Burhanuddin Abdullah: Opening the path to stability, safeguarding the nation's economic development

Speech by Mr Burhanuddin Abdullah, Governor of Bank Indonesia, at the 2008 Annual Bankers' Dinner, Jakarta, 18 January 2008.

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Assalamu'alaikum wr.wb,

Good evening and may I wish you all a triumphant year ahead,

I. Introduction

To open my speech here today held in such salubrious settings, I would like to invite you all to join me in expressing thanks and praise to God Almighty who has again blessed us with the chance to congregate here for the 2008 Annual Bankers' Dinner. Taking advantage of such a wonderful opportunity and on behalf of the Board of Governors of Bank Indonesia, please allow me to wish you a very happy and prosperous year ahead in 2008. May you be blessed in every step that you take.

Ladies and Gentlemen,

In distinction from previous years, tonight is an exceptional one for me. Tonight marks the fifth time I stand here in the presence of you, distinguished ladies and gentlemen, to deliver my annual address. The five years has flown by. Unsuspectingly, this year is the final year of my tenure as the Governor of Bank Indonesia.

Together we have traveled far on our arduous journey. We have faced numerous trials and tribulations one after another. Some brought immense satisfaction, while others yielded grave disappointment. Together we have come to understand that the wide ranging and compelling changes in the global and national constellation over the past ten years have delivered new challenges in terms of managing national economic stability. Fluctuations and uncertainty seem to be a constant that incessantly shadows us along with the prevailing shifts and changes. Nevertheless, we should be grateful. Solid collaboration and close coordination, based on common understanding, have become fundamental elements in establishing and maintaining monetary, banking and payment system stability by Bank Indonesia.

Therefore, prior to delivering the main substance of my annual address this evening, please allow me to express my sincere appreciation to the banking community who has been so incredibly supportive of Bank Indonesia's policy measures in terms of reinforcing and driving the banking industry's performance in general. I would also like to offer praise and my highest admiration to all elements of the Central and Local Government, the Parliament, business community, academics, observers, the media and all other parties that I am, unfortunately, unable to acknowledge individually, who have provided technical and strategic support to Bank Indonesia in fulfilling its duties.

Ladies and Gentlemen,

It was ten years ago when our nation started to march towards the rise of a new democratic community in Asia. It is from early this year we witness the rise of Indonesia as a new economic star in Asia. We thank God that our beloved country has finally closed the final chapter of the painful Asian crisis. We pray that, God willing, it is closed for good.

We have now entered a new era, one that will be better than the past. Early on we are witness of several encouraging economic achievements. Our economy has started to gain speed using both its engine – its stability engine and growth engine – It is no surprise that many passengers aboard and bystanders outside are surprised by the acceleration taking place. For the first time since the Asian Economic Crisis, economic growth in Indonesia has surpassed 6% annually. Meanwhile, in the past five years, we have been witness to bold macro economic developments despite the various encounters of hardships. The financial system resilience and stability are now in much better shape than that of pre-crisis. We now can make note that the national banking industry has withstood and even held back impacts of significant shocks. We are thus able to say that stronger resilience is within our national economy.

Ladies and Gentlemen,

The new Indonesia of the 21st century holds many hopes and opportunities. As such, the eyes of the world are steadily focused on us as we take steps to our future. All that we have achieved by deconstructing institutions of the past, and constructing new ones, and doing this in the midst of a true democracy, is definitely not something to be given only light regard. We have now become a reference for countries of the third world on how democracy and positive achievements in the economy go hand in hand. Our country's history and surrounding *polity* has never, until now, traveled this road before.

The early years following the 1945 Proclamation of Independence have actually seen democratic life, as the one we see today. The period after the 1945 Proclamation of Independence to the mid 1950's are penned in our national history as the time in which political openness and democracy were part of this nation's everyday lives. A multiparty political system was in close harmony with strong spirits of civility. Life within our nation then was filled with dialogues, arguments on the nation's ideals, and exchange of thoughts amongst first class intellectuals which were political elites revered for their wide horizons in the era they were in. It was during this era that our Nation and its Founding Fathers were Asia's ray of lights, which later scripted in gold as what sparked the Asia-Africa spirit.

However, we must admittedly write in our books that the period of openness, democracy, and civility did not last long as there was a lack of seriousness in planning and implementing economic development for the benefits of the society in general. Political freedom was emphasized over economic development which resulted into a free, open, and democratic country, but one with no real improvements towards the welfare of the people. This oversight led us to the 1960's which was marked by the deterioration in nation's social, political, and economic life.

It is during the next era that history writes about the positive dynamics of the New Order development. From the end of the 1970s, we had been able to come closer to fulfilling our promise of independence with the quality of life improvements and economic prosperity for the people. In the next decade until the mid 1990s, the world was witness to the contributions of Indonesia as one of the Tigers in Asia's economic-political arena. However, it was also during the three decades of the New Order era that the urgency to develop open and democratic political system was lost. This oversight eventually led us to a severe economic and political crisis.

In that journey through our labyrinth of collective memory, we find many contradictions regarding who should take role as captain of our nation ship. "The economy as captain or politics as captain" is the coffee shop debate that has kept us amused for some time. However, something very different has arisen in the last five years. In our minds and hearts, we perceive a fundamental change in the life in our nation-state which represents a break from the past.

The difference lies in the fact that, over the last five years, there has been a consolidation of political life in a free and open democracy taking place alongside an increasingly solid economic consolidation. On one side we are once again living in a free and open democratic society. We have also implemented regional autonomy and economic decentralization. We have elected the president and head of regions through direct election, while the press enjoys greater freedom and is maturing at noticeable pace. Alongside, the economy continues to grow while economic stability is maintained. We even have formulated and implemented economic policies without the guidance and interference of foreign parties, such as the IMF, whose interest often lie incongruously with that of the people of Indonesia. The period we were in IMF's Extended Fund Facility until the completion of the Post-Program Monitoring represents a trying time in our nation's history. During that era, we were not able to formulate and implement adjustment policies with a scope and pace which were in complete agreement with the interests of and needs of the Indonesian people. Many compromises were demanded and many of them did not fully benefit our nation's interest, but rather, only the interest of various other parties. The hand below is never the hand of dignity. Never again do we to live in an era in which our people and nation-state were reduced in dignity. Democracy, openness, freedom, and the courage for sovereignty in public policy have made us become our true selves, with many opportunities to achieve prosperity for all Indonesians. This brings proof of validity to what our Founding Fathers have believed in all along. We must always maintain the right view and attitude in fulfilling the promise of freedom and independence – something for which our Founding Fathers have fought dearly.

Admittedly, if we only look at the figures, at this point, what we have achieved is far from dramatic. However, behind such developments emerge a strategic shift. We have gradually strengthened our state institutions, which has enabled us to take continuous steps forward towards more sustainable improvements, and thus reducing *ad-hoc* actions. Various institutions, Bank Indonesia included, have taken gradual steps towards improvements, which will then continue to take place in all essential fields. In almost the same context with Muhammad Hatta's view regarding Indonesia's 1945 Revolution, our ability to put democracy parallel with prosperity becomes "a link of a long chain of fundamental and significant changes" in the life of people in other developing countries in Asia and Africa in the future.

Therefore, we should be uplifted by such an extraordinary achievement; one that was achieved by our own initiatives and hard work. We are also thankful to God for giving us such a rare opportunity. As one of only a handful of democratic developing economies and one of the largest republic in Asia, it is appropriate that in the future we continue to strive towards further identifying our strengths and abilities to autonomously determine our own choices and take unerring decisions in the interest of our nation. It has been our belief since the 1945 Proclamation of Independence that the sustainability of the Republic will be better guaranteed if democracy is upheld. Such was the case during the past five years.

It also befalls on us to use the success thus far achieved as priceless capital to prepare our future steps and answer the challenges of the 21st century. Founding Fathers of this nation, Sutan Sjahrir, Soekarno and Muhammad Hatta, once said that the independence of Indonesia as a nation-state in 1945 is but a vehicle to achieve the independence of the people of Indonesia. However, 62 years after the 1945 Proclamation of Independence, a great many of the people find themselves longing for an order which allows them to gain their independence. Such would be from a nation-state which provides prosperity and educates the majority, and not minority, of the people. Such longing is our biggest challenge and is also a call of history to us all.

Ladies and Gentlemen,

For me personally, my journey in leading Bank Indonesia, a state institution mandated by the public to maintain national economic stability, is an extremely precious experience. The experience has bestowed upon me a deeper understanding of our economic dynamics, current and upcoming challenges and opportunities, as well as the means to accomplish the aspirations of the general public, namely improved welfare for all Indonesians. And of course as a citizen of this great nation myself, the mandate has also provided great honor and opportunity for me to pay homage to our nation and all Indonesians.

This evening, the time has come for me to reflect on what Bank Indonesia has achieved in my five years of leadership. It would not be excessive to say that I would like to make this a part of my moral responsibility to the stakeholders of Bank Indonesia. Tonight, I will also present views regarding the economic prospects and challenges to be faced over the next five years and their implications on Bank Indonesia. I genuinely hope that the future perspective I plan to present here this evening can serve as a contribution for us all in determining some common measures to achieve a better national economic future.

The theme of my oration this evening is **"Opening the Path to Stability, Safeguarding the Nation's Economic Development".** As for the systematic of my presentation, at the beginning I would like to reopen pages of my work log and take you all on the journey of Bank Indonesia in fulfilling its constitutional mission over the last five years. Some of the questions my comments are based upon include: What policy initiatives have been adopted and what are their considering factors? How far has progress been achieved in its implementation? What has it contributed to the overall process of economic growth in the post crisis era?

In the subsequent part, I would like to address future economic prospects and challenges, as well as measures that need to be taken by Bank Indonesia to ensure that the institution remains an integral part of the solution to the nation's economic woes. Several of the challenges are not totally new since they have persisted for some time and continue to persist to this day. In the future, however, such challenges could intensify further, and therefore the urgency of our preparedness will become critical.

Finally, prior to concluding my address here this evening, I would like to present some views on possible follow-up measures and policies that I believe need to be taken over the next five years; giving 2008 new momentum for the establishment of Bank Indonesia that is more relevant for the prosperity of all Indonesians.

II. A recap of Bank Indonesia task implementation 2003-2007

1. National economic achievements

Ladies and Gentlemen,

At the beginning of 2007 we had restored macroeconomic stability following the global oil price hikes towards the end of 2005 and minimized their effects on the exchange rate, inflation and interest rate up to mid 2006. Then, you may recall, on this very same occasion last year, I likened our economic condition in 2006 to an airplane flying on just a single engine. On one side we had succeeded in restoring macroeconomic conditions back on track. However, due to intricate micro and structural challenges in the economy, the pace and quality of economic growth was still below expectations. Furthermore, productive business activity in the real sector was quite sluggish.

At the beginning of 2008, we should all be grateful for closing 2007 behind satisfactory accomplishments as evident by primary economic indicators (Table 1). As such, maintaining our airplane analogy, our economic airplane has started to soar with both engines running. Consequently, it should not be completely unexpected that many of its passengers are shocked by the new found acceleration.

Allow me to briefly present several salient economic achievements up to the end of 2007.

Regarding economic growth, for the first time since the Asian Economic Crisis, economic growth in Indonesia has surpassed 6% annually, reaching 6.3% in 2007. The growth is characterized by a balance between demand and supply, as reflected by the resilience of consumption expenditure followed by favorable growth in investment. The realization of Gross Fixed Capital Formation (GFCF) through 2007 increased by 8.37%, while private investment grew 7.18% from last year's level. Such growth caused the investment to GDP ratio to rise from 19.5% in 2003 to 23% in 2007. Widespread diversification is also evident in the economy. Therefore, despite a manufacturing sector that has not yet fully recovered, many other sectors have developed and consequently supported wealth creation in our economy throughout 2007. Such diversification is verified by expansion in the mining, trade, telecommunications, transportation, utilities, construction and services sectors. All the improvements gained in the real sector have provided strong initial indications that structural constraints stemming from the microeconomic side (supply side constraints) are improving.

Table 1.
Main Economic Indicators

Indicators	2002	2003	2004	2005	2006	2007*
Macro						
GDP (% - yoy)	4.38	4.72	5.03	5.68	5.48	6.3
Inflation (% - yoy)	10.03	5.06	6.40	17.11	6.60	6.59
External						
Export (Billion USD)	59,165	64,109	70,767	86,995	103,514	118,937
Import (Billion USD)	35,652	39,546	50,615	69,462	73,868	86,354
Debt to GDP ratio (%)	65,71	57,01	53,40	45,12	35,28	31,3
Foreign Reserve (Billion USD)	32,039	36,296	36,320	34,724	42,586	56,900
Exchange Rate	8.950	8.570	8.948	9.713	9.167	9.140
Government Finance						
Revenue (Billion Rp)	298,605	341,396	403,367	495,224	637,796	
Spending (Billion Rp)	322,180	376,505	427,177	509,632	670,591	
Budget Deficit/Surplus (%of GDP)	-1.3	-1.7	-1.0	-0.5	-1.0	-1.1
Financial Market						
Yield Global SUN (%)**	6.08	4.72	3.71	4.92	5.93	5.89
JSX Index	425	692	1,000	1,163	1,806	2,746

Net:
* Position as of December (estimation)
**Since 2006 using global bond due in 2014

Externally, the Indonesian balance of payments (BoP) has run a surplus for four years consecutively. At the end of 2007, the BoP surplus was 3.1% of GDP, giving a surplus for the past three years of 2.4% of GDP. Net capital inflows to the financial markets, direct capital investment, net exports, and the net remittance from Indonesian migrant workers have all contributed to positive BoP performance. In this respect we can observe that Indonesian non oil and gas exports remained high amidst a slowing global economy. This shows that the destination countries for our exports have become more diversified, negating some of the adverse effects of the economic slowdown in developed countries, which has also been compensated by exports to countries with high economic growth such as China and India. Impressive BoP performance over the past four years has provided room for us to fund development activities, service our foreign debt without triggering significant fluctuations in the foreign exchange market, strengthen our position through additional foreign exchange reserves, and most importantly, through the contribution of net remittance inflows from migrant workers, the resilience of domestic demand in the national economy has been maintained. Regarding foreign exchanges reserves, I would like to announce that by the end of 2007, our foreign exchange reserves had reached USD 56.9 billion; equal to 5.7 months of imports and servicing of the government's foreign debt.

Strong BoP performance has also provided the opportunity for us to expedite servicing the debt to IMF in 2006. This was taken through careful calculations in the spirit of public policy independence and confidence in future economic performance. Payments due over the next 3.5 years were serviced on 12th October 2006. Consequently, Indonesia no longer has to comply with the programs in the IMF Letter of Intent. Although debt repayments to IMF were finalized, financial market conditions remain stable and foreign exchange reserves have continued to grow.

More balanced economic growth, a balance of payments surplus, and a healthy foreign exchange reserve position have largely assisted efforts to preserve rupiah stability, especially over the mid to long term. Over the past five years, with the exception of 2005 which was marked by severe global oil price hikes, headline inflation, measured by the Consumer Price Index, and core inflation recorded 6.19% and 6.28% annually, compared to an annual average during the pre-crisis era of 8.21% and 9.13% respectively.

Meanwhile, ignoring exchange rate fluctuations in 2005, the rupiah exchange rate in the past five years appears to have been well maintained within a range conducive to maintaining the internal and external balance of our macro economy. Furthermore, rupiah exchange volatility is currently far below that of the early years following the crisis. Overall, this provides greater certainty to business players in the real and the financial sector regarding the average exchange rate in the long run. Therefore, I would like to state that the positive developments occurring in the inflation and exchange rates have subsequently supported the management of expectations regarding macroeconomic stability and underpinned the competitiveness of exports in the mid to long term .

If we observe the progress made by banks, at least since the beginning of 2004, it would be a fair assessment to assert that the current growth in banking indicators is satisfactory (Table 2). Growth in total bank assets has increased sharply by 60%, from Rp737.85 trillion (63.7%) to Rp1,895 trillion in November 2007. Meanwhile, credit has expanded by Rp529.6 trillion; more than twice its level in 2004 to Rp1,004.6 trillion at the end of last year. The expansion in credit extension was supported by a rise in deposits by Rp551 trillion or 62% compared to its level in 2004 and thereby making the level of deposits Rp1,437.5 trillion in November 2007.

Table 2.

Perkembangan Indikator Utama Perbankan

Indicators	Dec 2002	Dec 2003	Dec 2004	Dec 2005	Dec 2006	Nov 2007
Credit (T Rp)	410.3	477.2	595.1	730.2	832.9	1.004.6
Third Party Deposits (T Rp)	835.8	888.6	963.1	1,127.9	1,287.0	1,437.5
NPL Gross (%)	8.1	8.2	5.8	8.3	7.0	5.4
NPL Nett (%)	2.1	3.0	1.7	4.8	3.6	2.3
Interest (Work. Cap.) (%)*	18.3	15.1	13.4	16.2	15.1	13.2
Interest (Investment) (%) *	17.8	15.7	14.1	15.7	15.1	13.3
Interest (Consumption) (%)*	20.2	18.7	16.6	16.8	17.6	16.3
Number of Banks**		138.0	133.0	131.0	130.0	128.0

*) As of October 2007

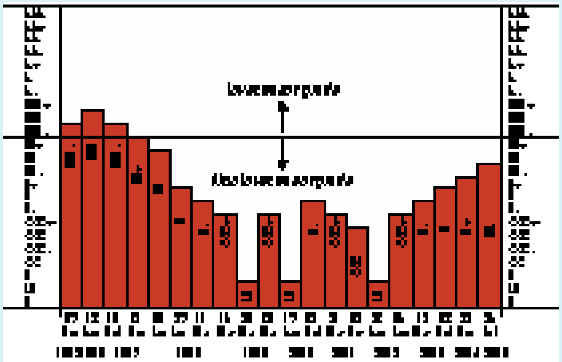
**) As of the above date there are 16 banks with capital below Rp. 80 bill.

Throughout 2007, supported by a decline in the BI rate along with macroeconomic stability, credit grew according to the targets set by banks at the beginning of the year and recorded growth of 24.3%. The recent noteworthy credit growth indicates that banks have returned to contributing significantly to the funding of overall national development.

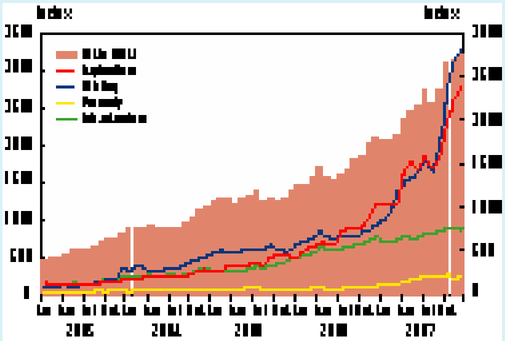
One aspect that requires attention in regards to bank performance up to the end of 2007 is that bank stability in the post-crisis era already far exceeds that of the pre-crisis era. Nowadays, the majority of banks maintain their capital adequacy at a high level, with an average CAR in the range of 19.5%. Total assets have experienced a substantial increase of 11.9% to Rp1,845 trillion. Regarding profitability, bank ROA has risen from 2.6% to 2.8%, which generally stems from improvements in the efficiency of operational banking activities. Meanwhile, bank NPL has performed satisfactorily, improving from 6.98% (gross) and 3.63% (net) to 5.41% and 2.29% respectively. This is primarily attributable to the implementation of government legislation, namely PP No. 33, 2006, by government-owned banks. Moreover, banks have also been able to absorb the numerous substantial fluctuations in the economy such as oil price hikes and their follow-through effects on the exchange rate, inflation and the interest rate, as well as the contagion effects of the subprime mortgage crisis in the US. This resilience is tightly enshrined in our ever improving bank risk management capability and prudential principles that are strictly enforced throughout the national banking industry.

Ladies and Gentlemen,

Maintained macroeconomic stability coupled with a sounder and more resilient banking industry has restored investor confidence regarding the future prospects of the Indonesian economy. This is strongly reflected by the improvement in Indonesia's rating awarded by international ratings agencies. Currently Indonesia is approaching investment grade and closing in on the pre-crisis level (Graph 1). Notwithstanding, along with strong corporate profits and positive future expectations, investor confidence is also high due to the resurgent global excess liquidity inflows to Indonesian financial markets, making the JSX Composite one of the best performing indices in the world (Graph 2). Several sub-sectors that support the improvement of the JSX Composite confirm the existence of diversification in the sources of wealth creation in the economy.

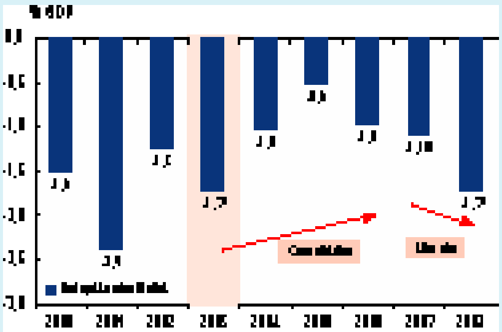


Graph 1.
Rating of Indonesia



Graph 2.
JSX Indices

The above achievements will surely come as some relief to many as they endured amidst many trials and fluctuations stemming from domestic issues such as the natural disasters that struck one after the other, and globally from oil price fluctuations and the subprime mortgage crisis. It is therefore understandable if we then declare that our national macro economy is sufficiently resilient to face unpredictable fluctuations.



Graph 3.
Fiscal Consolidation

We can also observe that such achievements represent the fruits of collaboration amongst all elements of public policymakers in espousing national economic recovery. Policy aimed towards fiscal consolidation during the early post-crisis era followed by a more expansive fiscal policy over the past two years has stimulated economic activity without triggering price or exchange rate instability, thus preserving economic expansion. The fiscal authority has also succeeded in periodically trimming the foreign debt liability, from above 100% at the beginning of the crisis, to around 35% in 2007. This will further strengthen the prospects of future fiscal sustainability (Graph 3). Furthermore, with respect to fiscal resilience, the policy to reduce fuel subsidies in line with oil price fluctuations in 2005 represent concrete steps to further reinforce our fiscal posture over the mid to long term. Such policy has also helped reduce uncertainty in the foreign exchange market in response to oil price hikes at the end of 2007.

As regards policies relating to the improvement of social indicators and the investment climate, we have also witnessed some gratifying developments. The drop in abject poverty is something we can all be pleased about. The poverty rate, measured by the percentage of people living below the poverty line, dropped from 17.75% in 2006 to 16.6% in 2007; a decline in absolute terms of 1.88 million people. The progress of the program to end poverty is supported, in many aspects, by the increase in economic growth and macroeconomic stability. No less important are the social programs implemented to assist the underprivileged to survive amidst fluctuations and natural disasters.

The decline in poverty has improved the achievement indicators of Indonesia's Millennium Development Goals (MDGs). Of the eight MDGs, Indonesia managed to record its most progress in the program to end poverty. A World Bank report (November 2007) states that the percentage of the population living on an income of less than US$1 per day is 8.5% lower than the 2015 MDG target, namely 10.3%. Other MDG indicators have also shown improvements, as illustrated by the high number of students enrolled in primary education; the low child mortality rate of under-5 year olds; and significantly improved public access to clean water. In addition, the World Bank noted that in nearly all aspects, the achievement of MDGs in Indonesia has progressed according to appropriate targets.

To promote investment activity incentives, the government has also strived to improve the investment climate through the issuance of an integrated economic policy package (*Inpres* No. 6 – July 2007) which covers the renewal of three previous packages, namely the investment improvement package, the infrastructure acceleration package, as well as the financial sector reform and small medium enterprise (SME) sector empowerment policy package. In improving investment, the new policy package also includes government legislation concerning the implementation of capital investment and reducing the time taken to process investment permit applications in Indonesia. Meanwhile, in terms of infrastructure, banks have actively participated in providing funding access. This has been supported by a credit insurance program and an investment scheme through a Public Private Partnership (PPP) mechanism.

Relating to the domestic investment climate I have already mentioned, we have also seen satisfactory achievements towards regional autonomy. Currently, a group of progressive regional governments have arisen whose regional development performance exceeds that of others. These success stories are demonstrated through the ability of the bureaucracy in progressive areas to unfurl the benefits to all people in the regions. A survey conducted by The Committee for the Monitoring of Regional Autonomy Implementation (*KPPOD)* indicates that important achievements in progressive areas are tightly related to improvements in the national investment climate, such as the rising human development index, better service efficiency and quality from the regional governments, completion of infrastructure networks, and improved governance in the government. These all represent positive developments in terms of addressing the supply side constraints in our economy over the long run. We now have a far greater hope that in the future, given the support of all elements, a critical mass of progressive regional governments can be achieved, and thus resulting in a faster paced economic growth that is higher in quality and better balanced.

2. Contribution of the financial sector

2.1. Strengthening the three pillars of stability

Ladies and Gentlemen,

Numerous achievements in 2007, in relation to economic performance as a whole and the advancement of several public policies, have been undertaken collaboratively by all policymakers. Such collaboration has also been actively supported by the diligence of all economic players in the business community and by the general public. I would also like to reiterate that we should be pleased of these achievements since many policies to catalyze economic growth over the past five years have been taken amidst a free democracy and policy independence.

With the same pride and faith in national faculty to live in an autonomous polity, I would like to acknowledge that public policymakers in the financial sector and all business players in their respective industries have provided tangible contributions in encouraging public policy independence, and furthermore Bank Indonesia welcomes each and every current economic achievement.

Like other public policy-making institutions, Bank Indonesia has its own niche in public policy continuum in the country. Bank Indonesia is one of the primary institutions that provide the three pillars of stability which support and represent the elements of continuity for sustainable economic development. The three pillars of stability include: (a) stability of the rupiah value; (b) a healthy and resilient financial industry to support financial system stability; and (c) a modern and efficient payment system to support economic transactions. Mirroring humankind's need for air to breathe, the presence of the three pillars of stability is in constant demand, and hence appropriate for the People to underline them as the constitutional mandate of Bank Indonesia through legislation for the central bank ratified by the Parliament.

Looking back at Bank Indonesia's tumultuous journey over the past five years, I feel confident to announce that efforts to meet the various aspirations set forth in the mandate have yielded significant results, which have maintained the momentum of sustainable national economic development and improved its future prospects. The results have been obtained in the spirit of autonomous policy making in line with the interest of our economy as a whole, and without interference from foreign parties. For that reason I would like to take this opportunity to extend my sincere appreciation to all my staff at Bank Indonesia who, over the last five years, have given their all and shown exceptional quality as first-rate professionals, thinking independently and consistently taking decisions that prioritize our nation's interests.

Ladies and Gentlemen,

A key achievement for our economy in the past five years has been the availability of a more stable national financial system, compared to the pre-crisis period, that supports economic resilience. The stability of the financial system is evidenced by the fact that our financial system is clearly better prepared to resist and absorb the numerous shocks arising from both the global and/or domestic economy. In addition, the national financial system has shown greater efficiency and effectiveness in allocating funds through intermediation and risk management, and continued to expand its role in supporting economic transactions. The establishment and maintenance of a more stable financial system has been supported by various achievements made in the three pillars of stability that have become the elements of continuity in national economic development. The most salient achievements can be summarized as follows:

- The rise in confidence of international and domestic economic players towards the ability of the monetary authority to maintain macroeconomic stability and support the quality of national macroeconomic policy management.
- A more effective banking industry to buttress financial system stability as a whole and galvanize national economic growth, as well as being more prepared to face the challenges associated with globalization.
- A more modern payment system infrastructure that is supporting and lowering the costs of transaction activity throughout the nation.

The establishment of a more stable and useful financial system, along with the reinforcement of the three pillars of stability, has provided breathing space for public policymakers in other sectors to implement various micro-structural policies to precipitate the restoration of the post-crisis economic growth dynamic to its original position. With more space, structural improvements in the real sector are better managed in terms of complexity, direction and pace. Furthermore, structural improvements are no longer disrupted by other issues related to instability in the monetary system, financial system or payment system

2.2. Strategic policy initiatives regarding the three pillars of stability

The achievements made for the three pillars of stability that I have already discussed, in many aspects relate to strategic policies instituted by Bank Indonesia as the monetary, banking and national payment system authority. Permit me now to present some of the strategic initiatives taken.

2.2.1. Initiatives in the monetary sector

Ladies and Gentlemen,

Regarding monetary policy, strategic initiatives taken include the implicit implementation of the Inflation Targeting Framework (ITF) since 2003, and the full-fledged ITF since 2005. This measure represents an effort to ensure monetary policy is more effective in stabilizing the rupiah amid shocks in global financial markets, as well as maintaining stability when conditions are calm. Effectiveness is very much required in the era of global financial market maturity, especially as we adopt a free foreign exchange regime with a free-floating exchange rate regime. Shocks emanating from global financial markets can quickly spread to our financial markets even in the absence of any additional shocks stemming from fundamental conditions in the domestic economy. Such contagion is rapidly reflected in the foreign exchange market in the form of exchange rate shocks, which can eventually adversely affect inflation and macroeconomic stability. Such shocks require mitigation as exchange rate and inflation instability intensifies the market risk borne by our financial system as a whole. Since its implementation, I can declare that the ITF has provided concrete results in the form of maintained macroeconomic stability over the last five years, despite significant shocks to our economy. Along with ITF implementation, headline inflation has remained within the inflation target set by the Government.

Full-fledged ITF implementation since July 2005 has been marked by the use of the BI rate as the operational target for monetary policy, replacing previously used base money. The change in instruments enabled monetary policy implementation to be well monitored by market participants. The use of the BI rate has also ensured expeditious monetary policy response to influence market expectations amidst shocks; therefore, monetary policy has been more effective as a stabilization tool. Two events have epitomized this stability, namely the fuel price shocks in 2005 and the US subprime mortgage crisis mid 2007.

The global oil price shock that violently shook price stability in 2005 signified a tremendous shock. Its direct effect was evidenced by headline inflation rising to 17.1% in 2005 and the exchange rate depreciated significantly. However, a strong combination of fiscal and monetary policies at that time to correct negative market expectations towards fiscal resilience in the long run and to suppress the second-round effects of fuel price shocks and exchange rate depreciation on inflation through ITF, brought macroeconomic stability back on track in 2006. Macroeconomic stabilization subsequent to the 2005 fuel price shock has also yielded positive results, where amidst escalating volatility in the financial markets, our economy expanded by 5.5% in 2006.

In addition, amidst the subprime mortgage crisis last year, BI rate policy in the context of ITF also helped maintain market expectations towards macroeconomic stability in the mid to long term. With further support from the fact that our banking industry was sufficiently resilient to confront market risk and the subprime mortgage crisis, macroeconomic and financial system stability was maintained despite strong contagion at the time. Taken as a whole, this helped us maintain sustainable economic growth in 2007; surpassing 6%.

In the context of preserving macroeconomic stability over the mid to long term, one advantage of ITF is that the BI rate is set in a forward looking manner and, therefore, is anticipative towards economic prospects, both in terms of price and economic growth development. This helps the central bank to periodically build upon its reputation and credibility in the market regarding its commitment to maintain macroeconomic stability. With a strong reputation and good credibility the costs that arise in maintaining economic stability are reduced and policy is more effective in achieving its target.

To this end, I would like to acknowledge that the macroeconomic stability and boost in economic growth we currently enjoy is a reflection of the gain in credibility as a result of stabilization policies taken in recent years. Such a gain in credibility constitutes very precious capital to further reinforce economic stability and increase economic resilience going forward.

In the context of wider macroeconomic stability, although we follow a floating exchange rate system, smoothing exchange rate fluctuations, including through supply and demand adjustments in the foreign exchange market, is still pertinent. Efforts to minimize volatility are not something that uniquely occur on our side, but are also a global phenomenon. Nearly all countries that have adopted a *de jure* floating exchange rate system, in practice, intervene to overcome volatility in the exchange rate, either through direct intervention in the foreign exchange market or by using open market operation instruments. Therefore, at certain times, Bank Indonesia has always maintained a presence in the foreign exchange market, especially when conditions could potentially trigger an imbalance. These measures have been able to suppress volatility, avoiding potential exchange rate instability attributable to speculative activity.

In order to further reinforce its ability to overcome shocks in the financial market, Bank Indonesia over the past five years has strengthened the national foreign exchange reserve position. This step is taken as insurance against future macroeconomic instability amidst uncertainty with respect to the correction of global imbalances and resurgent cross-border capital flows. Although we follow a floating exchange rate system and free foreign exchange regime, a sufficient *first line of defense* is needed to help absorb shocks and thus maintain macroeconomic stability. In implementing such policy, we must ascertain that the increase of outstanding SBIs, which is the cost of strengthening foreign reserves, remains at a level Bank Indonesia's budget can accommodate. Observation on various central banks in the region, such as the Bank of Korea, Bank of Thailand, and People's Bank of China suggests which have taken similar steps suggests that outstanding central bank bills can decrease in due time as economic activity improves in the medium term.

Table 3.
Outstanding Central Bank Bills in Select Countries

	Bank of Thailand	Bank of Korea	People Bank of China	Bank Indonesia
CB Bills	593.5 Billion Baht	158,390 Billion Won	3,230 Billion Renmimbi	207.4 Trillion Rupiah
% of GDP	8%	19%	7%	6%

*) As of 2006 (except Thailand 2005)
Source: CEIC, central bank web sites

Meanwhile, as a second line of defense, a bilateral swap arrangement with Japan, Korea, and China was signed by Bank Indonesia under the ASEAN+3 Chiang Mai Initiatives framework. Bank Indonesia was given the responsibility to do so by the Indonesian government. This regional self-help initiative is a strategic step taken by the Ministers of Finance of the ASEAN and three industrial countries in order to maintain regional economic and financial stability. From Indonesia's viewpoint, such arrangement could provide encouragement to terminate IMF's Post-Program Monitoring and ensure that autonomous policy-making is maintained.

2.2.2. *Initiatives in the banking sector*

Ladies and Gentlemen,

Moving on I would like to talk from the point of view of bank policy. As in other emerging countries, the banking sector is the main sub-system of the financial system as a whole. Currently, the share of our banks within the financial system remains above 80% of total assets in the financial system. Therefore, the banks form a strategic industry with the significant role of supporting the dynamics of national economic development and growth. Until today, the intermediation function of the banking industry remains a dominant source of funding for businesses in productive sectors.

Learning from past experiences, banking system stability is a primary aspect that must be maintained to ensure sustainable national economic growth. Volatility in one bank can quickly spread and affect public confidence in the banking system itself and also the economic system as a whole. Therefore, it is not excessive to say that efforts to guarantee the maintenance of banking system stability represent a serious policy priority that requires consistency in its implementation.

Generally speaking, satisfactory achievements made by the banks up to the end of 2007 are not independent of strategic policies summarized in the initiatives to prevent bank crises from reoccurring and resolution initiatives should such crises reoccur. With respect to the former, two primary strategic policy initiatives include the implementation of Indonesian Banking Architecture since 2004 and the preparation towards Basel II in 2008. Meanwhile, with the respect the latter, Bank Indonesia along with the Ministry of Finance and other related institutions continues to strengthen initiatives within the national Financial System Safety Net.

A. Indonesian banking architecture

Ladies and Gentlemen,

A few days ago was the fourth anniversary of the launch of the Indonesian Banking Architecture (API) program. Undoubtedly API has produced numerous tangible benefits in the post-crisis economy. Our national banks are currently a part of the solution for other national economic development issues. In other words, our national banking industry that was previously a hindrance to national economic development has become obsolete. Strengthening banks through the API framework has aggressively bulwarked the economy as banks currently constitute the main safeguard of financial system stability. The Indonesian financial system that has, hitherto, been dominated by banks strengthens my view that the role of banks in crisis prevention as well as maintaining macroeconomic stability remains particularly apposite.

Through its six pillars, API has complemented the banking sector and its authority with instruments expected to form deep and strong foundations for further bank reinforcement and development. From the beginning it has been clear that the constraints faced by each API pillar are different, however in general, I am pleased to see that API program development has progressed according to plan and the banking industry is showing numerous signs of seriousness in supporting our reinforcement efforts.

Let me briefly outline several of the most prominent achievements related to API. Banking consolidation, which began since the launch of Pillar I of API, has reached its final stage of preparation, the stage where some banks have determined their strategic future direction. As we are all aware, 2008 is the year when all commercial banks must maintain a minimum capital requirement of Rp80 billion to uphold its status as a fully-operational commercial bank. From the 128 banks in the industry, currently all of them have met the above capital requirement. We will follow-up twenty of these banks with an examination regarding to their capital addition. However, under the assumption of the banks' good intentions, we can say that all banks have been able to meet the minimum capital requirement, and will also be able to meet the Rp100 billion capital requirement by the end of 2010. It is important for me to acknowledge this achievement as, at least to this point, the banking industry's resilience in absorbing risks in general has increased. This is basically one of the aims of Pillar I of API.

The year 2008 will also be when banks determine their future strategic steps regarding ownership of more than one bank in Indonesia under the Single Presence Policy. Consequently, I expect that the affected banks will be able to realize those steps according to the determined time line. The year 2010 will see a banking industry comprising of banks that are not only stronger in their capital structure, but also with greater focus regarding their direction and strategies. In this regard, I would also like to state that there are several follow-up steps that need to be and are being taken by state-owned banks. The complexity of banks whose owners are the government requires the government to make several strategic adjustments. This obviously requires time. And as such, in accordance to the issued regulation, additional time may be provided for banks with issues which are high in its complexity to ensure that the benefits obtained from the implementation the policy is optimal.

Several dynamics and realities in global and national economic condition; the yet to be established tax incentives for mergers; as well as cultural differences among banks should not hinder steps to consolidation considering that this is for the greater good of the Indonesian banking industry when confronting future challenges in the era of financial globalization. Bank consolidation will create banks with greater capacity and potential to operate on a larger scale to penetrate new markets that have previously been off-limits to our national banks, such as the foreign markets of regional Asia and farther a field.

In addition, large, sound banks as a result of consolidation will provide greater contributions to the country, both in the form of dividends (for government owned banks) or tax income (for all banks). It is important to note that various tax incentives implemented to promote the consolidation process will be compensated many fold by the higher income derived by the state through taxes. Higher state income could, in turn, promote the realization of numerous infrastructure projects where, again, Indonesian banks would be able to play a substantial role considering their increased capacity.

The purpose of Pillar 2 of API is to enhance the quality of bank regulations and has succeeded in establishing Regional Banking Research Institutions (*LPRD*) in a number of chosen regions. As of now, *LPRD* have been established in collaboration with four regional universities, namely Andalas University in Padang, Brawijaya University in Malang, Hasanuddin University in Makassar, and the North Sumatera University in Medan. The resultant 16 research papers comprise of studies that address the necessities of each specific region. Research topics are quite varied, covering the potential of establishing new banks, customer cover, as well as the perception and the attitude of the *Santri* people towards sharia banks. Considering the substantial role of MSMEs in driving the economy both at a central and regional level, it is hardly surprising that each *LPRD* has its own research topics related to the funding and development of micro and small enterprises.

To balance and anticipate the future increasing complexity in the banking world and to address the demands made by stakeholders regarding enhancing Bank Indonesia's performance quality, some improvements in bank oversight have been undertaken. The related improvement programs, incorporated in Pillar 3 of API, are aimed at creating effective supervision and regulation referring to international standards.

In order to enhance the effectiveness of bank supervision and regulation, Bank Indonesia has taken steps to intensify coordination with other supervisory institutions, reorganizing the banking sector within Bank Indonesia, refining bank supervision infrastructure support, refining the implementation of a risk-based bank supervision system, and improving the effectiveness of supervision enforcement. The form of the new Bank Indonesia supervisory organization will further support the implementation of risk-based supervision (RBS).

The RBS approach demands the supervisor thoroughly and comprehensively understand the conditions and problems faced by a bank, which is then followed by another set of actions and criteria utilizing a swift and accurate process. The new shape of the Bank Indonesia supervisory organization is also designed to support the implementation of consolidated supervision enabling the supervisor to see a bank's problem not only as a single entity but also see the existing relationships from that bank's business group. Therefore, we have provisioned our supervisors with relevant knowledge through a continual education program for bank supervisors.

Meanwhile, Pillar 4 of API which encompasses improvements to management quality and bank operations has been implemented through a risk-management certification program for bankers designed to authenticate the risk-management ability of an independent institution. Certification is based on internationally recognized standards and is crucial for Indonesian banks. Other than to standardize the ability of the Indonesian banking society, these efforts also represent one way to address the strong current of globalization. Basel II has made the banking world more convergent so that the risk management of human resources in Indonesian banks must be equal to their overseas counterparts.

The enhancement of local bankers' capabilities is also critical in welcoming the 2015 ASEAN Economic Community. Currently, over 19,000 certificates from various levels have been bestowed upon bankers who have graduated the program. However, I feel it important to remind you that no certificate can act as a substitute for a competence and integrity. This certificate is a vehicle for a banker to improve his or herself and each banker must continuously strive to prove that they deserve their certificate.

Under Pillar 4 of API, Bank Indonesia has also set forth standards for Good Corporate Governance (GCG) through Bank Indonesia Regulation 2006. Due to diverse bank conditions, we have so far tolerated and given substantial leniency to banks during the early stages of policy implementation. However, beginning in 2008 it is expected that all banks have fully applied GCG principles. 2008 is the new anchor year for bank transparency to the public. This year, all banks are required to submit a self-assessment report pertaining to GCG implementation. With such transparency, it is expected that public social controls will be formed. The public will have full access to a bank's performance and GCG implementation, which will assist them in determining which bank to entrust their savings and fund management to. I hope that the public will already be able to access a bank's GCG report from the respective bank's website by the middle of this year.

To complete the existing bank infrastructure and contribute to improving bank risk management, Bank Indonesia is refining the Credit Information Bureau (*BIK*). *BIK* is part of Pillar 5 of API. The Credit Information Bureau was established to overcome problems of asymmetric information that often hinders the effectiveness and efficiency of bank intermediation.

From a creditor's point of view, *BIK* is expected to expedite the analysis process and decision-making of credit approval, help lower the risks inherent with non-performing loans, and reduce the dependency of creditors on conventional collateral as creditors are able to assess the credit reputation of their candidate debtor. From a debtor's point of view, *BIK* will accelerate the time taken to obtain credit approval. Information sharing will address the problems of asymmetric information which, in turn, will significantly improve the efficiency and effectiveness of financial institution intermediation.

Other than the benefits of *BIK* implementation I have already mentioned, *BIK* is also expected to trigger a positive change in debtor attitude. By accurately and thoroughly monitoring credit exposure, debtors should be motivated to service their debt more promptly to avoid damaging their personal credit history.

In the future, with greater awareness on the benefits and consequences of credit history, the public should become more motivated to build a good credit history in order to help them in case they wish to apply for a loan one day. This practice has been witnessed in many countries where the credit bureau infrastructure has been around for a prolonged period.

Finally, with regards to Pillar 6 of API, a program to improve customer protection and empowerment has been implemented since 2005. In improving such customer protection and empowerment, regulations have been promulgated to govern product information transparency, the use of a customer's private data, a mechanism to address customer complaints, and provisions for alternative dispute settlement between a customer and a bank.

The three regulations were issued as a Bank Indonesia response to numerous complaints and problems faced by customers in utilizing bank products and services. However, it has always been known that the dissemination of the above three regulations would not actually resolve the root of the real problem, namely the low level of public understanding regarding the characteristics of bank products and services, especially those related to risks and costs.

In response to the circumstances I have outlined, Bank Indonesia launched a public education program in banking. This activity is expected to minimize the problems faced by the public related to banks. We also hope that this program can contribute in enhancing the ability of the public to better plan for their future by utilizing bank products and services accurately in the current financial globalization era. We would like public education in banking to move away from being limited by time and become a continuous national-scale program.

If previously Bank Indonesia has tended to focus on establishing bank and financial system stability enabling the public to conduct business and receive an income to support their quality of life, then the current focus will provide greater attention on how the public should plan and manage their finances. Public education on bank products is also in line with efforts of financial deepening, where the public will be faced with a growing variety of investment products. Sound public understanding regarding the characteristics, use and risk of bank products and services is becoming increasingly crucial.

With the above background, we have launched an education program called “Ayo ke Bank” (Let's Go to the Bank) which will continue to 2008. We will see that the slogan does not become a meaningless catchphrase, but rather, represent the banking community's commitment to increase the larger community's participation in national development through the understanding and utilization of various banking products.

B. Preparation for Basel II implementation

Ladies and Gentlemen,

Still within the context of crisis prevention, to maintain stability and improve the strength of the Indonesian bank system, four years ago Bank Indonesia set a strategic policy to adopt Basel II commencing in 2008 using the simplest approaches possible.

In harmony with the Basel II implementation roadmap, the completed work program is expected to provide the foundations for effective implementation of the chosen approach in the calculation of bank capital adequacy according to Basel II. The work program comprises of Pillar 1 regarding the minimum capital requirement, Pillar 2 regarding the supervision review process, and Pillar 3 regarding market discipline under the framework of Basel II, which will be actualized through intensive discussion by the Basel II Working Group, including communication and socialization with the banking industry.

Some of the achievements regarding Road Map towards Basel II are as follow. Regarding Pillar 1, in preparing regulation towards using internal model by bank in calculating capital charge for market risk, regulation has been issued regarding the Capital Adequacy Ratio (CAR) of Commercial Banks by Calculating Market Risk.

In terms of credit risk, the preparation of the regulations have also been discussed by stakeholders, including the government. Some crucial issues included in Basel II that require follow-up coordination between Bank Indonesia and the government, include: (i) better defining small and medium enterprises (SME), which can be used to define retail debtors and small medium entities (SME); and (ii) a list of state-owned enterprise (*BUMN*) supported by the government that can be categorized as public sector entities (PSE). Still in the confines of credit risk, Bank Indonesia has also begun the recognition process for domestic ranking agencies namely PT Pefindo, PT Moody's Indonesia and PT Fitch Rating Indonesia by applying several parameters that comprise of six detailed eligibility criteria according to Basel II.

A similar process has also been applied for the preparation of regulations regarding capital charge calculations for operational risk. Further descriptions of gross income definitions and profit/loss items included in gross income have also been discussed by the working group.

Pillar 2 is more oriented towards internal Bank Indonesia preparation. The work program translates into the 4 principles of Pillar 2, namely internal capital adequacy assessment process (ICAAP), supervisory review evaluation and process (SREP), CAR above minimum and early intervention into the bank supervisory system constellation. Risk-based supervision is expected to support effective and efficient Pillar 2 application. In time, Bank Indonesia will comprehensively issue consultative papers relevant to the implementation of Pillar 2.

The Pillar 3 work program is aimed at enhancing the framework of bank publications and reporting according to international standards, namely international accounting standards – IAS. For this purpose, Bank Indonesia has adopted IAS 32 and IAS 39 in the form of PSAK 50 and PSAK 55 followed by the compilation of PAPI. There is also the need to enhance bank reporting, namely the commercial bank monthly report (*LBU*), by facilitating additional data and information required by Basel II.

It is important to note that based on the quantitative impact study – QIS on systemically important banks, Bank Indonesia accepts that, generally speaking, our banks are ready to adopt BASEL II using the simplest approaches. However, we also see that eventually, Basel II implementation will not only require the readiness of the banking industry to implement better risk management including improving the quality of the capital and information system, but also require Bank Indonesia readiness to improve the quality of regulation, supervisors, the information system and practices, as well as follow-up on bank supervision.

Other than the common achievements made to date, I see that in order to reach enhance banks through Basel II implementation, our attention often deviates by the perceptions or information that are not always entirely accurate regarding Basel II implementation, which in turn could be detrimental. One of the common misconceptions is that Basel II implementation for commercial banks in Indonesia will heavily burden the banks.

Here I feel it necessary to reiterate the achievement for Indonesian banks in adopting Basel II is to use the simplest approach. Therefore, other than the inclusion of operational risk in their capital calculation, there is no material difference with Basel I as been practiced for some time. Another common fallacy is applied to the preparation of Basel II implementation support infrastructure. Considering the approach that must be used is the simplest one, such minimal requirements in terms of infrastructure remain well within the reach of Indonesian banks.

By minimizing and separating some of the current erroneousness, we will be able to see the actual requirements of Basel II much easier. It can be said that the spirit of Basel II is the effort to continuously improve quality and the effectiveness of risk management – from banks and supervisors alike – to strengthen the overall banking system. How to achieve this Basel II spirit should have received a greater attention. Generally speaking, improving bank risk-management quality requires collaboration between banks and Bank Indonesia to improve the risk-management practiced by banks, improve the effectiveness of risk-based supervision by Bank Indonesia, and improve the quality of constructive dialog between the two. Such cooperation will breed a thought pattern and culture which continuously minimizes the potential of bank failures through better risk management.

Therefore, we should focus our energy and minds not only on achieving tangible items, such as using various approaches to measure market, credit or operational risk, but it is more important to achieve the intangibles, such as adopting a mindset or risk-management culture that supports the spirit of Basel II. Our achievements to date are reasonably satisfying; let us now complement these achievements by nurturing an appropriate culture and mindset to fully enjoy the fruits of Basel II implementation.

C. Refining coordination in line with crisis resolution

Ladies and Gentlemen,

Concerning crisis resolution, allow me to explain the background that led to this initiative. The economic crisis that struck Indonesia in 1997 was extremely expensive from a financial point of view and in terms of the lessons learnt. To this end, there are three primary policy responses from Bank Indonesia, namely first, efforts to recover banks and the economic system post crisis through restructuring banks; second, preventing crises in the future through strengthening the banking system, namely through IBA and Basel II implementation; and third, resolution should a crisis reoccur.

To create a crisis resolution mechanism, the government established the Financial Sector Safety Net (FSSN) where Bank Indonesia is one key element. FSSN is a mechanism formed under the macro-prudential framework and has the mandate of establishing and maintaining financial system stability as well as protecting the interests of financial services users. Considering that the financial system comprises of many industries, FSSN coverage not only includes banks but also non-bank financial institutions, the capital market and payment system. For FSSN to run effectively, tight regulations and high supervision quality, a sufficient lender-of-last-resort facility, an adequate customer deposit insurance program, and concise financial crisis management procedures all play critical roles. Solid regulations and close supervision represent the first lines of defence.

Coordination between all institutions involved (Bank Indonesia, Ministry of Finance and the Deposit Insurance Corporation) is a crucial factor of FSSN. Therefore, through the Financial System Stability Forum (FSSK) established last year, Bank Indonesia has and will continue to tighten coordination with all related parties.

2.2.3. Initiatives in the payment system

Ladies and Gentlemen,

Within the national payment system, Bank Indonesia has implemented various strategic policies to develop payment system infrastructure to become more reliable, fast, accurate, secure and effective in supporting all transactions nationwide. Such a developed payment system can contribute significantly to the maintenance of payment system stability as a whole. Failure to settle by one payment system participant could lead to serious risk, however, and disrupt the smoothness of the payment system. Such failure may also trigger contagion risk and trigger systemic disruption in the financial system, including serious disruptions to macroeconomic stability.

For that reason, in managing and maintaining the smoothness of the payment system, Bank Indonesia has tried and will always endeavor to reduce various risks in the national payment system and improve its efficiency.

In relation to the large value of the payment system, Bank Indonesia has continuously improved the quality of the BI-Real Time Gross Settlement (RTGS) system; implemented at year end 2000. In 2007, the BI-RTGS system, which is a real-time payment and transaction settlement system, processed an average of 33,000 transactions per day with an average daily value of Rp172 trillion Realizing the importance of the BI-RTGS system in supporting smooth payment transactions, as a systemically important payment system, we at Bank Indonesia have always strived to enhance the BI-RTGS, referring to The Core Principles for

Systemically Important Payment System (CP-SIPS) issued by the Bank for International Settlements. We have also improved operational security and the reliability of the BI-RTGS system by enhancing security instruments and the overall information technology used in implementation, including improving the back-up quality and instituting a business continuity plan in case of natural disasters.

Subsequently, as part of the efforts to realize an efficient, fast, secure and reliable payment system, Bank Indonesia has improved the quality of the clearing process through the development of the Bank Indonesia National Clearing System (*SKNBI*). *SKNBI*, which was implemented in July 2005, processed an average of 318,000 transactions per day in 2007 with an average daily value of Rp5.5 trillion Since *SKNBI* implementation, the use of credit notes to transfer funds between banks through clearing, which was deemed inefficient particularly with regard to the printing fee and processing procedure, has become obsolete and is now paperless. The implementation of paperless clearing is national, which allows participants to transfer credit to any bank office throughout Indonesia.

Regarding customer protection principles, Bank Indonesia has set forth the duties and responsibilities of banks when sending transfer instructions and receiving transfers through BI-RTGS and *SKNBI*. The regulation principally attempts to protect the interest of the customer who sends or receives a transfer instruction, therefore the efficiency and security of the payment system is felt by the general public.

The development of a non-cash payment system, especially card based payments, prompted Bank Indonesia to issue PBI No. 7/52/PBI/2005 on 28th December 2005 regarding the Implementation of a Card-based Payment System as well as several External Circulars regarding the procedures, Customer Protection and Prudential Principles, improved security, as well as supervision. In order to support the establishment of a healthy credit card industry, Bank Indonesia actively encourages the formation of a self-regulating organization (SRO) able to set the standards to be adopted in the credit card industry in Indonesia. Through the SRO, the standards set will be able to safeguard the security of credit card instruments and maintain healthy competition.

In the meantime, to anticipate the public requirement for non-cash payment instruments, Bank Indonesia continues to facilitate electronic payments (e-money) and is preparing relevant policy and regulations to manage the implementation of e-money ensuring efficiency and security. Bank Indonesia is aware of the importance of developing micro-scale non-cash payment instruments to complement the existing high value and low/retail value instruments. The micro-payment instrument would be designed to serve extremely low value, high frequency payments in an expeditious manner. The must suitable micro-payment instrument to satisfy this requirement is e-money. E-money is a micro-payment instrument that constitutes a stored value facility instrument. A benefit of E-money is its ease of use; it can be recharged through various facilities provided by the issuer, such that e-money is capable of reaching all strata of the public, including those without access to the usual non-cash payment instruments offered by banks.

In December 2007, as the government's cashier administrating various government income and expense accounts, Bank Indonesia implemented the "Bank Indonesia Government – electronic Banking (BIG-eB) System" in order to provide a better service to the Government. The BIG-eB system is provided by Bank Indonesia to the Department of Finance to facilitate information exchange as well as to perform electronic and online transactions on Government Accounts which are administrated in Bank Indonesia. The facility is expected to serve the government's treasury single account requirement and simplify the management of the government's accounts.

2.2.4 Initiatives in the real sector

Ladies and Gentlemen,

Since I began speaking at forums such as this evening's there have been several fundamental issues that represent the primary focus of Bank Indonesia in fulfilling its duty as a state institution and central bank. One thing that is institutionally cemented to nearly all central banks in the world is the vital function of maintaining national macroeconomic stability. This function provides operational room for the central bank but is limited by the instruments it has at its disposal. A central bank cannot directly move beyond these borders since it lacks the necessary instruments and also because it has no intention of doing so.

However, real sector performance remains the key focus of a central bank, especially since unhealthy growth in the real sector can disrupt economic stability, which is the focus of a central bank. Therefore, to continuously follow the performance of all economic sectors in Indonesia is an integral part of the central bank's duty. Furthermore, the central bank must, from time to time, provide appropriate signals regarding upcoming issues to be aware of, and also contribute to micro-structural efforts to improve real sector conditions. This is necessary considering that each time the central bank institutes a policy to maintain national economic stability all sectors are affected by that policy, either directly or indirectly.

Thus, it would be unwise for the central bank not to take a more sensitive approach to ongoing economic and social developments that may trigger widespread effects on the long-term stability of our economy. As such, it would be imprudent for the central bank to be mechanical and bureaucratic in its approach to developments in the economy. Consequently, Bank Indonesia has taken direct steps to invigorate the real sector without violating its mandate as the guardian of stability, not only in advancing Bank Indonesia's role in policy advisory but also facilitating role to strengthen bank's intermediation function.

In terms of policy advisory, in the middle of last year, Bank Indonesia launched a multi-year work program, namely Bank Indonesia Regional Office Reorientation. This step was taken to allow Bank Indonesia's regional offices (KBI) to be more proactive in observing economic and social development throughout the nation, as well as building strategic partnerships with local governments.

Meanwhile, as a facilitator to expedite economic development Bank Indonesia has initiated Small Medium Scale Enterprise (SMSE) cluster pilot project program and established a task force, named "*Tim Fasilitasi Percepatan Pemberdayaan Ekonomi Daerah*" (*TFPPED*), that provides technical assistance to SMSE. The team was formed to help expedite regional "grass root" economic development by improving the commercial bank's intermediation function. In time, this Task Force will unify with the duties of Bank Indonesia's regional offices. The team members consist of heads of local government, Bank Indonesia (central and regional), banks, associations and institutions or other related institutions. As a pilot project, TFPPED has been established in eight Bank Indonesia' regional offices: Bandung, Medan, Manado, Cirebon, Pontianak, Jambi, Kupang and Purwokerto.

Another initiative taken to facilitate bank intermediation includes the implementation of Indonesian Business Information Data (DIBI). DIBI has been introduced to reduce asymmetric information between banks and the real sector, which we suspect as one of several causes of the sub-optimal bank intermediation function. The design of information architecture developed in DIBI is expected to serve the information requirement of banks and MSME economic players in many regions of Indonesia. For MSME economic players, we expect DIBI to broaden their knowledge range not only to generate new ideas for business opportunities but also to serve the needs of business expansion. Whereas for banks, DIBI is expected to encourage creativity in credit extension. To begin, the design of the information architecture in DIBI was adjusted to the information resources currently available in Bank Indonesia, including regional economic reviews which are conducted periodically. We strive to ensure that the macro and micro information presented strongly correlates and is germane with the needs MSME economic players, either directly or indirectly. According to its purpose, future DIBI development will be directed towards presenting more micro-business related data and information.

On top of rolling out initiatives as part of its future routine duties, Bank Indonesia has also taken a comprehensive range of strategic measures together with the Government in directing the activities of Bank Indonesia's subsidiary companies that must be divested prior to 2009. Through the Askrindo divestment, Bank Indonesia's stake in the company has declined from 55% to about 25% following a capital deposit by the Government of Rp850 billion. The capital deposit by the Government to Askrindo has substantially helped overcome the constraints associated with the prevailing high business risk perceived by the banking community. With such additional capital, Askrindo's ability to insure credit extended by banks has increased. On 5 November 2007, the Government launched a credit program for activities of the poor (*KUR*), which is distributed through banks and insured by Askrindo.

PT Bahana Pembinaan Usaha Indonesia (BPUI) continues to contribute significantly in terms of providing financing and business opportunities to MSMEs. Through its subsidiary company, PT Bahana Artha Ventura (BAV), there are currently over 90 thousand MSME players that receive financing and assistance. Despite the constraints connected with the limited capital currently faced by BPUI due to the delay in converting the government's Investment Fund Account debt into capital, the latest BAV business plan includes arrangements to continue extending business financing to MSMEs, which is projected could potentially reach about 275 thousands MSMEs by 2012. This credit extension to MSMEs is projected to create around 2,5 million new jobs.

III. Future economic challenges and prospects

1. Future economic challenges

Ladies and Gentlemen,

The strategic initiatives introduced by Bank Indonesia since 2003 and up to the end of 2007, as I have discussed so far are far from complete. We still have much outstanding homework left to attend to further strengthen financial system resilience to confront the challenges of tomorrow. Some of the challenges I have addressed that we face imminently will continue over the next five years with higher intensity. In addition, further challenges loom on the horizon, which require anticipative measures to be taken post-haste. In the context of such challenges I would like to reiterate that we cannot and should not take for granted continues financial system stability into the future. Such an assumption could leave us vulnerable in a comfort zone that shatters our ability to adapt and anticipate problems. Therefore, allow me to continue this discussion by outlining my views on the challenges facing our economy and financial system, which require the diligence of all relevant parties to anticipate and subsequently further strengthen financial system stability and ensure the continuation of economic achievements into 2008 and beyond.

1.1. Changes in the global financial market

Ladies and Gentlemen,

An increasingly imminent challenge which lies before us is the changes taking place in the world financial system. If we fail to respond to these changes by strengthening our efforts in maintaining financial system stability, the potential of a crisis reoccurring will increase. These changes have taken place since at least the 1980s but are increasing in their intensity with the rapid development of information technology.

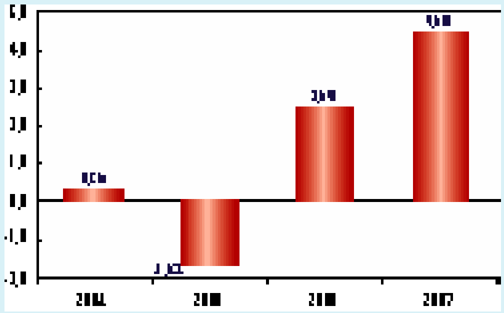
We can now witness very rapid changes in derivative instruments and structured finance instruments. The innovations and developments of such instruments increase the complexity and financial transactional links. Such changes are also supported by increasing levels of excess liquidity in the global financial market and the increased demand for variations in financial instruments, given different consumers' risk profiles. Consequently, there is a blurring of financial intermediation roles between the traditional banks and non-bank market players. It is observed that the banking industry tends to distant itself from relationship lending practices and lean towards asset securitization strategies in its efforts to transfer risks by trading instruments repackaged to be traded in the secondary market.

We also see tighter integration between international financial markets, which is reflected by a higher volume of cross-border financial flows. Greater integration between the markets is supported by the emergence of new players, that operate across borders and are owned privately, such as hedge funds, or those that are the subsidiary company of state-owned institutions, such as sovereign wealth funds. Other factors adding to cross-border financial flows include asset portfolio management by pension companies as well as insurance companies from large nations, and the re-emergence of leveraged buy-outs by private equity companies.

Changes in the global financial market have swelled global excess liquidity, exacerbated by more varied sources of liquidity for funding, cheaper financing cost as a result of a permanent decline in global inflation over the last decade, and the emergence of new growth centers that support wealth creation of the growing middle-class ("new money") in the global economy, especially in emerging countries.

With its free foreign exchange regime, changes in the global financial system and increased global excess liquidity have made our domestic financial system appear shallow, with instruments limited to mainly shares, SUN and SBI. Problems then arise as, despite its lack of depth, our financial market in the past few years have provided yields that attract short-term investors. In the stock market, such attractive yields are supported by increasing corporate profit prospects, IPOs, and macroeconomic stability. Meanwhile, differences in productivity between developed countries and us have created a spread in interest rates. Such spreads tend to attract portfolio investments into our financial market through carry trades in stocks or risk free instruments, such as SUN and SBI.

Although short-term capital inflows are useful to meet the short-term national financial requirement, they are also very volatile and vulnerable to sudden reversal. This is because they are sensitive to the changes in expectations and are often associated with irrational behaviour. Sensitivity to expectations is currently clearly evidenced by the sensitivity of the rupiah towards changes in the risk appetite of global investors towards US-Dollar denominated debt instruments issued by developed countries, including Indonesia, through the global financial market. In the last two years, we have observed an improving positive relationship between the value of the rupiah and EMBIG spread fluctuations (Graph 4). This is a challenge in itself for the management of rupiah stability by Bank Indonesia. Meanwhile, short-term capital inflows can also send the wrong signals about the fundamental condition of the rupiah. As a result the exchange rate can suffer serious misalignment that attracts speculation if not addressed appropriately.



Graph 4.
Rupiah Sensitivity to EMBIG Spread

It would seem obvious that what I have outlined so far implies that maintaining macroeconomic stability is clearly one of the supporting pillars of overall financial system stability. High uncertainty has made the task of monetary policy more complex. Meanwhile, although preferred by speculators, exchange rate volatility could trigger adverse effects on inflation expectation through pass-through effects. Excessive exchange rate volatility also can affect the balance sheet of corporations and financial institutions, especially when outstanding liabilities in foreign denomination are not hedged. Furthermore, exchange rate volatility can disrupt international trade activity due to capacity limitations affecting either the exporter or importer when adjusting to changes in the exchange rate. Additionally, when the Government also has foreign-denominated liabilities, for example in Indonesia, exchange rate volatility can disrupt market valuation for SUN as well as fiscal sustainability.

Therefore, from a macroeconomic management point of view, our exchange rate policy in the overall framework of monetary policy requires special attention. We at Bank Indonesia accept that the measured intervention policies we take to smooth exchange rate volatility, without imposing a specific level, is consistent with our focus on rupiah stability in the mid to long term. I would like to restate that Bank Indonesia policy for exchange rate volatility, be it through a measured intervention policy, BI rate interest rate policy, or prudential banking policy, to date remains effective. However in future, Bank Indonesia is aware of the need to improve the OMO mechanism and short-term money market infrastructure, which will improve the contour of the yield curve in our financial system. I will revisit this topic at the end of my speech this evening.

As for the resilience of the banking system as the other pillar of financial system stability, I can say that extensive stress testing performed by Bank Indonesia has categorically shown that our banks are able to overcome market risk related to macro instability. However, we need to further reinforce the resilience of the banking industry because bank overconfidence can easily overstretch activity. Bank Indonesia would like to avoid this in the future.

1.2. Changes in the global commodities market

Ladies and Gentlemen,

Another challenge that will shape the Indonesian economy of the future is more severe turbulence in the commodities market, which also stems from the external sector. Three important factors require cautious observation, namely structural changes in the global energy market, international food prices and the effects of global warming. These three factors are inter-connected and, if not carefully addressed, could have an adverse impact on domestic economic growth.

In the last few years, commodity prices, especially the global oil price, has experienced a significant surge. Fundamentally, oil price hikes reflect a rise in demand amidst contracted production. Although demand for fossil-based fuels from OECD countries, such as the US, Europe and Japan has tended to be lower due to the warmer winter in the northern hemisphere as a result of global warming, we have observed a structural change in the energy market. The changes have arisen because of the significant rise in demand from China, India and other developing countries, along with the rise in their economic activity. Conversely, global oil production has tended to stagnate.

The global race to provide alternative energy sources has triggered soaring international food prices. In the first eight months of 2007, average international food prices – especially corn, wheat and soybean – rose by up to 10.5%. Biofuel production has been blamed as one of the reasons for the price hikes. Biofuel has raised the demand for corn and soybean. The global oil price hikes have provided the impetus for biofuel production. In emerging countries, the rise in global food prices could have serious negative impacts and trigger a direct or indirect rise in the cost of living through inflation of non-food prices. The transmission of food price hikes to non-food prices will be more significantly felt in emerging countries than the developed world because of the high portion the food basket holds in the household expenses of families in emerging countries.

Moreover, the effect of extreme weather changes related to global warming is also promoting a rise in international food prices. To illustrate my point, the 2006 drought in Australia decimated wheat production by up to 60%. Experts predict that the effects of global warming will not only place additional pressures global food production but also threaten global harmony, such as by rising sea levels due to the melting polar caps, changes in sea currents and worsening droughts in many countries. For us in developing countries, these threats are extremely serious because they directly relate to the ability of underprivileged peoples to deal with shocks and natural disaster. We are aware that global warming is a reflection of global externality where the negative impacts do not stem from current trends but from an accumulation of past and future events. As a result, it is our future generations that will feel the full brunt of the negative impacts brought about by global warming.

1.3. Social-economic exclusion

Ladies and Gentlemen,

If we reflect back on the economic crisis we endured 10 years ago, it would be fair to claim that the crisis caused significant social-economic exclusion for many Indonesians. The exclusion occurred due to income redistribution and, of course, a sudden redistribution of economic-political power as the crisis hit. The exclusion faced by those who were already poor and those who became poor as a direct result of the crisis is not theatrical but extremely real. The ultimate effects of this redistribution still suffocate the lower strata of the social-economic pyramid to this day.

Widening income disparity, decreasing human development quality and increasing informality combined with no social protection in the labor market, when compared to the pre-crisis era, are Asian crisis excesses for which improvements we continue to strive. Therefore, Bank Indonesia gratefully welcomes the current efforts being undertaken to expedite improvements in all forms of public social-economic prosperity. This acceleration is indeed necessary. In the present economic globalization era, rapid resolution of the social exclusion problems is demanded by our human worth. Social exclusion causes asymmetry to both groups in the social economic pyramid when addressing economic shocks. Meanwhile, as I mentioned earlier, our economy in the future will also face greater volatility regarding the exchange rate as a result of cross-border capital flows and rising food supply prices due to structural changes in the global economy. Vulnerability to shocks is compounding the already difficult situation the underprivileged find themselves in, whereas wealthier members of society are lucky to have a cushion and can therefore adjust better. This kind of gap disrupts our human worth.

Such a contrasting gap eventually has the potential to provide negative feed-back on the continuity of our current economic achievements. The negative feed-back may arise mainly due to the poverty trap and *a* trickle up economy. In other words, the potential exists for the emergence of rogue elements in our economy. This would certainly restrict our process in continuing the many positive achievements made to the end of 2007.

Meanwhile, a burgeoning socio-economic gap will also impede our attempts to confront the already very real challenges ahead, namely the establishment of 2015 ASEAN Economic Society. Lackluster public socio-economic prosperity could trigger adverse follow-through effects for our nation in the era of economic integration. The competitiveness of our economy will drop below that of its peer-group due to incomparable production factor total productivity, a contracted domestic market and a lack of interest from the business community to expand production capacity. We will then become less compatible for other countries to establish joint collaboration, therefore, on the one side we fail to take any benefits of globalization and on the other side we only receive the negative effects.

The views I am trying to put across to you all this evening imply the importance of adjusting the way we view our priority scale to improve the various positive achievements already made. Amidst an external environment that could trigger serious challenges and a domestic environment that is becoming more integrated in line with globalization, numerous issues related to economic competitiveness should motivate us to redouble our existing achievements. However, in improving our economic competitiveness, we must not neglect the social inclusion of all our nation's citizens. Any established competitiveness will be unsustainable without such empathy, as competitiveness does not provide any meaning to the social contract that we base our lives upon.

Ladies and Gentlemen,

In relation to the social exclusion issue as I have mentioned, we are challenged to improve the social-economic condition of small farmers and laborers in the agricultural sector, which make up the majority of workers in our economy. The agricultural sector has not been able to bring prosperity for the small farmers and can bring the whole economy into a prolonged stagnation. Meanwhile, from the perspective of national resilience, the agricultural sector cannot support sustainability in food supply and also cannot be expected to absorb employment. Externalities in the form of potential poverty traps and persistent inflation in food prices are felt in rural areas as well as cities. This is a concern for Bank Indonesia.

Aside of that, we are faced with the paradox of growth phenomenon. Such phenomenon exists as there is a tendency of businesses to utilize more capital than labor. The preferences of these businesses are rational. National and global excess liquidity has brought the cost of capital to relatively low levels while much challenge remains within the labor market. Taken from a global perspective, such phenomena is one of global capitalism and free competition which requires businesses to increase their competitiveness to capture market share. A method to achieve efficiency is by exchanging low skilled workers with capital-intensive machinery or capital. Such technology switching will become more common in the future with increasingly sophisticated innovations in production technology.

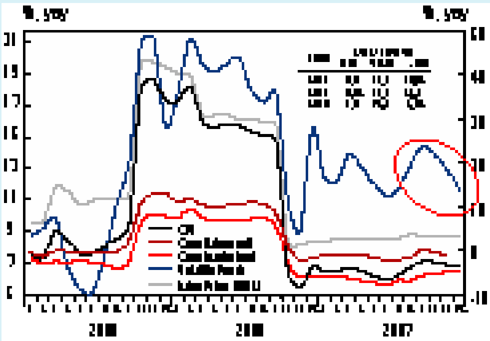
For us in an emerging country, this phenomenon requires greater attention, especially since growth in the manufacturing sector has slowed in the post-crisis era compared to pre crisis. Manufacturing sector growth in the pre-crisis era was 11.7% on average (1994-1997), whereas post crisis it has dropped to 5.2% (2003-2007). A downturn in the manufacturing industry has increased the role of the non-tradables sector. However, growth in the non-tradables sector is currently supported by lower added-value activities. Despite the positive impact of such growth in the form of less exchange-rate pass-through to inflation, the negative impacts include lower added-value for the economy as a whole. The negative effects have also slowed growth in public income on average in the post-crisis era and reduced private consumption growth to a level below that of the pre-crisis period.

To address this paradox of growth we need to ensure that the emerging added-value emanating from technological advancement does not focus on a select portion of the population. We will also have to be more sensitive to the requirement for a transparent, efficient and accurate redistributive income policy, which ensures that the benefits are shared with those considered left behind socio-economically. Moreover, policy incentives to develop and strengthen the growth of labor-intensive micro, small and medium enterprise, particularly in the non-farm sectors in rural villages, need to be considered. This will provide a safety net for the public should shocks undermine the economy.

1.4. Persistent inflation

Ladies and Gentlemen,

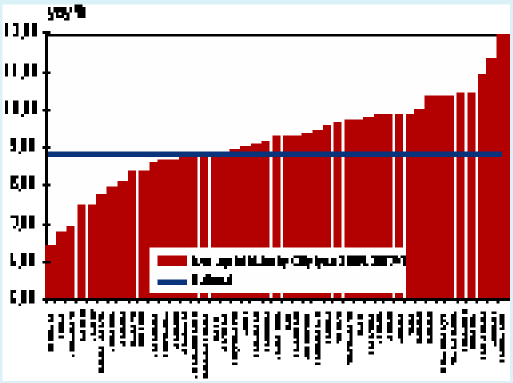
Another challenge we face together is the rigidity of our inflation rate, which seems to begrudge a decline. Many reasons exist to motivate us to immediately address this challenge with unbroken commitment. One of them is that with permanently lower and more congruent inflation towards the inflation rates of trading partners, our macroeconomic fundamentals and balance of payments will improve. However for Bank Indonesia the drive towards permanently lower inflation is to dissipate pressures stemming from social exclusion. Low inflation will preserve the continuity of purchasing power, especially for the underprivileged, whose numbers are immense in our country, while also helping to achieve better quality of economic development for everybody. We know that a rise in the number of the poor can be attributable to a rise in inflation because a rise in inflation signals an erosion of public purchasing power, given the low growth in nominal income. Nevertheless, high inflation will also widen the income disparity gap due to asymmetries between the rich and poor when addressing price inflation.



Graph 5.
Inflation Indicators

I must add, however, that to permanently lower inflation is not a trivial task by any stretch of the imagination, especially in Indonesia. Our headline inflation rate is highly affected by volatile food inflation, which is persistent in nature. Persistent in this regards means that every time a shock occurs, inflation of this group tends to take a long time to return to its initial rate. As I have shown in Graph 5, it can be seen that although headline inflation has returned to “normal” subsequent to the 2005 shocks, volatile food inflation remains persistently high.

Many hypotheses have been proffered regarding the source of such persistence. One that is often put forward is that the persistence arises because of inefficiencies due to imperfections in the food commodity distribution market. Several hypothetical factors have been offered that could trigger these imperfections such as the underdevelopment of markets in relation to: (a) provision of logistics, transport and transportation infrastructure for food; (b) the management of perishable goods by the producers; and (c) the supply of symmetrical information for the suppliers, middlemen and retailers. Another hypothesis often suggested are distortions triggered by policies that favour certain market players so that oligopsony and oligopolistic practices as well as rent-seeking activity arise in the distribution market. If we assume that these hypotheses are valid, then the persistence of food price inflation is a microeconomic phenomenon. This implicates the relevancy of monetary policy as a direct control instrument for food inflation, and suggests the importance of a deeper microeconomic review with regards the food distribution market nationwide, so as to enable us to formulate and implement more effective policies. We should also be motivated by the fact that over the last four years disparity has appeared in regional headline inflation. As illustrated in Graph 6, over the last four years 34 cities out of the 45 surveyed by *BPS* show a headline inflation rate above the national rate.



Graph 6.
Regional Disparity of CPI Inflation

Our headline inflation rate also seems to follow a long-term trend, or core inflation, that is rigid and difficult to bring down (sticky inflation). Data shows that since 1990, our lowest inflation ever recorded was 5% during a brief period before the crisis, namely between Quarter III/1996 and Quarter II/1997, and then also between Quarter IV/2003 and Quarter I/2004. Meanwhile, our research shows that during the current post-crisis era inflation has remained persistently high at around 5% annually. This situation beckons the next question of what is the lowest inflation rate we can expect to achieve over the mid to long term? Is it possible to achieve permanent inflation in the rage of 2% to 3% annually such as our trading partner countries? Are there any specific characteristics of our economy that keep our inflation rate permanently higher than that of our primary trading partners?

I believe that the steep difference between our inflation and that of our trading partners is closely related to the formation of public expectations that tends to look to the past at a time when our inflation rate never fell permanently below 5% on average. There are yet more hypotheses that can explain this. *First* is that monetary policy still has room to further increase its credibility. Since ITF implementation there have been signs that the average core inflation rate, whose movement is highly affected by monetary policy credibility, has shown a declining average since 2003, towards a rate significantly below pre-crisis levels. A linear trend of core inflation since 2003 is recorded at 7% annually; meanwhile the similar trend from 1992-1997 is recorded at 8.50%. This means that since ITF implementation there has been long-term declining trend in core inflation of 1.5 percentage points. I feel certain that in future consistent ITF implementation will improve monetary policy credibility further and subsequently bring down the long-term trend of core inflation permanently.

Second, the reduction of core inflation is hindered by the abundant room for improvements in the productivity and efficiency of the economy as a whole. Improvements will affect microeconomic aspects that form the core inflation rate, especially improvements to economic capacity in terms of product supply and services. Through continuous capacity improvements, demand pressure on products and services will be absorbed avoiding inflationary pressures on the economy. Market players that deal with the supply and distribution of products and services on a daily basis will rapidly observe such improvements and apportion them in their future price adjustment plans. The resultant positive expectations will further help reduce core inflation to a level that is permanently lower.

The close relationship between the inflation rate and economic productivity and efficiency implies that a disinflation policy needs to be implemented by consistently complying with the principles of gradualism and balance. Overly tight monetary policy amidst rather low economic productivity and inefficiency can lead to recession. Meanwhile, too loose monetary policy amidst low productivity and inefficiency can turn the economy inflationary and not pro-poor. The subsequent inflation will erode the purchasing power of the poor, which will widen the socio-economic gap.

Meanwhile, the tight correlation between the inflation rate and structural aspects implies that to successfully undertake a credible disinflation process requires thorough and integrated coordination between all institutions in the Government including Bank Indonesia. Generally speaking, such coordination can be conducted by dividing policy direction into three major parts. First is to continuously maintain internal and external rupiah stability through pre-emptive and prudential monetary principles as well as policies for the money market, banks and the payment system that strive to buttress financial system stability. This first policy direction is the responsibility of Bank Indonesia and is aimed at dissipating instability risk in the financial sector that can disrupt rupiah stability. Second is to maintain fiscal resiliency and sustainability in the long run to prevent the emergence of fiscal domination that could adversely impact the expectations of SUN investors towards the prospects of future inflation. This then can disrupt and hamper monetary policy effectiveness in maintaining macroeconomic stability as a whole. Third is to improve the structure and infrastructure of the food distribution market and increase the efficiency and productivity of the economy as a whole.

1.5. Regional competitiveness in the era of regional autonomy and globalization

Ladies and Gentlemen,

Yet another future challenge we face is regional competitiveness in the era of regional autonomy and globalization. The World Economic Forum (WEF) reported in their 2006-2007 "Global Competitiveness Report" that Indonesian competitiveness ranks 50th out of 125 countries; compared to 69th out of 107 countries in the previous year. Despite the obvious improvement that has taken place, Indonesia is still considered among the least competitive countries in the Asian region. Indonesian competitiveness continues to languish behind Singapore (ranked 5th), Japan (7th), Malaysia (26th), Thailand (35th) and India (43rd). Meanwhile, based on an International Institute for Management Development (IMD) report in the World Competitiveness Yearbook 2007, Indonesian competitiveness was ranked among the two lowest countries surveyed, namely Indonesia ranked 54th, whereas Venezuela ranked 55th out of the 55 countries sampled.

As appears to be common knowledge, increasing economic globalization has made competition amongst countries even tighter. On top of this, tighter global competition directly affects the regional economy, especially in the era of regional autonomy and fiscal decentralization. Consequently, the need has arisen for each region in Indonesia to improve their competitiveness. Furthermore, tight competition among the regions of Indonesia forms the "spear head" for the improvement of national competitiveness amidst the growing desire to compete globally.

This has left me wondering about the overall picture of competitiveness in each region in the country today. We can observe that based on overall competitiveness, about 65% of municipalities in Indonesia remain below the national average, whereas only 17% have actually exceeded the national average. This indicates a significant distortion in economic growth in municipalities across Indonesia. The regional economy still requires improvements in primary infrastructure quality, as well as business expansion to absorb excess labor and improve labor quality. Meanwhile, regions struggling with low competitiveness are often characterized by an agricultural sector that does not relate to the region's primary economic sector, as well as insignificant private sector funding.

As a result, we currently face the challenge of improving regional economic competitiveness. To confront this challenge we must not neglect the escalating political-economic relevance of the ever emerging local governments, which tend to be highly location specific. This provides insight that the uniform engineering of economic and social growth on a national scale is irrelevant at the local level. We therefore need to formulate methods to solve the national problem based on the idiosyncrasies of local wisdom buried in heterogeneity. This is a challenge in its own right for a nation that has always thought in terms of monolithic uniformity. Such an objective fact sends a message to all policymakers to deconstruct and then reconstruct the meaning and role of overall national growth.

1.6. Preserving cultural capital in the globalization era

Ladies and Gentlemen,

With regards to our efforts to adapt to globalization, we are also required to seek and build an appropriate cultural spirit for economic growth from the diversity of our nation. Economic growth is merely a reflection and consequence of the cultural spirit entrenched in a country. The continuity of our cultural spirit to address the variety and multi-faceted socio-cultural aspects of our economic regions will determine our achievements in economic growth and the restoration of competitiveness in the future.

It is necessary to comprehend that development through the transformation of the economy, social and political, in its entirety is very much affected by human factors and cultural richness. In the lesser context of economic growth, over two decades ago Soedjatmoko informed us that economic growth demands not merely the presence of formal institutions and technocratic skills but also cultural factors such as certain norms and social capital that support economic development.

However, in a wider context of development, diversity in culture plays a fundamental role in developing good for humankind. In every culture lies the collective memory of a nation. Upon entering the labyrinth of that collective memory each individual will remember, forget, reconstruct, redefine his views and even build a new view for the continuity of common cultural advancement. In that process, cultural diversity can become the instrument that opens the door to world-view enrichment. Such enrichment through exchange can result in not only abstract matters such as world views and philosophical speculation, but also practical matters such as the discovery of traditional medicines that have been discovered through local wisdom for centuries.

This goes to show the importance of cultural work to ensure our nationality continues to possess a rich and colorful cultural mosaic. However, confronting the upcoming challenges will be immense, especially due to the strong undercurrent of global culture homogenization that tends to form a uniform world view, i.e. the world of commercial consumer based on the most fleeting of cultures in the west. The challenge for us becomes one that is daunting as the homogenization process appears seductive to our subliminal perceptions with its impacts to the local culture being gradual at best. Without us knowing, we have become part of a huge market comprising of those who are very consumptive and dominated by industrialization.

2. Future economic prospects

Ladies and Gentlemen,

The panoply of future challenges does not inherently imply that our prospective economic achievements will lose their passion. I believe that the current trend of optimism, where the economy is running on both engines, can be maintained into the future. To me a vital reason for this optimism is that our democracy is already consolidated, therefore, we have confidence in the effectiveness of our government in delivering results. Furthermore, our bureaucratic tools will be even more effective despite us hosting one of the largest democratic events in Asia next year, namely the 2009 Indonesian direct election. I have also witnessed myself that the ongoing efforts to address the remaining structural constraints in our economy have been up-scaled. This represents a rational step for our incumbent government since it nurtures even greater tangible benefits for the people that support a free and open democratic system.

The second reason for my optimism is the availability of stable economic condition and robust macroeconomic resilience currently within our grasp. This resilience is briefly illustrated in Table 5 and will become the trigger of better and sustainable economic expansion over the next two years despite strong external challenges in the financial market and global commodity market in the form of oil price hikes and soaring global food prices.

On the whole, projections of future economic growth compiled by Bank Indonesia are as follows. We expect economic growth to continue to rise through 2009 and will gradually reach 7% annually. Economic growth will primarily be supported by an increase in economic capacity in line with the BoP surplus, a stable exchange rate, and a reduction in inflation.

Strong BoP performance will be supported by several factors. From a current account perspective, the performance of our non oil and gas exports will remain strong due to diversification in export destination countries and strong global demand for primary commodities relating to alternative energy. In terms of the capital account, portfolio investment flows, especially for equities, will remain robust along with numerous IPOs and high expectations for corporate profits in Indonesia. Several prominent facts that I have gleaned from the global financial community also indicate a large global investor appetite for capital investment in Asian emerging market countries, especially due to prevailing high global excess liquidity. Regarding the net remittance from Indonesian migrant laborers, I expect that in the future income transfer will remain strong and steady, representing substantial capital inflows to Indonesia.

BoP performance, taken as a whole, will support Bank Indonesia in taking the necessary steps to maintain rupiah stability. We will continue our ongoing measured foreign exchange intervention policies to smooth out volatility in the exchange rate, without imposing a specific level. We are also aware that our policy to maintain adequate foreign exchange reserves must remain consistent by maintaining macroeconomic stability in the long run. We at Bank Indonesia are clear that maintaining a stable exchange rate and nurturing a favorable climate so as to strike a balance between internal and external balance are pre-requisites to further reduce price sensitivity to exchange rate fluctuations. By lowering the exchange rate pass-through effects, core inflation, which is the mid to long term trend of headline inflation, will be preserved at a consistent rate approaching the inflation targets.

We see that the ex-ante inflation targets up to 2010 are not impossible to achieve, namely 5 $\pm$1% in 2008, 4.5 $\pm$1% in 2009, and 4 $\pm$1% in 2010. This disinflation trend will further bring our inflation rate closer to that of our trading partners, which on average is within the range of 2-3% annually. The achievement of inflation targets will be supported by the following policy mix.

On the fiscal side, the fiscal authority will continuously strive to improve fiscal sustainability amidst the oil price shocks and future global uncertainty. To this end, the 9 steps announced to safeguard the budget formulated last year will constitute the initial guidelines for market players regarding fiscal resilience. Meanwhile, as part of a thorough anti-inflation policy, all government ministries and agencies related to the control of food inflation will take measures to lower its rate and ease its persistence.

Table 4.
Indicators of Financial System and Macroeconomic Resiliency

Indicators	2006	2007	Forecast: 2008
Macroeconomy			
Macroeconomic condition in 2007 was more resilient than that in 2006, with CPI inflation kept in check, stable rupiah exchange rate, increased foreign reserves, lower debt ratio and maintained fiscal sustainability			
CPI Inflation	6.6% yoy	6.6% yoy	5% + 1%
Rupiah Exchange Rate	Appreciated by 5.96%, with volatility of 3.79%	Appreciated by 0.29%, with volatility of 1.37%	Rupiah exchange rate slightly depreciates as a result of rising import in tandem with increasing economic activities
Foreign Reserves	Dec' 06 = USD42.6 Billion, equivalent to 4.5 months of import and government foreign debt repayment	Dec' 07 = USD57 Billion, equivalent to 5.7 months of import and government foreign debt repayment	USD 72.9 Billion
• Debt to GDP • Short-term debt to foreign reserves ratio	• 35.3% • 70.1%	• Oct 2007 = 33% • 52.4%	
Primary Balance	Surplus 1.4% of GDP	Surplus 0.7% of GDP	
Banking Industry			
Banking industry's resiliency strengthened, demonstrated by increase in capital, improvement in quality of credit, rise in profit and enhancement of risk management			
Main indicators of performance	• CAR= 20.47%, NPL Gross= 6.98% (NPL Net = 3.63%), ROA = 2.60%	• CAR= 19.82%, NPL Gross= 5.63% (NPL Net = 2.49%), ROA = 2.80% (Oct 2007)	• NPL Gross : 5.11%
Credit growth	• 14,1% with LDR of 64.7%	• 23.1% with LDR of 69.0% (Oct 2007)	• 24% with LDR of 72.0%
Capital Market			
Capital Market's resiliency improved, as market capitalization, volume and frequency of transaction continued to grow			
Liquidity in Capital Market	• Market Capitalization = 45% of GDP • Avg. vol of Bond Trading = IDR3.3 trillion a day, freq. of bond trading= 146.7 times • NAV of mutual fund = IDR50.87 trillion	• Market capitalization = 49% of GDP • Avg. vol of Bond Trading = IDR5.8 trillion a day, freq. of bond trading= 253.4 times • NAV of mutual fund = IDR90.4 trillion	

Monetary policy will contribute significantly through the preservation of exchange rate stability, which is to become a key policy. Moreover, through the BI rate policy under the inflation targeting framework, Bank Indonesia will continually maintain a consistent monetary policy stance to achieve the inflation targets set ex-ante. From time to time, we will compare how far the BI rate stance complies with the forward-looking expectations that we form through Bank Indonesia projections and surveys of inflation expectations. We will also take policy steps to reinforce financial system stability in order to reduce the potential of global financial market shocks affecting the domestic foreign exchange market. To strengthen the financial system Bank Indonesia will take strategic steps, for example through domestic financial market deepening, and further improve the performance and resilience of the banking industry. I will elaborate on these steps further in the final part of my speech this evening.

The proposed low inflation rate will help support the development of permanent income, therefore strengthening purchasing power, especially in the middle to low income group. Supported by further improvements in MDG indicators, stronger purchasing power will become more permanent in nature and subsequently broaden the consumption base of the domestic economy. Provisions and improvements to primary infrastructure, bank credit, adequate energy supply and wider access to entrepreneurship will boost domestic market capacity. This will then become a catalyst for national production capacity expansion through FDI and domestic investment in both the corporate and MSME sectors. A rise in continuous investment will further push Indonesia towards investment grade status.

IV. Strengthening stability, safeguarding development

Ladies and Gentlemen,

All of the predictions I have just outlined are highly dependent on the assumption that financial system stability as a whole is maintained over the next two years. This assumption in many cases is reliant on policy initiatives instituted by Bank Indonesia relating to the three pillars of stability. Therefore, in the following section, allow me to present several views on the steps that need to be taken by Bank Indonesia to strengthen stability and subsequently safeguard our current economic progress.

The realization of three robust pillars of stability in the national economy requires knowledge and patience in making adjustments, which in the long term will improve the effectiveness of various policy initiatives and programs. Adjustments made in the short term sometimes encourage our stakeholders to question the credibility, and even the continuity of policy initiatives we introduce ex-ante. There are a few gloomy moments on our path towards stability, however, there are also many bright days where the stakeholders finally comprehend that ex-post adjustments do not mean a lack of commitment to achieve what we have announced ex-ante.

To characterize Bank Indonesia's policy initiative management over the last five years I would use two keywords: gradualism and balancing. Within the two keywords, there is an understanding that the management of policy initiatives and programs cannot merely be rule-based. It is sometimes necessary to be discretionary when changes in the strategic environment and in the economic constraints occur. Nevertheless, when implementing discretionary policy, we do not entirely abandon the merit of being guided by some rules so as to ensure we stay congruent with our *mandates* to strengthen the three pillars of stability. Against this backdrop, our freedom and creativity in implementing policy adjustments will always be a measured discretion. I feel this needs to be reiterated to banish any doubt in Bank Indonesia's commitment to continually provide three pillars of stability that form the pre-conditions and elements of continuity for sustainable economic development.

Therefore, in the short term we will continue and complete, post haste, our outstanding homework. However, in anticipation of the numerous future constraints we face, there are several new policy initiatives that I deem necessary to be taken in the monetary sector as well as banks, the payment system and the real sector.

1. Initiatives in the monetary sector

Ladies and Gentlemen,

In the monetary sector, Bank Indonesia will introduce initiatives to mitigate the challenges thrown on us by financial globalization, while preparing monetary policy to conform to AEC 2015. The initiatives are divided into three key groups: initiatives to develop the domestic financial market, initiatives to strengthen monetary policy effectiveness, and initiatives to improve policy tools for AEC 2015.

1.1. Domestic financial market development

Currently we can see that the domestic financial market has developed very rapidly, particularly the Government Debt Instrument (SUN) market. In future, the role of the domestic financial market will become more significant, in ensuring monetary policy effectiveness as well as maintaining economic stability in a broader sense. If we look further, challenges related to financial globalization, as I mentioned before, have a greater potential to disrupt our domestic economy. This has been very discernible lately with respect to the global financial market crisis stemming from the collapse of the low-quality household sector, or subprime mortgages, in the US. Although to this point the impact on our domestic financial market remains contained, this crisis proves the importance of a stronger, deeper and more liquid financial market so that potential disturbances emanating from external factors can be minimized.

Considering these factors, it is important that we enrich the instruments and types of transaction used in implementing monetary policy. This includes reactivating repo transactions with underlying SUN, reactivating longer tenure SBI (6, 9 and 12-month SBI), and foreign exchange swap transactions. Reactivation of SUN repo transactions through liquidity management will also improve activity and liquidity in the SUN market. As a result the SUN market will be more efficient and more resilient to shocks. Meanwhile, FX Swap transactions will synchronize and harmonize steps to manage liquidity and maintain rupiah market stability with the domestic foreign exchange market. We expect these steps to support various efforts to deepen the financial market as a whole (*financial market deepening)*.

Still related to our effort to expedite financial market deepening, we have also looked at the significance of expediting the development of the sharia financial industry. Developing the sharia financial industry will broaden the types of instruments available to the public in managing their financial assets portfolio. This will greatly assist the domestic financial market to absorb shocks. Besides, developing the sharia financial industry will also allow sharia banks to grow more rapidly. This mutually beneficial interaction will expand the share of sharia banks in our national banking industry.

The global excess liquidity phenomenon that principally stems from the middle-east leaving the US market after the implementation of the Patriot Act will help develop the sharia financial industry further. Many other countries such as Qatar, United Arab Emirates, Malaysia, Japan and Singapore have also taken strategic steps and have been successful in attracting the excess liquidity. Malaysia and Singapore have even used Indonesia as a source of funds through attractive sharia instruments. However, in the case of Indonesia, much more needs to be done in the near future, especially when considering that Indonesia is believed to hold great potential in the global sharia financial industry due to its large Moslem population; the largest Moslem population in the world.

In the future, in line with the upcoming implementation of the AEC 2015, competition in the sharia financial industry will be tougher. Many constraints to the growth of the domestic sharia financial industry, such as tax issues, still impede the common efforts currently underway. In addition, the development and improvement of the national sharia financial industry competitiveness still requires the support of infrastructure: institutions, regulations, a sound legal framework, human resources and market infrastructure. To fill this void solid coordination is required by us all. In support of such coordination Bank Indonesia will formulate a grand strategy for national sharia financial industry development, through collaboration with other related institutions. Bank Indonesia will also review various aspects related to the strategy and implementation of monetary policy in our economy that uses a double financial system, namely conventional and sharia.

1.2 Strengthening monetary policy effectiveness

Ladies and Gentlemen,

There have been many sections of my talk here this evening that emphasize how rapid the changes are happening around us. To survive amidst such conditions there is no other option but to adapt by making the necessary improvements to mitigate our problems and weaknesses.

In the monetary sector, one of the policy strategies we consider necessary for continuous review and improvement is the effectiveness of ITF implementation. From the assessment results of ITF implementation over the past three years, the opportunities to optimize existing strategy effectiveness remain wide open. This is primarily due to liquidity management, predominantly performed through 1-month SBI issuance that still triggers fluctuations in available liquidity in daily money market, high interest rate volatility and a steep short-term yield curve in the money market.

These factors do not effectively promote portfolio management efficiency in financial institutions and further encourage them to seek profit by utilizing the difference in the short-term interest rate. High fluctuations in the money market interest rate also exacerbate the uncertainty surrounding the liquidity of financial institutions that invest their funds in longer term assets than the source of funds. In other words, the cost of being temporarily illiquid becomes expensive. Market players tend to be short-term orientated which, in turn, distorts monetary policy transmission and is also inefficient in promoting the role of the financial market in the economy.

Steps to improve monetary policy effectiveness that we envisage are basically **tactical move** deemed necessary to optimize the effectiveness of monetary policy implementation under ITF. In its implementation, this tactical move will be focused on efforts to maintain interest rate stability in the short-term inter-bank money market (*PUAB*), especially the overnight rate, as a transmission tool of monetary policy, while also serving as a mechanism to generate a more reasonable short-term yield curve.

In a wider context, the move will also aim at improving asset pricing efficiency in the financial market and bank products. Therefore, steps to introduce SBI issuance over a longer maturity period is a precondition that must also be met. This is to absorb excess structural liquidity through the auction mechanism. The amount of SBI issued for various time periods will be based on projections of the bank liquidity requirement.

Simultaneously, Bank Indonesia will continue to monitor liquidity and the PUAB O/N daily interest rate as well as responding to deviations within certain limits, through Fine Tuning Operations. In principle this will ensure that there will be sufficient daily liquidity to settle bank transactions and, therefore, the PUAB O/N interest rate will remain steady. If Bank Indonesia needs to add or remove liquidity temporarily then repo transactions can be introduced, either by issuing SBI or SUN, or FX Swap transactions.

With a genuine short-term yield curve market players no longer focus on profit taking with a short horizon in the money market. This will encourage them to be more active in seeking profit through fund investment and management over a longer horizon. This policy initiative is expected to maintain the overnight PUAB interest rate at a consistent level that reflects the direction of Bank Indonesia monetary policy, namely the BI rate level.

These policies, in turn will also promote banks and other financial market players to use asset and liabilities management (ALMA) more professionally, including risk management. Money market interest rate stability will reduce the risk of long-term investment liquidity risk while also improving financial market infrastructure, therefore, it is more efficient in promoting quality and sustainable economic growth.

1.3 Strengthening analytical tools for In anticipation of ASEAN economic community 2015

Ladies and Gentlemen,

The third initiative in the monetary sector is strengthening policy analysis related to AEC 2015. The ASEAN Charter in Singapore on 20th November 2007 witnessed the introduction of the ASEAN economic integration program that is no longer up for negotiation. The AEC 2015 intra ASEAN free-trade agenda is nearly complete and will usher in a significant change in the movement of the production factor. The effect of free movement in the production factor is the establishment of a new configuration of intra ASEAN economic production distribution. It is therefore imperative for a central bank to understand the determinants of this new configuration. We need to project new characteristics and determinants of economic production distribution. As we are discussing something that will take place in the future, we do not have any data that can be interpreted through empirical study. Therefore, Bank Indonesia will initiate several theoretical and analytical research programs.

Also, to investigate in more detail the effects of trade constraints (tariffs and non tariffs) on the export performance and public welfare of every ASEAN country, multiyear research is necessary involving enthusiastic, competent and highly dedicated parties. To this end we will develop a modelling technique based on Computable General Equilibrium (CGE) using the database of the Global Trade Analysis Project (GTAP) and Financial-Social Accounting Matrix (FSAM). To my knowledge, to date there are few public institutions in the country that have conducted this very important research agenda.

If we reflect together, future Indonesian success in AEC is not independent of our competitiveness relative to the competitiveness of the other nine ASEAN member countries. I believe that competitiveness has three dimensions, namely (1) basic necessities, which include institutions, infrastructure, macroeconomic stability, primary education and health; (2) efficiency determinants, which include follow-up education and workshops, an efficient products and services market, financial market development, technological readiness and market measurements; and (3) innovation and sophistication, which include advancement determinants and the level of innovation. Therefore, research that can map the competitiveness of ASEAN countries and reveal where Indonesia's competitiveness can be improved is a vital input, which should be followed up immediately by all elements of the nation, including Bank Indonesia.

Finally we also need to understand the role of the monetary authority amidst AEC 2015 implementation. We need to see whether our prudent monetary policy, which targets low inflation and macroeconomic stability, remains in our nation's best interest. Up until now we have been convinced that prudent anti-inflationary monetary policy is pro-poor domestically.

2. Banking sector initiatives

2.1 Direction of follow-up policy in the context of restructuring the national banking industry

Ladies and Gentlemen,

Moving on I would like to discuss my thoughts on the future direction of banks. Since Indonesian Banking Architecture was launched at the beginning of 2004 we should be grateful for the strength and resilience of the banking industry when confronting the various risks and shocks that have increased gradually over time. Industry performance has also improved slowly. Bank profits are steadily increasing in line with the expansion of the intermediation function and efficiency improvements, as well as effective risk management.

Although much has been accomplished, a lot more still remains to do. In this current globalization era, the speed of change often impresses. Our achievements today do not guarantee success tomorrow. Only the fundamentals are not prone to rapid change.

We have always utilized this awareness as the foundation of IBA formulation for banking industry policy. The achievement of six fundamentals, namely the pillars of IBA, represent, in essence, a transformation process; from the chaos that came from the crisis, to a solid industry resilient to shocks that can compete globally and benefit all strata of society. This process requires an implementation strategy that ensures every initiative and program introduced can succeed and become a fundamental strength in the future.

Therefore, every step needs to be carefully and cautiously calculated. It is imperative that we remain always sensitive when addressing the changes and dynamics of this process. We also have to be able to calculate the implications of each step on all related dimensions, prioritize policy, and maintain a good balance in the implementation to avoid unnecessary shocks.

One endeavor undertaken to achieve the fundamental goals of API, with its lengthy complexity, is the restructuring of the banking industry as set forth in API Pillar 1. This objective requires the fulfillment of many preconditions in the strategic environment, including the banking industry, and also the support and participation of all parties. Clearly, within in the implementation of this policy, Bank Indonesia cannot progress single-handedly. Support from all stakeholders, particularly the banking community, Government, and People's Representative Council, is the key to successfully achieving the ultimate goal.

From our journey is an important note that requires attention, namely that a sound and robust banking industry is capable of playing its role optimally.

Realizing this, steps to strengthen bank resilience, as part of the strategy to restructure the banking industry, do not always have to be taken sequentially with steps to optimize the function of the industry. Both can be performed simultaneously, filling in and complementing one another depending upon the prevailing economic priority. Therefore, in the face of a range of problems and limitations in policy implementation, it would not be taboo to adjust our strategy. We know that in the market economic system we currently follow, regulation can only be effective and no disrupt stability if the strategies and mechanisms adopted follow the guidelines and principles of the market system.

As I have previously mentioned, many steps to support this process have already been instituted. By mapping the strengths as well as the weaknesses and directing them into the operational scheme of each bank, we have been able to line up a bank consolidation program, a capital adequacy requirement, and a single presence policy. On the other hand, we must also continue reviewing the conditions and potential of the public economy through expanding the role of Bank Indonesia branch offices, rolling out programs that support real sector growth and improving information quality as well as data, business and economic analysis. Furthermore, we must upgrade the information system to enable banks to access information more thoroughly and accurately regarding conditions in the public economy throughout Indonesia. Such policies have to be followed by consultative and persuasive steps for each bank manager to position oneself to fill every structural layer of the industry.

Based on my thoughts, I would like to take this opportunity to outline three key strategies that I suggest to use as a reference when continuing banking policy over the next five years.

First is follow-up policy direction in terms of restructuring the national banking industry. Within this policy scope, I have placed three initiatives aimed at solidifying the consolidation process according to projections of economic growth against what I consider to be a bank's role in the future, namely:

a) Determining the possibility of re-establishing banking policy dedicated to support the funding of long-term development projects.

b) Broadening operational opportunities for universal banking by banks deemed capable and worthy of running it.

c) Optimizing the bank's role in funding development, especially for foreign-owned banks.

Second is the direction of rural bank development, which represents one pillar of the local economy, considering the potential of the local economy and the welfare of the public.

Third is to catalyze the growth of Sharia Banking.

Allow me to elaborate further on the backdrop of my thoughts and offer some initiative ideas we can take to materialize them.

A. *Investigating the possibility of re-establishing a policy bank dedicated to support the funding of long-term development projects*

Ladies and Gentlemen,

At the 2007 bankers' dinner, I elaborated upon supply side rigidity in response to demand, which hinders the smoothness of our economic growth. I also stated that one of the causes of such a phenomenon is low investment growth by both foreign and domestic parties as well as in other strategic and long-term productive business activities. In the past 10 years since the crisis, the accumulation and quality of capital has been slow and its proportion to GDP has not recovered to pre-crisis levels.

Clearly I do not need to repeat what I covered last year. I imagine we can all recall and explain the many constraints undermining strategic investment to our economy. However, our explanations are no longer viable if we then take no further action. What is far more important and urgent is how we can direct our efforts, strength and hard work to immediately succeed in overcoming this impasse in investment. We all know that the Government and other related parties have continued to strive for reform in many sectors and tried many ways to prevail over the numerous existing investment constraints. Nonetheless, we also know that such efforts are problematic because the issues we face are incredibly structural and complex, and often inter-related.

From the abundant investment constraints we have identified, one is the limitation or absence of physical infrastructure. It is all too commonplace to see or feel much of our physical infrastructure is malfunctioning, obsolete or insufficient in capacity. Developing facilities and infrastructure such as electricity, roads, seaports, storage, manufacturing sites, dams, irrigation and many others is relatively still limited. Even for routine public economic activity, such infrastructure is no longer worthy of attracting new investment.

In my view, this is due to at least three factors. First, in the first few years during and after the crisis, our economy contracted. Against this backdrop, fund sources for development purposes became limited and priority was allotted to the payment of short-term liabilities. Second, despite economic improvements over the past few years the majority of the state budget has gone to regional areas, for which the use of development funds is highly dependent on the ability of the local governments. From existing data it is clear that local government absorption of the state budget remains sub-optimal. As a result, development funds have mutated into short-term funds, which only circulate in the financial sector. Third, infrastructure projects of national interest require substantial budget allocation that cannot be fully covered by the state budget. Other commercial sources of funding are required, such as from banks or the capital market. Unfortunately, bank funding is still dominated by short-term fund sources; therefore, the funding of long-term infrastructure projects is relatively limited.

We cannot allow this to persist. Appropriate infrastructure is dearly needed if we want our economy to expand further in a more balanced and prosperous way. Regarding the challenge of persistent inflation that I mentioned earlier, improvements and the expansion of infrastructure nationwide is crucial. Good quality infrastructure will counter product supply distribution constraints and lower costs on the supply side, thus making the economy more efficient. Consequently, better efficiency will enable the supply side to be more responsive to demand, alleviating the susceptibility of our economy to inflation. In the longer term, better infrastructure will also support economic productivity, which will provide the opportunity for more permanent disinflation.

We must thoroughly address these three development constraints collectively. This evening I am advocating an idea that is actually not totally new to us but is now extremely pertinent and urgent. The idea is the re-establishment of a special bank policy to fund long-term development projects.

This Policy Bank, in essence, is an extension of the Government's desire to seek long-term funding through numerous methods and mechanisms. Other than direct public funding, banks must focus on long-term funding from the financial market by issuing bonds, and seek overseas loans from multilateral institutions. Funds gathered through this bank policy are subsequently distributed to long-term projects and development programs, particularly infrastructure, to complement development funding allocated through the state budget.

Operational activity will be focused as an investment bank to provide support and facilitate the Government, including regional development banks (*BPD*), in issuing bonds in the capital market, both conventional banks and sharia. In the context of strategic policy and growth management, the bank policy represents the primary motor and drive for the Government to build a collaborative framework for effective and efficient funding of public and private partnerships. To facilitate this policy direction, Bank Indonesia will continue to undertake numerous reviews and preparation policy steps, including the initiative to expand universal banking which I would like to expand upon shortly.

After in-depth reviews and detailed preparations, the Government could establish such a bank through the consolidation of banks or financial institutions that have this bank policy, or by establishing a brand new bank. The ownership of such a bank can subsequently be diversified to many parties, such as the general public, other state-owned banks, state-owned enterprises, foreign private parties or domestic international institutions, provided that the Government remains the majority shareholder and controller.

It is important to note the implications of establishing a government bank to administrate this special duty. With the existence of this bank, other government banks will be required to adjust their role, function and strategy to avoid any unnecessary competition. Each government-owned bank will have its own function and role to support the growth process by optimally providing services to the public according to its own market share.

With the adjustment in focus and business strategy of the government banks, I expect each government-owned to compete with other banks according to their vision and mission as well as their competitive strengths. For Bank Indonesia, this policy measure will generate significant results in terms of reinforcing the bank consolidation program, while also serving as an integral part of national bank restructuring as a whole.

B. <u>Expanding operational opportunities concerning universal banking for suitable banks</u>

Ladies and Gentlemen,

Recently, Bank Indonesia presented a plan to the public regarding the possibility of adopting universal banking to substitute our current commercial banking approach. We have adjusted legislation to serve as a legal foundation for our banks. Action to adopt this universal system is basically a response to our position amidst financial sector globalization that is becoming more real in our daily lives. In practice, to improve the banks' function and role in mobilizing public funds, current global bank development direction is innovative. This enables the integrated packaging of a bank's products with other financial industry products.

In terms of the banking industry, this is undertaken to achieve several objectives simultaneously, more specifically to hasten fund flows managed by banks, as well as expand the operational base to be capable of increasing the income margin and reducing risk exposure. From a public policy management standpoint, the adoption of universal banking into the Indonesian banking system will also support financial market deepening, which will eventually contribute to financial stability and economic growth. Broader bank product variety may also be instrumental in maintaining financial stability as it provides investment diversification for the public. Without concentrating placements in only one or several types of product, it is expected that the economy will become more resilient when confronting shocks. In this case, a deeper financial market is often identified as a more resilient and stable financial market. Financial intermediation that is required to drive an economy will also be assisted by the growing number of available financial products.

Integration of bank activities and products in the form of asset securitization, mutual funds, and derivative transactions will obviously increase risk exposure, not only for the institutions involved, but also the financial system as a whole. Consequently, we will have to be prepared to meet the various supporting conditions to continuously maintain stability. Banks involved in universal banking are required to have capable human resources, solid financial and operational power, as well as the ability to manage risk effectively before commencing such activity.

In fact, it is clear that our banks currently have indeed undertaken *de facto* universal banking activities through collaboration with other financial institutions or subsidiary companies. To avoid any unwelcome surprises that may lead to fluctuations, the relevant authorities will inevitably have to announce their determination in observing the overall operational dimension so far undertaken by banks. It is imperative that management of the banking financial industry is complementary and compatible by clearly detailing each stakeholder's responsibility and authority. This has to be followed up by close collaboration and coordination among the relevant authorities to protect overall system stability.

To this end, consolidated risk-based supervision implemented by Bank Indonesia will be improved by observing the relationships between banks and other financial companies. Once we have finished formulating the management of universal banking, we will offer several options to banks permitted to operate in this sector:

1. Merge with their subsidiary company, especially those that operate in securities.
2. Maintain the subsidiary company in the financial sector but declare all of its activities within the business activity of the principle bank. In this context, we will collaborate with the applicable authorities to compile prudential principles and a set of uniform operational data and information standards for each product or activity categorized as a universal product.
3. Choose to execute a vision, mission and business activity strategy focused on investment activity (investment bank).
4. As a consequence of the options on offer, Bank Indonesia will determine the portion of activity related to universal banking within differing definitive limits. The differences relate to the three options I just outlined and are based on the results of Bank Indonesia research regarding the ability of each bank in undertaking this activity.

From the viewpoint of Bank Indonesia, universal banking embodies a hope that our banks can position themselves internationally within *our* banking industry structure. Such banks will have to be adequately equipped to compete globally. If consensus can be reached on this matter then we must scramble to prepare ourselves immediately. The demands of the global financial market render it impossible for us to freely and leisurely set our own schedule. AEC 2015 is just around the corner with its various implications on various socio-economic aspects of our nation.

The main key to begin stepping towards our destined place is already in our hands. As we realize that the adoption of the universal banking pattern will entail much preparation, we can see that the many aspects of the banking industry enhanced by API are starting points from which we start. The banking consolidation program, enhancements in bank's financial and operational aspects such as capital, risk management, and efforts in consumer education are programs which we must complete according to the set schedule. As we move forward, the enhancements conducted by API are increasingly showing its merits. The adoption of universal banking is only one possibility made possible by API. As such, we would be amiss to think that the final structure of API will be completed in 2010; that year is only the starting point for the industry's further enhancements.

C. *Optimising the role of banks in development funding, especially foreign-owned banks*

Ladies and Gentlemen,

From Bank Indonesia's point of view, the process of reinforcing the banking industry, which we began shortly after the Asian Crisis, has yielded essential changes in the banking industry constellation in Indonesia. Currently, there are 49 commercial banks that are majority owned by foreign parties, totalling 46% of total national bank industry assets. Providing we can maintain financial system stability and policy direction, Bank Indonesia estimates that the acquisition process of domestic private banks by foreign parties will continue.

From the point of view as an authority, the change in industry constellation is multi-dimensional and must be followed and monitored in terms of the function and role of banks in the economy in future. I often ask myself what implications will arise as a result of the change in structure. In addition, I regularly discuss this matter with a variety of stakeholders, both domestic and foreign, who can assist me with the answers to my questions.

Obviously, there are many countries in the world where their banking industry is dominated by foreign stakeholders. However, Indonesia is different. The change in constellation has prompted many questions, such as will we as a nation be able to reap the benefits of a banking industry dominated by foreign parties? What policy response must Bank Indonesia take to address this, primarily in order for Indonesian banks to contribute optimally to the growth process?

From my investigation, I have come to a temporary conclusion that such questions are perennial and will continue to shadow us all, especially us at Bank Indonesia. The answers will very much depend on numerous factors concerning the banking industry itself. We all know that one crucial factor that can affect the optimization of the function and role of foreign banks in Indonesian economic growth lies in the response and policy direction taken by the authorities.

Realizing this, I feel the need to propose some basic principles to determine the direction of Indonesian banking policy to address our concerns as a nation in overcoming and benefiting from the change in ownership constellation. I would like to bring our thoughts and views in line to see the opportunities available for banks to be the motor and director of economic activity. This principle is known as "banks leading the development." This basic principle is contrary to the general principle commonly used as the cornerstone of banking activity in an economy, namely "banks follow the trade".

How have I come to the conclusion that banks should be the motor and director of the economy? The answer returns me to the future economic challenges I have already discussed here this evening. The challenges implicate the importance of the contribution made by the banking sector in joint efforts to address the challenges of social exclusion. Therefore, we require banks to utilize the public economy (a socially inclusive banking sector) and open access to assets at the grass-root level to improve the quality of economic growth and support domestic market growth.

We are all aware that bank activity is commercial, which obviously is mandated with maximizing profit. There is nothing wrong with this; however, it is important to understand that sustainable banks in the long term also demand a developing domestic market. Fund mobilization that is not followed by growth in productive assets at the grass-root level to augment the permanent purchasing power of middle to working-class citizens that represent the majority of producers and consumers in the country, will slowly bring banks into a race to the bottom.

Therefore, I would like to encourage foreign banks in Indonesia to jointly empower and expand their customer base because this is where the future expected returns lie. The efficiency you have gained, which shows your professionalism as bankers, is capital to build your customer base to further ensure your business resilience in the future. I fully understand that in many ways what you are experiencing in terms of your competitive environment is similar to what is known as a prisoner's dilemma. Individually, the benefits you enjoy as initiators of a more prosperous customer base are not necessarily followed by a constructive tit-for-tat strategy by all participants. The absence of this coordination mechanism has become our concern because such circumstances could eventually trigger "stagnation" that disrupts the expediency of all participants in the banking industry. Consequently, Bank Indonesia will provide equal incentives for all and will be a fair mediator to ensure that no one plays outside of the rules commonly made and agreed upon.

In line with this, I would like to propose three policy programs to constitute guidelines in optimizing the role of banks in addressing the numerous economic challenges we currently face. These policy programs are primarily targeted at foreign-owned commercial banks, which continue to direct most of their credit extension to the consumptive sector. However, implementation does not imply that other domestic banks are exempt from enjoying the benefits of this policy. Bank Indonesia will institute this affirmative policy for the greater good of all banks; differentiating the weight of liability according to the portfolio conditions of each bank.

First is the responsibility of every bank to nurture entrepreneurs of productive ventures in certain regions or sectors who have always had potential but never been properly developed. This nurturing process is in line with the extension of business loans, in the form of working or investment capital, the amount of which is tailored to the prospects and ability of the business. The ratio or portion of total credit to each debtor in meeting this liability will be calculated referring to several indicators. One crucial indicator to be used is the relative comparison of the amount of existing consumption credit on a bank's portfolio. The costs involved in this process to be borne by the banks can be calculated as the cost of funds acceptable to the debtor, or as part of the operational (overheads) costs of a bank.

Second is the obligation to extend credit to the productive MSME sector at a given ratio or portion of total credit distributed by each bank. This policy is not completely new. Before the crisis, Bank Indonesia once implemented this policy in the national banking industry to promote MSME growth. By taking into account past experiences, a refined version of this policy is being considered for implementation.

Third is the duty to implement a Corporate Social Responsibility program in every bank at a ratio to be commonly agreed upon. I take the view that a bank's CSR program should be directed towards the strategic efforts to shape our nation's future. One of the strategic fields in this respect is education. I hope that banks can substantially contribute to education through innovation and creativity to provide better opportunities for our children to achieve their dream of a brighter future.

Fourth are Bank Indonesia measures to immediately finalize reviewing the possibility of reducing the calculation for risk-weighted assets (*ATMR*) on credit for activities of the poor (*KUR*). Based on a thorough review, the opportunity has arisen to reduce the *ATMR* of such credit, considering that it has been re-insured by Askrindo, which is a state-owned enterprise itself. In practice, the current portion of *KUR* distribution not covered by Askrindo and therefore the responsibility of banks is 30%. Taking into account current *ATMR* calculation regulations, where credits insured by state-owned enterprises have a risk weighting of 50%, then we project that we will immediately adjust the *ATMR* calculation for *KUR* to around 30 to 40%. Hopefully in the near future we can promulgate new regulations pertaining to this credit. There is also the possibility of a new *ATMR* calculation for MSME credit guaranteed by insurance companies other than Askrindo, as long as the respective insurance company can meet a set of conditions to be determined.

As usual we will fully cooperate with all of you in the formulation process to discuss the best measures we can achieve jointly together. I believe that the three policy steps I have outline can act as the trigger to establishing strategic national assets for our future, including the banking industry. Good communication needs to be maintained and improved in quality. The banking community does not have to hesitate in presenting the many concerns that require an appropriate response from Bank Indonesia, but should do so without creating unnecessary noise in the public domain. We must agree that the future of this nation does not only lie in the big cities dominated by non-tradable sector activity. This nation should rely on the potential and power of its resources, which remain overlooked in many rural areas. Therefore, if we in the banking community wish to survive and continue generating profit in the long run, the existing potential must be developed and realized in order to achieve growth.

2.2. Development direction of rural banks as a support of local economic strength

Ladies and Gentlemen,

I would like to now turn my thoughts to rural banks. As I mentioned in my guidelines last year, rural banks need to be redefined in the context of serving the range of dynamics in the lives of the underprivileged. When we see many rural banks in suburbs or even the city, it beckons the question of whether it is a true rural bank that is actually serving the Poor. What is so wrong with our villages that rural banks hesitate to go there? Or maybe we approach this from the opposite point of view, what is wrong with the rural banks that they choose to enter the cities?

Finding answers to these questions is hardly a difficult task. We have to admit that the economic condition of many people in the villages is still a concern. On the other hand, by following the current trend of approaching the matter as a commercial business venture, rural banks take short cuts by operating as commercial banks seeking to generate a profit. However, the original concept based the placement of rural banks in the national banking industry to operate specifically to serve a particular public segment, which require special treatment.

From our standpoint as the monetary authority, rural banks are not banks that issue checks, debit cards and wire transfers or electronic money; therefore, from the outset we have not placed rural banks under monetary policy transmission. This exclusiveness is intended to allow rural banks to be more flexible when penetrating rural areas in order to serve underprivileged people, which is indeed the purpose of their existence. Having almost 10 times more premises than commercial banks, rural banks should be able to spread throughout the country without having to concentrate on entering the large cities or operating like commercial banks. From the point of view of the banking authority, rural banks do not have systemic impact in the case of a problem. However, if many rural banks fail to compete with commercial banks due to their inability to utilize their exclusivity, the breakdown will significantly burden the banking system.

Against this backdrop, it is normal for Bank Indonesia to deem a review of existing policy and a subsequent response necessary, according to the basic concept and principles we jointly agreed upon. I would like to reiterate that rural banks are required to become more efficient in performing their role and function to serve the public in rural areas. Rural banks must to return to their mandate of supporting the local economies, which are the target and focus of their business activity. Economic localities which grow and stem from local people's socio-culture values should form the backbone of rural banks. The fundamental difference between rural banks and commercial banks is the ability of rural banks to enter and become part of norms and dynamics of their surrounding community. Thus, the approach and operational activity of rural banks must reflect the habits, traditions and culture of the public being served, therefore, they feel comfortable and safe with the respective rural bank. Consequently, the operational structure of rural banks must be customized according to its target market.

Realizing the need to redefine and redirect the policy direction of rural banks in the future, I would like to highlight several initiatives we can take over the next five years.

1. Thoroughly conduct research studies and reviews concerning local economic strengths that would be more relevantly served by rural banks instead of commercial banks. From the results of the study, rural banks should be able to formulate and prepare an operational structure suitable to local conditions, and therefore exploit the niche opportunities to generate profit.
2. As a starting point, Bank Indonesia is currently preparing the internal establishment of the Centre for Micro Finance Study. This study centre will be established together with many parties; including international institutions with extensive experience and deep knowledge on micro funding like GTZ, Swisscontact and IFC. The study centre is expected to sharpen numerous efforts taken by the Government and other parties to support the development and utilization of poor public economies in various rural areas and villages.
3. Compile a blueprint for future rural bank policy direction involving various stakeholders, particularly the local government, in order to synergize the function and role of rural banks in supporting the provision of region/village development funding, together with other micro financial institutions that currently exist. Under this initiative, numerous policy options will be reviewed to reorganize the rural bank industry according to the socio-economic potential of the local cultures where rural banks are deemed to have strong development possibilities.
4. Discover the most suitable form of supervision and management to be adopted by rural banks. In line with the variety present in the operational structure of rural banks Bank Indonesia's role as the authority must also adjust to maintain the health and strength of rural banks without constraining the operational structure of each individual rural bank. Under such circumstances, a one-size-fits-all principle is no longer relevant. Therefore, the opportunity has presented itself, in the management and supervision of rural banks, that Bank Indonesia will include other stakeholders that genuinely understand rural bank conditions in each region, such as the local government, *LSM*, consultants and other stakeholders. The function and role of Bank Indonesia in future will focus more on providing guidelines, prudential signs as well as illustrating the overall industry conditions and dynamics.

2.3. Measures to expedite sharia banking expansion

Ladies and Gentlemen,

My final thought for the banking sector concerns sharia banking. In an effort to support sharia industry growth, this year, we have targeted 5% of overall bank assets to be owned by sharia banking. Furthermore, up to 2015, we expect this share to increase to 15%. This is certainly an ambitious target but definitely attainable. We need to garner all banking industry stakeholders and other related parties to work harder and be more innovative to achieve this target. Based on our observations and by monitoring the performance of sharia banking worldwide, we believe that the potential strength and competitiveness of sharia banking in Indonesia will grow and develop substantially. We will also see that sharia banking is a financial product and service whose universal values are fair, beneficial and practical for everybody served.

Referring to current conditions, the target of 5% of total bank assets may still be considered a huge challenge for sharia banking. Therefore, besides efforts from the sharia industry itself, common goals and close collaboration between industry players, Bank Indonesia, the Government, as well as other related parties are needed. Moreover, the development of sharia banking has to be shifted from being an issue of Bank Indonesia and other related parties to a national issue. Each stakeholder has their own role to perform optimally, referring to the mutually agreed upon agenda to realize their objectives. As a national agenda, sharia banking development can be achieved through the following steps:

i. Offer incentives, simplicity and facilities to attract new investors.

ii. Conduct intensive sharia banking socialization to provide knowledge and also encourage the public at all groups/segments/strata to use financial services / products offered by sharia banking.

iii. Foster MSEs and create an Account Officer for Sharia Banks to improve the real sector which is expected to strengthen sharia banking funding from the demand side.

iv. Expand the involvement of sharia banking in government projects.

v. Complete the promulgation or amendment of several favorable laws to catalyze sharia banking development. For example, amend taxation laws, complete the sharia banking law, and *Sukuk* Law.

Meanwhile, over the next few years, Bank Indonesia will continue to apportion greater attention to three key matters to support sharia banking growth. First is capital. Strong capital is important to maintain rapid and prudential sharia banking growth. Bank expansion and rapid deposit growth need to be balanced against capital; therefore, growth in sharia banks will remain sustainable and prudential.

Second is human resources. As a budding industry, the quality of sharia banking human resources is a critical element in its success to serve the sharia needs of the Indonesian public. Professional and competent human resources are required, at least on a par with those in conventional banking. This will provide evidence to the public that sharia banking is a highly professional industry that can offer many benefits and has strong potential.

Third is service coverage. Expansion of service coverage through “office channeling” has helped the public to place their savings in proven sharia banks. Strong interest from the public will subsequently broaden office channeling coverage to serve not only the public requirement to place funds, but also serve the public’s needs related to financing. We have also noticed that demand for exemplary service quality has enabled sharia banking to absorb the very best employees available in banking.

3. Initiatives in the national payment system

Ladies and Gentlemen,

In terms of the payment system, some future measures that I personally consider important to support financial system stability include making the national payment system more useful for the public as well as complying further with international best practices. Implementation of the Bank Indonesia Government – Electronic Banking system (BIG-eB), which was officially launched at the end of last year, will be improved in quality and service coverage. Better service quality and coverage is expected to boost the effectiveness and efficiency of monitoring and national government financial transactions, and thus support overall efforts to stimulate national economic growth. I also acknowledge the importance of improving the efficiency of the BI-RTGS system. The plan to launch BI-RTGS Version 2.0 is an important step in our efforts to build a more reliable national payment system.

In the coming five years, Bank Indonesia will continue to maintain the adequacy of good quality bank notes and to improve the efficiency of its distribution to Indonesia’s border regions. The provision of sufficient amounts of high quality bank notes is a means of strengthening the presence of our state’s symbols in those remote areas, and thereby the territorial integrity of the Unitary State of the Republic of Indonesia.

4. Initiatives in real sector

Ladies and Gentlemen,

Beginning this 21st century, we are still faced with the issue of social exclusion that I mentioned earlier this evening. When a group in society is systematically overlooked socio-economically they feel a great desire to improve their rights and welfare, or what Amartya Sen coined social deprivation. Then, at that point poverty exists as an ontological entity.

Amidst unlimited supply of labor, social exclusion is shaking the very meaning of the social contract in our country. Those confined to the lower echelons of the socio-economic pyramid feel that their world is not protected by the social contract they are engaged in. A sort of insecurity and existential concern exist in their mind. The most logical explanation about their situation is limited access to upward social mobility and such limitations create a thirst for more opened doors.

In response to that challenge the *KBI* Reorientation Program, launched mid 2007, will be intensified in its implementation. The role of Bank Indonesia branch offices in stimulating economic growth in rural areas will be strengthened, so as to ensure a more socially-inclusive Indonesia that is also better prepared to join the AEC 2015. Included in this program is the establishment of branch offices in regions with progressive achievements in all sectors of growth – political, economic, social and cultural – and have the potential to become new growth centers in Indonesia. As part of the first phase, we will soon be opening branch offices in Banten and Gorontalo Province, and reopen branch offices in Tegal and Pematang Siantar.

I would now quickly like to present several salient points of the work program in future, which we will be implemented gradually, as follows:

First is to improve the coverage and quality of regional economic statistical data owned by KBI and integrate the reporting of regional economic statistics, so as to improve the effectiveness of KBI's policy advisory role. The information is to be compiled in DIBI, which can be accessed by all elements of the nation who require it.

Second is to conduct strategic regional economic research concerning the opportunities and potential of the regional economy, preparedness in welcoming AEC 2015, MDG achievements, the effect of climate change on the economy and the welfare of the people, the production and distribution network, the structure-conduct-performance of industries, as well as the development of cultural and social capital.

Third is to improve the facilitation role in KBI regarding banking intermediation to the micro-small-medium enterprise group using DIBI and information held by *BIK*.

Fourth is to analyze thoroughly the sources of regional inflation, develop an early detection system for regional inflation, coordinate with the local governments regarding the stabilization of regional inflation, and facilitate the establishment of a Regional Inflation Stabilization Team.

Fifth is to improve the quality and utilization of the libraries in KBI as well as making the library a learning & cultural centre for the public of the respective region. As part of its role as a learning centre, the KBI libraries will provide reference sources for entrepreneurs and potential entrepreneurs in the regional areas. The availability of an adequate business library in this globalization era, in addition to widening the public's skills in adapting to this era, can also open opportunities for those who are creative, innovative and independent to look for their own solution and therefore mobilize upwards. With its function as a cultural centre, KBI libraries will become a place where cultural diversity and local wisdom is read, stored, studied and celebrated.

V. Conclusion

Ladies and Gentlemen,

This has been what I could present to you here this evening regarding the strategic initiatives to be taken by Bank Indonesia this year. Allow me to conclude, if you will, by delivering some footnotes as follows.

The past five years in the journey of post-crisis economic growth has been a transitional period from the clutches of a multidimensional crisis to reconsolidation of economic growth that strengthens the key foundations of our economy. The results of this reconsolidation are beginning to appear and now, therefore, comes the time for us to move away from policies focused on initially centring efforts towards economic recovery and restoring the social fabric of a society decimated by a serious emergency, towards solidifying this social fabric. Therefore, in the upcoming periods the time has come to gradually reduce our attention on rescue operations and refocus on restructuring efforts that provide long-term fundamental improvements. In the future, we want the establishment of an economic life that can compete globally, increase the prosperity of the public and adapt to the best practices in the world. Establishment of such an economic life requires consistence, patience and persistence in taking appropriate improvement measures whenever the chance presents itself, no matter how small that step is. Even the longest journey begins with the first step…

In line with the process to become more anticipative, a new aspect will affect us all in the near future that requires all of our attention, namely the commitment among governments of ASEAN countries to implement economic integration in the ASEAN region in 2015. Formally, this commitment, written into a binding agreement, will open up the economies of ASEAN countries in the form of a free trade area. Irrespective of the final form, national economic policy will need to be adjusted to fit with this new trend. Thoughts and anticipative measure have to be prepared as soon as possible because formally the market opening process has been agreed to be in effect by 2015. With such wide-reaching developments the banking community is also required to prepare a number of changes and improvements institutionally, procedurally, technically, technologically and in terms of human resources development and capital. We have run tread this path together periodically and continue to apply international best practices, which have already been implemented around the world.

The widespread growth I have mentioned also has internal implications for Bank Indonesia as one of the state institutions that plays a special role in the life of Indonesia. Many internal adjustments also need to be taken considering the upcoming challenges. This includes paying attention to the operational and organizational implications on Bank Indonesia branch offices around the country.

Ladies and Gentlemen,

In the last five years we have faced many fundamental changes in the dynamics of the economy, which in many aspects are the results of the great tide of economic globalization. In terms of progress as a civilization, there is not a single country in the world that could resist and close itself away from globalization, let alone reverse such a process. It seems that the global economy is undergoing a rapid transition to become one large market, which will produce excess.

The excess we have already felt is global warming due to a waste of production activity that is growing too fast compared to the Earth’s capacity to absorb it. The effects of such an excess for us in a developing country cannot be ignored. Global warming has triggered climate change that has recently disrupted our efforts to expedite economic growth. We must surely take this matter seriously since for the majority of our people the effect of climate change is the dimmed hope of a better life, which subsequently causes existential concerns. We also need to ensure that as a country and part of humankind, we do not fail to take care of the environment that is part of the crucial solution to climate change.

Transition of the global economy into a global market also yields a wide effect on human behavior as “*homo economicus”*. We have experienced changes in preference and vision of economic players on the life that they are living. In an analytic structure, these changes seem to be shaking the validity of casualty relationships between economic factors. A number of theories we previously took for granted, that policymakers could base their important decisions on, are gradually changing into myths. This phenomenon may cause confusion even for those with vast experience in public policy, especially since addressing this phenomenon requires the policymaker to continuously deconstruct and reconstruct assumptions they base their analysis tools upon. Such an exercise possesses many risks, particularly as the decision of public policy does not allow the luxury of repeatable experiments. Therefore, any mistakes in choosing which assumptions are the most accurate when formulating policy can have wide-reaching effects on the public's welfare. In the end, public policy is an art form in grouping assumptions with policy considerations, for which the process requires wisdom, maturity and most importantly: guts and intuition.

Ladies and Gentlemen,

Globalization has also alerted us to the importance of continuously ensuring that Indonesia is possibility that is not absurd. When this republic was established we knew that there was only a handful of people that did not question the possibility of Indonesia as an "imagined community". We have realized, and our nation's forefathers also knew, that not many countries have an objective chance to remain intact as a modern, democratic and open country amidst the mosaic of diversity and contrast. Therefore, to borrow from an Indonesianist at Cornell University, Indonesia as an imagined community is a common project that we need to strive for with positive achievements in all aspects of life. Ten years following the crisis is a perfect time for us to strengthen the viability of this great country that is endowed with many vital foundations for the advancement of humankind. The advice offered by Muhammad Hatta over 60 years ago remains pertinent to us at the beginning of the 21st century:

> *"With struggle comes progress!*
> *We should take advantage of the current transition we are facing to plant good seeds for the future of our country. This is a crucial moment that will determine our fate as a nation for centuries."*

Finally, before I conclude, please allow me to offer my sincerest appreciation to my senior, who represents the generation before me, namely Mr. Rachmat Saleh, former Governor of Bank Indonesia, who because of his visionary leadership built Bank Indonesia and the Indonesian banking industry as crucial economic institutions. Mr. Rachmat Saleh was the Governor of Bank Indonesia who purposefully promoted efforts to strengthen the institution and provide opportunities for Bank Indonesia staff to improve their professional knowledge and expertise. A successful leader is one who has created as many successors as possible, and that is exactly what Mr. Rachmat Saleh did. He also frequently reminded us to always maintain the unity of Bank Indonesia, as a strategic institution that plays a decisive public role in our republic, and to always make our institution better in fulfilling its function as a public servant. I would like to offer our most heartfelt gratitude and respect from all Bank Indonesia staff, including the leadership, to Mr. Rachmat Saleh. If you still remember 15 years back when I was talking with you at Bethesda-Maryland, I told you that you are "the living legend". Tonight I would like to reiterate my statement that you will always be "the living legend" in Bank Indonesia's history. May you be blessed with good health and continue to contribute to the progress of Bank Indonesia and our economy.

Finally, Happy New Year 2008. Let us all keep working hard together. We believe that God will always be with us to bless and enlighten our path towards a better future.

Thank you. Wassalamu'alaikum wr. Wb.