillions of rupiah

Deposits	2010		2011		Growth	
	Nominal	Share (%)	Nominal	Share (%)	Nominal	(%)
Total Disbursement	94.88	100	140.98	100	46.1	48.59
Financing	68.18	71.86	102.65	72.81	34.47	50.56
<i>Murabahah</i> <i>Account Receivable</i>	37.51	39.53	56.36	39.98	18.85	50.25
<i>Qardh</i> <i>Account</i> <i>Receivable</i>	4.73	4.99	12.94	9.18	8.21	173.57
<i>Mudharabah</i>	8.63	9.1	10.23	7.26	1.6	18.54
<i>Musarakah</i>	14.62	15.41	18.96	18.96	4.34	29.69
Others	2.69	2.84	4.16	2.95	1.47	54.65
Inter Bank	4.14	4.36	4.85	3.44	0.71	17.15
Placement to BI	16.39	17.27	27.13	19.24	10.74	65.53
Marketable Securities	5.73	6.04	5.9	4.18	0.17	2.97
Investment	0.09	0.09	0.05	0.04	-0.04	-44.44
Others Receivable	0.35	0.37	0.4	0.28	0.05	14.29

continued to rally as reflected by a number of banking indicators including CAR, which reached 23%. The effective use of capital by Islamic rural banks was adequate, denoted by return on equity ratio of 18.95%. However, the effective use of assets (ROA) declined slightly from 3.49% to 2.67%. Meanwhile, cost efficiency improved, thereby reducing the BOPO ratio from 78.08% to 76.31%. The burgeoning role of Islamic rural banks in the economy was further evidenced by the FDR indicator, which reached 127.71% in 2011. The higher financing by rural banks were followed by a decline in the gross NPF ratio from 6.50% to 6.11%.

#### Micro, Small and Medium (MSM) Bank Loans

The performance of MSM credit continued to improve, marked by the successful accomplishment of the targets set. Credit growth in 2011 based on MSM data was 23.9%, while credit growth based on the newly defined MSME was 21.7%. Therefore, MSME credit growth had exceeded its corresponding target set at 20%. The composition of MSME credit was dominated by working capital credit accounting for as much as 78.2%, while the remaining 21.8% was made up of investment credit (Table 8.7). By region, 62.0% of MSME credit was disbursed in Java and Bali. By sector, the largest portion of MSME credit was allocated to the trade sector, which was accounted for 44.7%, followed by the manufacturing industry with 11.0%. State-owned banks extended most of MSME credit with total amount Rp222.6 trillion (46.4%), followed by national private foreign exchange banks Rp176.9 trillion (36.9%) and regional development banks Rp31.3 trillion (6.5%).

Bank Indonesia redefined the presentation of MSM credit data pursuant to Act No. 20, 2008 on Micro, Small and Medium Enterprises (MSME), which defined MSME based on business criteria (assets and turnover). This redefinition altered the currently used MSM credit data that based on a credit ceiling to MSME credit data that based on the business criteria of a potential borrower referring to Act No. 20, 2008. Commencing in January 2011, Bank Indonesia provided the new MSME data in parallel with the old MSM data. With the introduction of a new definition for credit, the portion of MSE credit reached 21.2% of total bank credit compared to a 51.9% share for MSM credit. This decline was due to the exclusion of consumption loans from MSME credit.

## 8.2 CAPITAL MARKET AND OTHER FINANCIAL INSTITUTIONS

### POLICY FOR CAPITAL MARKET AND OTHER FINANCIAL INSTITUTIONS

Capital market and financial industry policy was directed towards developing a competitive, transparent, stable and credible financial industry as well as conform to international standard according to the Capital Market Masterplan of Indonesia 2010-2014. In pursuit this objectives, the Capital Market and Financial Institution Supervisory Board (Bapepam-LK) issued several policies as follows: (i) develop the capital market into an effective, competitive and easily accessible source of funding; (ii) make stock and bond an attractive mode of investment, supported by reliable risk management; (iii) develop a liquid industry based on stability; (iv) develop a regulatory framework that guarantee legal assurance; and (v) build infrastructure of an international standard. In addition, the Capital Market and Financial Institution Supervisory Board released a set of rules in 2011 through the issuance and amendment of Finance Minister Regulations (PMK), capital market regulations and regulations for financial institutions.

A stable financial market and industry was one of the priorities of the Capital Market and Financial Institution Supervisory Board. To this end, the efforts taken include raising the quality of industry players and the quality of corporate governance. Higher quality industry players involved broadening the domestic investor base as well as long-term funds. In addition, the Capital Market and Financial Institution Supervisory Board enhanced risk management in the industry as well as supervisory capacity over industry players. In this context, the government continued to push forward with its bond stabilization framework to maintain price stability on the government bond market. Indonesia Stock Exchange (IDX) policy on securities trading, margins and short selling issued in 2009 were the basis for improving stability on the stock market, particularly in terms of reducing excessive speculation, in addition to several regulations on the transaction mechanism and

membership in 2011.<sup>8</sup>

Enhancing the quality of institutional industry players was crucial when developing a stable financial industry. Improving institutional quality involved applying good corporate governance, developing guidelines on good corporate governance, refining regulations to conform to international standards and raising the quality of implementation. Regarding insurance companies, this manifested in an increase in the minimum capital

requirement from Rp40 billion in 2010 to Rp100 billion in 2014. In addition, adjustments were made to working capital, particularly to securities companies. The focus was to amend capital regulations, standardise information technology, refine the licensing requirements and control outsourcing.

Raising the quality of individual industry players was also pivotal when developing a stable financial industry. Raising the standard of qualifications prior to receiving a license as well as promoting professionalism after receiving a license helped to enhance the quality of individual players. On the capital market, efforts to raise the standard of qualifications for those involved with securities were taken by restructuring the licensing of representatives of securities companies. For pension funds, the Capital Market and Financial Institution Supervisory Board complemented individual

8 1. II-A Kep-00005/BEI/01-2011 Amendment to II-A regarding securities trading, 2. III-C Kep-00082/BEI/10-2011 on stock exchange membership to trade EBU, Sukuk and EBA fixed cash flow, 3. III-D Kep-00083/BEI/10-2011 on reporting by stock exchange members and participant dealers 72, 4. III-E Kep-00084/BEI/10-2011 on the examination of stock exchange members 21, 5. III-F Kep-00085/BEI/10-2011 on sanctions, 6. III-G Kep-00086/BEI/10-2011 on suspensions and revocation of stock exchange membership.

**Table 8.7 Small Medium Enterprises (SMEs) Credit<sup>\*)</sup>**

Information	Position (Trillions of rupiah)		Growth (%)	Share (%)	
	2010	2011	2011	2010	2011
Type of Use					
Working Capital	314.7	375.3	19.3	79.8	78.2
Investment	79.6	104.6	31.4	20.2	21.8
Total	394.3	479.9	21.7	100	100
Sectoral					
Agriculture	19.5	30.3	55.6	4.9	6.3
Fishery	2.2	2.7	23.4	0.5	0.6
Mining	3.2	4	25	0.8	0.8
Manufacturing Industries	43.4	52.8	21.6	11	11
Electricity, Water and Gas	1.4	1.2	-8.5	0.3	0.3
Construction	20.7	25	20.7	5.2	5.2
Trade	177.5	214.6	20.9	45	44.7
Accommodation	7.3	10.3	40.4	1.9	2.1
Transport	13.9	19.3	38.8	3.5	4
Finance	6.8	10.4	52	1.7	2.2
Real Estate	13	20.3	56.9	3.3	4.2
Administration	0.3	0.4	48.7	0.1	0.1
Education Services	1.3	1.6	25.1	0.3	0.3
Health Services	2.8	3	8.9	0.7	0.6
Social Services	21.7	27	24.6	5.5	5.6
Individual Services	1.6	1	-33.9	0.4	0.2
International Agencies	0.08	2.4	2698.4	0	0.5
Business activities are not clearly defined	49.8	53.7	7.8	12.6	11.2
Un-identified					
Total	8.1	0	-100	2	0
	394.3	479.9	21.7	100	100
SMEs Credit/Total Credit Ratio	21.8	21.2	-	-	-

<sup>\*)</sup> MSME credit data does not incorporate data from Islamic commercial banks (BUS) but does include data from (Islamic) rural banks from September 2011

qualifications by including aspects of integrity as part of the strategy to raise the quality of individuals. The strategy for the insurance industry was to develop certification channels appropriate to the areas of specialisation.

Policy to improve the quality of market players must be accompanied by comprehensive supporting infrastructure when developing a stable industry, for instance enhanced risk management and financial system supervision. Risk management also incorporated managing risk in the clearing system, guaranteeing transactions on the stock exchange and formulating a Business Continuity Plan. Meanwhile, development of a capital market surveillance system remained directed on risk-based. In addition, single identification was imposed on investors and early warning indicators were constantly monitored, especially signs of insider trading. Furthermore, capital market players and securities rating agencies were also subject to surveillance.

Strengthening long-term investor base supported a stable financial industry. This policy was in line with the increase in domestic investors through regulations that make it mandatory for securities companies that members of the stock exchange to maintain a specific level of capital. This was supplemented through targeted and integrated education and socialisation activities. In this context, there were three targets to be achieved, namely increasing IPOs and the number of retail investors and short-medium term institutional investors. In the long term emphasis focused on creating a culture of investment. The Capital Market and Financial Institution Supervisory Board was also in the midst of reviewing regulations relating to the implementation of mandatory insurance and pension programs.

## NON-BANK FINANCIAL INSTITUTIONS

### Finance Companies

Finance companies posted positive growth in 2011, thereby maintaining their contribution to the national economy. The total assets of finance companies experienced an increase of 24% to Rp286.2 trillion.<sup>9</sup> The majority of financing offered was for consumption, which was accounted for 67.4% of total financing

<sup>9</sup> Corporate data for November 2011. Growth was measured by comparing the position in December 2010 to that in November 2011.

or Rp163.1 trillion. Growth in activity by finance companies was primarily driven by strong demand for motor vehicles. Meanwhile, financing for leasing, which was considered productive financing, only made up around 17% of total financing.

Greater allocation of financing was followed by improvements in the risk profile. During 2011, relatively stable macroeconomic conditions encouraged finance companies to extend more financing. This was accompanied by the application of selective and prudent policies concerning the allocation of financing. Consequently, financing risk in the industry has tended to ease since 2008, as reflected by a decline in non-performing financing from 2.7% in 2008 to 1.4% with indications of further declines.<sup>10</sup>

Concerning the funding source structure, the primary source of funds for finance companies originated from bank loans. These loans were split into offshore and onshore loans and the majority are from onshore. The remainder, however, stemmed from foreign banks, non-bank financial institutions, issuing securities, other loans and supplementary capital. Low interest rates, domestically and abroad, encouraged finance companies to seek more bank loans.

### Insurance Companies

Similar to finance companies, insurance companies recorded significant growth in 2011, thereby maintaining their role by managing risk on the financial market. Solid performance was indicated, among others, by increases in total assets and investment. Total assets of the insurance industry soared from Rp236.7 trillion in 2010 to Rp258.9 trillion in quarter III 2011, while total investment increased from Rp202.9 trillion in 2010 to Rp219.8 trillion in the same period. Consequently, insurance premiums also experienced an upward trend. This upward trend was offset by a corresponding hike in the number of claims despite lower growth rate. The growth in insurance premiums and claims in 2011 reached 17% and 5% respectively.<sup>11</sup>

Improved performance in 2011 was followed by greater diversity in the insurance products offered. The product diversification raised the competitiveness of the insurance industry amid an increasingly competitive

<sup>10</sup> 2010 data.

<sup>11</sup> Data announced in the press releases of the Capital Market and Financial Institution Supervisory Board in 2011. The assets of insurance companies reached Rp399.7 trillion at the end of December 2011, up 11% from the preceding year.

financial market and industry. In general, the insurance products most warmly received by the public are those that incorporated an element of investment. This kind of insurance emerged as an investment alternative to term deposits, mutual funds, ORI and shares. Other insurance products that had strong potential growth included those that offer additional advantages like returning the premium if no claims were made. However, increased performance in 2011 was not complemented by a corresponding surge in the number of operating insurance companies. A downward trend in the number of insurance companies persisted since 2003 before stabilising in the past two years at around 139 insurance companies and 240 supporting insurance agencies.

Better insurance company performance helped strengthen the long-term investor base for financial instruments. The portions of mutual funds and stock were the largest, accounted for 19.7% and 19.1% respectively in December 2011.<sup>12</sup> Consequently, there was a shift in the investment pattern of insurance companies from government bonds to shares and mutual funds, despite only in a limited amount. This was inline with the increasing diversity of insurance products, especially those that contain an element of investment. This phenomenon has a positive effect on future government bonds and stock market development because pension funds, which manage private funds over the long term, are strategic investors on the financial markets. Nonetheless, the portion of placements in term deposits and government bonds remained high at 22.2% and 21.4% respectively<sup>13</sup> due to caution motives from the insurance industry.

### Pension Funds

Pension funds also grew expansively, thus maintaining its role in terms of risk management on the financial markets. Net total assets of the pension fund industry had consistently increased over the years despite declining the number of pension fund operators since 2002. Up to 2011, the number of pension fund operators was 270; down from 276 in 2009. Net total

assets of the pension fund industry in 2011 reached around Rp136.2 trillion, which was up from the position reported in 2010 at Rp112.5 trillion. This demonstrated the resilience of the pension fund industry in facing shocks on global financial markets.<sup>14</sup>

Better pension fund performance helped strengthen the long-term investor base for financial instruments. Placements in government bonds, term deposits and corporate bonds had dominated the industry over the past few years, amounting to Rp29.2 trillion, Rp29.1 trillion and Rp28.4 trillion in October 2011 respectively.<sup>15</sup> The placement was motivated by prudent pension fund management. However, there was a shift in the investment pattern of pension fund companies. The companies put a surge investments in stock instruments. This was in line with greater product diversification, particularly at the end of the year that offer investment features. Placements in shares reached Rp22.0 trillion. This phenomenon had a positive effect on future government bonds and stock market development because pension funds, which manage private funds over the long term, were strategic investors on the bond and stock markets.

## FINANCIAL MARKET PERFORMANCE

### Stock Market

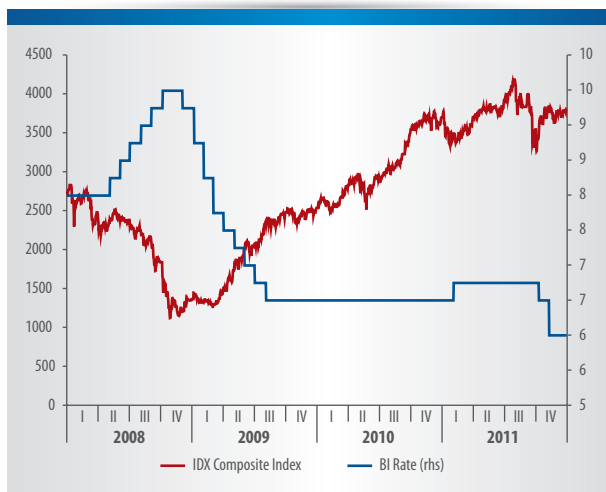
The domestic stock market maintained positive performance amid widespread uncertainty surrounding the global economy. Conducive macroeconomic conditions, stable issuer performance as well as accommodative economic policy all served to bolster stock market performance, as reflected by increases in the IDX Composite. IDX peaked at a new historical high of 4.193 in August 2011, closing out the year at a level of 3,821.9; up 3.2% from 2010 (Chart 8.6). Domestic stock market performance was marred by a number of external shocks, particularly at the beginning of 2011 as well as in August - September 2011. Nevertheless, the achievement was still able to put Indonesia as the best performing stock market in the area after Philippines.

<sup>12</sup> The share of placements in shares and mutual funds as of 30th September 2011 and announced in the press releases of the Capital Market and Financial Institution Supervisory Board in 2011 was 21.8% and 28.9% respectively.

<sup>13</sup> The share of placements in term deposits and SUN as of 30th September 2011, as announced by the Capital Market and Financial Institution Supervisory Board in its press releases for 2011, was 20.1% and 16.1% respectively.

<sup>14</sup> Pension fund data as per the report on "Capital Market and Non-Bank Financial Industry Development" released by the Capital Market and Financial Institution Supervisory Board on 25th November 2011

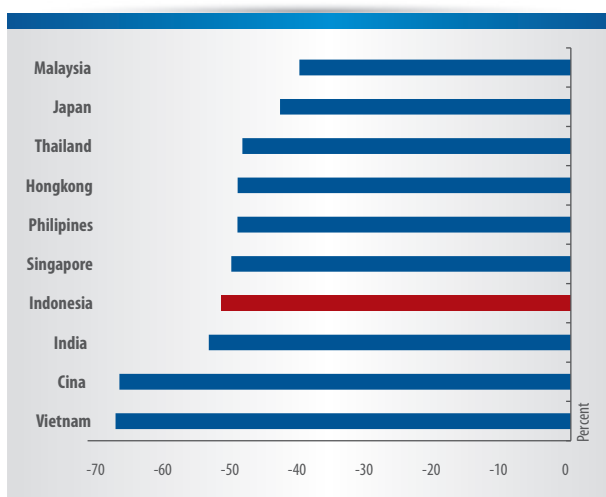
<sup>15</sup> Data released by the Capital Market and Financial Institution Supervisory Board through its press releases in 2011.



**Chart 8.6 IDX Composite and BI Rate**

Overall, the JSX Composite performed better due to its low volatility compared to period when the Lehman Brothers collapsed and compared to other bourses in the region (Chart 8.7 and Chart 8.8).

The domestic stock market was more resilient to global uncertainty risk in 2011. This was reflected in the pace of economic recovery compared to neighbouring countries. Shocks from the global economy eroded domestic stock market performance by 22%. The decline was relatively significant compared to other countries in the region. However, the domestic stock market showed its ability to recover faster. In this context, the IDX Composite required just three weeks to rebound, which was faster than for other bourses in the region (Table 8.8).



**Chart 8.7 IDX Composite and Regional Index in 2007-2008**



**Chart 8.8 IDX Composite and Regional Index in 2010-2011**

The IDX Composite growth was bolstered by uneven sectoral growth. Sectors that posted growth in 2011 included miscellaneous industries, consumption goods, trade and the financial sector. In addition to solid issuer fundamentals, a number of encouraging macro indicators as well as the large share of consumption in economic growth were explanatory factors behind sectoral growth. These circumstances were favourable compared to sectoral performance in 2008. The global economic downturn that occurred in 2008 caused commodity prices to plunge, thus triggering corrections in the mining sector that were subsequently followed by other sectors. Conditions were different in 2011 when large corrections in the mining sector did not precipitate any further corrections in other sectors (Chart 8.9 and Chart 8.10).

A more balanced and higher quality sectoral structure that contributed to stock market growth helped strengthen the resilience of the domestic bourse. Compared to 2008 when the mining sector dominated, the contribution of miscellaneous industries was more pronounced in 2011. Miscellaneous industry didn't only experienced an increase in capitalisation but also an acceleration in trade transaction value. Consequently, the vulnerability of the domestic stock market to commodity price speculation was now lower compared to 2008. The capitalisation structure of tradable sectors that sourced from the industrial sector increased from 28% in 2010 to 30% at yearend 2011. Meanwhile, the tradable sector that sourced from commodities, mining and plantation, declined from 19% in 2010 to 18% in

**Table 8.8 Speed of Stock Recovery in Regional Countries**

Countries	Peak	Trough	Average 2011	Shock Impact 2011	Speed of Adjustment*
Philippines	4,507.04	3,721.22	4,263.00	-17.44%	± 3,5 Months
Indonesia	4,174.11	3,269.45	3,799.30	-21.67%	± 3 Months
Malaysia	1,594.74	1,331.80	1,486.45	-16.49%	± 4 Months
Singapore	3,193.54	2,528.71	3,119.65	-21.35%	± 3 Months
Thailand	1,134.38	855.45	1,035.78	-24.59%	± 4.5 Months
Vietnam	486.58	347.80	446.24	-28.52%	

Countries	Peak	Trough	Average 2007-2008	Shock Impact 2008	Speed of Adjustment*
Philippines	3,873.50	1,704.41	3,022.46	-56.00%	± 25 Months
Indonesia	2,830.26	1,111.39	2,068.30	-60.73%	± 17 Months
Malaysia	1,516.22	829.41	1,229.93	-45.30%	± 21 Months
Singapore	3,831.19	1,600.28	3,020.13	-58.23%	± 35 Months**
Thailand	915.03	384.15	727.93	-58.02%	± 23 Months
Vietnam	1,170.67	286.85	755.38	-75.50%	

\*) Calculated since the beginning of the pressures until recovery.

Periods of observation vary among countries

\*\*\*) Index recovery was still on process. Index level still pre-pressured period.

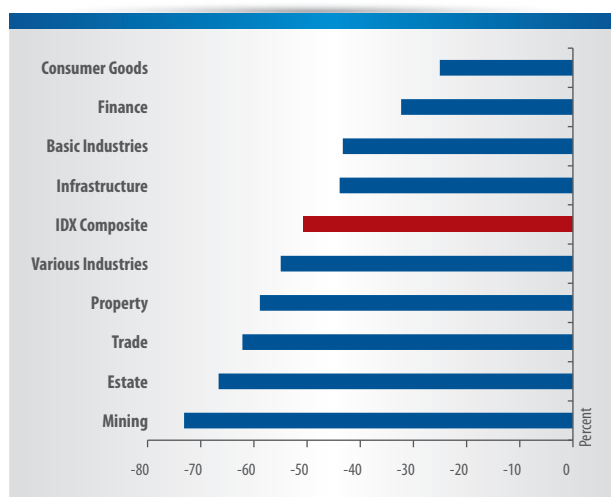
2011 (Chart 8.11).<sup>16</sup>

Macroeconomic and micro issuer fundamentals supported positive growth on the domestic stock market. A conducive macroeconomic fundamentals, were reflected by controlled inflation, economic growth outlook as well as rupiah exchange rate stability. From micro issuer standpoint, the financial performance of domestic issuers remained sound. Up to quarter III

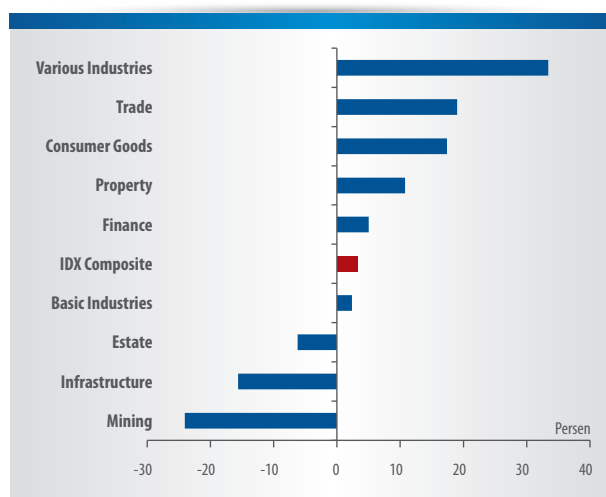
2011, the net profit of LQ 45 issuers grew by an average of 26.3% compared to quarter III 2010. In this context, the miscellaneous industries sector was considered to have the most solid fundamentals, which reinforced the tradable sector in stimulating IDX Composite growth. Additionally, based on technical analyses the domestic stock market was currently undervalued subsequent to significant corrections in August – September 2011. Therefore, the risk of a bubble tend to subside.

16 The definition of the tradable sector is any sector that can generate foreign exchange (from goods or services) and can raise the living standards of the public.

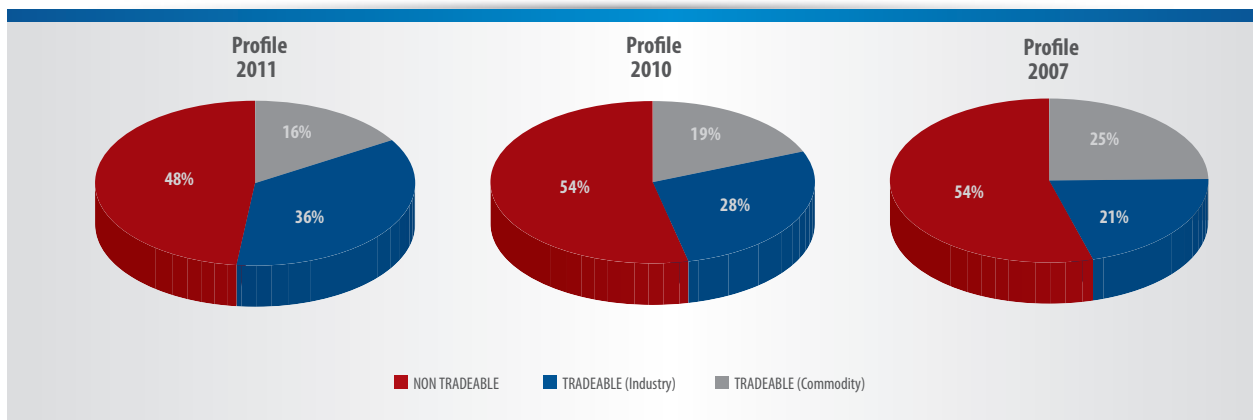
Solid fundamentals of the issuers ultimately encouraged self market stabilization when market conditions under pressure. Under such market conditions, in particular



**Chart 8.9 IDX by Sector in 2007-2008**



**Chart 8.10 IDX by Sector in 2010-2011**

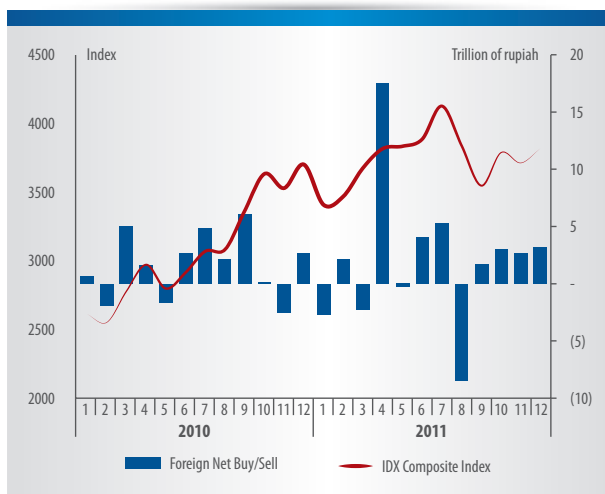


**Chart 8.11 Tradeable and Non-Tradeable Sector Capitalization**

during January 2011 and August-September 2011, non-residents tended to reduce their exposure in domestic stock market. Net foreign selling eventually suppressed share prices beyond their fundamental condition and resulted in shares being undervalued. However, non-residents responded to this by buy back the stocks (natural self market stabilization). This behaviour was linked to positive market player expectations concerning the future outlook of the economy as well as macro stability. During periods when the market was under pressure, non-resident investors posted net selling totalling Rp2.6 trillion and Rp14.5 trillion. Subsequently, foreign investors re-entered the market, therefore, net buying amounted to Rp23.6 trillion for 2011 as a whole. During October-December 2011, foreign investors recorded Rp8.7 trillion in net buying (Chart 8.12).

### Government Securities (SBN)

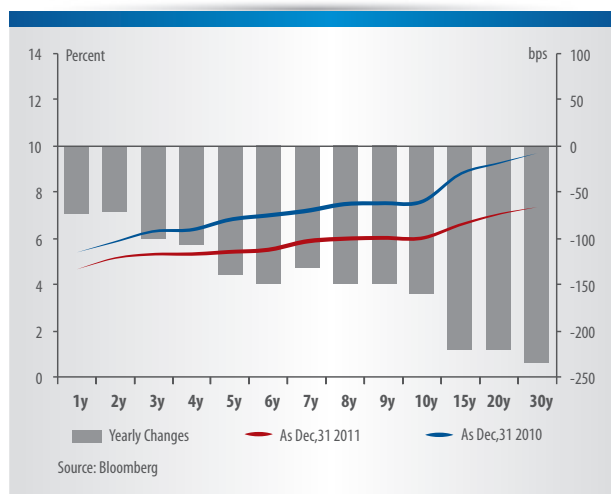
SBN market performance remained positive despite uncertainty surrounding the global economic recovery. This was reflected by declines in the yields for all tenors from 7.34% to 5.88% (Chart 8.13). During the reporting period of 2011, the SBN market experienced shocks triggered by market sentiment, which raised the yield of SBN. This was due to weaker global economic prospects at the beginning of the year and spiralling problems in the US and Europe (August – September 2011). During these two periods, the yield of 10-year benchmark SBN peaked at 9.2% and 7.6% (Chart 8.14). Notwithstanding, conducive macroeconomic conditions, controlled fiscal risk and the positive policy response from the Government and Bank Indonesia helped bring the yield back to normal, thereby posting positive performance on government bonds with lower volatility compared to neighbouring countries and when the Lehman Brothers collapsed.



**Chart 8.12 Net Buy/Sell IDX Composite Index**



**Chart 8.13 Government Bonds (SUN) and BI Rate Yields**



**Chart 8.14 Term Structure of Govt. Bonds in 2010-2011**

The movement in SBN yield throughout 2011 indicated greater resilience compared to conditions in 2008. This was demonstrated by relatively limited hikes in yield as well as rapid recovery. Irrespective of the different shock characteristics, the increase in yield was relatively lower than that recorded in 2008 at 20.9%. In fact, when the US debt rating was downgraded, price-side pressures were minimal when compared to the domestic stock market. Regarding the pace of recovery, the SBN market only took seven months to return to normal after the Lehman Brothers crisis in 2008. When the debt crises hit Europe and fiscal problems emerged in the US in 2011, the SBN market needed just eight days to recover (Table 8.9).

The structure of SBN market players also supported SBN price stability amid global financial market pressures. Differing from SBN investor behaviour in 2008, when foreign selling pressures were not offset

by sufficient available buyers, hence driving the yield up to 20.9% on average for all tenors, foreign selling pressures in 2011 were counteracted by other market players. As an illustration, when negative sentiment emerged stemming from the downgraded US debt rating in September 2011, purchases by banks and Bank Indonesia could offset foreign selling pressures on the SBN market. This conducive market structure was linked to well-maintained liquidity on the SBN market, as indicated by the increase in trade volume.

The fiscal and monetary authorities played important role in maintaining SBN and foreign exchange market stability in 2011. During the crisis in 2008, the government introduced buyback two times. Meanwhile in 2011, when negative sentiment concerning a global economic slowdown was prevalent (October 2010 - January 2011), the government initiated SBN price stabilisation through buyback as many as 14 times. When the markets fluctuated due to the downgrading of the US debt rating, the government again introduced buyback on six occasions.

Although SBN prices relatively well maintained, SBN selling by non-residents placed additional pressures that spread to the foreign exchange market. This episode occurred in August-September 2011, when foreign investors booked net selling amounting to Rp30.8 trillion. Foreign selling pressures on SBN spread to the foreign exchange market; consequently, Bank Indonesia intervened with stabilisation measures on the foreign exchange market and purchased SBN in order to maintain rupiah liquidity adequacy. This was due to tight correlation between price dynamics on the two markets, where foreign ownership of SBN

**Table 8.9 Speed Of Recovery of Government Bonds**

US Rating Downgrade in 2011	Indonesia	Thailand	Philippines	Malaysia
Maximum Yields	6.46	3.57	5.55	3.41
Minimum Yields	5.43	3.02	4.89	3.20
Max-Min Deviation	1.03	0.55	0.67	0.21
Speed of Adjustment*	± 1 month	± 1 month	± 2 months	± 2 months
Lehman Brothers 2008	Indonesia	Thailand	Philippines	Malaysia
Maximum Yields	20.1	5.6	10.1	4.4
Minimum Yields	8.4	2.1	5.6	3.0
Max-Min Deviation	11.6	3.6	4.5	1.4
Speed of Adjustment*	± 9 months	± 8 months	± 3.5 months	± 6.5 months

\*) Calculated since the beginning of the pressures until recovery.  
Periods of observation vary among countries

was sufficiently large. In line with greater investor confidence, foreign investors recorded net buying amounting to Rp4.8 trillion in October-December 2011 or Rp27.1 trillion for the year of 2011 (Chart 8.15 and Chart 8.16).

Greater resilience on the SBN market was not merely reflected by behaviour on the secondary market but also on the primary market. In this context, SBN auctions conducted by the government met their targets, which helped to finance the 2011 state budget. This was further offset by widespread interest in SBN, among others based on the average bid to cover ratio. Such conditions ultimately encouraged the government to introduce rationing in order to limit the number of winners. During the period reported, conditions on the primary market were disrupted by shocks occurring on the global financial market, forcing the government not to accept bids following the high yields demand by the bidders.

### Mutual Funds

Mutual funds posted positive growth in 2011 in line with the performance of underlying assets. In general, the performance of mutual funds, as reflected by net asset value (NAV), was satisfactory. The increase in NAV for all products was 13.4% over the previous year on the back of equity funds and mix funds. The improvement in performance even exceeded underlying assets, like the IDX Composite on the stock market and the Inter Market Dealer Association (IDMA) for the SBN market. When the financial market

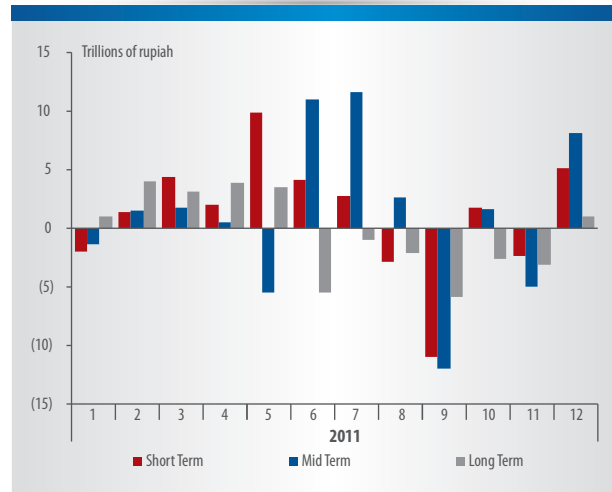


Chart 8.16 SBN Net Buy/Sell in 2011

experienced pressures, mutual funds were subject to corrections but of smaller magnitude.

Mutual fund market deepening helped play a role in the distribution of risk. Market deepening was indicated by greater product diversification as well as an increase in the value of assets managed. Product diversification stemmed from the introduction of new products including the Collective Investment Contract for Asset-Backed Securities (KIK-EBA) and private equity funds. Diversification helped ease excessive risk on a particular type of product. In addition, the variety of features offered also alleviated pressures on the mutual funds markets when bearish sentiment threatened the financial market. For example, the feature of protected mutual funds that maintained the investment value at a specified nominal value.

Strong investor interest in mutual funds, accompanied by an improvement in investor quality, bolstered the performance of mutual funds in 2011, when net subscriptions reached Rp98.2 trillion. This value was higher than that posted in 2010, when net redemptions totalling Rp34.8 trillion were reported. This data demonstrated the public's desire to invest in mutual funds. In fact, subscriptions to equity funds were followed by low redemption rates during market fluctuations, especially during February and August-September 2011. Such conditions were made possible by the educational efforts of the Capital Market Executive Agency (Bapepam), which continued to familiarise the public with new products.

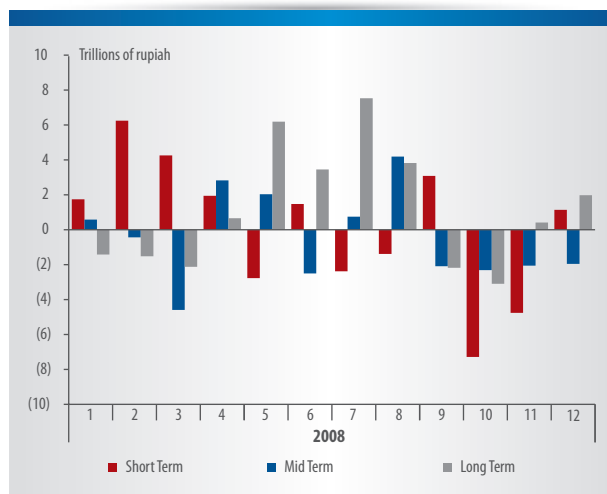
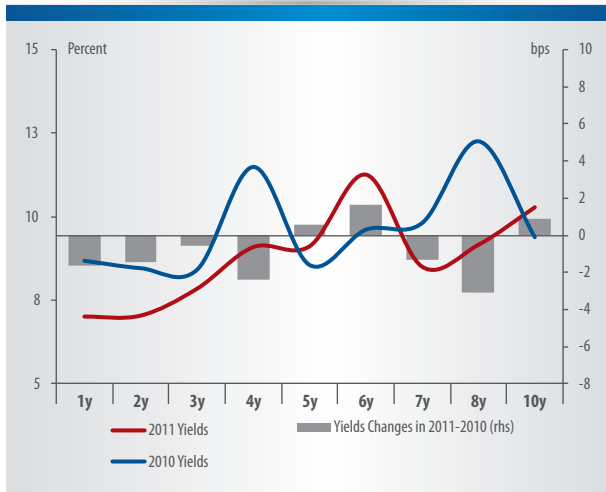
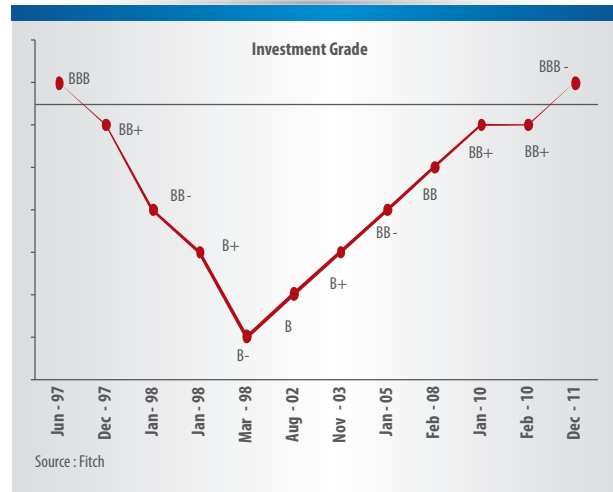


Chart 8.15 SBN Net Buy/Sell in 2008



**Chart 8.17 Term Structure of Corporate Bonds**



**Chart 8.18 Government Bonds Rating**

### Corporate Bonds

The performance of the corporate bond market was relatively well preserved amid deteriorating global economic conditions. Lower corporate bond yields were congruent to reductions in the BI Rate at the end of 2011. In general, the relatively well-maintained corporate bond market was reflected by a decline in average yield for all tenors. At yearend 2010, the average yield for all tenors of corporate bonds was 9.63%, while the yield on corporate bonds in 2011 was 8.81%. Accordingly, over the past year the yield on corporate bonds had declined by 81bps. Nonetheless,

this decline was not uniform over all tenors, with some tenors even experiencing an increase (Chart 8.17).

The improved performance of corporate bonds was further evidenced by the increase in activity by market players when compared to the preceding year. The volume and frequency of corporate bonds trading increased. Average daily trade volume and frequency in 2010 was Rp349.2 billion and 57.8 transactions per day respectively, compared to Rp467.8 billion and 68.9 in 2011. This had a favourable impact on corporate bonds issuance on the primary market, in line with the upgraded government debt rating, which spilled over

**Table 8.10 Economic Financing From Non Bank Institutions**

Activity	2010	2011
<b>IPO Emissions</b>		
- Total Company	22	23
- Value (Trillion of rupiah)	29.3	19.2
<b>Right Issue Emissions</b>		
- Total Company	31	24
- Value (Trillion of rupiah)	48.7	38.3
<b>Corporate Obligation Emissions</b>		
- Total Company	24	28
- Value (Trillion of rupiah)	34.7	30.2
<b>Continuous Public Offering Emissions</b>		
- Total Company		4
- Value (millions of USD)		80
- Value (Trillion of rupiah)		6
<b>Corporate Sukuk Emissions</b>		
- Total Company	2	1
- Value (Trillion of rupiah)	0.7	0.1

onto the corporate debt market. The upgraded rating was favourable for corporate bonds issuance on the primary market (Chart 8.18).

### Economic Financing through the Capital Market

Economic financing was well maintained, amid uncertainty in the global economy despite at a slightly lower level than the previous year. Total financing through IPOs, rights issues and corporate bonds achieved Rp19.6 trillion, Rp38.3 trillion and Rp30.16 trillion respectively (Table 8.10). These values were slightly lower compared to the preceding year. Other channels of financing like Medium Term Notes (MTN), promissory notes and the offering scheme also gained momentum in 2011. This condition indicated a deeper financial market. Economic financing through the non-bank channel was impeded by a number of external shocks in 2011.

The maintained contribution of internal corporate funds to support real activities demonstrated the financial market resilience to the economy despite facing widespread uncertainty. However, several issues

required close monitoring, including the growing share of financing by financial sector issuer that could be potentially placed in fiscal and monetary instruments. Other issue was the utilization of the influx of foreign capital flows to stock and corporate bond issuances that still not optimal.

Growth in issuer profit during 2011 provided strong indications of the far larger potential for non-bank financing. In line with the profits booked by most issuers, the potential to utilize these benefits as part of the financing and investment activities of the company continued to expand. The profitability of issuers increased on average by 26.3% compared to the previous period in 2010. Several studies have shown that internal funds still represent the largest contribution to support economic growth.<sup>17</sup> Financing through internal funds has greater advantages for the economy, particularly when the bank intermediation function is not running optimally and the financial markets face shocks.

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<sup>17</sup> Survey of the Economic Research Bureau, DKM (2010)

## BOX 8.1 | OPTIMISING THE ROLE OF RURAL BANKS IN FINANCIAL INCLUSION THROUGH MSME FINANCING

The robust economic growth in Indonesia today is accompanied by improvements in the quality of growth, as demonstrated by the expanding role of investment and exports as well as more balanced regional economic growth. In order to maintain robust growth, it is necessary to optimise the financial sector's contribution, including the banking sector, in the form of financing. Therefore, it is imperative for this financing to reach as broader spectrum of business players as possible, in particular micro, small and medium enterprises (MSME). This is the very essence of financial inclusion.

In this context, Bank Indonesia intensively introduces an array of policies in order to optimise the role of rural banks (BPR). The presence of rural banks as financial institutions that prioritise financing to micro and small enterprises should always be nurtured. To this end, Bank Indonesia policy is aimed at realising the stability and sustainability of rural banks in order to create rural banks that are sound, sustainable and play a role in supporting the local economy. This effort represents one form of business activity that fosters financial inclusion through the MSME financing. The policy packages include issuing guidelines for the establishment of Generic Model Apex Rural Banks and a business model for rural banks as a reference for the success operation of rural banks. This policy package was introduced on 5th December 2011.

### **GENERIC MODEL APEX RURAL BANKS**

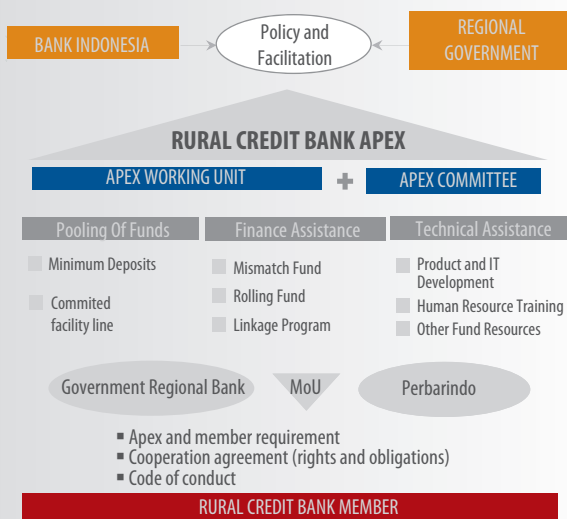
Apex rural banks are cooperation between commercial banks as the parent company and rural banks as members of the Apex cooperative. The emergence of Apex is an ideal synergy to serve MSME and concomitantly minimise unhealthy competition between commercial banks and rural banks. The term Apex itself is taken from the Greek meaning protector. This means that Apex rural banks must protect their rural banks member. In broad terms, Apex rural bank cooperatives are

also part of the efforts to rebalance competition between commercial banks and rural banks on the micro finance.

The Apex cooperative model has been applied in some countries. India is one country that has successfully applied the Apex model. In this country, Apex banks that focused on micro finance is conducted by the National Bank for Agriculture and Rural Development (NABARD). This institution is mandated with facilitating the flow of credit to develop the agricultural sector, MSE, rural industries, handicrafts and other productive rural activities. In addition, NABARD also assesses and examines partner of rural banks as well as providing training and research facilities for rural banks and organisations that work with local communities. This mandate allows NABARD to be successful in promoting linkage programmes as well as broadening access to banks in small and remote areas

The Apex rural bank model formulated by Bank Indonesia is presented in the book titled *Generic Model Apex Rural Banks*. The book provides guidelines and understanding for the banking industry and public concerning Apex banks cooperation. Furthermore, the book contains general guidelines in initiating the establishment of Apex banks and operational procedure in the preliminary phase. The book is intended as a guideline for the formation and implementation of Apex rural banks for regional development banks acting as Apex banks. This is part of the follow up to the BPD Regional Champion (BRC) program launched on 21st December 2010. Accordingly, the role of regional development banks will continue to expand as agents of regional development. The second edition will review the possibility of other banks, not just regional development banks, acting as Apex banks.

Apex banks generally consist of three main components. The first is a commercial bank as the



**Diagram 1. Rural Credit Bank Cooperation Model**

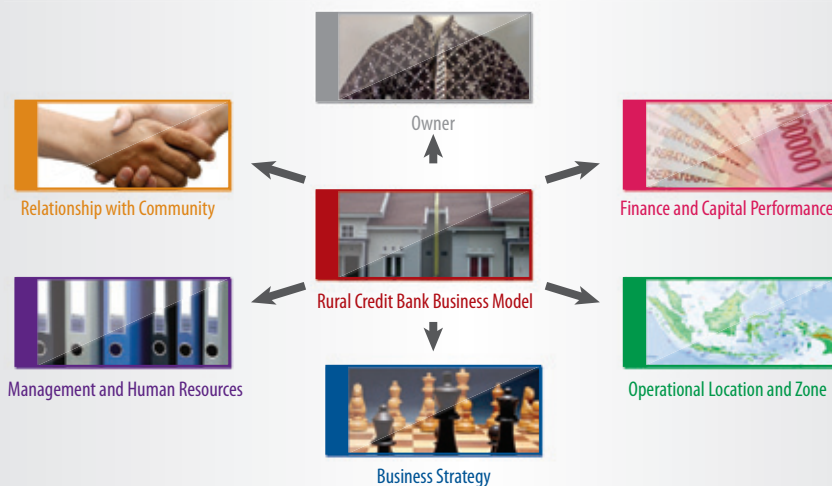
Apex, which is responsible for preparing supporting infrastructure for the operational implementation of the Apex. The activities include for instance creating a work unit or branch office to serve Apex members, recruiting human resources, formulating the standard operating procedure (SOP) and handling the information technology. The second is the rural bank as a member of the Apex. The third is the Apex Committee consisting of commercial banks, representatives from the Micro Banks Association (Perbarindo).

## RURAL BANK BUSINESS MODEL

The next policy is the publication of the Rural Bank Business Model, which is expected to benefit both rural bank executives and the public. The publication was formulated as a reference for potential investors interested in setting up a rural bank as well as a benchmark success for existing rural banks. Additionally, the Rural Bank Business Model can also benefit the wider community by, among others, providing a clearer picture of the rural bank business process, thereby introducing related rural banking issues.

The model was formulated through in-depth observations of rural banking industry practices. During these observations, the highest performing rural banks as well as those that had improved their businesses significantly over the preceding five years were chosen. This observation period was sufficient to assess the behaviour and performance of successful rural banks, while simultaneously capturing the dynamics of the economic cycle.

The success factor of rural banks are presented in the rural bank business model as a general reference for the establishment of new rural banks and for management of existing rural banks. Based on this analysis, the success of rural banks depends upon aspects of ownership, capital, location, business strategy, human resources and public relations.



**Diagram 2. Ideal Business Model Rural Credit Bank**

### Ownership

Ideally, rural banks owned by people from the area of origin, who are committed to sound rural bank management and to gain a reasonable profit. This is to guarantee the sustainability of the rural bank in harmony with development in the surrounding community.

### Capital

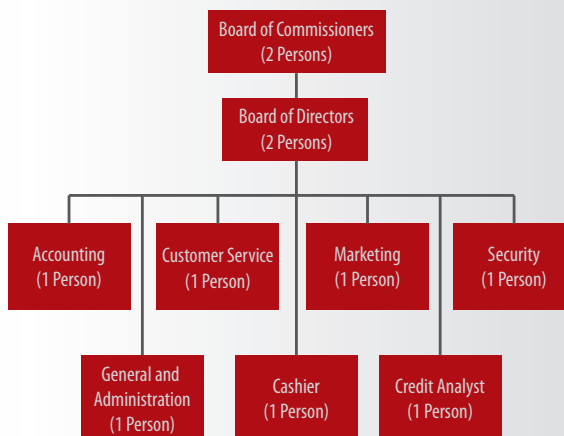
Rural bank owners are expected to have the ability and commitment to supply the required capital to maintain operational sustainability and credit channeling.

### Location and Operational Area

The choice of location should consider several factors such as the economic potential, the level of competition and public accessibility, in particular rural communities and MSME.

### Business Strategy

An appropriate business strategy is required to ensure the rural banks grow and develop properly. This would incorporate : (i) a focus on well-known micro and small finance; (ii) a competitive and affordable lending rate; (iii) a rapid yet simple service procedure that cautiously monitors the performance of the customer's business through communication and friendship; and (iv) rural bank operational support like information technology (IT) and an office network.



**Diagram 3. Ideal Organizational Structure of Rural Credit Bank**

### Human Resource Management and Policy

Successful rural banks are managed by human resources that adhere to the following criteria: (i) professional with integrity; (ii) have an understanding business potential, local characteristics and the community to be served; (iii) prioritise candidate employees from local area who understand the local customs, culture and characteristics of the community; (iv) estimate the number of human resources and skills required to support the operational implementation of the rural bank in accordance with the organisational structure of rural banks.

### Public Relations

The ability to assimilate and become part of the local community is key to the success of a rural bank. This is important when building relationships and bonds through rural bank involvement in social activities , for instance religious holidays, local celebrations and customer celebrations.







# Chapter IX

## PAYMENT SYSTEM AND CURRENCY CIRCULATION POLICY AND PERFORMANCE



# PAYMENT SYSTEM AND CURRENCY CIRCULATION POLICY AND PERFORMANCE



*The Bank Indonesia payment system policy was directed at ensuring a secure and efficient payment system. The policy was taken due the system's strategic role in establishing financial system stability and supporting monetary policy implementation. The policy was pursued through the restructuring of the payment system infrastructure that included, among others, the standardization of Chip-Based Automatic Teller Machine (ATM)/Debit Cards, revisions to the rules on Card-Based Payment Instruments (APMK), the phasing of the development of the Second Generation of Bank Indonesia Real Time Gross Settlement (BI-RTGS) System and Bank Indonesia Scrippless Securities Settlement System (BI-SSSS), as well as the development of a National Payment Gateway (NPG). Through the pursuance of the policies, the performance of the payment system in 2011 managed to support to the financial system stability and increased the velocity of money in the economy through increased payment transactions without incurring any failure in the settlement of (non-cash) transactions.*

*Meanwhile, the Bank Indonesia's currency circulation policy was geared to meet the public's need for currency fit for circulation, both in value and denomination. To achieve this goal among others, Bank Indonesia developed cash services in frontier and remote areas to ensure the availability of currency throughout Indonesia. Meanwhile, In order to improve the effectiveness and efficiency of commercial banks' cash management, Bank Indonesia revised to the policy of depositing and withdrawing rupiah by commercial banks in Bank Indonesia. Through such efforts, Bank Indonesia's currency circulation policy managed to support the financial system stability and need for currency as economic growth remained strong.*



## 9.1 POLICY AND PERFORMANCE OF THE PAYMENT SYSTEM

### PAYMENT SYSTEM POLICY

Payment system plays a strategic role in establishing financial system stability and supporting monetary policy implementation. The role is to ensure the accomplishment of various payment transactions in the course of economic activities conducted by society and business community.

Bank Indonesia's payment system policy is geared to ensure the establishment of a secure and efficient payment system. Therefore throughout 2011 Bank Indonesia's payment system policy was focused on improving the security and efficiency, as well as strengthening the payment system infrastructures and interconnection among such infrastructures. The policy was taken due to increasingly higher payment transactions conducted through BI-RTGS, Bank Indonesia's National Clearing System (SKNBI), and other means of payments such as credit cards, ATM/debit cards, and electronic money (e-money). The policy and system development adopted by Bank Indonesia during 2011 entailed (i) the standardization of chip-based ATM /debit cards, (ii) the revision to the rules on the Card-Based Payment Instruments (APMK); (iii) the phasing of the development of the second generation of BI-RTGS and BI-SSSS; (iv) the improvement in the Government's account management services, (v) the development of the National Payment Gateway (NPG), and (vi) the preparation of electronic money standardization.

In order to improve the security of payment Bank Indonesia obligated the operators of ATM/debit cards to the use of chip-based technology and the use of at least 6 (six) digits of Personal Identification Numbers (PIN) in the ATM/debit cards issued. The policy was also aimed at improving the efficiency of investment cost of the domestic ATM/debit card industry and strengthening its technological infrastructure in the face of their foreign competitors' strength. Currently, the processing standards in the country's ATM/debit card industry were still segmented according to their respective principals. As a result, banks as the issuers of ATM/debit cards had to accommodate different standards set by different principals. This induced high investment costs which in turn led to the imposition of additional costs for ATM card/debit users.

In realizing standardization in the ATM/debit card industry, Bank Indonesia throughout 2011, had conducted a series of coordination with the banking industry and the forum of principals to discuss the formation of an institution that will manage the certification of the ATM/debit card industry. At the end of the reporting period, the forum of principals was still setting up a Certification Body and Key Management infrastructure to support the implementation of technical standards for chip-based ATM/debit cards. As regulator of the card payment industry, Bank Indonesia had issued a regulation for the implementation of the policy.

In an effort to improve aspects of prudence and consumer protection in the use of Card-Based Payment Instruments (AMPK), Bank Indonesia has made a revision to the AMPK regulation. In essence, the revision includes rules regarding cooperation between Payment Card operators and other parties, especially with companies that carry out credit card billing, as well as the imposition of a more selective requirements for obtaining a credit card.

To strengthen the infrastructure, Bank Indonesia pursued the policy of developing the Second Generation of BI-RTGS and BI-SSSS Systems. In 2011, Bank Indonesia had begun developing applications for the Second Generation which intended to enhance and improve the performance of the existing systems. The development was carried out to meet the need for, and adapt to, the latest technological developments, such as the need for improved efficiency, services, and risk mitigation capabilities through the development of a payment system in accordance with the international

best practices. Under this development, the system also provided the advanced liquidity management services that support a more efficient liquidity management. Moreover, the use of standard platforms in this development was needed to support the need for domestic as well as cross-border transactions in preparation for a more integrated economies. In terms of the provision of information, the development of the Second Generation of BI-RTGS and BI-SSSS Systems was intended to provide a-real time information to support Bank Indonesia's functions in the monetary, banking and payment system.

To improve services associated with the management of Government's accounts, Bank Indonesia had improved its Government e-Banking (BIG-eB) system. The improvement was carried out by adding a certain function to the application of BIG-eB system and through on-line transactions for specific government accounts. Aside from assisting the management of the government account, the improvement would also assist the management of the state finances. Throughout 2011, Bank Indonesia together with the Directorate General of Treasury (DJPB) of the Ministry of Finance, coordinated the discussion on the preparation of the interconnected business processes and information technology. The coordination was intended to develop a State Treasury and Budgetary System (SPAN) at the Ministry of Finance which will be implemented in 2012.

The development of SPAN led to change in the business processes at the Ministry of Finance. The changes required synchronization of system and policy within Bank Indonesia which serve as the manager of government's accounts. In this regard, the improvement of the BIG-eB system was also intended to meet the needs of the government for the expansion of connectivity facilities between SPAN and the BIG-eB System.

To enhance the efficiency of payment system, Bank Indonesia pursued the effort to develop a National Payment Gateway (NPG) system. The development of the NPG focussed on efforts to lead the players in the payment systems industry to create a standard platform system or infrastructure that could be used together as an industry. This effort was expected to increase payment efficiency nationwide, therefore enabling investments to be allocated to expand access to remote areas that still lacking of payment systems technology and infrastructure. To build similar perception on the

development of NPG, intensive coordination between Bank Indonesia and the Association of Indonesia Payment System (ASPI) had been made throughout 2011. The coordination was also intended to prepare a proposed NPG model that can be agreed upon by the players in the Indonesia's retail payment systems industry.

In order to improve efficiency in the application of electronic money, Bank Indonesia sought to achieve standardization of electronic money which expected to facilitate the interoperability between electronic money providers. Throughout 2011, efforts to achieve the interoperability of electronic money were focused on improving coordination with the government authorities and facilitating the electronic money industry. Coordination with the government authorities was mainly conducted with the Ministry of Transportation, the Ministry of Communications and Information and with the Presidential Working Unit for the Supervision and Control of Development (UKP4). To strengthen such coordination, Bank Indonesia, together with the Ministry of Transportation and the Ministry of Communications and Information had signed a joint agreement on the Formulation of Policies and Interconnection Standards and Interoperability of Electronic Money within the Transportation Sector.

Moreover, in the preparation for the implementation of the ASEAN Economic Community (MEA) in 2015, Bank Indonesia showed active participation in the Working Committee on Payment and Settlement Systems (WC-PSS) Forum through various activities and coordination with the ASEAN countries. The implementation of the ASEAN Economic Community in 2015 was expected to boost the volume and amount of cross-border economic transactions within the ASEAN region (intra-ASEAN cross-border transactions). The active role of Bank Indonesia and other ASEAN central banks on the WC-PSS platform constituted the initial step in assessing the readiness of the ASEAN's payment and settlement systems in order to support the integration of ASEAN finances. The implementation of an efficient and safe payment and settlement system at the ASEAN regional level was essential to ensuring the smooth running of economic activities among ASEAN countries.

The WC-PSS which was established in 2010 had developed a number of studies and policy recommendations, both for the development of payment and settlement systems as well as for coordination purposes in order to harmonize the

payment and settlement systems within the ASEAN region. Over 2011, the WC-PSS had been formulating priority of policy recommendations in the development and harmonization of ASEAN's short, medium and long-term payment and settlement systems, which had been approved in the ASEAN Central Bank Governors Meeting (ACGM) in April 2011. The priority of policy recommendations entailed the following: (i) encouraging the use of common standards that allow interoperability and interlinkage between various instruments and payment systems infrastructure, (ii) increasing the use of existing payment systems infrastructure to meet the needs of the business community, and (iii) assessing the possibilities of developing interconnection among payment systems applicable in ASEAN region to support a faster cross-border payment system.

### PAYMENT SYSTEM PERFORMANCE

Payment system performance during 2011 improved compared to the previous year. This improvement was supported by Indonesia's economic condition which remained favourable amid increasing global economic uncertainties. The increasing performance of the payment system in 2011 was reflected in the value of transactions which grew by 23.20% to Rp71.56 thousand trillion compared to that of 2010, while the volume of transactions increased by 22.66% and stood at 2.63 billion. The total value of payment transactions made through various account of payment systems available was 9.63 times higher than the value of Indonesia's gross domestic product (GDP) in 2011, higher than that of 2010 with 9.02 times.

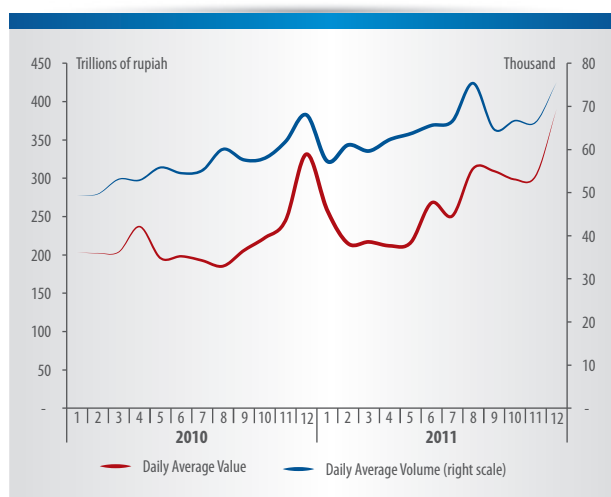


Chart 9.1. BI RTGS Transaction

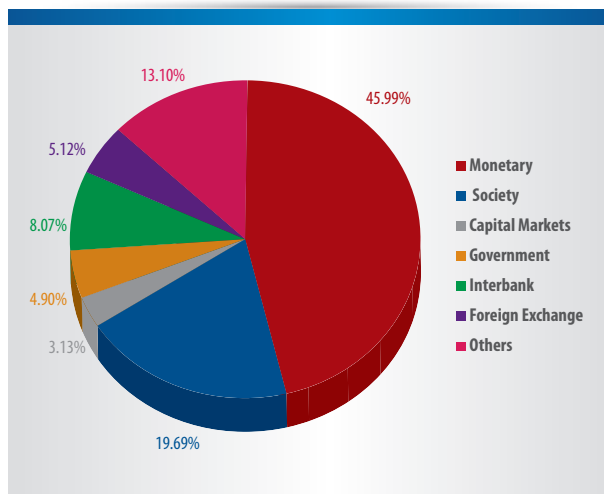


Chart 9.2 BI RTGS Value Transaction Share

The payment transactions activity conducted through BI-RTGS system increased in 2011 compared to the previous year (Chart 9.1).<sup>1</sup> The value of transactions settled through the BI-RTGS system reached Rp66.93 thousand trillion, up by 23.55% compared to 2010. Transaction volume was recorded at 16.16 million, up by 15.51% over the previous year. Thus, throughout 2011, average daily transactions conducted through BI-RTGS system reached the value of Rp270.96 trillion, with a daily volume amounting to 65.45 thousand transactions.

The increase in the value of transactions conducted through BI-RTGS was primarily due to the increase in monetary management transactions which accounted for 45.99% of BI-RTGS total transaction value (Chart 9.2). The value of monetary management transactions in 2011 grew by 33.23% over the previous year, indicating the increase in monetary management activities conducted by Bank Indonesia to maintain monetary and financial system stability.

Payment transactions conducted through BI-RTGS were dominated by individual transaction payment, making up 86.28% of the total transactions (Chart 9.3). In 2011, individual transaction volume rose by 20.73% (Table 9.1), indicating that the transfer of funds through the BI-RTGS was considered as an alternative to fund transfer made via Bank Indonesia's National Clearing System (SKNBI) and Card Payments (APMK). It also

1 BI-RTGS is a payment system to process large-value and immediate (time critical) interbank fund transfer, settlement of financial markets' transactions, the results of monetary operations conducted by Bank Indonesia, and the results of clearing from interbank payment transactions.

**Table 9.1 BI RTGS Transaction by type**

BI RTGS Transaction	Value (trillions of rupiah)		
	2010	2011	% Growth
Interbank	4,723.21	5,403.79	14.41%
Society	10,558.10	13,176.74	24.80%
Foreign Exchange	3,290.60	3,425.24	4.09%
Capital Markets Settlement	2,362.95	2,097.71	-11.23%
Government	2,507.08	3,276.34	30.68%
Monetary Management	23,104.42	30,782.68	33.23%
Others	7,623.39	8,764.89	14.97%
Total	54,169.75	66,927.38	23.55%

BI RTGS Transaction	Volume		
	2010	2011	% Growth
Interbank	97.432	95.585	-1.90%
Society	11,553,796	13,948,983	20.73%
Foreign Exchange	133.786	112.852	-15.65%
Capital Markets Settlement	60.372	65.444	8.40%
Government	841.071	769.957	-8.46%
Monetary Management	81.068	78.552	-3.10%
Others	1,227,835	1,094,973	-10.82%
Total	13,995,360	16,166,346	15.51%

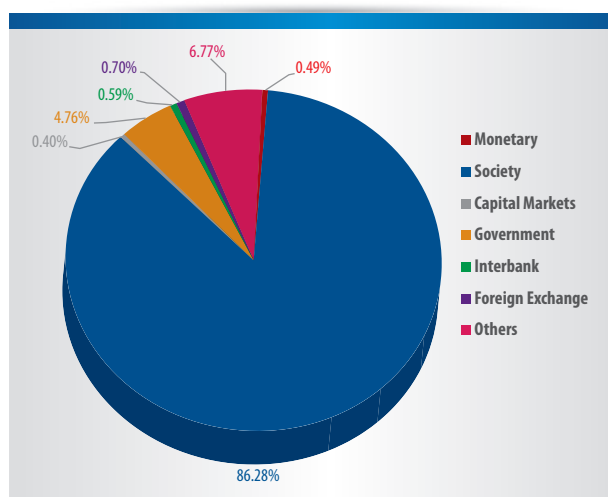
suggested that some segments in the society required a faster funds-transfer system. In terms of payment efficiency, BI-RTGS system helped to accelerate the settlement of transactions and thus timely efficient.

The increasing payment activities conducted through BI-RTGS system were supported by the system's reliability and availability. This was measured from the

percentage of settled transactions, system availability, and discipline in meeting the window time of the BI-RTGS system. The reliability and availability of BI-RTGS system throughout 2011 were indicated by the fact that there was no occurrence of faulty conditions experienced by the system which might lead to failure in the completion of transactions.

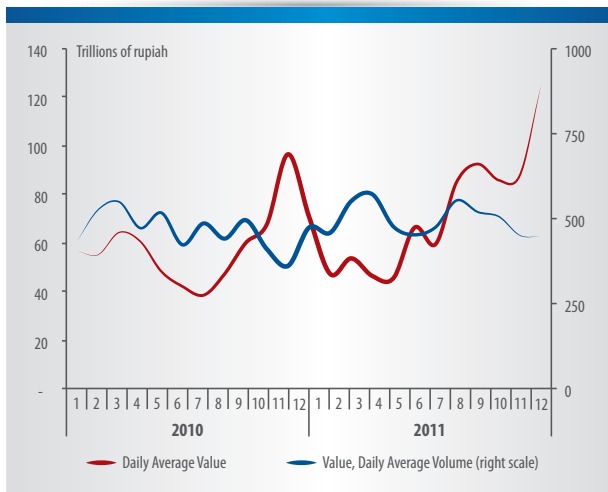
In 2011, payment transactions conducted through BI-SSSS increased from the preceding year (Chart 9.4).<sup>2</sup> The value of transactions conducted through BI-SSSS reached Rp17.86 thousand trillion or increased by 35.41% with a volume of transactions recorded at 122.17 thousand transactions which constitute a growth of 15.07% compared to previous year. Thus, throughout 2011, the average daily transactions conducted through BI-SSSS reached the value of Rp72.30 trillion, with a daily volume of 495 transactions.

More diverse non-cash payment instruments supported the development of retail payment systems, providing a more efficient, safe, comfortable and quick transaction



**Chart 9.3 BI RTGS Volume Transaction Share**

<sup>2</sup> BI-SSSS is a system used to process payment transactions and administer securities and monetary operation instruments carried out by Bank Indonesia.

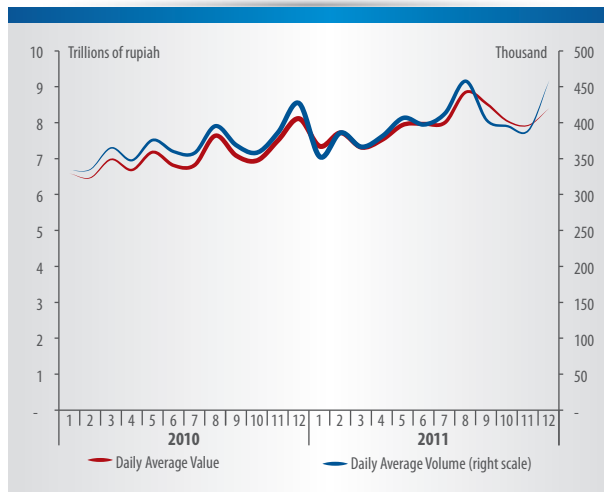


**Chart 9.4 BI SSSS Transaction**

payment. The rapid development of technology-based payment instruments were gradually encouraging people, especially in big cities, to switch to non-cash payment system, although cash was still widely used as a means of payment. The increasing transaction activities through the retail payment systems were expected to bolster Indonesia's less cash society.

The strategic role of retail payment systems in supporting the economic activities is supported by the rapid development of technology-based payment systems. Throughout 2011, the value of payment transactions conducted through retail payment systems (SKNBI, APMK, and Electronic Money) throughout 2011 reached Rp4.63 thousand trillions, an increase of 18.34% compared to 2010. Volume of transactions climbed to 2.61 billion or grew by 22.70% compared to the previous year. Transactions through retail payment systems, especially Card-Based Payment Instruments (APMK), provided easier access to payment whilst providing comfort to its users. The increase in APMK transactions were in line with the increase of public consumption, which in turn led to an increase in the velocity of money.

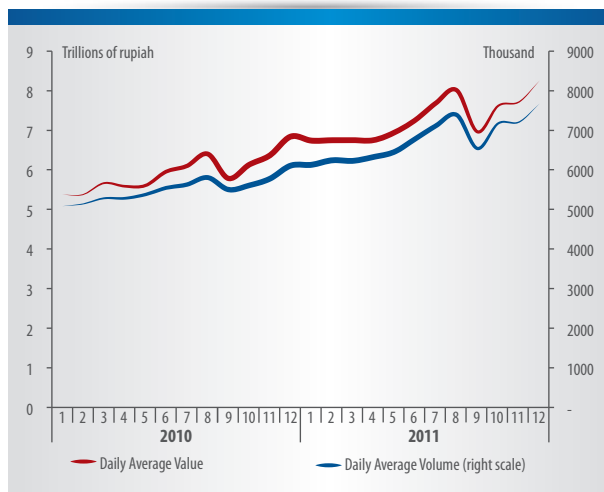
In term of public consumption, the role of retail payment systems in supporting Indonesia's economic growth improved. This development was reflected in the total value of payment transactions through retail payment systems nationwide which, in 2011, amounted to 1.14 times the value of public consumption, higher than that of 2010, which was 1.07 times.



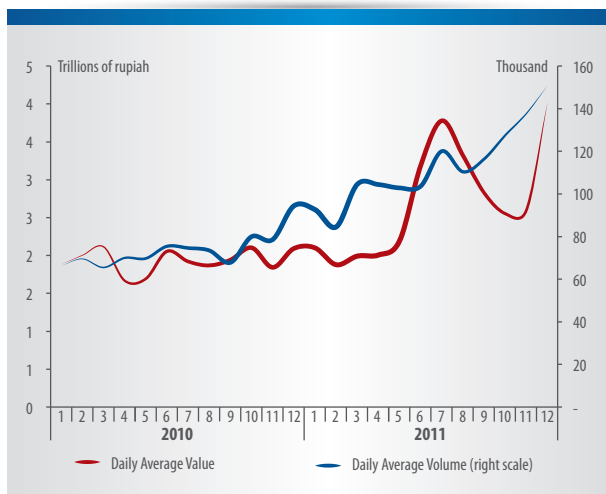
**Chart 9.5 SKNBI Transaction**

In 2011, transactions activities conducted through Bank Indonesia's National Clearing System (SKNBI) increased compared to the previous year (Chart 9.5). The value of payment transactions conducted through SKNBI stood at Rp1.97 thousand trillion or grew by 12.75%, with the volume of transactions recorded at 99.18 million, up by 9.03% compared to 2010. Thus, the average daily transactions conducted through SKNBI in 2011 reached a value of Rp7.95 trillion, with a daily volume of 399.92 thousand transactions. The increase in the value of SKNBI transactions through the use of cheques indicated people's preference to use the instruments, especially among businesses, for providing a smoother economic transactions.

In 2011, transaction activities conducted through Card-Based Payment Instruments (APMK) increased from the preceding year (Chart 9.6). The value of payment



**Chart 9.6 APMK Transaction**



**Chart 9.7 E-Money Transaction**

transactions conducted through APMK in 2011 climbed to Rp2.66 thousand trillion or grew by 22.84%, with the volume of transactions recorded at 2.47 billion, up by 22.90% compared to 2010. Thus, the average daily transactions conducted through APMK stood at a value of Rp7.29 trillions with a daily volume of 6.77 million transactions. The increase in APMK transactions, in addition to being driven by the ease and convenience in conducting transactions, was also bolstered by the availability of infrastructure which was increasing in number and spreading in various parts of Indonesia.

During 2011, transaction activities using electronic money increased compared to the previous year (Chart 9.7). The value of transactions using the electronic money reached Rp981.30 billions, grew by 41.51%, with the volume of transactions recorded at 41.06 million, up by 54.70% compared to 2010. Thus, throughout 2011, the average daily transactions using electronic money stood at a value of Rp2.69 billions with a daily volume of 112.49 thousand transactions.

## 9.2 POLICY AND PERFORMANCE OF THE CURRENCY CIRCULATION

### CURRENCY CIRCULATION POLICY

Currency circulation played an important role in supporting the smooth running of economic transactions. The role was primarily aimed at ensuring the fulfillment of the public's need for currency as a means of payment.

To this end, Bank Indonesia's currency circulation policy was geared to meet the needs for currency by taking in to account various strategic factors. Economic growth and people's preference to use cash in their transaction activities were amongst the strategic factors considered in currency circulation's policy making during 2011. Another strategic factor considered, was the need to improve the quality of currency and its security features while ensuring the availability of currency worthy for circulation more evenly throughout Indonesia. In addition, the enforcement of Act of the Republic of Indonesia No. 7 of 2011 concerning Currency by the end of June 2011 clarified Bank Indonesia's authority in rupiah currency management. It became Bank Indonesia's point of consideration in its policy making. Under the act, BI is required to adjust its policy regarding currency circulation management as a whole.

Throughout 2011, Bank Indonesia pursued a range of currency circulation policies based on three main pillars, i) improvements on the quality of currency in circulation and the fulfillment of the needs for currency based on the required value and denomination ii) improvements on the efficiency of the cash operations in BI and commercial banks iii) development of BI's cash services by engaging commercial banks and other related institutions.

#### Improvements on the quality of currency in circulation and the fulfillment of the needs for currency based on the required value and denomination

Efforts to improve the quality of currency in circulation were carried out through the implementation of a number of strategies. The strategies involved the dissemination of the standard for currency worthy for circulation in corporation with commercial banks and Cash In Transit (CIT) companies, currency quality monitoring surveys, the enhancement of currency security features in banknotes Rp100,000, Rp50,000 and Rp20,000 denominations, and also the improvement in counterfeit deterrence effectiveness.

Currency quality monitoring surveys were conducted in BI's Head Office and in 9 of its coordinating regional offices, covering 30 districts/cities throughout Indonesia, with total of 1.231 respondents. The surveys revealed that in general, currency in higher denominations tend to have better quality than those of the lower ones, the quality of banknotes Rp10,000 and above were exceeding the expectation of the respondents, and that the quality of banknotes

circulated in places distant from BI's regional offices were lower and shabbier than that circulated within the area of BI's regional offices.

In attempts to optimize the elements of design in banknotes Rp100,000, Rp50,000 and Rp20,000 denominations, Bank Indonesia had officially issued and circulated the new series of banknotes Rp100,000, Rp50,000 and Rp20,000 with enhanced security features. The issuance of the new series was governed by Bank Indonesia Regulation dated August 1, 2011, while being circulated for the first time on October 28, 2011.

In combating the counterfeit rupiah, Bank Indonesia pursued the policies to improve counterfeit deterrence effectiveness through preventive and repressive measures. Preventive measures were taken by improving public's knowledge on the characteristics of rupiah banknotes through awareness-raising campaigns and trainings. Whereas, repressive measures were carried out through Bank Indonesia's involvement as an expert witness in counterfeiting trials and through its involvement within the special task force for counterfeit deterrence, in cooperation with the Indonesian National Police (POLRI).

Meanwhile, to meet the needs for rupiah currency based on the required value and denomination, Bank Indonesia had set the plan for currency and currency materials procurement for 2012. The plan was developed based on the estimation of currency demand for the year 2012, which predicted to increase by 14.0% from the previous year.

#### Improvements on the efficiency of the cash operations in BI and commercial banks

One important strategy to improve the efficiency of the cash operation was carried out through the improvements in systems and procedures of its cash services to the commercial banks. The improvement was aimed at enhancing the effectiveness and efficiency of cash management and optimizing cash handling by the banks. The activities started in March 2011 and followed by the issuance of regulation on depositing and withdrawing rupiah by banks in Bank Indonesia. Through the implementation of such policy, Bank Indonesia provided a broader access for the commercial banks in depositing its excess liquidity, while encouraging the interbank currency transaction and the efficiency of currency handling in commercial banks.

Another strategy was the monitoring of currency processing and customer services' activities provided by commercial banks and cash in transit (CIT) companies. This strategy was aimed at improving the ability of commercial banks and CIT companies to meet the standard requirement for currency processing set by Bank Indonesia.

Commercial banks and CIT companies' currency processing was critical in improving the quality of currency in circulation. During 2011, the monitoring of commercial banks and CIT companies' currency processing and customer services' activities had been conducted in 9 commercial banks and 6 CIT companies all over Indonesia.

#### Development of Bank Indonesia's cash services by engaging commercial banks and other related institutions

Bank Indonesia's cash services were carried out by engaging commercial banks and other related institutions through the cooperation to expand BI's cash services coverage areas to meet the needs for currency fit for circulation based on the required value and denomination. In 2011, Bank Indonesia developed its cash services coverage by adding the number of its cash custodian services<sup>3</sup> and through the expansion of currency exchange services.

Cash services development was also carried out by increasing the availability of rupiah currency in Indonesia's frontier and remote areas, while also providing cash services within the areas. This policy was aimed at ensuring the availability of rupiah in a fit for circulation condition, providing cash services and at the same time maintaining the existence of rupiah. Cash services in frontier and remote areas were conducted by Bank Indonesia using its own transportation fleet or by means of public transportation, or by engaging other related institutions such as the Maritime Police (POLAIR) or the Indonesian Navy (TNI-AL). Cash services in cooperation with the Maritime Police (POLAIR) were carried out in the Seribu Islands in DKI Jakarta province, the Sangihe and Talaud Islands in North Sulawesi province, and the Natuna and Bintan Islands in Riau province. Meanwhile, in cooperation with the Indonesian Navy (TNI-AL), cash services were conducted in the islands of Ternate in North Maluku

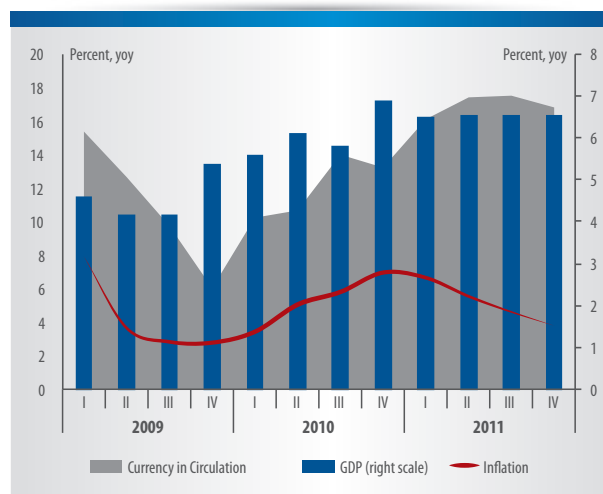
<sup>3</sup> Cash Custodian Service is an outdoor cash services provided by Bank Indonesia in certain areas by appointing one of the local banks as the cash custodian.

province, Negeri Lama in North Sumatera province, Bengkayang in West Kalimantan province, Atambua in East Nusa Tenggara province and also in Berau and Malinau in East Kalimantan province.

In regards to the enforcement of the Currency Act by the end of June 2011, Bank Indonesia took prompt policy actions both internally and externally to cope with the new Act. The act regulated the types, value, characteristics, designs and materials of rupiah, rupiah handling; the use of rupiah; the exchange of rupiah; eradication of rupiah counterfeits, as well as the investigation of rupiah counterfeiting and its punishment. The enforcement of the Currency Act impacted BI's internal workflows and its operations in rupiah currency handling. Therefore, since the beginning of the second half of 2011, Bank Indonesia had been preparing the revision to its internal regulations. Meanwhile, the Currency Act mandated the coordination between Bank Indonesia and the government in terms of planning, printing and destroying rupiah currency. A draft of Memorandum of Understanding regarding the coordination of Bank Indonesia and the government on rupiah currency management will be completed by the first semester of 2012 to accommodate the Currency Act. In addition, Bank Indonesia, together with other related institutions, had actively participated in the preparatory arrangements for the establishment of the Coordinating Agency for Counterfeits Eradication.

## CURRENCY CIRCULATION PERFORMANCE

Currency circulation performance in 2011 was improving compared to that of 2010. The improved performance was well reflected in the fulfillment of the needs for currency which increased along with the improving economic conditions and the enduring societal culture which bolster people's preference to use cash in their daily transactions. The increasing demand for currency indicated the importance of currency as a payment instrument.



**Chart 9.8 Currency in Circulation, GDP and Inflation**

### Currency in Circulation

The position and the average amount of currency in circulation (UYD) in 2011 increased compared to 2010. At year end, the amount of currency in circulation climbed up to Rp373.0 trillion, rose by 17.1% over the previous year (Table 9.2). The increasing amount of currency in circulation was mainly influenced by the economic growth during 2011.

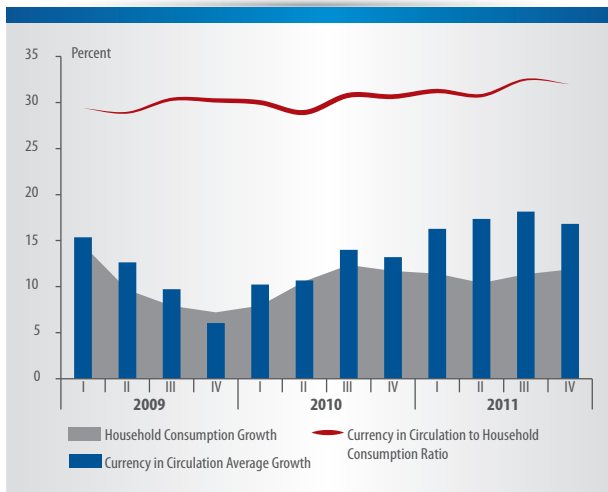
On average, the amount of currency in circulation in 2011 stood at Rp320.4 trillion, grew by 16.9% over 2010 with an annual growth of 12.1%. The higher demand for currency was encouraged by the country's high economic performance throughout the year (Chart 9.8).

The average growth of currency in circulation in 2011 was also higher than the household consumption's expenditure (Chart 9.9). Throughout 2011, the household expenditure grew by 11.3%, lower than the average growth of currency in circulation with growth of 16.9%, indicating the importance of currency as a payment instrument in economic transactions.

The dynamics fluctuations of currency in circulation were largely affected by seasonal patterns, such as

**Table 9.2 Currency in Circulation Position**

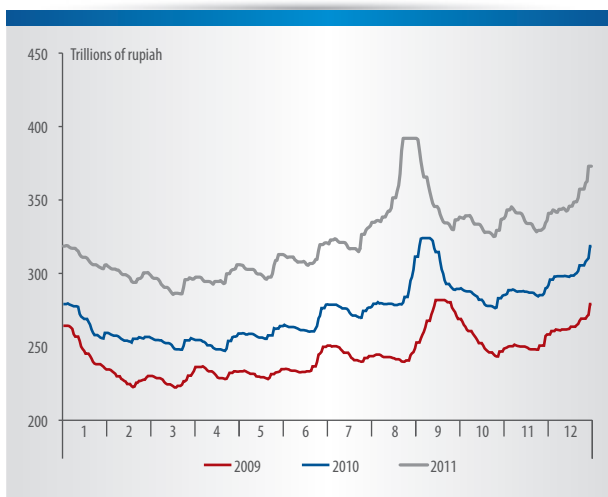
Period	2010	Growth (yoy)	2011	Growth (yoy)
1st Quarter	250.6	10.6%	290.5	15.9%
2nd Quarter	269.4	10.1%	315.5	17.1%
3rd Quarter	288.9	5.5%	336.5	16.5%
4rd Quarter	318.6	14.2%	373.0	17.1%



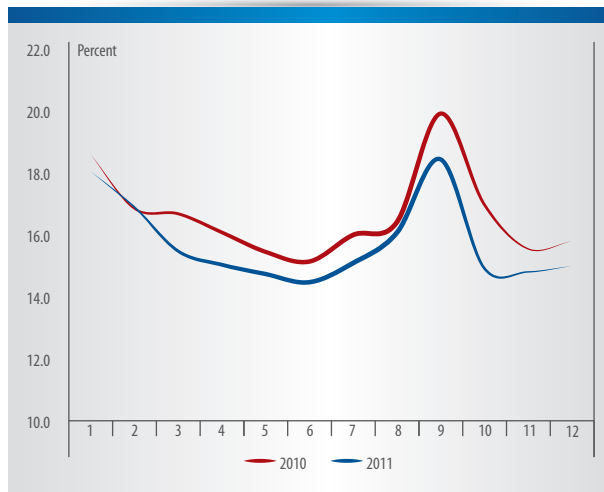
**Chart 9.9 Currency in Circulation and Household Consumption Growth, Currency in Circulation to Household Consumption Ratio**

religious festivities, New Year, and school holidays (Chart 9.10). This was clearly demonstrated by the amount of currency in circulation which peaked in September after the passing of Iedl-Fitr holidays, which stood at Rp350.1 trillion and in December at Rp349.3 trillion during the Christmas and New Year holidays.

The revision to the policy of depositing and withdrawing rupiah currency by commercial banks in Bank Indonesia had resulted in the declining average share of currency in circulation in commercial banks, despite a slight increase to anticipate the rising demand for currency prior to the fasting month and Iedl-Fitr periods. The average share of currency in circulation in commercial banks reached 15.8% of the total currency in circulation, slightly decreased from the previous year which stood at 16.6%. This was followed by the



**Chart 9.10 Currency in Circulation**

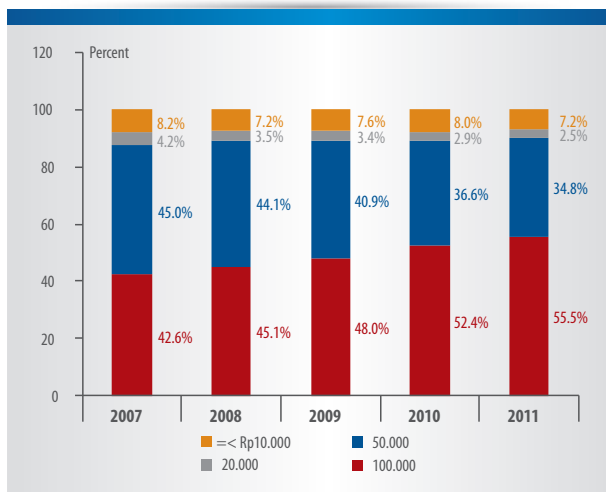


**Chart 9.11 Currency in Circulation Share in Banking**

increasing average share of currency in circulation outside the commercial banks to 84.2% of the total currency in circulation from 83.4% in 2010 (Chart 9.11). Through the implementation of the policy, Bank Indonesia provided a broader access to commercial banks in depositing its excess liquidity to Bank Indonesia.

In term of value, the largest portion of currency in circulation were in higher denomination (Rp20,000 denomination and above), making up 92.8% of the total currency in circulation. The shares of banknotes Rp.100,000, Rp50,000 and Rp20,000 denominations were accounted for 55.5%, 34.8% and 2.5% respectively (Chart 9.12). Based on the number of banknotes/coins circulated, the majority of currency in circulation were in lower denomination (Rp10,000 denomination and lower). They counted for 79.2% of the total currency in circulation, dominated by coins Rp100 and Rp500 denominations which make up 18.5% and 17.6% of the circulated currency respectively. Meanwhile, higher denominations of Rp.100,000, Rp50,000 and Rp20,000 denominations were accounted for 8.4%, 10.5% and 1.9% respectively, totaling at 20.8% of the total number of banknotes/coins circulated in 2011 (Chart 9.13).

The share of banknotes Rp100,000 denomination to the total amount of currency in circulation showed an upward trend within recent years. This upward trend was followed with the downward trend of banknotes Rp50,000 denomination, while other denominations followed similar trend to that of 2010. The increasing share of banknotes Rp100,000 denomination to the total amount of currency in circulation was followed



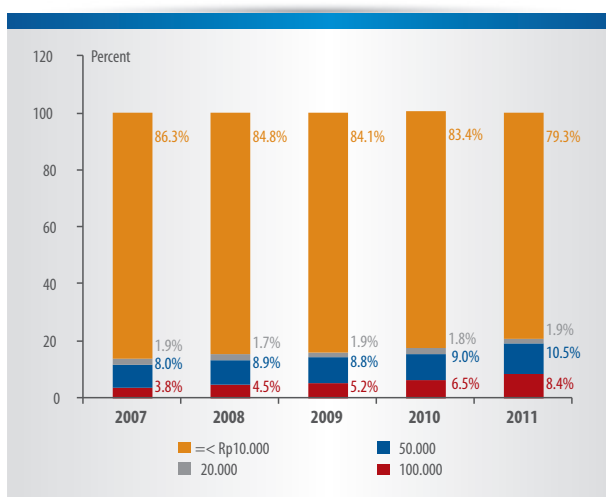
**Chart 9.12 Currency in Circulation Denominations by Nominal**

by the increasing number of banknotes Rp100,000 denomination in circulation. This phenomenon reflected the increasing public demand for the highest rupiah denomination available to be used in transaction activities and fulfilling the commercial banks need for liquidity.

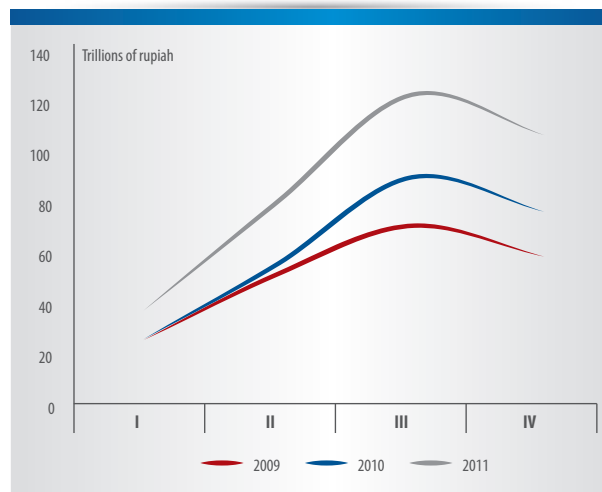
At the end of 2011, the shares of banknotes and coins in circulation was recorded at 99.0% and 1.0% respectively from the total amount of currency in circulation. That was similar to 2010 with shares accounted for 98.9% for banknotes and 1.1% for coins.

### Currency Outflow and Inflow

In 2011, the flow of currency through Bank Indonesia increased in line with the increasing amount of circulated currency. The amount of currency outflow



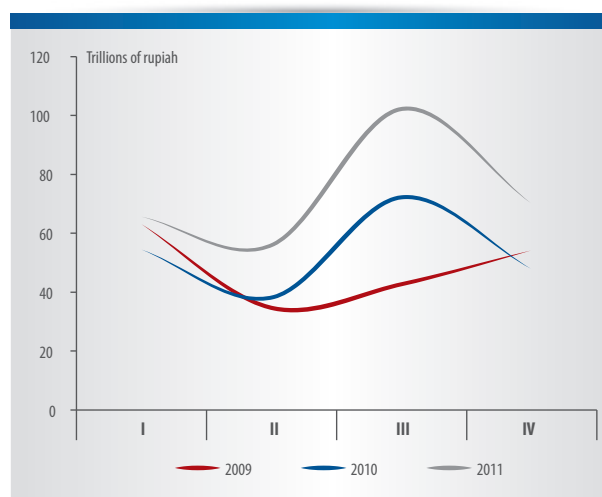
**Chart 9.13 Currency in Circulation Denominations by Bills/Piece**



**Chart 9.14 Currency Outflows**

and inflow increased by 40.6% and 39.1% respectively, reaching Rp347.6 trillion and Rp293.4 trillion. The outflow and inflow fluctuation during 2011 was similar to that of the previous year (Chart 9.14 and Chart 9.15).

Aside from the increasing economic activities, the flow of currency through Bank Indonesia was pretty much influenced by the currency circulation policies taken in 2011. The increasing economic activities and people's preference to use cash in their daily transactions had boosted the amount of currency outflow (Chart 9.16). Meanwhile, BI's policy to implement the revision to the policy of depositing and withdrawing of rupiah currency by commercial banks in Bank Indonesia in early March 2011, had triggered a fairly significant increased of inflow. The new policy allowed commercial banks to deposit both currencies fit and unfit for circulation to Bank Indonesia to balance its excess liquidity. These



**Chart 9.15 Currency Inflows**

deposits boosted the amount of currency inflow throughout year 2011.

A considerable part of the currency outflow from Bank Indonesia was intended to meet commercial banks withdrawals. Throughout the year, commercial banks' withdrawals accounted for 94.9% of the total outflow, leaving less than 1% for currency exchange and cash custodian payouts. The fulfillment of currency demand, both in value and denomination, had helped supporting the smoothness of economic transactions and contributing to the performance of the banking industry and financial system stability.

Throughout the year, the flow of currency through Bank Indonesia was characterized by a higher currency outflow than inflow, or referred to as net outflow. The currency net outflow increased by 49.2% with total net outflow of Rp54.2 trillion (Chart 9.17), reflecting the increasing demand for currency along with the growth of economic activities.

From regional point of view, the pattern of currency net outflow in 2011 remained unchanged from that of the previous year, where net outflow occurred in BI's head office in Jakarta and some of its regional offices in regions outside Java. Currency net outflow in BI's head office indicated an increase of Rp21.5 trillion from the previous year and reached Rp38.6 trillion. Meanwhile, currency net inflow occurred in Java region excluding BI's head office in Jakarta, had an upward trend (Chart 9.18).

The net outflow pattern indicated the preference of people in regions outside Java to withdraw money

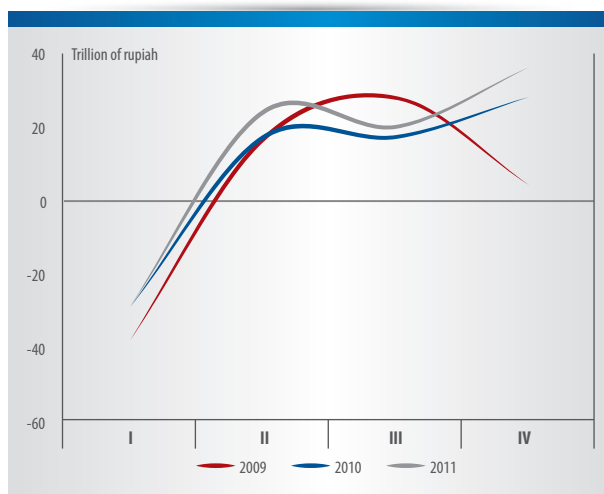


Chart 9.17 Net Outflow

from the local banks and use it for payment of transactions conducted within the Java region. This condition indicated that economic resources were still concentrated in Java, amid the flourishing of economic resources outside Java.

### Cash Position

Despite the increasing public's demand for currency, Bank Indonesia was capable of maintaining the cash adequacy ratio at a safe level. The cash adequacy ratio in 2011 arrived at 3.2 months of average outflow, lower compared to the previous year which stood at 5.9 months. This was primarily due to the increase of average outflow reflecting the increasing public and banking demand for currency. During 2011, the lowest cash position of Bank Indonesia took place in August in line with religious festive period of Iedl-Fitr,

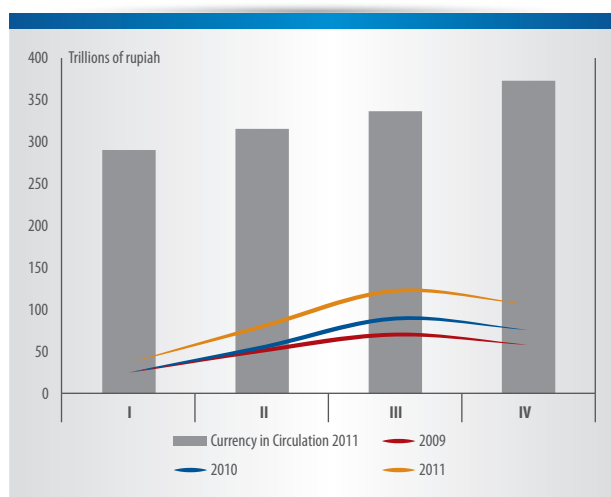


Chart 9.16 Currency Outflow and Currency in Circulation

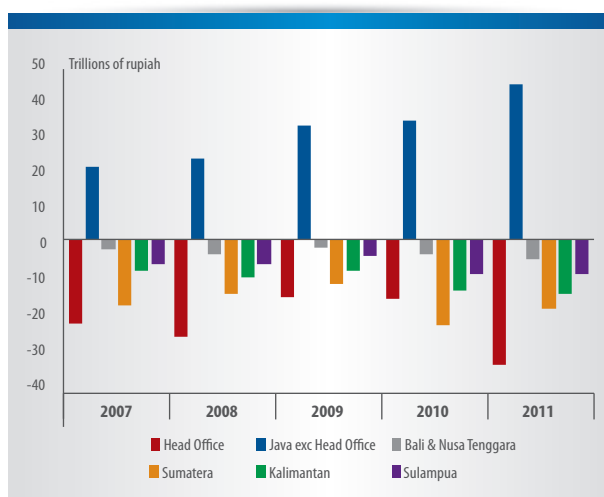


Chart 9.18 Net Outflow in Head Office and Regional Office

with cash adequacy ratio of 2.7 months of average outflow. Whereas, the highest cash position occurred in February 2011, reaching 7.1 months of average outflow.

As of the end of 2011, the composition of currency denomination held by Bank Indonesia was mostly in higher denomination or banknotes with denomination of Rp20,000 and above. The higher denominations accounted for 82.7% of the total cash position, where banknotes of Rp100,000 and Rp50,000 denominations made up 50.6% and 21.0% of the total cash position respectively.

### Currency Destruction

Currency destruction was carried out by Bank Indonesia to improve the standard quality of currency that will be re-circulated to the public. In line with the effort, the amount of currency unfit for circulation (UTLE) destroyed during 2011 increased by 17.7% compared to the previous year, while in numbers, the quantity of banknotes destroyed rose by 19.6% from 4.9 billion in 2010 to 5.9 billion. The increasing amount and numbers of currency destruction as part of the clean money policy implementation was in line with the high volume of currency inflow to Bank Indonesia in 2011.

Based on the region, the highest amount of currency destroyed was in BI's regional offices in Java other than the Head Office, followed by BI's head office in Jakarta, which made up 46.3% and 19.8% of the total amount of currency destruction respectively. The high rate of

currency destruction in the regions was in line with the regional currency flow pattern which tends to be net inflow.

### Counterfeit Currency

There was a significant decrease in the number of detected counterfeit currency during 2011, which slide 42.3% compared to the previous year. The preventive and repressive measures applied in counterfeit deterrence had consistently brought down the counterfeiting level of rupiah currency. Preventive measures were taken by disseminating information regarding rupiah counterfeiting and educating the public with a broader knowledge of the characteristics of rupiah currency, while repressive measures were performed through coordination with the Indonesian National Police (POLRI).

The ratio of detected counterfeits in 2011 slid accordingly and recorded at 10 notes for every million of banknotes in circulation, lower than the previous year with ratio of 20 notes per million of circulated banknotes.

By denomination, the majority of detected counterfeits were Rp100,000 (52.2% of total) and Rp50,000 denominations (40.7% of total), while the largest number of detected counterfeits were reported from BI's Head Office in Jakarta followed by its coordinating office in Surabaya, with 32.0% and 29.6% of the total detected counterfeits respectively. .





# Chapter X

## GOVERNMENT POLICY AND FISCAL PERFORMANCE





# GOVERNMENT POLICY AND FISCAL PERFORMANCE



*Fiscal policy in 2011 was directed at providing stimulus while continuing to maintain fiscal sustainability. Through this direction, the Government implemented various policies to maintain macroeconomic stability and to achieve economic growth targets. In the midst of increased subsidies, the Government implemented prudent fiscal policy specifically in deficit financing and government expenditure. Government expenditure improved as indicated by better expenditure absorption especially in capital expenditure. At regional level, the allocation of capital expenditure, specifically at the provinces of DKI Jakarta and provinces in Java, also expanded. Overall, fiscal performance in 2011 was much better compared to that of the previous year and had supported the economic growth with sound budget deficit amounting to 1.2% of GDP while maintaining fiscal sustainability with low level of debt ratio.*

*Furthermore, to strengthen the resilience of domestic economy, the Government executed a number of sectoral policies. The policies were especially focused on structural improvements to enhance economic capacity, particularly in the areas of investment and trade. Other policies were targeted at priority sectors, such as the industrial and agricultural sectors. To promote employment opportunities and reduce poverty, the Government continued to implement community empowerment policies and programs as well as provide social assistance for the poor. Meanwhile, good coordination and communication between the Government and Bank Indonesia was able to overcome inflationary pressures derived from supplies constraints and distributional problems, specifically in foodstuffs and energy commodities.*



## 10.1 FISCAL POLICY AND PERFORMANCE

The direction for 2011 fiscal policy was aimed at providing economic stimulus while simultaneously keeping fiscal sustainability. In the revenues side, the policies were targeted at enhancing revenues sources, particularly in taxation, while at the same time keeping favourable investment climate and business continuity. In the expenditures side, the policies were focussed to increase budget absorption and the quality of expenditure in order to provide effective stimulus to the economy. Meanwhile, subsidies were aimed at providing public welfare in the form of food and energy safety as well as price stability for strategic commodities. In the financing side, the policies were

aimed at maintaining a declining debt ratio on a gradual basis to ensure fiscal sustainability.

Fiscal performance in 2011 was better compared to that of 2010 with sound fiscal sustainability. This performance was reflected in better fiscal capacity driven by over-the-target revenues. Meanwhile, the expenditure absorption also improved as indicated by better capital expenditure absorption in the midst of large subsidies. This condition led to fiscal support to this year economic growth with manageable budget deficit of 1.2% of GDP and debt ratio at around 24.3% of GDP (Chart 10.1).

### GOVERNMENT REVENUES AND GRANTS

The realization of government revenues was higher than initially targeted in the 2011 Revised Budget. Actual government revenues and grants received in 2011 amounting to Rp1,201 trillion or 20.7% higher compared to the achievement in 2010 (Table 10.1). Tax revenues continued to be the main sources of government revenues comprising of 73% of government revenues (Chart 10.2). Higher tax revenues were backed by economic growth that remain strong as well as by improved tax policies. The higher revenues were also attributed to higher global oil prices. Better revenues allow more fiscal space to increase fuel subsidies while maintaining low deficit.

Actual tax revenues amounted to Rp873.7 trillion or 20.8% higher compared to that achieved in 2010. This resulted in higher tax ratio of 12.3% to GDP compared to 11.3% in 2010 (Chart 10.3). In addition to coming from stronger domestic economy and improvements

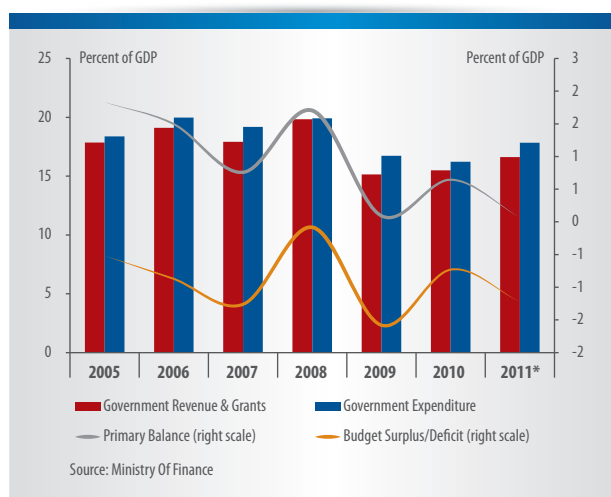


Chart 10.1 Government Financial Operations

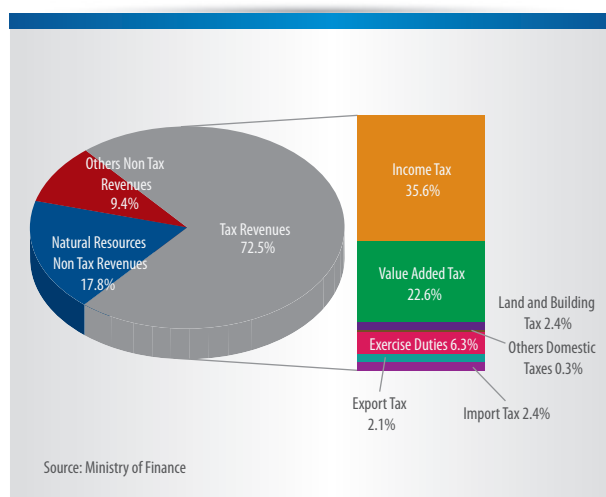


Chart 10.2 Government Revenues Composition in 2011

**Table 10.1 Government Finance Operation Summary**

Details	2010 Budget		2010 Actual			2011 Budget		2010 Actual*		
	Trillions of rupiah	% PDB	Trillions of rupiah	%PDB	% Revised Budget	Trillions of rupiah	%PDB	Trillions of rupiah	%PDB	% Revised Budget
A. Government Revenues and Grants	992	15.5	995	15.5	100.3	1,170	16.2	1,199	16.6	102.5
I. Domestic Revenues	991	15.4	992	15.4	100.2	1,165	16.1	1,197	16.6	102.7
1. Tax Revenues	743	11.6	723	11.3	97.3	879	12.2	873	12.1	99.3
a.l. - Domestic Taxes	721	11.2	694	10.8	96.3	832	11.5	820	11.3	98.5
- International Trade Taxes	23	0.4	29	0.5	128.2	47	0.6	54	0.7	115.2
2. Non Tax Revenues	247	3.8	269	4.2	108.8	287	4.0	324	4.5	113.2
a.l. - Natural Resources	165	2.6	169	2.6	102.5	192	2.7	214	3.0	111.5
- Profit Transfers from SOE's	30	0.5	30	0.5	102.0	29	0.4	28	0.4	97.7
- Others Non Tax Revenues	43	0.7	59	0.9	136.7	50	0.7	69	0.9	136.3
- Revenues from Public Service Inst.	9	0.1	11	0.2	111.6	15	0.2	14	0.2	91.7
II. Grants	2	0.0	3	0.0	159.4	5	0.1	3	0.0	55.4
B. Government Expenditures	1,126	17.5	1,042	16.2	92.5	1,321	18.3	1,290	17.8	97.6
I. Central Government Expenditures	782	12.2	697	10.9	89.2	908	12.6	878	12.2	96.7
a.l. 1. Personnel	163	2.5	148	2.3	91.0	183	2.5	176	2.4	96.0
2. Goods and Services	113	1.8	98	1.5	86.7	143	2.0	121	1.7	84.7
3. Capital	95	1.5	80	1.3	84.5	141	2.0	116	1.6	82.2
4. Interest payment	106	1.6	88	1.4	83.7	107	1.5	93	1.3	87.5
5. Subsidies	201	3.1	193	3.0	95.7	237	3.3	295	4.1	124.3
6. Grant Assistance	0	0.0	0	0.0	28.8	0	0.0	0	0.0	74.1
7. Social Assistance	71	1.1	69	1.1	96.4	82	1.1	71	1.0	86.6
8. Others	33	0.5	22	0.3	65.8	16	0.2	7	0.1	41.8
II. Regional Budget Expenditures	345	5.4	345	5.4	100.0	413	5.7	411	5.7	99.7
1. Balance Budget	314	4.9	317	4.9	100.7	348	4.8	347	4.8	99.9
- Revenue Sharing Funds	90	1.4	92	1.4	102.9	97	1.3	97	1.3	100.1
- General Allocation Funds	204	3.2	204	3.2	100.0	226	3.1	226	3.1	100.0
- Special Allocation Funds	21	0.3	21	0.3	99.1	25	0.3	25	0.3	98.3
2. Special Autonomy	30	0.5	28	0.4	92.6	65	0.9	64	0.9	98.7
C. Primary Balance	-28	-0.4	41	0.6	-147.5	-44	-0.6	3	0.0	-7.1
D. Budget Surplus/Deficit	-134	-2.1	-47	-0.7	35.1	-151	-2.1	-90	-1.2	59.8
E. Financing	160	2.5	117	1.8	73.4	182	2.5	156	2.2	85.5
I. Domestic Financing	143	2.2	113	1.8	79.0	173	2.4	170	2.3	98.2
1. Domestic Bank Financing	46	0.7	22	0.3	48.8	46	0.6	49	0.7	105.6
2. Domestic Non Bank Financing	97.9	1.5	91	1.4	93.1	127	1.8	121	1.7	95.5
a.l. Government Bonds, Net	108	1.7	91	1.4	84.7	127	1.8	121	1.7	95.5
II. Foreign Financing (nett)	17	0.3	4	0.1	500.0	10	0.1	-14	-0.2	-143.3
a.l. 1. Gross Drawing	71	1.1	55	0.9	77.4	57	0.8	45	0.6	78.3
2. Amortization	-54	-0.8	-51	-0.8	93.6	-47	-0.7	-58	-0.8	123.2
Assumptions:										
Economic Growth (%)	5.8		6.1			6.5		6.5		
Inflation y.o.y (%)	5.3		7,0			5.7		3.8		
Exchange Rate (Rp/USD)	9,200		9,087			8,700		8,776		
3 Month Average SBI Rate (%)	6.5		6.6			5.6		4.8		
International Oil Price (USD/barrel)	80.0		79.4			95,0		111.5		
Indonesia Oil Lifting (thousand barrel per day)	965		954			945		898		

Sourcer: Ministry of Finance

notes: \*provisional figures

\*\* 3 Month SPN applied since Februari 2011

in tax policies, higher Tax Revenues were also driven by oil price increase. This oil price increase was able to compensate the impact from declining oil production due to unplanned shutdowns and natural decline in oil fields productivity.

International trade tax revenues, both import taxes and Export Duties, increased due to higher import activities and higher outbound customs rates. The rise in imports was also due to stronger domestic economy and better trade cooperation (Free Trade Agreement). In the meantime, the increase in outbound customs rates was particularly for crude palm oil.

Better tax performance was also brought about by the consistency in implementing tax policies to enhance sources of government revenues. The policies included extensification and intensification programs, as well as optimization of tax data<sup>1</sup>. Other policies are aimed at increasing the quality of tax inspections and investigations, as well as improving the mechanisms for handling complaints and appeals.

Improved customs and excise policy was carried out by extensification of taxable goods and adjustments to excise tariffs. In accordance with the road map for excise on tobacco products, excise tariffs for tobacco were increased by an average of 5% as of January 2011. Other efforts carried out included intensification of customs and excise supervision.

1 The intensification program aims at improving taxpayer profiles, while the extensification program aims at increasing the number of personal taxpayers, particularly professionals, employers, feeding from 1,000 Large Taxpayers and Specific Entrepreneurs Personal Taxpayer.

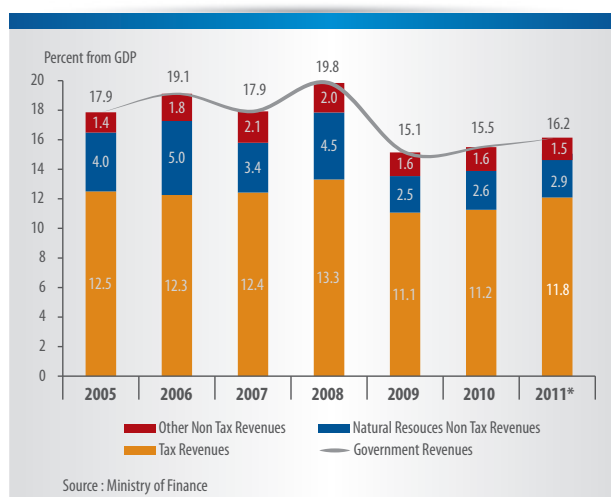


Chart 10.3 Government Revenues

In order to stimulate the economic growth, the Government provided fiscal incentives in the form of government-borne taxes and eliminating outbound travel taxes for all taxpayers. The Government also improved tax administration, continued tax reform program part II, and carried out various extra efforts through tax inspections and collections.

Meanwhile, to improve tax administration system, the Government reassigned tax on land and building acquisition into Subnational Government Budget beginning in 2011. In addition, there are also plans to gradually reassign municipal and rural property tax into Subnational Government Budget by December 2013. These policies are carried out in accordance with Law Number 28 of 2009 pertaining to Regional Tax and Retribution. Through these policies, tax revenues share in total revenues in Subnational Government Budget will increase especially in Sumatra, Jakarta, and the eastern regions of Indonesia.

The Government also provided tax facilities in accordance with the Law on Taxes to support business. The tax facilities included, among others, waiving, reducing and/or deferring tax expenses. The Government also committed to provide tax stimulus among which to maintain consumer purchasing power (through cooking oil and fuel subsidy), increase investment (through government securities and oil and gas exploration), and enhance the competitiveness of certain industries (through government-borne import duties).

Nontax revenues also increased. Actual nontax revenues in 2011 amounted to Rp325.0 trillion or 20.8% higher compared to that achieved in 2010. These revenues were generated mainly from natural resources revenues which increased sharply in line with the oil price increase and expansion of mining areas.

Also contributed to these revenues were revenues from optimization policies in mining, forestry, fisheries, and geothermal sectors as well as from cost recovery (replacement cost for exploration and production activities) efficiency policy and from improvements in oil and gas infrastructure. Meanwhile, though still below target, the Government attempted to increase oil production by, among others, providing tax incentives for import of oil and gas heavy equipments and optimizing production from non-productive oil fields. The Government also worked closely with the Joint Contracts contractors to improve the performance and achieve production target. In addition to oil and

gas, efforts were also carried out to boost production of other mineral commodities as well as to improve regulations in the mining sector.

Higher nontax revenues were also generated from Ministry/State Agency services. This was resulted from the efforts to enhance other nontax revenues through reviewing the types and rates of Ministry/State Agency services as well as improving the services and administration. In addition, the increase in other nontax revenues was also derived from Domestic Market Obligation (DMO) of crude oil revenues and increased sales from mining commodities.

**GOVERNMENT EXPENDITURE**

Actual government expenditures in 2011 amounted to Rp1,289.6 trillion, or 23.8% higher compared to that of 2010 (table 10.1 and Chart 10.4). This condition was generated from central government expenditures and transfer to regions, which respectively grew by 25.9% and 19.3%.

The increase in central government expenditures was particularly driven by significant rise in subsidies payments. Capital expenditures and goods expenditures also rose but below initially targeted in the 2011 Revised Budget. The below-the-target condition was the result of efficiency efforts in office buildings’ construction, lower absorption of foreign loans and grants, problems in land procurement/clearance, natural disasters and social issues. The low absorption was also caused by spending pattern of Ministries and State Agencies that concentrated towards the end of the budgetary year.

Low expenditure absorption also occurred in the Subnational Government Budgets despite early endorsement of the Regional Regulation on Regional Government Budget in almost all the regions. There were 32 provinces that endorsed the Regional Regulation on Regional Government Budget by early 2011, substantially more than in 2010 (Chart 10.5). However, accelerated approval for the budget was not followed by faster pace in budgetary realization, particularly in Jakarta and Bali. In the meantime, the increase in budgetary realization in Sumatra was mainly due to the implementation of projects in preparation for large events such as the SEA Games (in South Sumatra) and the Pekan Olahraga Nasional (national sports week (in Riau). The low absorption of the expenditure in Subnational Government Budget was also indicated by the regional government’s accounts position in the banks which remain high and lower ratio of regional expenditure in the Subnational Government Budget to balanced funds in the Central Government Budget compared to that of the past two years (Chart 10.6).

The Government initiated a number of policies to intensify budget realization. The measures included revising Presidential Decree No. 80 of 2003 regarding Guidelines For Procuring Public Goods/Services (such as accelerating and improving tender process including requirements for determining the winning bidders) into Presidential Regulation No. 54 of 2010 regarding Procurement of Goods and Services. This revision was carried out to improve the quality of the competition in the procurement process of public goods/services. In addition, to resolve problems in land clearance for public purposes, the Government and the House of

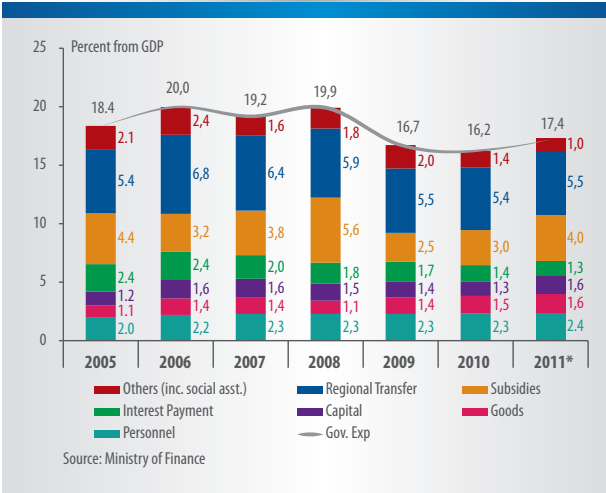


Chart 10.4 Government Expenditures

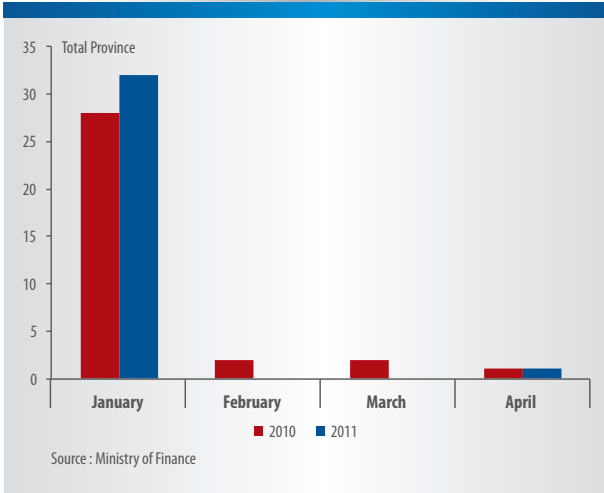
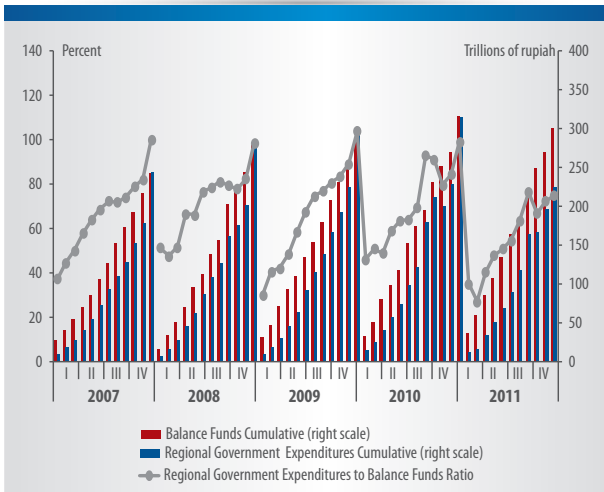


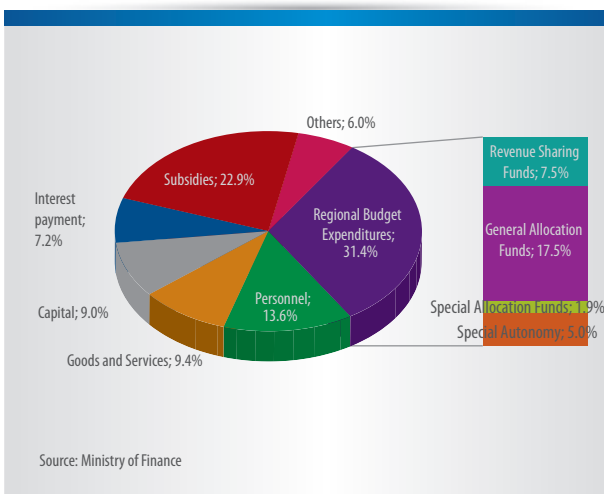
Chart 10.5 Province Budget Endorsement



**Chart 10.6 Regional Government Expenditures to Balance Funds Ratio**

Representatives introduced Law of Land Procurement for Public Purposes Development at the end of 2011.

The Government also established the Masterplan of Acceleration and Expansion of Indonesia Economic Development (MP3EI) in order to speed up the process of infrastructure development (national connectivity). Until the end of 2011, the performance of the infrastructure projects, initiated in May 2011, had not progressed as anticipated. A number of multiyears projects continued to be within the ground-breaking stage. Funding for the projects was derived from the Government, State-Owned Companies and the private sectors through a cooperative venture between the Government and the private sectors. The MP3EI program covers power plants construction, airports construction, ferry fleets expansion, harbor



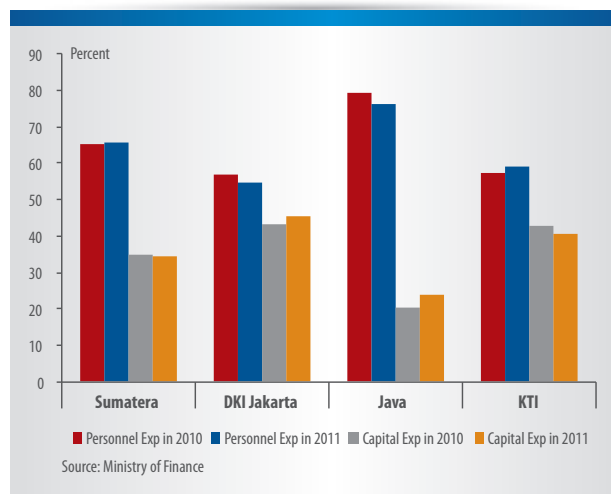
**Chart 10.7 Government Expenditures Composition in 2011**

development, railroad construction, as well as tollroad construction projects.

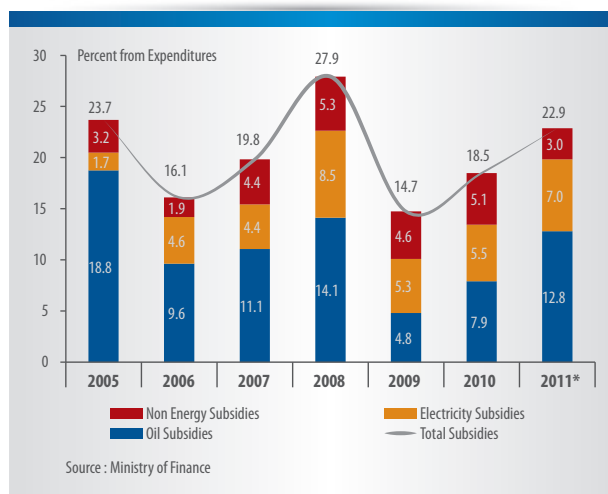
Realization of central government expenditure amounted to Rp878.3 trillion or 25.9% higher compared to that of 2010. This increase was largely driven by subsidies payment, which increased significantly, and personnel expenditure. The increase in personnel expenditure was due to increase in basic salary and pensions (of around 10%), a 13th month pay and pension, increase in food allowances for civil servants, increase in allowances for members of the Armed Forces and Police, as well as remuneration payment to support bureaucratic reforms (Chart 10.7). In regional level, personnel expenditure continued to dominate Subnational Government Budget (of more than 50%) in all regions, particularly in Java<sup>2</sup>. However, for 2011, the regional governments in Java and Jakarta reallocated their expenditure budget towards more productive activities. This was indicated in lower allocation of personnel expenditure and higher allocation of capital expenditure (Chart 10.8).

Policies to allocate larger amount of subsidies and personnel expenditures reflected Government's intention to maintain the purchasing power in order to drive household consumption. These policies also provided multiplier effect to programs of alleviating poverty, enhancing public welfare, and promoting economic growth while simultaneously maintaining stable prices.

<sup>2</sup> Compared with other regions, the eastern part of Indonesia consists of 249 regencies/cities out of 477 regencies/cities and 17 provinces out of 33 provinces.



**Chart 10.8 Personnel and Capital Expenditure Portion**



**Chart 10.9 Subsidies**

Subsidies throughout 2011 increased significantly to reach Rp294.9 trillion, or 53.0% higher compared to that achieved in 2010 (Chart 10.9). The increase was mainly caused by much higher oil price (ICP) of 111.6 dollars US per barrel compared to the assumption of oil price in the 2011 Revised Budget of 95.0 dollars US per barrel<sup>3</sup>. In addition, the increase was also attributed to the higher energy input usage for electricity than its target and the unplanned payment of a 13th distribution of Rice for Poor.

Subsidies expenditures were dominated by energy subsidies. Energy subsidies were used to subsidize certain type of fuels, small LPG tanks and electricity. The increase in energy subsidies was mainly driven by higher oil price (ICP) and larger consumption of subsidized fuel than their target. The higher consumption was the result of the delay in implementing the policy of subsidized fuel consumption ration for private vehicles<sup>4</sup>.

In order to manage energy subsidies, the Government has implemented a number of policies to reduce subsidized fuel consumption as well as to build alternative energy. Those policies included optimizing conversion program from kerosene to LPG (small tanks), mixing alternative energy such as biofuels with fuel and gas, contemplating subsidized fuel consumption ration,

3 The oil price assumption used in the State Budget is the Indonesian Crude Oil Price (ICP), which represents a basket of five types of crude oil that is traded internationally.

4 In the 2011 Revised Budget the quota for subsidized fuel consumption was 40.5 million kilo liters, higher than that of the 2011 Budget of 38.6 million kilo liters. The additional quota has incorporated the policy of subsidized fuel consumption ration for private vehicles.

as well as controlling subsidized fuel consumption through a closed distribution system on a gradual basis and enhancing the regulation. Government also improved production parameters and other parameters used to calculate subsidized fuel and subsidized electricity as well as enhanced efficiency within PT. Pertamina and PT. Perusahaan Listrik Negara (PLN).

Meanwhile non-energy subsidies were directed for food security, price stability and public welfare protection. Non-energy subsidies comprised of Rice for poor program (through BULOG), fertilizer subsidies, and subsidized loan interest rate program. The increase in rice subsidies was influenced by higher Basic Purchasing Price (HPP) for rice and more quantum for each target households. The increase in fertilizer subsidies was driven by the increase in the volume of subsidized fertilizer.

The Government's commitment to improve investment was reflected in ratio of capital expenditure to government expenditure that rose from 8.4% in 2010 to 10.7% in the 2011 Revised Budget. Infrastructure funds also rose from Rp99.4 trillion in 2010 to Rp153.0 trillion in the 2011 Revised Budget.

Debt interest payments in 2011 also went up compared to that in 2010. The increase corresponded to new issuances of domestic and global bonds in the first half of 2011 and the issuance of retail bond in the second half of 2011. However, the debt interest payments were below the budget due to lower interest rate of the 3-months government bills, reduction of the issuance target of government securities and lower foreign loan disbursement.

Transfer to regions also increased. Actual transfer to regions amounted to Rp411 trillion or 19.3% higher compared to that in 2010. The increase was especially due to the hike in General Allocated Funds (DAU) and Special Autonomy Funds and Adjustments (DOKP). The absorption of the transfer to regions expenditure was as targeted.

The dependence of subnational governments on transfers from central government has been declining though still relatively high. This is particularly evident for regions such as Jakarta, East Java, Bali and Nusa Tenggara that have increasing local taxes revenues (PAD).

## DEFICIT FINANCING

Budget performance in 2011 recorded a deficit of Rp88 trillion or 1.2% of GDP (Table 10.1). Implementation of prudent fiscal policies facilitated stronger economic growth with sound budget deficit.

The Government used non-debt and debt financing both from domestic and foreign sources to finance the deficit. Total financing secured by the Government in 2011 amounted to Rp129.3 trillion that was mainly generated from domestic sources. On a net basis, debt financing on average (from 2005-2011 period) contributes to 78.3% of total financing required.

The Government prioritizes using domestic financing and seeks to reduce foreign financing. This policy is carried out while continuing efforts to gradually reduce the debt to GDP ratio to ensure fiscal sustainability (Chart 10.10). Other efforts to maintain fiscal sustainability includes the issuance of government securities at the beginning of the year (front loading), and the buyback and debt switching strategy in portfolio management.

Actual domestic financing in 2011 amounted to Rp148.5 trillion, which is lower than the target in the 2011 Revised Budget. This was mainly caused by the reduction in the net issuance of government securities amounting to Rp6.6 trillion and substantially lower foreign loan disbursement.

Government securities issuances still dominated domestic financing structure. The issuance strategy in

2011 comprised of frontloading strategy, instruments diversification, and domestic issuances priority. The frontloading strategy was reflected in the largest portion of the issuances (54.5%) in the first half of 2011. Instruments diversification was reflected in the issuance of global government securities, global SUKUK, retail domestic SUKUK and retail government securities with the issuance of rupiah-denominated securities amounted to 85.1% of total securities issued. The target issuance was accomplished due to favorable economic condition with declining returns as foreign investors' appetite towards Indonesian sovereign bonds remain high (Chart 10.11).

The financing policy held such principles as low risk financing sources priority, domestic financing priority, foreign loans reduction as well as loan utilization for productive activities. In line with this, debt financing was primarily carried out through the issuance of rupiah-denominated government securities (both conventional and SUKUK) in the domestic market. In the meantime, foreign loans were concentrated on ones from efficient, low risk and no political agenda sources.

To reduce dependence on foreign debt, foreign loans disbursed throughout 2011 were relatively low. Net foreign financing amounted to deficit Rp19.2 trillion, substantially lower than targeted in the 2011 Revised Budget which was due to higher loan payment than loan disbursement. It largely corresponded with the cancellation of the Low Carbon and Resilient Development Loan Program disbursement, as well as lower project loan and Subsidiary Loan Agreement

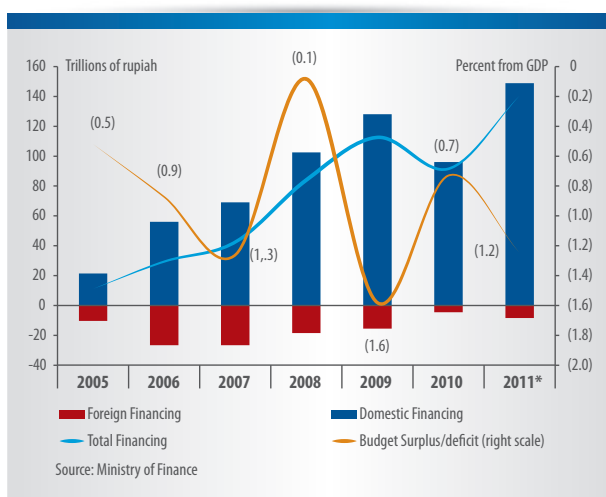


Chart 10.10 Budget Financing

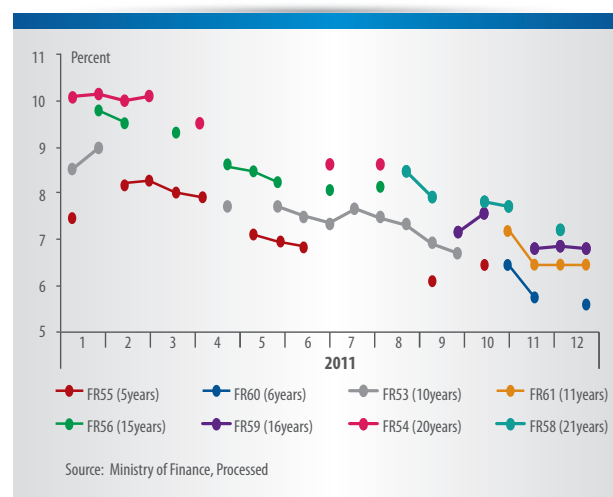
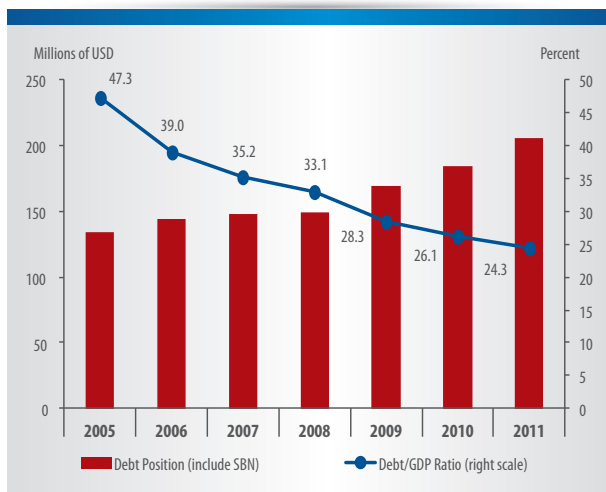


Chart 10.11 Government Bonds (SUN) Yields



**Chart 10.12 Government Debt**

disbursement. This resulted in the declining ratio of government debt to GDP to 24.3%, even though in nominal terms the amount of debt was still rising (Chart 10.12). Meanwhile, deficit financing from privatization proceeds reached its target. The privatization proceeds came from the 2010 target of right issue and divestment of a number of State-Owned Companies. However, deficit financing from PT. Perusahaan Pengelolaan Aset (PT. PPA) continued to be relatively smaller than initially targeted.

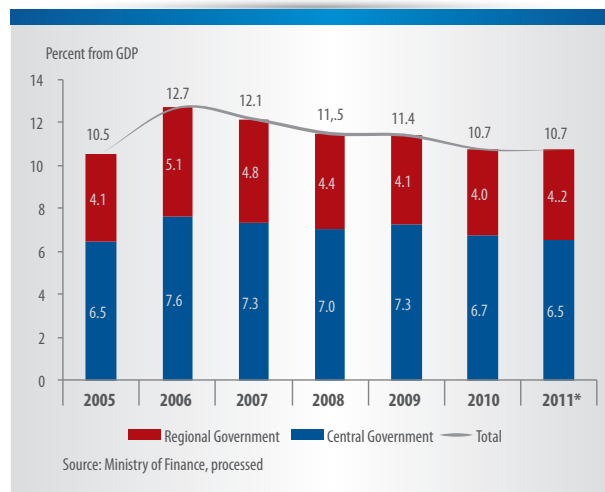
With budget deficit reaching Rp88.4 trillion and budget financing reaching Rp129.3 trillion, there was excess budget financing amounting to Rp40.9 trillion. This fund can be used to finance next year budget, including infrastructure fund for the following year.

## IMPACT ON THE REAL SECTOR AND MONETARY SECTOR

Fiscal policy was aimed at providing stimulus to the economy while maintaining fiscal sustainability. Overall, the government's financial operations in 2011 had a relatively larger impact on government consumption compared to government investment.

Government consumption and investment, both at central and regional level, accelerated this year. This was reflected in higher ratio of government consumption and government investment to GDP compared to that in 2010 (Chart 10.13 and 10.14).

Transfers to real sector, which comprised of subsidies payment, social assistance and interest payment, increased particularly due to higher subsidies (Chart

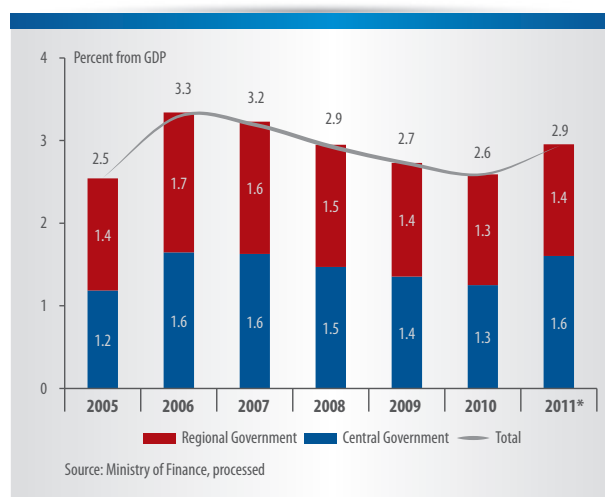


**Chart 10.13 Government Consumption**

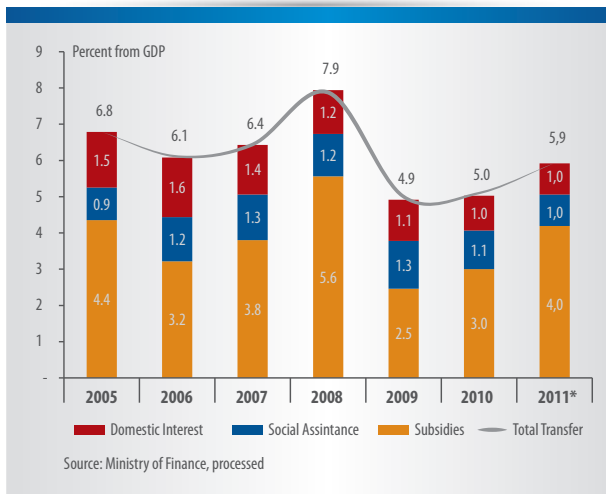
10.15). The subsidies also caused transfers to real sector exceeded its target.

In the monetary sector, the government's financial operations in rupiah throughout 2011 increased banking liquidity particularly in the fourth quarter of 2011. This development was reflected in the declining of central government's rupiah accounts in Bank Indonesia since September. The impact to banking liquidity throughout the fourth quarter amounted to Rp128.2 trillion.

For the whole year, net expansion from government's financial operations reached Rp2.0 trillion. The operations caused liquidity contraction during the first half of the year and liquidity expansion during the rest of the year. The total net expansion of rupiah during



**Chart 10.14 Government Investment**



**Chart 10.15 Transfer to Riil Sector**

2011 resulted in lower central government's account in Bank Indonesia in 2011 (Rp89.6 trillion) compared to 2010 (Rp91.6 trillion) (Chart 10.16).

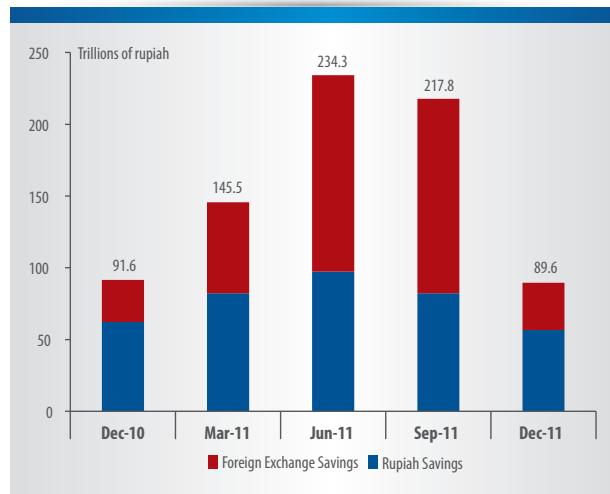
The main component of the net expansion of rupiah was subsidies payments due to high oil prices. In addition, the rupiah expansions also came from DAU payments, salary payments, project term payments as well as Revenue Sharing Funds (DBH) payments.

Overall, the impact of government's financial operations on rupiah liquidity 2011 reached Rp120.8 trillion, higher than that in 2010 of Rp107.8 triliun (Grafik 10.17).

## 10.2 SECTORAL POLICY

In order to strengthen the resilience of domestic economy, the Government implemented a number of sectoral policies. The policies were primarily aimed for structural improvements to enhance economic capacity, specifically in regards to consumption, investment and international trade. In addition, some policies were also focused on the priority business sectors such as industry, agriculture, as well as other strategic sectors. Meanwhile, the coordination and communication between the Government and Bank Indonesia managed to overcome inflationary pressure from supply constraints and disruptions to distribution especially in foodstuff and energy commodities.

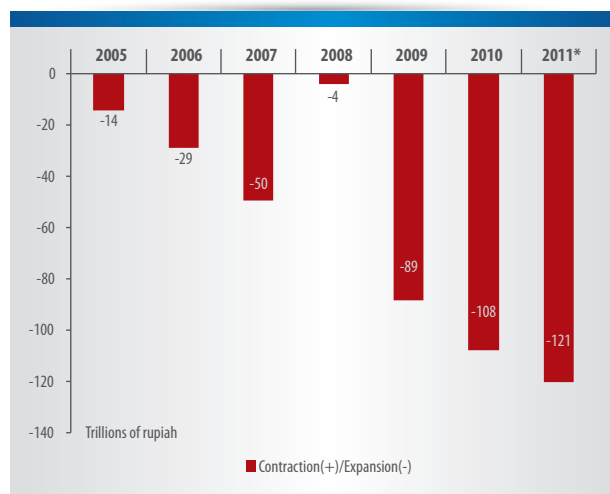
One of the main challenges faced by the Government as specified in the 2011 Government's Working Plan (RKP) was promoting employment opportunities



**Chart 10.16 Central Government Savings in BI**

and poverty eradication. In accordance with this, the Government designed policies to provide social assistance and protection to the poor. These policies comprised of, among others, rice for poor program, community health insurance, family hope program, operational assistance for schools, the national community empowerment program and other subsidies. Those programs were expected to increase public welfare.

In the investment aspect, policies were aimed at providing infrastructure and suprastructure, as well as improving investment climate. The policies included making regulatory reforms both at national and regional level; simplifying business procedures with the formation of Information Services System on the One-Door Integrated Services in a number of cities; and improving national logistics by developing National



**Chart 10.17 Impact of Government Finance Operations**

Logistics System to ensure distribution of goods and reduce high cost economy.

In the international trade aspect, the focus was to increase exports by enhancing the competitiveness of non-oil and gas exports as well as diversifying the markets. The strategies comprised of developing commodities with high added value, natural resources based, and have substantial market demand; promoting creative export products and services particularly produced by the SMEs; diversifying export destinations; expanding access to the market, promoting, and facilitating for non-oil and gas export to Africa and Asia; and promoting better international trade schemes and cooperation for the benefit of Indonesia's exports.

In the industrial sector aspect, a national industrial policy was set up by grouping priority industries. The group of industries covered the agro industry, transport equipment industry, electronics and telematics industry, manufacturing-based industry, supporting industry for creative industry, and certain small and medium industries. To support the policy, the strategies to develop manufacturing industries comprised of the enhancement of business competitiveness and business climate, machinery restructuring program, the construction of specific industrial area, the prioritization of domestic product usage, biofuels industry development, and industrial standardization arrangement.

In order to enhance the national industry competitiveness, the Government developed industrial support infrastructure (energy and foodstuffs); developed SME-based manufacturing industry; enhanced financial access for the manufacturing industry; provided fiscal and non-fiscal incentives

for pioneering industries and industries in specific locations; opening Special Economic Zones (SEZ); and enhancing human resources capabilities and capacity as well as technology to support industries.

In line with this, the Government, through Government Regulation No. 62/2008, provided a tax incentive program in the form of Government-Borne Import Duties for specific industries. In addition, to promote local industries, the Government provided deferred and reduced income tax for a specified timeframe (tax holiday) for pioneering industries<sup>5</sup>. These industries included basic metal industries, petroleum/basic chemicals processing industries, machineries, and renewable energy industry.

In the agricultural sector aspect, the policies were aimed at providing national food security. These policies were carried out through enhancing the productivity and quality of agricultural land; providing seed and fertilizer supports, post-harvest handling assistance and agricultural funding; developing self-food sufficient villages; managing risky harvests, as well as developing irrigation. Those efforts were supported by better coordination, monitoring, and evaluation of food stocks and better management of strategic food.

In the price stabilization aspect, the Government implemented various programs to manage the prices of strategic commodities, both at national and regional level. Supported by good coordination and cooperation between the Government and Bank Indonesia both at central level through the Inflation Control Team and at regional level through the Regional Inflation Control Team, those programs resulted in benign inflation in 2011.

<sup>5</sup> The Minister of Finance's Regulation No. 130/PMK.011/2011 regarding Provision of Income Tax-Free and Reduced Facilities effective on 15 August 2011.