

## **Optimization of Indonesian Economic Management In Beginning Era of Global Economic Crisis**

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**ABSTRACT:** *Indonesian economy and financial has undergone three global economic and financial crisis, a cause of the Asian financial crisis in 1997, then the American financial crisis in 2008, and finally the European government financial crisis in some years ago.*

*What is interesting from the two financial crises in the advanced economies is that though initially it gave negative impact on Indonesian economy, however it has generally given even greater positive impact. Nevertheless, without doubt, the crises has generated risks on the Indonesian development due to the factor of global economic uncertainties so that it must always be monitored by monetary and fiscal authorities in Indonesia.*

*Several policies and strategies have been put in practice to respond and anticipate the changes in the new order of global economy and finance, in the process of economic and financial integration in global scale, especially in Asian regional scale in order to strengthen domestic economic networks.*

*This paper will analyze the Indonesian economy and the role of management of government and monetary authorities in beginning era of global crisis and will describe the optimization of Indonesian economic and financial integration in global and regional scale in order to anticipate the uncertainty of looming new order of global economy and finance.*

**KEYWORDS:** *Economic and financial integration; Global economic and financial crisis; Management of government and monetary authorities*

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### **I. INTRODUCTION**

Economic and financial crisis can occur at any point along the economic cycles and can happen to any country with both weak and strong economy, and it is caused mainly by weaknesses in the system and regulation, management and monitoring in private financial sectors, capital market, banking sector and government fiscal sector. The negative impact of such crises for the advanced economies has lately spread quickly and deeply into the many aspects of economic life in many countries, including in other countries. This has created a lack of trust from the world community towards the business, capital market and banking sector, including towards the government of advanced economies itself [1].

Indonesia is one of the ASEAN countries which bore the brunt of the crises from advanced economies. This is evident from the initial condition of each crisis, such as reduction of economic growth indicators, unstable value of currency and increasing inflation and slow reduction of unemployment and of the incidence of poverty. However, sometime later, the national economy began to recover and become more stable. This was made possible by the flow or transfer of economic and strategic financial resources from the advanced economies to the emerging market, including Indonesia, and by the strength of national economic foundations.

However, Indonesian economic and financial authorities realize that the good condition may not last long, and therefore they have prepared and implemented optimally several economic and financial policies and strategies which are designed to be pragmatic, anticipatory and sometimes accommodating, though some of the policies require the approval from the Parliament (*DPR*), which sometimes go through torturous process. The policies include the mix of monetary and banking policies for macro-prudential policy, the strengthening of protocols for crisis management between BI and the government, designing anticipatory and accommodating fiscal policies, and designing structural policies for real sectors of the economy.

It is also realized by Indonesian policy authorities that the good condition may not last in middle and long term. Therefore, the authorities continue to coordinate and improve their policies and strategies to anticipate the behavior and direction of global economic and financial crisis with its uncertainties and risk since the dynamics of global crisis determinants are changing and difficult to predict.

### **II. THEORIES AND MANAGEMENT OF GLOBAL ECONOMIC-FINANCIAL CRISIS**

Theoretically, economic and financial crisis is a situation where the economic and financial institution and behavior is generally losing their economic value and credibility in the eyes of economic agents. Several

economists have argued that many of economic crises in the world is always preceded by financial crisis, where the cycle is getting faster due to the integration of world global economy with the complex factors influencing it [2].

At present, the global economic condition is still under heavy pressure due to the financial crisis, beginning from the housing credit crunch in the United States in 2008, which had spread into crises in banking sector, capital market and economy as a whole. This crisis is believed to be the result of weakness in regulation, management and monitoring in private financial and banking sector by financial authority. The crisis then spread to Europe in mid-2010 up to the present, which was initially caused by growing sovereign debt, especially among European countries of the first order, such as Greece, Ireland and Portugal. The growing sovereign debt was accompanied by a high debt ratio, resulting in the severe narrowing of the ability to obtain financing for the deficit. The problem was getting worse since positive impact of the recovery effort was not forthcoming and this has resulted in the slowing down of the economy of several European countries [3].

It is understood that the crisis would result in the worsening of global condition as a whole. Almost all countries in the Americas, Europe and Asia, including Indonesia, have felt its impact. Generally, countries which are most vulnerable to the negative impact of the crisis are those without strong domestic economic fundamentals. However, since the impact of the global financial crisis on a country is different from another, the treatment of the crisis through policies planned and executed by monetary and financial authority in each country would also be different.

## **2.1 Review of Theories and Experience of the Global Economic-Financial Crisis**

In accordance with theoretical perspective and empirical cases, there are many factors in a financial crisis, both economic and political, both domestic and foreign. The primary factors are discussed below.

Global imbalances are one of the roots of the crisis, as seen in American and European financial crises. The flow of global finance has lately become unstable due to the fact that several countries such as China, India and Germany have surplus of trade every year (fiscal and current transaction) while other countries such as the United States and Great Britain are having deficit. The internal deficit of the United States is reflected by the deficit in consumers and the government. Due to the large inflow of capital into the United States, the interest rate is depressed and this has motivated the society to increase their consumption, including for housing. The result was a bubble in housing. Standards for loan is reduced and many people bought houses which they actually could not afford. When the performance of loans was getting worse, the financial system in the United States sustained a shock. The same also applies for the crisis in Europe, where global financial imbalances had resulted in a policy of greater fiscal deficit in several European countries, which in turn causes a financial crisis for the government [4].

Innovations in financial instruments is also one of the causes of the crisis. New financial instruments were developed quickly but the infrastructure of the market and financial system was not ready when pressures were mounting from the financial instrument. The instruments should be given time to develop and mature before it was traded in significant amount. This is necessary for the accountants, regulators, rating agencies and settlement system to catch up. The subprime mortgage crisis in the United States is the example of this, with its innovation on mortgage back securities. The innovation was meant to reduce risk and improve the probability of success for financial instrument. However, there were two things that caused this instrument to fail and result in prolonged financial crisis, that is, lack of transparency and lack of opportunity for trying out the product in the market [5].

Leverage is also a factor in financial crisis. Acquiring debt for investment is often cited as one of factors stimulating financial crises. Taking debt to increase investment has the potential for improving profit but also has the same potential for increased loss. Leverage is a risk that amplifies the probability of bankruptcy. Minsky has explained that the risks in financial crisis would emerge when the economy is involved in Ponzi scheme. There are three types of company, that is hedged, speculative and Ponzi. A company is categorized as a Ponzi scheme when its profit is not enough to pay its obligations and the company is forced to acquire debt for it and increase its debt incessantly. The increasing proportion of debt relative to company cash flow will make financial agencies more vulnerable to risk of non-performing loan. The result is that the company has to sell its asset to pay for its debts. When the asset and value of many companies or their shares plummet, investment and consumption would also fall and this would exacerbate the cash flow situation of business, banking sector and financial institutions in general [6]. Such was the trigger for financial crises in Thailand and ASEAN countries in 1997.

Asset-liability mismatch is also believed to be one of the triggers of financial crisis. Asset-liability mismatch is a situation where the risk is not compatible between asset and liability. For example, a commercial bank offers deposit service to its customer where the fund can be withdrawn anytime. Then the bank invests the fund for long-term investment (housing credit). Such a large difference between asset and liability can trigger a

bank run. When the customers of the bank begin to find it difficult to withdraw their fund, the negative sentiment would spill over to other customers. In international contexts, usually government of emerging economies issue bonds for raising fund. However, since the currency of the country is still weak, the government of emerging economies must issue bonds in dollar denomination. This would open a potential for asset-liability mismatch. Hence the risk of sovereign default due to the fluctuation of exchange rate between the emerging country's currencies with dollar would increase.

Government regulation plays an important role in financial policies and also can trigger financial crisis. Government in any countries would naturally try to regulate their financial sector so as to avert financial crisis. The objective of the regulation is transparency for the institutional financial report to the public in accordance with accounting standard procedures. Another objective of the regulation is also to make sure that financial institution can always fulfill requirements imposed on them such as CAR and limit of leverage. However, overregulation can trigger financial crisis. For example, Basel Accord II as one of the international regulation for banking under the Basel Committee on Banking Supervision, stipulates that bank should increase their capital when credit risk is on the rise. This would make banks reduce the credit for the economy and has the potential to trigger a crisis. However, on the other hand, financial crisis can also occur because of weak regulation. Such was the explanation of IMF Managing Director, Dominique Strauss-Kahn, that the 2008 financial crisis was a result of the failure in regulating risk taking in a financial system, in that case the United States.

Fraud in financial industry can also trigger a collapse of financial institution. One glaring example is the Madoff Investment Securities, which in 2008 acquired many depositors by giving false information on investment strategy and embezzle part of the investment fund. Fraud is often committed by traders of financial institutions where they try to hide losses. This loss can make the financial institution bankrupt and trigger a financial crisis.

Contagion is a situation where a financial crisis is trigger by another financial crisis in different place, or in other words, spreading from one institution to another, such as a bank run which spills over to other countries, or currency/stock market crash which propels the same crash in other countries. When the failure of a financial system threatens the stability of other institution, it is called "systemic risk". One of the causes of Indonesian financial crisis is contagion.

In 1997, Indonesia was in a fairly decent economic condition with low inflation, a trade surplus of USD 900 million and foreign reserve of USD 20 billion. However, big companies in Indonesia acquired their debt in dollar. When Thailand let its currency to float, making it devalued due to pressures from speculators, rupiah took the brunt. High level of debt in dollar denomination on Indonesian big companies is one of the accelerator for the 1998 crisis in Indonesia [7].

Economic shock is also a trigger for the financial crisis. The example is natural disasters such as earthquake (1906), war (1914), the change of power in Soviet Union (1998), tsunami in Japan (2009). Such shocks are real, not manufactured, incur great loss, unambiguous and sudden. Similar shock was also evident in the high level of default for sub-prime mortgage in the United States since 2007, and also the sovereign financial crisis due to large amount of deficit in Europe which reached its peak in 2010 and the repercussions are felt until the present.

## **2.2. Monetary Policies and Economic Management of Government for Global Economic and Financial Crisis Integration**

The economic and financial in Indonesia under the influence of the crises in the United States and Europe for last several years can be analyzed using two primary approach, that is analysis of financial sector (financial channel) and analysis of real sector (trade and investment channel). The two channels are influenced by several possibilities of transmission, that is the factors under the influence policy authority and factors which cannot be influenced by policy authority, which includes: (1) transmission through monetary and financial channel, such as changes in interest rate, rupiah exchange rate and yield from government bonds, (2) transmission through fiscal means such as foreign debt and taxation policy, (3) transmission through trade, that is export and import, (4) transmission through investment, in the form of FDI and portfolio, and (5) transmission through commodity such as the changes in commodity price [8].

In the midst of situation where global economy is increasingly uncertain, Indonesian macroeconomic development and financial system during the global crisis has shown a strong resilience. The repercussions of global crisis for Indonesian economy through trade channel is relatively limited. Indonesian export performance was initially still strong, but dissipated after some time, especially due to natural-resource-based commodity export and increasing market diversification in intra-regional trade in Asia.

In general, up to the present time the impact of the crises in the United States and Europe on Indonesian economic dynamics is still under control. Though there were times when it brought negative impact

on financial sector due to negative sentiment in global financial market, fundamentally the national economy is still relatively robust and strong. While for real sector in short term, the economic and financial crisis in the United States and Europe have not brought significant impact.

However, the outlook in middle and long terms is not certain, and therefore economic and financial policy authorities in Indonesia is still alert and ready to face the possibility of worsening economic and financial condition, since it is still now considered to be uncertain. The negative impact of crisis on real sector and especially on financial sector, both direct and indirect, should be monitored in terms of its transmission and the steps to deal with it. The impact of crisis can be mapped into short, middle and long term. In general, the policies are directed towards maintaining market confidence through policies of monetary and banking stability, which is the responsibility of Bank Indonesia, towards improvement and refinement of state budget (APBN) policies, and towards improving and strengthening investment in real sector, export and small and mid-sized enterprise (UMKM), which is the responsibility of the government [9].

### **2.2.1. The Role Stabilizing Monetary and Banking Sector of Bank Indonesia**

The positive achievement in the national economic performance is a result of the hard work and cooperation among all policy makers. In terms of the policy authority, several policy steps have been taken by Bank Indonesia and the Government to achieve better economic growth and to maintain macroeconomic stability in accordance with the dynamics of national economy. This cooperation is also actively supported by the banking community, the business and the public in general.

Bank Indonesia's policies are basically efforts to strengthen the policy mix which have been implemented beforehand. The policy for interest rate is designed to be consistent with the achievement of targeted inflation, that is  $5\% \pm 1\%$  in 2011 and  $4.5\% \pm 1\%$  in 2012. Exchange rate policy is designed to maintain the flexibility of rupiah development so that it remains consistent with macroeconomic development in the future, especially the achievement of target inflation and maintenance of its stability in short term. The macro-prudential policy should also be strengthened by issuing rules for managing domestic liquidity and manage the flow of foreign capital, especially short term ones.

The mix of monetary and macro-prudential policies is also supported by communication strategy in the effort to improve the effectiveness of monetary policy transmission and to reduce market uncertainties [10]. The determination of monetary and macro-prudential policy mix is adapted to the dynamics of current economic challenges. In the first semester of 2011, for instance, the national economy was characterized by the increasing pressure of inflation due to the increasing international commodity prices and delay in the supply and distribution of food, especially in the beginning of the year. At the same time, the strong inflow of foreign capital, which is beneficial for financing the economy and deepening of financial market, has also created a tendency of increasing risk for net outflow, especially for short-term investment which tends to be speculative. Therefore, on February 2011, Bank Indonesia has increased BI Rate 25 bps into 6.75% as a response to the increasing inflationary pressure in the beginning of 2011. In relation to exchange rate, the response of interest rate policy is supported by giving room for greater strengthening of the rupiah to suppress inflationary pressure from the increasing international commodity price (imported inflation).

Bank Indonesia has also strengthened its macro-prudential policy related to the management of foreign capital inflow which had been implemented the previous year. The target of this policy is to motivate the foreign investors to invest more long-term funds for financing the economy and deepening the financial market and to mitigate the potential impact of short-term capital flow on the risk of net outflow and instability in the financial market. Various macro-prudential policies have been taken, such as: (i) extending the minimum holding period (*masa endap minimal*) for SBI from 1 to 6 months, (ii) limiting banks' short-term foreign loan into a maximum of 30% of bank capital, and (iii) improving the management for banking liquidity by increasing the mandatory minimum deposit (*Giro Wajib Minimum*) of foreign reserve to prepare for the possibility of withdrawals in foreign exchange.

In the mid of second semester, 2011, the worsening economic and financial global condition created a risk for the performance of Indonesian economy. Other than the risk of reduction of growth due to the slowing down of world economic performance, perceived risk in global financial market would also increase and this would result in net outflow out of emerging markets, including Indonesia. To deal with drastic changes in global economic outlook, Bank Indonesia has taken accommodating monetary policies.

In October and November 2011, Bank Indonesia has reduced BI Rate as much as 25 bps and 50 bps, respectively, and the resulting BI Rate is 6.0%. This decision was based on the strong conviction that inflation will be lower in the future. On the other hand, this policy is also necessary to strengthen the base of domestic demand as a countercyclical step in anticipating the risk of slowing down of the global economy. The accommodating monetary policy response is also supported by reducing the lower threshold of monetary

operation interest rate for the deposit facility in Bank Indonesia O/N from 100 bps into 150 bps under the BI Rate since September 2011.

In order to mitigate the pressure in financial market, especially pressure on exchange rate, which is getting stronger due to foreign net outflow, Bank Indonesia has taken the policy of stabilizing rupiah by making use of foreign reserves which have been accumulated before. This policy was implemented through the intervention to increase the supply of foreign exchange in the market. At the same time, Bank Indonesia has also been buying SBN in secondary market in bilateral transaction and in auctions. This policy can directly address the sources of pressure on rupiah from the sale of SBN from foreign investor and also can prevent the rigidity of liquidity in rupiah money market due to the foreign exchange intervention by Bank Indonesia. This policy is also consistent with Bank Indonesia's effort to gradually increase SBN's role as monetary instrument.

In the effort to improve the prevention and management of crisis, including the ones caused by increasing global risk and uncertainties, Bank Indonesia has also designed the Crisis Management Protocol (*Protokol Manajemen Krisis*, PMK), based on the formal procedures in current practice. Basically, PMK is a mechanism and framework which regulates the process of preventing and managing a crisis in a systematic and integrated manner in national scale. The protocol contains indicators for vulnerability which can cause a crisis, determination of the condition of pressure, mechanism for decision making and related organizations. In this case, Bank Indonesia is more focused on the PMK in relation to the exchange rate and banking crises. Meanwhile, the government designs a PMK for financial market crisis, fiscal crisis and non-bank financial institutional crisis.

Further, in order to support the achievement of stability for rupiah exchange rate stability and deepening of foreign exchange market, breakthroughs in policies which are more structural in nature should be applied within the framework of free foreign reserve regime (Law No. 24/1999). This policy is important for strengthening the availability of foreign exchange in a more permanent manner. Therefore, at the end of September 2011, Bank Indonesia issued a requirement of the foreign reserve from export (*Devisa Hasil Ekspor*, DHE) and the foreign reserve from foreign debt (*Devisa Hutang Luar Negeri*, DULN) should be transferred through domestic foreign reserve banks (*bank devisa*), effective from January 2012.

In banking sector, during 2011, Bank Indonesia has continuously strengthened the banking sector by improving supervisory function and supporting the intermediary function which is directed towards productive sectors. Many policy steps have been taken within the framework of the following four pillars.

The first is the policy for driving the intermediary role of banks, which aims to make intermediary function more efficiently. Included in this policy is the requirement in transparency in the landing rate (*Suku Bunga Dasar Kredit*, SBDK) and the continuation of financial inclusion program.

The second is the policy for improving the banking system so that banks remain strong and healthy in facing competition through a more transparent management by referring to good governance principles. This policy includes the improvement of capital calculation to better match the risk and requirement that banks should apply anti-fraud strategy and prudential principle in transfer of resource (*alih daya*) and risk management in giving excellent service to customers.

The third is the policy to strengthen the supervisory function, which aims to improve the effectiveness of bank supervision, especially for the quality of early warning system. Therefore improvement is made on the requirement for related bank reporting to Bank Indonesia. Meanwhile, in order to improve the effectiveness of bank problem solving, Bank Indonesia through its rule on Determination of Status and Follow-Up on Supervision (*Penetapan Status dan Tindak Lanjut Pengawasan*) has issued a requirement on the deadline for bank recovery effort.

The fourth is strengthening the macro-prudential policy. This policy aims to maintain the stability of financial system through the application of time dimension (cyclical) and inter-sector dimension (risk distribution on the financial system). Included in this policy is the increase on foreign reserve GWM and GWM LDR.

For payment system, Bank Indonesia has taken several policies for making sure the delivery of safe and efficient payment system. This policy is the more important nowadays in dealing with increasing level of payment transaction going through the system, such as Bank Indonesia Real Time Gross Settlement (BI-RTGS), Bank Indonesia Scripless Securities Settlement System (BI-SSSS), *Sistem Kliring Nasional Bank Indonesia* (SKNBI) and other channels of payment such as credit card, ATM/debit card and e-money. Various policy steps and system development carried out by Bank Indonesia in 2011 includes: (i) standardization of chip-based ATM/debit card, (ii) improvement of requirements for Card-Using Payment Method (*Alat Pembayaran Menggunakan Kartu*, APMK), (iii) stages in the development of second generation BI-RTGS and BI-SSSS, (iv) development of National Payment Gateway (NPG), and (v) improvement of management for government accounts.

For currency, Bank Indonesia's strategy for 2011 was focused on fulfilling the demand of currency in the society in sufficient value, correct unit of account, in the right moment and in legible condition for circulation. This policy is summarized in three steps, that is: (i) improvement of the quality of circulated currency and fulfillment of money demand; (ii) improvement of the efficiency of cash operation in Bank Indonesia and commercial banks; and (iii) improvement of cash services of Bank Indonesia for the public by involving commercial banks and related institutions.

### **2.2.2. The Economic Management of Government's Effort in Maintaining the Stability of Real Sector Economy**

From government's perspective, there are several policies which can be taken in macroeconomic and sectoral terms in order to improve the capability and dynamics of national economy. From macro perspective, prudent fiscal policy would be able to maintain the continuity of government financial operation and drive economic growth and maintain the macroeconomic stability by giving stimuli and increasing subsidies. The fiscal performance is getting better from time to time and it is always maintain at the safe level which enables the financial system to support the efforts to achieve national development goals. This performance is reflected in the fiscal capacity, which is getting better all the time, since the realization of tax revenue has relatively been within target and even the realization of non-tax state revenue (*Penerimaan Negara Bukan Pajak* (PNBP),) has exceeded the budgeted target [11].

State expenditure is also getting better, as reflected in the significant capital expenditure. The consistent fiscal performance lends support for the improvement of economic growth where state budget deficit (*defisit APBN*) is 1.2% of the GDP. Meanwhile, allocation of subsidies has also increased and this supports food sufficiency and energy sufficiency and can avert high inflationary pressure by delaying further the implementation of gas price hike despite rising world oil prices.

In terms of price control, the government in coordination with Bank Indonesia has often found a problem in supply. Both parties have given feedback to each other concerning the policy for stabilization of volatile foods and the policy for minimizing the impact of price policy has been regulated by the government. In this case, Bank Indonesia and the government continues to optimize the role of Inflation Control Team (*Tim Pengendalian Inflasi*, TPI,) and Regional Inflation Control Team (*Tim Pengendalian Inflasi Daerah*, TPID).

In sectoral terms, government policies are often emphasized on the structural improvement in order to increase economic capacity, especially for investment and foreign trade. Policies are also focused on prioritized sectors of business, such as industry, agriculture and other strategic sectors.

For investment, government policy aims to prepare the infrastructure, superstructure and improvement of investment climate. The policies for investment include among others improvement of legal assurance by a reform of regulation in national and regional level; simplification of procedures through electronic system for information and licensing service (*Sistem Pelayanan Informasi dan Perijinan Investasi Secara Elektronik*, SPIPISE) and one-stop integrated service (*Pelayanan Terpadu Satu Pintu*, PTSP) in several cities, improvement of national logistics by developing (*Sistem Logistik Nasional*) in order to guarantee the distribution of goods and reduce cost.

The government has also designed a masterplan for the acceleration and expansion of Indonesian economic development (*Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia*, MP3EI) for the acceleration of infrastructure development process (national connectivity). The project is funded by the government, state-owned enterprise and private interest through public private partnership. The MP3EI project would include the construction of steam powered power plant (PLTU), airports, ferries, development of harbor, railway and toll roads.

In terms of foreign trade, the effort to improve export is directed towards improving the competitiveness of non-oil export products and market diversification. The strategy being employed here includes among other improving non-oil and gas export for products with higher value added, which is based on natural resource and has great demand in the market; driving export for creative product and service, especially those produced by SME; driving the effort to diversify export target market; giving emphasis on the expansion of market access, promotion and facilitation of non-oil and gas export in Africa and Asia; and driving the use of various trade schemes and international trade cooperation which will be beneficial for national interest.

For industrial sector, the government has also determined the national industry policy by clustering priority industries, which includes: agro industries, transportation, electronics and telematics, manufacturing, supporting industry, creative industry and special creative industry and certain small and mid-sized industry. In order to support this policy, the strategy for development manufacturing is taken through steps to improve competitiveness and policies to improve business climate, restructuring machinery, development of special industry zone, use of domestic product, development of industry for vegetable fuel and development of industry standardization.

In order to achieve these goals, the government by means of Government Regulation (PP) No. 62 which is in force since 2008 has provided tax incentives in the form of government-paid import tax (*Bea Masuk Pajak Ditanggung Pemerintah*, BMPTD) for certain industry sectors. In order to drive the development of domestic industry, the government has also provided tax holiday for pioneering industry sectors.

For agriculture, the development policy is focused on increasing national food security. This policy is carried out through strategy of improving the productivity and quality of planted soil, assistance in the form of seeds and fertilizer, post-harvest treatment, financing for agriculture, development of the food secure villages (*desa mandiri pangan*) and treatment of food insecurity and construction of irrigation system. The strategy for food production improvement is supported by the betterment of steps in coordination, monitoring and evaluation of food reserve and strategic treatment of food.

The government has also taken several policies to improve people's welfare [12]. One the biggest challenges listed in the government work plan (*Rencana Kerja Pemerintah*, RKP) for 2011 is job creation and poverty reduction. The government continues the policy of assistance and social protection for the poor. The policies include food subsidy in the form of rice distribution for the poor (*raskin*), free health facilities (*Jamkesmas*), *Program Keluarga Harapan* (PKH, planned family program), financial assistance for schools (*Bantuan Operasional Sekolah*, BOS), the national program for community empowerment (*Program Nasional Pemberdayaan Masyarakat*, PNPM) and other subsidies. The policies and programs for community empowerment and social assistance for the poor can drive the increase in people's purchasing power.

### **III. ANTICIPATION OF INDONESIAN ECONOMIC DURING THE UNCERTAIN ERA OF GLOBAL ECONOMIC AND FINANCIAL CRISES**

#### **3.1 Potential, Challenges and Economic-Financial Anticipation and Policy for Economic Authorities**

The potential of national economy shows a picture of optimistic outlook where the prospect of the economy is still strong and economic stability would be maintained for some time in the future. The solid domestic economy is predicted to be able to drive the economy to achieve high level of growth during the slowing down of global economy. Investment is predicted to grow continuously and this has become a stimulus for high economic growth of 6.3% - 6.5% in 2012. Increasing growth of investment is supported by economic stability, conducive investment climate and investment rank, great potential of the market and relatively low interest rate. Other than improving economic capacity, increasing investment would in turn maintain the purchasing power of the society, so that household consumption can grow into high levels [13].

Improved investment climate has also stimulated the inflow of FDI and this supports the NPI surplus in 2012. Portfolio capital is expected to flow in due to competitive yield, low perceived risk and high excess of global liquidity. Meanwhile, transaction balance is expected to show deficit due to high import and improved growth of domestic economy in the weakening export growth due to low performance of global economy. However, as a whole, the surplus of capital and financial transaction would be able to maintain NPI surplus and this can be a supporting factor for achieving the stability of rupiah exchange rate in 2012.

Inflation in 2012 is expected to be controlled at target range. Since the global economy is slowing down, the price of global commodity tends to decrease and with strong capacity of domestic production and stable exchange rate, the IHK inflation for 2012 is expected to be within its target range in 2012-2013, that is  $4.5\% \pm 1\%$ . This estimation is supported by the prudent and consistent application of monetary policies by Bank Indonesia, and the strengthening of policy coordination with the government in the effort to improve the capability in supplying primary goods and price control. However, there are several risk which can increase inflationary pressure in the future, especially government's plan to issue a policy on fuel in 2012.

The stability of financial system in 2012 is expected to be maintained due to the success in achieving macroeconomic stability and strong fundamentals of the financial sector in absorbing risks. For the banking system, the intermediary function will continue to improve with high level of credit growth and stable level of credit risk. Though interest rate would tend to decrease, the improvement in efficiency is expected to be able to maintain the profitability of banks. High availability of liquidity and capital would help the strength of banking system in absorbing risks which may occur due to the economic uncertainties in global and domestic level.

For financial market, the volume of transaction is expected to continue its upward trend and the yield would remain competitive. The issuance of stocks and bonds is expected to increase in line with the increasing need for economic financing and this would lend further support for the process of financial market deepening in Indonesia. Though perceived risk in short terms still largely depends on the resolution to the crisis in Europe, the investor are largely interested to place their fund in financial assets in Indonesia since the yield is decent, credit ranking is rising and economic prospect is better. The strengthened (*Protokol Manajemen Krisis*, PMK) by Bank Indonesia and the government would embolden investors' confidence in the domestic financial market and this would serve as the basis for the strong performance and stability of Indonesian financial market in the future.

In mid-term, due to continuing structural improvement, the capacity and productivity of the economy is getting better and global condition is making progress, and therefore Indonesian economic prospect is expected to have high and sustainable level of growth with stable macroeconomic indicators. The national economy is expected to grow as much as 6.6% - 7.4% and inflation is expected to be reduced, reaching 4.0%±1% in 2016. Such a high mid-term economic growth is supported by improved productivity and economic capacity, and this is in line with increased investment, both physical and human resource investment. In terms of financing, the high level of investment is related to high FDI and high level of public savings. Meanwhile, demographic strength in the form of increasing number of persons in productive age in the population and rational consumption behavior of the society would support the accumulation of public savings.

On the other hand, there are several challenges and risk which requires attention, both foreign and domestic, since they can influence the optimistic outlook of Indonesian economic prospect in the future. Without a response in the form of measured and correct policies, the challenges can hinder the achievement of the prospective high growth economic and macroeconomic stability.

Among the challenges from foreign source, one of the most important is the vulnerability in global economic recovery, which can lead to worse performance than initial estimation (downside risk). The complexity of the crisis in Europe can create deeper recession in the region and this can spill over to the global economic performance. The close relation between sovereign debt crisis, vulnerable banking condition and slowing down of economic activities, can create an adverse feedback loop which can delay the solution for the crisis to uncertain time. The recovery process in the U.S. is also expected to take some time in order to return to its long-term trend. Through trade channel, the risk of economic performance downturn in the advanced economies can result in the slowing down of economic growth in emerging markets, including Indonesia.

Increased uncertainties in the performance of global economy through financial channel can result in higher volatility for the flow of foreign portfolio investment capital to emerging markets, including Indonesia. In contradistinction with the capital flow in the period up to second quarter of 2011, which was huge and had one direction, the foreign portfolio investment in 2012 tends to be lower and two-ways (two-ways capital flows). The impact of excess global liquidity and the need of investors to obtain higher yield in emerging markets, on one hand, and the probability of increase risk of economic downturn in advanced economies on the other hand, can result in positive or negative news which would make an impact on the volatility of foreign capital flow. This is a serious policy challenge for the economic authorities in emerging markets in their effort to maintain the macro stability and financial system, including Indonesia [14].

One of the domestic risks which requires serious attention is government plan for strategic commodity pricing. For the APBN (State Budget) of 2012, the government has planned that the distribution of subsidized fuel for cars in Java and Bali would be limited, and the price of electric energy (*Tarif Tenaga Listrik, TTL*) would be increase 10% in average. The other alternative under government consideration is by increasing the fuel price. On the one hand, this policy is necessary in order to deal with the drastic increase in subsidized budget due to the high price of oil and its use for increasing budget for capital expenditure and welfare. However, on the other hand, the plan for such policy can increase the risk for higher inflationary pressure. The decision concerning the alternatives and the time for implementation of this government policy would have a great impact on the achievement of economic growth and inflation in 2012.

In the stabilization of rupiah exchange rate, the challenge so far is the relatively high level of excess of demand in structural terms in the market for foreign exchange. So far, the excess for demand of foreign exchange is being filled by inflow of foreign capital, especially those in the form of portfolio investment. This condition, to which we must also add the lack of development of domestic foreign exchange market, has resulted in the vulnerability of response exchange rate when it sustains external shocks. The policy of Bank Indonesia which requires that DHE and DULN should be transferred to domestic foreign reserve bank (*bank devisa*) which is in effect in 2012 is a basic step to deal with this problem. This policy should be followed by further steps to deepen the market for foreign exchange and to improve the ability of the banking sector to make use of the incoming foreign reserve from DHE and DULN for financing the economy.

Another domestic challenge is the optimization for the use of excess liquidity in the banking system for financing the economy. So far, the excess liquidity is placed in monetary instrument and the government security (*Surat Berharga Negara, SBN*). Other than the inflow of foreign capital, the amount of the excess liquidity comes from accumulation of fund which the banking sector is not capable yet to distribution to the real sector, both due to the reason of internal condition of the bank or to the reason of the capacity of the real sector to make use of the fund. Such condition has resulted in a high level of industrial assets in banking but it has not been balanced by improved contribution to the economy. The excess liquidity is one of the factor which causes the decoupling between banking and real sector, and this has reduced the effectiveness of Bank Indonesia's monetary policies.

Other than the insignificant role of the banking sector in financing the economy, the low efficiency of the banking sector is also one of the challenges which requires speedy solution. Bank Indonesia has always endeavored to create a strong and healthy banking system, which is capable of playing its role in financing the economy in an efficient and effective manner. The efficiency level of banking industry is still low in terms of its contribution towards the high credit interest rate. The low efficiency is evident from the ratio of operational load to operational income (BOPO), which reached 85.4% (October 2012). As a comparison, the BOPO ratio for banking sectors in ASEAN countries is within 40%-60%.

In longer terms, there are several challenges which must be solved in order to support a sustainable economic growth to anticipate the possibility of problems in production and distribution, especially for food. Another challenge is the improvement of competitiveness and resilience of the economy towards external shocks, which is necessary to maintain the macroeconomic stability and performance.

Another thing is which no less important is the implementation of The Masterplan for Acceleration and Expansion of Indonesia's Economic Development (MP3EI) program to support the improvement of productivity and efficiency of the economy in order to increase the competitiveness and resilience of the economy.

In order to support the achievement of macroeconomic prospect in the future, Bank Indonesia in facing the various challenges, both external and domestic, would focus on the following five points:

The first is to optimize the role of monetary policy in controlling the value of domestic currency that is maintaining inflation. Bank Indonesia has taken the policy in driving economic capacity and mitigating the risk of slowing down global economy. In this case, the monetary policy would be directed to maintain the stability of the macro-economy and financial system, and at the same time to provide stimuli for the economy. The response of interest rate would be directed so as to be consistent with the achievement of target IHK inflation of  $4.5\% \pm 1\%$  in 2012 and 2013. By still giving highest priority to the inflation target, the interest rate response is meant to also provide stimulus for the domestic economy in order to mitigate the risk that global economy might slow down. The interest rate policy will be accompanied by a macro-prudential policy for the management of liquidity in the economy and to control banking credit, especially for certain sectors of consumption which tend to growth out of control and create vulnerable [15].

Concerning the value of rupiah against foreign currency, Bank Indonesia's policy is aimed to maintain the stability of rupiah exchange rate and to give assurance for all economic actors. The stability of exchange rate is expected to be achieved by considering the internal and external balance of the economy. Starting from 2012, the policy for exchange rate stabilization will be supported by the implementation of the requirement that DHE and DULN should be transferred through domestic bank. Bank Indonesia has also reviewed existing regulations to enrich the instruments in foreign exchange market which can be used for hedging.

The second is that the efficiency of banking system should be improved by optimizing its contribution to the economy, and at the same time strengthening the banking system. In order to improve the efficiency and competitiveness of the banking system, the policy of SBDK (*Suku Bunga Dasar Kredit*) will be continued. This is needed to make sure that the market mechanism works well so that the policy targets can be achieved. To follow up the policies in terms of bank supervision, the enforcement of the regulation that requires bank business plan (*Rencana Bisnis Bank*, RBB) to contain targets of efficiency improvement and reduction of credit interest rate into reasonable level will be enhanced. Policy for improvement of financing will be continued to support the strengthening of banking system. This is necessary for supporting the economic growth in the future and for anticipating changes in business cycle.

Bank Indonesia consider that customer protection and banking management are two aspects which require attention. Fraud cases in banking had received a lot of attention in 2011 and this requires a restructuring on the policies related to the two aspects. Therefore in 2012, Bank Indonesia would continue its policy to improve protection for customer and potential customer. In order to improve the quality of banking management, BI would improve the requirement concerning transparency in financial report, especially for published financial report and the regulation for the use of public accountant by banks. BI also continues to review the policy for bank ownership and multi-license policy due to the increasing complexity of banking business.

The third is that in order to improve the efficiency, reliability and security of payment system, both in terms of national payment system and payment to foreign partners, several steps have been taken, including: (i) improving the security and reliability of payment service by risk mitigation which makes use of advanced technology, strengthening the legal framework, strengthening supervision and improving the role of national payment service industry; (ii) improving the efficiency of national payment service, including giving support to interoperability and interconnectivity among payment service providers; and (iii) improving the protection for customer through the improvement of transparency by payment service providers and strengthening the regulation for customer protection.

The fourth is strengthening the macroeconomic security by improving coordination in the prevention and management of crisis (*pencegahan dan penanganan krisis*, PMK). Policy coordination with the government for controlling inflation to minimize the impact of inflation due to volatile food and government policy would result in the increasing administered price and this would be strengthened further. The coordination is necessary for guaranteeing the consistency of policies which will be implemented. In order to support the achievement of targeted inflation, coordination between monetary authorities and the government through the inflation control team (*Tim Pengendali Inflasi*, TPI) in central and regional level, will be strengthened.

The fifth is the support for real sector empowerment, including providing wider access for banking service to the society (financial inclusion). This is carried out by giving low-cost banking service to rural communities, including the quality improvement for the program of my saving (*Tabunganku*), development of financial education, implementation of Financial Identity Number, and survey of literacy. In order to empower real sector, BI would facilitate the intermediation for supporting the financing for many potential sectors by cooperating with government institutions. For the sectors which are not viable commercially but plays strategic role in the economy, BI and the government would develop various financing schemes. BI would also develop products and activities for Islamic banking (*Bank Syariah*, BPRS). The strategy of BPRS development in the future is directed in a manner consistent with the characteristics of BPRS as strong, healthy and productive community bank, which is focused on the provision of financial service for SMEs and local population in the region.

BI as monetary authority realizes that the complexity of the challenges and effectiveness in the implementation of many policies for supporting national economy requires close coordination with government policies and requires the support from banking system, business and public at large. Therefore, the policy coordination which has gone well so far with related institutions will be strengthened further in order to maintain the stability of macro-economy and financial system, inflation control, deepening financial market and stimulating real sector. Strengthening of the coordination with the government and related authorities is carried out in the central and regional level. BI would continue to optimize the function of the branch office of the central bank (Kantor Bank Indonesia, KBI) in the regions to support inflation control and to stimulate development in the region with close coordination with the regional government.

### **3.2 Optimizing Management of Integration Indonesian Economic in Dealing with Global Crisis**

For Indonesian economy, the present crisis is a lesson for understanding the impact of increasing integration between Indonesian economy and the global economy. At present, in terms of trade, the integration between Indonesia and the global economy is increasing compared to previous years. This is reflected in the ratio of export and import towards the GDP, which has increased drastically since 1980. The integration level is also accompanied by the diversification of export destination countries and the kinds of commodity.

In financial terms, Indonesian economy is relatively open compared to ASEAN countries, for instance after Singapore. This is evident from the ratio of net foreign asset and foreign investment to GDP and foreign ownership of investment is increasing. However, the structure of capital inflow into Indonesia is still dominated by short term portfolio and therefore it is still vulnerable to the risk of capital reversal since it is very sensitive to sentiments. Also, the FDI into Indonesia is mostly not export-oriented since Indonesia has not become part of the supply chain of global economy.

The economic integration on the one hand has improved the dynamics of economic and financial activities in Indonesia and has given much benefit for Indonesian economy. However, on the other hand, such economic integration also contains a risk of instability, as evident during the global crisis.

In terms of the benefit, economic integration would improve welfare through the increased flow of goods and capital goods among the countries. The movement of goods through international trade would improve general welfare in the countries. Meanwhile, the movement of capital would also be beneficial since resource would always be allocated to place where the economic activities is most productive. Financial globalization can also support a country to minimize its domestic economic fluctuation. Access to funding from overseas can be used for accelerating the growth of aggregate demand when the sources of domestic financing is limited. In domestic terms, the integration of capital flow would also stimulate the development of domestic financial sector through the improved market liquidity. Therefore, the improved integration in financial sector is considered to be a key in applying market discipline for decision makers, in introducing new innovation for financial products and in supporting the development of technology and in stimulating a competition which would have a positive impact on efficiency improvement in the national banking industry [16].

However, economic integration would also present a risk of instability. The presence of asymmetric information and distortion in the global and domestic economy has reduced the benefits of financial liberalization. In reality, the information flow in financial market is not perfect both in terms of transparency and truth-value. This has created several problems in incentive, such as moral hazard and adverse selection. This has

driven the investors to herding, that is simply following other investor whom he/she thinks has better information.

The global financial crisis which was triggered by subprime mortgage is an example of the vulnerability of financial liberalization. The crisis spread to many other countries, making capital flow vulnerable. The global crisis had forced the corporation, financial institution and households in advanced economies to improve their balance structure, among others by withdrawing the portfolio capital back to their own countries. The portfolio capital which had been injected into Indonesia was suddenly withdrawn in significant amount and this gave tremendous pressure on Indonesian trade balance and weakened the rupiah considerably. However, the outflow of capital from emerging markets, including Indonesia, has abated now.

In responding to this problem, one can conclude that the challenges to Indonesian economy and finance with its increasing integration can be predicted to be more complex in the future. The policies which optimize benefit and minimize risk from the economic integration are inevitable. The role of international cooperation in various area, especially in relation to trading system and financial system, is also increasingly important [17].

The dynamics of Indonesian economy as described above cannot be separated from Indonesia's participation in various international cooperation. For international trade, several existing international cooperation has given positive impact on the growth of export. It has widened the market to primary trading partner such as Japan, China, European Union and the US and effort to gain new partners is also underway, such as with Turkey, Mexico and India, the countries which are expected to be able to become alternative solution since the trade with primary trading partner is slowing down.

Based on a study by BI, international cooperation in the Bilateral Investment Treaty (BIT) with several countries has been proven to be able to make an impact on the inflow of foreign investment into Indonesia. Also, in order to contribute to the establishment of ASEAN Economic Community (*Masyarakat Ekonomi, ASEAN-MEA*,) in last 2015, Indonesia is also active in trade and investment cooperation both with ASEAN countries and with ASEAN dialogue partners such as Korea, Australia, New Zealand (ANZ) and China. For the inflow of foreign investment into Indonesia, in 2008 Indonesia has intensified its cooperation with Canada in Foreign Investment Promotion and Protection Agreement (FIPPA) in investment.

For the prevention and mitigation of crisis, several international cooperation such as Chiang Mai Initiative through the facility of Bilateral Swap Agreement (CMI-BSA) can reduce the negative impact of the crisis, though it cannot fully prevent and deal with the crisis. Indonesia is actively involved in Chiang Mai Initiative Multilateralization (CMIM) which aims to fulfill the need of short term loans among ASEAN countries due to external imbalance. In wider forum, Indonesia has always followed the development in the multilateral cooperation of IMF and G20.

Besides continuing existing cooperation, Indonesia has strengthened its cooperation with strategic partner countries in order to reduce the negative impact of global economic crisis in bilateral, regional and multilateral framework. In 2008, IMF has provided a new and more flexible loan scheme which is more suitable for the needs of IMF members such as Short Term Liquidity Facility (SLF) for countries with good macro condition but under BOP pressure due to global crisis. Indonesia is one of the countries eligible for this facility but did not make use of the facility due to strong NPI. In the forum of G20, Indonesia is also actively involved in many summit in order to discuss the strategic steps which need to be taken by the countries in dealing with deepening global economic crisis.

Therefore, for some time in the future, international cooperation, both for the liberalization of flow of goods, facilitating the flow of payment and investment, must be continued and improved optimally, considering that the global crisis is always uncertain. This is necessary to prevent and deal with the impact of global crisis which may occur and sweep into Indonesian economy and finance.

Several steps have been taken in that direction, among others through the Chiang Mai Initiative Multilateralisation (CMIM), which aims to mitigate crisis, surveillance and improve access to financing. Several cooperation has also been carried out which is expected to increase the flow of goods and payment in the future, and to prevent and deal with crisis. This is achieved among others by making ASEAN an international basis for production in accordance with the framework of MEA in 2015 through FTA, ASEAN Comprehensive Investment Agreement (ACIA) and strengthening of monitoring, crisis management and information sharing in the EMEAP forum (Executives Meeting of East Asia Pacific Central Banks).

However, it seems that the mechanism and implementation of these policies should always be adapted in dynamic and rational manner since Indonesian condition is more strategic in many aspects or sectors, for instance its abundant natural resource and human resource, wide market, large population and its promising geo-strategic location. Therefore, in terms of integration, it can bring much benefit for the Indonesian people. Otherwise, the plan for economic integration process would be a hindrance or obstacle for the national interest of Indonesia.

#### IV. CONCLUSION

Uncertainties in the recovery from global crisis began to show when European debt crisis emerged on the end of 2010-2011. This has triggered shocks in financial market and weakened the global economic growth. The impact of global fluctuation for Indonesia is felt mostly in financial market, especially stock and bond market, while the impact on real sector is relatively minimum. Though lately the external sector seems to be in trouble due to the deficit in trade balance, but the steps taken by BI and the government through their strategic policies in monetary and financial public sector, supported by the strong fundamentals of the economic and financial sector, it is safe to say that the economic and financial dynamics in Indonesia is still stable and under control during the crisis until the present time.

During the crisis in 2008, the policy and strategy from monetary authority, that is BI, includes the following: liquidity easing, improving public confidence on banking system, establishment of the deposit underwriting institution (*Lembaga Penjamin Simpanan*) and the requirement of safety net for the financial sector (*Jaring Pengaman Sektor Keuangan*, JPSK). While the policy of government as monetary authority includes fiscal stimulus and optimization for APBN expenditure and strengthening real sector and SME (small- and mid-sized enterprise, UMKM).

After the financial crisis in Europe in mid-2010-2011, the policy and strategy is refined and better coordinated among the authorities of economic policies. This includes: maintaining the confidence of financial market, such as maintaining monetary stability, exchange rate and fiscal continuity to stimulate investment. Support is given to external sector by improving the diversification of export market, strengthening and improving competitiveness in domestic, regional and global market, improving the value added of export product, and improving supervision on illegal import especially consumer products. In terms of state budget (*APBN*), it is being enlarged and expenditures are optimized, including the efforts to maintain purchasing power of the public through the policy of pro-people program (*Program Pro-Rakyat*) and to maintain the momentum of the continuing emergence of middle class.

However, in order to anticipate the potential, opportunity and dynamics of global crisis which is still difficult to predict in middle and long term, the monetary and financial authorities have planned and will implement several anticipatory, adaptive and accommodating policies which are consistent with global economy and the needs of national economy. One of the policy which is considered to be strategic is the need to optimize the policy for integrating the economy and finance globally, regionally and nationally, which is limited in its implementation so far.

For the integration of national economy, it is recommended that the existing discretionary strategic policies should be optimized in order to strengthen the economic network between the regions, since this has the potential for the production network, trade and consumption, using the model of clusters of productive areas, in accordance with the availability of natural and human resource and the market potential of each region.

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