Strengthening fundamentals

INTERVIEW WITH DARMIN NASUTION
GOVERNOR, BANK INDONESIA

DARMIN NASUTION took his office as Governor in 2010. He holds a PhD in Economics from the University of Paris, Sorbonne and served as an eminent academic for 17 years before being appointed as an assistant to the Coordinating Minister for Economic Affairs (1993-2000). Later he became Chairman of Indonesian Capital Market and Financial Institutions Supervisory Agency. His last position, before the parliament approved him as Governor, was Senior Deputy of Bank Indonesia.

Please explain the role of the bank and its key aims and objectives.

Bank Indonesia implements the country's monetary policy, manages currency circulation, ensures a smooth payment system, and regulates and supervises the national banking system. These tasks are carried out with one principal objective: the stability of the rupiah, which in turn has two aspects, the currency's stability against goods and services; and its stability against other currencies. The first aspect is measured by the rate of inflation and the second is reflected by the exchange rate.

To what extent is Bank Indonesia independent from the government?

Bank Indonesia is fully autonomous in formulating and implementing its policies, which is necessary for the Central Bank to carry out its role as the country's monetary authority more effectively and efficiently. The Central Bank Act stipulates that it has the duty to refuse or disregard any attempt of interference in any form by all external parties, including the government. Nevertheless, Bank Indonesia maintains a close working relationship with the government in many issues, in particular working with it to preserve macroeconomic stability and attain sustainable economic growth. On some occasions, the government may even attend Bank Indonesia's Board of Governors' meetings with the right to be heard but no right to vote.

What is your policy on foreign-owned banks wishing to enter the Indonesian market, either as new entities or by acquisition?

Indonesia's banking sector is among the most open in ASEAN, both in terms of its international commitments as well as its regulations. This is a consequence of the free and open capital flows regime adopted since the 1970s. The sector was liberalised in October 1988, which made it easier to establish new banks, rural banks, as well as facilitating access to foreign investment in the banking sector. Entry barriers to establish commercial banks were substantially lowered to allow foreign investors to establish joint-venture commercial banks. Distribution networks in the form of branches, sub-branches, and ATMs were also expanded significantly, making banking services easier to access. Liberalisation measures have made Indonesia's banking sector among the most open to foreign investors in Asia.

In 2009 commercial banks' licensing for opening, transferring, and closing branch offices and distribution networks banks were deregulated to accommodate more competition in the market and to simplify licensing procedures. This facilitated the growth of new branches, ATMs, cash offices, mobile services units, payment points, loan centres, and other networks. Banks that wish to expand their networks must first report their plans to Bank Indonesia.

Although Indonesia experienced a severe banking crisis between 1997 and 1998, the banking sector remains attractive to foreign investors. In fact, the banking crisis was a major factor in opening Indonesia up to foreign investors. Between 1999 and 2000, foreign investors took part ownership in many Indonesian banks. Since then Indonesia has allowed up to 99 per cent foreign ownership. The results have been very positive for foreign investors. The number of banks owned by foreigners – whether subsidiaries, joint ventures with Indonesian entities, or ownership of Indonesian banks – increased from 42 in 2009 to 49 in 2012. The number of foreign-owned banks in Indonesia has grown significantly since the 1990s: in 1995, it was 26 per cent, but by 2009 it was 52 per cent.

What are the key challenges facing the banking sector in Indonesia?

Despite sound macroeconomic conditions, Indonesia's economy still faces some challenges. From the external side, the uncertainty in global economic recovery remains high. The eurozone debt crisis increasingly overshadows the global economy, with no clear resolution in sight. This situation has impacted on the global economy, as reflected in the world's financial markets and trade. This global crisis affects the Indonesian economy financially and in terms of trade. Investors' perceptions of risk as a result of the world economy have caused volatility in domestic financial markets, including heightened pressure on exchange rates. In terms of trade, declining global demand has directly weakened Indonesia's exports, directly. At the same time, strong domestic demand amid declining export performance has led to a current account

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deficit. If not properly managed, this could eventually compromise macroeconomic stability. In addition, Indonesia's industrial infrastructure also needs improving, so that Indonesia's economic dependence on imports can be reduced. From the fiscal standpoint, large energy subsidies also pose another challenge to the economy.

In response to these challenges, Bank Indonesia, in close coordination with the government, is undertaking several policies to bring the current account deficit to a sustainable level. Bank Indonesia will continue to strengthen the management of the exchange rate, supported by further measures related to monetary operations and in the foreign exchange market to ensure that any adjustment in external balances take place in an orderly manner. These policy measures should relieve pressure on the balance of payments in the second half of 2012. Going forward, Bank Indonesia will continue to focus on measures to maintain external balances and contain inflation. In this regard, Bank Indonesia will continue to strengthen the existing monetary and macro prudential policy mix. In addition, coordination with the government will also be strengthened.

The key challenges facing Indonesia's banks at the moment are how to strengthen their capital, risk management, and governance practices. Those factors are deemed important to make our national banking industry more competitive and efficient.

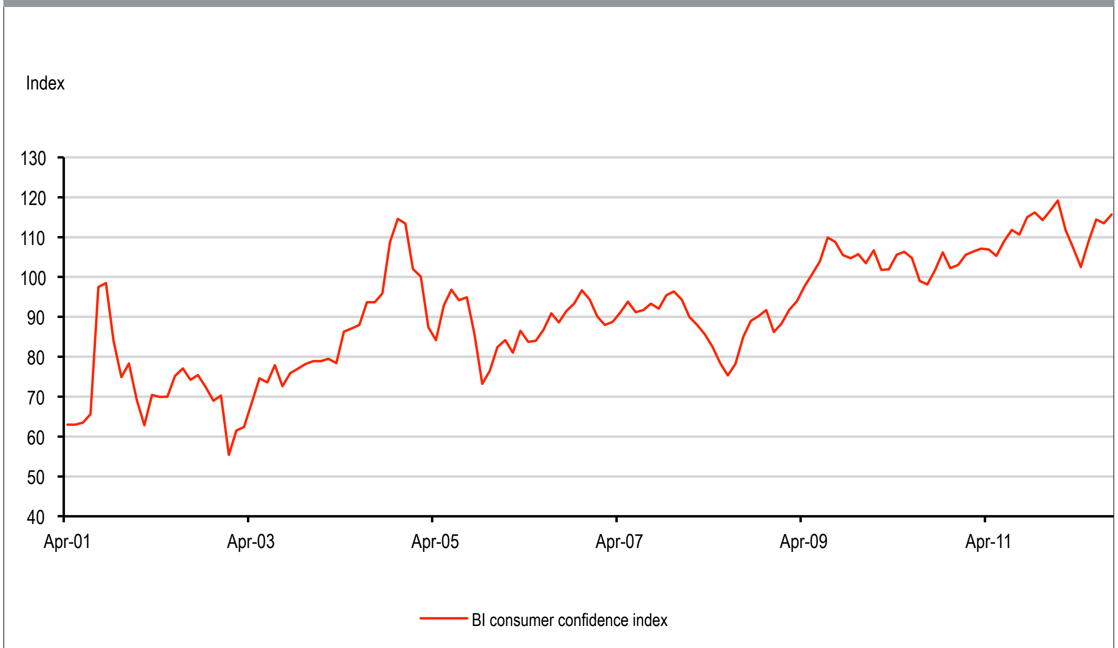
To strengthen capital and bank resiliency in case of crisis, Bank Indonesia will implement the Basel III regulatory framework. To improve governance, Bank Indonesia will place a threshold of majority shareholders in publicly traded commercial banks. To increase risk management practices, Bank Indonesia will limit the business activities and branch network based on banks' capital reserves.

Bank Indonesia has been aiming for low interest lending rates to help spur business activity and will continue its efforts to increase the transparency of banks' prime lending rates.

What is the medium term outlook for Indonesia's key financial indicators, such as the benchmark interest rate, currency value, inflation rate, and GDP growth?

Despite the ongoing uncertainty about a global economic recovery, we believe that economic growth in 2012 and beyond will remain high, thanks to favourable demographics and our abundance of natural resources. Indonesia's strong domestic market is due to its youthful population, which forms the basis of a burgeoning middle class. Our optimism is based on the continued potential of Indonesia's economy. Thus, despite the slowdown in exports, we estimate the economy will grow around 6.1 to 6.5 per cent in 2012. Next year, we expect the economy will continue to expand by around 6.3 to 6.7 per cent. Supported by better economic capacity due to high investment growth in recent years, we expect inflation can be maintained within the target range of around 4.5 per cent.

Chart 1: Indonesian consumer sentiment remains upbeat



Source: CEIC, HSBC

Rising index of domestic consumer sentiment

In the medium term, the Indonesian economic outlook is predicted to remain solid due to continuing macroeconomic stability. Indonesia's economy is expected to grow by around 7 per cent a year, with inflation slowing down to around 4 per cent. This projection is based on improvements in economic fundamentals and efforts to boost domestic economic productivity. Resilient economic fundamentals in Indonesia are the result of significant advances in macroeconomic performance and economic stability and improvements in the business climate. Meanwhile, efforts to overcome constraints such as a lack of soft and hard infrastructure are expected to strengthen our economic foundations. The government has formulated *The Master plan of Acceleration and Expansion of Indonesia Economic Development* (MP3EI) for 2011-2025, aimed at boosting investment, including in infrastructure. Therefore, the Indonesian economy in the medium term is projected to continue expanding as it has done until now.

How concerned are you about Indonesia's exposure to the fallout from the European banking and debt crisis?

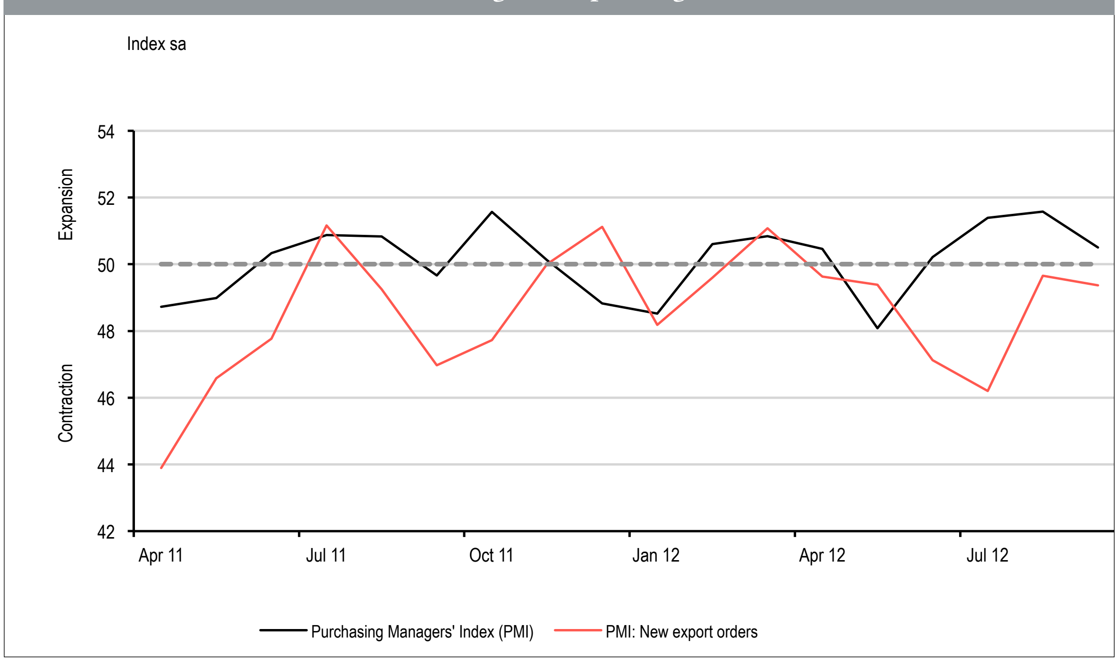
Indonesia's exposure to the European banking system is limited. But Bank Indonesia will continue to monitor the crisis, and has taken precautionary steps in anticipation that it might worsen. BI will increase the supply of foreign exchange in the market to stabilise the rupiah. This will require intervention in the foreign exchange market, as well as the purchase of government securities in the secondary market, issuing foreign exchange deposits, and developing other domestic foreign exchange instruments. As of April 2012, Indonesia's private foreign debt to Europe was US$21.6 billion, which mostly came from the Netherlands (57.3 per cent), the UK (10.7 per cent), Germany (6.4 per cent), and France (2.5 per cent). Debt exposure to the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) is very limited.

What is your vision for the development of the banking and financial services sector in Indonesia, in the context of the ASEAN region?

Declining inflation and interest rates in Indonesia reflect the trend in most of the major economies in ASEAN, something that will support competitiveness in business and finance. This is a key factor in facilitating the integration of ASEAN's economies in 2015 and the integration of the financial sector in 2020. Financial integration in ASEAN will start with the integration of the banking sector. Through the framework of the ASEAN Banking Integration Framework (ABIF), ASEAN's banks will be able to expand their business and operations. This new framework will present both opportunities and challenges for the Indonesian banking sector. From a regulatory perspective, Bank Indonesia will anticipate this challenge by continuing to refine its policies to promote better efficiency, resilience, and to improve governance. F

Bank Indonesia is fully autonomous in formulating and implementing its policies

Chart 2: Indonesian manufacturing still expanding, but not on external demand



Source: Markit, HSBC

Domestic demand is fuelling economic growth