Country Report

Economic Research Department

First semester 2008

Contents

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This publication was coordinated by:

Alicia García-Herrero alicia.garcia-herrero@bbva.com.hk
Joaquín Vial jvial@grupobbva.com

Contributors:

Tatiana Alonso tatiana.alonso@grupobbva.com
Clara Barrabés cvictoria.barrabes@grupobbva.com
Guadalupe Borreguero guadalupe.borreguero@bbva.com.hk
Erikson Castro erikson_castro@provincial.com
Ya-Lan Liu yalan@grupobbva.com
David Mathieson david.mathieson@grupobbva.com
Angel Melguizo angel.melguizo@grupobbva.com
Andrew Tsang andrew.tsang@bbva.com.hk

Economy

ECONOMIC STRUCTURE

Indonesia's economic structure before and after the Asian financial crisis has undergone significant changes. On the sector level, the 1970-1997 period was marked on the supply side by a rapid ascent of the secondary sector (including manufacturing), followed by growth in the tertiary sector and, by the investment and private consumption as main drivers of growth on the demand side.

INDONESIA: GDP, INVESTMENT AND CONSUMPTION GROWTH

Source: ERD BBVA

The structural transformation that began in the 1970's came to an abrupt end with the economic crisis in 1997 and 1998. Economic growth turned deeply negative then and did not turnaround until year 2000. For the period 2000-2004, annual growth partially recovered to 4.6% in average but still far from 7.2% achieved in the five years prior to the crisis. The secondary sectors and especially manufacturing stagnated. The share of investment in the GDP was displaced by consumption and net exports. Weakened investment growth negatively affected the productivity of the economy and, total factor productivity (TFP) is estimated to have dropped below 1% in the 2000-2004 period, far below the 3% in the 1993-1997 period[1].

Of all the emerging market economies hit by the 1997-98 financial crisis, Indonesia was the most severely affected, and took longest to recover. This happened despite Indonesia's economy appearing prior to the crisis to be in better shape than some of the other affected countries, based on headline macroeconomic indicators.

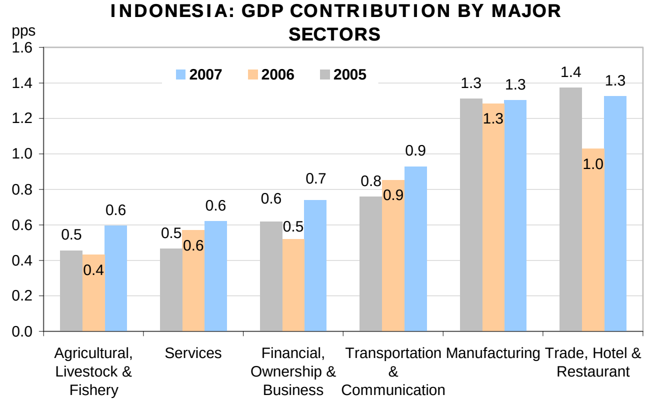
The experience of the crisis in Indonesia triggered deep institutional reforms and structural changes, which have fueled the economic recovery in recent years.

RECENT DEVELOPMENTS

The improvement of macroeconomic fundamentals was reflected last year in the gains in the domestic financial markets and the upgrading of Indonesia's sovereign rating by Moody's (Ba3) and Fitch (BB) –two notches below investment grade-, with a stable outlook.

In 2007, Indonesia's economy reached 6.3%, its fastest growth in a decade. The main contributors to last year's economic expansion were consumption and investment, namely a recovery in construction, while the manufacturing, services (including trade, hotel and restaurants), transport and communications accounted for the largest contribution to growth by major sectors.

INDONESIA: GDP CONTRIBUTION BY MAJOR SECTORS



Source: ERD BBVA

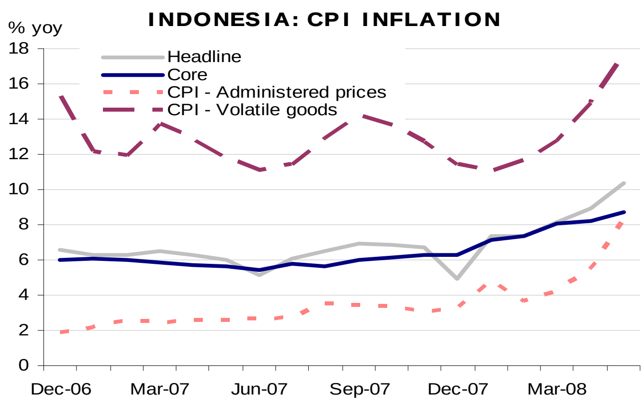
Overall economic expansion continued in the first quarter of 2008, posting the sixth consecutive quarter of 6% plus growth at 6.3% year-on-year, on the back of a strong performance in the external sector and still solid consumption growth. Exports were dominated by commodities and primary products, mostly palm oil and rubber, while import growth was especially strong in

[1] 2006 Economic Report on Indonesia, Bank Indonesia.

machinery and equipment, reflecting higher demand for investment.

Source: National Sources

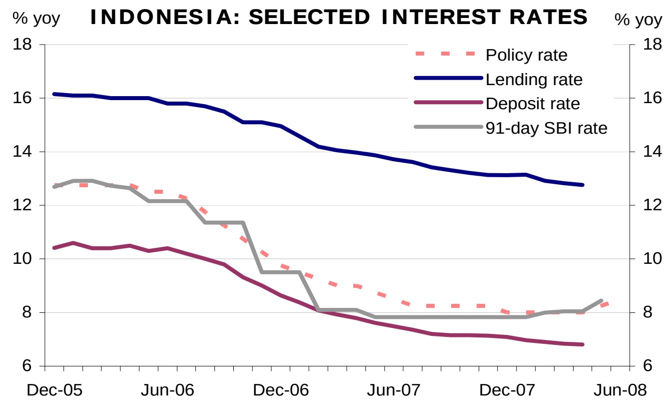
Inflation remains higher and more volatile than in other regional economies and reached 10.4% in May, the highest rate since September 2006. The inflation has been driven primarily by higher volatile foods and administered[2] prices, namely subsidized fuels (29% average increase) and cigarette price excise. As a result, the government launched a price stabilization program in February 2008, targeting a range of staple food commodities (rice, cooking oil, soybeans and wheat flour) although its impact on prices has not been shown yet. The government remains optimistic about agricultural prices declining later in the year, on the back of a good harvesting season.



Source: ERD BBVA, Thomson Datastream

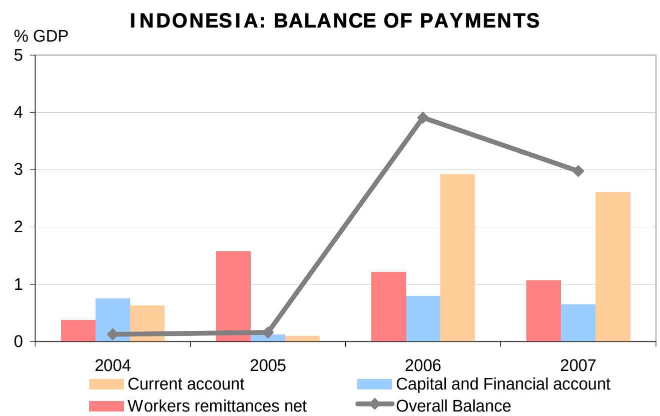
Monetary conditions were loose during 2007 as the central bank[3] (BI) proceeded with gradual easing of its interest rate policy from May 2006. Both broad money and credit rose at faster rates around 19% and 22% in 2007 from 15% and 12%, respectively in 2006. Credit expansion has recently picked up driven by consumption and working capital loans.

Interest rates dropped from 12.75% in April 2006 to 8% early this year. In May 2008, Bank Indonesia began tightening 75 basis points in three steps, following a sharp adjustment in subsidized fuel prices. Moreover, since June 2008, the central bank switched to the overnight interbank rate as the monetary policy rate.



Source: ERD BBVA, Thomson Datastream

On the balance of payments side, Indonesia has been recording twin surpluses in the current and capital accounts since 2004. The improved economic fundamentals coupled with a relatively high return on the rupiah led to an increase in capital inflows invested in short-term bills, government securities and stocks. The stock exchange index increased 52% in 2007 following a 55% gain the previous year; in the first seven months of this year, the Jakarta stock index has declined by 17%. Overall, portfolio net inflows increased 63% in 2007, amounting to more than 7 billion dollars or 1.7% of GDP. On the other hand, the risk from a reversal of short-term portfolio flows should remain moderate as foreign investment share in Bank Indonesia Certificates (SBI) and government bonds (SUN) accounts for a manageable 13% and 17% of total outstanding, respectively and less than ¼ of the stock trading value, by end of April 2008.



Source: ERD BBVA

[2] Fuel, electricity tariffs, retail cigarette excise and transport fares.
[3] Bank Indonesia adopted inflation targeting in 2002.

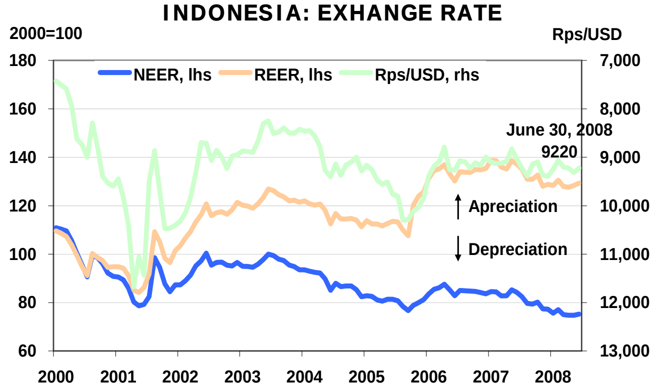
SUMMARY OF THE BALANCE OF PAYMENTS

US$ millions	2003	2004	2005	2006	2007*
A. Current account balance	8,106	1,563	278	10,836	11,009
Trade balance (f.o.b.)	24,563	20,152	17,534	29,660	33,083
Services	-16,456	-8,811	-9,122	-9,888	-11,103
Investment Income	--	-10,917	-12,927	-13,800	-15,875
Transfers	--	1,139	4,793	4,863	4,903
B. Capital account balance	-949	1,852	345	2,943	2,753
FDI	-597	-1,512	5,271	2,211	1,164
Portfolio investments	2,251	4,409	4,190	4,174	6,981
C. Total (=A+B)	7,157	3,415	623	13,779	13,762
D. Change in international reserves	-3,655	-309	-444	-14,510	-12,543

*Preliminary
Source: Bank Indonesia

Despite the overall balance of payments surplus last year, the rupiah exchange rate against the dollar maintained relative stability. However, in the first five months of 2008, the rupiah slightly weakened following net foreign selling in the stock market, which was partly driven by concerns on the impact of inflation in the fiscal balance and output growth. In real effective terms, the rupiah also depreciated 6% since January over the last year. Going forward, as the central bank would probably maintain a tightening stance for the rest of 2008, rising interest rate differentials with the US could eventually help mitigate the depreciation pressures on the currency, assuming there is no further deterioration in the investors' sentiment.

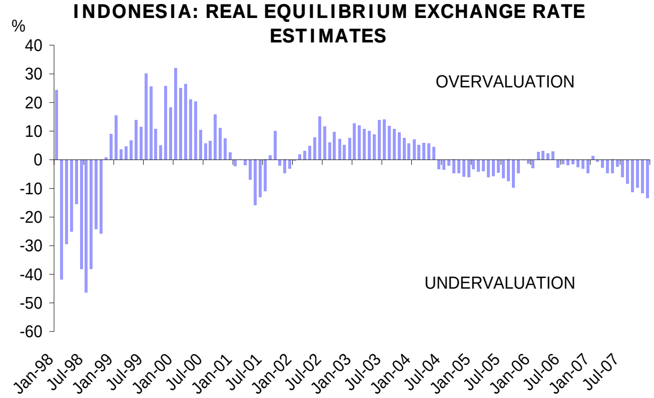
INDONESIA: EXHANGE RATE



Source: ERD BBVA

As for the adequate level of the exchange rate, the evidence on external competitiveness is mixed. The authorities emphasize that the exchange rate is market determined with the central bank's intervention limited to smooth volatility and build up reserves. REER measures suggest a modest undervaluation, as reflected in the current account surplus, albeit the performance of manufacturing exports has been modest relative to Indonesia's trading partners. Going forward, it is more probable a modest strengthening of the rupee from the current levels as the monetary policy tightens and to help mitigate the impact of rising imported crude oil prices.

INDONESIA: REAL EQUILIBRIUM EXCHANGE RATE ESTIMATES



Source: ERD BBVA

PUBLIC AND EXTERNAL FINANCE

Public and external debt has declined from historical peaks. Fiscal deficits are contained (below the threshold of 3% of GDP) and primary balance remains in surplus since 2003.

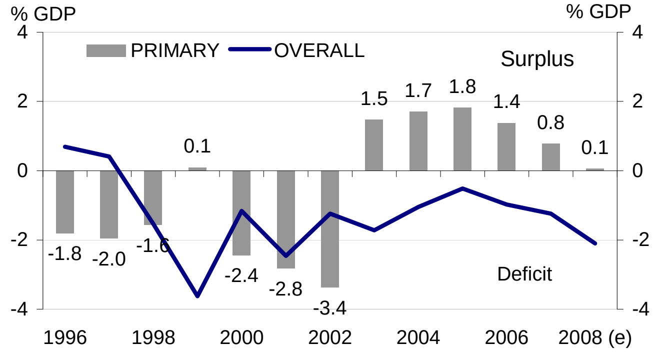
Reserve accumulation and lower external borrowing has increased the reserve assets position to 5.2 months of imports and 40% of foreign debt in 2007.

INDONESIA: GOVERNMENT DEBT TO GDP

Source: Ministry of Finance, ERD BBVA

Over the past five to ten years, fiscal policy has been geared toward consolidation and reducing the public debt. Overall fiscal deficit has declined to 1.2% of GDP from a peak of 3.9% in 1999. Budget deficit in 2008 is estimated at 2.1% of GDP, up from 2007 as a result of higher subsidy expenditures, but primary deficit should remain in small surplus.

INDONESIA: FISCAL BALANCE



Source: ERD BBVA

More recently in May, the government decided to reduce significantly domestic fuel subsidies in order to contain an increasing overall deficit and create fiscal room for spending in priority areas. However, a substantial increase in public spending will be needed to achieve the government's economic growth target of 7% in the medium term, and to reduce poverty from the current 18% level. Additionally, the government needs to deal with the decline in oil revenues, which is expected to continue deteriorating due to falling production levels.

GOVERNMENT FINANCE SUMMARY

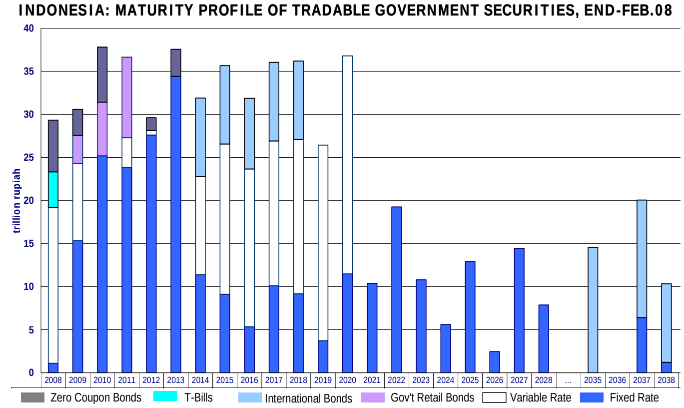
% of GDP	2003	2004	2005	2006	2007
A. Revenue (ex.privatisation)	16.7	17.7	17.8	19.1	18.0
I. Domestic Revenues	16.7	17.7	17.7	19.1	17.9
Tax	11.8	12.3	12.5	12.3	12.5
Oil/gas	1.0	0.9	1.3	1.3	1.1
Non-Tax	4.8	5.4	5.3	6.8	5.5
B. Expenditures, total	18.4	18.8	18.3	20.1	19.2
I. Central Gov't Current	12.5	13.1	13.0	13.3	12.8
Interest Payment	3.2	2.7	2.3	2.4	2.0
o/w domestic	2.3	1.7	1.6	1.6	1.4
external	0.9	1.0	0.8	0.7	0.7
Subsidies	2.1	4.0	4.3	3.2	3.8
o/w oil	1.5	3.0	3.4	1.9	2.1
Capital Expenditure	3.4	2.1	1.2	1.8	1.6
II. Regional Transfers	5.9	5.7	5.4	6.8	6.4
C. Primary Balance	**1.5**	**1.7**	**1.8**	**1.4**	**0.8**
D. Surplus/Deficit	**-1.7**	**-1.0**	**-0.5**	**-1.0**	**-1.2**
E. Financing, net	1.7	0.9	0.4	1.0	1.1
I. Domestic	1.7	2.1	0.8	1.6	1.7
o/w Privatisation	1.2	0.2	0.0	0.0	0.0
Bank asset recoveries	0.4	0.7	0.2	0.1	0.1
Bond issuance	1.0	0.3	0.8	1.1	1.4
II. Foreign, net	0.0	-1.2	-0.4	-0.6	-0.6
Amortisation	-1.0	-2.0	-1.3	-1.6	-1.5

Source: Bank Indonesia, BBVA

As for the public debt, it has experienced a remarkable turnaround in terms of size, risk diversification and maturity profile in a short period of time. The government debt ratio fell to 33.6% of GDP in 2007 from over 82% in 2001. Similarly, the government external debt dropped to 14% of GDP from 40% of GDP in the same period and, moreover, reduced its share from over 90% of government debt to less than 75%. Multilateral and country bilateral loans continue representing the bulk of government's foreign debt and accounted for nearly 42% of government's debt by end-2007. The balance was composed of government's securities, of which more than 90% were denominated in local currency. Foreign owners of domestic government securities accounted for 17% at end of April 2008 with preference for medium to long-term securities maturing over 5 years and hence, lowering the risk of a sudden reversal in investor sentiment. By type of currency, 19% of government debt was denominated in US dollars, 18% in euro and 51% in local currency. Overall, only 30% of the total public debt outstanding was at variable rate and the rest was at fixed rate.

In 2006 and 2007, the government successfully switched Rps 46 trillion (US$5 bn aproximately) of maturing domestic government bonds into longer dated bonds, reducing the need for new bond issues at the risk of higher yields. Retail bond issuance contribution has been increasing and last year accounted for 18% of total domestic debt.

INDONESIA: MATURITY PROFILE OF TRADABLE GOVERNMENT SECURITIES, END-FEB.08



Source: Ministry of Finance, ERD BBVA

Indonesia's foreign debt appears in general sustainable, evidenced by indicators such as the external debt-to-GDP ratio, external debt to exports ratio and debt service ratio (DSR). In particular, external debt to GDP declined from over 48% in 1996 to 31.2% in 2007, external debt as a percentage of exports from over 188% to 97.3% in 2007, while the external debt service ratio declined to 19.2% in 2007.

INDICATORS OF EXTERNAL VULNERABILITY

	1996	1997	2005	2006	2007
Current Account/GDP (%)	-3.4	-2.3	0.1	2.9	2.5
Exports/GDP (%)	25.7	29.1	37.5	33.5	32.0
Non-Oil and Gas Exports/GDP (%)	16.7	19.7	23.1	21.8	21.2
Foreign Debt Interest/GDP (%)	2.7	3.0	1.0	1.3	1.2
Debt Service Ratio (%)	35.9	44.5	17.3	24.8	19.2
Capital Flows/GDP (%)	4.8	1.1	0.1	0.7	1.3
Foreign Debt/Exports (%)	188.7	207.3	120.7	104.1	97.3
Foreign Debt/GDP (%)	48.5	60.3	45.3	34.9	31.2
Reserves/Foreign Debt (%)	17.4	15.7	26.6	33.1	41.7
Reserves/Imports (months)	4.3	3.5	3.7	4.3	5.2
Foreign Debt (US$ bn)	110,171	136,088	130,652	128,736	136,640
International Reserves (US$ bn)	19,215	21,418	34,724	42,586	56,920

Source: Bank Indonesia, ERD BBVA

In January 2008, the debt management office issued a US$2 bn international bond and more recently in June, an additional US$2.2 bn in order to contain the fiscal deficit. The government aims to regularly diversify the type of securities to be issued into treasury bills and bonds, zero-coupon bonds, retail (ORI) and sharia (Islamic) notes.

RISKS AND CHALLENGES AHEAD

Despite the remarkable turnaround experienced in recent years, Indonesia's economy faces significant challenges to sustain high and stable growth. Among them:

- Weak legal framework and frequent government intervention

Indonesia's legal system is a civil law system based on written statutes in which judicial and administrative decisions do not constitute binding precedents and are not systematically published. The system is highly unreliable owing to a lack of consistency in the application of the legal principles. The regime is not supportive of creditor rights and there is no certainty on security enforceability or consistency in court decisions. Creditors –especially foreign creditors- had difficulty petitioning for bankruptcy or demanding debt recovery in the event of default.

There is also a proven track record of direct intervention of members of the government in court decisions and even in the corporate sector. Previous to the 1997-1998 crisis, banks were often owned by corporate groups with strong political connections. The resulting problems of connected lending, poor credit quality and weak supervision led to a chain of arbitrary bank closures and recapitalization initiatives by the authorities

Despite significant reforms to this date, namely in the banking system, more changes need to be seen in order to strengthen Indonesia's institutional and legal framework.

- Very low levels of public and private investment which hampers potential growth

Total private and public annual infrastructure investment as a percentage of GDP remains at half the pre-crisis levels. As a consequence, poor infrastructure is regarded as a key bottleneck to faster economic growth. Central government's realized investment has been as low as 2% of GDP in average and, declined to 1.6% in 2007. In recent years, actual spending has been significantly below budget as a result of hindrances in the legal system, weak project preparation and implementation, and significant delays in the budget process. In the medium term, insufficient capital accumulation will hamper the economy's potential growth and reduce its competitiveness. Labor contribution may increase depending on the appropriate regulatory reforms: currently, hiring and firing legislation ranks among the stricter in Asia and more flexibility is needed to reduce informality and unemployment.

- Limited fiscal space and declining revenues

Several policies since 2001 have aimed at efficiency gains in tax administration and broadening of the tax base. The fiscal burden of the public debt and subsidy expenditure leaves no room for public expenditure in priority areas. Since the decentralization in 2001, the regional governments have been transferred the health and education programs and are expected to share more fiscal space to the central government. However, planning delays and constraints in implementation capacity of local governments have left them with large surpluses due to under-spending.

Additionally, revenues from oil taxation are expected to decline as oil production has been falling. The challenge will be to maintain the fiscal discipline by enlarging the tax base and cutting subsidies, in order to continue reducing the government's public deficit and thereby, the stock of public debt.

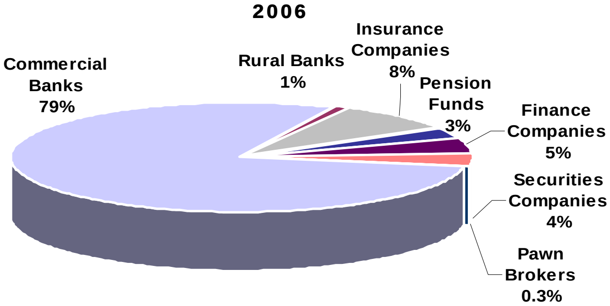
- Increasing dependency on oil and falling production levels

Ironically, Indonesia has a deficit in oil production and even more so in refinery products, due to the lack of investment in oil plants. Moreover, dependency on oil has increased rapidly as domestic demand has been growing on the back of government subsidies on energy prices. The government needs to reduce its currently high oil dependency (from 67% at present) by shifting to other energy sources. The mitigating factor is that Indonesia counts with significant reserves of coal, natural gas and other primary energy sources, albeit some of them need a high cost to extract. However, in order to meet these targets the government will need to solve the current infrastructure bottlenecks, extensive subsidization which creates uncertainty in price setting and commercial return objectives as well as improve the regulatory and investment environment in order to attract private and foreign investment in the energy sector.

FINANCIAL SYSTEM STRUCTURE

Indonesia's financial system consists of commercial banks, rural banks and the non bank financial industry which includes insurance, pension funds, finance institutions, securities and pawn brokers. Banks continue to dominate the sector, albeit slightly shrinking, with a share of 79% of the financial system's assets. In addition to banks, finance companies have also witnessed a declining share. Meanwhile, the share of securities companies increased to 3.7% in 2006 from 1% the previous year, followed by insurance companies to a share of 8.2% from 7.3% in the same period. As an aggregate, total funds managed by the financial sector amount to 64% of Indonesia's GDP.

FINANCIAL INSTITUTIONS´ ASSETS 2006



Source: FSR March 2008

The Indonesian Banking Architecture – a long term development plan- has set out measures to strengthen the stability of the financial system. These measures include the incentive for merger and consolidation process, new regulation on corporate governance of banks, and bank risk-management certification. Furthermore, as a step forward to introduce Basel II, risk-based supervision was implemented in 2006. A regulation on the financial safety net (FSN) was introduced in March 2007, aimed at preventing financial distress by clarifying responsibilities in the provision of lender-of-last resort facilities, the administration of the explicit limited deposit protection, the management of bank resolution processes, and the monitoring of systemic risks. The FSN included the gradual removal of the blanket deposit guarantee introduced at the peak of the 1997-1998 crisis and the creation of a deposit insurance corporation. Meanwhile, the Credit Information Bureau was established covering all borrowers of commercial banks, credit unions, and non-bank financial institutions.

BANKING SECTOR STRUCTURE

Consolidation and divestment have somewhat reduced the number of banks from 138 in 2003 to 128 as of March 2008 but the system is still fragmented. Indonesia's five largest banks control less than half of system assets. Additionally, 15 major banks hold an aggregate share of some 70% of banks' assets.

BANK RANKING BASED ON ASSETS (As of March 2008)

Rank	Bank Name	Total Assets, Rp bn	% Total Assets at Commercial Banks
1	**PT Bank Mandiri Tbk**	282.71	**14.54**
2	**PT Bank Central Asia Tbk**	213.957	**11.00**
3	**PT Bank Rakyat Indonesia**	200.075	**10.29**
4	**PT Bank Negara Indonesia**	162.344	**8.35**
5	**PT Bank Danamon Indonesia Tbk**	89.8	**4.62**
6	PT Bank Niaga	55.137	2.84
7	PT PanIndonesia Bank Tbk	54.846	2.82
8	PT Bank Internasional Indonesia Tbk	50.55	2.60
9	Citibank N.A.	43.558	2.24
10	PT Bank Permata Tbk	41.224	2.12
	Total	**1.194.200**	**61.41**

Source: BI, BBVA

Under the current banking law[4] Indonesia maintains a dual banking system composed by conventional bank activities or sharia compliant activities. In any event, the share of Islamic banking is as low as 3% of total business volume. Industry-wise there are 3 Islamic

[4] Law No. 7 Year 1992 on Banking which was amended by Law No. 10 Year 1998.

Commercial Banks[5] (BUS), 28 sharia business units and 117 sharia rural banks, at end-March 2008.

INDONESIA: BANK TYPE AND NUMBER OF BANKS

End of period

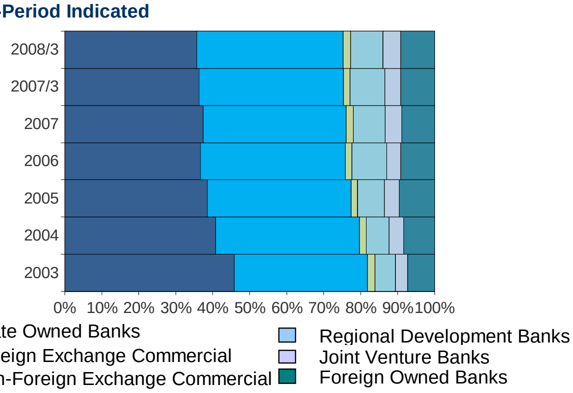
Category of Bank	2003	2005	2007	Mar-08
1. State Banks	5	5	5	5
2. Regional Development B.	26	26	26	26
3. Private Commercial Banks	76	71	71	69
4. Joint Venture Banks	20	18	17	17
5. Foreign Banks	11	11	11	11
Total Commercial Banks	138	131	130	128
Total Rural Banks	2141	2009	1817	1811
Total Sharia Banks*	10	22	143	148

* Includes Sharia Commercial Banks, Business Units and Rural Banks
Source: Bank Indonesia

Conventional banks are divided into commercial banks, and rural banks. Unlike commercial banks, rural banks are specialized in one activity and may not issue checks or provide services involving foreign currencies. By ownership, commercial banks are owned either by the government (state-owned banks), national private (private commercial banks), joint-venture private, foreign-owned private or regional government (regional development banks). In contrast, rural banks can solely be owned by Indonesian citizens, Indonesian legal entities whose owners are all Indonesian citizens, regional governments or a combination of the three.

Indonesian Commercial Banking System: Distribution of Assets

For End-Period Indicated



Source: BBVA

On the system's ownership structure, the Indonesian government has been trimming its own exposure to the banking sector. In July 2007, the government conducted a secondary share offering of Bank Negara Indonesia, reducing its stake to 73% from 99%. Three of four state-owned banks have now been partially privatized and discussions are ongoing whether the remaining wholly state-owned bank, Bank Tabungan Negara, should be privatized, merged with another state bank or transformed into a new development bank in order to facilitate long-term financing. The current government shareholding is equivalent to around 25% of system assets, according to some estimates.

As of March 2008, the commercial banking sector was dominated by foreign exchange commercial banks accounting for 39.6% of banks' assets, followed by state-owned banks with 35.7% share. Foreign owned banks maintained 9.2% share, regional development banks hold 8.7%, joint-venture banks 4.8% share and non-foreign exchange commercial banks 2% share.

THE ROLE OF FOREIGN BANKS

The Indonesian banking system remains one of the most open to foreign investors in terms of the maximum foreign stake allowed in a domestic bank of 99%[6].

The latest acquisition is the sale of Temasek's (Singapore) 55.7% stake in the 10th largest Indonesian bank (BII) to Maybank of Malaysia in order for Temasek to comply with the Single Presence Policy. Maybank will have to make a tender offer for the remaining 44.3% to the shareholders of BII, whereas Temasek will be able to keep its stake in Bank Danamon, ranked the 7th largest Indonesian bank by assets. However, the last wave of foreign banks in 2007 invested in small, niche Indonesian banks such as the acquisitions of Commonwealth Bank of Australia in Bank Arta Niaga Kencana and ICBC for the full control of Bank Halim, which changed to Bank ICBC Indonesia (ranked 36th by assets) after the acquisition. The sector's relatively high P/B value could be attributed to a large equity or capital base of Indonesian banks due to their sizeable holdings of government bonds.

[5] Bank Indonesia Regulation (PBI) No.8/3/PBI/2006 concerning the conversion of conventional commercial bank business to banks based on Islamic principles.

[6] Bank Indonesia regulation No. 2/27/PBI/2000

FOREIGN BANKS ACQUISITIONS IN INDONESIAN BANKS

DATE	ACQUIROR	DOMESTIC TARGET	VALUE (US$ mn)	STAKE
Mar-08	Maybank	Bank Internasional Indonesia	2,707	100.0%
Nov-07	Temasek Holdings	Bank Internasional Indonesia	182	13.9%
May-07	TPG Capital	PT Bank Tabungan Pensiunan Nasional	200	71.6%
May-07	PT Dian Intan Perkasa	PT Bank Finconesia	60	51.0%
Jan-07	Commonwealth Bank of Australia	Bank Arta Niaga Kencana	29	83.0%
Dec-06	Industrial and Commercial Bank of China	Halim	10	90.0%
Nov-06	Acom (55.41%);Bank of Tokyo-Mitsubishi (20%)	Bank Nusantara Parahyangan	NA	75.4%
Sep-06	Standard Chartered, Astra Int'l	PT Bank Permata Tbk	193	26.0%
Jul-06	Rabobank	Bank Haga/Haga Kita	107	100.0%
Oct-05	UOB	PT Bank Buana Indonesia	44	8.1%
Jul-05	Khazanah Nasional	Lippo Bank	331	52.1%
Jul-05	UOB	PT Bank Buana Indonesia	283	53.0%
Apr-05	OCBC Bank	Bank NISP	76	19.6%
Dec-04	Standard Chartered, Astra Int'l	Bank Permata Tbk PT	71	11.2%
Dec-04	OCBC Bank	Bank NISP	112	28.5%
Oct-04	Standard Chartered, Astra Int'l	Bank Permata Tbk	305	51.0%
Apr-04	UOB	PT Bank Buana Indonesia	115	23.0%
Mar-04	OCBC Bank	Bank NISP	71	22.5%
Jan-04	Swissasia Global	Lippo Bank	145	52.1%
Oct-03	Sorak Financial Holdings (Temasek)	Bank Internasional Indonesia	236	51.0%
May-03	Temasek Holdings & Deutsche Bank	Bank Danamon	364	51.0%
Nov-02	Commerse Asset-Holding Berhad	PT Bank Niaga TBK	120	51.0%
Mar-02	Farallon Capital Consortium	Bank Central Asia	534	51.0%

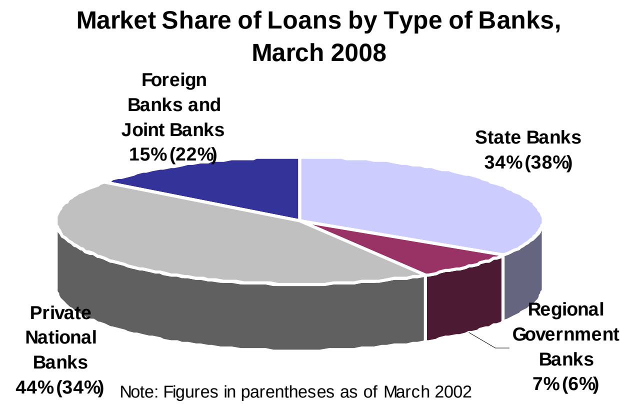
Source: Investment banks' reports

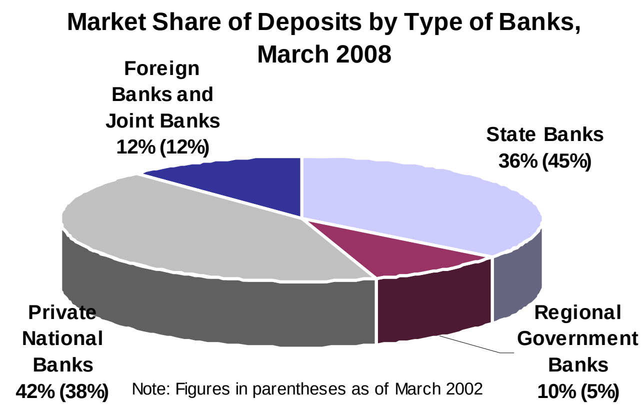
By end-2007, there were 45 banks with foreign capital ownership, accounting for 42% of the total system's assets. Among the joint-venture banks, DBS Indonesia is the largest in terms of assets with less than 0.6% share of the system and a ROA of 1.53%. Citibank ranks first in the subgroup of foreign banks and 8th in the total system with a 2.2% share of the system's assets and a ROA of 5%, well above the ratio of its foreign peers and domestic banks. Joint-venture and foreign banks hold a 14% share in credit, same as in the previous year, and 12% in total deposits, up from 10% in 2006. Overall, joint-venture and foreign banks registered lower net interest margin but lower NPL ratios than domestic banks.

FOREIGN BANKS OWNERSHIP BASED ON TOTAL ASSETS

TYPE OF FOREIGN PARTICIPATION	2007			
	TOTAL	ASSETS (Rps bn)	Share to Foreign Owned Banks	Share to Total Industry
BRANCH OFFICES OF FOREIGN BANKS	11	176	21%	9%
JOINT VENTURE BANKS	17	91.0	11%	5%
FOREIGN ACQUISITIONED BANKS	17	569	68%	29%
TOTAL FOREIGN BANKS OWNERSHIP	45	836	100%	42%
TOTAL BANK INDUSTRY	128	1.986		

Source: Bank Indonesia





The government has continued fueling the consolidation and divestment in the banking system by setting higher minimum capital requirements and the Single Presence Policy, which restricts a single domestic or foreign owner from holding a controlling stake in more than one domestic bank (excluding foreign bank branches and joint venture banks). Owners affected by the Single Presence Policy, including in the state-owned banks, are given the option to merge, divest or form a holding company from 2007 to 2010.

In any event, there are still several restrictions on foreign bank operations:

- the central bank restricts the opening of foreign bank branches to the major cities and,
- according to the commercial banking regulation[4] not less than 1 member of the Board of Commissioners and 1 member of the Board of Directors shall be an Indonesian citizen,
- the employment of expatriates in middle management positions also faces constraints and requires the transfer of knowledge. By 2009, expatriates are limited to two at levels below the board of directors, except for areas of work that cannot be filled by domestic employees,
- industry-wide, there is a maximum dividend pay-out ratio of 50%.

BANK DEVELOPMENTS

In 2007, banks continued to be well capitalized and profitable. Loan and deposit growth was strong and loan to deposit ratio continued increasing steadily.

INDONESIA: COMMERCIAL BANKS PERFORMANCE INDICATORS

Key Indicator	2003	2004	2005	2006	2007
Total Assets ($ bn)	143.36	136.93	149.35	186.79	212.34
Deposits ($ bn)	104.97	103.67	114.61	141.92	161.48
Credit ($ bn) 1/	56.37	64.06	74.20	91.85	111.78
Loan-to-Deposit Ratio (%)	53.7	61.8	64.7	64.7	69.2
Net Interest Margin (%)	4.64	5.9	5.63	5.8	5.7
ROA (%)	2.5	3.5	2.6	2.6	2.8
ROE (%)	21.5	23.0	18.0	17.1	18.0
NPLs Gross (%)	8.2	5.8	8.3	7	4.6
CAR (%)	19.4	19.4	19.5	20.5	19.3

1/ Including channeling

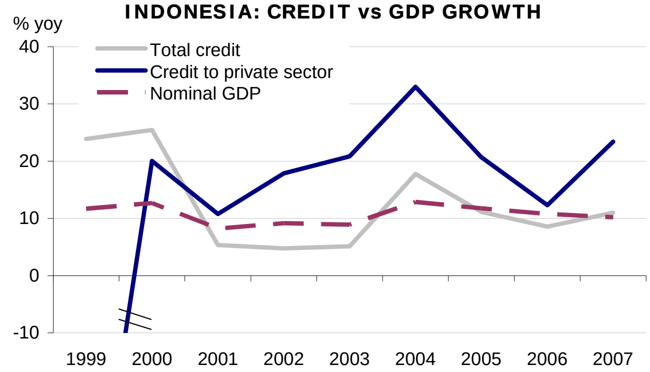
Source: Bank Indonesia

Deposits held by the banking industry registered a strong growth in 2007 at 17.4%, the fastest pace in the last four years. Term deposits continued to represent the largest share of total deposits, albeit at a slower growth rate as the return on term deposits fell following reductions in the central bank's interest rate last year. By the end of last year, short-term funds accounted for 93.3% of deposits. Total assets surpassed Rp 2 trillion, representing an annual growth of 17.3% but it has since slowed to 14.2% in the first quarter of 2008.

Banks maintained sufficient liquidity as result of higher growth of liquid assets compared to short-term liabilities and, increased their placements of liquid assets in Bank Indonesia Certificates (SBI) and FasBI (Bank Indonesia Deposit Facility), rising 11.9% in the second half of 2007.

The most notable development is the robust credit growth, albeit coming from very low levels in the aftermath of the 1997-1998 financial crisis. The level of private sector lending to GDP at 25% continues to be significantly below pre-crisis levels and very low relative to the average 70% level in the rest of Emerging Asia. During 2004 and 2005, credit grew at an annual rate above 20% but slowed to 14% in 2006 in response to an increase in interest rate and a sharp upward adjustment in subsidized energy prices. By end 2007, private credit growth was 25.5% (23.4% excluding off-balance sheet credits) and, exceeding both the central bank's target of 22% and nominal GDP growth of 18.5%.

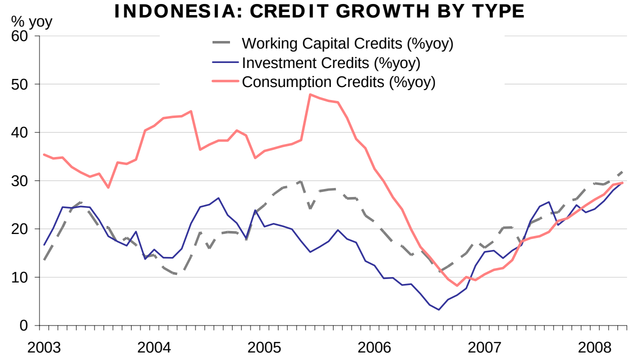
INDONESIA: CREDIT vs GDP GROWTH



Source: ERD BBVA

By type of loan, working capital credit growth was 28.6%, followed by consumption credit growth at 24.6% whereas investment credit remained sluggish. Credit share was still dominated by working capital credit, representing 53.5% of total bank loans, 28.2% share by consumption credit and finally investment credit. Foreign currency loans in total bank credit were relatively stable at around 21% at end of 2007. In the first quarter of 2008, the credit expansion continued accelerating to 29.4%, slightly up from 26.6% in the previous quarter.

INDONESIA: CREDIT GROWTH BY TYPE



Source: CEIC, ERD BBVA

Asset quality has significantly improved following a sharp rise in 2005 due to stricter asset classification rules issued by the central bank. Such reporting adjustment caused the gross NPL ratio to jump to 8.3% in 2005 from a post-crisis low of 5.8% in 2004. Similarly, the net NPL ratio rose to 4.8% from 1.7%. Over the past two years, the NPL has improved and the gross ratio fell to 4.6%, the lowest since the crisis, and the net NPL ratio fell to 1.9%. The decline is attributed to restructuring and write-offs by state-owned banks but also to a faster lending growth and improved macroeconomic conditions. However, non-performing loans increased for the group of foreign bank branches by 14.3% year-on-year and gross NPL ratio reached 5.2% in 2007. The highest gross NPL ratios are registered in the manufacturing sector, accounting for over 35% of total bank NPLs and by type of loans, for the credit cards reporting a NPL ratio of 12%. The medium-term outlook for NPLs remains difficult to predict as most of the new loans have been granted in the last few years and risk management improvements haven't been tested yet.

Capital adequacy ratio (CAR) declined slightly to 19.3% but higher than the regulatory requirement of 12%. The CAR of Indonesia's banks remains the highest in Asia and can be partly attributed to the large holding of government recapitalization bonds. The banks received these securities in exchange for massive non-performing assets during the 1997-1998 crisis. For the four largest banks, government bonds comprise in average 24% of their assets, albeit down from a third three years ago, according to some agencies estimates. Additionally, government bonds carry a zero risk weighting for regulatory capital reporting. By end-January 2008, CAR has recovered to above 20% whereas ROA has climbed further to 3.2% from 2.8% at end 2007. Meanwhile, net interest margin of commercial banks is stable at 5.7% and liquidity risk remains low. Looking forward, a slight deterioration in CAR could be expected with the planned regulatory changes, namely an increase in the risk-weighting of government bonds from 0 to 10% of assets, and from 0% to 1% of assets for private debt.

FUTURE DEVELOPMENTS

More regulatory initiatives are expected under the Indonesian Banking Architecture, the financial authorities' long-term roadmap for developing a more robust financial system with fewer and larger commercial banks.

Among some of the initiatives, the central bank plans to extend the relaxation of the legal lending limits[7] not only for banks financing infrastructure projects of state-owned enterprises and development sector but also, to public-listed companies in an effort to further develop the domestic capital market. Other measures would consist of increasing the risk weights on government bonds from zero to 10% and lowering the risk weights on some categories of loans, namely to SMEs and small size loans. The central bank will also promote the market for longer tenor securities and a planned amendment to the Banking Law in order to promote universal banking. To continue the bank consolidation process, the central bank will require a minimum core capital requirement of Rp 100 billion (around US$11 million) by 2010 (by end of 2007, 20 banks had a core capital of between Rp 80 billion and Rp 100 billion). Some other measures introduced in the aftermath of the crisis could also be reformed, in particular, the structure of the reserve requirement that progressively penalizes banks with low loan-to-deposit ratios is expected to become homogeneous for every bank.

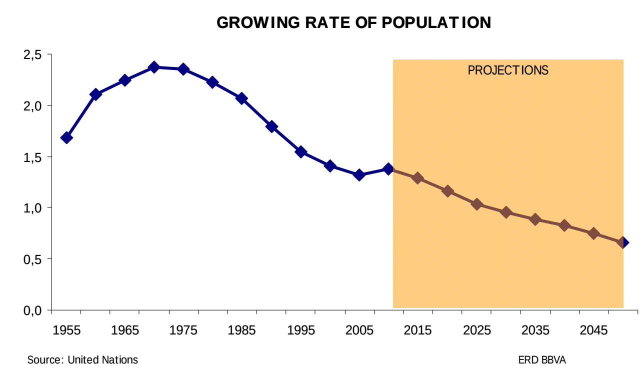
[7] Currently, maximum lending limit of 30% (10% to a related company and 20% to a single borrower).

Demography

July 2008

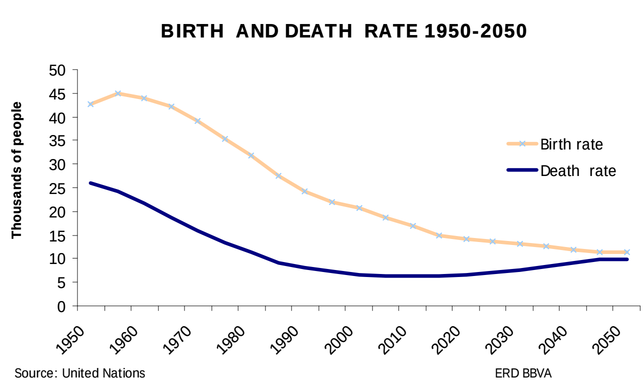
DEMOGRAPHIC PROJECTION

The World Health Statistic Database states that in 2006, the population in Indonesia reached 228.864.000 people. Indonesia, like most other countries in Asia, finds itself in the "second stage" of the demographic transition where the working age population (15 to 64 years) is still increasing at the same time as the decline in fertility and birth rates means that society is ageing.



DEMOGRAPHIC TRANSITION

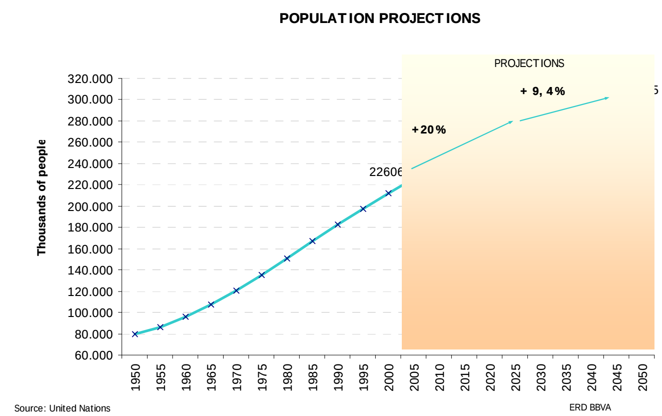
In fact, Indonesia is in the midst of a population boom that began during the 1970s. According to UN projections, the country would have completed the demographic transition process by 2050 when the mortality and birth rates would have similar figures and thus, the population would be more or less constant and close to 300 million people.



It has been increasing during the seventies at a rate close to 2.5% per year. In the seventies we witnessed the biggest increase in population, and from that period the growth rate is smoothly declining until 2050 when the growth rate is almost zero. The population is growing but at smaller rates over time.

POPULATION STRUCTURE

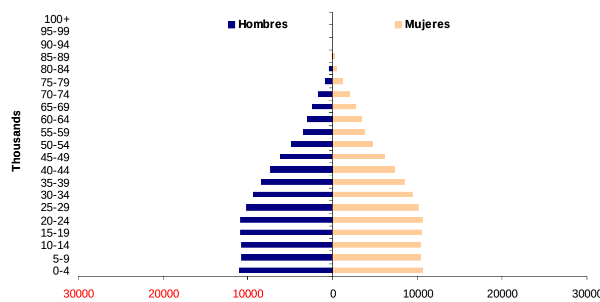
The United Nations estimations for population pyramids indicate no significant gender imbalance; although among the elderly, females exceed the number of males, but this trend is also typical for most countries.



The number of children (0 to 14 years) has been relatively stable and from 2005 it began to edge downward. Between 2005 and 2050, the number of children will decline at a rate of 0.7% per year; as a consequence of the fall in the fertility rate from 2.5 children per female to 1.9 in 2020. The birth rate will show an even larger decline proportionally from 21.3 births per 1000 inhabitants to 14.5. Largely as a consequence of these trends, the country's median age will rise from 24.8 years to 32 years. The highest rates of growth are for Indonesians 30 years and older with the number of elderly increasing fastest. For instance, the number of Indonesians between 45 and 49 years will grow by almost an average of 2% per year during these decades while the corresponding figures for those between 50 and 54 years will be 0.6 percentage points higher.

These demographic trends are producing a number of impacts. There are approximately 2.5 million new entrants to the workforce each year but the number of jobs being created is far lower. Officially unemployment was 10.3% in 2006 but labour market surveys suggest that it is much higher and continues to rise. Indonesia's plentiful supply of labour in the coming decades should make the country attractive to foreign investors but it must compete with other Asian giants. However, it might also be a source of political and economic instability as well as migration. China and India have made great progress in developing the type of business environment which appeals to foreign firms and Indonesia is finding problems to create enough jobs. The absolute number of people in Indonesia living in poverty is increasing.

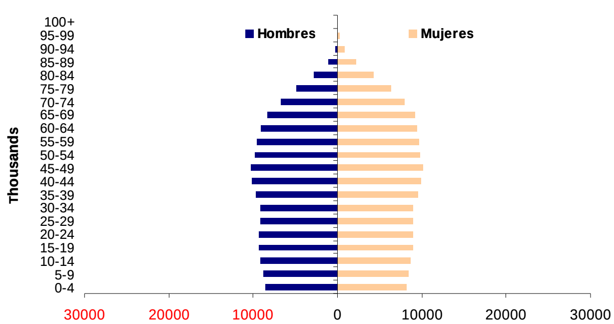
POPULATION PYRAMIDES 2005



Source: United Nations ERD BBVA

Indonesia is relatively well placed with a young population and the expectation that the ageing process will come later than in other countries in the region. Undeniably, the population is ageing but certainly not at the rate of other Asian countries. Nowadays, 2 out of 10 people have more than 65 years old and this ratio is expected to move to 4 out of 10 by 2050.

POPULATION PYRAMIDES 2050



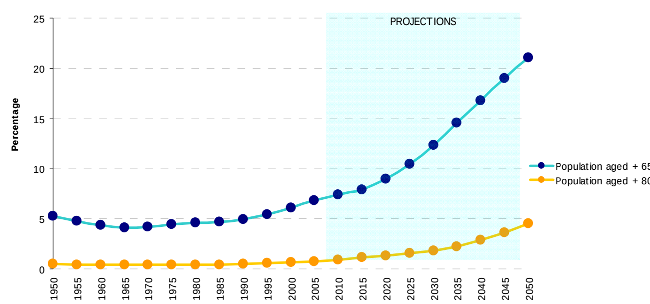
Source: United Nations ERD BBVA

PENSION SYSTEM

The Indonesian pension system has a mandatory saving system (Jamsostek), fully funded which is paid out as a lump-sum at retirement or early termination and made of the contributions of both the employer and the employee. The system has also a defined benefit component, mostly unfunded, which is essentially a labor law that applies to the entire labor force. There are also voluntary occupational, defined benefit (DB) or defined contribution (DC) plans, and/or individual DC plans which operate on a funded basis. Nevertheless, in this voluntary part the private coverage is very limited. All mandatory social security institutions are state owned enterprises.

The main challenge of the Indonesian pension system is the low coverage; current schemes focus on civil servants and formal sector workers, with no coverage for informal sector and self employed who constitute around 70% of the Indonesian workforce. Therefore, the pension system does not provide a sound social safety net to the vast majority of workers. Furthermore, the private sector system does not provide adequate level of old-age benefits and has also a very limited coverage. On top of that, it does not encourage labour market flexibility neither contribute to financial sector strengthening.

DEVELOPMENT OF OLD POPULATION



Source: United Nations ERD BBVA

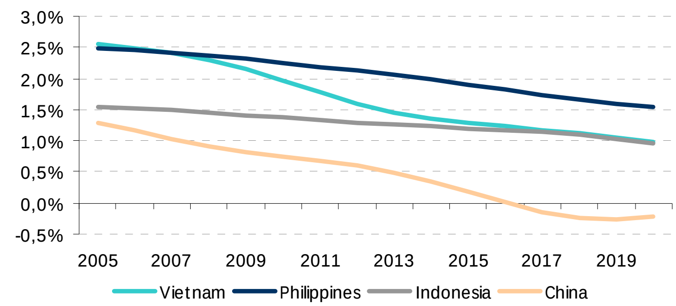
Overall, in the pension system and other insurance markets there is considerable room to grow and become more effective.

Labor Markets

WORKING-AGE POPULATION

There will be no labor shortages in the next decades. According to UN projections, both total population and working-age population will keep on growing in the medium term (between 1.5% and 1% annually up to 2020). Albeit modest (between 0.5 and one percentage points lower than other Asian emerging economies), the contribution of working-age population to economic growth seems stable.

Working-age population growth in Asia



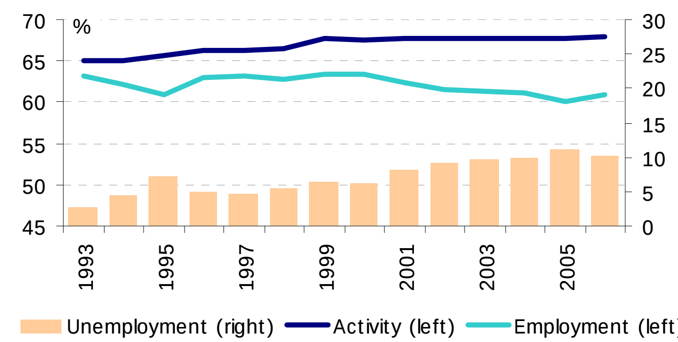
Source: ILO — ERD BBVA

EMPLOYMENT RATE

There is additional slack in labor markets from low participation and high unemployment rates. Despite recent improvements both due to an increase in participation and a reduction of unemployment figures, the main labor market indicators are below the average in China, Indonesia or Vietnam. Thus, the employment rate in 2006 (defined as the ratio of workers over population over 15) is 61.0%, vs. 65.3% in the region.

On the other hand, this fact may prove to be an additional support for economic growth, if population growth slows down further.

Labor market rates in Indonesia



Source: ILO — ERD BBVA

LABOR FLEXIBILITY

Labor rigidities, concentrated on the extensive margin (entry and exit regulations), may impede these improvements. However, this compensating factor cannot be taken for granted. *Doing Business 2008* indicators (World Bank) show that Indonesian labor market regulations are very rigid (ranks 153 over 178 economies, while in the global indicator, Indonesia rises to the 123th).

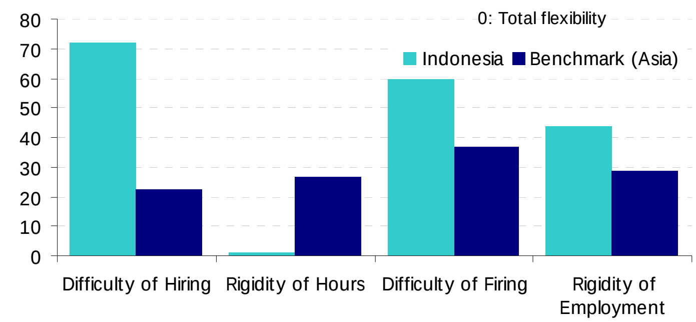
This unfavorable position is mainly explained by restrictions in firing and hiring (the minimum wage represents 55% of average productivity, and the impediments to extend fixed-term contracts are significant). In contrast, working hours are fully flexible and non-wage labor costs are low.

Finally, some estimates point to a limited shadow economy (24% of GDP)[8].

[8] Schneider, F. (2007): "Shadow Economies and Corruption All Over the World: New Estimates for 145 Countries", Economics E-journal, July).

Ángel Melguizo: angel.melguizo@grupobbva.com

Employing workers in Indonesia

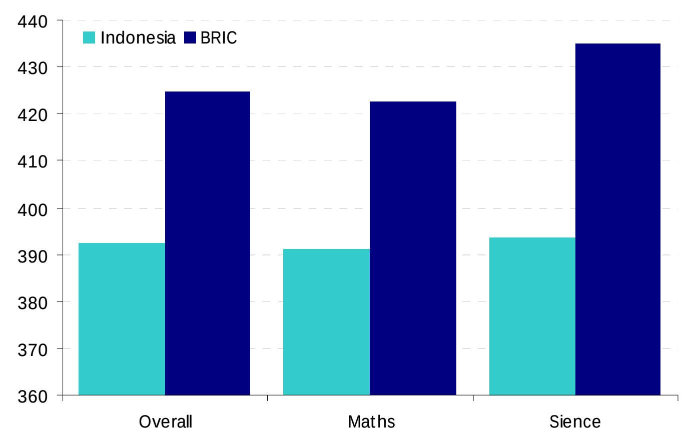


Benchmark: China, Indonesia, Phillipines, Vietnam
Source: Doing Business 2008 ERD BBVA

HUMAN CAPITAL

Human capital is not being accumulated at a sufficient pace. According to UN data, the ratio of labor force with secondary education is under 20% (vs. 40% in Philippines, and 70% in industrialized economies). World Bank data shows even poorer records (less than 14.5% of working population holds an upper secondary degree)[9]. Besides, the quality of primary education is poor. Indonesian students rank in the lowest quintile[10], both in math and science disciplines.

Quality of primary education in Indonesia



Source:OECD PISA 2006 ERD BBVA

Labor indicators summary

Indonesia. Main labor market indicators

	1996-2000	2001-2005	2006	2007
Population				
Million	203.782	217.345	225.465	228.121
Active population				
Million	93.697	104.529	110.432	112.518
Employment				
Million	88.529	94.530	99.080	---
Unemployment rate				
Per cent	5,5	9,6	10,3	---
Informality				
% Employment	---	---	---	---
% GDP	19,4	23,1	---	---
Rigidity				
Doing Business Ranking	---	---	154 / 178	153 / 178
Human capital				
PISA Ranking	---	---	50 / 57	---
Secondary	---	---	14,5	---
Tertiary	---	---	5,3	---

Source: ILO, WB-Doing Business 2008, World Bank (2006) and Schneider (2007)

9 World Bank (2006): Meeting the challenges of secondary education in Latin America and East Asia. Washington.
10 OECD, PISA 2006.

Energy

July 2008

GENERAL OVERVIEW

Indonesia holds 0.3%, 1.5% and 0.5% of world oil, gas and coal proven reserves respectively. These reserves are the most important source of energy, covering 75% of primary energy needs (16% coal, 20% gas, 35% oil).

However, reserves of oil and gas are rapidly depleting. Oil production has decreased steadily during the last 20 years owing to, lack of investment, disappointing exploration efforts and declining output from mature, aging, oil fields.

Oil Balance. Indonesia 1990-2006

Source: Enerdata BBVA ERD

As for natural gas, a big percentage of the reserves are associated to oil, and thus production started decreasing only a few years later than for oil. Until 2006 Indonesia was the single largest LNG exporter in the world but now it ranks third, after Qatar and Malaysia.

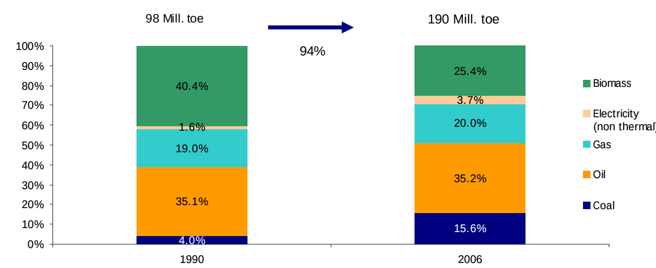
Natural Gas Balance. Indonesia 1990-2006

Source: Enerdata BBVA ERD

Coal production has greatly increased in recent years and the country is one of the world's chief coal exporters. Coal supplies 40% of the energy needed to produce electricity, followed by oil (31%), gas (17%), hydro (7%) and geothermal (6%). No nuclear energy is used.

Indonesia is endowed with large renewable energy resources but the use of modern renewable energies is almost inexistent. According to the IEA, the electrification rate is amongst the lowest in developing Asia, with more than 40% of the population not having access to electricity. Moreover, 70% of the population relies on traditional biomass as their primary energy for cooking (95% in rural areas and 45% in the cities).

Total Primary Energy Supply by source. Indonesia 1990-2006



Source: Enerdata BBVA ERD

Households consume 43% of final energy, followed by the industry (24%) and the transport sector (19%). Traditional biomass and oil supply roughly a third of final energy needs although the later is increasing its share over the energy mix at the expense of the former.

The country presents a low energy efficiency and energy intensity (TPES/GDP, see table below) has barely decreased since 1990. However, potential for improvements exists as subsidies are gradually removed and old industry infrastructure is refurbished or renewed.

Indonesia has one of the biggest energy subsidies in the world (as a percentage of final energy prices). However, despite a wave of protests, in May 2008 gasoline rose by 33% and gas oil by 28% in an attempt to moderate energy consumption and to stop the increasing burden of this government subsidy.

Indonesia's per capita carbon emissions remain low by regional comparisons, but the country faces severe environmental challenges.

Tatiana Alonso: tatiana.alonso@grupobbva.com

Primary energy statistis for selected countries (2005)

	Indonesia	China	OECD
Total Primary Energy Supply (TPES) (Mtoe)	180	1717	5548
TPES per capita (toe/capita)	0.81	1.32	4.74
TPES/GDP (toe/000 2000 US$)	0.86	0.91	0.2
TPES/GDP (PPP) (toe/000 2000 US$ PPP)	0.24	0.22	0.18
Electricity consumed per capita (kWh/capita)	509	1781	8365
CO_2* per capita (t CO_2/capita)	1.55	3.88	11.02
CO_2/GDP (kg CO_2/2000 US$)	1.64	2.68	0.45
Net Imports (Mtoe)	-84	100	1813

Source: International Energy Agency

**CO_2 Emissions from fuel combustion only.*

THE OIL MARKET: CURRENT SITUATION AND FUTURE PERSPECTIVES

Since its global peak in 1977, Indonesia's oil production has slumped by nearly 50% due to maturing oil fields and lack of investments. On the other hand, strong domestic oil demand supported by subsidies contributes to drag its export potential. In fact, the country imports more than one third of its oil needs at present.

The country faces the prospect of declining capacity unless new investment is encouraged and bureaucratic barriers are softened. After a decade of inaction, the government has finally taken action to reverse this situation. The long term goal is to resume Indonesia's net-exporter status as soon as possible. However, in order to do that, the country will first need to reduce its imports while increasing investment in exploration, production and refining.

Mid term official goal is to push production to 1 mmb/d by 2009 and 1.2 mmb/d by 2010 whereas in the long term the goal is to resume the 1990's production figure of 1.5 mmb/d.

Actions taken for the moment include abandoning OPEC (after more than 45 years of membership) and increasing domestic oil prices (to foster energy efficiency and substitution of oil for coal and gas). Moreover, the state-owned oil and gas company Pertamina[11], aims to lift investments by 50% until 2.2 billion USD (2/3 upstream, 1/3 downstream) in 2008 to boost crude oil production and upgrade refineries. On the regulatory front, a new head of the regulator (BP Migas) has been appointed in an effort to bring more transparency and efficiency and there are plans to change the current Production sharing contracts (PSC) in order to reduce government spending and to provide incentives to foreign oil firms to invest in oil exploration and production.

But industry observers are still skeptic on the ground of investment related, technical and bureaucratic barriers.

In fact, there has only been one new big oil discovery in decades: the giant onshore Cepu block (Java) which is estimated to hold up to 600 million barrels of recoverable oil reserves (14% of current oil reserves). In the absence of new significant discoveries, future expansion of production will be mainly concentrated at Cepu and a myriad of small fields.

After several years of negotiations, ExxonMobil and Pertamina signed a joint operation agreement in March 2006 to develop the Cepu field by which each company will have a 45 percent stake in the project. The project may start producing small quantities (10.000-20.000 mmb/d in December 2008).

Further development of Cepu will depend on the resolution of the rampant land speculation movement originated ahead of the construction of the field (the unit price of the 600 hectares needed to construct the field facilities have jumped by more than 1000% due to speculation from land brokers).

In any case, Cepu's best estimate peak capacity is 165000kb/day by 2011 whereas other small projects could collectively deliver a maximum 100000 kb/day by that date. These figures imply that, in the best case, new additions would counteract the decline of mature fields, leaving current conventional crude capacity at 1 mmb/d.

Only new discoveries can change this, so investments in exploration will be badly needed in the coming years. Still, geological forecasts are not very promising. We do not expect a big increase in production in the long term.

Authorities have tried to promote investment in the upstream sector by introducing incentive programs to develop marginal oil resources (such as waiving import taxes on capital goods for O&G exploration and production and bidding new upstream projects on a competitive basis). During the last bid round (2006) dozens of new E&P licenses were awarded. However, in a context of restricted exports, the profitability of investments may be jeopardized by low fuel retail domestic prices.

Yet, under Indonesia's PSC system the contractor is entitled to recover all costs. Moreover, the profit is split between the government and the contractor in a 85:15 ratio for oil and 70:30 for gas. Cost recovery amounts claimed by private contractors have been rising over time (US$8 billion in 2007) and the Indonesian government is now looking to change the PSC system in order to rationalize these expenses.

[11] Pertamina contributes less than 15% to Indonesia's crude oil production. The remaining comes from Production-Sharing Contractors (PSC), mainly International Oil Companies (IOCs) from the US, Europe and China. However, Pertamina operates all eight of the country's refineries and progress to open the downstream sector to competition has been slow up to date. Refineries can only meet two thirds of demand for gasoline and gas oil at present.

BBVA

For more information please contact:

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