Burhanuddin Abdullah: Capitalizing on stability for sustained growth

Speech by Dr Burhanuddin Abdullah, Governor of Bank Indonesia, at the Annual Bankers' Dinner 2007, Jakarta, 12 January 2007.

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Assalamu'alaikum wr. wb,

Good evening and greetings to you all,

I. Introduction

In commencing my speech, I would like to invite you to join me in expressing thanks and praise to God Almighty who has again blessed us with the chance to meet in this pleasant and congenial setting at the Annual Bankers' Dinner 2007.

On this wonderful opportunity and on behalf of the Board of Governors of Bank Indonesia, please allow me to wish you all a Happy New Year for 2007. May we all be blessed in every step that we take.

Tonight marks the fourth time I stand at this prominent forum, in the presence of you, distinguished ladies and gentlemen, to deliver the Governor of Bank Indonesia's start-of-year briefing. This also suggests that it has been almost 4 (four) years since I was appointed to the position of Governor of Bank Indonesia. Despite some shortcomings as well as successes, I would like to thank you all for your support and cooperation that has been so forthcoming over the years.

II. Reflection of 2006 economic dynamics

A. Year 2006 - the year to restore stability

Distinguished guests,

The year 2006, which only passed a few days ago, was replete with splendid colours which I found most impressive. To policymakers in Government, Parliament, and also Bank Indonesia, 2006 was a year which finally provided some breathing space, albeit with several footnotes. To entrepreneurs, 2006 was a year of mixed achievements. Enterprises in the real sector, in the manufacturing industry in particular, found 2006 a constrictive year. Competition pressures from more efficient and productive countries were enormous. Notwithstanding, 2006 was a year that generated much profit for participants in extractive industries, as reflected by the surging export level to countries that are our primary trading partners. Nonetheless, to the majority of the general public, 2006 was a truly trying year. It was a test of resilience and patience as a result of high inflation, which were direct and indirect effects of fuel price hikes in the previous year. With all these episodes, phenomena and dynamics, 2006 was a year we should nevertheless be thankful for.

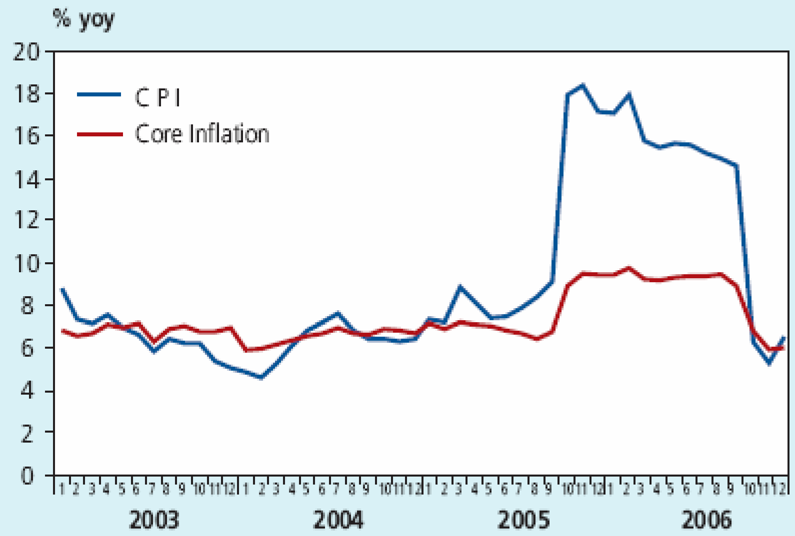
For that reason, at the beginning of my speech tonight, I would like to invite you all, distinguished ladies and gentlemen, to compare notes and ask imperative questions regarding the intentions, motivation, steps and achievements for the year that has just passed us by. What have we achieved so far? What must we persevere within the coming year? What are our problems? Is it lack of hard work? Sincerity? Determination? Or is it something else? We are asking such questions while looking throughout the country and wondering where are we in the race to seek prosperity for all of our people? Could we be left behind by our neighbouring countries?

In the following section I will explicate the targets, hopes and dreams we must knit together this coming year, 2007. Inevitably, deep observation and sharp analysis are required on the numerous predicaments and on the social and cultural order of society, which will become the foundation of growth and development in our economy. Subsequently, towards the end of my speech I will present some messages, follow-up steps and policy measures that will take place this coming year, under one common goal, that is to make our economy a more prosperous one.

Distinguished guests,

The transition from 2005 is still fresh in our minds. We left 2005 full of hopes and concerns, because we were convinced that at the earlier part of 2006 we would still see some difficulties as a result of adverse external shocks, particularly the soaring global oil price. Nevertheless, hopes abounded during the early part of 2006. We were optimistic, firstly, that macro economic stability would be restored to its proper path and be maintained so that economic enthusiasm would return to where it should be. Secondly, we also strived to achieve the first goals in order to quickly minimize the rigidities and structural inefficiencies in our economy.

We should be grateful because we were able to maintain macroeconomic and financial system stability during 2006. Numerous indicators which endured pressures in 2005 have shown positive improvement in 2006. Relatively high inflationary pressures at the beginning of 2006 have gradually dissipated throughout 2006. By the end of 2006, the inflation rate was recorded at 6.6% (y-o-y); below the targeted rate of 8±1% set by the Government and Bank Indonesia. Success in controlling inflation in 2006 also reveals that monetary policy was able to mitigate the second round effects of soaring global oil prices at the end of 2005 on inflation expectations (See Graph 1)[1].



Graph 1.
The Rate of CPI and Core Inflation

Inflation stabilization in 2006 and relatively good performance in the balance of payments, with a surplus of 3.7% of GDP, also contributed towards a stable rupiah exchange rate throughout 2006, after significant depreciation in 2005. Entering 2006, exchange rate volatility had also decreased.

The year 2006 was also an important one as we settled our outstanding obligations to the IMF without triggering significant turbulence in the market. With the debt now cleared, we are now a 'regular' member of the IMF. Even though the outstanding obligations have been paid, our foreign exchange reserves position was maintained at an acceptable level. This improved the confidence of market players in the foreign exchange markets. Throughout 2006, the rupiah to US dollar exchange rate tended to be stable at a level of Rp.9,100 – 9,400 per USD with relatively lower volatility than the previous year (See Graph 2).

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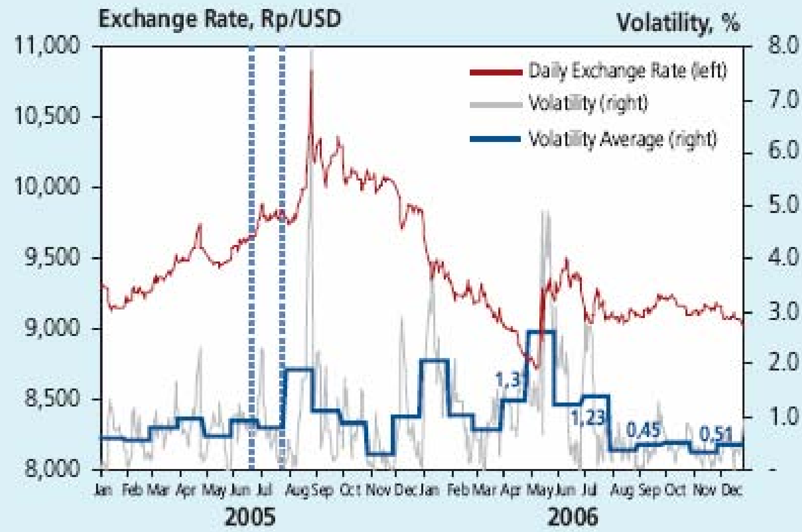
1 If we look a little further back, the outlier period, as a result of significant price changes in the economy, is generally beyond the control of monetary policy. On average, CPI inflation from 2003-2006 was recorded at 6% y-o-y outside its outlier in 2005, which was recorded at 17%.



Graph 2.
Exchange Rate and its Volatility

Towards the end of 2006, uncertainty regarding shocks in regional financial markets emerged as a result of the Bank of Thailand's policy aimed at stemming the flow of short-term capital into its financial system. Fortunately such fears never materialized. Although the rupiah fluctuated momentarily, it soon stabilised in line with its external balance. The policy taken by Thailand was based on its domestic considerations and economic interests. We also have our own considerations in formulating policies that match our own particular circumstances and interests. In this case, Bank Indonesia believes that the liberal capital account regime that has been implemented for many years remains congruent to our wider national interests. The economic theory of Kydland and Prescott regarding time inconsistency in employing a policy seems a relevant reference point with respect to the choice of policy regime which we have instituted *ex-ante*. We cannot simply alter our capital account regime to become more closed without precipitating a loss of credibility. Credibility, which we have strived painfully to achieve over the years, should not be thrown away merely due to the temptation of temporary benefits.

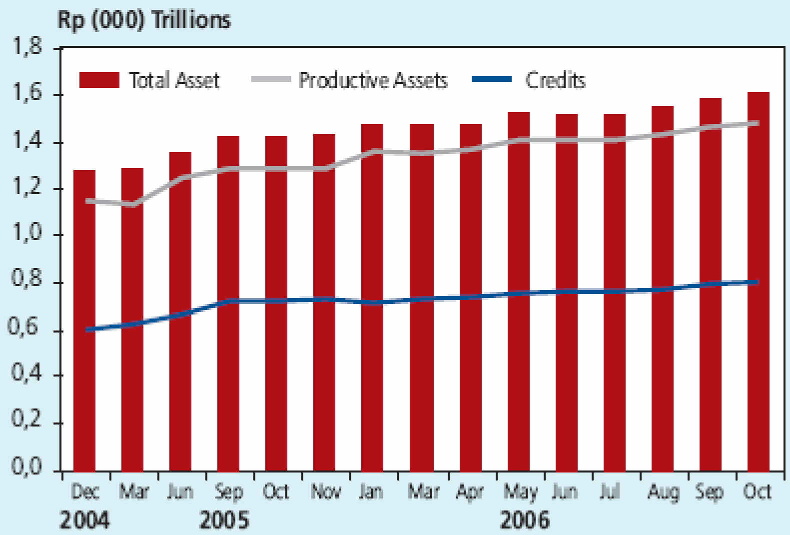
With the above positive developments, Bank Indonesia found the opportunity to gradually reduce the BI Rate during 2006. Throughout 2006, Bank Indonesia trimmed the BI Rate by 300 basis points, which by end of 2006 was recorded below 2 (two) digits, namely 9.75%. Such reductions were taken to preserve the positive market perceptions and support a more conducive business climate, while safeguarding stability in the financial markets amid capital inflows for portfolio placements.

The regained macroeconomic stability provided opportunity for a broad-based economic recovery. National economic expansion became visible in the second half of 2006, particularly in the growth of production indicators, although insufficiently balanced due to a less-than-conducive investment climate and the high-cost economy. Investment slowed compared to the previous year, and therefore made exports and private consumption the primary base of economic growth. Furthermore, beginning in the second half of 2006 we witnessed an upswing in credit growth, which was followed by acceleration in government spending, and thus helping to boost economic growth. At the end of 2006, economic growth was recorded at 5.5% y-o-y2[2].

The national banking industry has achieved a gradual marked improvement over the last three years. Quantitatively, there has been a significant upswing across various financial performance indicators and banking industry activity. This was underpinned by growth in total assets, which was bolstered by a build-up in earning assets, including credit (See Graph 3). As of November, total assets in the banking industry had risen to Rp.1,635 trillion, whereas credit portfolio rose by Rp.78,2 trillion (10.7%). This was funded by growth in deposits to the tune of Rp.123 trillion (10.9%). Banking capital was also

2 Bank Indonesia's estimation.

maintained at a level deemed more than adequate, as reflected by the Capital Adequacy Ratio (CAR) which was maintained at the relatively high level of 20%.



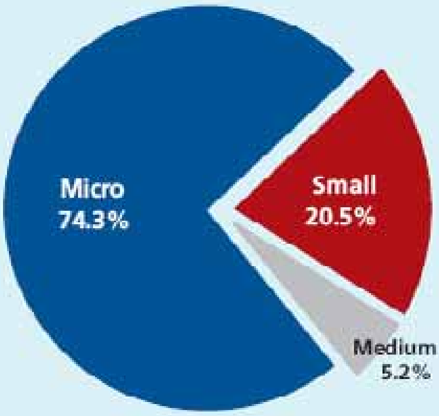
Graph 3.
Banking Performance Indicators

Meanwhile, the level of Non-Performing Loans (NPL) in the industry has taken a significant dive, which indicates that, essentially, the prevailing condition of the banking industry has experienced a marked and continual improvement. It should be noted that the current level of NPL in the banking industry is heavily influenced by the NPL of state-owned banks, which still carry some long-standing problems from the past.

Qualitatively, the health and resilience of the banking industry over the last few years have also witnessed significant improvements. The human resources capacity within the banking industry has increased, along with the enhanced understanding of prudential concepts and risk management throughout the banks' organization hierarchies. The management information system, internal control system, risk-management system, good governance and all operational procedures that follow; have generally strengthened. The quality of the banking service is also a crucial factor for which progress is managed through the creation of a trusted customer protection system.

In the capital markets, the price of bank shares experienced a rather significant hike before finally stabilizing. Bank issued bonds also received a positive response from the market at an acceptable price. Deposits at banks steadily accrued year by year reaching 10% annually despite a continuous fall in the savings' interest rate, following cuts in the BI Rate. This could be considered as a strong indication that public confidence in the banking industry has recovered and even grown. Alterations to the Bank Deposit Guarantee Scheme, implemented in the latter part of last year, were performed smoothly and without triggering turbulence that could threaten overall financial system stability. Concerns regarding flight-to-safety and flight-to-quality from the customers of small banks, as a result of changes in the blanket guarantee scheme to a limited guarantee scheme instituted by the Deposit Insurance Corporation (*LPS*) have proved not to materialise, or at least minimised.

Meanwhile, the Rural Bank (BPR) industry has also shown growth. This industry plays an important role in developing Small and Micro Enterprises (Graph 4), and communities of villages and suburbs. There are currently 1,935 Rural Banks with 3,157 bank offices with a credit portfolio reaching Rp.16,9 trillion (Table 1). As the nominal amount of credit is usually small, to reach a particular amount of credits extended, Rural Banks will have a much higher client ratio compared to that of Commercial Banks.



Graph 4.
Financing to MSMEs

Table 1.

Performance of Rural Banks

Billion Rp

Description	Dec-03	Dec-04	Dec-05	Nov-06	Growth (Nov 06 - Dec 06)	
					Nominal	%
Total Asset	12,635	16,707	20,393	22,825	2,432	11.93
Total Third Party Fund	8,868	11,161	13,178	15,561	2,383	18.08
- Savings	2,617	3,301	3,757	4,448	691	18.39
- Deposits	6,251	7,860	9,421	11,113	1,692	17.96
Credit	8,985	12,149	14,654	17,041	2,387	16.29
Profit/Loss (on going year)	429	539	604	576	-28	-4.64
LDR	74.5%	80.7%	82.0%	82.2%	0.2%	
NPLs Gross	8.0%	7.6%	8.0%	9.9%	1.9%	
NPLs Net	5.5%	5.5%	5.8%	7.4%	1.6%	
CAR				19.5%		

Ladies and Gentlemen,

Speaking about the development of the financial industry, and the banking industry to be more specific, four years ago, we clearly realized that banking industry supervision and regulation must be based on a long-term vision in its achievement strategy, and such a vision must be approached through systematic and measurable efforts.

Therefore, at the beginning of 2004, Bank Indonesia issued Indonesian Banking Architecture (*API*), a blueprint of upcoming banking industry guidelines, and the kind of vision, direction and form to be achieved. The holistic policies that Bank Indonesia issue to achieve such goals up until the end of 2010 are included as part of the *API* policy structure.

Since then, as our distinguished guests may observe, Bank Indonesia has continuously strived to manage and improve all aspects of banking activities. Each regulation, from strategic ones to the technical guidelines of operational courses of action, was designed to be a torch to light the darkness and lead the way. Steadily, albeit sometimes slowly, the national banking industry has achieved good progress and alleviated many of its problems. The pillars set forth in the Indonesian Banking Architecture have begun to transform into pillars of banking industry strengths, promoting greater stability.

Through the implementation of good corporate governance (GCG), the most recent Bank Indonesia survey suggested that nearly all banks have conducted self-assessments. The results of the self-assessments concluded that approximately 98% of banks in Indonesia have applied a minimum of 50% of the GCG principles, as mandated by PBI 8/4/PBI/2006 regarding GCG Implementation for Commercial Banks. Management information systems, internal control systems, risk management systems, and all operational procedures that follow, have generally progressed, however, there remains room for improvement.

As another step to greater ensure that good governance in the banking industry is upheld, in 2006 we took a step which we deem to be strategic. A step that we believe may help rebuild a good image and erase any negative perceptions that abound within the Indonesian financial system which can be exploited for illegal activities, such as money laundering. The step taken is the cooperation with various law enforcement authorities – The Indonesian Police, the Attorney General, The Indonesian Financial Transaction Reports and Analysis Centre (PPATK) – and most recently the Corruption Eradication Commission (KPK).

The aforementioned cooperation between Bank Indonesia and the various law enforcement institutions is hoped to be able to clear any misperceptions regarding to coordination efforts in handling various banking crimes, including corruption. Perception, understanding, competence and the work ethic in dealing with multiple banking problems will be settled through a performance structure that is prompt, objective and proportionate. Therefore, it is expected that public confidence, as the foundation of banking business, can be safeguarded and continually improved since it is guaranteed by a trustworthy law enforcement system.

As a result of our relentless endeavours, the dark cloud that has overshadowed the national banking industry for so long has begun to disperse little by little. We should also reinforce our pledge and commitment, as well as find the faith that we will, in time, accomplish our ultimate goal: “the establishment of a sound, strong, beneficial and rewarding national banking industry”.

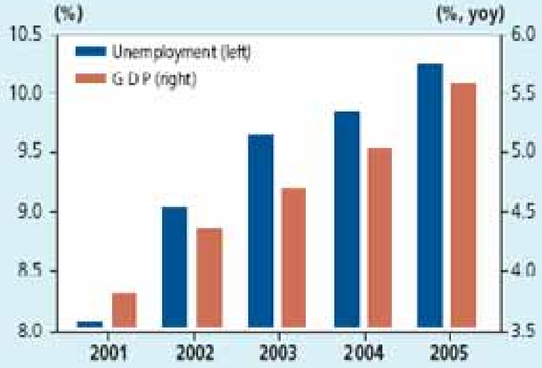
B. Several problems in 2006

Ladies and Gentlemen,

Based on my previous comments, it would not be excessive to say that there have been numerous successes achieved during 2006. We have successfully enticed our economic machines back on the proper track. We have reduced the cost of financing, which was the direct result of high inflation. We have reiterated that the economic management of our country will only succeed if it is us, ladies and gentlemen**,** who do it. However, against this backdrop, we also comprehend how serious our perennial carry-over problems have become, which we have shouldered year after year. That is the structural rigidities within our economy, which in turn has paved the way for inefficiency, squandering time and resources in the form of excess liquidity and unemployment, and abject poverty that continues to worsen.

Meanwhile, the condition of the real sector, which forms the spine of the country, is faced with an inevitable paradoxical phenomenon. The growth and expansion of economic capacity that took place over the last few years tended to favour capital intensive sectors rather than labour intensive ones. Unemployment continues to grow despite a prospective economy. Lately, we have also observed the exacerbation of poverty. Graphs 5 and 6 provide an illustration of the paradox of growth phenomenon.

(The Paradox of Growth)

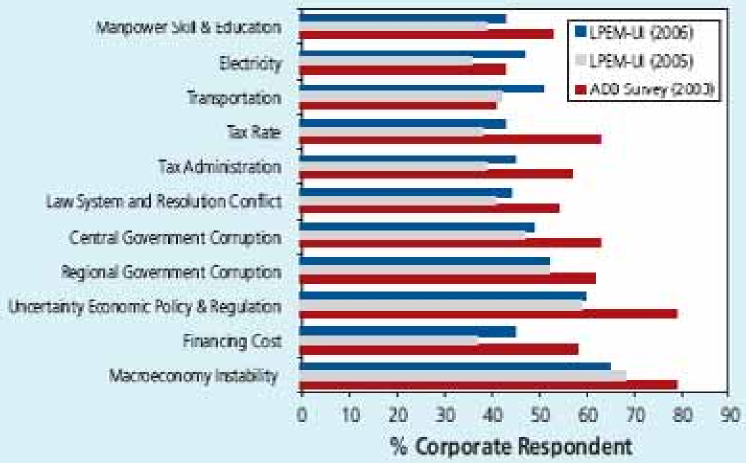


Graph 5.
Growth of GDP and Unemployment

Graph 6.
Numbers and Percentage of the Poor

There is a suggestion that such paradox of growth occurs due to structural imbalances in the Indonesian economy. Distortions caused by imperfect market structure and the presence of oligopolystic industries, which were legacies of Indonesia's economy history, have caused the economy to work only sub-optimally and restrain the market's ability to allocate resources efficiently. Such distortions limit access and broader participation in economic activities. This situation has been present for too long and thus making it easy for us to forget to address it. We must now immediately open the doors of access and invite broader participation in the economy through improvements in investment climate, licence process simplifications, and other improvements. I believe that we all understand that it is only through these means we can achieve high quality growth, which in turn will resolve the large income gap issue.

From this argument, it is clear that improving investment climate, opening easier access and broader participation in the economy are important factors in post-crisis economic recovery. Meanwhile, it has been found by non-governmental institutions such as LPEM UI and ADB that there remain many constraints to investment. The development of these constraints in the recent year hints us that the investment climate has yet to improve on a general level. Moreover, referring to the most recent survey results, illustrated on Graph 7, some of the constraints have followed an increasing trend, such as uncertainty surrounding economic policies and regulations; corruption; taxation related matters; the skills and education of human resources; infrastructure, particularly electricity and public transport; a poor legal system and protracted conflict resolution; as well as cost of financing. In connection to these survey results, we can also observe that the revision of Taxation Law; Labour Law; Customs Law; Investment Law; infrastructure improvement and future energy security; legal certainty; and the harmonisation of regulations between central and regional governments, were regarded by both domestic as well as international investors as constraints to investment activities in 2006.



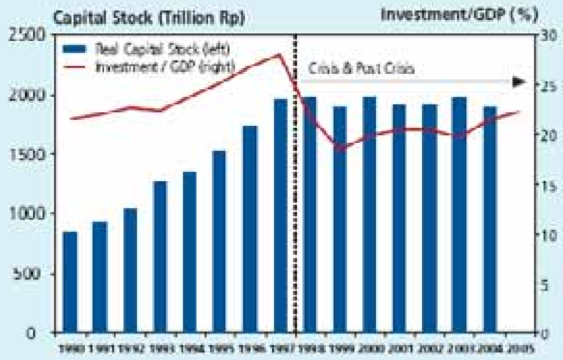
Graph 7. Investment Constraints (Survey Result of 3 Periods)

As a result of the above, investors and the banking industry; be they domestic or international, perceive the presence of high micro-structural risks in our real sectors. This is why only minimal interest abounds in long-term investments, as shown by the low growth of Foreign Direct Investment (FDI) to Indonesia in the post-crisis era, despite the very high FDI potential of other countries in the Asian region at the moment.

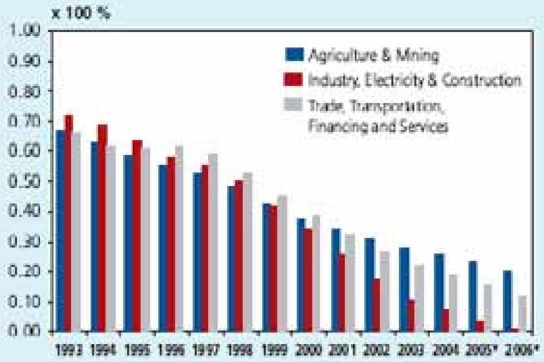
Table 2. Indonesian Position Relative to its Peer Group Survey Results of IMD *(World Competitiveness Report)*

Country	2001	2002	2003	2004	2005	2006
China	26	28	29	24	31	19
India	42	41	50	34	39	29
Indonesia	46	47	57	58	59	60
Korea	29	29	37	35	29	38
Malaysia	28	24	21	16	28	23
Philippines	39	40	49	52	49	49
Singapore	3	8	4	2	3	3
Taiwan	16	20	17	12	11	18
# Countries	*49*	*49*	*59*	*60*	*60*	*61*

Compared to other countries in the Asian region, the micro risk and distortions prevalent in the real sector have contributed to lower efficiency and productivity in the Indonesian economy. IMD survey results published in the World Competitiveness Report 2006 show that, based on economic performance, government efficiency, business environment efficiency and the infrastructure in Indonesia, our country is positioned at 60th out of 61 countries (See Table 2). Meanwhile, a World Bank survey on investment supporting factors shows that Indonesia has dropped to 135th place in 2006; from 131st in the previous year.

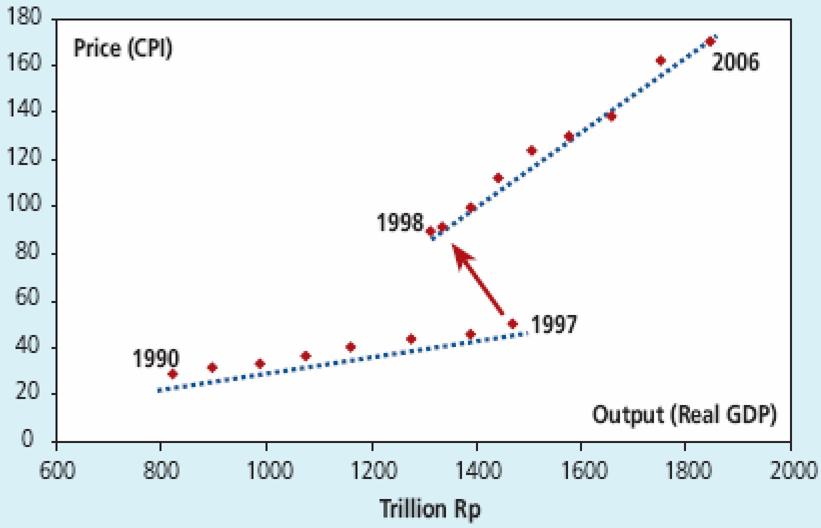


Graph 8a. Accumulation of Capital and Investment Share in GDP

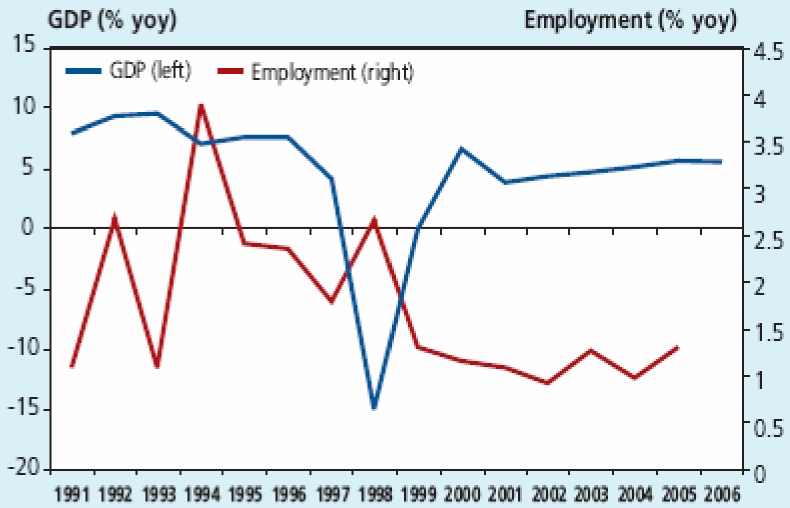


Graph 8b. Age of Productive Capital

The tribulations I have just mentioned, compounded by the passage of time, have caused a slower accumulation of capital, reflected by a stagnant investment growth, and a contraction in the share of investment in GDP (See Graph 8a), as well as a significant reduction in the quality of capital in the economy (See Graph 8b). The downside of such low accumulation and quality of capital is reflected by the phenomenon of supply side rigidity in the post-crisis economy. Such a case is illustrated in Graph 9, which shows a steeper slope in the dynamics of price and output in Indonesia in the post-crisis era. The supply side rigidity in the post-crisis economy has in turn triggered the low absorption of labour and reduced the speed of economic growth (See Graph 10). These last two aspects clearly pave the way to wide-reaching social and economic effects: Our poverty level has risen along with widening socio-economic inequalities (See Table 3).



Graph 9. Comparison of Price and Output Dynamics between 1990 & 2006 as a Reflection of Supply-Side Rigidity in the Post-Crisis Era



Graph 10.
GDP Growth and Labour Absorption

Table 3. Gini Ratio

Region/Group of Residents	2002	2003	2004	2005	2006*
40% Lowest	20.92	20.57	20.80	20.25	19.20
40% Middle	36.89	37.10	37.13	35.05	35.08
20% Highest	42.19	42.33	42.07	44.70	45.72
Gini Ratio	**0.290**	**0.320**	**0.320**	**0.340**	**0.345**

Source : BPS-Statistic Indonesia
* Projection

From a different perspective, micro risk and economic distortions, which curb investment, are also reflected by the decoupling of the financial and real sectors. Banks become reluctant to distribute funds to the real sector and tend to place their funds in low risk financial instruments, such as *SBI* and *SUN*. Bank funding to the real sector significantly drops and we are then left facing a liquidity overhang in the form of outstanding *SBI,* which currently amounts to slightly above Rp.200 trillion, forcing an imbalanced economic growth. Our economy only grows with one engine. **We are flying with only one engine**! The real sector tends to move slowly since micro-structural risk impedes on banking intermediation, whereas the financial sector continues to expand due to the constancy of funds invested into it. Such conditions are very unhealthy to our economic system as a whole if they persist.

In addition, micro risk and the structural distortions in the economy, which trigger supply side rigidity, have caused the economy to be more vulnerable to external shocks and inflationary pressures. Our core inflation rate has remained persistent. This constraint has surely affected the funding interest rate in the economy as a whole, which tends to be relatively high. This series of events have caused collective suffering for all. By looking deeper to see who will suffer the most from such situation, we can all agree that it is not morally justified. My whole argument is to reaffirm that corrections to structural distortions and improvements in investment climate are the primary determining factors of the interest rate's ability to slide naturally, whilst maintaining stability. It is through these means that a sustainable development may be realized.

Distinguished guests,

Prevailing conditions combined with our turbulent economy, noted or not, will continue to aggravate other problems in social, political and cultural life. I have noted some of the disarray in public social life that tends to prioritize the interests of a limited group compared to broader national interests. Consensus and commitment, which we have all agreed upon, are barely felt. Many of us move towards self-interest fulfilment and it is, therefore, very difficult to connect with one another to achieve our national interests. More than ever we require a common thread that can unite us as a unified country. In terms of global relations, upon seeing other countries marching forward, concern, powerlessness and a sense of alienation abound. We praise and study their successes, nevertheless we remain unable to match their lead.

Meanwhile, violent culture, self-centred social conduct, regressive ideas, extremism, intolerance and a terrible work ethic are becoming the bread and butter of this nation. Political developments in the post-crisis era have only provided a minimal level of valid rewards that could possibly affect public prosperity. Democracy, which we have adopted as the cornerstone of development, remains primarily out of reach and unable to optimise the greater interest of our nation.

These inauspicious events, which I have briefly outlined today, unfortunately have been made even worse, marked by a series of natural disasters that ripped at the heart of our beloved country. Another disaster seems to strike and rub salt in our wounds while we are still mourning and trying to recover from the one before. Earthquakes, tsunamis, long droughts, bush fires, a mud volcano, and the most recent floods and landslides, all struck in succession at different regions of the nation. The economy of the victims in the disaster areas is extremely constricted despite all the aid that has poured in. We at Bank Indonesia have asked the banking industry to provide special allowance for credits to business enterprises throughout the nation that are affected by the disaster. We hope that this will further assist them with the establishment and reconstruction of their business ventures. Regrettably, this step remains far from adequate.

Against this abhorrent backdrop, the public urgently requires a united front from all of the nation's components to share concern and hope. We all feel troubled by the crises we are facing. We need a political and cultural strategy to restore the nation's consensus and commitment, awaken the sense of importance, eliminate the feeling of being alienated, and become more receptive towards hope. For this reason, we, distinguished ladies and gentlemen, should be able to demonstrate to the public that we are performing to our fullest capacity, be it as the regulatory authority, banking, the business world, mass media, or any other key role, all in the interest of the affected masses. We must unite, help one another, and work much harder to overcome our economic pitfalls. Only by doing so will the very real hope of improvements in all aspects of our nation's life be established.

Regarding to economic issues we face, I am sure that we can all agree that coordination and cooperation with various other institutions which have the authority, expertise, and appropriate policy instruments will be instrumental in resolving those issues. It is clear that monetary and banking policies cannot resolve various structural problems related with unfavourable investment climate and distortions in the goods and services market which in turn cause high costs in the economy. Bank Indonesia, as the monetary and banking authority, has limitations in its tasks and its policy instrument's scope of reach.

In accordance with the mandate given by the Law, Bank Indonesia can only contribute to the nation through its efforts in maintaining macroeconomic and financial system stability. Still, the achievement of such a mandate will largely depend on coordination with other authorities, cooperation with various parties, and the help and support of various stakeholders. We do realize that there remain many weaknesses in the area of banking supervision, even though today's banking industry is much sounder, stronger and more profitable compared to several years ago.

III. Economic outlook for 2007

A. 2007 - a defining moment

Ladies and Gentlemen,

With respect to the overall condition and dynamics of the economy in 2006, it would not be excessive to say that 2007 is **a defining moment**: the year when capitalizing on macroeconomic stability to generate greater optimism for the lasting recovery of our nation's economy becomes essential.

In this defining moment, the journey of development for our country is entering a critical phase. Everything that we achieved back in 2006 has led us towards the middle of a bridge of hope, which we should immediately cross by expending our every effort and wholeheartedness but while exercising caution at all times. If we are able to keep pacing forward and safely across that bridge, then the hope of a better future will open wide before us. However, if we are forced to halt because of our uncertainty or loss of direction, then the proverbial bridge will crumble beneath us due to the excessive burden that we carry. We would drop back to square one and would, in fact, then face an even higher mountain to climb.

Entering 2007 means that we are entering the 10th (tenth) year since we were hit by the multi-dimensional crisis that so devastated all aspects of our nation's life. 10 (ten) years is a lengthy period of time for a nation to recover. **We need to tell ourselves that enough is enough**! Delay will only continue to marginalise and alienate our great nation in the ever increasing pace of globalization era; filled with stiffer competition between countries. Delay will crush us in time. There's only one way for us to resolve our problems. If you want to have a prosperous life, work hard! There's no substitute for a hard work. Hard work towards self-improvement is a sufficient condition on the road to better future. Therefore, 2007 is the perfect time for us to work harder with better focus and greater commitment. **It is now time to act because inaction can be fatal!**

In the midst of World War II, under extreme pressure, Sir Winston Churchill once said "**We shall prevail**". This phrase is relevant to our condition at the moment. There will not be any chance of losing sight of the prize if we grab tightly with both hands our spirit, faith and hope. The crisis ten years ago may have almost severed most of our life lines, but it could not extinguish our hopes for the future of our nation. Never have we surrendered to any predicament in the history of our nation. We have always risen from the depths to fight for our dignity and pride as a sovereign nation.

From Bank Indonesia's perspective, the macroeconomic condition in 2007 is expected to remain stable and will become the primary foundation to achieve higher growth, provided that micro risk factors and distortions in the real sector can be minimized and the investment climate improves significantly.

Economic growth in 2007 is projected to reach 6.0% (within a range of 5.7%-6.3%), which surpasses economic growth in 2005 and 2006. In the first semester of 2007, the main thrust of economic growth will stem from consumption with some assistance from private investment. Such a rise in consumption will be fostered by an upswing in public purchasing power as a result of the plan to raise the salary of civil servants and the regional minimum wage early in the first semester of 2007 and to maintain inflation at a low targeted rate. Economic growth is projected to be even more robust in the second semester of 2007 along with significant improvements in private investment and greater government capital expenditure. The expected increase in private investment will be encouraged by greater confidence among economic agents regarding improved economic prospects, but also by the positive effects brought about by a slide in both the inflation and interest rates, on top of a stable exchange rate.

Externally, exports are projected to grow steadily but remain stunted due to global economic growth, which is not as buoyant as during 2006. On the other hand, imports of goods and services are projected to rise along with a surge in domestic demand. Judging by the most recent export growth figures, which are primarily attributable to natural resource commodities, the falling trend in the prices of global commodities is projected to be offset by export of manufactured goods, as investment climate improves. A number of commodities are expected to provide the largest contribution; including textiles, electrical appliances, chemical products and machinery.

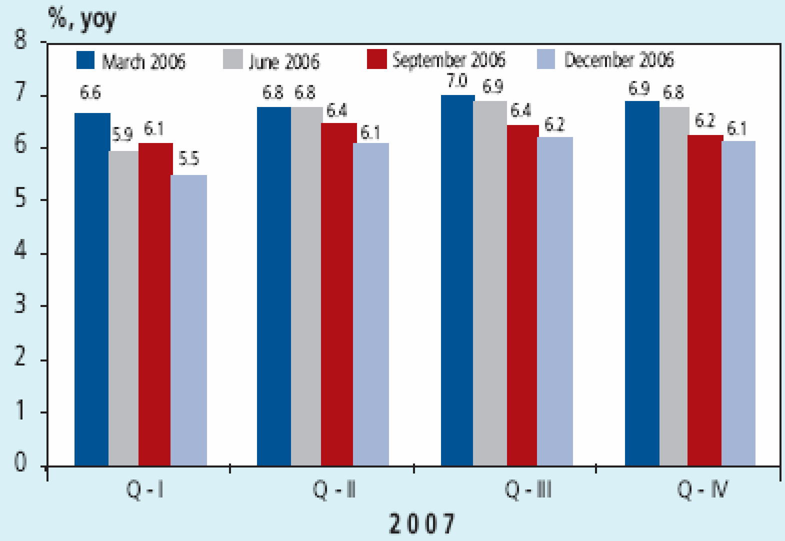
Table 4.
The Outlook of Indonesia's Balance of Payments

	2005	2006*	2007**
I. CURRENT ACCOUNT	**0.11**	**2.73**	**1.87**
II. CAPITAL & FINANCIAL ACCOUNT	**0.10**	**-0.24**	**-0.41**
III. OVERALL BALANCE	**0.16**	**3.67**	**1.46**
Memorandum Item:			
Reserve Assets Position (US$ Million)	34,724	40,422	46,466
(In Months of Imports & Official Debt Repayment)	4.4	4.3	5.0
DSR (%)	17.3	24.6	19.3

Notes: * Preliminary, ** Projection

The balance of payments in 2007 is expected to record a surplus, although not as large as the surplus in 2006 (See Table 4). The smaller surplus is attributable to an increase in import demand along with a boost in economic activities. According to our projection, the current account balance for 2007 will reach a surplus of 1,87% of GDP. As per the projected balance of payments, foreign exchange reserves in 2007 are expected to be around US$47 billion. The surplus in the balance of payments, the increase in foreign exchange reserves and market confidence in the quality of macroeconomic policy management will, in turn, support the stability of the rupiah exchange rate in 2007, which is projected to move in line with the external balance.

Greater economic activity in 2007 is not expected to add excessive pressure on prices, in general, so that CPI inflation is expected to remain within the target range set forth by the government, namely 6% ±1%. The growth in demand is expected to be offset by improvements in supply as investment climate improves and, as such, is not anticipated to heap more pressure onto core inflation. Projected CPI inflation in 2007 is also supported by the preserved inflation expectations of market players (See consensus forecast in Graph 11) and low upward pressure on administered prices along with the scrapped government plan to hike the prices of strategic administered groups of goods. In addition, inflationary pressure on the volatile foods group is estimated to be low thanks to government commitment to ensure the smooth supply of food, particularly basic necessities.



Graph 11. Projected Inflation in 2007 based on the Consensus Forecast

Nevertheless, I must underline some factors that may affect the economy in 2007. Economic growth in 2007 has the potential to surpass expectations provided that some crucial facets of the government's agenda for 2007 are implemented immediately; such as improving the investment climate; reducing economic distortions; bolstering infrastructure development, particularly energy, public transport; and, modernization of industrial machineries. Against this backdrop, Bank Indonesia predicts that economic growth may reach 6.3% with private investment as the primary driver as well as consumption

Conversely, the opposite may also be true in the form of sluggish economic growth; reaching just 5.7%, if various constraints and downside risks are unable to be mitigated. The constraints are related to production capacity flexibility in balancing the mounting demand, primarily stemming from an unchanged and unfavourable investment climate and the high-cost economy. Furthermore, economic projections for 2007 will also be influenced by the ability of the domestic economy to absorb the risks that may emerge in 2007, in particular those related to global financial flows.

Whichever scenario that would actually take place in the process, the ever increasing support role of banks to provide funding will also be a critical factor if the projections are to be realised. In 2007, credit growth is expected to reach 15%-18% with a focus on infrastructure and labor intensive - low import content sectors, such as the agricultural sector and its respective sub-sectors.

To this end, the hitherto constricted capacity and capability of particular banks to distribute funds, due to the prevailing high NPL value, should be resolved post-haste. Presently, we can witness how an array of accelerated infrastructure projects desperately require bank funding, particularly state-owned banks. If this is undertaken with proper sequencing and at a measurable pace so as not to induce macroeconomic instability, the success of these projects is predicted to generate significant multiplier effects on the dynamics of other sectors.

If the projections I have mentioned come to fruition, it is expected that the liquidity overhang and value of un-disbursed loans, which are currently rather large in the banking industry, will fall in 2007. Moreover, funding from outside the banking sector, which recently saw a rise, is expected to continue to bolster the recovery of a broad-based economy. In relation to this, the banking industry is faced with the threat of even tighter competition, be it between the actors within the banking industry or even from actors outside of the banking industry in funding provision. This requires players in the industry to look more introspectively, to judge if they can weather the storm of such stiff competition. Each actor is obliged to improve their operational efficiency, which is currently deemed as insufficient, particularly for domestic banks. Thus, a constrictive interest rate environment would immediately be followed by a fall in the banking credit interest rate, which has been suggested is rigid throughout the adjustment process. Over time, this would, in turn, boost the competitiveness of the banking industry, and the actors could enjoy a lower interest rate.

B. Direction of economic policy in 2007

With respect to the projections that I have been discussing, I would like to reiterate that distortions and the unfavourable investment climate are the primary constraints faced that could retard a balanced economic recovery in 2007. From Bank Indonesia's perspective, all of the limitations I have mentioned could hamper the array of measures taken by Bank Indonesia to achieve and preserve macroeconomic stability. The economy will become more vulnerable and less able to mitigate the range of domestic and external shocks. Our monetary policy stance would tend to be particularly cautious, especially when unexpected shocks occur that may trigger risk to price stability.

In terms of the wider national interest, it will not be possible to permanently and continuously alleviate poverty and reduce unemployment without structural improvements that slash the high-cost economy and enhance the investment climate.

I therefore see the benefits of the following policy strategy :

1. From the monetary policy side: the implementation of inflation targeting framework (ITF), within the wider structure of macroeconomic policy, is a strategic step that must continually be taken by Bank Indonesia to maintain market confidence on macroeconomic stability and overall financial system stability. A number of issues related to capital flows, exchange rates and the interest rate within a liberal capital account regime and a floating exchange rate environment should be placed in the context of global economic adjustments and the kind of macro-monetary policy response that would be appropriate to deal with them. In this context, policies that provide incentives for long-term capital flows should be prioritized over policies that punish short-term capital flows. In addition, to support the financial market development and to improve monetary policy effectiveness, we also see the need to improve the operational structure of monetary policy.
2. In terms of financial sector policy: Bank Indonesia acknowledges the importance of bolstering the financial market development to mitigate economic shocks. To this end, and by observing numerous potential shocks in the global and domestic markets over the next 1-3 years, some policies to expand and deepen the domestic financial sector need to be instituted without delay in 2007. This requires a coordinated and collaborative effort involving Bank Indonesia, government institutions and banking institutions – as the primary component of the financial sector – as well as non-bank financial institutions.
3. From the banking policy side: Bank Indonesia sees the need to promote indirect banking intermediation through diverse efforts to foster universal banking without jeopardizing the ongoing banking sector consolidation. We must also direct such endeavours to encourage financial market deepening.
4. From the government's side: the implementation of sharper government policies to reduce micro risk in the real sector through thorough improvement of the investment climate is critical in 2007, including to expedite infrastructure development and the provision of a sustainable energy supply. It is also necessary to eliminate the range of distortions in the goods and services markets expeditiously so that the high-cost economy may be suppressed immediately. Moreover, 2007 would be a great year to develop sectoral focus in the strategy and implementation of long-term national development, with more weight given to labour-intensive sectors with high local input.

On that last note over the economic outlook for 2007, allow me next to elaborate some of my thoughts on the essence of the problems and challenges that national banking needs to address this coming year.

IV. The essence of the problems and challenges facing banking in 2007

Distinguished guests,

Before profoundly focusing on the forward direction of banking industry policy, please allow me to centre our view on a broader illustration of the problem. This evening, I will not venture too deep in emphasizing the micro technical problems confronting the banking industry; something I have normally done in my speeches over the last three years. On this blessed occasion, I will try to guide your thoughts and views to participate in figuring out how the role and purpose of the banking industry are supposed to be placed in achieving the goal of national economic development.

In my understanding, our ultimate target of economic development that we strive to achieve is the establishment of "Perpetually Higher and Better Economic Development". Only with higher economic growth with a better quality of economic development can we, **together**, alleviate poverty and overcome unemployment problems.

To achieve our target will require cooperation and hard work from various parties, including the national banking industry. The role of banking has become incredibly strategic in accelerating our national economy. This is the reason why we need a healthy and robust banking system which significantly contributes to funding the economy. Such banking system will strengthen the capacity of the financial system in particular, and the economy in general in confronting multiple shocks amidst a national economy that is becoming increasingly internationalized and integrated with the global economy.

The aim of strengthening banking institutions on the one side, and optimising the banking intermediation function on the other are not two separable or debatable things; they are not dichotomous. They both resemble two sides that make up one coin as a whole. Only through strong banking, which is able to execute its intermediary role properly, can we achieve financial system stability and ensure the usefulness of banking to the general public. Throughout the past three years, Bank Indonesia has undertaken numerous measures to fortify our regulation as well as supervision of; to persist with the restructuring of individual banks; to establish sound banking industry infrastructure

Throughout 2004-2006, we have personally experienced activities which should have been concluded expeditiously but ended up protracted. Conversely, there have been activities that we thought would take a long time which were concluded swiftly. This is why we make adjustments to our policy. However, in the process of determining policy, the overarching goal, which is to build a solid and beneficial banking system, is something that we must consistently strive to achieve. In the process, policy instruments may require adjustment depending on the prevalent situation.

This restructuring process to me is a continuous and dialectic social process, which we can all dynamically comprehend and participate in. We have overcome numerous troubles and challenges, but there are even more that we must address, since it is true that "**Life is a game of improvement, not a game of perfection**". Therefore, it is quite ordinary if adjustments occur in a policy, especially when the conditions and dynamics of our environment demand so. There is, however, a contemplation that we rely on as the monetary and banking authority: we will only consider adjustments to micro policy on condition that adjustments are taken measurably and cautiously, without sacrificing macroeconomic stability as a whole and consistent in the context of the overarching goal.

In entering this defining moment, it also critical to note that in order to achieve such continuous economic growth, we require the presence of a robust formal sector which able to perform optimally. Emphasis on the informal and micro, small and medium enterprise sectors, albeit with significant growth, should be considered as a temporary supporting pillar. It is true that we must push these two sectors to become a formal sector that is thriving, large, reliable and not merely serving as a social pillar. We must also encourage the expansion of the formal industry sector so that it can absorb more of the available unemployed human resources. Regrettably, since the dynamic and developing crisis, this sector has remained insufficiently significant to achieve the desired growth. Investment in this sector is limited compared to the amount required for noteworthy growth.

Perhaps we should remain patient and wait for investment to come to this country. After all, we all are aware that the government has strong commitment and is working hard to overcome the numerous obstacles in the investment climate. However, while waiting for the investors to arrive, there is one thing that worries many parties: the snail-like pace of the banking intermediation function. Anxiety stabs at our hearts and pierces our thoughts. Why would the banking industry hesitate to utilize the available potential: while banking industry restructuring has shown its success; while infrastructure has been equipped by the presence of the Deposit Insurance Corporation and the Credit Bureau; while banking institutions have been bolstered; and amidst improving macroeconomic conditions? The pattern of banking operations still contradicts funding the consumption sector and the allocation of funds in financial markets. The latter issue reflects an unproductive, and thus unsustainable, operational pattern. Such limited operations are also, in essence, skewed away from our commonly agreed banking industry goal, namely to ensure an effective, efficient and significant banking industry for the good of the Indonesian economy.

This issue requires serious attention and immediate resolution. The banking industry would like to avoid being deemed as indifferent, insensitive and not serious in comprehending the national complexity. Apart from the existence of unresolved problems in the real sector, this condition should not be used as an excuse for banks to stagnate and cease trying to stimulate activity in the sector. Moreover, the banking industry is the most anticipated catalyst to create a breakthrough, to lure investments that will kindle corporate industry activity and take over the role of consumption that has been the spine of economic growth for the last 5 years. These hopes are not excessive considering all the efforts expended to provide us with the confidence in banks' capabilities as the primary engine driving the rise of the Indonesian economy.

The banking industry must take the reins immediately through its role in intermediation. Banking has to be able to redirect its operations from financing consumption credits and placements in financial sectors which has been representing its principal weapon for more than the past 9 years; towards a more productive way of funding working capital and investment credits. We even believe that if banks are able to raise their productive funding to Rp.150 trillion in 2007, especially towards ventures with low imports and which are highly labour intensive, then the economy will be able to expand above and beyond current projections.

To this end, banking is required to be able and willing to open up and look for new opportunities in terms of funding. Current economic demand dictates that extra effort from the banking industry is required to communicate and to better recognize the characteristics of the surrounding business world. With better recognition, I believe that the perception of banks to a high level of risk exposure in the domestic business environment can drastically be reduced. There are abundant industries out there that are waiting for assistance from banking. To name a few, there are the aquaculture industry, agriculture, plantations, mining and other industries that have always perceived banking to not be on their side. In addition, I also demand that the banking industry seek innovations in its funding products. The problem with infrastructure funding is that requires a great amount of finance, albeit vital in stimulating economic activity. I am confident, however, that it can be dealt with through the innovation of funding products by the banks themselves. A credit consortium and syndicate represent another choice for bank in reduce their risk exposure that has to be born in funding projects of relatively high value.

Therefore, in 2007 I expect bankers to work harder, be more innovative and more creative in packaging credit as well as bear credit risk exposure together. Bank Indonesia will assist all of you, with policy support, through the steps necessary, which I will elaborate on in my briefing this evening.

V. Direction of banking policy in 2007

Ladies and Gentleman,

With the desire and spirit to rise above the existing problems, allow me this evening to deliver my thoughts and views concerning measures that can be undertaken by Bank Indonesia to support national economic growth. My views comprise of 8 (eight) leading principles of policy direction and strategy, which will be enacted in the coming years.

Firstly, Bank Indonesia will more actively function as a catalyst in the process of increasing bank intermediation function towards the real sector. In facilitating bank disbursals in the financing process, Bank Indonesia will seek and dominate information as well as thoroughly observe the dynamics of the real sector, as an inseparable part of studying macroeconomic indicators. Various movements and dynamics in this sector will be analyzed, studied and monitored routinely by Bank Indonesia, since this sector can influence macro indicators.

For me, Bank Indonesia's understanding of real sector conditions, which has always been sought through research, studies and surveys as well as direct participation to observe actual conditions, need to be utilized by other parties, particularly banking institutions. BI will promote itself as the National Economic Database as well as the Information Centre of Economic Studies that is available to all parties. Against this backdrop and in addition to propagating the fruits of its labour, BI will service the requirements of its stakeholders by conducting researches and studies on various business sectors and industries, including micro, small and medium enterprises (MSME), both independently and in collaboration with the banking industry. Initiatives to establish the research subject in the various business sectors is offered to parties in need rather than by BI itself; as has been tradition. Within this framework, it would be acceptable for me to say that the banking industry is the industry most likely to fully utilize Bank Indonesia's endeavours.

In the recent decentralization era, Bank Indonesia feels the need to take a critical role in encouraging provincial business movement. Having 37 offices in provincial capital cities and other major cities in Indonesia, physical proximity between Bank Indonesia and people throughout Indonesia will be narrowed through the improvement of its role and function, as well as supporting regional economic research in order to satisfy public needs wherever we are.

For that reason, we have formulated an initiative to adjust the overall BI organization, including the initiative to revitalize the function and role of Bank Indonesia branch offices (KBI), and the possibility of opening new offices in areas whose development requires KBI support. The ability of KBI to participate as the extension of Bank Indonesia in communicating the results of research and studies on the business environment will be greatly improved. Apart from taking part in this generic role, the potential of KBI will also be sharpened in order to comprehend specific issues faced in its locale; being more active in providing advices to regional government and economic actors/agents; resolving existing issues; and providing a useful source of information to participants of the regional economy.

Through the realisation of this measure, Bank Indonesia is constantly ready to serve and utilize its significant resources. Skills, competency, data, information as well as the infrastructure held by Bank Indonesia is, in essence, nationally owned and has to be accessible for development purposes. We are also ready to place researchers from Bank Indonesia on various research projects or helping with the preparation of development policy throughout the nation. With these numerous collaborations efforts, it is hoped that the outcomes of Bank Indonesia work will be seen to support national issue resolution and directly deliver the needs of its stakeholders.

We realize that the decentralization phenomenon present amidst the pace of globalization and economic democratization requires advanced economic management. Currently, without questioning their readiness, regions have been directly faced with global competition. For instance, the tourism industry in Bali directly competes with Phuket in Thailand. The dried fruits industry in East Java has to jockey with the same industry in Cebu Philippines. Without adequate knowledge regarding the state of the competition and various upcoming challenges, as well as guidance in confronting those obstacles, it is possible that regional industries will experience uncertainty or even make unfeasible moves that can weaken their competitiveness in international trade. To this end, Bank Indonesia will participate and conduct real sector studies from the perspective of regional uniqueness and niches.

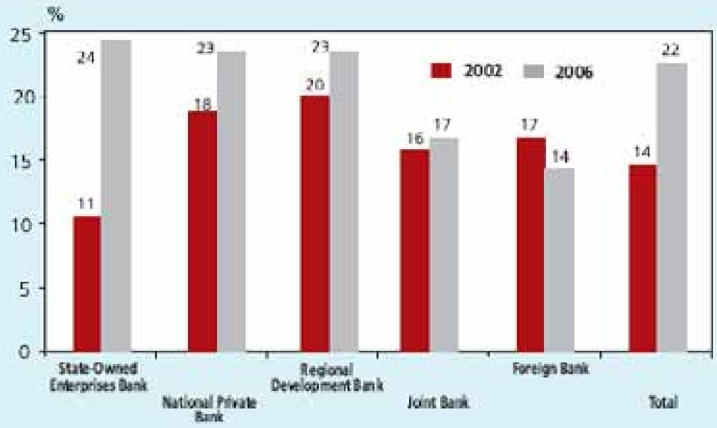
The **second** strategy and direction of policy which will be taken in the coming year is to collaborate and coordinate with the government in order to reorganize the national banking industry through the revitalization of existing banks and their role, especially state-owned banks.

We fully support and openly welcome the policy steps taken by government to improve the performance of state-owned banks. In our view, the rejuvenation of state-owned banks is a step that needs to be taken immediately, especially due to their strategic role and position in the national banking industry. At present, the total assets of state-owned banks amount to 37% of the total assets of the banking industry with share of credits at almost the same level of around 36%. We have a high expectation that state-owned banks are capable of taking the lead in endorsing the bank intermediary function, which is currently sub-optimal. Furthermore, we also rely on their power and competence to fund various development projects that are in the interest of many people.

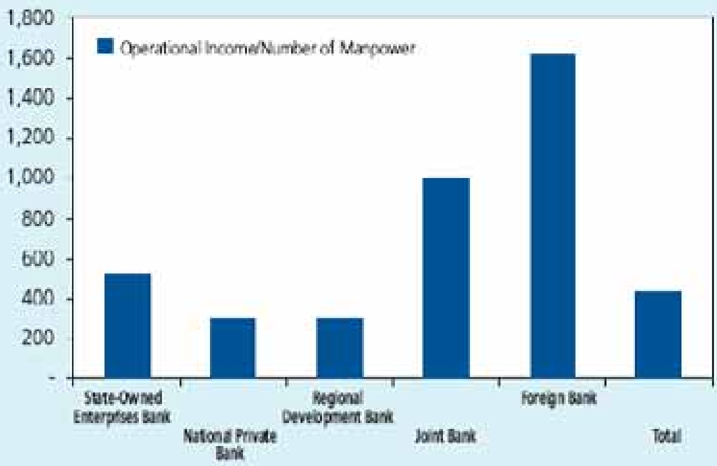
However from recent progress, we have notice that competition within the banking industry for potential customers with good track records is becoming very heated; it is neck and neck. What is noteworthy is the participation of foreign-owned banks, including joint-venture banks, adding to the competition with their readiness and strength of service.

Competition challenges from foreign-owned banks will gradually become an important factor that must be noted by domestic banks, particularly state-owned banks within the same peer group. Looking at the data, it appears that the credit allocated by foreign-owned banks is showing improvement.

One of the key strengths of foreign-owned banks in penetrating the markets is their higher efficiency level compared to state-owned banks. The efficiency of foreign-owned banks is clearly reflected by their low ratio of overhead costs to operational costs, such that they are capable of offering credit at a lower interest rate without sacrificing profit (See Graph 12 and 13). This efficiency is also supported by excellent credibility and image, so that foreign-owned banks are able to incur relatively lower costs of funds. On the other hand, the efficiency level of state-owned banks, which is relatively low at present, is associated with expenses and operational costs that must be covered. Consequently, the interest rates offered by state-owned banks are relatively higher and difficult to reduce since this would mean taking a cut in revenue. With this in mind, there is a clear gap in level of playing field between the two, which will widen if not controlled immediately.



Graph 12. Ratio of Overhead Cost over Operational Income in Banking



Graph 13.
Ratio of Workers' Efficiency in Banking

There is no other alternative for state-owned banks other than to try to keep pace with the efficiency level of foreign-owned banks. Clear policy direction and strategy has to be set without delay. Various issues that have caused soaring overhead costs in state-owned banks have to be resolved immediately. The problem of high NPL has to be rectified without delay as this represents the primary source of the higher costs in terms of the provision for bad assets. Improvements in human resource productivity as well as efficiency in utilizing information technology and other resources have to be made continually in order to attain and even surpass the efficiency level of foreign-owned banks.

Furthermore, ladies and gentlemen, the size of the bank also determines the level of efficiency achieved. First of all, in general, a larger bank is able to obtain funds at a cheaper price than the smaller banks. Secondly, larger banks are able to efficiently utilize economies of scale which allow them to split their operational costs over a larger unit. Obviously, foreign-owned banks, which mostly form part of the multinational banking industry, can optimise this advantage.

In this context, banking consolidation, which began in 2005, has become critical and must be accelerated further. We should focus our attention on the options laid out in the Single Presence Policy. We hope that an accurate choice of policy and strategy will allow existing state-owned banks to expand and become healthier, more robust and powerful that are able to serve as Indonesian banking's flag carriers and compete with the global banking industry. Meanwhile, where state-owned banks are expected to support the execution of development programs, these banks must be able to seek and discover market niches that reflect their strengths. Existing state-owned banks must have an edge in expertise, so that their very existence is felt and all elements of the community can be proud.

With regards to the consolidation process, which began three years ago, the **third** step that we are going to take in 2007 is to attempt to facilitate the merger process between banks that we deem in need of assistance. In October 2006, we issued PBI that contains a number of incentives to be distributed in the merger and consolidation process. These incentives represent our greatest endeavours in the form of banking industry initiatives to facilitate mergers, which can immediately reap concrete results.

However, if it becomes clear that in 2007 our efforts to support mergers, particularly those aimed at reducing the number of banks with systemic risk, still lack the necessary positive response, Bank Indonesia will have to become more decisively involved. The matchmaking process, which seeks compatible partners among problematic banks, needs to be facilitated in a more direct and concise way. From our data and information, both quantitative and qualitative, we will try to establish stronger, sounder and more profitable banking institutions that are the result of a useful merger. Matching business patterns, characteristics, targets and market segments are all aspects that are thoroughly considered in this process. However, this is not the case in terms of the majority shareholders' or bank owners' interests. We will exercise extreme caution in accommodating their needs. The balance of needs between one party and another is the result of an agreement that absolutely must be reached in the process. Those parties must be willing to accept and provide deal options that are mutually beneficial. This is where Bank Indonesia will try to take a role in the negotiations, which will head towards the principles of honest brokering; namely neutral, proper and optimal.

The process in its entirety will involve our role as supervisor and also as regulator of the banking industry. The supervisors in Bank Indonesia will commence work as soon as possible. Therefore, as bank owners, it would be appreciated if you could kindly be more susceptible to cooperation and coordination to achieve the results that we all strive for.

Moving on, the **fourth** step that we will take in 2007 is directed towards facilitating a smooth banking intermediary function, which has become the focal point of the problems faced by our banking industry recently. In my calculation, no fewer than seven Bank Indonesia Regulations have been issued in the past two years to provide breathing space for the banking industry in performing its primary role. I believe it is our role, distinguished ladies and gentlemen, to maintain monetary and banking stability. On the one side, we strive to be sensitive towards a plethora of difficulties faced by the banking industry in its efforts to fund development. On the other side however, we also do not wish to see the privileges and dispensation that we have granted destroy our accomplishments. Naturally, the banking industry is a risky industry, and is therefore prone to experience difficulties if not managed carefully.

With respect to these well-known industry characteristics, we strive to ensure that every policy measure taken can strike the optimal balance between the potential risk and rewards gained. For that reason, the policy we have taken this time to foster the intermediary function is not fully relaxed in nature. It is more a policy to facilitate.

One effort that can be immediately done is to study the possibility for banks to finance some specific sectors such as agriculture which until currently is still lacking of banks attention. Banks credit to this sector is still relatively small, only around 5.3% of total banks credit portfolio. Without special regulation, the agriculture sector would still find it difficult to grow, even though Indonesia has been internationally known as the agriculture nation. Even now, we still have 10 commodities which outperform other countries in the international market, providing good living to the people and generating adequate foreign exchange reserves. In this respect, focus upon agriculture sector is of relevance, at least for the time being before we can move to wider aspects of agriculture industry. We also need to consider developing agriculture sector within the context of backward and forward linkage. That is why developing partnership between small farmer and medium/large farmer along with the established agriculture corporations will serve as one major condition in developing the sector, so the efforts will not only aiming at increasing production but will also involve technical assistance, marketing as well as to improve small farmers eligibility in accessing banks' credit.

Of the policies that we will issue presently, there will be one to amend the content of a particular PBI, and one will purely be a confirmation letter on the interpretation on some regulations that we have promulgated in the past. We feel that there are numerous regulations that require commonality in interpreting and understanding the substance they are trying to achieve. Some of the regulations, for which the content we shall adjust and/or clarify include:

1. **Regulation concerning guidelines to evaluate credit collectibility**. Currently, the guideline to evaluate earning assets over Rp.500 million is based on three criterion pillars, namely prospects, debtor performance and the promptness of payment. There are also some conditions in the evaluation, such as: the obligation to submit an audit report conducted by a public accountant. As such, companies that record losses must be classified as unhealthy**.** Shortly, we are going to review these regulations and conditions and make the following adjustments:

   a. The assessment of earning assets of up to Rp.5 billion can be conducted by referring to 1 of the 3 pillars, namely the promptness of payment. The main purpose of this policy is to ease banking in the distribution of credit to potential customers of micro, small and medium enterprises, who still require the support of banking to build and develop their ventures further. To the banking industry itself, this evaluation would improve the condition of debtor collectibility; classified as unhealthy by the three pillars. The improvement in collectibility is attributable to the relaxing of this criterion, which would also reduce the burden of the provision for assets associated with the presence of NPL. Banking costs could also be minimized which would precipitate a drop in the credit interest rate offered. To the pubic, we predict that micro, small and medium enterprises make up the sector that can directly make use of this privilege. However, we need to bear in mind that all existing privileges must not influence the implementation of risk management and prudential principles that must be exercised when allocating credit. Integrity, professionalism and good governance from banking industry actors fully reflect the quality and competence of you, distinguished guests here this evening, in undertaking your responsibilities. We all realize that this is the toughness and robustness that the banking industry stands on.

   b. An exception to the three pillars is granted for financing of debtors/projects that have obtained government assurance as regulated by PBI No 7/2/PBI 2005 regarding Quality Evaluation of Commercial Banks. With this exception, development projects guaranteed by the government can easily obtain financing from the banking industry. Even a consortium to grant this syndicated credit would be simpler to assemble since the risk signals are concise and measurable.

   c. Pressures on the risk-management ability of banks in credit allocation and evaluation are comparable to the compliance of various secondary qualifications. Some of the collectibility evaluation conditions that are currently deemed as burdensome to banking will be bypassed, as long as the banking industry understands the risk exposure and is prepared with an assortment of mitigation measures as required.

2. **Adjustments to the regulations related to prudential principles** will be as follows:

   d. Raising the limit for earning asset value through uniform classification from the current value of Rp.500 million to Rp.5 billion; which is sufficient for the top 50 bank debtors.

   e. Including additional types of collateral that can be used to reduce the provision for bad assets. With respect to ongoing dynamics and prevailing conditions, the types of collateral currently regulated will be widened by including equipment and warehouse receipts, as stated in established laws and regulations.

   f. Confirming the Legal Lending Limit (LLL) at 30% of capital for state-owned enterprises that reside in the various development sectors. Currently, the banking industry gives the impression that state-owned enterprises eligible for a 30% LLL are only those related to infrastructure. In the future, a 30% LLL will be applicable not only to infrastructure related state-owned enterprises but also state-owned enterprises in other sectors.

   g. Stressing and re-explaining to related parties within LLL regarding the joint financing of some companies (including banks) on a common project. It must be understood that the financial relations of companies involved in joint financing does not restrict their relationship. Therefore, the relationships between the joint financed companies are not classified as interrelated as long as there is no other relationship restriction.

h. Reiterating that it is possible to allocate credit to problematic debtors providing that the debtors maintain good intentions and that the credit only became bad due to reasons beyond the control of the debtor. It will be possible for such debtors to be eligible for new credit but only after thorough analysis and under close supervision.

The amalgamation of the adjustment and confirmation steps I have just described to you, ladies and gentlemen, is expected to underpin the intermediary function of the banking industry, which has been constrained for many years. A holistic, thorough and accurate understanding of valid regulations should form the foundation of every strategic step we take, backed up by a legitimate argument, without over-regulating to maintain stability.

To this end, we internally at Bank Indonesia will also strive to build the capacity of our supervisors in terms of seeing, comprehending and interpreting the existing risk exposure. This way the gap between the supervisor and supervisee of perception and comprehension, utilizing prudential signs when reviewing potential credit, can be eliminated.

The hopes rested on the banking sector to improve the intermediary function are also applicable to foreign-owned banks. Since 2006, this challenge seems to have been addressed positively by the foreign-owned banks. Therefore, the burgeoning credit allocation to productive sectors by foreign-owned banks is very encouraging to see. To maintain the continuity of this wonderful momentum, our **fifth** step in the coming year is to provide guidance to foreign banks to contribute more optimally to the development of the Indonesian economy. It is about time that foreign banks in Indonesia be better focused on more productive and useful endeavours to their host country, especially in their respective position that has dominated the ownership of banks in Indonesia. It is not excessive for us to expect foreign-owned banks to improve their commitment and compliance to support the funding of national development.

Furthermore, the escalating number of foreign-owned banks in Indonesia raises concerns regarding the work opportunities of the domestic professional workforce. The current soaring unemployment rate in Indonesia urges us to ask foreign banks to think about and cooperate to overcome this situation. Concerns of a lull in work opportunities for the local workforce are escalating along with the rising number of foreigners in the Indonesian banking industry. As per what we promised back in 2006, this problem will have to be addressed through a special policy aimed at limiting the number of foreign workers at the middle management level; which is two levels below the director, except in fields that have proven to be beyond the capabilities of local workers due their rare nature or scarce expertise. Such tenures are limited to a maximum of three years. Using this time frame will force banks that utilize foreign workers in middle management to transfer the knowledge and technology to local employees.

The **sixth** strategic step that will be taken in the near future is to more proactively develop the financial market as well as financial instruments. As I briefly mentioned earlier, our economic recovery in the future calls for a sound, healthy and deep national financial sector that can effectively mitigate the negative effects of shocks in the global financial market. There are currently other implications of a shallow financial market, especially amidst high micro risk. The implications include the constriction of economic funding for long-term investment and less effective monetary policy transmission mechanisms.

The limited numbers of financial products with various durations, as well as primary and secondary markets that support trading, have triggered excess funds to the *SBI* market and short-term portfolio placements. This has pushed the real sector of the economy to rely on consumption stemming from the wealth effect in the financial sector.

Meanwhile, the liquidity overhang in the financial sector, particularly in the banking sector, has reached an alarming level as banking only focuses on short-term financial activities, particularly the short-term deposit market and *SBI* market, without distributing credit for investment.

To address the issues above, I am convinced that the policy to deepen the domestic financial market, as well as to develop innovative financial products, can be a strategic step that will support investment in real sector, which, in turn, may reduce the liquidity overhang. Efforts that can be made to deepen the domestic financial market and widen its products range include issuing SPN and fostering *SBI* of the longer term durations; providing an effective regulatory environment for financial product development that covers medium-term notes, corporate bonds and commercial papers; and providing a greater opportunity for activities related to asset securitization, universal banking and the growth of sharia-based financial instruments. These steps clearly require collaborative efforts from Bank Indonesia, the government as well as banking and non-bank financial institutions. In relation to this, Bank Indonesia will incorporate the issue of financial market development in the Banking Law.

The **seventh** strategic step concerns policy and strategy related to the expansion of sharia banking. Witnessing the rapid growth of the sharia banking industry in our nation, Bank Indonesia believes that it is necessary to expedite such growth in order for the public to reap even greater benefits. We estimate that the total assets of sharia banking, which currently account for about 1.5% of total banking assets, to increase to at least 5% by the end of 2008. Consequently, we will conduct an accelerated program of sharia banking, which will be effectively carried out beginning in 2007. The program to accelerate the expansion of Indonesian sharia banking will be undertaken through three key measures:

First, through more intensive societal education regarding sharia banking. This measure will be taken to improve public understanding and awareness of sharia financing and banking. **Second**, we will stress a review of sharia products, sharia financing services, and encourage the expansion of service outlets to boost the accessibility of sharia banks in line with the public requirement. And **third**, Bank Indonesia will actively participate in supporting incoming foreign investment through sharia financial instruments.

Through these three measures, we hope to make sharia banking the pride of its followers. Sharia banking is not a flash-in-the-pan but something truly monumental, with comparable quality and reach to conventional banking. Sharia banking products and services have to be attractive and formulated in line with public demand. In essence, better realization and understanding from society precipitates greater, real and effective, demand from the public.

In this context I would like to invite you all, distinguished ladies and gentlemen, to actively participate and work hard together to improve integrity, so that the existence of higher quality and more useful sharia banking can be established in society. A unified vision from all stakeholders is crucial when establishing a sound and efficient sharia banking system, considering how sharia banking can position itself as a solution provider. In turn, such circumstances will create a sense of belonging in the community towards sharia banking.

Last but not least, the policy to be implemented in 2007 is associated with the existence of a rural banking industry and its relation to the livelihoods of rural people who are involved in the informal business sector.

We cannot hide the truth that the informal business sector exists and, in fact, supports most of our people's livelihoods. I would even like to note that this sector is indeed a form of social safety net which allows our people to have dreams, hopes and optimism to survive in their, often difficult, journey through life. Small-scale farmers in villages, traders in traditional markets, cigarette sellers, small-scale grocery vendors and many other agricultural labourers are marginalized by the situation and indeed make up the largest segment of our society. If we want to alleviate the drudgery and improve the quality of life of our people, this is the sector which we must focus our attention. These people are currently in furthermost row; however it is time to now put them on the forefront in our policies. Putting the last first.

Understanding the dynamics of rural people's lives should be redefined within the context of their relationship with rural banks. Due to the size and specific criteria of commercial banks it is almost impossible for them to finance the informal business sector. We have noticed that credit disbursement to informal sectors requires a particular approach and strategy that are specific to the conditions of these particular sectors, without ignoring the significance of the risk-management system. Prudential principles must reflect market characteristics for which they serve. If a commercial bank client's track record is obtained through standard mechanisms, then the track record of clients or potential clients of BPRs may be sought through the social system established in the society. A supporting empirical fact to this is that BPRs are located within proximity to their clients, furthermore, the BPR's employees are recruited from the banks immediate surrounding. From the very beginning, we have to realize that the relatively small business size of rural banks which located in a specific and limited social environment; are the rural banks' competitive advantage over commercial banks. Advanced rural banks do not existentially have to operate like commercial banks.

Therefore, going forward, we will review regulations concerning the development of BPRs in increasing its role and contribution as a Micro Finance Agent (LKM). It is hoped that BPRs will be able to maintain the interest of the Small and Medium Enterprises (SME) and the village community and be as agile as other LKM's in meeting the public's needs.

Good functioning BPRs and LKMs must be able to distribute themselves across the country. Indonesia has more than 60.000 villages, however formal banking services have only reached less than 10.000 locations. Therefore, expansion in BPR and LKM's reach is a concrete answer to the SME and village community's need in general.

One of the efforts Bank Indonesia has implemented to support BPR growth is the Linkage Program. The Program entails the channeling of credits to Micro, Small, and Medium Enterprises from Commercial Banks or from Syariah Commercial Banks to BPRs or Syariah BPRs. Without compromising prudential principles, efficiencies and synergies are created from these relationships.

Against this backdrop, the policy direction applied by Bank Indonesia is to redirect the role, function and operational design of rural banks to their fundamental purpose, that is, to serve the common people, particularly those in informal sectors and living in remote areas. The role of rural banks, which was initially to satisfy the financial needs of the common people and in the past primarily meant the informal financial sector, has to be reutilized. The relationship between rural banks and the informal financial sector has to become complementary, looking for assistance and complementing each other to best serve ordinary people.

Meanwhile, as we see the BPRs develop, another issue will need to earn our attention. This is the prevalence of other forms of Micro Finance Institutions (LKMs) which behave very similar to a bank in the sense that they mobilize public funds. Examples include Savings & Loans Cooperations (KSP), Baitul Maal Tamwiil (BMT), Community Credit Institutions (BKD), and Community Funding Body (LPD). The number of the aforementioned institutions reaches not less than 10.000. On the one hand such prevalence provides an array of variations of non-bank financial institutions which add to Micro and Small Enterprises and communities in villages funding alternatives. Its unique characteristics and closeness to the village community enables various LKM's to continue to exist in various communities. However, on the other hand, such LKM's come with its problems, such as lack of clarity as to their various types, forms, and its supervisory authority. Such condition creates situations whereby protection for LKM's stakeholders and the LKM itself are weak. This issue should receive our attention here, ladies and gentlemen. Moving forward, regulation towards various LKMs need to be strengthened.

With that as a background, and also taking into consideration that two years ago was the Year of Micro Credit, we must move quickly and complete initiatives started in 2001 and finalize the Draft for the Law on LKM to become the Law on LKM. I feel that this is worthy of your and our support.

VI. Conclusion

Ladies and Gentlemen, Fellow bankers,

This is what I can convey this evening. While reviewing the set of problems and challenges we face, we all realize that the years to come will not necessarily be any easier than the years that have passed us by. An array of measures to achieve policy success, both from the government and Bank Indonesia, require your unrelenting support and cooperation throughout their execution.

Therefore, we are always open to suggestions and recommendations regarding any of the policies that we have promulgated. We now have time, be it through this informal forum, breakfast meetings with bankers, or chief editors meeting with the mass media; to discuss the various issues raised here this evening. I expect that the existence of such avenues of discussion will minimize any potential arguments and differences that seem to be picked up by and dominate the mass media, which, in turn, do nothing but confuse the general public.

I would also like to take this opportunity to express that in confronting future challenges, we need the involvement and participation of all public elements, including the press. The complexity of our problems requires agents and institutions that never cease worrying or reminding us about them. This is where the role and contribution of the press becomes crucial. The press have the concerns of the common man at heart and therefore always ask questions. The press play a strategic role in building social infrastructure and democracy by remaining impartial and sensitive, always paying attention and constantly reminding us all about the importance of common principals and goals in establishing public prosperity.

An inspiring press core is crucial for the people, especially to us as the policymakers. Constructive reviews from press agents regarding the choices laid bare before us, with their accurate and objective explanations, will make it easier for society as a whole to face the challenges that obstruct the journey ahead. For that reason, I would like to express my appreciation to the press core that has helped us glean enlightened information throughout the years. I hope that the press remain constant in fighting for the establishment of public prosperity. I hope that constructive cooperation may endure into the future between us all.

Finally, let us all work harder and collectively to shoulder this nation, which is currently at a crossroads, towards a new and better horizon.

This is an example of how our attitudes must be in terms of progressing into the New Year. We should keep striving to resolve national problems. National banking, on the one side, will continue to clean house and reorganise itself to re-establish its role as a significant intermediary institution. On the other side, Bank Indonesia will strive to consistently steer the required improvements in a disciplined manner.

Once again, Happy New Year for 2007. May Allah SWT bless us all and help illuminate our steps towards a better future. Thank you.

Wassalamu'alaikum wr. wb.