



Chapter 6

Monetary Developments

Chapter 6: Monetary Developments

Monetary policy in 2007 faced challenges from the considerable impact of the global economic turmoil and excess liquidity on the domestic money market. Bank Indonesia announced a series of cuts in the BI Rate before a pause in rate cuts that lasted until close to end of year. In operational side, monetary policy was conducted by adjusting money market liquidity through open market operations. The BI Rate cuts were effectively transmitted to the financial market and raised real sector economic agents confidence. This circumstances was supported by adequate liquidity in the economy, despite the continued buildup of excess liquidity on the money market. Overall, monetary policy with the support of fiscal policy was able to balance the dual goals of achieving the inflation target and promoting economic growth.

In early 2007, considering the confidence in macroeconomic stability, progress towards the inflation target and financial system resilience, Bank Indonesia embarked on a series of measured cuts in the reference rate before pausing rate movement until close to end of year. As Indonesia entered 2007, domestic economic conditions increasingly pointed to recovery in the wake of the fuel price hikes of 2005. This improvement was reinforced by macroeconomic stability reflected in the stable exchange rate and downward trend in inflation. After assessing these conditions, Bank Indonesia resumed the loose bias monetary policy stance first launched in May 2006. However, early in the second half of 2007, the domestic economy came under pressure triggered by the impact of the subprime mortgage crisis in the United States. The resulting turmoil stirred negative sentiment across global financial markets, with subsequent implications for weakening in the exchange rate. Exacerbating the shocks were surging world oil prices that carried the risk of heightened inflation. In response to these risks, Bank Indonesia kept the BI Rate on hold from August until November 2007. At year end, BI announced a new rate cut to 8% following the signal of declining future inflationary pressure and to support for renewed economic expansion.

In monetary policy, consistency and commitment in curbing inflation was reinforced by policy transparency

and improved coordination with the Government. Transparency was implemented through a revamped strategy and intense communication and dissemination of monetary policy through a range of media and to stakeholders at the central government and regional levels. Through these communications, stakeholder perceptions would be brought into line with Bank Indonesia's intentions for implementing monetary policy. In addition, policy transparency would encourage a shift from the prevailing backward-looking formation of public inflation expectations towards greater alignment with the future inflation target. In related moves, the closer monetary-fiscal coordination has created a level of macroeconomic stability conducive for sustainable economic expansion. This policy coordination operates, among others, through regular meetings between Bank Indonesia, the Government and relevant agencies in a coordination forum and within the Inflation Control Team.

This monetary policy met with positive response from the financial market and strengthened the optimism of economic agents in the real sector. Response from financial market players was manifested in the continued rise in stock market activity accompanied by accelerated gains in the Indonesian Composite Index. Activity was also brisk on the government securities market, bolstered by attractive yields. Banks continued to lower their deposit and lending rates, in

turn providing added momentum to economic activity in the real sector and encouraging alternative forms of financing through stock and bond issues. In the real sector, positive response was reflected in relatively stable inflation expectations among economic agents and rising consumer and business confidence in the domestic economy. This represents an important signal bolstering the performance of the economy.

Domestic economic expansion was matched by accelerated growth in economic liquidity particularly in lending to the private sector. However, the banking system still carried high levels of excess liquidity, a condition that must be carefully monitored in regard to implications for macroeconomic and financial market stability.

Monetary Policy Implementation

The monetary policy strategy involving the setting of the BI Rate is directed towards achieving the Government-set inflation target. The strategy is pursued through measured, prudent actions with careful consideration the state of the economy including future inflation pressure, latest dynamics in the economy and financial system stability. Under these conditions, the safeguarding of macroeconomic stability continued alongside lowering of the BI Rate from 9.5% to 8.25% in a series of rate cuts from January to July 2007. In March 2007, about midway during this period, issues over subprime mortgages began to surface, but without significantly impacting economic stability.

In the second half of 2007, the subprime mortgage problem took a more serious turn with spreading impact that also affected Bank Indonesia in determining the BI Rate. In August, investors began reassessing their investment risks and adjusting portfolio holdings in a flight to quality. This in turn impacted the rupiah exchange rate, as well as exchange rates in other emerging market countries. Conditions took a further turn for the worse with soaring oil prices that put added pressure on both the exchange rate and future inflation. Responding to this, Bank Indonesia halted the downward movement in interest rates from July to November 2007. The BI Rate was held at 8.25% to fend off accelerated inflation expectations and ease pressure on the financial market. At the end of 2007, in view of the safe level inflation expectations, adequate production capacity and renewed equilibrium in financial markets, BI lowered the rate to 8%. This

policy sent a positive signal for the ongoing economic expansion while nevertheless prioritizing achievement of the inflation target.

This policy strategy was implemented through liquidity management in Open Market Operations (OMO) and other instruments. Following the reductions in the BI Rate, all instruments directly linked to the BI Rate were automatically lowered by the same margin. At the end of 2007, the overnight Bank Indonesia Short-Term Deposit Facility (FASBI O/N), customarily used as the floor for overnight rate movements on the interbank market, stood at 3% (down from 4.75% at end-2006). Likewise, the SBI repo rate, which marks the ceiling on overnight interbank rate movements, eased to 11% (from 12.75% at end-2006). OMOs were held primarily to absorb excess liquidity and ensure availability of interbank liquidity. The regular OMOs relied mainly on the weekly auction of 1-month SBIs in a fixed rate tender at the level of the BI Rate. However, the non-regular Fine Tune Operations (FTOs) were implemented on a limited scale and with varying pricing, adjusted to the conditions on the money market. Complementing these monetary instruments on the rupiah market was forex intervention used to curb excessive exchange rate volatility.

Response to BI Rate by Financial Market and Economic Agents

Financial Market Response

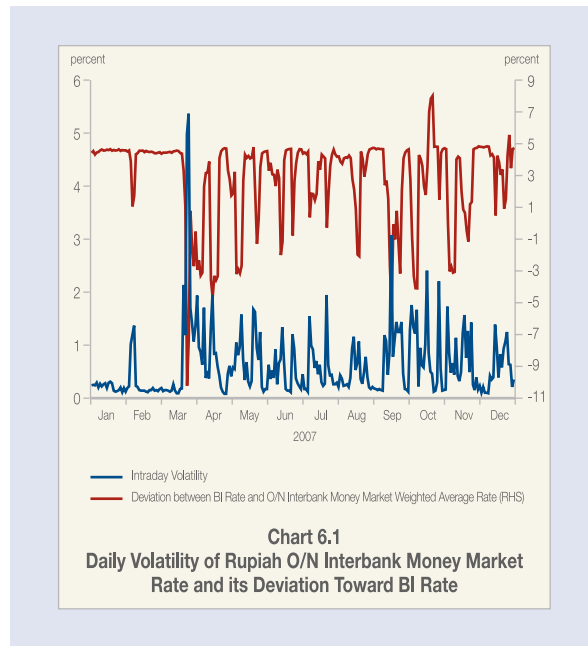
Changes in the BI Rate were followed by commensurate movement in money market rates. During 2007, the overnight rupiah interbank rate showed greater average decline than the BI Rate, as could be expected with the over liquid condition of the money market. Volatility, however, was relatively unchanged from 2006 (Table 6.1). These interest rate movements were strongly influenced by the microstructural condition of the money market and the effect of movement in autonomous factors, most importantly government financial operations. On a day-to-day basis, this condition was reflected in the fluctuating movement in the overnight interbank rate, which varied considerably against the BI Rate (Chart 6.1).

Movement in the BI Rate met with strong response in bank deposit rates. The magnitude of this response also reflected the excess liquidity and was consistent

Table 6.1
Rupiah Interbank Money Market O/N Interest Rate and its Volatility

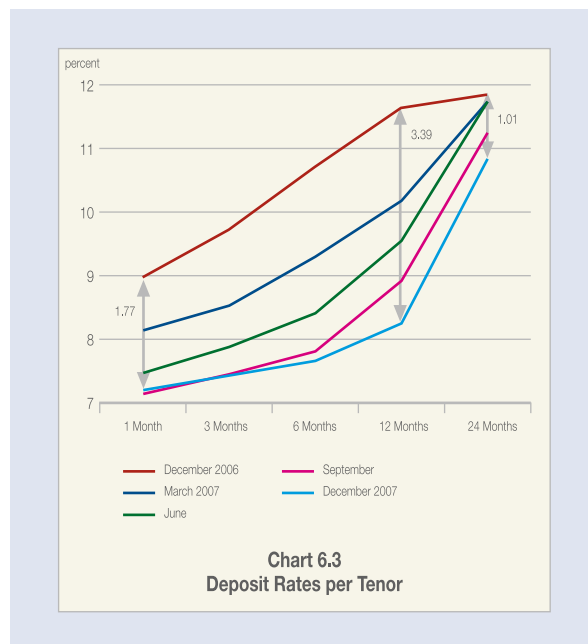
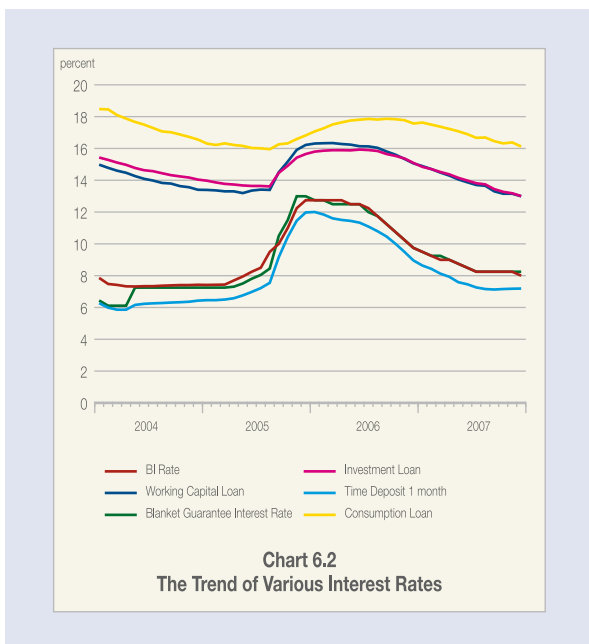
Period	Weighted Average Interbank Money Market O/N (%)		Volatility O/N (%)	
	Morning	Afternoon	Morning	Afternoon
2006	9.2	8.7	2.2	2.1
January	5.0	4.9	0.1	0.1
February	5.2	5.1	1.2	0.9
March	7.5	7.3	5.1	3.7
May	8.5	7.9	3.8	3.5
June	6.9	6.3	3.1	2.9
July	5.6	5.3	2.3	1.9
September	5.2	4.8	1.8	1.2
October	4.9	4.8	2.0	2.0
November	6.8	6.7	3.3	3.0
January	5.1	4.7	3.7	3.4
February	6.5	6.4	3.0	3.0
March	4.3	4.2	1.4	1.4
2007	6.0	5.8	2.6	2.2

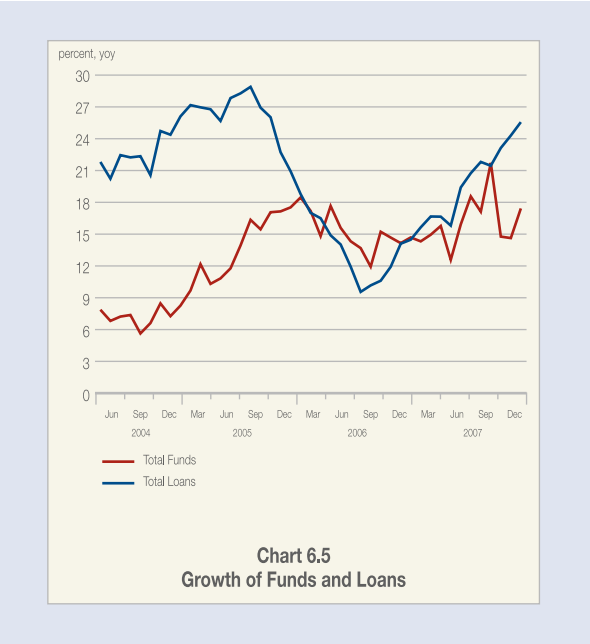
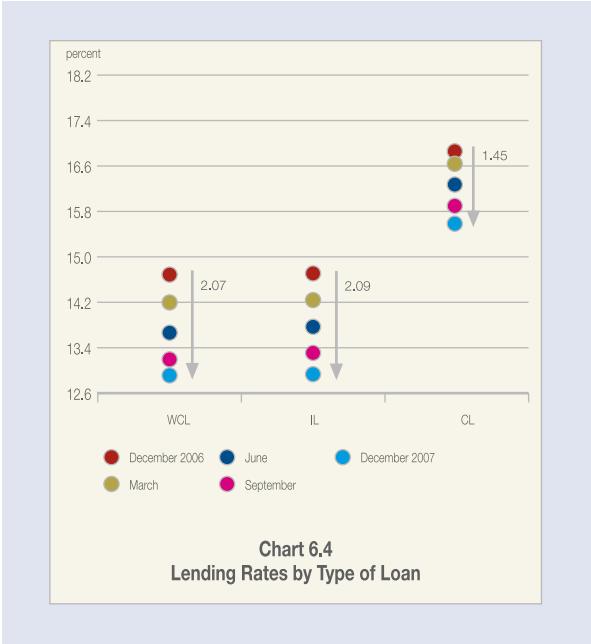
with movement in the rupiah deposit guarantee rate (Chart 6.2). Bank deposit rates averaged over all tenors fell by 2.3%, more than the cumulative reduction in the BI Rate over the same period (1.75%). The steepest rate cuts took place in the 12 and 6 month tenors (Chart 6.3). Leading in rate cuts on deposit funds were state-owned banks, while foreign and joint venture banks registered the slowest decline compared to the banking system as a whole. In September 2007, the downward movement in deposit rates began levelling off in all



tenors, with the 1-month deposit rate even edging up slightly from October 2007. This appears to be related to bank efforts to retain customers by ensuring that depositors would continue to receive positive and competitive real interest rate.

On the other hand, lending rates were slower to respond. The sluggishness of the response was indicated by the variation in variables affecting the pricing of lending rate, including overhead costs, profit margins and risks, not all of which can be influenced

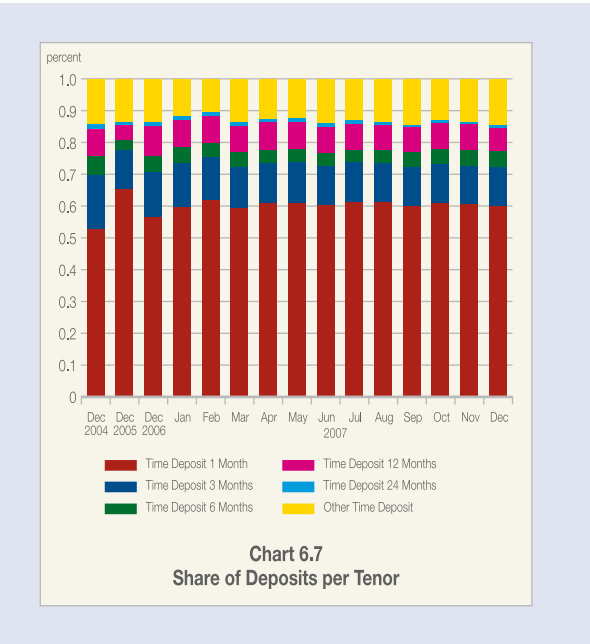
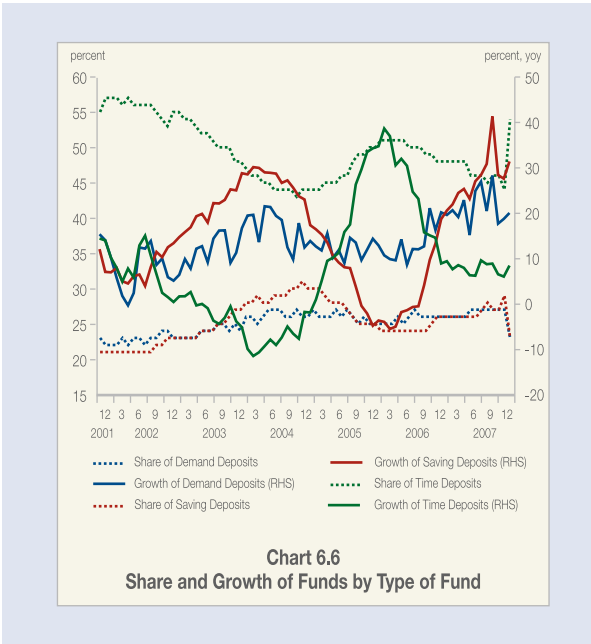


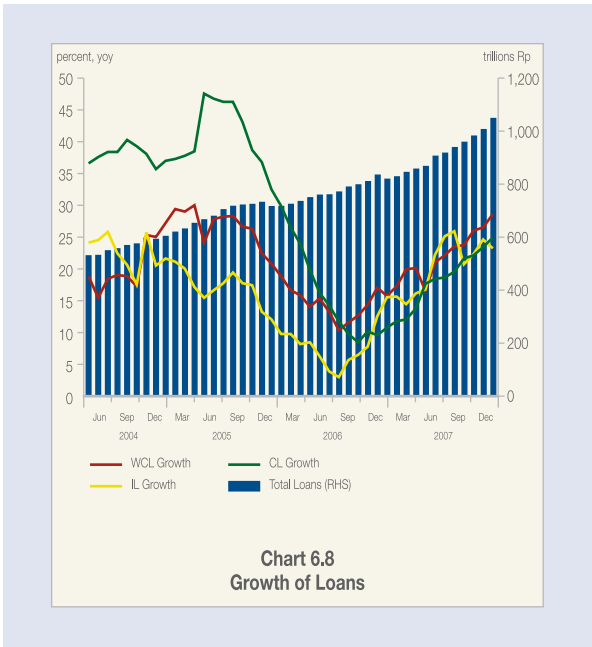


by monetary policy. In December 2007, the steepest drop in lending rates was recorded in working capital and investment credit, in contrast to the thin decline in rates for consumption credit and especially unsecured loans and credit cards (Chart 6.4). However, when overall average lending rates are compared by category of bank, regional development banks were the most reluctant to lower their lending rates, while private national banks in fact cut their loan rates by more than the banking industry average. Since September 2007, lending rates for various uses have been

marked by slowing decline understood to be linked to the achievement of bank business plans, renewed increases in deposit rates and bank caution regarding the future of the economy.

Banks responded to the movement in the BI Rate by switching to shorter-term funding structures. At end-2007, growth in depositor funds reached 17.4%, ahead of 14.1% at the end of 2006 (Chart 6.5), providing banks with ample liquidity. This increase was dominated by savings deposits, which now command

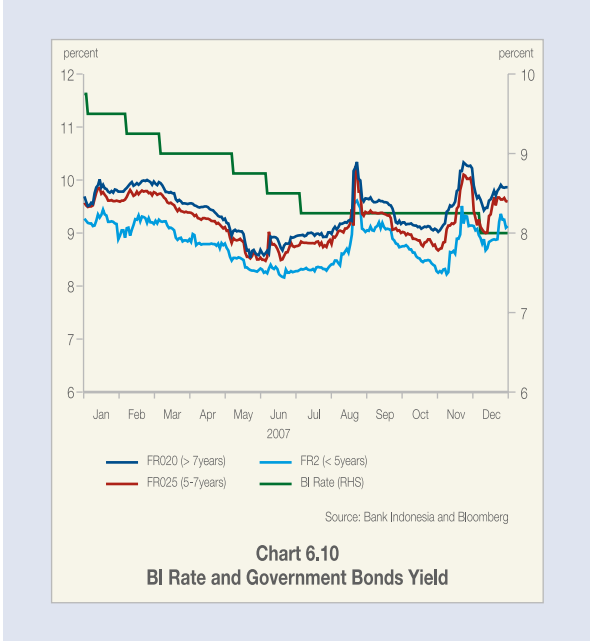
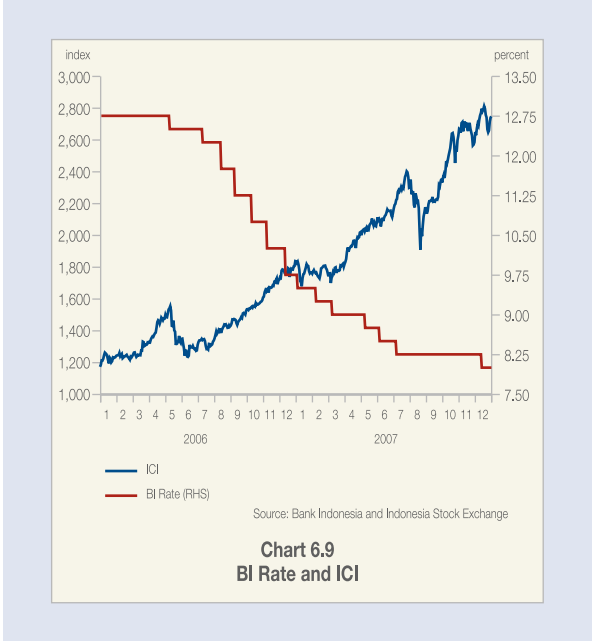




a larger share than demand deposits (Chart 6.6). Time deposits, on the other hand, saw growth taper off, particularly in the case of 24 and 12 month deposits in response to the steep interest rate decline for these tenors. As a result, deposit funds became increasingly concentrated in the 1-month tenor (Chart 6.7). At the same time, the upward trend in foreign currency deposits led by time deposits, which appears to be generally linked to falling returns on rupiah deposits, heightened perceptions of depreciation and inflation expectations over a certain period.

The strong response to the BI rate was also evident in accelerated credit expansion. Credit expansion at end-2007 was recorded at 25.5%, having climbed sharply from only 14.1% at the end of 2006 (Chart 6.5). More robust credit expansion was particularly noticeable during the second half of 2007, when the economy gained momentum. As a result, credit expansion for the banking industry as a whole surpassed the initial forecast early in the year (22%). Accelerated credit expansion was reported for all categories of use, with working capital credit in the lead (Chart 6.8). This credit was channelled into a wide range of economic sectors, with credit growth advancing most rapidly in mining, business services, transportation and construction. The year 2007 also recorded brisk growth in foreign currency lending, which surpassed the overall rate of credit expansion. This strong growth in foreign currency lending was channelled mainly for working capital and investment in traded sectors, including mining, and non-traded sectors such as trade, construction and business services. The surge in foreign currency loans appears to be related to attractive interest rates for these loans in the 6.9%-10.4% range and the confidence demonstrated by some business actors in Bank Indonesia's commitment to exchange rate stability.

On the stock market, response to the BI Rate was evident in the bullish market trend. Stock index movement varied considerably during 2007, while maintaining an upward trend. At end of year, the IDX



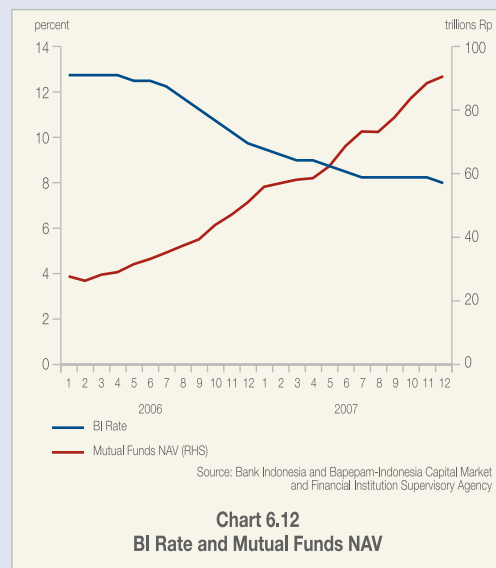
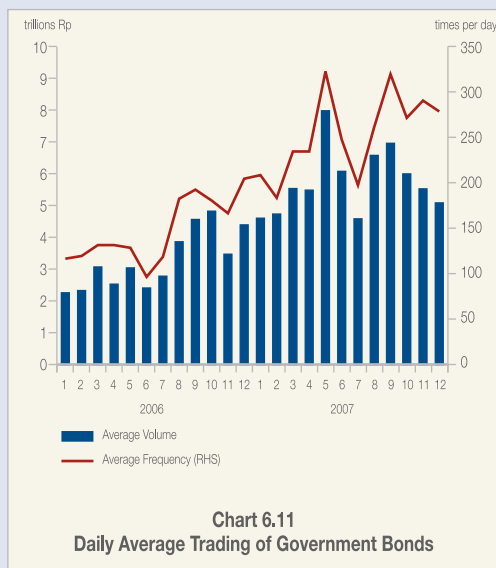
Composite Index closed at 2,745 points or 52.1% up from the end of 2006 (Chart 6.9). With this index growth, the Indonesian Stock Exchange (IDX) ranked the second best-performing market in 2007 after China. This achievement was underpinned by a range of domestic and global factors. Domestic factors included macroeconomic stability, represented by movement in the BI Rate, rising purchasing power and the sound condition of the micro fundamentals of some listed companies. At the same time, global factors included positive perceptions among foreign investors and sustained high world commodity prices. The irrepressible rise in the IDX index also stimulated market liquidity, with average turnover reaching Rp4.3 trillion per day compared to the previous year's average of only Rp1.8 trillion per day.

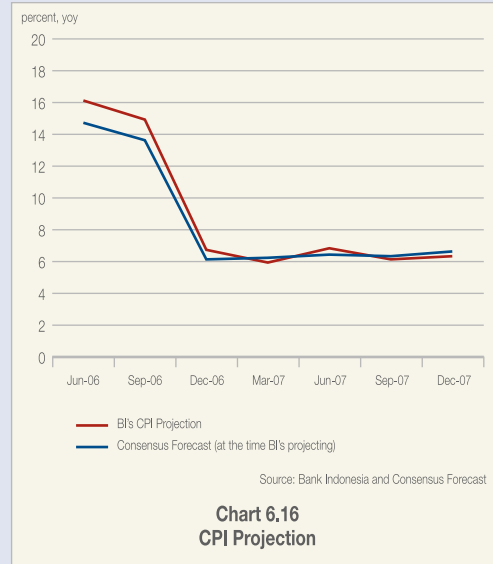
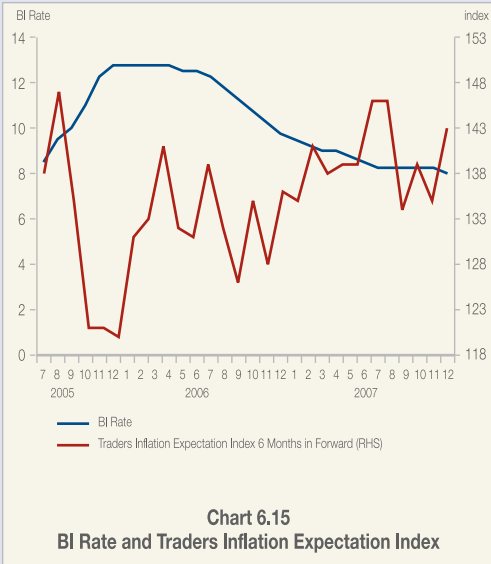
The government bonds market responded to the BI Rate with a renewed surge in trading activity despite relatively stable yields. Trading in government securities maintained an overall upward trend, reflected in rising volume and frequency of transactions. Government bonds trading in 2007 averaged Rp5.8 trillion per day, up significantly from the preceding year (Rp3.3 trillion per day). Average frequency of trading mounted to 253.4 transactions per day, also representing a significant climb in comparison to 146.7 per day in 2006 (Chart 6.11). At the end of 2007, average yield on government bonds in various tenors eased by a thin 17 bps from one year earlier. The modest decline in yield is explained most importantly by strong global sentiment

over the subprime mortgage crisis and soaring world crude oil prices in the second half of 2007 (Chart 6.10). Before this, yield had been in steady decline in keeping with stable macroeconomic conditions.

The BI Rate was one factor that encouraged steady growth in mutual fund Net Asset Value (NAV). At end-2007, NAV in mutual funds reached Rp92.2 trillion, representing growth of 78.6% over the end of 2006 (Chart 6.12). The steep rise in NAV resulted largely from price appreciation, particularly in equity funds. Total net subscriptions/new cash flow mounted Rp20.2 trillion, also dominated by equity funds. While conducive macroeconomic conditions played a role, these gains were also bolstered by growing investor knowledge following the aggressive public education and promotion campaign launched by mutual fund sales agents, as well as support from a more robust legal framework. As a result, mutual funds have not only expanded in NAV, but also in diversity of offerings. At end-2007, mutual funds represented a total of 473 products, up from 403 products one year earlier.

The adjustments in the BI Rate met with positive response in more vigorous financing of economic activity from outside the banking sector. The ongoing economic expansion amid macroeconomic stability and a bullish stockmarket trend prompted greater demand for corporate financing. In 2007, corporate financing from the capital market reached Rp78.3 trillion, a remarkable increase of 236.1% over the end of 2006



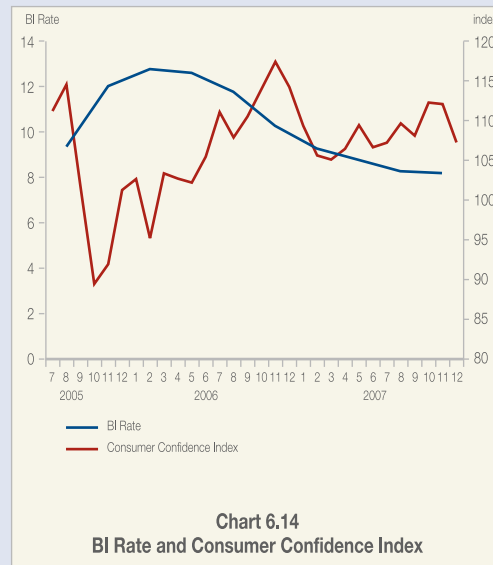
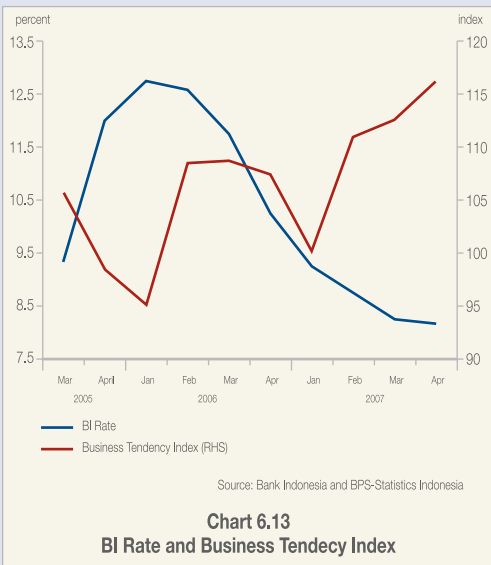


(Rp23.3 trillion). Of this total, Rp47.0 trillion originated from initial public offering (IPOs) and right issues and the remainder was raised through bond issues. IPOs were held by 21 companies for a total value of Rp17.2 trillion, with rights issues mobilizing a further Rp29.8 trillion used primarily for business expansion. Forty-three companies issued bonds, with proceeds used mostly for refinancing.

Real Sector Response

The lowering of the BI Rate was regarded as adequate to boost optimism for doing business in Indonesia.

Confirming this were the findings in the business tendencies survey by the Central Statistics Agency (BPS). This survey pointed to an improving trend in business tendencies in keeping with the prudently managed macroeconomic conditions and outlook for continued economic expansion (Chart 6.13). Consumers also developed positive perceptions of monetary policy, reflected in the upswing in aggregate consumer expectations for economic outlook, incomes and availability of employment (Chart 6.14).



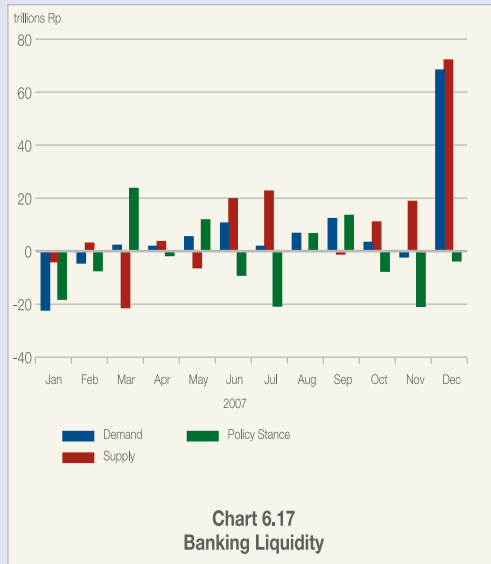


Chart 6.17
Banking Liquidity

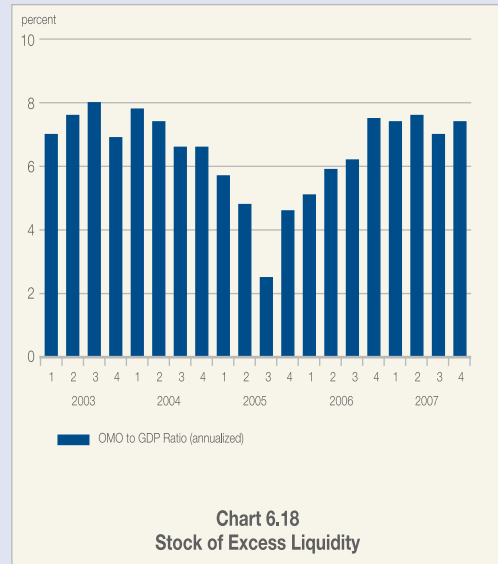


Chart 6.18
Stock of Excess Liquidity

The monetary policy stance also eased inflation expectations among economic agents. In 2007, the commitment and consistency upheld in monetary policy for inflation control proved adequately effective in influencing the inflation expectations of real sector agents (Chart 6.15) and financial market analysts (Chart 6.16). This points to steady improvement in policy transparency, reflected in the growing ability among stakeholders to understand the Bank Indonesia monetary policy. This has enabled Bank Indonesia to

chart credibility gains, which has paid off in addressing the challenges for achievement of the inflation target in the coming years.

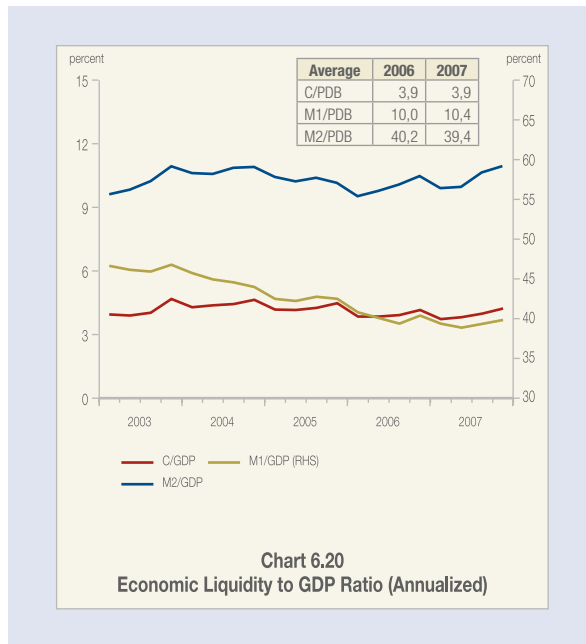
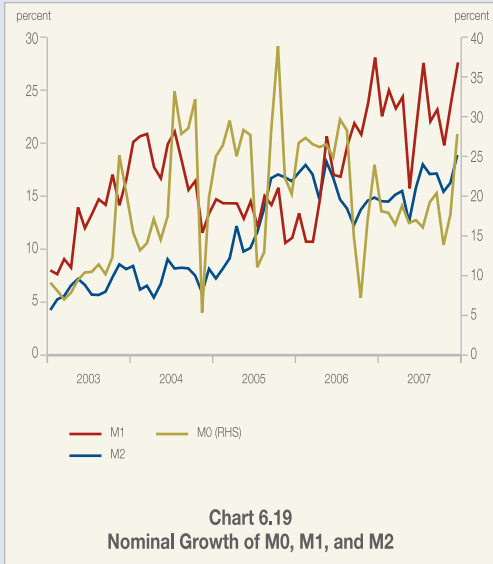
Liquidity

Base Money and Excess Banking Liquidity

Base money underwent expansion in line with the pace of economic activity. At end-2007, base money reached Rp379.6 trillion with growth at 27.8% (Table 6.2). This is

Table 6.2
Developments in Base Money

	billions Rp		
	2005	2006	2007
Base Money	239,781	297,080	379,582
I Currency in Circulation	144,869	178,572	220,785
1. Currency Outside Banks	124,316	151,009	183,419
2. Cash in Banks Vaults	20,553	27,563	37,366
II Commercial Bank Transferable Deposits at BI	94,531	118,417	158,452
III Private Sector Transferable Deposits	381	91	345
Net Foreign Assets	173,806	274,694	356,883
Net Domestic Assets	65,976	22,386	22,700
I Net Claims on Central Government	39,357	49,865	49,458
II Claims on Banks	233,398	243,220	227,555
III Other Claims	19,984	19,919	8,407
IV Open Market Operation	(121,325)	(242,001)	(281,163)
1. SBI	(74,632)	(208,762)	(247,687)
2. BI Deposits Facility	(57,212)	(41,568)	(48,933)
3. Government Bonds	10,519	8,330	15,457
V Net Other Items	-105,438	-48,618	18,444



explained mainly a steep rise in currency in circulation consistent with the ongoing economic expansion in the real sector. However, statutory reserves held by banks grew at a more moderate rate. The Loan to Deposit Ratio (LDR) incentive resulted in a reduction of Rp1.0 trillion in the statutory reserve requirement. Besides statutory reserves, bank excess reserves were up significantly over the previous year. This occurred during the closing days of 2007, a result of realized government expenditures at the end of the year.

Base money expansion was driven primarily by activity on the part of the Government and Bank Indonesia. The Rp82.5 trillion surge in demand for base money over the previous year was adequately offset by expansionary Government rupiah transactions and activity by Bank Indonesia (Chart 6.17). Net liquidity expansion from Government account at Bank Indonesia reached Rp66.9 trillion, down significantly from 2006 (Rp115.1 trillion). With the fiscal deficit widening from 0.9% of GDP in 2006 to about 1.3% of GDP in 2007, this decline was reportedly related to the switch in the

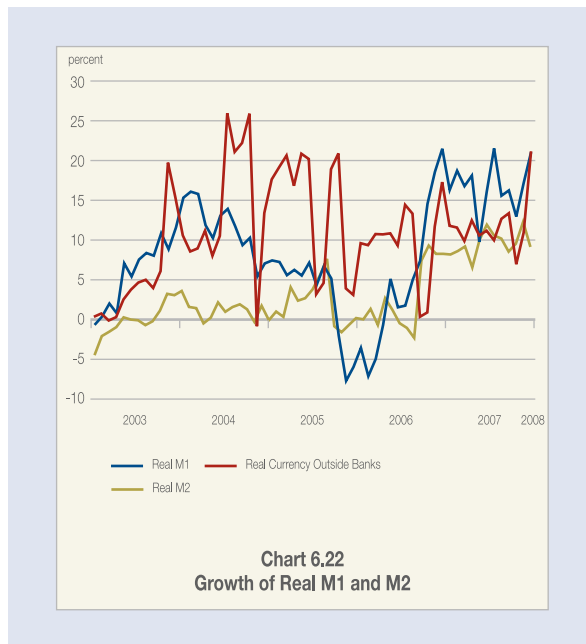
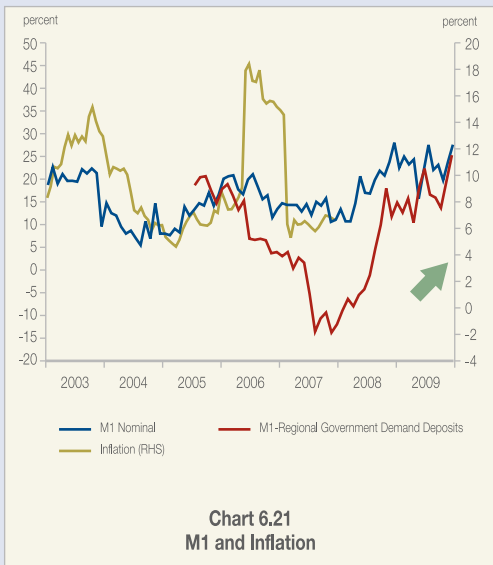


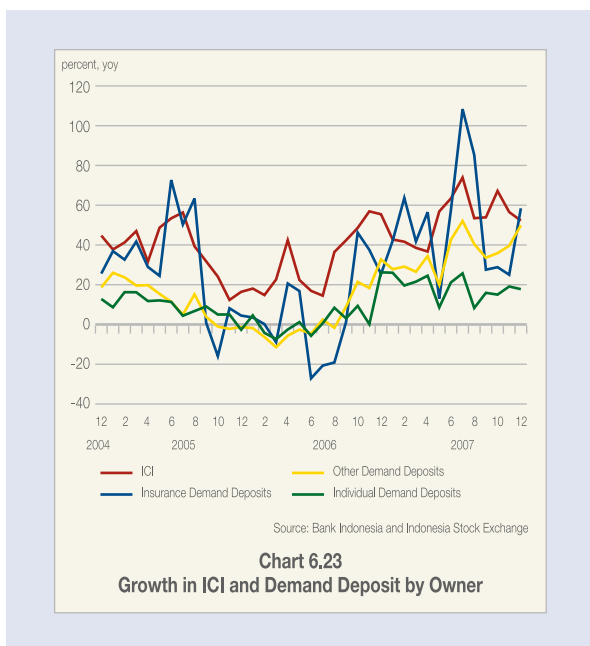
Table 6.3
Monetary Aggregates

	2006	2007	2006	2007
	Billions Rp		Growth (percent)	
Broad Money (M2)	1,382,074	1,643,203	14.87	18.89
M2 Rupiah	1,198,141	1,427,296	18.13	19.13
Narrow Money (M1)	361,073	460,842	28.08	27.63
– Currency Outside Banks	151,009	183,419	21.47	21.46
– Demand Deposits	210,064	277,423	33.30	32.07
Quasi Money	1,021,001	1,182,361	10.82	15.80
– Deposits in Rupiah	837,068	966,454	14.30	15.46
= Time Deposits	506,565	533,376	11.94	5.29
= Saving Deposits	330,503	433,078	18.10	31.04
– Deposits in Foreign Currencies (billions \$)	183,933 20,392	215,907 22,922	(2.65) 6.09	17.38 12.41
Net Foreign Assets	413,265	524,703	32.00	26.97
Bank Indonesia:	377,936	530,913	51.09	40.48
– Foreign Assets	385,820	538,775	12.19	39.64
– Foreign Liabilities	7,884	7,862	(91.59)	(0.28)
Commercial Banks:	35,329	-6,210	(43.87)	(117.58)
– Foreign Assets	93,924	70,907	(20.89)	(24.51)
– Foreign Liabilities	58,595	77,117	5.03	31.61
Net Domestic Assets	968,809	1,118,500	8.84	15.45
1. Net Claims on Central Government	506,488	497,478	1.52	(1.78)
– Bank Indonesia	265,919	249,069	11.19	(6.34)
– Commercial Banks	240,569	248,409	(7.39)	3.26
2. Net Claims to IBRA	0	0		
3. Claims to Enterprises	837,072	1,040,996	13.29	24.36
– Loans to Private Sector	787,136	995,111	14.13	26.42
Loans to Private Sector (billions \$)	87,27	105,65	24.38	21.07
= Loans in Rupiah	639,152	793,186	12.84	24.10
= Loans in Foreign Currency	147,984	201,925	20.09	36.45
Loans in Foreign Currency (billions \$)	16,41	21,44	30.88	30.67
– Other Claims	49,936	45,885	1.55	(8.11)
4. Net Other Items	-374,751	-419,974	7.81	12.07

Government financing strategy to renewed emphasis on domestic issuance of government bonds rather than making use of the account at Bank Indonesia. At the same time, Bank Indonesia activity boosted liquidity from the costs of monetary management. This was consistent with the Bank Indonesia commitment for maintaining rupiah stability in support of sustainable macroeconomic stability.

With mounting excess liquidity on the money market, Bank Indonesia took action in OMOs to absorb liquidity. During 2007, the aggregate OMO position widened by

Rp39.2 trillion to Rp281.2 trillion. The rise in the OMO position reflects the steady increase in excess liquidity on the money market that could not be optimally absorbed into economic activities in the real sector (Chart 6.18). This will be addressed through a range of actions, including financial deepening, and further strengthening of commitment and consistency on the part of Bank Indonesia in its monetary operations on the money market. Added to this, various policies in the real sector will be reinforced to accelerate economic growth and create greater capacity to absorb excess liquidity on a permanent basis.



Economic Liquidity

Economic liquidity, reflected in M1 and M2, expanded considerably during 2007. At the end of December, the narrow money (M1) widened 27.6%, to Rp460.8 trillion. The broad money (M2) grew 18.9% to reach Rp1,643.2 trillion. This growth in economic liquidity is markedly high compared to the historical condition over the past five years, despite relative stability in terms of ratio to GDP compare to the previous year (Chart 6.20). The rapid expansion in economic liquidity is an indication of potential for future inflationary pressure¹ (Chart 6.21). As a result of this nominal expansion, real M1 and M2² growth reached 21.0% and 12.3% (Chart 6.22).

The BI Rate has a strong bearing on movement in the components of economic liquidity. The downward movement in the BI Rate influenced economic liquidity components by producing a shift in public liquidity preferences, as evident in the accelerated growth in savings deposits relative to time deposits. This was followed by mounting activity in privately-held demand deposits in line with bullish activity on the stock market. Activity in privately-held demand deposits was dominated by insurance companies, pension funds and other private business (including securities companies and investment managers). As shown in Chart 6.23, the stock index has demonstrated a markedly increased correlation with this category of demand deposits since 2005. This augurs for the possibility of an expanded institutional investor role on the domestic stock market.

The expansion in economic liquidity was dominated by domestic factors. Claims on business sector had a leading influence over levels of economic liquidity. Growth in claims on business sector reached 26.4% in December 2007, representing an increase of Rp208.0 trillion over the end of 2006. Of this total, Rp154.0 trillion comprised credit extended in rupiahs, while the remaining Rp54 trillion, equivalent to US\$5 billion, was loans extended in foreign currencies. External factors bearing on economic liquidity were reflected in the overall 27.0% expansion in net foreign assets (NFA), representing an increase of Rp111.4 trillion. This increase took place in NFA held by Bank Indonesia in line with the hefty rise international reserves from the windfall in oil and gas revenues generated by soaring oil 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.

1 In the chart, M1 growth is a leading indicator for inflation 18 months forward.

2 Calculated by CPI inflation.