Darmin Nasution: Strengthening stability towards sustainable growth – a transformation challenge

Speech by Dr Darmin Nasution, Governor of Bank Indonesia, at the Bankers' Dinner 2011, Jakarta, 21 January 2011.

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Honorable Ministers and Members of Parliament,
Prominent Bankers,
Distinguished Guests, Ladies and Gentlemen,

Assalamu'alaikum Wr. Wb,

Good evening and may God bless us all,

1. In this beautiful evening, I would like to invite all of us to jointly extend our gratitude to God Almighty for the opportunity to meet in such wonderful settings at the Annual Bankers' Dinner 2011.

2. Although slightly belated, please allow me on behalf of all members of the Board of Governors of Bank Indonesia, to wish you a Happy New Year 2011. We hope this new year will be the year of our great achievement.

Distinguished guests, ladies, and gentlemen,

3. We have just passed the global economic crisis 2008/2009 and if I may construe our economy in the period of 2010–2011 will be in the stage of transformation to a new era, shifting from a recovery phase towards a sustainable growth. Our journey during the course of transformation stage, however, would not be an easy one.

4. As the first line of defence, Bank Indonesia always puts a prudent and consistent management of monetary and banking policies as a priority. Nevertheless, this prudence and carefulness would not be enough. It seems that the risks and challenges after the crash of 2008/2009 will be as tough as what we have pursued in the midst of crisis. The risks and challenges ahead are much more diverse and complex with global economic policy constellation tending to escalate.

5. Thus, our transformation process towards a sustainable growth inevitably needs a new mindset and approach. To put things in the context, let me recite Einstein's observation that "The whole of science is nothing more than a refinement of everyday thinking." This statement seems to apply to our state of affairs. The effectiveness of a particular policy will always diminish and render obsolete along the way, and therefore it should be evaluated, aligned and even modified without sacrificing its main principles.

6. In a very dynamic world and in the face of uncertainty with all of its possible risks, our creativity and ability to explore possibilities through simulation will be tested. Indeed, policy makers cannot rely on a single policy instrument, they have to create a multi-front policy and formulate an accurate mix which could provide an optimum trade-off. Decisive actions and top-down approach sometimes are required when complexity and uncertainty are on the rise.

Distinguished guests, ladies, and gentlemen,

7. In the beginning of 2011, we should be gratitude that we have gone through all of the challenges in 2010 with a number of noted achievements. Nevertheless, a series of concerns which has bearing on economic and financial performance remains.

8. In the past two years Indonesia was among a few Asian countries which consistently reached positive economic growth. In the midst of financial crisis, Indonesia was able to grow 4.5% in 2009, and in 2010 our economy has expanded even higher by achieving a 6.0% growth.

9. The structure of growth is now relatively more broad-based. Although the contribution of private consumption is still dominant, the contribution of investment to growth began to pick up by 2.0%. The performance of export was also significant, contributing a 5.7% growth.

10. On the other hand, CPI inflation reached 6.96% in 2010, predominantly pushed by the high pressure of food prices at year end. Such increase of food prices is a global phenomenon, and it has generated inflation pressures in a number of countries. Nevertheless, the pressure on core inflation was still manageable, recorded at 4.28%, due to rupiah appreciation and vigorous economic capacity to respond to rising consumption pressure.

11. We also recognized that the upward trend of consumption and investment has brought on high rate of import activities. The rise of import activities was still met by adequate export revenues hence could keep a net surplus on Indonesia’s current account balance amounting to USD 6.2 billion or 0.9% of GDP.

Distinguished guests, ladies, and gentlemen,

12. We have all witnessed how many countries have undergone severe circumstances during 2008/2009 crisis and we have all witnessed how our economy has remarkable resilience during the crisis. Apparently, it has inspired global portfolio managers of a new economic power in Asia aside from China and India which has a huge market potential, solid economic fundamental, and attractive yields and capital gains.

13. Indonesian financial market was perceived as a magnet which attracted abundant global liquidity. We saw the surge of capital inflows into the country, mainly to several portfolio instruments such as government debt securities (SUN), Bank Indonesia Certificate (SBI), and equities. In total, inflow of portfolio investment to Indonesia has reached USD 15.2 billions during 2010.

14. A better prospect and resilience of our economy also attracted foreign direct investors, though still limited to resource-based sectors such as mining. This was evident from the foreign direct investment which reached USD 12.6 billions, increasing threefold from 2009 which was recorded at USD 4.9 billions.

15. Indonesia’s balance of payments reached a surplus of around USD 30 billions in 2010. International reserves also posted an increase as it reached USD 96.2 billions or grew 45.5% higher than 2009, equivalent to 7.1 months of import and the repayment of short-term government debts due.

16. A solid balance of payments and increased international reserves has put Indonesia’s external liquidity position on a stronger footing. Furthermore, a decreasing ratio of government debt to GDP (29.5% of GDP as of October 2010) provides further contribution to the robustness of Indonesia’s external sector.

17. We believe that stronger performance and resilience of the external sector was among the reason behind the recent improvement of our sovereign ratings. I am optimistic that now we are on the way to investment grade. The primary obstacles to achieve investment grade mainly relates to infrastructure development, which I believe is a task that must be resolved together. Issues on infrastructure development have been discussed numerously and policy recommendations have been formulated as well. It is time now to consistently implement them.

18. A surplus balance of payments was also reflected by a relatively stable rupiah. In 2010, rupiah strengthened 4.2%, in a range that we view is quite ideal and consistent with the macroeconomic and business environment.

19. Increased economic activity during the course of 2010 was also supported by the performance of banking sector which was reflected in improving intermediation function and stability of the sector. This was evident from several aspects such as credit expansion which reached 22.8% in 2010, a relatively high capital adequacy ratio (CAR), and a steady low gross non-performing loan (NPL) which was kept under 5%. Overall, resilience of domestic financial market was improving. The escalated debt crisis in Europe which peaked in May and November 2010 only put temporary pressure on the domestic market.

Distinguished guests, ladies, and gentlemen,

20. All of the achievements which I have mentioned are the fruits of our hard work, including the banking community. Those achievements are much more appreciated and cherished since they were achieved in the midst of global uncertainty and calamity.

21. In this opportunity, allow me to address Bank Indonesia's policy responses in 2010 in preserving macroeconomic and financial system stability. In accordance with tonight's theme, I believe that strengthened stability will support the transformation process of our economy in the aftermath of the global financial crisis from a recovery stage to a more sustainable growth.

22. The way Bank Indonesia formulates policy responses is indeed a meticulous process involving deep internal discussion. This was undeniable since the threats and challenges in 2010 was so diverse and unpredictable creating complexity in the policy making process.

23. In general, there are three challenges in 2010 which will persist in the future. First, the challenge of global economic imbalance. Two years after the crisis, the global economy underwent two speeds of recovery in which the recovery in emerging markets is more rapid than that in advanced economies. To ensure durability of recovery, policy makers in developed countries rely on accommodative policies. On the other hand, policy makers in emerging markets have to deal with economic overheating. We may say that almost all emerging markets have undergone policy normalization in 2010, some countries even have shifted to tightening mode.

24. Second, challenges associated with global capital mobility and currency war. The differences of economic cycles and policy stances between developed countries and emerging markets unfortunately have led to unfavorable consequences for emerging market. This is evident in the context of tidal wave of capital inflows into emerging markets including Indonesia. The surge of capital inflows bring about complexities of macroeconomic policy management to emerging market, including Indonesia, since it has bearing on currency appreciation pressure, asset bubble risks, and financial fragility following capital reversal.

25. Policy responses by way of foreign exchange intervention and managing capital flows in several emerging market have generated different appreciation pressures among countries. In the mean time, since keeping large stock of international reserves is deemed too costly, emerging markets tend to put their reserves in other emerging markets. This situation indeed entails a significant negative externality in the emerging markets region. Hence, a policy coordination in the multilateral level is necessary to avoid negative externality of individual country policy response.

26. Third, challenges related to domestic demand and inflationary pressure. Global financial crisis 2008/2009 has deteriorated inter and intra-regional trade which prompted many countries to focus on promoting domestic demand. However, in the

context of Indonesia, relying solely on domestic demand has two significant implications.

27. Firstly, a high domestic demand may generate inflation since supply side is quite less flexible to respond to accelerated demand. Secondly, a high domestic demand may accelerate import even faster since import content in our industry is still perceived high. This situation will bring about decreasing current account surplus or even a deficit. Since the ratio of short-term capital to total capital inflows is quite high, the risk of current account deficit should be monitored closely.

Distinguished guests, ladies, and gentlemen,

28. On that note, a number of policy mix of monetary and macroprudential instruments have been implemented during 2010 to mitigate the global and domestic risks. In the midst of surging capital inflows and abundant excess liquidity, efforts to combat inflationary pressure cannot solely rely on conventional policy instruments such as the interest rate. Increasing interest rate may attract even more capital inflows. It is for this reason, a mix of policy instruments is needed.

29. The policy mix implemented is intended to address the challenge of maintaining external and internal economic stability. Achieving external stability means, maintaining strong and sustainable balance of payment, meanwhile internal stability implies attaining low and stable inflation to support sustainable economic growth.

30. To maintain external stability, a policy mix is aimed at exchange rate stabilization and capital flows management through macro prudential policies. In the midst of surging capital inflows and appreciation pressures, exchange rate stabilization policy through intervention is maintained to minimize the exchange rate volatility, taking into consideration the direction and movement of exchange rates in the region. Given the complexity of relying only on intervention, macroprudential policies are also pursued. Since June 2010, Bank Indonesia has started to implement macroprudential policies with the imposing of the one-month-holding-period (OMHP) for SBI buyers. This regulation requires SBI buyers to hold their holdings for one month before selling them to other parties. I view this policy very useful in preventing large and sudden capital outflows originating from SBI transactions such that it can manage to reduce exchange rate volatility. The scope, timing and sequencing of the policy mix are based on the consistency of the exchange rate to macroeconomic target and the impact of excess liquidity resulting from exchange rate stabilization on monetary operation.

31. Meanwhile, to sustain internal stability a policy mix is introduced to maintain price stability and appropriately manage domestic demand. Measures taken include among others imposing a level of interest rate in combination with macroprudential measure to manage excess liquidity. This is done through increasing Minimum Reserve Requirement. The scope, sequencing and timing of the policy mix took into consideration inflation and macroeconomic projections, the current excess liquidity (including the impact of foreign exchange intervention and fiscal expansion), and the cost of monetary operation.

32. We continue to calibrate the mix of policy measures taken to strike an optimal trade off between various macroeconomic targets. Bank Indonesia also maintains on going coordination with the government especially to minimize the impact of volatile foods and administered prices inflation on the economy.

Distinguished guests, ladies, and gentlemen,

33. In the short run, I believe the opportunity for higher economic growth is still very much wide open. Bank Indonesia projects economic growth in 2011 to reach the range of 6.0%–6.5%, and increasing to 6,1%–6,6% in 2012. Investment which

began to improve since 2010 is expected to continue its growth hence creating a more balanced economic growth structure.

34. Higher growth in 2011 is also supported by solid performance of the external sector. Exports is expected to be more diversified and grow stronger while the fast growing imports is in line with robust investment and consumption.

35. The portion of foreign direct investment as a composition of capital inflows is estimated to expand. Overall, the 2011 balance of payment is projected to reach a surplus of USD16.4 billion, and the foreign reserves to reach USD112.6 billion by the end of the year. This is equivalent to 7.5 months of imports and short-term government debt repayment. The sizable foreign reserves will strengthen sustainability of the Indonesian economy in mitigating various external shocks (a self insurance mechanism).

Distinguished guests, ladies, and gentlemen,

36. We observe stronger economic growth in 2011 is expected to be accompanied with rising inflationary pressure. We are well aware of the number of sources of inflationary pressure, especially those coming from increase food prices as well as possible adjustment of administered prices. The rise in inflation expectation due to the impact of food price increase on the perception and dynamics of the domestic financial market recently, is also a special concern to us.

37. In this context, Bank Indonesia together with the government will continuously coordinate to fine tune various programs to increase supply and improve distribution of staple goods. Bank Indonesia has high hopes and is certain that the Government will thoughtfully address this issue. The synergy between an appropriate policy mix and a well-built coordination will undoubtedly bring inflation to its target of 5%±1% in 2011 and 4,5%±1% in 2012.

38. In my capacity as a monetary authority, I would like to reemphasize that Bank Indonesia is still very much committed to direct the BI rate to reach the medium term inflation target which is in the range of 3.5%. The setting of the BI rate is formulated with excise measurement so that inflation and expected inflation will move towards the corresponding target without sacrificing economic growth.

39. I have strong believe that by the official establishment of the ASEAN Economic Community by 2015, we can achieve the medium term inflation target hence bring our inflation rate to the level of neighbouring countries in the region. A low and stable inflation accompanied with improvements to various structural impediments will support the Indonesian economy which is estimated to grow by 7.5% by 2015.

Distinguished guests, ladies, and gentlemen,

40. The picture of our state of economy which I have just portrayed is still prone to a number of global and domestic risks. The global economy will continue to move dynamically in its search for equilibrium. However, this process may well be described as an indefinite search within a dark and never ending tunnel.

41. An imbalanced global economic recovery, a persistent debt crisis in the peripheral European area, signs of economic overheating in emerging markets, and extreme climate change and its impact on food prices are still considered as risks that may affect the stability of the global financial market in years to come. The dynamics of the global financial market can have an immediate impact to Indonesia as we currently have a relatively open financial market. Our ***first challenge*** is how, on the one hand, we can strengthen our domestic financial system while, on the other hand, reap the benefits of this relatively open market, including efforts to deepen our market.

42. Based on my observation, efforts to deepen our financial market are moving on a relatively slow track. In this context, the strengthening of the domestic investor base must be a priority so that the dynamics of our financial market is not solely dependent on changing global investor risk appetite. Furthermore, we may no longer have to fear the risk of capital reversal. In this opportunity, I welcome efforts made by the Ministry of Finance and the Ministry of State Owned Enterprises on their cooperation to maintain the stability of the government debt securities.

Distinguished guests, ladies, and gentlemen,

43. A number of domestic issues in 2010 are still pending and must be resolved. In this context, our ***second challenge*** is how to transform the Indonesian economy into a more sustained economy supported by sustainable growth. Despite its relatively more stable growth compared to most other countries in the region, the structure of the domestic demand of the Indonesian economy must be further boosted to be an investment-driven demand. For example, the high economic growth of China and India are supported by a share of investment to GDP of 45% and 33%, respectively. This is compared to Indonesia with a 24% investment to GDP ratio.

44. Indonesia still lags in attracting FDI compared to the two countries. Despite its increasing trend in 2010, according to the United Nation's World Investment report, the ratio of the stock of incoming investments to GDP for Indonesia is only 13.5%, far below Thailand (37.5%) or Malaysia (39%).

45. The dynamics of our economic growth structure in terms of sector must also be put to our attention. Labour intensive sectors which facilitate transfer of technology, especially the manufacturing industry, are contributing less and less to the economy. On the other hand, an accelerating growth is depicted in small value added, resource-based industry and non-tradable sectors such as telecommunication. If left unattended, this problem may lead to deindustrialization that may cause reduction in the value added of the national industry.

46. Our domestic manufacturing industry is also heavily dependent on imports. As a consequence, economic growth is followed by rising imports which causes the current account surplus to decline. Such a trend is actually already happening. In 2009, our current account recorded a surplus of USD 10.7 billion (2.0% of GDP), and in 2010 in line with strengthening consumption and investment, it fell to USD 6.2 billion (0.87% of GDP).

Distinguished guests, ladies, and gentlemen,

47. ***The third challenge*** is how to direct inflation to a low and stable level in line with the set target. Recently, market perception on inflation is based more on short term phenomena or cyclical factors.

48. In the last ten years, Indonesian inflation on average reached 8.2% and is on a declining trend. This rate is well above regional average during the same time period. However, there has been significant progress as the inflation gap during this period is declining. In fact, compared to the BRIC countries, all having an investment grade rating, the inflation rate in Indonesia is relatively close to the level of the rate in Russia and Brazil, and even lower than in India. Regardless its improving inflation profile, Indonesia needs structural reforms in order to further lower inflation to be in line with neighbouring countries.

49. ***The fourth challenge*** is reaping the benefits of incoming capital flows. Foreign investors' appetite for domestic financial market should ideally be directed to facilitate domestic financial market deepening and corporate financing. In this context, we need to find breakthroughs on how to provide incentives to boost initial/secondary public offering or even bond issuance. Also, imperative measure

needed to provide assurance to foreign investors is the strengthening of infrastructure, which includes institutional aspects, regulation, and market efficiency.

Distinguished guests, ladies, and gentlemen,

50. I am certain that through commitment, active participation, and strings of coordination among affiliated parties, we are able to face the various risks and challenges mentioned. To direct inflation towards its target, policy taken by Bank Indonesia during 2011 will take the form of stronger monetary and macro prudential policy mix that have been implemented in 2010. This effort is done by taking into consideration all available instruments to be optimally calibrated. These instruments include:

    a) BI rate is directed to be consistent with announced inflation targets, 5%±1% and 4,5%±1% for 2011 and 2012, respectively, while keeping in mind the increasing inflationary pressure.

    b) Foreign exchange policy is aimed at achieving inflation target while keeping consistence with other macroeconomic targets and providing certainty to the business world. The possible trinity solution Bank Indonesia has opted for will be the optimal configuration of foreign exchange stability, management of capital flows, and interest rate response. In other words, taking into consideration the various complexities, Bank Indonesia's strategy to go around the impossible trinity is by choosing middle ground solution instead of corner solution.

    c) Monetary operation and macroprudential policy to manage domestic liquidity are directed to be consistent and supportive of the interest rate policy in achieving the inflation target and managing domestic demand.

    d) Macroprudential policy on capital flows is aimed at supporting foreign exchange policy and preventing excessive impact on domestic liquidity. Two policy packages announced in December 2010, an increase in reserve requirement in foreign currency and reinstatement of the limit of daily short term foreign debt position, fall into the category of macroprudential instruments directed to manage capital flow. In the midst of capital inflows, such increase in reserve requirement in foreign currency will strengthen banking liquidity management. Meanwhile, the limit of daily short term foreign debt position will increase prudence in managing banking short term foreign debt.

51. In the formulation and implementation of the policy mix, it is important to keep in mind linkages between monetary and financial stability. Bank Indonesia will continue to calibrate various measures so that the policy mix taken will bring optimal trade off between monetary stability, financial system stability, and sustainable economic growth.

Distinguished guests, ladies, and gentlemen,

52. In line with the macroeconomic development, allow me to give explanation on Indonesia's banking condition, much of which certainly needs to be encouraged and dealt with. To this end, I will underscore principal aspects that I believe require closer attention.

53. I would like to begin with financial system stability and the positive banking performance in 2010. In general, financial system stability is reasonably maintained as indicated by the Financial Stability Index of 1.75, much lower than the 2.43 figure recorded during the 2007/2008 crisis. The performance of the banking industry, as I mentioned before is also quite satisfying. The intermediation function is enhanced

although still leaving room for growth, the credit risk is maintained, and the capital is adequate with the support from ample liquidity which I believe is more than enough.

54. The indication of excess liquidity in the banking sector is reflected by the size of the liquid instruments as of 15 December 2010 including SBI amounting to Rp 494.5 trillion and Government Debt Securities amounting to Rp 229.9 trillion. The banking undisbursed loan amounting to Rp 556.8 trillion also indicated the presence of excess liquidity. This highlights that our economy is not short of liquidity. The challenge is in how to channel that liquidity to finance productive business sector and economic development as a whole.

55. I see a serious issue here, where in a condition of excess liquidity, the role of banks in promoting economic growth is still small. The ratio of credit to GDP in 2010 is only 26.1%, just a slight increase from 25.7% in 2009. This low figure is caused by the impact of the 1997/1998 crisis which has pushed Indonesia into a low leverage economy. In this condition, deleveraging process in the corporate sector occurred for quite a long period. Not surprisingly, during that period, credit to the corporate sector grew at a low pace. I indeed hope that banks have the courage to take bigger role in reviving the corporate sector, off course with high quality service and efficient cost.

56. In my opinion, banks need to take a closer look at non-bank sources of financing which have developed to be more competitive. To illustrate, in 2010 financing through equity and bond market reached Rp 280.6 trillion or 4.4% of GDP, compared to 3.7% of GDP in 2009. The number of issuers increased from 57 (2009) to 74 (2010). This condition should be able to encourage banks to increase their efficiency so as to maintain sound competitiveness.

57. Apart form the above matter, I see a potential opportunity for SMEs to become an engine for the economy. Data as of end 2010 showed that the share of SME credit have reached 53.32%, growing 25.17%. These figures indicated the dominance of SME to the total credit. Furthermore, the 2.65% non-performing SME loan is lower than that of the non-SME (3.51%).

58. On top of that, there is room for improvement for the SME sector. The lending rate for this sector is still higher than for the other corporate sector. This is a challenge for us together, because if the interest rate for SME can be lowered further, the benefit will be high for the economic activity.

59. Regional wide, our banking competitiveness in terms of efficiency, capital and asset is still lower compared to other countries in the region. Based on data from Bank Indonesia and Bank Scope as of end 2009, our ratio of operational expenses to operational income (OEOI) and net interest margin (NIM) are 81.6% and 5.8%, respectively. Meanwhile, Singapore, Malaysia, Thailand and the Philippines charted OEOI of 32.7%–73.1% and NIM 2.3%–4.5%. This fact indicates how Indonesian banking efficiency is the lowest among ASEAN-5. This is ironic to the other fact that the average increase in bank equity price in Indonesia is very fantastic. To this end, I request banks to catch up in terms of efficiency.

60. Moreover, the challenge ahead that we should confront together is how to reach an equal footing for our banking competitiveness as we are heading toward the ASEAN Economic Community (AEC). The banking sector liberalization under the AEC will be effective in 2020. Like the saying: “9 years a short period of time, the future will be here before we know it,” we all have to be ready for the challenge. Therefore, banks are demanded to have the capability to compete while enhancing their resilience individually, among others through capital accumulation for sound expansion of assets.

61. At the global level, as a highly regulated industry, banks cannot disregard international standards, all the more with Indonesia being a member of the Group of 20 (G-20), Financial Stability Board (FSB), Bank for International Settlements (BIS) and Islamic Financial Services Board (IFSB). By implementing various agreed commitments, it is expected that Indonesian banking sector keeps growing healthy in the corridor of international prudential standard.

62. Considering the various global concessions in maintaining the financial system stability, I notice that the capital and liquidity aspects need to be reviewed. Meanwhile, crisis resolutions for the possible systemic impact of failing financial institutions also need to be strengthened. All these challenges pose serious concerns and adopted by Bank Indonesia as the basis for strengthening the program of the Indonesian Banking Architecture (API).

63. By the end of 2010, Indonesia has completed the Financial Sector Assessment Program (FSAP) as part of its commitment as the member in G-20 global community. FSAP assesses the extent of resistance, and compliance with international standards of financial sector. The results of FSAP are encouraging. The level of Indonesian banking sector resilience is deemed robust and sound. The stress tests indicate that the resilience of our domestic banking industry is sufficient in time of a crisis. Furthermore, the level of Indonesian compliance with the main principles of effective bank supervision is considered to be sound. Therefore, let me extend our appreciation to distinguished ladies and gentlemen for this achievement.

Distinguished guests, ladies, and gentlemen,

64. Albeit those various issues to be addressed, I have faith the macro economic outlook for 2011 still provide hope for banking industries to grow. The industry should see credit growth in the range of 20%–23% in 2011. However, this growth is vulnerable to the potential risk of commodity price increases and inflationary pressures, as well as the increased role of non-bank financing. In return, those factors might potentially surpress credit growth in the range of 19%–21%.

65. To encourage the growth of micro-, small- and medium-scale business credit (UMKM), Bank Indonesia requires banks to include micro-, small- and medium-scale business financing scheme in their business plan. Let me take this opportunity to thank all stakeholders who have supported the initiative of synergy through the commercial banks – rural banks linkage program, and the initiative of using guarantee schemes as one of risk mitigation efforts.

66. To increase the role of rural banks in micro-, small- and medium-scale business credit sector and the communities in their vicinities, particularly lower and middle class society, adjustments in the asset quality rules are applied to obtain a more encouraging atmosphere, hitherto creating an agile rural bank sectors without neglecting the prudential credit principles. Likewise, redesigning the rural banks efficiency, specifically on how to substantially reduce lending rates, is profoundly necessary.

67. To strengthen the regional economic development, BPD Regional Champion program is launched to help boosting up the role of Regional Development Banks (BPDs). The program is aimed to improve the viability and competitiveness of regional development banks; hence they can effectively perform their function as agents of development in the regions.

68. Related efforts in improving the quality of national Islamic banking industry, I view that there are 3 respective aspects to take into consideration: (i) improving the professionalism and the quantity of manpower in the industry, (ii) providing robust and sound incentives, especially in the form of conducive regulatory environment,

and (iii) strengthening product innovation and infrastructure in Islamic banking industries.

Distinguished guests, ladies and gentlemen,

69. Of various opportunities and problems arising in 2010, Bank Indonesia has issued the December 2010 Policy Package. Its main objective is to strengthen and improve macroeconomic stability as well as banking resilience and intermediation.

70. An improved bank intermediation policy seeks to ensure the availability of supplies through the deepening of the market (Home Ownership Loans (KPR) securitization provisions), to create competitive loan costs (provision of transparency base rate loans), to adjust credit risk weighting of retail and KMK (provision RWA) as well as to reduce asymmetric information with the provision of credit information data (private credit bureau requirements). In addition, to extend the scope and depth of intermediation, enormous efforts through expanded access to financial institutions (financial inclusion) and BPD Regional Championship program are continuously carried out.

71. An improved resilience of banking industry policy seeks to sustain the banking industry growth, to strengthen competitiveness and to mitigate the crisis surprises. To achieve these goals, banking industries are required to strengthen their qualitative and quantitative improvement aspects, which is attained through the existing sets of rules in fit and proper test, increased compliance of commercial banks, risk based balance asset (ATMR) and associated effective risk management in business cooperation Bancassurance.

72. Policies related to institutional empowerment, competitiveness and the resilience of rural banks and Islamic banks are aimed to create an equal playing field with conventional banks. These efforts will be endorsed by sets of rules and regulations in earning assets quality rating, bank financing and sharia unit restructuring, the maximum limit of funds for rural banks (RB) sharia financing, and changes in licensing change from conventional banks into Islamic banks.

73. Through this policy package, Bank Indonesia attempted to strengthen the effectiveness of banking supervision, particularly through the creation and implementation of early warning system and macro prudential supervision. These efforts will be in line with the refinement of rules and regulation in risk-based banking supervision, improvement in bank entry and exit policies, and adoption of risk-based supervision and consolidated supervision.

Distinguished guests, ladies and gentlemen,

74. Let me also seize this opportunity to propose my ideas on Indonesia’s policies and guidelines for desirable future to cope with economic turbulence ahead. These are generally basics but in my humble opinion these issues are critically important as steps to be taken in order to transform the post-economic conditions of economic and banking crisis today, towards sustainable economic growth.

75. ***First,*** I recognize that the sustainable supply of Indonesian foreign exchange is crucial to sustain macroeconomic stability, particularly in maintaining exchange rate stability. We need to think thoroughly how the foreign exchange, particularly from export, can comprehensively cover import and financing needs, in addition to its contribution to financial deepening.

76. ***Second,*** I believe the strengthening of banking supervision system and the deepening of the banking industry through consolidation remains vital to determine the success for overcoming a crisis amid the global competition. Banking capital might be sufficient to boost up the national economy pillars progressively; however I develop a feeling this is not sufficient to face the incoming potential crisis. Lessons

learned from the crises in 1997/1998 and 2007/2008 have taught us to understand an important message that the fragility of banking industries would inflict harms on the nation, the central bank and eventually bring misery and misfortune upon the citizens.

77. Bail-out may be necessary in time of crisis, but past experience shows that such measure might create another new turbulence in terms of economic, political and legal complications. We need to develop preventive steps and an overall soundness and strong capital defence. This paradigm has been intensively discussed among regulators and practitioners in banking industries by replacing the paradigm of bail-out with bail-in. It means the banks themselves should have a buffer to absorb risks and mitigate shocks in establishing the proper crisis protocol.

78. This concern has reinforced my conviction that consolidation, both in the capital as well as in the institutional dimensions, needs to be accelerated. Thereby, it is necessary to evaluate alternatives for the improved soundness and higher efficiency in implementing consolidation based on the more interesting incentives and disincentives regulation scheme, either in the areas of merger, acquisition, or any other corporate actions. The robust and sound banking capital is also beneficial for developing competitiveness such as in the development of information technology and business scale. This endeavour is required to meet MEA implementation prerequisites, since the average capital level of Indonesian banks is the lowest among those in ASEAN-5.

79. ***Third,*** I extremely emphasize the magnitude importance of efficiency; hence expect banking industries to promote a lower and efficient NIM. In my modest opinion, efficiency is the key to untie the knots of the extricable intermediary complexity, therefore increasing credit and is expected to stimulate further economic growth. Efficiency as well encourages the banks behaviours in providing prudential, selective, productive and prospective credit. Such behaviours in the long run will accelerate the prudential banking practices, which is the prerequisite of financial stability. This provides evidence that banking efficiency bear fruitful growth and stability as well in banking industries.

80. Efforts to increase banking efficiency have been initiated. We certainly still recall an agreement setting a fixed deposit rate more than a year ago. This is then followed by endeavours to review the spread of interest rate led to the implementation of prime lending rate. Bank Indonesia, needless to say, will continue to analyse further measures, including those related in providing gifts to customers, and benchmarking between banks.

81. ***Fourth,*** to be better prepared in the era of economic integration, facilitate the flows of banking transaction and boost the national economy, the policies for the development of the payment system are aimed to make the system more efficient, reliable, simple and secure. The focus is on the development of system and infrastructure, as well as on strengthening the regulatory basis.

82. Starting 2011, Bank Indonesia will enhance the existing systems, including BI-RTGS, BI-SSSS G-II, Direct Debit-SKNBI, Retail Payment Interconnectivity, and ATM chip standardization. Efficiency in the payment system will also be increased with the plan to ingrate the existing payment system network through National Payment Gateway (NPG), the further promotion of financial inclusion through payment system by retail agent, and the proposal of rupiah redenomination program which is currently in the phase of coordination with the government.

83. ***Fifth,*** my view is that the Indonesian Banking Architecture should not only elaborate the ideal condition of banking industry with all the important pillars as its components. Two other dimensions should be covered. First, how should we place each of different types of banks in Indonesia on its deserved position, based on its

reason of existence. This should include the consideration on the positions of conventional bank vs. syariah bank, general bank vs. people's credit bank, local bank vs. foreign bank, and national bank vs. rural development bank. Moreover, it should also be studied how to produce synergy among those.

84. Second, the Indonesian banking architecture should contain a roadmap that can guide us from the present situation to the ideal condition architectured. Indonesian banking architecture should not be a static snapshot, but a dynamic roadmap. Such roadmap should include the implementation of best practices in the banking industry covering many dimensions, including business model, standard setting, information system, and ownership.

85. ***Sixth,*** there are many lessons learned since the 2008 global crisis which contribute to a new framework of thinking. Despite the repetitive nature of crisis, we cannot rely on yesterday logic, or solely relying on conventional macro policy to resolve current issues. The introduction of the macroprudential policy strengthens the effectiveness of conventional policy and brings new hope to the crisis recovery. Such a policy requires a more collaboration, coordination, interaction and integration between micro supervisory function and macro monetary function in maintaining financial stability. The challenge ahead is securing a comprehensive policy framework and I myself hope that it can be maintained and further continued in the future.

86. ***Seventh,*** I would like to invite all banking sector colleagues to utilize Indonesia's demographic potentials with its large population and still relatively limited access to financial sector. Bank Indonesia, hand in hand, with the government is currently formulating a financial inclusion national strategy. This national strategy will serve as a framework consisting of strategic actions to open the access of unfinanced persons as well as unbanked persons to the financial sector.

87. ***Lastly,*** to promote good governance, I am of the view that excessive risk taking which can potentially induce moral hazard as witnessed during the 2008 crisis needs to be prevented. On that note, compensation or remuneration structure of bank executives conducive to the development of professionalism and integration is needed.

Distinguished guests, ladies and gentlemen,

88. In addition to the policy direction I have described, we must also formulate medium to long term strategies. My view is that capital accumulation, both in the form of physical and human capital, and productivity improvement is key to boosting a balanced aggregate supply and aggregate demand. It is hoped that this ideal condition will lead to higher GDP and lower inflation which will in turn be followed with an increase in GDP per capita.

89. Different speed of convergence to levels of developed countries is seen in the development of income per capita of several main Asian countries. Singapore has out-achieved developed countries since the 1990s decade, while Korea is converging to Japan following the 1997–1998 Asia crisis. To illustrate, for the case of Indonesia, the ratio of Japan's income per capita to Indonesia's income per capita is on a gradual decline since the 1990s decade, with a slight interruption during the Asia crisis. This means that Indonesia's income per capita is catching up to Japan's income per capita.

90. According to the October 2010 IMF's projection, the ratio is estimated to further decline until 2015 and may continue onwards. However, further analysis shows that the speed of convergence to match developed countries is not yet sufficient.

91. Bank Indonesia study shows that in addition to low capital accumulation and productivity, the non optimal speed of convergence is also caused by most binding constraints in the economy. Should these constraints be untangled, a more

accelerated economic growth through increasing investment could be achieved. The five most binding constraints are: 1) insufficient innovation through research and development; 2) a low standard quality of education and health; 3) insufficient possession of information and communication technology; 4) inadequate transportation and distribution infrastructure; and 5) unsustainable supply of energy (for example electricity). Undoubtedly, the role of the state is needed to resolve such binding constraints.

92. In my view, there is a key policy that should be a priority, namely human capital reforms. This would be a crucial precondition to elevate Indonesian economy to knowledge based-economy of 21st century. Human capital reforms could be initiate by a simple yet fundamental initiative on health and education.

93. Furthermore, by focusing on human capital reform, Indonesia could avoid middle-income trap, a phenomenon in which a developing country (as defined as middle income country group) is unable to move up to higher level of income. I believe that all of us have the same vision that in 2050 Indonesia will be free from poverty and could achieve an inclusive growth with notable surplus in key areas, including agriculture.

Distinguished guests, ladies and gentlemen,

94. I hereby invite bankers to shift the mindset of business from “opportunities capture mode” in respect of the recovery after the crisis to the “sustainable growth plan” as the global economic crisis begins to fade. I am certain the resilient solidity we have demonstrated in the previous economic thunderstorm has momentously motivated us to go forward in creating a sustainable and robust banking and economic growth

95. Let us all join hands in unity and walk confidently towards a better tomorrow. And once again, Happy New Year 2011. May God Almighty give our work His blessing; strengthen our purpose in achieving a more developed and prosperous Indonesia. God bless us all.

Wassalamu’alaikum Wr. Wb.