

QUARTERLY ANALYSIS: The Progress of Monetary, Banking and Payment System Quarter I, 2010

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The process of strengthening the domestic economy was continually supported by the conducive global economic performance. Indonesia's economic activities showed a significant increase in the fourth quarter of 2009. In that quarter, the Indonesian economy grew by 5.4% (yoy), so that in general, the economy grew by 4.5% (yoy) in 2009. These economic conditions continued to show the optimistic atmosphere that support better economic prospects than previously thought. The Indonesian economy in 2010 was expected to reach 5.5% -6.0% and in 2011 reached 6.0% -6.5%. Price stability was still maintained, as reflected in lower CPI growth during the first quarter of 2010. This was in line with the estimates of significant inflationary pressures, which will not appear until at least the first semester of 2010. For the entire year, CPI inflation in 2010 was targeted at the range of $5\% \pm 1\%$.

Bank Indonesia expected that the global economy continues to recover and gets stronger. The economy of developed countries, especially in the U.S. and Japan continued to improve. Likewise, the economic recovery of non-Japan countries in Asia, especially China and India, was also getting stronger. Meanwhile, the indications of economic recovery in Europe began to be seen though still limited. The settlement of the Greek crisis has so far responded positively by economic actors and only has limited impact on financial markets.

Global economic recovery aligned with the perception of risk sparked optimism in the financial markets and commodity markets. This was reflected by the price index in the global stock markets and commodity prices that recorded an increase in the international market which tends to increase. The flow of foreign capital into the emerging markets financial markets continues along with the improvement in risk perception. These conditions encouraged the strengthening of exchange rates in the region. This optimism that was getting stronger against the global economic recovery and improved global demand, has elevated the prices of various commodities. The price increase was accompanied by a strengthening currency, which so far has not triggered a significant increase in global inflation, especially in developed countries. In the process of world economic recovery which has not fully recovered to normal, the monetary

authorities, especially in developed countries tend to still implement an accommodative monetary policy stance. The signals of monetary tightening policy appeared more in the emerging markets related to increased inflationary pressures in line with high economic expansion.

Domestic economic performance in the first quarter of 2010 had better potential than the previous estimation. In the first quarter of 2010, the domestic economy was expected to grow by 5.7% (yoy). This development was supported by the following matters. First, export performance was expected to increase along with global economic recovery and improvement in international commodity prices. Second, consumption was expected to remain strong supported by consumer purchase power and the maintained consumer expectations. Third, in line with the increased exports and household consumption, investment recovery was expected to be stronger and supported by the efforts of government to promote infrastructure projects. In addition, the investment climate in 2010 was also supported by improved Indonesia's sovereign credit rating by S & P which increased from BB- to BB. With this increase, Indonesia's rating is only one notch away to advance toward *investment grade*. Fourth, in line with improved performance on the external side, a number of sectors were expected to grow higher, particularly the manufacturing and trade sector. The higher growth in manufacturing sector was driven by the improvement in export-oriented and the automotive industries. Meanwhile, the growth in the trade sector was getting higher in line with the increased in export and import activities and the improvement in manufacturing performance. However, there were some challenges in encouraging higher growth, especially related to the efforts to accelerate the implementation of infrastructure programs and to optimally utilize the opportunity of the implementation of the ASEAN-China Free Trade Agreement (AC-FTA).

The continued strengthening of the economy was also reflected in the development of regional economy that continues to show improvement. The performance of the regional economy was sustained by the economy in Sumatra, Kalimantan, Sulawesi, Maluku and Papua (Kali-Sulampua), and Jakarta. Meanwhile, economic activities in other regions (Java, Bali and Nusa Tenggara or Jabalnustra) indicated deceleration. The improved regional economic performance was derived from the increased exports, investment, and consumption. The improved export performance in each area came from the primary commodity exports, such as mining and palm oil products in Sumatra and Kali-Sulampua, and chemical products in Jabalnustra. In terms of the main destination countries, exports of each region experienced a shift which was originally to Japan, America and Europe, turned to the ASEAN countries and China as the economic recovery mainly occurs in these regions. Even the export portion of Sumatra and Kali-Sulampua to India showed a significant increase, especially for palm oil products and coal. In line with increased economic activity, investment was indicated to get stronger.

This was reflected from the growth in cement consumption and the imports of capital goods which growth remain positive. As for the local government investment, the capital expenditure also showed improvement. This was primarily related to infrastructure projects such as reparation and construction of roads, dams, bridges, and airports. As in the field of business and employment, industry sector experienced an increase associated with the improving domestic and external demand. The performance was reflected in the inclining capacity of production and raw material imports in all regions. From the mining sector, the improvement in this sector was mainly due to the increase in non-oil mining and gas production (non-oil), particularly coal and copper, while oil and gas production still tended to slow down.

In terms of prices, inflation remained under control in the first quarter of 2010. Inflationary pressure in the first quarter 2010 tended to be low, marked by deflation in March 2010 by 0.14% (mtm), so that annual CPI inflation reached 3.43% (yoy). This controlled inflation at a relatively low level was in line with the strengthening of the rupiah and the adequacy of supply in response to the increased demands. In addition, the low inflation in March 2010 was also supported by the wining of inflationary pressure that comes from volatile food (mainly rice) due to the start of harvesting season in some areas and minimal inflationary pressures originating from the administered price

The performance of Indonesia's balance of payments (BOP) in the first quarter of 2010 was expected to remain solid, supported by the world economic recovery. The current account was expected to record surpluses. This is in line with export performance that continues to improve primarily that come from natural resource-based commodities, such as coal and copper. On the other hand, imports also increased, in line with the rising of domestic demand and exports. In terms of balance sheet of capital and financial (neraca transaksi modal dan finansial/TMF), the first quarter in 2010 was also expected to record a surplus associated with capital inflows and the issuance of government's foreign denominated bond. The Indonesia risk indicators also improved, as reflected in indicators of credit default swaps (CDS) which was at that time placed at the lowest level, the decline in yield spreads of Indonesia Government Bond U.S. Treasury Note, as well as the improved rating of Indonesia. With these developments, the national reserves at the end of March 2010 was estimated to reach 71.8 billion dollars, equivalent to 5.8 months of imports and foreign debt repayments by the Government.

In line with the performance of BOP, rupiah exchange rate tended to strengthen. Overall, during the first quarter 2010, rupiah rose by an average of 2.2% to the level of Rp9.254/USD. At the end of first quarter 2010, the rupiah reached the level of Rp9.090/USD or gained 3.7% (point to point). The strengthening of the rupiah was supported by a conducive macroeconomic fundamental, reflected on the BOP performance that was quite good and the improved

perceptions of risk. In addition, the strengthening of the rupiah was also supported by the attractive yield of rupiah, reflected in the uncovered interest parity (UIP), covered interest parity (CIP) and the yield spread Indonesian Government Bond which was relatively high, the highest compared with other regional countries. The strengthening of rupiah was also followed by the volatility of relatively stable rupiah exchange rate that reached 0.57% compared to the fourth quarter 2009 that reached 0.56%.

Improved financial sector performance was aligned with global and domestic economic recovery. The Jakarta Stock Exchange Index (IHSG) during the first quarter 2010 experienced a significant strengthening, reaching 10.2%. The performance index was the highest in the region. Some of the factors driving this increase of IHSG included the improving Indonesia's economic prospects, followed by a decline in risk perception, improved credit rating, and high yields on rupiah. It was also reflected in other financial indicators such as the declining yield on government securities (SUN). On the interbank money market, excess liquidity is still large enough to push the PUAB O/N interest rate close to the lower limit of the BI Rate. The step taken by Bank Indonesia to extend the term of the SBI can be viewed among others, in the context of financial deepening runs very well reflected in the declining of the highest and the lowest interest rate spread PUAB O/N market. In addition, the current portion of SBI with a tenor of 3 months has increased to 67.04% from 24.64% at the end of the previous quarter. Along with lowered risk perception of banking, the deposit and credit rates were still decreasing although not as big as expected. In the future, monetary policy transmission was expected to further improve with the increased optimism of banking on the economic conditions

As for the micro-banking, national banking conditions remained stable. This could be indicated from the maintained capital adequacy ratio (CAR) in February amounted to 19.3%. Meanwhile, the ratio of gross non-performing loans (NPLs) ratio remained at 4% with net NPL ratio of 1%. In addition, bank liquidity, including liquidity in the interbank money market was getting better. Similarly, third-party funds (TPF) have shown improvement.

Global and domestic economic developments that improved during the first quarter of 2010 are expected to continue ahead. This supports Bank Indonesia's belief that Indonesia's economic will have better prospect than expected. Economic growth in 2010 was estimated at 5.5% -6.0%, higher than original estimates of 5.0% -5.5%. The economic recovery was sustained not only by consumption which remained strong, but also by the increased exports in line with the global economic recovery. Increasing demand coupled by the improved investment climate was expected to encourage the increase of investment significantly. The economic recovery was expected to continue in 2011 with economic growth to reach 6.0% -6.5%. Increased demand which could be adequately responded by the supply side, was expected to

keep inflation pressures at a low level. The medium and long term economic prospects of year 2010-2014 were presented in the Indonesian Economy Report 2009 which can be accessed through the website of Bank Indonesia.

It was considered that the BI Rate at 6.5% rate is still consistent with the inflation target for 2010 at $5\% \pm 1\%$ and the current direction of monetary policy were also considered conducive for the ongoing process of economic recovery and banking intermediation. The meeting of the Board of Governors of Bank Indonesia on 6 April 2010 decided to maintain the BI Rate at 6.5% with interest rate corridor of $\pm 50\text{bps}$ in the vicinity of the BI Rate.

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