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Indonesia: 2004 Article IV Consultation and Post-Program Monitoring Discussions—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with Indonesia, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation and post-program monitoring discussions, prepared by a staff team of the IMF, following discussions that ended on **March 5, 2004,** with the officials of Indonesia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 9, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **May 3, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 3, 2004 discussion** of the staff report that concluded the Article IV consultation.

The document listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INDONESIA

Staff Report for the 2004 Article IV Consultation and Post-Program Monitoring Discussions

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by David Burton and Carlos Muñiz

April 9, 2004

- The 2004 Article IV Consultation and first Post-Program Monitoring discussions were held in Jakarta during February 24–March 5. The mission met with Coordinating Minister for Economic Affairs Dorodjatun Kuntjoro-Jakti, Coordinating Minister for Social Affairs Yusuf Kalla, Minister of Finance Boediono, Minister of Trade and Industry Rini Soewandi, Bank Indonesia Governor Burhanuddin Abdullah, other senior officials, parliamentarians and representatives of civil society and the private sector.
- The staff team comprised Messrs. Citrin (head), Schwartz, Bingham, Bhundia, and Wolfson (all APD), Baldacci (FAD), Tadesse (PDR), and Federici (LEG), and was assisted by Messrs. Nellor, Khatri, and Taylor of the Fund's Jakarta office. Ms. Indrawati (OED) also attended many of the meetings. The mission worked closely with an overlapping MFD technical assistance mission, and with the World Bank and AsDB.
- Indonesia's Extended Arrangement (SDR 3.6 billion) expired on December 31, 2003. All available purchases were made, and total outstanding obligations to the Fund currently amount to SDR 6.8 billion (Annex I). Under the existing repayment schedule (expectations basis), outstanding obligations to the Fund would remain above 100 percent of quota until August 2008.
- The last Article IV Consultation took place in April 2002. At the conclusion of the eleventh and final review of the Extended Arrangement (December 19, 2003), Directors welcomed the progress that had been made under the four-year arrangement. They were encouraged that sustained policy implementation had contributed to an ongoing improvement in macroeconomic performance, but noted that a durable recovery was yet to take hold. They urged the authorities to maintain investor confidence through continued sound policies, and to act vigorously to strengthen the investment climate to enable Indonesia to realize its economic potential.
- Indonesia has accepted the obligations under Article VIII, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.
- Indonesia is in compliance with the SDDS, but there are a number of data weaknesses that hamper effective surveillance (Annex II). In particular, fiscal data is of uneven quality, and key components of the balance of payments need to be strengthened. Efforts are underway to address these data shortcomings.

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EXECUTIVE SUMMARY

Background

- **The Article IV consultation provided a timely opportunity to assess achievements under recent Fund arrangements and to take stock of remaining challenges**. While significant progress has been made in restoring macroeconomic stability and implementing key areas of the structural reform agenda, notably in rehabilitating the banking sector, Indonesia's overall economic performance has lagged behind others in the region.

- **Economic developments and policies in the coming months are likely to be influenced by the protracted electoral cycle**. Parliamentary elections were held on April 5, and will be followed by the Presidential election in July, with a possible second round to take place in September. The electoral process has proceeded relatively smoothly and peacefully so far.

- **Assuming that market confidence can be sustained, economic performance is expected to strengthen in 2004**. Growth is expected to pick up to 4.8 percent and inflation should remain subdued at around 5 percent. Notwithstanding the absence of exceptional financing from the Fund and Paris Club, the external position should remain comfortable, with reserve cover staying at over 150 percent of short-term debt.

Key Issues and Staff Recommendations

- **The discussions focused on policies to strengthen Indonesia's growth prospects**. The emphasis was on identifying a set of policy actions to bolster competitiveness and growth that the authorities could implement even in an election environment. To this end, the mission recommended that the government focus on measures to address weaknesses in taxation and regulation, labor market uncertainties, and weaknesses in the legal system.

- **Maintaining macroeconomic stability and continuing the restructuring of the financial sector will also be key**. In this context the discussions focused on the following:

  - **Monetary policy**. The mission urged Bank Indonesia to maintain a firm monetary stance during the election period, and to proceed cautiously with further reductions in interest rates.

  - **Fiscal policy**. The mission noted that there was a risk that the 2004 deficit target of 1.3 percent of GDP could be exceeded, unless non-oil revenues pick up. The authorities stressed their determination to bolster revenue collections to ensure that the deficit target is met.

  - **Financial sector reform**. State bank reform remains a priority, given the sector's large size and weak asset quality. The mission urged the authorities to monitor closely the business plans of the state banks, to ensure sound lending practices. Over the longer term the staff encouraged the authorities to press ahead with the transfer of these banks to private sector management. The mission was encouraged by the progress being made to develop a robust financial sector safety net.

I. Introduction

1. **Indonesia's extended arrangement concluded at end-2003, bringing to a close six years of Fund-supported programs since the Asian financial crisis**.[1] The programs can claim a number of important successes, particularly over the past few years when greater political stability facilitated policy implementation (Box 1). The macroeconomic situation was stabilized, the fiscal position placed on a sustainable path, and external vulnerability reduced. Good progress was also made in key areas of structural reform, notably in rehabilitating the banking sector.

2. **Despite the gains in macroeconomic stabilization and structural reforms, Indonesia's overall economic performance has lagged behind others in the region** (Chart 1). In particular, GDP growth, investment, and exports have continued to perform poorly when set against the experience of other Asian economies (Figures 1 and 2). Further structural reforms are needed to enhance the investment climate and raise growth prospects sufficiently to reduce unemployment and make further inroads in poverty alleviation.

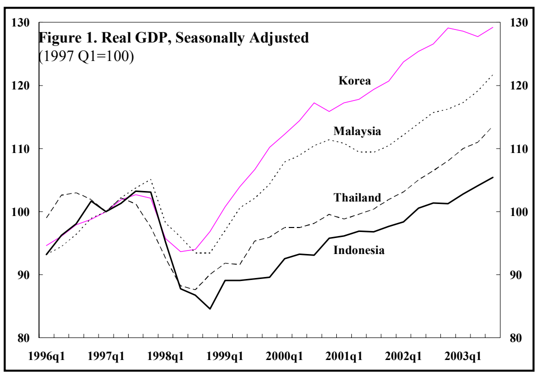

Figure 1. Real GDP, Seasonally Adjusted
(1997 Q1=100)

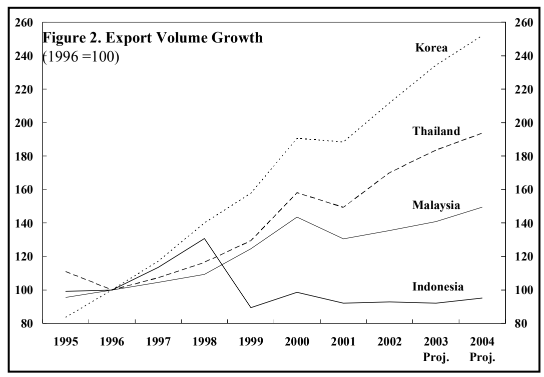

Figure 2. Export Volume Growth
(1996 =100)

3. **The Article IV consultation discussions provided a timely opportunity to assess recent policy achievements and to take stock of the remaining challenges**.[2] The discussions focused in particular on policies to strengthen Indonesia's growth prospects. In addition to maintaining macroeconomic stability, it remains essential to continue restructuring the financial sector, and to implement further structural reforms to bolster competitiveness and enhance the investment climate.

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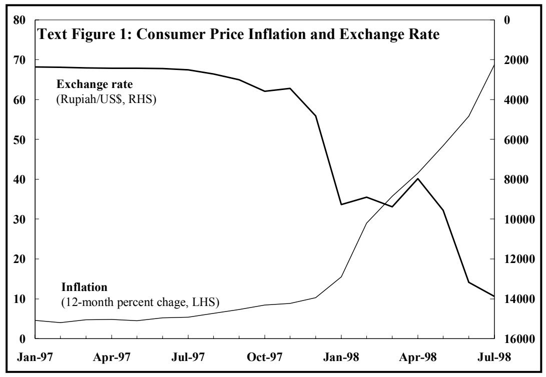
[1] The extended arrangement was approved in February 2000, and was extended by an additional year in early 2002. It replaced an extended arrangement approved in August 1998, which in turn succeeded a stand-by arrangement that was approved in November 1997.

[2] The accompanying Selected Issues paper provides an in-depth discussion of policy outcomes and key challenges.

Box 1. The Economic Recovery Strategy (1998–2003)

The economic recovery strategy was formulated in 1998 against the background of deep crisis. Initial efforts at stabilization and economic reform supported by the November 1997 stand-by arrangement had failed to take root. The economy in early 1998 was under severe financial stress, reflected most notably in a freefall of the rupiah and a rapid acceleration in inflation (Text Figure 1). The banking system had imploded, the corporate sector was insolvent, crushed by its external debt burden, and output had collapsed (GDP had fallen by 13 percent, the sharpest such decline of the crisis-stricken Asian economies). Poverty was rising rapidly as a result.



The immediate priorities were to stabilize the macroeconomic situation and lay the basis for a recovery in economic activity. The principal macroeconomic objectives were to break inflation, reduce external vulnerability and restore economic growth. Public finances also had to be placed back on a sustainable footing, as restructuring the banking system while preserving the public's deposits had resulted in a huge increase in public debt.

A number of fundamental structural weaknesses needed to be addressed to secure these objectives. In addition to securing adequate recoveries from bank assets taken over during the crisis, the key strategic objectives were to restore a functioning banking system and resolve the debt overhang in the corporate sector.

Five years on, there have been a number of important successes:

- **The macroeconomic situation has stabilized**. The exchange rate has recovered from a crisis low of Rp 16,000 per dollar and has remained in a narrow range of Rp 8,300-8,600 per dollar since July 2003. Inflation has declined sharply to mid-single digits and interest rates have fallen correspondingly.
- **Progress has been made in restoring a sustainable budget situation**. Reforms to reduce subsidies and raise non-oil revenues have halved the budget deficit to 2¼ percent of GDP, and public debt has declined to around 65 percent of GDP from a peak of 100 percent.
- **External vulnerability has been reduced**. A substantial build-up in reserves has significantly increased the reserve coverage to 7½ months of imports. External debt has been halved to around 60 percent of GDP.

Progress has also been made in key areas of structural reform. After a slow start, IBRA asset recoveries accelerated, reaching Rp 163 trillion by the time of its closure in February, and the government has divested all but one of the banks taken over during the crisis. The banking system's fundamentals have been strengthened (although vulnerabilities remain, especially among state banks) and the process of establishing a robust financial infrastructure is advancing. An independent central bank is in place, bank supervision is being overhauled and a new financial safety net is well on the way to being established.

Nevertheless , the economic recovery has not been robust enough to ensure a sustained reduction in poverty and unemployment. Slow progress in addressing underlying structural weaknesses has impeded the development of the institutions needed for a stable and efficient market-based economy, and contributed to the sluggish recovery. In particular, legal and judicial reforms have lagged; despite recent advances, tax administration remains inconsistent and nontransparent; and corruption and weak governance remains a major source of concern.

4. **The discussions took place in the context of strong market sentiment and an improvement in macroeconomic indicators, but with some uncertainty relating to the forthcoming parliamentary and presidential elections**. Indeed, economic developments and policies through much of 2004 are likely to be influenced by the protracted electoral cycle. Campaigning for parliamentary elections (held on April 5) began in early March; the presidential election is scheduled for early July, with a possible second round to take place in September if no candidate wins an outright majority of votes in the first round. The electoral process has been proceeding relatively smoothly so far, although there is still a possibility that political tensions could escalate in the months ahead. The new government is scheduled to take office on October 20.

II. Economic Setting and Outlook

Economic setting

5. **Short-term financial market indicators have continued to improve, although there have been some signs of cooling off as the elections approach** (Figure 3 and Chart 2). The rupiah has remained in a relatively narrow range against the U.S. dollar, at around Rp 8,300–8,600 since mid-2003, and the stock market reached a new high in late February (up 80 percent since end-2002) before leveling off in line with recent regional and global trends. The positive trend in market sentiment was evident in the highly successful $1 billion sovereign bond issue in early March.[3] Domestic bond yields are also declining, although the yield curve remains relatively steep, reflecting lingering uncertainties over the economic outlook (Figure 4). Market sentiment weakened somewhat ahead of the elections, with the stock market falling briefly by almost 10 percent from its peak, but has recovered following the peaceful election outcome.

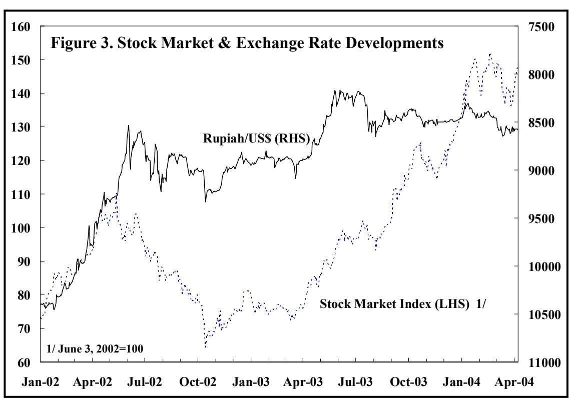


Figure 3. Stock Market & Exchange Rate Developments

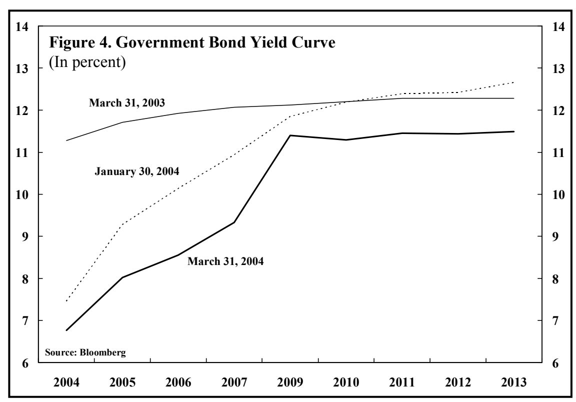


Figure 4. Government Bond Yield Curve
(In percent)

[3] Over $4 billion in bids were received for the 10-year issue (the first sovereign issue since 1996). The bonds yielded 6.85 percent, reflecting a spread of some 280 basis points over comparable US treasury bonds, below the yields achieved for some recent higher-rated sovereign issues. The issue included a collective action clause.

6. **Real GDP growth edged up to 4.1 percent in 2003, slightly above earlier projections** (Table 1, Figure 5, and Chart 3). The economy proved resilient to a number of shocks, including the regional impact of SARS early in the year, and the lingering effects of the Bali bombing in October 2002 (tourist arrivals were down 10 percent for 2003 as a whole). Economic activity in 2003 was supported by continued robust private consumption. Indicators of corporate sector health (for listed companies) have also improved in recent years, although indebtedness remains high (debt ratios as of 2002 were still above their pre-crisis levels).

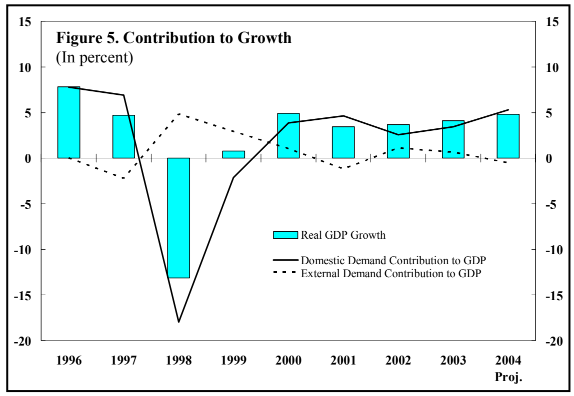


Figure 5. Contribution to Growth
(In percent)

7. **Inflation has remained subdued in recent months** (Figure 6 and Chart 4). After rising to 15 percent in early 2002, headline inflation fell steadily, to stand at 5.1 percent (y/y) in March 2004. While part of this reflects declines in raw food prices, core inflation has also fallen over this period, and now stands at 5¾ percent. The ongoing reduction in inflation has enabled Bank Indonesia (BI) to lower policy interest rates, with the one-month SBI rate declining to 7¼ percent by early April 2004 (a fall of 1,000 basis points over the past two years). While base money growth accelerated at the end of 2003 (exceeding the end-year projection) this mainly reflected larger-than-anticipated seasonal effects.

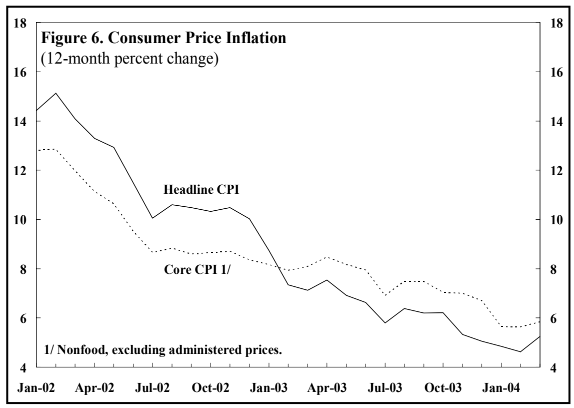


Figure 6. Consumer Price Inflation
(12-month percent change)

8. **The government's 2003 fiscal deficit target was exceeded by a small margin, but public debt ratios have continued to decline** (Table 2). The 2003 budget deficit outturn was 2.3 percent of GDP, somewhat above the 1.9 percent of GDP target in the revised budget. This outcome was largely due to higher than expected donor-financed development spending, although shortfalls in non-oil tax revenues also contributed. Nonetheless, public debt declined to below 70 percent of GDP at end-2003, from 80 percent the previous year.

9. **Sustained current account surpluses and improved capital flows have led to a reduction in external vulnerability** (Tables 3 and 4). The current account surplus reached $8 billion in 2003 (4 percent of GDP), well above earlier projections, helped in part by high oil prices. Private capital inflows have strengthened, driven by renewed portfolio inflows, and greater access to international capital markets among corporations and banks. Gross reserves increased by about $4 billion in both of 2002 and 2003, and now stand at around $37 billion, equivalent to 7½ months of imports and about 150 percent of short-term debt.

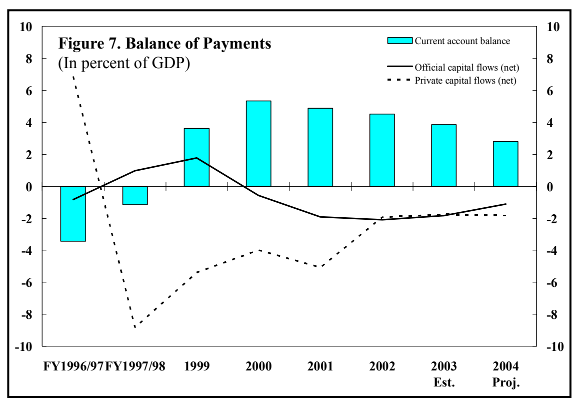
10. **The ongoing improvement in economic performance has been underpinned by steady policy implementation**. Performance against the EFF's targets for 2003 was good, with all four reviews completed on schedule and significant advances made in bank

divestment and fiscal reforms.[4] The government's economic strategy for the post-program period, as set out in the White Paper, has provided continuity in the reform process, with a number of notable advances achieved so far in 2004. The sale of bank Lippo has been concluded, a further minority stake in bank Mandiri has been divested, IBRA has completed operations, and long-delayed amendments to the BI Law have been adopted. More generally, policy implementation over the past couple of years has been largely in line with Fund recommendations, with differences mainly limited to the pace of legal and institutional reforms, and the strategy for privatizing and strengthening state banks.

11. **Nevertheless, Indonesia's growth performance remains below potential, and the economy has yet to share fully in Asia's recovery** (Box 2).[5] Per capita income remains below pre-crisis levels, and there has been only limited progress in reducing unemployment and poverty (Annex III and Box 3). While the social and political turmoil of the crisis period may have delayed the recovery, slow progress in addressing underlying weaknesses in the investment climate have also contributed. A particularly sharp fall-off in gross FDI inflows (to around 2 percent of GDP from 5 percent in the pre-crisis period) has been a factor for the relatively slow export growth, particularly in manufacturing sectors such as textiles, apparel, and footwear. While exports to China have grown rapidly (averaging 11 percent over the past two years), other countries have experienced even stronger growth.

Near-term Outlook

12. **Economic performance is projected to strengthen in 2004, provided that market confidence can be sustained through the election period**. Growth is forecast to pick up to 4.8 percent, sustained by robust consumption and a supportive external environment. With lower inflation expectations becoming more firmly entrenched, and in the absence of planned increases in administered prices, headline inflation would remain at around 5 percent in 2004 (implying a modest further decline in core inflation to 5¼ percent). On the external front, the trade surplus is expected to narrow slightly as imports rebound from compressed levels, but the current account would remain in substantial surplus at about 3 percent of GDP (Figure 7). The capital account deficit is envisaged to decline slightly, with modest improvements in both official and private flows. In the absence of exceptional financing from the Fund and Paris Club, gross reserves are projected to decline by about $1 billion during the year, in line with scheduled repayments to the Fund, but should remain

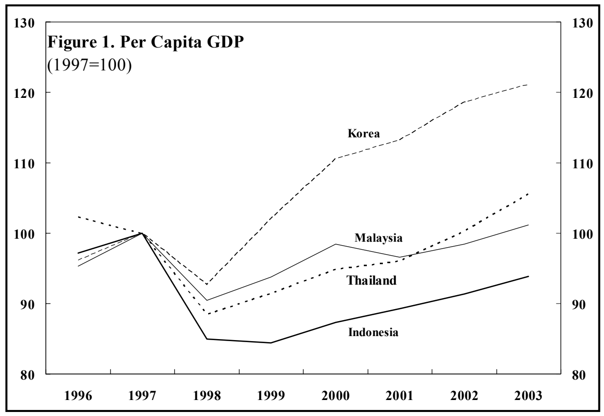


[4] Performance against the program's quantitative performance criteria and indicative targets (Table 5) and structural benchmarks (Table 6) was satisfactory.

[5] See Chapter I of the Selected Issues paper.

Box 2. Indonesia's Recovery

Indonesia suffered a larger initial fall in GDP during the 1997/98 crisis, and has had a slower recovery than other Asian crisis economies. The more severe downturn was in part the result of adverse political developments during the crisis which led to policy uncertainty and economic dislocation. Output was back to pre-crisis levels only in 2002, lagging other Asian crisis countries by about 1–2 years, and per capita incomes are still below pre-crisis levels (Figure 1). At an average of 3–4 percent, economic growth since the crisis has been significantly below the levels that are needed to make headway in reducing poverty and absorb new entrants into the labor market.



The relatively slow recovery has been characterized by weak investment and export performance compared to other Asian economies (Table 1). Growth in Indonesia has been narrowly based on private consumption. In contrast, export performance has been much weaker than in other Asian crisis economies, and investment has also lagged.

Table 1. Components of Real GDP in 2003
(Index; 1998=100)

	Indonesia	Korea	Malaysia	Thailand
GDP	118	136	127	126
Private consumption	119	135	131	127
Investment	103	134	118	123
Exports	92	174	135	147

Source: CEIC.

There is no single factor behind the weak investment and export performance. One important impediment to growth has been the weak investment climate due to shortcomings in taxation and regulation, labor relations, and the legal system. These weaknesses have also adversely affected export performance. A collapse in FDI to export sectors since the crisis and a deterioration in cost competitiveness over the last two years have also undermined export performance.

Many of the structural weaknesses that need to be addressed were present prior to the crisis, when growth performance was much stronger. In particular, weaknesses in governance and in the banking and legal systems were widespread prior to the crisis. The change in investor sentiment may be explained in part by heightened market scrutiny, as evidenced by sovereign ratings. These remain more depressed relative to their pre-crisis level than in other Asian crisis economies (Table 2). A number of questionable high profile legal decisions have also lowered Indonesia's image as an investment destination.

Table 2. S&P Sovereign Ratings

Country	Before Crisis	Current	Change (in notches)
Indonesia	BBB	B	-6
Korea	AA-	A-	-3
Malaysia	A+	A-	-2
Thailand	A	BBB	-3

Box 3. Poverty Developments[1]

The level of poverty has fallen sharply from its crisis levels (Table 1). The share of the population below the poverty line (currently about $1.55 per day) has fallen from 27 percent in 1999 to 16 percent in 2002. The reduction in expenditure poverty since the crisis appears to have benefited almost all regions, including strong recoveries for some regions in the East. Macroeconomic stabilization and readjustment of relative prices and the exchange rate after the crisis have been key factors in reducing expenditure poverty.

Nevertheless, poverty remains extensive and there is a large cluster of households just above the official poverty line. A large share of households remain just above the official poverty line: 7.4 percent of Indonesians fall under the dollar-a-day poverty line whereas 53.4 percent fall under the two dollars-a-day poverty line.

Table 1. Poverty headcount
(in percent of population)

	1996	1999	2002
National poverty line	15.7	27.1	16.0
International poverty lines			
1 dollar a day	7.8	12.0	7.4
2 dollars a day	50.5	65.1	53.4

Source: World Bank estimates

The national headcount index masks wide disparities in poverty incidence across the country. While the poverty rates are 15.7 percent and 4 percent on Java and Bali, the Eastern Islands lag, with poverty rates of 36.8 percent. Despite regional disparities, 78 percent of Indonesia's expenditure poor live in Java, Bali, and Sumatra. Addressing poverty in Indonesia will not only require efforts to tackle the issues affecting the poor in all regions.

High levels of unemployment are limiting progress in raising income levels. Open unemployment has risen from 4.7 percent 1997 to 5.8 percent in 2002, and the latest surveys suggest that almost 30 percent of the labor force is "under-employed" (i.e., work less than 35 hours per week). Employment growth remains below pre-crisis rates, making it difficult to absorb the approximate 2 million people entering the labor force each year. Improving the investment climate for growth and job creation, both in rural and urban areas, will be essential for poverty reduction.

Other dimensions of poverty also need to be tackled. Many Indonesians lack access to basic services, particularly water and sanitation. Inadequate service delivery affects the poor and is itself a cause of poverty and deprivation in Indonesia. These shortcomings are also reflected in poor outcomes against the MDG goals, especially in health. Women in particular suffer problems of access to quality services and bear the consequences: for example, Indonesia's maternal mortality rate is two times higher than the Philippines and five times higher than Vietnam. Directed efforts to improve the delivery of basic services will be critical to reduce multidimensional poverty in Indonesia.

The government continues to make progress toward completing its poverty reduction strategy. The lead agency charged with developing such a strategy aims at completing a draft by May 2004, in line with the schedule in the White Paper. It is expected that the government will work to refine and integrate the strategy into a new national five-year plan, to be completed in draft before the start of the new incoming government in October 2004. This plan is expected to be ratified by the new government early in its term.

[1] Prepared by World Bank staff.

comfortable relative to imports (6¾ months) and short-term debt (150 percent). Correspondingly, Indonesia's capacity to repay the Fund should remain adequate (Table 7).

13. **The primary vulnerability in the period ahead relates to the possibility of an erosion in market confidence related to the elections**. In particular, an escalation in political tensions or deterioration in policy implementation could lead to pressure on the exchange rate, interest rates, and reserves. The staff's preliminary assessment is that, although external financing requirements will increase sharply in 2004 in the absence of exceptional balance of payments support, financing risks should be manageable even in an adverse scenario (Text Table 1).[6] While net external financing needs would increase by about $2 billion in the adverse case, relative to the baseline, this could be fully met through a larger drawdown in reserves. On the domestic front, such a shock would have adverse implications for inflation and the budget.[7]

Text Table 1. External Financing Requirements
(in USD billions)

		2003	2004	
		Est.	Baseline	Adverse
Financing requirements		**5.1**	**11.1**	**12.1**
Current account deficit		-8.0	-6.7	-7.8
Debt amortization (net of rescheduling)		4.3	7.7	7.7
Other flows (net)		9.4	9.1	11.2
IMF repayments (net)		-0.6	1.0	1.0
Available Financing		**9.3**	**10.2**	**9.0**
Foreign direct investment		3.0	3.0	3.0
Loan disbursements		6.3	7.2	6.0
Use of Reserves		**-4.2**	**1.0**	**3.2**
Memorandum items:	2002			
Gross reserves (end of period)	32.0	36.2	35.2	33.0

Medium-term outlook

14. **The staff has updated its assessment of the medium-term outlook, under the assumption that strong efforts are made to improve the investment climate** (Annex IV). In such a scenario, GDP growth could reach 5–6 percent, in line with the government's medium-term objectives. This outturn would be predicated on a rise in the investment ratio by about 2½ percentage points of GDP, to about 22 percent of GDP by 2009, and a pick-up in annual export growth to around 5–6 percent. However, the achievement of this outlook depends on progress in addressing the factors underlying the recent poor performance of exports and investment.

15. **The staff has also considered a scenario where Indonesia is unable to make headway in addressing the constraints to export and investment performance**. In such a "muddle-through" scenario, growth would remain at around 3–4 percent. While public debt levels would still decline slowly, the economy would be relatively more vulnerable to setbacks and shifts in confidence. In addition, poverty levels and unemployment would remain high.

[6] The adverse scenario considers a temporary shock involving a 30 percent depreciation, a 250 basis point rise in domestic interest rates, and a slowdown in growth to 3 percent.

[7] Absent compensating measures, the budget deficit would increase by ½ percent of GDP, and the public debt-to-GDP ratio would rise by about 8 percentage points.

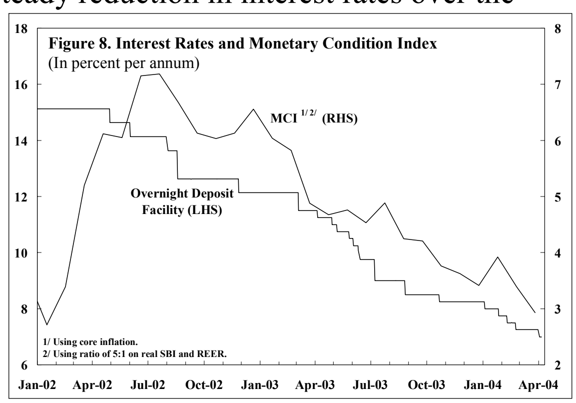
III. Policies for Stronger Growth

16. **The discussions focused on policy priorities needed to put Indonesia on a higher growth path**. In addition to maintaining macroeconomic stability and continuing financial sector reforms, the priority is to address weaknesses in the investment climate. With respect to the latter, the mission emphasized that efforts are needed to tackle shortcomings in taxation and regulation, enhance labor market flexibility, and address fundamental legal issues such as contract enforcement.[8] In light of the difficulties posed to the reform process by the electoral cycle, the discussions focused on specific steps which could realistically be taken in the near term to tackle the impediments to higher growth. The authorities agreed with these priorities, and noted that initiatives were underway to address them in the context of the government's White Paper. While they were pleased with policy implementation so far, looking ahead they shared the mission's assessment that it would be desirable to undertake a more visible and determined effort to strengthen the investment climate, and for the new government to carry these efforts forward.

A. Maintaining Macroeconomic and Financial Stability

Monetary and Exchange Rate Policy

17. **The stable rupiah and fall in inflation have allowed BI to adopt a more accommodative monetary stance** (Table 8). A steady reduction in interest rates over the past year has led to a gradual and beneficial easing of monetary conditions (Figure 8). Indeed, through much of the past year, a virtuous cycle had set in. Strengthened policies bolstered market sentiment and confidence in the rupiah, which enabled lower interest rates to support economic activity. This in turn further boosted confidence paving the way for additional interest rate reductions. Looking ahead, however, the mission noted that while there may still be scope for so me further modest reductions in interest rates (the spread with offshore rates still remained modestly higher than other countries in the region), this would depend on the inflation outlook remaining favorable. A cautious approach would be especially important given the potential for market sentiment to be fragile through the election period, and the possibility that interest rates abroad could soon begin to rise. The recent retrenchment in market sentiment, associated in part with domestic political developments, underscored the need for BI to maintain a steady hand over the coming period. The mission also expressed some concern that monetary policy in the recent past may have been driven by an excessive concern about BI's profit-and-loss position in the context of large outstanding stocks of central bank paper,



[8] These are the most frequently cited shortcomings by the business community, as reflected in survey results and in the mission's discussions with private sector representatives.

and encouraged the authorities to maintain their focus on inflation and exchange rate developments. The authorities largely agreed, and explained that they planned to maintain a cautious approach.

18. **It will be important to ensure a smooth transition from a base money framework to full-fledged inflation targeting**. For 2004, BI has indicated that it will seek to keep inflation in a range of 4½–6½ percent; to that end, it is monitoring a variety of indicators to guide the setting of interest rates. In early March, BI publicly announced its intention to gradually adopt an inflation-targeting framework. The mission recommended that to achieve a smooth transition, BI should still retain a base money framework with an announced target path consistent with the growth and inflation outlook. At the same time, the mission encouraged BI to accelerate the preparatory work for the adoption of inflation-targeting, drawing on the work of the overlapping MFD team.[9] The authorities agreed on the merits of retaining a base money framework in the lead-up to inflation targeting, although they preferred to maintain their current practice of using the path as an internal guide, while focusing the public's attention on interest rates as the operational tool. Going forward, the mission encouraged the government, in consultation with BI, to adopt an inflation target for 2005 and beyond that would be consistent with preserving the downward trend in inflationary expectations.

19. **The mission shared the authorities' view that the current level of the exchange rate was not seriously misaligned from a competitiveness point of view**. While the real effective exchange rate (relative CPI basis) has appreciated about 20 percent since early 2002, it remains some 25 percent below pre-crisis levels, broadly in line with regional currencies (Figure 9). The strengthening of the rupiah has facilitated the recent decline in inflation and interest rates, and eased the external debt burden of the corporate sector. However, recent increases in minimum wages have combined with a stronger nominal exchange rate to lead to a significant rise in relative unit labor costs, eroding the cost

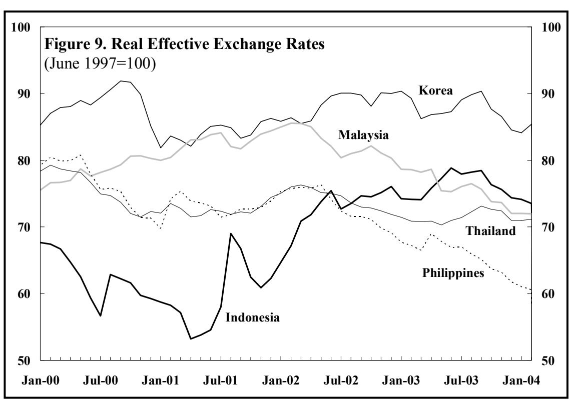


Figure 9. Real Effective Exchange Rates
(June 1997=100)

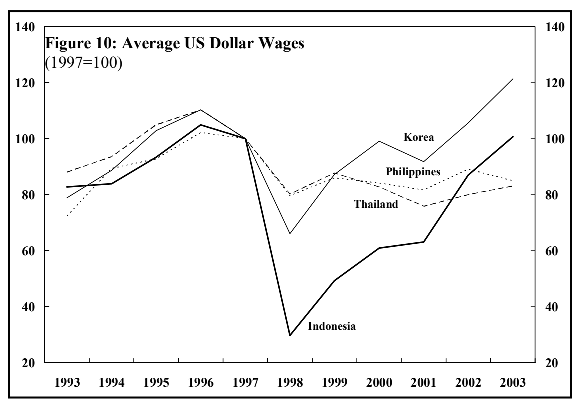


Figure 10: Average US Dollar Wages
(1997=100)

[9] The MFD team recommended that the BI Board establish a monetary policy committee to decide on the appropriate monetary stance in light of the inflation outlook. BI's assessment of the inflation outlook, in turn, would be clearly communicated to the public through the preparation of regular inflation reports. The team also proposed a number of parallel reforms to improve the efficiency and transparency of BI's monetary operations.

advantage Indonesia had gained during the post crisis period (Figure 10).[10] The erosion of labor cost competitiveness places a premium on addressing structural weaknesses in Indonesia's investment climate, which staff analysis suggests is a key factor for export underperformance.[11] That said, cost competitiveness is an emerging issue that should be monitored.

20. **There was also agreement on the merits of maintaining a floating exchange rate regime, which has served the economy well over the past few years**. A floating regime would continue to act as a shock absorber and reduce external vulnerability. Consistent with the approach of recent years, BI has recently intervened sporadically in the foreign exchange market to limit abrupt depreciation. The staff supports the approach of smoothing volatility, but has also encouraged BI to be prepared to intervene in both directions, and to take advantage of appreciation pressures to accumulate reserves.

Fiscal Policy

21. **The mission welcomed the government's commitment to further fiscal consolidation to reduce vulnerability arising from the high level of public debt**. The authorities explained that they remained fully committed to meeting their 2004 deficit target of 1.3 percent of GDP (entailing a decline of 0.6 percent of GDP decline in the non-oil primary deficit, to 2.2 percent of GDP). In light of the non-oil tax revenue shortfall in 2003, however, the mission noted that there was a risk that the deficit target could be exceeded, perhaps by ½ percent of GDP, unless the performance of non-oil revenues improved. The authorities responded that they intend to bolster revenue collection efforts, with a particular emphasis on non-oil tax revenues. There may also be scope for expenditure savings, including on the wage bill (0.2 percent of GDP) following a recent civil service census. The authorities agreed that close monitoring will be essential to ensure that budget execution evolves as expected.

22. **The mission also updated the 2004 budget financing outlook, in light of the large required step-up in market financing**. Recent developments have been favorable, with the government's sovereign issue attracting strong investor interest, and yields on domestic debt issues declining.[12] So far in 2004, the government has raised about Rp 12 trillion from

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[10] A shift toward organized labor and the new decentralized minimum wage setting process may have been contributing factors to the large wage increases in recent years. A new tripartite wage council (comprising government, labor, and employers) has been established to set national guidelines on wage policies.

[11] As described in Chapter VI of the Selected Issues paper, the comparatively weak export performance reflects lower global demand for Indonesia's mix of export products, a sharp decline in export-oriented FDI, and a number of obstacles related to tax, legal, and labor relations issues.

[12] At the most recent auction in mid-March, Rp 2 trillion in eight-year bonds were placed at a yield of 11.6 percent (down from 13 percent in December).

domestic and international bond issues, against a gross annual target of about Rp 30 trillion. The mission encouraged the authorities to take advantage of the current favorable market conditions by accelerating bond issuance to the extent possible. The authorities also plan to raise Rp 5 trillion in privatization proceeds (mainly from the sales of shares in state banks Mandiri and BNI).

23. **The mission reviewed the strategy for strengthening the budget position over the medium term** (Table 9). The authorities' objective is to achieve broad balance by 2006–07, consistent with lowering public debt to below 50 percent of GDP. The authorities agreed that the main priority is to enhance non-oil tax revenues to provide adequate resources for physical and social infrastructure, and to reduce reliance on oil revenues. In line with previous advice, the mission recommended that this be done through a broadening of the tax base and a further strengthening of tax administration. The mission also encouraged that care be taken to ensure that new policy initiatives do not weaken the budget situation. In particular, the mission emphasized that revenue losses associated with a proposed plan to simplify personal and corporate income taxes (estimated at around ½ percent of GDP) should be offset by measures to expand the tax base (e.g., by scaling back exemptions under the VAT), and that measures should be taken to ensure that a social security bill now in Parliament does not create unfunded mandates.[13] Going forward, the mission recommended that fiscal reforms should focus on addressing identified weaknesses in tax collections through enhanced taxpayer registration, improved audit procedures, and tax compliance initiatives. The staff emphasized that it would also be important to press ahead with reforms to modernize tax and customs administration (as discussed below, this has become a major issue for investors). The authorities largely agreed with these priorities, although they did not presently have a strategy to ensure that the tax policy proposals were implemented in a revenue-neutral manner.

24. **Another key element of the fiscal reform strategy is to strengthen expenditure management and the decentralization framework**. Reforms in these areas would improve control over the public finances and limit risks to fiscal sustainability:

- **Expenditure management**. The ongoing reorganization of the Ministry of Finance and the establishment of a well-functioning treasury system are key elements of the plan to improve budget preparation and execution.[14] The mission stressed that it will also be important to reduce poorly targeted subsidies by reintroducing the automatic fuel price mechanism (a measure that had originally been planned for early 2003, but which was rolled back in response to popular protest). The authorities explained that they planned to do so once currently high oil prices return to more normal levels, most likely in 2005 at the earliest. In the meantime, the mission encouraged the authorities to clarify the timetable and accelerate technical preparations for the reintroduction of the mechanism.

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[13] The bill proposes a gradual expansion of health care, work accident insurance and pension coverage.

[14] The Fund and World Bank are providing technical assistance to support these efforts.

- **Decentralization framework**. The subnational government budgets have been in surplus, and the decentralization process that was started in 2001 has not undermined fiscal stability. However, a mismatch between expenditure functions and revenue sources assigned to subnational governments and lack of clarity in expenditure assignments pose a risk to the implementation of fiscal policy and public service delivery. The authorities explained that amendments to the decentralization laws that they have presented to Parliament should reduce the scope for mismatches of revenue and expenditure assignments. They have also made progress to improve subnational budget reporting, although further work is still needed to strengthen regions' capacity to produce timely reports. There is also a need to develop a robust framework for borrowing by subnational governments, to replace the temporary blanket ban.

Financial Sector Reform

25. **While considerable progress has been made in restoring the banking system to health, the process remains incomplete particularly among the state banks**.[15] All but one of the banks taken over during the crisis has been returned to private ownership, and initial stakes in state banks have been divested. However, while overall bank financial indicators have improved steadily, the state banks are in a significantly weaker financial condition than private banks (Text Table 2). In addition, accountability at the state banks remains poor, as highlighted by the discovery of a large-scale fraud at bank BNI in late 2003. A particular concern is state banks' financial performance and some lingering tendencies to pursue aggressive lending strategies.

Text Table 2. Banking Indicators, September 2003

	Private Banks	State Banks
Capital adequacy ratio	24.9	21.4
Equity/assets	10.1	7.5
Core earnings/average assets	2.5	2.3
NPLs/total loans	5.6	6.2
Compromised assets/total loans 1/	11.2	27.7
Compromised assets/Tier 1 capital	17.2	114.7
Loan-loss reserves/compromised assets	69.2	32.2
Liquid assets/total assets	28.0	12.9
Memorandum item:		
Share of banking system assets	53.6	46.4

1/ Compromised assets includes NPLs, restructured loans, and foreclosed real estate and equities.

26. **With the authorities sharing the mission's concern about the state banks, the discussions focused on near-term measures to address the problems**. The mission encouraged continued close oversight of the state banks, and urged BI and the government to be prepared to take swift action if necessary, as they had in dealing with the fraud at BNI (including wholesale changes to the bank's boards of directors and commissioners). With respect to bank Mandiri, the authorities agreed that the bank's 2004 business plan should incorporate a relatively restrained pace of credit expansion, and were hopeful that a BI-endorsed business plan would be finalized shortly. In view of recent statements by various BI and government officials, the mission also urged BI to refrain from using moral suasion to encourage banks to accelerate lending, as this could ultimately undermine the health of the banking system.

[15] See Chapter II of the Selected Issues paper.

27. **The mission also encouraged the authorities to press ahead with plans to increase private sector participation in the state bank sector**. On top of the recent divestment of a 10 percent stake in Mandiri, the government noted that it was also planning to divest up to 30 percent of bank BNI in the middle of the year. The mission argued that it would be desirable to adopt a more fundamental reorientation toward private management to ensure efficiency and improve governance. In particular, the mission encouraged the authorities to consider the sale of strategic stakes or private management contracts in a competitive and transparent process.

28. **The mission congratulated the authorities on the successful closure of IBRA at end-February**. Over its five-year mandate, IBRA had made significant progress toward meeting its primary objectives of securing recoveries from bank assets taken over during the crisis and returning the banks it took over to private ownership.[16] The mission reviewed the plans for dealing with remaining unsold assets.[17] The bulk of these will be handled by a new public sector asset management company with a mandate to dispose of all assets within five years. In addition, a new high-level committee, chaired by the Minister of Finance, has been charged with resolving problematic assets (e.g., those with outstanding legal issues). With respect to the agreements with former bank owners, the mission noted that most had been brought to closure by the end of IBRA's mandate.[18] The authorities were hopeful that the remaining cases would be concluded shortly.

29. **Progress continues to be made in developing a robust financial sector safety net**. The authorities' strategic goal is to have the key elements in place by the end of the year, to allow the gradual phase-out of the blanket guarantee to commence. Toward this end, the authorities noted that legislation establishing a deposit insurance agency with broad bank resolution powers was expected to be approved by Parliament during its next session (some of these powers had lapsed with the closure of IBRA; in the interim, troubled banks are to be handled under existing law, which requires that they be liquidated). The BI Law has also been amended to provide the central bank with an appropriate lender of last resort facility. The specific modalities for dealing with banks encountering difficulties (in both systemic and nonsystemic cases) have been elaborated in a MOU between BI and the government. These understandings are to be codified in a financial safety net law due to be completed by the end of the year. Improving the accountability of the central bank is also a key element of the

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[16] See Chapter III of the Selected Issues paper.

[17] As of end-February, assets with a face value of about Rp 270 trillion, including Rp 166 trillion in litigation, remained unsold. Recoveries on these assets—which have been offered in earlier sales processes—are likely to be very low.

[18] Of the 30 settlements with owners of banks closed in 1999, 16 are now complete or almost complete, 8 have been forwarded to legal authorities for enforcement, and the remaining 6 are expected to be concluded shortly. Five of the nine agreements with owners of banks closed in 1997 and 1998—which in some cases involved personal guarantees—have now been settled, with an additional agreement nearing conclusion.

financial sector safety net. In this regard, the mission encouraged the authorities to establish the supervisory body for BI, as set out in the recent amendments to the BI Law, as soon as possible.

B. Improving the Investment Climate

30. **The authorities agreed that achieving higher economic growth will require a concerted effort to improve Indonesia's investment climate**. They emphasized that this has been a central theme of their economic strategy as laid out in the White Paper. Discussions with a wide range of interlocutors suggested that in addition to lingering concerns about the re-emergence of macroeconomic instability, investors are most affected by uncertainties in the investment framework arising from poor tax administration, burdensome regulations, labor market rigidities, and a weak and inefficient legal system (Box 4).[19]

Weaknesses in taxation and regulation

31. **Tax administration and enforcement remains a significant source of uncertainty to business**. The main weaknesses relate to arbitrary tax assessments and inefficiencies in the refund systems for the VAT and income taxes. The mission noted that pending amendments to the legal framework for tax administration could be used to help address these issues, and recommended the following priority areas for reform, drawing on ongoing FAD technical assistance:

- **Tax assessments**. The key priority will be to reduce the discretion of tax officials in the assessment of tax returns. This will require further reform of internal audit and assessment procedures, as well as steps to strengthen the tax court (to provide taxpayers with recourse to an external review of their tax assessments). Additional steps are also needed to strengthen the governance framework, notably with regard to investigations of misconduct of tax officials.

- **Refund system**. The key step is the elimination of the legal requirement to audit all refund claims. The recent decree to simplify refund procedures for gold card taxpayers is a helpful step, but a more fundamental shift towards ex-post auditing of refunds is needed to simplify the system.

[19] See Chapter V of Selected Issues paper.

Box 4. Investment Climate

Indonesia's weak investment climate remains a significant obstacle to reviving investment and growth. Indonesia's low score in the 2003 Global Competitiveness Report by the International Institute for Management Development provides the broad context (Table 1). Indonesia is ranked as significantly less competitive than its ASEAN neighbors and major regional competitors. Other surveys also suggest that Indonesia's investment climate is seen to be very weak. The recent World Investment Report 2003 by UNCTAD ranks Indonesia at number 138 out of 140 countries surveyed for Foreign Direct Investment performance. Surveys of business risk undertaken by the International Country Risk Group have consistently given Indonesia one of the lowest ratings in the region. In general, doing business in Indonesia is more costly, time consuming and complicated than in neighboring countries. For example, the World Bank's Doing Business Database indicates that it takes almost 170 days on average to start a business in Indonesia, compared with 66 days in other Asian economies.

Table 1. Global Competitiveness Index

	Overall comp. index	
	Score*	Rank
Indonesia	3.42	72
Philippines	3.58	66
Thailand	4.63	32
Malaysia	4.83	29
Singapore	5.54	6
India	3.90	54
People's Republic of China	4.19	44
Korea	5.07	18

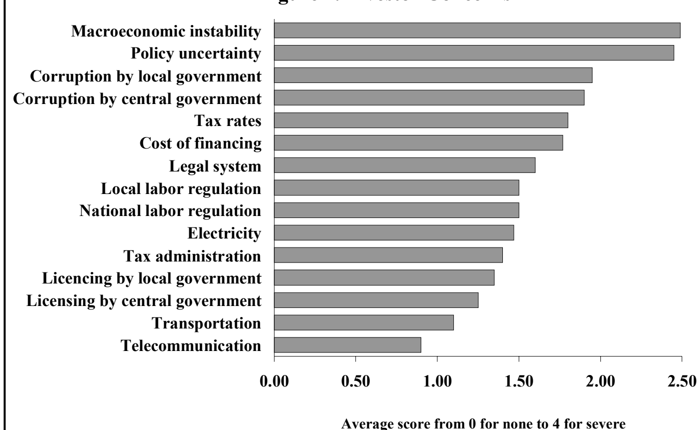
*Range is 2.30 (Haiti) to 6.01 (Finland).

Recent surveys highlight the following key concerns of firms in Indonesia (Figure 1):

- **Macroeconomic stability—**the impact of large swings in exchange rates, interest rates, and inflation on the corporate sector remains fresh in the minds of investors. Thus extending the recent macroeconomic gains is vital.

- **Labor market—**increases in formal sector labor costs and minimum wages that have far outpaced inflation in past 5 years; severance costs which are high by regional standards; inflexible labor markets, given restrictions on hiring and firing; and the policy uncertainty created during the long period of formulation and implementation of the new labor laws, all act to deter labor-intensive investment.

Figure 1. Investor Concerns



Source: Preliminary results from World Bank-ADB Private Investment Climate Survey (ongoing).

- **Corruption—**illegal fees are a major problem of doing business in Indonesia, and decentralization has exacerbated the problem (see below). Moreover, as the major recipients of illegal fees are the courts and police, businesses are unable to avoid these fees. Extortion by customs and tax officials is increasingly cited as a problem.

- **Institutional, social and physical infrastructure—**the legal system is perceived to be corrupt, inefficient, and an impediment to orderly workouts (through bankruptcy for example); decentralization has increased uncertainty (through conflicting laws and regulations and proliferation of taxes and charges), and created new rent-seeking opportunities at different levels of government; the low labor value added in manufacturing reflects the quality of education and training; and insufficient investment in physical infrastructure is leading to bottlenecks (particularly in the power sector).

- **Tax administration**. The mission noted that the introduction of large taxpayer offices had resulted in a significant improvement in the services provided to these taxpayers. The mission encouraged the authorities to expand the number of large taxpayers covered by these offices and to extend the approach to other taxpayers through the development of similar dedicated tax offices for medium-sized taxpayers.

32. **The authorities largely agreed with the priorities outlined above**. They noted that they had already seen benefits from their steps to improve tax administration, and planned to continue with such efforts in the period ahead.

33. **In the same vein, the mission encouraged an acceleration of efforts to improve customs procedures**. The authorities indicated that a major reorganization of the unit responsible for managing the customs modernization strategy had slowed progress in recent months, but that they were committed to pushing ahead with the reform process. The main priority would be to continue the implementation of measures to facilitate trade through streamlining clearance procedures for importers. These reforms would be complemented by reforms to improve valuation control and combat smuggling.

34. **The mission also encouraged the authorities to address the proliferation of local tax regulations**. The authorities informed the mission that they had recently taken steps to establish greater central control over local regulations (all regulations now need to be pre-approved by the central government). The mission welcomed this step, but noted that further action to rationalize the range of taxes that regions could levy would be beneficial. Regions could be compensated for this restriction on their powers by granting them greater autonomy over the main parameters (rate and base) of key local taxes such as the property tax.

Labor market uncertainties

35. **The lack of a clear and competitive framework for labor relations is a major impediment to investment in Indonesia**. The importance of labor policy to the investment climate has risen sharply in recent years, following a shift in government policy toward organized labor.[20] Forging a consensus on the key elements of a modern industrial relations framework—one that provides an appropriate balance between protecting worker rights while maintaining a competitive labor market—has been relatively difficult, and complementary legal reforms in this area have consequently proceeded slowly.

36. **The recently enacted manpower and industrial dispute laws provide a basic framework, but important details have been left to the implementing regulations**. Although some implementing regulations have been finalized in recent months, progress has been slow, and a number of contentious issues remain unresolved. Of particular concern to investors is that the new legislation contains provisions regarding the use of short-term

[20] The process started in 1998, with the ratification of the ILO conventions on worker rights, and was followed in 2000 by a major reform of legislation governing rights of association and union activity.

contracts, outsourcing, and overtime that may tend to limit firms' flexibility in making employment and production decisions. Much will ultimately depend on how the law is interpreted in the regulations. The mission urged the authorities, employers, and labor groups to resolve these issues in a timely manner, and to ensure that Indonesia's labor market framework does not put Indonesia at a competitive disadvantage. This would be to key to attracting investment in labor-intensive industries needed to make progress in reducing unemployment.

Weak and inefficient legal system

37. **Further progress in legal and judicial reforms is needed to strengthen property rights and contract enforcement**. Improvements in these areas are essential to developing normal commercial and banking operations. While steps have been taken in recent years to strengthen the court system, uncertainty about the rule of commercial law remains a serious problem.[21] Accordingly, the mission encouraged the authorities to bolster ongoing efforts to strengthen the judiciary, particularly in the following key areas:

- **Improving accountability and governance**. The planned establishment of an independent Judicial Commission, responsible for appointing judges and maintaining their professional discipline, will be key to ensuring the accountability and governance of the judiciary once it becomes fully independent under the "one-roof" system.[22] A draft bill establishing the commission has been prepared, and is awaiting the government's appointment of a team to discuss it with Parliament.

- **Placing court finances on a sounder footing**. A needs assessment of the Commercial Court is expected to be completed in early July, which will provide recommendations on the court's budget and personnel requirements. The mission emphasized that it would be important that the findings be incorporated into the medium-term expenditure framework being prepared for the 2005 budget.

- **Strengthening the administration of the judiciary**. The Fund, through technical assistance from LEG, has been closely involved in strengthening the Commercial Court, by building up its administrative capacity and improving its transparency and accountability. Similar assistance has been provided to the Supreme Court, where the emphasis has been on developing plans to strengthen personnel management, financial transparency and accountability, and the professional development of

[21] See Chapter IV of the Selected Issues paper. Amendments to the bankruptcy law remain in Parliament, due to the legislative backlog.

[22] In early 2004 Parliament passed the final piece of legislation transferring responsibility for administering all aspects of the court system from the Ministry of Justice to the Supreme Court. The process, which has been implemented in phases since 1999, is expected to be completed by the end of this year.

judges. The mission emphasized the importance of continuing the work to build-up the capacity of the judiciary.

38. **The authorities agreed that combating corruption should remain an important element of the strategy to reduce the cost of doing business**. The mission noted that the Anti-Corruption Commission, which is part of this effort, is not yet fully operational. While the commissioners have been appointed, the Secretary-General is yet to take office, and a number of operational issues concerning the autonomy and prosecutorial authority of the commission have to be resolved. In addition to addressing these issues, the mission also urged the authorities to expedite the establishment of the Anti-Corruption Court, which is integral to the effective functioning of the Commission.

Trade policy

39. **The mission also emphasized that maintaining a liberal trade regime would be an important element of the strategy to foster medium-term growth**. Indonesia's trade regime is relatively open: at 7 percent, its average tariff rate is among the lowest in the region and it has a relatively low (four out of ten) rating on the Fund's trade restrictiveness scale. Nevertheless, the mission noted that several restrictive measures had been implemented in recent years, including the imposition of restrictions on the imports of certain sugar, textile, and steel products and, more recently, a temporary ban on the import of rice. The authorities indicated that these restrictions were temporary measures to safeguard domestic producers (the steel import restriction was removed in February 2004) and that they intended to allow any remaining measures to expire as scheduled.[23]

C. Other Issues

40. **The mission reviewed progress in strengthening Indonesia's anti-money laundering (AML) framework**. The Financial Intelligence Unit (PPATK) was officially established in October 2003. Outstanding issues related to the financing of the PPATK and the procedures for protecting witnesses have now been resolved. An implementation plan for further reforms was presented to the Financial Action Task Force on Money Laundering (FATF) in February. The FATF has indicated that progress against the plan will be needed to allow Indonesia to be removed from the list of non-complying countries.

41. **While Indonesia subscribes to the SDDS, a number of data weaknesses remain**. Fiscal data is of uneven quality with significant statistical discrepancies in the central government accounts in some years. The presence of off-budgetary operations and inadequate coverage and timely recording of general government statistics is also of concern, especially in the wake of the decentralization effort. New fiscal data recording and reporting mechanisms are being developed to address these weaknesses. Efforts are also needed to strengthen key components of the balance of payments, including service transactions in the current account and the recording of foreign direct investment and corporate sector debt flows in the capital account.

[23] The ban on rice imports is due to expire in June 2004.

42. **The mission explored the authorities' interest in undertaking fiscal and statistics ROSCs**. The authorities were of the view that there would be merits in undertaking a fiscal ROSC, but indicated that a final decision would need to be taken by the new government after it took office in October. Similar interest was expressed in a statistical ROSC, although it was noted that any commitment in this area would need to secure the agreement of a number of agencies.

43. **The authorities agreed that post-program monitoring provided a useful vehicle for maintaining a close dialogue with the Fund**. They looked forward to continuing this dialogue in the period ahead and supported the staff's proposal that the next PPM consultation take place toward the end of the year, after the presidential election. The staff will also continue to coordinate closely with the World Bank and the Asian Development Bank during this period (Annexes V and VI).

IV. Staff Appraisal

44. **Sound macroeconomic management and progress in key structural reforms have resulted in a steady improvement in economic performance**. Over the past couple of years, real GDP has surpassed its pre-crisis level, the exchange rate has stabilized, inflation has fallen steadily, and external viability has been restored. Commendably, under the framework of the government's White Paper, the authorities have succeeded in maintaining market confidence since the expiration of the Fund-supported program at end-2003. Indonesia's recent return to international capital markets has been marked by the successful sovereign bond issue, which is further testimony to the authorities' success in policy implementation.

45. **While much has been achieved, Indonesia's economic performance has lagged behind its regional peers, and the economy is yet to share fully in Asia's recovery**. Investment remains weak, and export growth has been particularly disappointing when set against the recent experience of other Asian economies. The main priority for economic policies is to put Indonesia on a higher growth path. Appropriately, the government's strategy is to create a conducive business climate through good policies and institutions, in addition to maintaining macroeconomic stability and continuing the restructuring of the financial sector. In the staff's view, key areas that need to be addressed include weaknesses in taxation and regulation, labor market rigidities, and a weak and inefficient legal system.

46. **The near-term economic outlook is favorable, provided that the authorities can continue to maintain market confidence through the forthcoming election period**. Real GDP growth is likely to pick up further in 2004 on the basis of a favorable global environment and continued strength of private consumption, and the staff projects inflation to remain subdued. The current account is projected to remain in substantial surplus, and reserve coverage should continue to be comfortable.

The staff welcomes the government's commitment to achieve its 2004 budget deficit target. While there was a modest overrun in the 2003 deficit outturn, this mainly reflected larger than expected donor-financed development spending, although shortfalls in non-oil tax revenues also contributed. In light of the continued shortfalls in non-oil tax revenues, the staff urges the authorities to monitor budget developments closely, and welcomes the authorities' intention to intensify revenue collection efforts.

48. **Further efforts will be needed to strengthen the budget position over the medium term in order to reduce public debt**. The main priority is to enhance non-oil tax revenues through broadening the tax base and strengthening tax administration, in order to provide adequate resources for spending on physical and social infrastructure, and to reduce reliance on declining oil revenues. In this context, the staff encourages the authorities to ensure that the tax policy reforms under consideration are revenue neutral. In particular, the staff encourages the authorities to offset any revenue losses from income tax rate reductions with measures to broaden the tax base. Efforts should also be made to improve the efficiency of spending, including by eliminating poorly targeted subsidies over time, and to ensure that any revisions to the decentralization framework do not weaken the central government's fiscal position.

49. **Progress in reducing inflation has enabled Bank Indonesia to adopt a more accommodative monetary stance**. Interest rates have been reduced substantially over the past year without undermining the gains in price and exchange rate stability. Looking ahead, it will be important to maintain a cautious approach given the potential for market sentiment to be fragile during the election period, and the possibility that interest rates abroad may begin to rise. The staff supports the authorities' intention to adopt an inflation targeting framework. To provide a solid anchor for policy during the transition, the staff encourages BI to maintain a base money framework, with an announced target path consistent with the growth and inflation outlook.

50. **Returning Indonesia to a high growth path also requires further progress in financial sector reform**. The authorities are to be congratulated on the successful closure of IBRA, which serves as an important signal of Indonesia's emergence from the financial crisis. The staff is also encouraged by progress being made to develop a robust financial safety net, with the completion of the MOU between BI and the government on bank resolution and lender of last resort procedures now complete, and the safety net legislation expected to be in place by end-year. Early passage of deposit insurance legislation will also be important, to enable a phased removal of the blanket guarantee on bank liabilities. Another key element of the financial safety net is to improve the accountability of the central bank. The staff encourages the authorities to establish the planned supervisory body for BI, as set out in recent amendments to the BI Law.

47. **The state bank sector remains a source of fragility in the financial system, given its large size and weak asset quality**. The staff encourages the authorities to continue their close oversight of the state banks to ensure that their lending policies are consistent with sound banking practice and to strengthen their financial condition. The staff also encourages the authorities to refrain from exerting moral suasion on banks to encourage increased lending and lower interest spreads, as it could ultimately undermine the health of the banking system. Going forward, the staff encourages the authorities to increase private sector participation in the state banks to improve efficiency and governance.

48. **The authorities' structural reform strategy appropriately focuses on strengthening the investment climate and bolstering competitiveness and exports**. In the

area of tax administration, the staff encourages the authorities to address weaknesses arising from arbitrary tax assessments, burdensome customs procedures, and inefficiencies in the refund systems for the VAT and income taxes. The pending tax legislation could be used to help address these issues. Action is also needed to address the proliferation of local tax regulations by rationalizing the range of taxes that regions can levy.

49. **The lack of a clear and competitive framework for labor relations remains a major impediment to investment**. In this regard, the staff urges the authorities to finalize the implementing regulations associated with the manpower and industrial disputes legislation that was passed last year, in a manner that protects worker rights while maintaining labor market flexibility in line with regional competitors. In addition, the staff urges the authorities to ensure that minimum wage increases are contained in order to retain competitiveness. This is crucial to attracting investment in labor-intensive industries, which is needed to make progress in reducing unemployment.

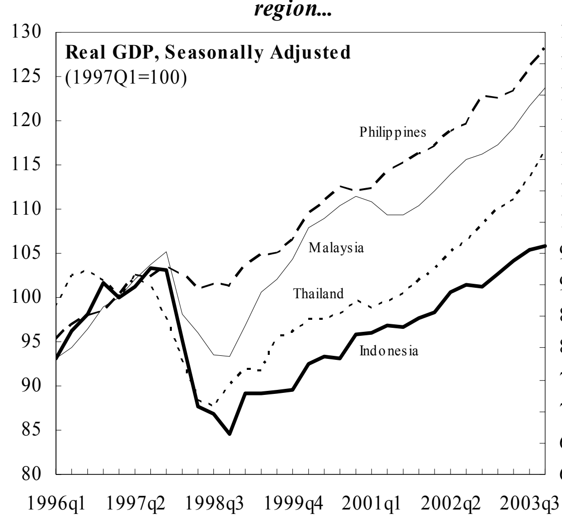
50. **Progress in legal and judicial reforms is needed to enhance certainty with regard to property rights and contract enforcement**. While steps have been taken in recent years to strengthen the court system, much still needs to be done to improve the implementation of commercial law. In this regard, the authorities are encouraged to foster ongoing efforts to strengthen the administrative capacity of the judiciary and enhance its accountability and governance including through establishing the planned Judicial Commission. The staff also encourages the authorities to continue with ongoing efforts to combat corruption and promote good governance, including by completing the steps required to make the Anti-Corruption Commission fully operational, and expediting the establishment of the Anti-Corruption Court.

51. **The maintenance of a liberal trade regime would enhance Indonesia's medium-term growth potential**. The staff welcomes the authorities' commitment to further multilateral trade liberalization under the Doha round, and the overall openness of Indonesia's trade regime. The authorities' intention to allow temporary measures imposed over the past couple of years to expire as scheduled is also welcome, and the staff urges the authorities to refrain from implementing new restrictive measures.

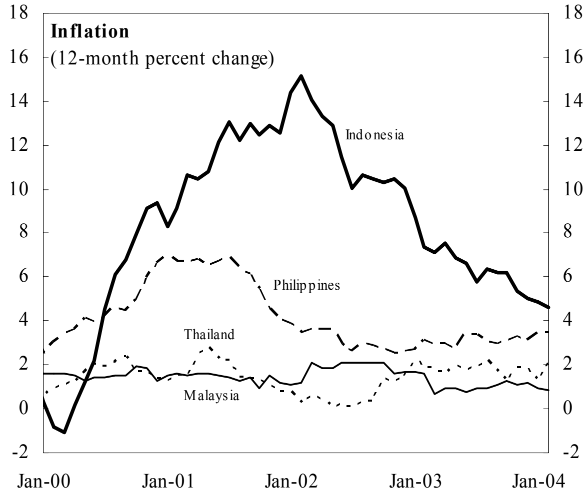
52. **It is recommended that the next Article IV consultation with Indonesia be held on the standard 12-month cycle**.

Chart 1. Regional Comparisons

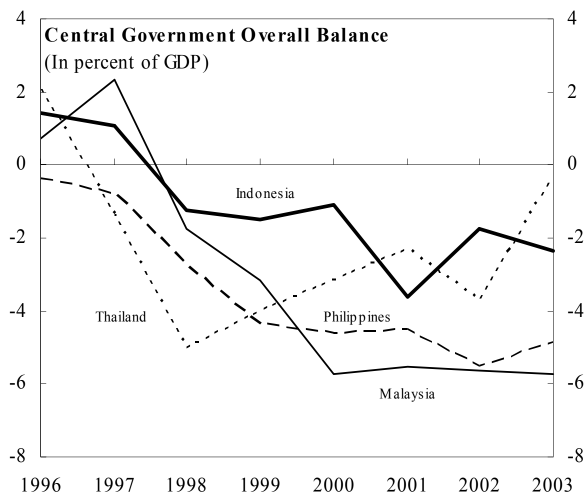
Economic growth in Indonesia has lagged others in the region...



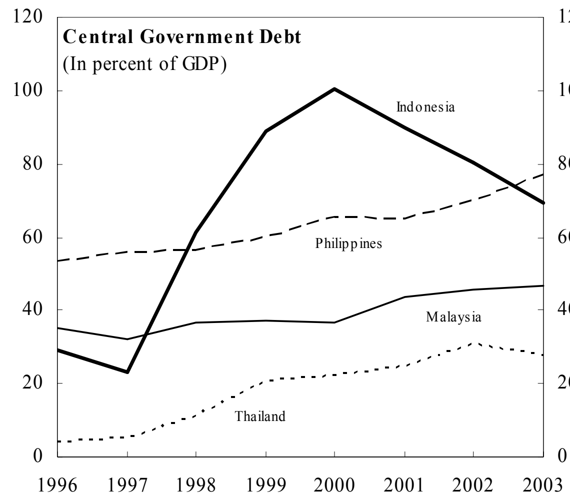
... and while inflation has declined, it remains relatively high.



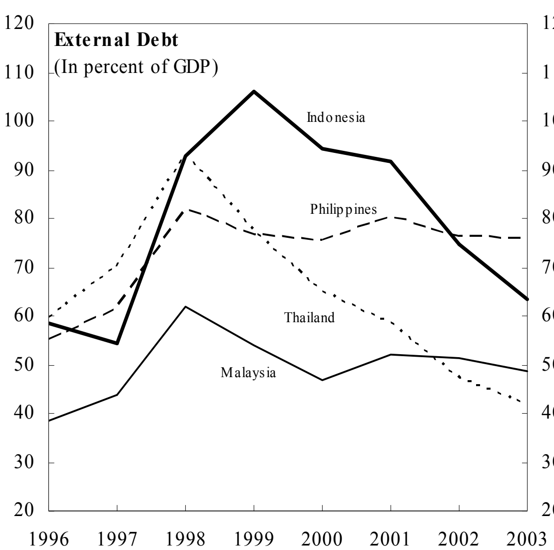
Indonesia's budget deficit is low by regional standards...



...but public debt remains high...



... as does external debt.



Export performance has been weak by regional standards.

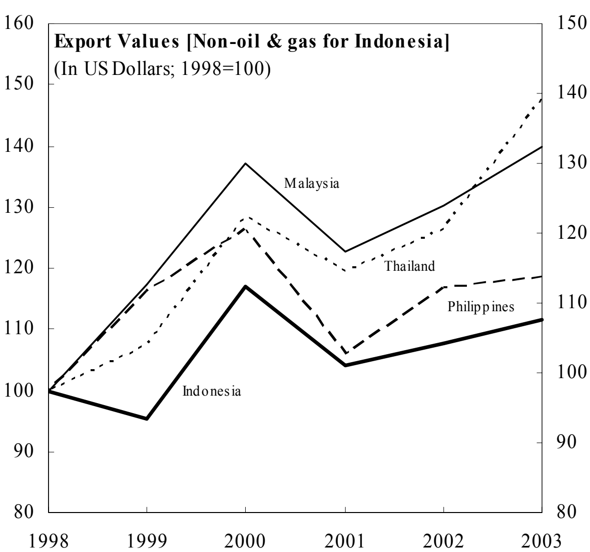
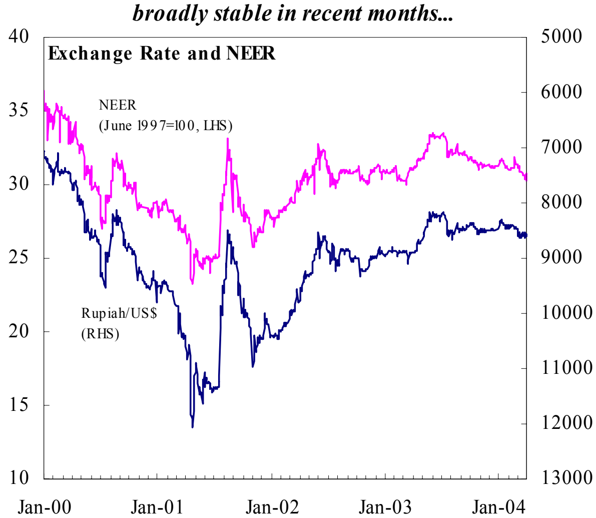
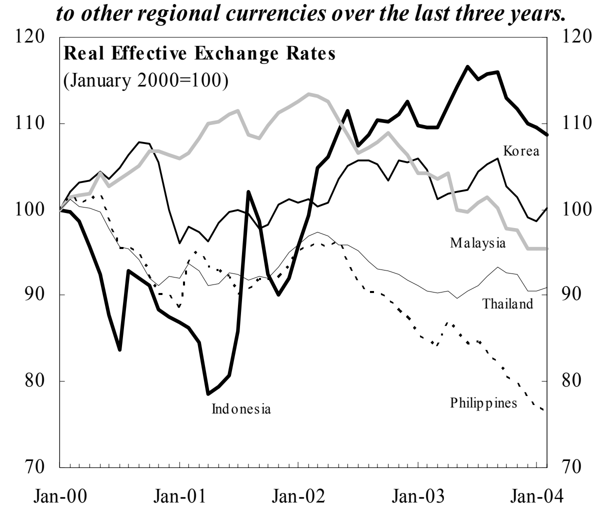


Chart 2. Market Sentiment and Financial Indicators

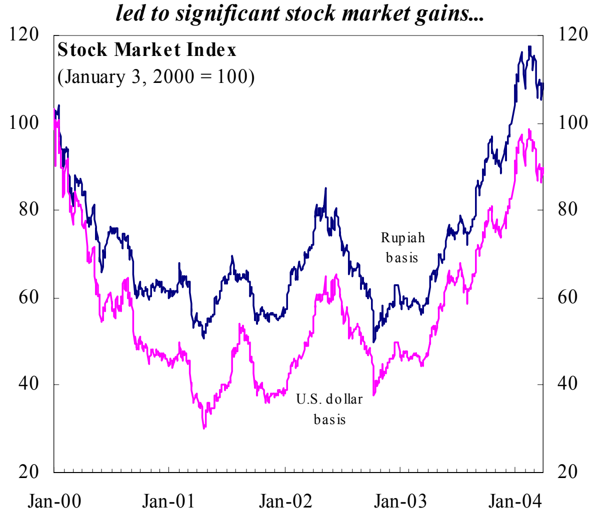
The exchange rate has remained broadly stable in recent months...



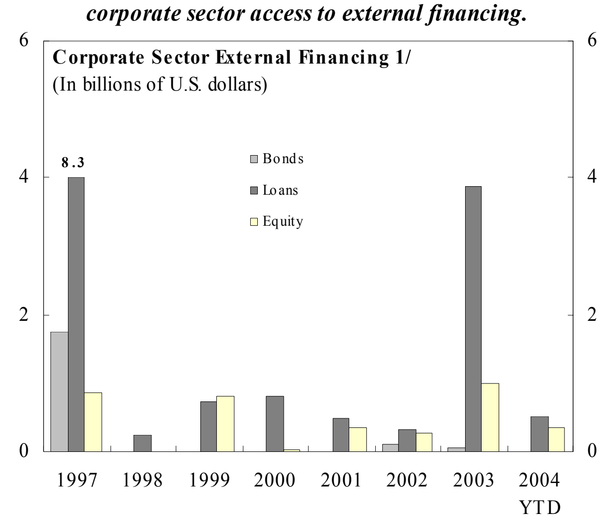
...following a significant appreciation relative to other regional currencies over the last three years.



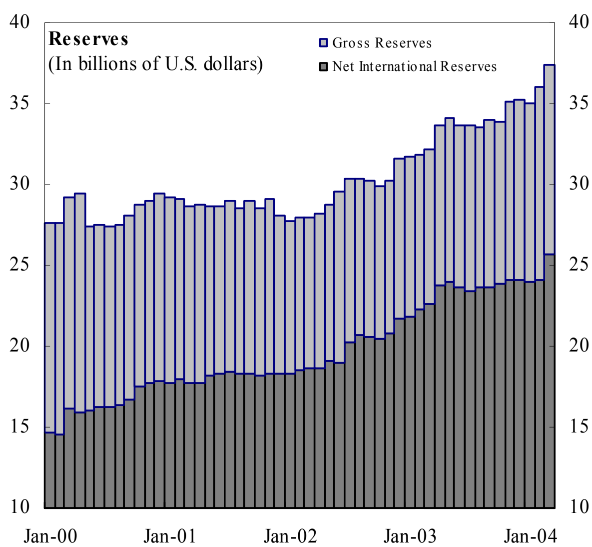
Robust market sentiment has led to significant stock market gains...



...and has facilitated a sharp rise in corporate sector access to external financing.



External reserves remain comfortable...



...and external debt continues to decline.

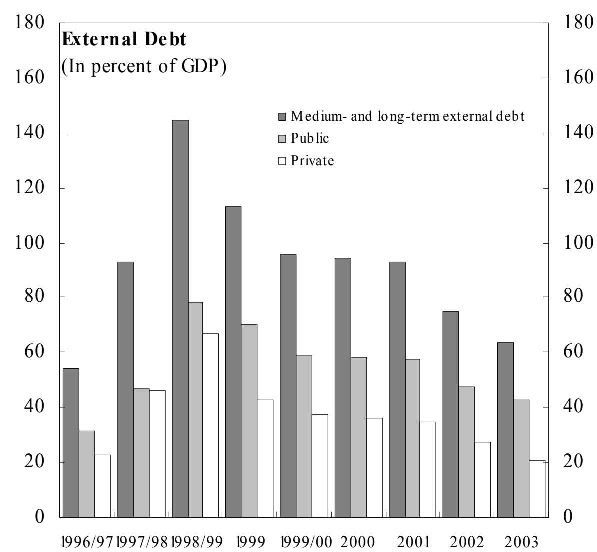
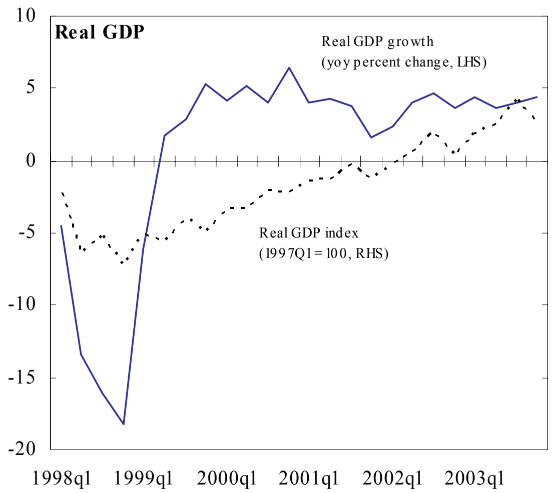
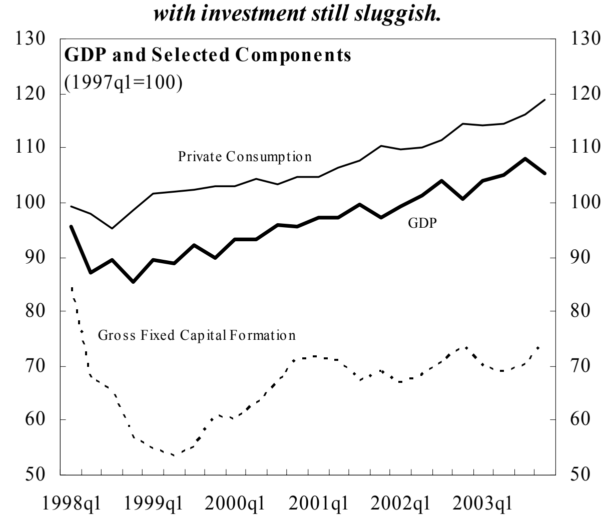


Chart 3. Recent Macroeconomic Developments

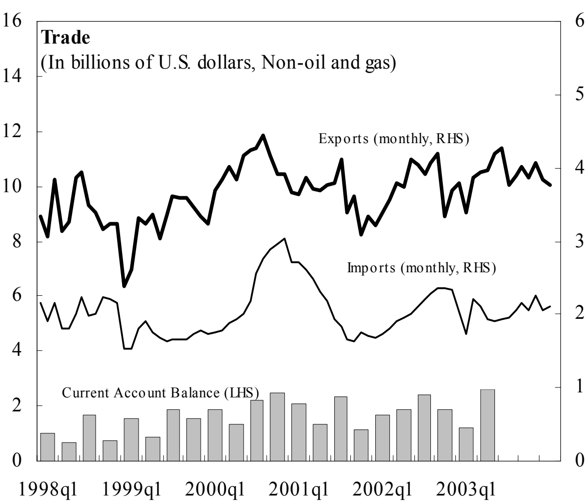
GDP growth has picked up slightly...



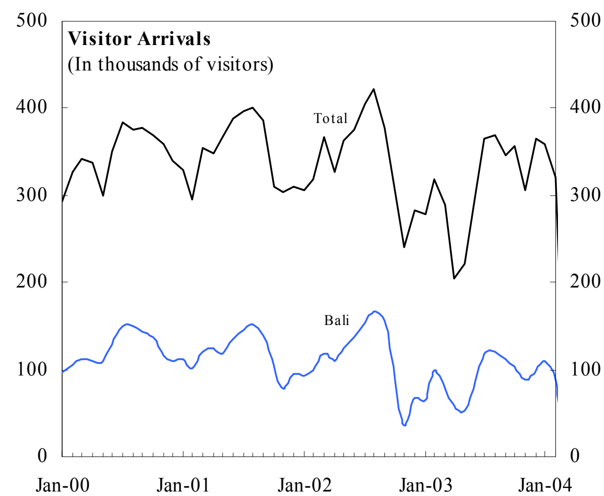
...on the strength of private consumption, with investment still sluggish.



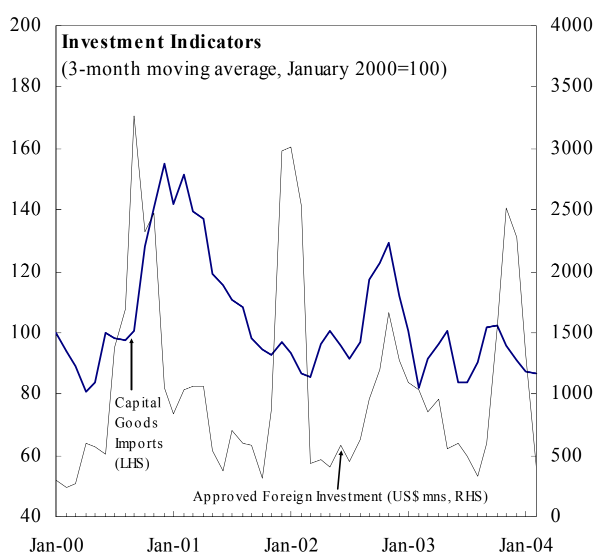
Export performance has been weaker than expected...



...although tourist arrivals have been recovering.



While investment indicators remain weak...



...the outlook for growth remains generally positive.

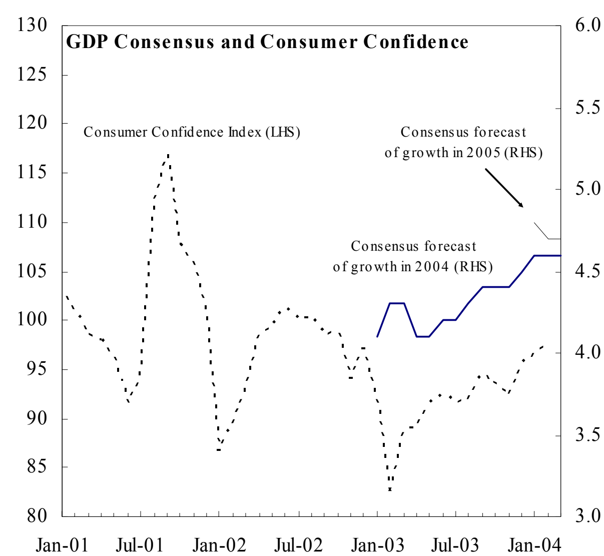
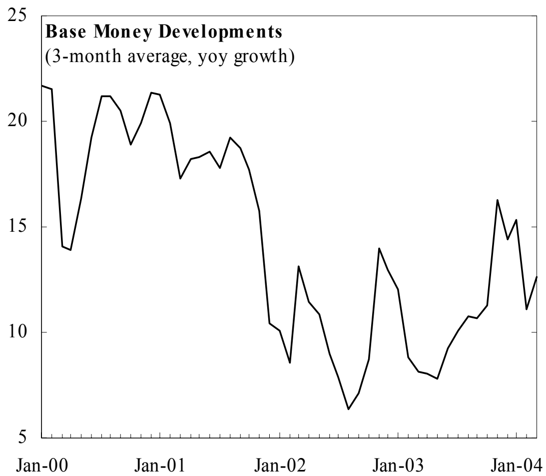
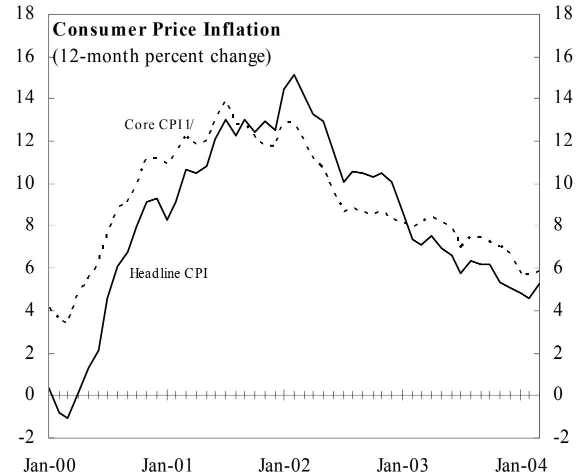


Chart 4. Monetary and Banking Developments

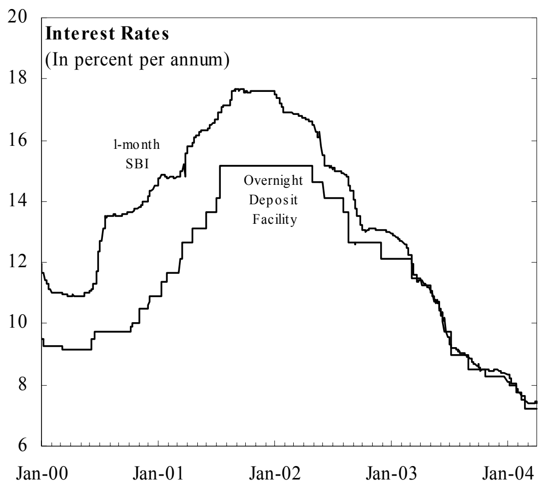
Base money growth has picked up.



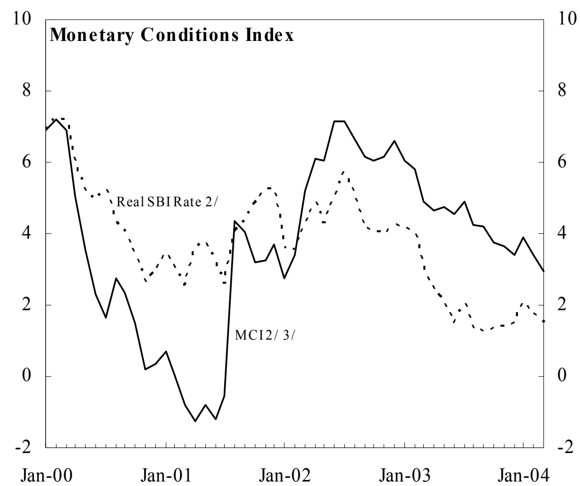
Inflation continues to trend down...



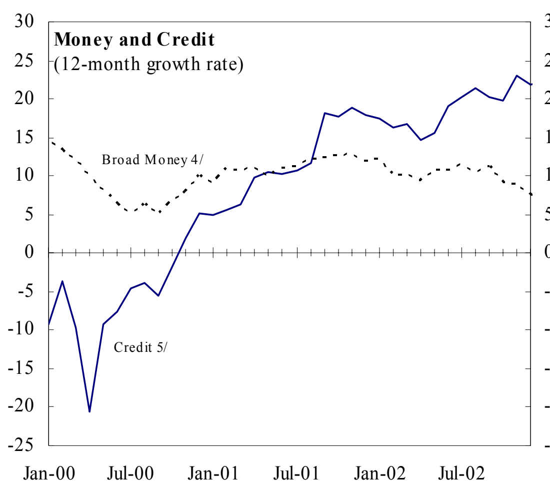
...enabling policy rates to be lowered further...



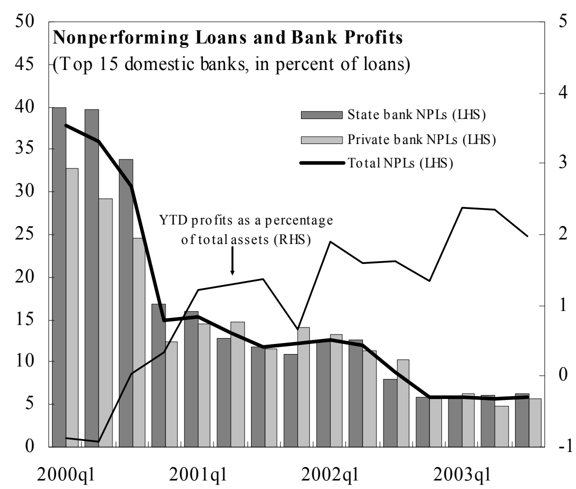
...and contributing to an easing in monetary conditions.



Credit growth continues to outpace broad money growth...



...with increased intermediation supported by steady improvement in bank financial indicators.



Sources: Data provided by the Indonesian authorities; CEIC; and Fund staff estimates.
1/ Nonfood, excluding administered prices.
2/ Using core inflation.
3/ Using ratio of 5:1 on real SBI and REER.
4/ At constant exchange rate.
5/ Data adjusted to account for loan transfers to and from IBRA.

Table 1. Indonesia: Selected Economic Indicators, 2000–04 1/

	2000	2001	2002	2003 Est.	2004 Proj.
Real GDP (percent change)	4.9	3.5	3.7	4.1	4.8
Domestic demand	4.0		2.6	3.6	5.6
Of which:					
Private consumption	1.6	3.4	3.8	4.0	6.3
Gross fixed investment	16.7	6.5	0.2	1.4	3.5
Net exports 2/	1.0	-1.2	1.1	0.7	-0.5
Errors and omissions 2/	-1.1	0.2	-1.1	-0.5	0.0
Savings and investment (in percent of GDP)					
Gross fixed capital investment	21.8	21.4	20.3	19.7	19.5
Gross national savings	27.2	26.2	24.8	23.6	22.4
Foreign savings	-5.3	-4.8	-4.5	-3.9	-2.9
Prices (12-month percent change)					
Consumer prices (end period)	9.3	12.5	10.0	5.1	5.0
Consumer prices (period average)	3.8	11.5	11.9	6.6	5.0
Public finances (in percent of GDP)					
Central government revenue 3/	20.0	20.8	18.6	18.7	18.5
Central government expenditure	21.1	24.5	20.4	21.0	19.8
Central government balance	-1.1	-3.7	-1.8	-2.3	-1.3
Central government debt	100.3	90.9	80.3	66.5	61.0
Money and credit (percent change; end of period)					
Rupiah M2	13.8	13.6	7.9	10.0	12.3
Base money (test-period) 4/	22.8	2.1	6.0	14.3	8.6
Private sector credit 5/	5.2	18.0	21.9	22.0	18.4
One-month SBI rate (period average)	12.4	16.5	14.9	9.9	7.1
Balance of payments (in billions of U.S. dollars)					
Oil and gas (net)	8.6	6.4	5.7	5.7	6.6
Non-oil exports (f.o.b)	50.3	44.8	46.3	48.6	50.3
Non-oil imports (c.i.f)	-37.1	-31.3	-31.1	-32.9	-36.1
Current account balance	8.0	6.9	7.8	8.0	6.7
Overall balance	1.2	-2.9	0.9	0.6	0.0
Gross reserves					
In billions of U.S. dollars (end period) 6/	29.4	28.0	32.0	36.2	35.2
In months of imports	7.1	6.6	7.0	7.4	6.7
As a percent of short-term debt 7/	98.4	84.6	134.3	154.2	164.5
External debt (medium- and long-term)					
In billions of U.S. dollars	141.7	131.2	129.8	132.4	127.9
(In percent of GDP)	94.3	91.6	74.9	63.6	55.9
Exchange rate					
Rupiah per U.S. dollar (period average)	8,422	10,246	9,295	8,578	...
Nominal effective exchange rate 8/	32.3	28.0	30.7	30.7	...
Real effective exchange rate 8/	62.7	59.7	72.5	76.3	...
Memorandum items:					
Indonesia oil production ('000 bcpd)	1,388	1,320	1,260	1,200	1,152
Indonesian oil price (US$/bbl)	27.4	23.3	24.2	27.4	28.5
Nominal GDP (in trillions of rupiah)	1,265	1,468	1,610	1,787	1,968
Nominal GDP (in billions of U.S. dollars)	150	142	173	208	229

Sources: Data provided by the Indonesian authorities; and Fund staff estimates.

1/ Calendar years with the exception of public finances for 2000, which are based on the 9 month fiscal year from April to December.
2/ Contribution to GDP growth. Errors and omissions includes stockbuilding.
3/ Includes grants.
4/ 30-day average centered on end-December.
5/ At constant exchange rate, adjusted for loan transfers to and from IBRA.
6/ From 2002 onward reflects higher reserves reported in general ledger.
7/ Short-term debt is on a remaining maturity basis before rescheduling and including IMF repurchases.
8/ Period average (June 1997=100).

Table 2. Indonesia: Summary of Central Government Operations, 2001–04

	2001	2002	2003		2004	
			11th Review	Est.	Budget 1/	Staff proj.
			(In trillions of rupiah)			
Revenues and grants	301.1	300.1	333.3	334.1	348.1	364.2
Oil and gas revenues	104.1	77.8	78.6	80.4	57.1	82.6
Non-oil and gas revenues	196.5	221.9	254.4	253.3	290.5	281.0
Tax revenues	162.4	193.1	221.4	218.0	259.2	247.0
Nontax revenues 2/	34.5	28.8	33.4	35.3	31.9	34.0
Expenditure and net lending	354.4	328.4	367.8	375.8	374.3	390.4
Current expenditure	226.1	192.8	195.0	194.9	191.5	206.5
Personnel	38.7	39.8	49.7	46.6	56.7	50.5
Subsidies	77.4	40.0	34.2	39.9	26.3	48.6
Interest	94.9	89.9	72.2	71.7	65.7	66.0
External	28.9	25.4	23.3	22.9	24.4	24.4
Domestic	66.0	64.5	48.9	48.8	41.3	41.6
Other	15.0	23.2	38.8	36.7	42.8	41.4
Development expenditure 3/	41.6	37.0	54.6	60.3	63.8	59.6
Transfers to regions	81.1	98.5	118.2	120.7	119.0	124.4
Overall balance	-53.3	-28.3	-34.4	-41.8	-26.2	-26.2
Financing	53.3	28.3	34.4	41.8	26.2	26.2
Domestic	46.5	24.0	37.7	37.4	42.4	33.0
Bank financing 4/	7.2	-21.8	1.2	4.0	30.7	23.0
Cash recovery of bank assets 5/	28.0	43.3	26.0	26.1	5.0	5.0
Privatization of nonfinancial assets	3.5	7.6	8.0	7.3	5.0	5.0
Other 6/	7.8	-5.1	2.5	4.6	1.8	5.0
External	6.8	4.3	-3.2	-0.2	-16.2	-11.8
			(In percent of GDP)			
Revenues and grants	20.8	18.6	18.7	18.7	17.4	18.5
Oil and gas revenues	7.2	4.8	4.4	4.5	2.9	4.2
Non-oil and gas revenues	13.6	13.8	14.3	14.2	14.5	14.3
Tax revenues	11.2	12.0	12.4	12.2	13.0	12.6
Nontax revenues 2/	2.3	1.8	1.9	2.0	1.6	1.7
Expenditure and net lending	24.5	20.4	20.7	21.0	18.7	19.8
Central government expenditure	18.9	14.3	14.0	14.0	12.8	10.0
Current expenditure	15.6	12.0	11.0	10.9	9.6	10.5
Personnel	2.7	2.5	2.8	2.6	2.8	2.6
Subsidies	5.3	2.5	1.9	2.2	1.3	2.5
Interest	6.6	5.6	4.1	4.0	3.3	3.4
External	2.0	1.6	1.3	1.3	1.2	1.2
Domestic	4.6	4.0	2.7	2.7	2.1	2.1
Other	1.0	1.4	2.2	2.1	2.1	2.1
Development expenditure 3/	2.9	2.3	3.1	3.4	3.2	3.0
Transfers to regions	5.6	6.1	6.6	6.8	6.0	6.3
Overall balance	-3.7	-1.8	-1.9	-2.3	-1.3	-1.3
Financing	3.7	1.8	1.9	2.3	1.3	1.3
Domestic	3.2	1.5	2.1	2.3	2.1	1.9
Bank financing 4/	0.5	-1.9	0.1	0.2	1.5	1.2
Cash recovery of bank assets 5/	1.9	2.7	1.5	1.5	0.3	0.3
Privatization of nonfinancial assets	0.2	0.5	0.4	0.4	0.3	0.3
Other 6/	0.5	0.3	0.1	0.3	0.1	0.3
External	0.5	0.3	-0.2	0.0	-0.8	-0.6
Memorandum items:						
Primary balance	2.9	3.8	2.1	1.7	2.0	2.2
Non-oil primary balance	-4.3	-1.0	-2.3	-2.8	-0.9	-2.2
Indonesian oil price	23.6	23.5	27.4	28.8	22.0	28.5
GDP (in trillions of rupiah)	1,449	1,610	1,780	1,787	2,000	1,968

Sources: Data provided by the Indonesian authorities; and Fund staff estimates.

1/ In the authorities' presentation (i.e., treating deposit insurance premia as nontax revenues) the deficit would be Rp 24.4 trillion.
2/ Includes grants (Rp 0.5 trillion in 2001, Rp 0.3 trillion in 2002 and 2003, and Rp 0.6 trillion in 2004).
3/ Excludes military expenditures, which are included in other current expenditure.
4/ For 2003 onward, includes net issuance of domestic debt.
5/ Total IBRA receipts from 2002 onwards.
6/ In 2003 and 2004 includes deposit insurance premia and unpaid scheduled interest to BI.

Table 3. Indonesia: Balance of Payments, 2000–09
(In billions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
	Act.	Act.	Act.	Est.			Proj.			
Current account	**8.0**	**6.9**	**7.8**	**8.0**	**6.7**	**5.2**	**4.3**	**3.5**	**2.6**	**1.5**
Trade balance	21.8	19.8	20.9	21.4	20.8	19.4	18.9	18.7	18.2	17.9
Exports (f.o.b)	65.4	57.4	59.2	62.8	66.1	67.5	69.8	73.6	77.3	81.2
Oil and gas	15.1	12.6	12.9	14.3	15.7	14.0	12.5	12.6	12.6	12.5
Non-oil and gas	50.3	44.8	46.3	48.6	50.3	53.5	57.3	61.1	64.7	68.7
Imports (c.i.f)	-43.6	-37.5	-38.3	-41.5	-45.2	-48.1	-50.9	-54.9	-59.1	-63.3
Oil and gas	-6.5	-6.2	-7.2	-8.6	-9.1	-8.7	-8.1	-8.5	-8.9	-9.3
Non-oil and gas	-37.1	-31.3	-31.1	-32.9	-36.1	-39.4	-42.8	-46.5	-50.2	-54.0
Services (net)	-13.8	-12.9	-13.0	-13.4	-14.1	-14.2	-14.7	-15.2	-15.6	-16.4
Nonfactor services (net)	-6.6	-7.1	-7.4	-7.8	-9.3	-9.1	-9.6	-10.0	-10.5	-11.4
Factor services	-7.2	-5.8	-5.6	-4.7	-4.8	-5.0	-5.1	-5.1	-5.1	-5.0
Capital account	**-6.8**	**-9.8**	**-7.0**	**-7.4**	**-6.7**	**-5.1**	**-2.6**	**0.3**	**2.0**	**3.0**
Nonfinancial public sector	-0.8	-2.7	-3.6	-3.8	-2.5	-2.9	-2.7	-1.1	-0.7	-0.5
Disbursements	4.1	2.9	2.3	2.2	3.7	3.7	4.0	4.3	4.9	5.2
Amortization	-4.9	-5.6	-6.0	-6.0	-6.2	-6.6	-6.7	-5.4	-5.6	-5.7
Banking sector (net)	-0.6	0.5	0.9	2.7	2.0	2.8	3.0	3.6	3.9	4.2
Disbursements	1.3	2.2	2.5	4.1	3.5	3.8	4.0	4.5	4.8	5.0
Amortization	-1.9	-1.7	-1.6	-1.4	-1.4	-1.0	-1.0	-1.0	-0.9	-0.8
Private sector (net)	-5.4	-7.6	-4.3	-6.3	-6.1	-5.0	-2.8	-2.1	-1.2	-0.6
FDI, gross inflows 1/	3.4	2.3	4.9	3.0	3.0	3.4	4.2	4.5	4.8	5.0
Portfolio investment	-1.9	-0.2	1.2	2.3	2.8	3.0	3.4	3.5	3.6	3.8
Other private sector (net) 2/	-6.8	-9.7	-10.4	-11.6	-11.9	-11.4	-10.4	-10.1	-9.6	-9.4
Overall balance	**1.2**	**-2.9**	**0.9**	**0.6**	**0.0**	**0.2**	**1.7**	**3.8**	**4.7**	**4.5**
Financing	**-1.2**	**2.9**	**-0.9**	**-0.6**	**0.0**	**-0.2**	**-1.7**	**-3.8**	**-4.7**	**-4.5**
Change in NIR	-3.5	0.0	-4.5	-3.6	0.0	-0.2	-1.7	-3.8	-4.7	-4.5
Gross reserves	-5.0	1.4	-3.6	-4.2	1.0	1.0	-0.2	-1.8	-2.1	-3.1
Reserve liabilities	1.5	-1.4	-0.9	0.6	-1.0	-1.2	-1.5	-2.0	-2.6	-1.4
Public sector rescheduling	2.4	2.9	3.6	3.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Gross reserves (eop) 3/	29.4	28.0	32.0	36.2	35.2	34.3	34.5	36.3	38.4	41.5
In months of imports of goods and services	7.1	6.6	7.0	7.4	6.7	6.2	5.8	5.6	5.6	5.6
In percent of short-term debt	98.4	84.6	134.3	154.2	164.5	172.6	202.2	228.3	256.9	294.3
Non-oil and gas exports, volume growth	17.6	-7.9	1.1	-0.8	3.5	5.0	6.0	5.5	5.0	5.0
Non-oil and gas imports, volume growth	28.9	-13.1	-2.4	2.1	5.5	8.0	7.5	7.5	7.0	6.5
Terms of trade, percent change (including oil)	10.0	-1.4	0.2	0.3	-1.4	-0.6	-0.7	0.0	-0.1	-0.1
Current account (percent of GDP)	5.3	4.9	4.5	3.8	2.9	2.2	1.7	1.3	0.9	0.5
Stock of nonfinancial public sector external debt	80.0	75.8	78.4	85.8	82.4	78.4	74.1	71.0	67.7	65.7
(In percent of GDP)	53.3	53.6	45.2	41.2	36.0	32.2	28.5	25.3	22.4	20.1
Nonfinancial public sector debt service/XGNFS	12.4	17.4	18.0	15.2	14.8	14.7	14.6	12.6	12.6	10.9
Indonesian oil price	27.4	23.3	24.2	27.4	28.5	25.0	22.0	22.0	22.0	22.0
GDP (in billions of US$)	150.2	141.5	173.3	208.3	228.8	243.4	259.8	280.7	302.3	327.5

Sources: Data provided by the Indonesian authorities; and Fund staff estimates.

1/ FDI series has been revised to include privatization and IBRA sales to nonresidents. From 2002 onward, the definition of FDI has been updated in line with a change in methodology of the official statistics (the ownership threshold has been reduced from 50 to 10 percent).
2/ Comprised largely of private sector debt repayments, changes in banks' foreign currency balances, and errors and omissions.
3/ From 2002 onward reflect higher reserves reported in BI's general ledger.

Table 4. Indonesia: Indicators of External Vulnerability, 2000–04

	2000	2001	2002	2003	2004
Key economic and market indicators					
Real GDP growth (in percent)	4.9	3.5	3.7	4.1	4.8
CPI inflation (period average, in percent)	3.8	11.5	11.9	6.6	5.0
Short-term (ST) interest rate (in percent)	12.4	16.5	14.9	9.9	7.1
Sovereign bond secondary market spread (bps, end of period)	677	479	345	260.1	...
Exchange rate NC/US$ (end of period)	9,595	10,400	8,950	8,425	...
External sector					
Current account balance (in percent of GDP)	5.3	4.9	4.5	3.8	2.9
Gross FDI inflows (in percent of GDP)	1.8	2.2	3.0	1.5	1.3
Export growth (U.S. dollar value, GNFS)	26.5	-10.9	2.9	4.8	4.5
Real effective exchange rate (1995 = 100)	68.3	65.1	79.1	83.2	84.7
Gross international reserves (GIR) (in billions of U.S. dollars)	29.4	28.0	32.0	36.2	35.2
GIR in percent of short-term debt at remaining maturity	98.4	84.6	134.3	154.2	164.5
Net international reserves (NIR) (in billions of U.S. dollars)	17.8	18.3	22.2	24.2	24.2
Total gross external debt (in percent of GDP)	99.6	96.3	75.8	64.7	57.0
Of which : Short-term debt (original maturity in percent of GDP)	5.3	4.7	0.9	1.2	1.1
Private sector debt (in percent of GDP)	43.5	41.8	28.9	21.6	18.7
Total gross external debt in percent of exports of GNFS	212.7	220.2	203.8	199.7	184.7
	56.1	54.5	46.9	43.1	38.3
Public sector 1/					
Overall balance (in percent of GDP)	-1.1	-3.7	-1.8	-2.3	-1.3
Primary balance (in percent of GDP)	4.0	2.8	3.8	1.7	2.0
Debt-stabilizing primary balance (in percent of GDP) 2/	2.3	2.5	2.3	2.1	1.8
Public sector gross debt (in percent of GDP) 3/	104.1	93.0	82.3	71.5	66.0
External debt from official creditors (in percent of total)	44.4	43.8	42.5	44.3	43.1
External debt from private creditors (in percent of total)	0.6	0.5	0.4	0.7	2.6
Domestic debt linked to foreign currency (in percent of total)	2.7	3.0	1.6	0.9	0.0
Domestic debt linked to ST interest rate or inflation (in percent of total)	17.3	16.7	18.9	19.5	18.1
Public sector net debt (in percent of GDP)	…	…	…	…	...
Financial sector					
Capital adequacy ratio (in percent) 4/ 5/	21.6	18.2	20.1	22.9	...
NPLs in percent of total loans 4/ 5/	14.2	11.0	6.3	6.0	...
Provisions in percent of NPLs 4/ 5/	88.8	94.0	119.6	143.2	...
Return on average assets (in percent) 4/ 5/	0.3	0.6	1.3	8.0	...
FX deposits (in percent of total deposits)	20.8	20.2	18.2	14.2	14.2
FX deposits (in percent of gross international reserves)	30.8	52.5	49.0	46.6	52.9
FX loans (in percent of total loans)	39.8	32.6	28.9	18.2	18.2
Financing requirements					
Gross external financing requirement (GEFR) (in billions of U.S. dollars)	14.3	19.4	12.9	12.6	13.6
Of which : Amortization of MLT debt, public (in percent of total GEFR) 6/	47.6	46.1	76.8	69.5	64.0
Amortization of MLT debt, private (in percent of total GEFR) 7/	53.3	55.0	72.3	74.7	67.3
Maturing ST debt (in percent of total GEFR)	55.4	34.5	11.7	19.4	18.0
Current account balance (in percent of total GEFR)	-56.3	-35.6	-60.7	-63.6	-49.3
Gross public sector financing requirements (GPSFR) (in billions of U.S. dollars) 8/	5.2	11.8	10.0	13.2	10.9
Of which : Amortization of MLT debt (in percent of total GPSFR) 8/	17.3	30.1	46.0	36.6	56.8
Maturing short-term debt (in percent of total GPSFR)	3.2	1.4	2.0	1.5	1.9
Overall public sector deficit (in percent of total GPSFR)	24.7	43.9	30.5	36.9	28.1

1/ Nonfinancial public sector (including state-owned enterprises). For 2000, data are for FY 2000.
2/ Based on GDP growth of 2.4 percent (annual average for 1995/96–2002) and a real interest rate of 5 percent.
3/ Medium- and long-term debt. Excludes outstanding IMF purchases.
4/ Top 15 banks only (which account for over 80 percent of total deposits).
5/ End-September data for 2003.
6/ Includes banking sector amortizations and IMF repurchases.
7/ Due to data deficiencies, this item represents net MLT capital flows to the corporate sector (which were positive prior to 1997/98) and net portfolio investment flows.
8/ Based on fiscal data for external MLT amortization (net of rescheduling), domestic debt amortization, and IMF repurchases.

Table 5. Indonesia: Quantitative Performance Criteria (PC) and Indicative Targets (IT)
Under the Extended Arrangement, 2003 1/

	Mar.		Jun.		Sep.		Dec.	
	PC	Actual	PC 2/	Actual	PC 2/	Actual	IT 2/	Actual
Monetary and fiscal targets								
Net domestic assets (NDA) of Bank Indonesia	-24.5	-36.9	-18.0	-32.9	-21.9	-28.9	-3.0	-2.9
Base money (indicative target) 3/	129.3	123.0	134.5	128.7	134.1	135.0	146.6	151.0
Overall central government balance 4/	-7.6	10.1	-15.6	-2.2	-25.6	-16.2	-34.4	-41.8
External targets (in billions of U.S. dollars)								
Net international reserves (NIR) of Bank Indonesia 5/	22.2	23.2	22.0	23.6	22.5	23.6	22.1	24.2
Contracting or guaranteeing of new nonconcessional external debt 6/	0.3	0.2	0.6	0.2	1.0	0.6	1.5	1.2
Of which : Government debt to commercial creditors	0.2	0.0	0.2	0.0	0.2	0.0	0.2	0.0
Stock of short-term external debt outstanding	2.5	0.3	2.5	0.1	2.5	0.1	2.5	0.1

1/ Definitions are contained in the Technical Memorandum of Understanding (IMF Country Report No. 03/3-75). Continuous performance criteria are: the non-accumulation of public external arrears and no securitization or forward sale of receipts from natural resources.
2/ Adjusted targets for NIR and NDA.
3/ Base money targets are one-month averages centered on end-month.
4/ Cumulative balances from beginning of fiscal year (floor). Central government bonds issued to district and provincial government are included as financing of the central government deficit.

Table 6. Indonesia: Structural Benchmarks

March 2003	
• Finalize comprehensive plan for financial sector safety net.	✓
• Formulate plans and targets for audits, tax arrears collection, and registration of taxpayers.	✓
• Collect at least Rp 3 trillion in cash by IBRA (net of expenses).	Rp 1.2 tn
• Adopt implementation schedule for the restructuring of BTN.	✓
April 2003	
• Conclude majority divestment of Bank Danamon.	✓
• Launch majority divestment of Bank Lippo.	✓
• Finalize blueprint for strengthening the treasury and budget functions of the Ministry of Finance.	✓
• Issue ministerial decree liberalizing conditions under which VAT refund claims may be approved.	✓
June 2003	
• Collect at least Rp 7 trillion in cash by IBRA (net of expenses).	Rp 9.7 tn
• List IPO for Bank Mandiri on the stock exchange.	✓
• Appoint additional commissioners to ensure each state bank has four to five commissioners in place.	✓
• Launch a fourth round of performance audits of state enterprises.	✓
• Produce report on 2002 local government finances, with coverage of at least 85 percent of jurisdictions.	✓
• Complete sale of BI's overseas subsidiary.	In process
September 2003	
• Collect at least Rp 18 trillion in cash by IBRA (net of expenses).	Rp 13.8 tn
• Launch IPO for BRI.	✓
• Finalize strategy for the resolution of assets that may remain unsold at the end of IBRA's mandate.	✓
December 2003	
• Launch majority divestment of remaining two IBRA banks.	In process
• Announce strategic plan for future of Bank Mandiri.	✗
• Complete the expansion of large taxpayer offices to increase coverage to 35 percent of the tax collections of the Directorate General of Taxation.	✓
• Ensure that the Anti-Corruption Commission is fully operational.	In process
• Achieve budget privatization target of Rp 8 trillion.	Rp 7.3 tn

Table 7. Indonesia: Indicators of Debt Service to the Fund, 2001–10

(In billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Debt service to the Fund										
Charges	0.48	0.28	0.28	0.29	0.26	0.22	0.19	0.14	0.09	0.06
Repurchases (expectations basis)	1.75	2.37	1.36	1.01	1.16	1.53	2.05	2.56	1.42	0.66
In percent of exports of goods and nonfactor services	3.6	4.1	2.4	1.8	1.9	2.3	2.8	3.2	1.7	0.8
In percent of total nonfinancial public sector debt service	20.3	22.8	16.3	12.8	13.5	16.1	22.4	25.5	15.7	8.4
In percent of reserves of Bank Indonesia 1/	8.0	8.3	4.5	3.7	4.1	5.1	6.2	7.1	3.6	1.6
Outstanding Fund credit	9.21	8.83	9.84	9.32	8.19	6.69	4.65	2.08	0.66	0.00
In percent of GDP	6.5	5.1	4.7	4.1	3.4	2.6	1.7	0.7	0.2	0.0
In percent of nonfinancial public debt	12.4	11.3	11.5	11.3	10.4	9.0	6.5	3.1	1.0	0.0
In percent of reserves of Bank Indonesia 1/	32.9	27.6	27.2	26.4	23.9	19.4	12.8	5.4	1.6	0.0
In percent of quota	348.8	313.5	332.6	300.0	262.7	213.8	148.5	66.5	21.2	0.0
Total nonfinancial public sector debt service										
In percent of exports of goods and nonfactor services	17.6	18.0	14.9	14.4	14.3	14.3	12.4	12.5	10.8	9.2
In percent of GDP	7.8	6.7	4.8	4.4	4.3	4.2	3.6	3.5	2.9	2.4

1/ End of period reserves.

Table 8. Indonesia: Monetary Survey, December 2002–December 2004
(In trillions of rupiah, unless otherwise indicated) 1/

	2002	2003					2004
	Dec.	Mar.	Jun.	Sep.	Dec.		Dec.
		Actual	Actual	Actual	Program	Actual	Proj.
			(End-of-period)				
Monetary Survey							
Net foreign assets	178.8	181.1	186.9	193.4	186.9	216.8	221.0
(In billions of U.S. dollars)	25.5	25.9	26.7	27.6	26.7	31.0	31.6
Net domestic assets	674.6	667.3	687.0	695.0	748.1	703.7	826.1
Net claims on government	515.2	518.6	507.0	484.2	507.4	482.1	510.2
Claims on private sector	369.0	380.0	404.0	425.8	443.7	450.2	532.9
Rupiah claims	295.7	305.0	327.0	348.3	366.6	370.9	453.6
Foreign exchange claims	73.3	75.0	77.0	77.5	77.1	79.3	79.3
Other items (net)	-209.6	-231.3	-224.0	-215.0	-203.0	-228.6	-217.0
Broad money (M2)	853.4	848.4	873.9	888.4	935.0	932.6	1047.3
Rupiah broad money	743.4	740.2	759.5	773.7	813.9	817.5	917.8
Currency	80.7	72.3	77.1	81.1	91.0	95.5	105.4
Deposits 2/	662.8	667.9	682.4	692.6	722.8	722.0	812.4
Foreign exchange deposits	110.0	108.2	114.4	114.7	121.1	115.1	129.5
Bank of Indonesia							
Net international reserves	155.1	162.1	165.3	165.4	161.0	169.4	169.4
Net domestic assets	-16.8	-36.9	-33.3	-29.4	-9.0	-2.9	10.5
Net claims on government 3/	172.0	175.9	188.1	182.6	184.2	175.5	197.5
Claims on private sector	8.3	8.4	8.6	9.2	8.6	7.8	8.0
Claims on DMBs	-80.9	-96.2	-110.5	-122.6	-102.6	-105.0	-113.8
Open market operations	-113.3	-127.9	-142.6	-154.3	-134.7	-136.5	-145.3
Other items (net)	-116.3	-125.1	-119.5	-98.7	-99.3	-81.1	-81.1
Base money	138.3	125.2	132.0	135.9	152.0	166.5	179.9
Currency outside banks	80.7	72.3	77.1	81.1	91.0	95.5	105.4
DMBs	56.0	51.0	53.1	53.1	59.2	69.5	73.0
Nonbank deposits	1.6	1.9	1.8	1.7	1.8	1.5	1.5
Memorandum items:							
Base money test date 4/	132.2	123.0	128.7	135.0	146.6	151.0	...
NIR of BI (in billions of U.S. dollars)	22.2	23.2	23.6	23.6	23.0	24.2	24.2
Money multiplier (rupiah broad money)	5.4	5.9	5.8	5.7	5.4	4.9	5.1
Base money velocity 5/	11.7	14.2	13.6	13.5	12.0	10.9	11.0
Rupiah broad money velocity 5/	2.2	2.4	2.4	2.4	2.2	2.2	2.2
Annual percentage change:							
Broad money (constant exchange rate)	7.6	7.4	7.7	7.3	9.6	9.3	12.3
Rupiah broad money	7.9	8.6	8.5	8.0	9.5	10.0	12.3
Base money (test period)	6.0	6.9	9.0	11.7	10.9	14.3	8.6
Private sector claims 6/	21.9	24.9	25.0	23.6	20.1	22.0	18.4

Sources: Data provided by Indonesian authorities; and Fund staff estimates.

1/ All foreign currency denominated components are valued at the constant exchange rate (Rp 7,000=US$1).
2/ Includes nonbank private sector deposits held at BI (Rp 1.5 trillion at December 2003).
3/ As part of the BLBI resolution, BI's net claims on government were reduced by Rp 20.2 trillion (reflected in the figures from September 2003). BI's capital reserves (under other items, net) have been reduced by a corresponding amount.
4/ Test date outcome based on 30-day average centered at end-month.
5/ Calculated using end-period quarterly GDP, annualized.
6/ Adjusted for transfers of bank loans to and from IBRA.

Table 9. Indonesia: Fiscal Reform Agenda

Area	Measures	Timing[1]
Tax Administration	Implement 2004 revenue generation program	S
	Simplify VAT refund procedures[2]	S
	Expand the Large Taxpayer Office	M
	Establish a tax office for medium-size taxpayers	M
	Revise the legal framework for tax administration[2]	M
	Strengthen tax directorate governance framework[2]	M
Customs Administration	Reform trade facilitation procedures	S
	Reform and computerize payment system	S
	Improve reporting and management information systems	S
	Strengthen compliance and anti-smuggling initiatives	M
	Strengthen customs governance framework[2]	M
	Improve risk management and valuation controls	M
Public Expenditure Management	Strengthen treasury and debt management functions[2]	S
	Revise budget classifications	S
	Consolidate off-budget funds[2]	S
	Establish financial management system	M
Fiscal Decentralization	Revise decentralization laws[2]	S
	Strengthen regional borrowing framework[2]	M
Tax Policy	Reform VAT, excises and luxury taxes[2]	S
	Reform income tax system[2]	M
Expenditure Policy	Phase-out poorly-targeted subsidy system[2]	M

[1] S: short-term measures to be implemented during 2004; M: medium-term reforms to be implemented through 2006.
[2] These reforms require legislative or regulatory changes.

INDONESIA: FUND RELATIONS
(As of February 29, 2004)

I. Membership Status: Joined February 21, 1967; Article VIII

II. General Resources Account	SDR Millions	Percent of Quota
Quota	2,079.30	100.00
Fund holdings of currency	8,759.65	421.28
Reserve position in Fund	145.50	7.00

III. SDR Department	SDR Millions	Percent of Allocation
Net cumulative allocation	238.96	100.00
Holdings	4.91	2.06

IV. Outstanding Purchases and Loans	SDR Millions	Percent of Quota
Extended arrangements	6,825.85	328.28

V. Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Millions)	Amount Drawn (SDR Millions)
EFF	Feb. 04, 2000	Dec. 31, 2003	3,638.00	3,638.00
EFF	Aug. 25, 1998	Feb. 04, 2000	5,383.10	3,797.70
Stand-by	Nov. 05, 1997	Aug. 25, 1998	8,338.24	3,669.12

VI. Projected Obligations to Fund (SDR Millions; expectation basis, based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	588.84	774.81	1,015.64	1,359.70	1,703.76
Charges/Interest	112.91	136.42	118.13	93.69	61.71
Total	701.76	911.23	1,133.77	1,453.39	1,765.47

VII. Exchange Arrangements

The rupiah has floated since August 14, 1997. The market exchange rate was Rp 8,457 per U.S. dollar on February 29, 2004. Indonesia has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

VIII. Article IV Consultation

The last Article IV consultation report was discussed by the Executive Board on April 26, 2002.

IX. Safeguards Assessments

Under the Extended Arrangement, Bank Indonesia (BI) was subject to the transitional procedures under the Fund's safeguards assessment policy. This required a review of BI's external audit mechanism, which was completed on March 15, 2002. The assessment recommended remedial actions to address a number of vulnerabilities. The main recommendations have been implemented. These included the establishment of an independent audit committee at BI and the publication of BI's audited financial statements. A mid-year audit of BI's foreign exchange reserves (conducted by the independent accounting firm of PricewaterhouseCoopers) was also completed in October 2002. The report indicated that international reserves data reported to the Fund had been underestimated at June 30, 2002, due to timing issues and other compilation discrepancies. The audit also found control weaknesses in BI's foreign reserves operations, which have been addressed. The staff has recommended the continued involvement of an independent firm in BI's external audit mechanism.

INDONESIA: STATISTICAL ISSUES

1. Indonesia has subscribed to the Special Data Dissemination Standard (SDDS) since September 1996.

Real Sector

2. Annual national accounts data are based on a 1993 base year. Quarterly GDP data are made available to Fund staff in a timely manner, but data are subject to frequent, significant revisions. Furthermore, the estimates are based on a limited set of indirect indicators of uncertain quality; although some sectors are influenced strongly by seasonality, seasonally adjusted data are not prepared. No recent disaggregation of gross fixed capital formation between government and nongovernment sectors is available and changes in inventories are calculated residually, and therefore, include any statistical discrepancies. Exports of goods and services in the national accounts differ substantially from the balance of payments data.

3. Labor market data, including wages and employment, are available, albeit reported with some delay, through the annual labor market survey (Sakernas) published by the Bureau of Statistics. Data are also available on minimum and maximum wages for the formal sector. Quarterly data are available on industrial wages, again with some delay.

4. Both consumer (CPI) and wholesale price (WPI) data are collected and published monthly and on a timely basis. Beginning January 2004, the base year for the CPI was changed to 2002 and weights used to calculate the index were updated. In addition, the CPI survey was expanded in terms of its geographical coverage from 43 to 45 cities and the number of products surveyed has increased from 662 to 744 items.

Public Finance

5. Comprehensive public finance data are generally not available, and the data that are available are of questionable quality in terms of definition, coverage and timeliness. Subnational government fiscal data are available with a lag of nine months, but the quality is variable. Data on the central government budget are available on a timely basis, although significant "statistical" discrepancies exist in some years. The coverage and timeliness of public debt statistics is generally adequate. However, little data is available on contingent liabilities. There are a large number of quasi-government entities (such as foundations) and extra-budgetary funds, resulting in non-transparent and unaccountable off-budget activities. The authorities are considering the adoption of the GFS standards as their general reporting framework; however, no timetable has been set.

Monetary Accounts

6. BI balance sheet data are generally of good quality, and available in a timely manner. The quality of monetary survey data is compromised by a number of methodological

problems associated with the restructuring of the banking sector, in particular transfers of non-performing assets to (and purchases from) the Indonesian Bank Restructuring Agency (IBRA), and some misclassification of foreign assets and liabilities by banks.

7. BI has developed an integrated database from which alternative presentations of monetary statistics can be drawn to meet the needs of BI and the Fund, but no data have been reported yet under this system. Further work is needed to expand the coverage of depository corporations to include mutual funds, adopt a fuller sectorization scheme, and improve monthly compilation methods.

Balance of Payments

8. The compilation of Indonesia's balance of payments is in need of major improvements in several areas. An important initiative in this regard is taking place through work on the development of an International Transaction Reporting System (ITRS) that will provide regular data reports on the external transactions of banks, nonbanks financial institutions, nonfinancial corporations, and the central bank. The use of the ITRS is expected to address many of the weaknesses in current compilation procedures. At present, while many components of the ITRS have been developed and are available for use, the data generated are still being tested and methodologies refined. In the June 2003 technical assistance mission, STA used the ITRS and other information to compile several components of a balance of payments statement for two quarters; in a number of areas the compiled data differed considerably from the published data. The February 2004 mission noted that starting from the first quarter of 2004, macroeconomic adjustments to the current account and financial account will be replaced by use of source data, and the ITRS will be used to compile several balance of payments components.

9. There are a number of weaknesses in the compilation of current account data. With respect to merchandise trade data, while customs sources utilized by BI are considered generally reliable, there is believed to be undercoverage in selected areas. Data on services suffer from outdated surveys and weak methodologies.

10. In the capital and financial account, the methodological basis for the compilation of FDI data needs substantial improvement, as inflows are currently calculated based on loan disbursements to FDI companies and the application of a fixed ratio to the loan disbursements data to estimate equity inflows. Surveys conducted by BI to collect FDI data since 2000 have a low response rate and the directory of enterprises requires substantial enhancement in terms of its coverage. Other areas that need improvement include the recording of trade credits and the assets data for portfolio investment and other investment transactions. In general, there remain serious deficiencies in the recording of financial transactions of the private sector.

11. An annual international investment position is compiled, but the underlying data are weak in several areas, notably for foreign direct investment. External sector debt statistics have improved considerably with the introduction of a External Debt Information System

(EDIS) in 2002. The system records external debt of government and over 800 other entities that report to BI on a monthly basis. The data that this system generates for public sector external debt and debt service as well as that for private banks are considered reliable. However, improvements are still needed with respect to components of private corporate sector data, particularly in distinguishing between scheduled and actual debt service, in estimating the accumulation/reduction of private sector payments arrears, and in estimating reschedulings and debt reductions being received by the private sector from external creditors.

Indonesia: Core Statistical Indicators

(As of March 31, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt/Debt Service
Date of latest observation	03/31/04	03/30/04	03/30/04	03/30/04	01/04	03/30/04	02/04	01/04	Q3/03	01/04	Q4/03	10/03
Date received	03/31/04	03/31/04	03/31/04	03/31/04	03/04	03/31/04	03/04	01/04	Q3/03	03/04	Q1/04	10/03
Frequency of data	D	D	D	D	M	D	M	M	Q	M	Q	M
Frequency of reporting	D	D	D	D	M	D	M	M	Q	M	Q	M
Source of update	R	CB	CB	CB	CB	R	STAT	CB	CB	MOF	STAT	CB
Mode of reporting	E	F	F	F	F	E	E	P	S	S	E	S
Confidentiality 1/	P	S	S	S	S	P	P	P	P	S	P	S
Frequency of publication	D	W	M	W	M	W	M	M	Q	Semi-annual	Q	M

1/ All data are made available publicly, with a lag.

CB = Central Bank; D = daily; E = electronic; F = fax; M = monthly; MOF = Ministry of Finance, P = public; R = Reuters; S = staff; STAT = BPS (Central Bureau of Statistics); W = weekly.

INDONESIA: SOCIAL AND DEMOGRAPHIC INDICATORS

	Unit of Measurement	Most Recent Estimate (2001)
Natural resources		
Area	Thousand sq. km.	1,812
Agricultural land	Percent of land area	25
Forests and woodland	Percent of land area	62
Access to improved water source 1/	Percent of population	78
Rural	Percent of population	69
Urban	Percent of population	90
Human resources		
Total population	In millions	209.0
Urban population	Percent of population	42.0
Population growth	Percent per annum	1.3
Life expectancy at birth	Years	66
Infant morality rate	Per thousand live births	33
Labor force (ages 15–64)	Millions	88
Health and education		
Physicians 1/	Per 100,000 population	16
Immunization rate 1/		
Measels	Percent of population under 12 months	72
DPT	Percent of population under 12 months	58
Child malnutrition 1/	Percent of population under 5 years	28
Primary school enrollment	Percent of school-age group	93
Secondary school enrollment	Percent of school-age group	57
Illiteracy rate (age 15 plus)	Percent of population	13
Income and poverty		
GDP per capita (PPP basis)	U.S. dollars annually	3,138
Share of top 25 percent 1/	Percent of income	43.3
Share of bottom 25 percent 1/	Percent of income	8.4
Population below poverty line	Percent of population	15

Sources: World Bank, *World Development Indicators*, 2003; Susenas, 2003 and World Bank and Fund staff estimates.
1/ Data for 2000

Indonesia: Medium-Term Outlook and Risks

1. **Achieving a sustained higher growth path depends critically on a revival in investment and exports**. In addition to maintaining sound macroeconomic policies and further financial sector reforms, this will require sustained efforts to address the institutional weaknesses in the investment climate by strengthening the legal system, improving public sector government, and increasing ertainty in the framework for labor relations. Consistent implementation of such reforms would be expected to strengthen market confidence further, and allow the creation of a virtuous circle in support of additional reforms and improved macroeconomic outcomes.

2. **The staff has prepared a medium-term outlook on the basis of such a scenario**. The results are broadly in line with previous assessments (Annex Table 1). Growth would pick up to 5–6 percent, driven primarily by a rebound in private investment and a recovery in exports associated with strengthening external demand. The investment ratio would increase by about ½ percent of GDP annually, reaching 22 percent by 2009 (but still about 8 percentage points below the pre-crisis level). As Indonesia's competitiveness as an investment destination improved, export growth would gradually rise to around 6 percent per annum. Progress in achieving price stability would continue, with inflation declining further to around 3 percent, in line with trading partner inflation. The real exchange rate would remain broadly stable at its present level, and real interest rates would stabilize at around 3 percent.

3. **Fiscal policy would be geared toward further reducing public debt levels**. Continued fiscal consolidation would be critical to maintain macroeconomic stability and market confidence. Under the baseline scenario, primary surpluses would remain in their current range of around 2½ percent of GDP. In light of the expected secular decline in oil revenues (reflecting projected declines in both production volumes and prices) this would require a steady improvement in the non-oil primary balance of about ⅓ percent of GDP annually. In this scenario, public debt would decline below 50 percent of GDP by 2007 (from 66.5 percent at end-2003).

4. **Fiscal consolidation would be underpinned by efforts to enhance non-oil revenue collections and improve the efficiency of spending**. Ongoing programs to improve tax and customs administration would be extended, and complemented by additional revenue-generating initiatives, with an emphasis on enhancing audit and arrears collection procedures. Going forward, efforts will be needed to modernize tax administration and expand the revenue base. Expenditure reforms would focus on improving budget preparation and execution procedures, enhancing budget reporting, and strengthening debt management. Over the medium-term a gradual move toward performance budgeting would increase the efficiency and transparency of government operations. Together with the planned elimination of remaining untargeted fuel subsidies, this would support a reorientation of expenditure toward priority social and development spending even as overall expenditures as a share of GDP decline.

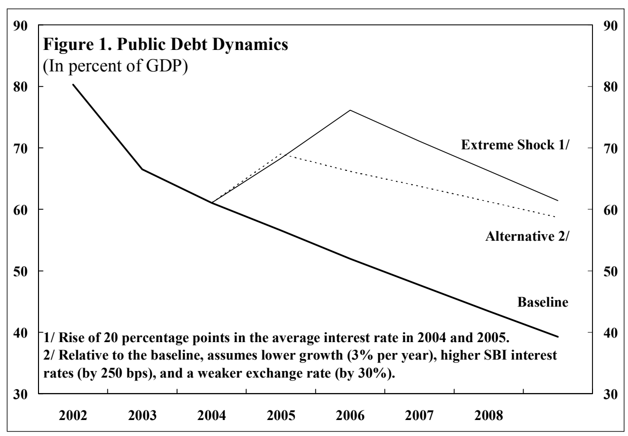
5. **The government's financing needs would remain manageable under this scenario** (Annex Table 2). In the absence of exceptional balance of payments support, budget financing will rely primarily on domestic sources. With IBRA's asset sales program largely complete, the emphasis will be on stepped-up issuance of government debt. While net bond issuance will remain relatively

modest at around ½ percent of GDP, gross bond financing needs would remain substantial (around 1½–2 percent of GDP) as significant volumes of bank recapitalization bonds mature. Staff projections continue to suggest that the increased reliance on market financing can be managed while still allowing adequate scope for an expansion in private sector credit.

6. **The external current account surplus would gradually decline**. As noted above, non-oil export volume growth is projected to improve to about 5–6 percent, but non-oil imports would grow even more rapidly as they recover from compressed levels. Net official capital flows are projected to increase modestly, in line with the medium-term country assistance strategies elaborated by Indonesia's main multilateral creditors. Critically, the scenario anticipates that sustained efforts to improve the investment climate acts as a catalyst to renewed private capital inflows. FDI and portfolio investments are projected to increase steadily, with overall private capital flows moving towards balance by 2009 (from an estimated net outflow of $6½ billion or 3 percent of GDP in 2003). Under this scenario, gross reserves are projected to decline in 2004 and 2005 (matching repayments to the Fund), but would increase steadily thereafter.

Key risks and vulnerabilities

7. **In the short term, the outlook is susceptible to a loss in market confidence**. A weakening in market sentiment—associated, for example, with an unexpected increase in political tension—would be expected to result in pressure on the exchange rate, interest rates and reserves. The standard sensitivity analysis suggest that external and public debt dynamics are relatively robust to such shocks, with the outlook most susceptible to large movements in the exchange rate and interest rates (Annex Tables 3 and 4). A severe shock involving a 30 percent depreciation, a 250 basis point rise in interest rates, and a slowdown in growth to 3 percent would raise the public debt ratio by 10 percentage points of GDP. Despite this increase, the debt ratios would not reach unsustainable levels, and the path of consolidation would be expected to continue (Figure 1).



8. **A longer-term risk relates to the possibility that slow progress in reforms could hold back a revival in investment and export performance**. In such a "muddle through" scenario, output growth would be expected to remain steady around 3–4 percent per year, well below the levels projected for regional peers. Market confidence would be expected to erode as Indonesia became increasingly decoupled from Asia's recovery. The exchange rate would be weaker than in the baseline scenario, and risk premia higher. The improvement in private capital flows would slow, and reserves could come under some pressure. Going forward, the virtuous circle could reverse, as a weaker macroeconomic position made it more difficult to adopt needed structural reforms.

Annex Table 1. Indonesia: Medium-term Framework, Selected Economic Indicators, 2001–2009

	2001 Act.	2002 Act.	2003 Est.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
Output and prices (percent change)									
GDP	3.4	3.7	4.1	4.8	5.0	5.5	6.0	6.0	6.0
Consumer prices (end period)	12.5	10.0	5.1	5.0	4.0	3.0	3.0	3.0	3.0
Consumer prices (period average)	11.5	11.9	6.6	5.0	4.5	3.5	3.5	3.0	3.0
Savings and investment (percent of GDP)									
Gross fixed capital investment	21.4	20.3	19.7	19.5	19.9	20.3	20.8	21.4	22.0
Gross national savings	26.2	24.8	23.6	22.4	22.0	22.0	22.1	22.3	22.5
Foreign savings	-4.8	-4.5	-3.9	-2.9	-2.2	-1.7	-1.3	-0.9	-0.5
Public finances (central government, in percent of GDP)									
Revenue 1/	20.8	18.6	18.7	18.5	17.0	16.8	16.7	16.6	16.4
Expenditure	24.5	20.4	21.0	19.8	17.8	17.3	16.8	16.5	16.3
Primary balance	2.8	3.8	1.7	2.0	2.5	2.5	2.5	2.5	2.4
Overall balance	-3.7	-1.8	-2.3	-1.3	-0.8	-0.4	-0.1	0.0	0.1
Debt	90.9	80.3	66.5	61.0	56.6	52.0	47.7	43.4	39.3
Balance of payments (billions of U.S. dollars)									
Current account balance	6.9	7.8	8.0	6.7	5.2	4.3	3.5	2.6	1.5
Oil and gas (net)	6.4	5.7	5.7	6.6	5.3	4.4	4.1	3.7	3.2
Non-oil exports (f.o.b)	44.8	46.3	48.6	50.3	53.5	57.3	61.1	64.7	68.7
Non-oil imports (c.i.f)	-31.3	-31.1	-32.9	-36.1	-39.4	-42.8	-46.5	-50.2	-54.0
Capital account balance	-9.8	-7.0	-7.4	-6.7	-5.1	-2.6	0.3	2.0	3.0
Overall balance	-2.9	0.9	0.6	0.0	0.2	1.7	3.8	4.7	4.5
Gross reserves									
In billions of U.S. dollars (end period)	28.0	32.0	36.2	35.2	34.3	34.5	36.3	38.4	41.5
In months of imports	6.6	7.0	7.4	6.7	6.2	5.8	5.6	5.6	5.6
External debt (medium- and long-term)									
In billions of U.S. dollars	131.2	129.8	132.4	127.9	123.7	119.5	116.9	114.5	113.7
(In percent of GDP)	91.6	74.9	63.6	55.9	50.8	46.0	41.6	37.9	34.7
Memorandum items:									
Indonesia oil production (000bcpd)	1,320	1,260	1,200	1,152	1,106	1,062	1,019	978	939
Indonesian oil price (US$/bbl)	23.6	23.5	27.4	28.5	25.0	22.0	22.0	22.0	22.0
Nominal GDP in trillions of rupiah	1,468	1,610	1,787	1,968	2,159	2,358	2,574	2,811	3,069
Nominal GDP in billions of U.S. dollars	143	173	208	229	243	260	281	302	327

Sources: Data provided by the Indonesian authorities; and Fund staff estimates.

1/ Includes grants.

Annex Table 2. Indonesia: Medium-Term Fiscal Projections, 2001–09

	2001	2002	2003	2004	2005	2006	2007	2008	2009
	(In percent of GDP)								
Fiscal accounts									
Primary balance	2.9	3.8	1.7	2.0	2.5	2.5	2.5	2.5	2.4
Interest	6.5	5.6	4.0	3.4	3.3	2.9	2.6	2.4	2.3
Overall balance	-3.7	-1.8	-2.3	-1.3	-0.8	-0.4	-0.1	0.0	0.1
Financing									
Gross requirements	8.3	5.5	6.1	4.9	4.3	4.1	3.9	4.0	5.0
Deficit	3.7	1.8	2.3	1.3	0.8	0.4	0.1	0.0	-0.1
Amortization	4.6	3.8	3.8	3.6	3.5	3.7	3.7	4.0	5.2
External	3.3	3.0	2.4	2.3	2.1	2.0	1.8	1.9	1.7
Domestic 1/	1.2	0.7	1.4	1.3	1.4	1.7	1.9	2.1	3.4
Sources	8.3	5.5	6.1	4.9	4.3	4.1	3.9	4.0	5.0
External disbursements (including rescheduling)	3.8	3.3	2.4	1.7	1.8	1.7	1.5	1.4	1.3
Privatization and asset recoveries	2.1	3.2	1.9	0.5	0.5	0.5	0.5	0.5	0.5
Other domestic financing 2/	2.3	-1.0	1.9	2.7	2.0	1.9	1.9	2.0	3.2
Public debt									
Total	90.9	80.3	66.5	61.0	56.6	52.0	47.7	43.4	39.3
External 3/	41.8	35.4	29.5	27.1	25.3	23.0	21.2	19.1	17.2
Domestic 4/	49.1	44.9	37.0	34.0	31.2	29.0	26.5	24.3	22.1
Memorandum items:									
Other domestic financing (in trillions of rupiah)	34.0	-15.5	34.0	53.8	43.2	45.9	48.3	57.6	99.1
Deficit financing	3.7	1.8	2.3	1.3	0.8	0.4	0.1	0.0	-0.1
Net domestic financing	3.2	1.5	2.3	1.9	1.1	0.7	0.4	0.5	0.3
Net external financing	0.5	0.3	0.0	-0.6	-0.3	-0.3	-0.3	-0.5	-0.4

Sources: Data are provided by the Indonesian authorities; and Fund staff estimates.

1/ Excludes amortization on the stock of hedge bonds and BI indexed bonds, which are to be rolled over.
In 2003, includes IBRA debt redemption of Rp 3.6 trillion, and debt buybacks of Rp 8.3 trillion.
2/ Includes domestic debt issuance.
3/ Includes short-term debt.
4/ In 2003 reflects Rp 51.5 trillion for debt write-off related to BLBI resolution.

Annex Table 3. Indonesia: Public Sector Debt Sustainability Framework, 2000-2009
(In percent of GDP, unless otherwise indicated)

	Actual						Projections						
	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009	
							I. Baseline Projections						**Debt-stabilizing primary balance 11/**
Public sector debt 1/	98.2	90.9	80.3	66.5			**61.0**	**56.6**	**52.0**	**47.7**	**43.4**	**39.3**	**-1.7**
o/w foreign-currency denominated	49.0	42.4	36.9	29.3			29.6	27.2	24.9	22.3	20.4	18.6	
Change in public sector debt	8.1	-7.4	-10.6	-13.8			-5.5	-4.5	-4.6	-4.3	-4.3	-4.1	
Identified debt-creating flows (4+7+12)	9.6	-7.5	-16.0	-10.1			-6.0	-5.3	-4.8	-4.7	-4.5	-4.3	
Primary deficit	-3.0	-2.9	-3.8	-1.7			-2.0	-2.5	-2.5	-2.5	-2.5	-2.4	
Revenue and grants	15.3	20.7	18.6	18.7			18.5	17.0	16.9	16.7	16.5	16.4	
Primary (noninterest) expenditure	12.2	17.8	14.8	17.0			16.5	14.5	14.4	14.2	14.1	14.0	
Automatic debt dynamics 2/	3.9	-2.5	-9.1	-6.5			-2.8	-2.1	-1.8	-1.8	-1.6	-1.4	
Contribution from interest rate/growth differential 3/	-7.0	-6.1	-3.5	-3.9			-2.8	-2.1	-1.8	-1.8	-1.6	-1.4	
Of which contribution from real interest rate	-4.0	-3.1	-0.5	-0.9			0.1	0.7	1.0	1.1	1.0	1.0	
Of which contribution from real GDP growth	-3.1	-2.9	-3.0	-3.1			-2.9	-2.8	-2.8	-2.9	-2.6	-2.4	
Contribution from exchange rate depreciation 4/	11.0	3.6	-5.6	-2.6			0.0	0.0	0.0	0.0	0.0	3.5	
Other identified debt-creating flows	8.7	-2.1	-3.1	-1.9			-1.2	-0.6	-0.5	-0.5	-0.5	-0.5	
Privatization receipts (negative)	-1.4	-2.1	-3.1	-1.9			-1.2	-0.6	-0.5	-0.5	-0.5	-0.5	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	10.1	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3)	-1.4	0.1	5.5	-3.7			0.5	0.8	0.2	0.4	0.3	0.1	
Public sector debt-to-revenue ratio 1/	642.4	439.4	430.9	355.7			329.8	331.8	308.4	286.0	262.4	239.4	
Gross financing need 5/	.	.	7.7	9.5			7.0	4.7	4.4	4.2	4.2	5.2	
in billions of U.S. dollars	.	.	13.3	19.8	10-Year Historical Average	10-Year Standard Deviation	15.9	11.5	11.5	11.7	12.7	17.1	
Key Macroeconomic and Fiscal Assumptions													Projected Average
Real GDP growth (in percent)	3.9	3.4	3.7	4.2	4.8	2.6	4.8	5.0	5.5	6.1	6.0	6.0	5.3
Average nominal interest rate on public debt (in percent) 6/	5.0	7.5	6.8	5.5	7.2	1.1	5.6	5.9	5.6	5.6	5.5	5.7	5.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.7	-3.3	-0.3	-1.0	-5.0	13.6	0.5	1.4	2.1	2.6	2.5	2.7	1.4
Nominal appreciation (increase in US dollar value of local currency, in percent)	-20.9	-7.7	16.2	8.4	-13.6	27.5	-0.3	-3.1	-2.2	-1.1	-1.3	-0.8	0.1
Inflation rate (GDP deflator, in percent)	9.6	10.8	7.2	6.5	12.2	13.7	5.1	4.5	3.5	3.0	3.0	3.0	4.3
Growth of real primary spending (deflated by GDP deflator, in percent)	-11.0	47.2	-13.7	19.8	4.2	22.4	1.4	-7.4	4.2	4.7	5.5	5.4	4.7
Primary deficit	-3.0	-2.9	-3.8	-1.7	-2.2	1.1	-2.0	-2.5	-2.5	-2.5	-2.5	-2.4	-2.3
							II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 10/**
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2004-08 7/							**61.0**	**50.2**	**43.1**	**36.8**	**30.9**	**25.5**	**-1.3**
A2. Primary balance under no policy change in 2004-08							**61.0**	**56.6**	**52.8**	**49.4**	**45.9**	**42.7**	**-1.7**
A3. Country-specific shock in 2004, with reduction in GDP growth (relative to baseline) of one standard deviation							**61.0**	**56.6**	**52.0**	**47.7**	**43.4**	**39.3**	**-1.7**
A4. Alternative scenario 8/							**61.0**	**69.0**	**66.2**	**63.8**	**61.2**	**58.7**	**-2.2**
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005							**61.0**	**68.3**	**76.1**	**71.1**	**66.2**	**61.4**	**-2.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005							**61.0**	**60.6**	**60.9**	**58.0**	**55.0**	**52.2**	**-2.0**
B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005							**61.0**	**59.2**	**57.1**	**52.6**	**48.3**	**44.0**	**-1.8**
B4. Combination of 2-4 using one standard deviation shocks							**61.0**	**63.8**	**66.4**	**61.7**	**57.0**	**52.5**	**-2.0**
B5. One time 30 percent real depreciation in 2004 9/							**61.0**	**70.6**	**65.7**	**61.0**	**56.3**	**51.8**	**-2.0**
B6. 10 percent of GDP increase in other debt-creating flows in 2004							**61.0**	**66.6**	**61.8**	**57.2**	**52.7**	**48.3**	**-1.9**

1/ Gross debt of central government.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ GDP growth assumed at 3 percent; interest rate 250 bps higher than in baseline and exchange rate 30 more depreciated than in baseline.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ GDP growth assumed at 3 percent; interest rate 250 bps higher than in baseline and exchange rate 30 more depreciated than in baseline.
11/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Annex Table 4. Indonesia: External Debt Sustainability Framework, 2000-2008
(In percent of GDP, unless otherwise indicated)

	Actual 2000	Actual 2001	Actual 2002	10-Year Historical Average	10-Year Standard Deviation	Projections 2003	Projections 2004	Projections 2005	Projections 2006	Projections 2007	Projections 2008	
												Debt-stabilizing non-interest current account 6/
I. Baseline Projections												
External debt	94.3	94.1	75.8			**64.7**	**57.0**	**51.8**	**46.9**	**42.5**	**38.7**	**-4.4**
Change in external debt	-17.8	-0.2	-18.3			-11.1	-7.8	-5.1	-4.9	-4.4	-3.8	
Identified external debt-creating flows (4+8+9)	-18.1	-12.2	-20.0			-9.0	-8.3	-7.5	-7.2	-6.7	-6.0	
Current account deficit, excluding interest payments	-10.4	-9.1	-6.9			-5.8	-5.0	-4.0	-3.3	-2.8	-2.2	
Deficit in balance of goods and services	-10.1	-9.0	-7.9			-6.1	-5.0	-4.2	-3.6	-3.1	-2.6	
Exports	46.9	44.3	37.2			32.4	30.8	30.1	29.3	28.7	28.1	
Imports	36.7	35.2	29.3			26.3	25.8	25.8	25.7	25.6	25.6	
Net non-debt creating capital inflows (negative)	-1.0	-2.0	-3.7			-2.5	-2.5	-2.6	-2.9	-2.9	-2.8	
Automatic debt dynamics 1/	-6.7	-1.1	-9.4			-0.6	-0.8	-0.8	-1.0	-1.1	-1.0	
Contribution from nominal interest rate	5.1	4.2	2.4			2.0	2.1	1.9	1.7	1.5	1.4	
Contribution from real GDP growth	-5.1	-3.4	-2.9			-2.6	-2.8	-2.7	-2.7	-2.6	-2.4	
Contribution from price and exchange rate changes 2/	-6.7	-1.8	-9.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.3	12.0	1.7			-2.1	0.5	2.3	2.3	2.3	2.2	
External debt-to-exports ratio (in percent)	201.3	212.6	203.8			199.7	184.7	172.5	160.2	148.1	137.6	
Gross external financing need (in billions of US dollars) 4/	24.5	27.6	30.6			19.8	17.8	13.5	13.8	12.8	13.5	
in percent of GDP	16.3	19.5	17.6			9.5	7.8	5.6	5.3	4.6	4.5	
Key Macroeconomic Assumptions												Projected Average
Real GDP growth (in percent)	4.9	3.5	3.7	5.9 7/	2.0	4.1	4.8	5.0	5.5	6.0	6.0	5.2
GDP deflator in US dollars (change in percent)	2.8	-7.8	16.7	2.8 7/	8.2	15.5	4.8	1.3	1.2	1.9	1.6	4.4
Nominal external interest rate (in percent)	4.9	4.2	3.1	5.1	1.0	3.1	3.5	3.5	3.5	3.5	3.5	3.4
Growth of exports (US dollar terms, in percent)	26.6	-11.0	2.9	9.2	11.0	4.8	4.5	3.6	4.1	5.9	5.4	4.7
Growth of imports (US dollar terms, in percent)	29.8	-9.6	2.0	10.5	11.7	7.8	7.8	6.4	6.1	7.7	7.4	7.2
Current account balance, excluding interest payments	10.4	9.1	6.9	3.7	4.4	5.8	5.0	4.0	3.3	2.8	2.2	3.9
Net non-debt creating capital inflows	1.0	2.0	3.7	2.5	2.1	2.5	2.5	2.6	2.9	2.9	2.8	2.7
II. Stress Tests for External Debt Ratio												**Debt-stabilizing non-interest current account**
A. Alternative Scenarios												
A1. Key variables are at their historical averages in 2004-08 5/						**64.7**	**59.8**	**54.5**	**49.2**	**44.4**	**39.3**	**-4.3**
A2. Reduction in GDP growth (relative to baseline) of one standard deviation						**64.7**	**58.3**	**54.0**	**49.9**	**46.0**	**42.7**	**-4.1**
A3. Selected variables are consistent with market forecast in 2004-08						**64.7**	**56.2**	**49.9**	**44.9**	**40.5**	**36.6**	**-4.3**
B. Bound Tests												
B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005						**64.7**	**59.1**	**55.8**	**50.7**	**46.2**	**42.2**	**-4.5**
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005						**64.7**	**58.7**	**55.3**	**50.2**	**45.7**	**41.8**	**-4.7**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005						**64.7**	**66.6**	**69.8**	**64.3**	**59.3**	**54.9**	**-6.2**
B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005						**64.7**	**67.1**	**70.8**	**65.2**	**60.0**	**55.4**	**-5.1**
B5. Combination of 2-5 using one standard deviation shocks						**64.7**	**71.6**	**78.4**	**71.9**	**65.9**	**60.7**	**-5.9**
B6. One time 30 percent nominal depreciation in 2004						**64.7**	**76.2**	**70.8**	**65.3**	**60.3**	**55.8**	**-6.3**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes price and exchange rate changes
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year.
7/ Excluding 1998-99, which represented extreme outliers due to the depth the crisis in Indonesia, average real GDP growth over the past decade is 6 percent and GDP deflator growth has been 3 percent.

INDONESIA: WORLD BANK–IMF RELATIONS[1]

For questions relating to this annex, contact Mona Haddad (phone: 473-6127) at the World Bank.

The World Bank has a wide-ranging policy dialogue in Indonesia focusing on improving the climate for high quality investment, making service delivery responsive to the needs of the poor, and addressing the core issue of governance. This focus, reflected in the new Country Assistance Strategy (CAS) of October 2003, is motivated by the fact that further progress in reducing poverty is prevented by two major factors—low investment and weak service provision—which in turn are caused primarily by governance problems.

World Bank Policy Dialogue

Poverty alleviation and PRSP. Macroeconomic stability and modest growth have reduced income poverty to pre-crisis levels. But progress is lagging in other aspects of poverty reduction, with basic services still failing the poor—some 53 percent of Indonesians lack access to at least one basic service (water, sanitation, education, and health), particularly with respect to water and sanitation. The Government continues to make progress toward completing a poverty reduction strategy by end-May 2004. In early 2003, the Government completed its interim PRSP (I-PRSP) which laid out four thematic pillars that would support its full strategy: (i) creating opportunities; (ii) empowerment; (iii) human capital development; and (iv) social protection. The Bank continues to actively support this process, through analytical work aimed to help the Government formulate policy options for poverty reduction. A PRSP trust fund supported by the World Bank and other donors, and executed by the government, is also in place to support the Ministry of Planning (Bappenas) in refining and implementing the PRSP, linking it to planning and budgeting, and integrating it in the new five-year plan.

Fiscal issues. While the Fund is in the lead in developing fiscal policy and overall fiscal targets, the Bank takes the lead on: the development budget and sectoral allocation, fiscal decentralization, and civil service reform. The Bank also plays a significant role in public financial management and in capacity building for long-term debt management. In the area of tax and customs administration, the Bank supports institutional reforms initiated under the Fund-supported program and complemented by ongoing Fund technical assistance.

Development budget and sectoral allocations. Persistent under-spending of development expenditures remains a concern. While Parliament opted for higher development expenditures in 2003 (to 3.4 percent of GDP from 2.8 percent) to stimulate the economy and improve the deteriorating infrastructure which was underfunded during the crisis, actual spending remained well below budgeted. These sectoral spendings are now largely responsibilities assigned to subnational entities; their implementation depends on putting in place adequate mechanisms to foster decentralization in each sector and redefining a new role for the center.

[1] Prepared by World Bank staff.

Decentralization. While the transition to decentralization went smoother than expected, and promising reforms are emerging in numerous regions, serious challenges could endanger the success of decentralization in the medium term. First, the assignment of functions across levels of government lacks clarity. Second, the distribution of revenues through the general allocations fund is highly inequitable and leads to large inter-regional imbalances. Third, there is no clear policy on regional borrowing, beyond on-lending and on-granting of donor funds through the central government. Fourth, local tax authority is limited, with only minor taxes assigned to local governments; at the same time, a plethora of local nuisance taxes and charges are being introduced. Fifth, the authority over civil service is unclear.

The Bank has been an active supporter of the decentralization process in Indonesia. Through the Dutch Trust Fund, it has been providing technical assistance and policy advice to improve the policy framework for decentralization, including intergovernmental transfers, regional revenue, regional borrowing, reporting of regional budgets, minimum service standards, monitoring and evaluation, and review of regional regulations. Various sector reports, including on health, education, and environment, analyzed the impact of decentralization on sector management. A Regional Public Expenditure Review process was started in 1999, and is being expanded to new regions. An overview report on Decentralizing Indonesia was issued in June 2003. The Indonesia Decentralization Empirical Analysis (IDEA) research program was launched in September 2003 and will provide a comprehensive analysis of the impact of decentralization on governance and service delivery. The Bank is also supporting the regions through its sectoral projects at the local and provincial level. At the core of the decentralized lending program are the projects to improve governance at the local rural and urban levels through the Initiative for Local Government Reform and the Urban Sector Development and Reform Project.

Civil service reform. Indonesia's civil service size is at par with countries of similar per capita income. But decentralization created imbalances in the staffing of local governments, and regions have little discretion in personnel decisions. Moreover, there is an ongoing debate about whether civil service pay is appropriate, and whether it is linked to corruption in the public sector. The political will to embark on a major reform of the civil service has been lacking. Through its support for the Partnership for Governance Reforms, the Bank has been supporting civil service reform experiments at the local level. But the legal and institutional basis for greater flexibility to reforming regional governments will need to be put in place. In the medium term, a civil service reform agenda would need to comprise core elements such as a review of the administrative structures at the central and sub-national levels based on the new role of the state.

Tax and customs administration. Major multi-year reform strategies have been developed by the Ministry of Finance (drawing on Fund technical assistance) for tax and customs administration aiming at improving compliance and facilitating trade. These require major changes in the organizational structure of tax administration, a redesign of procedures, and substantial investment in IT and office infrastructure. The Bank is providing additional technical assistance to finalize and implement key elements of the reform strategies, in particular regarding performance measurement, human resource management, and redesign of procedures. Special emphasis will be put on improving stakeholder relations and accountability mechanisms.

Long-term debt management capacity building. The government has made significant progress in debt management. With the government's financing needs rising sharply in 2004, developing the domestic bonds market is crucial for fiscal sustainability. Along with AusAID, the Bank is providing technical assistance and advice on building debt management capacity, including setting up an integrated debt management unit to establish a debt strategy and manage risk, implement an integrated debt reporting and risk management system that assesses vulnerability, risk, and cost in a sovereign liabilities portfolio, improve the "front, back, and middle-office" functions for public debt management, and monitor fiscal risks associated with the government's contingent liabilities and incorporate them into debt management policy decisions.

Public financial management. Much progress has been achieved in this area. The new Law on State Finances, while at a high level of generality, provides for the first time a modern and coherent framework for Indonesia's PFM system on which the reform agenda will build. The planned reorganization of the Ministry of Finance is on track, and may even be advanced. At the request of the Ministry of Finance, the Bank is preparing a Government Financial Management and Revenue Administration Project (GFMRAP). The project is intended to finance a set of core institutional reforms initiated by the Ministry of Finance. The reforms cover three major areas: public financial management (including MOF reorganization, budget preparation and scope, Treasury modernization and e-procurement), tax administration and customs. The Bank is working closely with Fund staff on this project.

Financial Sector. Collaboration among the IFIs has been extensive and strong since the onset of the banking crisis in the late 1997. The Bank assumed lead responsibility for the oversight of IBRA and three of the four state-owned banks; the Fund for the central bank, Bank Mandiri, and development of the financial safety net; and the AsDB for the pension, insurance, SME, and capital market sectors. Bank staff have participated in many Fund missions and are continuously coordinating with the Fund and AsDB staff in providing regular inputs and technical assistance to the financial sector authorities. The division of labor described above largely remains in place.

The health of the banking sector has improved significantly since the 1997 crisis. The government, through state-owned banks and the one remaining IBRA bank, is still the largest shareholder of the sector. Banks frauds brought to light recently indicate weaknesses in governance, internal control, and risk management at state owned banks. The insurance and pension sectors are growing steadily. The capital market is buoyant due to low interest rates and a stream of new bonds offerings and SOEs privatization. The Bank's overall financial sector program is shifting from a banking crisis management to a medium- and longer-term development of the financial sector aiming at improving the climate for high quality investment. This requires (i) finishing the banking sector restructuring agenda and creating an appropriate financial sector safety net; and (ii) increasing the role of non-bank financial institutions to provide better support of development finance and to achieve a more diversified financial sector that can provide a cushion in the event of shocks to the economy. With these building blocks, the Bank will continue and extend its policy dialogue with post-IBRA institutions, continue monitoring the three state-owned banks overseen by the Bank, and provide assistance to the regulatory and supervisory authorities of capital market, pension funds, insurance and other nonbank financial institutions.

Private Sector. The Bank was the only donor to receive a capital market recognition award by the government in December 2003 for providing comprehensive technical assistance programs since 2001 to the Capital Market Supervisory Agency and Jakarta Stock Exchange, which include a strategic plan on its demutualization. The Bank has been requested by the Finance Minister to further engage in this area, specifically in debt management, secondary markets for government debt, corporate bond market, and equity markets. The Bank is also involved in capacity building of non-bank financial institutions regulators, including for insurance and pension funds. The Corporate Restructuring Technical Assistance project, which funded the establishment of a temporary corporate debt mediation institution—the Jakarta Initiative Task Force (JITF)—was completed in December 2003. By the end of the project, JITF had finalized the mediation of debt restructuring in the amount of $20.6 billion, or around one third of the total corporate loans that had become nonperforming as a result of the crisis. In addition, JITF had produced a commendable corporate debt monitoring tool with its quarterly debt survey.

In corporate governance, the Bank provided support to the National Committee on Corporate Governance to disseminate the Code of Good Corporate Governance, and to the Indonesian Institute for Corporate Directorship Institute in its curriculum design and training for trainers and directors. A ROSC on corporate governance is about to be completed for Indonesia and the Bank's future work will be aligned with its findings. In competition policy, the Bank was an active donor since the inception of the competition agency in 2000 until recently, and has participated in the regional ASEAN conference on competition policy in 2003. By hosting private sector fora, the Bank played a catalytic role in encouraging more open dialog between the Government and the private sector to improve the investment climate. Recognizing the impact of decentralization on the business environment, the Bank took the fora to the local (municipal) level.

Trade. Indonesia is a very open economy and has greatly benefited from its export-oriented growth strategy over the past two decades. But new challenges—including a deteriorating investment climate and increased external competitive pressures—have adversely affected its export performance. The government has resorted to short-term, ad hoc measures to shield critical labor-intensive sectors, such as garments and key agriculture commodities. The Bank is preparing a comprehensive Diagnostics for Trade Integration Study, which includes topics such as trade in services, trade facilitation and logistics, and the institutional framework for trade policy. The Bank has also provided the government short policy notes on key WTO issues of interest to the Ministry of Industry and Trade, as well as a series of training (on trade in services and WITS, a trade database) and seminars (on recent WTO issues and market access).

Investment climate. Even with macroeconomic stability now back on track, growth remains modest and investment is not picking up as the investment climate deteriorated following the crisis. Preliminary results from the World Bank-AsDB Private Investment Climate Survey (PICS) show that the main concerns of investors in Indonesia are macroeconomic instability, policy uncertainty, and corruption. The government has recognized the importance of improving the investment climate and has laid out a whole set of measures for that purpose, ranging from trade policy, a new investment law with a one-stop shop, improvement in licensing procedures, tax and customs administration, revamping of infrastructure, and improving the legal framework and labor regulations. The Bank is undertaking jointly with the AsDB an investment climate survey (of about 800 firms) and will prepare an investment climate assessment to identify and prioritize the main constraints to investment and firm performance. A joint Bank-AsDB workshop was organized in February 2004 for the private sector and the government to present preliminary results of the survey.

Corruption, justice and legal reforms. Indonesia's transition to a more open, competitive society provides new opportunities for improving governance. But there has been weak implementation of many of the major policy and institutional reforms introduced under *Reformasi*. The Bank's country assistance strategy is to allocate its activities based on where there is scope for achieving, demonstrating, and multiplying governance improvements. Rather than proposing a set of stand-alone governance and anti-corruption projects, these issues are central to all aspects of the program. The Bank's program is designed to foster transparency and accountability through two complementary approaches: (i) by enhancing the demand for good governance through greater public participation in policy-making and policy-monitoring processes across different levels of government, and (ii) by strengthening the institutions that are accountable for implementing the impressive body of laws to improve governance already passed during the *Reformasi* period. The goal of the program is to help Indonesia address what might be described as an increasing accountability gap—i.e., the perception that the tremendous gains in transparency and democratic competition since the fall of the New Order have not been matched by genuine government accountability for demonstrable results in restoring integrity to the public sector and reducing corruption. The Bank issued a report on Combating Corruption in Indonesia in October 2003.

World Bank-Fund Overall Collaboration

Bank-Fund collaboration in Indonesia has taken place at two levels: (i) through the lending program; and (ii) through analytical and advisory services. With the end of the Fund-supported program and with the Bank's new CAS, macroeconomic stabilization through the Fund program is no longer an explicit conditionality of Bank lending. But there is close collaboration in a number of areas, including on the PFM/tax and customs administration initiatives, decentralization, debt management, financial sector reforms, and legal reforms.

Lending Operations

For the new CAS period (FY04–07) the Bank Group will continue to focus its program on those areas most crucial to poverty reduction. At present there are two primary constraints to further reductions in poverty: (i) inadequate productive employment opportunities, which result from low investment and a weak investment climate; and (ii) lack of quality service delivery to poor people. Progress in these two areas, in turn, is being compromised by the underlying problem of weak governance. The World Bank Group's strategy is to address the objectives of strengthening the investment climate and service delivery including, critically, the issue of governance. Four delivery platforms—corresponding to the community, local (district and provinces), public utilities, and national levels—will be used to deliver results in these areas.

The base case lending would be of $450–$850 million per year. Under the last CAS, the base case was set at $400 million and the high case at $800 million. By the end of the last CAS's period, Indonesia had broadly achieved the high case triggers and thus became eligible for $1billion lending per year. The base case is premised on continued but incremental reforms that lead to gradual improvements in governance and the investment climate. In the event of sharply accelerated reform, the high case lending would reach up to $1.4 billion per year. This would require strong measures in the areas of governance and the investment climate that would result in a more immediate resumption of higher growth rates and more decisive action and results in reducing poverty. In response to the government's request, a policy-based program loan supporting the government's reform program is proposed for the first half of FY05. This program loan would be made available under an "enhanced" base case situation. The Bank's projects proposed for FY04–07 fall into five categories: community development, infrastructure, human development, decentralization/governance reform, and environment.

Summary of Nonlending Services (FY03–06)

Recently completed products	***Products underway or planned***
Public Expenditure Review	Aceh Regional Public Expenditure Review
Regional Public Expenditure Review	Justice and the Poor
Decentralizing Indonesia	
	Education Sector Study
Development Policy Review/CGI Brief	Public Expenditure Review
Bali Impact Monitoring	Forest Policy Strategy
Urban Competitiveness Study	Averting an Infrastructure Crisis
Promoting Peaceful Development in Aceh	Mining Indonesia's Wealth Responsibly
Rural Services for the Poor	Trade Competitiveness Study
Financial Sector Strategy	Policy Briefs for Incoming Government
Road Management Study	Investment Climate Flagship
Sectoral Perspectives on Corruption	Local Government Reforms Flagship
	Corruption and Legal Reforms Flagship
	Poverty Assessment
	Making Services Work for the Poor

Source: *Indonesia Country Assistance Strategy, October 2003.*

INDONESIA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

Asian Development Bank (AsDB) cumulative loans to Indonesia reached over $19.4 billion at end-December 2003. Technical assistance projects amounted to $212 million as of December 31, 2003. In 2003, the AsDB approved a total of $262 million which consisted of six loans for three projects in health, irrigation and housing. The AsDB is working closely with government agencies to develop and implement reform agendas in other sectors including corporate governance, trade and industry, financial sector, power sector restructuring, decentralization and environmental management. AsDB has also stepped up efforts to implement the Anti-Corruption Action Plan agreed with the government.

Table 1. Loan Approvals and Disbursements to Indonesia[1]
(In millions of U.S. dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Loan approvals	1,055.7	952.1	1,108.8	1,836.0	1,020.0	800.0	500.0	767.2	261.6
Loan disbursement	710.0	722.3	676.6	1,079.0	1,329.4	748.4	686.0	1000.5	442.9
Undisbursed balance at the beginning of the year	3,642.8	3,668.2	3,957.3	3,902.0	4,503.0	3,799.0	3,048.0	2814.7	2633.4

Source: Asian Development Bank, *2003 Annual Report*, and AsDB staff.
[1]Include loans to private sector without government guarantee but excludes equity investments.

Table 2. Cumulative Lending to Indonesia
(As of December 31, 2003)

Sector	No of Loans	$ Million	%
Social infrastructure	60	4,687.7	24.2
Agriculture and natural resources	100	4,018.7	20.8
Energy	30	3,431.0	17.7
Transport and communication	31	2,544.9	13.1
Finance	12	3,087.0	15.9
Multisector	7	689.0	3.6
Industry	15	716.7	3.7
Others	5	182.8	0.9
Total	**269**	**19,357.8**	**100.0**

Source: Asian Development Bank, *2003 Annual Report*, and AsDB staff.

[1] Prepared by AsDB staff.

Statement by the IMF Staff Representative
May 3, 2004

1. **This statement provides a factual update of economic and policy developments since the issuance of the staff report**. The staff appraisal remains valid.

2. **The April 5 parliamentary elections proceeded smoothly and peacefully**. Pending the completion of vote-counting, indications are that Golkar (ex-President Suharto's party) has won around 21 percent of the vote, with President Megawati's PDI-P party coming second with 19½ percent, and a couple of smaller parties doing better than expected. The focus is now shifting to the presidential election scheduled for July 5. The main candidates are: President Megawati (PDI-P); head of the People's Assembly (MPR), Amien Rais (PAN party); former Coordinating Minister for Security Affairs, Susilo Bambang Yudhoyono (Democrat party); and ex-general Wiranto (Golkar).

3. **Financial markets have reacted positively to the peaceful election outcome**. The stock market rallied to new highs in the weeks following the election, before falling back somewhat in recent days, in line with regional developments. The rupiah has remained broadly stable in recent weeks, at around Rp 8,600 – 8,700 per dollar. Yields on long-term government bonds have continued to decline. At the most recent auction on April 27, Rp 3 trillion in 7½ year bonds were placed at a yield of 10.7 percent, down from 11.6 percent in the previous auction in March.

4. **In mid-April, Bank Indonesia revoked the licenses of two small banks which were in violation of prudential requirements**. The closure of the banks was implemented smoothly, with coordination among the relevant agencies. Market sentiment was not adversely affected.

5. **A recent controversial bankruptcy ruling has again underscored the need to accelerate legal reforms to improve the investment climate**. On April 23, Prudential Life Assurance, the Indonesian subsidiary of a major United Kingdom-based insurance company, was declared bankrupt by the Central Jakarta Commercial Court, in response to a petition from a former consultant whose contract had been terminated. The ruling is widely considered as not supported by law, and echoes a similar finding of bankruptcy against the subsidiary of a Canadian insurance firm in 2002 (later overturned by Indonesia's Supreme Court). Prudential is appealing the decision, and senior officials have expressed serious concern over the ruling and their hope that it will be overturned eventually. The episode highlights the need to improve governance and proceed with judicial sector reforms.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with Indonesia

On May 3, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Indonesia.[1]

Background

Since the last Article IV consultation, Indonesia has made significant progress in strengthening macroeconomic policies and implementing key areas of the structural reform agenda, notably with regard to rehabilitating the banking sector. Indonesia's economic performance has improved correspondingly, and following an impressive fiscal consolidation and disinflation effort, and a significant reduction in external vulnerability, the authorities have laid a strong macroeconomic foundation for Indonesia's economic development.

Nevertheless, Indonesia's economic performance has continued to lag behind other countries in the region, with GDP growth, investment, and exports, continuing to perform less favorably when compared to the experience of other Asian economies. Remaining structural weaknesses, particularly with regard to the development of institutions needed for a stable and efficient market-based economy, have impeded the pace of Indonesia's economic recovery.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies.
On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The economy performed relatively well in 2003, showing commendable resilience to a number of shocks, including the regional impact of Severe Acute Respiratory Syndrome (SARS) early in the year, the Marriott bombing in August and the lingering after-effects of the Bali bombing in late 2002. Growth edged up to 4.1 percent, supported by strong private consumption. Inflation continued to fall, reaching 5.1 percent in March 2004, and sustained current account surpluses and improved capital flows have led to a significant increase in external reserves and a corresponding reduction in external vulnerability. Although the fiscal deficit exceeded the budget target by a small margin, public debt ratios continued to decline.

The ongoing improvement in the economy was underpinned by steady policy implementation. Performance in the last year of the extended arrangement was relatively good, with all four reviews completed on schedule and significant advances made in bank divestment and fiscal reforms. The government's economic strategy for the post-program period, set out in its White Paper, has provided continuity in the reform process, with a number of notable advances achieved so far in 2004. The sale of Lippo Bank has been concluded, a further minority stake in bank Mandiri has been divested, Indonesian Bank Restructuring Agency (IBRA) has successfully completed its operations, and long-delayed amendments to the BI law have been adopted.

Indonesia's economic performance is projected to continue to strengthen in 2004, provided that sound policy implementation is sustained during the remainder of the year. Growth is projected to pick up to 4.8 percent, sustained by robust consumption. Inflation should remain subdued at around 5 percent. Although the trade surplus is expected to narrow, as imports recover, the current account surplus is expected to remain in substantial surplus. This, together with some improvement in the capital account, would enable Indonesia to absorb the absence of exceptional financing from the Fund and Paris Club creditors, while maintaining a comfortable external reserve position.

The medium-term outlook is sensitive to progress made to improve the investment climate. If strong progress is made, the government's medium-term objectives of raising GDP growth to 5-6 percent could be realized. Such an outturn would be predicated on a rise in investment and a pick-up in exports. Achievement of this outlook depends on progress on addressing institutional weaknesses, particularly with regard to strengthening the legal system, reducing regulatory uncertainty, and improving public sector institutions.

Indonesia's first Stand-By Arrangement was approved on November 5, 1997, with a total of SDR 3.7 billion being drawn (out of a total SDR 8.3 billion). The Stand-By was replaced by an extended arrangement on August 25, 1998, under which about SDR 3.8 billion was drawn (out of an augmented total of SDR 5.4 billion). A new Extended Arrangement in the amount of SDR 3.6 billion was approved on February 4, 2000, and was extended by a year in January 2002. The arrangement concluded on December 31, 2003, with all available purchases drawn. Indonesia's obligations to the Fund now amount to the equivalent of about US$10 billion.

Executive Board Assessment

Executive Directors commended the Indonesian authorities for their good record of policy implementation in recent years, which has successfully restored macroeconomic stability and reduced external vulnerability. Real GDP has surpassed its pre-crisis levels, inflation has declined, the exchange rate has stabilized, gross reserves have risen to comfortable levels, and the public debt has fallen significantly as a share of GDP. These developments have contributed to a strengthening in market sentiment, as underscored by the recent successful sovereign bond issue, marking Indonesia's return to the international capital markets.

Directors noted that despite these achievements, the authorities face the significant challenge of putting Indonesia on a higher sustainable medium-term growth path while maintaining market confidence going forward. Directors observed in this connection that Indonesia's economic performance has lagged behind that of its regional partners, and that the economy is yet to fully share in Asia's recovery. GDP growth continues to be below potential, and investment and exports remain weak. Directors considered that strong efforts to enhance the investment climate will be crucial for achieving higher rates of growth and poverty reduction. In this regard, they welcomed the authorities' focus on improving the business environment, as well as on maintaining macroeconomic stability and continuing the restructuring of the financial system.

Directors commended the authorities for their continued emphasis on fiscal consolidation, which should help further reduce the level of public debt. They welcomed the government's commitment to achieving its 2004 budget deficit target despite the challenges and spending pressures of an election year. Directors noted that over the medium term it will be important to reduce reliance on declining oil revenue by enhancing non-oil tax revenues through broadening the tax base and strengthening tax administration. A priority will also be to strengthen the governance framework in the institutions responsible for tax policy and administration. Directors saw scope for savings in the wage bill and noted the need to improve the efficiency of spending by phasing out poorly targeted subsidies—including for petroleum products—and to ensure that any revisions to the decentralization framework do not weaken the central government's fiscal position. Directors recommended a continued strengthening of debt management and a cautious approach to foreign currency bond issues, and they welcomed the use of a collective action clause in the recent foreign currency bond issue.

Directors welcomed the authorities' progress in reducing inflation. Together with the stability of the rupiah, this has provided room for significant reductions in policy interest rates over the past year. Looking ahead, Directors urged Bank Indonesia to maintain a cautious monetary stance, particularly in light of the potential for shifts in market sentiment and the prospect of higher interest rates abroad. They supported the authorities' intention to move over time to an inflation targeting framework, as well as their continued commitment to a floating exchange rate regime.

Directors emphasized that continued financial sector reform will be key to returning Indonesia to a higher growth path. They commended the authorities on the successful closure of IBRA, and emphasized that the successor public sector asset management company should press ahead with the disposal of remaining assets. Directors were encouraged by the progress made in putting in place a financial safety net, including the establishment of procedures on bank resolution and lender of last resort support. They called for early passage of the deposit insurance legislation to enable a phased removal of the blanket guarantee on bank liabilities, and emphasized the importance of improving the accountability of the central bank by establishing the planned supervisory body for Bank Indonesia. The authorities were commended for the steps taken to strengthen the Anti Money Laundering (AML)/Combating the Financing Terrorism (CFT) framework, and were encouraged to move ahead with the implementation of further planned reforms.

Directors noted that state banks continue to be the main source of fragility in the financial system. They urged the authorities to maintain close oversight of state banks to strengthen their financial position and ensure that their lending practices are in line with sound banking standards. Also, they stressed that exerting moral suasion on banks to increase lending and lower interest rate spreads, could entail risks for the health of the banking system. Directors encouraged the development of a strategic plan aimed at reducing the risks posed by the state banks by increasing private sector participation and improving their efficiency and governance.

Directors were encouraged that further structural reforms to strengthen the investment climate and bolster export performance are a central theme of the government's White Paper. They welcomed the authorities' recognition that priorities include addressing weaknesses in the area of tax administration, and recommended that emphasis be placed on avoiding arbitrary tax assessments, illegal fees, burdensome customs procedures, and inefficiencies in the refund system for VAT and income taxes. Directors suggested that the authorities use the pending tax legislation to address these issues.

Directors urged the authorities to strengthen their efforts to establish a clear and competitive framework for labor relations, the absence of which remains a major impediment to investment. Specific steps in this direction should include finalizing the implementing regulations associated with the manpower and industrial disputes legislation, in a manner that protects workers' rights while maintaining labor flexibility. They urged that minimum wage increases be contained to preserve competitiveness and reduce unemployment.

Directors underscored the need for progress in strengthening key institutions, particularly in the legal and judicial areas, to enhance certainty with regard to property rights and contract enforcement. In this regard, Directors urged the authorities to secure approval of the relevant amendments to the bankruptcy law, and to support the ongoing efforts to strengthen the administrative capacity of the judiciary and enhance its accountability and the public's confidence, including through establishing the planned Judicial Commission. It will also be essential to push ahead with efforts to combat corruption and promote good governance by taking the steps necessary to make the Anti-Corruption Commission fully operational, and by expediting the establishment of the Anti-Corruption Court.

Directors welcomed the overall openness of Indonesia's trade regime and the authorities' commitment to further multilateral trade liberalization under the Doha round. They also welcomed the government's intention to allow temporary restrictive trade measures imposed in recent years to expire as scheduled, and urged the authorities to refrain from imposing any new restrictive measures.

Directors welcomed the use of post-program monitoring to maintain a close policy dialogue between the Indonesian authorities and the Fund, which should aim to help support Indonesia's reform efforts to promote foreign direct investment, economic growth, and poverty alleviation. Some Directors looked forward to early completion of the Poverty Reduction Strategy Paper (PRSP).

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

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	2000	2001	2002	2003 Est.	2004 Proj.
Real GDP (percent change)	4.9	3.5	3.7	4.1	4.8
Domestic demand	4.0	4.8	2.6	3.6	5.6
Of which:					
Private consumption	1.6	3.4	3.8	4.0	6.3
Gross fixed investment	16.7	6.5	0.2	1.4	3.5
Net exports 2/	1.0	-1.2	1.1	0.7	-0.5
Errors and omissions 2/	-1.1	0.2	-1.1	-0.5	0.0
Savings and investment (in percent of GDP)					
Gross fixed capital investment	21.8	21.4	20.3	19.7	19.5
Gross national savings	27.2	26.2	24.8	23.6	22.4
Foreign savings	-5.3	-4.8	-4.5	-3.9	-2.9
Prices (12-month percent change)					
Consumer prices (end period)	9.3	12.5	10.0	5.1	5.0
Consumer prices (period average)	3.8	11.5	11.9	6.6	5.0
Public finances (in percent of GDP)					
Central government revenue 3/	20.0	20.8	18.6	18.7	18.5
Central government expenditure	21.1	24.5	20.4	21.0	19.8
Central government balance	-1.1	-3.7	-1.8	-2.3	-1.3
Central government debt	100.3	90.9	80.3	66.5	61.0
Money and credit (end of period)					
Rupiah M2	13.8	13.6	7.9	10.0	12.3
Base money (test-period) 4/	22.8	2.1	6.0	14.3	8.6
Private sector credit 5/	5.2	18.0	21.9	22.0	18.4
One-month SBI rate (period average)	12.4	16.5	14.9	9.9	7.1
Balance of payments (in billions of U.S. dollars)					
Oil and gas (net)	8.6	6.4	5.7	5.7	6.6
Non-oil exports (f.o.b)	50.3	44.8	46.3	48.6	50.3
Non-oil imports (c.i.f)	-37.1	-31.3	-31.1	-32.9	-36.1
Current account balance	8.0	6.9	7.8	8.0	6.7
Overall balance	1.2	-2.9	0.9	0.6	0.0
Gross reserves					
In billions of U.S. dollars (end period) 6/	29.4	28.0	32.0	36.2	35.2
In months of imports	7.1	6.6	7.0	7.4	6.7
As a percent of short-term debt 7/	98.4	84.6	134.3	154.2	164.5

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External debt (medium- and long-term)					
In billions of U.S. dollars	141.7	131.2	129.8	132.4	127.9
(In percent of GDP)	94.3	91.6	74.9	63.6	55.9
Exchange rate					
Rupiah per U.S. dollar (period average)	8,422	10,246	9,295	8,578	...
Nominal effective exchange rate 8/	32.3	28.0	30.7	30.7	...
Real effective exchange rate 8/	62.7	59.7	72.5	76.3	...
Memorandum items:					
Indonesia oil production ('000 bcpd)	1,388	1,320	1,260	1,200	1,152
Indonesian oil price (US$/bbl)	27.4	23.3	24.2	27.4	28.5
Nominal GDP (in trillions of rupiah)	1,265	1,468	1,610	1,787	1,968
Nominal GDP (in billions of U.S. dollars)	150	142	173	208	229

Sources: Data provided by the Indonesian authorities; and IMF Staff estimates.

1/ Calendar years with the exception of public finances for 2000, which are based on the 9 month fiscal year from April to December.
2/ Contribution to GDP growth. Errors and omissions includes stockbuilding.
3/ Includes grants.
4/ 30-day average centered on end-December.
5/ At constant exchange rate, adjusted for loan transfers to and from IBRA.
6/ From 2002 onward reflects higher reserves reported in general ledger.
7/ Short-term debt is on a remaining maturity basis before rescheduling and including IMF repurchases.
8/ Period average (June 1997=100).