



Chapter 1

Overview

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The year 2007 witnessed a remarkable achievement of the Indonesian economy most notably in key areas despite mounting external pressures. For the first time since the crisis, the economy grew at a rapid level of above 6%, with macroeconomic stability kept in check. The favorable performances were reflected in significant surplus of balance of payments, reinforcing the international reserves, exchange rate stability, strong credit expansion and inflation under controlled. Soaring international commodity prices, led by oil, and the unfolding of the subprime mortgage crisis figured prominently among the challenges confronting the Indonesian economy during the year. In the face of these multiple adversities, the Indonesian economy had appeared to show a higher level of resilience in support of economic growth.

Indonesia's improved economic resilience has been built upon a combination of macroeconomic and sectoral policies. Monetary and fiscal policy coordination has been markedly strengthened. The Government and Bank Indonesia have been in close collaboration in the delivery of economic stimulus and safeguarding economic stability. In the monetary sector, the pursuit of prudent and consistent policies responses have contributed to keeping inflation on a medium to long-term downward trend. Fiscal sustainability has also been safeguarded through appropriate control over strategic commodity prices. The banking system has seen steady progress as reflected in a raise in the intermediary function and strengthened institutions, including the accelerated development of Sharia banking. At the sectoral level, the government has sought to improve the quality of economic growth through improvements in the investment climate, accelerated construction of infrastructure, empowerment of MSMEs and the financial sector reform.

On the external front, the Indonesian economy is expected to encounter onerous challenges arising from global economy turbulence. Accordingly, economic growth is predicted to slow down in 2008 compared to 2007. Inflation is higher than the established target, while the rupiah exchange rate is expected to remain stable. Looking ahead, the synergy in monetary and fiscal policy will become more essential to mitigate the prevailing of risks. In this regard, Bank Indonesia will continue the pursuit of a consistent monetary policy directed in containing inflation so as to support sustainable economic growth. In the banking sector, Bank Indonesia will focus on improvement of the banking intermediary function and the institutional strengthening of the banking system. At the same time, the strengthening of economic competitiveness, including improvements to the investment climate and accelerated construction of infrastructure, will become increasingly important in paving the way for higher levels of growth in a structurally more robust economy.

The beginning of the year was marked by buoyant public optimism over the economic outlook. As Indonesia entered 2007, macroeconomic stability was back on track following the oil prices shock at the end of 2005, the impact of which prevail until mid-2006. This optimism was underpinned by strengthening public confidence in the management of macroeconomic policy, supported by consistent alignment in monetary and fiscal policies for achievement of the inflation target and a strong commitment to fiscal sustainability. Rising confidence in the credibility of macroeconomic policy was accompanied by improving international confidence in the Indonesian economy as reflected in the upgrading of Indonesia's sovereign credit rating and easing of investment risk premiums.

In the second half of 2007, the Indonesian economy faced renewed global economic challenges, including the knock-on effects of the sub-prime mortgage crisis, as well as high oil and other international commodity prices. World oil prices hovering near \$100 per barrel¹, prompted higher demand for foreign currency to pay for imports and increased fiscal burden, mainly for covering the mounting fuel subsidy. The unfolding impact of the sub-prime mortgage crisis triggered pessimism over the world economic outlook, prompting global investors to pull out of perceived high-risk assets in a flight to quality. Most affected were assets in emerging markets, including Indonesia. This also triggered a round of capital reversal on the domestic financial market, with Bank Indonesia Certificate (SBI), government securities and stocks most affected.

The global economic turmoil has in turn undermined the foundation of Indonesia's macroeconomic stability. In the second half of 2007, the rupiah came under pressure with the monthly average of Rp9,372 to the US dollar in August 2007. To address these challenges, the Government and Bank Indonesia have introduced a series of measures to maintain macroeconomic stability while sustaining the momentum for economic growth. These macroeconomic policy actions have been implemented in a prudent and consistent manner so as to build public and business confidence in the rupiah. In addition, the high yields on the domestic financial market encouraged renewed capital inflows into Indonesia at a time of excess liquidity in the global financial markets.

Despite the temporary pressure on the exchange rate, the rupiah exchange rate remained relatively stable. Among the factors contributing to stability in 2007 were positive developments in domestic economic fundamentals consistent with the achievement of internal and external equilibrium. Foreign Exchange (Forex) market interventions to contain exchange rate volatility were conducted on a limited scale. This policy was reinforced by more robust communications and improved effectiveness in prudential regulation and monitoring of foreign currency movements. The exchange rate was also bolstered by the strong performance in the balance of payments. In 2007, the balance of payments recorded another surplus of \$12.5 billion. The current account surplus reached \$11.0 billion or 2.5% of GDP, up from \$10.8 billion in 2006, driven mainly by rising non-oil and gas exports. Despite a temporary capital reversal in Q3-2007, the capital and financial account booked a \$2.8 billion surplus for 2007, consistent with the continued attractiveness of rupiah investment yields. Reflecting the strong performance in the balance of payments was increasing accumulation of international reserves at \$56.9 billion, equivalent to 5.7 months of imports and official debt repayments and well ahead of the end-2006 position of \$42.6 billion.

The stability of the exchange rate also contributed to keeping CPI inflation within the target. The success in reigning in inflation also benefited from the subdued volatile foods prices and low inflation in administered prices. In this regard, the government commitment to refrain from increases in administered prices for strategic commodities (oil-based fuels and electricity billing rates) played a vital role. Other government contribution to contain inflation was the control of prices in traded goods including non oil and gas. Furthermore, improved policy credibility also has a beneficial effect on public expectations on inflation.

With stability in place, economic growth accelerated reaching a record high of 6.32% in 2007. Much of acceleration of the economic growth was accounted for buoyant demand for both private consumption and investment. Private consumption escalated on the back of rising purchasing power. At the same time, investment growth was supported by improved investor perceptions, higher returns on investment and adequate availability of financing from banks and financial markets in general. Exports continued to forge

¹ Intraday WTI oil price, 20 November 2007.

ahead amid the slowdown in global economic growth. Key to this was the ongoing diversification of export destinations to high-growth economies such as China and India. Thereby outweighing a decline demand from developed countries. The acceleration of aggregate demand was met with rapid expansion in production across almost all economic sectors, most notably manufacturing, agriculture and trade.

Economic performance also improved at the regional level during 2007, as reflected in the strong growth and relatively stable inflation in some regions. Analyzed by contribution, the economies in the Java, Bali and Nusa Tenggara (Jabalnustra) region and the Jakarta-Banten region provided the strongest driving force for national economic growth. Concerning prices, national inflation was kept stable due to relatively low levels of inflation in some of the most important regions contributing to the national inflation figure. Despite the improved economic performance in some regions, considerable disparities persisted among regions in their levels of growth and inflation.

In view of the stable outlook for various economic indicators with projected inflation within the targeted range, Bank Indonesia gradually lowered the BI Rate to 8%, representing a cumulative reduction of 175 basis points from the end of 2006. These rate cuts were followed by downward movement in market interest rates, including rates for deposit funds and credit. Lending showed significant expansion of 25.5%, ahead of the 22.0% target at the beginning of the year. On the stock and bond markets, the BI Rate reductions contributed to stock index gains with positive response from buyers of bonds, even in spite of the negative sentiment bearing down on regional and global markets. These trends were also accompanied by increased net asset value (NAV) in mutual fund investments, and particularly the NAV per unit for fixed income funds. Nevertheless, the BI Rate was kept on hold from August to November 2007 to anticipate risks from escalating inflationary pressure from external shocks.

On the fiscal front, the policy has been targeted at maintaining price stability for energy and staple needs, while also delivering an economic stimulus. Escalating world oil prices in combination with below-target lifting of domestic oil led to a considerable pressure

in the budget deficit. To address this challenge, the government pursued a series of anticipatory measures for budget revenues and expenditures. On the revenues side, the government strengthened the collection of tax revenues and increased the target of dividends from State Owned Enterprises (SOEs). On the expenditures side, the government maintained domestic fuel prices at steady levels through subsidy payments, leading to higher than targeted government spending. In budget financing, issuance of government securities ahead of schedule to secure deficit funding enabled the deficit funding target to be met before the recent turmoil in the financial sector.

Looking ahead, after a thorough assessment on economic performance, opportunities and risks, Bank Indonesia forecasts economic growth in 2008 to reach 6.2%, somewhat lower than in the preceding year. This growth will be driven primarily by private consumption and investment. Key to the brisk growth in private consumption are the planned increases in civil servant salaries and provincial minimum wage levels. Also providing momentum for higher consumption will be adequate availability of consumer financing from banking sources and other financial institutions. Investment growth is also predicted to gather pace partly in response to a conducive investment climate, but also from the construction of government and private sector-funded infrastructure projects, including toll roads and power plants. With the world economy heading for a slowdown, export performance is predicted to decline.

Indonesia's economic performance will remain firmly underpinned by macroeconomic and financial system stability. The rupiah exchange rate is forecasted to remain stable in 2008 in view of attractive investment returns and availability of foreign exchange from export earnings and capital inflows. However, strong upward pressures are predicted for CPI inflation, mainly from imported inflation. An added source of inflationary pressure is predicted to come from mounting inflation expectations. Taking into account to these factors, inflation is estimated to reach 6.0%-6.5% overall, with the probability of tailing towards the upper limit. Accordingly, measures to maintain prices and exchange rate stability will gain increasing importance given that the economic expansion in 2008 will mainly rest on domestic demand, most notably private consumption.

In sum, the economic outlook for 2008 will be reinforced by Government consistency in taking the envisaged anticipatory measures (Box: Nine Actions for Securing Fiscal Outcomes, including Tax Reductions for Food Commodities and Added Food Subsidies). In addition to this, the economic outlook is contingent on Bank Indonesia's consistency in safeguarding macroeconomic and financial system stability, particularly in the exchange rate, and on further strengthening of fiscal and monetary policy coordination.

Evaluation of the Indonesian Economy in 2007

Against the backdrop of external turbulence, the Indonesian economy demonstrated improved performance during 2007. Underscoring this were the robust balance of payments, higher economic growth and more equitable income distribution, thereby reducing unemployment and poverty although remaining at high level. Macroeconomic stability in combination with an array of sectoral policies contributed to the favorable economic performance as reflected in the stable exchange rate, subdued inflation and a containment of fiscal deficit. With stability in check, perceptions among investors and market agents improved.

Indonesia's economic performance in 2007 was supported by a series of consistent policies in building domestic economic resilience against external and domestic shocks. This range of policies included the pursuit of monetary policy geared towards achieving inflation target, fiscal sustainability, prudential banking policies and sectoral policies for promoting investment and export market expansion.

Macroeconomic Conditions

Indonesia's economic growth in 2007 reached 6.32%, having climbed from the previous year's level of 5.5%. Accelerated growth momentum in 2007 came largely from the strong growth recorded in household consumption and investment. On the supply side, the main contributors to economic growth were the manufacturing, trade and agriculture sectors. The high rate of economic growth was accompanied by improvement in public prosperity indicators. The percentage of the population living below the poverty line fell from 17.7% in 2006 to 16.6% in 2007, a reduction of 1.9 million persons. Besides higher

economic growth and stable inflation, the improvement in poverty indicators is also supported by the implementation of various social programmes targeting the poor, including disaster relief.

On the demand side, economic expansion was driven by 5.0% growth in household consumption, well ahead of the 3.2% increase recorded in the previous year. The accelerated growth in household consumption came on the strength of improved public purchasing power and adequate availability of consumer financing. The improvement in public purchasing power was the combined result of subdued inflation, pay increases for formal sector employees and laborers and high levels of remittance transfers from Indonesians working overseas. Most sections of society, including low-income groups, saw their income levels rise. Improvement in middle-class incomes was indicated in the findings of a survey of executive salaries and the 10%-15% salary increase awarded to civil servants. Among low-income groups, the improvement in purchasing power benefited mainly farmers and workers employed in the formal industrial sector. Purchasing power among low-income groups was also bolstered by the high volume of remittances from Indonesians working overseas, recorded at US\$6.0 billion or 1.4% of GDP.

Investment grew by 9.2% in 2007 buoyed by strong domestic demand and improving business optimism over the condition of the domestic economy reflected in various survey findings pointing to buoyant confidence in the growth outlook for the domestic economy. The upswing in investment was also accompanied by improvement in capital productivity, reflected in the downward trend in the Incremental Capital Output Ratio (ICOR). The higher productivity of capital is an indication of improvement in investment return and efficiency.

On the financing side, while investors tapped sources of credit and the capital market, indications pointed to an increase in self-financing. This was borne out in the financial statements published by stock-exchange listed companies indicating greater use of retained earnings in support of business expansion. More potential sources of investment financing became available, as indicated by the increase in the savings ratio. In 2007, the savings ratio reached 26.8%, up from the previous year's level of 23.7%. Even so, this financing potential has not

been fully tapped for physical investment, as reflected in the prevailing considerable savings-investment gap at 2.6% of GDP. Analyzed by contributing source, the surplus of savings over investment was generated in the private sector, in contrast to the increased deficit in the government sector. This is an indication of the predominance of sources of private sector savings in investments in the financial sector.

Despite the resurgent investment growth, complacency should be avoided as Indonesia's business competitiveness lags behind the neighboring countries - in terms of operations, corporate strategy and quality of the business environment. Confirming this is a survey by the World Bank (October 2007), in which Indonesia's competitiveness rating is essentially unchanged (54th out of 131 countries), despite some improvement in efficiency indicators in terms of market size, efficiency on the market for goods and efficiency on the labour market. Some key indicators of concern include infrastructure shortages, inefficiency in bureaucratic processes and difficulties in access to finance. In consequence, the investment to GDP ratio remained at about 24.9%, below the pre-crisis ratio of about 29% and levels reached in other ASEAN countries.

In the midst of the global economic slowdown, real exports continued to grow at 8.0%. This is explained not only by steadily climbing world prices, but also by strong demand from developing countries like China and India. Analyzed by commodity, robust export growth was driven by keen demand for coal, palm oil and rubber. The large volume of palm oil and coal exports is related to the energy diversification programmes under way in developed countries to find alternative sources of energy in response to soaring oil prices.

Economic expansion resulted in an upsurge in imports with growth at 8.9%, ahead of the preceding year. Import growth benefited not only from relative stability in the exchange rate, but also strong domestic demand for consumption and investment. Analyzed by component, imports of consumer and capital goods registered exceptionally high levels of growth at 42.4% and 23.1%.

On the supply side, the main contributors to GDP growth, remain unchanged, which were manufacturing sector, trade, hotels and restaurant sector, and

agriculture sector. Manufacturing growth during 2007 reached 4.7%, up slightly from 4.6% in 2006. In a similar trend, the trade sector saw growth climb from 6.1% in 2006 to 8.5%. The high growth rates in both sectors were attributable to rising domestic demand and improved business confidence in the condition of the economy. The agricultural sector also recorded more vigorous growth alongside increased productivity, particularly in the food crops subsector, as well as robust export demand for rubber and palm oil. The rice crop also reached its highest level in the past five years.

The upsurge in economic growth during 2007 also improved the welfare of the population. This was indicated in per capita income that reached \$1,946 in 2007, up about 17% over 2006. In addition, the economic growth generated employment for approximately 4.5 million new entrants to the workforce, bringing open unemployment down from 10.3% in August 2006 to 9.1% in August 2007. Analyzed by educational level, unemployment among those with academy and university qualifications continued to rise. However, unemployment eased among low income groups, partly due to the reinvigorated role of agriculture in driving economic growth.

Poverty indicators also improved, as reflected in the downward movement in total numbers of people living in poverty, the poverty gap index and the poverty severity index. The March 2007 report issued by BPS (Statistics Indonesia) cited 37.2 million living in poverty, a reduction from 39.3 million in previous year. The decline in numbers of poor was more pronounced in rural areas at 1.20 million, while numbers of urban poor fell by 0.93 million. Analyzed by rural-urban population, rural poverty predominated, with 65% of Indonesia's poor living in rural areas. Nevertheless, improvement took place in the average expenditure gap for the poor, as reflected in the poverty gap index and poverty severity index. Alongside the reduction in poverty levels, income disparities also eased in 2007, as indicated by a drop in the Gini coefficient.

The reduction in poverty levels was also accompanied by improvement in quality of life. In a World Bank report published in November 2007, the percentage of population living with less than \$1 per day was 8.5%, well inside the targeted 10.3% in the Millennium Development Goals (MDG) for 2015. Improvement also

Table 1.1
Selected Macroeconomic Indicators

percent

Descriptions	2003	2004	2005	2006	2007
GDP Growth	4.7	5.0	5.7	5.5	6.3
CPI Inflation	5.1	6.4	17.11	6.60	6.59
Core Inflation	6.9	6.7	9.75	6.03	6.29
Average Exchange Rate (Rp/\$)	8,572	8,940	9,713	9,167	9,140
SBI (1 month)/BI Rate since July 2005	8.31	7.43	12.75	9.75	8.00
Current Account/GDP	3.4	0.6	0.1	2.9	2.5
GDP by Expenditure					
Consumption	3.9	5.0	4.0	3.2	5.0
Gross Fixed Capital Formation	0.6	14.7	10.9	2.5	9.2
Exports of Goods and Services	5.9	13.5	16.6	9.4	8.0
Imports of Goods and Services	1.6	26.7	17.8	8.6	8.9
GDP by Sector					
Agriculture	3.8	2.8	2.7	3.4	3.5
Mining and Quarrying	-1.4	-4.5	3.2	1.7	2.0
Manufacturing	5.3	6.4	4.6	4.6	4.7
Electricity, Gas, and Water Supply	4.9	5.3	6.3	5.8	10.4
Construction	6.1	7.5	7.5	8.3	8.6
Trade, Hotels, and Restaurants	5.4	5.7	8.3	6.4	8.5
Transportation and Communication	12.2	13.4	12.8	14.4	14.4
Finance, Rental, and Business Services	6.7	7.7	6.7	5.5	8.0
Services	4.4	5.4	5.2	6.2	6.6
Unemployment Rate	9.5	9.4	10.8	10.3	9.1
Poverty Rate	17.4	16.7	16.0	17.7	16.6
Real GDP per Capita, thousands Rp	9,574	10,506	12,700	15,000	17,600
Real GDP per Capita, \$	1,116	1,167	1,321	1,663	1,947
Monetary Aggregate					
M2 Growth, End of Period	8.12	8.14	16.42	14.87	18.89
M1 Growth, End of Period	16.60	13.41	11.07	28.08	27.63
Base Money Growth, End of Period (test date)	20.42	19.81	20.22	23.90	27.77
Interest Rate					
Interbank Money Market (overnight)	8.18	6.86	10.03	5.97	6.50
1-Month Time Deposit	6.62	6.43	10.43	8.96	7.19
Working Capital Loan	15.07	13.41	15.18	15.07	13.00
Investment Loan	15.68	14.05	14.92	15.10	13.01
Balance of Payments					
DSR (Debt to Service Ratio)	34.1	27.1	17.3	24.8	19.2
International Reserves, in months of imports and foreign debt repayment	7.1	5.5	4.3	4.5	5.7

Sources: BPS-Statistics Indonesia
Bank Indonesia

took place in other MDG indicators, including number of children entering primary school, child mortality under 5 years and public access to clean water. The World Bank also noted that Indonesia's MDG programmes

were on target in almost all areas. Among the eight MDGs, Indonesia has made significant progress in the poverty alleviation program.

At the regional level, economic performance improved during 2007, as reflected in brisk growth and relatively stable inflation in some regions. Analyzed by contribution, the economies in the Java, Bali and Nusa Tenggara region and the Jakarta-Banten region provided the strongest driving force for national economic growth. At the same time, buoyant economic growth in the Kalimantan, Sulawesi, Maluku and Papua (Kali-Sulampua) region elevated the contribution of this region to national growth. Concerning prices, national inflation was kept stable due to relatively low levels of inflation in some of the most important regions contributing to the national inflation figure. Despite the improved economic performance in some areas, considerable disparities persist among regions in growth and inflation. This calls for a common effort for reduction in interregional income disparities.

Fiscal sustainability came under pressure from the global economic turmoil. World oil prices, which reached an average of \$72.3 per barrel, and the low lifting of domestically produced crude oil (899 thousand barrels per day) combined to escalate expenditure on the fuel subsidy while simultaneously reducing state oil revenues. The rising burden of the subsidy was also related to the government commitment to maintain stability in domestic fuel prices, even as world oil prices continued to soar. To mitigate pressure from rapidly escalating world oil prices, government spending on the fuel and electricity subsidies mounted significantly to 151% and 102% of budget planning. Exacerbating the burden of the fuel subsidy was higher than predicted consumption of subsidized fuels at 38 million kiloliters instead of the targeted 36 million kiloliters.

Faced with these external shocks, the Government pursued a series of policy actions to curb the fiscal deficit. On the revenues side, the Government sought to increase budget receipts by boosting taxation receipts, including export tax on CPO and higher dividend payments by SOEs. Otherwise, the absorption of some budget expenditure components progressed slowly due to administrative hurdles, which also helped restrain the fiscal deficit. Through these actions, the fiscal deficit was managed within safe limits at 1.3% of GDP, below the targeted 1.5% of GDP. The consistency of government actions for maintaining fiscal sustainability was also reflected in the decline in the debt to GDP ratio to 31.2% in 2007.

Improvement in the domestic economy also was reflected in the robust performance on balance of payments during 2007, reflected in a \$12.5 billion surplus. Despite worries over the potential for a world economic slowdown triggered by the subprime mortgage crisis and high oil prices, at \$11.0 billion the current account surplus was nevertheless ahead of the \$10.8 billion surplus in the preceding year. The increased surplus was bolstered by stronger export growth in response to robust world demand and rising export commodity prices. Analyzed by commodity, export growth was driven primarily by manufactured products and mining commodities. Imports also grew at a faster pace in keeping with increased domestic demand and exports.

The capital and financial account still managed a \$2.8 billion surplus even in spite of negative sentiment on global financial markets that set off a round of capital reversal. Key to this was attractive yield on rupiah investments, macroeconomic stability and improving investor perceptions of risk. The improved performance in the capital account is also explained by foreign direct investment (FDI) that reached \$1.2 billion. Alongside this, portfolio transactions generated an increased surplus at \$7.0 billion, buoyed by high levels of excess liquidity on global markets and improving investor perceptions of risk. In response to these developments, international reserves mounted to \$56.9 billion at the end of 2007, equivalent to 5.7 months of imports and servicing of official foreign debt.

The dynamics of the rupiah exchange rate were marked by an appreciating trend in 2007 accompanied by reduced volatility. Average value of the rupiah came to Rp9,140 to the US dollar, a gain of 0.3% appreciation over Rp9,167 per dollar in the preceding year. Appreciation in the rupiah was bolstered by the balance of payments surplus, improvement in risks and continued attractiveness of yields on rupiah investments. Foreign capital kept flowing in response to the attraction of investing in domestic financial market instruments, despite temporary capital reversal prompted by external shocks in the second half of 2007. Brisk capital inflows on the domestic forex market during the first half of 2007 contributed to a significant strengthening of the rupiah. However, the second half of the year saw an escalation of global risks, with the domestic forex market reporting excess demand for the year overall. Point to point, the rupiah weakened 4.2%

to end-2007 level of Rp9,393 to the US dollar. The downturn in the rupiah occurred late in 2007 triggered by the unfolding of subprime mortgage crisis and a hike of oil prices. Averaged over the year, the rupiah underwent appreciation with volatility down from 3.8% in 2006 to 1.4%.

The stable, appreciating trend in the rupiah helped to keep 2007 inflation within the targeted range. CPI inflation for 2007 arrived at 6.59%, which was within the government-set range of 6.0% \pm 1%. Inflation during the year under review was influenced by various fundamental and non-fundamental factors. Fundamentals contributing to stable inflation included subdued inflation expectations, stability in the exchange rate and low inflationary pressure from the output gap. Analyzed by non-fundamental factors, reduced inflationary pressure in the CPI came from minimum increases in administered prices and lower volatile foods inflation.

Inflation expectations were relatively stable throughout 2007, as reflected in the findings of various surveys of consumers, producers and financial markets. Stable inflation expectations were largely attributable to a combination of policy actions by Bank Indonesia and the Government, particularly to fend off inflationary pressures from high oil prices and the crisis on global financial markets. Added to this, the absence of hikes in administered prices for strategic commodities during 2007 also contributed to public expectations of stable, low inflation. Externally, the stable movement in the rupiah helped to mitigate rising imported inflation driven by soaring international commodity prices. Through these actions, core inflation for 2007 was held at 6.29%.

Volatile foods inflation reached 11.41%, well below the 15.27% recorded for the preceding year. Key to the lower volatile foods inflation was reduced inflation in rice due to adequate stocks and smooth distribution. Increased rice production helped to keep rice stocks at adequate levels, bolstered also by rice imported by the National Logistics Agency (BULOG). Although rice inflation eased, heightened inflation in other food commodities from soaring international commodity prices and natural disasters calls for vigilance. Among the affected commodities are corn, cooking oil and derivative products.

Inflationary pressure from administered prices was very low, given the absence of price increases for strategic goods such as subsidized fuels (gasoline, automotive diesel, kerosene) and electricity billing rates. This policy had a significant bearing on efforts to subdue inflation during the year, given the sizeable weighting of these items in the CPI basket and the considerable magnitude of second round effects on other products. Although considered low, inflation in administered prices for the year under review mounted from 1.8% (yoy) in the preceding year to 3.3% (yoy). This increase is explained by decisions to raise the retail selling prices for cigarettes by 7% in March 2007, the decision to apply specific rates for cigarette excise as of 1 July 2007, water billing rate hikes in several cities, higher toll road charges and increased prices for non-subsidized fuels (Pertamax, Pertamax Plus and Pertamina Dex).

In view of the improving inflation outlook and relative stability in macroeconomic conditions, Bank Indonesia gradually lowered the BI Rate from 9.5% at the beginning of 2007 to 8.25% in July 2007. In August, the decision was made to keep the rate on hold because of concerns over mounting future inflationary pressure brought on by swelling world oil prices and a wave of negative sentiment bearing down on the exchange rate due to the subprime mortgage crisis in the United States. However, in view of the lower inflationary pressure and rising optimism in the future of the economy, Bank Indonesia announced a 25 basis point cut in the BI Rate in December. Thus at the end of 2007, the BI Rate reached a level of 8.0%.

The reductions in the BI Rate and accompanying economic expansion also boosted performance on the domestic financial market. Indonesia's capital market recorded an index gain of 52.1% in 2007 to close at 2,745.8. Amid conditions of excess global liquidity, mounting interest on investment on the stock market was stimulated by the secure condition of macro fundamentals, downward trend in the BI Rate and improved micro-corporate performance reported by stock exchange-listed companies in their financial statements. Analyzed by sector, the index gains were spurred most importantly by the mining, agriculture and property sectors. Performance was also up on the government securities and mutual funds markets. Yield on government securities eased in response to growing investor interest. On the mutual funds market, NAV steadily mounted throughout the year to reach Rp92.2

trillion in December 2007, with growth driven mainly by performance in equity-based and mixed funds.

The downward movement in the BI Rate was also accompanied by improvement in the bank intermediary function, with banks providing an increasingly significant contribution to overall financing in the economy. With the deposit rates declining, loan interest rates began to ease although not to the same extent as deposit rates. This change led to substantial expansion in credit, surpassing the target set at the beginning of the year. Total lending in 2007 mounted 25.5% over the previous year to Rp1,045.7 trillion. Alongside this, depositor funds widened by 17.4% to Rp1,510.7 trillion. The more robust expansion in credit compared to depositor funds resulted in an improvement in the banking system Loan to Deposit Ratio (LDR) to 69.2%, the highest ever during the post-crisis period. Among rural banks, this positive trend was also evident with the LDR climbing to 109.7%. Micro Small Medium Enterprises (MSMEs) lending widened to Rp502.8 trillion, an increase of 22.5% over the past year. Sharia banks also achieved impressive performance, reflected in expansion of service coverage, growth in depositor funds and higher levels of financing compared to past years.

The healthy performance in bank intermediation was matched by improvement in risk management capability. This was reflected in across the board gains in various financial and operational performance indicators, such as credit quality, earnings and capital. Industry-wide non-performing loans (NPLs) were lower, mainly in response to the restructuring of large corporate loans at state-owned banks. Bank capital held firm at a reassuring level, reflected in the bank capital adequacy ratio (CAR) at a solid 19.2%.

Economic liquidity in 2007 was flush in comparison to historical levels over the past 5 years. The narrow measure of economic liquidity (M1) reached Rp460.8 trillion, representing growth of 27.6%. At the same time, M2 widened by 18.9% to Rp1,643.2 trillion. This movement in monetary aggregates is indicative of the daunting challenge of managing economic liquidity. Analyzed by influencing factors, the expansion in liquidity is explained by a significant rise in lending to the business sector, up Rp208.0 trillion or 26.4% from the preceding year. Of this total, Rp154 trillion

comprised rupiah-denominated loans, while the remaining Rp54 trillion, equivalent to \$5 billion, was extended in foreign currencies. Net Foreign Assets (NFA) were also up 27.0% or Rp111.4 trillion over the previous year's position. This increase was dominated by NFA at Bank Indonesia in line with the hefty rise international reserves generated by increased oil and gas revenues on the back of soaring world oil prices. Despite this, the banking system reported a decline in NFA, particularly in foreign assets held in call money and demand deposits at overseas banks.

The improved economic performance in 2007 was also reflected in mounting activity in the payment system. Cash retained its place as a dominant instrument for transactions, reflected in average volume of currency in circulation at Rp174.8 trillion in 2007. At this level, volume of currency in circulation was up 21.0%, representing considerably higher growth than the 14.6% recorded in the preceding year. In non-cash payments, average daily transaction volume in 2007 processed in the BI-RTGS system and the Bank Indonesia National Clearing System (SKNBI) climbed 46.5% and 13.1% over the previous year. Alongside this, there was considerable use of card-based instruments, with volume dominated by account-based cards at 77.6% and the remainder comprising credit cards transactions. While part of this trend is explained by economic growth, the increase is also the result of financial market trading activity, changing preferences in means of payment and technological innovations in the payment system.

Macroeconomic and Sectoral Policy in 2007

The overall direction of Bank Indonesia policy in 2007, covering monetary affairs, banking and the payment system, focused on strengthening macroeconomic stability as a basis for sustainable, quality economic growth. The pursuit of prudent and consistent monetary policy was directed at guiding inflation expectations towards the established inflation target. Banking policy was directed towards promoting the bank role as an intermediary institution without sacrificing prudential banking principles, in addition to continuing the institutional strengthening of the banking system. Payment system policy was directed at supporting the effectiveness of monetary and banking policies through the provision of a secure, fast, efficient and reliable system for payments. On the government

side, fiscal policy was aimed at delivering a more robust stimulus while maintaining fiscal sustainability, while sectoral policy priorities targeted efforts to boost productivity and economic growth in order to reduce unemployment and poverty.

Monetary Policy

In monetary policy, Bank Indonesia (BI) again focused on measures for achievement of low inflation in the medium-term. To this end, Bank Indonesia has consistently set the BI Rate, established as part of the inflation targeting framework, on the basis of inflation projections and comprehensive assessment of macroeconomic conditions. At the implementation level, the monetary policy stance in 2007 can be divided into 2 periods, the period of decline in the BI Rate (January-July 2007) and the period of flat movement in the rate (August-November 2007). The decision to lower the BI Rate was based primarily on achievement of the inflation target and maintenance of financial system stability. On the other hand, the BI Rate was kept on hold in anticipation of potential inflation risks brought about by the turbulence on global financial markets beginning at the end of July 2007, as well as the upward trend in world oil prices.

To strengthen monetary policy effectiveness, Bank Indonesia has steadily improved the operating framework for monetary policy, expanded the range of monetary instruments and strengthened communication and transparency in regard to monetary policy. Improvements to the operating framework include development of infrastructure to enhance the effectiveness of open market operations through the introduction of fixed rate tenders in the Bank Indonesia Certificate auctions. Available monetary instruments have been supplemented by the launching of fine tune operations (FTOs) and progressive improvements in liquidity projections and management. To strengthen the credibility of monetary policy, Bank Indonesia has revamped its monetary policy communications and transparency with the use of press releases and publication of monthly, quarterly and annual economic reports, while also holding seminars and discussion programmes (Box: Communications Strategy, Monetary Policy and Central Bank Credibility).

In 2007, Bank Indonesia consistently applied a flexible exchange rate policy, allowing the rupiah to move in line with economic fundamentals. On one hand, this

alignment with fundamentals was aimed at sustaining export competitiveness, while the management of exchange rate volatility was also intended to safeguard business certainty and minimize inflationary impact. To manage volatility in the rupiah, Bank Indonesia conducted forex market interventions on a limited scale.

Coordination of fiscal and monetary policy was strengthened for further optimization of monetary policy. The Inflation Control Team (TPI), consisting of Bank Indonesia and relevant government agencies, was made more effective in providing policy recommendations for inflation control. Complementing this, the Government also established the Staple Foods Stabilization Coordinating Team tasked with stabilizing prices for staple foods at affordable levels. This team was made responsible for (i) planning and formulating the stabilization policy for rice, sugar and cooking oil; (ii) coordinating the operation of staple food stabilization measures; and (iii) monitoring and evaluation of price stability for staple food items.

Banking Policy

Banking policy in 2007 focused on improvement in the intermediary function and the institutional strengthening of the banking system, including capacity building for the sharia banking industry. The policy for strengthening the intermediary function was implemented through changes in some regulations on bank credit to promote lending to MSMEs and labor-intensive sectors, without sacrificing prudential banking principles. Measures for institutional strengthening of the banking system included further action to promote consolidation and an active role in the development of financial markets and instruments aimed at building a sound, robust financial sector in support of improved economic resilience. In sharia banking, policy was directed towards expanding the sharia banking role in the economy through a more diversified offering of sharia-compliant products and services and strengthening the attractiveness of Islamic financial instruments as an outlet for fund placements from outside Indonesia.

The policy for further strengthening of bank intermediation involves four key areas of action. First, Bank Indonesia is actively engaged in providing the data and information needed by banks and other business actors. To do this, Bank Indonesia launched the National Economic Database and Economic

Studies Information Centre on Bank Indonesia web site and revitalized the roles and functions of Bank Indonesia Regional Offices. Second is the revitalization of the state bank role through strengthened coordination and cooperation with the Government in the restructuring of the national banking industry. Third, amendments were made to series of regulations to introduce revised procedures for assessment of loan collectibility and other aspects of prudential banking². Fourth are efforts to strengthen the role and contribution of rural banks in the MSME sector through the linkage program. Reflecting progress made in these four key actions was the launching of the Indonesia Business Information Database (DIBI), establishment of the Facilitation Team for Accelerated Economic Empowerment of the Regions, operation of the linkage program for commercial banks and rural banks, holding of intermediation bazaars in various regions and efforts to develop a more effective strategic partnership with Regional Governments through a strengthened advisory function at Bank Indonesia's regional offices.

The policy for institutional strengthening of the banking system is aimed at building the resilience of the national banking system in the face of global competition. This policy is divided into three key areas of action. First, Bank Indonesia plays a facilitating role in the merger process for the banking consolidation programme, particularly for banks with potential to trigger instability in the banking industry. Second, Bank Indonesia has called on foreign banks to play a more optimum role in the banking intermediation process as foreign banks step up their lending to productive sectors. Third, Bank Indonesia has taken on an increased role in the development of financial markets and instruments in order to create a sound, robust financial sector. Reflecting the progress achieved in these three areas is the strengthening of prudential regulations, implementation of the Indonesian Banking Architecture (API) and preparations for implementation of Basel II. The launching of Basel II for the Indonesian banking system is targeted for 2008.

In addition, Bank Indonesia has coordinated actions with the Ministry of Finance and other agencies in the development of an efficient and effective Financial

Sector Safety Net. To develop a comprehensive framework for the financial sector, Bank Indonesia worked in coordination with other relevant agencies to develop the Indonesian Financial System Architecture (ASKI) and lay the groundwork for the Financial Sector Assessment Program (FSAP).

The policy for strengthening service capacity in the sharia banking industry was aimed at accelerating the growth of sharia banking. To this end, Bank Indonesia formulated a plan for increasing service capacity in the sharia banking industry, as envisaged in the Indonesian sharia Banking Blue Print. This capacity expansion was carried out simultaneously on the supply side and demand side with the share of sharia banking targeted to expand to 5% of total national banking volume by end-2008. To provide the public with a wider range of sharia banking services, the Codification of Sharia Banking Products was prepared in 2007 to present information on various Sharia banking products available on the domestic market and as a reference for sharia banks in expanding their range of financial services.

Payment System Policy

The payment system policy is divided into policy for currency circulation and policy for non-cash payments. In 2007, currency circulation policy sought to improve the security, reliability and efficiency of currency circulation, quality of cash services and quality of the currency itself. Alongside this, the policy for non-cash payments is directed at mitigating payment system risks, conducting oversight of the payment system, reinforcing discipline in the use of cheques and *bilyet giro*, regulating money remittances, efficiency improvements in the management of government accounts and promotion of non-cash payments.

The policy for secure, reliable and efficient circulation of money was implemented through provision of cash in adequate volume based on planned and realized printing of currency, effectiveness and efficiency in currency distribution, launching of large cash vaults at 13 Bank Indonesia regional offices and amendment of regulations pertaining to the deposit and withdrawal of rupiah currency by commercial banks in Indonesia.

Improvements in primary level cash services were aimed at raising effectiveness and efficiency in currency distribution to stakeholders. This policy

² Bank Indonesia Regulation No. 9/6/PBI/2007 dated 30 March 2007 concerning Second Amendment to Bank Indonesia Regulation No. 8/2/PBI/2006 concerning Amendment to Bank Indonesia Regulation No. 7/2/PBI/2005 concerning Asset Quality Rating for Commercial Banks.

was implemented through measures that included expanded areas for cooperation with PT Pos Indonesia (Posindo) in provision of currency in border regions and remote areas, further restrictions on bank cash deposit and withdrawal transactions (or trial run for bank deposits and withdrawals) and preparations for outsourcing of currency sorting to third parties.

Efforts to improve the quality of currency in circulation focused on reducing counterfeiting risks and extending the lifetime of rupiah in circulation. At the implementation level, practical actions included the continuation of awareness campaigns and public education programmes on the marks of authenticity of the rupiah currency and development of the Bank Indonesia-Counterfeit Analysis Center (BI-CAC). Concerning the quality of materials used for currency, Bank Indonesia conducted a study of the materials used for production of the Rp1,000 denomination.

In the non-cash payment system, measures to mitigate payment system risk include regular main system and backup system testing to ensure the operational reliability of the BI-Real Time Gross Settlement (BI-RTGS) system. Similar testing was also conducted for the Bank Indonesia National Clearing System (SKNBI), including the introduction of the Failure to Settle (FtS) mechanism designed to secure the clearing system from potential credit risk by requiring all clearing members to provide prefunding and securities through the Bank Indonesia Scriptless Securities Settlement System (BI-SSSS) as collateral for participation in clearing throughout the day. Bank Indonesia also revamped the infrastructure and regulation structure for the payment system, in particular the use of Card-Based Payment Instruments, provided facilitation for launching of e-money and issued new regulations on money remittances.

Oversight of the payment system also involves a series of activities to test the operational quality of the BI-RTGS system to ensure compliance with the international quality standards established by the Bank for International Settlements (BIS) in the Core Principles on Systemically Important Payment Systems (CP SIPS). Similarly, to mitigate settlement risk in securities transactions, the Finality of Settlement principle based on the recommendations of the International Organization of Securities Commissions (IOSCO) has been adopted for the BI-SSSS securities settlement

system. Under this principle, securities settlement is final, and therefore does not accommodate unwinding of settlements.

To reinforce discipline in the use of cheques and the *bilyet giro* clearing payment orders, Bank Indonesia issued a new regulation on the National Black List. One fundamental difference with the former regulation is self-assessment by banks of customers writing bad cheques or *bilyet giro*, given that banks are better informed as to whether a cheque or *bilyet giro* written by customer is backed by sufficient funds.

As part of its effort to improve efficiency in the management of Government accounts, Bank Indonesia has developed the Bank Indonesia Government-Electronic Banking (BIG-eB) application to simplify the work of the Government in managing its accounts. In the initial stage, the BIG-eB application will provide an online, real time transaction information module. This module will assist the Ministry of Finance in monitoring transaction activity on an up to date and accurate basis, thus expediting the process for preparation of budget outcome reports.

Fiscal and Sectoral Policy

Fiscal policy in 2007 sought to deliver a more robust economic stimulus while maintaining fiscal sustainability. The heftier fiscal stimulus was reflected in the increased budget deficit in comparison to the preceding year, while fiscal sustainability was evident from the steady decline in the ratio of official debt to GDP and the surplus in the budget primary balance. The economic stimulus was delivered not only through government expenditures, but included a series of limited tax incentives to stimulate activity in the real sector³ in addition to continuation of social aid programmes for the poor.

Confronted by the challenges of high oil prices and low budget absorption, the government responded with fiscal consolidation to curb the budget deficit within the prescribed limit. On the revenues side, fiscal consolidation involved revenue enhancement measures through increases in dividend payments from SOEs and tax on crude palm oil (CPO). On the expenditures side, the consolidation involved economy measures and efficiency improvements in government agency and

³ Government Regulation No. 1 of 2007 concerning Income Tax Facilities for Investment in Specified Business Lines and/or Specified Regions.

line ministry expenditures while retaining the policy for payment of subsidies.

Sectoral policies aimed at enhancing the quality of economic growth include improvements to the investment climate, accelerated construction of infrastructure, empowerment of MSMEs and the strengthening and reform of the financial sector⁴. The investment climate policy covers three main areas: (i) institutional reforms aimed at reinforcing the institutional basis for investment services and synchronizing the regulations issued by central and regional governments, (ii) smooth flows of exports and imports, including improvements to cargo services and faster customs processing, and (iii) tax reforms including revamped tax administration and protection of taxpayer rights. The primary objective of this package is to boost economic growth beyond the 6% level by promoting investment as a driving force for this growth.

The Financial Sector Reform Policy is a continuation of the Financial Sector Policy launched in mid-2006 covering five main areas: (i) financial system stability, including reinforcement of financial sector coordinating mechanisms and strengthening of financial institutions, (ii) banking institutions, including improved banking policy coordination and facilitation for Sharia banking expansion, (iii) non-bank financial institutions, including development of export financing and laying the groundwork for risk-based supervision of multi finance companies, (iv) the capital market, including improved efficiency and liquidity on the capital market and more robust liquidity and stability on the bond market (debt securities), and (v) other policies, including diversification of development financing sources. The main objectives of this package are to build financial sector stability and diversify sources of business funding, including sources from the banking system, the capital market and other financial institutions.

To strengthen the quality of economic growth and increase employment, the policy for accelerated construction of infrastructure was continued during the year under review. This policy covers three key areas: (i) improvements to the legal and regulatory framework with fast-tracked work on completion of infrastructure-related regulations, (ii) institution building, including

capacity building for contracting agencies in projects undertaken in private sector partnerships under Presidential Instruction No. 67/2005 and division of central and regional government powers and functions in infrastructure development, and (iii) improvement management of infrastructure construction, including a process for accelerated land expropriation in the public interest and preparation of standard operating procedures for public-private partnership under Presidential Instruction No.67/2005. This policy is essentially a consolidation of coordinated strategic measures designed to bring about reforms in the policy, regulatory and institutional framework for provision of infrastructure.

To reduce poverty levels, the policy for empowerment of MSMEs aims to strengthen productivity and effectiveness in programme implementation. The MSME Empowerment Policy covers the four key aspects of: (i) improved MSME access to financing sources, (ii) development of entrepreneurship and human capital, (iii) increased market opportunities for MSME products and (iv) regulatory reform. The primary target of this package is to raise MSME productivity and strengthen the effectiveness of programmes and activities related to empowerment of MSMEs. The policy is also intended to send a more positive signal of the importance of joint commitment in support of measures for empowerment of MSMEs.

Economic Outlook and Policy Direction in 2008

The Indonesian economy is predicted to face major challenges in 2008 with heavy pressure from high international commodity prices in tandem with the risk of slumping world economic growth. On one hand, economic growth is forecasted lower than the preceding year. Slowing world economic expansion will dampen export performance. Furthermore, the Government policy emphasis on maintaining macroeconomic stability to fend off external pressures augurs for a reduced economic stimulus compared to the previous year. External shocks will also stoke inflationary pressure. CPI inflation is predicted at the upper limit of the established inflation targeting range. The economic outlook will remain daunted by risks from external and domestic factors. To address this, various policies will be pursued to bolster the performance of the economy. Bank Indonesia policy in 2008 will be consistently directed towards safeguarding

⁴ Presidential Instruction (Inpres) Number 6 of 2007 concerning Policy for Accelerated Real Sector Growth and Empowerment of Micro, Small and Medium Enterprises (MSMEs) dated 12 June 2007.

macroeconomic stability in support of sustainable national economic growth.

Global Economic Forecast

The global economy is predicted to grow by 4.1% in 2008, reflecting a slow down performance compared to 4.9% in the preceding year. World economic expansion in 2008 will be constrained by a range of issues stemming largely from the spreading impact the subprime mortgage crisis in the United States. Despite repeated actions by the United States Federal Reserve and the Bank of England, there is still a risk that the problems currently besetting the financial sector are far from over. The unfolding of the turmoil are predicted to impact investment activity, consumer spending and international trade. Global economic disturbances will also be exacerbated by soaring world crude oil prices predicted to hamper economic growth and inflation control during the coming year. The combination of these problems is expected to produce slowed growth in developed countries. On the other hand, developing countries are predicted to maintain reasonably high growth buoyed by domestic demand despite the inevitable negative impact from the world economic slowdown.

Despite the expected slow down in world economic, there is a downside risk of higher inflation. High international commodity prices are expected to intensify global inflationary pressures. The lack of adequate growth in production capacity, continued high demand from China and India, geopolitical conditions and climatic disturbances are forecasted to keep oil prices high throughout 2008. Upward pressure on oil prices is also likely to originate from speculative actions by financial market agents on commodity markets. On the other hand, non-oil and gas commodity prices are predicted to ease in comparison to the past year. However, unrelentingly high oil prices will encourage more intensive development of alternative energy sources, which in turn will ensure continued high demand for food commodities such as corn, crude palm oil and sugar.

With the world economy forecasted to enter a slowdown, developed nations are expected to follow a loose bias monetary policy in 2008. Despite the predicted rise in inflationary pressure, the potential for more abrupt decline in global economic expansion will prompt many central banks in developed economies

to adopt a loose bias policy stance. In contrast, central banks in most emerging market countries are likely to adopt a tight bias monetary policy to fend off high inflationary pressures.

Capital inflows to emerging markets are predicted to ease from the previous year's levels. However, the excess global liquidity and positive outlook for economic fundamentals support the outlook for emerging markets to continue benefiting from capital inflows, most notably in the form of FDI and portfolio investments. The improving economic outlook is key to investor decisions to pour capital into FDI on emerging markets. Portfolio capital inflows are also predicted to rise, drawn by continued attractive investment returns and subdued economic risks.

Economic Growth Forecast

Economic growth in 2008 is forecasted at 6.2%, down slightly from the preceding year. The intensity of external pressures is expected to slow economic expansion. Export performance will weaken in comparison to the preceding year due to the effect of less vigorous world economic expansion. The persistently high level of international commodity prices has prompted the Government to make adjustments to expenditure patterns in the Draft Revised 2008 Budget, reflecting efficiency improvements in consumption and investment spending, as well as increased subsidy payments. These expenditure cutbacks designed to free up funds for subsidies will in turn lead to reduced government expenditures on consumption and investment during 2008.

The driving force for economic growth in 2008 is predicted to come mainly from private consumption and investment. Rising public purchasing power resulting among others from increases in provincial minimum wages and civil servant salaries, combined with price stabilization policies for staple goods, will pave the way for increased public consumption. Also providing added boost to consumption will be consumer optimism in the outlook for improvement in the economy, bolstered by availability of lower-cost financing with interest rates at more attractive levels. Optimism for the economic outlook will also provide added momentum for investment. Construction investment is predicted to rise with growing number of infrastructure projects implemented by the government and private sector. Government efforts to resolve

various roadblocks to infrastructure construction are expected to provide an added boost to this investment activity. Similar growth is also forecasted for non-construction investment. Growing demand and optimism for the economic outlook will stimulate business interest in expanding economic capacity. The launching of a range of investment policies will also provide incentives for investment activity, as also indicated by the surge in approvals for domestic investment projects and FDI.

Export growth is forecasted to taper off in comparison to the preceding year, a result of the world economic slowdown. Accordingly, Indonesia has sought to diversify export destinations with focus on China, India and Eastern Europe, and therefore it is possible to mitigate the adverse effects of softer demand from developed nations caused by the economic slowdown. At the same time, imports of goods and services are expected to mount in keeping with rising domestic demand.

This economic growth forecast also has support from the fiscal stimulus, even though less than in the previous year. In the Draft Revised 2008 Budget, the Government targets a deficit at 2.0% of GDP, up from the Revised 2007 Budget deficit at 1.3% of GDP. The increased deficit in 2008 is largely explained by the Government role in maintaining domestic price stability. To protect public purchasing power amid the forecasts of pressure from persistently high international commodity prices, the Government has decided to increase budget spending on the fuel and electricity subsidies and on the price stabilization program for strategic food commodities. Added to this, fiscal policy in 2008 is still aimed at delivering a stimulus for the economy. The Government plans increases in both routine and capital expenditures, although not to the same extent as in the past year. Higher routine expenditures are partly explained by the drive to improve the welfare of civil servants in a planned increase in basic salaries of about 20%. At the same time, government capital expenditures will flow into infrastructure projects, such as roads, bridges and irrigation channels. These Government policies will in turn contribute to economic growth during 2008.

Analyzed by economic sector, the economic growth forecast for 2008 relies heavily on performance in manufacturing sector, trade, hotels and restaurants

sector and the transport and communications sector. Rising demand will strengthen manufacturing performance. Mounting public consumption will stimulate increased growth in the food, beverages and tobacco subsector and in the transportation equipment manufacturing subsector. Furthermore, infrastructure projects will strengthen performance in the basic metals, iron and steel subsector, cement industry subsector and non-metal quarrying subsector. Manufacturing growth is set to improve not only from growing demand, but also a series of Government incentives designed to strengthen that sector, including the rescinding of import duties on hot rolled steel and reduction in luxury goods tax on electronic products. Rising economic activity will in turn generate added momentum in services sectors, such as transportation and communications sector, as well as trade sector.

Investment financing in 2008 will be provided mainly from equity, bank financing and government capital expenditures. Sources of equity funds, include self-financing and reinvestment of profits, are expected to dominate investment financing with more than 50% of the total. On the domestic front, the Government, banking system and capital market are expected to provide about 30% of needed investment financing. A further 10% will be provided from external sources.

Balance of Payments Forecast

The balance of payments in 2008 is predicted to record a \$11.3 billion surplus, bringing international reserves at end of year to \$68.2 billion or equivalent to 6.2 months of imports and servicing of official foreign debt. The forecasted balance of payments surplus is down from the preceding year, with reduced surpluses in the current account and the capital and financial account. The current account in 2008 is predicted to chart a respectable surplus, although not as high as before. Amid the slowdown in world economic expansion, export performance is predicted to decline. However, a deeper slowdown can be avoided to some extent by diversification of export destinations, with softer demand from developed countries compensated by robust demand from developing economies such as China, India and Eastern European countries. Export performance will also be bolstered by international prices for oil and non-oil commodities, which is predicted to remain strong. At the same time, the upward trend in domestic economic activity will continue to fuel brisk growth in imports.

The capital and financial account is predicted to register a more modest surplus compared to the past year. Nevertheless, performance will be supported by a rise in long-term capital inflows in response to the improving investment climate in Indonesia. FDI is predicted to climb significantly over the previous year. Portfolio capital inflows are also forecasted to be strong, although not as high as before. Continued attractive yields amid conditions of excess global liquidity will stimulate keen investor interest in emerging market countries. Increased capital inflows will be invested primarily in government securities.

Exchange Rate Forecast

The rupiah exchange rate is expected to remain stable during 2008. Stability in the rupiah will be reinforced by improvements in fundamentals as reflected in the continued high balance of payments surplus and attractive yields on rupiah investments when compared with the region. Demand for international reserves is estimated to increase due to higher volume of non-oil imports and higher prices of oil in international markets. Nevertheless, the increased foreign currency demand is expected to be offset by adequate supply. Hence rupiah stability can be maintained.

Inflation Forecast

CPI inflation in 2008 is predicted at 6.0%-6.5%, above the targeted range. Global economic conditions marked by persistently high international commodity prices will bring considerable pressure to bear, with CPI inflation forecasted at the upper limit of the inflation targeting range. Steep world commodity prices are expected to boost imported inflation and fuel public inflation expectations. These conditions will in turn drive up core inflation. Nevertheless, these external factors can most likely be mitigated by the stable exchange rate and support from government policy support for domestic price stability. Demand-side pressure is predicted to be adequately balanced by higher investment in added economic capacity. In the volatile foods category, inflationary pressure will ease with the support of government commitments to safeguard supplies of food under the agricultural intensification programme and greater flexibility for imports by the National Logistics Agency (BULOG). In the administered prices category, price increases are predicted to be minimal in keeping with the government policy of not raising administered prices for strategic goods.

Forecast for the Banking System

In 2008, bank lending growth in support of economic expansion is forecasted to reach 22%-24% alongside improvement in credit quality (NPLs gross below 5%) and strengthening in the LDR to 72%. The continued robust economic expansion in tandem with conducive interest rate movements are expected to provide added momentum to bank lending. The improving condition of the banking system, reflected in the rising strength of bank capital, will also contribute to the accelerated lending growth. The more vigorous credit expansion will be supported primarily by lending in the infrastructure sector, which is expected to generate multiplier effects in other economic sectors. Added support for credit expansion will also come from growth in depositor funds, forecasted at 16%-18%.

Sharia banking is also predicted to keep forging ahead, with its share of the national banking system expanding to 5% of total national banking assets in 2008. Growth in sharia-compliant financing is predicted to outpace credit growth in the conventional banking system. This forecast is related to the potential for increased mobilisation of depositor funds in the sharia banking system in keeping with the buoyant outlook for the economy and growing competitiveness of investment products offered by sharia banks. On the financing side, stronger economic expansion is expected to generate increased demand for sharia bank financing. The types of financing provided by sharia banks will be dominated by sale-and-purchase based financing for the services and trade sectors.

Risks to the Indonesian Economy in 2008

The economic forecast described above also entails eminent downside risks that could potentially change the projected outcomes. Higher than predicted international prices for both oil and non-oil commodities represent the most serious risk factor to be monitored. Persistent strong demand, limited production capacity and various sentiment factors, including geopolitical issues, are expected to keep international oil prices at high levels throughout 2008. On the other hand, unabated high oil prices have prompted more vigorous efforts to develop alternative energy sources. International prices for foodstuff commodities such as corn and soybeans are projected to soar in response to biofuel production. In addition, climate change caused by global warming will also notch up pressure in food commodity prices due to crop failures. The high

commodity prices will benefit the balance of payments of exporting countries, but on the other hand these prices will have a significant bearing on economies through increased inflationary pressure.

High world oil prices coupled with uncertainty over the end of the global financial market turmoil brought on by the spreading subprime mortgage crisis are predicted to impact world economic performance. The economic slowdown in developed countries, most importantly the United States, is set to continue and thus erode optimism for global economic expansion, which may in turn hurt Indonesia's exports. Uncertainty over the global financial market turbulence could also derail macroeconomic stability. Since the risk associated with the reversal of capital inflows remain, given the share of short term capital inflows and the shallowness of domestic financial market.

In addition to international crude oil prices soaring beyond the budget assumption, potential pressure on the fiscal deficit will also come from increased demand for domestic consumption of oil-based fuels triggered by such factors as the price disparity between subsidized and non-subsidized fuels and the failure to achieve targeted levels of domestic oil production. Any increase in the budget deficit could potentially derail fiscal sustainability, which in turn may fuel negative sentiment and impact the overall economic outlook. This negative sentiment could set off another round of portfolio capital reversal. This in turn would reduce the balance of payments surplus and in so doing undermine the strength of the rupiah.

Investment activity could potentially become hampered by various hurdles preventing the completion of infrastructure projects, including lack of clarity of regulations on land expropriation and inadequate synchronisation of central government and regional government policies. Furthermore, the lack of significant improvement in infrastructure and risks of natural disasters could hamper the supply of goods, which might give rise to inflationary pressure. Risk of price increases may also arise from difficulties in the kerosene to LPG conversion programme, which could lead to shortages of these commodities and drive up kerosene prices.

Policy Direction

In the monetary sector, Bank Indonesia policy will be directed at maintaining macroeconomic stability by consistently containing inflation expectations towards the established target. Monetary policy will continue to emphasize consistency and commitment in managing inflation in line with the government-set target for 2008. This monetary policy stance not only requires support from interest rate policy, but also policies restraining volatility in the rupiah. In this regard, the maintenance of safe levels of international reserves is consistent with the safeguarding of macroeconomic stability. Reinforcing this are standby measures established through the ASEAN+3 cooperation under the Chiang Mai Initiative, in which Bank Indonesia has concluded bilateral swap arrangements with Japan, Korea and China. These regional self-help measures are of strategic importance in maintaining the future economic and financial stability of the region.

This monetary policy will require support from an improved operational framework. To this end, Bank Indonesia will launch a series of tactical measures to enhance the effectiveness of monetary instruments in absorbing excess liquidity in the banking system. Open Market Operations (OMOs) will use instruments with a broader range of tenors to maintain stability in the overnight (O/N) interbank market. Also enhancing the use of OMOs will be fine tuning operations (FTOs), repo transactions with underlying government securities and Forex swaps. On the financial market, the strategy for financial market deepening and expansion of the financial instrument base will take on increasing importance. The reactivation of existing instruments and transactions is one measure for financial market development that is expected to improve effectiveness in the management of liquidity held by financial market players.

To promote economic growth, the primary thrust of banking policy in 2008 will be on quality lending, improved MSME access to financing, expansion in the direction of universal banking and further consolidation of the banking system. Higher quality lending will involve such actions as increased lending to productive sectors and exploration of possibilities for reestablishment of a policy bank concentrating on mobilisation of long-term funds for financing infrastructure projects. To improve MSME access to financing, Bank Indonesia is pressing forward with expansion of the linkage program,

development of a loan guarantee scheme for MSMEs, reduction in the risk-weighted asset calculation for people's business loans (KUR) and MSMEs credit, and redefinition and redirection of the rural bank role in local economic empowerment. Greater room has been created for banks to expand operations into universal banking as a response to the mounting demand for innovative bank products integrated with other products from the financial industry. The adoption of universal banking within the banking system will not only help ensure provision of needed financing, but also support financial market deepening.

The drive to optimize the bank intermediary function must be accompanied by measures for strengthening the resilience of the banking industry, Bank Indonesia will keep moving forward with bank consolidation, including the launching of regulations pertaining to the criteria for High Performing Banks and Anchor Banks, as well as examining the effectiveness of the increase of minimum bank capital to Rp80 billion. Preparations for implementation of Basel II, primarily in relation to the three pillars of capital adequacy, supervisory review process and market discipline, will continue.

Banking policy will also focus on strengthening banking transparency towards the public and the launching of Banking Education Year. By mid-2008, all banks will be expected to be fully compliant with good corporate governance (GCG) including disclosure of their GCG in reports to the public. The Banking Education Year in 2008 will mark the launching of a comprehensive, integrated public education programme on banking in coordination with all banking industry stakeholders. This programme is envisaged as empowering the public with greater ability to choose and make more carefully planned, considered use of banking products and services. The banking system is also expected to play a community social role under the corporate social responsibility (CSR) programme. The banking industry CSR may focus on strategic efforts in education as a contribution to the nation's social and human capital.

To support economic activity and the effectiveness of monetary and banking policy, the currency circulation policy will continue to focus on improvements in the security, reliability and efficiency in currency circulation; improved primary level cash services; and enhanced quality of currency. Existing policies will be continued, including the strategy for secure, effective

and efficient currency distribution and measures to combat the circulation of counterfeit currency through the strengthening of infrastructure at Bank Indonesia and enhanced anti-counterfeiting collaboration with other agencies. Bank Indonesia will also launch the pilot implementation of cash centres at the Bank Indonesia Head Office and some Bank Indonesia Regional Offices as part of the strategy for outsourcing cash management to third parties. In addition, Bank Indonesia plans to issue a new Rp20,000 denomination in 2008 for reasons of cost efficiency and longer retention in circulation.

Policy for non-cash payments is aimed at curbing risks, raising efficiency, ensuring equitable access and enhancing consumer protection. Actions to mitigate risk in the payment system and thus support financial system stability include the ongoing trials of disaster recovery planning to safeguard the operational reliability of the payment system (RTGS and national clearing system) and a study exploring possibilities for operation of a payment versus payment (PVP) mechanism for foreign exchange transactions and development of a risk mitigation model for funds transfers. Efficiency improvements include the introduction of interoperability in the card-based payment instrument networks, while the principle of equitable access is set out in the system operating regulations by emphasizing Bank Indonesia's position as regulator, operator and member. Consumer protection will be strengthened through the introduction of a regulation on e-money and broader coverage of application of the rules on money remittance activities.

To optimize policy effectiveness, Bank Indonesia will continue to strengthen coordination with other macroeconomic policies. The drive to safeguard macroeconomic stability and promote more robust, more healthily structured economic growth is integral to overall economic policy. A key prerequisite is greater competitiveness in the economy through improvement in the investment climate and accelerated construction of infrastructure. Work will continue on the harmonization of a range of policies for these objectives. Further strengthening will take place in the coordination and synergy established between Bank Indonesia and the Government. Policy coordination for inflation control, in addition to the Inflation Control Team (TPI) and Coordinating Team for Stabilization of Food Staples, will also involve the Coordinating Forum

for Inflation Control coordinated by the Office of the Coordinating Minister for the Economy. At the regional level, the Bank Indonesia Regional Offices will take on a strengthened role in local economic empowerment and accelerated economic development, among others through establishment of Regional Inflation Control Teams for coordination between Bank Indonesia Regional Offices and relevant agencies. In the payment system, Bank Indonesia will launch the government e-banking application (BIG-eB) to complement the implementation of the Treasury Single Account. The BIG-eB application will offer a range of modules for

conducting transactions and providing information on Government financial transactions. In a further move to safeguard and reinforce financial system stability, coordination will be strengthened further in the Financial System Stability Forum (FSSK) for collaboration between the Ministry of Finance, Bank Indonesia and the Indonesian Deposit Insurance Corporation (LPS) under the auspices of the Coordinating Minister for the Economy. In 2008, the FSSK plans to finalize the Crisis Management Protocol and the Macro Early Warning System while taking forward a series of programmes under the Indonesian Financial System Architecture initiative.

Communications Strategy, Monetary Policy and Central Bank Credibility

One interesting feature of Bank Indonesia in the past several years is public transparency, particularly in regard to monetary policy. In the past, monetary policy decisions were made in closed sessions with outcomes not announced to the general public. Now, the public can easily access information on monetary policy and the decisions adopted in the Board of Governors' Meeting held at Bank Indonesia each month. Bank Indonesia has also opened itself to members of the public interested in learning and understanding monetary policy. Other means of communications, such as the web site, workshops, seminars, student visits and formal and informal meetings have been organized to improve public understanding of monetary policy and the national economy. Bank Indonesia is now working to bring itself closer to the public.

The drive to bring Bank Indonesia closer to the public is integral to the monetary policy framework adopted in 2005. The launching of the Inflation Targeting Framework (ITF) as a working framework for monetary policy in Indonesia has influenced the operation of monetary policy itself. The ITF introduced the public to a new logic in the policy actions taken by the central bank. The ITF also brought structural change to the communications approach previously followed by the central bank¹. Central bank policy is now consistently steered towards achievement of a future inflation target, established for the medium and long-term. To achieve the target, communication represents the front line of the drive to build the credibility of the central bank.

Central bankers now understand that credibility is one of the most important elements in monetary policy effectiveness. In the 1960's and 1970's, policy makers

did not yet fully understand the correlation between determinants of credibility and policy outcomes. However, in 1977, Finn Kydland and Edward Prescott published their dissertation, "Rules Rather than Discretion: The Inconsistency of Optimal Plans" (Kydland and Prescott, 1977), which presents a cogent analysis of the credibility of decision making authorities. Kydland and Prescott specifically pointed out how economic indicators in many situations will show better results if policy makers are able to make credible statements or promises on specific aspects of their envisaged policies. "Credible" in this context means that the public believes that policy makers will honour their promises even when tempted to do otherwise.

Much has now been written on the relationship between central bank communications and the operation of the ITF. Early references are found in Leiderman and Svensson (1995) and the basic line of thought in Svensson (1999). General viewpoints are also found in Bernanke et. al. (1998), Loayza and Soto (2001), Mishkin and Schmidt-Hebbel (2001) and Gjedrem (2001). Evaluations of individual country experiments have also been prepared by Kohn (2000) for the United Kingdom, Svensson (2001) for New Zealand and Svensson et. al. (2002) for Norway.

More specifically, Kydland and Prescott cite examples in which central banks will tend to announce or publicly commit themselves to low inflation targets. If the public trusts these statements (the central bank has credibility), the public will place their confidence accordingly. As a result, demands for wage increases and even prices will moderate, adjusting to the expectations in place. This public behavior will then ease the task of the central bank in fulfilling its commitment to maintaining low inflation. Conversely, if the public is sceptical of the central bank commitment to low inflation (e.g., the public believes that the central bank will be tempted to take a more populist approach at the expense of

¹ Initial reference came from Leiderman and Svensson (1995) and basic thoughts came from Svensson (1999). Several general view could be found in Bernanke et al (1998), Loayza and Soto (2001), Mishkin and Schmidt-Hebble (2001) and Gjedrem (2001). Each country's experiment had been evaluated by Kohn (2000) for England, Svensson (2001) for New Zealand, and Svensson et al (2002) for Norway.

long-term objectives), public expectations of inflation will mount. The public expectations of higher levels of future inflation will in turn drive up prices and ultimately increase the difficulty and expense for the central bank in achieving and maintaining low, stable inflation. It is here that the credibility of the central bank plays a major role in achievement of the inflation target.

From a theoretical standpoint, the importance of central bank credibility is supported by a number of views, such as the school of new macroeconomics of monetary policy with its new neoclassical synthesis (NNS) or the New Keynesian Economics approach. The benchmarks of the NNS approach include some features from classical economics, such as the real business cycle (RBC), intertemporal optimization and rational expectations. The NNS approach also has Keynesian features such as monopolistically competitive firms, a markup of price over marginal cost and sticky prices (costly price adjustment). The understanding of these theories has helped central banks to grasp and to explain to the public how monetary policy builds and maintains the credibility of a low inflation outlook and why inflation targeting can achieve balanced improvement in the stability of inflation and output.

In Indonesia, inflation is influenced by three main factors. First is volatile foods, in which inflation is customarily determined by the harvest season, tight supply, distribution bottlenecks or even natural disasters. Second are administered prices, such as fuel prices and electricity billing rates. Third is the core inflation, comprising inflation generated by the output gap, inflation from external factors, such as the exchange rate and rising international commodity prices, and public expectations of inflation. Among these inflation determinants, one of the most dominant factors in Indonesia is the persistently high level of public inflation expectations.

Public expectations are shaped by two factors. The first is adaptive or backward looking expectations, in which inflation is determined by the subjective views of economic actors based on past economic data and events. This subjective view still predominates in the expectations formed by the public in Indonesia. Second are rational or forward-looking expectations in which inflation is based on monetary scenarios projected by the central bank, which in this case has an inflation target. It is these forward monetary projections that are envisaged for further development to guide the behavior of economic actors. To achieve this, the credibility of the

central bank is essential, as well as mutual trust between the central bank and the public.

It is here that a communication strategy is key to strengthening the effectiveness of monetary policy. On a structural level, monetary policy communications at Bank Indonesia form part of the overall Bank Indonesia communications strategy. This strategy is formulated as a guide for Bank Indonesia in communicating with the public, influencing expectations and ultimately strengthening the credibility of the central bank. Various monetary policy communications were put into place beginning in 2005 and subsequently in 2007 were incorporated permanently into the strategy for monetary policy communications.

The monetary policy communications strategy has been formulated down to the operational level. The strategy sets out the main objectives, target groups (stakeholders) and communication tools. Communications are conveyed in a transparent, comprehensive and predictable manner. Transparency in monetary policy communications is upheld through timely provision of factual information. Identification of stakeholders is a vital prerequisite to an effective communications strategy. Bank Indonesia's communications or even the monetary policy education itself is focused on the media, financial market and banking system actors, economic analysts, industry (business associations, Chamber of Commerce and Industry, etc.), academics, students, politicians, members of parliament, NGOs and the general public.

Looking ahead, monetary policy communications in Indonesia remain daunted by formidable challenges. These challenges are exacerbated by widely varying levels of public understanding, public expectations of future inflation and the economic outlook and the struggling credibility of the central bank itself. Low, stable inflation cannot be achieved in a simple, one-off undertaking, but instead demands a long series of complex measures. A key factor in this is the credibility of the central bank. In the absence of credibility, low public confidence will engender public behavior detrimental of the economy. In this modern age, a key task for central banks is the management of expectations. For this reason, a common effort among all the constituent elements of our society in maintaining the credibility of the central bank is of strategic importance in building our nation's economic stability.