



BANK INDONESIA IN FIRST QUARTER 2004: ECONOMIC AND MONETARY TRENDS, BANKING SYSTEM, AND FUTURE POLICY DIRECTION

*This report is a fulfilment of Bank Indonesia's obligation to provide public **accountability and transparency** as mandated by Act Number 23 of 1999 concerning Bank Indonesia. Presented in this report are the results achieved under Bank Indonesia's powers and functions in monetary affairs, banking and the payment system. A complete report will be presented to the Indonesian Parliament at the end of April 2004.*

"... The condition of the Indonesian economy improved further in Q1/2004, as reflected in higher economic growth, rupiah and interest rate stability, and low inflation. Looking ahead, the outlook is one of sustained macroeconomic stability. In view of these trends, monetary policy will focus on achievement of the medium term inflation target while strengthening the economic recovery process through measures designed to promote economic growth. This policy will also provide room for further cautious easing of interest rates"

Meeting of the Board of Governors, April 8, 2004

► General Review

Indonesia's macroeconomic conditions in Q1/2004 reflected ongoing progress in economic recovery towards the desired objectives. Economic growth improved in line with earlier forecasts, supported by stable monetary and financial conditions as indicated by relative stability in the rupiah, low inflation, and base money within the indicative limits.

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Economic growth is estimated to have improved in Q1/2004 to 4.3% (y-o-y). During this period, the largest factor contributing to economic performance was consumption. Almost all sectors charted positive growth, with leading contributions coming from transport and communications and electrical power.

The rupiah maintained relative stability in Q1/2004 within the range of Rp 8,300-8,500 to the US dollar. Key factors promoting stability in the currency are the conducive trends in domestic economic fundamentals, positive market expectations of movement in the rupiah, rising investor confidence, and stable social and political conditions.

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Inflation maintained a downward trend, easing to 5.11% (y-o-y). Food prices accounted for the steepest decline in inflation, a result of abundant supply from harvests and imports, low impact from administered prices, and the stable rupiah. The combination of lower inflation and stability in the rupiah allowed room for cautious easing of interest rates for monetary instruments. During Q1/2004, the 1-month SBI rate moved 89 bps lower to 7.42% while the 3-month SBI rate came down

Financial system stability held firm. Performance in the banking system is improving

Looking ahead, Indonesia's economic growth is predicted at 4.3%-4.8% (y-o-y).

101 bps to 7.33%. The drop in the SBI rates was transmitted with varying magnitude to other interest rates.

In line with these conducive trends in monetary conditions, financial system stability held firm in Q1/2004. At the end of February, improved performance among bank was reflected by expansion in loan disbursements while figures for earning assets and net interest income attested to higher earning assets and stable conditions in the banking system.

Looking ahead, Indonesia's Q2 economic growth will come within the 4.3%-4.8% range (y-o-y). Consumption, like in past periods, will provide the largest contribution to the performance of the economy, while investment and exports will again have only a limited role. The leading high-growth sectors will be transportation, construction, and electricity, although industry, agriculture, and commerce will continue to dominate in overall output. The rupiah is expected to remain steady at Rp 8,200-8,700 to the US dollar, supported by predictions of continued stability in domestic economic fundamentals and the downward trend in the US dollar brought on by the twin deficits in the US. For the remainder of 2004, the exchange rate is set to remain within the Rp 8,200-8,700 range forecasted at the beginning of the year. Similarly, world economic conditions hold promise for improved performance in the balance of payments and especially exports. Adequate supplies of goods and stability in the rupiah also support the outlook for sustained low inflation.

Consistent with the economic and monetary conditions described above, Bank Indonesia's monetary policy will retain its focus on maintaining macroeconomic stability in order to achieve the medium-term inflation target while strengthening the economic recovery process through measures to promote economic growth. While this policy still allows room for further lowering of SBI interest rates, these reductions must be implemented cautiously in line with medium-term inflation targeting. To prevent excessive fluctuation in the rupiah, Bank Indonesia will intervene on the forex market on an as-needed basis.

Policy in the banking sector will continue to focus on strengthening the condition of the national banking system to create the enabling conditions for further improvement in the bank intermediary function. In addition, Bank Indonesia is actively engaged in some of the 19 program initiatives envisaged in the 6 pillars of the Indonesian Banking Architecture (API). These initiatives have been designed to promote the creation of a sound, strong, and efficient banking system capable of meeting public needs and providing an adequate contribution to economic growth. Under the working framework for the Financial Safety Net, the Governor of Bank Indonesia and the Minister of Finance have also signed a Memorandum of Understanding on the Emergency Financing Facility. The MoU sets out the details of systemic impact, procedure for extending the facility, and sources of funds. Implementation guidelines are to be stipulated in a Decree of the Minister of Finance and a Bank Indonesia Regulation. Complementing this measure, work on the draft law for the Financial Safety Net is scheduled for completion by the end of 2004.

► Evaluation of Monetary Policy and Indicators

Base Money and Interest Rates

Monetary conditions held relatively stable in Q1/2004, as demonstrated by steady, controlled growth in monetary aggregates. Contributing to this stability were conducive domestic economic fundamentals and positive expectations for inflation.



Interest rates on monetary instruments continued to ease, while growth in the money supply was controlled within the indicative target.

Base money eased to Rp 142.73 trillion

Consistent with seasonal trends, base money contracted by Rp 23.74 trillion from the previous quarter to Rp 142.73 trillion in Q1/2004. This drop is explained mainly by lower positions in physical cash and funds held in demand deposits.

SBI rates showed further decline in line with improved expectations of inflation, the stable rupiah, and controlled base money, as reflected in the outcome of SBI auctions in open market operations. In Q1/2004, the 1-month SBI rate eased by 89 bps to 7.42% while the 3-month SBI rate fell even further by 109 bps to 7.33%. This interest rate decline was markedly steeper than the 35 bps and 41 bps easing in rates during the previous quarter. Alongside this, rates for the Bank Indonesia Deposit Facility (FASBI) fell by 75 bps to 7.25% at end of Q1/2004. The falling rates for monetary instruments and particularly FASBI during times of continued flush liquidity on the market drove down the weighted average overnight rates in morning and afternoon sessions on the rupiah money market to 7.33% and 6.34%.

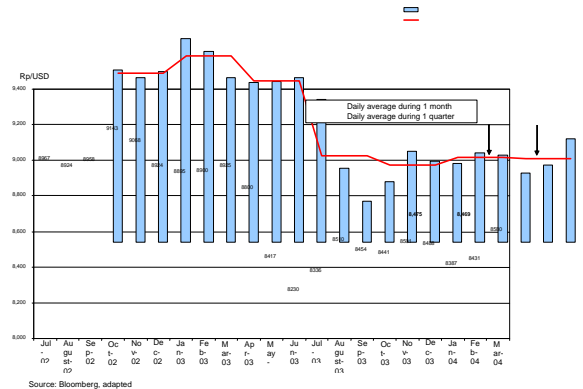
The easing of SBI rates has not met with commensurate response in bank lending rates

The downward trend in SBI rates has also been followed by lower rates for funds and especially for time deposits. Interest rates on 1-month deposits moved down 63 bps and for 3-month deposits by 76 bps from the end of the previous quarter to close Q1/2004 at 5.99% and 6.98%. Despite this, the easing of SBI rates has not met with commensurate response in bank lending rates due to the constraints imposed by bank profitability targets and risk factors. Banks prefer to maintain a large spread due to the lack of operating efficiency caused by high overhead costs and the overriding priority of keeping profits on target with business plans. In Q1/2004, interest rates for working capital credit fell to 14.79% and for investment credit and consumption credit to 15.29% and 18.47%. The lower rates on monetary instruments also encouraged monetary transmission through the capital market for financing the real sector through corporate bond issues.

The rupiah averaged Rp 8,469.

Inflation and the Rupiah

Despite temporary weakening in the rupiah during the second half of Q1/2004, the average rupiah exchange rate for the quarter held relatively stable in comparison to the last quarter of 2003. In Q1/2004, the rupiah averaged Rp 8,469, well within the Rp 8,300-8,500 range forecasted at the beginning of the year. Among the factors contributing to a stable rupiah were the conducive fundamentals in the domestic economy that helped to maintain adequate supply on the domestic forex market, positive market expectations of movement in the rupiah, rising investor confidence following the upgrading in credit rating by the Moody's and Fitch international rating agency, and stable social and political conditions.



Graph: Average Rupiah Exchange Rate

Inflation showed a downward trend, easing to 0.91% (q-t-q)

With the relative stability in the rupiah, inflation also showed a downward trend. The inflation rate eased to 0.36% (m-t-m) in March 2004, bringing CPI-based inflation for Q1/2004 to 0.91% (q-t-q) or significantly less than the 2.51% inflation recorded in the previous quarter. In annual terms, CPI-based inflation rose slightly from 5.06% in Q4/2003 to 5.11%, but still came within the 5%-6% (y-o-y) projection for CPI-based



inflation made at the beginning of the quarter. The downward trend in inflation during Q1/2004 is explained mainly by plentiful supply of domestically produced and imported goods, low impact from administered prices, and the relative stability in the rupiah.

► Policy and Developments in the Banking System

Banking policy is focused on a range of measures to reinforce the condition of the national banking system

Throughout Q1/2004, banking policy remained focused on a range of measures to reinforce the condition of the national banking system in follow up to the bank restructuring program. The core objectives of the current programs are the continued restoration of the bank intermediary function and building of resilience into the banking system through such measures as strengthened corporate governance and improvements to the bank regulatory framework and bank supervision.

Under the program for improvement of the banking regulatory framework, Bank Indonesia issued two new regulations in Q1/2004: (i) concerning Corrective Actions and Designation of Bank Status, comprising amendments to previous regulations in the wake of dissolution of IBRA, and (ii) the Interest Rate Margin Determined for Third Party Deposits Covered by Government Blanket Guarantee as part of the realignment of interest rates.

Several key banking indicators registered gains, consistent with the conducive trend in monetary conditions. The bank intermediary function saw modest improvement reflected in higher numbers for loan disbursement, although more must be done to achieve an optimum level of operation in this area. Trends in other banking indicators were marked by the absence of any signs potentially undermining the stability of the banking system, as demonstrated by rising net interest income (NII), low non-performing loans (NPLs), and relatively stable bank capital and earnings ratios.

Total third party funds held in the banking system fell by Rp11.5 trillion

Total assets held by the banking system reached Rp 1,157.2 trillion in Q1/2004 (February 2004). Despite this, total third party funds fell by Rp 11.5 trillion from Rp 877.1 trillion in the previous quarter, mainly due to the drawing of about Rp 2.5 trillion in IBRA funds and a possible movement of Rp 6 trillion to mutual funds. The cautious stance adopted by banks in extending loans is reflected in the minimal rise in loan disbursements. In Q1/2004, bank lending expanded by Rp 0.1 trillion (0.02%) to Rp 447.30 trillion. New loan disbursements in Q1/2004 reached Rp 4.3 trillion, 53.9% of which was channeled to the SME sector. Analyzed by intended use, the new loans were extended most importantly for working capital, which accounted for 45.6% of the total, followed by investment credit at 24.3% and consumption credit at 30.1%. The low rate of new loan disbursement is attributable to the steep interest rates charged for loans in comparison to interest rates paid when banks issue corporate bonds, as well as low demand for credit reflected in the higher rate of undisbursed loans. As a result, banks are flush with liquidity and the excess funds have been placed in SBIs. Thus in Q1/2004, the national banking system recorded a loan to deposit ratio (LDR) of only 42.9%.

Improving performance in the banking system is also reflected in the NII, up from Rp 3.2 trillion in Q4/2003 to Rp 5.1 trillion in Q1/2004. This increase resulted mainly from higher lending and the more rapid decline in interest rates on third party funds compared to loan interest rates. Return on Assets (ROA) for the banking system reached 2.6%, up from 2.5% in the previous quarter. Overall capital in the banking system in Q1/2004 remained well above the minimum requirement with a CAR of



23.2%, up from 19.4% in Q4/2003. The industry-wide CAR for the banking system in Indonesia is generally higher than the capital levels recorded in a number of other ASEAN countries.

NPLs gross in the banking system rose to 8.29%

NPLs gross in the banking system rose from 8.21% to 8.29%, while NPLs net fell from 3.04% to 2.55%. The NPLs ratio may potentially rise largely because of the deteriorating condition of certain sectors, such as textiles, steel, plastics, and forestry. Added to this, the period in which ex-IBRA loans were rated current has now expired. While the NPLs figure is higher, this increase will have no short-term impact on financial system stability.

Table: Key Banking Indicators (Rp trillions)

Indicator	Q3-2003	Q4-2003	Q1-2004*)
Total Assets	1,130.4	1,196.2	1,152.7
Third Party Funds	863.4	888.6	877.1
Credit	454.17	477.19	447.30
NII	4.69	3.2	5.1
LDR (%)	42.0	43.2	42.9
NPL - gross (%)	7.9	8.21	8.29
NPL - net (%)	1.3	3.04	2.55
CAR (%)	20.0	19.4	23.0

*) data as at February 2004

► Policy and Developments in the Payment System

Policy for the cash payment system will focus on provision of adequate rupiah currency for the needs of the public.

Overall policy for the cash payment system will continue to focus on meeting the needs of the public through timely provision of adequate quantities of rupiah currency in terms of nominal, appropriate denominations, and condition fit for circulation. In the non-cash payment system, policy will be directed at the creation of an effective, efficient, secure, and reliable payment system. Consistent with the seasonal pattern in social activities in Q1/2004 following the end of religious festivities and the new year celebrations, activity in both the cash and non-cash payment systems showed similar downward trends.

Cash payment activity saw modest decline in Q1/2004 in line with falling public demand for cash in the aftermath of religious festivities and the new year. This decline was indicated by a 9.29% drop in Money In Circulation from Rp 112.75 trillion in Q4/2003 to Rp 102.27 trillion at the end of Q1/2004.

Total BI-RTGS transactions in Q1/2004 reached Rp 6,729 trillion, up 7.95% from Rp 6,233 trillion in the previous quarter. Total volume handled by BI-RTGS came to 1,123 thousand transactions, or 3.72% fewer than the 1,166 thousand transactions in Q4/2003. Daily average turnover in these transactions was thus Rp 112.1 trillion in average volume of 18,726 transactions. Disaggregated by region of transaction origin, the highest numbers for volume and value of RTGS transactions were recorded in Jakarta.

In contrast to the BI-RTGS system, Q1/2004 was marked by reduced activity in clearing, both in transaction value and number of items processed. Total value of clearing items processed in incoming clearing nationwide came to Rp 239 trillion for 14.7 million clearing items. Compared to the previous quarter, these figures

represented declines of 20.8% in clearing value and 19.7% in transaction volume. Accordingly, daily average clearing value and volume of transactions eased by 3.9% to Rp 4.9 trillion and 26.5% to 300 thousand clearing items.

► Economic and Monetary Outlook for the Coming Quarter

Macroeconomic Outlook

The outlook for Indonesia in Q2/2004 is stronger economic growth

The improving condition of the world economy, marked by expanding economic activity and international trade, are expected to deliver a positive impact on Indonesia's economic growth in Q2/2004. The outlook for Indonesia in Q2/2004 is stronger growth compared to the preceding quarter. Domestically, increased consumer confidence and higher growth in investment spending from the previous quarter supported by additional financing sources from the banking sector and the capital market are predicted to deliver a positive contribution to economic growth. Furthermore, government is expected to take measures to deliver a larger fiscal stimulus through the development budget and spending of contingency funds. This is reflected, among others, in the high level of Government expenditures planned for the coming quarter.

Economic growth is predicted to come within the range of 4.3%-4.8% (y-o-y)

Indonesia's economic growth in Q2/2004 is predicted to come within the range of 4.3%-4.8% (y-o-y). Disaggregated by sector, this growth will be driven mainly by transportation, construction, and electricity, even though the largest contributing sectors are industry, agriculture, and commerce. On the demand side, like in previous quarters, consumption represented the most important source of growth during the reporting quarter with growth estimated in the 4.7%-5.2% range. Q2/2004 is also predicted to see higher growth in investment and exports compared to earlier quarters. Despite weak growth at the beginning of the year, investment spending is set to expand more quickly in Q2/2004 at 2.4%-2.9%. This is supported by the increasing availability of financing sources in the banking system and on the capital market. Exports of goods and services are predicted to rise by 5.1%-5.6%, driven most importantly by higher non oil-gas exports to major trading partners such as the United States, Japan, and Europe, as well as firmer prices for some mainstay commodities. The outlook for overall export growth in 1004 is on track with earlier forecasts in the range of 4%-5%.

Outlook for Inflation and the Exchange Rate

The outlook is for low CPI-based inflation within the 5%-6% range (y-o-y)

CPI-based inflation in Q2/2004 is predicted to remain low within the 5%-6% range (y-o-y). The low inflation trend in this projection is supported by various fundamentals, such as improving expectations of inflation reinforced by domestic security and political stability, adequate levels of food supplies in the wake of an abundant harvest, and the relative stability in the rupiah. Added to this, election activities are expected to lead to postponement of a round of increases in administered prices, particularly for vital goods such as fuel and electricity and in cigarette excise, thus generally easing any inflationary pressure from administered prices. CPI-based inflation for the full year of 2004 is predicted to come within the originally forecasted range of 5.5% \pm 1% (y-o-y).

The exchange rate is set to hold stable at an average of Rp 8,200-8,700 to the US dollar

In Q2/2004, the exchange rate is set to hold stable at an average of Rp 8,200-8,700 to the US dollar. Factors in this forecast including stable fundamentals in the domestic economy and the continued weakening of the US dollar as a result of the massive twin deficits in the US. Nevertheless, other factors could still bear down on



the rupiah. Concerns exist that the possibility of continued intervention by the government of Japan to restrain the yen appreciation against the US dollar could drive the rupiah to lower levels. For the full year of 2004, the rupiah is expected to average Rp 8,200-8,700 to the US dollar as envisaged at the beginning of the year.

► Policy Direction for the Coming Quarter

In view of the various looming economic challenges and the economic and monetary outlook, the policy direction adopted by Bank Indonesia for the coming quarter in monetary affairs, banking, and the payment system is as follows:

In monetary affairs, the focus of monetary policy will be to ensure continued monetary stability for achievement of the medium-term inflation target while strengthening the economic recovery process through promotion of economic growth. This policy will allow room for cautious easing of interest rates in line with the inflation target. To prevent excessive volatility in the rupiah, intervention on the forex market will take place as needed in line with the monitoring of foreign exchange transactions by major market players.

In the banking system, policy will aim for further measures to reinforce stability of in financial and banking system and promote the operation of the bank intermediary function. Bank Indonesia will move forward with the implementation of some of the 19 initiatives envisaged under the Indonesian Banking Architecture (API), including the establishment of a panel of banking experts, customer complaints mechanism, establishment of a bank mediation agency, transparency of product information, consumer education, good corporate governance, credit bureau, certification of risk managers, linkage program, and relaxation of restrictions on the opening of rural bank branch offices. Added to this, following the signing by Minister of Finance and the Governor of Bank Indonesia of the Memorandum of Understanding on the Emergency Financing Facility, which comprises part of the working framework for the Financial Safety Net with implementation guidelines to be set out in a Decree of the Minister of Finance and a Bank Indonesia Regulation, Bank Indonesia has commenced work on drafting the guidelines to be included in this Bank Indonesia Regulation.

In the cash payment system, the policy emphasis will be to meet public demand for physical cash in adequate amounts during the period of peak election activity in Q2 and Q3/2004. Bank Indonesia will also take further measures to strengthen coordination with relevant agencies in ensuring the smooth distribution of money throughout Indonesia and will strengthen action against counterfeiting through expanded networking and cooperation with agencies involved in the combating these crimes. These efforts will be complemented by public service information in the print and electronic media to familiarize the public with the specific marks of authenticity in the rupiah currency.

In the non-cash payment system, policy will continue to target reduction in payment risks and improved efficiency and regulation in system operation with the aim of building an efficient, fast, secure, and reliable national payment system. These measures will include the development of paperless credit notes, the failure to settle mechanism, and the clearing system for paperless credit and debit items, and preparation of a review of the blueprint for the national payment system.

Jakarta, April 15, 2004

