

STATEMENT BY GOVERNOR OF BANK INDONESIA
MR. BURHANUDDIN ABDULLAH
AT THE 15TH MEETING OF THE CONSULTATIVE GROUP ON INDONESIA
JAKARTA, JUNE 14, 2006

**Chairman of the CGI,
Excellencies,
Distinguished Delegates,
Ladies and Gentleman,**

First of all, I wish to express my sincere gratitude to the donor countries that have been supportive to Indonesia's development so as to improve the well being of our people. We may all be aware that only last year at the turn of 2005, we witnessed the tsunami striking Aceh and North Sumatra, a catastrophe of unprecedented scale in Indonesia. Unfortunately, this year we also were shocked by the earthquake disaster causing a massive devastation in the historic dan tranquil city of Yogyakarta and its vicinity claiming more than 5000 lives and leaving hundreds of thousands homeless. Therefore, your presence here in the 15th Meeting of the CGI marks an important event reflecting your unwavering commitment to our development for which I wish to convey our profound appreciation.

Ladies and Gentlemen,

On this important occasion, allow me to highlight briefly an overview of the recent economic developments of Indonesia, particularly from the monetary perspective. Last year we registered a respectable economic growth of 5.6 percent, the highest ever recorded since the economic crisis in 1997. Initially, given the benign external environment, the general thrusts of monetary policy in 2005 was accommodative so as to allow room for even faster economic growth. However, starting mid-2005 external pressure started to build up, which undermined our hard-won macroeconomic stability.

The mounting pressure on macroeconomic stability last year was mainly triggered by the unfavorable world environment, especially surging world oil prices together with sustained monetary tightening cycle in the United States. With the oil price reaching their all time high around USD70 per barrel, demand for foreign exchange escalated to meet rising oil import bills. Sizable government subsidies for domestic fuel consumption at that time propagated growing market unease against the sustainability of fiscal condition. The situation was further exacerbated by the global trend of stronger US dollar, leading to increasing short-term capital outflows. Consequently, rupiah came under strong pressure, depreciating by almost one thousand rupiah per USD in less than 7 months as sentiment turned sour since market doubted fiscal sustainability due to ballooning domestic oil subsidy. These, coupled with widening current account deficit owing to higher oil import bills, have contributed to the pressure on rupiah.

The hike in domestic fuel prices following the government's bold measure to maintain fiscal sustainability and regain market confidence put immense pressure on inflation in 2005. Domestic fuel prices were raised by an average of 126% on October 1st last year. Other factors contributing to the inflationary pressure included supply and distribution problems, mounting expectation of inflation, and weakening rupiah, while pressures from the output gap remained modest. The combination of these factors led inflation to soar from 6.4% in 2004 to 17.1% on annual basis in 2005, well above the 5-7% target range. Core inflation was also rising from 6.7% to 9.75%.

To restore stability, Bank Indonesia pursued a tight biased monetary policy, especially after the second quarter of 2005 subsequent to the implementation of ITF in July 2005. Bank Indonesia then decisively raised BI rate by 425 basis points cumulatively to 12.75 percent. As the inflationary pressure eased somewhat, the rate was slightly lowered to 12.50% in May and stayed at that level up to the present.

Following the pursuit of tight monetary policy, market confidence has been swiftly restored, thereby forestalling macroeconomic stability from further deterioration of a "mini crisis" last year. The strong signal of Bank Indonesia to keep stability in check has resulted in the gradual easing of inflationary pressure from 17.1% on annual basis at the end of last year to 15.6% in May this year.

Rupiah exchange rate, on monthly average, was traded at IDR9.008 per USD in May this year, dramatically stronger than IDR10.310 at the peak of last year's turbulence in September 2005. A massive influx of short-term capital to the country, taking advantage of improved risk perceptions and favorable interest rate differentials was one of the main factors behind the rebound of rupiah.

On the banking sector, its performance indicators have generally remained sound. Indicators of this included relatively strong performance of the intermediary function. Last year, banks' credit grew by almost 22% and this year, we expect to see the high growth trend to continue to reach at least the level of 20%. Banks' capital has been strengthened with the capital adequacy ratio (CAR) now stabilized at around 22%. Market and liquidity risks were adequately managed and have not yet appeared to trigger any potential instability. However, the banking sector was confronted with intensified credit risks, reflected by higher rate of non-performing loans (NPLs) from 8.3% in December last year to 9.4% in March 2006.

Ladies and Gentlemen,

Looking ahead, the economy continues to improve in 2006, with the growth rate estimated closed to the upper level of around 5.7% target. We are hoping that more favorable world environment, improved balance of payments, larger fiscal stimulus, accommodative stance of monetary policy, and favorable investment climate will enhanced real sector activity and restored macro stability. The economy however remains subdued till Q2-2006 before picking up in the second half of 2006 when the purchasing power of consumers start to recover from the depressing impacts of higher domestic fuel prices.

With respect to the banking sector, credit risks will remain relatively high, yet overall bank performance will be positive. The prevailing high credit risks will force banks to become more conservative in allocating credits and tend to expand their portfolio in low risk-weighted assets. The pressures from the rising costs of funds and overhead costs will shrink their profit margins. However, banking capital adequacy is well above the minimum required threshold and, therefore, sufficient to absorb any shocks and potential instability.

Finally, before closing my short remarks, let me assure you that the central bank will remain fully committed to pursuing a sound monetary policy as well as prudent bank supervision in line with our mission to ensure macroeconomic stability. In doing so, Bank Indonesia has taken serious measures to improve our monetary policy framework and introduced a series of prudential banking package that intended among other adjustment to the quality of earning assets of commercial banks, extension of banking service network to micro and SME's, and implementation of good corporate governance for commercial banks.

Thank you.

Jakarta, June 14, 2006

GOVERNOR
BANK INDONESIA

Burhanuddin Abdullah