

Cultivating good things, the beginning of a generation

All life has a beginning. And the beginning of a tree to grow is the selection of the seed quality. It is similar to human life. Planting the good values of the life in early age generates a new generation with the power of life in higher quality



CHAPTER I

THE INDONESIAN ECONOMY:
GLOBAL INFLUENCES,
DOMESTIC PERFORMANCE
AND POLICY RESPONSES



CHAPTER I

The Indonesian Economy: Global Influences, Domestic Performance and Policy Responses



Indonesian economy was continuously improving during 2010, bolstered by solid domestic demand and favorable external conditions. The global economic recovery that began gaining traction during the first half of 2009 progressed further during 2010, underpinned by vigorous growth in emerging market nations. This upward trend was accompanied by sustained increases in global commodity prices that have increase inflationary pressure, particularly in emerging market economies. In advanced economies, however, economic growth is relatively limited, accompanied by low inflationary pressure. This condition prompted emerging markets to start monetary tightening by implementing macroprudential policies and raising policy rates. In contrast, advanced countries have generally opted for maintaining a loose monetary stance by holding interest rates down, while some countries have even injected their economies with substantial amount of liquidity (quantitative easing). The difference in the crisis responses between emerging market countries and the developed world spurred massive capital inflows to emerging market economies, including Indonesia.

Amid the more upbeat trend in global economic conditions, Indonesia's economic growth achieved 6.1% growth in 2010, higher than the previous year's growth that was only 4.6%. This robust increase in economic growth is supported by an expanding role of investment and exports. Investment growth took a heartening turn in 2010, being directed more towards building economic capacity as indicated by the expanding role of non-construction investment led by investment in machinery. Meanwhile, more robust export performance was

accompanied by broader diversity of exported commodities and destination markets, reflected in improved performance in tradable sectors, particularly manufacturing industry. Nevertheless, the main driving force of economic growth came from non-tradable sectors, primarily transport and communications, and trading, hotels and restaurants sector.

These favorable developments in the global economy supported the strengthening of Indonesia's balance of payments in 2010. During 2010, Indonesia's balance of payments recorded USD 30.3 billion surplus that came both from the current account and capital and financial account. Exports recorded high growth, enabling the current account to maintain a surplus amid high increase in imports and income transfers. Capital and financial account, bolstered by the high rate of foreign capital inflows, also posted a large surplus with improving composition. This was reflected by a significant increase in foreign direct investment (FDI) in addition to a very significant rise in portfolio investment. In response to these developments, foreign reserves position at the end of 2010 reached USD 96.2 billion, more than adequate to cover imports and external obligations while assuring exchange rate stability.

In line with this balance of payments performance, the rupiah appreciated with low volatility. During 2010, the average rupiah exchange rate was Rp 9,081 per US dollar, appreciated by 3.8% since the end of 2009. This performance was supported by sustained positive perception on Indonesian economy, as indicated by the upgrading of Indonesia's sovereign credit rating and improvement



in risk indices. Compared with other countries in the region, rupiah appreciation during the year was also fairly moderate, and therefore did not significantly deteriorate export performance. This achievement was also a result of policies undertaken for managing foreign capital inflows in order to bolster economic resilience to cope with short-term capital reversal.

Consumer Price Index (CPI) inflation in 2010 climbed to 6.96%, beyond the inflation target corridor of $5\% \pm 1\%$. During the first half of the year, price stability remained in check as indicated by the low rate of inflation (5.05%, yoy). In early third quarter of 2010, foodstuffs supply was disrupted by anomalous weather conditions in Indonesia and worldwide. In response, food commodity prices soared in global markets, while prices for the same commodities in Indonesia also mounted sharply. Staple commodities, in particular rice and seasonings, contributed heavily to steep price increases that drive up the inflation of volatile food prices to 17.74%, far higher than the previous year's level at only 3.95%. Despite the surge in volatile food price inflation during the year, core inflation remained low at 4.28%. This development was supported by prudently managed economic fundamentals, as indicated by the appreciating exchange rate, subdued inflation expectations, and economic capacity that was still adequate to meet the expansion of demand. Meanwhile, the administered prices inflation recorded moderate level at 5.40%.

Financial system stability remained under control during 2010. The solid condition of the banking industry was reflected in the high capital adequacy ratio (CAR) and low non-performing loans (NPLs).

Banking intermediation improved further, reflected in credit growth at 22.8%. Performance of the stock market and bond market was bolstered by lower investment risk and attractive returns that fuelled inflows of foreign capital into these instruments. On the stock market, upbeat performance in Indonesia Composite Index (IHSG) was also underpinned by improved performance of corporate financial statements and a more favorable market structure. Such a performance enabled the IHSG to chart the largest gain in the region. On the bond market, the improvement was reflected in higher trading volume and diminished yield on Indonesian Government Securities from the beginning of the year, among others, explained by prudently managed fiscal sustainability. The money market underwent expansion in liquidity while the interest rate moved towards the lower limit of the corridor. This fact indicates excess liquidity in the banking sector and bank preferences for holding excess liquidity in short-term instruments.

These developments were closely linked to various policies implemented by Bank Indonesia and the Government. Bank Indonesia has maintained a monetary policy stance focused on pursuit of the inflation target and safeguarding of macroeconomic stability. Under this policy direction, Bank Indonesia held BI Rate at a level commensurate with achievement of the inflation target and economic growth. Bank Indonesia also launched a mix of monetary and macroprudential policies to manage excess banking liquidity and foreign capital inflows. Banking and payments system policy focused on improving the resilience, efficiency and operation of banking intermediation and measures

to ensure the creation of an efficient, reliable, convenient and secure payment system. Meanwhile, government policy is directed to bolster the economic capacity through accelerating the construction of infrastructure and provision of energy, addressing supply shocks on food staples, and protecting public purchasing power.

1.1

Global Economy



The recovery of global economy that started in mid 2009 continued in 2010. High global economic growth at the beginning of the year brought optimism for the acceleration of global economic recovery. Nevertheless, debt crisis in some European countries and high unemployment rate in advanced countries led to a weakening of the global economic recovery, particularly since the second quarter of 2010. On the contrary, economic recovery in emerging markets continued strengthening, reflecting an imbalance in the speed of the recovery between advanced and emerging market economies. Notwithstanding such an imbalance, overall the world economic growth in 2010 was higher than initially projected. International financial institutions, such as the IMF, revised up their projections on the world economic growth in 2010, which was in line with higher realization of global economic growth towards the end of 2010 (Table 1.1.).

A stronger expansion of emerging market economies becomes the main factor contributing to a higher world

economic growth. Strengthening domestic consumption accompanied by good export performance boosted emerging market economies to achieve high growth. The IMF predicted the economic growth of emerging market countries in 2010 was 7.1%. Meanwhile, advanced economy grew at only moderate level, supported by fiscal and monetary stimulus. Overall, household consumption started to improve, as reflected by retail sales growth in line with the increase in income and improvement in labor market condition. But the prospect of household consumption was still confronted with high unemployment rate and worsening economic expectation.

In line with the increasing world economic growth, world trade also grew substantially. World trade volume in 2010 grew by 12.0%, following the contraction by 11% in the previous year (Chart 1.1). Developing countries with strong trade basis were the key engine of the rise in the world trade volume. Moreover, a more intensified trade among developing countries also contributed to the increase in the world trade volume in such a way that the impact of slow recovery in advanced countries was moderate.

The speed up of global economic growth, in turn, contributed to the rise in global commodity prices. World demand for oil increased and triggered significant increase in oil prices. This development is shown by various reports of international energy institutions such as International Energy Agency (IEA) and Organization of the Petroleum Exporting Countries (OPEC) that revised up the outlook for oil demand in 2010. In average, the prices of oil West Texas Intermediate (WTI) and Minyak Nasional (Minas) in 2010 reached USD 79,4 per barrel and USD 81.1 per barrel, respectively. Although, not as high as the rise in oil prices, non-oil commodity prices were also increased significantly

Table 1.1 World Economic Growth 2010

percent

Countries	Period of Projection					
	Oct-09	Jan-10	Apr-10	Jul-10	Oct-10	Jan-11
World	3.1	3.9	4.2	4.6	4.8	5.0
Advanced Economies	1.3	2.1	2.3	2.6	2.7	3.0
United States	1.5	2.7	3.1	3.3	2.6	2.8
European Union	0.3	1.0	1.0	1.0	1.7	1.8
Japan	1.7	1.7	1.9	2.4	2.8	4.3
Emerging Market	5.1	6.0	6.3	6.8	7.1	7.1
Commonwealth Countries in Eastern Europe	2.1	3.8	4.0	4.3	4.3	4.2
Asia	7.3	8.4	8.7	9.2	9.4	9.3
China	9.0	10.0	10.0	10.5	10.5	10.3
India	6.4	7.7	8.8	9.4	9.7	9.7
ASEAN-5	4.0	4.7	5.4	6.4	6.6	6.7
World Trade Volume (goods and services)	2.5	5.8	7.0	9.0	11.4	12.0

Source: IMF, World Economic Outlook

in 2010, agricultural and mining commodities (Chart 1.3). The increase in global commodity prices can be attributed partly to the lax monetary policy stance in advanced economies together with the weakening of US dollar.

Overall, the development in global commodity prices and demand led to a rise in global inflation. A higher inflationary pressure due to higher commodity prices particularly took place in emerging market countries. A rise in food prices, triggered by a fall in production due to weather anomaly in many countries, also contributed to the increase in inflation, particularly in mid 2010.

Meanwhile, inflation in advanced countries was relatively low and stable due to their moderate economic recovery. In 2010, emerging markets inflation reached 5.54% while advanced countries inflation was only 1.44% (Chart 1.4).

In global financial markets, the development during 2010 also showed improvement, although uncertainty risks remained. Global financial markets in early 2010 were characterized by a fall in global investors' risk appetite due to PIIGS¹ crisis. In the first half of 2010, debt crisis in PIIGS

1 Portugal, Ireland, Italy, Greece and Spain

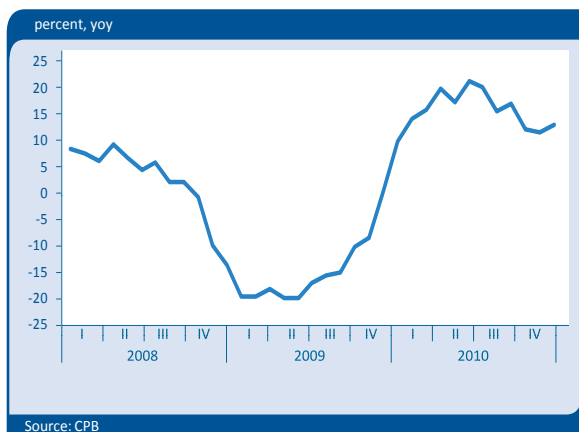


Chart 1.1 World Trade Volume

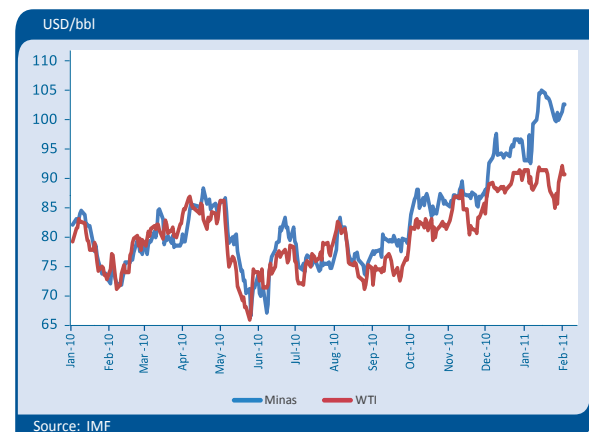


Chart 1.2 Oil Price

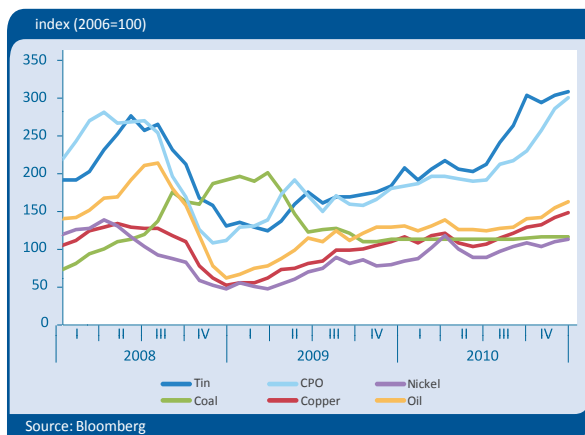


Chart 1.3 Commodity Prices

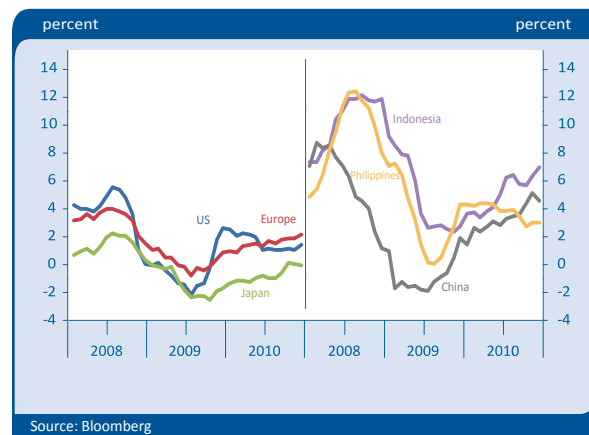


Chart 1.4 Inflation in Advanced and Asia Emerging Markets Countries

triggered tenses and jitters in global financial markets that led to a significant correction of asset prices in financial markets. Toward the second half of 2010, the risks in financial markets started to subside and the condition of financial markets continuously improved, particularly in emerging markets, as reflected by a fall in Composite Sovereign Credit (Chart 1.5). Meanwhile, investment risks in advanced economies remained unfavorable in the second half of 2010. Measures to deal with fiscal crisis undertaken by European Commission (EC) and the IMF, together with loose monetary policy signal in advanced countries, in turn managed to make a rebound in global financial markets. Stock markets in advanced economies started to show an improvement, although not as strong as stock markets in emerging economies. Notwithstanding with such a rebound, fiscal crisis that occurred in Ireland towards the end of 2010 brought down market sentiment and triggered liquidity tightening in Europe. This indicated that global financial markets remained facing high uncertainties.

From economic policy side, an imbalance in economic and financial market progresses led to different responses undertaken by advanced countries and emerging market countries. Monetary policy in advanced economy is generally loose as an effort to minimize pressures in financial markets and to maintain the momentum of economic recovery. Furthermore, some central banks of advanced countries, such as Federal Reserve, Bank of Japan, and Bank of England, also kept on loosening monetary policy by purchasing bonds (quantitative easing). Nevertheless, some advanced countries that have already experienced accelerating economic growth—such as Australia, Canada, Sweden, and New Zealand—started to raise policy rate. Meanwhile, in facing higher inflationary pressure, central banks in emerging markets—such as Chile, Brazil, Peru, India, Malaysia, and China—normalized their policy by raising policy rate (Chart 1.7).

The difference in policy responses between advanced countries and emerging markets is one of the factors that

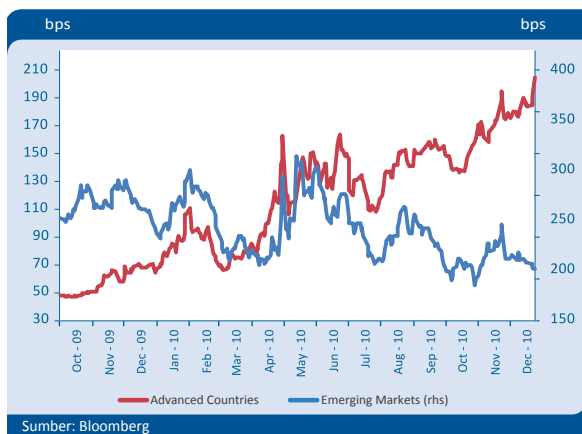


Chart 1.5 Composite Sovereign Indices (Markit ITraxx)



Chart 1.6 Global Stock Markets

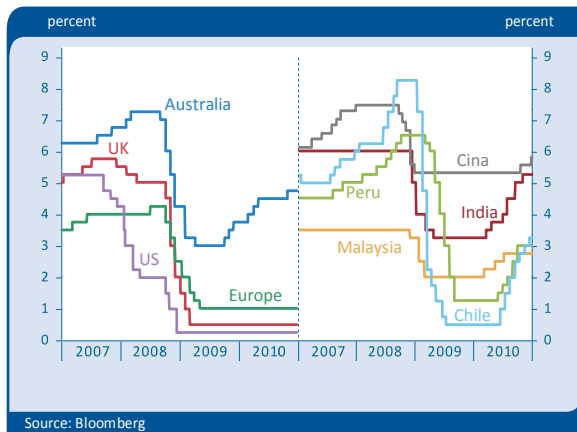


Chart 1.7 Policy Rate

triggered massive capital inflows to emerging market economies. The abundance of liquidity in advanced countries amid low interest rate and the sluggish real sector recovery caused investors to invest largely in

emerging market countries that provide higher return and lower risks. Facing with such massive capital inflows, a number of emerging markets' central banks made the management of excess liquidity as a priority through the implementation of a higher reserve requirement. The surge in capital inflows resulted in significant appreciation of the currency of the capital receiving countries that potentially reduce their export competitiveness. In this case, some countries implemented various policies to defend their currencies. The policies undertaken to defend domestic currency in turn may trigger the so called 'currency war', and then hamper the process of rebalancing global economy.

1.2

Performance of the Domestic Economy

In 2010, Indonesia's economic performance was influenced by the dynamics of the global economy. The more upbeat pace of global economic growth and the resultant increase in volume of world trade and sharply rising commodity prices boosted growth in Indonesian exports. Exports represented the largest contribution to economic growth during 2010. The hefty improvement in exports helped maintain a current account surplus, despite sharply rising imports and profit transfers. In the capital and financial account, global economic recovery combined with heavy capital inflows to produce a sizeable capital surplus in the balance of payments. This improving trend in macroeconomic conditions fuelled positive developments on the Indonesian capital market. Share prices soared, placing the Indonesian Stock Exchange as the best-performing market in the region. Alongside this, yield on Indonesian government securities has come down significantly since 2009. The high volume of capital inflows also resulted in significant appreciation of rupiah and mushrooming liquidity on the short-term money market. These conditions pushed the overnight (O/N) interbank rate down below the BI Rate level, nearing the lower limit of the corridor.

At home, rising levels of consumer confidence and public purchasing power were key factors in buoyant consumption growth during 2010. In response, investment growth gathered momentum in line with improving business tendencies and robust export demand. On the other hand, realized government expenditures were marked by reduced growth compared to the previous year. In response to these developments, Indonesia's economic growth strengthened to 6.5% from 4.6% one year before. However, inflation mounted significantly during 2010 with CPI inflation running at 6.96%, above the 2010 inflation target (5±1%). The high rate of inflation

was driven by an inflationary spike in volatile foods related to adverse weather conditions that have disrupted the supply of goods in this category. Nevertheless, inflation developments on a more fundamental level remained well under control, consistent with the appreciation of rupiah, subdued public expectations of inflation and still adequate supply-side conditions for responding to increased demand. This was visible in the stable level of core inflation, comparatively unchanged from the previous year at 4.28%.

■ Balance of Payments

Befitting Indonesia's position as an open economy, external performance was strongly influenced by the dynamics of the global economy and financial markets. During 2010, the balance of payments recorded a sharply increased surplus at USD 30.3 billion, driven by heavy capital inflows and more robust export performance. In the capital and financial account, the sharply increased surplus came in response to steady improvement in domestic economic fundamentals and low interest rates in advanced economies that fuelled inflows of portfolio and direct investment capital into Indonesia. However, the current account, while posting a surplus, performed less strongly compared to the year before. More rapid acceleration in imports compared to exports resulted in a smaller increase in the trade surplus compared to the rise in the income deficit. In response to these developments, Indonesia's international reserves climbed from USD 66.1 billion at end-2009 to USD 96.2 billion at the end of 2010, a level equivalent to 7.0 months of imports and servicing of official external debt (Table 1.2).

During 2010, the current account surplus narrowed to USD 6.3 billion from USD 10.2 billion one year earlier.

This condition represents the outcome from interaction between externals and growing domestic demand. The drop in the current account surplus is explained by a reduced increase in the non-oil and gas trade surplus during 2010 compared to the rise in the oil trade and income account deficits. The Indonesian economy has profited from the momentum of world economic recovery through growth in the non-oil and gas trade surplus. However, high demand for imports dampened potential for an even greater improvement in the trade surplus. In related developments, an added contribution to the current account surplus came from increased gas production. However, the oil trade balance generated an increased deficit contribution due to falling oil production while oil imports kept mounting to satisfy growing domestic demand. The income account similarly posted an enlarged deficit, explained by the rising value of foreign investment in Indonesia and the associated increase in profit transfers to foreign investors.

In the non-oil and gas trade balance, high export growth fuelled by the accelerating recovery in the world economy pushed the surplus to USD 27.4 billion from USD 25.5 billion in the preceding year. Export revenues advanced by a robust 31.1% to USD 129.8 billion, with growth recorded across all sectors in volume and value. Mining exports forged ahead with 27.9% growth, while agricultural exports grew at a more modest 21.4%. In analysis by commodity, resource-based commodities such as coal, crude palm oil (CPO), copper, rubber and metal goods provided the backbone of non-oil and gas export performance during the year. Significant growth was also observed in non-resource-based commodities, such as textiles and textile products, electrical equipment and chemicals. In disaggregation by share, non-oil and gas exports to China maintained vigorous growth, raising China's position from fifth place in 2009 to the third most important export destination for Indonesia while displacing the US and Singapore. At the same time, Indonesia widened the share of exports to destinations outside the top ten, reflecting a growing diversification in the country's export markets.

Non-oil and gas imports recorded faster growth compared to 2009 in response to keen domestic demand. During 2010, imports climbed 42% to 102.4 billion US dollars. Raw materials again dominated imports, indicating that so far, imports have risen in support of domestic industrial production. Imports of raw materials and consumption goods were in relative balance at 41.6% and 47.4%. The

surge in imports was fuelled not only by strong domestic demand, but also linked to appreciation in the rupiah.

The oil trade balance posted a significantly increased deficit during 2010. The most important contribution to this deficit came from rising oil imports alongside an escalation in world oil prices. Oil export revenues registered only limited growth by comparison, with revenue growth driven only by rising oil prices amid a downward trend in volume caused by various production constraints that lasted throughout 2010. Nevertheless, the gas balance again recorded an increased surplus on improved production levels, as well as high prices on world markets.

The services and income account, another component in the current account that consistently contributes deficit figures, again recorded a sizeable deficit in 2010. A sharply increased deficit was recorded in the income account from the effect of mounting profit transfers to foreign investors. The vast tide of capital inflows during the year also increased Indonesia's obligation to provide returns on fund placements by foreign investors, particularly in portfolio investments and FDI.

In the capital and financial account, the high volume of capital inflows also contributed to a sharply increased surplus. The capital and financial account surplus soared to USD 26.2 billion from the previous year's level of only USD 5.0 billion. The main factor in the increased surplus was a sharp rise in direct investment during the year (Chart 1.8). The improvement in the investment climate and domestic economic performance provided a lift to foreign investor confidence for direct investment in Indonesia. Further indication of improvement in foreign direct investment during the year came from the expanding share of the non-oil and gas sector. Within this sector, foreign direct investment targeted primarily manufacturing, mining and quarrying, trade and communications.

Portfolio investment mounted sharply in 2010 compared to 2009 in keeping with the continuation of monetary relaxation in advanced nations and more attractive yields in Indonesia. Despite charting growth for the year as a whole, portfolio inflows maintained a fluctuating trend, even taking a sharp dip during Q2 2010 due to the impact of the Greek crisis. During the fourth quarter, portfolio capital inflows also came under renewed pressure from the outbreak of the Ireland crisis, tensions on the Korean

Table 1.2 Indonesia Balance Of Payment

millions of USD

Items	2008	2009	2010*				
			I	II	III	IV	Total
CURRENT ACCOUNT	126	10,192	2,093	1,603	1,374	1,224	6,294
A. Goods, net (Trade Balance)	22,916	30,147	7,045	6,961	7,807	9,279	31,093
- Export, fob.	139,606	119,646	35,084	37,439	39,708	45,970	158,201
- Import, fob.	-116,690	-89,499	-28,039	-30,478	-31,901	-36,690	-127,108
1. Non Oil and Gas, net (Trade Balance)	15,130	25,541	5,777	5,852	6,677	9,132	27,437
1.1. Export, fob.	107,885	99,029	28,511	30,298	32,763	38,226	129,797
1.2. Import, fob.	-92,755	-73,489	-22,734	-24,446	-26,086	-29,094	-102,360
2. Oil, net	-8,362	-4,796	-1,544	-2,004	-1,856	-2,860	-8,264
2.1. Export, fob.	15,387	10,790	3,551	3,835	3,744	4,305	15,436
2.2. Import, fob.	-23,749	-15,586	-5,095	-5,839	-5,600	-7,166	-23,700
3. Gas, net	16,147	9,402	2,812	3,113	2,987	3,008	11,920
3.1. Export, fob.	16,333	9,826	3,022	3,306	3,201	3,438	12,968
3.2. Import, fob.	-186	-424	-210	-193	-215	-430	-1,048
B. Services, net	-12,998	-9,675	-2,129	-2,307	-2,286	-2,770	-9,491
C. Income, net	-15,155	-15,140	-3,993	-4,262	-5,385	-6,619	-20,258
D. Current Transfer, net	5,364	4,861	1,169	1,210	1,238	1,334	4,950
II. CAPITAL AND FINANCIAL ACCOUNT	-1,832	5,002	5,013	4,661	6,669	9,874	26,218
A. Capital Account	294	96	18	0	0	14	32
B. Financial Account	-2,126	4,906	4,995	4,661	6,669	9,861	26,186
1. Direct Investment	3,419	2,628	2,484	2,298	1,615	3,439	9,836
2. Portfolio Investment	1,764	10,336	6,159	1,089	5,994	1,964	15,205
3. Others Investment	-7,309	-8,058	-3,648	1,274	-939	4,458	1,145
III. TOTAL (I+II)	-1,706	15,194	7,106	6,264	8,044	11,098	32,512
IV. NET ERROR AND OMISSIONS	-238	-2,688	-485	-843	-1,089	191	-2,227
V. OVERALL BALANCE (III+IV)	-1,945	12,506	6,621	5,421	6,955	11,289	30,285
VI. RESERVES AND RELATED ITEMS (A+B)¹⁾	1,945	-12,506	-6,621	-5,421	-6,955	-11,289	-30,285
Memorandum:							
- Reserve Asset Positions ²⁾	51,639	66,105	71,823	76,321	86,551	96,207	96,207
(in months of import and servicing of government external debt)	4.0	6.4	5.3	5.6	6.3	7.0	7.0

1) Negative means surplus and positive means deficit

2) "Since 1998, reserve asset positions was based on gross foreign assets concept to replace official reserve asset concept"

* Provisional Figures

peninsula and monetary tightening in China. The sharp rise in portfolio investment during the year was recorded mostly in placements in rupiah-denominated Indonesian government bonds and corporate stocks, in contrast to declining placements in Bank Indonesia Certificates (SBIs) and Indonesia Global Bonds.

Other investment components, consisting of private and public debt, recorded a USD 1.1 billion surplus in 2010 following the USD 8.1 billion deficit one year previously. However, this surplus is explained more by lower repayment of official debt, rather than drawing down new borrowings. The less than forecasted increase in borrowing is explained by underperformance in national budget outcomes for 2010 that resulted in more modest disbursement of official debt. Alongside this, private sector debt eased, reflecting the improving financial condition of the private sector. This was also related to a very steep rise in corporate debt repayments that exceeded the level of drawing on new borrowings (Chart 1.9).

■ Financial Markets

The dynamics of the global financial system during 2010 exerted a major influence on Indonesia's financial market performance. The high volume of capital inflows pouring into Indonesia was driven not only by the marked contrast in policies between advanced economies and emerging markets, but also by the strength of domestic economic fundamentals and the upgrading of Indonesia's sovereign rating with the approaching likelihood of achieving investment grade. These conditions positively impacted the performance of Indonesia's financial markets. The capital market gathered momentum with share prices charting substantial gains alongside diminishing yield on

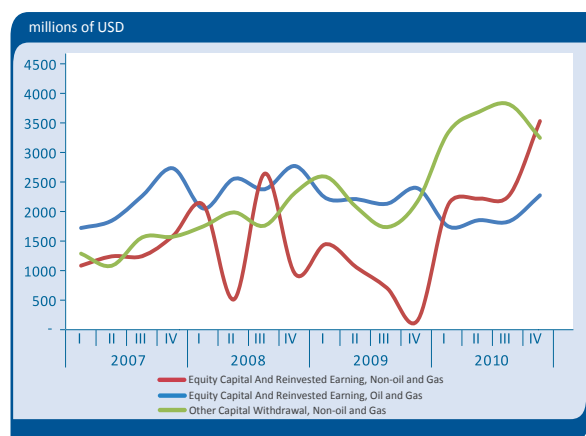


Chart 1.8 FDI Composition

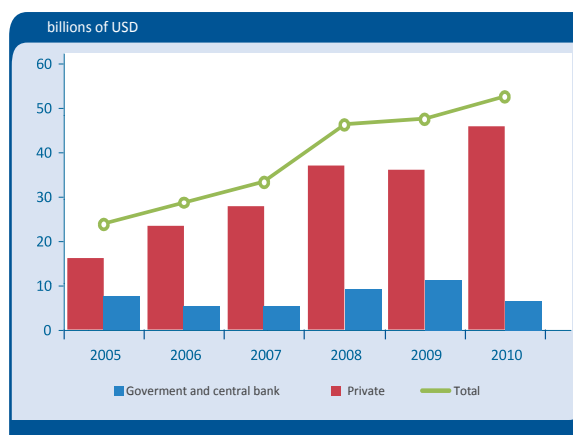


Chart 1.9 Loan Withdrawal

Indonesian government securities. From the beginning of the year, the stock market maintained a bullish trend buoyed by the stronger financial outlook for listed companies in comparison to markets in the region. At the same time, yield on Indonesian government securities narrowed by 212 bps while remaining more attractive compared to other countries in the region. Surging capital inflows resulted in very high liquidity on the short-term rupiah money market with the effect of driving down interbank interest rates.

Confidence in Indonesia's stock market was strengthened by developments in macroeconomically important indicators, such as relative stability in the exchange rate, the economic growth outlook, moderate inflation, low interest rates and expectations of achieving investment grade in the near future, all of which encouraged foreign investors to place their funds on the market (Chart 1.10). Reinforcing this were massive capital inflows driving buoyant growth in stock market trading activity and liquidity during 2010. The net foreign purchase mounted to Rp 18.4 trillion from Rp 13.9 trillion in the preceding year, driving stock market turnover to Rp 4.8 trillion per day in 2010 compared to the previous year's daily average of Rp 3.9 trillion (Chart 1.11). As a result, the IHSG recorded steep gains in 2010, earning the Indonesian Stock Exchange (IDX) the distinction of the best performing market in the region with an index gain of 46.1% (yoy). From 2,534.4 in December 2009, the IHSG maintained an upward trend to hit 3,703.5 at end-December 2010.

During the course of the year, the IHSG came under pressure on a number of occasions. Significant index losses came in response to sentiment over the Greek crisis in Q2/2010 and other external issues, such as

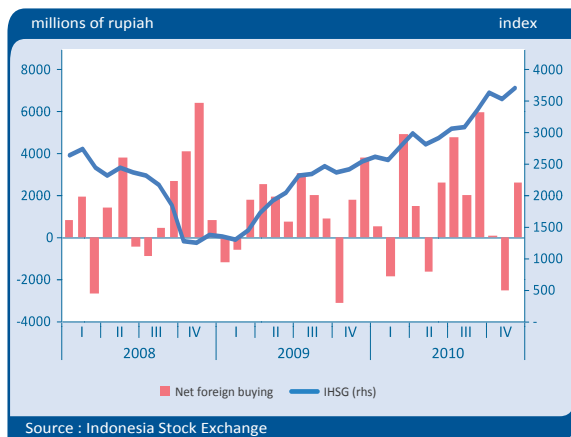


Chart 1.10 IHSI and Net Foreign Buying

monetary tightening in China, the Ireland crisis and escalating conflict on the Korean peninsula at the end of the year. Even so, the bullish trend in the IHSI also calls for vigilance given that the price gains, which are indicated to have outpaced developments in fundamentals, have potential to fuel an asset price bubble.

IHSI performance in 2010 also received a boost from the micro condition of the listed companies, which offered brighter financial prospects compared to other countries in the region (Chart 1.12). In some financial statements released for Q3/2010, corporate earnings levels remained comfortable strong. In fact, return on equity reported by Indonesian listed companies remained superior to other countries in the region. The upbeat micro condition of listed companies was also visible in dividend payouts by some stock issuers, which also indicated robust levels of solvability among publicly traded companies. Market actors displayed considerable optimism in the

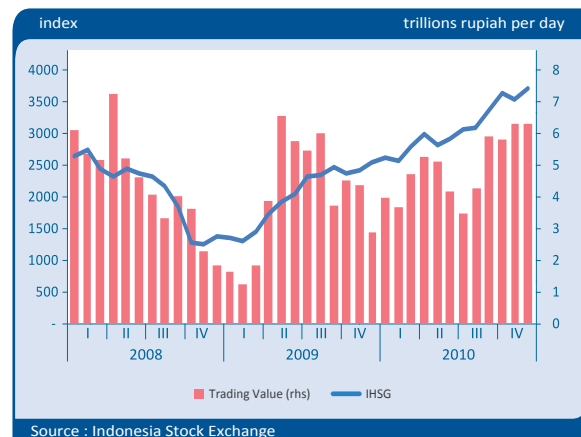


Chart 1.11 IHSI and Trading Value

future earnings growth of listed companies, given the high expectations of corporate players regarding budget allocations for capital expenditures.

Improvement on the bond market was marked by a downward trend in government securities yield during 2010. This trend was prompted by a combination of monetary policy relaxation signalled by advanced economies, high yields on domestic instruments and improving perceptions of risk in line with macroeconomic conditions. Reflecting this was steady improvement in the level of Credit Default Swaps (CDS) since early 2009 (Chart 1.13). In addition, performance in Indonesian government securities was bolstered by prudently managed fiscal sustainability accompanied by limited fiscal risks. Following these developments, the foreign-held position of Indonesian government securities widened by Rp 82.2 trillion during 2010, more than in the net purchase recorded in the preceding year at Rp 20.3 trillion (Chart

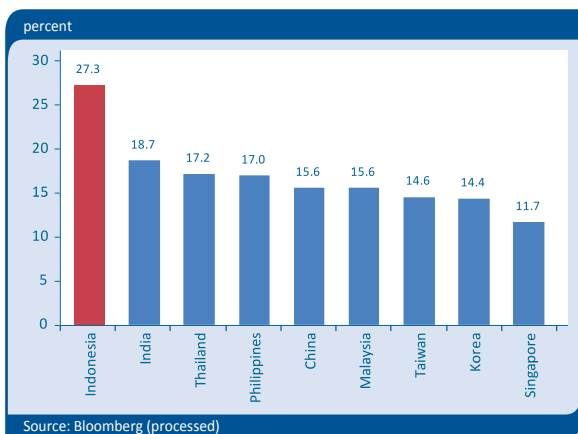


Chart 1.12 ROE Comparison in the Region

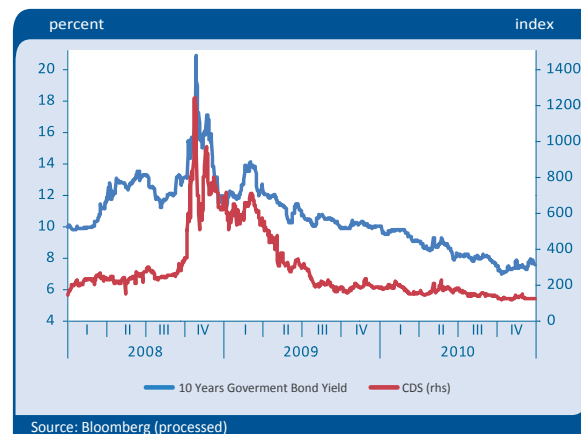


Chart 1.13 Treasury Bills Yield and CDS

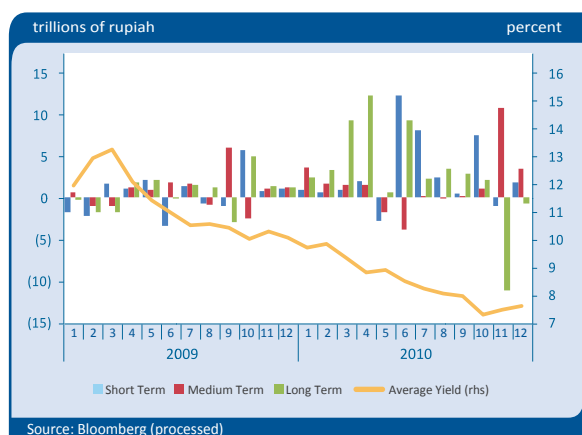


Chart 1.14 Treasury Bills Yield and Foreign Investors Activity

1.14). The low net purchase in 2009 was linked to flagging market turnover (Rp 3.4 trillion per day) caused by lack of recovery in market confidence following the 2008 crisis and the resultant tendency among market actors to buy and hold. With economic recovery gaining traction, trading activity resumed growth with market turnover in 2010 reaching Rp 4.7 trillion per day (Chart 1.15).

These positive domestic and external factors converged to stimulate foreign investor interest in Indonesian government securities and keep yields on a downward trend. Yield on short, medium and long-term government securities narrowed by 207 bps, 232 bps and 181 bps, with overall yield down 212 bps to close the year at 7.16%. Within a broader perspective, the 7.5% yield on 10-year Indonesian government securities retained greater attraction compared to other countries in the region, such as Thailand, Malaysia and the Philippines, where yields reached 3.6%, 3.8% and 6.0%.

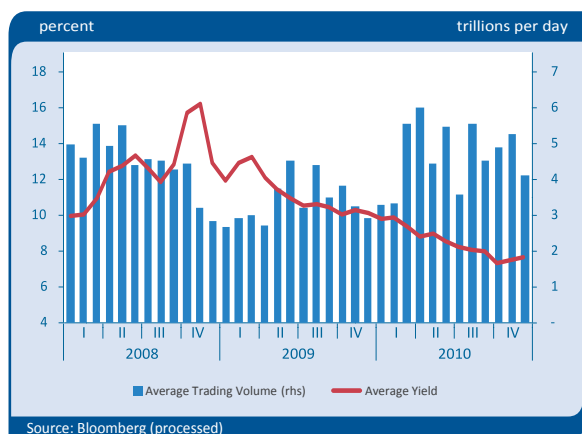


Chart 1.15 Treasury Bills Yield and Trading Volume

This more robust performance in Indonesian government securities had a positive effect on corporate bond issuances on the domestic capital market. The decline in government securities yield, frequently used as a benchmark in bond issues, encouraged companies to float bonds to finance their business activities. This was indicated by a 22.7% rise in the value of corporate bond offerings compared to one year earlier. Volume of bond issuances climbed Rp 40 trillion to Rp 215.13 trillion, with the market expanding by 6 corporate issuers to a total of 189 (Chart 1.16). Most of the corporate bond issues (Rp 28.1 trillion) were launched by multifinance companies to refinance existing debt. Other sectors reporting higher levels of bond issuances were infrastructure, utilities and transport and the agriculture and estates sector.

On the mutual funds market, upbeat performance in underlying assets during 2010 spurred rapid growth in mutual funds NAV. This was also supported by a decline in deposit rates that positioned mutual funds as a promising investment alternative for retail investors. In analysis of underlying assets, the performance gains charted by mutual funds were commensurate with gains in financial asset prices, such as for shares, Indonesian government securities and corporate bonds. In response to these developments, mutual funds NAV mounted by 22.7%.² However, NAV per unit gained only 9.9%. During the year, NAV growth owed more to the higher number of units rather than appreciating value of the managed assets (NAV per product) (Chart 1.17).

In analysis by product, investment manager performance in managing their funds varied considerably, as was visible

² Excluding limited asset-based mutual funds.

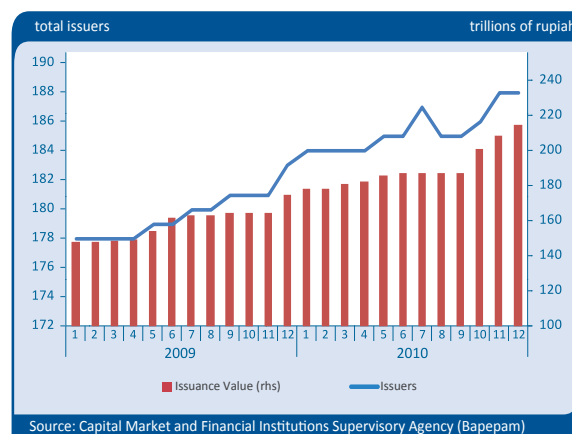


Chart 1.16 Total Issuance and Corporate Bond Issuers

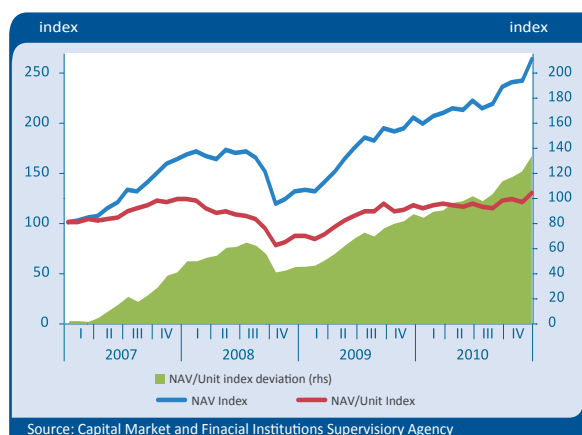


Chart 1.17 Net Assets Value and NAV/Unit Mutual Fund

from the NAV for each mutual fund product. NAV growth in equity-based fund products, such as equity funds (22.6%), index funds (-39%), mixed funds (13.3%) and Exchange Traded Funds (ETF) (-29.3%), fell far short of the benchmark set by IHSG gains at 46.1%. In contrast, debt-based mutual funds products outperformed the 12.2% price gain in the IDMA Bond Index benchmark, with NAV growth for fixed income, money market and protected funds recorded at 31.4%, 41.5% and 21.7%.

On the short-term financial market, key developments included a downward trend in the overnight interbank rate below the BI Rate level, even dropping to near the lower limit of the interest rate corridor due to the effect of excess short-term liquidity in the banking system. This is explained by continued modest demand while the money market was awash with liquidity from surging waves of capital inflows. During 2010, the overnight interbank rate hovered below the BI Rate to average 6.08% over the

year, well below the annual average recorded one year previously at 7.11% (Chart 1.18). Lack of optimum demand creation on the interbank money market was indicated by the low volume of interbank transactions. Daily average volume on the interbank market during 2010 reached Rp 9.4 trillion, relatively stable when compared to volume in 2009 (Rp 9.1 trillion) and still below the pre-crisis volume recorded at Rp 12.5 trillion (Chart 1.19). On the supply side, increased money market liquidity during 2010 resulted mainly from heavy volume of capital inflows placed in stocks, Indonesian government securities and SBIs. While supply of liquidity at home was down slightly from the previous year, substantial volume was supplied through hefty expansion in the government account during the end-of-year period. To address this condition, Bank Indonesia took action to manage liquidity through open market operations (OMOs) conducted throughout the year and the introduction of an increased statutory reserve requirement near the end of 2010, thus curbing the increased potential for excess liquidity.

■ The Exchange Rate

During 2010, the rupiah exchange rate charted significant appreciation, mainly from the effect of heavy capital inflows. Also contributing to the rupiah gains was equilibrium in supply and demand interaction on the domestic foreign exchange market and strong domestic economic fundamentals. The rupiah exchange rate maintained appreciation from the beginning of the year to reach Rp 9,081 to the US dollar, a gain of 3.8% over the end-2009 level. Measured point-to-point, the rupiah gained 4.4% (Chart 1.20). The gradual appreciation was accompanied by volatility at 0.4%, down from the 0.9% volatility recorded in 2009 (Chart 1.21).

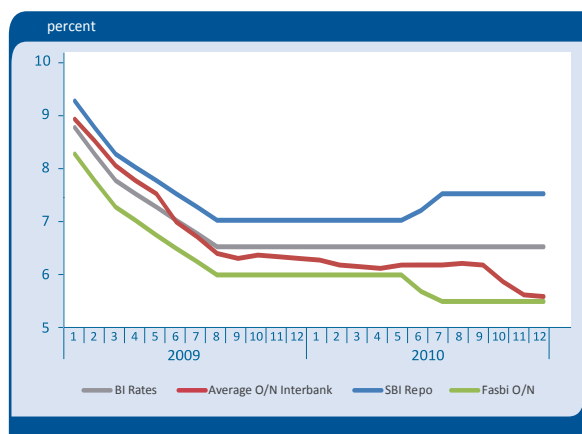


Chart 1.18 O/N Interbank Rates

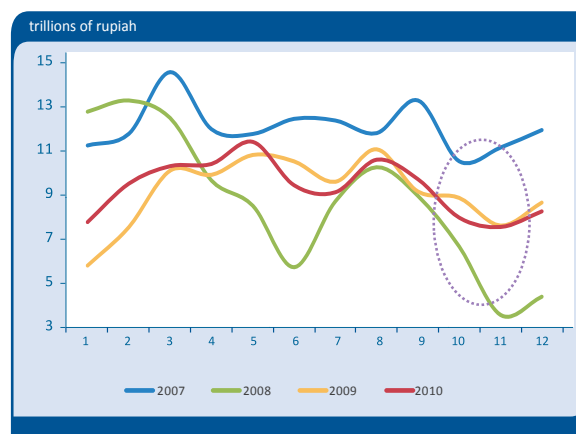


Chart 1.19 Interbank Transaction Volume

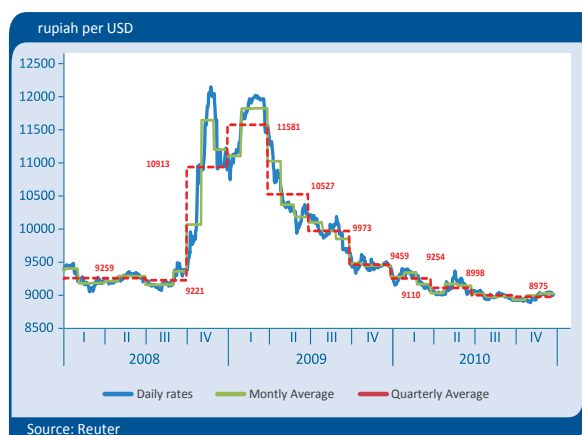


Chart 1.20 Average Rupiah Exchange Rate

In early 2010, the rupiah sustained turbulence brought on by the fiscal crisis in Greek that led to a wave of risk averse sentiment towards emerging market assets. Nevertheless, optimism for global recovery, the EC-IMF bailout for Greek and the upgrading of Indonesia's debt rating quelled the negative sentiment arising from the Greek crisis and paved the way for significant rupiah gains from Rp 9,400 to the USD in early February 2010 to a level beyond Rp 9,000 to the USD in early May 2010. At the beginning of June 2010, the fiscal crisis in Greek unfolded into the PIIGS crisis that sent shudders through global financial markets. The risk aversion behaviour that peaked during this quarter drove the exchange rate down to Rp 9,400 to the USD. Nevertheless, the ongoing recovery in the world economy, the broader interest rate differential between advanced economies and emerging markets and improvement in Indonesia's outlook helped to calm market jitters, and by the end of Q2 2010, the rupiah had returned to stable movement with an appreciating trend.

Following this, the rupiah maintained stable movement with an appreciating trend during the second half of 2010. The appreciation of rupiah took place against a background of sustained flows of funds to Asia amid conditions of flush global liquidity and the difference in policy responses between advanced nations and emerging market economies. Although marked by various corrections, the gains in the rupiah were strongly influenced by the outlook for the USD and the downward pressure on the currency. At home, the solid fundamentals of the economy and the looming prospect of upgrading in Indonesia's rating to investment grade became factors attracting capital inflows.

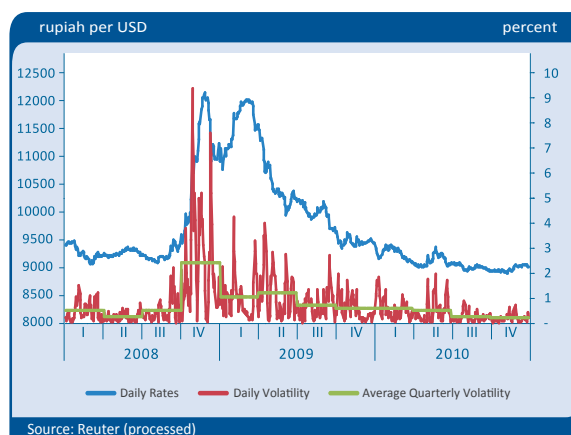


Chart 1.21 Rupiah Exchange Rate Volatility

Capital inflows again poured into emerging markets, this time triggered by strong expectations of low policy rates in advanced nations and the launching of the second round of quantitative easing by the Federal Reserve. The latter developments set off adverse sentiment driving down the USD that spurred even greater waves of capital flows in pursuit of higher yield assets in emerging markets, including Indonesia. From the domestic side, increased activity was also visible among domestic forex market players. While yet to recover to pre-crisis levels, corporates forex buying maintained an upward trend during 2010 in keeping with growing economic activity. Conversely, domestic corporations provided a steady stream of forex supply from export revenues. Since early 2010, the supply of foreign exchange from currency sales by domestic corporations has steadily expanded in line with the improving performance of Indonesia's exports. The top five corporate sellers of foreign exchange during 2010 were dominated by exporters of estate crops and

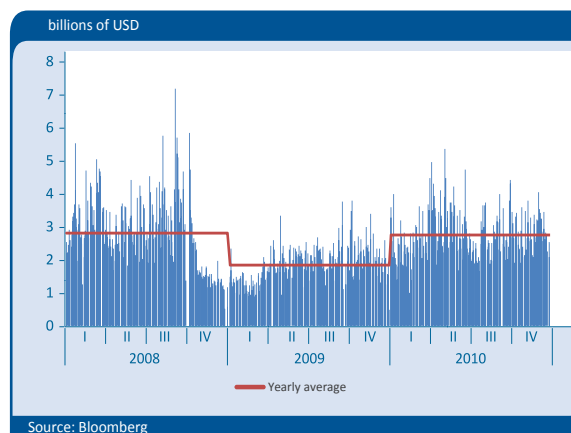


Chart 1.22 Daily Foreign Exchange Market Transaction Volume

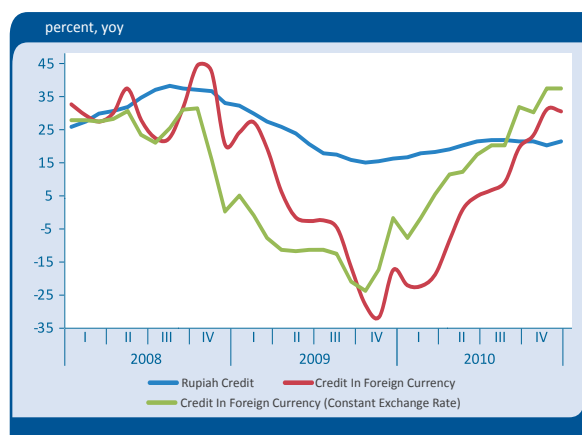


Chart 1.23 Credit Growth by Currency

other agricultural products. This combination of foreign and domestic activity drove average daily transaction volume on the forex market to near pre-crisis levels (USD 3 billion per day), indicating that the currency market was gradually returning to normal following the onslaught of the earlier crisis (Chart 1.22).

The high volume of capital inflows and strength of pressures driving rupiah appreciation created new complexities for macroeconomic policy. On one hand, appreciation in the rupiah works to the advantage of inflation control, but on the other, it can depress economic growth and fuel a more rapid build-up of a current account deficit. Moreover, in keeping with their short-term nature, portfolio capital inflows are highly susceptible to changes in global perceptions. If the external sentiment presently taking shape is more supportive of exchange rate appreciation, this sentiment could change in the future in the event of global economic shocks. This could set off a round of risk averse behaviour that would ultimately bring on turbulent movement in the exchange rate.

■ The Banking System

As the main entity in the financial system, banking industry in Indonesia also showed its performance influenced by massive capital inflows. This was indicated by a high excess banking liquidity amid its improving performance. Responding to high inflows of funds, foreign currency lending mounted sharply during 2010. However, given the short-term nature of most capital inflows, banks responded it with more asset placements in demand deposits and interbank call money at overseas banks.

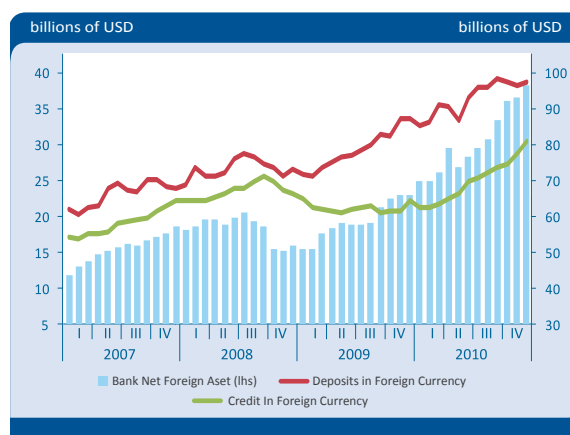


Chart 1.24 Bank NFA, Foreign Currency Credit and Deposits

Despite these developments, the banking industry in general achieved more solid performance as reflected in the high capital adequacy ratio (CAR), low ratio of non-performing loans (NPLs), and further improvement in banking intermediation.

Persistent increase in foreign exchange liquidity, which related to sharp increase in foreign assets and foreign currency deposits held in the banking system, was not balanced by an increase in foreign currency lending. Although growth in foreign currency lending picked up significantly in 2010 to 30.7% from 17.4% in the preceding year, this acceleration was still limited when compared to more rapid growth in bank foreign assets and foreign currency deposits (Charts 1.23 and 1.24). This condition reflected surging capital inflows, of which very little was channelled into the real sector (in the form of bank lending). In addition, the size of the surplus in expansion in bank foreign assets and foreign currency deposits over foreign currency lending reflects the extent of bank's foreign currency liquidity that had not been placed on the domestic market.

At the same time, the banking intermediation function also showed overall improvement during 2010, accompanied by more robust business performance. High credit expansion was extended more into productive uses and was channelled into strategic economic sectors. Improvement in the intermediation role was also indicated by higher acceleration in credit growth compared to deposits growth. At the same time, improvement in the banking industry was also seen in the declining levels of risk assessed in relation to both lending and financial market conditions. Credit risk eased in line with the

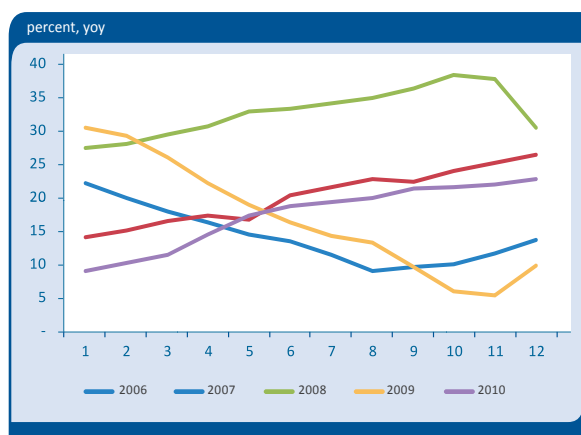


Chart 1.25 Credit Growth

downward trend in NPLs, while pressure from market risk also reduced as a result of stable movement in interest rates and the exchange rate.

Credit growth strengthened to 22.8% in 2010 in relation with increasing economic activity (Chart 1.25). Disaggregated by type of expenditures, high expansion in working capital credit was a key driver in the total credit growth, replacing the role of consumption credit. This indicates that absorption of bank lending shifted in favour of more productive economic activity. Growth in working capital credit reached 25.2%, went up considerably from the preceding year (2.7%). Similarly, investment credit accelerated significantly with growth reaching 17.0%. In contrast, the expansion in consumption credit during early 2010 was in a downward trend since May 2010, although growth remained quite strong at 22.9% (Chart 1.26). During 2010, credit expansion was accompanied by reduction in NPLs. At end-2010, NPLs (gross) had

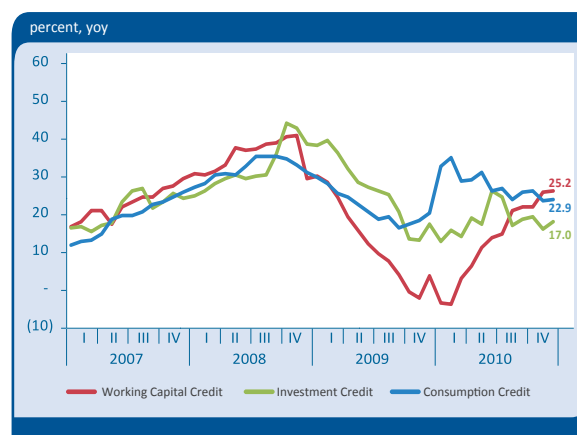


Chart 1.26 Credit Growth by Type of Usage

narrowed to 2.9% from 3.8% at the end of the preceding year (Chart 1.27).

From the sectoral side, despite strategic sectors representing major contributions to GDP showed an accelerating credit expansion, other sectors provided the driving force in total credit expansion during 2010³ (Chart 1.28). With a 37.2% contribution to credit growth and 34.4% share of total credit, other sectors played an important role in total credit expansion, albeit with a slowing trend since May 2010, which was in line with lowering performance in consumption credit. At the same time, lending forged ahead with accelerating momentum in other strategic sectors, in particular trade, manufacturing, business services and social services, resulting in widening contributions to total lending from early Q1 2010.

3 Includes home mortgages, vehicle loans and credit for home fittings and appliances. This expansion in other credit reflected the dominant role of consumption credit

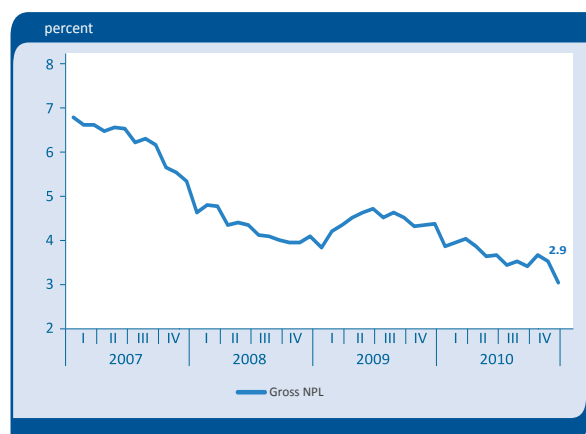


Chart 1.27 NPL Growth

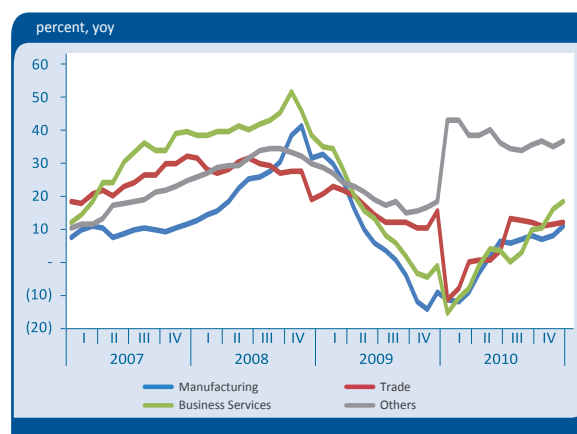


Chart 1.28 Sectoral Credit

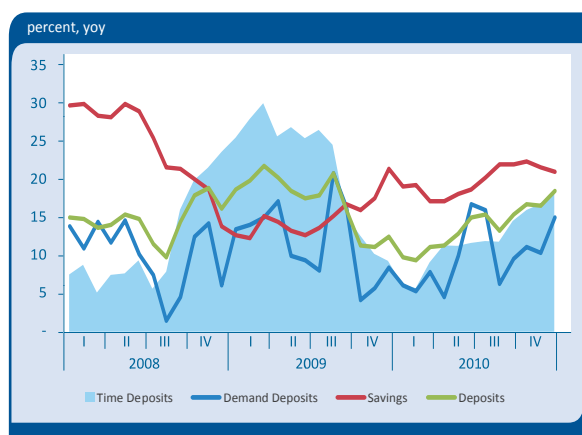


Chart 1.29 Deposits Growth

On the funding side, deposits growth strengthened to 18.5% in 2010 from 12.5% in the previous year (Chart 1.29). This deposits growth was supported mainly by expansion in quasi-money, comprising savings deposits and time deposits. Growth in time deposits climbed to 18.6% from the previous year-end growth recorded at 9.34%. However, growth in savings deposits was comparatively stable at 21.1% compared to 21.4% at the end of the preceding year. Demand deposits expanded by 15.0% during 2010, representing an upward trend compared to the previous end-of-year growth at 8.35%.

■ Economic Liquidity and the Payment System

Growing economic activity boosted growth in cash outside banks and base money during 2010. Average growth in cash outside banks was 12.7%, higher than the previous average in 2009 at 8.3%, while the annual

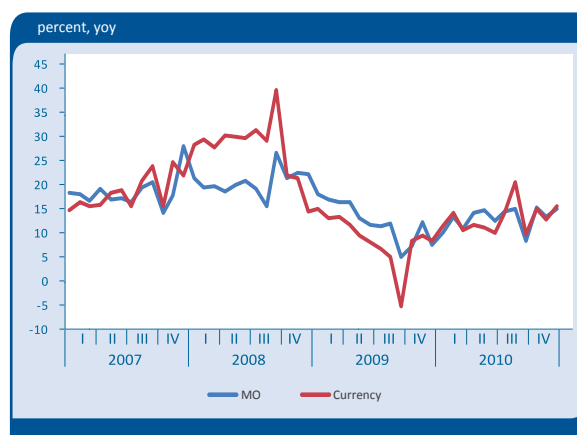


Chart 1.30 Base Money and Currency Growth

rate of expansion at end-2010 reached 15.2%. Alongside this, base money (M0) grew by an average 12.8%, with growth at end-of-year recorded at 14.7% (Chart 1.30). The sharp increase in base money growth near year-end was influenced by the policy in November 2010 to raise the requirement for Primary Statutory Reserves.

Economic liquidity underwent expansion in 2010 (Chart 1.31), although M1 growth remained lower than pre-2009 levels. M1 growth averaged 12.9% over 2010, albeit surging to 17.8% at the end of the year. However, in real terms, no significant acceleration took place in M1 growth and the rate of expansion remained below the 21.5% average for May 2006–December 2008 (Chart 1.32).

Meanwhile, expansion in M2 resulted mainly from an increase in quasi-money driven by surging foreign capital inflows. M2 growth in 2010 was spurred by the sharp rise in net foreign assets, most of which were held as quasi-

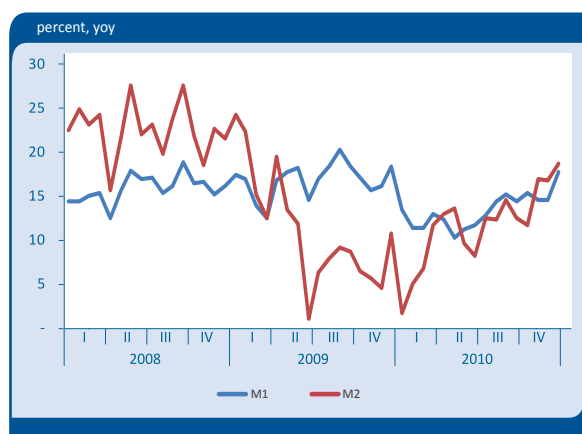


Chart 1.31 Economic Liquidity

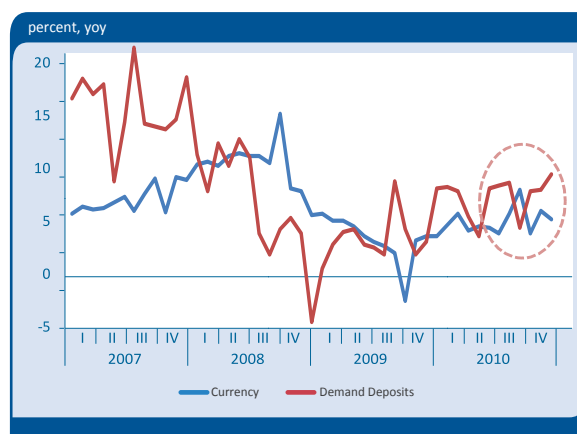


Chart 1.32. M1 Growth Contribution

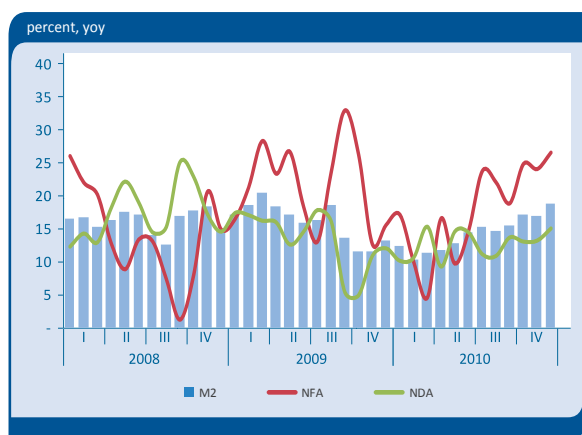


Chart 1.33. M2, NFA and NDA

money in banks. In addition, net domestic assets mounted during 2010 mainly due to accelerated credit expansion that contributed to more rapid growth in M2 (Chart 1.33).

At the same time, growing economic activity was also reflected in the growth of transactions in the payment system. During 2010, total value of electronic transaction processed through the BI RTGS (Real Time Gross Settlement System) system grew 26.3% over the preceding year, with average daily turnover at Rp 220.2 trillion. Similarly, the value of financial transactions processed through the National Clearing System (SKN) climbed 11.8% with average daily turnover reaching Rp 7.1 trillion. Strengthening demand also contributed to growth in total use of payment instruments, with use of cards and electronic money also went up 11.1% during 2010.

Economic Growth

Along with ongoing recovery in the global economy, the Indonesian economy charted a higher growth compared to the preceding year. GDP growth in 2010 reached 6.1%, rose from 4.6% in 2009. On the demand side, higher economic growth was supported by robust exports, brisk investment growth and continued buoyant household consumption. Rising international commodity prices contributed to more vigorous growth in national exports. The upbeat performance in exports was also accompanied by more diversified export commodities and a growing role of emerging markets as destinations for Indonesian exports. Vibrant external and domestic demand had a positive effect on business optimism for the economic outlook, which ultimately boosted investment growth. Meanwhile, high levels of household consumption were supported by comfortable levels of public purchasing power reinforced by the expanding financial institution role in financing. Buoyant domestic and external demand in turn boosted import growth, which outpaced growth in exports (Table 1.3).

The upbeat trend in export performance paralleled with continuing global economic recovery. Exports showed their strongest performance in the first half of 2010, particularly at the beginning of the year, bolstered by both oil and non-oil commodities. However, early in the second half, exports begin tapering off as a result of declining oil production, slowing growth in trading partner nations and softening prices for manufactured products and agricultural commodities. At the end of 2010, exports

Table 1.3 GDP Growth by Expenditure

Table 2.10. GDP (Current prices)												percent
Component	2007	2008	2009*				2009	2010**				2010
			I	II	III	IV		I	II	III	IV	
Consumption	4.9	5.9	7.2	6.2	5.4	6.1	6.2	2.7	3.4	5.1	4.9	4.0
Household Consumption	5.0	5.3	6.0	4.8	4.7	4.0	4.9	3.9	5.0	5.2	4.4	4.6
Government Consumption	3.9	10.4	18.8	16.3	9.8	18.0	15.7	-7.6	-7.3	4.8	7.3	0.3
Gross Fixed Capital Formation	9.3	11.9	3.5	2.3	3.2	4.1	3.3	8.0	8.0	9.2	8.7	8.5
Non-construction Investment	11.9	25.4	-4.4	-7.8	-8.2	-6.4	-6.7	10.2	10.6	16.6	14.7	13.1
Construction Investment	8.5	7.5	6.3	6.1	7.7	8.1	7.1	7.3	7.2	6.8	6.7	7.0
Net Export	6.5	7.6	5.3	9.4	25.2	10.9	12.5	12.1	2.0	1.4	13.7	7.5
Export of Goods and Services	8.5	9.5	-18.7	-15.5	-7.8	3.7	-9.7	20.0	14.6	9.6	16.1	14.9
Import of Goods and Services	9.1	10.0	-24.4	-21.0	-14.7	1.6	-15.0	22.6	18.4	12.2	16.9	17.3
Gross Domestic Product	6.3	6.0	4.6	4.2	4.2	5.4	4.6	5.6	6.1	5.8	6.9	6.1

Source : BPS - Statistik Indonesia

* provisional figures

**very provisional figures

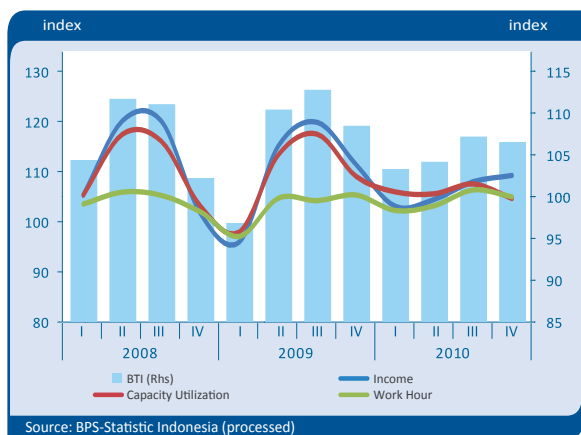


Chart 1.34. Business Tendency Index

improved mainly in agricultural and manufacturing products bolstered by rising commodity prices. Overall, export growth reached an impressive level at 14.9% in 2010. This represents the highest record in export growth for the past 10 years - with the exception of 2005 - with more diversified export commodities. In addition to the robust achievement in national export growth, emerging markets claimed a growing share in Indonesia's export destinations.

Upbeat export performance and more conducive macroeconomic condition fuelled vigorous investment growth. Improvement in the investment climate was supported by growing availability of domestic and external financing that accelerated the rate of investment responding to higher levels of capacity utilisation in line with brisk demand. The Business Tendencies Survey conducted by Statistics Indonesia pointed to positive business optimism in keeping with rising domestic and foreign orders for goods, better selling prices and increased orders of input goods (Chart 1.34). Exchange rate appreciation also enabled capital goods to be imported at comparatively low prices. Taken together, non-construction investment accelerated with 13.1% growth following a steep contraction in 2009. In contrast, construction investment maintained stable growth at 7.0% (Chart 1.35). The surge in non-construction investment indicates more investment being channelled for increasing economic capacity. By the type of investment, the growth was driven by foreign direct investment at Rp 208.6 trillion and domestic direct investment that reached Rp 60.5 trillion.

Investment performance forged ahead with support from domestic and external financing. Expansion in domestic

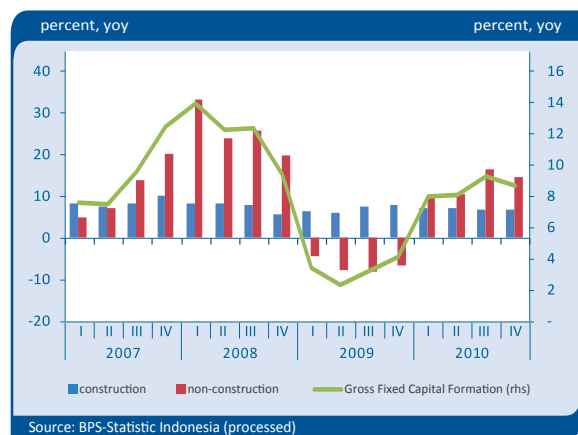


Chart 1.35 Construction and Non-construction Investment

financing was indicated in the substantial increase in initial public offerings (IPOs) of stocks and bonds during 2010. In addition, increased support for investment from banking institution was reflected in real growth in investment credit, which climbed significantly along with low real interest rates (Chart 1.36). Availability of investment financing from outside Indonesia was evident in increased disbursement levels on private sector external borrowings. In general, the increase in external borrowing commitments during 2010 was recorded in non-tradable sectors.

The upward trend in investment was in line with the improvement in business and investor perceptions of the investment climate in Indonesia. Improvement in the investment climate was attributable to policies designed to improve national economic competitiveness. It was reflected in various agency reports and studies that put Indonesia in a more favourable position. An OECD

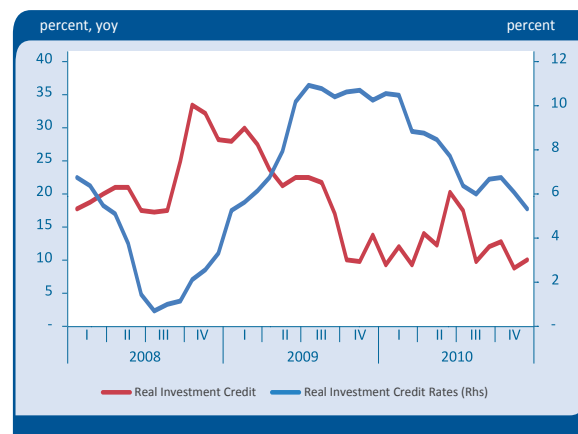


Chart 1.36. Real Credit Growth and Investment Rates

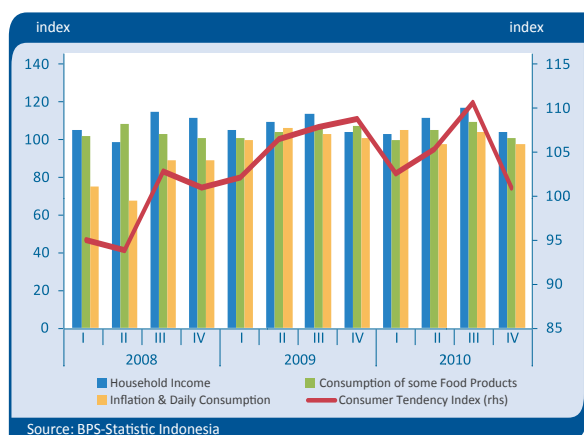


Chart 1.37. Consumer Tendency Index

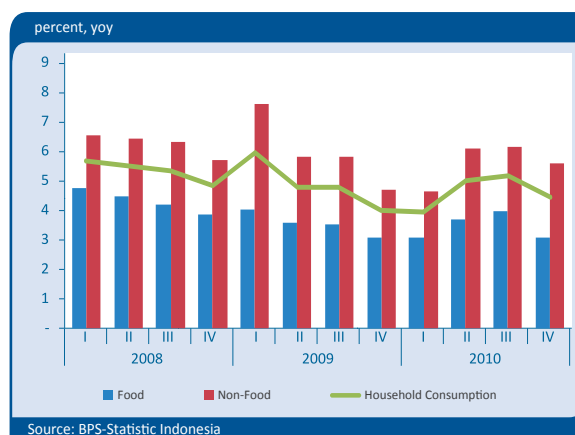


Chart 1.38 Household Consumption Growth

report classified Indonesia alongside seven other G20 nations⁴ as countries that have improved the clarity of their investment regulatory framework and are following the trend to investment liberalisation in their investment reforms.⁵ Improvement in the investment climate was also reflected in Indonesia's competitiveness rating released by the World Economic Forum (WEF). In this regard, Indonesia's ranking improved from 54 to 44 during 2010.⁶ The WEF stresses the importance of maintaining macroeconomic stability as the main source of improved competitiveness in the Indonesian economy. However, low ratings for road infrastructure and energy still pose challenge to further improvement in Indonesia's competitiveness rating. Positive perceptions

in expectations for Indonesia's macroeconomic conditions were also reflected in further improvement in Indonesia's sovereign credit rating and the opportunity for Indonesia to move faster toward investment grade.

In other developments, household consumption maintained vigorous and continued to contribute to economic growth in 2010, even with slightly more modest growth. Household consumption growth reached 4.6%, down slightly from 4.9% in the preceding year. The growth in 2010 was driven by strong public purchasing power, exchange rate appreciation, increased financing through consumption credit and sustained public optimism over the condition of the economy. Public confidence of the stable economic condition was seen from consumer surveys conducted by a number of institutions, although optimism faded slightly at the end of the year following surges in food prices (Chart 1.37). By its component, household consumption growth in 2010 was bolstered

- 4 Australia, Brazil, Canada, China, India, Saudi Arabia and South Africa
 5 Third Report on G20 Investment Measures, OECD and UNCTAD Secretariat, June 2010
 6 The Global Competitiveness Report 2010-2011, World Economic Forum, 2010

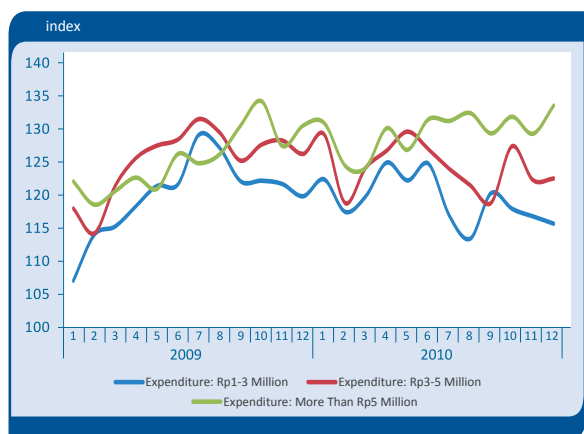


Chart 1.39 Current Income Index based on Group of Household - BI Consumer Survey

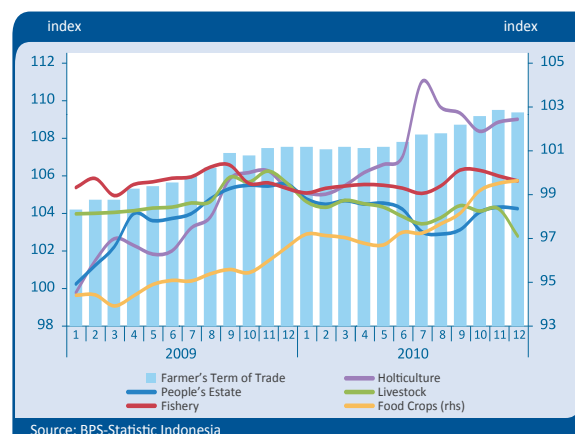


Chart 1.40 Farmer's Term Of Trade

mainly by the 5.6% rise in non-food consumption (Chart 1.38).

Relative improvement in public purchasing power contributed to the strong household consumption. In this regard, the middle and upper income classes were the classes that showed improving purchasing power in 2010. This was seen in the results of Bank Indonesia surveys pointing to higher income received by people with monthly spending above Rp 5 million (Chart 1.39). A wage survey conducted by an independent research institution found that during 2010, wages in a number of sectors increased by an average 11%. In Indonesia, the salary increases in the fast-moving consumer goods industry, such as producers of foods and beverages, body care products and household needs, even surpassed equivalent salary hikes in other countries in the Asia-Pacific region.⁷ At the same time, farmer's purchasing power showed some improvement, reflected in the upward trend in the Farmer Terms of Trade (FTT) indicator. However, the gains in FTT accrued mainly to farmers growing horticultural crops and food staples as a result of the substantially increased prices for both commodities from mid-2010 (Chart 1.40).

The limited expansion in government consumption in turn affected overall consumption performance. This development was closely tied to the lower-than-expected fiscal deficit at only 0.6% of GDP, well below the targeted 2.1%. During the first half of 2010, government consumption contracted, despite resuming positive growth in the second half of the year. The reduced

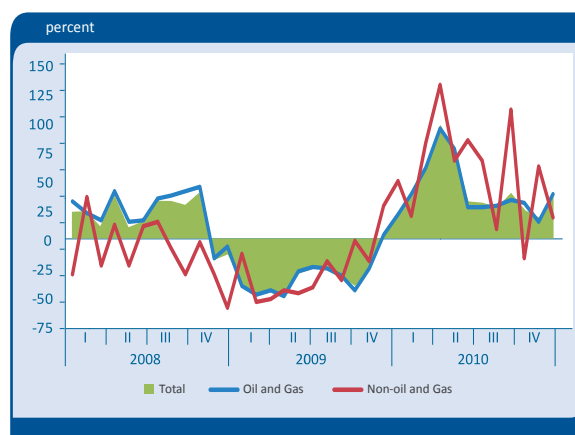


Chart 1.41 Import Growth

absorption of the state budget was explained mainly by lower personnel expenditures, goods procurement and other expenditures relative to their target. Subsidies was the only item in spending that exceeded the target. Measured over the year, the contribution of government consumption and investment to the real sector eased in comparison to 2009 due to the effect of sharply reduced growth in government consumption during the first half of 2010. These developments combined to produce only 0.3% growth in government consumption for 2010, well below the previous year's expansion recorded at 15.7%.

In response to vibrant domestic and external demand, imports showed more aggressive growth in both the oil and non-oil sectors. During 2010, imports grew by a brisk 17.3%, rebounding from the steep 15.0% contraction of the preceding year. Also contributing to sharply rising

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Table 1.4 GDP Growth by Sectors

percent

Sector	2007	2008	2009*				2009	2010**				2010
			I	II	III	IV		I	II	III	IV	
Agriculture	3.5	4.8	5.7	2.8	3.4	4.1	4.0	3.0	3.1	1.8	3.8	2.9
Mining and Quarrying	1.9	0.7	2.6	3.5	6.3	5.3	4.4	3.1	3.9	2.7	4.2	3.5
Manufacturing	4.7	3.7	1.5	1.5	1.3	4.5	2.2	3.9	4.5	4.3	5.3	4.5
Electricity, Gas and Water Supply	10.3	10.9	11.6	15.6	14.9	14.9	14.3	8.8	5.1	3.4	4.3	5.3
Construction	8.5	7.5	6.3	6.1	7.7	8.1	7.1	7.3	7.2	6.8	6.7	7.0
Trade, Hotel & Restaurant	8.9	6.9	1.2	0.5	-0.1	3.7	1.3	8.6	9.1	8.7	8.4	8.7
Transportation and Communication	14.0	16.6	16.8	17.0	16.1	12.4	15.5	12.0	13.0	13.2	15.5	13.5
Financial, Rental and Business Service	8.0	8.2	6.2	5.3	4.9	3.8	5.1	4.8	5.6	5.9	6.3	5.7
Services	6.4	6.2	6.6	7.2	6.1	5.8	6.4	4.7	5.3	6.4	7.5	6.0
GDP	6.3	6.0	4.6	4.2	4.2	5.4	4.6	5.6	6.1	5.8	6.9	6.1

Source: BPS - Statistik Indonesia

* provisional figures

**very provisional figures

imports was rupiah appreciation that lowered prices for imported products. The surge in consumer goods imports, led by processed foods and passenger vehicles was consistent with vibrant domestic consumption demand. At the same time, high demand for exports caused higher imports of raw materials to support production of manufactured goods. Rising production activity positively influenced business optimism for expanding production capacity through new investments, which in turn fuelled imports of capital goods. In other developments, the rise in oil and gas imports was linked to increased domestic fuel consumption (Chart 1.41).

The expanding role of exports and investment alongside continued robust household consumption was in line with GDP performance from production side (Table 1.4). Manufacturing performance maintained an upbeat trend from the beginning of the year in line with strengthening export performance and keen domestic demand. Manufacturing growth over the year reached 4.5%, a heartening development given the low 2.2% growth one year earlier. In the non-tradable sectors, growth strengthened in trade, hotels and restaurants and the financial, leasing and services sectors. Upbeat growth in the trade sector was driven by the level of activity in the domestic economy alongside rising imports. In the financial sector, growth was more closely linked to an increase in credit both by banks and non-bank financial institutions (NBFIs). The more robust performance in the three sectors contributed significantly to the overall level of economic activity, due to their high share in the economy.

While manufacturing growth gained momentum in 2010, growth in tradable sectors still lagged behind the robustly performing non-tradable sectors in the economy. Tradable sectors registered 3.9% growth in comparison to 8.2%

growth in non-tradable sectors. The vibrant growth in non-tradable sectors resulted in an expanding share of these sectors in the economy. Meanwhile, growth in manufacturing sector has recovered to around its average before the global financial crisis, and this has expanded the contribution of tradable sectors to the economy. Even so, manufacturing growth in 2010 remained lower than the earlier record average posted over 1986-1996 at 10.5%. Gains achieved in manufacturing, however, were not matched by similar improvement in other tradable sectors. In the agriculture sector, problems with declining productivity, diminishing land and weather anomalies depressed growth in 2010 compared to the preceding year. The mining sector reflected a similar situation with performance inhibited by disruptions to oil production at some oil refineries, in addition to adverse weather conditions.

■ Inflation

Inflation rose significantly in 2010 from the preceding year. CPI inflation jumped to 6.96% from 2.78% one year earlier, overshooting the $5\pm 1\%$ inflation target for 2010 (see Box 1.1: Accountability for the 2010 Inflation Target). This inflationary surge strongly influenced by external and domestic factors throughout the year. On the external side, the higher inflation in Indonesia was in line with global inflation, especially in emerging markets due to the effects of resurgent economic growth and international commodity prices. Even so, appreciation in the rupiah during the year mitigated the impact of burgeoning prices for globally-traded commodities. From domestic side, developments in inflation expectations, demand and supply conditions and price adjustment for government-regulated commodities did not result in excessive inflation. Inflationary pressures emerged mainly as a

Table 1.5 Inflation by Group Of Commodities

percent

	Group	Weight (SBH 2007)	2007	2008	2009	2010
1	Foodstuff	19.57	10.74	16.35	3.88	15.64
2	Processed Food, Cigarettes and Tobacco	16.55	5.70	12.53	7.81	6.96
3	Housing, Electricity, and Water Supply	25.41	4.85	10.92	1.83	4.08
4	Clothing	7.09	7.53	7.33	6.00	6.51
5	Health	4.44	3.52	7.96	3.89	2.19
6	Education, Recreation and Sport	7.81	6.94	6.66	3.89	3.29
7	Transportation, Communication, and Financial Services	19.12	0.46	7.49	-3.67	2.69
	CPI Inflation	100.00	5.61	11.06	2.78	6.96

Source: BPS-Statistic Indonesia (processed)

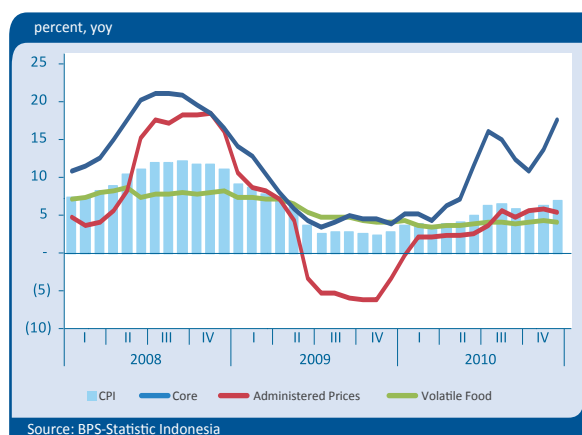


Chart 1.42 CPI Inflation and Its Components

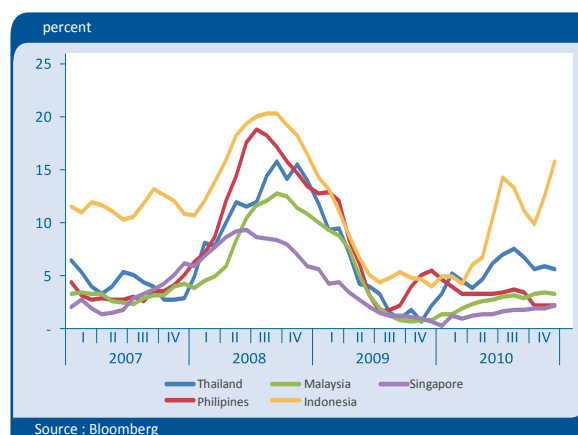


Chart 1.43 Foodstuff Inflation in Regional Countries

result of disruptions in the supply of foodstuff, which were strongly influenced by adverse weather conditions.

Analysed by category of goods, the highest inflation was in the foodstuff, followed by processed food, cigarettes and tobacco, clothing and the housing, electricity and water utilities category (Table 1.5). In the foodstuff category, high inflation resulted primarily from disruptions to distribution related to adverse weather conditions. These conditions led to produce high inflation in the processed foods, cigarettes and tobacco category, due to soaring prices for the raw materials used in the production. Inflation in the clothing category was driven by rising prices for gold jewelry in keeping with soaring international gold prices during the year. In the housing, electricity and water sector, the major driver of inflation was the government decision to raise electricity tariffs. In contrast, three other categories within the services sector recorded only mild inflation. A key factor behind these developments was the buoyant growth in services during recent years, which was accompanied by capacity expansion in this sector. This trend was most evident in service-related sectors, such as transportation and communications, the financial services,

leasing and corporate services sector and the general services sector.

Analysed by source of pressure, the key factor driving heightened CPI inflation during 2010 was the volatile foods component. During the year, volatile foods inflation surged to 17.74% in contrast to the modest 3.95% one year before (Chart 1.42). During the first half of 2010, CPI inflation was curbed at a relatively mild 5.05%. However, in the second half of the year, disruptions in distribution of some food commodities as a result of anomalous weather conditions triggered a sharp rise in volatile foods inflation. In July 2010, volatile foods inflation jumped to 16.18%, pushing CPI inflation to 6.22%. Other countries also experienced soaring volatile foods inflation, as reflected in foodstuff inflation in regional countries that also mounted during the same period (Chart 1.43). Nevertheless, regarding fundamental conditions, inflation remained stable with core inflation on par with the preceding year's level of 4.28%. Key to this was the subdued level of fundamentals affecting factor of inflation, as indicated by the strengthening of the exchange rate, modest inflation expectations and availability of capacity in the economy to

Table 1.6 CPI Inflation by Components

Component	Weight	percent				
	(SBH 2007)	2007	2008	2009	2010	
Core	65.6	6.29	6.29	4.28	4.28	
Administered prices	16.1	11.41	16.48	(3.26)	5.40	
Volatile food	18.3	3.30	15.99	3.95	17.74	
CPI Inflation	100.0	5.61	11.06	2.78	6.96	

Source: BPS-Statistic Indonesia (processed)

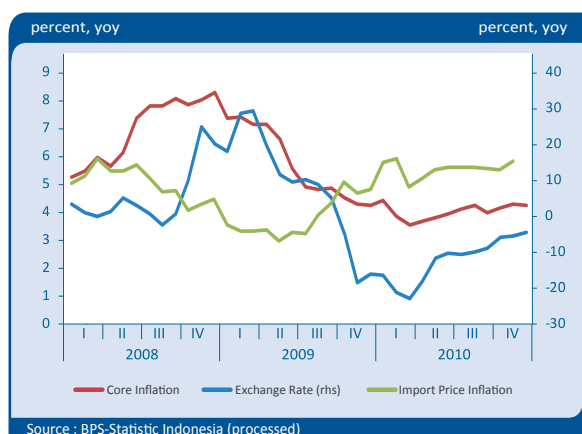


Chart 1.44 Core Inflation and External Determinants

respond to demand pressures. On the other hand, a series of government policy decisions involving prices pushed administered prices inflation to a moderate level of 5.40%.

Core Inflation

Core inflation, a component that better reflects macroeconomic influences on prices, remained stable in 2010 at 4.28% (Table 1.6). Following the end of 2009, core inflation went down to a low level in March 2010 and then gradually resumed. This movement was linked to developments in the fundamental determinants of inflation throughout 2010. The factors affecting these inflation determinants were both from external and domestic.

On the external side, significant increases in international commodity prices during 2010, reflected in prices for commodities imported into Indonesia, had minimal impact on core inflation. This was explained by the strong appreciation in the rupiah during the same period that

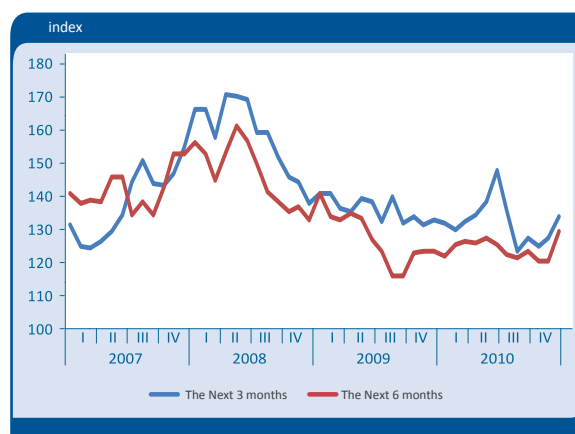


Chart 1.45 Retailer Inflation Expectation

mitigated the impact of rising commodity prices. In fact, the strengthening of the rupiah helped to lower core inflation to 3.56% in March 2010. Following this, sustained increases in import prices began to fuel a rise in core inflation, while appreciation in the rupiah followed a more moderate trend (Chart 1.44).

From domestic side, relatively subdued inflation expectations and availability of capacity in the economy to respond to increasing demand had helped keep pressure to core inflation minimum. Throughout 2010, inflation expectations were maintained at a subdued level despite a jump in the middle of the year associated with a surge in food prices. Reflecting this were expectations of price increases among both traders and consumers. No increase had been observed in trader expectations of price increases since the second half of 2009 (Chart 1.45). Meanwhile from the consumer side, even though there was an increase in expectations of future price, the level remained below the highest average figure for the



Chart 1.46 Consumers Inflation Expectation

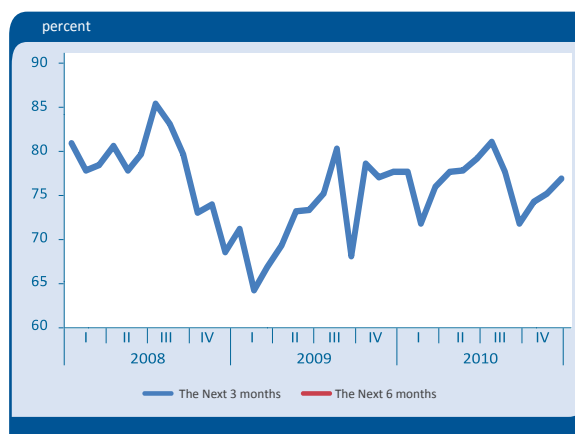


Chart 1.47 Capacity Utilization of Manufacturing

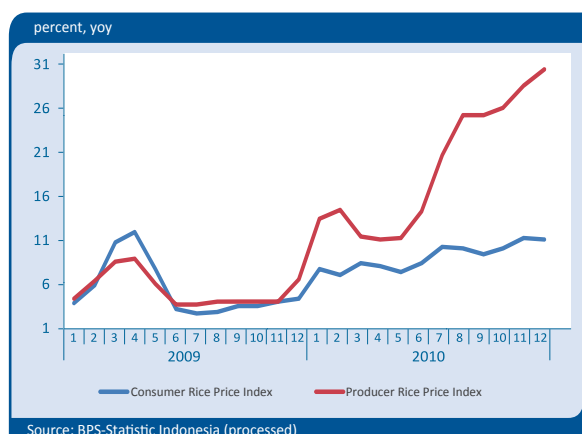


Chart 1.48 Growth of Rice Price Index at Farmer and Consumer Level

past two years recorded at 182 in the first half of 2008 (Chart 1.46). Expectations in 2010 were at a moderate 162, below the historical average (2002-2008) of 172. In regard to the output gap, the ability of supply to meet an increasing demand was reflected in normal levels of capacity utilisation (Chart 1.47).

Volatile Foods and Administered Prices Inflation

Inflation in the volatile foods category escalated during 2010. This extreme surge dominated movement in CPI inflation and was the major factor explaining the inflation target overshooting in 2010. Weather conditions represented the most important cause of price escalation for commodities in the volatile foods category, due to its impact on food supply. Weather anomalies in 2010 that brought heavy, sustained rains bore down on agricultural production and impeded distribution of a range of fresh food commodities, such as rice and seasonings (see Box 1.2: Weather Anomalies and Food Production). Sharply increased rice prices contributed significantly to inflation

during 2010 and gave pressure to volatile foods inflation, particularly during the second half of the year. On a wider scale, food price increases caused by adverse weather conditions were also observed in other countries in the region. From domestic, while soaring food commodity prices were triggered by weather conditions, higher prices was also driven by speculative trading, as indicated in the widening margin in rice prices between the producer and consumer levels (Chart 1.48). In response to these developments, the government pushed forward with policy actions to stabilise prices, including distribution of subsidised rice, market operations and temporary imports. Despite this, rice imports of as much as 600 thousand tons by the end of 2010 could not fully contain prices volatility. In addition, mounting CPO prices on world markets also spurred increases in domestic cooking oil prices, with CPO becoming one of the most important contributors to inflation during the last quarter of 2010 (Table 1.7).

During 2010, the administered prices category contributed more to inflation compared to the previous year, mainly due to the hike in electricity tariffs. The significant rise in administered prices inflation early in the second half of 2010 resulted from the decision to raise electricity billing rates on July 1, followed by increases in vehicle registration and driving licence renewal fees in August 2010. The new electricity billing rates had a major impact on administered prices inflation during 2010, with the direct impact on inflation reaching 0.38% (Table 1.8). Nevertheless, this hike did not result in any significant rise in other commodity prices and public expectations of inflation. The increases in vehicle registration and driving licence fees, however, had a significant 0.23% impact on the inflation figure. In other developments, the kerosene conversion programme has progressed well in the absence of significant impediments from shortages, generating a

Table 1.7 Contribution of Volatile Food Commodities to Inflation

Commodities	Increased Price (%)	Contribution to Inflation (%)
Rice	30.45	1.26
Red chili	62.90	0.29
Shallot	68.19	0.23
Cayenne pepper	124.85	0.19
Broiler chicken	10.52	0.15
Garlic	49.98	0.15
Cooking oil	9.59	0.12
Chicken eggs	10.12	0.07

Source: BPS-Statistic Indonesia (processed)

Table 1.8 Contribution of Administered Prices Commodities to Inflation

Commodities	Price Increased (%)	Contribution to Inflation (%)
Electricity Tariff	15.80	0.38
Vehicle Registration Renewal Fee	75.40	0.23
Cigarettes Filter	7.33	0.14
Clove Cigarettes	6.76	0.08
Household Fuel	2.14	0.07
White Cigarettes	9.24	0.04

Source: BPS-Statistic Indonesia (processed)

Table 1.9 GDP Growth by Region

Regions	GRDP Growth (%yoy)			CPI Inflation (%yoy)		
	2008	2009*	2010**	2008	2009	2010
Northern Part of Sumatera	4.9	3.5	5.4	11.37	2.44	7.83
Central Part of Sumatera	3.3	2.5	5.7	10.84	2.72	7.79
Southern Part of Sumatera	6.1	3.7	5.0	10.51	1.93	7.85
Jakarta	5.1	4.4	5.8	13.00	2.75	7.86
Java	6.2	5.0	6.5	11.11	2.34	6.21
Western Part of Java	5.8	4.7	6.2	10.54	2.73	7.36
Central Part of Java	5.8	4.4	6.0	11.27	2.27	7.59
Eastern Part of Java	5.4	4.7	5.7	9.60	3.26	6.96
Eastern Indonesia	5.9	5.0	6.7	9.51	3.41	7.10
Eastern Indonesia	5.5	8.0	5.5	11.90	3.91	7.56
Bali, Nusa Tenggara	4.6	6.3	5.8	11.02	4.39	9.05
Kalimantan	5.3	3.3	5.3	12.10	3.95	8.14
Sulampua	6.1	8.9	5.7	12.10	3.67	6.40

Source : BPS-Statistic Indonesia (processed)

* provisional figures

** very provisional figures

limited contribution to the inflation rate. This condition was reflected in the slightly rising household fuel prices (2.14%).

■ Economic Growth and Inflation at the Regional Level⁸

The dynamic of global economic activity that influenced domestic economic recovery had a generally positive impact on regional economic performance (Table 1.9). Economic growth in Jakarta and Java again exceeded 6.0% in 2010, ahead of 5.0% and 4.7% recorded for the two regions in 2009. The buoyant economic growth in the two regions was closely linked to upbeat performance in the manufacturing and trade sectors driven by strong domestic demand and exports of manufactured goods. Alongside this, economic growth in Sumatera strengthened during 2010 from 3.5% to 5.4%. Rising estate production, despite adverse weather conditions that bore down on output, contributed to improved economic growth in Sumatera. Economic growth in Eastern Indonesia came in the 5.5% range, albeit down from the levels reached in 2009. The continued mining sector expansion in Kalimantan offset the effect of declining mineral

commodity production in the Sulawesi-Maluku-Papua (Sulampua) region. In general, the factor of soaring prices for natural resource-based commodities on world markets had helped sustain buoyant economic performance and vibrant growth in Sumatera and Eastern Indonesia.

In regard to inflation, the sharp rise in volatile food commodities exacerbated inflationary pressure in some regions. Sumatera and Eastern Indonesia were the two regions reporting the steepest rise in inflation at 7.86% and 7.56%. By comparison, Java and Jakarta recorded inflation at 7.36% and 6.21%. Soaring prices for rice and seasonings had considerable impact on inflation in all regions. Anomalous weather conditions marked by heavy rainfall during 2010 impacted foodstuff production, with horticultural crops in some major production centres. The steeper rise in inflation in Sumatera and Eastern Indonesia was driven by pressures bearing down on food production as a result of disruption caused by adverse weather conditions, while many areas had only limited capacity to meet local consumption needs. Demand in local communities that exceeded local production capacity has left some areas heavily dependent on other regions. In addition, the lack of integrated, transparent data and information on supply conditions made prices highly susceptible to rumours amid risks of disruption to distribution and logistics due to limited connectivity among the regions. Regarding administered prices, the hike in the annual fees for renewal of vehicle registrations and driver licences also caused inflationary pressures in

⁸ Bank Indonesia divides its regional economic assessment into four major geographical areas, each divided into a number of regions. These are Sumatera (comprising Northern Sumatera, Central Sumatera and Southern Sumatera), Jakarta, Java (Western Java, Central Java and Eastern Java) and Eastern Indonesia (Bali-Nusa Tenggara, Kalimantan and Sulawesi-Maluku-Papua).

Table 1.10 Labor Force and Open Unemployment Rate In Indonesia

percent

Type of Activity		2008		2009		2010	
		Feb	Aug	Feb	Aug	Feb	Aug
1	Population 15+	165.6	166.6	168.3	169.3	171.0	172.1
2	Labor Force	111.5	112.0	113.7	113.8	116.0	116.5
	- Employed	102.1	102.6	104.5	104.9	107.4	108.2
	- Unemployed	9.4	9.4	9.3	9.0	8.6	8.3
3	Non-Labor Force	54.1	54.7	54.5	55.5	55.0	55.5
4	Labor Force Participation Rate	67.3	67.2	67.6	67.2	67.8	67.7
5	Unemployment Rate	8.5	8.4	8.1	7.9	7.4	7.1
6	Underemployment	30.6	31.1	31.4	31.6	32.8	33.3

Source : BPS-Statistic Indonesia

some regions during 2010. The rise in inter-provincial transport fares that took effect at the end of 2010 are also predicted to drive up the costs for distribution of goods, particularly outside Java.

During 2010, efforts by the Regional Inflation Control Teams (TPIDs)⁹ to curb supply-side shocks were focused on reinforcing buffer stocks of foodstuff and managing public expectations on the sufficiency of foods. The TPIDs intensified activities in 2010, among other by optimizing the strategy for conducting wider market operations to all regions considering consumption characteristics in particular area. Complementing this were field inspections by Regional Government officials in cooperation with local police to monitor availability of stocks and anticipate speculative activities, while TPIDs also strengthened their communication with the public through the media. In addition, the strong interregional linkages in the goods distribution called for stronger TPID coordination at the cross-regional level. Issues that have come to the attention of TPIDs in some areas to control prices include (1) dependence on big players for distribution of strategic food commodities and long distribution channel, which represent major factors in price formation at the consumer level, while increases in food crop prices have not resulted in corresponding improvement for farmers, as indicated by the widening price margin between producer and consumer prices; (2) limited access to information on supply conditions and prices for strategic food commodities made prices vulnerable to rumours and expectations; and (3) heavy interregional supply dependencies are not offset by a flexible buffer stock

mechanism appropriate to the specific food consumption needs in that area.

■ Unemployment and Poverty

Improving domestic economic conditions had a positive impact on employment (Table 1.10). The latest employment data indicates that unemployment is in decline while the workforce structure has shifted back towards the formal sector accompanied by improving educational levels in the workforce. Open unemployment was recorded at 7.14% during 2010, down from the previous year's level of 7.87%. Similarly, the share of formal sector employment widened from 30% in 2009 to 33% (Chart 1.49).

The resurgence of the formal sector in provision of employment is expected to have a positive effect on the sustainability of household consumption, mainly in regard to greater assurance of adequate income levels. Other positive developments were also visible in the improving quality of the workforce. In 2010, workers with primary education background declined in proportion to the total workforce, while workers with higher levels of education showed a growing share (Chart 1.50). The nine-year compulsory education programme is one factor that had helped raise the educational level of the workforce. Although labour conditions are visibly on an upward trend, attention is still needed to the issues of high unemployment among the highly educated and the ability of the economy to absorb new workers.

After 1997, non-tradable sectors became the main engine of growth. While the tradable sectors continued to advance, their growth proceeded at more moderate pace.

⁹ By the end of 2010, 53 TPIDs had been established at the municipal and district level.

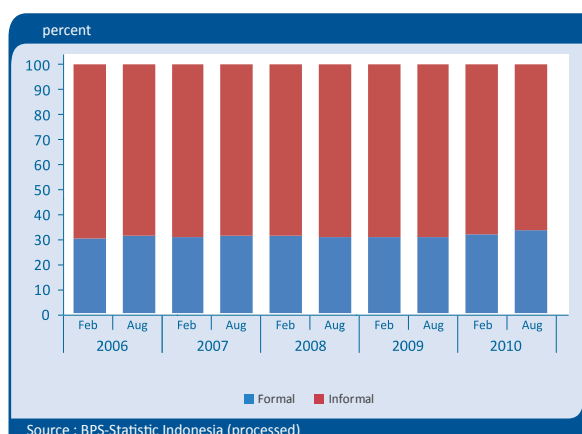


Chart 1.49 Workers Composition based on Job Status

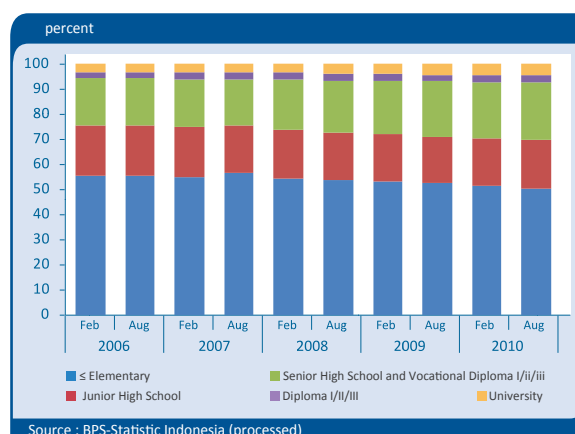


Chart 1.50 Worker Composition based on Education

The more capital intensive nature of the non-tradable sectors also meant that high growth was not immediately followed by increased employment. In contrast, the tradable sectors, with the notable exception of mining, tend to be labour intensive. However, given the moderate growth in tradable sectors, only limited benefits were realised in new employment creation. A sectoral picture of employment was also visible in the close relationship between GDP growth in individual sectors and growth in their workforce. Indications based on recursive correlation values suggest that non-tradable sectors generally manifested a weaker relationship with its workforce in comparison to tradable sectors. At the same time, the issue of high unemployment among diploma holders and university graduates also represents an important agenda that needs to be addressed. On one hand, this

is a symptom of lack of job vacancies in the formal sector for workers with higher educational background. On the other, this also shows that workers with higher educational qualifications put more interest to work in the formal sector. Although formal sector employment has improved, faster progress is still needed to bring down unemployment among graduates, accompanied by promoting greater entrepreneurship.

With the decline in unemployment, the level of poverty in Indonesia also showed an improvement (Table 1.11). In 2010, 31.02 million people in Indonesia were living in poverty, representing 13.33% of the population. It was lower comparing to 32.53 million people or 14.15% of the population in 2009. The improvement in poverty levels was also accompanied by a reduction in income disparities

Table 1.11 Gini Ratio and Poverty Condition In Indonesia

Area/Year	Gini Ratio	Poverty Line (Rp/Capita/Month)			Number of Poor People (Millions)	Percentage of Poor People
		Food	Non-Food	Total		
Urban						
2008	0.367	143,897	60,999	204,896	12.77	11.65
2009	0.362	155,909	66,214	222,123	11.91	10.72
2010	0.352	163,077	69,912	232,989	11.10	9.87
Rural						
2008	0.300	127,207	34,624	161,831	22.19	18.93
2009	0.288	139,331	40,503	179,834	20.62	17.53
2010	0.297	148,939	43,415	192,354	19.93	16.56
Urban + Rural						
2008	0.367	135,270	47,366	182,636	34.96	15.42
2009	0.357	147,339	52,923	200,262	32.53	14.15
2010	0.331	155,615	56,111	211,726	31.02	13.33

Source: BPS

in society, as indicated by the downward trend in the gini ratio. However, among the rural population, the gini ratio showed opposite behaviour. This is understood to have developed as a result of soaring prices in the agriculture sector and particularly in the estates subsector in Sumatra and Kalimantan. On one hand, higher prices bolstered the purchasing power of rural communities, but on the other, income disparities widened in the rural population. In addition, the prevailing improvement in the welfare of the population still leaves the issue of broad disparities between the regions, marked by the contrast between Jakarta, where poverty level is the lowest, and Indonesia's highest poverty rate region of Papua (Chart 1.51).

Poverty levels showed relative improvement in 2010. A range of government programmes targeting poverty alleviation also contributed in various ways to lowering poverty levels. These programmes were essentially a continuation of efforts launched in earlier years, such as the Community Block Grant Empowerment Programme (PNPM Mandiri), subsidised rice for the poor (Raskin) and microcredit extended under the People's Business Credit programme (KUR). The KUR programme in particular achieved the targeted level of disbursed lending in 2010 at Rp 13.1 trillion. In a further measure to improve effectiveness in KUR lending, at the end of 2010 the government also announced a new KUR lending policy specifically targeting Indonesian migrant workers working overseas. In February 2010, the Government also established the National Team for Accelerated Poverty

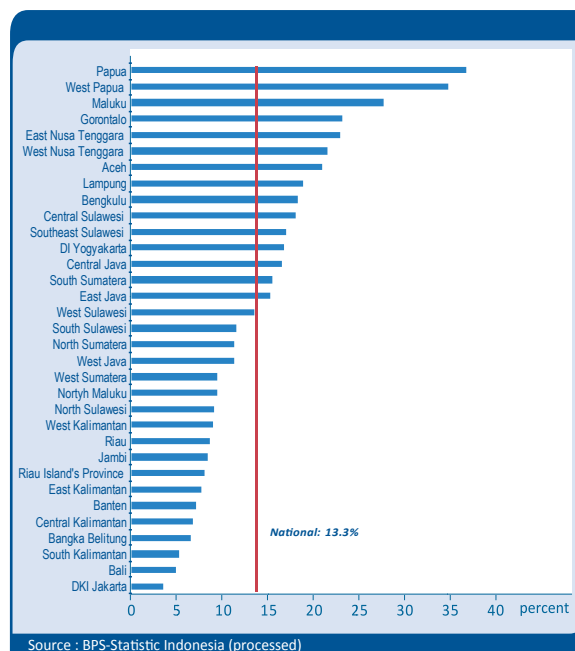


Chart 1.51 Poverty Disparity Across Indonesia - March 2010

Alleviation (TNP2K)¹⁰ to bolster cross-sectoral coordination in support of the government commitment to reduce the numbers of Indonesians living in poverty to 8%-10% by 2014.¹¹

10 Presidential Regulation No. 15 of 2010 concerning Acceleration of Poverty Alleviation

11 2010-2014 Medium-Term Development Plan

1.3

Policy Response

The dynamics of the Indonesian economy during 2010 were strongly influenced by a range of policy actions launched by Bank Indonesia and the Government. Monetary policy focused on the anchoring inflation expectations to the target and maintaining macroeconomic stability. Huge capital inflows and abundance of excess liquidity created more complex policy challenges and therefore the response to pressure of inflation could not rely solely on interest rate instruments. To this end, Bank Indonesia applied several instruments in a monetary policy mix and macroprudential policy. Policy coordination with the Government was improved continuously to minimise the impact of shocks from soaring volatile food prices and announcements of changes in administered prices. In regard to banking, Bank Indonesia introduced a number of reforms to strengthen the resilience of banking system in the face of various financial sector risks and to promote the role of banking industry in financing the real sector. For the national payment system, Bank Indonesia made some policies that put more emphasise on supporting efficient, reliable, convenient and secure payment system.

Meanwhile, government policy is directed to accelerate national economic development through various incentives and the fiscal stimulus. Regarding the budget, a series of fiscal stimulus were launched involving both revenues and expenditures while kept maintaining fiscal sustainability. The fiscal stimulus was channelled to develop infrastructure, agriculture and energy sectors and labour-intensive projects, while tax and import duty incentives were implemented to promote business recovery. To safeguard fiscal sustainability, the Government pursued a strategy for optimum management of budget financing from domestic and international sources. The Government strategy to accelerate

implementation of national development priorities¹² emphasised measures to structurally reinforce capacity of the economy, such as improved provision of infrastructure and energy. In response to the increased volatility in food prices, the Government pursued a range of policies to address disruptions in supply and maintaining public purchasing power.

■ Monetary Policy Response

In the monetary area, policy management was confronted with the challenges of rising inflationary pressure, huge capital inflows and excess liquidity in the financial sector. During the first half of 2010, at a time of low inflationary pressures and conducive global economic condition, monetary policy maintained an accommodative bias to boost domestic economic recovery. However, the beginning of the second half of 2010 was marked by the renewed risk of mounting inflationary pressure linked to the sharp escalation in food commodity prices that hit many countries, including Indonesia. The huge capital inflows and abundant excess liquidity in the financial system added to the complexities of implementing monetary policy. Reliance only on interest rate instruments to curb the risk of rising inflationary pressure would have had broader implications. To address this situation, Bank Indonesia launched a combination of policies packaged as a monetary and macroprudential policy mix.

In general, the aim of Bank Indonesia's policy mix is to maintain external and internal balances. External balance is reflected in the sustainability of the balance

¹² Presidential Instruction No. 1 of 2010 concerning Accelerated Implementation of National Development Priorities in 2010.

of payments, while internal balance is achieved by maintaining low, stable inflation. The implementation of macroprudential policy was consistently put within the inflation targeting framework (ITF) to achieve the inflation target and economic growth. The introduction of a monetary policy that did not rely only on interest rate in responding to demand side pressure, but accompanied by a mix of other monetary policy instruments in controlling the liquidity, reflected a more flexible policy approach under the ITF framework.

At the operational level, the improvements of monetary policy focused on strengthening the effectiveness of monetary policy transmission and delivering a response to money market. In June 2010, Bank Indonesia released the Monetary Management Enhancement and Financial Market Development Policy Package. The launching of this policy package came in response to the challenges posed by the rush of capital inflows under conditions of persistent excess liquidity and lack of depth on the domestic money market. Other reasons for introducing the policy package include the susceptibility of economic recovery to external shocks, potential financial markets instability and a range of structural issues in the real sector. An important part of the policy package was the emphasis on bank to do more transaction on secondary market and restructuring the maturity profile in the transaction between banks and Bank Indonesia by lengthening maturity to absorb excess liquidity.

To strengthen liquidity management on the money market, Bank Indonesia announced some policy changes concerning reserves requirement and the net foreign borrowing position. In November 2010, Bank Indonesia raised the primary statutory reserve requirement from 5% to 8%, while the 2.5% secondary reserve requirement remained effective. Bank Indonesia also announced a reserve requirement based on the loan to deposit ratio (LDR) that would take effect in March 2011. As part of the Bank Indonesia policy priorities,¹³ the foreign currency reserve requirement was raised to 5% effective March 2011 with a subsequent increase to 8% scheduled for June 2011. To complement the regulatory framework for liquidity management and to minimise the risk of sudden capital reversal, Bank Indonesia reinstituted a policy restricting the daily position in short-term foreign borrowings to 30% of bank capital, effective from end-January 2011.

On the foreign exchange market, Bank Indonesia policy was aimed to maintain exchange rate stability amid the huge inflows of foreign capital. This policy was implemented through measured capital inflows management to mitigate the risk of sudden capital reversal. Under the exchange rate stabilisation policy, market interventions were conducted to minimise volatility in the exchange rate. In a further measure to strengthen policy for stabilisation of the exchange rate, Bank Indonesia introduced a one-month holding period (OMHP) on SBI that requires buyers to retain ownership for a minimum of one month before reselling to another party. This mix of policy instruments could minimize the potential risk of large and sudden capital reversal. Bank Indonesia also introduced reforms to improve monitoring of foreign exchange transactions¹⁴ and external borrowings by non-bank¹⁵ to support the monetary authority in operating a more anticipative and responsive exchange rate policy.

As part of an effort to bolster the foreign currency liquidity position, Bank Indonesia strengthened collaborative linkages with other central banks in the region. Implementation of the Chiang Mai Initiative Multilateralization (CMIM) agreement among the ASEAN+3 group was commenced on March 24th, 2010. The CMIM agreement - amounting to USD 120 billion - is a multilateral swap arrangement aimed at resolving balance of payment difficulties and short-term liquidity problems in the region and complements the existing international financial collaboration. This agreement enables each CMIM member to swap local currencies with USD to the maximum of the each country's contribution factored by a certain multiplier.

While launching the CMIM agreement, the ASEAN+3 nations also committed to the joint establishment of an independent surveillance unit in the region to strengthen safeguards against the risks and challenges in the global economy. Following the Bilateral Currency Swap Arrangement (BCSA) concluded in 2009 with the People's Bank of China, Bank Indonesia also issued regulations governing the mechanism for implementing this agreement. The implementation of the BCSA will provide greater assurance of availability of foreign exchange to support economic activity in the real sector, which in turn will contribute positively in maintaining rupiah stability.

14 Bank Indonesia Regulation No. 12/16/PBI/2010 concerning the Foreign Currency Rupiah Transaction Monitoring System

15 Bank Indonesia Regulation No. 12/1/PBI/2010 concerning Non-Bank Corporate Foreign Borrowings

13 Bank Indonesia Policy Package, December 2010

To complement measures to keep inflation on track with the inflation target, Bank Indonesia and the Government stayed the course with a coordinated price controlling strategy. The rising intensity of supply side shocks that sent food prices soaring called for more comprehensive measures with a greater synergy through a series of policies that able to minimize these pressures. The policy coordination between Bank Indonesia and the Government, first established in 2005, was strengthened further with the issuance of Decree of the Minister of Finance No. 795/KM.01/2010 concerning “Establishment of the Inflation Monitoring and Control Coordination Team”, which more popularly known as the Inflation Control Team or TPI. The TPI has been strengthened through accelerating the establishment of Inflation Control Teams in various regions (TPIDs), with 53 TPIDs set up by the end of 2010.

■ Banking and Payment System Policy Responses

In the banking system, Bank Indonesia policy focused on building the resilience of the national banking system and promoting the banking intermediation role in supporting of economic growth. To reinforce bank capital, Bank Indonesia monitored and encouraged banks to comply with the Rp 100 billion Tier 1 bank capital requirement established in 2005.¹⁶ Other regulatory improvements by Bank Indonesia were related to risk management certification for management and officers of commercial banks, improved reporting and compilation of Bank Business Plans and the net open position.

Optimum risk management is strongly dependent on support from competent human resources. Bank Indonesia therefore revamped the rules for risk management certification and expanded the definition of risk management certification to bring it more align with prevailing international standards.¹⁷ Improvements to the fit and proper test were also made by Bank Indonesia to provide greater assurance of good corporate governance in the conduct of bank management.¹⁸ Besides this, Bank Indonesia issued technical instructions for implementation

of good corporate governance in sharia-compliant banking.¹⁹

Improved reporting requirements and regulations pertaining to Bank Business Plans were introduced to complement the framework for capacity building in bank risk management strategy.²⁰ The enhanced bank reporting requirements sought to improve the quality and transparency of reports submitted to Bank Indonesia and released to the public.²¹ The regulatory provisions dealing with Bank Business Plans do not only serve as a tool for banks in developing business strategy and assessing strategic risks, but also as a consideration by the monetary authority in policy making and macroprudential supervision and as a reference for development optimum and effective risk-based supervision. To improve effectiveness and cooperation in cross-border banking supervision, during 2010 Bank Indonesia signed memorandum of understanding with Bank Negara Malaysia²², the China Banking Regulatory Commission²³ and the Monetary Authority of Singapore²⁴.

The changes in the regulation governing the net open position²⁵ were introduced to allow banks greater flexibility in management of their foreign currency liquidity while upholding prudential banking principles. Prudential regulation with focus on customer protection also became a key basis for issuing Bank Indonesia Regulations related to agency services for foreign products operated by national banks²⁶ and rules for implementation of risk management for banks engaged in marketing collaboration with insurance companies (bancassurance).²⁷

16 Bank Indonesia Regulation No. 7/15/PBI/2005 concerning Minimum Tier 1 Capital for Commercial Banks as amended by Bank Indonesia Regulation No. 9/16/2007.

17 Bank Indonesia Regulation No. 12/7/PBI/2010 concerning Amendment to Bank Indonesia Regulation No. 11/19/PBI/2009 concerning Risk Management Certification for Management and Officers of Commercial Banks

18 Bank Indonesia Regulation No. 12/23/PBI/2010 concerning the Fit and Proper Test

19 Circular Letter No. 12/13/DPbS concerning Implementation of Good Corporate Governance for Sharia Commercial Banks and Sharia Banking Divisions

20 Bank Indonesia Regulation No. 12/21/PBI/2010 concerning Bank Business Plans

21 Bank Indonesia Regulation No. 12/2/PBI/2010 concerning the Second Amendment to Bank Indonesia Regulation No. 10/40/PBI/2008 concerning Commercial Bank Monthly Reports, and Circular Letter of Bank Indonesia No. 12/11/DPNP concerning the Second Amendment to Circular Letter of Bank Indonesia No. 3/30/DPNP dated 14 December 2001 concerning Published Quarterly and Monthly Financial Statements of Commercial Banks and Specific Reports Submitted to Bank Indonesia

22 July 2010

23 April 2010

24 November 2010

25 Bank Indonesia Regulation No. 12/10/PBI/2010 concerning the Third Amendment to Bank Indonesia Regulation Number 5/13/PBI/2003 concerning the Net Open Position for Commercial Banks

26 Bank Indonesia Regulation No. 12/9/PBI/2010 concerning Prudential Principles in Activities Conducted by Commercial Banks as Agents for Foreign Financial Products

27 Circular Letter No. 12/35/DPNP concerning Implementation of Risk Management at Banks Engaged in Marketing Collaboration with Insurance Companies

Towards the end of 2010, Bank Indonesia implemented a number of policy changes to promote the role of banking intermediation, to strengthen banking resilience and to improve the supervision function. Efforts to strengthen the role of bank financing in the economy include a new requirement to announce the prime lending rate to the public, effective from March 2011; the launching of the programme for strengthening Regional Development Banks (RDBs) as the engine of regional economic growth; and a programme for expanding public access to financial institutions. Further policies for strengthening the resilience of the banking system involved improvements to the fit and proper test, enhancement of the compliance function for commercial banks, and implementation of risk management for banks involved in marketing collaboration with insurance companies. To strengthen the supervision function, Bank Indonesia announced improvements in the risk-based bank supervision system, designation of status and follow up to bank supervision, and improvements in risk-based rating of bank soundness. In addition, Bank Indonesia introduced special rules for credit in disaster-hit areas to support economic recovery in regions affected by disaster.

The fine tuning of policy in the payment system also involved measures to improve efficiency and reliability in the operation of the payment system and to support improvements in the rules governing monetary management and the banking system. Payment system regulations introduced in 2010 include improvements to the operation of the Bank Indonesia Real Time Gross Settlement (BI-RTGS) System²⁸ to accommodate the payment versus payment (PvP) mechanism in interbank foreign currency trading. The new mechanism supports settlement of the rupiah and USD simultaneously. In other developments, improvements were made to the Bank Indonesia National Clearing System (SKNBI) to mitigate credit risk in the debit clearing mechanism.²⁹ To support the smooth operation of the payment system and to develop financial markets in Indonesia, improvements were also made to the Intraday Liquidity Facility (FLI). It allowed banks to use sharia-complaint government securities as collateral for the FLI. Improvements were also made to money, as a legal tender, to support economic transactions through the issuance of certain denominations and revocation of others. In 2010, Bank

Indonesia launched an improved design for the Rp 10,000 banknote,³⁰ issued a Rp 1,000 coin,³¹ and withdrew the 1991 issue of Rp 25 coins from circulation.³²

■ Fiscal Policy Response

The thrust of fiscal policy in 2010 was again to maintain fiscal consolidation, sustainability, and delivering a stimulus to the economy. In a drive to provide a fiscal stimulus designed to accelerate economic growth, the Government continued with the fiscal incentive programme and set the fiscal deficit in the Revised State Budget at 2.1% of GDP. A range of fiscal stimulus actions targeted in both sides, revenues and expenditures. On the revenues side, the provision of tax and import duty incentives is expected to promote business recovery. At the same time, the Government expenditure involved the continuation of people's welfare programmes, accelerated construction of infrastructure, bureaucratic reforms, increase in the defence budget, maintaining educational expenditures at a minimum of 20% of total state expenditures, and rising salary and payment of a 13th month salary to maintain real income levels for state personnel and retired civil servants. To safeguard fiscal sustainability, the Government prioritised optimum management of budget financing from domestic and international sources as a leading priority. Other government measures included increases in some tariffs and reductions in subsidies.

In 2010, revenues were higher than its target while expenditures were below its target. As a result, the fiscal deficit was lower than what was estimated in Revised State Budget. Revenues surpassed the budget target, reaching Rp 1,016.5 trillion (102.4% of the Revised State Budget), while the expenditure outcome came to Rp 1,056.5 trillion, below the targeted level (93.8% of the Revised State Budget target). This produced overall fiscal deficit of Rp 40 trillion or only 0.6% of GDP, compared to the originally targeted 2.1% of GDP. The modest deficit left the Government with unused budget financing recorded for 2010 at Rp 47.1 trillion. The low fiscal deficit outcome

28 Circular Letter No. 12/1/DASP concerning Operation of the Bank Indonesia Real Time Gross Settlement System

29 Bank Indonesia Regulation No. 12/5/PBI/2010 concerning Amendment to Bank Indonesia Regulation No. 7/18/PBI/2005 concerning the Bank Indonesia National Clearing System

30 Bank Indonesia Regulation No. 12/8/PBI/2010 dated 3 June 2010 concerning Second Amendment to Bank Indonesia Regulation No. 7/40/PBI/2005 concerning Issuance and Circulation of Year 2005 Banknotes in the 10,000 (Ten Thousand) Rupiah Denomination

31 Bank Indonesia Regulation No. 12/4/PBI/2010 dated 1 March 2010 concerning Issuance and Circulation of Coins in the 1,000 (One Thousand) Rupiah Denomination

32 Bank Indonesia Regulation No. 12/14/PBI/2010 concerning Revocation and Withdrawal from Circulation of Coins Issued in 1999 in the 25 (Twenty-Five) Rupiah Denomination

Table 1.12 Realization of The Revised State Budget (APBNP)

Items	2009			2010		
	APBNP	Jan-Dec	% APBNP	APBNP	Jan-Dec	% APBNP
A. Government Revenue And Grants	871.0	848.8	97.4	992.4	1.016.5	102.4
I. Tax Revenues	652.0	619.9	95.1	743.3	744.4	100.1
1. Domestic Taxes	631.9	601.3	95.1	720.8	715.5	99.3
2. International Trade Taxes	20.0	18.7	93.2	22.6	28.9	127.9
II. Non-Tax Revenues	218.0	2.272.0	104.2	247.2	269.4	109.0
III. Grants	1.0	1.7	165.6	1.9	2.8	146.8
B. Government Expenditures	1,000.8	937.4	93.7	1,126.1	1,056.5	93.8
I. Central Government Expenditures	691.5	628.8	90.9	781.5	711.8	91.1
1. Personnel Expenditures	133.7	127.7	95.5	162.7	147.8	90.8
2. Goods Expenditures	85.5	80.7	94.4	112.6	96.0	85.3
3. Capital Expenditures	73.4	75.9	103.4	95.0	77.0	81.0
4. Interest Payment	109.6	93.8	85.6	105.7	88.3	83.6
5. Subsidy	158.1	138.1	87.3	201.3	214.1	106.4
6. Grants Expenditures	0	0	0	0.2	0.1	28.8
7. Social Aid	77.9	73.8	94.7	71.2	68.4	96.1
8. Others Expenditures	53.3	38.9	73.0	32.9	20.1	61.1
II. Regional Expenditures	309.3	308.6	99.8	344.6	344.7	100.0
C. Primary Balance	-20.3	5.1		-28.1	48.4	
D. Budget Surplus/Deficit	-129.8	-88.6		-133.7	-40.0	
Surplus/Deficit (Percent of GDP)	-2.4	-1.6		-2.1	-0.6	

Source: Ministry of Finance

resulted in a lower fiscal sector contribution to the real sector in comparison to 2009.

On the revenues side, strategy is directed towards safeguarding fiscal sustainability. The financing strategy was essentially a continuation of the strategy pursued in 2009, among others by issuing a larger number of Indonesian government securities at the beginning of the year (front loading) and portfolio management under a strategy of buyback and debt switching. The success of the front loading strategy in 2009 was replicated in the issuance of Indonesian government securities in 2010 marked by a narrowing yield trend at each auction. During 2010, issuance of Indonesian government securities totalled Rp 161.9 trillion, or 91.3% of the Revised State Budget target. The actual deficit from the Revised State Budget came short of target, leaving the Government with surplus that were used to manage the government securities portfolio through buybacks and debt switching to reduce the financing burden and improve the maturity profile. During 2010, the Government held 13 buybacks representing a total

value of Rp 3.2 trillion and 6 debt switching transactions similarly worth Rp 3.9 trillion.

■ Sectoral Policy Response

The Government has adopted a number of sectoral policies to bolster the capacity of the national economy amid the ongoing momentum of economic recovery. This policy involved structural reforms to boost economic capacity through provision of vital infrastructure with emphasis on domestic connectivity, energy resilience, and improvement in the investment climate.³³ To support the implementation of this policy, the Government inaugurated a state-owned company dedicated to provide financing for infrastructure construction in January 2010. At the same time, the Government introduced a joint financing scheme for developments programmes involving central and regional government partnerships and public-private partnerships, including partnerships with SOEs.

33 Part of the economic policy priorities set forth in Presidential Instruction No. 1 of 2010 concerning National Development Priorities in 2010

The government introduced procedural rules and strategies designed to support priority development objectives. Among others, rules for procurement of goods and services were revamped to support more rapid implementation of central government and regional budgets³⁴ and improvements were also made to support regulations to expedite processes for submission and settlement of claims charged to the State Budget.³⁵ In the energy sector, the government has adopted the 2010-2025 master plan for the national gas transmission and distribution network³⁶ and has pursued other strategic actions to accelerate power plant construction with emphasis on renewable energies, gas and coal. In other measures to bolster the investment climate, the government adopted the integrated national single window service system at five major seaports,³⁷ promoted the implementation of Integrated Services for investment activities in some regions, developed special economic

zones,³⁸ and updated the Negative Investment List³⁹ to offer convenience, certainty and attractiveness of investment and improve the investment climate.

The government responded to surging food prices with a range of policies aimed at ensuring adequate supply and smooth distribution of food crops. Market operations to maintain rice prices stability were accompanied by distribution of rice for poor people and a strategy to expand the national rice buffer stock. At the end of 2010, the Government announced a suspension of import tariffs on rice.⁴⁰ Interagency and cross-regional coordination under the Inflation Control Team (TPI) were strengthened at the central and regional levels through cross-regional mapping and monitoring of food stocks, minimising bottlenecks in distribution logistics, and improved information on prices and availability of food staples for the public.

34 Presidential Regulation No. 54 of 2010 concerning Government Procurement of Goods/Services dated 6 August 2010

35 Minister of Finance Regulation No. 170 of 2010 concerning Settlement of Claims Charged to the State Budget

36 Decree of the Minister of Energy and Mineral Resources No. 0225/11/MEM/2010 dated 27 January 2010

37 Belawan, Tanjung Priok, Tanjung Perak, Tanjung Emas seaports and Soekarno-Hatta Airport

38 As a follow up measure for the implementation of Act No. 39 of 2009 concerning Special Economic Zones, the Government established the National Council for Special Economic Zones in May 2010

39 Presidential Regulation 36 of 2010 superseded Presidential Regulation 77 of 2007 and Presidential Regulation 111 of 2007

40 MoF Regulation No. 241/PMK.011/2010 concerning Establishment of the Merchandise Classification System and Imposition of Duties on Imported Goods

BOX 1.1: Accountability for the 2010 Inflation Target

CPI inflation in 2010 reached 6.96%, overshooting the targeted level of $5\% \pm 1\%$.¹ During the first half of 2010, price stability remained well under control as indicated by the low rate of inflation (5.05%). However, in early Q3 2010, supply-side disruptions impacting food prices as a result of anomalous weather conditions in Indonesia and worldwide. These conditions produced a steep rise in global food commodity prices, while domestic market prices for the same commodities also mounted. The main factor behind soaring inflation was resulted more from the high price volatility in the volatile foods category. In contrast, administered prices generated only moderate inflationary pressure, while core inflation, reflecting aggregate demand and supply interaction, was contained at a quite modest level.

The surge in prices of staple foods, which are prone to adverse weather condition, produced a very sharp spike in volatile foods inflation. Adverse weather conditions marked by heavy rainfall and distribution problem resulted in supply shocks for some domestic staple foods, including rice, seasonings and vegetables, which in turn caused escalating prices hike. Soaring volatile foods inflation was also experienced by other countries in the region. In addition, the rising global food prices during the second half of 2010, as can be seen in prices for crude palm oil (CPO), wheat and corn, also pushed domestic inflationary pressure in food items although they had been mitigated to some extent by appreciation in the rupiah. In general, inflation in the volatile foods category represented the largest contribution to CPI inflation in 2010 at 3.13%. The 17.74% inflation in the volatile foods category far surpassed the 9% average recorded over the previous ten years.

1 The inflation target is decided by the Government with advice from Bank Indonesia. The current inflation target was adopted in Decree of the Minister of Finance No. 1/KMK.011/2008 dated 3 January 2008 concerning the Inflation Target for 2008, 2009 and 2010. The inflation target is set on a regular basis to accommodate the targeted inflation level for the next three years. The government has adopted inflation targets for 2010, 2011 and 2012 in Minister of Finance Regulation (PMK) No. 143/PMK.011/2010 dated 24 August 2010, representing a downward trend at 5% for 2010 and 2011 and 4.5% for 2012 with tolerance (point with deviation) limited to $\pm 1\%$.

On the other side, the decision to increase electricity billing rates as a strategic administered prices item, had a moderate effect on inflationary pressure. Business had already anticipated the government decision to increase the billing rate for business customers and households with equal to or more than 900 kilovolt-ampere (kVA) category. As a result, the hike in electricity billing rates only affected CPI inflation moderately with a direct contribution to inflation at 0.38%, and did not produce any significant second round effects on inflation expectations. A major source of inflationary pressure in the administered prices category in 2010 laid in government announcement of substantial increases in fees for motor vehicle renewal registration (STNK) and driving licences, as high as 75% and 48%, which resulted in a 0.24% contribution to the CPI inflation figure. For the whole 2010, administered prices inflation reached 5.40%, contributing 0.99% to the inflation figure. At this level, administered prices inflation was quite low when compared to the 13% average for the previous ten years.

Otherwise, inflationary pressure on the fundamentals side remained well under control. This was indicated in the stable core inflation during 2010, which remained well below its historical level. This shows that macroeconomic equilibrium has generally been sustained quite well, enabling demand-side acceleration to be managed in line with capacity on the supply side while curbing inflation expectations. Besides this, an important factor contributing to low core inflation was appreciation in the rupiah accompanied by reduced volatility. This rupiah appreciation minimised the impact of imported inflation from rising global commodity prices and helped contain the inflation expectations of economic agents. Following these developments, core inflation at end-2010 was recorded at 4.28% (yoy), contributing 2.8% of the CPI inflation figure. This represented a quite modest outcome when compared to the 7.5% average for the previous ten years.

The huge impact of the supply side shocks posed challenges in accurately predict volatile foods inflation. This inflation category is strongly influenced by supply shocks that frequently occurred and was beyond the control of the central bank. For example, in 2010, many

supply shocks came from adverse weather conditions and natural disasters that struck various places in Indonesia. In response, Bank Indonesia adopted a range of policies within the scope of its powers while securing Government support, given that the main sources of inflationary pressure were supply shocks in the foodstuffs category.

On the monetary side, Bank Indonesia pursued a series of policy actions in 2010 aimed at maintaining macroeconomic stability. Bank Indonesia was confronted with complex and multidimensional policy challenges due to the huge of capital inflows, a flood of excess liquidity and mounting domestic inflationary pressure. For this reason, the policy course pursued by Bank Indonesia could not rely solely on single instrument. Instead, Bank Indonesia adopted a policy mix set out in the following four policies: 1) BI Rate policy aimed towards achievement of the inflation target while building conducive conditions for the financial system stability and economic growth; 2) Exchange rate stabilisation policy for curbing volatility in the rupiah and managing exchange rate movement in line with economic fundamentals, which is expected to bolster economic resilience against the risk of capital reversal (self-insurance); 3) Macroprudential policies for managing capital inflows mainly for short-term and speculative investments to prevent these inflows from causing instability, and to steer inflows towards longer-term placements; and 4) Strengthened monetary operations and macroprudential policy to manage liquidity to keep it at the adequate level for the economy.

During 2010, Bank Indonesia held the BI Rate unchanged at 6.5%, based largely on the reason that the main sources of inflationary pressure came from the supply side, due to supply disruptions and problems in food distribution. Regarding domestic demand, various indicators point to early signs of economic recovery accompanied by a more robust structure with increased consumption matched by investment growth. Bank Indonesia is cognizant of the importance of sustaining the momentum of economic recovery.

Measures taken to guide inflation expectations towards the inflation target also had a very important role. In addition to maintain exchange rate stability, other actions to shape expectations involved more robust

communication of monetary policy through media such as focus group discussions (FGDs) with corporate management and CEOs, economists and financial analysts. Bank Indonesia availed the opportunity of these discussions to explain its views on the latest economic conditions and outlook for the economy and the policy direction, while also benefiting from comments and suggestions regarding developments in the real sector. The effort to manage inflation has been strengthened through intensive policy coordination between Bank Indonesia and the Government at both the national and regional levels.

This policy coordination between Bank Indonesia and the Government was reinforced with the establishment of Regional Inflation Control Teams (TPIDs). In 2005, the Coordinating Team for Targeting, Monitoring and Controlling Inflation (TPI) was established with members from Bank Indonesia and other relevant institutions, including the Ministry of Finance, Coordinating Ministry for Economic Affairs, Ministry of Trade, Ministry of Communications, Ministry of Energy and Mineral Resources, National Development Planning Agency, Ministry of Agriculture and the Ministry of Labour and Transmigration. Rising inflationary pressure on the supply side prompted Bank Indonesia to strengthen inflation control with the support of regional governments. The TPIDs were initially established in a few regions in 2008. Since then, the teams have met with positive support and response from the regions and have now become established in 53 regions across Indonesia.

The work of the TPI and TPIDs is expected to bring solutions to the various inflation issues related to supply-side disruptions. In broader terms, the range of activities and programmes conducted during 2010 can be grouped into three areas. The first area covered improvement in distribution, supply and managing expectations. Actions taken so far include measures to promote market operations in some regions and a communications strategy to guide inflation expectations through improved communication to the media. Second activities are linked to improvement in coordination through promoting cross-regional flows of the information and data necessary to formulate price stabilisation policies at the regional level. Third activities rely on support from the development of a database of strategic commodity

prices in each city with TPID. The availability of this data and information provides a vital basis for price stabilisation policy.

Coordination with the Government was also strengthened through more robust collaboration on statistics between Bank Indonesia and Statistics Indonesia (BPS). This collaborative arrangement, agreed on November 2010, covered three main areas: exchange, acquisition and compilation of data

and information; a coordination forum for data and information; and human resources development. This cooperation is crucial, given that the BPS data and information on the real sector at both central government and regional levels is vital for the Bank Indonesia's policy formulation on monetary, banking, and payment system. Conversely, BPS also needs the information and data from Bank Indonesia financial and monetary area to be presented to the Government and the public.

BOX 1.2: Weather Anomalies and Food Production

Volatile foods inflation ran at a high 17.74% during 2010, well above the 9% average for the past ten years. The most important factor driving this volatile foods inflation was adverse weather conditions. Beginning in July 2010, prices soared for commodities susceptible to weather condition, such as rice, seasonings, fruit and vegetables. The high inflation in this category during the year under review is explained by anomalous weather also known as La Nina.

La Nina is a global phenomenon which surface temperatures in the central and eastern Pacific Ocean within the tropical zone drop below normal, while surface temperatures in Indonesian waters rise above normal levels.¹ Lower surface temperatures in the Pacific Ocean cause the warm pool to move from the Pacific to Indonesian waters. This meteorological phenomenon increased rainfall to Indonesia accompanied by a shift in the dry season. Heavy rain accompanied by fierce wind resulted in flooding, landslides and tropical cyclones in some regions where weather conditions should have been dry because of the dry season. From July 2010, the intensity of La Nina ranged from moderate to strong (Chart 1).

- 1 La Nina is the opposite of the El Nino phenomenon, which is marked by rising ocean surface temperatures in the Pacific Ocean. In Indonesia, El Nino results in a prolonged dry season and widespread drought conditions.

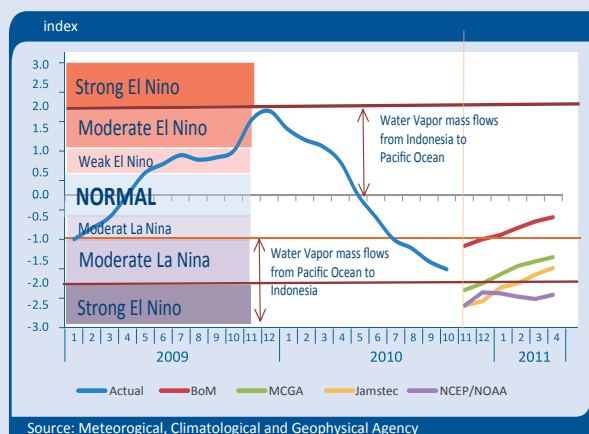


Chart 1. Nino Index

This shifting in seasons hampered agricultural production. Plants were easily damaged and became more vulnerable to pests, while crop quality deteriorated. This led to loss of crop productivity and drove up foodstuff prices.²

One of the most affected commodities in this category marked by sharply rising prices was rice³. The sizeable area of rice paddies hit by heavy rainfall curbed the increase in rice production, causing its prices to jump and generating considerable inflationary pressure towards the end of 2010. Inflation in rice prices during 2010 (30.4%) was markedly higher than the historical trend (12.4%)⁴ (Chart 2). In response to these rising prices, the Government launched policy actions to stabilise prices through market operations and imports (Chart 3).

Another factor hampering growth in rice production was inadequately maintained agricultural infrastructure and especially poorly operating irrigation systems, combined with loss of arable land from conversion under the present trend of rapid urbanisation. However, efforts to repair ageing infrastructure and construct new

- 2 Not only Indonesia suffered from surging food crop prices spurred by weather conditions, but also other countries in the region.
- 3 The weighting assigned to rice in the Consumer Price Index basket is 4.58%.
- 4 Average rice inflation (yoy) for 2003-2009.

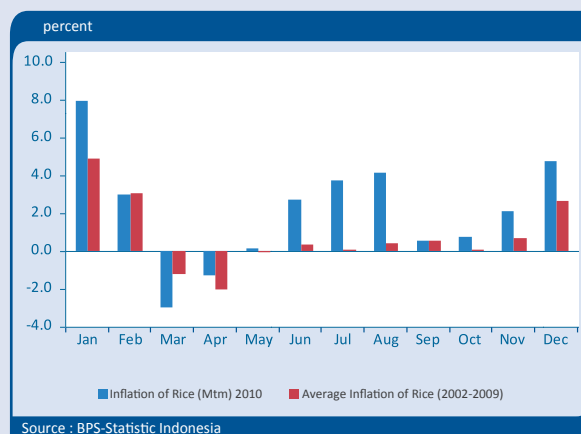


Chart 2. Inflation of Rice in 2010

infrastructure have been daunted by various challenges, such as limited budget resources, land clearing issues and environmental damage.

Another commodity that significantly impacted volatile foods inflation during 2010 was seasonings (Chart 3). Besides the harvest failures, the use of conventional drying technology and inadequate pest control also drove up prices for these commodities. Even so, while the surging prices for seasonings had only moderate impact on downstream products such as processed foods, the escalating prices for these items and volatile foods in general worsened expectations of inflation, producing second round effects of price increases in other commodities.



Chart 3. Inflation of Spices Commodities (red pepper, cayenne pepper, red onion, onion)