September 2005
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Indonesia: 2005 Article IV Consultation and Third Post-Program Monitoring Discussions—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Indonesia

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 2005 Article IV consultation with Indonesia, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 19, 2005, 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 June 21, 2005. 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 supplement of July 14, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 18, 2005 discussion of the staff report that concluded the Article IV consultation.

The document listed below has 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.

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INTERNATIONAL MONETARY FUND

INDONESIA

Staff Report for the 2005 Article IV Consultation and Third Post-Program Monitoring Discussions

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

Approved by Daniel Citrin and Carlo Cottarelli

June 21, 2005

- **The 2005 Article IV Consultation and Third Post-Program Monitoring discussions were held during May 9–19**. The mission met with Vice President Jusuf Kalla, Coordinating Minister for Economic Affairs Aburizal Bakrie, Coordinating Minister for Social Affairs Alwi Shihab, Minister of Finance Jusuf Anwar, Minister of Planning Sri Mulyani Indrawati, Minister of Trade Mari Pangestu, Minister of State Enterprises Sugiharto, Minister of Energy Purnomo Yusgiantoro, Minister of Labor Fahmi Idris, Bank Indonesia Governor Burhanuddin Abdullah, other senior officials, parliamentarians, trade unions, and private sector representatives.

- **The staff team** comprised Odd Per Brekk (head), Nita Thacker, Ashok Bhundia, Geremia Palomba (all APD), Amine Mati (FAD), Leslie Teo (MFD) and Matthew Jones (PDR); Messrs. Schwartz, Senior Resident Representative, and Khatri, Deputy Resident Representative, also participated. Ms. Phang (Executive Director) and Mr. Sukada (Alternate Executive Director), as well as Mr. Citrin (APD), attended some of the meetings. The mission liaised with the World Bank, AsDB, and key donors.

- **Indonesia's extended Fund arrangement expired on December 31, 2003**. Outstanding obligations to the Fund amounted to SDR 5.958 billion (286.5 percent of quota) on May 31, 2005, and would remain above 100 percent of quota until 2008 (expectations basis; Annex I, Fund relations).

- **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's exchange rate regime is a managed float.

- **Indonesia's economic data are adequate for surveillance purposes** (Annex II). Indonesia subscribes to the SDDS. A statistics ROSC was completed in early 2005; the government is expected to strengthen data quality based on the ROSC recommendations.

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EXECUTIVE SUMMARY

Background

Indonesia's sustained economic growth during the decades before the Asian crisis lifted millions out of poverty. The crisis had more severe ramifications in Indonesia than in other countries in the region. The previous government (2001-2004) restored macroeconomic and financial stability and also initiated structural reforms needed to boost investment and growth. While tackling the challenges posed by the tsunami disaster, the new government led by President Yudhoyono, which took office in October 2004, has continued and deepened these policies, notably by maintaining a restrained budget stance, replacing managements in state banks in a bid to improve governance, and taking steps to enhance the investment environment. The economic strategy has produced positive results over time; economic growth has gained momentum year by year, inflation has been substantially reduced (although underlying inflation has edged up during the last year), and the external position has remained sound. In spite of these achievements, considering Indonesia's widespread poverty and unemployment, the key policy challenge is to further deepen the reforms in order to place the economy on an even higher growth path. Moreover, financial markets have experienced pressures in early 2005, underscoring the need to protect the stabilization gains.

Key Issues and Staff Recommendations

The staff report fully supports the new government's economic strategy for 2005–09, which has the potential to realize Indonesia's growth potential and gradually reduce vulnerabilities. With determined implementation of this strategy, Indonesia could see real GDP growth increase to 7 percent per annum over the medium term. At the same time, uncertainties in the international environment pose risks to this economic outlook, putting a premium on sound economic policies. Concerning specific policy areas, the report:

- Welcomes the new government's focus on fiscal prudence and reduction in the debt burden, and advises that the government move ahead on fiscal-structural reforms and re-prioritize spending to improve the quality of fiscal policy.

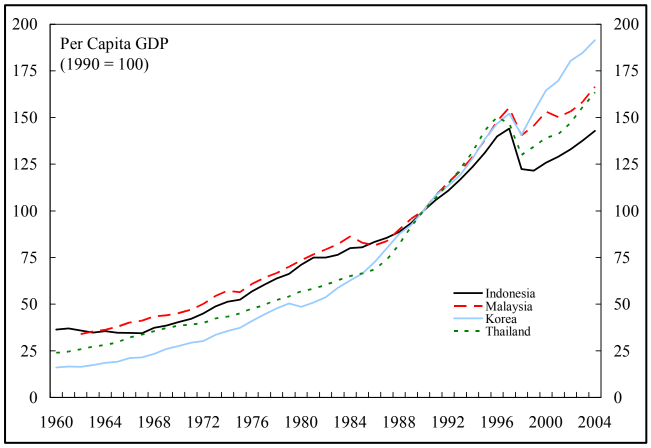
- Supports Bank Indonesia's plans to move to formal inflation targeting and its focus on putting inflation on a downward path through further interest rates increases as necessary, while maintaining the flexible exchange rate system. In this context, the report notes the importance of strong credibility in monetary policy.

- Advises further improvements in banking sector performance, especially state banks, and in financial sector supervision and governance. The report also notes the importance of establishing the financial sector safety net.

- Notes the plans to enhance the investment climate through improvements in the judiciary, infrastructure, governance and sectoral regulations, while stressing that sustained efforts will be needed to address deep-seated issues in these areas.

I. Background: The Economic Setting

1. **Indonesia's continuous economic growth during the decades leading up to the Asian crisis lifted millions out of poverty**. From the mid-1960s through the late 1990s, growth in Indonesia's income per capita kept pace with that of its neighbors. The Suharto regime, in power during this period, pursued an economic growth strategy spearheaded by well-connected industrial groupings financed in large part by directed lending from state-owned banks.

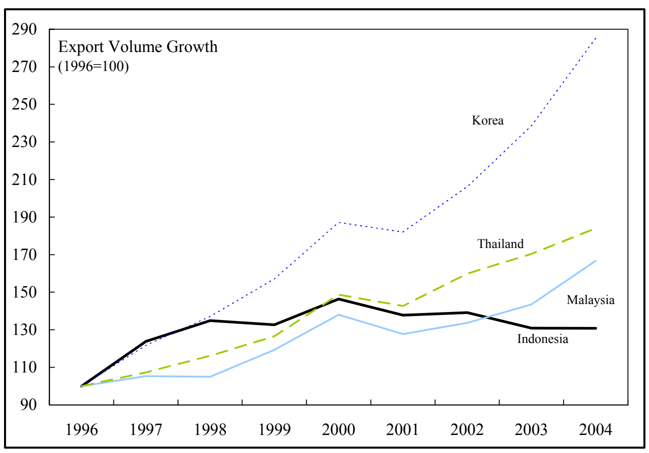


2. **In a regional perspective, the Asian crisis had relatively severe ramifications for Indonesia, and in the subsequent years the country has benefited less than others from the buoyant growth in the region**. The shock of the crisis was larger in Indonesia in part because the corporate and banking sectors had built up large foreign exchange exposures before the crisis, and were relatively more vulnerable to the exchange rate correction that followed. The subsequent recovery was slower than in other countries in the region, and also differed in that investment and export growth played a lesser role; Indonesia's economic growth was until recently driven by private consumption (Figure 1 and text table). The recovery in investment was hampered by political factors, as well as economic instability and weaknesses in the business climate. Indeed, the economic crisis set off a period of political change and a succession of governments, which created uncertainties and disruptions in the conduct of economic policies that in turn discouraged investment. Moreover, the instability contributed to exchange rate pressures and also higher inflation and real interest rates. Private investors were deterred also by institutional weaknesses in Indonesia's regulatory framework for key sectors, its judiciary, and its tax administration. The export sectors, in particular,

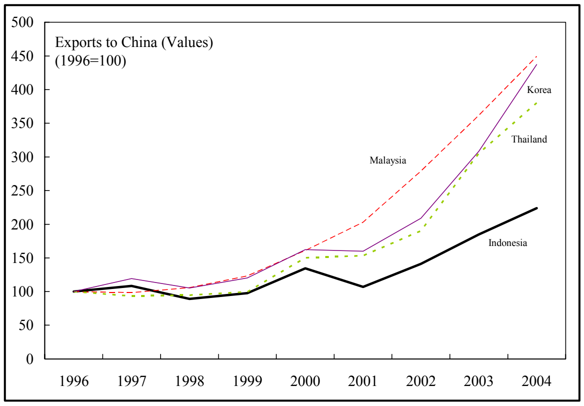
Components of Real GDP in 2004
(Index 1998=100)

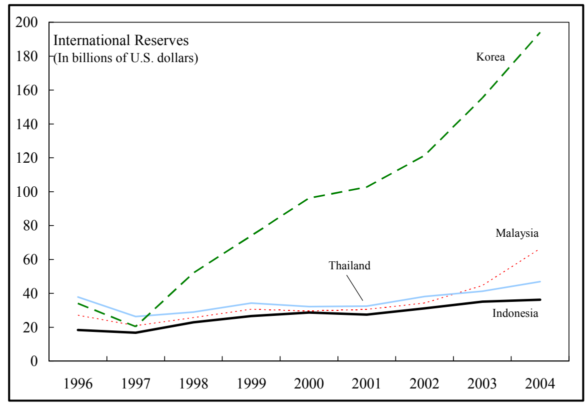
	Indonesia	Korea	Malaysia	Thailand
GDP	127	142	137	134
Private consumption	126	135	147	135
Investment	116	156	132	172
Exports	103	209	156	159

Source: CEIC.



appear to have suffered from the lack of investment, with Indonesia's exports—including exports to China—falling behind that of its peers (text charts). This was evident not only in manufacturing but also in the petroleum sector, where production has been on a steady decline, Indonesia's considerable petroleum resources notwithstanding. The relatively weak export performance also led to a slower build-up of official international reserves in Indonesia than among its peers (text chart).





3. **The previous government—in power from July 2001 to October 2004—restored macroeconomic and financial stability and also initiated structural reforms needed to boost investment and growth**.[1] Macroeconomic stability was aided by a reduction in the fiscal deficit, from 3.2 percent of GDP in 2001 to 1.4 percent of GDP in 2004 (Tables 1 and 2). Fiscal consolidation helped to bolster confidence and lower interest rates, laying a basis for the economic recovery. These developments combined to reduce public debt from 76 percent of GDP at end-2001 to 54 percent of GDP at end-2004. Meanwhile, important strides were made to stabilize and re-privatize intervened banks and strengthen bank profitability. Also, reform legislation was adopted in a number of structural policy areas. Against this background, Bank Indonesia was able to reduce interest rates gradually. These considerable achievements notwithstanding, the previous government left important reforms to be completed, notably with regard to the banking sector and the investment environment.

4. **The new government led by President Yudhoyono took office in October 2004 with a strong emphasis on reducing unemployment and poverty**. Indonesia's first direct presidential elections were held in 2004, giving the new government a solid mandate to carry

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[1] During 2000–03, Indonesia's economic program was supported by the Fund under an EFF arrangement. See the staff report (IMF Country Report, 04/188)) and Selected Economic Issues paper (IMF Country Report, 04/189) for the 2004 Article IV consultation for a retrospective on Indonesia's achievements under the Fund-supported program. The staff report for the second PPM discussions (IMF Country Report, 05/108) provides a detailed discussion of developments in 2004.

forward the necessary economic reforms. Upon assuming office, the government drew up a medium-term program designed to sustain and deepen the economic policy reforms carried out by its predecessor. The program, which was adopted in January, seeks to spur sustainable economic growth through a continuation of fiscal consolidation aimed at lowering the debt burden, a monetary policy geared toward low and stable inflation, and a strengthening of the financial sector, combined with an intensified drive to improve the investment climate by rebuilding infrastructure, bolstering the legal framework, and enhancing governance. Besides deepening economic reforms, the new government has faced the formidable challenge of managing emergency assistance and reconstruction in the aftermath of the earthquake and tsunami disasters in late 2004 and early 2005. In that regard, the government rapidly formulated a blueprint for reconstruction in the affected regions, although implementation has subsequently faced bottlenecks.[2] In spite of these challenges, eight months into its term, the new government has carried the economic agenda forward. In particular, it has:

- **Continued conservative budget management**. On March 1 this year, the government implemented a politically difficult increase in administered fuel prices, of almost 30 percent on average, to reduce the budgetary burden of poorly targeted fuel subsidies. Preliminary data for the first four months of 2005 show a better fiscal performance than expected caused by strong revenues and a marked slowdown in spending. On the revenue side, VAT and income tax receipts received a boost from domestic demand. The low expenditures mainly reflected postponement of capital spending owing to implementation problems and delays caused by new disbursement guidelines.[3]

- **Replaced management in state bank Mandiri in a bid to improve governance**. The management of Indonesia's largest bank, state-owned Bank Mandiri, was replaced in May, amidst a corruption inquiry, and three top officers were detained. There were management changes also in the second and third largest state banks.

- **Taken steps to enhance the investment environment**. The government's Infrastructure Summit in January attracted considerable investor interest, and the government is reforming the regulatory framework in the relevant sectors. Also, the government has published a new petroleum sector strategy designed to revitalize the sector. A new investment law aimed at reducing substantially the number of days needed to start a business is being prepared. Finally, various government agencies are investigating cases of irregularities and corruption, in state banks as well as in state-owned enterprises.

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[2] Box 1 provides an overview of the economic implications of the natural disasters, including the financial support and rebuilding efforts.

[3] New budget implementation documents allocating appropriations to spending units are now part of the central government budget process. The spending delays occurred as the Ministry of Finance awaited clarification of authority before signing appropriations.

Box 1. Macroeconomic Effects of the Natural Disasters

The December 26, 2004 earthquake and tsunamis—and the earthquake that hit in March 2005—inflicted a huge toll on Indonesia in terms of loss of life and damage to infrastructure and homes in the province of Nanggroe Aceh Darussalam (Aceh). However, the macroeconomic impact has been modest. This reflects the fact that Aceh accounts for only 2 percent of national GDP, and that the oil and gas sector, accounting for almost half of the region's GDP, remains intact. Moreover, the negative supply side impact, in terms of reduced agricultural production in the region, is expected to be largely offset by reconstruction spending.

The Ministry of Development Planning has developed a blueprint for the reconstruction of Aceh based on a sector-by-sector study done for the Consultative Group meeting in January. This study puts the total cost of reconstruction at US$4.5 billion. These estimates may be further adjusted once the actual reconstruction begins.

The financing needs arising from the reconstruction will be met largely through international financial assistance. At the Consultative Group meeting, donors pledged nearly US$4 billion to finance reconstruction over the period 2005–09. Of this total, US$1.7 billion was pledged for 2005, with US$1 billion expected to be on-budget and the remainder disbursed directly or through NGOs. One third of the budget support in 2005 is expected to be in the form of grants and the rest in concessional loans. In addition, the Indonesian authorities have accepted the Paris Club offer of a moratorium on debt service due in 2005. They have contacted creditors to discuss the moratorium interest, which is to be negotiated on a bilateral basis. The moratorium will provide US$2.6 billion in budget savings to be spent on tsunami reconstruction. The overall impact on the 2005 budget deficit of the tsunami-related transaction is expected to be relatively modest.

Budgetary Impact of Tsunami
(In millions of U.S. dollars, unless otherwise indicated)

	2005	2006	2007	2008	2009	2005-2009
Additional expenditures	1,050	1,200	450	150	150	3,000
Additional grants	283	88	49	16	8	444
Additional financing	3,290	474	-289	-598	-676	2,201
Project loans	700	851	464	155	77	2,247
Paris Club principal	1,569	-370	-740	-740	-740	-1,021
Paris Club interest	1,021	-7	-13	-13	-13	975
Impact on overall fiscal balance (in percent of GDP)	-0.3	-0.3	-0.1	0.0	0.0	-0.7

The institutional framework for managing the reconstruction process is being set up. A special treasury field office, responsible for making disbursements and recording expenditures, has been created. A Rehabilitation and Reconstruction Agency was established in May to coordinate, supervise and prevent duplication and inefficiency in the rehabilitation and reconstruction process. The Agency is expected to start using private donor aid immediately (including US$600 million from the International Red Cross/Red Crescent Society). A multi-donor trust fund (MDTF) has also been established so as to maximize transparency, efficiency, and accountability. Four project concepts of about US$250 million, including housing for about 1,000 villages, have so far been approved by the MDTF; the start of disbursements is expected in July. In the meantime, some donor spending has been done directly by donors and has not been recorded. Aid organizations based in the United States have reported a spending rate of about 17 percent of private funds raised for all tsunami-affected countries.

With Aceh reconstruction spending largely financed by donor flows, the government should be able to maintain the budget deficit at about 1 percent of GDP. Donor flows will also help ease the pressure on the balance of payments, by providing financing for reconstruction-related imports. Moreover, with the additional financing for Aceh amounting to some 1–1½ percent of GDP over five years and with creditors offering to provide this financing on highly concessional terms, the associated debt service is not expected to put pressure on the balance of payments nor threaten medium-term debt sustainability.

5. **The economic strategy pursued by the previous government, and now being built on and deepened by the current government, has produced positive results**. In developing this strategy the authorities have remained engaged in a close policy dialogue with the Fund, initially in the context of the EFF arrangement and subsequently in the context of Article IV consultation and Post-Program Monitoring discussions (see text table).[4] Economic developments have overall been favorable:

- **Economic growth has gained momentum year by year**, increasing from 3.8 percent in 2001 to 5.1 percent in 2004 (Figure 2). After several sluggish years, investment grew by as much as 15¾ percent in 2004, up sharply from previous years. In the meantime, private consumption has been buoyant. Growth strengthened further in the first quarter of 2005, when real GDP increased by almost 6½ percent (y/y).

- **Inflation has been substantially reduced over the last several years, although underlying inflation has edged up during the last year**. Inflation declined from 12.5 percent (y/y) at end-2001 to 6.4 percent at end-2004. Underlying inflation has been on an upward trend since mid-2004 reflecting robust domestic demand, ample liquidity and, in early 2005, a weaker exchange rate. Headline inflation peaked at 8.8 percent (y/y) in March, in the wake of the increase in administered fuel prices, and has since declined, reaching 7.4 percent in May.

- **On the external front, the current account surplus has been on a downward trend in relation to GDP** (Table 3). A decline in both oil and non-oil export volumes has been offset by higher commodity and oil prices, and export values have been increasing steadily. Increasing demand for imports of capital goods and raw materials, as the economy has been picking up, as well as a rising oil import bill, have nevertheless led to a decline in the trade surplus. Meanwhile, the services account has deteriorated, reflecting higher transport charges associated with strong imports and lower tourism receipts. All told, the current account surplus fell from 4¼ percent of GDP in 2001 to 1¼ percent of GDP in 2004. The net outflows on the capital account (including errors and omissions) have been more moderate, allowing a build-up of international reserves. Indeed, until early 2005, the international reserves position gradually strengthened, with reserves reaching US$36 billion (4.8 months of imports, or 195.7 percent of short-term external debt) at end-2004.

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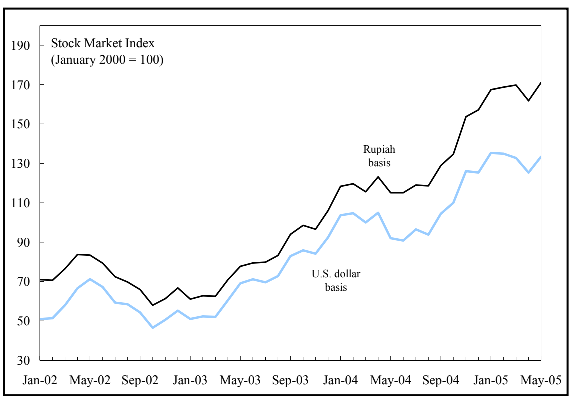
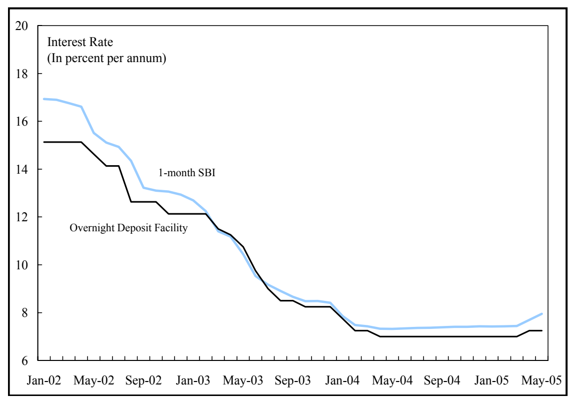
[4] The Executive Board's assessments for the 2004 Article IV consultation and Second Post-Program Monitoring discussion can be found at: http://www.imf.org/external/pubs/cat/longres.cfm?sk=17501.0 and http://www.imf.org/external/np/sec/pn/2005/pn0538.htm, respectively.

The Authorities' Response to Recent Fund Policy Advice	
Advice in the Context of 2004 Article IV Consultation and PPM Discussions	**Actions Taken in 2004–05**
I. Fiscal and monetary policy	
Maintain fiscal restraint to reduce the debt burden.	Fiscal deficit reduced from 1.9 percent of GDP in 2003 to 1.4 percent of GDP in 2004. As a result, public debt fell from 59 percent of GDP in 2003 to 54 percent of GDP in 2004. Further deficit reduction planned for 2005 and 2006.
Address identified weaknesses in non-oil tax revenue collections.	Taxpayer registration and arrears collection improved, although few new tax compliance initiatives were undertaken.
Ensure that any revisions to the decentralization framework do not weaken the government's fiscal position.	While revisions to decentralization laws have been adopted, key regulations relating to the subnational borrowing framework have yet to be drafted.
Continue to prepare for formal inflation targeting.	Preparations ongoing; BI to adopt interest rate targeting from mid-2005.
II. Banking and structural reforms	
Pursue medium-term privatization plan for state banks.	Little progress made.
Further strengthen state banks' management and operations.	Business plans have been put in place. New management has been appointed at state bank Mandiri.
Take early and decisive action to resolve investor disputes to help bolster investor confidence.	Efforts being made, although progress slower than expected.
Improve governance in the public sector.	Three top managers at the largest state bank replaced following corruption charges; other corruption cases being investigated.
Allow temporary trade restrictions to expire as scheduled, and refrain from implementing new restrictive measures.	No new restrictive trade measures implemented; the temporary trade restrictions imposed on imports of rice and sugar have been renewed.
Ensure flexible labor market.	Limited progress made.

- **External competitiveness nevertheless appears adequate**. Following some appreciation through mid-2003, the real effective exchange rate has since depreciated, easing emerging concerns about external competitiveness. While the evidence is mixed, on balance, the staff's assessment is that the current level of the exchange rate does not pose a threat to Indonesia's external competitiveness.[5]

6. **Against this generally favorable background, financial markets have all the same experienced some pressures in early 2005**. After the initial market rally in the wake of the elections last year, market sentiment may have adjusted to the reality that dealing with the deep-seated impediments to growth in the Indonesian economy inevitably will take time. In early April, government bond markets came under pressure, owing to a sell-off by mutual funds, as redemptions from fixed-income funds picked up on the back of interest rate increases. Bank Indonesia responded by purchasing bonds, and the markets have since been relatively stable. Moreover, the strong imports, a softer international sentiment toward emerging markets, and accommodating monetary conditions have recently put pressure on the exchange rate (Table 4 and Figure 3). In response, Bank Indonesia has increased interest rates gradually, introduced higher frequency open market operations, undertaken substantial foreign exchange market interventions, tightened the net foreign exchange open position regulation for banks, and placed limitations on foreign exchange swaps. These measures have helped stabilize the exchange rate since mid-May, although pressures remain evident.



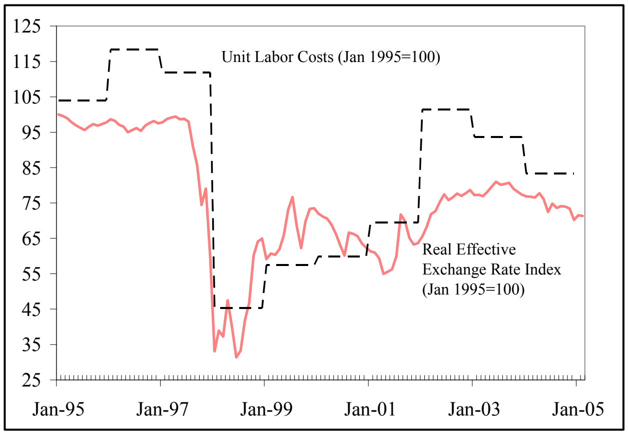


II. Report on the Discussions

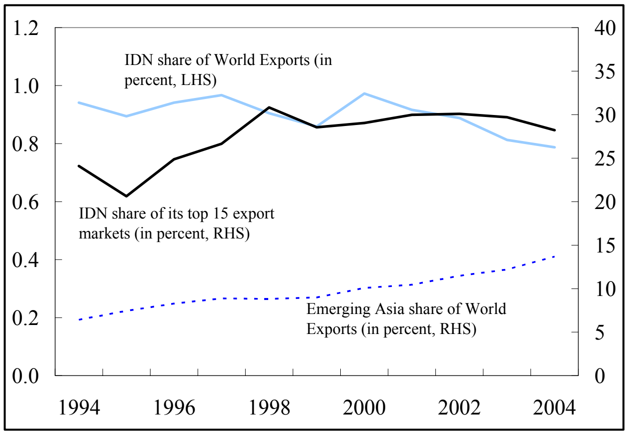
7. **The authorities and the staff agreed that, despite the achievements of the last several years, the central policy challenge facing Indonesia remains to deepen the reforms in order to place the economy on an even higher growth path**. While poverty indicators have improved since the immediate period following the crisis (text table),

[5] See Box 2 and Chapter V of the Selected Economic Issues paper.

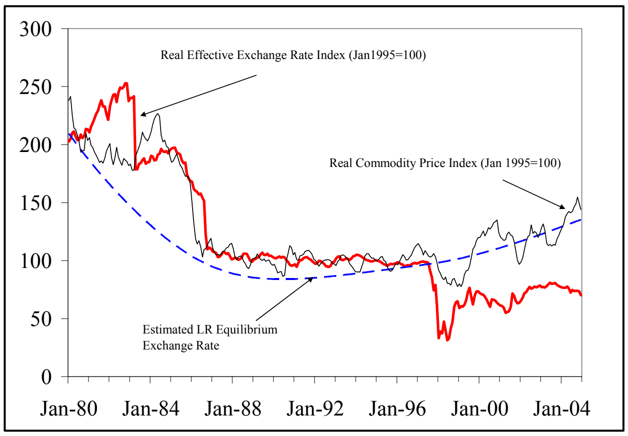
Box 2. External Competitiveness



Indicators of Indonesia's external competitiveness paint a mixed picture. Real exchange rate measures (e.g., based on relative CPI or Unit Labor Costs) suggest that Indonesia's competitive position has improved gradually since mid-2003. This is largely due to nominal depreciation against the U.S. dollar. Econometric estimates of the equilibrium real exchange rate suggest there is some room for appreciation before the currency becomes over-valued. Other macroeconomic indicators, such as the current account (still in surplus, albeit declining), stock of external debt (steady in nominal terms, but falling as a share of GDP), private capital inflows, and country risk premia have all exhibited favorable dynamics, providing little evidence of any fundamental misalignment of the exchange rate.



Trade performance measures provide a less optimistic picture, showing a modest deterioration in the share of Indonesia's exports in its largest markets and for the world market as a whole. Indonesia's share of its top 15 export markets (accounting for over 80 percent of exports) has declined since 2000, at a time when other countries in the region have expanded their trade shares considerably. Indonesia's share of world exports has also fallen in 7 out of 10 SITC export categories since 2000, as well as for total world exports, suggesting a loss of competitiveness across a wide range of exports.



The deteriorating export performance reflects a number of factors, including inadequate investment and a heavy reliance on primary exports, particularly due to higher oil prices. FDI, which in the past tended to generate exports of manufactured goods, has fallen by almost half in the post-crisis period. The increased attractiveness of other investment destinations, with lower wage costs and less policy uncertainty, may have further contributed to Indonesia's loss of FDI and hence export competitiveness.

Thus, the macro-level data suggest that Indonesia's external competitiveness remains adequate, while more disaggregated data indicate considerable scope for structural reform to improve external performance. This apparent conflict may be explained by noting that the equilibrium real exchange rate tends to move in line with commodity prices, and that recent high prices for Indonesia's oil and gas exports have generated favorable macroeconomic balances, possibly masking a broader underlying loss of competitiveness.

widespread poverty remains a central concern. Also, with 2–2½ million new job seekers entering the labor market each year, growth has been insufficient to prevent unemployment from edging up.

Unemployment and Poverty Rates

	1996	1999	2002	2003	2004
National poverty line 1/	15.7	27.1	16.0	15.1	15.2
International poverty lines					
1 dollar a day	7.8	12.0	7.2	5.7	4.8
2 dollars a day	50.5	65.1	53.5	48.8	45.4
Unemployment 2/	4.9	6.4	9.1	9.5	9.9

Sources: Indonesian authorities; and World Bank estimates.
1/ Poverty headcount, in percent of population.
2/ In percent of labor force

8. **To meet this challenge, the new government has adopted a medium-term economic strategy aimed at achieving higher growth on a sustained basis**. The mission endorsed the government's emphasis on continued fiscal and monetary prudence and further strengthening of the financial sector, combined with an intensified drive to make Indonesia's investment climate more attractive. Indeed, the staff considered that this strategy has the potential to bring Indonesia to a sustained higher growth path and further reduce vulnerabilities. The government is preparing annual work plans under the medium-term program, setting out more detailed policy plans for each year. Against this background, the discussions focused on the economic outlook and on the concrete policy issues facing the government as it implements its overall economic program, specifically:

- The medium-term budget strategy and the supporting fiscal-structural reforms, including the budget targets and actions planned for 2005 and 2006;
- The planned transition to a formal inflation targeting framework for monetary policy and, as an immediate issue, the monetary policy stance consistent with putting inflation on a downward path;
- The priority reforms in the banking sector, aimed to address remaining vulnerabilities;
- The specific plans of the government to enhance the investment environment.

A. Economic Outlook: Growth Prospects and Vulnerabilities

9. **The government's economic strategy for 2005–09 is well designed to realize Indonesia's growth potential and gradually reduce vulnerabilities**. Indeed, determined implementation of this strategy would lay the basis for higher sustained growth, which in turn would allow important progress toward reducing unemployment and poverty. Under this "strong–policy scenario" planned by the new government, there is good likelihood that:

- **Real GDP growth** would increase further to 6 percent in 2005 and 6–7 percent per annum over the medium term, as productivity growth increases towards pre-crisis levels and investment picks up in response to economic reforms (Table 5). Specifically, investment is projected to increase to some 26 percent of GDP over the medium term, boosted by new infrastructure investment as well as a favorable response of private investment more generally to the improved investment climate.

- The planned structural reforms are expected to contribute to growth also by improving the quality of institutions and governance and by increasing productivity.[6]

- **Inflation** would be contained to 8 percent (end-period) or less in 2005, somewhat higher than earlier expected, reflecting the pass-through from the fuel price increase and the recent exchange rate depreciation. Inflation would resume its downward trend, reaching some 6 percent in 2006 followed by a further decline toward 3 percent over the medium term, in line with trading partners. Restrained **monetary policy** in the context of a formal inflation targeting framework will play the central role in anchoring expectations and achieving low and stable inflation.

- A gradual reduction in the **fiscal deficit** would reduce public debt to some 30 percent of GDP by 2010 which, together with a strengthening of tax and expenditure management, would significantly reduce fiscal vulnerabilities.

- On **the balance of payments** side, the current account would move into deficit as strong domestic demand leads to higher imports. Meanwhile, higher capital inflows reflecting improvements in the investment climate could more than cover the current account deficits, allowing some increase in international reserves. External competitiveness is maintained through a steady growth in productivity brought about by structural reforms and investment in new productive capacity.

10. **Uncertainties in the international environment pose risks to this economic outlook, putting a premium on sound economic policies**. The possibility of a growth slowdown in Asia as well as globally, rising international interest rates, and increased competition within Asia all underscore the need for robust economic policies. The staff has developed two alternative scenarios: one with lower growth among Indonesia's trading partners combined with higher international interest rates; and one with lower productivity growth (exemplifying a situation of delays in improving the investment climate) and smaller government primary surpluses (Annex V). In both cases, growth would be below the strong-policy scenario based on the government's medium-term strategy, and unemployment would remain high (Figure 4). Moreover, with public debt levels being higher and international reserves lower, the economy would be more vulnerable to shocks.[7]

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[6] The growth projections are based on staff analysis of growth determinants in Indonesia; see Box 3 and Chapter II of the Selected Issues paper.

[7] Changes in international oil prices could also affect the medium-term outlook: (i) the growth effects would be modest, as the impulse through petroleum exports would be partly offset by changes in global economic growth; (ii) the impact on inflation would depend on the pass-through to domestic prices; staff analysis suggests that inflation would increase by 0.5 percentage points for each 10 percent increase in domestic fuel prices; (iii) on the budgetary side, higher international petroleum prices would result in a higher deficit in the

(continued)

11. **The staff's analysis of debt sustainability underscores that strong policies will be needed to continue the move toward a more robust economy**.[8] The staff's updated debt sustainability analysis suggests that fluctuations in interest and exchange rates would have a substantial effect on debt ratios. Specifically, the standard shocks to the real interest rate and the exchange rate would increase projected public debt in 2010 by 19 percent of GDP and 14 percent of GDP, respectively. External debt sustainability is most susceptible to the exchange rate shock, which would increase projected external debt in 2010 by 12 percent of GDP. The authorities acknowledged these risks, noting that their economic strategy is in fact designed to reduce vulnerabilities over time. By the same token they believed that there were upsides to the outlook, including the possibility of even higher economic growth over the medium term.

B. Maintaining Macroeconomic and Financial Stability

Budget policies: fiscal prudence and improved quality of policies

Overall targets: reducing the public debt burden and limiting crowding out

12. **The government's plan emphasizes further fiscal consolidation and debt reduction over the medium term**. Recognizing that the current high level of public debt is a source of vulnerability and may have adverse effects on longer-term economic growth, the government's medium-term program envisages a reduction in the debt-to-GDP ratio over time, to a little more than 30 percent by 2009.[9] In the staff's analysis, achieving such a debt target would require central government primary surpluses in the order of 1½–2 percent of GDP annually over the medium term. Given the likely decline in oil revenues and pressing spending needs in social sectors and infrastructure, maintaining primary surpluses in this range would in turn require increases in non-oil revenue and improvements in the efficiency of public expenditure. Within this overall framework, the government aims to further reduce the fiscal deficit to about 1 percent of GDP in 2005[10] and below 1 percent of GDP in 2006.

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short term, assuming no change in fuel subsidy policy, but could substantially improve the fiscal position in the medium term; and (iv) a one-dollar increase in international oil prices would increase the current account balance modestly (by US$200 million, or 0.1 percent of GDP, in 2006).

[8] Table 6 provides summary vulnerability indicators.

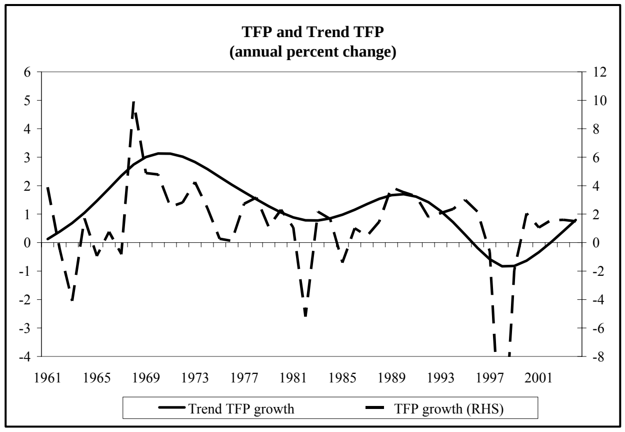
[9] The staff's research suggests that an appropriate public debt level for Indonesia may be in the range of 35–42 percent of GDP. Box 4 and Chapter III of the Selected Economic Issues paper explore the appropriate public debt level for Indonesia in light of the implications for vulnerability and growth.

[10] This would correspond to a deficit of 0.8 percent of GDP in the government's classification, which treats interest deferred by the Paris Club on a cash basis.

Box 3. Indonesia's Growth Experience

Indonesia's weaker growth performance since the economic crisis has been associated with a slower growth in productivity and potential output. Indeed, the recent improvement in growth performance has been led by robust domestic demand, primarily private consumption, and with private investment demand making a significant contribution since 2004. The most recent data for 2005Q1 suggest that investment and consumption demand continue to be strong, with real GDP growth accelerating further to almost 6½ percent (y/y).

For growth to increase to the 7 percent range on a sustained basis, as envisaged under the medium-term scenario, would however require improvements in productivity growth. A simple Solow growth accounting exercise suggests that total factor productivity (TFP) growth slowed to around 1½ percent per annum in 2000-04 compared to almost 3 percent per annum over the period 1989–96 (chart). Going forward, this indicates that an acceleration in TFP growth toward levels seen in the past would allow a significant and sustained acceleration in growth over the medium term. As an illustration, labor force growth at the historical average, growth in fixed investment as envisaged under the staff's baseline macroeconomic scenario, and TFP growth at current levels would yield growth in potential output of about 6 percent per annum. If TFP growth were to move back to its pre-crisis peak of almost 3 percent per annum, however, the economy would grow in the range of 7–7½ percent annually over the medium term.



Growth would be further enhanced through improvements in the quality of institutions. A cross-country analysis of growth over the period 1961-2000 indicates that relative growth performance across a large sample of countries is positively correlated with the quality of institutions. "Institutional quality" is measured by the International Country Risk Guide Index, which is based on 22 risk components, including enforcement of property rights, quality of economic management, and extent of corruption. Moreover, once institutional quality is included, most other variables lose some explanatory power, suggesting a dominant role for institutions in explaining cross country variations in growth performance. Together, these results support the government's emphasis on improving the investment climate to boost productivity, combined with a strong reform agenda aimed at improving the quality of institutions, including by addressing corruption.

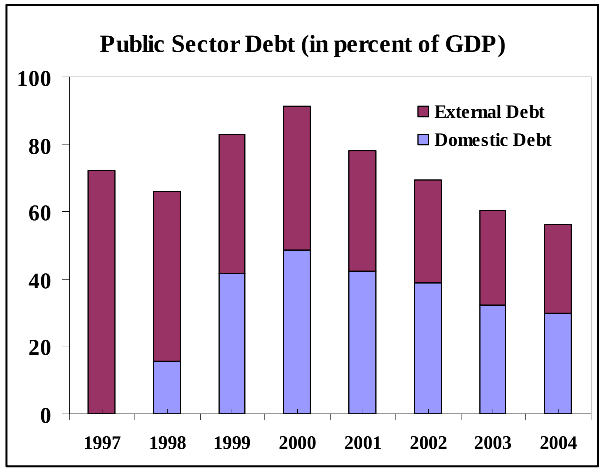
Explaining cross-country variations in growth performance
(t-statistics in parentheses)

Dependent variable	**Real GDP growth**	
Terms of trade volatility	-0.68 (-6.40)**	-0.19 (-1.45)
Initial GDP per capita	0.12 (2.56)*	0.12 (2.88)*
Average schooling	0.02 (4.01)**	0.007 (1.82)
Institutional quality		2.27 (5.73)**
Constant	10.1 (18.61)**	8.09 (12.93)**
Indonesia dummy	0.3 (0.48)	0.25 (0.48)
Observations	74	74
Adjusted R2	0.63	0.62

Significance level: ** 1 percent, * 5 percent)

Box 4. Public Debt Target for Indonesia

A central question for Indonesia is how to define an appropriate medium-term debt target. While Indonesia's public debt has declined since its peak in 2000, it remains relatively high. In an attempt to answer the question of what would be an appropriate debt target, three methods were used to evaluate what would constitute a sustainable debt level and one that would not substantially undermine medium-term growth. The analysis indicates that a debt level in the range of 35–42 percent of GDP would be an appropriate goal. This range was derived by assessing the public debt level from three angles:



- **Vulnerability to financial crisis**: Looking at a sample of fourteen emerging market countries for the past twenty years and using the early warning signals approach, the analysis indicates that Indonesia's debt/GDP threshold for being "safe" from a currency crisis is about 42 percent of GDP. This is close to thresholds found for some of its Asian neighbors but lower than in some other emerging market countries.

- **Debt overhang**: The theoretical rationale implies that a higher debt ratio would lead to higher future tax burden and lower investor expectations for net returns, which in turn would lead to lower investment and growth. A panel regression of growth on the debt-to-GDP ratio after controlling for other factors affecting growth suggest that an increase in the debt ratio above 38 percent of GDP would lead to a lower growth rate.

- **Stochastic debt sustainability**: This approach assumes that public debt is sustainable if the debt-to-GDP ratio would remain constant or decline in the medium term, assuming a certain path of key variables such as primary surplus, growth, exchange rate, and interest rates. The results indicate that Indonesia's debt would have to be 35 percent of GDP or less in the medium term in the baseline scenario in order to keep debt at or below 2005 levels under standard sensitivity shocks.

While it is not possible to be precise about the appropriate public debt level, and drawbacks exist for each method utilized, not the least of which is the short time series available for the evolution of public debt in Indonesia, the analysis summarized above suggests that Indonesia's current public debt ratio is on the high side. The government's medium-term target of bringing the public debt ratio toward 30 percent of GDP would bring the debt ratio to a "safe" level.

At the time of the mission, the government was in the process of further revising the 2005 budget, and was just getting underway with the 2006 budget preparations with a view to presenting the budget to Parliament in August. The mission supported the government's 2005 and 2006 deficit targets, which would entail a decline in the public debt ratio by some 10 percent of GDP over the two years.

13. **Additional measures may be needed to achieve the 2005 budget targets**. The mission noted the desirability of reflecting appropriately recent developments in inflation, the exchange rate, interest rates, and oil prices, as well as savings from the Paris Club moratorium. Its analysis indicated that, on the basis of updated assumptions, including higher interest rates, higher oil prices, more depreciated exchange rates and lower oil production, additional measures of up to ½ percent of GDP might be required to ensure that the 2005 deficit target is achieved.[11] The government representatives, while mindful of the need for further measures, stressed that the strong budget performance so far this year had provided some breathing space, albeit partly of a temporary nature. Also, limited absorptive capacity might reduce reconstruction spending for tsunami-ravaged regions. Nevertheless, the government is committed to meeting its deficit target through additional measures if need be, as shown by its recent announcement to raise the retail prices for tobacco, in effect increasing *ad valorem* tobacco excise yields.

14. **Looking to 2006, the mission encouraged the government to further enhance non-oil tax revenue and rationalize low-priority spending**. This would be especially important given the expected decline in oil revenues (as a percent of GDP) and the planned wage increases. In particular, the mission recommended that the government consider carefully the revenue implications of the tax policy package that was under preparation (see next paragraph). The mission also welcomed the government's general intention to continue lowering the poorly targeted fuel subsidies and to channel some of the savings toward social programs, and to better target non-oil subsidies. An acceleration of the privatization program would also help ease the pressure on government borrowing, while improving efficiency.

Structural fiscal reforms: strengthening the underpinnings of fiscal policy [12]

15. **The government has for some time been preparing a tax policy package aimed at improving revenue collections while providing incentives for private investment**. Key measures envisaged in the draft legislation are a reduction in the standard corporate income

[11] Possible measures discussed by the mission included (i) tax arrears collection from the state-owned oil company, (ii) further increases in excise rates, (iii) revitalization of the short-term tax administration revenue generation program, (iv) increases in non tax revenues, and (v) reductions in non-priority spending.

[12] See Box 5 for a summary overview of recent reforms in the fiscal-structural area and of priority reforms for the future.

Box 5. Fiscal Structural Reforms

Key fiscal structural reforms have been implemented in the last several years, although important issues still need to be addressed:

Revenue. Progress has been made in modernizing tax administration and implementing short-term tax administration revenue generation measures (registering additional tax payers; ensuring timely filing of tax returns; recovering tax arrears; and expanding audit coverage). The tax system, however, remains marred by low non-oil revenue collection caused by large VAT exemptions, low excise tax levels, as well as poor enforcement and widespread corruption.

Expenditure. Good progress has been made on improving the institutional, legal, and regulatory environment for budget management by restructuring the Ministry of Finance and adopting new laws on state finances, treasury and audit. However, even after the March 2005 increase in domestic fuel prices, large untargeted fuel subsidies continue to crowd out higher-priority spending, including on social programs. Meanwhile, the proliferation of extra budgetary funds, weak cash and debt management, and shortcomings in the decentralization framework continue to hamper fiscal management.

High-priority reforms for the medium term could include:

Revenue

Income Tax: Unifying the CIT rate to a single 30 percent rate to be gradually reduced to 25 percent over a 5 year period, allowing a preferential rate for small businesses (defined by turnover and profits), and removing exemptions on interest earned by mutual funds.*/

Excise tax: Increase excise on a number of products, especially on tobacco, which are low by international standards.*/ Introduce excises on petroleum products, provided that subsidies are phased out.

Luxury sales tax: Remove luxury sales taxes currently applied to a large list of goods, as they complicate tax administration and provide incentives for tax avoidance. The revenue loss from this removal could be offset by increasing excise tax rates for selected goods and introducing a higher VAT rate.

VAT exemptions: Remove exemptions on VAT from capital goods, mining sector, and hotel and restaurant services. Limit new exemptions granted.

Stamp duties and fees. Abolish stamp duties to simplify the tax system.

Tax administration: Formulate a new short-term revenue generation program focused on the same areas as the earlier programs, and modernize the administration by: (i) amending law on tax administration procedures; (ii) simplifying compliance requirements; (iii) revamping the tax agency's audit program; and (iv) extending the pilot offices for medium and small taxpayers to additional regions. */

Expenditure

Subsidies: Scale back the untargeted fuel subsidies and strengthen targeting of non-oil subsidies.*/

Social spending: Increase spending and utilization of budget appropriations in the areas of health and education by improving procurement procedures and coordination among spending agencies.*/

Provinces: Improve the framework for transferring resources to regions to achieve more equalization, and establish appropriate safeguards for local government borrowing.*/

Efficiency of government operations: Simplify budget execution procedures, rationalize banking arrangements, consolidate off-budgetary funds, establish a single treasury account, strengthen oversight of public enterprises, and establish a double entry accounting framework.*/

*/ Measures currently being implemented or under consideration by the authorities.

tax (CIT) rate of 5 percentage points (to 25 percent) over as many years, a lower CIT rate for SMEs, and accelerated depreciation allowances for capital investments. Also, the government was considering an expansion of VAT exemptions in specific sectors. Estimates suggested that the net revenue loss from the set of measures under consideration would be in the order of ⅓ percent of GDP or more next year. The mission recommended that, to protect the non-oil revenue base, such losses be offset by other tax policy measures, which could include a broadening of the VAT tax base by eliminating exemptions for capital goods and mining, strengthening property tax assessment, and increasing excise tax rates. The government representatives were mindful of the possible loss from the tax policy measures being considered. They indicated that a final assessment would be made once the entire package had been formulated, and would be factored into the 2006 budget.

16. **A meaningful strengthening of tax administration would help provide funds for high-priority spending while maintaining the prudent fiscal stance**. The mission recommended that, as a first priority, the revenue generation plan which was formulated in 2001 be revitalized, focusing on increasing the number of registered taxpayers, collecting tax arrears, and broadening tax audits. Looking further ahead, strengthening the governance framework, amending the laws to provide greater balance between tax collectors and tax payers, and modernizing tax and customs administration would be important. The authorities agreed on the need for reinforced measures in these areas. As for the tax amnesty that has been under consideration since late last year, while it was not imminent, the government was still considering the modalities. The mission reiterated its concerns about the moral hazard aspects of such a measure, and stressed that in the event the government goes ahead, it should improve tax administration ahead of time, set a past cut-off date, and prepare a transparent and non-discretionary law, in order not to undermine ongoing tax collection.

17. **The government is moving ahead with treasury and debt management reforms**. Good progress has been achieved in making the Treasury fully operational, with the reorganization of the Ministry of Finance leading to the consolidation of treasury management functions and all Ministry of Finance top-level officials appointed. The immediate focus as regards implementation has been on improving government banking arrangements.[13] In that regard, regulations to accompany the new Treasury Law are currently under preparation. Meanwhile, the government is conducting an inventory of government bank accounts with a view to rationalizing them, as a first step before consolidating them into a single treasury account. To further improve the management of public resources and limit fiscal risks, the government is developing guidelines for debt management. In this context, the mission suggested that the eventual establishment of a debt unit at the Ministry of Finance accompanied by close monitoring and strict limits on contingent liabilities be key elements of the debt management strategy. The authorities agreed that contingent liabilities relating to public enterprises and infrastructure projects should be closely monitored, although work has yet to start on consolidating and assessing fiscal implications of the numerous extra-budgetary funds. Finally, the authorities are mindful that the implementing regulations for the new Social Security Bill, passed last October, should avoid the creation of unfunded liabilities.

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[13] The Fund is providing technical assistance in support of this effort.

18. **The authorities are aware of the need to ensure consistent rules across different levels of government and maintain fiscal control as decentralization is being implemented**. They noted that, while decentralization of functions is well advanced, supporting safeguards still need strengthening. In this connection, implementing regulations, to be drafted by August, would aim to limit the scope for local regulations in conflict with national goals, including on taxation. These regulations would also seek to ensure that appropriate safeguards are in place following the lifting of the ban on sub-national government borrowing; such safeguards could include the adoption of a debt service coverage ratio, fiscal rules, and bankruptcy provisions and sanctions on non-compliant governments. In support of these efforts, the government intends to improve fiscal reporting at the local government level.

Monetary policy: anchoring low and stable inflation

19. **Bank Indonesia reconfirmed its intention to adopt a formal inflation targeting regime**. Noting that a strong and coordinated commitment by the authorities to price stability is a prerequisite for sustainable growth, the mission supported such a move, and the discussions focused on the preparations for the transition. In that regard, BI indicated that it plans to switch from base money to the one-month SBI interest rate as the intermediate monetary policy target in mid-2005. The mission welcomed this step, as the targeting of a single interest rate will help send a clearer signal about BI's monetary stance in the context of inflation targeting. More generally, the mission noted the importance of ensuring that the conditions and operational requirements for meeting the inflation target are in place before the move to inflation targeting. In that regard, the authorities noted that BI is working to enhance the effectiveness of its monetary policy instruments[14] and to strengthen its external communications, including through a periodic inflation report. To support the internal decision making process at BI, a Monetary Policy Committee is being established. The authorities also acknowledged the importance of conducive economic policies more generally—notably a sound budget position and banking system—in ensuring that BI can credibly meet the inflation target.

20. **As for the near-term monetary stance, the Bank Indonesia Governor indicated that further interest rate increases may be needed to reduce inflation, and viewed a measured pace of monetary tightening as being appropriate**. The mission thought that higher interest rates were now warranted in order to counter inflationary pressures and limit any second-round effects of the fuel price increase. The aim would be to substantially catch up with global interest rate movements, and send a signal that BI will convincingly address inflationary pressures, including through the exchange rate channel. BI officials expressed concerns about the adverse growth implications of an excessive monetary tightening, and also pointed to their experience last year, when pressures on the exchange rate turned out to be temporary and a cautious monetary policy response proved warranted. With these considerations in mind, they suggested that a more gradual monetary tightening was called for. They noted that BI had already increased the frequency of open market operations and

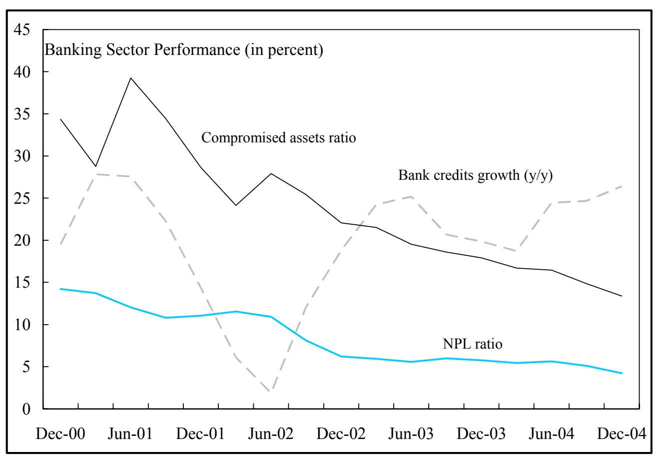
[14] The Fund is providing technical assistance in monetary operations.

allowed interest rates to edge up to absorb idle liquidity in the banking system, and stressed that BI is monitoring inflation closely, standing ready to take additional measures as needed.

21. **A continuation of the flexible exchange rate system will help insulate the economy against shocks and facilitate the transition to formal inflation targeting**. The authorities agreed with the mission that a flexible exchange rate will act as a useful shock absorber for the economy and be integral to successful inflation targeting. With this in mind, the mission advised BI to limit any foreign exchange interventions in response to pressures on the rupiah to those needed to dampen short-term volatility. It also noted that, while the various technical measures introduced recently to limit exchange rate volatility (see paragraph 6) might help stabilize the exchange rate in the short run, they come at the potential cost of hampering development of the foreign exchange market and do not address the underlying imbalances causing exchange rate pressures. If the pressures on the exchange rate were to persist, with attendant implications for inflation, a monetary policy response entailing further interest rate increases would be called for. The authorities concurred, but saw the technical measures as a useful supplement to a regular monetary policy response in limiting short-run disturbances in the foreign exchange market.

Banking reforms: ensuring efficient intermediation and a sound financial system[15]

22. **While the performance of the banking sector has continued to improve, risks remain**.[16] Benefiting from a growing economy and falling interest rates, banks have been able to improve earnings and asset quality, and maintain high levels of profitability and liquidity. However, the decline in overall NPL ratios may overstate the actual improvements, as the decline has been driven in large part by extension of new loans. Indeed, the robust credit growth is a concern in light of lingering weaknesses in banks' corporate governance, internal controls, and risk management. The easing of prudential regulations in January, designed *inter alia* to facilitate infrastructure lending, reinforce this concern. More broadly, BI's intervention in three smaller banks last year and the recent turmoil in the government securities market, stemming in part from the sell-off by mutual funds, are reminders that the financial sector needs continued attention.



[15] The Fund is providing technical assistance in banking issues, including supervision.

[16] See Chapter IV of the Selected Issues paper for an analysis of banking sector developments, including the recent credit growth, and their implications for bank soundness and prudential supervision. See also Table 6 for summary indicators of bank vulnerabilities.

23. **Against this background, the mission welcomed the authorities' continued commitment to address vulnerabilities in the financial system**. Indeed, further efforts are needed toward a financial sector that can efficiently perform financial intermediation and withstand disturbances. The specific policy issues that arise relate to:

- **State bank governance**. The recent shakeup in the management team at the largest state bank may help bring about improvements in governance. The mission stressed that moral suasion to lend to particular sectors or projects, including infrastructure, should be avoided as it could compromise the soundness of the banking system. Over the medium term, private-sector ownership control, through sale of voting shares, would help improve efficiency in the sector.

- **Bank consolidation**. Recognizing that the banking system needs strengthening and further rationalization, BI has developed a strategy centered on raising capital requirements and creating incentives for "strong banks," which could serve as core banks in the case of mergers. The central bank stressed that it will allow the consolidation process to be market driven once it has announced the criteria for a "strong bank" in mid-2005. In this connection it will be important to ensure that the legal framework for consolidation is in place, that there will be appropriate vertical and horizontal integration of the management of the institutions that will be merged, that proper valuation and due diligence will be conducted by the institutions, and that the additional capital raised will be efficiently deployed.

- **Prudential supervision**. BI is making encouraging strides towards risk-based supervision and continued upgrading of banking regulations in line with international standards, and is progressing with preparations for Basel II. Notably, BI has recently introduced new asset classification rules. Looking beyond the banking sector, the mission welcomed the efforts being made to bolster the supervision of nonbank financial institutions, such as insurance companies, finance companies, and mutual funds. These efforts include the strengthening of supervision of insurance companies toward international standards, including introduction of risk-based supervision, tightening of investment regulations and greater transparency in the investment activities of pension funds, enhanced supervision of finance companies through better reporting of their operations, and enforcement of mark-to-market valuation for mutual funds.

- **Financial sector safety net**. As the gradual elimination of the blanket guarantee has commenced, the authorities are expediting actions needed to ensure a smooth transition to regular, limited deposit insurance. These actions include the issuance of regulations on emergency lending, adoption of joint Ministry of Finance/BI workout procedures for troubled banks, and appointment of staff and approval of the budget and operating procedures for the new deposit insurance fund. With these steps completed, the deposit insurance fund could be made operational by September 2005 and the financial sector safety net made fully operational by end-2005, as planned.

C. Structural Reforms: Encouraging Private Investment

24. **A central objective of the government's medium-term program is to improve the investment environment**. In this regard, the authorities stressed the ongoing efforts to simplify the regulatory framework, reduce corruption, strengthen the legal system, and encourage infrastructure investment. The discussions focused on the following areas:

- **The efforts to reduce corruption**. The Supreme Audit Agency, the Corruption Eradication Commission (which became operational in 2004), and the Attorney General have sought to address governance problems at various institutions, including banks. The corruption charges brought against top officials of Bank Mandiri have sent an important signal about the government's expectations from state bank officers, and civil servants more generally. The mission welcomed the government's commitment to address corruption, and suggested that better coordination of the activities of the various agencies and improved budget allocations could help the effectiveness of their efforts.[17]

- **The new energy policy, aimed at better utilizing Indonesia's considerable energy resources**.[18] The new policy seeks to attract investment in the oil and gas sectors by offering concessions in the form of enhanced production sharing agreements and accelerated depreciation for capital investment. Expediting VAT reimbursements for capital imports and completing the regulatory framework for the sector would act as catalysts for new investment. The mission welcomed these efforts, and at the same time noted the importance of resolving outstanding issues in the sector with foreign investors as a means of attracting new investor interest.

- **Improvements in labor market flexibility**. A well-functioning labor market will help translate new investment and growth into job creation.[19] In this context, the mission supported the recently established regional tripartite councils, which bring together employers, employees, and the government, and are designed to address concerns of both labor and employers and set the minimum wage. The mission encouraged the use of this framework to resolve other labor-related issues, such as severance pay levels and outsourcing, with a view to making the labor market more flexible and increase competitiveness vis-à-vis the region.

- **The drive to improve infrastructure**. Following the encouraging interest in the Infrastructure Summit in January, the government has invited tenders to private

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[17] The management of technical assistance for judicial reforms was transferred from the Fund to the World Bank at end-2004.

[18] Chapter VI of the Selected Issues paper reviews the role of the oil and gas sectors in Indonesia's economy, including policies to better utilize the available resources.

[19] Chapter VII of the Selected Issues paper provides an overview of labor market issues and policies from this perspective.

investors for several projects. The government also intends to play a role in this sector, including through public-private partnerships (PPPs). To ensure that these efforts have the intended effects, the government is working to develop selection mechanisms that prioritize projects with a high social rate of return, and to establish procedures to limit contingent liabilities, including for government schemes relating to PPPs. The government is also developing complementary reforms of the regulatory framework in sectors where private investment is sought, and in this regard pointed to the recent change in land acquisition regulations as an important step toward facilitating road construction.

- **Trade policy**. The new government is committed to maintaining Indonesia's open trade regime. While the overall level of import tariffs has been gradually lowered (the average unweighted tariff rate is around 7 percent), the government has extended the existing import bans on sugar and rice, with the objective of promoting domestic production through higher farm prices. The mission encouraged the government to consider phasing out such import restrictions, because of their effects on the prices on foods important for the poor, and suggested their replacement with more transparent and less distortionary mechanisms for regulating imports and promoting domestic production. The mission was encouraged by the recent review of existing restrictions on trade and the decisions to ease export restrictions on selected commodities. In regard to trade liberalization more broadly, the Indonesian authorities have been pursuing a series of bilateral and multilateral free trade and investment agreements with major trading partners, while supporting an ambitious conclusion to the Doha Round in multilateral fora. On the bilateral side, negotiations have begun with ASEAN and its partner countries, including Australia, China, and Japan, while discussions with several other countries are at a more preliminary stage.

III. Other Issues

A. Capacity to Repay the Fund

25. **With the strong set of economic policies envisaged under the government's medium-term economic program, debt service payments to the Fund are expected to be readily manageable**. Scheduled repayments to the Fund peak in 2008 at US$2 billion, projected to be equivalent to about 2 percent exports of goods and services, 5 percent of international reserve assets, and one fifth of nonfinancial public sector debt service (Table 7).

B. Data and Standards

26. **The authorities have demonstrated their strong interest in benefiting from the Fund's various transparency and standards initiatives**. In particular:

- Indonesia subscribes to **the SDDS**, although a number of data weaknesses remain. A **statistics ROSC** conducted in March identified several shortcomings in the national accounts and government finance statistics, and to a lesser degree in the balance of payments statistics. These shortcomings may have implications for the scope for effective monitoring of economic developments and policy formulation. In that regard, staff would support the authorities' request for Fund technical assistance in addressing shortcomings identified under the data ROSC, especially in government finance statistics.

- The government has requested that the Fund conduct **a fiscal ROSC**, and expressed interest in having the work done in late 2005.

- While the authorities remain interested in **an FSAP**, they indicated that more time would be needed before going ahead, in order to coordinate among related institutions and monitor the outcome of the ongoing efforts to strengthen and consolidate the banking system.

27. **In February, Indonesia was removed from the list of Non-Cooperative Countries and Territories maintained by the Financial Action Task Force (FATF)**. This step followed considerable progress in the implementation of an effective anti-money laundering regime.[20] Indonesia will be subject to strict monitoring for further progress in the implementation of AML measures on a quarterly basis and possibly another on-site visit by the FATF to review progress.

IV. Staff Appraisal

28. **In the years since the Asian crisis, Indonesia has come a long way toward establishing the basis for sustained economic growth**. With macroeconomic stability restored and the condition of the banking system improved, the economy has registered increasing growth rates over the last several years. By the same token, Indonesia's rapid labor force growth and widespread poverty call for even higher economic growth. Meanwhile, the recent pressure in financial markets is evidence that Indonesia remains vulnerable to shocks and a reminder that maintaining macro stability continues to be a priority.

29. **Building on this progress, the new government's economic program is well designed to realize Indonesia's growth potential and further reduce vulnerabilities**. The government that took office in late 2004 faces a historical opportunity and has a strong political mandate to put Indonesia on a higher sustainable growth path. To that end, its focus on continued fiscal and monetary restraint combined with reinforced structural reforms is appropriate. Indeed, provided that the government follows through on its economic strategy, the outlook for the economy is favorable, with real GDP expected to grow by 6–7 percent annually over the medium term boosted by higher investment and productivity. Public debt ratios would improve and international reserves coverage remain healthy.

30. **The government's intention to continue a prudent fiscal policy is welcome**. Achievement of the government's aim to reduce the budget deficit to 1 percent of GDP or below this year and next would help further reduce government debt ratios. In revising the 2005 budget, the government would be well advised to take account of the budgetary implications of the changed economic environment, which will in all likelihood require additional measures to meet the 2005 deficit target. Looking to next year, achievement of the

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[20] The Fund is providing technical assistance in this area, in coordination with donors.

government's deficit target calls for a careful consideration of the revenue implications of the tax policy package underway—including any plans to introduce further exemptions—and domestic fuel price policy. In moving forward in both areas, care is needed to ensure that resources are available for high-priority spending and that the government borrowing requirement is kept at a manageable level. Looking to the medium term, the staff supports the government's objective of reducing the public debt ratio toward 30–35 percent of GDP. Achieving this objective will require the maintenance of primary surpluses in the range of 1½–2 percent of GDP.

31. **Moving ahead on a range of fiscal structural reforms as planned will improve the durability and quality of fiscal adjustment**. On the revenue side, the government's goal to broaden the tax base through strengthened tax administration is welcome. Revitalizing the short-term revenue generation plan, focused on ensuring that all taxpayers contribute as intended through increased registration and better auditing, would potentially make an important contribution. Beyond these short-term measures, a strengthening of governance and modernization of tax and customs administration would be important objectives. On the spending side, reorientation of outlays toward capital and social expenditure would bring tangible results in terms of creating jobs and improving productive capacity. Careful management of government liabilities, including the adoption of a debt management strategy and a framework for limiting contingent liabilities, is a high priority. Staff would encourage the authorities to ensure consistency of regulations at different levels of government and to maintain fiscal control while implementing the decentralization framework.

32. **Bank Indonesia's focus on putting inflation on a downward path is salutary**. Recent pressures on inflation and the exchange rate underscore the need to use monetary policy convincingly to maintain stability. From that perspective, Bank Indonesia's stated commitment to adjust interest rates as needed is welcome. By demonstrating Bank Indonesia's commitment to using interest rate policy actively to respond to inflationary pressures, this would also help achieve a successful move to formal inflation targeting and facilitate the lowering of inflation on a sustained basis. In this regard, Bank Indonesia's switch to an interest rate as its intermediate target in the middle of this year will be an important move in the right direction, which will enhance the transparency of monetary policy and support the move to inflation targeting. Moreover, ensuring that other conditions for making the transition to inflation targeting a success are in place will be key, and the central bank's efforts to improve its monetary instruments and communication strategy are encouraging in this regard. The maintenance of the flexible exchange rate system would protect the economy against shocks and help the functioning of the new monetary framework. In that connection, it will be important that Bank Indonesia limit interventions in the foreign exchange market to those needed to counter short-term volatility. The staff's analysis does not suggest that the current level of the exchange rate represents a threat to external competitiveness.

33. **While the banking system's performance has improved, important challenges remain**. As banks may be moving into a more difficult period, with higher interest rates putting pressure on margins, even more care is needed to ensure close supervision of the financial sector. In that regard, the authorities' efforts to further enhance financial sector supervision, promote a strengthening and consolidation of the banking system, and improve

governance are encouraging. Ultimately, a transfer of ownership in state banks to the private sector would help strengthen governance and performance. Finally, the staff supports the ongoing work to establish the deposit insurance fund and other elements of the financial sector safety net, as this will be important to maintain confidence in the banking system as the blanket guarantee is phased out. The staff would recommend that Indonesia undertake an FSAP at an early date.

34. **The staff welcomes the government's efforts to improve the investment climate**. With macroeconomic stability largely restored, improving the investment environment holds the key to unlocking growth in investment and production. From that perspective, the recent steps to address corruption, attract investment in the oil and gas sector, and put in place a new investment law are commendable. The government faces further challenges in improving the functioning of the legal system, strengthening infrastructure, improving labor market flexibility, and bolstering tax administration. While by their very nature these elements of the private investment environment will take time to address, the government has made a solid start.

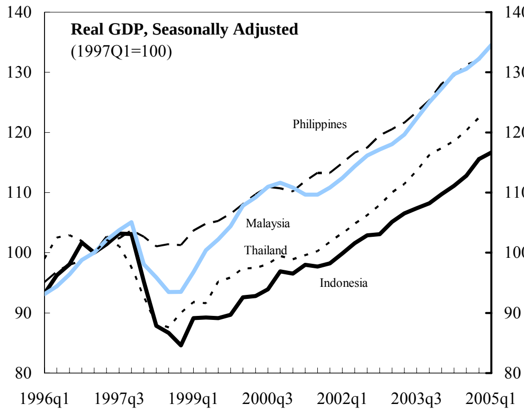
35. **The authorities' attention to improving economic statistics is welcome**. While available date are adequate for surveillance purposes, the staff supports the authorities' intentions to further enhance data quality, including with technical assistance from the Fund.

36. **All told, the new government's commitment to sustain and to deepen the economic reforms of the past several years should help Indonesia reach its full economic potential**. Indonesia is still facing risks associated with an uncertain international environment, as well as its government debt level and weaknesses in the banking system, which put a premium on sound economic policies. Going forward, the government's strategy, provided that it is implemented with determination, will help achieve sustainable growth in incomes and meaningful reductions in unemployment and poverty in the context of a more robust economy. The government's track record during its first eight months holds out hope that the reforms will come to fruition and its economic goals be achieved.

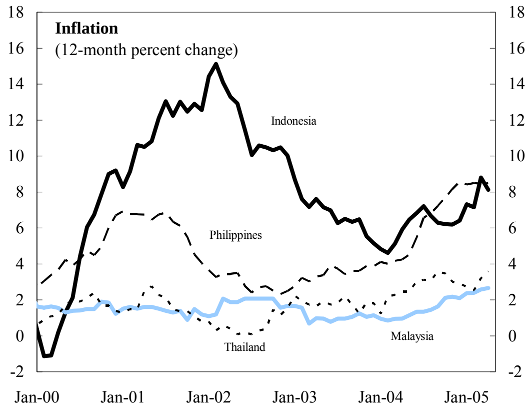
37. **It is recommended that the next Article IV consultation take place on the standard 12-month cycle**.

Figure 1. Regional Comparisons

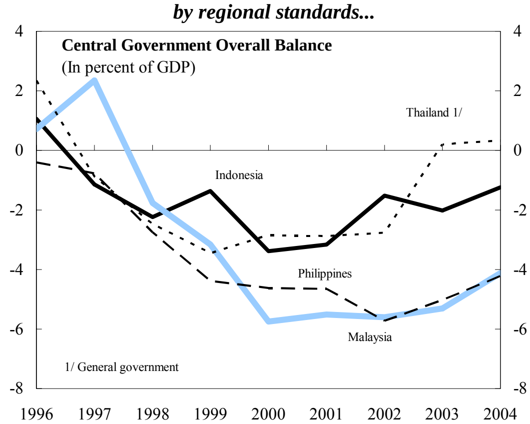
Economic growth in Indonesia is picking up, but still lags behind other countries in the region...



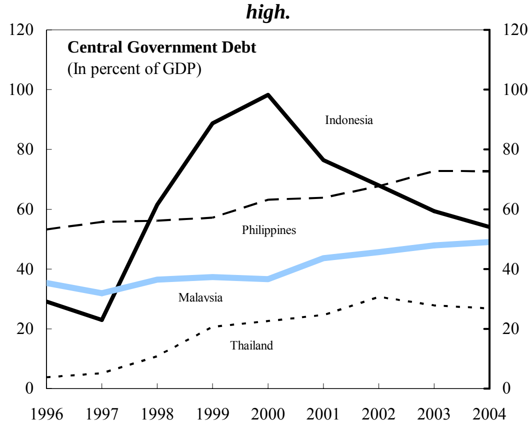
... while inflation is increasing.



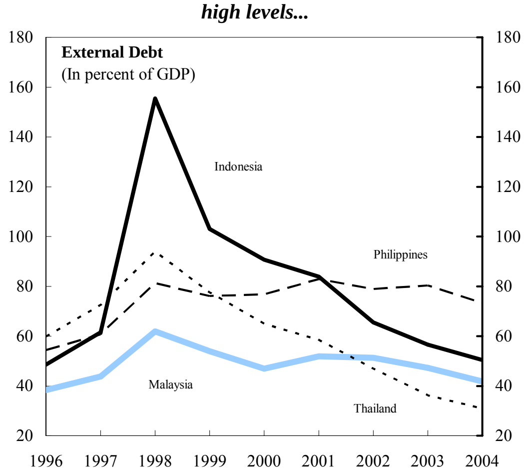
Indonesia's budget deficit has been reduced and is low by regional standards...



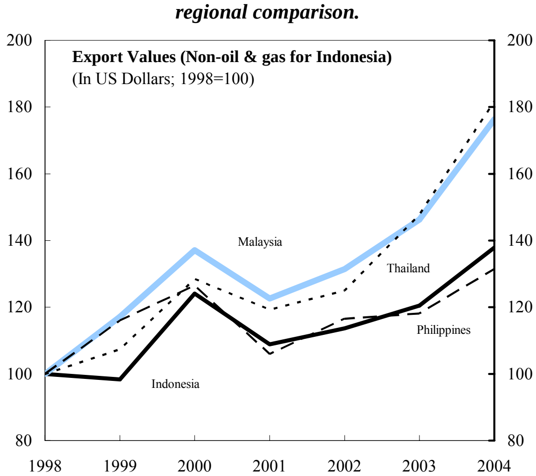
...while public debt, although declining, remains relatively high.



External debt is also declining from relatively high levels...



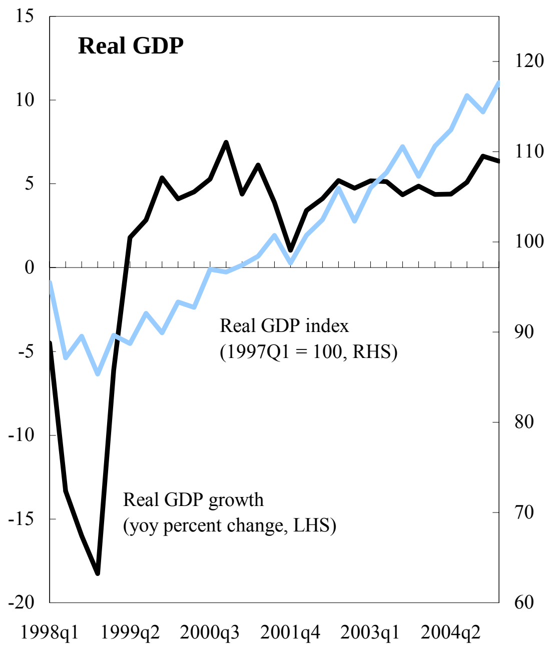
...although export performance remains weak in a regional comparison.



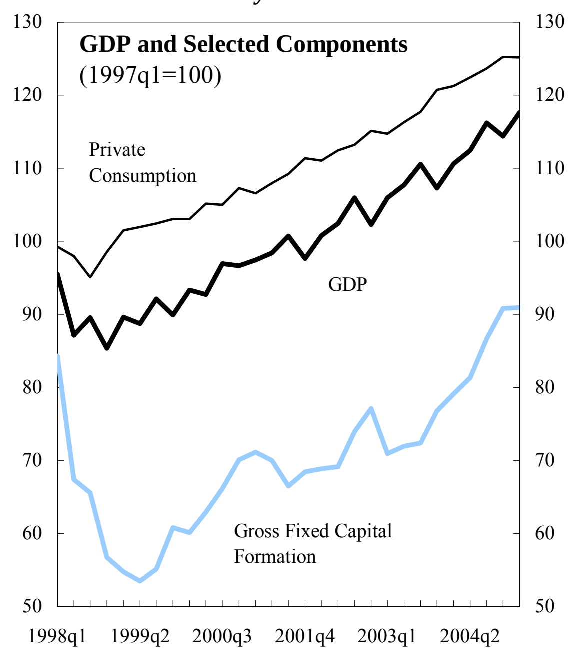
Sources: Data provided by the authorities; CEIC; and Fund staff estimates

Figure 2. Indonesia: Recent Macroeconomic Developments

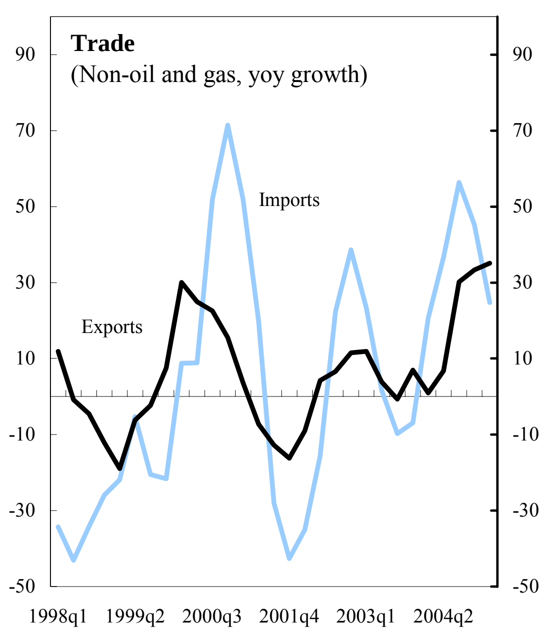
GDP growth has picked up...



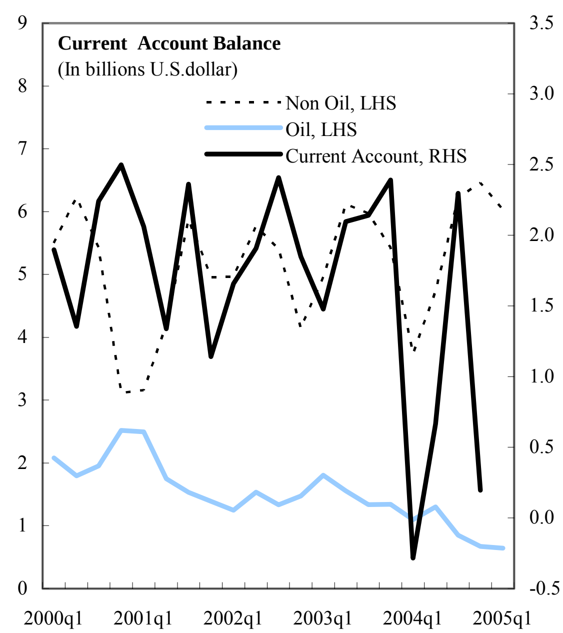
...driven by strong domestic demand, including a recent recovery in investment.



Exports are increasing moderately compared to imports...

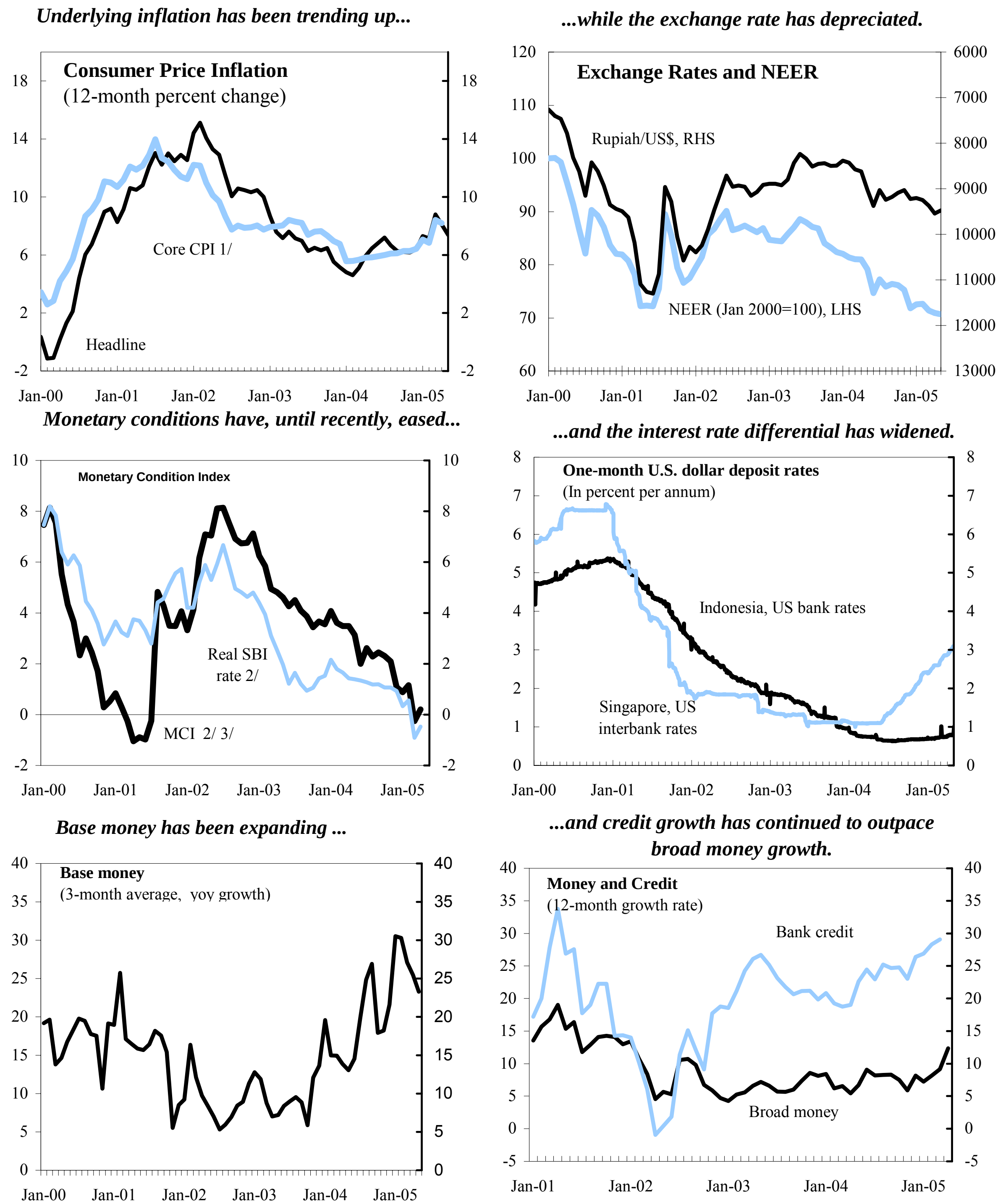


...and the current account is deteriorating.



Source: Data provided by the Indonesian authorities, CEIC, Danareksa Research Institute, and Fund staff estimates.

Figure 3. Indonesia: Inflation and Monetary Developments



Source: Data provided by the Indonesian authorities; CEIC, and Fund staff estimates.
1/ Nonfood, excluding administered prices.
2/ Using core inflation
3/ Using a ratio of 5:1 between real SBI and REER.

Figure 4. Indonesia: Selected Macroeconomic Indicators Under Alternative Scenarios, 2004-2010
(In percent)

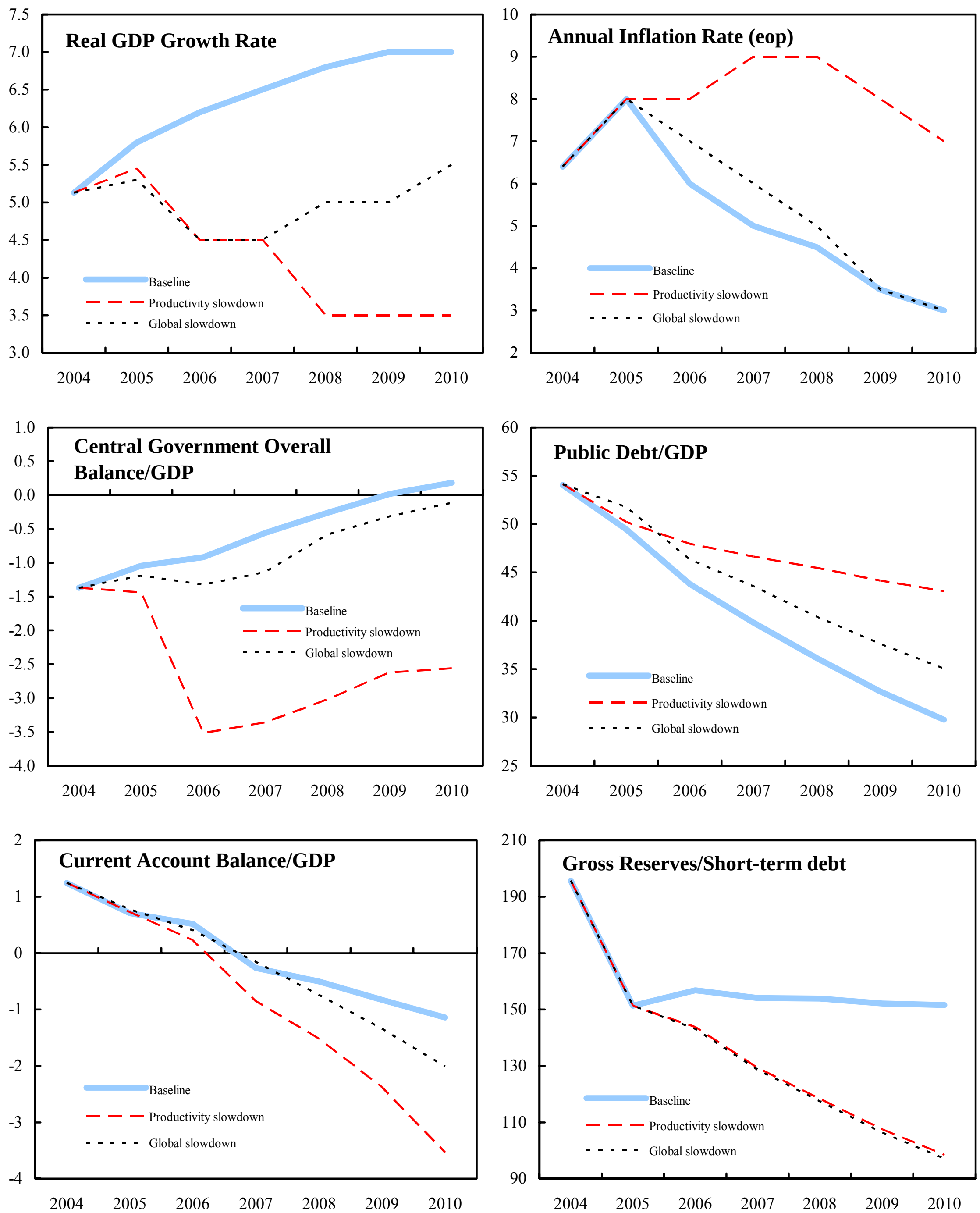


Table 1. Indonesia: Selected Economic Indicators, 2001–05 1/

	2001	2002	2003	2004	2005
		Act		Est.	Proj.
Real GDP (percent change)	3.8	4.4	4.9	5.1	6.0
Domestic demand	5.0	2.4	2.4	10.3	8.0
Of which:					
Private consumption	3.5	3.8	3.9	4.9	6.0
Gross fixed investment	6.5	4.7	1.0	15.7	14.5
Change in stocks 2/	0.5	-2.0	-1.2	2.8	0.5
Net exports 2/	-1.0	0.8	2.3	-3.6	-1.3
Statistical discrepancy 2/	0.4	1.4	0.4	-0.4	-0.1
Saving and investment (in percent of GDP)					
Gross investment 3/	23.3	21.3	19.4	24.1	23.4
Gross national saving	27.5	25.2	22.8	25.3	24.1
Foreign saving	-4.2	-3.9	-3.4	-1.2	-0.7
Prices (12-month percent change)					
Consumer prices (end period)	12.5	10.0	5.2	6.4	8.0
Consumer prices (period average)	11.5	11.9	6.8	6.1	7.9
Public finances (in percent of GDP)					
Central government revenue	17.9	16.1	16.4	17.7	18.1
Central government expenditure	21.0	17.6	18.4	19.1	19.7
Central government balance 4/	-3.2	-1.5	-1.9	-1.4	-1.0
Primary balance 4/	2.5	3.3	1.6	1.3	1.7
Central government debt	76.4	68.0	59.3	54.0	49.4
Money and credit (12-month percent change; end of period)					
Rupiah M2	13.6	7.9	9.8	10.0	14.1
Base money	2.1	8.3	19.1	20.1	12.5
Private sector credit	18.8	25.1	22.0	30.6	22.4
One-month SBI rate (period average)	16.5	14.9	10.0	7.4	9.0
Balance of Payments (in billions of US$)					
Oil and gas (net)	6.9	6.2	7.4	6.5	9.0
Non-oil exports (f.o.b)	44.8	46.3	48.9	54.5	57.7
Non-oil imports (f.o.b)	-29.0	-29.0	-31.7	-39.5	-46.1
Current account balance	6.9	7.8	8.1	3.2	1.9
Foreign direct investment	-3.0	0.1	-0.6	1.1	0.8
Overall balance	0.0	5.0	3.7	0.1	-0.3
Gross reserves					
In billions of US dollars (end period)	28.0	32.0	36.3	36.3	34.8
In months of imports	6.5	6.8	5.6	4.8	4.4
As a percent of short-term debt 5/	78.5	126.2	153.2	195.7	152.6
Total external debt					
In billions of US dollars	133.1	131.3	135.4	137.0	131.7
In percent of GDP	81.0	65.7	56.8	53.2	48.0
Exchange rate (period average)					
Rupiah per US$ (period average)	10,247	9,314	8,575	8,933	...
Nominal effective exchange rate (2000=100)	86.6	94.9	94.4	85.7	...
Real effective exchange rate (2000=100)	95.3	116.0	122.0	115.7	...
Memorandum items:					
Oil production (000bcpd)	1,320	1,260	1,200	1,040	1,070
Indonesian oil price (US$/bbl)	23.6	24.1	28.8	37.8	45.9
Nominal GDP (in trillions of Rupiah)	1,684	1,863	2,046	2,303	2,634
Nominal GDP (in billions of US$)	164	200	239	258	274

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

1/ National accounts figures (and ratios to GDP) are based on the revised national accounts (2000 prices).

2/ Contribution to GDP growth (percentage points).

3/ Includes changes in stocks.

4/ The figure for 2005 includes discretionary measures of about 0.5 percent of GDP.

5/ Short-term debt on a remaining maturity basis, before rescheduling, and including IMF repurchases.

Table 2. Indonesia: Summary of Central Government Operations, 2001–05

	2001	2002	2003	2004		2005	
	Act.	Act.	Act.	Revised budget	Prel. actuals	Draft revised budget	Staff projections
			(In trillions of rupiah)				
Revenues and grants	301.1	300.1	336.3	403.8	407.8	443.7	476.4
Oil and gas revenues	104.1	77.8	80.4	110.7	108.2	103.5	139.3
Non-oil and gas revenues	196.5	221.9	257.7	292.3	299.3	334.5	330.8
Tax revenues	162.4	193.1	218.0	256.1	257.9	298.1	294.5
Nontax revenues 1/	34.0	28.8	39.7	36.2	41.4	36.3	36.3
Grants	0.5	0.3	0.4	0.7	0.3	5.8	6.2
o/w Reconstruction for Aceh	...	...	...	...	...	2.6	2.8
Expenditure and net lending	354.4	328.4	375.8	430.0	439.4	472.2	517.8
Central government expenditure	273.3	229.9	255.1	300.0	309.7	331.3	369.6
Current expenditure	226.1	192.9	194.9	235.2	245.0	247.8	286.0
Personnel	38.7	39.8	46.6	54.2	54.2	60.9	60.9
Subsidies	77.4	40.0	39.9	69.9	85.5	60.3	98.5
Interest	94.9	89.9	71.7	63.2	62.3	68.6	73.2
External 2/	28.9	25.4	22.9	23.4	22.8	27.0	29.2
Domestic	66.0	64.5	48.8	39.8	39.6	41.6	44.0
Other	15.0	23.2	36.7	47.9	43.0	57.9	53.4
Development expenditure 3/	41.6	35.6	58.0	64.8	61.7	83.6	83.6
Domestically financed	21.4	24.7	44.3	49.1	47.1	61.0	61.0
o/w Reconstruction for Aceh	...	...	...	...	...	...	0.5
Foreign financed	20.2	10.9	13.7	15.7	14.6	22.6	22.6
o/w Reconstruction for Aceh	...	...	...	...	...	...	9.5
Statistical discrepancy	5.6	1.4	2.3	0.0	3.0	0.0	0.0
Transfers to regions	81.1	98.5	120.7	130.0	129.7	140.9	148.2
Discretionary measures	0.0	0.0	0.0	0.0	0.0	0.0	14.0
Overall balance 3/	-53.3	-28.3	-39.6	-26.3	-31.6	-28.4	-27.5
Financing	53.3	28.3	39.6	26.3	31.6	28.4	27.5
Domestic	46.5	24.0	39.8	41.4	46.0	25.2	10.7
Bank financing	7.2	-21.8	18.1	23.9	28.5	-3.5	-8.4
Net issuance of government securities			-14.1	-0.4	-1.7	21.2	11.6
Recovery of bank assets 4/	28.0	43.3	26.1	12.9	15.8	4.0	4.0
Privatization of nonfinancial assets	3.5	7.6	7.3	5.0	3.5	3.5	3.5
Other 5/	7.8	-5.1	2.4	0.0	0.0	0.0	0.0
External	6.8	4.3	-0.2	-15.1	-14.4	3.2	16.7
o/w Reconstruction for Aceh	...	...	...	...	...	...	6.7
			(In percent of GDP)				
Revenues and grants	17.9	16.1	16.4	17.3	17.7	17.1	18.1
Oil and gas revenues	6.2	4.2	3.9	4.8	4.7	4.0	5.3
Non-oil and gas revenues	11.7	11.9	12.6	12.5	13.0	12.9	12.6
Tax revenues	9.6	10.4	10.7	11.0	11.2	11.5	11.2
Nontax revenues 1/	2.0	1.5	1.9	1.6	1.8	1.4	1.4
Grants	0.0	0.0	0.0	0.0	0.0	0.2	0.2
o/w Reconstruction for Aceh	...	...	...	...	...	...	0.1
Expenditure and net lending	21.0	17.6	18.4	18.5	19.1	18.2	19.7
Current expenditure	13.4	10.4	9.5	10.1	10.6	9.5	10.9
Personnel	2.3	2.1	2.3	2.3	2.4	2.3	2.3
Subsidies	4.6	2.1	2.0	3.0	3.7	2.3	3.7
Interest 2/	5.6	4.8	3.5	2.7	2.7	2.6	2.8
Other	0.9	1.2	1.8	2.1	1.9	2.2	2.0
Development expenditure 3/	2.5	1.9	2.8	2.8	2.7	3.2	3.2
o/w Reconstruction for Aceh	...	...	...	...	...	...	0.4
Transfers to regions	4.8	5.3	5.9	5.6	5.6	5.4	5.6
Discretionary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.5
Overall balance 3/	-3.2	-1.5	-1.9	-1.1	-1.4	-1.1	-1.0
Financing	3.2	1.5	1.9	1.1	1.4	1.1	1.0
Domestic	2.8	1.3	1.9	1.8	2.0	1.0	0.4
External	0.4	0.2	0.0	-0.6	-0.6	0.1	0.6
Memorandum items:							
Primary balance	2.5	3.3	1.6	1.6	1.3	1.5	1.7
Non-oil primary balance	-3.7	-0.9	-2.4	-3.2	-3.4	-2.4	-3.6
Crude oil price (US $ per barrel)	23.6	24.1	28.8	36.0	37.8	35.0	45.9
Oil production (mbpd)	1.320	1.260	1.200	1.072	1.040	1.125	1.070
GDP (in trillions of rupiah)	1,684	1,863	2,046	2,329	2,303	2,600	2,634

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

1/ From 2004 onwards, deposit insurance premia are treated as nontax revenues.
2/ Interest on a due basis (Paris Club moratoria is shown as a financing item).
3/ In 2005, comprises capital spending and social assistance spending.
4/ Total IBRA receipts. After 2003, PPA receipts.
5/ Includes unpaid scheduled interest to BI (in 2003 includes deposit insurance premia).

Table 3. Indonesia: Balance of Payments, 2001–2005
(In billions of U.S. dollars)

	2001	2002	2003	2004 Est.	2005 Proj.
I. Current Account	6.9	7.8	8.1	3.2	1.9
A. Goods, Net (Trade Balance)	22.7	23.5	24.6	21.5	20.6
1. Exports, f.o.b.	57.4	59.2	64.1	72.2	81.3
Of which: Oil and Gas	12.6	12.9	15.2	17.7	23.6
2. Imports, f.o.b.	-34.7	-35.7	-39.5	-50.6	-60.7
Of which: Oil and Gas	-5.7	-6.7	-7.8	-11.2	-14.6
Tsunami related	...	...	...	...	-0.8
B. Services, Net	-9.9	-9.9	-11.7	-11.2	-14.2
C. Income, Net	-6.9	-7.0	-6.2	-8.3	-8.1
D. Current Transfers, Net	1.0	1.3	1.5	1.1	3.6
Of Which: Grants for Tsunami Reconstruction	...	...	...	...	0.3
II. Capital and Financial Account	-7.6	-1.1	-0.9	2.3	-0.7
A. Capital Account	0.0	0.0	0.0	0.0	0.0
B. Financial Account	-7.6	-1.1	-0.9	2.3	-0.7
1. Direct Investment, net	-3.0	0.1	-0.6	1.1	0.8
2. Portfolio Investment, net	-0.2	1.2	2.3	2.8	2.7
3. Other Investment	-4.4	-2.5	-2.6	-1.6	-4.2
Of which: Official Debt Rescheduling 1/	2.9	3.6	3.1	0.0	2.6
III. Total (I+II)	-0.7	6.7	7.2	5.5	1.2
IV. Errors and Omissions	0.7	-1.7	-3.5	-5.4	-1.5
V. Overall Balance (III+IV)	0.0	5.0	3.7	0.1	-0.3
VI. Reserves and Related Items	0.0	-5.0	-3.7	-0.1	0.3
Changes in Reserve Assets	1.4	-4.0	-4.3	0.9	1.5
Of which: Transactions	...	...	...	0.9	1.5
Use of Fund Credit and Loans	-1.4	-1.0	0.6	-1.0	-1.2
Purchases	0.4	1.4	2.0	0.0	0.0
Repurchases	-1.8	-2.4	-1.4	-1.0	-1.2
Memorandum items:					
Reserve Assets Position (eop)	28.0	32.0	36.3	36.3	34.8
in months of imports of goods and services	6.5	6.8	5.6	4.8	4.4
in percent of short-term debt	78.5	126.2	153.2	195.7	152.6
Current account (percent of GDP)	4.2	3.9	3.4	1.2	0.7
Non-oil and gas exports, volume growth	-7.2	0.9	-6.7	0.3	2.0
Non-oil and gas imports, volume growth	-11.5	-2.1	-3.4	10.8	13.7
Terms of trade, percent change (excluding oil)	0.8	0.2	-0.1	-0.9	1.3
Stock of non-fin public sector external debt	69.4	74.5	80.9	85.7	84.5
in percent of GDP	42.2	37.2	33.9	33.3	30.8
Non-fin public sector debt service (percent of exports)	18.0	17.9	15.1	11.1	11.4

Sources: Bank Indonesia; and Fund staff estimates

1/ For 2005, refers to the debt moratorium offered by Paris Club creditors in the wake of the tsunami.

Table 4. Indonesia: Monetary Data, December 2001–March 2005

(In trillions of rupiah, unless otherwise indicated, end of period) 1/

	2001	2002	2003	2004				2005
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
Monetary Survey								
Net foreign assets	141.9	178.5	215.9	220.7	199.6	194.1	193.1	188.0
(in USD billions)	20.3	24.3	30.8	31.5	28.5	27.7	27.6	26.9
Net domestic assets	651.6	674.8	715.3	688.6	737.9	759.9	807.0	796.2
Net claims on government	539.3	515.3	482.3	453.5	477.2	482.8	498.1	465.8
Claims on business sector	294.8	368.9	450.0	459.4	522.0	551.3	587.6	609.7
Rupiah claims	224.2	295.7	370.9	378.3	439.9	467.8	501.1	522.0
Foreign exchange claims	70.7	73.2	79.1	81.1	82.1	83.5	86.4	87.7
Other items (net)	-182.6	-209.4	-216.9	-224.3	-261.2	-274.2	-278.6	-279.2
Broad money (M2)	793.5	853.3	931.3	909.3	937.6	954.0	1000.2	984.2
Rupiah M2	689.3	743.4	816.5	793.2	827.2	846.6	897.9	881.0
Currency in circulation	76.3	80.7	94.5	86.9	97.6	99.5	109.3	98.6
Deposits	612.9	662.8	722.0	706.3	729.6	747.1	788.7	782.5
Foreign exchange deposits	104.2	109.9	114.7	116.1	110.4	107.4	102.2	103.1
Bank of Indonesia								
Net international reserves	128.1	155.1	169.4	169.4	165.9	165.6	170.8	173.3
Net domestic assets	-0.5	-16.8	-4.7	-26.7	-10.4	11.3	27.0	11.5
Net claims on government 2/ 3/	166.8	172.1	175.6	160.7	200.0	208.7	225.7	196.0
Claims on business sector	7.8	8.3	8.5	11.6	41.2	41.0	39.6	39.6
Claims on DMBs	-55.1	-65.9	-91.1	-126.3	-107.7	-94.6	-101.6	-87.9
Open market operations	-102.6	-113.3	-136.5	-156.9	-152.8	-139.3	-144.5	-130.8
Other items (net)	-120.0	-131.3	-97.8	-72.8	-143.9	-143.8	-136.7	-136.1
Base money	127.7	138.3	164.7	142.6	155.5	177.0	197.8	184.8
Currency in circulation	76.3	80.7	94.5	86.9	97.6	99.5	109.3	98.6
DMBs	49.6	56.0	69.5	54.4	57.0	76.7	88.0	85.5
Nonbank deposits	1.7	1.6	0.7	0.8	0.9	0.7	0.5	0.7
Memorandum items:								
Money multiplier (rupiah M2)	5.4	5.4	5.0	5.6	5.3	4.8	4.5	4.8
Base money velocity 4/	13.4	13.7	12.5	15.2	14.6	13.4	12.1	13.0
Rupiah broad money velocity 4/	2.5	2.5	2.5	2.7	2.7	2.8	2.7	2.7
Annual percentage change:								
Broad money (constant exchange rate)	12.2	7.5	9.1	7.2	7.3	7.4	7.4	8.2
Rupiah broad money	13.6	7.9	9.8	7.2	8.9	9.4	10.0	11.1
Base money	2.1	8.3	19.1	13.9	17.8	30.2	20.1	29.6
Private sector claims	18.8	25.1	22.0	20.9	29.2	29.5	30.6	32.7

Sources: Bank Indonesia; and Fund staff estimates.

1/ All foreign currency denominated components are valued at a constant exchange rate.

2/ The introduction of a 9-digit system of accounts at BI in May 2004 resulted in a reclassification of some government accounts from other items net to net claims on government.

3/ As part of the BLBI resolution, BI's net claims on government were reduced by Rp 20.2 trillion (reflected in the figure for 2003). BI's capital reserves (under other items net) have been reduced by a corresponding amount.

4/ Calculated using end-period quarterly GDP, annualized.

Table 5. Indonesia: Medium-Term Macroeconomic Framework, 2001–05 1/

	2004	2005	2006	2007	2008	2009	2010
	Est.			Proj.			
Real GDP (percent change)	5.1	6.0	6.2	6.5	6.8	7.0	7.0
Domestic demand	10.3	8.0	7.7	5.7	7.3	7.3	7.3
Of which:							
Private consumption	4.9	6.0	6.9	8.5	7.1	7.6	7.8
Gross fixed investment	15.7	14.5	12.0	10.0	8.5	7.5	7.0
Change in stocks 2/	2.8	0.5	0.0	0.0	0.0	0.0	0.0
Net exports 2/	-3.6	-1.3	-1.1	-1.0	-0.1	0.0	0.0
Statistical discrepancy 2/	-0.4	-0.1	0.0	0.0	0.0	0.0	0.0
Saving and investment (in percent of GDP)							
Gross investment 3/	24.1	23.4	24.7	25.5	25.9	26.1	26.1
Gross national saving	25.3	24.1	25.2	25.2	25.4	25.2	24.9
Foreign saving	-1.2	-0.7	-0.5	0.3	0.6	0.9	1.2
Prices (12-month percent change)							
Consumer prices (end period)	6.4	8.0	6.0	5.0	4.5	3.5	3.0
Consumer prices (period average)	6.1	7.9	6.5	5.8	4.7	3.8	3.2
Public finances (in percent of GDP)							
Central government revenue	17.7	18.1	17.7	17.3	17.0	16.7	16.4
Central government expenditure	19.1	19.7	18.6	17.8	17.3	16.7	16.3
Central government balance 4/	-1.4	-1.0	-0.8	-0.5	-0.3	0.0	0.1
Primary balance 4/	1.3	1.7	1.7	1.7	1.8	1.8	1.8
Central government debt	54.0	49.4	43.8	39.8	36.1	32.7	29.8
Balance of Payments (in billions of US$)							
Oil and gas (net)	6.5	9.0	8.8	8.3	7.8	7.2	6.6
Non-oil exports (f.o.b)	54.5	57.8	61.216	64.9	70.1	75.8	82.2
Non-oil imports (f.o.b)	-39.5	-46.1	-51.0	-55.0	-59.9	-65.4	-71.6
Current account balance	3.2	1.9	1.5	-1.1	-2.0	-3.5	-5.2
Direct foreign investment	1.1	0.8	1.7	1.7	3.6	4.5	5.5
Overall balance	0.1	-0.3	3.8	4.1	4.4	3.6	3.3
Gross reserves							
In billions of US dollars (end period)	36.3	34.8	37.3	39.8	42.3	44.8	47.3
In months of imports	4.8	4.4	4.3	4.3	4.2	4.1	4.1
As a percent of short-term debt 5/	195.7	152.6	158.0	155.2	154.9	153.1	152.5
Total external debt							
In billions of US dollars	137.0	131.7	130.1	128.3	126.9	125.1	122.8
In percent of GDP	53.2	48.0	43.4	39.0	35.1	31.4	28.0
Memorandum items:							
Oil production (000bcpd)	1,040	1,070	1,102	1,135	1,169	1,204	1,240
Indonesian oil price (US$/bbl)	37.8	45.9	46.0	44.8	43.5	42.5	42.0
Nominal GDP (in trillions of Rupiah)	2,303	2,634	2,979	3,357	3,754	4,169	4,604
Nominal GDP (in billions of US$)	258	274	299	328	361	397	438

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

1/ National accounts figures (and ratios to GDP) are based on the revised national accounts (2000 prices).

2/ Contribution to GDP growth (percentage points).

3/ Includes changes in stocks.

4/ The figure for 2005 includes discretionary measures of about 0.5 percent of GDP.

5/ Short-term debt on a remaining maturity basis, before rescheduling, and including IMF repurchases.

Table 6. Indonesia: Selected Vulnerability Indicators, 2001–05

	2001	2002	2003	2004	2005 1/	Latest observation
Key Economic and Market Indicators						
Real GDP growth (in percent)	3.8	4.4	4.9	5.1	6.3	2005Q1
CPI inflation (in percent)	11.5	11.9	6.8	6.1	7.4	May-05
Short-term (ST) interest rate (in percent)	17.6	12.9	8.4	7.4	8.0	31-May-05
EMBI secondary market spread (bps, end of period)				244	280	30-May-05
Exchange rate NC/US$ (end of period)	10,400	8,950	8,425	9,285	9,495	31-May-05
External Sector						
Exchange rate regime			Managed Float			
Current account balance (percent of GDP)	4.2	3.9	3.4	1.2	0.7	Proj.
Net FDI inflows (percent of GDP)	-1.8	0.1	-0.3	0.4	0.3	Proj.
Exports (percentage change of US$ value, GNFS)	-11.0	4.6	5.3	27.3	10.5	Proj.
Real effective exchange rate (2000=100)	86.6	95.0	94.4	85.7	...	Mar-05
Gross international reserves (GIR) in US$ billion	28.0	32.0	36.3	36.3	34.8	Mar-05
GIR in percent of ST debt at remaining maturity (RM)	78.5	126.2	153.2	195.7	152.6	Proj.
Net international reserves (NIR) in US$ billion	18.3	22.2	24.2	24.4	28.7	Mar-05
Total gross external debt (ED) in percent of GDP	81.0	65.7	56.8	53.2	...	Dec-04
o/w ST external debt (original maturity, in percent of total ED)	5.0	1.1	1.7	3.0	...	Dec-04
ED of domestic private sector (in percent of total ED)	46.4	43.2	39.7	41.1	...	Dec-04
ED to foreign official sector (in percent of total ED)	50.1	54.7	57.8	56.4	...	Dec-04
Total gross external debt in percent of exports of GNFS	212.0	200.1	195.8	155.7	...	Dec-04
Gross external financing requirement (in US$ billion) 2/	19.7	18.1	12.1	11.2	...	Dec-04
Public Sector (PS) 3/						
Overall balance (percent of GDP)	-3.2	-1.5	-1.9	-1.4	-1.0	Proj
Primary balance (percent of GDP)	2.5	3.3	1.6	1.3	1.7	Proj
Gross PS financing requirement (in percent of GDP) 4/	7.1	6.6	8.2	5.5	4.3	Proj
Public sector gross debt (PSGD, in percent of GDP)	76.4	68.0	59.3	54.0	...	Dec-04
o/w Exposed to rollover risk (in percent of total PSGD) 5/	1.5	3.7	7.0	3.9	...	Dec-04
Exposed to exchange rate risk (in percent of total PSGD) 6/		45.9	44.0	46.8	...	Dec-04
Exposed to interest rate risk (in percent of total PSGD) 7/	17.0	18.9	18.6	17.0	...	Dec-04
Financial Sector (FS) 8/						
Capital adequacy ratio (in percent)	18.2	20.1	22.3	20.9	...	Dec-04
NPLs in percent of total loans	11.0	6.2	5.8	4.2	...	Dec-04
Provisions in percent of NPLs	94.0	130.0	137.5	138.1	...	Dec-04
Return on average assets (in percent)	0.6	1.3	1.7	2.6	...	Dec-04
Return on equity (in percent)	12.0	19.0	19.2	25.7	...	Dec-04
FX deposits held by residents (in percent of total deposits)	20.2	18.2	16.6	11.5	11.6	Mar-05
FX loans to residents (in percent of total loans)	32.6	28.9	22.6	20.4	14.4	Mar-05
Government debt held by FS (percent of total FS assets)	49.1	43.4	35.9	31.6	...	Dec-04
Credit to private sector (percent change)	18.8	25.1	22.0	30.6	22.4	Proj.

1/ Staff estimates, projections, or latest available observations as indicated in the last column.
2/ Current account deficit plus amortization of external debt.
3/ Public sector covers central government.
4/ Overall balance plus debt amortization.
5/ ST debt and maturing medium- and long-term debt, domestic and external, excluding external debt to official creditors.
6/ Debt in foreign currency or linked to the exchange rate, domestic and external, excluding external debt on concessional terms.
7/ ST debt and maturing medium- and long-term debt at variable interest rates, domestic and external.
8/ Financial sector includes largest 16 banks by assets.

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 1/	2.2	2.6	1.6	1.2	1.5	1.6	1.9	2.1	1.2	0.9
Charges	0.5	0.3	0.3	0.2	0.3	0.3	0.2	0.2	0.1	0.1
Repurchases	1.8	2.4	1.4	1.0	1.2	1.3	1.6	1.9	1.1	0.8
In percent of exports of goods and nonfactor services	3.6	4.0	2.4	1.4	1.5	1.6	1.7	1.8	1.0	0.7
In percent of total non-financial public sector debt service	20.3	22.7	16.1	12.8	13.8	15.1	18.6	20.3	12.6	10.1
In percent of reserves of Bank Indonesia 2/	8.0	8.2	4.5	3.4	4.3	4.4	4.7	4.9	2.7	2.0
Outstanding Fund credit 1/	9.2	8.8	9.8	9.2	8.3	6.9	5.3	3.4	2.3	1.5
In percent of GDP	5.6	4.4	4.1	3.6	3.0	2.3	1.6	0.9	0.6	0.3
In percent of non-financial public debt	12.4	11.3	11.5	10.8	9.8	8.5	6.9	4.7	3.4	2.3
In percent of reserves of Bank Indonesia 2/	32.9	27.6	27.1	25.4	23.7	18.5	13.3	8.1	5.2	3.1
In percent of quota	348.8	313.5	332.6	300.0	262.7	219.6	168.3	108.7	74.2	47.2
Total non-financial public sector debt service										
In percent of exports of goods and nonfactor services	17.5	17.7	14.8	10.8	11.1	10.6	9.1	8.7	7.8	7.0
In percent of GDP	6.7	5.8	4.3	3.7	3.9	3.6	3.0	2.8	2.4	2.1

Sources: Indonesian authorities, and Fund staff estimates.
1/ Obligations basis.
2/ End of period reserves.

INDONESIA: FUND RELATIONS
(As of May 31, 2005)

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	7,891.98	379.55
Reserve position in Fund	145.50	7.00

III. SDR Department	SDR Millions	Percent of Allocation
Net cumulative allocation	238.96	100.00
Holdings	10.12	4.23

IV. Outstanding Purchases and Loans	SDR Millions	Percent of Quota
Extended arrangements	5,958.17	286.55

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 Payments to Fund (expectations basis)
(SDR Millions; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	495.97	1,015.64	1,359.70	1,703.76	942.31
Charges/Interest	110.78	196.68	155.87	102.27	46.76
Total	606.75	1,212.32	1,515.56	1,806.02	989.07

VII. Exchange Arrangements

The rupiah has floated since August 14, 1997. The market exchange rate was Rp 9,495 per U.S. dollar on May 31, 2005. 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 (EBS/04/54) was discussed by the Executive Board on May 3, 2004.

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, including the establishment of an independent audit committee at BI and the publication of BI's audited financial statements.

INDONESIA: STATISTICAL ISSUES[21]

1. Indonesia has subscribed to the Special Data Dissemination Standard (SDDS) since September 1996. Indonesia's macroeconomic statistics and statistical base are broadly adequate to conduct effective surveillance at this time.

Real Sector

2. Annual national accounts data are based on a 2000 base year. Quarterly GDP data are published in a timely manner. 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 prepared but not published, and no survey of nonfinancial services is conducted. An economic census of businesses is undertaken every 10 years, but not updated in the intervening periods. The household budget survey does not cover higher income households. The staff have recommended: (i) development of a system to continuously update the census of businesses; (ii) introduction of comprehensive annual establishment surveys for nonfinancial services industries; (iii) publication of annual GDP estimates, including a time series of at least 20 years; (iv) development of a set of annual supply and use tables (SUTS) starting from 2000; and (v) expedited conversion to the *1993 System of National Accounts*.

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.

Public Finance

4. 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 two years, and the quality is variable. Data on the central government budget become available with a two months lag.

5. Discrepancies between financing and elements above the line are evident for some years. The coverage and timeliness of public debt statistics is generally adequate; however, only limited information on contingent liabilities is available. There are a large number of quasi-government entities (such as utility platform includes Domestic Gas Project which aims at expanding the use of natural gas in the West Java market. This project, which is

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[21] The section is based on a Detailed Assessment of Indonesia's observance of the IMF's Data Quality Assessment Framework, prepared by STA in March 2005.

negotiated now and will be committed in July 2005, involves expansion of the gas distribution system in West Java and capacity building activities for PGN. foundations) and extra-budgetary funds, resulting in non-transparent and unaccountable off-budget activities. A new expenditure classification has been introduced in the 2005 budget and the authorities are considering the adoption of the GFS standards as their general reporting framework by 2008

6. In this context, the Fund staff have recommended: (i) establishment of a register of all central government public sector units, classified by sector; (ii) amendment of accounting regulations to ensure that general government units report all transactions and balances over which they exert control; (iii) establishment of arrangements to obtain timely preliminary data for local government statistics; and (iv) development of *Government Financial Statistic Manual 2001* operating statements, statements of sources and uses of cash, and partial balance sheets, all of which should be published on the MOF websites. Further TA from the Fund is likely to be requested in this area.

Monetary Accounts

7. Good quality monetary statistics are compiled by the BI on a timely basis. With STA assistance 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. Further work, however, is needed to expand the coverage of depository corporations to include mutual funds (REKSA DANA), which report data to BAPEPAM—a supervisory agency located in the Ministry of Finance. To this end, BI is currently developing institutional data-sharing arrangements that would enable it to access the register of—and data on—mutual funds.

8. In order to strengthen monetary statistics Fund TA missions have recommended to: (i) collect source data on mutual funds in a format that meets statistical requirements; (ii) expand the coverage of the monetary statistics to include mutual funds; and (iii) harmonize reported interbank positions between the BI and commercial banks.

Balance of Payments

9. Indonesia's balance of payments statistics are broadly adequate to conduct effective surveillance, but certain weaknesses remain. In general, there are some deficiencies in the recording of financial transactions of the private sector.

10. With respect to merchandise trade data, while customs sources utilized by BI are considered generally reliable, there is believed to be under-coverage in selected areas. When the online reporting system for exports and imports was introduced in 2004, the historical series were reconstructed only as far back as 2003. Therefore, prior to 2003, balance of payments statistics are not entirely consistent with the national accounts estimates. Data on services suffer from outdated surveys and weak methodologies. BI adjusts the customs data to cover exports and imports of Batam and other bonded zones. Adjustments are also made to

data on compensation of employees and workers remittances to cover professional workers, legal workers not reported to the Ministry of Manpower, and illegal workers.

11. For the capital and financial account, the methodological basis for the compilation of FDI data needs substantial improvement. 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 have a low response rate and the directory of enterprises requires 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. The magnitude of the errors and omissions item has been significant and appears to be related to the methodology used, for instance, for unrecorded assets in the financial account. Financial transactions data have not been reconciled with changes in the International Investment Position (IIP).

12. BI has proposed a range of measures to address these weaknesses. On trade-related data, a working group has been established to reconcile differences between BI and customs data. BI is planning to collect and publish data on goods imported for processing, goods procured in ports by carriers, and transactions with the oil and gas sector. On the financial account, the BI is planning to collect and publish data on direct investment abroad, portfolio investment assets, other investment assets, and trade credits, to help address some of the identified shortcomings in the recording of private financial flows.

13. An annual IIP is compiled, but the underlying data are weak in several areas, notably for FDI. External 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 the BI on a monthly basis. The data that this system generates for public sector external debt and debt service, as well as those 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 rescheduling and debt reductions being received by the private sector from external creditors.

Indonesia: Table of Common Indicators Required for Surveillance

(As of June 8, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	6/6/05	6/6/05	D	D	W/M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/6/05	6/6/05	D	D	W/M
Reserve/Base Money	6/6/05	6/6/05	D	D	W/M
Broad Money	3/05	6/05	M	M	M
Central Bank Balance Sheet	6/5/05	6/5/05	M	M	M
Consolidated Balance Sheet of the Banking System	3/05	5/05	M	M	M
Interest Rates[2]	6/6/05	6/6/05	D	D	W/M
Consumer Price Index	5/05	5/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	4/05	5/05	M	M	NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	4/05	5/05	M	M	NA
Stocks of Central Government and Central Government-Guaranteed Debt	12/04	3/05	NA	NA	NA
External Current Account Balance	12/04	3/05	Q	Q	Q
Exports and Imports of Goods and Services	4/05	6/05	M	M	M
GDP/GNP	2005Q1	5/05	Q	Q	Q
Gross External Debt[5]	2005Q1	3/05	Q	Q	A

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); NA: Not Available

INDONESIA: WORLD BANK RELATIONS

For questions relating to this annex, contact Mona Haddad (phone: 202-473-6127) at the World Bank.

The World Bank is engaged in a wide-ranging policy dialogue 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 is developed in the Country Assistance Strategy (CAS) of October 2003 and is based on the fact that 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—Selected Highlights

Poverty reduction. Continued macroeconomic stability and growth have reduced measured income poverty to pre-crisis levels. However the provision of basic services, non-income dimensions of poverty, including such indicators as the maternal mortality rate, continue to be weak relative to other countries in the region. The newly elected Government has made a strong commitment to poverty reduction in its Medium-Term Plan, targeting a halving of the poverty and unemployment rates in five years. The Medium-Term Plan (PJM), which draws on the Government's draft poverty reduction strategy (SNPK), is based on three agendas: (i) creating an Indonesia that is safe and peaceful; (ii) establishing democracy and justice for all; and (iii) improving prosperity. In April 2005, the World Bank assisted the Government in hosting a major National Poverty Conference, opened by the Vice President, and focusing on improving service delivery to the poor. Over the next fiscal year, the Bank will undertake a Poverty Assessment and continue to provide the Government advice on policy issues related to poverty reduction.

Fuel Subsidies. In March 2005 the Government reduced regressive fuel subsidies increasing average fuel prices by close to 30 percent. Some US$1 billion of the increase was reallocated to spending on health, education, and village infrastructure, with advice and input from the Bank and Fund.

Aceh. The government's challenge in reducing poverty and enhancing prosperity was severely tested by the tsunami and earthquake that struck Aceh and Northern Sumatra on December 26, 2004. The natural disaster, which is expected to have a modest overall macro-economic impact, had a devastating impact on local livelihoods. The World Bank led a joint Government-donor team, including the Fund, that prepared two key reports for the January 2005 Consultative Group Meeting: "Indonesia: Preliminary Damage and Loss Assessment" and "Indonesia: Notes on Reconstruction". The Bank has continued to play an important role in support of the government's response to the crisis; notably through assistance with the development of the government's "blue-print for reconstruction" and through technical assistance in setting up and operation of the Aceh Reconstruction Agency. Finally, the World Bank is managing a US$500 million multi-donor trust fund (MDTF) in support of the reconstruction effort. In its initial meeting, the MDTF approved four projects; land titling, housing support, community development and urban poverty reduction.

Fiscal Issues. The Bank works closely with the Fund on fiscal policy, with the Bank taking 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 capacity building for long-term debt management.

Initiative for Public Expenditure Analysis. Insufficient and poorly allocated public investment is a key concern. In order to address these public expenditure issues, the Bank with the support of the Dutch Trust Fund, put in place IPEA in April 2004. IPEA is a multi-year program that focuses on (i) fiscal space and public investment needs, (ii) sectoral expenditure reviews, (iii) decentralization and intergovernmental fiscal relations, (iv) regional public expenditure reviews and (v) public financial management. IPEA focuses on ownership and capacity building. For example, public finance days are regularly held with participation by the authorities, the donor community and Indonesian academics.

Public Financial Management. There has been a great deal of progress in this area. Three key laws (the State Finance Law, the State Treasury Law and the State Audit Law) provide a comprehensive framework for Indonesia's public financial management. Implementing regulations for these laws are under development with Bank and Fund assistance. The Ministry of Finance completed a major reorganization in early 2005. At the request of the Ministry of Finance, the Bank approved a Government Financial Management and Revenue Administration Project (GFMRAP). The GFMRAP project supports public finance reforms in three major areas: public financial management (including budget preparation and treasury modernization), tax administration and customs administration. The Ministry of Finance is in the process of adopting a results-oriented modernization strategy and plan for tax and a modernization action plan of customs. The Bank is working closely with the Fund on all aspects.

Long-term Debt Management Capacity Building. The government is making good progress on debt management. Under the new organization of the Ministry of Finance, domestic and external government debt is now managed within the Treasury. Currently, the Ministry of Finance with other stakeholders (e.g. Bank Indonesia) is developing a comprehensive debt management strategy with Bank technical assistance and advice. The program of assistance includes establishing a debt and risk management strategy, integrated debt reporting and improved capacity. This will allow the government to assesses vulnerability (risks and costs) in the sovereign liabilities portfolio, improve the "front, back and middle-office" function, and monitor fiscal risks associated with the government's contingent liabilities.

Decentralization. The passage of Law 32/2004 (revised Law 22/1999) and Law 33/2004 (revised Law 25/1999), revised the two main pillars of decentralization. The government is now working on finalizing revisions to the legal framework governing sub-national taxation (Law 34/2000). The modified legislation generally moves the decentralization process in the right direction, although the progress of reform is uneven. The World Bank supports the government's decentralization program with economic, fiscal, and financial analyses. This is done in collaboration with government; by providing policy advice on expenditure and tax assignments, intergovernmental transfers, and sub-national borrowing; and through the implementation of projects at the local level. The World Bank receives support in carrying out these activities from trust funds made available by the Dutch and the British aid agencies.

Financial and Private Sector. The Bank's overall financial sector program is focused on medium- and longer-term development of the financial sector aiming at improving the climate for investment. In the banking sector, the Bank continues its policy-dialogue with Bank Indonesia, the Ministry of Finance, and the Ministry of State owned Enterprises as well as with the State Asset Management Company (PPA). The Bank is working closely with the government to create a more diversified financial sector through the development of the capital markets and non-bank financial institutions, especially on industry structure and product development in NBFIs. A second ASEM grant for capacity building, knowledge transfer and sharing of best practices in the areas of equities, bonds, mutual funds, insurance, pensions, leasing and venture capital has been provided. Recently in April 2005, the Bank co-hosted an international conference on NBFIs with the Ministry of Finance and AusAID. A series of conferences in specific areas of the NBFI sector are expected to follow in 2005 – 2006. The Bank is also expanding its financial sector program with the support from Dutch Trust Fund to assist the Government in the area of infrastructure finance. In addition, the Bank together with the Fund continues its AML-CFT program.

In the corporate sector, the Bank had completed the Reports on the Observation of Standards and Codes (ROSC) on corporate governance and is undertaking another on accounting and auditing. The Bank will continue the quarterly debt survey previously carried out by the Jakarta Initiative Task Force (JITF); this institution designed to facilitate corporate restructuring post crisis has now been closed.

Trade. The Bank prepared a comprehensive Diagnostics for Trade Integration Study (published in November 2004). The study shows that in order to increase income growth and renew job creation in Indonesia the government should focus on measures that reduce costs for exporters, increase access to markets and revamp investment in export industries. Making use of Indonesia's abundant labor, 40 percent of the labor-force work in agriculture, and 70 percent in the informal sector, suggest that labor-intensive goods will remain Indonesia's strength for some time to come. In the medium-term, the government needs a comprehensive trade strategy to allow a gradual upgrading into higher value goods.

The new government has signaled its intent to maintain an open trade regime and on cutting the cost of doing business to improve competitiveness. Efforts are being made at simplifying or removing non-tariff barriers. Indonesia has recently made an initial offer on services at the WTO--an important step to becoming more pro-active in the multilateral negotiations. The Bank is working with the Ministry of Trade to assist in the development of an international and domestic trade strategy and associated capacity building.

Investment climate. Results from the World Bank-Asian Development Bank Private Investment Climate Survey (PICS) show that the main concerns of investors are macroeconomic instability, policy uncertainty, corruption, labor regulation and infrastructure. The government has recognized the importance of improving the investment climate. Measures include a continuing focus on fiscal and monetary stability, anti-corruption initiatives, policies to increase private infrastructure investment, and streamlining business registration. The World Bank and IFC-Pensa have worked closely with the government team drafting a new investment law including streamlining investment procedures. The Bank has completed and published the results of the PICS (Raising Investment in Indonesia: A Second Generation of Reforms in February 2005). New initiatives include a bi-annual investment climate monitor to assess progress and identify remaining weaknesses in the investment and business environment with the first results due in June 2005. The Bank is also launching a rural investment climate survey to identify constraints to the growth of non-farm income. IFC-Pensa is initiating a sub-national deregulation program to address business registration, licensing and permits at the local level.

Civil service reform. The World Bank has been providing support to administrative and civil service reform including a policy dialogue with key decision makers at the central level and support to regional governments.

The civil service is not large by regional standards but performance and governance are key issues and management is poor. Decentralization in 2001 did not solve the issue of poor service delivery, inefficiency and corruption. Central entities with responsibilities for civil service policy have overlapping mandates. There are unclear post-decentralization mandates. An opaque compensation regime, loose establishment controls and weak integrity systems govern civil service behavior.

The understanding and demand for civil service reform is high on the reform agenda in key agencies and some regional governments. The Bank's country assistance strategy allocates activities based on the scope to achieve, demonstrate, and leverage governance improvements. Governance and anti-corruption are central to all aspects of the Bank's program designed to foster transparency and accountability through two complementary approaches: (i) enhance the demand for good governance through greater public participation in policy-making and policy-monitoring processes, and (ii) by strengthening the institutions that are accountable for implementing the impressive body of laws to improve governance passed during the *Reformasi* period. The Bank has two projects; one in support of the Anti Corruption Commission and the second in support of Justice Sector and Legal Institutions reform more broadly.

The goal of the Bank's governance program is to help Indonesia with the structural progress needed to reduce corruption and restore integrity in the public sector. The new government has made governance a priority and a number of high profile cases are in process, but there continue to be concerns with the structural nature of corruption and measures needed to combat it.

The Bank issued a report on Combating Corruption in Indonesia in October 2003, and since then has assisted the anti-corruption effort notably through a grant to the Corruption Eradication Commission.

Lending Operations

During the CAS period (FY2004-2007), the Bank Group program is focused on areas most crucial to poverty reduction: (i) inadequate productive employment opportunities resulting from a weak investment climate; and (ii) the lack of quality service delivery especially to the poor. Progress in these two areas, is compromised by 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. To do this there are four broad client areas: the national government, communities, local governments (district and province), and public utilities. To deliver its program the bank has developed a platform approach at each level.

By end May of the Bank's FY2005 (July 2004-June 2005), US$917 million had been committed including:

- Central government platform lending includes the first Development Policy Loan (DPL) which disbursed US$300 million in December 2004 with Japanese co-financing disbursing US$100 million in March 2005. The DPL is designed to sustain macroeconomic stability and accelerate economic policy reform recognizing the country's progress in achieving the targets from the 2003 "White Paper", Indonesia's own reform package with time-bound targets. At the same time, the loan supports the comprehensive agenda of economic and governance reforms of the new government, as expressed in the 100-day plan, and other key policy statements. Also at the request of the Ministry of Finance, the Bank approved a US$60 million Government Financial Management and Revenue Administration Project (GFMRAP). The GFMRAP project supports public finance reforms in public financial management (including budget preparation and treasury modernization), as well as, tax and customs administration. The Higher Education projects provide support to the government's long-term strategy by creating an enabling environment for the evolution of autonomous and accountable public higher education institutions.
- Community based platform projects include the third Kecamatan Development Project (KDP, the third Urban Poverty Program (UPP) and a new Social and Economic Revitalization Project (SERP) focused on conflict areas. These projects feature a transparent "bottom-up" approach to decentralized participatory project identification and are designed to promote good governance, transparency, and increased accountability.
- Local government platform projects include: The Urban Sector Development Reform Project (USDRP) supports the establishment of accountable governments in Indonesia through the implementation of municipal governance reforms, institutional development and finances priority urban investments at the local level. The Initiative

for Local Governance Reform (ILGR) supports "reform-minded districts to enhance governance quality" by improving public accountability, the preparation of local regulations that ensure public access to information and decision-making processes.

- Public utility platform includes Domestic Gas Project which aims at expanding the use of natural gas in the West Java market. This project, which is negotiated now and will be committed in July 2005, involves expansion of the gas distribution system in West Java and capacity building activities for PGN.

Summary of Recently Completed Non-Lending Activities (FY2005)

- CGI brief: New Directions (January 2005)
- Trade Diagnostics (Making Indonesia Competitive: Promoting Exports, Managing Trade) (November 2004)
- Policy Notes for the New Government (January 2005)
- Investment Climate Assessment (Raising Investment in Indonesia: A Second Generation of Reforms) (February 2005)
- Indonesia: Preliminary Damage and Loss Assessment (January 2005)
- Indonesia: Notes on Reconstruction (January 2005)
- Raising Rural Productivity (underway)
- NBFI study (underway)

INDONESIA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

Asian Development Bank (AsDB) cumulative loans to Indonesia reached over $19.6 billion at end-December 2004. Technical assistance projects amounted to $231 million as of December 31, 2004. In 2004, the AsDB approved a total of $225 million which consisted of two loans for one project focused on enhancing governance in the public sector, with targeted support for State audit reforms. The AsDB is working closely with government agencies to develop and implement reforms in other areas including decentralization, social infrastructure, natural resources, trade and industry, financial sector reform, corporate governance and power sector restructuring. AsDB is pursuing its earlier efforts to implement anti-corruption reforms in line with an action plan agreed with the government.

In response to the December 26, 2004 earthquake and tsunami disaster, AsDB has reached agreement with the government in early 2005 to reallocate ongoing projects to mobilize support in the amount of $64.6 million. In addition, AsDB established the Asian Tsunami Fund with its own initial contribution of $600 million on a grant basis. Out of this Fund, AsDB has approved an emergency grant project to provide $300 million support for Aceh and Nias, including $10 million contribution the Multi-Donor Trust Fund. Cofinancing support has been mobilized for $20 million targeting support for community water and sanitation services, and fiduciary governance. The Japan Fund for Poverty Reduction will provide various grants totaling $10 million.

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

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Loan approvals	952.1	1,108.8	1,836.0	1,020.0	800.0	500.0	767.2	261.6	225.0
Loan disbursement	722.3	676.6	1,079.0	1,329.4	748.4	686.0	1000.5	442.9	593.5
Undisbursed balance at the beginning of the year	3,668.2	3,957.3	3,902.0	4,503.0	3,799.0	3,048.0	2814.7	2633.4	1991.2

Source: Asian Development Bank, *2004 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, 2004)

Sector	No of loans	$ Million	%
Social infrastructure	42	3,110.7	15.9
Agriculture and natural resources	100	4,156.6	21.2
Energy	30	3,431.1	17.5
Transport and communication	32	2,562.9	13.1
Finance	14	2,731.1	13.9
Multisector	32	1,895.6	9.7
Industry	14	665.7	3.4
Others	7	1,029.2	5.3
Total	**271**	**19,582.8**	**100.0**

Sources: Asian Development Bank, *2004 Annual Report*, and AsDB staff.

[1] Prepared by AsDB staff.

INDONESIA: MEDIUM-TERM OUTLOOK AND PUBLIC AND EXTERNAL DEBT SUSTAINABILITY

This annex compares the medium-term outlook under the baseline scenario discussed in the staff report text with two alternative scenarios based on different assumptions about global growth and interest rates and about domestic productivity growth. It also analyzes the impact of several exogenous shocks on the sustainability of public sector debt and external debt under the baseline scenario.

I. Alternative Scenarios

1. **The staff has developed two alternative scenarios to analyze the medium-term outlook**. The first alternative scenario looks at the implications of downside risks in the global environment, represented by lower growth in Indonesia's trading partner countries combined with higher international interest rates. The second alternative scenario assumes lower productivity growth due to delays in improving the investment climate and lower government surpluses. In both cases, growth is affected adversely, albeit for different reasons.

2. **In the first alternative scenario, lower growth reflects lower demand for Indonesia's exports and lower investment**. Growth is expected to average about 5 percent over the medium term compared with the baseline of 6–7 percent. Moreover, higher interest rates will raise government spending on the interest bill compared to the baseline and reduce capital spending, further exacerbating the slowdown. Public debt is about 5 percentage points higher than in the baseline scenario in 2010. Lower capital inflows combined with lower export growth also result in lower international reserves accumulation.

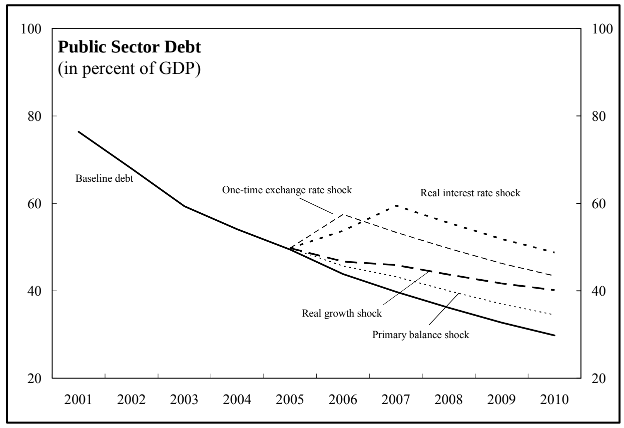
3. **In the second alternative scenario, lack of progress in improving the investment climate and less ambitious follow through on fiscal policy deters investors and slows down growth** to an average of 3–4 percent over the medium term due to deteriorating trends in investment and slowing productivity, including in the oil sector. Macroeconomic policy implementation also weakens, as both monetary and fiscal policy are relaxed. On the fiscal side, the overall fiscal deficit ranges between 2–2½ percent of GDP as the government relaxes spending to stimulate growth. This will increase the public debt ratio in the medium term by about 10 percentage points of GDP over the baseline by 2010.

II. Debt Sustainability Analysis Under the Baseline Scenario

A. Public debt

4. **The public sector debt ratio has steadily declined from 76 percent of GDP at end-2001 to an estimated 54 percent of GDP at end-2004** (Annex V, Table 1). This reflects the government's prudent fiscal policy, declining interest rates, and a sustained growth in real GDP. About half of the total outstanding public debt is owed to foreign creditors, mainly multilateral institutions.

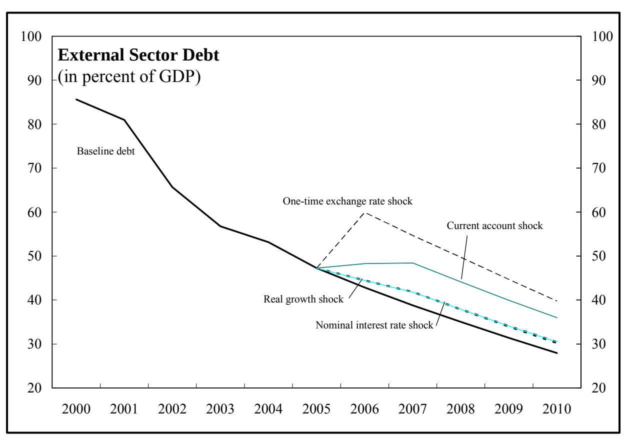
5. **Under the projected baseline scenario, the public sector debt ratio is expected to decline gradually to less than 30 percent of GDP by end-2010**. In terms of public sector revenues, public debt will decline from 273 percent to 181 percent over this period. These results are based on the assumptions underlying the baseline medium-term scenario in the staff report, specifically that: (1) real GDP growth rebounds to 6–7 percent over the medium term; (2) central government primary surpluses average 1½–2 percent of GDP; and (3) average nominal interest rates on public debt remain in the 5–6 percent range. The debt projections would be affected if contingent liabilities materialize, for example, if new banking sector bailouts are necessary or if the government decides to provide guarantees on investment projects which are subsequently executed.



6. **The standard sensitivity analysis shows that the trajectory of the debt ratio is particularly sensitive to changes in real interest rates and exchange rates** (Annex V, Table 1, panel B). A temporary upward shock in 2006 and 2007, equivalent to two standard deviations in the real interest above its historical average raises the debt ratio by about 10 percent of GDP in 2006 above the baseline, jumping to about 19 percent of GDP over the baseline during the remainder of the projection period. A one-time 30 percent real depreciation of the exchange rate raises the debt ratio by about 14 percentage points.

External debt

7. **Indonesia's external debt has also declined steadily since the crisis, from over 81 percent of GDP in 2001 to around 53 percent in 2004** (Annex V, Table 2). External debt as a percent of exports has also declined from over 212 percent in 2001 to 156 percent in 2004.



8. **External debt dynamics are sustainable under the baseline scenario, with the debt-to-GDP ratio declining to under 30 percent by 2010**. However, the favorable trend in the external debt burden could be reversed if the envisaged foreign direct investment and equity inflows fail to materialize, or if the associated investment does not generate growing export receipts.

9. **External debt sustainability is most vulnerable to shocks to the exchange rate**. A one-time shock of a 30 percent depreciation of the exchange rate in 2006 raises the debt ratio

immediately by about 17 percent of GDP with the impact declining gradually over the medium term to 12 percentage points by 2010.

Annex V, Table 1. Indonesia: Public Sector Debt Sustainability Framework, 2001-10
(In percent of GDP, unless otherwise indicated)

		Actual						Projections						
		2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabilizing primary balance 11/**
1	**Public sector debt 1/**	76.4	68.0	59.3	54.0			**49.4**	**43.8**	**39.8**	**36.1**	**32.7**	**29.8**	**-1.3**
	o/w foreign-currency denominated	36.0	30.4	28.1	27.0			25.8	22.9	20.3	17.9	15.5	13.5	
2	Change in public sector debt	-21.9	-8.4	-8.6	-5.3			-4.6	-5.6	-4.0	-3.7	-3.4	-2.9	
3	Identified debt-creating flows (4+7+12)	-12.0	-13.4	-7.5	-3.4			-5.2	-5.0	-4.5	-4.0	-3.6	-3.2	
4	Primary deficit	-2.5	-3.3	-1.6	-1.3			-1.7	-1.7	-1.7	-1.8	-1.8	-1.8	
5	Revenue and grants	17.8	16.1	16.4	17.7			18.1	17.7	17.3	17.0	16.7	16.4	
6	Primary (noninterest) expenditure	15.3	12.8	14.9	16.4			16.4	16.0	15.6	15.3	14.9	14.7	
7	Automatic debt dynamics 2/	-7.7	-7.4	-4.3	-1.2			-3.2	-3.1	-2.6	-2.1	-1.7	-1.4	
8	Contribution from interest rate/growth differential 3/	-11.1	-2.5	-2.6	-3.9			-3.2	-3.1	-2.6	-2.1	-1.7	-1.4	
9	Of which contribution from real interest rate	-8.0	0.5	0.5	-1.2			-0.3	-0.3	-0.1	0.3	0.6	0.7	
10	Of which contribution from real GDP growth	-3.1	-3.0	-3.0	-2.7			-2.9	-2.7	-2.5	-2.4	-2.3	-2.1	
11	Contribution from exchange rate depreciation 4/	3.4	-4.8	-1.7	2.7			...	...	...	...	...	...	
12	Other identified debt-creating flows	-1.8	-2.7	-1.7	-0.8			-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	
13	Privatization receipts (negative)	-1.8	-2.7	-1.7	-0.8			-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	
14	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	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	-9.9	5.0	-1.1	-1.9			0.4	-0.8	0.3	0.2	0.1	0.3	
	Public sector debt-to-revenue ratio 1/	429.1	422.1	361.0	305.2			273.4	247.1	229.6	212.3	196.1	181.3	
	Gross financing need 6/	7.1	6.6	8.2	5.5			4.1	4.4	4.5	4.2	3.2	3.0	
	Key Macroeconomic and Fiscal Assumptions					Historical Average	Standard Deviation							Projected Average
	Real GDP growth (in percent)	3.8	4.4	4.9	5.1	5.5 7/	1.6	6.0	6.2	6.5	6.8	7.0	7.0	6.6
	Average nominal interest rate on public debt (in percent) 8/	7.5	7.0	5.7	5.1	6.5	1.0	5.9	5.8	5.7	5.7	5.5	5.6	5.7
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-9.2	1.0	1.0	-2.0	-9.8	14.9	-0.3	-0.4	0.2	1.2	2.0	2.6	0.9
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.7	16.2	6.2	-9.3	-8.5	24.6	...	...	...	...	...	...	...
	Inflation rate (GDP deflator, in percent)	16.7	6.0	4.7	7.1	16.2	15.4	6.2	6.2	5.5	4.5	3.5	3.0	4.8
	Growth of real primary spending (deflated by GDP deflator, in percent)	39.7	-12.8	21.8	15.8	5.6	16.3	7.6	4.4	3.9	4.8	4.9	5.4	5.1
	Primary deficit	-2.5	-3.3	-1.6	-1.3	-2.0	0.9	-1.7	-1.7	-1.7	-1.8	-1.8	-1.8	-1.7
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 11/**
	A. Alternative Scenarios													
	A1. Key variables are at their historical averages in 2006-10 9/							**49.4**	**39.4**	**32.1**	**25.6**	**20.0**	**15.3**	**-2.3**
	A2. No policy change (constant primary balance) in 2006-10							**49.4**	**43.6**	**39.5**	**35.8**	**32.3**	**29.4**	**-1.3**
	A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 9/							**50.5**	**45.0**	**41.1**	**37.5**	**34.0**	**31.0**	**-1.3**
	B. Bound Tests													
	B1. Real interest rate is at historical average plus two standard deviations in 2006 and 2007							**49.8**	**53.7**	**59.4**	**55.5**	**51.8**	**48.7**	**-2.1**
	B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007							**49.8**	**46.7**	**45.9**	**43.7**	**41.7**	**40.2**	**-1.7**
	B3. Primary balance is at historical average minus two standard deviations in 2006 and 2007							**49.8**	**45.7**	**43.2**	**40.0**	**37.0**	**34.5**	**-1.5**
	B4. Combination of B1-B3 using one standard deviation shocks							**49.8**	**48.2**	**47.9**	**43.9**	**40.1**	**36.9**	**-1.6**
	B5. One time 30 percent real depreciation in 2006 10/							**49.8**	**57.5**	**53.4**	**49.7**	**46.2**	**43.4**	**-1.9**
	B6. 10 percent of GDP increase in other debt-creating flows in 2005							**49.8**	**54.1**	**49.6**	**45.5**	**41.7**	**38.4**	**-1.6**

1/ Includes only central government debt.
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/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/Excluding 1998 and 1999, which represented extreme ouliers due to the depth of the crisis in Indonesia. Including 1998 and 1999 reduces average Real GDP growth to 3.2 percent, with a corresponding standard deviation of 6.1.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
11/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex V, Table 2. Indonesia: External Debt Sustainability Framework, 2001-2010
(In percent of GDP, unless otherwise indicated)

	Actual						Projections						
	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
							I. Baseline Projections						**Debt-stabilizing non-interest current account 7/**
External debt	81.0	65.7	56.8	53.2			**48.0**	**43.4**	**39.0**	**35.1**	**31.4**	**28.0**	**-3.1**
Change in external debt	-4.6	-15.3	-8.9	-3.6			-5.1	-4.6	-4.4	-3.9	-3.7	-3.4	
Identified external debt-creating flows (4+8+9)	-4.5	-20.1	-15.1	-6.8			-4.9	-4.5	-3.2	-3.2	-2.8	-2.2	
Current account deficit, excluding interest payments	-8.3	-6.0	-5.1	-3.1			-2.2	-2.0	-1.0	-0.6	-0.2	0.2	
Deficit in balance of goods and services	-7.8	-6.8	-5.4	-4.0			-2.3	-2.2	-1.7	-1.3	-0.9	-0.5	
Exports	38.2	32.8	29.0	34.1			35.5	34.1	33.1	32.0	31.0	30.1	
Imports	30.4	26.0	23.6	30.1			33.1	31.8	31.5	30.7	30.0	29.5	
Net non-debt creating capital inflows (negative)	-0.9	-1.7	-1.1	-1.3			-1.2	-1.3	-0.9	-1.4	-1.4	-1.4	
Automatic debt dynamics 1/	4.7	-12.4	-8.9	-2.3			-1.5	-1.2	-1.2	-1.2	-1.1	-1.0	
Contribution from nominal interest rate	4.1	2.1	1.7	1.9			1.5	1.5	1.3	1.2	1.1	1.0	
Contribution from real GDP growth	-3.3	-2.9	-2.7	-2.7			-3.0	-2.7	-2.6	-2.4	-2.2	-2.0	
Contribution from price and exchange rate changes 2/	3.9	-11.5	-7.9	-1.5			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-0.2	4.8	6.2	3.2			-0.2	-0.1	-1.2	-0.7	-0.9	-1.2	
External debt-to-exports ratio (in percent)	212.0	200.1	195.8	155.7			135.4	127.4	117.8	109.7	101.5	93.1	
Gross external financing need (in billions of US dollars) 4/	27.0	30.8	19.9	20.5			18.2	21.3	24.7	27.7	30.8	34.5	
in percent of GDP	16.4	15.4	8.4	7.9			6.6	7.1	7.5	7.7	7.7	7.9	
Key Macroeconomic Assumptions					10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	3.8	4.4	4.9	5.1	5.5 8/	1.6	6.0	6.2	6.5	6.8	7.0	7.0	6.6
GDP deflator in US dollars (change in percent)	-4.4	16.6	13.7	2.8	4.3 8/	7.6	0.4	2.9	2.9	2.9	3.0	3.0	2.5
Nominal external interest rate (in percent)	4.7	3.1	3.1	3.6	4.7	1.1	2.9	3.4	3.4	3.4	3.4	3.5	3.3
Growth of exports (US dollar terms, in percent)	-11.0	4.6	5.3	27.3	7.4	13.7	10.5	5.0	6.6	6.2	6.5	7.0	7.0
Growth of imports (US dollar terms, in percent)	-9.6	4.1	8.2	37.9	6.7	19.7	17.0	5.0	8.4	7.2	7.7	8.4	9.0
Current account balance, excluding interest payments	8.3	6.0	5.1	3.1	5.3	4.3	2.2	2.0	1.0	0.6	0.2	-0.2	1.0
Net non-debt creating capital inflows	0.9	1.7	1.1	1.3	1.1	1.0	1.2	1.3	0.9	1.4	1.4	1.4	1.3
							II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 7/**
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2006-10 5/							**48.0**	**40.5**	**32.1**	**24.5**	**17.0**	**9.4**	**-1.6**
A2. Country-specific shock in 2006, with reduction in GDP growth (relative to baseline) of one standard deviation 6/							**47.3**	**44.1**	**41.1**	**39.4**	**37.8**	**36.7**	**-0.9**
A3. Selected variables are consistent with market forecast in 2006-10							**48.0**	**43.4**	**39.0**	**35.1**	**31.4**	**28.0**	**-3.1**
B. Bound Tests													
B1. Nominal interest rate is at historical average plus two standard deviations in 2006 and 2007							**48.0**	**45.0**	**42.0**	**37.9**	**34.0**	**30.4**	**-3.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007							**48.0**	**45.1**	**42.3**	**38.1**	**34.1**	**30.4**	**-3.4**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2006 and 2007 9/							**48.0**	**50.5**	**52.8**	**47.8**	**42.9**	**38.2**	**-4.2**
B4. Non-interest current account is at historical average minus two standard deviations in 2006 and 2007							**48.0**	**48.7**	**48.4**	**43.9**	**39.7**	**35.7**	**-3.6**
B5. Combination of B1-B4 using one standard deviation shocks							**48.0**	**49.6**	**50.2**	**45.3**	**40.7**	**36.4**	**-3.9**
B6. One time 30 percent nominal depreciation in 2006							**48.0**	**60.7**	**55.0**	**49.8**	**44.7**	**39.8**	**-4.4**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of 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/ The implied change in other key variables under this scenario is discussed in the text.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

8/ Excluding 1998 and 1999, which represented extreme outliers due to the depth of the crisis in Indonesia. Including 1998 and 1999 reduces average real GDP growth to 3.2 percent with a corresponding standard deviation of 6.1 percent; and the average growth of the GDP deflator in U.S. dollars to 5.4 percent with a standard deviation to 17.7 percent.

9/ Including 1998 and 1999 results in a debt to GDP ratio of 63.9 percent in 2006, 85.9 in 2007, 78.5 in 2008, 70.8 in 2009, and 63.0 in 2010.

Indonesia: Social and Demographic Indicators

	1990	1995	2000	2001	2002
General					
Land area (thousand sq.km.)	1,812	1,812	1,812	1,812	1,812
Land use, arable land (percent of land area)	11	10	11	11	...
Access to improved water source (percent of population)	71	...	78	...	...
Rural	62	...	69	...	...
Urban	92	...	90	...	...
Income and Poverty					
GDP per capita, PPP (current, US dollar)	1,840	2,770	3,060	3,090	3,230
Living on less than $1 a day (PPP) (percent of people)	...	...	...	...	8
Living on less than $2 a day (PPP) (percent of people)	...	...	...	...	52
GINI index	...	...	...	...	34
Demographic					
Total Population (millions)	178	193	206	209	212
Urban Population (percent of total)	31	36	41	42	43
Population growth (annual percent)	1.79	1.41	1.32	1.31	1.30
Population density (people per sq km) \ Indonesia	98	106	114	115	117
Life expectancy at birth, total (years)	62	64	66	...	67
Birth rate, crude (per 1,000 people) \ Indonesia	25	24	22	...	20
Labor Force					
Total labor force (millions)	78	89	100	102	104
Employment in agriculture (percent of total)	56	46	45	44	...
Employment in industry (percent of total)	14	19	17	17	...
Employment in services (percent of total)	30	35	37	38	...
Health and Education					
Immunization, DPT (percent of children ages 12-23 months)	60	69	75	76	75
Immunization, measles (percent of children ages 12-23 months)	58	63	73	76	76
Adult literacy rate (percent of people ages 15 and above)	80	84	87	87	88
School enrollment (percent gross)					
Primary	115	113	110	111	...
Secondary	44	51	57	58	...
Tertiary	9	11	14	15	...

Source: World Bank, *World Development Indicators* .

INTERNATIONAL MONETARY FUND

INDONESIA

Staff Report for the 2005 Article IV Consultation and Third Post-Program Monitoring Discussions

Supplementary Information

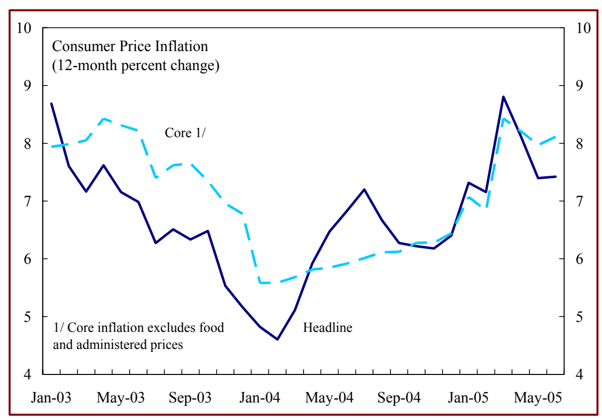
Prepared by the Asia and Pacific Department

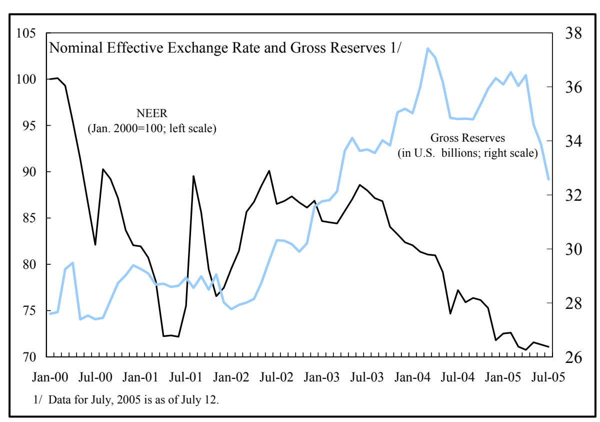
Approved by Daniel Citrin and Carlo Cottarelli

July 14, 2005

This supplement provides an update on developments since the issuance of the staff report. The thrust of the staff appraisal remains unchanged. In the staff's view, a continuation of exchange rate pressures, at the time of Bank Indonesia's adoption of interest rate targeting as part of its move toward formal inflation targeting, reinforces the staff report's emphasis on pursuing a firm interest rate policy .

Recent economic and financial market developments





1. **The increase in headline CPI was 7.4 percent (y/y) in June**, the same as in May. Meanwhile, underlying inflation edged up slightly, to some 8 percent.

2. **The exchange rate resumed its depreciating trend, touching a three-year low against the U.S. dollar in early July**. The rupiah exchange rate reached Rp/US$9,900 on July 5, but has since recovered slightly to Rp/US$9,805 on July 14. Bank Indonesia (BI) has continued to intervene in the foreign exchange market, while also increasing the one-month interest rate from just under 8 percent at the beginning of June to 8½ percent currently. The foreign exchange sales have contributed to a decline in BI's gross international reserves to about US$32½ billion at present, down from a peak of about US$37 billion in early April. The reserves level remains relatively comfortable, however, at some

140 percent of short-term external debt. Effective July 14, Bank Indonesia announced a set of measures designed to limit short-term capital flows and the scope for exchange rate volatility; these measures included: (i) a reduction in the limit on sell swaps with nonresidents from US$3 million to US$1 million; (ii) a new limit of US$1 million on buy swaps; and (iii) a new requirement that hedging activities with nonresidents for underlying financial investments must be of a maturity of 3 months or longer.

Budgetary developments

3. **Parliament approved the revised budget for 2005 based on updated assumptions on June 28**. The budget now assumes real GDP growth of 6 percent and consumer price inflation of 7½ percent (Dec/Dec) this year, and also incorporates new assumptions for the exchange rate and international oil prices. Total revenues are budgeted to be higher by 1.6 percent of GDP compared with the previous budget, reflecting higher oil revenues. At the same time, expenditure is to be higher by a corresponding amount, keeping the deficit target at some 0.8 percent of GDP (1.2 percent of GDP based on Fund classifications). The higher spending mainly reflects larger fuel subsidies, which are budgeted at about 3 percent of GDP, the same level as in 2004, notwithstanding the March increase in domestic fuel prices. Preliminary information through mid-June shows an overall fiscal surplus, reflecting buoyant oil and gas revenues and a low expenditure execution rate associated with new disbursement guidelines. While revenues could weaken in the period ahead, the expenditure delays are not likely to be fully reversed, facilitating the achievement of the overall budget deficit target, albeit at the risk of lower reconstruction activity in tsunami-affected areas. Also, the possibility of higher international oil prices remains a risk to the budget, although the ultimate impact will depend on domestic fuel pricing policies.

Table. Indonesia: Budgetary Aggregates, 2005
(In percent of GDP)

	Original revised budget	Adopted revised budget
Revenues and grants	17.1	18.7
Oil and gas revenues	4.0	5.6
Non-oil and gas revenues	12.9	12.9
Grants	0.2	0.3
Expenditure and net lending	18.2	19.9
Central government expenditure	12.7	14.3
Current expenditure	9.5	11.1
Of which : Subsidies	2.3	3.7
Development expenditure	3.2	3.2
Transfers to regions	5.4	5.6
Overall balance	-1.1	-1.2
Memorandum item:		
Crude oil price (US $ per barrel)	35.0	45.0

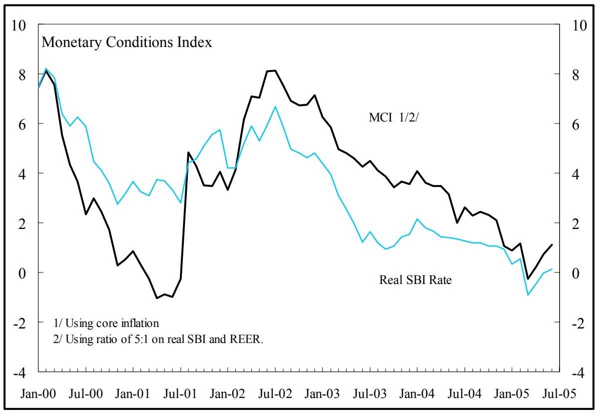
Sources: Indonesian authorities; and Fund staff estimates.

4. **The estimated total costs of reconstruction in the earthquake and tsunami-affected areas have been increased from US$4½ billion to about US$5 billion**. In addition to costs relating to Aceh and North Sumatra, the new estimate includes reconstruction costs in Nias, hit by the March 2005 earthquake. The amount of funds allocated for reconstruction and development activities has now reached about US$3 billion, of which US$1.2 billion is from NGOs. The revised 2005 budget includes allocations for reconstruction, partly financed by Paris Club rescheduling and partly covered under ongoing government-financed projects. The progress on the ground has been constrained by (i) the emphasis on checks and balances, which has slowed down budget implementation, (ii) the authorization process for donor pledges by some national governments, that in certain cases have been awaiting parliamentary approval, and (iii) sluggish capital and reconstruction spending at the local government level, in part due to delays in completing budget approval processes of lower-

level authorities. However, it is expected that funds for on-budget projects will flow within one month, following the approval of the revised 2005 budget.

Monetary policy

5. **At end-June, Bank Indonesia announced, as expected, that it will henceforth use interest rates as its intermediate target for monetary policy**. The central bank will use a one-month interest rate, dubbed the “BI rate,” as its intermediate target in lieu of base money, and as a step toward fully-fledged inflation targeting. The statement issued by BI envisages that the BI rate will be announced on a quarterly schedule following BI board meetings, although the rate could be changed also at intervening intervals if warranted. In keeping with the new policy, on July 5, the central bank announced a BI rate of 8½ percent, an increase of 25 basis points compared with the prevailing one-month SBI rate.



Banking and private investment environment

6. **Bank Indonesia announced as anticipated new regulations to guide the strengthening and consolidation of the banking system, at end-June**. The regulations set the minimum tier-1 capital level for banks at Rp 80 billion by end-2007 and Rp 100 billion by end-2010. Banks that do not meet the criteria have an option to merge with other banks; failing this, the scope of their operations would be curtailed. By the same token, banks with strong performance would be permitted to act as “anchor banks” allowed to acquire other banks. Criteria for qualifying as an “anchor bank” are *inter alia* that for at least the preceding three years, a bank has registered (i) a minimum capital adequacy ratio of 12 percent, with a tier-1 capital ratio of 6 percent, (ii) a healthy performance as reflected in a minimum return on assets of 1.5 percent, and (iii) stipulated minimum levels of credit growth or loan-to-deposit ratios. The authorities have noted that, while the “anchor bank” criteria emphasize credit expansion and growth potential, they are primarily designed to ensure that the balance sheets of such banks are sound.

7. An agreement in principle has been announced between Exxon Mobil and the state-owned petroleum company Pertamina concerning the Cepu oil field. The two parties had been negotiating an extension of Exxon Mobil’s contract, which was set to expire in 2010, following the discovery of large oil reserves at Cepu. While full agreement is yet to be reached, the announcement has been welcomed by observers, as the case has been considered an important test of the investment environment under the new government.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation and Third Post-Program Monitoring with Indonesia

On July 18, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the 2005 Article IV consultation and third post-program monitoring discussions with Indonesia.[1]

Background

Since the last Article IV consultation, Indonesia has undergone a historical political transition. In 2004, the country held parliamentary elections as well as its first direct presidential election, and a new government took office in October. The elections gave the government a strong mandate to carry forward the economic reforms initiated by its predecessor, aimed at placing Indonesia on a high and sustained growth path in order to reduce unemployment and poverty. To this end, the new government's medium-term economic strategy focuses on a continuation of macroeconomic stability combined with a deepening of structural reforms. Since the new government assumed office, it has continued the conservative budget stance, and taken important first steps toward strengthening the financial sector and enhancing the investment climate. At the same time, the government's Reconstruction and Rehabilitation Agency has started reconstruction in the tsunami-affected regions, with the support of the international

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with all member countries, usually every year. Post-Program Monitoring provides for frequent consultations between the Fund and members whose Fund arrangements have expired but who continue to have substantial Fund credit outstanding. Particular focus is placed on policies that have a bearing on external viability. For both purposes, 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.

community. Monetary policy is aiming to anchor inflation at a low and stable level; in June, Bank Indonesia announced a switch to a one-month interest rate as its intermediate target in a move toward fully-fledged formal inflation targeting.

Economic growth has gained momentum, with real GDP increasing by 5.1 percent in 2004 and 6½ percent in the first quarter of 2005, driven by private investment and consumption. Inflation has edged up, reaching 7.4 percent (y/y) in June this year reflecting partly the increase in domestic fuel prices in March, but also the vigorous domestic demand and a depreciation of the exchange rate. Following a reduction in the fiscal deficit to about 1½ percent of GDP in 2004, the fiscal accounts registered a surplus in the first half of 2005, largely reflecting underspending compared with allocations. The external current account surplus has been on a downward trend in relation to GDP, as demand for imports of capital goods and raw materials has picked up alongside the overall economy, while the oil import bill has risen.

Against this generally favorable background, financial markets have come under some pressure in early 2005. The exchange rate has been on a depreciating trend and has recently been trading at three-year lows against the U.S. dollar. Responding to these pressures, Bank Indonesia has intervened in the foreign exchange market, increased interest rates, and taken measures to limit the scope for short-term capital flows.

In order to strengthen the financial sector, Bank Indonesia has made encouraging strides in risk-based supervision and upgrading of banking regulations toward international standards, and has introduced new asset classification rules. Moreover, recent management changes at top state-owned banks are expected to help improve governance. The authorities have also started scaling back the blanket guarantee on bank deposits introduced during the crisis, replacing it with a limited deposit insurance scheme. Furthermore, Bank Indonesia in June announced new regulations to guide the strengthening and consolidation of the banking system. At the same time, efforts are being made to bolster the supervision of insurance companies, finance companies, and mutual funds.

The new government is focused on improving the investment climate. The efforts in this regard are centered on simplifying the regulatory framework, preparing a new streamlined investment law, reducing corruption, strengthening the legal system, and increasing infrastructure investment. The authorities have established a Corruption Eradication Commission, and various government agencies are investigating cases of irregularities and corruption, including in state banks and in local government offices. Finally, agreement has been reached in principle between Exxon Mobil and Pertamina with regard to the development of the large Cepu oilfield.

Economic growth is projected to reach 6 percent this year, before increasing further to 6-7 percent annually over the medium term**,** assuming that the government's economic policies are implemented as planned. Inflation would come down to around 6 percent next year and converge to trading partner country rates over the medium term. Fiscal consolidation is expected to continue, with the government debt ratio declining gradually towards 30 percent of GDP, reducing debt-related vulnerabilities. While the external current account is projected to turn into deficit as domestic demand remains strong, net capital inflows would lead to an increase in international reserves, helping to maintain a comfortable external position.

Executive Board Assessment

Executive Directors welcomed the continuing improvement in the overall performance of the Indonesian economy in recent years, which has been manifested in the considerable progress toward achieving macroeconomic stability, lowering public debt, restoring the health of the banking system, and reducing vulnerabilities. Going forward, Indonesia nevertheless faces key policy challenges in placing the economy on an even stronger footing for economic growth in order to create jobs and reduce widespread poverty. Directors accordingly welcomed the adoption of the medium-term economic strategy, which signals the new government's determination to use its political mandate to place Indonesia on a high and sustainable growth path, by pursuing sound macroeconomic policies, reducing the still-present economic vulnerabilities, and strengthening and completing the institutional and structural reforms required for a lasting improvement in the investment climate.

Directors commended the authorities for their efforts toward reconstruction in Indonesia's tsunami-affected areas. They noted the importance of rapid implementation of reconstruction projects, while also emphasizing the need for donors to follow through on the financing pledges they have made. In this context, Directors welcomed the establishment of the Multi-Donor Trust Fund and the authorities' commitment to transparent allocation and effective use of international aid.

Further fiscal consolidation over the medium tem is a key priority in the authorities' strategy to help further reduce the government debt burden and lay the basis for sustained economic growth. Directors accordingly welcomed the revised 2005 budget, which aims to further reduce the fiscal deficit. Achievement of this target will require careful budget management. Achievement of the budgetary targets in 2006 will require careful consideration of the revenue implications of the tax policy package under way. In this context, Directors advised caution in expanding tax exemptions, and several saw scope for reducing current tax exemptions. Directors also stressed the importance of further steps to mobilize non-oil revenues. Directors noted that unexpected further rises in international oil prices will call for continued budget vigilance. They commended the steps taken by the authorities toward reducing domestic fuel subsidies, and the allocation of these savings to spending for vulnerable population groups.
Several Directors recommended further progress toward market-based prices and away from fuel subsidies, in view of their still significant strain on the budget, along with continuing efforts to minimize the impact on vulnerable groups.

Directors noted the importance of continuing fiscal structural reforms in order to enhance the quality and sustainability of fiscal adjustment. In this context, they welcomed the authorities' intention to improve tax administration and emphasized the need to strengthen governance and modernize customs administration. Directors cautioned against introducing a tax amnesty, which could undermine revenue performance. On the spending side, Directors noted that the planned reorientation of spending toward capital and social expenditure should bring tangible results in terms of creating jobs and improving productive capacity. Key for reducing debt-related vulnerabilities will be careful management of government liabilities, including the adoption of a debt management strategy and a consolidated debt management unit; a framework for limiting contingent liabilities; and the inclusion of the many extra-budgetary funds into the budget. Directors applauded the authorities' intention to strengthen fiscal soundness at the regional level, and emphasized the importance of maintaining fiscal control as the decentralization framework is implemented. In particular, Directors encouraged the authorities to ensure the coherence of regulations at different levels of government, and to make sub-national borrowing contingent upon the establishment of appropriate safeguards and regular fiscal reporting.

Directors commended Bank Indonesia for its focus on anchoring inflation at a low level, and the steps taken to tighten monetary policy to ensure that inflation is contained. While recognizing the authorities' concern that significantly higher interest rates might affect economic growth, a number of Directors suggested that further tightening may still be desirable in view of the recent pressures on inflation and the exchange rate. Directors welcomed the recent announcement to use the interest rate as the intermediate target for monetary policy as part of the move toward formal inflation targeting. Convincing use of the new interest rate policy will help maintain stability and enhance confidence. More generally, Directors recognized the importance of a credible and transparent monetary policy for effective inflation targeting, and welcomed the steps being taken to put in place the operational and institutional pre-requisites for this monetary policy regime. Indonesia's flexible exchange rate system has helped protect the economy against shocks and will help the functioning of the new monetary framework. Directors recommended that Bank Indonesia limit interventions in the foreign exchange market to those needed to counter short-term volatility.

Directors noted the banking system's improved performance in asset quality and profitability, as well as the progress made in banking supervision. At the same time, they stressed that it will be important to move forward with further improvements in prudential regulations and strengthened risk management, especially against the background of higher interest rates that may put pressure on margins going forward. In this context, Directors welcomed the ongoing work toward introducing risk-based supervision and improving governance Directors also supported the authorities' objective of further bank consolidation, as well as their intention to allow the process to be market based and ensure that the merged banks are sound. Several Directors noted that the privatization of state banks over time would enhance the efficiency and soundness of the banking sector. With respect to the financial sector safety net, Directors welcomed the progress so far, and noted the importance of establishing the deposit insurance fund and putting in place the remaining elements of the financial sector safety net without delay. This will help maintain confidence in the banking system as the blanket guarantee is phased out. Several Directors encouraged the authorities to undertake a Financial Sector Assessment Program, which should help the authorities improve their understanding of financial sector vulnerabilities and address them. Directors welcomed the progress in enhancing the anti-money laundering regime in

Indonesia, which has led to its removal from the list of Non-Cooperative Countries and Territories maintained by the Financial Action Task Force (FATF), and encouraged the authorities to continue careful monitoring.

Directors underlined the importance of steps to improve the investment climate, especially against the background of the recent declines in some of Indonesia's export market shares and the relative attractiveness of other investment destinations. Accordingly, they welcomed the authorities' commitment to improve the investment climate. They commended in particular the recent steps taken to address corruption, to attract investment in the oil and gas sector, and to put in place a new investment law. It is acknowledged that dealing with deep-seated structural impediments to investment will take time. Directors nevertheless noted the importance of taking further decisive steps to improve the functioning of the legal system, simplify the regulatory framework, strengthen infrastructure, improve labor market flexibility, and bolster tax administration. Actions in all these areas will be helpful for enhancing productivity, improving external competitiveness, and boosting foreign direct investment flows. Directors welcomed the authorities' commitment to maintaining Indonesia's open trade regime, while some Directors suggested that the country phase out its import restrictions on sugar and rice.

Table 1. Indonesia: Selected Economic Indicators, 2001–05 1/

	2001	2002	2003	2004	2005
		Act		Est.	Proj.
Real GDP (percent change)	3.8	4.4	4.9	5.1	6.0
Domestic demand	5.0	2.4	2.4	10.3	8.0
Of which:					
Private consumption	3.5	3.8	3.9	4.9	6.0
Gross fixed investment	6.5	4.7	1.0	15.7	14.5
Change in stocks 2/	0.5	-2.0	-1.2	2.8	0.5
Net exports 2/	-1.0	0.8	2.3	-3.6	-1.3
Statistical discrepancy 2/	0.4	1.4	0.4	-0.4	-0.1
Saving and investment (in percent of GDP)					
Gross investment 3/	23.3	21.3	19.4	24.1	23.4
Gross national saving	27.5	25.2	22.8	25.3	24.1
Foreign saving	-4.2	-3.9	-3.4	-1.2	-0.7
Prices (12-month percent change)					
Consumer prices (end period)	12.5	10.0	5.2	6.4	8.0
Consumer prices (period average)	11.5	11.9	6.8	6.1	7.9
Public finances (in percent of GDP)					
Central government revenue	17.9	16.1	16.4	17.7	18.1
Central government expenditure	21.0	17.6	18.4	19.1	19.7
Central government balance 4/	-3.2	-1.5	-1.9	-1.4	-1.0
Primary balance 4/	2.5	3.3	1.6	1.3	1.7
Central government debt	76.4	68.0	59.3	54.0	49.4
Money and credit (12-month percent change; end of period)					
Rupiah M2	13.6	7.9	9.8	10.0	14.1
Base money	2.1	8.3	19.1	20.1	12.5
Private sector credit	18.8	25.1	22.0	30.6	16.8
One-month SBI rate (period average)	16.5	14.9	10.0	7.4	9.0
Balance of Payments (in billions of US$)					
Oil and gas (net)	6.9	6.2	7.4	6.5	9.0

Table 1. Indonesia: Selected Economic Indicators, 2001–05 1/

	2001	2002	2003	2004	2005
		Act		Est.	Proj.
Non-oil exports (f.o.b)	44.8	46.3	48.9	54.5	57.7
Non-oil imports (f.o.b)	-29.0	-29.0	-31.7	-39.5	-46.1
Current account balance	6.9	7.8	8.1	3.2	1.9
Foreign direct investment	-3.0	0.1	-0.6	1.1	0.8
Overall balance	0.0	5.0	3.7	0.1	-0.3
Gross reserves					
In billions of US dollars (end period)	28.0	32.0	36.3	36.3	34.8
In months of imports	6.5	6.8	5.6	4.8	4.4
As a percent of short-term debt 5/	78.5	126.2	153.2	195.7	152.6
Total external debt					
In billions of US dollars	133.1	131.3	135.4	137.0	131.7
In percent of GDP	81.0	65.7	56.8	53.2	48.0
Exchange rate (period average)					
Rupiah per US$ (period average)	10,247	9,314	8,575	8,933	...
Nominal effective exchange rate (2000=100)	86.6	94.9	94.4	85.7	...
Real effective exchange rate (2000=100)	95.3	116.0	122.0	115.7	...
Memorandum items:					
Oil production (000bcpd)	1,320	1,260	1,200	1,040	1,070
Indonesian oil price (US$/bbl)	23.6	24.1	28.8	37.8	45.9
Nominal GDP (in trillions of Rupiah)	1,684	1,863	2,046	2,303	2,634
Nominal GDP (in billions of US$)	164	200	239	258	274

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

1/ National accounts figures (and ratios to GDP) are based on the revised national accounts (2000 prices).

2/ Contribution to GDP growth (percentage points).

3/ Includes changes in stocks.

4/ The figure for 2005 includes discretionary measures of about 0.5 percent of GDP.

5/ Short-term debt on a remaining maturity basis, before rescheduling, and including IMF repurchases.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

**Statement by Hooi Eng Phang, Executive Director for Indonesia
and Made Sukada, Alternate Executive Director
July 18, 2005**

1. On behalf of the Indonesian authorities, we would like to thank the staff for a well-written and excellent set of reports. The selected issues paper is particularly useful since it has provided in-depth analysis and policy recommendations on key areas of the government's growth strategy. The authorities are appreciative of the extensive technical assistance and policy advice received from the Fund which has contributed to the favorable economic performance and the success of structural reforms in recent years.

2. The Indonesian authorities would like to take this opportunity to thank the members of the Board for their longstanding support and constructive comments expressed during the last Post Program Monitoring discussions held in February this year. They particularly took note of the suggestion to reduce the fuel subsidies and to channel the savings to development spending. The government has increased domestic fuel prices by an average of 30 percent, effective March 1, 2005 and used the budget savings to support expenditure on education, health, and rural development.

3. The authorities are pleased to note in the staff report that the mission team fully supports the Medium Term National Development Plan (RPJMN) for the period 2004-2009, launched by the new administration as part of the government's efforts to maintain sustainable growth. One of the main objectives of the RPJMN is to reduce the incidence of poverty from 16.6 percent to 8.2 percent and the unemployment rate from 9.7 percent to 5.1 percent over the period 2004-2009. The authorities are well aware that macroeconomic stability and rigorous structural reforms are required for sustained growth. Improving the investment climate and export competitiveness are also essential.

RECENT MACROECONOMIC DEVELOPMENT

4. Growth in the Indonesian economy increased over the last three years, reaching 5.1 percent in 2004. The underlying components of growth also showed a more sustainable trend, marked by the increasing role of private investment and exports. Investments rebounded to 15.7 percent after three years of sluggish growth, exports increased by 8.5 percent while consumption growth remained robust at 4.6 percent.

5. Inflation rose to 6.4 percent but was still within the authorities' target range while the exchange rate has remained stable in 2004. Indonesia's current account balance remained in surplus, albeit lower than last year, due primarily to substantial increases in imports of capital goods and raw materials on the back of a pick-up in domestic production. Exports reached a historic high of $72.2 billion last year, boosted by strong sales of palm oil, electronics, clothing, coal, and tin but high world oil prices only had a slight impact on the trade balance since Indonesia also imports oil for domestic consumption. Foreign exchange reserves were $ 36.3 billion at end-2004, equivalent to a safe level of 4.8 months of imports or 195 percent of short-term external debt. The forex reserves declined to about $33.9 billion

by end-June 2005, attributable mainly to debt service payments and the authorities' intervention to smoothen exchange rate volatility.

6. The fiscal position improved amidst increasing world oil prices which caused fuel subsidies to increase since the government had not adjusted domestic fuel prices in 2004. The banking sector performed favorably with loans increasing in line with the rebound in business activity. More importantly, bank financing to the micro, small and medium enterprises (MSME) increased. Overall, the loan to deposit ratio (LDR) rose to 50.0 percent at end-2004 and 51.3 percent in April 2005 but it is still well below the level before the Asian crisis.

7. The prospects for the Indonesian economy are promising, driven by buoyant investment and exports. The economy is projected to grow at 6 percent in 2005, which is a conservative projection, given that the y-o-y GDP growth in the first quarter of 2005 was already 6.4 percent. Growth is projected to increase by 6-6.5 percent in 2006 and 6 to 7 percent over the medium term. The growth performance in the first quarter of 2005 indicated that investment, including FDI, and export growth were relatively high in 2005, underpinned by improving business sentiments. The Jakarta Stock Exchange also reached a new high with the index reaching 1080 at the end of the first quarter this year and stabilized towards end June.

MONETARY AND EXCHANGE RATE POLICY

8. For 2005, upward pressure on inflation stemmed from the increase in domestic fuel prices and the depreciation of the rupiah. In the first quarter of 2005, inflation rose to 8.81 percent (y-o-y) compared with 5.11 percent over the same period last year and declined in the following months. The rupiah depreciated by 5.3 percent in the first semester 2005 as demand for foreign exchange increased to service debt payments and imports, particularly the imports of oil by PERTAMINA for domestic consumption. Bank Indonesia (BI) shifted the monetary policy stance from an accommodative to a tightening bias beginning Q3, 2004. Further monetary tightening ensued with several increases in the SBI rates from 7.43 percent in February to 8.25 percent as at end June to contain the second-round effects of the increase in domestic gasoline prices. Under the new monetary policy framework, the interest rate (the BI rate) has been set by BI at 8.5 percent early this month for third quarter-2005.

9. To support the effectiveness of monetary policy operations, a new monetary instrument, Fine Tuning Operations (FTO), was introduced by BI in April 2005. Under the FTO arrangement, BI can take the initiative to absorb liquidity with maturity up to 14 days. BI also tightened prudential regulations to reduce volatility in the foreign exchange market by temporarily adjusting the existing bank regulation on the Net Open Position from 30 percent to 20 percent, effective April 26, 2005. Foreign exchange intervention was also carried out cautiously by the central bank and was limited only to smoothing short-term exchange rate volatility. The government is considering changing the mechanism of transferring the oil subsidy to PERTAMINA from rupiah into foreign exchange in order to reduce the demand for foreign exchange in the market.

10. In consequence, inflation declined in the following months since March and stabilized in June. The volatility of the rupiah exchange rate was subsequently reduced. Inflation is estimated to reach 7.5 percent for 2005 and return to a declining path in 2006. BI is monitoring monetary developments very closely and stands ready to further tighten monetary policy to ensure that inflation is contained.

11. Bank Indonesia has further strengthened the monetary policy framework by formally shifting to interest rate targeting, as part of the steps to full inflation targeting (IT), effective July of this year. IT has implications on the conduct of monetary policy, including the use of the interest rate--called the BI-rate-- as the operational target, a forward looking decision making process, a more transparent communications strategy, and strengthened policy coordination with the government. It is expected that the new framework will enhance the credibility of monetary policy and facilitate the achievement of the 3 percent inflation target over the medium term.

12. As the staff report underscores, the flexible exchange rate system has served the economy well. The authorities are committed to maintaining the system since it will help to protect the economy against shocks.

FISCAL POLICY

13. The Indonesian authorities are fully committed to strengthening fiscal consolidation and debt reduction while recognizing the need for public investment in key infrastructure and social projects over the medium term. The overall budget deficit has declined from 3.2 percent of GDP in 2001 to 1.4 percent of GDP in 2004, with the external debt to GDP ratio falling from 81 percent to 53 percent over the same period. In light of domestic and external developments, particularly high world oil prices, the revised 2005 Budget was approved by the Parliament in June. The authorities are committed to containing the overall deficit at 0.8 percent of GDP for 2005. The deficit will be financed by domestic sources, primarily through the issuance of government bonds, proceeds from privatization and asset recovery. The debt to GDP ratio is expected to decline further from 53 percent in 2004 to 48 percent in 2005 and fall below 35 percent by 2009.

14. The government is mindful of the need for measures to meet its deficit target of 0.8 percent in 2005. Tax administration reforms ---including intensification and strict enforcement of tax and customs compliance-- are already underway and are now being accelerated in order to increase tax revenues. The measures are expected to increase tax collections in 2005, including 0.2 percent of GDP from non oil & gas income tax and 0.1 percent each from property tax, and excise tax. As noted by staff, the authorities are finalizing a package of tax reforms aimed at improving non-oil tax revenues while providing incentives for private investment. On the expenditure side, the tsunami disaster and increasing world oil prices have resulted in public expenditure increasing substantially by Rp.67.5 trillion from the initial budget of 2005, of which Rp.57.5 trillion is for fuel subsidies. On a net basis, high world oil prices have only a slight positive impact on the budget since the fuel subsidies increase as well. Oil production is expected to increase in the near term since the final deal on a new oil field with estimated capacity of 170,000 barrels/day has been agreed by the government in June.

BANKING SECTOR POLICY

15. The Indonesian banking sector has been on a steady recovery path since the Asian crisis. Banks have gradually resumed their financial intermediary role with improving capital bases**.** Banks are well-capitalized with capital asset ratios (CARs) far above 8 percent while profitability has remained strong, reflecting strong loan growth and increased efficiency. Gross NPLs declined from 18.8 percent in 2000 to 5.6 percent by April 2005. Banks are also adequately capitalized, reflecting their improved capacity to mitigate market risk.

16. Bank Indonesia is making progress in efforts to strengthen supervisory oversight of the banking system. In 2004, BI launched the Indonesian Banking Architecture (API), a blue-print that maps the direction of the banking sector in the next 10 to 15 years. All banks are required to meet a set of minimum performance criteria by 2010, including minimum CAR of 10 percent and a capital base of at least Rp.100 billion. On June 30, BI unveiled plans to accelerate bank consolidation and set eligibility criteria for key banks (called the anchor banks) to acquire smaller banks. Under the new policies, an anchor bank must meet, at least in the preceding three years, the following conditions: CAR of above 12 percent; tier-one capital of a minimum 6 percent; loan-to- deposit ratio (LDR) of above 50 percent; minimum annual credit growth of 22 percent; nonperforming loans of below 5 percent; and return on assets (ROA)of a minimum 1.5 percent. The authorities emphasize that qualifying banks should ensure sound credit expansion.

17. Progress has also been achieved at the supervisory and regulatory level**,** paving the way for more risk-based supervision. At the regulatory level, additional prudential regulations have been introduced. These include:

- incorporation of market risk in the calculation of CAR for banks with larger trading portfolios;
- new asset quality valuation rules that contain more stringent classification and provision requirements for earning and non-earning assets; and
- Higher statutory reserve requirements for banks with larger deposit bases.

Further reforms include the introduction of a financial safety net scheme while a gradual phasing out of the blanket guarantee scheme will be fully implemented by March 2007. The credit bureau commenced operations in April 2005, requiring all commercial banks and credit card operators to update information on all borrowers on a regular basis.

18. Steady progress has also been made in the implementation of the anti-money laundering regime since Indonesia's removal from the list of Non-Cooperative Countries and Territories (NCCTs) by the Financial Action Task Force (FATF) in February 2005. With the President signing the bill on the Mutual Legal Assistance Law, the legal framework for anti-money laundering will be improved. The bill has been submitted to the Parliament for approval.

STRUCTURAL REFORMS

19. The authorities recognize the importance of intensifying structural reforms in order to encourage private investment and sustain growth. Structural reforms are ongoing in a wide range of areas as elaborated in paragraph 24 of the staff report. Particular attention has been given to eradicating corruption, enhancing labor market flexibility and improving infrastructure through public-private partnerships (PPPs). Efficiency, transparency, and accountability in public expenditure management are also being improved with the support of the World Bank Program Loan.

20. One of the first measures adopted by the new Government has been the requirement that all cabinet ministers sign a contract committing themselves to maintaining high standards of integrity. All ministers also have to submit their personal asset declarations with the KPK (Commission for the Eradication of Corruption) for verification. New procedures have already been put in place to suspend government officials if they are under investigation for alleged corruption. Steady progress has been made in recent months by the Supreme Audit Agency, the KPK (which became operational in 2004), and the Attorney General in addressing governance problems through strict enforcement procedures in various institutions. The corruption charges brought against top officials of government agencies and a state related enterprise have sent an important signal to the public about the strong commitment of the new government to the eradication of corruption.

21. The selected issues paper (Chapter VII) has provided insights into Indonesia's labor market rigidities. The authorities recognize and fully agree with staff that labor market inflexibility is one of the main causes of rising unemployment in recent years. A number of measures are being undertaken in support of the government's medium-term program to halve the unemployment rate by 2009. In this context, the establishment of tripartite councils, which bring together employers, labor unions and the government, acknowledges the importance of labor productivity when considering minimum wage increases. The new government is also strongly committed to reprioritizing public spending by redirecting poorly targeted subsidies to health and education. This is essential for improving education levels and labor force skills. In addition, the government has finalized the bill on the Social Security system which would provide the basis for scaling back statutory severance payments.

22. In an effort to support PPPs, the government has launched the Infrastructure Road Map 2004-2009 outlining the regulatory framework of PPPs. Within the infrastructure development framework, four important government regulations (PPs) have been issued on electricity (PP 3/2005), toll road (PP 15/2005), water piping system (PP 16/2005), and most recently the regulation on land acquisitions for public use (PP 36/2005). The main components of the new regulations include clarifying and emphasizing the government's role only as a regulator; strengthening the legal framework for market determined price setting based on cost recovery; establishment of governing bodies; and clear and transparent procedures for land acquisition for public use. The authorities have indeed taken into account the Fund's advice during the last Board meeting, particularly on ensuring that the PPPs strategy does not create unfunded liabilities.

23. The government has offered 20 projects through an open tender system during April-June, including 8 toll roads, 1 power generator, 1 railway, and 3 airports, among others. Eighteen consortiums were shortlisted in the first prequalification selection. It is expected that some projects will materialize this year and will facilitate employment creation.

24. Structural reforms are also underway to address the complex issues of efficiency, transparency, and accountability in public financial management (PFM). Significant accomplishments have been achieved over the last two years through reforms supported by the World Bank loan and technical assistance provided by the Fund. Political consensus has been gained on a new legal framework leading to updated laws on State Finances, State Treasury, State Planning and State Audit in 2003-2004. These laws now provide an adequate architecture to modernize public resource management and oversight. The roles and responsibilities of BAPPENAS (The National Planning Agency) and the Ministry of Finance have also been clarified.

25. A new budget preparation process has been introduced, beginning 2005, to enhance budget transparency and good governance. Planning and budgeting have been integrated by linking ministerial work plans with budgets. The government presented to Parliament a more transparent 2005 fiscal budget with identifiable sectoral allocations. Furthermore, budget execution is being rapidly modernized and efforts are being devoted to streamlining the disbursement process. A new law on procurement is also being drafted while accounting and reporting systems for public resource management are being improved and implemented in phases. The government has presented to Parliament, for the first time, a consolidated Government Balance Sheet for 2004, marking a significant achievement in accountability.

Other Issues

26. The Government's strong commitment to improving governance is also being adopted in the program of rehabilitation and reconstruction of Aceh and Nias. A Master Plan for Rehabilitation and Reconstruction of Aceh and Nias was issued setting out the main principles to address the social, economic, institutional and financial needs of both regions while a special government unit, the Rehabilitation and Reconstruction Agency (BRR), was set-up to implement the rehabilitation process. In response to the government's commitment to good governance, several donor partners have, together with the government and civil society, established a Multi-Donor Trust Fund (MDTF). All activities of MDTF will be consistent with and guided by the government's master plan under the BRR's oversight. The authorities are thankful to donors for their financial support in the reconstruction and rehabilitation of Aceh and Nias.

27. The authorities' efforts to strengthen multilateral and regional trade arrangements are underway. Indonesia has also made a commitment, together with the ASEAN + 3 countries, to reduce import tariffs in stages as part of its commitment to pursue an open trade policy.

28. As noted by the staff, Indonesia's economic data are considered adequate for surveillance purposes. Nonetheless, the authorities have taken steps to further improve data quality and to follow up on recent ROSC recommendations.

29. The Indonesian authorities remain committed to transparency and consent to the publication of all staff reports.