



POLICY MIX RESPONSE

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The process of an orderly economic adjustment amid the challenges daunting the Indonesian economy was attributable to the policy responses of Bank Indonesia and the Government. Bank Indonesia has responded to these challenges by strengthening the policy mix that spans policies in monetary affairs, macroprudential and microprudential management and the payment system. In addition, Bank Indonesia has taken measures to strengthen monetary operations, reinforce management of foreign exchange flows and promote financial market deepening.

The policy mix has not been only implemented internally at Bank Indonesia, but also on a broader scale in coordination of monetary and fiscal policies aimed at safeguarding macroeconomic stability. Besides raising subsidised fuels price in order to maintain fiscal sustainability, the Government also deployed a range of policies to lower the current account deficit, safeguard economic growth and purchasing power, curb inflation and boost investment. Coordination among Bank Indonesia, the Government and relevant authorities has also been strengthened to improve the effectiveness of the stabilisation and structural policies put in place. These policy actions have proven effective in steering internal and external balances in a more favourable direction.

In the course of 2013, implementation of Bank Indonesia's policy mix was characterised by varying dynamics over time. From the start of the year in January until May 2013, Bank Indonesia kept the BI Rate on hold, a move regarded as consistent with achievement of the inflation target for 2013 and 2014 as well as the target for 2015. This followed the guidance of a comprehensive evaluation of performance in 2012 and the outlook for 2013-2014. In the evaluation, the Indonesian economy was predicted to maintain fairly high growth accompanied by subdued, low inflation. Although inflation remained quite low in the short-term, Bank Indonesia remained vigilant for inflationary pressure spurred by mounting inflation expectations over Government planning for fuel prices.

Mid-way through the second quarter of 2013, amid an upward trend in inflation expectations, the Indonesian

economy was buffeted by fallout from the weakening global economy that delivered increasingly adverse impact to the domestic economy, as well as the deteriorating performance of the current account. Early in June 2013, Government intentions for the policy-mandated increase in subsidised fuel prices began to take shape. Finally, on 13 June 2013, after factoring the upward tendency in inflation expectations, Bank Indonesia decided to raise the BI Rate by 25 bps. This action was taken after a previous move on 11 June 2013 to raise the deposit facility (DF) rate by 25 basis points. Following this, Bank Indonesia embarked on monetary tightening to bring inflation back into line with the inflation target of $4.5\pm 1\%$ in 2014 and $4.0\pm 1\%$ in 2015. By the end of 2013, the BI Rate had been raised by a cumulative 175 bps, bringing it to 7.50%. The interest rate policy also sought to manage domestic demand in order to bring down the current account deficit to a more sustainable level.

Besides embarking on monetary tightening within a context of more liquid conditions on the money market and mounting inflationary pressure from the hike in subsidised fuel prices, Bank Indonesia also strengthened monetary operations. Part of this involved strategic adjustments in open market operations (OMOs) and issuance of new OMO instruments. Keenly aware of the relative shallowness of the financial market, Bank Indonesia proceeded with further measures for deepening of the rupiah and forex markets. Similarly, to improve efficiency in price discovery on the market and support exchange rate stability, Bank Indonesia also launched the publication of the Jakarta Interbank Spot Dollar Rate (JISDOR), a reference rate for spot rupiah/USD transactions.

Interest rate policy was reinforced by a policy for managing exchange rate stability in line with the fundamentals of the rupiah. Among others, Bank Indonesia applied a strategy of dual intervention as a solution for bolstering exchange rate stability on one hand and stability in government bond prices on the other. Amendments were also made to other regulations, such

as the provisions concerning export proceeds in support of management of foreign exchange flows and a relaxation of the provisions concerning external debt in support of management of forex demand from non-residents. To promote a more rapid process of external adjustment, Bank Indonesia created greater room for adjustment in the exchange rate while taking account of the risks of possible impact on inflation, government finances, the real sector and financial system stability. In other actions, Bank Indonesia strengthened its collaboration with other central banks to reinforce its second line of defence for adequacy of international reserves.

As part of building a more robust policy mix, Bank Indonesia also launched macroprudential policies for maintaining financial system stability. In 2013, Bank Indonesia announced changes to the Loan to Value (LTV)/Financing to Value (FTV) rules for property credit and property-backed consumer loans in order to slow the growing concentration of credit risk in the residential property sector. To anticipate escalating credit risk and pressure on banking liquidity amid the brisk pace of credit expansion from 2012 to the first half of 2013, Bank Indonesia made changes to the minimum reserve requirement, specifically the Secondary Reserve Requirement and the Loan to Deposit Ratio (LDR) Reserve Requirement.

In addition to these macroprudential policy actions, measures to maintain financial system stability were also bolstered by microprudential policy. In 2013, microprudential policies were issued for the banking system in relation to strengthening the capital structure and competitiveness of banks, reinforcing bank supervision, improvement of good corporate governance, enhancement of transparency and implementation of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT). These policies were issued during a time of preparation for transfer of banking supervision

functions to the Financial Services Authority (FSA) to facilitate the smooth transfer of these functions, and for banking regulation and supervision operations to operate as normal. Alongside this, Bank Indonesia introduced policies for financial inclusion and MSMEs in order to expand access to finance.

Keys to the process of orderly economic adjustments were Bank Indonesia's policies in the payment system and money management. These policies gained added importance in keeping the wheels of the economy turning smoothly amid the disruptions to economic stability. Regarding the non-cash payment system, Bank Indonesia continued at least five policies introduced in the previous period. In the area of currency management, Bank Indonesia launched policies built around the three pillars of availability of quality, trusted rupiah currency, secure and optimum distribution and management of the currency and excellence in cash services to meet demand for cash in circulation.

To support policy effectiveness, Bank Indonesia worked continually to build closer coordination with the Government and relevant authorities. Policy coordination with the Government was pursued in four main areas involving measures to curb inflationary pressure, strengthen external sector resilience, improve interagency effectiveness in crisis prevention and resolution within the Financial System Stability Forum and coordinate the management of currency and the payment system.

The policies instituted by Bank Indonesia and the Government resulted in a positive contribution for mitigating pressure on economic stability and promoting an orderly economic adjustment towards a more balanced condition. Inflation was brought down, returning to the normal trend in September, while a significant reduction was achieved in the current account deficit during the fourth quarter of 2013.



Monetary Policy

Bank Indonesia took measures to strengthen the policy mix in order to bring inflation quickly back to its target range and to reduce the current account deficit to a more sound level. In a pre-emptive response to mounting inflationary pressure, Bank Indonesia raised the BI Rate by a cumulative 175 bps during 2013, bringing the rate to 7.50% by the end of the year. Bank Indonesia also introduced various policies to bolster monetary operations, deepen the financial market, safeguard the exchange rate stability in line with its fundamentals, manage foreign exchange flows, and engage in collaboration with other central banks.

In 2013, the Indonesian economy faced an array of daunting challenges. These challenges were triggered by a shift in global factors that had previously worked to the advantage of the Indonesian economy. However, these factors subsequently brought pressure to bear through the trade channel due to declining exports and through the financial channel as indicated by diminishing capital inflows. Amid conditions of vibrant domestic demand that kept imports running high, weakening exports led to pressure on the current account. This resulted in disequilibrium in the balance of payments, marked by a widening current account deficit and decline in foreign capital inflows that in terms of fundamentals put pressure on the rupiah exchange rate. Pressure on the rupiah then mounted further, spurred by domestic factors related to inflation expectations after the introduction of import restrictions on food commodities. The policy decision to cut back the fuel subsidy in order to rein in the fiscal and current account deficits also stoked inflationary pressure that in turn led to worsening sentiment.

Faced with these daunting challenges, Bank Indonesia bolstered its policy mix strategy by implementing monetary policy within an integrated framework of macroprudential, microprudential, and payment system policies. In doing so, it also coordinated actions with the Government in curbing inflation and the current account deficit. The coordination also covered structural policies for improving macroeconomic balance. In regard to monetary policy, Bank Indonesia raised the policy rate, strengthened monetary operations, deepened the financial market, pursued stabilisation of the rupiah exchange rate in line with its fundamental value, managed foreign exchange flows, and forged closer collaboration with other central banks to create greater room for monetary policy in maintaining external resilience. In a pre-emptive response to mounting inflationary pressure, Bank Indonesia raised the BI Rate by a cumulative 175 bps during 2013, bringing the rate to 7.50% by the end of the year. Similarly, the lending facility (LF) rate was increased 75 bps to 7.50% and the deposit facility (DF) rate moved up 175 bps to 5.75%.

Bank Indonesia also strengthened monetary operations by optimising the management of excess liquidity through use of longer tenor instruments. This was necessary for monetary operations to work more effectively in steering money market rates in keeping with achievement of the inflation target and to support financial market deepening. One of the actions for building more robust monetary operations was the launching of the Bank Indonesia Certificate of Deposit

(SDBI), a tradable interbank instrument. In the drive to strengthen financial market deepening, Bank Indonesia introduced changes on the rupiah money market for optimising the absorption of excess liquidity through the Reverse Repo (RR) instrument using government bonds as underlying and by launching the Mini Master Repo Agreement (Mini MRA) for use among some banks. Efforts to promote financial market deepening on the forex market included expanding the scope of medium-term and long-term hedging swaps with Bank Indonesia and additional variations in tenors for forex Term Deposits (TD). Following the improvements made to the Jakarta Inter Bank Offered Rate (JIBOR) in February 2013, Bank Indonesia began publishing the Rupiah/USD spot reference rate on the domestic market with the introduction of the Jakarta Interbank Spot Dollar Rate (JISDOR) in May 2013. A credible JISDOR is expected to pave the way for more efficient price discovery on the market and also support exchange rate stability.

Actions by Bank Indonesia to maintain the rupiah exchange rate stability in line with its fundamentals included a strategy of dual intervention as a solution for bolstering exchange rate stability on one hand and stability in government bond prices on the other. In addition, Bank Indonesia introduced new measures to manage foreign exchange flows in amendments to the regulation governing export proceeds and relaxation of the rules governing short-term bank external debt with added exemptions for managing forex demand from non-residents. In a parallel move to strengthen liquidity management, improve effectiveness in monetary operations, and manage capital flows, Bank Indonesia shortened the minimum holding period (MHP) for Bank Indonesia Certificates (SBIs) from six months to one month. Bank Indonesia also provided greater room for adjustment in the exchange rate to promote a more rapid process of external adjustment while keeping a close watch on risks of impact on inflation, government finances, the real sector, and financial system stability.

In addition, Bank Indonesia forged closer collaboration with central banks of other nations, including collaboration in swap transactions, to reinforce its second line of defense for adequacy of international reserves. Among the collaborative arrangements put in place was the Bilateral Swap Arrangement (BSA) with the Bank of Japan (BOJ) and the Bilateral Currency Swap Arrangements (BCSAs) with the People's Bank of China (PBOC) and the Bank of Korea (BOK).

The policy mix pursued by Bank Indonesia steered a course consistent with efforts to curb inflation in line

with the target of $4.5\pm 1\%$ in 2014 and $4.0\pm 1\%$ in 2015. The policy mix also proved successful in managing Indonesia's economic adjustment with the current account deficit brought down to a more prudent and sustainable level. The inflationary pressure that mounted sharply after the hike in subsidised fuel prices was gradually reined in, while also kept well below the levels experienced when subsidised fuel prices were raised in 2005 and 2008. In other developments, the Q4/2013 balance of payments showed significant improvement with a more robust surplus in the capital and financial account and a steep drop in the current account deficit to 2.0% of GDP. At this level, the deficit was considerably below that of the previous quarter, when it reached 3.9% of GDP. The improvement in Indonesia's economic fundamentals also had a positive impact through mitigating downward pressure on the rupiah. The 10.4% (average) depreciation in the exchange rate was nevertheless consistent with exchange rate movements in other countries in the region.

10.1. Interest Rate Policy

During 2013, Bank Indonesia raised the BI Rate by 175 bps to 7.50%. Similarly, the lending facility (LF) rate was increased by 75 bps to 7.50% and the deposit facility (DF) rate by 175 bps to 5.75%¹. The interest rate policy was not only intended to signal Bank Indonesia's commitment to curbing inflationary pressure, but also formed part of the strengthening of Bank Indonesia's policy mix focused on control of macroeconomic stability while ensuring continuity in adjustment in the current account deficit to a more sustainable level. Like before, the interest rate policy would have to be placed within the context of the policy mix, given that policy responses cannot rely on interest rates alone. If the policy response places excessive reliance on interest rates, steeper adjustments will be necessary

1 At the operational level, the BI Rate is reflected in short-term money market rates that comprise the operational target in monetary policy. For money market rates to serve as a credible operational target in inflation control, Bank Indonesia is constantly working to safeguard bank liquidity and meet liquidity needs on an equitable basis so that fair, stable interest rates can be formed through monetary operations (MOs). The MOs are the front line of Bank Indonesia's monetary policy implementation for control of monetary aggregates, and involve the use of open market operations (OMOs) and standing facilities. OMOs are money market transactions conducted at the initiative of Bank Indonesia in order to curb interest rate volatility in MOs. On the other hand, the standing facilities are rupiah lending facilities extended by Bank Indonesia to banks and rupiah deposit facilities extended by banks to Bank Indonesia for the purpose of shaping an interest rate corridor on the money market. OMOs are conducted at the initiative of Bank Indonesia, while standing facilities are initiated by banks.

with the consequences of greater trade-offs with heavier pressure bearing down on economic growth².

The significant rise in the BI Rate during 2013 was a vital step in bringing inflation back to its trajectory following a surge in pressure. Inflationary pressure was spurred mainly by the increase in subsidised fuel prices in June 2013 that kindled a surge in inflation expectations and prompted second round effects that exacerbated pressure in core inflation. Also fueling inflationary pressure were increases in food prices caused by supply shocks and the impact of pressure on the exchange rate transmitted through higher prices for consumer goods with imported content.

Concerning these issues, it is also important to emphasise that the dynamics and outlook for core inflation represent a major indicator in formulating monetary policy. At the same time, given their characteristics of not being directly influenced by monetary policy, the dynamics of volatile food prices and administered prices are indicators whose dynamics are monitored over time. Accordingly, interest rate policy was not only targeted at reining in expectations and the second round effects of the fuel price hike, but also directed towards demand management in order to curb the widening trade deficit. Management of demand gained importance because high demand for goods with high import content could lead to the downward pressure on the exchange rate. Increased pressure on the exchange rate would in turn also be passed through to mounting inflationary pressure.

Dynamics of Interest Rate Policy

During 2013, Bank Indonesia's implementation of interest rate policy showed varying dynamics as the year moved forward. From January to May 2013, Bank Indonesia held the BI Rate steady at 5.75%. At this level, the BI Rate was consistent with achievement of the $4.5\pm 1\%$ inflation target for 2013 and 2014 and the $4.0\pm 1\%$ inflation target for 2015. This was borne out in a comprehensive evaluation of performance in 2012 and the outlook for 2013-2014, in which Indonesia's economy was forecasted to chart brisk growth accompanied by low, subdued inflation. In April 2013, core inflation eased to 4.1% (yoy) in tandem with the fall in global commodity prices and generally subdued demand, despite indications of a renewed increase in inflation expectations linked to uncertainty over policy for

2 In this regard, interest rate policy is supported and complemented by optimising the various available instruments to steer the economy towards a new and more efficient equilibrium.

subsidized fuel price. In May, core inflation remained at a low 4.0% (yoy) as global commodity prices maintained their decline, the exchange rate held steady, and supply-side response remained at an adequate level.

Although in the short run inflation was quite subdued, the deflation in the consumer price index (CPI) in April and May 2013 that came after an inflationary surge triggered by food price shocks in Q1/2013 prompted Bank Indonesia to keep a close watch on inflationary pressure engendered by heightened inflation expectations over an impending fuel price hike to be announced by the Government. In April and May 2013, the CPI was recorded at -0.1% (mtm) or 5.6%(yoy) and -0.03% (mtm) or 5.5% (yoy) in response to deflation in volatile foods during a time of improved supply of food staples, seasonal harvests in various regions, and Government efforts to reform import policies of horticultural products, particularly garlic.

Mid-way through Q2/2013, amid rising inflation expectations, the Indonesian economy was buffeted by fallout from the weakening global economy that became increasingly felt at home, as well as the deteriorating performance of the current account. In the absence of serious measures to address these multifaceted challenges and risks, most importantly through clear, directed policy responses, the concern was of worsening risk of macroeconomic instability, which in turn could jeopardise the sustainability of future economic growth.

Therefore, from the viewpoint of Bank Indonesia, the strategy of a mix of monetary policy and other policies needed to take several basic concepts into consideration. First, it was essential to focus the policy mix on orderly adjustment to resolve imbalances and avoid any abrupt adjustment. For this, the policy mix had to be directed towards curbing the rise in inflation expectations and mitigating the impact of the fuel price hike in the short-term while sustaining the momentum for economic growth amid escalation in downside risks. These risks could be external, as in the global economic slowdown and correction in world commodity prices, or domestic such as from weakening investment. Another consideration in formulating the policy mix was the need for policies to bring about more rapid adjustment in external balances and bolster confidence while preventing speculative behaviour involving excessive risk taking.

In the short run, it was important to focus attention on how to curb mounting risks to macroeconomic stability. Therefore, a growing sense emerged of the need for greater clarity in monetary policy signals to reinforce

the Bank Indonesia commitment to maintaining stability in prices and the rupiah exchange rate. The policy actions for stabilising the exchange rate were aligned to fundamentals and sought to prevent expectations of excessive depreciation. If the Government were to move ahead with its fuel policy, the option of a hike in the policy rate would need to be considered for curbing the second round effects from the fuel price hike. These measures also need to be supported by more robust coordination with the Government and macroprudential policy within the framework of inflation control following the fuel price hike and other measures for financial system stability.

Within this situation, precise magnitude and timing of policy actions would be crucial. The uncertainty over when fuel prices would be raised posed a major challenge for Bank Indonesia in judging the correct level of policy response and how quickly Bank Indonesia would be able to bring inflation back on course with the target. A heavy-handed response and rushed process could have a harmful effect on the real sector. Conversely, an excessively weak response that results in inflation moving too slowly towards the target range would also negatively impact public confidence or expectations regarding Bank Indonesia's commitment and credibility in achieving this inflation target.

Early in June 2013, Government intentions for implementing the policy for a hike in subsidised fuel prices became increasingly clear. The plan under which premium-grade gasoline would go up Rp2,000 per litre and automotive diesel Rp1,000 per litre would trigger an inflationary surge in 2013, albeit still within the single digit range, while economic growth would slow down even in spite of the accompanying programme for full compensation from the government. Bank Indonesia prepared various simulations of the BI Rate increase that would be necessary to anchor inflation expectations within the targeting range for 2014. This became increasingly important because the hike in subsidised fuel prices alongside rupiah depreciation could lead to strong upward pressure in inflation.

After factoring in the upward trend in inflation expectations, the Bank Indonesia Board of Governors Meeting held on 13 June 2013 ultimately decided to raise the BI Rate by 25 bps, from the 5.75% level effective since February 2012 to 6.00%. At the same time, the deposit facility and lending facility rates were kept on hold at 4.25% and 6.75% (Chart 10.1). Previously, on 11 June 2013, Bank Indonesia had raised the deposit facility rate by 25 basis points from 4.0% to 4.25%, effective 12 June 2013.

These policies comprised part of the Bank Indonesia policy mix for a pre-emptive response to mounting inflation expectations and to maintain macroeconomic stability and financial system stability amid the uncertainty on global financial markets. These decisions, taken after a long debate in a process fraught with difficulty, were deemed sufficiently measured to maintain market confidence and forestall a temporary rise in inflation without an excessive downside on the momentum of economic growth.

The Government subsequently raised subsidised fuel prices, with premium gasoline selling at Rp6,500 per litre and diesel at Rp5,500 per litre with effect from 22 June 2013 as set forth in Regulation of the Minister for Mineral Resources Number 18 of 2013. The decision to raise subsidised fuel prices was taken alongside other Government actions in support of this policy, such as cost savings and control of government expenditures, control of subsidised fuels and conversion from use of subsidised fuels to gas. These measures were put into place to ensure that second round effects on the public could be properly managed and kept to a minimum. Nevertheless, the Government was cognizant that these measures would be insufficient to keep financing the ever-increasing consumption of petroleum fuels during a time of downward pressure on domestic economic growth.

Following the hike in subsidised fuel prices, monetary policy faced a two-fold challenges. The first involved managing the inflation-growth trade-off. The second challenge was to ensure stability in the exchange rate amid escalation in negative global sentiment related to the planned tapering off by the Fed and the sustained

high current account deficit. In responding to these challenges, the policy priority for Bank Indonesia was to safeguard macroeconomic stability through adjustments in the policy rate and exchange rate to prevent lingering inflation expectations and escalation in external imbalances. Bank Indonesia saw it necessary to apply a bold but measured response involving a mix of interest rate, macroprudential and exchange rate policies accompanied by measures to bolster international reserves in order to maintain market confidence.

To ensure that the inflationary spike after the fuel price hike could be quickly brought back into its target trajectory, Bank Indonesia announced another BI Rate hike on 11 July 2013, this time with an increase of 50 bps to 6.5%. At the same time, the deposit facility rate was raised 50 bps to 4.75% while the lending facility rate was left unchanged at 6.75%. In June 2013, inflation was recorded in 1.0% (mtm) or 5.9% (yoy), consistent with the Bank Indonesia forecast based on the results of the Price Monitoring Survey (SPH) as of the fourth week of June 2013. The surge in inflation can be traced mainly back to the effects of increases in fuel prices and transport fares. Inflation was predicted to peak in July 2013 in response to the fuel price hike and the seasonal trend during the month of Ramadan before dropping back in August 2013 with the easing of the second round effects of the fuel price hike. Bank Indonesia was confident that inflation would return to normal in September 2013.

Alongside this interest rate policy, Bank Indonesia also took actions to strengthen the policy mix. First, to continue with exchange rate stabilisation commensurate with the condition of fundamentals and to ensure adequate liquidity on the forex market. Second, to amend the regulation governing the loan-to-value ratio in relation to home mortgages (KPR)/apartment mortgages (KPA) for certain types of property. Third, to build closer cooperation with the Government focused on minimising inflationary pressure and maintaining macroeconomic and financial system stability. Bank Indonesia was confident that this policy mix would be sufficient to curb inflationary pressure and maintain exchange rate and financial system stability in order to sustain economic growth momentum in more prudent direction.

Although the policy mix responses of Bank Indonesia delivered results, the dynamics of the rapid changes in the global and national economy necessitated convening an additional monthly Board of Governors Meeting at the end of August 2013. This meeting was held to conduct a comprehensive evaluation of macroeconomic and monetary conditions and the financial system, which had

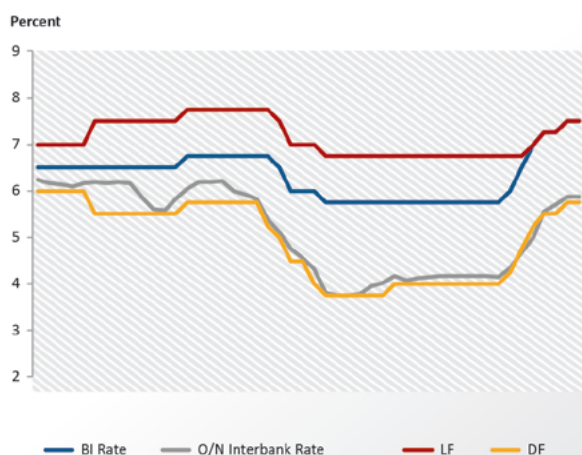


Chart 10.1. BI Rate, O/N Interbank Rate and Standing Facilities

come under more intense pressure in recent periods. All this happened against a background of rising uncertainty in the global economy, high inflation expectations, and negative perceptions on the sustainability of the current account.

In particular, Bank Indonesia took note of a number of important developments in economic, monetary, and financial indicators. First, lingering uncertainty over the tapering of the monetary stimulus by the Fed had worsened pressures on financial markets across a wide range of countries. Second was the pressure continuing to bear down on the balance of payments. Third, CPI inflation measured year-on-year was forecasted to remain high. However, measured month-to-month, CPI inflation in August was far below that of July and was set to return to normal in September. From an overall perspective, having factored in the inflation outcome as of July and the inflation forecast for the subsequent months, Bank Indonesia predicted CPI inflation at end-2013 to come within the 9.0 -9.8% range. This high inflation was attributable mostly to volatile foods and administered prices, while core inflation was comparatively subdued. Fourth, pressure on the rupiah continued unabated, due both to pressures from global financial markets, as has been the case in almost all emerging markets, and to domestic factors related mainly to the burgeoning current account deficit and mounting inflationary pressure. Fifth, economic activity showed signs of slowing from the effects of flagging world economic growth. Sixth, liquidity conditions on the money market and in the banking system remained within comfortably safe limits.

In Bank Indonesia's overall assessment, indicators pointed to an adjustment process under way in the national economy to cope with the economic slowdown. This was closely linked to the monetary and macroprudential policy mix pursued thus far as well as policy coordination with the Government and the Coordinating Forum for Financial System Stability (FKSSK). Despite this, Bank Indonesia could see that on the road ahead, the global economy was still fraught with pressure and uncertainty over the timing and magnitude of tapering off the monetary stimulus by the Fed, declining commodity prices, and flagging global growth. Regarding this, Bank Indonesia could clearly see the necessity of pursuing further measures to strengthen the monetary and macroprudential policy mix in inflation control, stabilisation of the rupiah exchange rate, reduction of the current account deficit and strengthening of macroeconomic resilience and financial system stability.

On 29 August 2013, against the background of these developments, Bank Indonesia raised the BI Rate by 50

bps to 7.00%, a move accompanied by increases of 25 bps in the Lending Facility (LF) rate to 7.00% and 50 bps in the Deposit Facility (DF) rate to 5.25%. The BI Rate increase, which comprises part of the policy mix strategy of Bank Indonesia, was envisaged to bolster management of inflation expectations and mitigate the risk of the possible effect of rupiah depreciation on inflation and vice versa. This policy was also among the measures for bringing down the current account deficit to a healthy and sustainable level.

Even so, the national economy still faced risks on several sides, marked by growing intensity. The problem of external imbalances that had arisen in the past two years took a turn for the worse because of adverse developments in global conditions. At the same time, this risk was exacerbated by growing pressure in oil prices on the international market due to the escalation in geopolitical crises in the Middle East. Furthermore, predictions indicated a high risk of inflationary pressure even though the second round effects of the hike in subsidised fuel prices had begun to ease and inflation expectations were coming under control. However, the pressure from the current account deficit bearing down on the rupiah was indeed considerable. The exchange rate depreciation would be passed on to prices of goods, thus driving inflationary pressure. The principal challenge for Bank Indonesia and the Government lay in how to move more quickly to bring about adjustment in the current account to a more sustainable level. For this reason, a policy focus was needed on efforts to ensure a soft landing in the process of economic and financial adjustments. An optimum policy mix, including policy coordination between the Government and Bank Indonesia, would therefore be essential for the adjustment process to move forward properly. Bank Indonesia policy mix, taking into account the risks faced, would need to focus strategically on more rapid adjustment in the current account and improving the overall of balance of payments. One noteworthy point was that so far, transmission of the BI Rate increases from 5.75% in May 2013 to 7.0% in August 2013 was visible only in the response of rates for deposits held in the banking system. Meanwhile, transmission to bank lending rates and credit growth was still limited.

Amid a number of risks escalating in their intensity, Bank Indonesia announced a further 25 bps increase in the BI Rate on 12 September 2013, bringing the rate to 7.25%. Similarly, BI raised the Lending Facility (LF) rate by 25 bps to 7.25% and the Deposit Facility (DF) rate by 25 bps to 5.50%. These rate increases represented a continuation of Bank Indonesia policy mix focused on controlling inflation, maintaining stability of the rupiah exchange rate,

and ensuring continuity of the adjustment in the current account deficit to a more sustainable level. Although the economy was already in slowdown, the adjustment process needed to be given greater impetus in view of the high rate of credit growth and only partial transmission of monetary policy. Bank Indonesia saw that these policies and other policy actions taken previously would accelerate the adjustment in the current account deficit and guide inflation towards the 4.5±1% target rate in 2014.

In keeping with these policy responses, a process of adjustment in the domestic economy began to gain traction while inflationary pressure eased. This was consistent with the reduction in food price volatility, despite the upward trend in core inflation in response to exchange rate pass through. The pass through from the weakening exchange rate and expectations of further depreciation stoked pressure in future inflation, particularly in core inflation, while risks from volatile foods were still estimated to be strong. On 8 October 2013, in response to these developments, Bank Indonesia decided to hold the BI Rate at 7.25% while also keeping the lending facility and deposit facility rates at 7.25% and 5.50%, respectively.

Although the adjustment process was in motion, Bank Indonesia kept a close watch on global and national economic developments while taking further measures to optimise the formulation of the monetary and macroprudential policy mix. These actions were intended to keep inflationary pressure under control, maintain exchange rate stability in line with its fundamentals, and bring down the current account deficit to a sustainable level. Bank Indonesia also worked tirelessly to build closer coordination with the Government in curbing inflation and the current account deficit. In particular, it did so taking into account the markedly dynamic economic and financial developments at the global and domestic levels in October and November 2013. Temporary risk on/risk off phenomena was observed amid two major global economic trends: slowdown in emerging market countries and expectations of increases in global interest rates. A sizeable current account deficit was again predicted for Q3/2013 in tandem with a flagging trend in the GDP. The lingering pressure bearing down heavily on the current account brought with it the possibility of exchange rate depreciation that in turn would stoke inflationary pressure.

Subsequently on 12 November 2013, Bank Indonesia decided to raise the BI Rate by a further 25 bps to 7.50%, with the lending facility and deposit facility rates similarly increased to 7.50% and 5.75%. This policy decision was

taken after taking into account the persistently high inflation expectations and the sizeable deficit in the current account against a background of sustained high risks of global uncertainty. Accordingly, the decision was made to ensure that inflation would remain on track with the 4.5±1% target in 2014 and the current account deficit would be brought down to a more prudent level in support of sustainable economic growth.

In December 2013, with inflationary pressure and the current account coming under control, Bank Indonesia decided to keep the BI Rate on hold at 7.50%. The lending facility and deposit facility rates were also maintained at 7.50% and 5.75%, respectively. In Bank Indonesia's assessment, this rate policy was consistent with efforts to guide inflation towards the target of 4.5±1% in 2014 and 4.0±1% in 2015 and to bring down the current account deficit to a more sound and sustainable level. These interest rate levels were also perceived as supportive of structural reforms to steer the economy on a more prudent path while avoiding a build-up of excessive pressure hampering economic growth. The interest rate policy response pursued by Bank Indonesia in 2013 succeeded in curbing the pressure fuelling inflation. Inflationary pressure was far below the level reached at the time of the fuel price hike several years previously. At 8.4%, inflation at the end of 2013 was still within the single digit range, even though above the prescribed target of 4.5±1%. Accompanying this was improvement in the current account. During Q4/2013, the combination of shrinking imports and improvement in exports brought about a significant reduction in the current account deficit to 2.0% of GDP, far below the deficit of 3.9% of GDP in the previous quarter.

The measured actions taken under the interest rate policy during 2013 also bolstered macroeconomic stability without a build-up of excessive pressure on economic growth. In Q4/2013, the Indonesian economy outperformed the Bank Indonesia growth forecast while also shifting to a more balanced structure. Economic growth during the quarter climbed from the previous 5.6% (yoy) in Q3/2013 to 5.7% (yoy). For the year of 2013, Indonesia's economic growth was recorded at 5.8%, outperforming the forecasts of many including domestic and foreign analysts.

Amid the various measures taken to improve the performance of the economy, Bank Indonesia kept a close watch on developments regarding risk of inflationary pressure, pressure on the current account, and the pace of the economic adjustment under way. From the viewpoint of Bank Indonesia, efforts for further improvement in the

current account to place it on a more sustainable path would need support from structural reforms to accelerate the rebalancing process in the economy.

10.2. Strengthening of Rupiah Monetary Operations

Amid the weight of pressures on economic stability, monetary operations were also daunted by an array of formidable challenges. Among these, some were related to the still considerable structural excess of short-term liquidity and the weight of pressure bearing down on the exchange rate as a result of the heightened level of global uncertainty, concerns over tapering by the Fed and mounting inflation expectations over the impact of the hike in subsidised fuel prices. Responding to these developments, monetary operations were strengthened by optimizing absorption of excess liquidity using longer-tenor instruments in open market operations (OMOs) and measures designed to promote the deepening of the money market. These measures for strengthening monetary operations were aligned to the policy mix strategy that Bank Indonesia implemented during 2013, with careful consideration for the dynamics of the economy throughout the year.

During the first half of 2013, the strengthening of monetary operations involved a continuation of the strategy for lengthening instrument tenors in the drive for absorption of excess liquidity. This strategy was conducted mainly through the use of Bank Indonesia Certificates (SBIs). After March 2010, the lengthening of the SBI tenors was phased in by shifting away from issuances of 1-month tenor SBIs in gradual movement towards longer tenors of 3, 6 and 9 months³. The process for lengthening SBI tenors brought positive results, leading to the issuance

of SBIs only in 9-month tenor throughout 2013. During this period, liquidity absorption was optimised with the use of non-tradable instruments, mainly rupiah Term Deposits (TDs) and SBIs with a 6-month minimum holding period (MHP). In response to the strategy for lengthening tenors to absorb excess liquidity, changes began to take place in the manner of liquidity absorption using OMO instruments. This brought about a reduction in excess daily liquidity resulted from matured OMO instruments. The reduction in excess liquidity also formed part of the measures for monetary tightening and stabilisation of the exchange rate in response to mounting inflation expectations related to the planned hike in subsidised fuel prices.

Early in the second half of 2013, expectations of market participants involved in liquidity management were strongly influenced by the dynamics of the global economy. The concerns over tapering off prompted banks to expand their holdings of tradable assets as a precautionary measure in case of a sudden need for liquidity. Market participants also preferred to hold liquidity in short-term instruments, and particularly the deposit facility. This had an effect on efforts to lengthen absorption tenors. The TD instrument position underwent steady contraction, in part due to the non-tradable nature of TDs. Similar results were achieved with absorption through SBI instruments subject to a time limit on trading under the 6-month MHP. This led to a downward trend in placements in 9-month SBIs and TD instruments. At the same time, short-tenor monetary instruments, in this case the deposit facility, recorded an expanding position. The large pool of excess liquidity held in short tenors and particularly DFs, which peaked at Rp 147 trillion in August 2013, was a condition that is less supportive to the effectiveness of monetary policy transmission (Chart 10.2).

In response to the more liquid money market condition following the build-up of short-term funds and amid mounting inflationary pressure triggered by the hike in subsidised fuel prices, Bank Indonesia conducted a tight bias strategy for liquidity management. In this regard, the policy response implemented through increases in the BI Rate was strengthened by this shift in the OMO strategy. The adjustment in the OMO strategy involved the shortening of the SBI MHP from six months to one month, expansion of instrument tenors and issuance of Bank Indonesia Certificates of Deposit (SDBIs) as new tradable OMO instruments⁴. Initially, SDBIs were

3 The overall condition of the domestic money market has been marked by a permanent/structural excess of liquidity, indicated by the progressive expansion in the monetary operations position over time. The excess liquidity meant that the daily supply of liquidity generally far exceeded the level of demand. This pushed the short-term money market rates, in this case overnight rates, to a low level. Under its operational targets for monetary policy, Bank Indonesia sought to keep these short-term money market rates at levels not varying widely from the policy rate (BI Rate) to support achievement of the ultimate monetary policy targets. Due to the supply of daily liquidity running high on the money market and in order to keep short-term money market rates from deviating too far from the BI Rate, Bank Indonesia conducted open market operations in varying tenors. Following from there, Bank Indonesia absorbed excess rupiah liquidity by giving priority to SBIs in longer tenors. This move was intended to ensure that monetary operations could be more effective in achieving targets, while shifting the preferences of market actors away from MOs in short tenors.

4 SDBIs are securities issued by Bank Indonesia and traded only among banks. SDBIs have been issued since 27 August 2013.

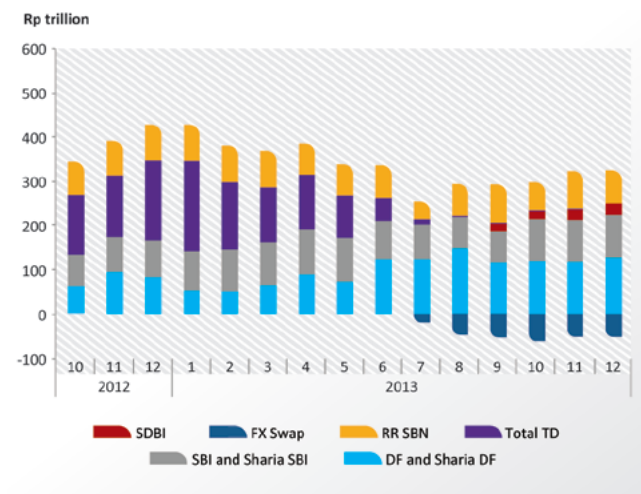


Chart 10.2. Outstanding of Monetary Operation by Instruments

issued in 1-month and 3-month tenors. Consistent with the strengthening of monetary operations, SDBI tenors were gradually lengthened so that from 24 October 2013, these instruments were available in 3-month and 6-month tenors. In addition, SDBIs became a component of the Secondary Minimum Reserve Requirement from 1 September 2013. The intention of this policy was to encourage banks to hold their funds in high quality, liquid assets. When needing liquidity, banks could immediately draw on these assets, among others by selling under repo to Bank Indonesia. At the end of 2013, the SDBI position had increased four-fold compared to September 2013.

The Bank Indonesia decision to shorten the SBI MHP to one month was aimed at enhancing liquidity management, improving monetary operations effectiveness and promoting financial market deepening as well as part of capital flow management. To support this strategy, absorption of excess liquidity was optimised with the use of the Reverse Repo instrument for Indonesian government bonds (RR SBN), BI Certificates of Deposit (SDBIs) and SBIs, while absorption through TDs was rendered non-active or offered only under certain conditions. Through this strategy, the instrument composition was steered back towards the desired path. Excess short-term liquidity, reflected in the previous upward trend in the DF, began progressively declining from September 2013.

During 2013, the measures for monetary tightening and exchange rate stabilisations succeeded in bringing down the position of monetary operations instruments by Rp155.6 trillion, equal to a 36.3% contraction from Rp429.1 trillion at end-2012 to Rp273.5 trillion at end-

2013. Under the strategy for expanding the use of tradable OM instruments, the monetary TD position recorded the greatest decline. In 2012, TDs were the principal instrument of absorption with an outstanding position of Rp180.8 trillion, but by the end of 2013, this had dropped to zero. With the reduction achieved in the monetary operations position during 2013, the SBI and Indonesian government bonds RR positions also moved downwards by Rp13.8 trillion and Rp 6.2 trillion.

After passing through a period of turbulence, the composition of monetary operations instruments saw some change in comparison to the end-2012 composition. The rupiah-denominated TD that served as the leading absorption instrument in 2012 was no longer a mainstay instrument at the end of 2013. Instead, the most important instruments for absorption in 2013 were SBIs, representing a 30% share of total MO instruments (Chart 10.3). Alongside this, the portions of the Government Bonds RR and SDBI instruments, both designed to promote market deepening, expanded to 23% and 8%. On the other hand, bank liquidity placements in the deposit facility, a very short tenor monetary instrument, widened from 20% at end-2012 to 39% at end-2013.

10.3. Deepening of the Rupiah Money Market and Forex Market

Previous work on strengthening Monetary Operations (MOs) was also reinforced by measures for deepening what was still a quite shallow financial market. Reflecting

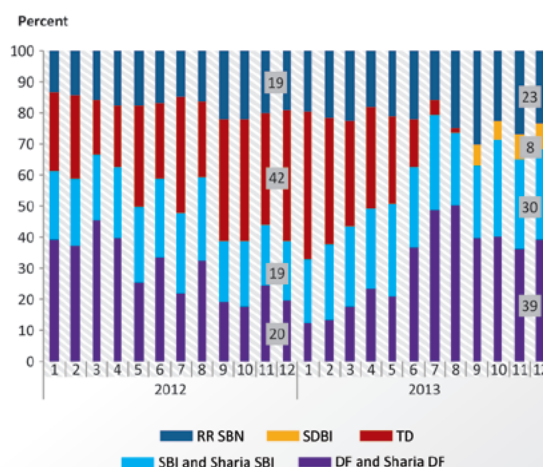


Chart 10.3. Composition of Monetary Operation Instrument

this was the relatively low volume and limited types of transactions taking place on Indonesia's financial market. Indonesia's financial market lacked depth in comparison to other countries in the region, a condition that necessitated immediate action through appropriate, measured and well-coordinated measures to accelerate the process for financial market deepening in Indonesia. Action taken for deepening the financial market would have a positive effect on economic growth and stability as a whole.

Volume on the interbank money market, which involves uncollateralised lending and borrowing among banks, was running at only Rp 10.7 trillion per day, mostly in very short tenors (overnight). This was a relatively small volume in comparison to Indonesia's 2013 GDP of Rp 2,770.3 trillion. Alongside this, the daily volume of collateralised transactions or repo transactions averaged only Rp 132 billion.

Being dominated by uncollateralised transactions, the money market was becoming more susceptible to shocks in line with mounting uncertainty and credit risk. Under these conditions, interbank market volume could plunge drastically by more than half the normal volume, after which considerable time (2-4) months would be needed for the market to recover (Chart 10.4).

Money markets will be more resilient to shocks by expanding the volume of collateralised transactions, in this case repo transactions. One of the issues in developing the repo market in Indonesia was the lack of an agreement that could set a standard and be used all domestic banks. Most interbank repo transactions still relied on non-standard bilateral agreements, and therefore often required a relatively long time to be executed.

One of the measures taken by Bank Indonesia for financial market deepening involved promoting the use of repo transactions in the management of bank liquidity. This action was taken within the context of bank liquidity management with Bank Indonesia and in interbank transactions. Bank liquidity management with Bank Indonesia was reflected in the optimised use of the Government Bonds RR instrument. The market share of Government Bonds RR instrument increased from 19% in 2012 to 23% in 2013.

In one effort to encourage repo transactions in interbank liquidity management, Bank Indonesia facilitated the establishment of a master agreement for interbank repo transactions known as the Mini Master Repo Agreement (Mini MRA). On 18 December 2013, eight banks signed the Memorandum of Understanding for use of the Mini

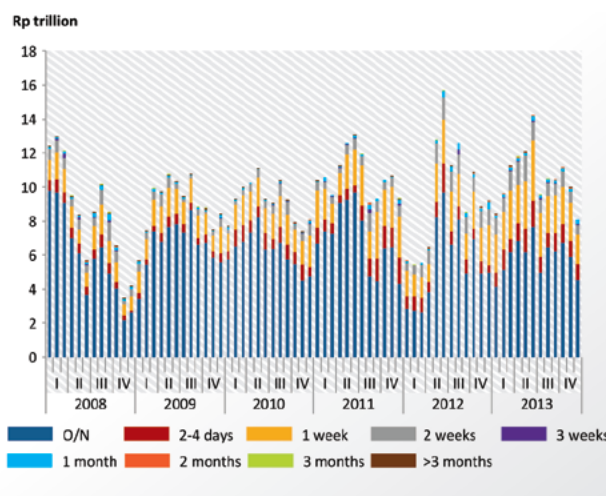


Chart 10.4. Interbank Money Market Daily Volume by Tenor

MRA, having agreed on the use of standard contracts in interbank repo transactions as a way of facilitating the execution of these transactions⁵. The implementation of the Mini MRA was intended to support the deepening of the rupiah money market by promoting the use of standard contract in interbank repo transactions and thus ease the process, save time and minimise potential risk in the execution of interbank repo transactions.

Agreement on use of a standard contractual form by the eight banks was envisaged as a measure to foster participation by banks on a wider scale, thus enabling a market line for interbank repo transactions to be established quickly. It was expected that a market line could be established more easily and would also be more homogeneous, as counterparty evaluation would be based more on the quality of the securities used in transactions, rather than other factors.

Average daily volume of interbank repo transactions mounted significantly following the drafting of the Mini MRA. From January to November 2013, repo transaction volume was recorded at Rp 132 billion per day. This volume soared to Rp 1,589 billion per day after the launching of the Mini MRA.

In other developments following the improvements to the JIBOR in February 2013, Bank Indonesia launched a benchmark exchange rate known as the Jakarta Interbank Spot Dollar Rate (JISDOR) in May 2013, in an effort to

⁵ The eight banks that signed the Mini MRA were Bank Mandiri, Bank Rakyat Indonesia, Bank Negara Indonesia, Bank Central Asia, Bank Panin, Bukopin, Bank DKI and Bank Jabar Banten.

support efficient price formation on the forex market. JISDOR is a USD/IDR spot price formulated on the basis of interbank forex transactions, with data obtained on a real time basis through the Bank Indonesia's monitoring system of foreign exchange transactions against Rupiah (SISMONTAVAR). The reference rate is not mandatory. It is, however, expected to yield credible information to serve as a benchmark for financial market actors in conducting transactions and thus make for more efficient price formation on the forex market, including minimisation of deviation in price formation among market actors. In addition, the benchmark rate serves as a monitoring and assessment tool for Bank Indonesia in building a healthily growing forex market with greater resilience to turbulent market conditions.

In early August 2013, faced with heightened external and internal pressures, Bank Indonesia launched a follow up policy package aimed at bolstering forex supply more effectively and promoting money market deepening. These policy actions include added variation in tenors of Forex Term Deposits (TD Valas), with the previous 7, 14 and 30-day tenors expanded to a range of 1-day to 12 months. The objective of this policy was to broaden the diversity of tenors for forex placements by commercial banks at Bank Indonesia.

To enrich the short-term instruments used in open market operations and strengthen the exchange rate management strategy, Bank Indonesia holds auctions for sales of FX swaps. The maximum term for concluding FX swap transactions is one year. The implementation of the FX swap auctions was aimed at supporting rupiah monetary operations and management of bank liquidity and broader availability of hedging instruments for stimulating investor interest in Indonesia while encouraging more transparent price discovery in line with market prices. Through the auction mechanism, it also became possible to resolve segmentation issues among market participants on the domestic forex market and ease the dependence of market participants on the cash market.

In practice, the FX swap auctions proved useful for management of bank liquidity. During times of rupiah tightening, banks experiencing rupiah liquidity difficulties could participate in swap auctions. On 29 August 2013, BI reformed the regulations governing FX swap auctions to enable banks to pass on the hedging transactions of their customers. This would also assist banks in dealing with constraints posed by the transaction limits of their counterparties and promote the use of hedging instruments, particularly in the long tenors traded in very thin volume on the market. The outcomes of FX swap

auctions would also offer guidance on prices/premium for particular tenors, most importantly at the longer end of the spectrum.

Following this, at the end of 2013, Bank Indonesia initiated the establishment of an internal task force for Financial Market Deepening in order to accelerate this process. This task force was assigned the functions of coordinating and integrating measures for financial market deepening, including the preparation of a working framework and the current roadmap. The establishment of this task force will bolster coordination and collaboration focused on the development of financial market instruments, infrastructure, institutions and regulation.

10.4. Exchange Rate Policy

The strengthening of the Bank Indonesia policy mix was also achieved through an exchange rate policy aimed at maintaining stability in the rupiah in line with its fundamental value. The fundamental exchange rate value is defined as exchange movement consistent with achievement of the future inflation target and aligned to the forex supply-demand interaction on the market, based on the condition of economic and financial market fundamentals. Accordingly, maintaining stability in the exchange rate in line with its fundamental value is of crucial importance in promoting adjustment in the economy to place it on a healthier and more sustainable path.

In order to manage exchange rate movement in line with its fundamental value, Bank Indonesia sought to minimise volatility in the rupiah. These efforts were directed so that short-term volatility in the exchange rate would not lead to subsequent pressure. Amid the considerable pressure bearing down on the exchange rate due to worsening performance in the balance of payments during 2013, efforts to manage the rupiah volatility became critically important. The reason for this was that excessive volatility in the rupiah could fuel expectations of depreciation and inflation among economic agents and ultimately risk putting pressure on economic stability and efforts to maintain the sustainability of economic growth⁶.

During the 2008-2012 periods, the Indonesian economy benefitted from significant inflows of foreign portfolio

⁶ A full account of developments in the rupiah exchange rate is presented in Chapter 5, The Exchange Rate.

capital. The determinant factors of these capital flows can be divided into push factors and pull factors. Push factors included the trend of global low interest rate policies and the quantitative easing (QE) by the US that created an over-abundance of global liquidity. On the other hand, pull factors included the upgrading of Indonesia's credit rating to investment grade and relatively high rates of return compared to other countries in the region and to global markets.

The dependence of Indonesia's financial market on these capital inflows has had a two-fold effect on exchange rate movement. When pouring in, these capital inflows lead to appreciation in the rupiah, but when a sudden large reversal takes place, considerable pressure builds up for currency depreciation. In addition, the domestic forex market is heavily dependent on foreign capital inflows to cover excess demand fuelled by imports and repatriation of profits by foreign corporations.

In early 2013, foreign capital inflows in emerging market nations, including Indonesia, were not as high as in previous periods. This is explained in part by the economic recovery process in advanced economies such as the US and the Eurozone nations. The healthy pace of recovery suggested there was a less potential for foreign capital to pour into emerging market nations. Given this kind of global financial environment, the downward trend in the rupiah commenced early in the year, albeit on a limited scale. The current account deficit that reached 2.6% of GDP in the first quarter of 2013 is also presumed to have put pressure on the rupiah. Nevertheless, further weakening in the rupiah was averted by the sizeable volume of foreign capital inflows on the domestic financial market, driven mainly by the more attractive yields on rupiah assets compared to those offered by other countries in the region. This was despite the heightened global uncertainties of recent periods and expectations of domestic inflation that disrupted capital inflows.

Pressure on the rupiah began to escalate sharply half-way through the second quarter of 2013. Triggering this were the heightened global uncertainties over the plan by the Fed for tapering off the US monetary stimulus in conjunction with indications of further weakening in economic activity and global commodity prices. The global uncertainties then prompted foreign capital outflows from the financial markets of emerging market economies. As a result, Indonesia also experienced a surge in capital outflows, with conditions exacerbated by rising expectations of inflation in anticipation of the hike in subsidised fuel prices.

The capital outflows from the domestic financial market subsequently fuelled pressure leading to currency depreciation. Pressure on the exchange rate steadily mounted, because at the same time the second quarter of 2013 current account deficit widened to 4.4% of GDP. Overall, during the second quarter of 2013 the rupiah depreciated 2.1% from the end of March 2013, representing a steeper rate of depreciation compared to 0.8% in the first quarter of 2013.

In the third quarter of 2013, pressure bearing down on the rupiah intensified further. During that period, the average value of the rupiah depreciated by 8.2% compared to one quarter earlier. The rupiah depreciation was also accompanied by a sharp increase in volatility from 3.1% in the second quarter of 2013 to 17.7%. The increasing pressure on the rupiah was also linked to growing pressure in the balance of payments and soaring inflation expectations from the effects of the fuel price hike. In addition, outflows of capital from the domestic financial market were also spurred by growing expectations of more rapid tapering off by the Fed.

In turn, the weakening in the rupiah stoked inflationary pressure. The dynamics of inflation indicated that inflation in Indonesia remained susceptible to external shocks. In this, the influences on inflation from exchange rate pass through and volatility in global commodity prices on inflation were quite strong. In fact, if exchange rate depreciation were to pass a certain threshold, this would have even more rapid and significant impact on inflation. Exchange rate depreciation also exerted influence on other economic indicators, such as increasing the burden of external debt payment by the government and the private sector. Alongside this, high exchange rate volatility would erode market confidence in the condition of the domestic economy.

Therefore, as one of several strategic approaches for maintaining exchange rate stability, Bank Indonesia engaged in dual intervention. Specifically, Bank Indonesia sought to stabilise the rupiah through forex market intervention accompanied by purchases of government bonds on the secondary market. This strategy was envisaged as a solution for supporting exchange rate stability on one hand and stability in Indonesian government bond prices on the other. Intervention on the forex market sought to close the gap between supply and demand within the context of a market structure that lacked depth. At the same time, intervention on the government bonds market, besides addressing the root cause of depreciation pressure on the rupiah, namely, reversals of government bonds by foreign investors, was

also intended to shore up the supply of rupiah liquidity that had decreased as a result of the forex intervention. This action also increased the Bank Indonesia holdings of Indonesian government bonds that would be used as underlying instruments in government bond reverse repo transactions. The dual intervention could be carried out in phases or simultaneously under a scheme for forex purchase transactions against Indonesian government bonds. Furthermore, in the midst of growing pressure from external imbalances, Bank Indonesia implemented its measures for keeping the exchange rate aligned to its fundamental value while creating more room for adjustment in the exchange rate. The purpose of allowing greater room for adjustment was to support a more rapid process of external adjustment in bringing down the current account deficit to a more prudent and sustainable level. Nevertheless, this exchange rate adjustment was carefully aimed and avoided excessive volatility that might inflame expectations of depreciation and inflation. In this regard, the intervention policy on the forex market involved measured actions to reduce volatility arising from imbalances in forex demand and supply.

Supporting this policy direction for the exchange rate was the concern for maintaining adequate international reserves as the first line of defence. This measure to strengthen international reserves was important in building confidence in resilience of the external sector as it responded to heightened global uncertainties.

In 2013, the Bank Indonesia policy mix proved able to steer the value of the rupiah in line with its fundamentals. Downward pressure on the rupiah eased to some extent during the fourth quarter of 2013. At the end of the last quarter of 2013, the rupiah had registered 4.9% depreciation, well below the 14.3% depreciation of the third quarter of 2013. This positive development was also accompanied by reduction in volatility from 17.7% in the third quarter of 2013 to 15.3%.

Furthermore, macro adjustment in the economy moved forward at a faster rate, with economic indicators showing steady improvement in the fourth quarter of 2013. The current account deficit fell to 2.0% of GDP, contributing to the easing of pressure for depreciation in the rupiah. The improving trend also benefited from rising capital inflows into domestic financial instruments spurred by improvement of domestic economic indicators such as the reductions in the current account deficit and inflation during the fourth quarter of 2013. The improvement in these domestic indicators led to a softening of foreign investor perceptions of risks,

reflected in the decline in credit default swap premium and swap premium in all tenors.

With these achievements, Bank Indonesia was confident that the economic adjustment process was on track. Nevertheless, Bank Indonesia was also aware that in the longer run, structural improvements would be necessary to maintain the stability of the financial market and mitigate risks of exchange rate shock. The scope of these reform measures includes the structure of the balance of trade and deepening of the forex market.

10.5. Management of Foreign Exchange Flows

The drive to keep the exchange rate stable in line with its fundamental value was also supported by a policy for management of foreign exchange flows. This policy was pursued with regard to the structure of a domestic foreign exchange market experiencing excess demand for foreign currency driven by high imports, while supply from export proceeds and foreign capital inflows was unable to keep pace with this demand.

In 2013, the domestic foreign exchange market recorded US\$34.9 billion in net foreign exchange demand, an increase from the preceding year. Foreign exchange demand came mainly from domestic investors representing trading volume of US\$34.0 billion, consistent with the high volume of foreign currency needed for imports and external debt payment. Meanwhile, non-resident investors booked far lower net foreign exchange demand at US\$949 million, after having supplied the market with foreign exchange in the previous year. This demonstrates that the volume of foreign exchange supply was insufficient to meet growing demand.

The imbalances on the foreign exchange market were also influenced by the condition in which not all export proceeds were sold on the foreign exchange market. Excess demand on the foreign exchange market also called for close monitoring, as it could result in mismatched growth in domestic foreign exchange market turnover and fuel high exchange rate volatility in the event of changes in foreign exchange supply and demand. Excess demand in a context of lack of depth on the market would also lead to widening in the buying-selling spread in foreign exchange prices, thus adding to the difficulty in obtaining foreign currency. Taken together, if the widening of exchange rate volatility and the spread between foreign exchange buying and

selling prices were permitted to continue, this could put pressure on the rupiah.

In this regard, Bank Indonesia saw the need for instituting more robust management of foreign exchange flows through a review of existing policies and regulations, improving the effectiveness of foreign exchange liquidity management and strengthening communications with market participants. Among the objectives of these actions was expansion in the turnover of foreign exchange transactions, reduction of the disequilibrium between supply and demand on the foreign exchange market and expansion of the instrument base, including a broader scope of the economic activities underlying foreign exchange transactions. The ultimate goal was to create conditions of greater sophistication, liquidity and efficiency on the domestic foreign exchange market in support of the goal of achieving and maintaining the stability of the rupiah.

One measure initiated by Bank Indonesia to reinforce the management of foreign exchange flows was coordination with the Government in managing foreign exchange demand from state owned enterprises (SOEs), as set forth in Regulation of the Minister for SOEs Number PER-09/MBU/2013 of 2013. This regulation, which includes the standard operating procedure for hedging, provides a legal basis for state owned enterprises to engage in hedging transactions. This offered a better planned and more measured means of meeting the market needs of SOEs and would avoid creating shock on the foreign exchange market.

In a parallel move with the issuance of hedging regulations for SOEs, Bank Indonesia also issued Bank Indonesia Regulation (PBI) No.15/8/PBI/2013 concerning Hedging Transactions with Banks. This regulation streamlined the process for customers in arranging hedging transactions with banks. Under the prevailing accounting standards, this regulation stipulates that gains on hedging transactions that satisfy the accounting criteria for hedging are to be treated as income from hedging. Conversely, any losses in hedging transactions are to be treated as an expense or premium of the hedging transaction. Further objectives in the launching of the Bank Indonesia Regulation included reducing the dependence of economic agents (bank customers) on money market transactions to meet their foreign currency needs, promoting growth in hedging transactions related to economic activities in Indonesia and supporting the creation of a more sophisticated, liquid and efficient domestic foreign exchange market. This would pave the way for more robust

risk management by banks and economic agents and support the achievement of Bank Indonesia objectives in maintaining stability of rupiah.

Management of foreign exchange supply was also provided by means of regulation of bank external debt under Bank Indonesia Regulation No. 15/6/PBI/2013 concerning the Third Amendment to Bank Indonesia Regulation Number 7/1/PBI/2005 concerning Bank External Debt. Under this regulation, Bank Indonesia eased the rules governing short-term external borrowing by banks by adding some exemptions to the restrictions on external debt. Short-term bank external debt covered by the exemptions includes rupiah demand deposits (vostro accounts) operated by non-residents for holding the proceeds of divestiture originating from direct equity participation, purchases of Indonesian shares and/or corporate bonds and Indonesian government bonds. The objective of this policy was to manage non-resident demand for foreign exchange without reducing the prudential aspects of banks in offshore borrowing.

During this period, in a move to bolster the structure of foreign exchange supply, Bank Indonesia relaxed the rules governing foreign exchange purchases for exporters having previously sold export proceeds. The objective of this policy was to provide an easier mechanism for exporters to buy foreign currency against underlying documents of previous sales of foreign currency.

Furthermore, the Bank Indonesia decision to shorten the SBI minimum holding period (MHP) to one month, effective September 2013, comprises part of the management of capital flows, by providing an incentive for inflows of foreign capital on the domestic financial market. The decision to shorten the MHP was taken amid global developments that were influencing market behaviour in liquidity management. The heightened uncertainties were spurred in part by concerns over tapering off, which prompted foreign investors to place more of their holdings in shorter tenor instruments. Under these conditions, the previous 6-month minimum holding period for SBIs was regarded as poorly suited to the role of maintaining stability in capital flows. While comprising part of the management of foreign exchange flows, the policy also improved liquidity management, strengthened the effectiveness of monetary operations and promoted financial market deepening.

Taken together, Bank Indonesia's policies for management of foreign exchange flows during 2013 ultimately worked for a more balanced supply and demand on the foreign exchange market. Inflows of foreign funds into SBIs

mounted in response to the change in the MHP from 6 months to 1 month. In aggregate transactions in SBIs during 2013, foreign investors recorded a net purchase of US\$305 million, following the previous year's net foreign selling of US\$789 million. Alongside this, supply improved in response to placement of export proceeds in the domestic banking system. In 2013, export proceeds placed in domestic banks represented about 84% of total export transactions, up from the 2011 level of 80%.

For even greater reinforcement of supply-demand equilibrium, further measures were pursued for deepening the domestic foreign exchange market involving enrichment of instruments, expansion of the investor base and promotion of investment in longer tenors. In the longer run, the equilibrium in foreign exchange supply and demand will also be strengthened through structural policies, including the creation of incentives to encourage exports and measures to bolster the import substitution industry.

10.6. Collaboration with Other Central Banks

To reinforce the policy mix strategy, Bank Indonesia worked steadily on forging closer collaboration among central banks in the areas of monetary policy and financial system stability. One of the measures taken was to bolster the second line of defence for adequacy of international reserves by means of a swap mechanism with ASEAN+3 counterparty nations (Table 10.1).

The collaboration with the ASEAN+3 nations operates within the context of strengthening Regional Financial Arrangements (RFAs) within the Chiang Mai Initiative Multilateralization (CMIM) scheme. The CMIM is a collaborative arrangement among the ASEAN+3 nations involving a pool of commitment capable of extending short-term liquidity assistance to members experiencing short-term liquidity and balance of payment difficulties, whether in the context of prevention or resolution of crisis. Expansion of CMIM capacity, which represents the focus of ASEAN+3 cooperation, entered a new phase. The CMIM underwent major improvement with an up scaling from the former US\$120 billion to US\$240 billion and the launching of a crisis prevention facility known as the CMIM Precautionary Line (CMIM-PL).

Besides strengthening the RFAs within the CMIM scheme, Bank Indonesia also initiated cooperation in the form of bilateral swap transactions with Japan, China and Korea under the Bilateral Swap Arrangement (BSA) and

Bilateral Currency Swap Arrangement (BCSA) schemes. The BSA is a form of bilateral cooperation involving USD-rupee swap transactions aimed at overcoming foreign currency liquidity difficulties arising from difficulties in the balance of payments and shortages of short-term foreign currency liquidity. On the other hand, the BCSA consists of bilateral cooperation in arranging swaps for the domestic currencies of the respective country for the purpose of promoting trade and/or direct investment between the two nations and to provide short-term liquidity assistance for stabilising the financial market, as well as for other purposes agreed by the two parties. This cooperation is envisaged as providing a second line of defence against the phenomenon of continuing uncertainty in the global economy.

Aside from the swap arrangement, Bank Indonesia and the Bank of Japan agreed to implement a Cross Border Collateral Arrangement (CBCA) mechanism. The CBCA enables domestic commercial banks to obtain a funding (liquidity) facility in the domestic currency from the central bank by pledging foreign currency denominated assets as collateral, whether in the form of foreign currency or foreign securities, during a time of crisis.

The CBCA scheme comprises part of the Bank Indonesia monetary operations, and is an extension of the eligible assets to be called on only during times of crisis. By the end of 2013, Bank Indonesia had entered into a CBCA agreement with the Bank of Japan (BoJ). With the CBCA, eligible banks in Indonesia in need of rupiah liquidity under conditions of crisis may obtain liquidity from Bank Indonesia through the sale and buyback of Japanese Government Bonds (JGBs) in Term Repo transactions. The CBCA scheme offers an additional facility for resolving crisis and complements the existing instruments for crisis management in Indonesia.

10.7. Monetary Policy Transmission

Monetary policy implemented through the setting of the BI Rate was generally transmitted through the various channels of inflation expectations, interest rates, credit and asset prices. During 2013, the 175 bps increase in the BI rate met with healthy responses through all four of these channels of transmission. In the inflation expectations channel, the increases in the BI Rate proved sufficient to anchor the formation of inflation expectations among economic agents. As indicated by the interbank market and third party fund rates, most importantly time deposits, bank interest rates moved up

across the board in tandem with the increases of BI Rate. However, BI Rate increases were not fully transmitted to lending rates. The relative impediments in policy transmission is explained by the prevailing strategy among banks of holding back from raising lending rates in order to maintain their credit market share. In addition, banks considered the potential increased of non-performing loans (NPLs) that might result from increasing their rates. Nevertheless, credit growth at the end of 2013 was marked by the onset of a slowing trend consistent with the upward movement in the BI Rate. At 21.6%, credit growth was down from the end-2012 level recorded at 23.1%.

Similarly, in the financial asset price channel, the signals

of increases in the BI Rate during the second half of 2013 were followed by changes in financial asset prices, albeit on a varying scale. On the stock market, the pressure driving interest rate increases resulted in large-scale portfolio adjustments by investors in emerging markets that ultimately contributed to losses in the Jakarta Composite Index (JCI). On the secondary market for government bonds, the monetary policy implemented during the second half of 2013 met with a strong response and resulted in diminishing trading activity in tandem with increased bond yields.

Consistent with the slowing domestic economy in 2013, liquidity growth also came under correction to sustain a level of domestic economic growth without creating

Tabel 10.1. Bank Indonesia's Swap Arrangements

Description	ASEAN Swap Arrangement	Bilateral Swap Arrangement (BSA)	Chiang Mai Initiative Multilateralization (CMIM)	Bilateral Currency Swap Arrangement (BCSA)
Definition	ASA is a multilateral arrangement in form of swap between USD/JPY/EUR with 10 ASEAN countries' currency	BSA is a bilateral swap arrangement between USD and local currency of ASEAN+3 countries (ASEAN + Japan, China and Korea).	CMIM is a multilateral swap arrangement between between USD and local currency of ASEAN+3 countries.	BCSA is an inter-central bank financial bilateral arrangement, in form of swap between each country's local currency.
MOU and Validity Period	<ul style="list-style-type: none"> - ASA MOU Principle worth US\$2 billion was first signed on 17 November 2005 - The arrangement has been renewed several times, the last one being 17 November 2013 (2 years validity period). 	<ul style="list-style-type: none"> - BSA with Japan was first signed on 17 February 2003, worth US\$ 3 billion. - It has been renewed several times (the latest was August 2013), reaching US\$ 12 billion. - On 12 December 2013, a new BSA was made, worth US\$ 22,76 billion. 	<ul style="list-style-type: none"> - CMIM Agreement worth US\$ 120 billion was first settled on March 2010. - On May 2012, an agreement was reached to reinforce CMIM, with the specifics: <ul style="list-style-type: none"> a. Increasing the agreement to US\$ 240 billion (from the previous US\$ 120 billion) b. An addition of CMIM Precautionary Line (CMIM-PL) to countries facing short term liquidity and/or balance of payment issues. <p>There is no time line to this agreement</p>	<ul style="list-style-type: none"> - BI-PBOC BCSA Valid since March 2009, on October 2013 an agreement was signed to extend the BCSA (3 years validity period), worth CNY 100 billion (equal to Rp150 trillion) - BI-BOK BCSA A bilateral swap arrangement between IDR/KRW was reached on 12 October 2013, worth kRW10,7 trillion/Rp115 trillion (equal to US\$10 billion), which is valid for 3 years with a renewal option based to agreement.
Purpose	Lending short term liquidity to member countries with balance of payment issues.	Overcoming liquidity problems icaused by balance of payment and short term liquidity issues in the region.	Overcoming liquidity problems icaused by balance of payment and short term liquidity issues in the region	<ul style="list-style-type: none"> - Aid with short term liquidity to maintain financial market stability (BI-PBOC BCSA only). - Promote trade and investment (strictly trade for BI-BOK BCSA). - Other purposes based on agreement (BI-PBOC BCSA only).

added pressure in prices. These developments in economic liquidity were consistent with the dynamics of their affecting factors, such as foreign and domestic assets including government financial operations.

Policy Transmission in the Inflation Expectations Channel

In the inflation expectations channel, the monetary tightening by Bank Indonesia through increases of BI Rate accompanied by adjustment in the interest rate corridor generally succeeded in anchoring the inflation expectations of economic agents. In turn, this averted further pressure stoking inflation. Among others, this was evident in the inflation expectations for 2014, which had begun to drop back within the target range of $4.5\% \pm 1\%$. Despite the mild inflation in the first quarter of 2013, Bank Indonesia remained alert to inflationary pressure spurred by rising inflation expectations over Government planning for fuel prices. Accordingly, the pre-emptive step taken by Bank Indonesia by raising the BI Rate before the fuel price hike came into force was an important milestone in Bank Indonesia's efforts to anticipate soaring inflation, including the mitigation of second round effects of heightened pressure in core inflation.

As a result of this policy, the high inflationary pressure that peaked early in the third quarter of 2013 gradually stabilised during the fourth quarter of 2013. When compared to the times of the fuel price hikes in 2005 and 2005, the more carefully managed increase in fuel prices in

2013 was inseparable from the success of Bank Indonesia policy in anchoring inflation expectations. During the time that followed, inflation expectations based on the consensus forecast for 2014 eased back within the target range of inflation (Chart 10.5).

Policy Transmission in the Interest Rate Channel

The effect of policy transmission through the interest rate channel was demonstrated by interbank rates that generally moved in tandem with the BI Rate increases throughout 2013. Reinforcing this were measures taken by Bank Indonesia to keep interbank rates stable by ensuring the availability of banking liquidity in rupiah and foreign currency. Response to the Bank Indonesia policy stance was positive. The steady BI Rate during the first five months of 2013 met with commensurate response in interbank rates, which was relatively stable during the first half of the year. Subsequently, in the second half of 2013, interbank rates began to climb in tandem with the increases in the BI Rate. With the BI Rate increasing by 175 bps, the daily average for overnight (O/N) interbank rate moved up by 174 bps from 4.41% in early 2013 to 6.15% at the end of the year. The 1-week interbank rate, which demonstrates greater elasticity in the daily average, climbed 329 bps from 4.59% to 7.88% at end-2013 (Chart 10.6).

The upward movement in interbank rates was also reflected in the Jakarta Interbank Offered Rate (JIBOR). At end-2013, the daily average JIBOR was recorded at 6.01%, having climbed by 177 bps from the previous year. Interest



Chart 10.5. Consensus Forecast Expectation of Inflation

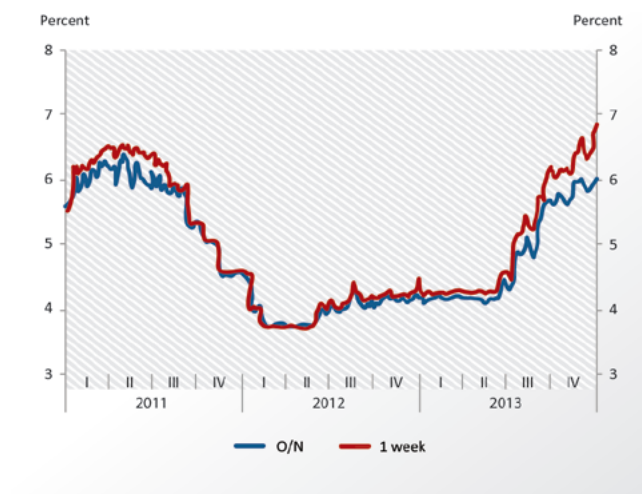


Chart 10.6. O/N and 1 Week Interbank Money Market Interest Rate

rates in other tenors also showed an escalating trend, as illustrated by the daily average 1-week JIBOR that climbed 245 bps to 6.43% and the 1-month JIBOR that increased 277 bps over the previous year to 7.56%. The stronger increase in the JIBOR for longer tenors (1 week and 1 month) reflected market expectations of higher interest rates (Chart 10.7).

Amid the rise in interbank rates, volume of interbank transactions in all tenors maintained an upward trend. During the reporting year, daily transaction volume on the interbank market averaged Rp 10.8 trillion, up from the previous year's volume of Rp 9.3 trillion. Interbank transaction volume experienced a sizeable downturn in July 2013 as a result of diminishing liquidity needs after the end of the school holiday period that contrasted with substantial availability of short-term bank liquidity in the form of DF placements. Despite this, tight liquidity conditions resumed at the end of July from the effect of contraction caused by expanding demand for currency as the public geared for the long religious festive season in early August 2013 and during the period from November to December 2013, in advance of the end-of-year holidays.

Meanwhile, volume on the domestic foreign exchange market declined in comparison to the previous year. The domestic interbank foreign exchange market⁷ shrank from a daily average of US\$518.5 million to US\$345.7 million. Similarly with the interbank rupiah market, the interbank foreign exchange market was dominated by lending and borrowing in the overnight tenor. Compared to the volume on the domestic foreign exchange market, volume on the domestic interbank foreign exchange market inclined to be lower. During the reporting period, the foreign exchange market averaged US\$1,119 million in daily turnover, triple the daily volume of the interbank foreign exchange market.

Increases in the BI Rate and interbank rates were transmitted to bank interest rates, led by deposit rates. At the end of 2013, time deposit rates reached 7.69%, increased by 193 bps over the 5.76% rate for time deposits at the end of 2012. Individually, some banks offered interest rates on par or higher than the rates of the Indonesian Deposit Insurance Corporation (LPS). In addition, some banks also offered non-interest

7 The forex money market or interbank forex market consists of interbank lending and borrowing denominated in foreign currencies (e.g. the US dollar). However, the foreign exchange market consists of transactions in which one currency is traded for another (e.g. rupiahs for US dollars).

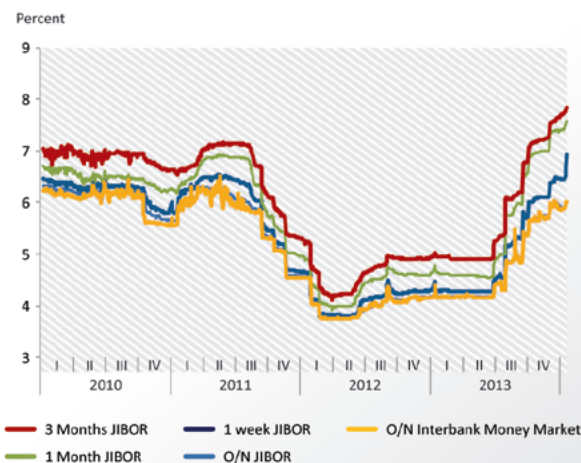


Chart 10.7. Interbank Money Market and JIBOR Interest Rate by Tenor

incentives (such as facilities and instant prizes) in an effort to prevent loss of customers in flight to quality (Chart 10.8).

Following this, the rise in deposit rates was transmitted to lending rates, although on a more limited scale. After having sustained a downward trend and reaching a lowest point of 11.93% in June 2013, lending rates began climbing in June 2013 in keeping with the increases in the BI Rate. At the end of 2013, the weighted average lending rate was recorded at 12.39%, an increase of 23 bps from the end-2012 position of 12.16%. In disaggregation by purpose of use, movement in lending rates was marked by greater variation. Compared to the end of 2012, rates for working capital credit mounted

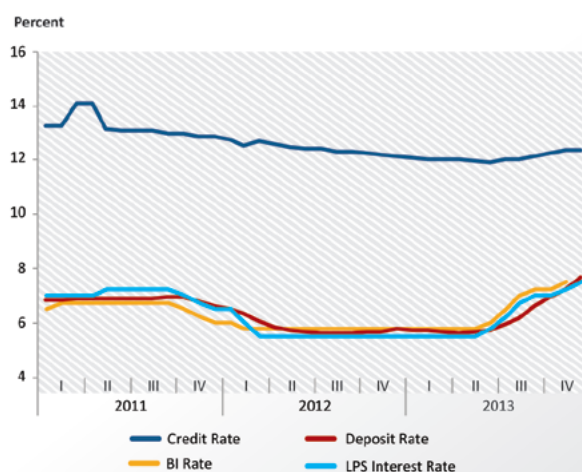


Chart 10.8. Interest Rates

63 bps to 12.12% and for investment credit by 55 bps to 11.82%, while consumption credit rates slipped 45 bps to 13.13% (Chart 10.9).

One reason for the slow rise in lending rates was the strategy applied by banks, which preferred to hold back on raising their lending rates in order to maintain their share of the credit market. Banks took this action after taking into account the still sizeable margin of the spread between lending rates and deposit rates. Besides this, bank concerns over higher NPLs triggered by increases in lending rates were another reason for holding back from rate increases for lending.

In this way, time deposit rates showed greater responsiveness to increases in the BI Rate and interbank rates in 2013, compared to lending rates. This also led to a narrowing in the spread between time deposit and lending rates, which eased to 470 bps by end-2013 compared to the end-2012 spread of 640 bps. At the micro level, this behaviour was closely related to bank attempts to defend their margins. However, from a macro perspective, the reduced spread indicated the improving efficiency in the banking system.

The rise in time deposit rates went on to influence the level of time deposits held in the banking system. After a period of lacklustre growth in early 2013, time deposits began climbing at a stronger rate in the second half of 2013. With time deposits accounting for 44% of the third party funds, the more vigorous expansion in these deposits helped to counter the slowing trend in bank funding growth. Savings deposits and demand deposits, as the other components of the third party funds, were marked

by varying trends. Savings deposits, which accounted for 33% of total third party funds in 2013, followed a tapering growth trend. However, demand deposits, representing 23% of total third party funds, underwent considerable fluctuation during 2013.

Policy Transmission through the Credit Channel

Increases in lending rates amid the launching of the tight bias Bank Indonesia policy mix and slowing growth in the domestic economy bore down on credit expansion in 2013. At the end of the year, a slowing trend was apparent with credit growth recorded at 21.6%. After eliminating the factor of rupiah depreciation, credit expansion at end-2013 came only in the range of 18%. At this level, credit growth was below that recorded at end-2012 at 23.1%. The slowdown in credit growth took place mainly in consumption credit, with home mortgages and automotive loans most affected, as well as in corporate loans as the result of persistently high global uncertainties that had adversely impacted exports and slowed the domestic economy.

In analysis by purpose of use, lending for productive uses remained predominant over consumer lending. Investment credit was marked by significant acceleration in growth compared to working capital credit and consumption credit. The more robust expansion in investment credit, up from 27.4% in 2012 to 35.0% in 2013, was matched by sustained business optimism for national economic conditions in the medium-term. This growth in investment credit is expected to provide a further boost to real sector growth in the national economy. In contrast, growth in working capital credit and consumption credit maintained a slowing trend. Working capital credit recorded only 20.4% growth, compared to the previous year's growth of 23.2%. Meanwhile, consumption credit demonstrated a weakening trend after 2012, with growth down from 19.9% to 13.7% (Chart 10.10).

Slowing rates of credit expansion were recorded across almost all economic sectors. Analysed by the top five economic sectors by share of credit, slackening credit growth was concentrated in the trade, agriculture and miscellaneous sectors (consumption credit), while credit expansion for manufacturing and business services remained on track and even showed an upward trend (Chart 10.11).

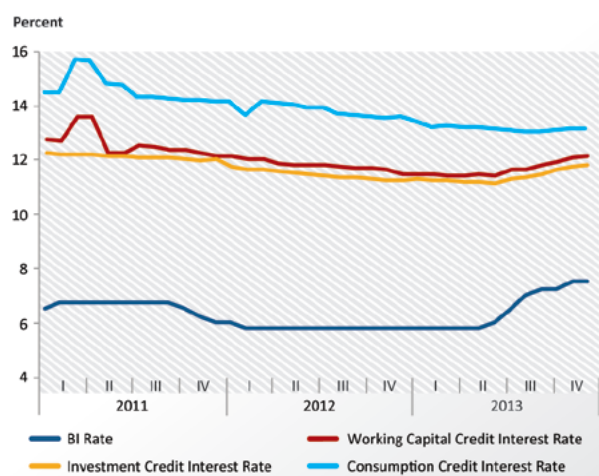


Chart 10.9. BI Rate and Credit Rate

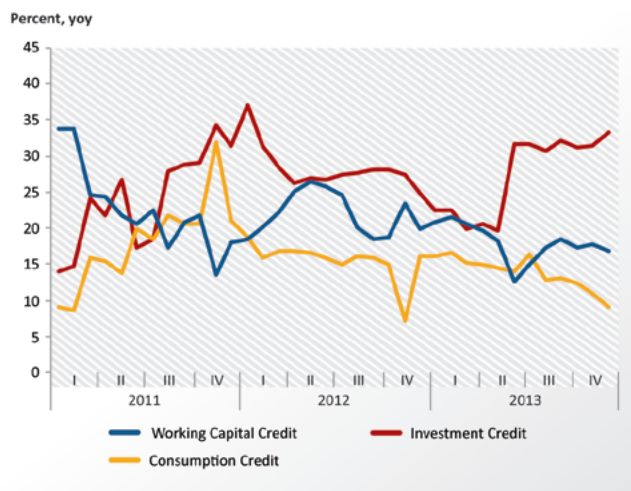


Chart 10.10. Credit Growth by Type of Loan

Policy Transmission in the Asset Price Channel

During the first half of 2013, while the BI Rate was kept on hold, financial asset prices maintained a heartening trend. On the stock market, gains in the JCI were bolstered by the steady level of the BI Rate at 5.25%, relatively well managed macroeconomic conditions and the on-going adjustment in external factors. However, during the second half of 2013, the signals of BI Rate hikes were followed by changes in financial asset prices, albeit on a varying scale. Pressure from correction in the JCI was exacerbated by a wave of portfolio adjustments by investors in emerging markets. Nevertheless, optimistic projections for corporate financial performance did much to hold back the pressure on the JCI. Under these conditions, the JCI still managed to chart modest gains, albeit with a fluctuating trend. At

the end of 2013, the JCI closed at 4,274.2, just under the end-2012 position recorded at 4,316.7 (Chart 10.12). In the meantime, negative sentiment on the domestic and global markets prompted non-resident investors to cut back their holdings on the stock market. During the second half of 2013, non-resident investors booked a net sale of Rp 19.7 trillion. Overall, the year 2013 was marked by a diminishing trend in non-resident holdings of domestic stocks.

On the secondary market for government bonds, monetary policy in the second half of 2013 met with a strong response in declining trading activity and mounting bond yields. Secondary market transactions of Government bonds moved on a downward trend in tandem with the effects of the weakening in the rupiah and mounting inflation expectations. This pressure on the Indonesian government bonds market was also marked by fears over the tapering off envisaged by the Fed, rising political tensions in the Middle East and the uncertainty over US budget deliberations that has kindled fears of a US government shutdown. Even so, the downward trend was restrained by an improvement in inflation expectations and reduction of volatility in the rupiah as the year 2013 drew to a close. In overall performance, yield on Indonesian government bonds climbed 328 bps during 2013 to 8.48% from the end-2012 position of 5.19% (Chart 10.13).

In the first half of 2013, the mutual funds market maintained an upward trend as indicated by Net Asset Value (NAV) that reached Rp195.7 trillion during May 2013. In the second half of the year, mutual funds NAV were marked by decline until August 2013, alongside the increases in the BI Rate. This downward trend in NAV was countered by the effects of improving performance on the financial market and secondary market for

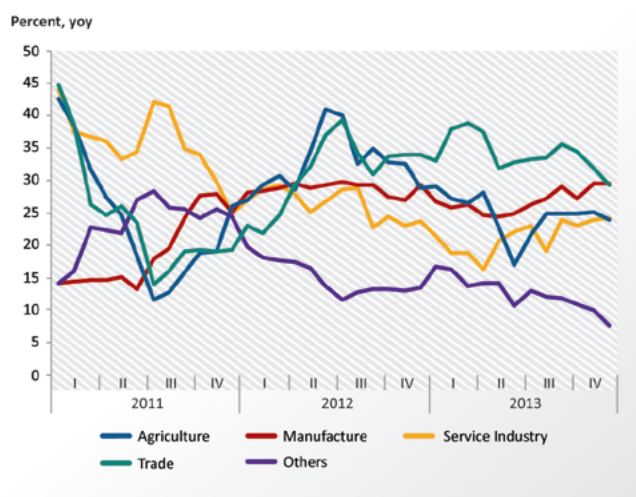


Chart 10.11. Credit Growth by Sector



Chart 10.12. BI Rate and Indonesia Composite Index

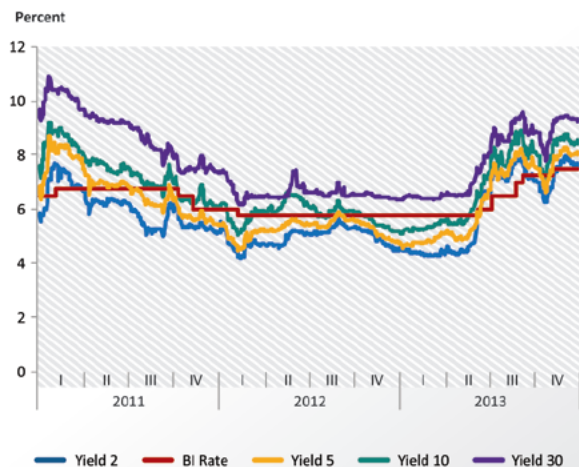


Chart 10.13. BI Rate and Government Securities (SBN) Yield by Tenor

Indonesian government bonds. Towards the end of 2013, mutual funds NAV resumed upward movement, reaching Rp185.5 trillion at the close of the year. At this level, NAV was just ahead of the end-2012 position recorded at Rp182.80 trillion.

Developments in Economic Liquidity and Influencing Factors

Consistent with the less vibrant pace of the domestic economy, slower expansion took place in economic liquidity. These developments in economic liquidity were consistent with the dynamics of their affecting factors, such as foreign and domestic assets including government financial operations. Domestic assets continued to play a major role in economic liquidity, despite a slight reduction in the contribution at the end of 2013. Nevertheless, this contribution remained substantial as government financial market operations were stepped up to cope with the increased fiscal expansion at the end of the year.

In 2013, M1 growth slowed to 5.4% from the 2012 level of 16.4%. This condition also represented the influence of slowing growth in currency outside banks and rupiah demand deposits (Chart 10.14). A further contribution to flagging behaviour in M1 growth was the gradual adjustment in the Secondary Minimum Reserve Requirement from 2.5% to 4%.

Consistent with slackening economic activity, growth in currency outside banks slowed to 10.4% in 2013, compared to 17.6% in 2012. Nevertheless, base money

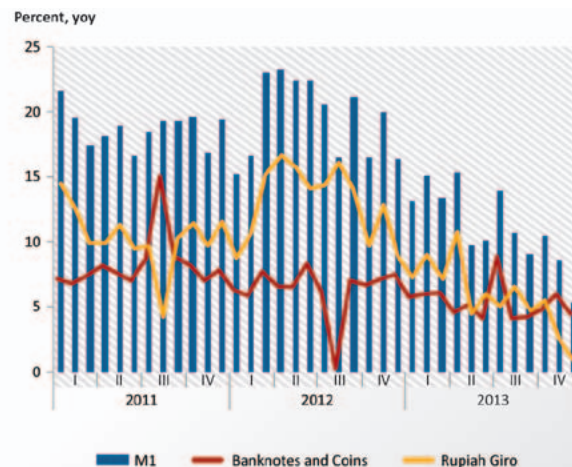


Chart 10.14. Growth of M1 and Its Components

growth gathered momentum to reach 16.6% in 2013, ahead of the 14.9% base money growth of 2012 (Chart 10.15). This more robust base money expansion took place alongside slackening growth in demand deposits at Bank Indonesia. Weaker growth in the third party funds, on which the calculation of the Minimum Reserve Requirement is based, was one reason for the muted growth in demand deposits at Bank Indonesia.

In 2013, the broad measure of economic liquidity (M2) was also marked by a slowing trend. That year, M2 growth slowed to 12.7% from the 2012 level of 15.0% (Chart 10.16). The tapering growth in M1 also contributed to a levelling growth trend in M2. Meanwhile, growth in quasi-money edged upwards slightly in 2013 to 14.8% from the 2012 level of 14.7%.

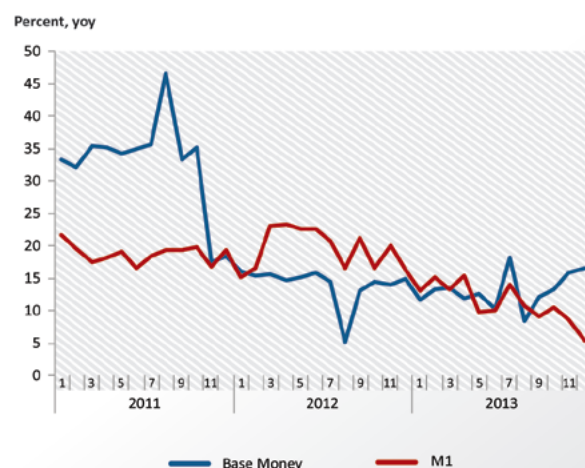


Chart 10.15. Growth of M1 and Base Money

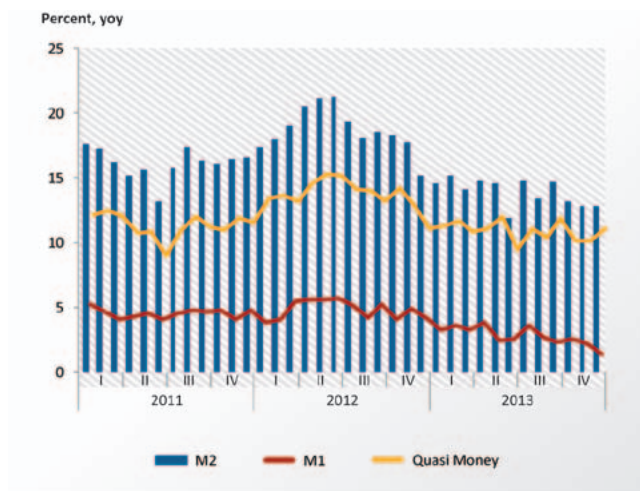


Chart 10.16. Growth of Economic Liquidity

Net domestic assets (NDA) continued to provide a major contribution to M2 growth, maintaining an upward trend in 2013. Even so, the NDA contribution to M2 fell off at the end of 2013 in keeping with the slowing activity in the domestic economy and more moderate credit growth.

Like in 2012, the dynamics of foreign exchange assets contribution to M2 in 2013 differed little from the behaviour of domestic assets and government financial operations. The contribution of net foreign assets (NFA) in M2 was marked by steady decline until mid-way through 2013. This contribution to growth even sank to a negative value, indicating a contraction in NFA as of the third quarter of 2013. The NFA contraction was consistent with the relatively constrained level of capital inflows due to the deteriorating performance of the global economy. The NFA contribution to M2

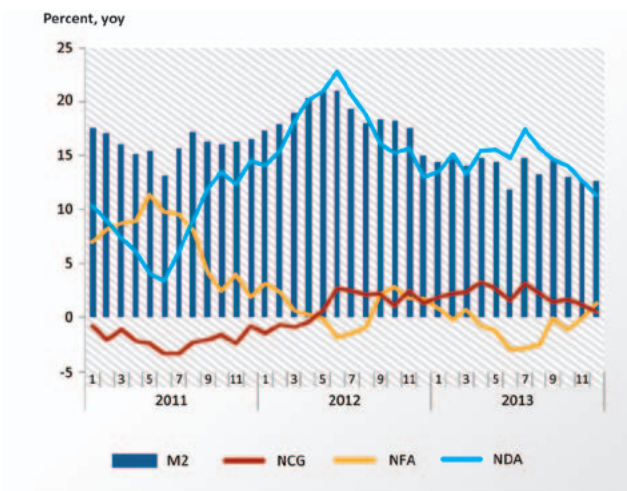


Chart 10.18. M2 Growth and Its Affecting Factors

began to widen in the second half of 2013, consistent with depreciation in the exchange rate. The increase in NFA during the second half of 2013 contributed to the increase in the NFA of the monetary system during a stable trend in bank NFA at a negative level. At the end of 2013, NFA recorded a positive contribution in M2 growth (Charts 10.17 and 10.18).

The monetary policy influencing monetary aggregates was also reflected in the developments in velocity of money during 2013. This velocity of money was an indication of the number of transactions among individuals in purchases of goods and services. In 2013, velocity of M1 showed a modest upward trend, while velocity of M2 was generally stable. The stronger velocity of M1 pointed to an increase in total transactions among individuals within the economy (Chart 10.19).

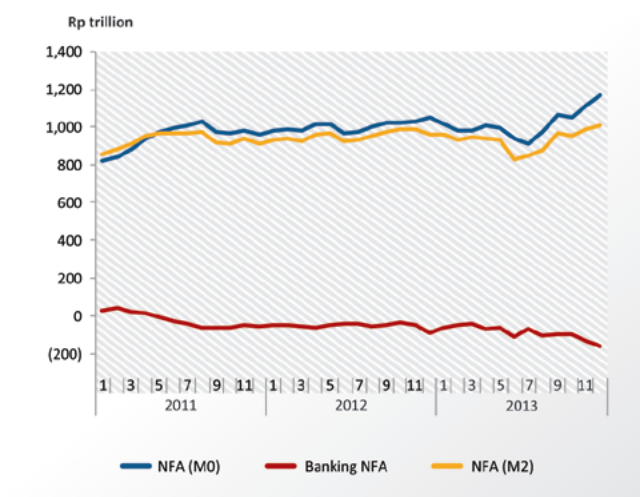


Chart 10.17. Net Foreign Assets

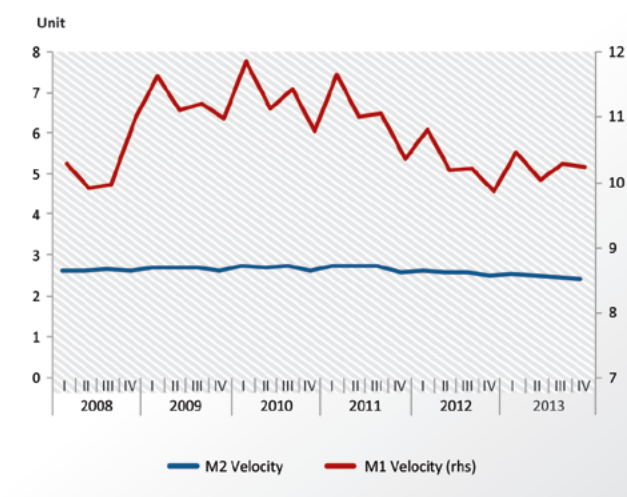


Chart 10.19. Money Velocity



Macroprudential and Microprudential Policy

Bank Indonesia adopts macroprudential policy as part of its policy mix. Macroprudential policy is directed toward preventing and mitigating systemic risk - which can endanger the financial system stability - as well as supporting efforts in managing domestic demand. Efforts to safeguard the financial system stability were also underpinned by microprudential policy. In general, these policies can uphold the financial system stability, thus supports the course of domestic economic adjustments and is conducive to the process of transferring the supervisory function to the Financial Services Authority.

The role of financial system stability is strategic in managing economic sustainability. The financial system stability does not only play a role in supporting the intermediary function and financing the economy. More than that, the financial system stability can function as a medium through which the effectiveness of monetary policy transmission is strengthened and simultaneously be absorbent the risks in the event of economic turmoil so that the economic adjustment process can be assured.

Amidst strong pressure on economic stability and heightened risks on economic growth sustainability, in 2013 Bank Indonesia adopted macroprudential policy as part of its policy mix to respond to these economic challenges. Macroprudential policy was aimed at preventing and mitigating systemic risk - which can endanger the financial system stability - as well as supporting efforts in managing domestic demand. In this regard, macroprudential policy was directed toward ensuring resiliency of the financial system, reinforcing the intermediary function, as well as improving access to and efficiency of the financial system. In 2013, Bank Indonesia implemented a number of macroprudential policies covering enhancement on Loan to Value (LTV) policy, amendment on secondary reserve requirements and statutory reserve requirement Loans to Deposits Ratio for commercial banks, and Prime Lending Rate transparency policy.

Efforts to safeguard the financial system stability were also underpinned by microprudential policy to establish healthy and prudent banking conditions. A number of banking microprudential policies issued in 2013 were, among other things, concerned with strengthening the capital structure and banking sector competitiveness, improving supervision of the banking sector, establishing better corporate governance, improving transparency and implementation of the Anti Money Laundering Program and Combating the Financing of Terrorism. Bank Indonesia also undertook supervisory actions in the banking sector to control the pace of lending growth which was deemed excessive in a number of sectors. In pursuance of widening access to the financial sector, Bank Indonesia implemented inclusive financial policy for micro, small and medium scale enterprises.

The implementation of macroprudential and microprudential policies, in addition to other policies, were able, in general, to safeguard financial system stability. This, in turn, was able to uphold the course of domestic economic adjustments and be conducive for the transferring process of supervisory function from Bank Indonesia to the Financial Services Authority. Toward

the end of 2013, the function and responsibilities for regulating and overseeing microprudential banking were transferred from Bank Indonesia to the Financial Services Authority. Bank Indonesia has coordinated with the Financial Services Authority to ensure smoothness of the process so that regulatory and supervisory operations on the banking sector can perform normally. Various preparatory steps were taken in order to minimize the risk of potential problems arising in the financial system during transition period and pursue strengthened macro-microprudential coordination to achieve the financial system stability. In the future, a legal basis is needed to ensure that Bank Indonesia and the Financial Services Authority are able to undertake their roles in safeguarding the financial system stability as stated by the mandate for each institution. Reliable integrated information system and excellent coordination also need to be strengthened in order to support the smooth exchange of data and information flows between these two institutions.

11.1. Macroprudential Policy

Macroprudential policy, in general, is directed toward preventing and mitigating systemic risk, supporting the intermediary function, in addition to improving access to the financial system and its efficiency. At the same time, macroprudential policy is also directed toward supporting the management of domestic demand such that economic activities can be more balanced.

This policy was implemented by using various instruments, namely: (a) instruments regulating liquidity risk such as stipulating statutory reserve requirements and adequate liquidity for systematic banks; (b) instruments regulating interest rate risk and market risk such as forex exposure limits or net open position; (c) instruments regulating credit risk on an industry scale, such as the loans to value ratio and the debt to income ratio; (d) managing the intermediary function, among other ways by setting the loans growth target, as well as prime lending rates transparency; (e) instruments regulating capital, among others by determining additional capital for systemic bank and capital buffers for anticipating the possibility of cyclical conditions and crises.

In line with these policies, in 2013 Bank Indonesia issued a number of macroprudential policies. Bank Indonesia revised its Loan to Value (LTV) policy for conventional banks and its Financing to Value (FTV) policy for syariah banks in relation to residential loans and property-backed

consumption loans¹ which had earlier been issued in 2012. The aim of perfecting the LTV/FTV policy is to strengthen the banking system resiliency by putting forward the prudential principle in channeling residential loans /apartment loans (KPR/KPRS). Bank Indonesia also revised the policy on secondary reserves and the LDR reserve requirements so that banks can keep a balance between liquidity adequacy and optimally performing their intermediary function. Besides that, Bank Indonesia required transparency on information concerning the prime lending rates of banks, to give clarity to the customer and facilitates customer in assessing the benefits and costs of loans offered by the bank.

Loan to Value (LTV) and Financing to Value (FTV) Policies

In the framework of safeguarding the financial system stability and strengthening the banking system, at the end of the first quarter of 2012, Bank Indonesia issued a regulation stipulating tighter risk management on banks concerning residential loans². This ruling, among other things, regulates the maximum LTV for KPR and KPRS above 70 m².

Nonetheless, the impact of this ruling on the growth of KPR/KPRS was still limited, as reflected in still high demand for residential property. This is indicated from the high growth in KPR/KPRS loans, although it has slowed down. Until September 2013, growth in KPR/KPRS reached 31.9%, higher than the total loans growth of 23.1%. These high growth on KPR/KPRS indicated that demand for residential property, either to live in or to invest, increased.

The strong demand for residential property in Indonesia is reflected in Bank Indonesia's survey (year 2013) on the investment preference of Indonesian people showed a greater preference to opt property as an investment vehicle. The greater preference to invest in property has been influenced by expectations of higher property prices. Last year, 49% of respondents selected property as their preferred investment choice over gold, stocks/ mutual funds and deposits. For the upcoming one-year

investment plan, 64% of respondents chose to invest in property compared to other option, with 81.1% of the respondents giving a quite rational reason, namely the expectations of price increases. The survey also reveal that not all purchases of houses or apartments using Residential Loans (KPR) or Apartment Loans (KPA) are to fulfill the primary needs of consumers. Some 13.9% of respondents used their first KPR/KPA loan to finance a residential property purchase for investment/ rental purposes, 65% of the second KPR/KPA loan was used to finance a residential property purchase for investment purposes and 100% of the third KPR/KPA loan was used to fund a residential property purchase for investment purposes.

The continued uptrend in property demand in line with expectations of higher property prices poses a potential risk which needs to be monitored. The expectations of further increases in property prices has encouraged consumers willing to purchase property regardless expensive prices offered, in the belief the price will continue to rise in the foreseeable future. In the absence of regulations, banks would likely be willing to provide property backed loans with a high LTV.

It is based on expectations that property prices will increase, thus can cover the expected cash inflow if the debtor fails to meet their obligations. The development will push up house prices even higher and become unfeasible for low incomes community. Higher house prices also can lead to an increase in KPR through bank lending. This could potentially trigger financial instability in the event of default by customers at the time when house prices are falling.

In 2013, the high growth in KPR/KPA was accompanied by high growth in the Residential Property Price Index (IHPR) which rose by 11.2% (yoy), 13.51% (yoy) and 14.64% (yoy) in the first, second and third quarter of 2013, respectively (Chart 11.1). In several cities, increases in residential property price even higher than national. In the first quarter of 2013, the increase in the IHPR already surpassed the GDP per capita growth in Indonesia. Excessive increases in residential prices can lead to unattainable home prices by most people. In this regard, Bank Indonesia aimed to balance the interests of property industry and the interests of public at large who need an affordable and decent house to live.

Looking at the risks associated with expectations of further increases in residential property prices, Bank Indonesia in 2013 revised its LTV/FTV policy for residential ownership loans and collateralized property consumer loans which

1 Bank Indonesia Circular Letter No.15/40/DKMP dated 24 September 2013 concerning the Application of Risk Management toward Banks Providing Loans or Financing for Housing Ownership, Consumption Loan Backed by Property and for Motor Vehicle Ownership.

2 Circular Letter No.14/10/DPNP dated 15 March 2012 concerning the Application of Risk Management to Banks Providing Loans for Housing Ownership (KPR) and Motor Vehicle Ownership (KKB).

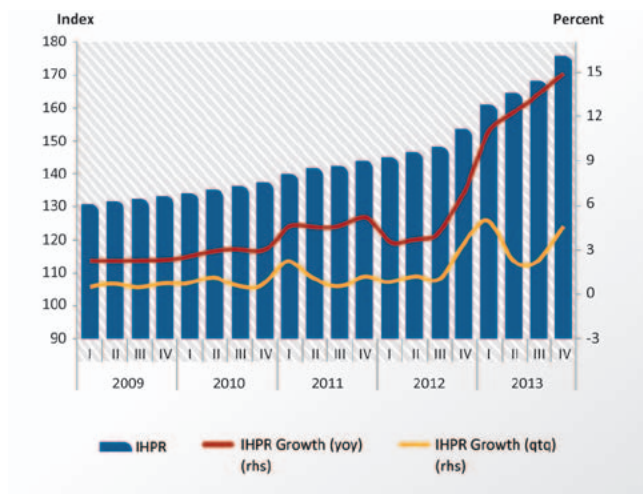


Chart 11.1. Residential Property Price Index (IHPR)

was initially issued in 2012. As the new regulation is in place, the credit risk on residential property is expected to lessen. This LTV regulation also preserve that the growth of property sector is sustainable over the medium and long term. This reflects the importance of the property sector as one of the main sectors driving economic growth.

Compared to previous policy, revisions to the LTV/FTV policy which became effective as of September 30, 2013 regulate on a wider scope. This policy not only considers aspects of prudential banking in risk management, but also incorporates elements of consumer protection and equal opportunity to get financing (see Box 11.1. Implementation of Loan to Value).

Given that the portion of bank lending for second, third, (and so on) KPR is still below 20% of the total KPR, room for banks to extend residential loans are ample. Similarly, there are still plenty of opportunities for participants in the property sector because the needs of housing are still very large, especially for small and medium sized houses which are within the range of most people's budgets. The policy gives barriers to the use of KPR for large sized houses as well as those using more than one KPR loan. This is intended to encourage the building of small and medium sized houses which, in turn, could lessen the housing backlog. At the same time, individuals which is the market for large sized houses is considered has the ability to keep acquiring their desired home regardless of Bank Indonesia's policy.

The recent revisions to the LTV policy regarding new residential loans became effective on September 30, 2013. Although the impact is still limited, the KPR growth in

December 2013 slowed to 26.4% (yoy) from 31.0% (yoy) in August 2013. The drop in KPR growth was most prominent in KPR loans for homes above 70m² and KPRS (Chart 11.2). Bank Indonesia will continue to monitor this condition periodically, evaluate and take actions that are deemed necessary to readjust policy with economic developments, either domestic or global.

With revisions to LTV policy in 2013, credit risk is expected to be mitigated, such that the property sector can grow sustainably. Besides that, people with middle to low incomes will have a greater opportunity to purchase a decent home. With the aim of improving consumer protection in the property sector, this policy also regulates that the payment of installments should be in accordance with developments on construction of the house or apartment which is financed. Thenceforth, the risk borne by customers if the developers were to be default can be minimized.

Revisions to secondary reserve requirements and the LDR reserve requirements

Banks, as financial intermediaries, play an important role in facilitating economic growth. Bank lending is one source of funding the economic activity. On average, bank lending growth in the first semester of 2013 posted around 22.0% compared to 23.1% at the end of December 2012. Excessive credit expansion, or surpassing that needed by the economy, can potentially increase the credit risk and liquidity risk of the banking sector at the same time.

To anticipate an increase in credit risk and heightened pressures on banking liquidity, Bank Indonesia adopted a policy to strike a balance between the pace of assets growth and adequate bank liquidity. The step taken by Bank Indonesia was to undertake readjustments to secondary reserve requirements and the LDR reserve requirements³ (see Box 11.2. Implementation of secondary reserve requirements and the LDR reserve requirements).

In principle, the policy on secondary reserve requirements was implemented by Bank Indonesia to ensure adequate liquidity in the banking sector to

³ Circular Letter No.15/41/DKMP dated 1 October 2013 concerning on Secondary Statutory Reserves (GWM) and Statutory Reserves Loan to Deposit Ratio (GWM LDR) in Rupiah.

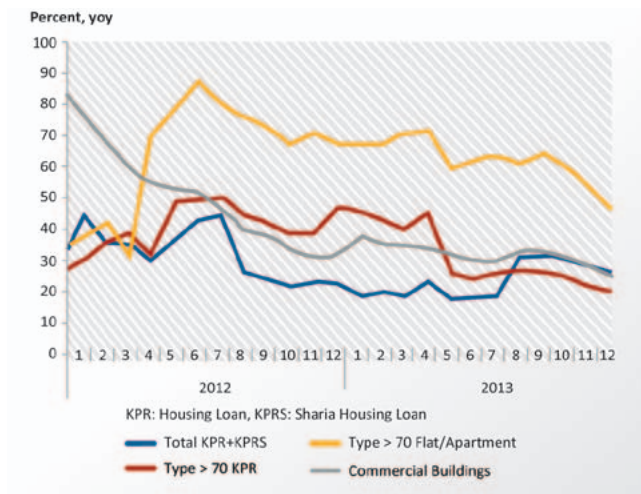


Chart 11.2. KPR and KPRS Growth

promote monetary stability. Revisions to secondary reserve requirements came into effect in October 2013, by raising the secondary reserve requirements progressively from 2.5% to 4% of third party funds. This policy was intended to ensure that banks had sufficient reserves of liquidity to anticipate various risks related to banking operations such as daily liquidity needs, fund withdrawals, transfers or clearing, yet still able to perform their intermediary function while taking into account capital and liquidity conditions. This was also in line with the issuance of Bank Indonesia Certificates of Deposit as one of monetary operation instruments. To increase the amount of liquid assets which can be taken into account in fulfilling secondary reserve requirements, Bank Indonesia Certificates of Deposit have been included as a component of secondary reserve requirements since September 1, 2013. This policy is intended to encourage banks to place their funds in high quality and liquid assets. As such, in the event of liquidity problems, banks can immediately use these assets, among other ways through repo with Bank Indonesia.

Meanwhile, the revision of the LDR target in determining the LDR reserve requirements was aimed at controlling credit expansion in the banking sector by reducing the upper limit of LDR from 98% to 92%, while keeping the LDR lower limit unchanged at 78%. The LDR upper limit was acted as disincentive for banks which had a LDR above 92% with a CAR less than 14%, while the LDR lower limit was targeted on banks with a LDR less than 78%. Through this policy, banks are expected to be able to preserve a balance between adequate liquidity and performing their intermediary function optimally. The change in the LDR reserve requirements was not only

aimed at reining in aggressive credit expansion but also to increase bank's awareness on their capital conditions while acting out their intermediary function.

Policy on Prime Lending Rate transparency

One aspect to improve the financial system efficiency is transparency, since it allows the public to easily assess the behaviors of the financial industry participants. As developments in international standards have shown, transparency is strongly believed can create market discipline.

One important aspect of transparency in the banking industry is the setting of interest rates. The customers choices of banking products are influenced by its benefit, cost and risk. Thus, it becomes highly relevant that Bank Indonesia issues a policy on Prime Lending Rate transparency because prime lending rate is widely used by the public.

Transparency on Prime Lending Rate information is needed to provide explanations to customers and make it easier for customers to assess the benefits and costs of loans offered by banks⁴. Besides that, Prime Lending Rate is needed as an indicator for the level of loan rates which will be charged to customers who submits a credit to the bank. Because of that, Bank Indonesia stipulates that transparency on information concerning the Prime Lending Rate information covers all loan segments, namely the corporate segment, retail loans, micro loans, and consumption loans (KPR and non-KPR).

Supervisory Action Policy

To support the objective of these macroprudential policies, Bank Indonesia also strengthened banks' surveillance and supervision. Surveillance of the financial system stability, including stress tests, was undertaken to identify potential credit risk, liquidity risk and market risk, which might arise if there is a change in policies or a shock on the economy which originates from either internal or external factors. Meanwhile, the supervisory action was, among other things, taken to ensure that the bank intermediary function was carried out as expected and in accordance

⁴ Circular Letter No.15/1/DPNP dated 15 January 2013 Regarding Transparency of Prime Lending Rate (SBDK).

with the needs of the economy. This was also aimed to ensure that banks were having sufficient liquidity as well as adequate capital to withstand the potential risks.

11.2. Microprudential Policy

In addition to macroprudential policies, Bank Indonesia also enacts microprudential policies. In between preparations to transfer the supervisory function of banks to the Financial Services Authority (OJK), Bank Indonesia enacted several microprudential policies in order to: support the achievement of a healthy banking sector, assist in the process of smoothly transferring the supervisory function of banks, and ensure the routine regulatory authority of banks continued normally⁵. Several microprudential policies enacted in 2013 were, among others, related with strengthening the capital structure and competitiveness of the banking sector, improving supervision of the banking sector, enhancing good corporate governance, as well as improving transparency and implementation of the Anti-Money Laundering and Prevention of Terrorism Financing program.

Policy on Supporting Banking Resilience and Competitiveness

With the intention to strengthen the resilience and competitiveness of banking sector, during 2013, Bank Indonesia revised its policy on Minimum Capital Adequacy Requirement (CAR) for banks in accordance with the Basel III international standard⁶. This policy of strengthening capital was a preventive effort by Bank Indonesia to ensure national banks resilience in the face of global economic uncertainty and to dampen excessive loan growth, thereby safeguarding financial system stability. This particular capital policy, which would be implemented gradually starting from 1 January 2014, is addressed towards strengthening banks capital structure, both in terms of quantity and quality.

In line with this policy, with respect to size, banks are required to create additional capital as a buffer, in the forms of: capital conservation buffer, counter cyclical capital buffer, and capital surcharge. Capital conservation buffer is additional capital which performs as buffer in

the event of losses during crisis periods. This policy is specifically applicable for commercial banks which are performing certain business activities. Meanwhile, capital surcharge will specifically be imposed on commercial banks which are deemed as Domestically Systemic Important Banks (DSIBs). Capital surcharge is meant to mitigate negative impacts from the failure of any systemic bank on financial system stability and economy, by increasing banks' ability to absorb loss. Other buffer capital, i.e. the counter cyclical capital buffer, is applicable for all banks as an effort to prevent excessive credit growth from disrupting financial system stability.

Implementation of these three forms of additional capital would be done gradually in order to provide banks with sufficient time to generate the additional capital. To enhance the quality of banks capital, Bank Indonesia deemed it necessary to adjust the components and requirements of capital instruments along with capital ratios in accordance with Basel III. These efforts were undertaken so that banks have ample room to absorb potential loss arising from credit risk, market risk, operational risk, and other risks, i.e. liquidity risk and other material risks. Implementation of Basel III is also done to fulfill Indonesia's commitment as a member of the G-20 and the Basel Committee on Banking Supervision (BCBS).

The policy above is aligned with efforts to increase competition among national banks in preparation for the implementation of ASEAN Economic Community (AEC) in 2015. As an effort to enhance resilience, competitiveness, and efficiency of national banks, Bank Indonesia revised its regulation on Equity Participation by banks⁷. This policy was enacted in response to developments within banking activities and global dynamics which necessitate more scope for banks to broaden their business activities, in accordance with their respective strategic business plans and efforts to enhance competitiveness within domestic banking industry.

Through the policy, Bank Indonesia regulates equity participation activities, including, among others, required health level and maximum amount of allowable equity participation. Furthermore, Bank Indonesia also provides room for banks to divest their equity participation, either on their own initiative or as required by prevailing regulations. On another note, Bank Indonesia deems equity participation as involving potential risk,

⁵ Financial Stability Report No.22, March 2014.

⁶ Bank Indonesia Regulation No.15/12/PBI/2013 dated 12 December 2013 Regarding Minimum Capital Adequacy Requirement (KPMR) of Commercial Banks.

⁷ Bank Indonesia Regulation No.15/11/PBI/2013 dated 22 November 2013 concerning on Prudential Principles in Equity Participation of Commercial Banks.

and therefore obliges banks to have adequate risk management. Through this policy, banks are allowed to perform equity participation into financial services related companies, including investing in mandatory convertible notes.

In line with increasing role of various parties in supporting banking transactions, Bank Indonesia realized that some efforts are needed so that control over banking transactions can be better integrated. One of the efforts for achieving that goal is by providing banks with more opportunities for equity participation through their subsidiaries into financial services related supporting companies. It is expected that this policy would assist banks in broadening their equity participation activities, and therefore benefiting banks in enhancing their competitiveness. Nevertheless, Bank Indonesia continues to monitor development of this policy so that broadening of business activities by banks must be balanced with improving quality of their respective risk management. This is important in order to anticipate the external risks which might arise from those subsidiaries and financial services supporting companies, which might ultimately impact the risk profile of the respective bank.

The necessity for enhanced resilience and competitiveness is also needed by Indonesian banks to anticipate the dynamic development of the regional and global economy. Hence, in order to enhance resilience and competitiveness, a strong national banking structure is necessary. In addressing this challenge, Bank Indonesia deemed it necessary to issue a regulation governing bank ownership structure in the form of single presence policy throughout Indonesian banking sector. This regulation stipulates approaches to implement the single presence policy, comprising merger or consolidation, formation of a bank holding company, and establishment of a holding company. This regulation also governs incentives for merger or consolidation to comply with the single presence policy, along with the procedures and time limits for undertaking such merger or consolidation, in addition to Bank Indonesia authority to perform fit and proper tests of candidates for controlling shareholder and/or candidates for management of the banks resulting from such merger or consolidation.

Efforts to strengthen the banking system have become more urgent due to the impending implementation of AEC for the banking sector beginning in 2020. This momentum represents both opportunities and challenges which must be utilized and anticipated to contribute positively towards progress of the national banking industry. With the implementation of AEC in 2020, which allows banks

with certain qualification (Qualified ASEAN Banks – QAB) to freely operate anywhere within the ASEAN region, national banks therefore needs to prepare themselves as early as possible through enhancing their resilience and efficiency in order to compete at the regional level. Furthermore, those global economic developments impacts will become apparent in the form of more complex business activities and increasing necessity to expand banks branches network.

On the other hand, the global economic developments above will impact banks in the form of more complex business activities and increasing necessity to expand banks branches network. The greater complexity in business activities will be reflected in increasing complexity of foreign exchange business activities. Therefore, national banks need to enhance their capital strength in order to anticipate various risks arising from the greater complexity of business activities and they also need to expand their branch network utilizing funding sources other than Third Party Funds. In response to the potential impact of regional financial sector integration, Bank Indonesia has already prepared implementation rules which more prudently govern banking activities based in foreign exchange⁸.

Greater cross-countries interaction will also lead to increased forex transactions domestically. Structurally, Indonesian forex market is in a state of excess demand due to corporation needs to pay for imports and to service foreign debts. This condition needs to be carefully managed because excessively high forex demand will affect domestic forex supply which, in turn, can potentially lead to financial market instability. Supply of forex in Indonesia is usually provided by forex receipts, primarily from export proceeds.

To optimize potential forex receipts generated through export proceeds, Bank Indonesia issued a policy on bank business activities related to trusts. Since the implementation of this policy, three banks have already received approval to perform trust activities. The three banks are BNI, BRI, and Bank Mandiri. In performing their activities, those three banks have formed their trust business units complete with the respective human resources and systems infrastructure (trustee). In supporting the trustee policy, during 2013, Bank Indonesia regulated the consolidated operating

8 Circular Letter No.15/27/DPNP dated 19 July 2013 concerning the Requirement for Commercial Bank conducting their Business Activities in Foreign Exchange .

statements of trusts and obliged banks to submit the report periodically for each trustee business unit to Bank Indonesia, as the basis for supervisory analysis of trust activities development⁹.

Policy on Strengthening Banking Supervision

In the context of supervision, microprudential policy is intended to improve banking system health in order to support financial system stability. Learning from past experience in handling troubled banks, Bank Indonesia considers it necessary to handle troubled banks at the earliest stage, even before it has been categorized under intensive supervision. In response to this matter, Bank Indonesia enacts a policy which regulates the determination of supervisory status and supervisory action plan for conventional commercial banks¹⁰. This policy is a preventive effort by Bank Indonesia to overcome bank problems at the earliest stage so that it doesn't impede the banks ongoing operations, and also include the harmonization of several parameters in determining banks supervisory status related to changes in their respective health level based on the latest risk-based method of Risk Based Bank Rating.

Increased supervision needs to be done during banks' normal condition if there are significant indications of problems which might potentially cause any particular bank to be placed under intensive supervision. Bank Indonesia also expanded its coverage criteria for banks under intensive supervision with possible time extension. This expanded coverage criteria is not only in the form of quantitative criteria but also in the form of qualitative criteria (based on a certain level of banks health). In order to push banks management to become more committed in resolving their problems, banks which are given time extension will have more stringent control measures imposed on them if the management is unable to resolve the problems during the time extension. This policy is also a harmonization of several parameters in determining the status of bank supervision; due to change in the methodology for assessing banks health level from CAMELS approach to Risk Based Bank Rating approach.

9 Circular Letter No.15/10/DPNP dated 28 March 2013 concerning Commercial Bank Trust Activity Report to Bank Indonesia.

10 Bank Indonesia Regulation (PBI) No.15/2/PBI/2013 dated 20 May 2013 concerning on Determination of Status and Follow-up of Bank Supervision.

Policy on Strengthening Implementation of Good Corporate Governance

Efforts to create a healthy banking system, aside from being pursued through improving banks financial conditions, was also pursued through strengthening the banking system by encouraging banks to implement good corporate governance as well as prudential principles. In this regard, Bank Indonesia enacted several policies which support enhancement of Good Corporate Governance (GCG) both for commercial banks and rural banks.

To improve banks performance, safeguard the interests of stakeholders, and increase compliance with prevailing regulations and ethical values within the banking industry, commercial banks are required to perform their business activities in conformity to the GCG principles. Implementing GCG within the banking industry should always be based on the five basic principles, namely: transparency, accountability, responsibility, independency, and fairness. In line with the assessment approach using Risk Based Bank Rating (RBBR), which also includes GCG aspects, Bank Indonesia needs to harmonize its GCG policy with the existing regulations¹¹.

Bank Indonesia is also making efforts to strengthen GCG at rural banks through, among others, demanding transparency of rural banks financial conditions, and enhancing policies on the fit and proper test process of candidates for owners, commissioners, and directors of rural banks^{12,13}. Policy on the transparency of rural banks financial conditions require them to issue financial statements to the general public in accordance with Indonesian Financial Accounting Standards for Non-Publicly-Accountable Entities (SAK ETAP) and Rural Banks Accounting Standards (PA BPR).

The adoption of these accounting standards has been accompanied by adjustments to the periodic reporting system for rural banks (Published Annual Report¹⁴ and

11 Circular Letter No.15/15/DPNP dated 29 April 2013 concerning the Implementation of Good Corporate Governance for Commercial Banks.

12 Bank Indonesia Regulation (PBI) No.15/3/PBI/2013 dated 21 May 2013 Regarding Transparency of Rural Banks Financial Condition.

13 Circular Letter No.15/45/DPNP/2013 dated 18 November 2013 concerning the Amendment of Circular Letter No.14/36/DKBU dated 21 December 2012 concerning Fit and Proper Test of Rural Banks.

14 Circular Letter No.15/43/DPNP dated 21 October 2013 concerning the Amendment of Circular Letter No.15/29/DKBU dated 31 July 2013 concerning Annual Report and Financial Publication Report of Rural Banks.

Monthly Report¹⁵). The various policies on rural banks transparency are intended to increase public confidence towards the rural banks which, ultimately, will optimize rural banks' role in providing credit to the MSME sector. Furthermore, transparency in the rural banks finances will also make it easier for commercial banks in assessing rural banks that may potentially be partners in channeling loans through the linkage program scheme in order to increase lending expansion towards MSME.

Meanwhile, policy enhancements to strengthen the fit and proper test process of candidates for owners, commissioners, and directors of rural banks is another effort by Bank Indonesia to strengthen the managerial process of rural banks so that they are supported by human resources with sound integrity and commitment as well as high ability to develop healthy rural banks. This effort has been realized through tightening the requirements for the fit and proper tests of candidates for owners, commissioners, and directors of rural banks, as well as imposing tougher sanctions on owners, commissioners, directors, and other executives who commit violations. This regulation is expected to increase confidence and protection for people within the banking industry, particularly rural banks.

In line with the increasingly complex business and risk profile, as well as to anticipate the impact of global economic developments, national banks need to improve their ability and effectiveness in managing credit risk, minimizing potential losses from funding provisions, and requiring higher rating for prime banks which are issuing Stand by Letter of Credit (SBLC) that is treated as cash collateral. Generally, the management of credit risk is performed by banks through determination of credit quality. Furthermore, in order to minimize loss which potentially arises from providing loans, banks can restructure outstanding credit towards debtors who retain good business prospects and ability to pay while simultaneously heeding to prudential principles and applicable financial accounting standards.

Banks, as the type of financial institutions which performs financial intermediation are required to present a set of financial statements which are accurate, comprehensive, and reflect the respective bank performance as a whole, and in accordance with applicable accounting standards. In order to maintain their business continuity, banks need to manage their

credit risk exposure at an acceptable level through, among others, preserving assets quality and continually recalculating their allowance for impairment loss. Furthermore, it is impossible to deny the fact that global economic conditions can affect the conditions and performance of the national banks. In response, Bank Indonesia has taken preventive steps to safeguard and protect the banking industry conditions. It was realized through revision of regulations concerning asset quality¹⁶.

As a follow-up of macroprudential regulation concerning the transparency of Prime Lending Rate, Bank Indonesia has also enhanced the regulations concerning Monthly Reports of Commercial Banks which are periodically submitted by banks to Bank Indonesia¹⁷. In addition to the enhancement on the Reporting Form for Prime Lending Rate, the regulation also enhanced the Specific Risks Report— exposure to securities (trading book).

Policy on Implementation of the Anti Money Laundering and Prevention of Terrorism Financing (AML/TF) Program

High dynamics of financial transactions, at national, regional and global level, in addition to increased complexity of financial products, activities, and banking IT, have resulted in heightened risk for banks to become conduit for money laundering and terrorism financing. Aware of this and in line with efforts by international agencies in improving to regulations and international standards concerning anti money laundering and prevention of terrorism financing, Bank Indonesia had enhanced on the policy and regulations concerning Implementation of the Anti Money Laundering and the Prevention of Terrorism Financing Program (AML/TF). The AML/TF program is applicable to commercial banks, and requires banks to establish Guidance for the Implementation of the AML/TF Program, in reference to the Guidance for the Implementation of the AML/TF Program as stipulated by Bank Indonesia¹⁸. This policy

15 Circular Letter No.15/39/DPNP dated 17 September 2013 concerning the Amendment of Circular Letter No.15/20/DKBU dated 22 May 2013 on Monthly Reports of Rural Banks.

16 Circular Letter No.15/28/DPNP dated 31 July 2013 concerning Asset Quality Determination of Bank.

17 Circular Letter No.15/14/DPNP dated 24 April 2013 concerning the Third Amendment of circular letter No.8/15/DPNP dated 12 July 2006 concerning Periodic Reports of Commercial Banks.

18 Circular Letter No.15/21/DPNP dated 19 July 2013 concerning the Application of Anti Money Laundering and Prevention of Terrorism Funding Programs for Commercial Banks.

is intended to prevent the use of banks as conduit for money laundering and terrorism financing.

11.3. Policy on Financial Inclusion

Financial inclusion is a holistic activity that aims to eliminate all barriers faced by the general public in terms of access to financial services, through appropriate services model, relevant products, and easy mechanism¹⁹. The provision of such financial services expands financial inclusion, and also positively impacts the banking sector. By providing financial inclusion, banks can diversify their liquidity risk and credit risk, whilst also increasing the level of competition within retail banking. Diversification of liquidity risk occurs through acquisition of new funding sources, gathered from still-unbanked people. Diversification of credit risk occurs through the opening of new market for potential debtors, namely the channeling of micro loans to previously unbanked people.

Financial inclusion also attempts to improve people's financial literacy, especially their ability to manage their personal finances by using appropriate financial products services. This, in turn, will help people improve their bargaining position in regards to selecting the appropriate products and services from various banks. Furthermore, good financial management can certainly help lessen the tendency for consumptive behavior and reduce the probability of defaulting. Overall, this effort will contribute in improving the efficiency of banks.

Bank Indonesia had pursued financial inclusion policy since 2010 to help improve the capability and welfare of Indonesian households. Financial inclusion also attempts to lessen the perception discrepancy between banks and unbanked people. On one hand, banks view unbanked people as being less profitable, whilst, on the other hand, a perception is built that bank are not for the poor. This perception was built because access to financial services is not easy to carry out, involving significant costs and fairly lengthy processes. It has discouraged people being involved with banks (financial exclusion). Meanwhile, banks view that limited historical data, characteristically low transaction value

with high frequency, as well as unstable incomes render this particular group of people as potentially risky and less profitable customers. In addition to low level of financial literacy and minimum information, Indonesia's demographic and geographical conditions are another factors limiting financial access, bearing in mind the large number of people on low incomes who are living in isolated areas.

Bank Indonesia attempts to improve financial access by supporting innovation and strengthening the payments system infrastructure system through the application of information technology and local economy network units. The efforts have been realized through a concept called branchless banking, i.e. banking activities whereas the customers do not need to come to the banks' branches but instead through any available agent nearby and the usage of cellular telephones. This concept is adopted due to the large numbers of local economic units and high penetration of cellular phones among the people.

As the initial step, a branchless banking trial test was undertaken in 2013 with the intent to bring about easier access to financial services towards all areas of Indonesia. The trial test was undertaken by five banks and two telecom companies starting from 15 May 2013 until the end of November 2013 throughout five provinces, namely: West Java, Central Java, East Java, Bali, and South Sumatra. The trial test was carried out to ensure that the business model being developed was relevant to Indonesian conditions, while simultaneously gathering input in formulating the regulations. Implementation of branchless banking is expected to reach out unbanked or marginal individuals wherever they are in an affordable and safe manner, so that the service can save time and money.

Based on the results of the pilot project which went well, and considering the practices in various countries, in addition to the future trend and potential going forward, the concept of branchless banking was updated into Digital Financial Services (DFS)²⁰. DFS is the conduct of payment system and financial services through technological means, such as mobile-based devices or web-based tools.

¹⁹ The right of every individual to have access to a full range of financial services in a timely, convenient, informed manner and at an affordable cost in full respect of his/her personal dignity. Financial services are provided to all segments of the society, with a particular attention to low-income poor, productive poor, migrant workers and people living in remote areas. (National Strategy for Financial Inclusion, 2012)

²⁰ Digital financial services is the provision of some mix of financial and payment services that are delivered and managed using mobile or Web technologies and a network of agents (Old Problems, New Solution: Harnessing Technology and Innovation in the Fight against Global Poverty, The 2012 Brookings Blum Roundtable Policy Briefs, Cameron Peake, Mercy Corps, 2012)

As for the main targets for these services are unbanked and underbanked people²¹. Bank Indonesia initiated DFS by using electronic money products which can be transacted within the local economic units by utilizing the vast networks of telecommunication and mobile phone, whose penetration is fairly extensive across Indonesia. The network of local economy units are agents who are native local residents with established businesses within permanent locations, and act on behalf of banks. Implementation of DFS is supported by regulations concerning DFS, which will be integrated within the electronic money regulations to be issued at the beginning of 2014.

Policy on financial inclusion was also conducted by improving the people's financial literacy through financial education. During 2013, financial education was conducted with a focus on making financial services as part of the people's basic living needs²². In this regard, Bank Indonesia conducted financial education by stressing the importance of good financial management as well as the importance of saving money. Those educational activities were carried out by instilling a sense of purpose and visualizing some experience that are easy to understand and put into practice. Therefore, some activities are done related to good financial management and the easiness of opening a saving account. This model is expected to encourage saving habit which are continuous and sustained compared to opening an account purely due to the incentives of prizes.

Implementation of the educational programs for the people has elicited positive responses, including from Indonesian Migrant Workers (TKI), students, as well as fishermen. These group of people acknowledge that financial education materials provided were easy to understand and easily applicable for daily life. Particularly for students, the educational programs were also carried out through the Indonesian Savings Movement campaign and integration with central banking education materials. A module on financial management is inserted within the central bank education materials for the Economics study curriculum, which applies nationally for the high school level.

21 Underbanked people are those who already a bank customer but in a very limited service due to some reasons , for example, they are just as savings customer, not yet able to enjoy other banking services optimally, or still rely on non-formal financial services.

22 At an early stage (years 2008-2012), financial education was done through mass campaign to create awareness to savings and it was emphasized on the introduction of banking products and consumer protection.

These financial education efforts were also accompanied by the development relevant banking products for those groups of people, such as the TabunganKu (MySavings) product, a saving product that does not incur any administration fees and low initial deposit for opening. TabunganKu has become a product offered by 75 commercial banks and at the end of third quarter of 2013 has registered 5.2 million accounts, increasing by 43.4% compared with 3.6 million accounts at the previous year. In nominal terms, the TabunganKu program has accumulated Rp10.6 trillion of third party funds, increasing from Rp6.7 trillion at the end of 2012. This is a reflection of the high public interest for the TabunganKu product as a positive response towards the financial education program which had already been conducted. In addition to that, surveillance of the development of the TabunganKu product, has demonstrated the need to improve the product features and the banking innovation in order to widen its reach. An example of the innovation is the use of TabunganKu to channel funds for the government's aid program, i.e. the Poor Students Program.

Efforts to develop access were also conducted through infrastructure development to lessen the information gap through the Financial Identity Number (FIN) program and the information system for commodities. The FIN program is an effort to map the information concerning people's potential, so that banks will be encouraged to provide products and services particularly to the unbanked group. During 2013, such efforts has been initiated through a data gathering survey to develop a business model, that is sustained, efficient, and adding-value for the general public and banks. In addition, efforts to reduce the information gap were also conducted by Bank Indonesia through data on commodities information, thus helping to strengthen the bargaining position of business units or productive individuals.

Policy on Promoting the Development of Micro, Small, and Medium Enterprises

Bank Indonesia policy on promoting the development of Micro, Small, and Medium Enterprises (MSME) during 2013 was focused on giving MSME increased access to the banking sector. This goal was pursued through two main strategies, namely by improving the capacity and capability of MSME as well as by encouraging banks to channel more funds to MSME. Implementation of those two strategies was, in principle, an effort to minimize

the existing information gap between banks and MSME which has been restraining MSME's access to the banking sector. Limited financial access has hindered MSME from developing their businesses optimally, thereby limiting the contribution of MSME towards the national economy.

In the strategy framework of improving the capacity and capability of MSME, during 2013, Bank Indonesia conducted a program of cluster development based on each region's main commodities as another way to support the empowerment of regional economies. At present, 71 clusters have been developed with membership numbering 7,000 MSME spread across 41 Bank Indonesia Regional Offices. These clusters comprise 32 farming clusters, 10 livestock clusters, 19 fishery clusters, and 10 regional handicrafts clusters. The pattern for clusters development was conducted by training the cluster members and facilitating them to attain access to funding sources as well as market access. Development of these clusters has contributed towards the regional economies through the creation of job opportunities as well as regional economic centers.

Efforts to improve the capacity and capability of MSME were also conducted through a program intended to create new entrepreneurs which, at the same time, also supports the National Entrepreneurship Movement, which was proclaimed by the government on 2 February 2011. Implementation of the program to create new entrepreneurs is expected to increase the number of entrepreneurs in Indonesia, which in turn, will reduce the level of unemployment, especially among educated groups. This entrepreneurship program was implemented in stages through programs to train and nurture prospective entrepreneurs, involving both mentoring and coaching, internships/field trips, facilitating business promotion and business formalization. Evaluation result of the activities has shown that there is potential for developing entrepreneurship in Indonesia, provided that sufficient mentoring and coaching is available. During the next stage, entrepreneurs who are already established will need to be provided with access to funding sources for developing their businesses and gaining broader market access. At the end of 2013, Bank Indonesia's entrepreneurship program has created 128 entrepreneurs through its implementation across ten regions.

Strategies for encouraging banks to channel more credit to MSME was undertaken by Bank Indonesia through PBI No. 14/22/PBI/2012 concerning Provision of Loans or Financing and Technical Aid for the Development of Micro, Small, and Medium Enterprises. As a technical

guideline for this PBI, Bank Indonesia also issued External Circular Letter No. 15/35/DPAU and Internal Circular Letter No. 15/27/Intern dated 29 August 2013. Through these regulations, banks are required to have a minimum portfolio of MSME loans amounting to 20% by 2018.

In an effort to overcome limited banking information concerning the prospects and creditworthiness of MSME, Bank Indonesia initiated the establishment of credit ratings for MSME. Through the assessments of credit ratings on those MSME, banks can gather additional information with which to assess loan applications from MSME. The initiative to establish credit ratings on MSME in 2013 was undertaken through a pilot project comprising 58 mid-sized enterprises across 4 regions, namely Jakarta, Bogor, Bekasi, and Semarang, in cooperation with 3 banks and 4 ratings agencies. The results of the pilot project suggest that conformance of assessments exists between rating agencies and banks. This indicates that the credit rating method for MSME can be utilized by banks as another one tool in analyzing loan applications from MSME. Credit ratings for MSME will help banks in identifying MSME which can potentially receive funding and can be another solution in overcoming the information gap between banks and MSME.

Bank Indonesia, in cooperation with the Ministry of Agriculture, also launched an insurance scheme for cattle which is intended for MSME-scale cattle breeders. With the existence of this cattle insurance, the risk of losses at the breeder level can be mitigated, thereby increasing the bargaining position of cattle breeders towards banks. It is expected to minimize the risks arising from cattle prices increases towards Indonesia inflation due to production scarcity. Limited production of beef stems from, among others, lack of funding for the animal husbandry sector, due to banks' perceptions of high riskiness within this sector, especially the sub-sectors of cattle cultivation and breeding, which is deemed susceptible towards the risks of loss from cattle disease and death.

One of the problems which limit MSME's access to funding sources is the collateral limitation of MSME. Aware of the issue, under the umbrella of an MoU between Bank Indonesia and the National Land Agency (BPN) No. 14/1/GBI/DKBU/NK dated 27 June 2012, Bank Indonesia will work together with BPN in conducting land certification program for MSME, as a way to facilitate upgrades in land rights status for micro businessmen, farmers, and fishermen, so that the land can be used as collateral for loans. As its implementation, Bank Indonesia conducted

a land certification pilot project program during 2013 for fishermen in the North Jakarta district. The land certification program was commenced with a Rural Rapid Assessment (RRA) survey to identify regional economic potential. MSME which had already received land certification were further facilitated to banks. Other efforts conducted by Bank Indonesia in cooperation with the government is to improve the bankability of MSME, including the establishment of regional credit guarantee company, PPKD, which is tasked with providing guarantees for MSME loan, especially those with limited collateral. During 2013, two PPKD have been established, in the province of West Java and West Sumatra, thereby increasing the total number of established PPKD across Indonesia to six (with the other four in the provinces of East Java, Bali, Riau, and West Nusa Tenggara).

11.4. Transfer of Regulation and Supervision of Banks from Bank Indonesia to the Financial Services Authority

As mandated by Act No.21 Year 2011 concerning the Financial Services Authority (OJK), on 31 December 2013, Bank Indonesia transferred its duties, functions and authority in regulating and supervising the banking system. This process was closely watched by concerned parties with direct and indirect interest in the banking industry, considering the dominant role of banks within the financial sector in Indonesia.

In regards to that, as an effort to ensure that the process of transferring the functions and authority of BI to continue smoothly, Bank Indonesia coordinated with OJK in conducting preparatory steps in order to minimize the risk of disturbance within the financial system which might arise during the transition period. Preparation during the transition period and coordinated support between Bank Indonesia and OJK has assisted in making the transfer process to occur smoothly.

The preparation was commenced with the establishment of a Task Force by a mandate from the Decision of the Governor of Bank Indonesia concerning support for the smooth and effective process of transferring the supervisory function of banks from Bank Indonesia to OJK. The mandates provide the authority to, among others, set up the transfer, coordinate the problems within Bank Indonesia during the transition period, and represent Bank Indonesia in discussions with OJK. This Task Force covers several components: (i) bank supervision; (ii) bank

development, regulation, and licensing; (iii) organization, human resources, and legal; (iv) logistics, documentation and communication; (v) data and information systems; and (vi) macro-micro coordination. In performing its tasks, this Task Force worked with the Transition Team which was already formed by OJK.

In the preparatory stage of transferring the supervisory function of banks, Bank Indonesia conducted a reorganization by forming a new organizational structure for bank supervision in the form of a compartment of Bank Supervision in the Central Office, in the Regional Offices and in the Branch Offices which mirror the departmental structure of bank supervision at OJK, when the transfer of this function later becomes effective. Meanwhile, to conduct the function of macroprudential supervision, Bank Indonesia formed the Department of Macroprudential Policy and the Department of Financial System Stability.

In regards to regulation of banks, all regulations and circular letters issued by Bank Indonesia remain effective after the transfer of the regulatory and supervisory functions of banks to OJK, up until OJK decides to make amendments to those regulations. In regards to supervision of banks, Bank Indonesia has already revised the Standard Operating Procedure (SOP) for the Supervision and Licensing of Commercial Banks, Sharia Banks, and Rural Banks/Sharia Banks for the Central Office, Regional Offices, and even Branch Offices, which would become guidance effective until 31 December 2013, after which date the task is transferred to OJK. In handing over its supervisory duties, Bank Indonesia attempts to ensure that there are no significant changes towards the approach/system/methodology of bank supervision and the organizational structure of bank supervision. This is to prevent the occurrence of disturbances to the banking system.

In the framework of coordinating the exchange of data and information, Bank Indonesia has mapped the whole information system as well as technology infrastructure within Bank Indonesia, including the applications which will be utilized individually or jointly. In addition, Bank Indonesia and OJK has also prepared the network infrastructure and information technology at the Central Office, Regional Offices and Branch Offices for Bank Supervision, under the framework of information exchange and application enhancement of banking application within the micro-macroprudential areas. Bank Indonesia and OJK have already agreed to facilitate crossed access of data and information resulting from bank supervision including the formation of coordinating

committee for the exchange of information and reporting system of financial services institutions. In the future, Bank Indonesia and OJK plan to develop an integrated data management system.

Bank Indonesia is aware that support of human resources is of utmost importance, especially during the transition period so that the financial system can operate normally. To that end, through several stages since August 2012, BI has already assigned several employees within the Transition Team formed by OJK. The assignment term of the Transition Team ended on 31 December 2013. Afterwards, commencing 31 December 2013, BI would assign 1,150 employees within bank supervision working units at the Central Office, Regional Offices and Branch Offices for Bank Supervision for a period of three years starting at the beginning of 2014. The assigned employees include 70 Bank Indonesia staffs who have been assigned previously since January 2013 to prepare the supporting organization covering human resources, IT, Logistics, Legal, Finance, as well as Education and Consumer Protection. In addition, Bank Indonesia together with OJK has also already formulated the Letter of Agreement on the Management of Staffs Assigned from Bank Indonesia to OJK, which specifically stipulated the management of those human resources during their assignments in OJK from 2014 to 2016.

Along with the transfer of its functions, duties and authority in regulating and supervising financial services activities in the banking sector from Bank Indonesia to OJK on 31 December 2013, Bank Indonesia is faced with several new challenges in performing its duties in micro-macroprudential areas, as mandated in OJK Act²³. To strengthen the implementation of its functions and new authority within the macroprudential areas, Bank Indonesia coordinated macroprudential-microprudential with OJK through the formulation of a Joint Decision Letter, which was signed by both the Governor of Bank Indonesia and the Chairman of the Board of Commissioners of OJK on 18 October 2013²⁴.

The agreement between Bank Indonesia and OJK covers coordination across four main areas. First, the mechanism for cooperation and coordination in conducting the duties of the two institutions. This mechanism covers, among others, the creation

and issuance of policy/regulations in the field of macroprudential and microprudential supervision within the financial industry, particularly banking, the exchange of information on the supervision reports of financial services institutions and macro-surveillance, the joint formulation of studies and research, the coordination in determining Indonesia's stance within international forums, along with the socialization and education for the public. Second, the exchange of data and information on financial services institutions and management of the reporting system for financial services institutions between Bank Indonesia and OJK, in order to make it easier for both institutions to access data and information. Coordination of the reporting system which is gathered from financial services institutions, both banks and nonbanks, and which is needed to support the conduct of duties. Thirdly, OJK's utilization of assets and documents owned by Bank Indonesia. Fourth, the management of officers and/or Bank Indonesia staffs who are employed by OJK. In this context, Bank Indonesia employees who are transferred to OJK are formally treated as being assigned by Bank Indonesia to OJK and after three years will be given the option to choose between returning to Bank Indonesia and remaining at OJK. This Joint Decision was followed up by the formulation of an operational mechanism to support the smooth implementation of the macroprudential and microprudential coordination functions.

Furthermore, to further streamline the conduct of duties by Bank Indonesia and OJK in safeguarding financial system stability in the future, a legal foundation is necessary to provide a clear mandate for each institution. The reliability of an integrated information system and excellent coordination still need to be enhanced in order to support the effectiveness of exchanging data and information between the two institutions. Strengthening of macro and microprudential coordination between the two institutions is also needed to improve the quality of decision making in the framework of conducting Crisis Management Protocols.

To anticipate and mitigate crises, BI also coordinates with other agencies beyond OJK, such as the Finance Ministry and the Indonesia Deposit Insurance Corporation (IDIC) within the Forum for Financial Sector Stability Coordination Forum (FKSSK)²⁵. The form of coordination within FKSSK is stipulated in a Memorandum of

²³ Act No.21 year 2011 concerning Financial Services Authority dated 22 November 2011.

²⁴ Joint Agreement Letter Bank Indonesia and OJK No.15/1/KEP. GBI/2013 and No.PRJ-11/D.01/2013 dated 18 October 2013 concerning on Cooperation and Coordination in order to implement the task of Bank Indonesia and OJK.

²⁵ Memorandum of Understanding between Minister of Finance and Governor of Bank Indonesia, No. MOU-8/ML.011/2012, No. 14/2/GBI/DKM/NK, No.01/NK-1/DK/XII/2012, and No. MOU.001/DK/XII/2012 concerning Coordination in order to maintain Financial System Stability, dated 3 December 2012.

Understanding which becomes guidance in coordinating policy making, conducting follow-up of policies, and exchanging data and information among authorities in the framework of safeguarding financial system stability.

Efforts to safeguard financial system stability could not only cover the four institutions incorporated within the above-mentioned FKSSK, but also need parliamentary support. In order to guarantee implementation effectiveness of conducting the framework for prevention and crisis management, a lot of works still need to be

done. Among others, the legal certainty for providing effectiveness towards the Law on Financial System Safety Net (FSSN), which has not been ratified yet by the House of Representatives (DPR). These Law is also necessary to provide legal foundation for Bank Indonesia function as the lender of last resort (LoLR) in terms of providing Emergency Funding Facilities, which are needed in the framework of crisis management, complementing the Short Term Funding Facilities which can be provided by Bank Indonesia towards temporarily illiquid but solvent banks.

Box 11.1. Implementation of Loan To Value

In the framework of safeguarding financial system stability and strengthening the banking system, Bank Indonesia issued a regulation at the end of the first quarter of 2012 concerning the application of prudential principles in banking¹. The regulation governs, among others, maximum limits on the Loan to Value (LTV) ratio on Mortgages Loans for Landed Houses (KPR) and Flats (KPRS) with area exceeding 70sqm (square meters).

Nevertheless, the impact from implementing this LTV policy on the growth of KPR/KPRS is still considered limited. It is indicated from the still high growth of KPR/KPRS, despite relatively slowing. Up until September 2013, growth of KPR/KPRS reached 31.9%, far above aggregate credit growth (Chart 1). In addition, based on data from the Debtor Information System (SID), as of April 2013, there were 35,298 debtors who hold more than one outstanding KPR/KPRS loan with total cumulative balance of Rp31.8 trillion.

Bank Indonesia then issued a regulation on LTV which not only regulates mortgage loans for landed houses and flats, but also regulates loans for shop-houses (ruko) and office-houses (rukan). Implementation of macroprudential policy concerning loans/financing for home ownership tied to Loan to Value /Financing to Value (LTV/FTV) ratio requirement became effective as of 30 September 2013². This regulation extends the reach of prior LTV regulation which not only regulates mortgage loans for landed houses and flats, but also shop-houses and office-houses. Furthermore, there is also a progressive regulation tied to the property area.

The scope of the regulation covers both Credit Facilities (FK) and Financing Facilities (FP), and applicable for commercial banks and sharia banks.

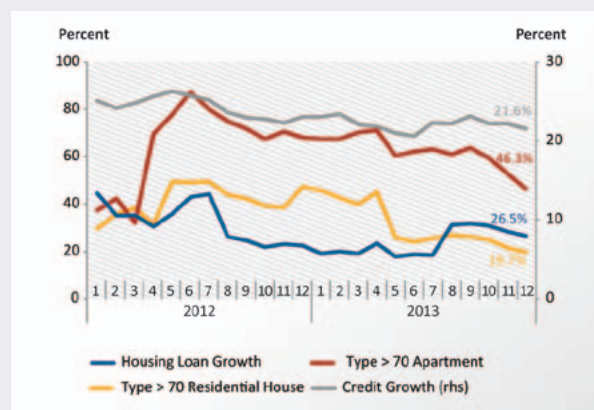


Chart 1. Growth of Housing Loan / Sharia Housing Loan

The financing schemes which are covered comprises loan, Murabahah Financing, Istishna'³, i.e. the FK and FP provided by commercial banks and sharia banks (Table 1), as well as Musyarakah Mutanaqisah Financing (MMQ)⁴, and Ijarah Muntahiya Bittamlik (IMBT)⁵ particularly for FP from sharia banks (Table 2).

The amendments to the LTV/FTV regulation also regulate the quality assurance by banks in regard to the completeness of documents submitted for loan/financing application, the treatment of married debtors, the regulation on new financing based

1 Circular Letter No.14/10/DPNP dated 15 March 2012 concerning the Application of Risk Management to Banks Providing Loans for Housing Ownership (KPR) and Motor Vehicle Ownership (KKB)

2 Bank Indonesia Circular Letter No.15/40/DKMP dated 24 September 2013 concerning the Application of Risk Management toward Banks Providing Loans or Financing for Housing Ownership, Consumption Loan Backed by Property and for Motor Vehicle Ownership

3 Financing based on murabahah contract is a financing contract of goods by fixing the purchase price to the buyer and the buyer pay the excess price as an agreed profit. Financing based on istishna' contract is a financing contract of goods in the form of order to make a certain good with certain criteria and requirements approved between the orderer or purchaser and the seller or maker. (Source: Elucidation Article 19 Paragraph (1) letter d Act No.21 Year 2008 concerning Sharia Banking).

4 Financing based on MMQ contract is a financing contract based on partnership (Musyarakah or Syirkah) in which one of the partners promises to buy the equity share of the other partner gradually until the title of the equity is completely transferred to him. (Source: Fatwa DSN No.73/DSN-MUI/XI/2008).

5 Financing based on IMBT contract is a contract for providing funds in the relation of transferring the right of usage or benefit of goods or services based on a lease transaction with the option of transferring the ownership of the goods. (Source: Elucidation Article 19 Paragraph (1) letter f Act No.21 Year 2008 concerning Sharia Banking).

Table 1. Credit, Murabahah Funding and Istishna'

Credit / Funding/ Collateral type	Maximum LTV / FTV		
	Credit Facility/ Funding Facility I	Credit Facility/ Funding Facility II	Credit Facility/ Funding Facility > III
Type > 70 KPR	70%	60%	50%
Type > 70 KPRS	70%	60%	50%
Type 22-70 KPR	-	70%	60%
Type 22-70 KPRS	80%	70%	60%
Type sd 21 KPRS	-	70%	60%
KP Commercial Building	-	70%	60%

on property which had been pledged as collateral for another KPR/KPRS earlier (top up credit), the regulation on property-collateralized consumer loan/financing, as well as the ban on banks to provide additional loan/financing facilities to fulfillment of down-payment for property ownership.

In addition, this amended LTV/FTV policy also regulates lower LTV/FTV which is for the second, third (and so on) loan/financing facility. This is intended to provide greater opportunities for first time home-buyers with less stringent requirements compared to individuals who seek loan/financing facilities for the purchase of a second, third (and so on) home. This regulation is also intended to improve consumer protection in regard to the purchases of indent (not-yet-available) property. Second, third (and so on) KPR/KPRS are prohibited for the purchase of property which have not yet been built (i.e. indent sales). This regulation will prevent the utilization of bank loan for purchasing more than one unit of indent property by certain parties. Nevertheless, purchase of indent property for first time buyers using KPR/KPRS is still permitted albeit with several related requirements concerning the banks and the developers.

Coordination with government ministries and related agencies is still maintained to affect property sales without utilizing loan. It is then realized that this particular BI regulation could only

Table 2. Musyarakah Mutanaqisah (MMQ) and Ijarah Muntahiya Bittamlik (IMBT) Funding

Funding / Collateral Type	Maximum FTV		
	Credit Facility/ Funding Facility I	Credit Facility/ Funding Facility II	Credit Facility/ Funding Facility > III
Type > 70 KPR	80%	70%	60%
Type > 70 KPRS	80%	70%	60%
Type 22-70 KPR	-	80%	70%
Type 22-70 KPRS	90%	80%	70%
Type sd 21 KPRS	-	80%	70%
KP Commercial Building	-	80%	70%

affect property purchases which are conducted using loan/financing whereas the purchase of property using cash or cash installments could not be affected. This is due to the fact that not all consumers purchase their properties using loans. A certain group of property buyers purchase properties using cash or cash installments without applying for KPR/KPRS. In this regard, in order to protect the property sector from unwanted risks while simultaneously allowing the domestic property sector to grow healthily and sustainably, then coordination with other ministries and related agencies is continuously conducted. Furthermore, these LTV/FTV regulations can be continually revised from time to time in accordance with prevailing economic conditions and overall development within the banking industry.

Implementation of the LTV/FTV regulation was able to slow the growth pace of property loans. Although one month period is still too short to arrive at any conclusion, it can nonetheless be stated that KPR growth in October 2013 was slower than in September 2013. Monthly growth in KPR during October 2013 reached 0.54%. This growth is lower than the average monthly growth at each month during the first nine months of 2013, which was approximately 2.42%. Furthermore, annual KPR growth in October 2013 reached 30.8%, lower than the annual growth in August and September 2013 which reached 31.0% and 31.9%, respectively.

Banks as a financial intermediation institution play an important role in facilitating economic growth. At the micro level, bank loans are a possible source of financing for economic players. In line with the strong pace of economic growth, credit growth has also been relatively high during recent periods. Nevertheless, that aggressive credit expansion has led to the drainage of banks liquidity reserves even though still relatively above minimum levels. If such condition persists, it is feared that banks will be exposed to simultaneously heightened credit risk and liquidity risk.

Adjustments to Secondary Reserve Requirement and LDR-based Reserve Requirement were intended to anticipate heightened credit risk as well as increased pressures on banks liquidity. Bank Indonesia considers it necessary to implement a policy which balances between the pace of assets growth and the liquidity resilience of banks. Achieving the balance between the pace of assets growth and the liquidity resilience of banks will lessen the credit risk as well as reduce pressures on banks liquidity. The step taken by Bank Indonesia was to make adjustments on its policy concerning Secondary Reserve Requirement and LDR-based Reserve Requirement.

Adjustments towards the regulation concerning Secondary Reserve Requirement is intended to encourage banks to hold sufficient liquidity reserves to anticipate various risks related to banking operations, such as daily liquidity needs, fund withdrawals, transfers and clearing, as well as ensuring that they would be able to perform their intermediation while being observant about their capital and liquidity conditions. In addition, adjustments towards the regulation concerning LDR-based reserve requirements is intended to rein in aggressive credit expansion by tightening the target range for Loans to Deposits Ratio.

Amendments to the regulation concerning Secondary Reserve Requirement and LDR-based Reserve Requirement were stipulated in Bank Indonesia Regulation No. 15/7/PBI/2013 dated 26 September 2013 and accompanied by Bank Indonesia Circular Letter No. 13/41/DKMP dated

1 October 2013. Bank Indonesia Regulation No. 15/7/PBI/2013 dated 26 September 2013 regulated the minimum reserves of commercial banks which should be held at Bank Indonesia in both rupiah and foreign currencies. This regulation complements Bank Indonesia Regulation No. 12/19/PBI/2010 concerning the Minimum Reserves of Commercial Banks in Bank Indonesia in both rupiah and foreign currencies. Meanwhile, Bank Indonesia Circular Letter No. 13/41/DKMP dated 1 October 2013 regulates the calculation of the secondary reserve requirement and the LDR-based reserve requirements in rupiah.

In short, a number of changes in the Reserve Requirement regulation cover:

1. An increase in Secondary Reserve Requirement from 2.5% to 4% which is applied progressively, whereas:
 - a. 3% of Third Party Funds (DPK) in rupiah from 1 October 2013 up to 31 October 2013;
 - b. 3.5% of Third Party Funds in rupiah from 1 November 2013 up to 1 December 2013; and
 - c. 4% of Third Party Funds in rupiah since 2 December 2013.

The amendments towards Secondary Reserve Requirement are intended to encourage banks to place their funds in assets which are of high quality and liquidity. Thus, in the event of liquidity difficulties, banks can immediately utilize these assets, among others, through repo facility with Bank Indonesia.

2. Including Bank Indonesia Certificates of Deposits as another component which is taken into account in fulfilling the Secondary Reserve Requirement. This amendment is issued in line with the issuance of Bank Indonesia Regulation No. 15/5/PBI/2013 concerning the Second Amendment on Bank Indonesia Regulation No. 12/11/PBI/2010 concerning Monetary Operations, which introduced Bank Indonesia Certificates of Deposits as another instruments in monetary operations. To increase the types of liquid assets which can be taken into account in fulfilling the Secondary Reserve Requirement, Bank Indonesia

Certificates of Deposits has been included as a component for Secondary Required Reserve since 1 September 2013.

3. Amendments in the LDR range from 78%-100% into 78%-92%. However, other parameters in the calculation of the LDR-based reserve requirement were not amended, namely:
 - a. Minimum Capital Adequacy Ratio (KPMM) was unchanged at 14%;

- b. Lower Limit for Disincentive Parameter was unchanged at 0.1; and
 - c. Upper Limit for Disincentive Parameter was unchanged at 0.2

Changes in the LDR-based reserve requirement were not only intended to rein in aggressive credit expansion but also to make banks increasingly observant of their capital conditions when performing their financial intermediation function.



Payment System Policy

The policy in non-cash payment system throughout 2013 was focused at increasing the reliability and efficiency of payment system as infrastructure to the economy with the support of appropriate regulations and effective oversight implementation. On currency management, three pillars of the policy was aimed at providing quality and trustworthy rupiah currency, ensuring secure and optimum cash processing and distributions, as well as excellence of cash services.

Bank Indonesia's policy in the non-cash payment system in 2013 was aimed for ensuring that payment system as infrastructure which supported the economy and financial system was well-operated. This was shown among others by the speed and accuracy in high value transaction settlements, the increasing efficiency in retail payment system operations, and the increasing usage of non-cash payment instruments in supporting the increase in economic efficiency.

In 2013, Bank Indonesia pursued policy to continue at least four policies in the non-cash payment system which have been implemented in the previous period. First, continuing the strengthening of payment system infrastructure in Bank Indonesia. Second, continuing the development of National Payment Gateway (NPG) with industry. Third, realizing electronic money interoperability. Fourth, continuing the development of Less Cash Society (LCS) areas.

On currency management, Bank Indonesia referred to three policy pillars, which were providing quality and trustworthy rupiah in sufficient level, secure and optimum cash processing and distributions, as well as excellence on cash services. Through these three pillars, Bank Indonesia tried to meet the people's demand for cash which was fit for circulation in terms of nominal or denominations. Bank Indonesia cooperated with the National Navy to widen the reach of cash services in remote areas. Bank Indonesia also cooperated with commercial banks in remote area to provide the people needs for cash out of Bank Indonesia's current service coverage areas. Another policy pursued was the standardization of rupiah, cash handling in banks as well as in Cash in Transit (CiT) companies, the optimization of Interbank Cash Exchanges policy and the policy to recirculate currencies fit for circulation to banks. These policies contributed to the increasing efficiency of banks' cash management as well as cash management in Bank Indonesia.

12.1. Non-Cash Payment System Policy

Bank Indonesia's policy in the non-cash payment system in 2013 was focused at ensuring that payment system's role as infrastructure which supported the economy and financial system was well operated. Several indicators used among others were the speed and accuracy of high value transaction settlements, the increasing efficiency in retail payment system operations, and the increasing use of non-cash payment instruments in supporting the increase in economic efficiency.

The Enhancement of Payment System Infrastructure in Bank Indonesia

The enhancement of high value payment system was made, among others, through the development of BI-RTGS and BI-SSSS Systems Generation II. The development of this system as an improvement to the BI-RTGS System which has been implemented since 2000. One of the aims of this enhancement is the increasing efficiency of high value payment system. This is achieved by completing the BI-RTGS System with hybrid settlement capability, which is the combination between gross settlement and net settlement, particularly when there is transaction queues. The hybrid settlement mechanism combines the benefit of gross settlement which is direct payment settlement for each transaction with the benefit of net settlement which is the efficiency of fund provisions by every payment system participants.

In 2013, Bank Indonesia continued its policy to develop the BI-RTGS and BI-SSSS Systems Generation II conducted in the previous year. The focus of 2013 activities was developing applications, preparing infrastructure, and doing pilot-testing on the system. In addition, there have been preparations for both the BI-RTGS and BI-SSSS Systems on business side as well as drafting regulations on BI-RTGS and BI-SSSS Systems Generation II. In developing and drafting regulation on BI-RTGS Systems Generation II, Bank Indonesia referred to international standard and best practice in payment system operations, such as Principles for Financial Market Infrastructure (PFMIs) issued by the Bank for International Settlements (BIS).

The Development of National Payment Gateway (NPG)

Throughout 2013, Bank Indonesia continued the initiative for NPG development to build interconnection between industry players of retail payment system. This was based on the knowledge that there were people's needs to use retail payment system services more efficiently and to increase efficiency nationwide. To accomplish those goals, it is necessary to develop a system which could connect operators of payment system needed to be developed. Previously, retail payment system service operators developed their own system which were not connected to one another.

In addition to increasing the efficiency of retail payment system, NPG will allow fund transfer information flows

to be better monitored. The increasing efficiency of NPG will ease Bank Indonesia in controlling fund movement domestically or between countries. Moreover, NPG can also be used to monitor the liquidity conditions of payment system industry which will allow the central bank to do early detection in supporting the stability of national payment system industry.

In 2013, Bank Indonesia continued the development of NPG which had been done in the previous period. Until the end of 2013, the development had reached the request for proposal submission phase, followed by nine potential developers.

Electronic Money Interoperability

The efforts to increase efficiency of non-cash payment system among others are aimed at increasing the use of electronic money. Currently, electronic money is only used for low value and mass-type transactions such as transportations. The usage of electronic money as payment instruments by public transport users will increase the efficiency of national economy by reducing the cost of printing and circulation of rupiah currency as well as the cost of cash handling by public transport operators. Moreover, the use of electronic money in public transports and toll gates is expected to increase the efficiency of national economy by savings queuing time and fuel consumptions of vehicles passing the toll gates.

Generally electronic money can only be used for one means of payment because there is not yet interconnection between electronic money issuers. For example, payment transactions for tolls and parking need two different electronic monies. This condition causes inefficiency and discomfort for electronic money users. To cope with the condition, Bank Indonesia facilitated interconnection in electronic money industries to construct interoperability in electronic money operations particularly for the transportation sector.

Other benefits obtained from interconnection are the optimization of infrastructure utilization provided by the banking industry. With interconnection, infrastructure such as Automatic Teller Machine (ATM) and Electronic Data Capture (EDC) machines can be used by several interconnected banks. Bank Indonesia continued to push the banking industry to distribute infrastructure more equally to reach remote areas. This effort was aimed at expanding the use of non-cash payment instruments by the public (See Box 12.1. Efficiency Increase and Access

Expansion Through Interconnection of Payment System Operations).

The frequency of transactions through electronic money in 2013 was recorded only at 137.9 million transactions. The amount was lower than the frequency of other non-cash payment instruments transactions such as credit cards which reached 239.1 million transactions and ATM/debit cards which reached 3.7 billion transactions. Besides the limitation in electronic money services which could only be used for one means of payment, the low awareness of electronic money also led to the small amount of electronic money transactions. The result of Bank Indonesia's surveys to University of Indonesia (UI) academic society in 2013 showed that there was no UI academic society who on their top of mind felt compelled to use electronic money (Chart 12.1). The survey result also showed that only 9% of UI academic society spontaneously answered that they knew about electronic money as a means of payment. This 2013 survey result was in line with BI's surveys in 12 cities which were conducted in 2011. The survey result showed that only 1% of the people who knew about electronic money (Chart 12.2). In an attempt to increase people's awareness, Bank Indonesia carried out electronic money educations through communication activities such as talk show in several televisions and radios, advertisements on print media, and roadshow events in several places.

In 2013, Bank Indonesia performed several related activities such as pushing for the implementation of electronic money interconnection at Trans Jakarta, launching Person to Person (P to P) transfer between three telecommunication firms, as well as implementation of

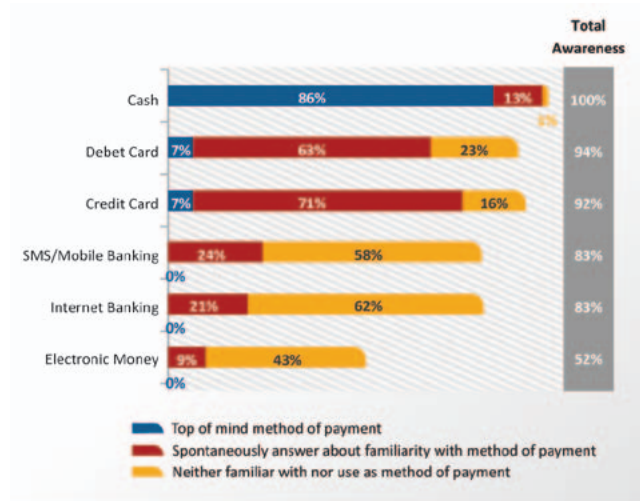


Chart 12.1. 2013 Method of Payment Familiarity Survey

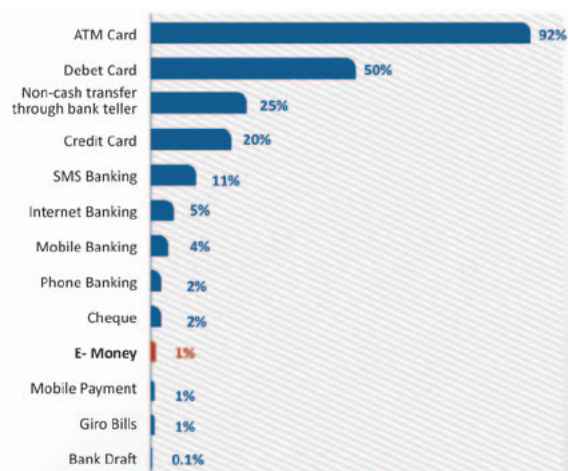


Chart 12.2. 2013 Method of Payment Familiarity Survey

e-ticketing at Kuala Namu Airport train, Greater Jakarta Commuter Train (KCJ) and Benoa-Bali Toll road. To support the activities and ensure electronic money operations run in the set corridors, Bank Indonesia issued business and technical guidelines of electronic money operations (see Box 12.1. Efficiency Increase and Access Expansion Through Interconnection of Payment System Operations).

The Development of Less Cash Society Areas

The efforts to raise efficiency of retail payment system as infrastructure to the economy are also performed by developing areas using non-cash payment instruments (Less Cash Society or LCS).

One of the potential areas for the use of non-cash payment instruments is universities which have several types of retail payment transactions, such as paying for foods and beverages in canteen, buying phone top-up vouchers, and buying or renting books. In that regards, Bank Indonesia selected UI as pilot project for the LCS program. The reason UI was selected as pilot project was because it was considered as a university that can roll out electronic money usage among universities and also the society in general, as well as the existence of pooling cashier transaction system in several place at UI. In addition, the population of UI was considerably large (about 60,000 students, lecturers and employees) meaning economic transaction activities in UI areas were quite high.

The implementation of LCS pilot project at UI involved Micro Small Medium Enterprises (MSME) bazaar which

used electronic money in all transactions as well as education to UI academic society about electronic money and other non-cash payment instruments. The development of LCS areas will be extended in other universities across Indonesia.

12.2. Currency Management Policy

The rupiah currency management policy always takes into account the development in macroeconomic and financial market situations. Referring to Act No. 7/2011 on Currency, rupiah management-related activities includes planning, printing, distributing, circulating, revocation and withdrawing, as well as destroying. For planning and printing activities, Bank Indonesia coordinates with the Government to project the availability of rupiah in sufficient amount, suitable denominations, in timely manner and fit for circulation (clean money policy). Several macroeconomic and financial indicators used in the projection, such as, inflation rate, economic growth, exchange rate and interest rate.

The policy also considered the implication of government policies in the fiscal and real sector, as well as recent strategic issues in rupiah management. In 2013, Government policies, the rise in subsidized fuel price, the increase in Provincial Minimum Wage (UMP), Non-Taxable Income (PTKP), and the disbursement of Direct Cash Transfer to the People (BLSM) were taken into account. Strategic issues to be addressed in formulating policies in rupiah currency management were the strong habit of Indonesians in holding physical money for transaction activities. Moreover, several other issues were also concerned, such as the needs to raise a sufficiency of currency fit for circulation equally throughout Indonesia, increasing the quality and security features on both banknotes and coins, and the role of other parties outside the central bank in processing the rupiah.

In 2013, Bank Indonesia in general pursued four rupiah currency management policies. First, maintaining the level of stock of rupiah banknotes and coins to fulfill cash withdrawal by the people. Second, developing and expanding cash services to banks and the people. Third, optimizing interbank cash transaction national byelaws¹.

¹ Byelaws are written agreements between banks in the operations of cash transaction activities. Meanwhile, TUKAB is activity that covers demand, supply and exchange of Fit notes and coins (ULE) providing the needs of nominal amount and/or denominations (SE No.13/9/ DPU dated April 5, 2011, on the Deposit and Withdrawal of Rupiah Currency by Commercial Banks in Bank Indonesia).

Fourth, increasing public education activities on rupiah authentication features and encourage people to treat the rupiah properly to support the implementation of clean money policy.

Those various Bank Indonesia's policies were drawn by referring to three pillars of currency management policy, which providing quality and trustworthy rupiah in sufficient amount, secure and optimum cash processing and distributions, and excellence on cash services.

Maintaining Sufficiency of Bank Indonesia's Cash Position

With the purpose of maintaining the cash position in sufficient level, Bank Indonesia cooperated with Perum Peruri and suppliers of money raw materials. The cooperation on were made to print money as planned and according to the agreed schedules. In the implementation, Perum Peruri can accelerate the money printing process, especially to fulfill the high seasonal needs during Ramadan and Eid al-Fitr holidays. This acceleration was realized in the first semester of 2013 with a target of 138.8% from schedules.

As an effort to maintain cash positions in sufficient level in all Bank Indonesia's Regional Representative Office (KPwDN-BI), Bank Indonesia also cooperated with shipping company PT. Pelayaran Nasional Indonesia (PELNI) and train operator PT. Kereta Api Indonesia (KAI). As the continuity from previous year mutual agreement which were aimed to maintain the smoothness of cash distribution, both from Bank Indonesia's Headquarters to KPwDN-BI or between KPwDN-BI. As a result of the cooperation, in the first semester of 2013 Bank Indonesia was able to distribute cash throughout Indonesia to meet the significantly increased demand for cash from banks and the people during periods of Ramadan and Eid al-Fitr in 2013.

Bank Indonesia's cooperation with the either state-company or private company were managed to provide rupiah in a sufficient amount in term of volume and value, appropriate denominations, in timely manner and quality. The needs for rupiah during the Ramadan, Eid al-Fitr, Christmas and year-end holiday periods could be well provided. This was reflected by the low deviation between projection and realization value of cash withdrawal from banks and people. During the Ramadan and Eid al-Fitr period (July-early August 2013), the realized cash withdrawal by banks and the people across Indonesia reached Rp103.16 trillion or 102.2% from Bank Indonesia's projection. Meanwhile, in the Christmas and 2013 year-

end holiday period, the amount of withdrawal by banks and the people in December 2013 reached Rp74.4 trillion or 97.7% from Bank Indonesia's projection.

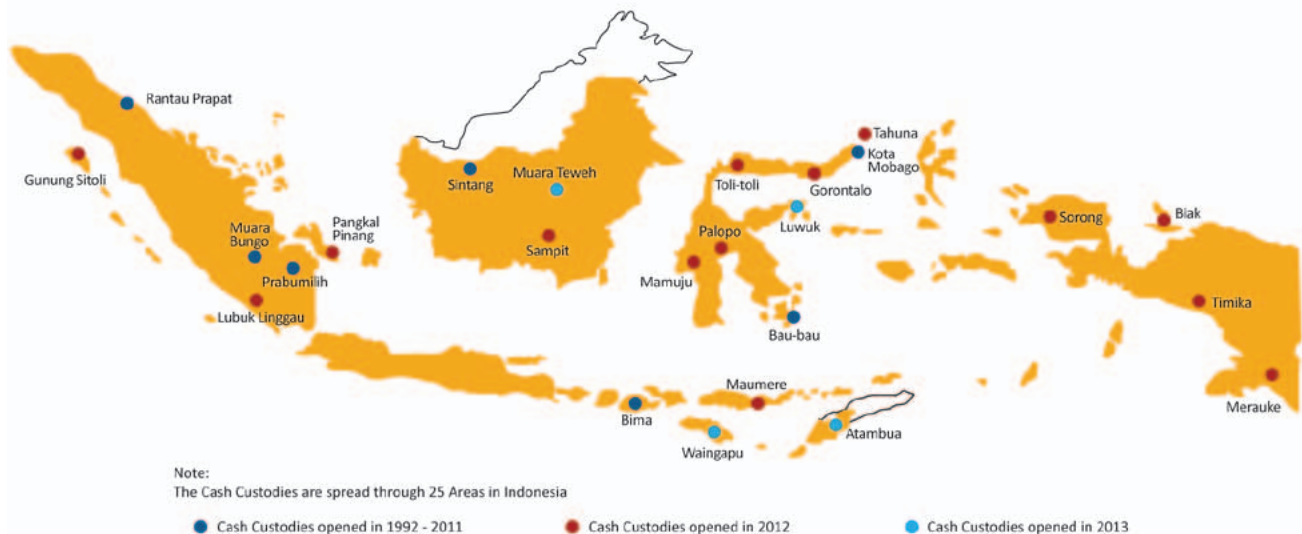
The Development and Expansion of Cash Services to Banks and the Society

Bank Indonesia cooperated with central government, state-owned companies (BUMN), and the commercial banks to do mobile cash services². This policy was performed by Bank Indonesia to ease the people in exchanging rupiah, both in crowd centers or even remote and borderline areas of the Republic of Indonesia (NKRI). The mobile cash services were especially held on religious holidays, by opening cash exchange services in some train stations, Jakarta Fair arena, and National Monument area. KPwDN-BI also performed mobile cash services in cooperation with regional governments. The amount of rupiah exchanged at mobile cash services nationwide was Rp1.3 trillion or reaching 0.3% of the total withdrawal throughout 2013. The Eastern Indonesia areas particularly in provinces located in Kalimantan Island and Papua Province, gain the highest amount of cash withdrawal through mobile cash services reached Rp461.8 billion (31.5% of the total outdoor cash services). Cash withdrawal in Java, Sumatra and Jakarta areas was about 21-22% of the total mobile cash services.

Aside from mobile cash services, Bank Indonesia also cooperated with banks to open Cash Custody³ services. Cash Custody Services are located in remote areas with high economic activities (blank spot area). Throughout 2013, six new locations for cash custody were opened in Muara Bungo (Jambi) managed by Bank Negara Indonesia, Bima (West Nusa Tenggara) managed by BPD Nusa Tenggara Barat Regional, Prabumulih (South Sumatra) managed by Sumsel Babel BPD, Kotamobagu (North Sulawesi) managed by BPD Sulawesi Utara, and Bau-Bau (Southeast Sulawesi) managed by Bank Negara Indonesia, as well as Sintang (Pontianak, West Kalimantan) managed by BPD Kalbar. With the increase, the number of cash custodians until 2013 was 25, with 215 commercial bank offices as members (Picture 12.1). The policy to add the number of location for cash custody was made as an

2 Mobile cash services are the activity in cash exchange service by working unit in BI's Headquarters or KPwDN-BI using certain means of transportations..

3 Cash Custodian is the activity in entrusted cash owned by Bank Indonesia to a bank appointed with agreements to meet banks' cash supply in providing the needs for cash of the people in remote areas.



Picture 12.1. Map of Cash Custody Deployment Area

efficient alternative as compared to mobile cash services, in areas without KPwDN-BI cash services. Throughout 2013, the amount of withdrawal by commercial banks in cash custody reached Rp19.1 trillion or 3.9% of the nationwide rupiah withdrawal. The highest amount of withdrawal was made by commercial banks in Eastern Indonesia (55.4%), particularly in Papua Province and West Kalimantan Province, as well as banks in Sumatra area (44.6%), particularly in Jambi Province and South Sumatra Province.

The Optimization of Rupiah Interbank Cash Exchange (TUKAB) National Bye Laws

The withdrawal and deposit of cash are not only made by banks through Bank Indonesia. Since 2011, Bank Indonesia performed the policy of Interbank Cash Transactions (TUKAB) which required the commercial bank to exchange banknotes and coins between banks before withdrawing or deposit cash in Bank Indonesia. The TUKAB policy in 2011 and 2012 was conducted only in one working area of KPwDN-BI. Since June 2013, Bank Indonesia expanded the TUKAB policy enforcement nationwide through the signing of mutual agreement of TUKAB National Bye Laws by 120 commercial banks. The TUKAB National Bye Laws were providing reference to all commercial banks operating in Indonesia for implementing TUKAB mechanism nationwide, which was expected to pace up the process of providing rupiah to the people.

To support TUKAB activities, Bank Indonesia pursued the cash distribution policy between Bank Indonesia's offices

with drop shot⁴ mechanism between areas nationwide. The policy allowed Bank Indonesia to directly hand over currency Fit in circulation (ULE) from bank deposits to the same bank or otherbank, without making detailed calculation or sorting. With this policy, the recirculation of fit banknotes and coins is expected to paced up as it widens the coverage area, not limited only to one work area of KPwDN-BI.

The TUKAB mechanism nationwide gives benefit on increasing efficiency in cost perspective mainly by saving cost insurance⁵, cash in vault⁶ and cash in transit⁷. Moreover, cash management in commercial banks can also be more efficient by having precise volume of iron stock⁸ so that the needs for cash will be more easily obtainable every time. With this mechanism, banks with lack of cash supply do not have to maintain excessive stock, while banks with more oversupply can use it immediately. Aside from

- 4 Drop shot is a payment policy of currency Fit in circulation (ULE) from bank deposits to the same bank (deposit bank) or to otherbank. Bank Indonesia does not make detailed calculation and sorting on ULE deposits from the bank. In this particular activities, payments made by Bank Indonesia to the bank are made in one transparent plastic packaging (10 bundles, each bundle consist of 10 packs) which remains intact, sealed and with the label of paying banks.
- 5 Cost insurance is insurance cost that should be borne by banks, either for the storage of physical banknotes and coins or for cash in delivery .
- 6 Cash in vault is supply of cash in banks, including the supply of cash in ATM machines.
- 7 Cash in transit is supply of cash for banks by cash in transit companies on behalve of the relevant banks including pick up and delivery activities..
- 8 Iron stock is cash reserve which should maintain for the needs of customer withdrawal.

those benefits, the TUKAB mechanism is also expected to push for uniformity of banknotes and coins' quality in all areas in NKRI.

The Education on Rupiah Authenticity Feature and Proper Treatment of Rupiah Currency

To raise people's awareness of rupiah , Bank Indonesia organized public educational activities on rupiah authenticity features and proper treatment of the currency. The educational activities were performed to law enforcement officers (Police, Attorneys, and Customs and Excise Office) as well as cash handlers such as bank cashiers, mini market cashiers, and taxi drivers. Bank Indonesia extended publication media in this educational activities, from public service advertisement 3D (See, Feel, Light) in electronic media, public education and training of trainers, to the use of social media such as YouTube, Twitter and Facebook. For the past few years, the educational activities were also complemented with traditional art performances in several regions, either by Bank Indonesia itself or in collaboration with Perum Peruri.

Bank Indonesia also gave support to the Indonesian Police in combating the circulation of counterfeit money. Bank Indonesia's role among others was conducting training of trainers regularly to crime investigators, the utilization of Bank Indonesia - Counterfeit Analysis Centre (BI-CAC) laboratory for counterfeit money analysis, and giving expert testimonies in counterfeit criminal case. Moreover, Bank Indonesia coordinated with the Counterfeit Money Eradication Coordinating Body (Botasupal) in various activities to eradicate counterfeit money.

Data on suspected counterfeit money which is reported by people and banks in Bank Indonesia , becomes a source for database about counterfeit money characteristics in BI-CAC laboratory. This will help the investigators to uncover counterfeit rupiah syndicate in Indonesia. For Bank Indonesia, the BI-CAC database is beneficial in analyzing the characteristic of counterfeit money, from the printing technology to the raw materials used. This knowledge gives an important input for Bank Indonesia to increase the quality of security features in rupiah. Moreover, the BI-CAC database is also useful to increase the people's awareness on rupiah authenticity features in various economic transaction activities they engage in.

Efficiency Increase and Access Expansion Through Interconnection of Payment System Operations

The rapid development of technology and with the payment systems users getting smarter triggered a technology evolution in payment system, particularly Card Based Payment Instruments (APMK) and e-Money. The development spurred the APMK and e-Money industry to compete in providing convenience and comfort to customers in making transactions. In APMK, especially for Automatic Teller Machine (ATM)/debit cards, the convenience and comfort was reflected in the convenience of customer transactions in several banks grouped under one principle authorized by Bank Indonesia.¹ As of the report period, there were six principles of ATM/debit cards which were ATM Bersama, Alto, Prima, Cirrus, Plus, and China Union Pay (CUP). Each principle would bridge every affiliated bank in making transactions, particularly interbank transfers. Furthermore, in e-Money, currently there are 17 authorized e-Money issuers in Indonesia either using server based or chip based.² This showed a quite significant development in the past 3 years of 90.4% in average.

However, there were still constraints in payment system related to transactions with customers of other principles and the frequency of e-Money usage which was still very small. The people still faced constraints in making transactions with customers of other banks which were not grouped under the same principle. To cope with the problem, customers did an initiative to open an account in the same bank with other customer to ease transactions. Another method was by opening an account in banks grouped under the same principle. However, this caused transactions to become less efficient and limited access to customers in making transaction activities. The limitation of transaction access to customers will hamper the economic development of Indonesian people. On the other hand, entering its sixth year, the frequency of e-Money transactions remained very small if compared to other non-cash payment instruments such as APMK, only reached 3.75%. Until

now the electronic money industry was dominated by the banking industry and telecommunication firms. Nevertheless, the scope of transactions in each industry was still separated (closed loop) or not consolidated. This caused efficiency and access of the people in making electronic money transactions to be limited. The public were forced to have more than one electronic money to make payment activities.

Bank Indonesia performed interconnection between payment system operators to expand access and raise efficiency of payment system. As a payment system regulator, Bank Indonesia played an important role to fix and find a way out in solving the problem in accordance with existing regulations. One of the policies pursued was through interconnection between payment system operators. With the policy, Bank Indonesia expected to increase efficiency and expand access to be able to help develop economy of the society. To accomplish that goal, Bank Indonesia made an initiative in facilitating 3 (three) principles of ATM/debit card operators which were ATM Bersama, Prima and Alto through coordinations to perform interconnection. In the initial stage, interconnection was focused at fund transfer services between costumers at banks grouped under the three principles. Bank Indonesia played a role in facilitating coordinations and discussions between ATM Bersama, Prima and Alto through the signing of Memorandum of Understanding (MoU) on Interconnection of Fund Transfer Services Between ATM/Debit Principles. The MoU signing was made on May 6, 2013, witnessed by the Governor of Bank Indonesia. Meanwhile, the implementation and operations of interconnections between the three principles were effective since July 15, 2013. Therefore fund transfer services could be performed by every customer of 103 banks and non-bank institutions grouped under the three principles. This could be the beginning of development in other payment service interconnection needed by the people.

Bank Indonesia also played a role in making interconnection between e-Money issuers. This interconnection facility was a follow-up to a series of activities that had been performed by Bank Indonesia since 2011. In December 2011, the DKI Jakarta Administration appointed five banks which were

1 Principle is a bank or non-bank institution which is responsible in managing system and/or network between members, both those who act as issuers and/or acquirers, in APMK transactions in which cooperations between members are based on written agreement.

2 The first e-Money was issued by BCA in 2007

BCA, Mandiri, BNI, BRI and Bank DKI to co-implement e-ticketing at Trans Jakarta as previously implemented at TransJogja and TransSolo. On January 22, 2013, TransJakarta e-ticketing was officially launched by the Governor of DKI at the National Monument in Central Jakarta. Member of Bank Indonesia's Board of Governors Ronald Waas and five President Directors of banks (Mandiri, BCA, BNI, BRI and DKI) attended the event. Six months after the launching, the banks performed joint educations. As of today all corridors (8 corridors) have been served by e-ticketing.

Bank Indonesia has implemented e-ticketing on trains in two locations, which was in Kuala Namu and Jakarta Commuter Train (KCI). This is the realization of MoU signing between PT. KAI as the parent of all train network operators in Indonesia with six banks, which included Bank Mandiri, BCA, BNI, BRI, Bank DKI and Bank Mega. The implementation of e-ticketing in Kuala Namu was inaugurated on July 25, 2013, which signed the new era of train payment method in Indonesia, from using traditional ticketing (manual) to a simple e-ticketing. The airport train was chosen as this mode was a new infrastructure connecting Kuala Namu airport with Medan city and was an example of transport mode from and to airport. The implementation of e-ticketing was also performed to KCI users. Since it was pioneered in 2010, the efforts to implement e-ticketing at KCI had repeatedly seen ups and downs. Bank Indonesia and KCI officials made coordinating steps to realize the implementation of KCI e-ticketing. Bank Indonesia facilitated various meetings to discuss the business side, technical

side, and e-ticketing mechanism. Meanwhile, KCI also prepared stations starting from cleaning, organizing, and providing security such as adding gates and security guards to fulfill the pre-requisite of e-ticketing. In November 2013, BCA was ready to contribute in the operation of e-ticketing in KCI. Officially, the use of Flazz BCA in KCI was implemented starting on December 8, 2013. In the future, other banks are expected to implement e-ticketing by using electronic money. The final aim expected by KCI and Bank Indonesia is electronic money can be used for trains and parking, as well as accepted by all vendors in stations passed by the commuter lines.

Bank Indonesia also made interconnection of P to P transfer³ service between three biggest telecommunications (telco) companies in Indonesia which acted as e-Money issuers. The interconnection of P to P transfer service was launched on May 15, 2013. P to P transfer allows telco subscribers who own e-Money to transfer funds even though they subscribe to different providers. The service was claimed as the first worldwide which could connect between telecommunications providers. The service is aimed at increasing the use of e-Money, particularly that uses server-based platform, considering the potential of server-based e-Money usage is very big, especially if calculated from the potential of mobile phone subscribers which reaches 230 million numbers which are spread evenly throughout Indonesia. The segment of mobile phone users is also spread more evenly if compared to bank customers, because it reaches the upper segment of the society to the lower segment.

³ Person to person transfer is electronic payment which allows transfers using mobile phones.



Policy Coordination

To improve the effectiveness of the policies taken, Bank Indonesia continuously strengthens its coordination with related authorities. Coordination with the Government includes policies in the area of controlling inflation, strengthening external sector resiliency, improving the effectiveness of crisis prevention and resolution, and managing currency and payment systems.

The year of 2013 had presented several demanding challenges for Indonesia's economy, which were both cyclical and structural in nature. The remained-sluggish global economy and tumbling commodity prices caused a downturn in Indonesia's exports, which eventually mounted pressure on the country's current account balance. Further pressure came from an overly dependence on imported goods, as a result of a relatively low competitiveness level and limited production capacity in the midst of ever-growing demand¹. This unduly reliance on imports and limited domestic production also had their effect on the inflation. The inflationary pressure was intensified even more by Indonesia's lack of infrastructure and underlying problems in the trade policies of certain commodities². Under such fundamentally weak economic environments, Indonesia's economic stability was further strained when the U.S. Federal Reserve announced in May 2013 its plan to taper off its monetary stimulus. This tapering-off policy triggered a significant outflow of foreign capital from Indonesia, putting a further pressure to the current account balance.

In response to such challenges, as well as to ensure the economic stability to remain intact, Bank Indonesia and the Indonesian government opt to run their economic policies jointly since any un-concerted policy measure would be too costly and considered to be less effective. This collaboration can be described in three main lines of policies. First line was on the monetary policy front. On this matter, Bank Indonesia not only focused on utilizing the bank's primary policy of interest rates, but also optimizing its other policies related to exchange rates and macro-prudential matters³. Second line was on the government's fiscal policies, which aimed at trimming the current account deficit by means of cutting fuel subsidies and enforcing import duties. These monetary and fiscal policies were then combined to manage domestic demand from creating excessive imports. Lastly, the third line of policies was related to structural reforms, such as improving Indonesia's investment climate and economic self-reliance.

Policy coordination was also aimed at other aspects of the economy apart from maintaining economic stability

1 More details on the balance of payments are provided in Chapter 4. Indonesia's Balance of Payments.

2 The topic of inflation is explored further in detail in Chapter 6. Inflation.

3 Details of Bank Indonesia's concerted policies are elaborated in Chapter 10. Monetary Policies, Chapter 11. Macroprudential and Microprudential Policies, and Chapter 12. Payment System Policies.

and managing aggregate demand. Bank Indonesia took necessary steps in the form of monetary policy mix to ease inflationary pressure and help bring down the current account deficit to a more manageable level. Controlling inflation in Indonesia requires intensive policy coordination with the government, both at the national and regional levels. The government itself had been improving the resiliency of the external and real sectors through various policies related to fiscal matters, energy, food and infrastructure. These policies were aimed at reducing the current account deficit, keeping inflation on track, boosting economic growth, maintaining purchasing power, and accelerating investment. The policy coordination was further cemented between related authorities through the Coordination Forum for Financial System Stability (FKSSK). Lastly, coordination was also carried out on policies related to the national currency management and payment systems, in the form of working together with related parties to increase the availability of rupiah, ensure consumer protection, administer remittance services, and improve the efficiency of retail payment systems.

The policy coordination had in the end proved to be effective in bringing Indonesia's economy back to a more balance and healthier state. By the final quarter of 2013, inflation had decreased and back to its 2014-2015 projected trajectory. The concerted policy measures had also resulted in a more convenient adjustment to the economy without excessive strains. At the same time, the current account deficit had also been sharply reduced to a more manageable level. Furthermore, the policy coordination in fiscal matters, energy, investment and infrastructure had helped improve the structural conditions needed to further enhance the capacity of Indonesia's economy.

13.1. Policy Coordination on Inflation

Increased inflationary pressure in 2013 due to rising food prices and the year's fuel price hike had prompted Bank Indonesia and the Indonesian government to intensify their policy coordination in the area of inflation control. Concerted efforts were necessary as the inflationary pressure came from the supply side, to which monetary policies alone would be insufficient and costly. Such policy coordination would also improve the effectiveness of any monetary policies in controlling inflation.

Bank Indonesia and the Indonesian government implemented the policy coordination through the National

Inflation Controlling Team (TPI), the Regional Inflation Controlling Teams (TPID) and the TPID National Working Group (Pokjanas TPID). The Pokjanas TPID acted as a coordinator in synchronizing the inflation management measures carried out by each TPID in each region. The TPI, meanwhile, acted as a coordinator between related ministries/institutions (see Diagram 13.1).

There were two main sources of inflationary pressure throughout 2013, namely: rising food prices during the year's first semester, and the government's fuel price hike in the second semester. TPI's main objective was thus to manage these two inflationary pressures.

The TPI had identified several factors contributing to the rising food prices. Import barriers set up in the first semester of 2013 against certain agricultural products to promote Indonesia's self-reliance in food had resulted in unwanted side effects. The supply of these agricultural products became limited, being worsened by unfavourable weather conditions affecting local production. The TPI therefore recommended several measures to be taken as follows: (a) relax the import restrictions to restore supply of the agricultural products; (b) increase imports of beef products within their quota while ensuring they meet domestic demand; (c) expedite the availability of instruments to stabilize prices in the event of rising global food prices; and (d) ensure that future policies affecting the supply of food products to be implemented with a better timing to prevent volatility in their prices. The government's response on the matter were in general in line with the TPI's recommendations, namely: (a)

expediting and simplifying import procedures through the INATRADE online system and streamlining the range of products whose imports were regulated; (b) scrapping the import quota for prime-cut beef products, speeding up their imports, appointing the Indonesian Bureau of Logistics (Bulog) to stabilize prices of beef products, and raising their import quota for the year 2013; and (c) change the import policies for beef and agricultural products from quota-based to reference price based.

The TPI also addressed the inflationary effects coming from the government's decision to adjust subsidized fuel prices in 2013. The TPI, the Ministry of Energy and Mineral Resources, and the Ministry of Finance first carried out an assessment on the various options to adjust the fuel price, gauging the inflationary effects of each option. The options are: (i) a single price hike, where the subsidized fuel prices would be raised for all vehicles; and (ii) a fuel price hike for certain vehicles, as private and government vehicles would be restricted from using subsidized fuel. The TPI also surveyed the progress and preparedness of implementing these scenarios.

By the time the fuel price hike was announced on June 22, the TPI had coordinated with the government and the regional administrations through the Pokjanas TPID in managing any imminent inflationary effects. The coordination included that with the Ministry of Transportation in regulating subsequent hikes in transportation costs. The Ministry of Transportation had set a 15% ceiling for any hikes in the Inter-city and Inter-region (AKAP) bus fees and a 17% ceiling hikes for

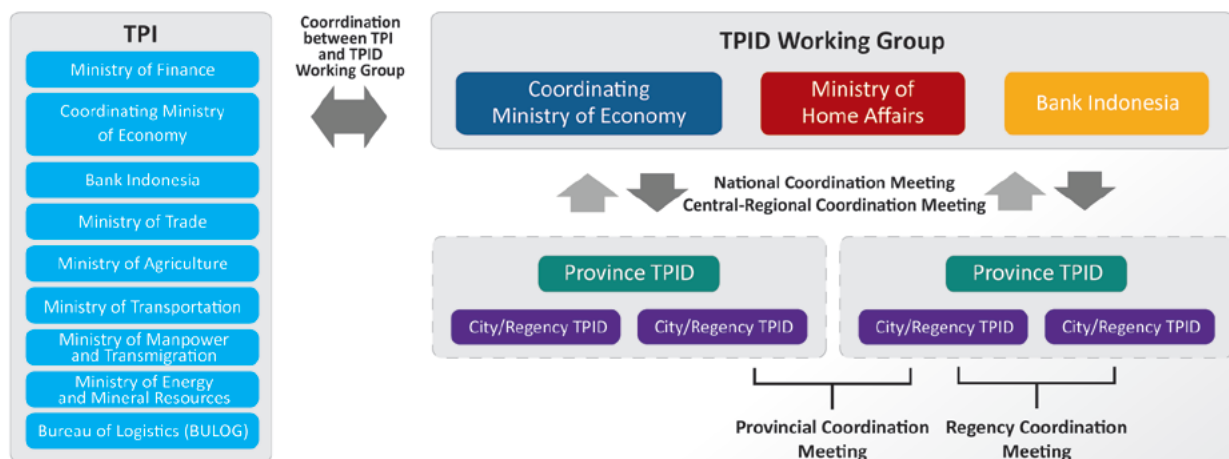


Diagram 13.1. Mechanism of Inflation Control Coordination

any River, Lake and Inter-island (ASDP) ferry fees. The Ministry of Home Affairs, meanwhile, issued Instruction No. 541/3209/SJ/20 in June 2013 as a reference for regional administrations in regulating local transportation fee hikes. All this resulted in an average of about 30% in transportation fee hikes across the regions, which was fairly moderate compared to the hike initially proposed by the transportation industry. The TPI further managed public expectations towards inflation by disseminating the situation through various talk shows in the media.

The coordinated efforts to stabilize prices were carried out not only at the ministry/institutional level, but also at the regional level through each TPID in coordination with the Pokjanas TPID. Throughout the year, the Pokjanas TPID had carried out various initiatives to strengthen its coordination in fostering more stable prices through each TPID, including improving the institutional capacity of each TPID and providing wider public access to information of market prices.

To strengthen the coordinated efforts, intensive meetings were taking place, culminating in the fourth TPID National Coordination Meeting (Rakornas) on May 8 in Jakarta, under the theme “Strengthening Regional Cooperation to Spur the Domestic Economy and Maintain the Price Stability for Public Welfare”. The event concluded several commitments in improving regional cooperation on the issues of food security and food price stability, in improving the planning and budgeting of food security policies between the provincial administration and the regencies, in providing a more convenient and integrated information of local food prices through the Strategic Food Price Information Center (PIHPS) in the regions, in improving policies relating to basic wages and investment climate, and in implementing mitigation action plans relating to effects of the fuel price hike on public welfare.

The results of the Rakornas were then followed up by coordination meetings between the Pokjanas TPID and each TPID. The coordination meetings discussed subsequent measures and the problems faced by each region. Along 2013, the coordination meetings were held for three regional groups: in Medan for regions in the Sumatra Island, in Semarang for regions in the Java Island, and in Makassar for the Eastern Indonesian regions. The coordination meetings concluded with agreements to foster inter-regional cooperation and provide wider access of information to the public.

The coordinated efforts to promote price stability need to be supported by stronger inter-regional cooperation. In an open market mechanism, food production from one

region should be readily distributed to another according to the laws of supply and demand. To achieve that, as a preliminary step, the TPID had identified each region’s potential and needs as the basis to develop inter-regional cooperation to further support food security and stable food prices on each region. The process started with the identification of food balance, focused on 3 (three) main commodities affecting inflation: rice, beef and poultry, along with 2 (two) other regions-specific commodities. In the future, in accordance to the roadmap from the coordination meetings, this program will be continued with a focus on Eastern Indonesia, where inflation in that region is usually higher than at the national level.

Apart from ensuring a more balance supply and demand, the Pokjanas TPID has also improved public access to food price information. This access to information is important in keeping inflation expectation at check and in promoting more efficient market prices. Empirical evidence shows that limited access to price information can lead to market prices being manipulated and marked up. The Pokjanas TPID has therefore been providing and campaigning for the use of web-based price information systems and electronic price information boards. As of 2013, these web-based price information systems have been available in at least six regions (see Table 13.1). Meanwhile, at the national level, the Information Centre for Strategic Food Prices (PIHPS) has also been established to integrate all regional information price systems.

Coordinated efforts to address the inflationary impacts from 2013’s fuel price hike towards transportation fees have also been carried out. The Pokjanas TPID has recommended regional administrations to regulate any hikes in local transportation fees so as not to exceed a 20% ceiling. The timing of the hikes should also be synchronized with possible hikes in other regionally administered prices, such as fees on tap water service (PAM), for vehicle registration (STNK) and for public health services (Puskesmas). In the end, these Pokjanas TPID’s recommendation proved to be effective in limiting any further inflationary impacts from the fuel price hike.

To complement the national-level coordinated efforts through the Pokjanas TPID, each TPID had also been pro-active in keeping local prices at check. Addressing a shortage in supply of agricultural products due to restrictions in existing seaports policies, the East Java TPID suggested that the issuance of Import Recommendations for Agricultural Products (RIPH) and Approval Letters for Agricultural Products (SPIPH) be expedited, and that the Tanjung Priok port be temporarily given an open seaport status. This proved to be effective in improving the flow of

Table 13.1. Price Information Site

No	Region	Site	Description
1	West Java	www.priangan.org	Information on foodstuff prices in several cities in West Java
2	Central Java	www.hargajateng.org	Information on foodstuff commodity prices in several cities in Central Java
3	East Java	www.siskaperbapo.com	Information on primary goods prices in several cities in East Java
4	South Sulawesi	www.biroekonomi.sulselprov.go.id	Information on foodstuff prices
5	North Sulawesi	www.tpidsulut.org	Information on strategic primary goods
6	East Nusa Tenggara	www.tpid-ntt.org	Information on commodity prices

goods, which had previously been held at port. Similarly, the North Sumatra TPID worked together with the Customs and Excise Office, Belawan seaport's quarantine authorities and the local police to expedite the flow of agricultural imports. The TPIDs in Central Java, West Java and Jakarta had also taken necessary measures to ensure an undisturbed flow of goods in their local markets. The TPIDs also encouraged a more self-reliant supply of food produce, by supporting the development of local food estates, such as the shallots farming cluster⁴ in Central Java's Brebes and Tegal regencies.

Coordinated efforts to control inflation through the local TPIDs intensified after the fuel price hike and prior to the Eid al-Fitr holidays, focusing on mitigating effects from the fuel price hike and ensuring a sufficient supply of staple food. The Ministry of Home Affairs properly guided local administrations in managing the supply and the distribution of staple food, and carried out market intervention measures when necessary. The local TPIDs supported in providing market surveillance, evaluation, and intervention. The TPIDs also participated directly in ensuring the proper disbursement of the government's Social Temporary Direct Aid (BLSM) and rice for the poor program (Raskin), while managing public's inflation expectations and awareness of the schemes, which were intended to protect the poor against inflationary impacts from the fuel price hike.

The institutional aspect of the TPIDs has also been strengthened in 2013, seeing it develop from a 'building awareness' phase (2008-2013) to a 'fostering commitment' phase (2013-2018). The first TPID was set up in 2008 and received welcome support from local administrations. Further improving the TPIDs, however, requires proper guidelines for their establishment and

their scope of duties. For this cause, the Ministry of Home Affairs issued the Instruction No. 027/1696/SJ on Managing the Availability and Affordability of Goods and Services in the Regions, which provides a reference for local administration in setting up TPIDs and carry out coordinated efforts to manage local price stability. The Ministry of Home Affairs had also issued a circulation letter requiring all regions to set up a local TPID by the end of 2013, aiming to raise the awareness of local administrations on the importance of inflation management⁵. This has somewhat been achieved, with 184 TPIDs already being established throughout the country, comprising of 33 TPIDs at the provincial level and 151 TPIDs at the regency/city level (see Diagram 13.2). The legal basis for the Pokjanas TPID has also been delivered, thus establishing its institutional authority.

Improving the TPIDs institutional aspect has also included capacity building through various workshops and trainings involving local administrations. Bank Indonesia has held several workshops with topics such as measuring the inflation rate and projecting economic growth to support regional development plans. Such trainings support the government's objective to harmonize regional macroeconomic assumptions to support national level macroeconomic projections. Bank Indonesia supported this effort by developing a Regional Macroeconomic Model (REMBI), which can be used by local administrations for their development planning and budgeting in accordance to the national development planning.

As a final note on the TPIDs, an annual evaluation of their performance was conducted to encourage their initiative and active participation in carrying out their roles in inflation management. The TPIDs are evaluated according to process-related marks on the intensity and quality of

⁴ A cluster is a collective of related producers / businesses located in one area.

⁵ Circulation Letter No. 500/6414/SJ issued on September 19, 2013.

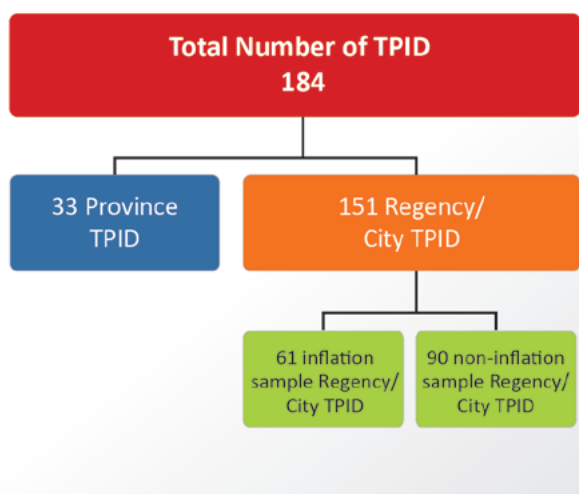


Diagram 13.2. Composition of TPID

their actions in addressing inflation, and result-oriented yardsticks of the actual inflation rate achieved and the volatility level of the inflation. Three TPIDs, each at the provincial and regency levels, were in the end named as the best performing ones (see Table 13.2).

13.2. Policy Coordination on the External Sector Resiliency

Policy coordination to strengthen the resiliency of the external sector was also carried out as 2013 saw increasing pressure towards Indonesia's balance of payments (NPI)⁶. Bank Indonesia and the Indonesian government agreed in the opinion that the problems plaguing the NPI were not only cyclical in nature, but also structural. To address this, concerted policies were therefore needed, by seeking to stabilize the economy in the short run, and enhancing the economy's capabilities in the longer run. In the end, the coordinated efforts proved to be effective in reducing the economy's current account deficit.

One main coordination forum in addressing issues concerning the NPI was the Round Table Policy Dialogue (RTPD). The RTPD is a high-level forum between Bank Indonesia and the Indonesian government to discuss crucial economic issues, including those on the NPI, which require inter-departmental policy responses. Decisions

⁶ Chapter 4. Indonesia's Balance of Payments provides more details on the topic.

Table 13.2. 2013 Best Performing TPID in Inflation Control

Area	Province TPID	Regency/City TPID
Sumatera	North Sumatera	Medan
Java	West Java	Cirebon
East Indonesia Area	East Nusa Tenggara	Balikpapan

derived from the forum would then be carried out by each ministry/agency according to their authorities.

For its part, the Indonesian government had set up several policies to address the current account deficit, including measures to discourage imports while at the same time encourage exports. These policies were in line with Bank Indonesia's own array of policies to mitigate the risks of the impacts of the economy's external imbalances⁷.

Among the government's most crucial policies in this case were those concerning fuel prices and the country's energy mix, both of which had an effect in reducing fuel imports. On June 22, the government raised the subsidized gasoline price by Rp2,000/litre, from Rp4,500/litre to Rp6,500/litre. It also raised the subsidized diesel fuel by Rp1,000/litre, from Rp4,500/litre to Rp5,500/litre. Following the fuel price hike, the growing trend in fuel consumption was able to be kept at check, thus reducing the oil and gas imports required to meet that demand. This was in overall favourable for controlling the deficit in oil and gas trade balance, which had been widened since 2012, at check as well.

Impacts from the fuel price hike made further way towards improvement in aggregate demand, especially on the demand for imported goods, which was favourable with Bank Indonesia's own policies to address the economic imbalances. Higher fuel prices affect the prices and demand for related complementary goods, particularly those with high import content. This will in the end discourage imports and adjust overall demand in the economy accordingly.

Apart from the fuel price hike, the Indonesian government also pursued policies to increase the use of biofuels. This would come in line with the government's aim to reduce

⁷ Bank Indonesia's response of policies for 2013 are explained in detail in Chapter 10. Monetary Policies and Chapter 11. Macroprudential and Microprudential Policies.

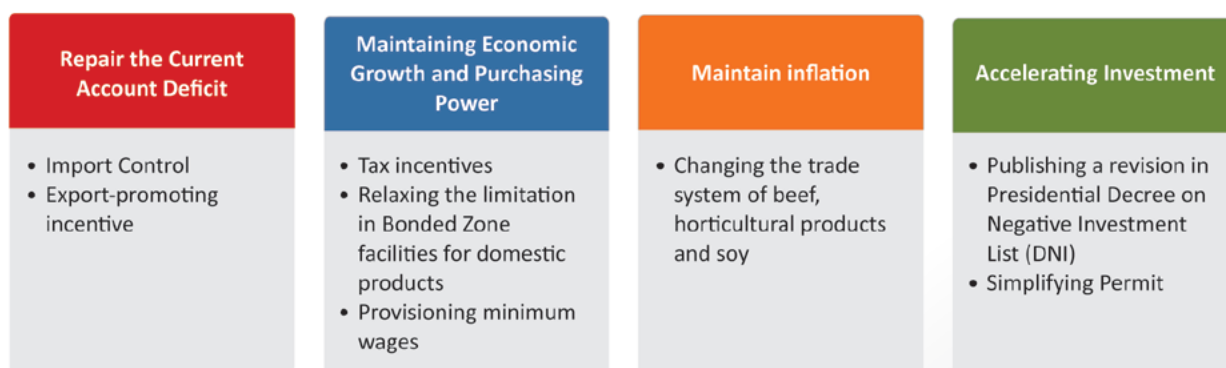


Diagram 13.3. Policy Package on 23 August 2013

the proportion of fossil fuels in the country's energy mix⁸, from 55% in 2006 to 20% in 2025. Renewable energy resources, including biofuel, is meanwhile expected to have a more significant proportion in the energy mix at 17%.

The biofuel policy, which is part of the government's August 23, 2013 Policy Package (see Diagram 13.3), requires a 10% blend of biodiesel in the fuel used for public transportation, 3% for private transportation, 5% for industrial and commercial purposes, and 7.5% for power generation. For 2014, the government decided to expedite the use of biofuel, by raising the required biodiesel blend to 10% for all transportation, industrial and commercial purposes, and 20% for power generation⁹.

The biofuel policy has resulted in an increase in the use of biodiesel fuel. In 2013, 1.07 million kilolitres of biodiesel fuel was used, up from 669,000 kilolitres the previous year. This amount is expected to continue growing in the following years, and should help the government save up to US\$4 billion in fossil fuel imports each year¹⁰.

The government has also placed measures to limit the use of subsidized fuel¹¹. Since February 2013, all government

official vehicles in Java, Bali, Sumatra and Kalimantan have been prohibited from using subsidized gasoline, while those in Sulawesi received an exemption until July. Similarly with diesel fuel, all government official vehicles in Greater Jakarta have since February 2013 been forbidden to use subsidized diesel fuel, with the ban being extended to the whole of Java and Bali on March 2013. Furthermore, since March 2013 all transport vehicles with more than four wheels used in the plantation, mining and logging industries have also been prohibited from using subsidized diesel fuel, while non-pioneer and non-public-transportation ships since February 2013.

Other policies in the energy sector include energy diversification, which was implemented through programs requiring households to convert their energy use from kerosene to liquefied petroleum gas (LPG), and the transportation sector from gasoline or diesel fuel to compressed natural gas (CNG). The kerosene-to-LPG conversion program managed to reduce kerosene use from around 10 million kilolitres to 1.7 million kilolitres, or Rp85 trillion in kerosene subsidies. In 2013, 1.7 million kerosene-to-LPG kits have been distributed in the 10 provinces of Aceh, West Sumatra, Bangka Belitung, East Kalimantan, South Kalimantan, Central Kalimantan, North Sulawesi, Gorontalo, Central Sulawesi dan Southeast Sulawesi. This adds to a total of 53 million conversion kits so far, with plans to distribute another 3.4 million kits. Meanwhile, conversion kits for the gasoline/diesel-fuel-to-CNG program has as of 2012 been installed on around 5,000 vehicles. Savings in fuel subsidies from the program is expected to amount to Rp270 billion per year, and

⁸ Presidential Regulation No. 5/2006 on the National Energy Policy.

⁹ Energy and Mineral Resources Minister Regulation No. 25/2013.

¹⁰ MoF (Fiscal) News, December 10, 2013 issue.

¹¹ Energy and Mineral Resources Minister Regulation No. 1/2013 on Regulating Fuel Usage.

hopefully more, as more conversion kits are distributed and more CNG refilling stations are set up.

All these structural reforms in the energy sector, particularly the fuel price hike and the campaign on biofuel use, improved Indonesia's energy resiliency, and falls in line with efforts to reduce the pressure on current account. They also helped to reduce the fiscal burden coming from energy subsidies, which amidst the country's growing demand for energy, is estimated to total Rp297 trillion for 2013 alone. Any savings from the energy subsidies could then be reallocated for other budget posts, such as capital expenditures or financing infrastructure projects, further improving the economy.

The Indonesian government has also utilized tax policies to help reduce the current account deficit. Indonesia's growing middle-class in recent years has driven the demand for luxury and quality products, thus increasing the imports of consumer goods. To keep those imports at check, the government has adjusted import duties accordingly, while at the same time providing tax incentives to promote exports.

As part of its August 23, 2013 Policy Package (see Picture 13.3), the government raised the Sales Tax on Luxury Goods (PPnBM) for completely built up (CBU) passenger cars and branded products by 25% to 50%. The government in December 2013 also issued the Ministry of Finance Regulation on the Collection of the Article 22 Income Tax (PPh), raising the tax collection rate for certain imported goods, from previously 2.5% to 7.5%. The particular imported products include consumer goods that are not used as material for local production purposes, whose total import value are significant, but whose prices do not inflict much inflationary effect. A total of 502 product items fall within the new tax collection rate, including laptops, cell phones, motorized vehicles, bags and clothing. Apart from reducing imports, the tax policy is also expected to encourage a wider use of locally made products.

Meanwhile, to encourage exports, the government launched the Import Facilities for Export-Oriented Production (KITE) scheme¹², providing several fiscal incentives and permit facilities. The fiscal incentives include exemptions from Value-Added Tax (PPN) and Sales Tax on Luxury Goods (PPnBM), apart from import duties, which have already been exempted. Export-oriented local producers also received streamlined permit application processing, including to apply for the KITE scheme itself.

¹² This policy is part of the December 2013 Policy Package.

The government's concerted policies in the energy sector, taxation, and other fiscal incentives were effective in reducing the current account deficit. By 2013's final quarter, the current account deficit had been reduced, on the back of a surplus in the trade balance from rising exports and lower imports. In the long run, the policies also intended to external balance.

13.3. Policy Coordination on the Real Sector

Apart from policies on the external sector, the Indonesian government had also taken on several policies to strengthen the country's real sector. The policies were mainly part of structural reforms to improve the economic capacity in the long term, and were in line with Bank Indonesia's own policies in promoting a healthier and more balanced economy.

Tax incentives supporting local industries are among such policies for the real sector, and were included in the government's August 23, 2013 Policy Package, which sought to maintain sufficient levels of economic growth and people's purchasing power. Maintaining economic growth was pursued through such policies as providing additional tax cuts for labour-intensive industries, whether their production is meant for domestic market, or whether at least 30% of it is intended for exports¹³. Other policies include relaxing the export requirements of industries in bonded zones, allowing them to allocate up to 50% of their production to the domestic market instead¹⁴. The policy is expected to improve local competitiveness and employment as the economic adjustments taking place.

Meanwhile, in maintaining people's purchasing power, the government exempted the Value-Added Tax (PPN) for several goods¹⁵, including imported textbooks, religious scriptures and religious textbooks. The Sales Tax on Luxury Goods (PPnBM) was also relieved for certain products no longer deemed as luxury goods. The government also set the minimum wage, based on the Decent Living Needs (KHL) criteria, productivity level, economic growth level, and whether industries were Micro Small and Medium Enterprises (MSME),

¹³ Finance Minister Regulation No.124/PMK.011/2013, which is part of the August 23, 2013 Policy Package.

¹⁴ Finance Minister Regulation No.120/PMK.04/2013, which is part of the August 23, 2013 Policy Package.

¹⁵ Finance Minister Regulation No.121/PMK.011/2013, which is part of the August 23, 2013 Policy Package.

labor-intensive, or capital-intensive¹⁶. The minimum wage policy is expected to maintain Indonesia's competitiveness in terms of wages compared to other countries, with Indonesian workers being better paid and more productive. Other efforts to maintain the people's purchasing power include a prompt respond to any rising trends in inflation; particularly those related to volatile food prices. Trade policies on certain food commodities were deregulated, with their import procedures being streamlined, and their quota-based import allotment changed to a market price mechanism¹⁷.

The government's policies proved to be effective in maintaining economic growth. The economy picked up again in 2013's fourth quarter after slowing down in the previous quarter. Unemployment levels, while still seeing an uptick, remained at check. With inflation returning to its normal levels by the end of the year, also showed that the government's efforts to stabilize prices had succeeded.

The Indonesian government has also carried out policies to structurally reform and improve the economic capacity. The policies include revisions to the Negative Investment List (DNI), further facilitating business activities, and initiating several strategic investment projects in the Master Plan to Expedite and Expand Indonesia's Economic Development (MP3EI). These policies are in line with efforts to improve business climate to attract more foreign direct investment, which may bolstering the external financing while improving the capacity and innovative capabilities of industries to drive further growth in the long run.

Regarding the Negative Investment List (DNI), revisions will be made on which sectors of the economy are still restricted from private and foreign investments, with those already open to be deregulated further to facilitate prospective investors. Investments in several sectors will be relaxed, namely in the health industry, manufacturing, trading, forestry, and tourism and creative economy.

As a follow-up to the August 23, 2013 Policy Package, the government on October 25 issued the Policy Package to Facilitate Doing Business, which involved related authorities such as the Supreme Court and Bank Indonesia. The policy package includes measures to streamline the application procedures for business permits, utility services, taxation, and property ownership

licenses. Procedures for bankruptcy were also upgraded in line with the Bankruptcy Law and the Bank Indonesia Regulation on Credit Information Agency. The policies are crucial in improving the country's investment climate, with Indonesia still ranked fairly poor in the global "Doing Business" list.

The Indonesian government has also followed through with several policies for the real sector as included in the MP3EI. The master plan has as of 2013 achieved several milestones, with 253 projects worth Rp737.9 trillion successfully reach the groundbreaking phase. The Rp737.9 trillion total investment consists of 66 projects worth Rp181.3 trillion coming from state-owned enterprises, 76 projects worth Rp254.9 trillion from the private sector, 82 projects worth Rp127.7 trillion from the government, and 29 projects worth Rp174 trillion in joint ventures.

As shown in Chart 13.1, the private sector has taken the lead in realizing the development projects, followed by state-owned enterprises and the government itself. However, projects by the private sector are still mainly in the real sector, while most infrastructure projects are still handled by the government. This shows that further efforts are still needed to encourage more participation from the private sector in infrastructure development projects.

Currently, three main issues still hinder the investments within the MP3EI scheme from being realized, namely problems on land ownership, financing security, and of legal certainty. Acquiring land for the projects face difficulties in the form of ongoing land disputes and complicated regulations regarding Spatial Planning (RTRW) and nature reserves. Legal complications go from local bylaws up to government regulations and

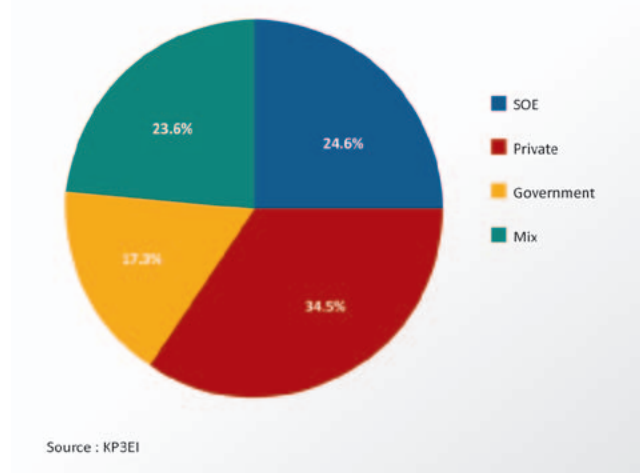


Chart 13.1. Source of Funds for MP3EI Groundbreaking Investment

¹⁶ Presidential Instruction No.9/2013.

¹⁷ This policy is part of the August 23, 2013 Package Policy. More details of this policy and its relation to inflation are provided in Chapter 6. Inflation.

Table 13.3. MP3EI Groundbreaking Realization by Corridor

Rp billion

Realization	Real Sector		Infrastructure		Total	
	Project	Investment	Project	Investment	Project	Investment
Sumatera	24	77,525.7	32	34,453.4	56	111,979.1
Java	32	56,291.3	33	220,499.0	65	276,790.3
Kalimantan	31	117,481.1	26	60,693.0	57	178,174.1
Sulawesi	7	16,066.5	17	7,490.0	24	23,556.5
Bali - Nusa Tenggara	5	33,352.0	19	14,198.0	24	47,550.0
Papua - Maluku Islands	5	81,209.2	22	18,691.9	27	99,901.1
Total	104	381,925.7	149	356,025.3	253	737,951.0

the main legislations themselves. Meanwhile, financing for infrastructure development projects through public-private-partnerships (KPS) has yet to be optimized. Despite these problems, the government has continued to improve related regulations to expedite the MP3EI projects.

Another government's policies for the real sector is its programs of providing a social safety net to buffer any inflationary impacts from 2013's fuel price hike on people's welfare. The government cut up to Rp13.2 trillion in costs from the annual expenditures for ministries and state agencies, topping it up with Rp29.4 trillion in funds in the form of BLSM (social temporary direct aid), Raskin (rice for the poor), BSM (educational subsidy funds for the poor), PKH (direct cash subsidies for the country's poorest households)¹⁸. These four programs were parts of the P4S (Program to Expedite and Expand the Social Safety Net). Funds were also provided for the Program to Expedite and Expand Infrastructure Development (P4I)¹⁹.

The government also launched the National Strategy for Financial Inclusion (SNKI), aiming to establish a more publicly accessible financial system, thus creating economic welfare through poverty reduction, income equality, and a more stable financial system. The strategy consists of 1) financial education, 2) public

financing facilities, 3) mapping on financial information, 4) supporting policy/regulations.

The SNKI program was implemented throughout the year in the form of public awareness campaigns for Indonesian migrant workers, and in coordinating the disbursements of the National Community Empowerment Program (PNPM) funds and the BSM educational subsidy funds through commercial banks. Meanwhile, efforts to improve financing information mapping include utilizing the electronic identity card (e-KTP) for disbursing the PKH direct cash subsidies for the poorest households.

13.4. Policy Coordination on Crisis Prevention and Resolution

Intensive policy coordination also covered crisis prevention and resolution according to the crisis management protocol (CMP) setup under the Coordination Forum for Financial System Stability (FKSSK). In 2013, amidst pressure on economy and domestic financial markets the coordination focused on strengthening the required legal basis and measures for crisis prevention and resolution. Throughout the year, the stability of Indonesia's financial systems remained at check despite challenges from both domestic and external factors.

The FKSSK²⁰ was established according to Articles 44, 45 and 46 of Act No. 21 / 2011 on the Financial Services Authority (OJK), with the primary objective of maintaining financial system stability. The FKSSK oversees the national

18 The BLSM scheme is a direct cash subsidy of Rp150,000/month for four months, to 15.5 million poor households. The poor households also received an additional 15kg of rice for the 3 months of June to September, amounting to a direct rice subsidy allocation of 30kg/month. The allotment of poor students receiving educational fee subsidies was also increased from 8.7 million to 16.6 million students. Meanwhile, 2.4 million of Indonesia's poorest households also received direct cash subsidies of Rp 1.8million/month, from previously Rp1.4 million/month.

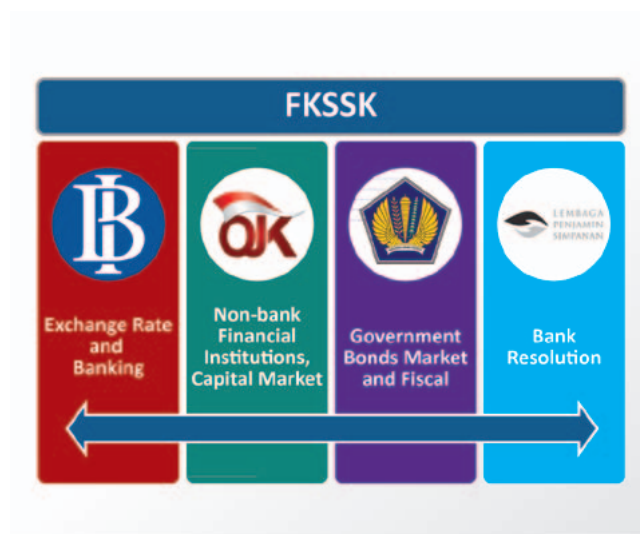
19 The P4I program comprises i) the Settlement Infrastructure Program covering 13,000 villages and 1,200 sub-districts; ii) the Tap Water Program covering 159 rural areas in 28 provinces, 341 urban areas in 31 provinces, and 260 water-scarce villages in 29 provinces; and (iii) Water Resources Infrastructure Program in 27 water-scarce provinces.

20 According to Article 69 Sub-Article 3 of the OJK Law, the FKSSK assumes the function, role and authority of the Coordination Committee (KK) as stipulated in Act No. 24 / 2004 on the Deposit Insurance Agency (LPS), and as revised in Act No. 7 / 2009 on the Legal Effectiveness of Government Regulation in lieu of Act No. 3 / 2008 on the Revision of Act No. 24 / 2004 on the LPS.

crisis management protocol that integrates related regulations regarding exchange rates, the banking industry, non-bank financial institutions, the capital markets, the bond markets, the fiscal sector, and surveillance activities by Bank Indonesia, the OJK and the LPS (see Picture 13.1).

Efforts in improving the crisis management protocol at the national level had begun since 2012, as noted in several FKSSK hallmark agendas. Following up the FKSSK meeting on June 7, 2012, which resulted in a Memorandum of Understanding²¹ between the Finance Minister, the Governor of Bank Indonesia and the Chief Commissioner of LPS on the coordination to maintain financial system stability, and a Joint Decree on the FKSSK Secretariat, the forum now has working draft guidelines in the form of Operational Procedures on Data and Information Exchange, Operational Procedures on Policy and Decision-Making Meetings, and Operational Procedures on Public Communications. These three operational procedures provide reference for each FKSSK's member institutions in doing their roles and duties to promote and maintain financial system stability.

Efforts to strengthen the legal aspects of policy coordination on crisis prevention and resolution was carried out along with the handing over of the banking supervision from Bank Indonesia to the OJK since December 31, 2013. On September 30, the Joint Decree on the FKSSK Secretariat was revised to include new members, particularly OJK officials. Bank Indonesia and the OJK then issued on October 18 the Joint Decree No. 15/1/KEP.GBI/2013 and No. PRJ-11/D.01/2013 on the cooperation and coordination regarding the banking industry's supervision hand-over. The joint decree, which was expected to make more effective and efficient coordination, as well as avoid overlapping of duties, includes such matters as information exchange on financial services institutions, management of the banking reporting system and financing companies, coordination on short-term financing²², and public awareness campaigns. Regarding to information exchange, a Coordinating Forum/Committee for Information Exchange and Reporting Systems of Financial Services Institutions will be set up, whose members will consist of Bank Indonesia's Board of



Picture 13.1. 2013 National CMP Framework

Governors, the OJK's Board of Commissioners, and other necessary officials from both Bank Indonesia and the OJK. The Forum/Committee will deliberate and develop the required integrated information exchange system, as well as coordinate and manage the reporting system for financial services institutions.

The FKSSK had in 2013 also compiled a Crisis Binder, which is a guideline for the FKSSK member institutions in taking appropriate policies/measures in the event of a financial crisis. The Crisis Binder, which incorporates inputs from the World Bank and the Toronto Center, consists of several key topics covering such decision-making aspects as Lender of the Last Resort, Payment Systems, Bond Markets, Resolution Options, Governance and Communication.

Putting all this legal and technical setup for crisis management protocol to the test, the FKSSK had twice run financial crisis simulations. The first, a mini-simulation, was ran against the technical management level in preparing for a nation-wide financial crisis. The impending full-dressed crisis simulation, involved such policy-makers as Bank Indonesia's Governor, the Finance Minister, as well as the Chief Commissioners of both the OJK and the LPS. The simulation's main objective was to test the preparedness of each member institution's crisis management protocols, particularly on the legal aspects, the policy instruments, the analytical tools, and the assessment methods, as well as to test the effectiveness of policy and decision-making in the forum under duress.

The FKSSK acknowledges that a full assessment of the financial system stability needs to be continuously improved. Coordination is thus routinely conducted: a

21 The Memorandum of Understanding was updated on December 3, 2013 with the inclusion of the OJK following the formation of its Board of Commissioners.

22 As stipulated in Article 7 Sub-Article 1 of the Joint Decree, in the event of a bank whose capital adequacy is still within the required limits but is experiencing liquidity problems and in need of short-term financing facilities, the OJK must duly submit its recommendations for such short-term financing facility along with comprehensive information on the bank's financial standing on that regard to Bank Indonesia.

Deputies' Meeting is held every month, while the FKSSK members meet every three months, as stipulated in Act No. 21 / 2011 on the OJK and the FKSSK Memorandum of Understanding. In these coordination meetings, each member institution carries out assessments according to their protocols and decides on a policy response, if needed. According to such assessments made throughout 2013, the crisis management protocols were sufficient in meeting economic challenges from both domestic and external factors, and maintaining stability in the financial system.

Bank Indonesia has internally carried out several efforts to improve its CMPs, strengthening the Regulation of the Board of Governors (PDG) No.14/1/PDG/2012 on Crisis Management Protocols which was issued on January 11, 2012, and the Internal Circular (SE) No.14/11/INTERN issued on April 9, 2012 regarding Crisis Management Guidelines for each of Bank Indonesia's units.

Meanwhile, in improving the surveillance on macroeconomic and financial market risks, Bank Indonesia has continuously updated its analytical tools and methods to identify any likelihoods of risks, and the impacts of such risk factors. Bank Indonesia's surveillance indicators have been improved to give prompt and early warnings against any vulnerabilities, while its policy toolkits to mitigate such risks have also been strengthened. In the event of any abnormal surveillance results, Bank Indonesia's CMP requires internal coordination and action to address the matter first, before taking it up with the FKSSK.

Bank Indonesia has also been updating its own internal Crisis Binder, in reference to the FKSSK's Crisis Binder and the national-level CMP. The internal Crisis Binder is essentially a collection of coordination mechanisms, standard procedures, and implementation instruments for crisis prevention and resolution. It also includes contingency plans, and is the main reference to coordinate and integrate crisis prevention and resolution measures. The Crisis Binder is continuously updated as a 'living document' by all of Bank Indonesia's units.

Policy coordination on crisis prevention and resolution has also been conducted at the Asia-Pacific regional level, with the Executives' Meeting of East Asia Pacific Central Banks (EMEAP)²³ having developed the Crisis Management

and Resolution Framework (CMRF) for the EMEAP region. The framework is expected to facilitate regular and timely interaction and cooperation among EMEAP country members in preventing and addressing any cross-border systemic risks, through the exchange of information, discussions of policy action, and the consideration of coordinated action. Several aspects of the CMRF that have been agreed upon include (1) using the CMRF document as a guideline in facilitating timely cooperation among EMEAP country members for crisis management; (2) the threshold conditions used as a reference for crisis surveillance and trigger action measures; (3) regional policy toolkits; and (4) improving several aspects of the framework in the future. The CMRF still requires improvement in addressing the role of Non-Central Bank Supervisory Authorities (NCBS), particularly in the event of crisis caused by distressed financial institutions. The CMRF still needs to formulate the mechanism for cooperation between the central banks and the NCBS, including involvement of the NCBS at the high-level policy response decision-making in the event of crisis of distressed financial institution.

Policy coordination on crisis prevention and resolution will continue to be improved, both in terms of its legal frameworks and effectiveness of the coordination. Among the legal frameworks on the FKSSK's focus for the near future is the deliberation of the Financial System Safety Net Bill (RUU JPSK), which will provide the needed legal umbrella for related institutions to coordinate their efforts. Besides that, commitment for effective and efficient coordination among FKSSK members and among other institutions in regional level need to be enhanced

13.5. Policy Coordination on the Management of Non-Cash Payment System

Bank Indonesia also realized the need to coordinate with related authorities, both domestic and foreign, on the management of non-cash payment systems. Coordination with domestic authorities included that with transportation-related authorities, regarding the interoperability of electronic money in the transportation sector.

Bank Indonesia has also coordinated with the Indonesian National Police regarding the issue of illegal remittances as stipulated in Act No. 3 / 2011 on Fund Transfers. Concerted efforts against illegal remittances were also carried out with the Bank Negara Malaysia (BNM), as well as combating acts of money laundering, particularly those

23 Members of EMEAP (*Executives' Meeting of East Asia Pacific Central Banks*) include the Reserve Bank of Australia, the People's Bank of China, the Hong Kong Monetary Authority, Bank Indonesia, the Bank of Japan, the Bank of Korea, Bank Negara Malaysia, the Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, the Monetary Authority of Singapore, and the Bank of Thailand.

between the two country's borders. Two main agreements with the BNM were (i) a formal coordination between Bank Indonesia and BNM on the exchange of information regarding illegal remittances, suspicious transactions and legal remittance services in the two countries, (ii) improving public awareness campaigns on the issues among Indonesian migrant workers in Malaysia.

Bank Indonesia has also coordinated with the Ministry of Communications and Informatics on policies regarding electronic money and on the deliberation of the Internet and Electronic Transactions Law.

Meanwhile, on the issuance of license and the oversight of payment systems in the banking industry, Bank Indonesia has coordinated accordingly with the Financial Services Authority (OJK), in the form of information exchange and consultation on related industry regulations.

13.6. Policy Coordination on the Currency Management

To complete the round of concerted policies in regulating non-cash payment systems, in improving the resilience of the external sector and on crisis management, Bank Indonesia has coordinated as well with the Indonesian government in managing the nationwide supply of currency, to ensure that payment systems remain secure, efficient and reliable. In this regard, the currency management policies included those of ensuring the availability and credibility of the Indonesian rupiah in circulation, the secure and optimal distribution and management of cash, and the availability of excellent on cash services.

Regarding the supply of rupiah currency, Act No. 7/2011 on Currencies stipulates that the overall process of planning, issuing and destroying the rupiah currency be carried out by Bank Indonesia in coordination with the Indonesian government. This coordination was thus implemented in the Memorandum of Understanding No. 14/1/GBI/DPU/NK/MOU-5/MK.05/2012 signed on June 27, 2012 between the Governor of Bank Indonesia and the Ministry of Finance. Bank Indonesia initiated the currency planning phase by firstly submitting the 2014 Money Demand Estimation (EKU) and the Money Printing Plan (RCU) to the Ministry of Finance. The plans are based on such macroeconomic assumptions as the inflation rate and economic growth, as well as the rupiah's planned denominations and amounts to be issued and retracted. The EKU becomes the basis for money procurement

according to the RCU. For the year of 2014, Bank Indonesia and the Ministry of Finance has agreed on a total currency issuance of Rp297 trillion, consisting of Rp295.9 trillion in banknotes and Rp1.1 trillion in coins. To meet this plan, Bank Indonesia has worked together with Perum Peruri, a state-owned printing company, in improving printing capacity in order to meet the delivery schedule which has been approved in advanced.

Bank Indonesia has also coordinated with the Ministry of Finance regarding the issuance of new rupiah banknotes for August 17, 2014. Coordination of the issuance plan, as stipulated in Article 42 of Act No. 7/2011 on Currencies, includes those regarding the denominations, the dimensions, as well as the design and theme. Coordination also included that with the Ministry of Social Affairs and the Secretary of the Cabinet, regarding the Presidential Decree to implement the use of national hero images in the new banknote design, as stipulated in Article 7 Sub-Article 3 of the Currencies Law.

Meanwhile, regarding the retraction and destruction of invalid rupiah banknotes and coins, Bank Indonesia has submitted both quarterly reports to the Ministry of Finance and annual reports to the Legislation and the Ministry of Justice and Human Rights on the issue, which are then made publicly available in the year's Official Gazette.

Apart from those already mentioned, Bank Indonesia has also coordinated with related authorities in combating counterfeit money, following up the Presidential Regulation No. 123/2012 on the Counterfeit Money Eradication Coordination Agency (BOTASUPAL), signed by the President on December 7, 2012. Coordination was carried out with the State Intelligence Agency, the National Police, the Attorney General's Office, and the Ministry of Finance, in the form of seminars and workshops for law enforcement officers. Such occasions were for the year 2013 held in Cirebon, Lampung and Padang, to agree on the proper enforcement measures against money-related crimes: enforcing the Currencies act to prosecute currency-related crimes, while still enforcing the code of criminal procedure law for other currency-related crimes (KUHP), to achieve the maximum punitive effect with fines and imprisonment.

Other coordination efforts included increasing public awareness against counterfeit money. In June, Bank Indonesia and the Curriculum and Reference Book Center of the Ministry of Education and Culture agreed to include central-bank-related study materials for the High School Economics class in the 2013 Curriculum. These learning

modules included topics on the banking industry, payment systems, currency management, non-cash payment systems, and counterfeit money. The agreement was a follow-up to a previous agreement in April with the Ministry of Religious Affairs Regional Office for the West Java Province, on improving the Economics and Social Studies curriculum for Islamic-based schools with central-bank-related study materials.

Meanwhile, regarding to the currency distribution and cash management, coordination was carried out upon activities of money transportation by cash-in-transit (CIT) companies. On July 20, Bank Indonesia and the Indonesian National Police signed the Memorandum of Understanding No. 15/1/DpG/DPU/NK No. B/29/VII/2013 on Coordination for the Development and Supervision on Money Transportation and Processing Firms, which provide a security guard for cash distribution and cash processing activities. The MoU authorized Bank Indonesia to provide coaching and supervision for CIT firms in their cash distribution, cash processing, cash safe storing, and managing cash replenishment machines (CDM) and automatic teller machines (ATM). The Indonesian National Police,

meanwhile, was authorized in the security aspects of the activities.

In regards to pursued excellent cash services, Bank Indonesia continued its coordination with the Indonesian Navy in providing mobile cash services to the country's outer islands in Papua and North Maluku, as well as to the Anambas Islands and the Natuna Islands. Bank Indonesia also coordinated with the Ministry of Social Affairs Ministry and the Coordinating Ministry for Public Welfare on holding related events such as Bakti Kesetiakawanan Sosial dan Bhakti Kesra Nusantara in two phases, which phase 1 in western area of Indonesia and phase II in eastern area of Indonesia.

To ensure the availability of valid currency throughout Indonesia, Bank Indonesia in 2013 updated its 1996 Memorandum of Understanding with the Bank of Papua New Guinea on the use of the rupiah and kina currencies at the two country's borders. A re-evaluation of the MoU was needed to address the growing outflow trend of Papua New Guinea's kina currency into Indonesia due to booming trade at the borders, and improve joint research on the use of the two currencies for inter-border trade.

