

**Indonesia: 2007 Article IV Consultation—Staff Report; Staff Statement; 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 2007 Article IV consultation with Indonesia, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 15, 2007, 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 26, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement of July 18, 2007 updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 18, 2007 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for Indonesia.

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.

**To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to [publicationpolicy@imf.org](mailto:publicationpolicy@imf.org).**

Copies of this report are available to the public from

International Monetary Fund • Publication Services  
700 19<sup>th</sup> Street, N.W. • Washington, D.C. 20431  
Telephone: (202) 623-7430 • Telefax: (202) 623-7201  
E-mail: [publications@imf.org](mailto:publications@imf.org) • Internet: <http://www.imf.org>

Price: \$18.00 a copy

**International Monetary Fund  
Washington, D.C.**



INTERNATIONAL MONETARY FUND

INDONESIA

**Staff Report for the 2007 Article IV Consultation**

Prepared by the Staff Representatives for the 2007 Consultation with Indonesia

Approved by Daniel Citrin and Carlo Cottarelli

June 26, 2007

- **This report is based on discussions held in Jakarta during May 3–15, 2007.** The staff team comprised Messrs. Zavadjil (head), Reichold, Crowe (all APD), Mati (FAD), Seelig (MCM), and Mesdames Thacker (APD) and Jain-Chandra (PDR). Messrs. Schwartz, Senior Resident Representative, and Morales, Deputy Resident Representative, participated in the mission. Messrs. Warjiyo and Agung from the Executive Director’s Office also attended meetings.
- **Counterparts:** Discussions were held with Coordinating Minister for Economic Affairs Boediono, Coordinating Minister for Social Affairs Aburizal Bakrie, Minister of Finance Sri Mulyani Indrawati, Bank Indonesia Governor Burhanuddin Abdullah, Minister of Trade Mari Pangestu, the newly appointed Minister of State-owned Enterprises Sofyan Djalil, Minister of Planning Paskah Suzetta, and other senior officials, as well as representatives of Parliament, the private sector, academia, and labor unions.
- **Context of past surveillance:** Close relations between the authorities and the Fund have been maintained following the expiration of the extended Fund arrangement on December 31, 2003. The staff has been supportive of the authorities’ policy priorities and policy implementation has been broadly consistent with recent Fund policy recommendations (Table 1).
- **Indonesia’s exchange rate regime is a managed float.** Indonesia has accepted the obligations under Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.
- **Statistics** are broadly adequate for surveillance purposes, although they could be improved in some areas (Annex II). Indonesia subscribes to the Special Data Dissemination Standard. The statistics ROSC was completed in early 2005. The fiscal ROSC was completed in September 2006 and the government is implementing the recommendations of this report.

Contents		Page
Executive Summary .....		3
I. Introduction.....		4
II. Economic and Financial Backdrop.....		4
III. Medium-Term Outlook and Risks .....		8
IV. Discussions of Key Policy Challenges .....		15
A. Dealing with Capital Inflows.....		15
B. How Much Room is There to Loosen Monetary Policy?.....		19
C. Deepening Financial Intermediation While Safeguarding Stability .....		21
D. Fiscal Policy to Support Sustainable Growth .....		25
E. Structural Reforms to Improve the Investment Climate .....		27
V. Staff Appraisal .....		29
Boxes		
1. 1997 Vs. 2007: How Far Has Crisis Vulnerability Been Reduced?.....		9
2. Update of Contingent Claims Analysis for Indonesia .....		10
3. Stress Test Analysis—The Impact of Adverse Macro Shocks on Banks .....		14
4. Assessment of Indonesia’s External Competitiveness.....		17
5. Further Improving the Effectiveness of the Inflation-Targeting Framework .....		22
Figures		
1. Recent Macroeconomic Performance and Outlook.....		5
2. Financial Market Performance.....		7
3. Banking Sector Indicators.....		11
4. Capital Flows and Exchange Rate Developments .....		16
5. Inflation and Interest Rates .....		20
6. Financial Intermediation .....		23
Tables		
1. The Authorities Response to Recent Fund Policy Advice.....		32
2. Selected Social Indicators, 2001–06 .....		33
3. Selected Economic Indicators, 2002–08.....		34
4. Balance of Payments, 2004–08.....		35
5. Monetary Survey, 2004–07.....		36
6. Summary of Central Government Operations, 2005–08 .....		37
7. Selected Vulnerability Indicators, 2003–07.....		38
8. Medium-Term Macroeconomic Framework, 2005–12.....		39
9. Progress on the Government’s Structural Policy Agenda.....		40
Appendices		
I. Medium-Term Outlook Under Alternative Assumptions and Public And External Debt Sustainability .....		41

## Executive Summary

### Background

- Macroeconomic policies have been geared successfully towards promoting stability while supporting growth.
- The economy has been growing at about 6 percent over the past year, fuelled by a recovery in domestic demand and strong export performance. Bank and corporate balance sheets have strengthened while the public debt-to-GDP ratio continues to trend down. The current account remains in surplus and international reserves have risen.
- Growth is expected to continue at the same pace for the rest of the year and pick up modestly over the medium term, driven mainly by domestic demand. This assumes a significant increase in investment, especially in infrastructure.
- Inflation reached a six-month low in May allowing Bank Indonesia (BI) to continue its easing stance. The policy rate has been reduced by 425 basis points since the easing cycle began in May last year.
- Indonesia's strengthening fundamentals and yield differentials have recently attracted significant, though volatile, portfolio inflows, resulting in appreciation pressures on the rupiah.

### Policy Discussions

- On policies to address the portfolio inflows, staff and authorities agreed that allowing the rupiah to appreciate while intervening to avoid disruptive changes in the exchange rate would be the best way to deal with the capital influx. Moreover, appreciation would help to dampen inflation further and allow BI to cut interest rates, in turn helping to moderate capital inflows and ease concerns about a sudden reversal.
- Monetary policy discussions focused on the need to exercise caution in reducing interest rates to ensure that the inflation target for 2008 is met.
- Fiscal policy, targeting 1.7–1.8 percent of GDP deficits for 2007 and 2008, is appropriately geared to further reducing the public debt burden, while providing space for some additional spending on infrastructure, a major bottleneck to sustainable growth.
- Staff and authorities agreed on the need to strengthen the nonbank financial sector and long-term financing. Several prudential regulations have been eased in order to encourage banks to lend. BI believes strong risk management practices at banks will help to limit risks, but they plan to review the changes next year. Staff believe such measures send the wrong signals to banks and supervisors.
- Successful implementation of the new structural reform agenda, including reducing infrastructure bottlenecks, passage of the tax law currently in parliament and modification of labor regulations, would help attract investment, create jobs and raise productivity, thus accelerating growth, reducing poverty, and supporting stability.

## I. INTRODUCTION

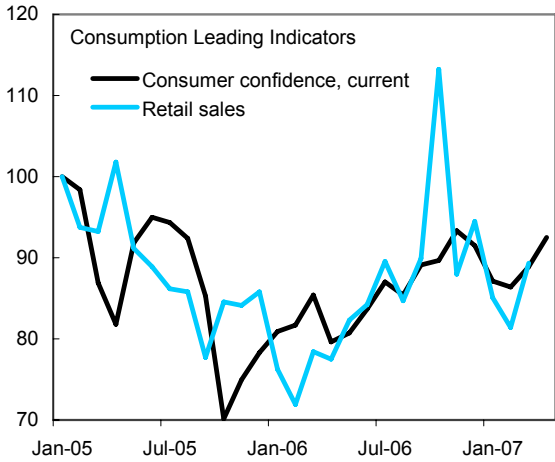
1. **Indonesia's economic performance has been strong since the last Article IV consultation.** Supported by sound policies and a favorable external environment, output has grown by about 6 percent, inflation has stabilized, and international reserves have risen to an all time high. The government, banking, and corporate sectors continued to reduce balance sheet vulnerabilities. Indonesia's financial markets have rallied in line with global trends and perceptions that risks have been reduced. Rising reserves enabled Indonesia to complete the early repayment of its remaining obligations to the Fund in October last year, thus ending post-program monitoring.
2. **Despite these successes, the benefits of growth have yet to be felt across society.** While the official unemployment rate dipped below 10 percent in 2007, formal sector employment opportunities remain limited. Meanwhile, higher prices for some household staples pushed the poverty rate back up to 18 percent in 2006, reversing the improvements of the previous three years (Table 2).
3. **The authorities' focus is therefore on accelerating economic growth to improve social conditions.** Key elements of their medium-term strategy include policies to strengthen financial intermediation, improve the business climate, and increase infrastructure investment. While substantial progress has been achieved, some measures are encountering bureaucratic and political resistance, driven in part by vested interests and ambivalence toward foreign investment. As the 2009 elections approach, the authorities will also need to resist pressures to achieve quick results through interventionist policies.
4. **Volatile portfolio inflows pose additional challenges for the authorities.** These include minimizing the erosion of competitiveness in labor-intensive manufacturing resulting from real exchange rate appreciation, and avoiding new external vulnerabilities (e.g., to a sudden reversal of inflows). Meanwhile, a slowdown in domestic credit growth in 2006 has triggered pressure on the central bank and state-owned banks to ensure accelerated lending. The recent loosening of prudential regulations in response to such pressures could risk the reversal of some of the hard-won gains in financial sector stability.

## II. ECONOMIC AND FINANCIAL BACKDROP

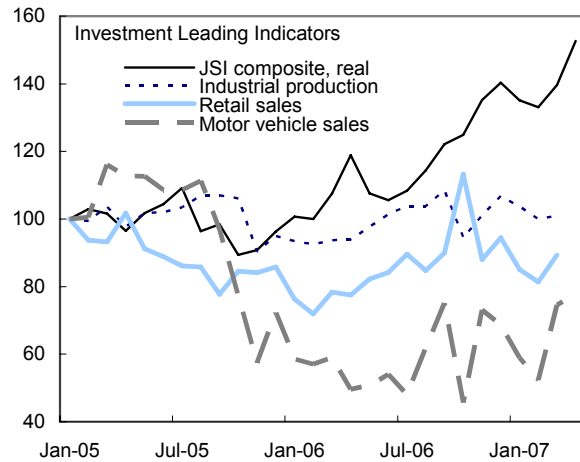
5. **Economic activity and fundamentals have strengthened and near-term prospects are favorable:**
  - *Growth* reached 5½ percent in 2006 as the dip in activity following the late 2005 fuel price and interest rate hikes proved shallow. Strong exports compensated for weak domestic demand. Although some leading consumption and investment indicators remain sluggish, they have improved over the past year. Staff projects growth at 6 percent in 2007—the pace maintained since Q3 2006—with some shift from external to domestic demand (Figure 1, Table 3).

Figure 1. Indonesia: Recent Macroeconomic Performance and Outlook

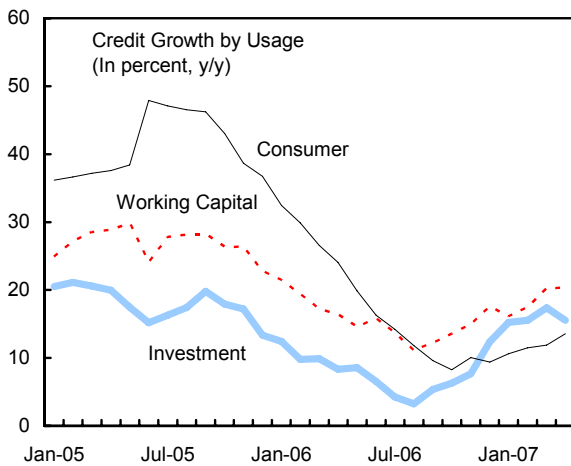
*Consumption leading indicators are recovering...*



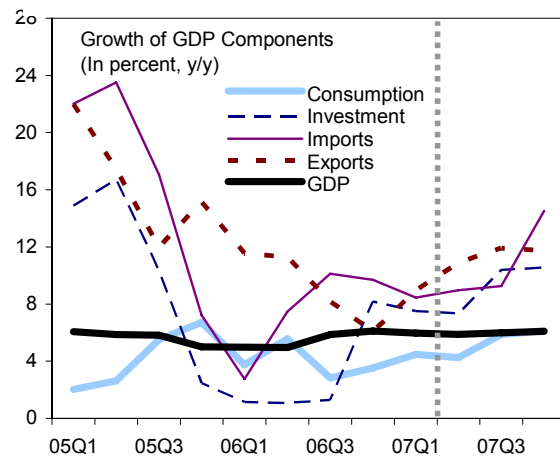
*...as are indicators for investment...*



*...while investment credit has also picked up.*

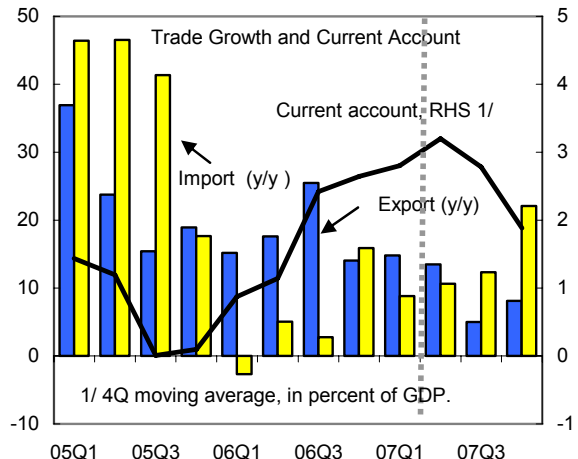
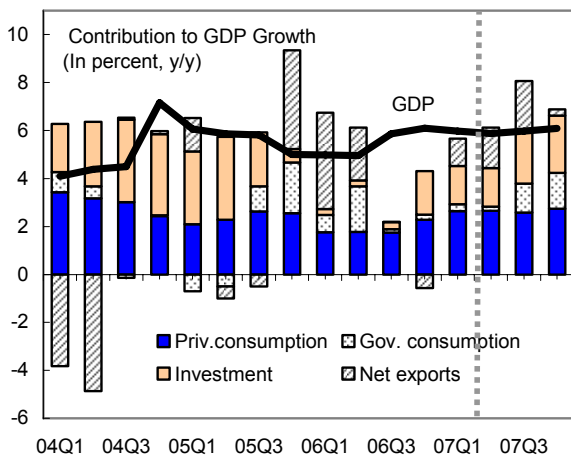


*GDP growth is expected to maintain momentum...*



*...although domestic demand will increasingly dominate*

*...reflecting lower export growth and surging imports.*



Sources: CEIC database; and Fund staff estimates.

- *The external current account surplus* is projected to decline from 2¾ percent of GDP in 2006 to 2 percent in 2007 (Table 4). This assumes a significant slowdown in non-oil and gas export value growth to 15 percent in 2007 (compared with 22 percent growth y/y in the first quarter) in line with the projected moderation in global growth and commodity prices. To the extent that the slowdown does not materialize, there are upside possibilities for GDP growth in 2007.
- *Bank credit expansion* supported the pick-up in GDP growth, as it recovered from its weakness during the first half of 2006. Credit growth reached 17½ percent y/y in April. Credit to businesses is now outpacing consumer credit, reversing the trend that prevailed in recent years (Table 5).
- *Inflation* has stabilized at around 6 percent. Bank Indonesia (BI) has lowered its policy rate 425 bps since May 2006 as the inflation rate moved toward its end-2007 target range of 5–7 percent, following the jump in late 2005.
- *Fiscal policy* has been geared toward reducing the debt burden, while attempting to accelerate development spending. The central government deficit increased modestly to 1.0 percent of GDP in 2006, as budget execution improved toward the end of the year (Table 6). However, the central government fiscal impulse was fully offset by the accumulation of regional government deposits, reflecting limited implementation capacity at the regional level.

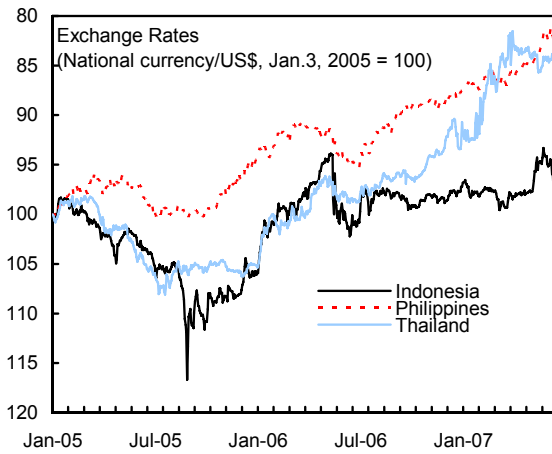
**6. Financial markets have rallied, supported by portfolio capital inflows:**

- *Equity and bond markets* have been buoyant since late 2005, interrupted only by global market sell-offs in May–June 2006 and, more modestly, in February–March 2007. In addition to increased global risk appetite, the rise in asset prices also reflected Indonesia-specific factors, such as lower domestic interest rates and perceptions of reduced vulnerability (Indonesian global bonds outperformed the EMBI index) (Figure 2).
- *Portfolio capital flows* mirrored these developments as foreign investors have been increasing their positions in Indonesian securities. Flows surged in April–May 2007 as investors expected the rupiah to appreciate against the U.S. dollar to catch up with other regional currencies.
- After considerable prior volatility, *the exchange rate* remained broadly stable during July 2006–April 2007, but appreciated by 3 percent in May vis-à-vis the U.S. dollar, in response to portfolio inflows, though some of this appreciation was reversed in early June.

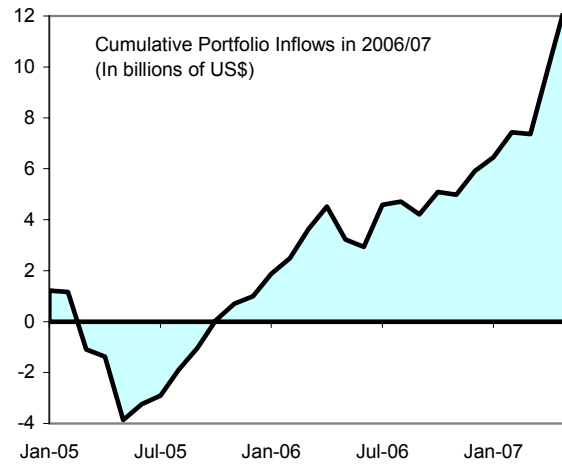


Figure 2. Indonesia: Financial Market Performance

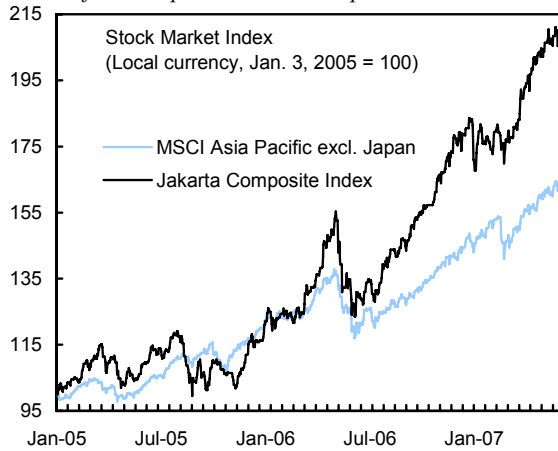
*The exchange rate has appreciated in recent months...*



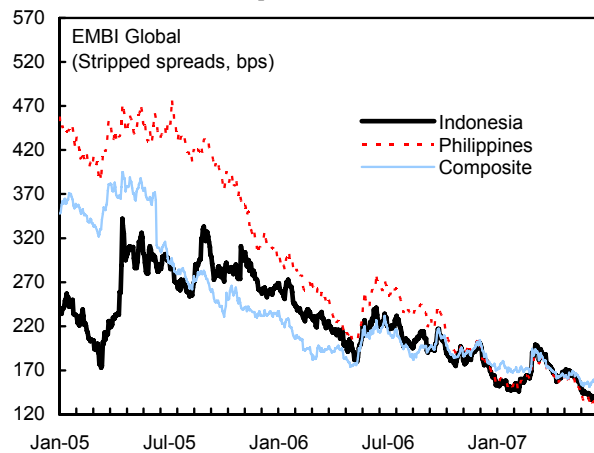
*...in response to a pick-up in portfolio capital inflows.*



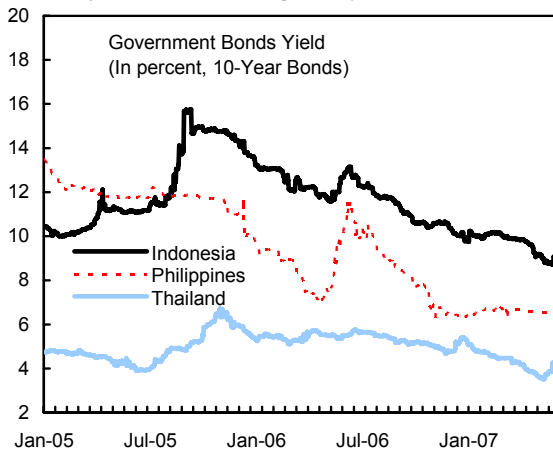
*Inflows helped to boost asset prices...*



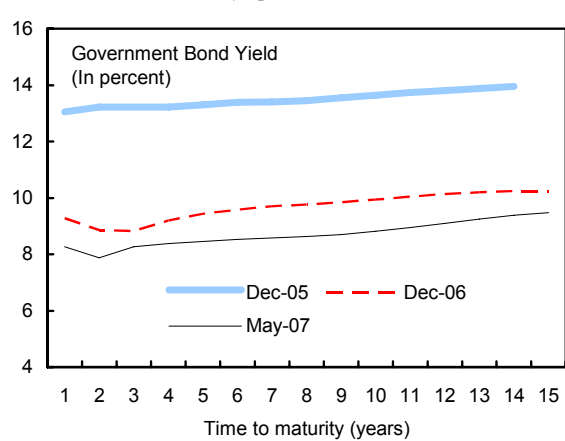
*...and drive down spreads...*



*...reflected in declining bond yields...*



*...across the maturity spectrum.*



Sources: CEIC database; Bloomberg; Country authorities; and Fund staff calculations..

7. **Vulnerability indicators improved further (Box 1):**

- *Banking sector indicators* strengthened recently in line with the performance of the economy. The profitability of banks started to improve with BI's rate cuts and widening net interest margins—lending rates are less elastic than deposit rates with respect to the policy rate. The system is well capitalized and private banks' nonperforming loans (NPLs) remain low (Table 7). State banks still have a high share of NPLs, although recent restructurings cut this significantly. Both contingent claim indicators and stress test analysis confirm the improving health of the banking sector under the macroeconomic baseline scenario discussed below (Box 2, Figure 3).
- *Foreign exchange reserves* have continued to accumulate, supported by the current account surplus and capital inflows. Despite the early repayment of all obligations to the Fund in 2006, standard indicators show adequate reserve levels (reserves covered 154 percent of short-term debt and 5 months of imports at end-2006).
- *Debt ratios* continue to decline, with external debt projected at 31 percent of GDP at end 2007, reflecting net repayments of loans by banks and corporations, despite a recent flurry of new external debt issuance.

### III. MEDIUM-TERM OUTLOOK AND RISKS

#### *Outlook and Risks*

8. **Indonesia's medium-term prospects remain favorable as recent economic progress is expected to continue (Table 8).**

- *Growth* is projected to pick up further, driven by domestic demand. Productivity gains and increased investment could raise potential output growth to about 6½–7 percent. However, this requires growth in investment of about 12 percent per annum, assuming that the current pace of overall productivity growth is broadly maintained. While this should be achievable, it assumes continued progress in improving the investment climate and infrastructure, as well as in attracting FDI and greater integration into the regional economy (selected issues paper). The authorities are somewhat more optimistic, with an official medium-term target of 7½ percent.
- *Financial intermediation* will need to deepen to support higher rates of investment. Private sector credit is expected to expand faster than nominal GDP, reflecting a continuation of the gradual trend of financial deepening and remonetization, supported by declining inflation and interest rates, and growing demand for financial services. In addition, capital markets should continue to gain in importance, continuing recent trends based on the authorities' efforts to promote nonbank financial development (see below).

### BOX 1. 1997 VS. 2007: HOW FAR HAS CRISIS VULNERABILITY BEEN REDUCED?

The tenth anniversary of the Asian financial crisis provides an occasion for assessing Indonesia's progress in reducing the crisis vulnerabilities that proved so devastating in 1997. These various sources of vulnerability, as well as some new potential concerns, are discussed in the accompanying selected issues paper. The paper's findings are summarized here:

- Macroeconomic policies are sound.** While fiscal policy remains conservative (as in 1997), lower credit growth and a more flexible exchange rate have reduced vulnerability. The real exchange rate has appreciated, but remains below its 1997 level, and does not generate major competitiveness concerns. Reserves have increased significantly and the external current account is in surplus. Above-average inflation, which increases macroeconomic volatility and could undermine competitiveness in the medium term, is still a concern.

	Current Account percent of GDP		M2 Growth Rate percent per year	
	1992-96	2002-06	1992-96	2002-06
Indonesia	-2.2	2.2	23.8	11.1
Korea	-1.6	1.9	16.3	4.5
Malaysia	-6.0	12.9	17.0	9.8
Philippines	-3.8	1.3	20.6	9.5
Thailand	-6.3	1.2	15.9	5.5

Source: World Economic Outlook

- Financial and corporate sector weaknesses have lessened.** The recapitalization of the banking sector and related regulatory and supervisory changes have substantially reduced the balance sheet and corporate governance problems that proved so damaging in 1997 (in particular excessive foreign borrowing and lending by banks to related corporate parties). Foreign borrowing (as a proportion of foreign exchange reserves and in U.S. dollar terms) has declined significantly since 1997, as has the share of domestic lending in foreign exchange. The level of nonperforming loans has declined, and is in line with other countries. The reorganization of the banking sector removed banks from their related corporate groups. Nevertheless, governance practices in non-listed companies and a sudden increase in their foreign borrowing could be a concern.

	Non-bank private sector cross-border borrowing (from BIS-reporting banks, percent of reserves)				
	Indonesia	Korea	Malaysia	Philippines	Thailand
1997 Q2	194.0	92.9	61.6	67.5	131.1
2006 Q3	56.0	20.0	24.9	42.5	18.6

Source: BIS Quarterly Review, International Financial Statistics

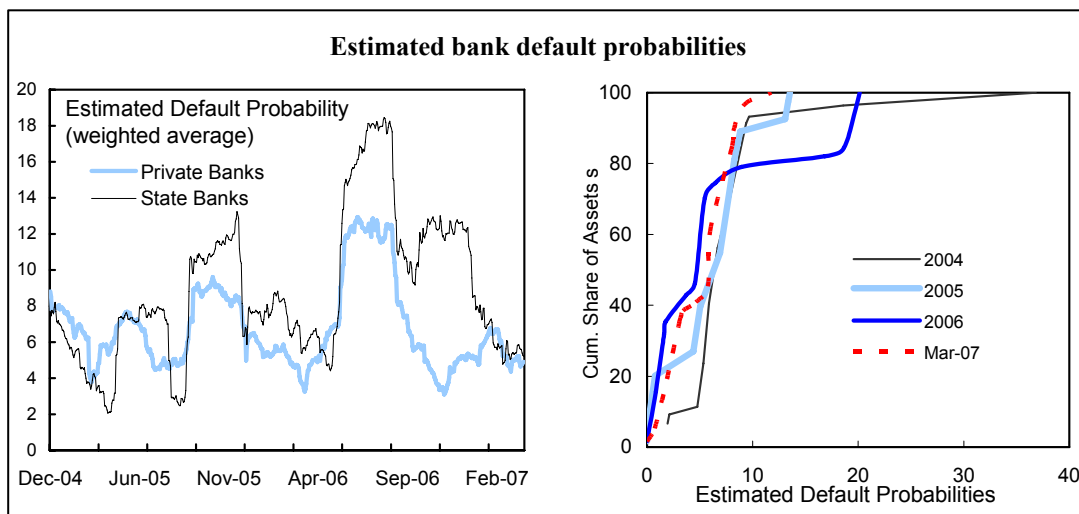
- However, a remaining source of vulnerability in the financial sector is the high share of state banks** (with generally inferior credit quality and more liable to pressure to lend for political reasons).
- Contagion remains a concern**, given the increased capital market integration. While Indonesia's exposure to intra-regional contagion via trade flows or competitive devaluation remains relatively limited, indicators of stock market comovement have increased.
- Major institutional reforms**, particularly in the areas of governance and financial supervision, help to minimize worries over the kinds of corporate-political links that helped to destabilize the financial system in 1997. However, Indonesia continues to lag in terms of perceptions according to many surveys (e.g., of corruption, despite some improvement).

**Some of the new sources of vulnerability in Asia that have been touted appear, for Indonesia, to be of less concern so far.** Indonesia is less dependent on external growth than many other Asian countries and its reserves build-up has been more limited. The surge in stock prices can be justified with reference to fundamentals and a reduction in the previously very large risk premium compared with regional markets.

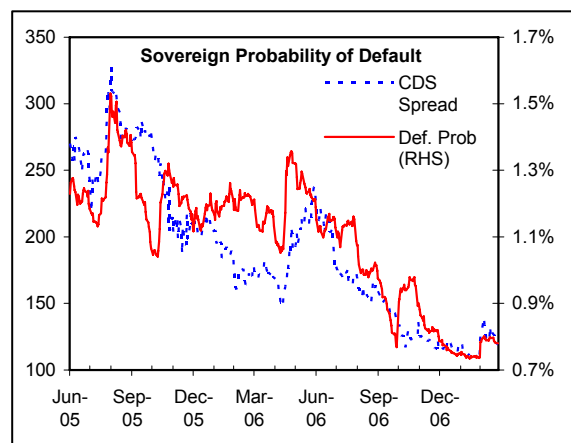
## BOX 2. UPDATE OF CONTINGENT CLAIMS (CCA) ANALYSIS FOR INDONESIA<sup>1</sup>

**Markets continue to price in a historically low probability of default for banks and the sovereign.<sup>2</sup>**

- Estimated average default probabilities of banks declined in 2007.** The global equity market sell-off in May 2006 raised default probabilities for all banks, but this effect disappeared toward the end of 2006, in particular for private banks. State banks' estimated default probability remained elevated through the remainder of 2006. This was the result of a surge in volatility of the shares of one state-owned bank, related to market perceptions of possible management and nonperforming loan problems. Other state banks showed a decline in default probabilities similar to that of private banks.



- The distribution of risks in the banking system also improved in 2007.** Risks are more evenly distributed across banks, as estimated default probabilities for riskier banks have declined more than for the banking system on average. However, the low perception of bank credit risk by the market may be driven not only by expected improvements in bank performance, but also by expectations that the authorities would bail out state banks.
- The CCA analysis for the sovereign confirms the improving outlook for sovereign credit risk.** Default probability of the sovereign increased somewhat in late February 2007, along with CDS spreads, but remained at a historically low level.

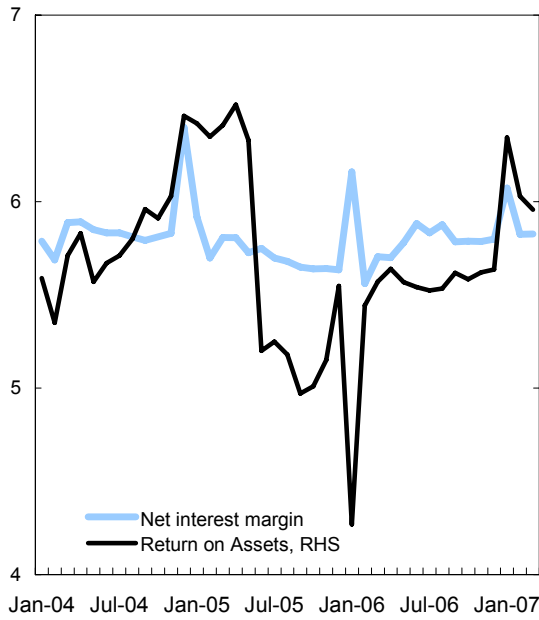


<sup>1</sup> This box updates the work done during the 2006 Article IV consultation (see IMF country report No. 06/318).

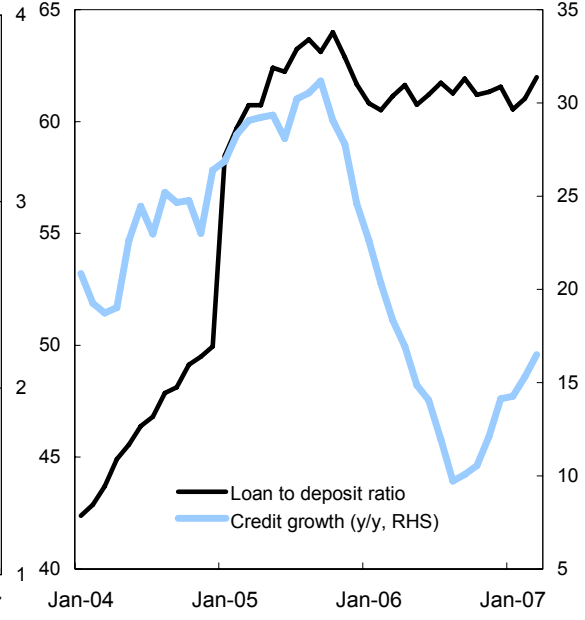
<sup>2</sup> The CCA uses option pricing formulae to infer default probabilities based on observed market prices.

Figure 3. Indonesia: Banking Sector Indicators

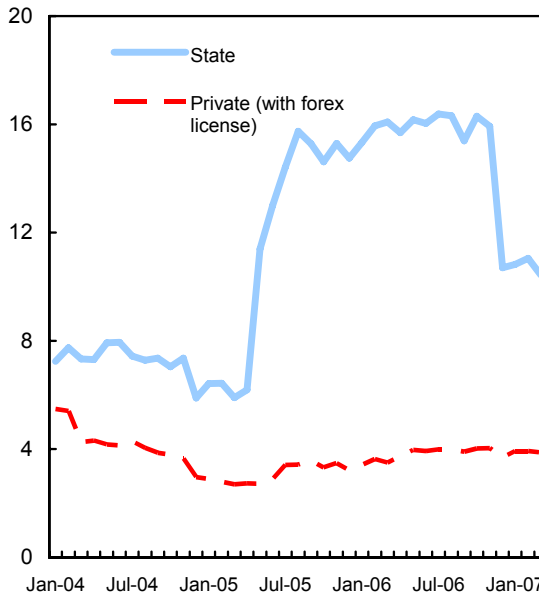
*Profitability has recently picked up...*



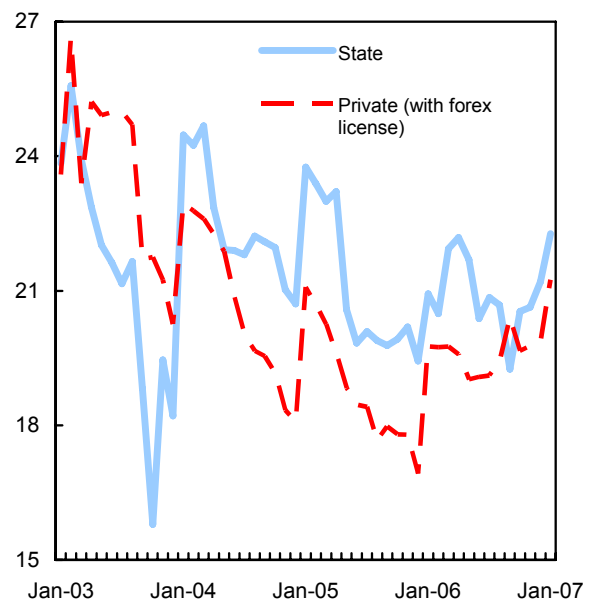
*...along with credit growth...*



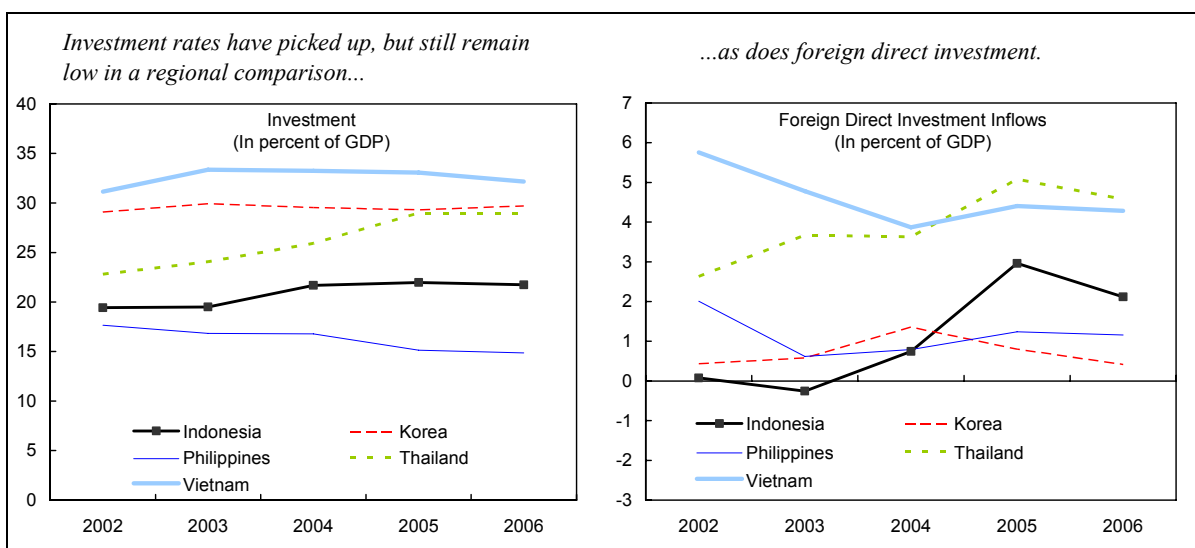
*...while state banks' NPLs are declining...*



*...and Capital/Asset ratios remain healthy.*



Sources: Indonesian authorities; CEIC database; and Fund staff calculations.



- *The current account* is expected to gradually shift to deficit as strengthening domestic demand boosts imports.
- *Inflation* is projected to decline to 3 percent in the medium term in line with BI's target. This requires that BI remains committed to achieving its targets, notwithstanding pressures to ease interest rates to support the government's near-term growth targets.
- *Public debt* could fall to about 26 percent of GDP in 2012, if overall deficits remain modest (gradually declining to 0.6 percent by 2012), consistent with current policies.

Indonesia: Medium-Term Macroeconomic Framework, 2005–12						
	2005	2006	2007	2008	2009	2012
	(percentage change)					
Real GDP growth	5.7	5.5	6.0	6.3	6.5	6.7
Domestic demand	5.3	3.3	5.2	7.5	7.7	9.4
Net exports 1/	1.1	1.4	1.3	-0.3	-0.4	-2.1
CPI inflation (end period)	17.1	6.6	6.3	5.5	4.0	3.0
	(in percent of GDP)					
Saving and investment						
Gross investment	23.5	22.6	22.5	24.3	25.9	31.8
Gross national saving	23.6	25.3	24.4	25.8	26.9	30.4
Current account balance	0.1	2.7	1.9	1.5	1.0	-1.4
Central government balance	-0.3	-1.0	-1.8	-1.8	-1.5	-0.6
Central government debt	45.6	38.6	35.7	33.9	31.9	26.1

1/ Contribution to GDP growth (percentage points).

9. **Risks to this positive medium-term baseline include external shocks as well as possible domestic policy slippages.<sup>1</sup>**

- *External shocks*, such as a capital account shock or a global growth slowdown, would lead to a temporary slowdown in activity. However, as vulnerabilities have declined, the economy should be able to withstand moderate shocks (see Appendix I).
  - *Factors limiting the potential impact* of external factors are the diversity of exports (both regionally and with respect to products), limited external debt exposure, and adequate reserve levels.
  - *Resilience of the banking system*. Stress tests show that the banking system is sufficiently strong to weather a moderate adverse external shock, thus limiting possible adverse macro-financial sector feedbacks (Box 3). A financial sector safety net is now largely in place (selected issues paper).
  - *A measured policy response* would be important to contain the impact of external shocks. This includes allowing the exchange rate to depreciate while using reserves to cushion capital outflows and avoid extreme exchange rate movements, as well as raising interest rates as needed to limit the impact on inflation.
- *Domestic policy slippages* could lead to a more persistent slowdown in growth. As in the past, slippages in monetary policy or doubts about debt sustainability could lead to capital outflows. Lack of progress in structural reforms or investment in infrastructure could soon lead to bottlenecks which would limit investment and potential growth. The risk of growing nationalist sentiment—especially vis-à-vis foreign investment in natural resources—could impede investment growth. In addition, pressures to boost bank lending could lead to a deterioration of supervisory standards and increased financial sector vulnerabilities. If this led to difficulties in the banking system, medium-term growth would be adversely affected.
- *On the upside*, growth could be higher than under the baseline projections if the pace of structural reforms can be accelerated. In particular, a breakthrough to a more flexible labor regime could unlock a higher growth potential in labor-intensive sectors such as textiles and footwear.

---

<sup>1</sup> Annex I describes in more detail the medium-term impact of three possible adverse shock scenarios: (1) a loss in global risk appetite triggering emerging market capital outflows; (2) domestic policy slippages; and (3) a slowdown in global growth.

### BOX 3: STRESS TEST ANALYSIS—THE IMPACT OF ADVERSE MACRO SHOCKS ON BANKS<sup>1</sup>

**Sufficient capital and the relatively low level of outstanding credit should enable Indonesian banks to withstand moderate macroeconomic shocks:**

- **At end-2006 the Indonesian banking system was well capitalized** as measured by the capital adequacy ratio (CAR) and by the ratio of Tier 1 capital to total assets (leverage ratio). The Tier 1 ratio is a better metric to compare bank soundness in Indonesia, as reported CARs are high due to large holdings of zero risk weighted assets, notably government bonds.
- **Stress tests were performed on the 15 largest banks** (accounting for 68 percent of banking sector assets) using BI's internal risk model. The impact was assessed based on the Tier 1 ratio: a bank with a ratio of 4 percent is considered seriously under capitalized, while a ratio of 6 percent is low but acceptable.
- **The macro shock in this scenario is a loss of confidence triggering capital outflows.** It also involves exchange rate depreciation, lower growth, and higher inflation and interest rates (see Scenario A, Annex I).
- **The largest Indonesian banks should be able to resist this adverse shock without major problems.** However, some of the smaller banks of the group (accounting for 6 percent of assets) would exhibit a material decline in their CAR and Tier 1 ratios. Liquidity should not be a problem, as most banks have ample liquid assets: only four banks in the group (18 percent of banking system assets) have less than 25 percent liquid assets.
- **Negative feedbacks from the banking sector to the macroeconomy should thus be limited.** The largest banks with sufficient capital would be able to continue to provide credit to the economy, although credit growth should slow down as the deteriorating macro environment raises risks of new lending. Some smaller banks with materially declining capital ratios, on the other hand, would see much sharper declines in new lending.
- **Additional stress tests show the banking system's vulnerability to different risks factors.** Exposure to *credit risk* is limited by the low share of loans to total assets. However, exposure and risk could increase substantially if efforts to boost lending significantly were successful. Generally low maturity mismatches and the high share of government bonds at floating rates limits *interest rate risk*. Finally, small net open positions limit the exposure to *exchange rate risk*.

Stress Tests and Scenario Analysis For the 15 Largest Indonesian banks (In percent unless otherwise noted)				
	Number of Banks with Tier 1 capital ratio below		Average Tier 1 Ratio	Average CAR ratio
	4 percent	6 percent		
Initial Values (December 2006)	0	3	8.2	19.4
Alternative Macro scenario (end 2008) <sup>4/</sup>	2	5	7.6	18.3
Stress Tests for Vulnerabilities to:				
Credit Risk 1/	2	5	7.4	17.9
Interest Rate Risk 2/	1	4	7.6	18.4
Exchange Rate Risk 3/	0	3	8.4	19.8

1/ 33 percent of loans in each classification were downgraded.  
2/ 350 basis point increase in interest rates.  
3/ 40 percent depreciation of the bilateral exchange rate with the U.S. dollar.  
4/ The alternative scenario assumes a tightening of global liquidity conditions triggering capital outflows, exchange rate depreciation, and higher inflation. The policy response includes higher domestic interest rates and FX intervention (see Scenario A in Annex I)

<sup>1</sup> Contributors: Kalin Tintchev and William Lee.



#### IV. DISCUSSIONS OF KEY POLICY CHALLENGES

10. **Against the background of strong macroeconomic performance and favorable medium-term prospects, the discussions focused on the two main issues currently confronting the authorities:**

- How to preserve macroeconomic and financial stability in an environment of capital account volatility, especially in light of the surge in inflows in April/May 2007. The authorities were concerned about the immediate effects of such inflows, as well as the potential adverse effects of abrupt changes in investor sentiment and capital account reversals.
- How to deploy macroeconomic, financial, and structural policies to achieve even more rapid and sustainable growth without undermining hard-won gains toward macroeconomic and financial stability. This would enable faster progress toward reducing unemployment and poverty, and alleviate political pressures to relax policies to attain tangible economic results.

##### A. Dealing with Capital Inflows

###### *Background and Staff Analysis*

11. **Appreciation pressures on the rupiah intensified during May** (Figure 4).

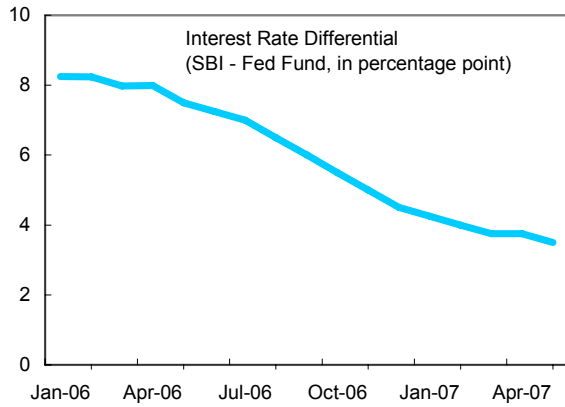
- *Portfolio capital inflows* increased significantly around mid-April, reflecting both the still significant interest rate differential, market expectations of rupiah appreciation, and positive investor views on Indonesia's vulnerabilities and fundamentals.
- However, *foreign exchange reserve accumulation* moderated the extent of appreciation, as BI continued to take advantage of the strong external position. Both net external debt disbursements and some oil revenues are automatically purchased by BI and account for most of the reserve accumulation in 2006-07. In addition, BI has intervened directly in the market—mostly at times of increased capital flows. While net purchases have dominated in 2006-07 (in contrast to 2005), there were also extended periods without direct intervention and BI sold reserves in mid-2006 in response to portfolio outflows.

12. **In assessing the appropriate policy response to appreciation pressures, staff discussed several issues with the authorities:**

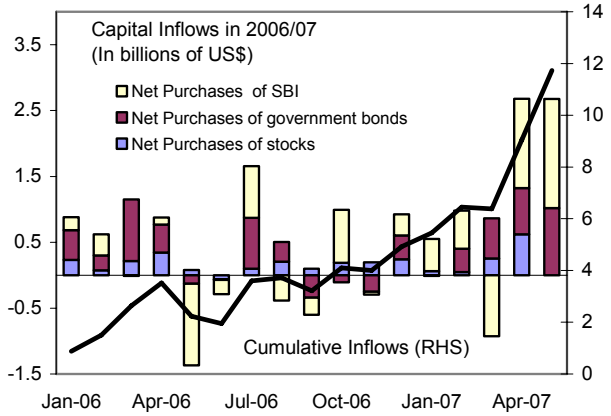
- *Valuation of the rupiah*: Some estimates of the equilibrium real effective exchange rate point to a modest undervaluation, as the recent boom in commodity prices has appreciated the equilibrium rate. However, the evidence (using three different methodologies), as well as other indicators, is far from conclusive (Box 4).

Figure 4. Indonesia: Capital Flows and Exchange Rate Developments

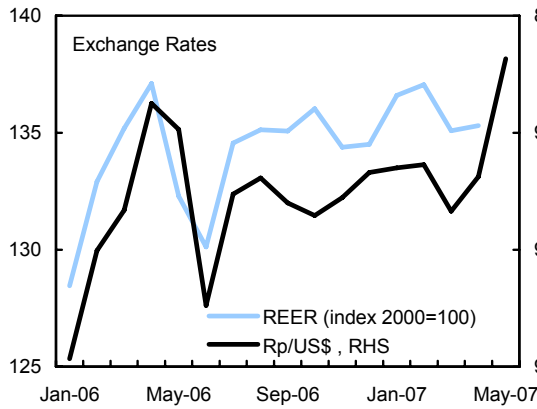
*Still favorable interest rate differentials and high global risk appetite...*



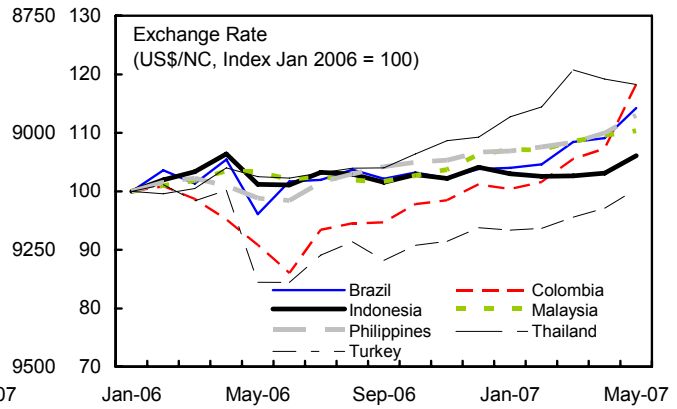
*...led to significant portfolio inflows...*



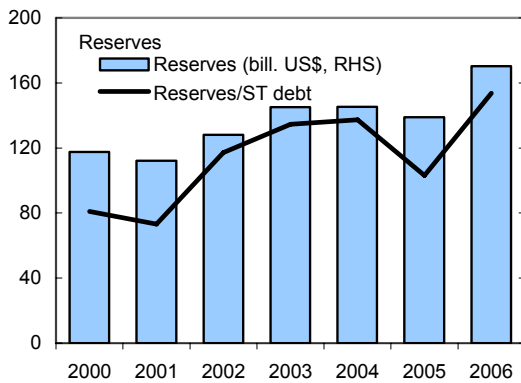
*...and some appreciation of the rupiah...*



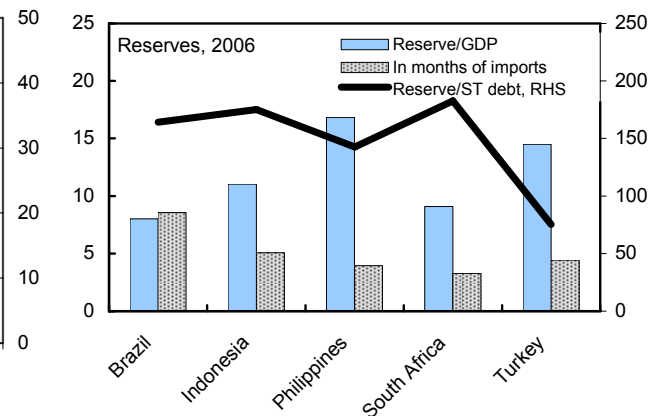
*...although to a lesser extent than in other emerging markets.*



*Inflows were used to build reserves...*



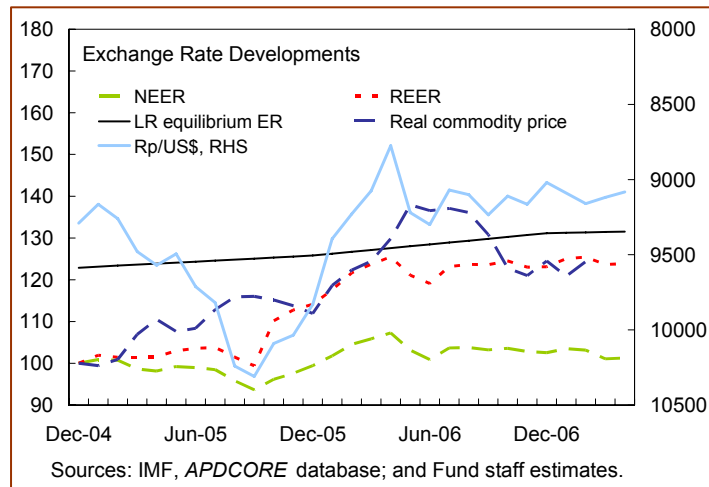
*...and strengthen reserve ratios.*



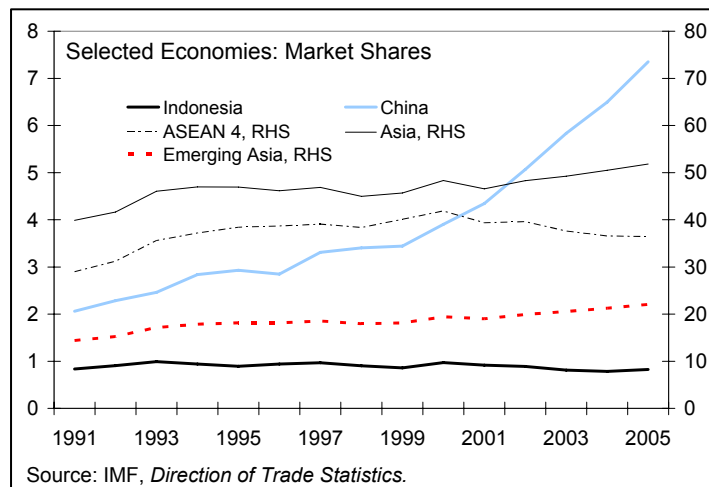
Sources: Country authorities; IMF, *World Economic Outlook*; Bloomberg; CEIC Database; and Fund staff calculations.

#### BOX 4. ASSESSMENT OF INDONESIA'S EXTERNAL COMPETITIVENESS

**Estimates of the real effective exchange rate point to declining, though adequate, competitiveness.** As of April 2007, the REER has appreciated by around 24 percent from the low level reached in September 2005. At the same time, the external current account improved by about 2½ percentage points of GDP between 2005 and 2006, in tandem with the run up in commodity prices. According to the equilibrium real exchange rate (ERER) methodology (which estimates the relation between fundamentals and real exchange rates using a cross-country panel regression), at end May 2006, the value of the rupiah was around 12 percent below the level justified by fundamentals. The macroeconomic balances and external sustainability approaches estimate the rupiah to be 1½ percent overvalued and 16 percent undervalued, respectively.<sup>1</sup> However, there is considerable uncertainty surrounding the estimates, given the possible structural changes in the economy.



**Despite recent robust export growth, Indonesia's export performance has lagged its competitors.** While most commodity exports performed well, overall market share has declined modestly, driven mostly by manufacturing exports. This is likely related to a larger degree of undervaluation in a number of competitor countries.



**Survey-based indicators of competitiveness identify several**

**structural impediments to strong external competitiveness.** The International Institute for Management Development and the World Economic Forum's Global Competitiveness Report rank Indonesia lower than many other Asian countries, with the inadequate supply of infrastructure, and inefficiencies in business and government as top impediments. The onus for boosting competitiveness therefore rests on removing these structural impediments.

<sup>1</sup> For a description of the methodologies see: "Methodology for CGER Exchange Rate Assessments" [www.imf.org/external/np/pp/eng/2006/110806.pdf](http://www.imf.org/external/np/pp/eng/2006/110806.pdf).

- A primarily *market-determined exchange rate* is supportive of the inflation-targeting framework. Attempts to target a specific exchange rate could create one-way bets and trigger additional speculative inflows. Allowing the rupiah to appreciate, on the other hand, improves inflation prospects and creates room for lower interest rates, weakening incentives for further inflows.
- *Reserve levels* are broadly sufficient according to standard indicators of reserve adequacy. Modest further accumulation would be warranted, though, to protect against volatile capital flows and further lower perceptions of vulnerabilities. However, the sterilization cost of maintaining higher reserves (currently estimated at about 0.1 percent of GDP for each US\$10 billion in reserves) need to be taken into account.

13. **Staff thus recommended addressing any appreciation pressures as follows:**

- *The monetary and exchange rate policy response* should include: (i) allowing further appreciation, (ii) possible intervention to limit excessively large exchange rate movements, and (iii) further interest rate cuts provided that appreciation improves the inflation outlook. This is broadly consistent with how inflows have been handled in 2006–07.
- *Export performance* should best be supported through structural measures to enhance the business climate (see below).
- *Deeper financial markets* could help limit the impact of volatile portfolio flows on domestic asset prices and the exchange rate. In addition, a broader range of available financial instruments (including hedging) would enable domestic companies to better deal with market volatility.

***The Authorities' Views and Policy Intentions***

14. **BI officials broadly agreed with staff and considered that the current exchange rate policy remains appropriate.**

- *Flexible exchange rate*: The authorities emphasized their commitment to the inflation-targeting regime and to a market-determined exchange rate.
- *The current real exchange rate level* is viewed by BI as consistent with improved fundamentals and is appropriate, but some appreciation or depreciation would not pose a significant problem.

15. **Nevertheless, the authorities expressed concern over “hot money” flows (portfolio holding of foreign investors) which raise the size of potential capital outflows.**

- *Investments in short-term instruments*, particularly central bank paper, were seen as speculative investments that are costly and have the potential to disrupt the foreign exchange market if positions unwind.
- *Need for reserves*: BI officials pointed out that significant reserve levels are needed to reduce vulnerability to “hot money” outflows. In that context, they would welcome some additional accumulation in the future. However, they remain concerned about potential sterilization costs.

**B. How Much Room is There to Loosen Monetary Policy?**

*Background and Staff Analysis*

16. **Inflation remains on-track to meet the end-2007 inflation target of 6±1 percent (Figure 5):**

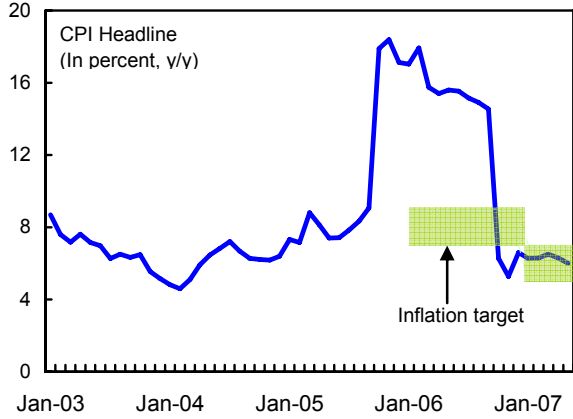
- *Rising rice prices* pushed up headline inflation modestly in early 2007. However, prices have begun to decline in line with normal seasonal patterns, and administered prices have remained stable. As a result, annual inflation declined to 6 percent in May.
- *The near-term inflation outlook* is positive, as there are no signs of immediate price pressures. The recent exchange rate appreciation contributes to the positive short-term outlook. As a result, BI is signaling further rate cuts for 2007. However, too much focus on the favorable near-term outlook carries the risk of rapid rate cuts, possibly worsening the inflation outlook for 2008.

17. **Staff therefore recommended that the focus of monetary policy shift toward meeting the 2008 target.**

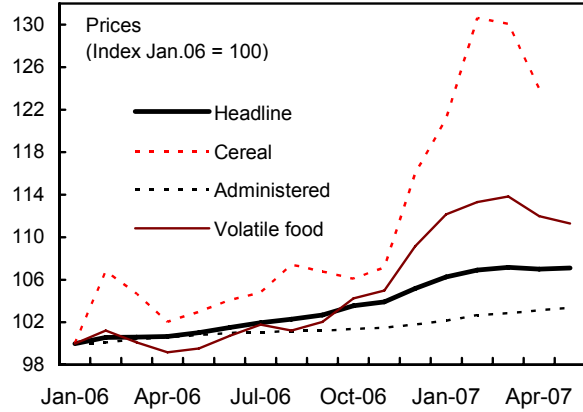
- *Staff’s conditional inflation forecasts* indicate that the 2007 target of 6±1 percent will be met and that the 2008 target of 5±1 percent remains within reach, assuming limited additional rate cuts. Real interest rates are now slightly less than 3 percent (measured against core inflation) below the historical (2000–07) average of 3½ percent, suggesting that the current stance might already be slightly expansionary.

Figure 5. Indonesia: Inflation and Interest Rates

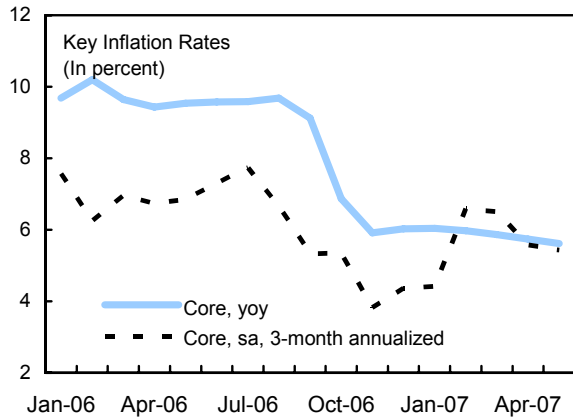
Headline CPI inflation remains within the 2007 target range...



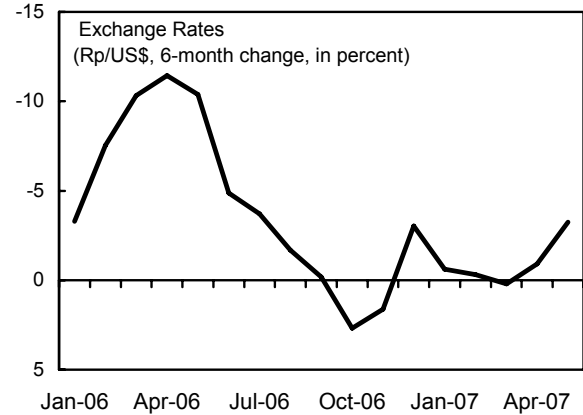
...as surging food, in particular rice, prices were offset by stable administered prices.



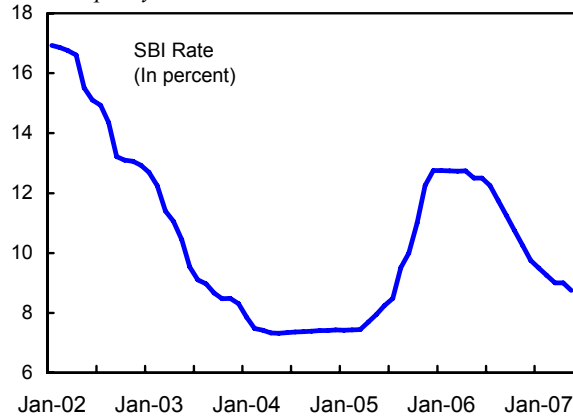
Core inflation has declined recently...



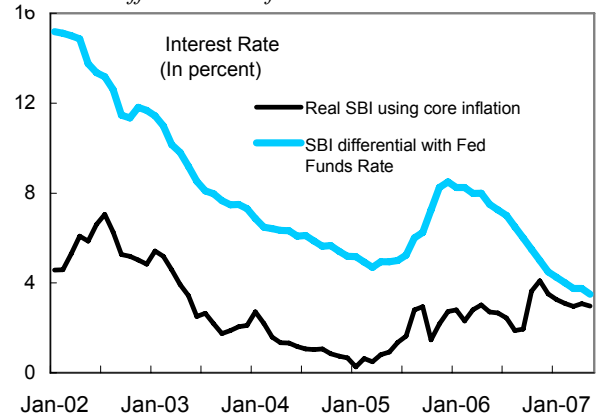
...supported by the appreciation of the rupiah...



...allowing substantial cuts in the policy rate over the past year.



Real interest rates remain at about 3 percent, but the interest differential has fallen to a record low.



Sources: CEIC database; Country authorities; IMF, APDCORE database; and Fund staff calculations.

- *Additional rate cuts* should be determined by forecast inflation for 2008 relative to the target. With current and projected 2008 inflation above the midpoint of the 2008 target range, BI should be cautious in cutting rates and take into account the significant lags in the monetary transmission mechanism. However, further appreciation of the rupiah could create room for lower rates.
- *Reducing macroeconomic volatility* remains a key objective and monetary policy has an important role to play. This includes continuing to reduce inflation to international levels and avoiding sharp policy reversals, such as in 2005 when concerns about excessively loose policies led to a loss of confidence and exchange rate depreciation. Further strengthening the credibility of the inflation targeting regime could contribute to lower macroeconomic volatility and staff made several recommendations in that regard, including on the planned change in the maturity of the policy rate (Box 5).

### *The Authorities' Views and Policy Intentions*

18. **BI officials broadly agreed with staff but remained slightly more optimistic regarding room for further rate cuts.** However, they emphasized their continued commitment to the inflation-targeting framework and to meeting the 2007 and 2008 targets. BI considers high food prices as the key risk to the inflation outlook but remains confident that it can meet the 2007 target range. While BI recognized that meeting the 2008 target will be more difficult, BI officials believe the target remains achievable, even with additional rate cuts, in light of recent rupiah appreciation.

### **C. Deepening Financial Intermediation While Safeguarding Stability**

#### *Background and Staff Analysis*

19. **Financial intermediation remains low and access to long-term financing is limited** (Figure 6).

- *Bank credit* continues to be the main form of financial intermediation. However, bank credit sharply declined in the wake of the Asian crisis and has not yet recovered despite significant credit growth in 2002–05. In late 2005 and 2006 credit growth slowed, due to interest rate hikes and slowing economic activity, although it has since recovered.
- *Loan-to-deposit ratios* are low. Banks still hold a significant share of their assets in government bonds and central bank certificates (SBIs). In part, this reflects the recapitalization bonds on banks' balance sheets.
- *Availability of long-term financing* is very limited, in part due to the relatively small size of corporate bond and equity markets. In addition, the exceptionally short maturity of bank deposits limits banks' ability to provide long-term loans, in particular at fixed rates.

**BOX 5: FURTHER IMPROVING THE EFFECTIVENESS OF THE INFLATION-TARGETING FRAMEWORK**

**Transparency and Communication.** Further improvements in this area would help signal BI's commitment to low and stable inflation and facilitate achieving the inflation target.

- *Clarity of the inflation target.* Currently, most private sector analysts project 2008 inflation slightly above the official target range, suggesting that either the target is not well communicated, or only enjoys limited credibility. A stronger emphasis on inflation targets beyond the current year could be useful to better anchor expectations.
- *Monetary policy and inflation reports.* Explicit discussion of risks to the inflation outlook and past inflation performance could improve credibility and predictability of BI's reaction to possible future shocks. In addition, consideration could be given to publishing explicit inflation forecasts, after more experience has been gained with the forecasting framework.
- *BI's public communication* should be aligned as much as possible with the official position, be less specific with regard to future interest rates or credit growth targets (which could conflict with the inflation objective), and place less emphasis on growth.
- *The authorities' view.* BI officials emphasized recent improvements in the Monetary Policy Report, including more forward-looking discussion and a more detailed treatment of risks. They are considering publishing quantitative inflation forecasts.

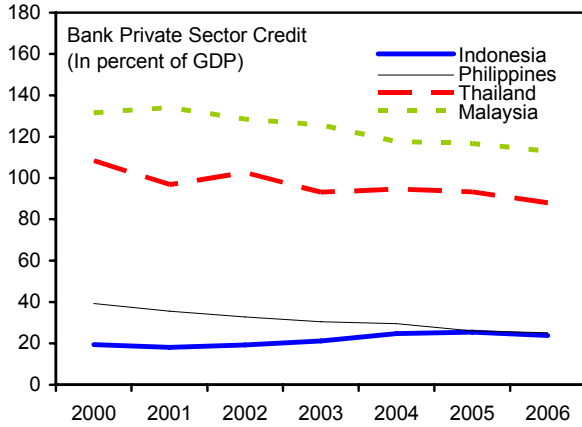
**Framework for Monetary Operations.** BI intends to change the monetary policy rate to the overnight interbank rate but has yet to announce a firm date.

- *Current framework.* BI uses the 1-month SBI rate as the policy rate, while participation in the overnight market is limited and rates are volatile. The new framework would facilitate the development of the short end of the yield curve.
- *Key conditions for changing the policy rate:*
  - *A stable overnight rate* is needed so that it can serve as an effective signal of the monetary policy stance. Moreover, it is important that BI exerts sufficient control over the new policy rate. This will require significant further progress, including in liquidity forecasting and management. Introducing required reserve averaging could also contribute achieving a more stable rate.
  - *Development of the interbank market*, including repos, is important to ensure that the interbank market adequately reflects liquidity conditions, while at the same time contributing to stabilizing the interbank rate. This would also facilitate convergence of the level of overnight rate toward the current policy rate.
- *The authorities' view.* BI officials concurred on the need to strengthen the overnight interbank market and highlighted ongoing work in that area, including efforts to develop the repo market. In addition, progress toward implementing the treasury single account (TSA) would facilitate liquidity forecasting and management.

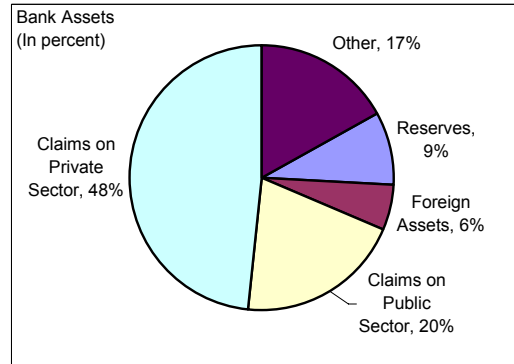


Figure 6. Indonesia: Financial Intermediation

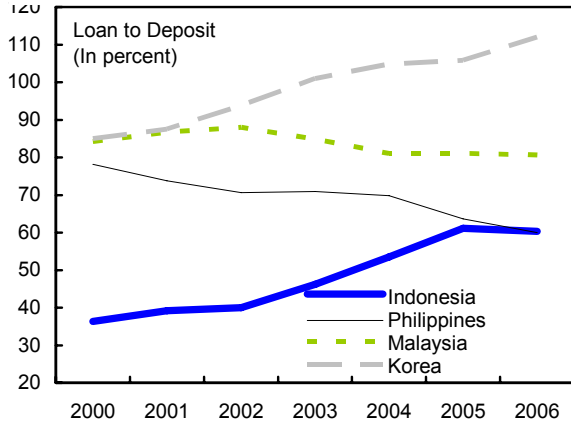
*Bank credit to the private sector remains low...*



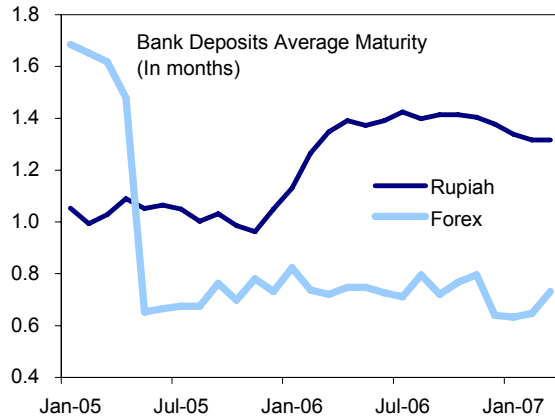
*...as such loans are less than 50 percent of banks' assets...*



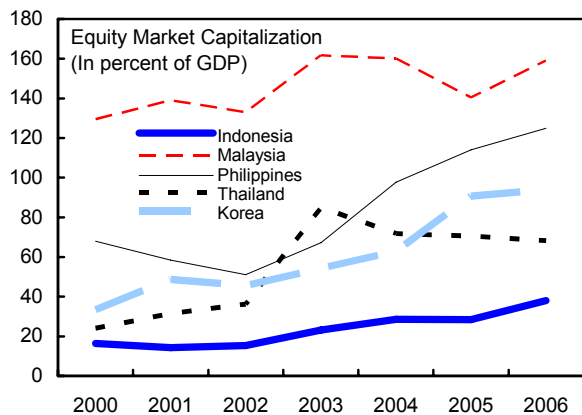
*...and loan-to-deposit ratios are still low by regional standards.*



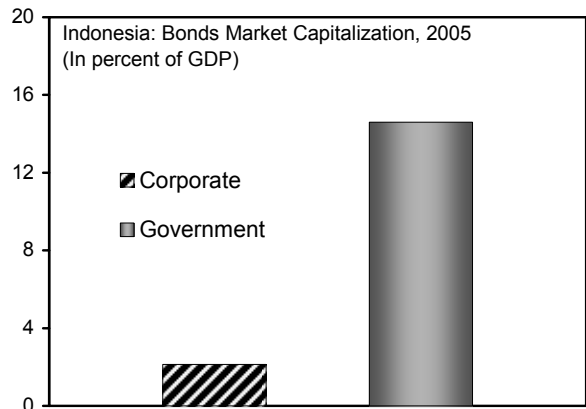
*Availability of long-term credit is constrained by the short maturity of deposits...*



*...as well as the small size of the equity...*



*...and bond markets.*



Sources: CEIC database; IMF, *World Economic Outlook*; and APDCORE database; and Fund staff calculations.

20. **Measures to stimulate credit growth have been taken recently.**

- *Changes in prudential regulations.* BI reduced capital requirements on banks by lowering the risk weights on small and medium enterprise (SME) and mortgage loans in late 2006. Subsequently, in April 2007 a relaxation of provisioning and loan classification rules, and limitations on loans to borrowers with credit history problems, were announced. While the measures are limited and intended to be temporary, some imply departures from international standards and risk having an adverse signaling effect on supervisors and banks.
- *Pressures on state banks:* State banks have been under pressure from parts of the government to limit investment in SBIs and to provide financing for infrastructure projects.

21. **Empirical research and discussions with analysts suggest that low credit in Indonesia reflects both supply and demand factors.** Lack of demand from creditworthy customers is the main reason for low credit, according to staff analysis (see selected issues paper). However, anecdotal evidence suggests that there is unmet demand for long-term credit to finance infrastructure, housing, and other projects. The problem is exacerbated by a legal system that often prevents enforcement of creditor rights.<sup>2</sup>

22. **Discussions with the authorities focused on the following steps to promote financial intermediation:**

- *Improvements in the legal system* resulting in greater protection of creditor rights would encourage banks to lend, although such efforts would only yield results over the long term.
- *The credit bureau* should be expanded to also provide information on nonbank firms, such as public utilities. This would encourage lending to creditworthy customers who have never borrowed before.
- *State banks:* Staff reiterated the need for a strategy on the role of state banks in Indonesia's banking system (as discussed comprehensively in the 2006 Article IV report).
- *Mortgage markets:* Efforts are underway to develop markets for mortgage-backed securities, including by removing legal, tax, and other impediments. This could be expanded to cover other assets. In addition, the government could also explore expanding the role of Ascrindo, a state-owned loan guarantee company, to include mortgages for lower-middle income borrowers.

---

<sup>2</sup> In addition to bank lending, weak legal protection is also an issue for bond financing, as highlighted by the recent ruling of an Indonesian court declaring international bonds issued by Asia Pulp and Paper to be an invalid debt that would not have to be honored.

- *Second-tier bank*: A state-owned bank could be converted into a second-tier development bank. This institution would be funded by issuing bonds and then, working through banks, finance infrastructure projects or other long-term projects.
- *A deeper nonbank financial sector* could be a significant source of long-term financing. This includes developing equity and corporate bond markets, as well as developing an institutional investor base such as pension funds and insurance companies, as proposed in a recent World Bank study.<sup>3</sup>

### *The Authorities' Views and Policy Intentions*

23. **The authorities agreed on the need to strengthen financial intermediation and long-term financing.** The recently presented policy package includes a variety of measures, including steps to strengthen the credit bureau, export financing, sharia banking, equity and bond markets, the insurance industry, and the venture capital industry.<sup>4</sup>

24. **BI officials noted that recent prudential measures would not undermine the soundness of the banking system.** They emphasized that the measures are temporary and subject to review. Moreover, some of the relaxations only apply to banks with strong risk management practices, thus limiting risk.

25. **The authorities have agreed in principle to participate in an FSAP** but have not committed to specific timing. They emphasized that good preparation on their side will help maximize the benefits of this exercise.

## **D. Fiscal Policy to Support Sustainable Growth**

### *Background and Staff Analysis*

26. **In supporting long-term growth, a key role of fiscal policy is to ensure adequate pro-growth spending.** Most importantly, this includes investment in infrastructure which fell from a pre-crisis high of 6 percent of GDP annually to about 2–3 percent of GDP following the crisis. Infrastructure indicators have deteriorated; the road network, port facilities, and the electricity supply require substantial new investments. The government is attempting to address this issue by forging partnerships with the private sector (PPPs). A sound risk management framework has been established to safeguard public finances, but poor project preparation often limits the start of PPPs.

---

<sup>3</sup> See “Unlocking Indonesia’s Domestic Financial Resources: The Role of Non-Bank Financial Institutions,” World Bank, December 2006.

<sup>4</sup> See <http://www.ekon.go.id>.

**27. A modestly less restrictive fiscal stance is expected in 2007–08, to account for weaker oil and gas revenues and the need to increase spending on infrastructure.**

- *2007:* Subject to parliamentary approval, the overall deficit is expected to reach 1.8 percent of GDP, compared to the original target of 1.1 percent of GDP (reflecting lower oil and gas revenues, higher payments linked to natural disasters, clearance of arrears to the state-owned electricity company, and higher fertilizer subsidy costs). A modest increase in non-oil and gas tax revenues is expected from improvements in tax administration.
- *2008:* The authorities are targeting a deficit of 1.7 percent of GDP. This takes into account planned reductions in the corporate and personal income tax rates, and some increase in personnel expenditures and infrastructure investment (about 0.5 percent of GDP).

**28. A modestly higher deficit can be accommodated without jeopardizing financial stability and the downward trend in debt ratios.**

- *Falling debt burden.* The currently projected deficits are consistent with a fall in the debt-to-GDP ratio to 36 percent of GDP by end-2007 (from 39 percent of GDP in 2006) and with the government's target of reducing this ratio to about 30 percent of GDP by 2009.
- *Additional financing of the deficit* can be secured mainly through higher concessional loans and domestic bond issuance. Given its modest size, the latter would likely have a limited impact on interest rates as there is sufficient demand for domestic government bonds. However, if deficits were to increase beyond the levels currently envisaged, the need for increased bank holdings of domestic bonds or higher portfolio capital inflows could conflict with other policy objectives.
- *The risks to the fiscal outlook* are mostly linked to higher energy prices (assuming no price adjustments), lack of progress on tax administration, and additional tax incentives as part of the new investment package.

**29. Additional measures could be sought to create fiscal space** (selected issues paper), given the expected decline in oil and gas revenues and the tax rate cuts planned for 2008–10. These include:

- *Increasing further non-oil and gas tax revenues.* As gains from tax administration are likely to take effect only gradually, the introduction of new tax policy measures could be considered, including raising the property tax rate, removing some exemptions (such as restaurant and hotel services) or introducing a fringe benefits tax. The granting of tax holidays and rate reductions should be avoided.

- *Efforts to limit non-productive expenditures*, such as reducing administrative expenses and phasing out untargeted energy subsidies by gradually raising retail fuel prices and introducing an automatic fuel price adjustment mechanism.
- *Improving local governments' ability to increase infrastructure investment*, including through co-financing schemes and encouraging a better spending allocation before approving regional budgets.

### ***The Authorities' Views and Policy Intentions***

30. **The government is committed to fiscal discipline.** The authorities are not considering a deficit beyond 1.8 percent of GDP in 2007–08.

31. **Within that context, the government is determined to alleviate infrastructure bottlenecks, including through use of public resources.** The strategy is to boost infrastructure spending in 2008 while keeping the central government deficit to 1.8 percent of GDP. However, new tax policy measures are unlikely to be adopted prior to approval of the tax package currently in Parliament. Moreover, increases in retail fuel prices before the 2009 elections would be politically difficult. However, the authorities pointed out that early progress should be possible in the following two areas:

- *Enhancing revenue*: The authorities consider that tax administration improvements, combined with future tax rate cuts, will help broaden the tax base and give a significant boost to revenues. They agreed that the staff's above proposals, as well as some additions, could be envisaged in the medium term.
- *Higher priority spending by local governments*: The authorities are encouraging local governments to use the large deposits accumulated in commercial banks to increase priority spending, notably in education, health, and infrastructure. The threat of sanctions facilitated early adoption of regional budgets in 2007 and regional spending is expected to increase further in 2008 and beyond as local governments' implementation capacity improves. However, sub-national data reporting remains weak.

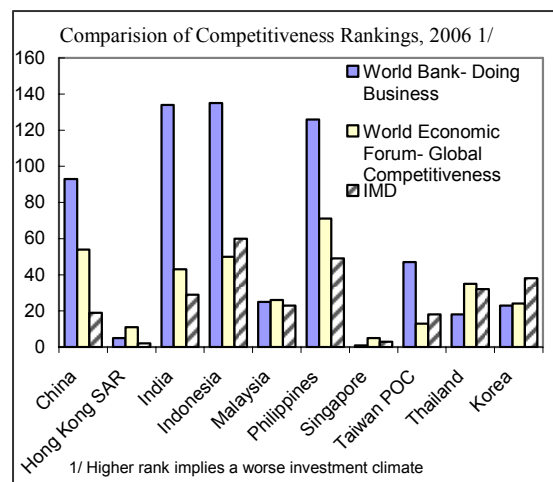
## **E. Structural Reforms to Improve the Investment Climate**

### ***Background***

32. **The investment climate still compares poorly in cross-country surveys.** In particular, strict labor legislation and a difficult legal and regulatory environment are considered impediments for higher investment and compare poorly within the region.

33. **Progress has been made in several areas of the government's structural reform agenda** (Table 9).

- *Fiscal reforms* continued apace. The objective is to improve spending efficiency, while strengthening tax collection, through improving the relevant institutions. The main achievements so far include: (i) restructuring the tax agency and modernizing the medium taxpayers' offices; (ii) approval in June of the most important of a package of tax laws before Parliament relating to administrative procedures, that should both enhance collection and improve the business climate; and (iii) strengthening the budget process and transparency, involving a reorganization of the MOF, as well as a simplification of budget execution procedures.



- *The Investment Law* was passed in March. The law provides equal treatment to domestic and foreign investors, allows for longer work permits for expatriates, extends the number of years for which land can be leased, and states explicitly that investors are entitled to repatriate and transfer funds in foreign exchange and that disputes between the government and investors can be settled through international arbitration. In addition, the law allows the Minister of Finance to issue regulations to provide various tax incentives.
- *However, efforts to make the labor market more competitive are proceeding slowly.* Indonesia's labor market is among the least competitive in the region with high severance payments making layoffs very costly and restricting the ability of firms to adapt to shifts in market demand.<sup>5</sup>

### *The Authorities' Views and Policy Intentions*

34. **The authorities emphasized their determination to press ahead with structural reforms but cautioned that reforms in politically sensitive areas will take time.** Specific plans include:

- *Fiscal reforms:* (i) the issuance of government regulations necessary for the establishment of a treasury single account; (ii) more regular monitoring of regional governments and public enterprise operations; and (iii) introducing a statement of fiscal risks and a medium-term fiscal framework.
- *Investment climate:* The next step is to complete the implementing regulations relating to the Investment Law expeditiously. A package of specific measures to improve the

<sup>5</sup> Labor market issues are discussed in detail in Chapter VII of IMF Country Report No. 05/327.

investment climate and support small and medium enterprises (in addition to measures on infrastructure and the financial sector, discussed above) was presented in June.

- *Labor reform* would continue, albeit without comprehensive legislative reforms. Efforts to link the reforms on severance payments to using well-managed pension funds to provide limited benefits to workers in case of unemployment hold promise. This could help to attract investment and support job-creation in the labor-intensive sectors.
- *State-owned enterprises (SOEs)*: following the cabinet reshuffle, the authorities indicated their intention to develop a new strategy for SOEs, including a revival of the privatization agenda. This includes the planned sale of a 30 percent stake in the state bank BNI.

## V. STAFF APPRAISAL

35. **Achievements.** Since the last Article IV consultation, Indonesia has seen strong growth, as well as declining inflation and balance sheet vulnerabilities. To some extent, this reflects favorable global and regional factors, but appropriate macroeconomic policies and political stability have also played a crucial role. Progress has also been made in building macroeconomic institutions, especially in the fiscal area. However, continued high poverty and unemployment have tended to devalue the gains toward stability in the eyes of much of the population.

36. **Key challenges.** Indonesia is well positioned to take advantage of continued favorable global conditions. With stronger financial intermediation, especially better availability of long-term financing, additional investment in infrastructure, and an improved investment climate, growth could be sustained at least in the 6–7 percent range necessary to alleviate poverty and unemployment. This would probably involve more integration in the global economy, including regional production chains. Such integration, however, can increase risks, enhancing the need for continued sound macroeconomic policies.

37. **Declining vulnerabilities.** Improved fundamentals, including lower debt and higher reserves, have increased resilience to adverse shocks. The banking system is well capitalized, profitability has improved, and stress tests suggest it is capable of withstanding reasonable adverse shocks. Experience from two recent episodes of financial market turbulence and scenario analysis suggests that Indonesia should be able to withstand moderate external shocks relatively well. That said, the recent flurry in corporate external debt issuance suggests that private sector borrowing needs to be monitored closely to detect any future vulnerabilities at an early stage.

38. **Capital inflows and external stability.** With a relatively small current account surplus, which is projected to move into deficit over time, and relatively modest net capital inflows (at least so far), macroeconomic pressures are manageable. Nevertheless, even with a generally benign global financial environment, portfolio inflows have been volatile and have led to significant price swings in Indonesia's shallow asset markets. The authorities remain committed to exchange rate flexibility but are concerned about the impact of exchange rate

appreciation on the labor-intensive manufacturing sector as well as the possibility of a reversal of portfolio inflows. Staff feels that these risks can be minimized, in case of further surges in inflows, through a combination of policies including allowing further rupiah appreciation, intervention to limit excessive exchange rate movements, and additional interest rate cuts, provided that appreciation improves the inflation outlook.

39. **Exchange rate level.** Evidence on external competitiveness is mixed. REER measures suggest a modest undervaluation, as reflected in the current account surplus. However, the performance of manufacturing exports has been modest relative to trading partners, as high commodity prices have strengthened the real exchange rate. On balance, some appreciation could take place without jeopardizing the external position. In any event, there is little to suggest that the authorities should diverge from the current macroeconomic policy mix, but should focus on structural measures to enhance competitiveness.

40. **Reducing inflation.** BI can make an important contribution to limiting capital account volatility by ensuring the convergence of inflation and interest rates with major trading partners. With the 2007 inflation target well within reach, monetary policy should now focus on achieving the 2008 target. While the recent rupiah appreciation and moderating core inflation may have opened room for limited interest rate cuts, BI needs to exercise caution and allow time for past rate cuts to affect the real economy.

41. **Monetary policy effectiveness.** The inflation-targeting framework has helped BI to regain credibility, but further improvements in transparency and communication could bolster confidence in its policies. BI also needs to be mindful that its policy communications to the public do not give mixed signals about policy priorities.

42. **Financial policies.** Staff believes the recent relaxation of prudential regulations to encourage lending is not likely to have much impact as demand constraints are mostly at play. However, the steps represent a departure from international standards and risk having an adverse signaling effect on supervisors and banks alike. BI should therefore reconsider the appropriateness of the measures as soon as possible. Moral suasion to encourage banks to lend to specific sectors could result in credit misallocation and should also be avoided. Instead, steps to promote the development of capital markets and instruments of longer-term financing would be more effective in the long run and help to preserve the soundness of the financial sector. Also, a strategy on the future role of state banks is needed. Staff encourages the authorities to confirm a date for the FSAP, as this could help to identify areas for further improvement in the financial system.

43. **Fiscal policy.** The fiscal stance is appropriate. The modest increase in the deficit target for 2007 and 2008 from earlier projections should create some room for additional development spending. However, the authorities should not go beyond the 1.7–1.8 percent deficits currently envisaged in light of potential negative consequences of higher debt financing. The authorities' objective of lowering public debt to about 30 percent of GDP by 2009 remains appropriate. Further improvements in tax administration, some new tax



measures, and the streamlining of expenditures, including through greater flexibility of energy prices, could create additional space for priority spending.

44. **Fiscal reform.** Good progress is being made on fiscal structural reforms. With the restructuring of the tax agency completed, the recent adoption of a key tax reform bill should improve revenue collection and contribute to improving the investment climate. Staff supports the planned introduction of a fiscal risk statement and the medium-term fiscal framework in the 2008 budget.

45. **Structural reform.** Accelerating structural reforms further would help to entrench the recovery in growth. The passage of the much awaited investment and tax administration laws are important steps. The authorities should now focus on, modifications in labor regulations to alleviate the burden of severance payments on employment generation and facilitating public private partnerships in infrastructure (in addition to more budgetary spending) while ensuring that they are adequately prepared and assessed.

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

**Table 1. Indonesia: The Authorities' Response to Recent Fund Policy Advice**

Advice from the 2006 Article IV Discussions	Actions Taken
<b>Monetary and exchange rate policy</b>	
<p>The downward trend in inflation has created room for reducing the policy rate, but a cautious approach to further reduction will help maintain BI's credibility.</p>	<p>BI reduced interest rates by a further 350 basis points between July 2006 and May 2007 and signaled additional rate cuts in 2007. Inflation has trended downwards and remains within the 2007 target range.</p>
<p>BI should intervene symmetrically to smooth fluctuations in the exchange market and limit volatility in the rupiah.</p>	<p>BI's interventions in the foreign exchange market have been limited over the past year, with the exception of April-May 2007, when there was sustained upwards pressure on the rupiah from capital inflows. Direct intervention has focused on limiting short-run volatility, although with pressure generally in one direction the intervention has also been somewhat asymmetric.</p>
<b>Fiscal policy</b>	
<p>Fiscal deficit targets of 1.2 percent and 0.9 percent of GDP in 2006 and 2007, respectively, are appropriate.</p>	<p>The fiscal deficit in 2006 was 1.0 percent of GDP. The projected deficit in 2007, 1.8 percent of GDP, is higher than originally targeted but remains appropriate and will still allow for a continued reduction in the debt to GDP ratio.</p>
<p>Fuel price adjustments should be depoliticized by the introduction of a mechanism for automatic adjustments of energy prices.</p>	<p>Energy prices are still fixed, with fuel prices at about 90 percent of international spot prices.</p>
<p>Create a Single Treasury Account to ensure better fiscal management.</p>	<p>The cash management regulations, which are crucial for the establishment of a Single Treasury Account, are expected to be signed soon.</p>
<p>Improvements are needed in a number of areas to better assess fiscal risks, including monitoring of SOEs, reporting of quasi-fiscal and extra-budgetary activities and monitoring contingent liabilities.</p>	<p>A fiscal policy office, risk management unit, debt unit, and directorates for monitoring regional governments and public enterprises have been set up and are operational. A statement of fiscal risks and a medium-term fiscal framework will be introduced in the 2008 budget.</p>
<b>Financial sector</b>	
<p>State Banks to take haircuts and resolve NPL problems at State Banks.</p>	<p>A presidential decree has been issued allowing State Banks to take haircuts. NPLs at State Banks declined by around 5 percentage points, to 10.7 percent, at the end of 2006.</p>
<p>Medium-term privatization strategies should be adopted for public banks that do not have a clear public policy objective.</p>	<p>The government plans to sell shares in a major state bank (equivalent to 30 percent of capital), while the new Minister of State-Owned enterprises is revisiting divestment plans for SOEs more generally.</p>
<p>The authorities should participate in an FSAP.</p>	<p>The authorities have agreed in principal to participate in an FSAP, but have yet to commit to a date.</p>
<b>Structural reforms</b>	
<p>Early approval of at least one or two of the customs, investment and tax laws should be pursued.</p>	<p>The customs law and investment law have been approved, as has a key tax law.</p>
<p>Improve flexibility in the labor market.</p>	<p>Legislative reform has been set aside because of opposition by unions, but authorities are trying to modify regulations to limit severance payments.</p>

Table 2. Indonesia: Selected Social Indicators, 2001-06

	2001	2002	2003	2004	2005	2006
<b>Education</b>						
Elementary school net enrollment ratio, percent of <i>relevant aged group</i>	92.9	92.6	92.6	93.0	93.3	...
Population > 10 yr old not completed primary school (in percent)	34.4	31.3	30.8	29.4	29.3	...
Population > 10 yr old finished primary and Junior high school (in percent)	47.6	49.2	47.1	49.9	49.4	...
Population > 10 yr old finished high school and college (in percent)	18.0	19.5	11.5	20.7	21.3	...
Adult literacy rate	89.3	90.7	90.9	90.5	90.9	...
<b>Health</b>						
Life expectancy rate	66.2	66.2	66.2	68.6	67.8	...
Fertility rate, <i>births per woman</i>	2.3	2.3	2.3	2.3	2.3	...
Children < 5 yr old that have good nutrition (in percent)	69.1	71.9	69.6	74.4	68.5	...
Children < 5 yr old that had been immunized (in percent)	89.9	90.6	...	92.1	...	...
<b>Housing and Sanitation</b>						
Household with access to piped water (in percent)	18.3	19.7	18.9	18.0	18.0	...
Household with electricity (in percent)	86.3	87.6	87.9	89.0	...	...
<b>Poverty and inequality</b>						
Number of people under poverty line (in millions)	37.9	38.4	37.3	36.1	35.1	...
Population under poverty line (in percent)	18.4	18.2	17.4	16.7	16.0	17.8
Gini Coefficient	0.32	0.33	0.32	0.33	0.33	...
<b>Employment</b>						
Total labor force (in millions)	99	101	100	104	107	...
Labor participation (in millions)	68.6	67.8	65.7	67.6	68.0	66.2
Unemployment rate	8.1	9.1	9.5	9.9	10.3	10.3

Sources: World Bank and CEIC Database.

Table 3. Indonesia: Selected Economic Indicators, 2002–08

	2002	2003	2004	2005	2006	2007	2008
			Act.			Proj.	
Real GDP (percent change)	4.5	4.8	5.0	5.7	5.5	6.0	6.3
Domestic demand	2.4	6.0	5.4	5.3	3.3	5.2	7.5
<i>Of which:</i>							
Private consumption	3.8	3.9	5.0	4.0	3.2	4.6	4.6
Gross fixed investment	4.7	0.6	14.7	10.8	2.9	9.0	11.9
Change in stocks 1/	-2.0	2.2	-1.3	-0.4	-0.3	-0.8	0.7
Net exports 1/	0.8	1.8	-2.1	1.1	1.4	1.3	-0.3
Statistical discrepancy 1/	1.5	-2.4	2.3	-0.3	1.1	0.0	0.0
Saving and investment (in percent of GDP)							
Gross investment 2/	21.3	22.5	22.9	23.5	22.6	22.5	24.3
Gross national saving	25.3	26.0	23.5	23.6	25.3	24.4	25.8
Foreign saving	-4.0	-3.5	-0.6	-0.1	-2.7	-1.9	-1.5
Prices (12-month percent change)							
Consumer prices (end period)	9.9	5.2	6.4	17.1	6.6	6.3	5.5
Consumer prices (period average)	11.8	6.8	6.1	10.5	13.1	6.2	5.4
Public finances (in percent of GDP)							
Central government revenue	16.5	16.7	17.8	17.8	19.0	17.7	17.1
Central government expenditure	18.0	18.7	19.1	18.1	20.0	19.5	18.9
Central government balance	-1.6	-2.0	-1.4	-0.3	-1.0	-1.8	-1.8
Primary balance	3.4	1.6	1.3	2.1	1.4	0.5	0.0
Central government debt	65.4	58.3	55.2	45.6	38.6	35.7	33.9
Money and credit (12-month percent change; end of period)							
Rupiah M2	7.9	9.8	10.0	13.0	18.1	18.0	...
Base money	8.3	19.8	20.4	21.9	22.2	17.8	...
Private sector credit	25.1	22.1	30.4	19.7	14.4	16.5	...
One-month SBI rate (period average)	15.1	10.1	7.5	9.1	11.9	...	...
Balance of Payments (in billions of US\$)							
Oil and gas (net)	6.2	7.4	5.1	4.2	6.8	6.4	4.3
Non-oil exports (f.o.b)	46.3	48.9	54.5	66.8	80.6	92.5	100.8
Non-oil imports (f.o.b)	-29.0	-31.7	-39.5	-53.4	-57.7	-68.7	-75.7
Current account balance	7.8	8.1	1.6	0.3	9.9	8.0	6.8
Foreign direct investment	0.1	-0.6	-1.5	5.3	3.3	2.8	4.0
Overall balance	5.0	3.7	1.0	-0.5	15.9	12.4	6.8
Gross reserves							
In billions of US dollars (end period)	32.0	36.3	36.3	34.7	42.6	55.0	61.8
In months of imports	6.8	6.1	4.8	4.4	4.8	5.7	5.8
As a percent of short-term debt 3/	117.3	134.5	137.4	103.0	153.7	187.8	197.8
Total external debt							
In billions of US dollars	131.3	135.4	137.4	133.8	133.4	130.5	132.1
In percent of GDP	67.2	57.7	53.5	46.6	36.6	31.2	28.6
Exchange rate (period average)							
Rupiah per US\$	9,314	8,575	8,933	9,705	9,165	...	...
Nominal effective exchange rate (Jan. 2000=100)	94.2	95.0	87.0	79.3	83.7	...	...
<b>Memorandum items:</b>							
Oil production (000bcpd)	1,260	1,200	1,040	999	956	956	956
Indonesian oil price (US\$/bbl)	23.5	28.8	37.2	51.8	63.9	60.3	64.3
Nominal GDP (in trillions of Rupiah)	1,822	2,014	2,296	2,785	3,338	3,756	4,211
Nominal GDP (in billions of US\$)	196	235	257	287	364	418	462

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

1/ Contribution to GDP growth (percentage points).

2/ Includes changes in stocks. Computed on real basis.

3/ Short-term debt on a remaining maturity basis.

Table 4. Indonesia: Balance of Payments, 2004–08  
(In billions of U.S. dollars)

	2004	2005	2006 Est.	2007 Proj.	2008 Proj.
I. Current Account	1.6	0.3	9.9	8.0	6.8
A. Goods, Net (Trade Balance)	20.2	17.5	29.6	30.2	29.5
1. Exports, f.o.b.	70.8	87.0	103.5	113.1	121.4
<i>Of which: Oil and Gas</i>	16.3	20.2	22.9	20.7	20.5
<i>Non-oil and Gas</i>	54.5	66.8	80.6	92.5	100.8
2. Imports, f.o.b.	-50.6	-69.5	-73.9	-83.0	-91.9
<i>Of which: Oil and Gas</i>	-11.2	-16.0	-16.2	-14.3	-16.2
<i>Non-oil and Gas</i>	-39.5	-53.4	-57.7	-68.7	-75.7
B. Services, Net	-8.8	-9.1	-10.1	-11.2	-12.2
C. Income, Net	-10.9	-12.9	-14.5	-16.0	-15.7
D. Current Transfers, Net	1.1	4.8	4.9	5.1	5.3
II. Capital and Financial Account	2.5	-0.6	3.0	4.4	0.0
A. Capital Account	0.0	0.3	0.3	0.4	0.2
B. Financial Account	2.5	-0.9	2.7	4.0	-0.2
1. Direct Investment, net	-1.5	5.3	3.3	2.8	4.0
2. Portfolio Investment, net	4.4	4.2	4.1	8.1	8.1
3. Other Investment	-0.3	-10.4	-4.7	-6.8	-12.3
Non-financial Public Sector	-2.7	-0.8	-2.2	-1.7	-2.1
Banking Sector	0.4	-1.3	0.4	1.1	1.2
Corporate Sector	0.1	1.0	-0.8	1.1	1.2
Other 1/	1.8	-9.3	-2.1	-7.3	-12.5
III. Total (I+II)	4.1	-0.3	12.9	12.4	6.8
IV. Errors and Omissions	-3.1	-0.2	3.0	0.0	0.0
V. Overall Balance (III+IV)	1.0	-0.5	15.9	12.4	6.8
VI. Reserves and Related Items	-1.0	0.5	-15.9	-12.4	-6.8
Changes in Reserve Assets	0.0	1.6	-7.9	-12.4	-6.8
<i>Of which: Transactions</i>	0.9	1.6	-7.9	-12.4	-6.8
Use of Fund Credit and Loans	-1.0	-1.1	-8.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0
Repurchases	-1.0	-1.1	-8.0	0.0	0.0
Memorandum items:					
Reserve Assets Position (eop)	36.3	34.7	42.6	55.0	61.8
in months of imports of goods and services	4.8	4.4	4.8	5.7	5.8
in percent of short-term debt	137	103	154	188	198
Current account (percent of GDP)	0.61	0.1	2.7	1.9	1.5
Non-oil and gas exports, volume growth	0.4	16.7	13.4	16.0	10.1
Non-oil and gas imports, volume growth	9.9	27.9	5.5	11.1	13.3

1/ Includes unrecorded capital flows and exceptional financing.

Sources: Bank Indonesia, Fund staff estimates.

Table 5. Indonesia: Monetary Survey, 2004-07  
(In trillions of rupiah, unless otherwise indicated, end of period) 1/

	2004	2005	2006			2007	
	Dec. Act.	Dec. Proj.	Mar. Act.	Jun Act.	Sep Act.	Dec. Act.	Dec. Proj.
<b>Monetary Survey</b>							
Net foreign assets (in US\$ billions)	193.1 27.6	218.2 31.2	262.6 37.5	274.2 39.2	293.0 41.9	309.2 44.2	420.1 60.0
Net domestic assets	807.0	930.6	889.2	935.5	956.2	1032.1	1162.7
Net claims on government	499.0	501.8	483.1	491.0	492.7	505.3	551.9
Claims on business sector	587.6	703.4	704.2	729.3	758.6	804.3	937.4
Rupiah claims	501.1	615.6	617.4	636.5	659.5	689.1	822.2
Foreign exchange claims	86.4	87.7	86.8	92.8	99.1	115.2	115.2
Other items (net)	-279.5	-274.5	-298.1	-284.8	-295.1	-277.5	-326.5
Broad money (M2)	1000.2	1148.8	1151.8	1209.7	1249.1	1341.4	1582.8
Rupiah M2	897.9	1014.3	1010.9	1073.4	1116.4	1198.1	1413.8
Currency in circulation	109.3	124.3	112.6	123.8	130.0	151.0	178.2
Deposits	788.7	890.0	898.3	949.6	986.5	1047.1	1235.6
Foreign exchange deposits	102.2	134.5	140.9	136.3	132.7	143.2	169.0
<b>Bank of Indonesia</b>							
Net international reserves	170.8	173.9	213.5	237.8	255.2	274.7	385.1
Net domestic assets 2/	28.6	69.3	20.3	10.0	2.7	22.4	-35.1
Net claims on government	226.6	240.9	219.1	223.6	225.4	263.8	263.7
Claims on business sector	39.6	25.9	25.9	25.9	25.9	25.8	25.8
Claims on DMBs	-101.6	-92.8	-114.3	-146.1	-161.1	-214.4	-281.8
Open market operations	-144.5	-121.2	-142.6	-174.3	-189.1	-242.0	-309.4
Other items (net)	-136.0	-104.7	-110.4	-93.5	-87.5	-52.8	-42.8
Base money	199.4	243.2	233.9	247.7	257.8	297.1	350.0
Currency in circulation	109.3	124.3	112.6	123.8	130.0	151.0	178.2
DMBs	89.7	118.5	120.9	123.7	127.7	146.0	171.7
Nonbank deposits	0.5	0.4	0.3	0.3	0.2	0.1	0.1
<u>Memorandum items:</u>							
NIR of BI (in billions of US\$)	24.4	24.8	30.5	34.0	36.5	39.2	55.0
Money multiplier (rupiah M2)	4.5	4.2	4.3	4.3	4.3	4.0	4.0
Base money velocity 3/	12.0	12.5	13.4	13.2	13.5	11.7	10.7
Rupiah broad money velocity 3/	2.7	3.0	3.1	3.0	3.1	2.9	2.7
Annual percentage change:							
Broad money	7.3	14.9	17.0	17.3	14.7	16.8	18.0
Rupiah broad money	10.0	13.0	14.7	16.3	16.5	18.1	18.0
Base money	20.4	21.9	26.5	24.9	14.9	22.2	17.8
Private sector claims	30.4	19.7	15.6	11.8	9.0	14.4	16.5

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/ Calculated using end-period quarterly GDP, annualized.

Table 6. Indonesia: Summary of Central Government Operations, 2005–2008

	2005	2006	2007		2008
	Act.	Est.	Budget	Staff Proj.	Staff Proj.
	(In trillions of rupiah)				
Revenues and grants	495.4	634.0	723.0	665.0	720.6
Oil and gas revenues	138.7	201.3	181.1	162.8	176.1
Non-oil and gas revenues	355.4	430.9	539.2	499.7	543.4
Tax revenues	311.8	365.9	468.2	428.7	481.3
Nontax revenues 1/	43.6	65.0	71.0	71.0	62.1
Grants	1.3	1.9	2.7	2.5	1.1
Expenditure and net lending	503.8	667.5	763.6	731.1	796.0
Central government expenditure	369.0	440.4	504.7	474.4	540.6
Current expenditure	306.6	338.1	380.2	354.3	397.1
Personnel	55.6	72.9	101.2	93.1	112.6
Subsidies	120.7	107.4	103.0	95.3	114.4
of which fuel subsidies	95.7	64.2	61.8	50.8	64.5
Interest	67.7	79.0	85.1	83.1	77.4
External 2/	24.2	24.1	26.7	24.1	23.7
Domestic	43.5	54.9	58.4	59.1	53.7
Other	62.6	78.8	90.9	82.8	92.8
Development expenditure 3/	62.4	102.3	124.5	120.1	143.5
Transfers to regions	150.5	226.4	258.9	256.7	255.4
Overall balance 3/	-8.4	-33.5	-40.6	-66.1	-75.4
Financing	8.5	33.5	40.6	66.1	75.4
Domestic	-17.4	34.4	36.8	69.1	84.1
Bank financing	-16.2	15.8	13.1	13.0	0.0
Net issuance of government securities	-2.1	17.5	22.2	56.0	83.3
Recovery of bank assets	6.1	2.7	1.5	0.0	0.0
Privatization of nonfinancial assets	0.0	0.4	2.0	2.1	2.8
Other 4/	-5.2	-2.0	-2.0	-2.0	-2.0
External	25.9	-0.9	3.8	-3.0	-8.7
	(In percent of GDP)				
Revenues and grants	17.8	19.0	20.5	17.7	17.1
Oil and gas revenues	5.0	6.0	5.1	4.3	4.2
Non-oil and gas revenues	12.8	12.9	15.3	13.3	12.9
Tax revenues	11.2	11.0	13.3	11.4	11.4
Nontax revenues 1/	1.6	1.9	2.0	1.9	1.5
Grants	0.0	0.1	0.1	0.1	0.0
Expenditure and net lending	18.1	20.0	21.6	19.5	18.9
Current expenditure	11.0	10.1	10.8	9.4	9.4
Personnel	2.0	2.2	2.9	2.5	2.7
Subsidies	4.3	3.2	2.9	2.5	2.7
of which fuel subsidies	3.4	1.9	1.8	1.4	1.5
Interest 2/	2.4	2.4	2.4	2.2	1.8
Other	2.2	2.4	2.6	2.2	2.2
Development expenditure 3/	2.2	3.1	3.5	3.2	3.4
Transfers to regions	5.4	6.8	7.3	6.8	6.1
Overall balance 3/	-0.3	-1.0	-1.1	-1.8	-1.8
Financing	0.3	1.0	1.1	1.8	1.8
Domestic	-0.6	1.0	1.0	1.8	2.0
External	0.9	0.0	0.1	-0.1	-0.2
Memorandum items:					
Primary balance	2.1	1.4	1.3	0.5	0.0
General government balance	0.3	-0.1	...	-1.4	-2.0
Non-oil primary balance	-2.9	-4.7	-3.9	-3.9	-4.1
Crude oil price (US \$ per barrel)	51.8	63.9	63.0	60.3	64.3
Oil production (mbpd)	0.999	0.956	1.000	0.956	0.956

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/ From 2005 onwards, comprises capital spending and social assistance spending.

4/ Includes capitalization of deposit insurance company in 2005.

Table 7. Indonesia: Selected Vulnerability Indicators, 2003–07

	2003	2004	2005	2006 1/	2007 1/	Latest observation
<b>Key Economic and Market Indicators</b>						
Real GDP growth (in percent)	4.8	5.0	5.7	5.5	6.0	Mar-07
CPI inflation (in percent)	5.2	6.4	17.1	6.6	6.0	May-07
Short-term (ST) interest rate (in percent)	8.3	7.4	12.8	9.8	8.5	Jun-07
EMBI secondary market spread (bps, end of period)		341	237	171	151	Jun-07
Exchange rate NC/US\$ (end of period)	8,425	9,285	9,830	8,990	9,080	Jun-07
<b>External Sector</b>						
Exchange rate regime		Managed Float				
Current account balance (percent of GDP)	3.5	0.6	0.1	2.7	...	Dec-06
Net FDI inflows (percent of GDP)	-0.3	-0.6	1.8	0.9	...	Dec-06
Exports (percentage change of US\$ value, GNFS)	5.3	19.7	20.7	15.1	...	Dec-06
Real effective exchange rate (End, period; Jan. 2000=100)	119.8	109.2	124.6	134.5	140.1	May-06
Gross international reserves (GIR) in US\$ billion	36.3	36.3	34.7	42.6	50.8	Jun-07
GIR in percent of ST debt at remaining maturity (RM)	134.5	137.4	103.0	153.7	...	Dec-06
Total gross external debt (ED) in percent of GDP	57.7	53.5	46.6	36.6	...	Dec-06
o/w ST external debt (original maturity, in percent of total ED)	1.7	3.0	5.9	5.3	...	Dec-06
ED of domestic private sector (in percent of total ED)	40.2	41.0	43.8	50.0	...	Dec-06
ED to foreign official sector (in percent of total ED)	57.8	55.3	51.5	44.5	...	Dec-06
Total gross external debt in percent of exports of GNFS	195.8	166.0	134.0	116.0	...	Dec-06
Gross external financing requirement (in US\$ billion) 2/	19.8	22.1	24.3	19.2	...	Dec-06
<b>Public Sector (PS) 3/</b>						
Overall balance (percent of GDP)	-2.0	-1.4	-0.3	-1.0	...	Dec-06
Primary balance (percent of GDP)	1.6	1.3	2.1	1.4	...	Dec-06
Gross PS financing requirement (in percent of GDP) 4/	8.3	4.5	2.4	3.1	...	Dec-06
Public sector gross debt (PSGD, in percent of GDP)	58.3	55.2	45.6	38.6	...	Dec-06
o/w Exposed to rollover risk (in percent of total PSGD) 5/	7.0	5.7	4.3	6.0	...	Dec-06
Exposed to exchange rate risk (in percent of total PSGD) 6/	47.3	50.9	51.1	46.1	...	Dec-06
Exposed to interest rate risk (in percent of total PSGD) 7/	18.6	17.4	16.6	15.7	...	Dec-06
<b>Financial Sector (FS)</b>						
Capital adequacy ratio (in percent)	19.4	19.4	19.3	21.3	22.1	Mar-07
NPLs in percent of total loans 8/	6.8	4.5	7.6	6.1	6.0	Mar-07
Provisions in percent of NPLs	146.5	158.7	82.2	99.7	105.6	Mar-07
Return on assets (in percent)	2.6	3.5	2.6	2.6	2.7	Mar-07
Return on equity (in percent)	25.3	37.1	32.3	33.2	35.5	Mar-07
FX deposits (in percent of total deposits)	16.6	11.5	13.1	15.5	15.5	Mar-07
FX loans (in percent of total loans)	20.4	18.7	16.0	18.8	19.4	Mar-07
Government debt held by banking system (in percent of total assets)	29.5	25.4	21.9	18.5	18.1	Mar-07
Credit to private sector (percent change)	22.1	30.4	19.7	12.8	17.4	Apr-07

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/ Short-term 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/ Domestic debt at variable interest rates. Information on external debt is not available.

8/ Loans are gross of any allowance for losses.



Table 8. Indonesia: Medium-Term Macroeconomic Framework, 2005–12

	2005	2006	2007	2008	2009	2010	2011	2012
	Act.				Proj.			
Real GDP (percent change)	5.7	5.5	6.0	6.3	6.5	6.7	6.7	6.7
Domestic demand	5.3	3.3	5.2	7.5	7.7	7.8	9.3	9.4
<i>Of which:</i>								
Private consumption	4.0	3.2	4.6	4.6	5.3	5.7	6.7	6.7
Gross fixed investment	10.8	2.9	9.0	11.9	11.8	12.6	11.5	11.7
Change in stocks 1/	-0.4	-0.3	-0.8	0.7	0.4	0.1	1.1	1.3
Net exports 1/	1.1	1.4	1.3	-0.3	-0.4	-0.3	-1.8	-2.1
Statistical discrepancy 1/	-0.3	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Saving and investment (in percent of GDP)								
Gross investment 2/	23.5	22.6	22.5	24.3	25.9	27.3	29.5	31.8
Gross national saving	23.6	25.3	24.4	25.8	26.9	27.6	28.9	30.4
Foreign saving	-0.1	-2.7	-1.9	-1.5	-1.0	-0.3	0.5	1.4
Prices (12-month percent change)								
Consumer prices (end period)	17.1	6.6	6.3	5.5	4.0	3.0	3.0	3.0
Consumer prices (period average)	10.5	13.1	6.2	5.4	4.9	3.2	3.0	3.0
Public finances (in percent of GDP)								
Central government revenue	17.8	19.0	17.7	17.1	17.0	17.1	16.9	16.6
Central government expenditure	18.1	20.0	19.5	18.9	18.5	18.2	17.7	17.2
Central government balance	-0.3	-1.0	-1.8	-1.8	-1.5	-1.1	-0.8	-0.6
Primary balance	2.1	1.4	0.5	0.0	0.1	0.2	0.2	0.3
Central government debt	45.6	38.6	35.7	33.9	31.9	30.0	28.1	26.1
Balance of Payments (in billions of US\$)								
Oil and gas (net)	4.2	6.8	6.4	4.3	3.9	4.5	3.0	1.6
Non-oil exports (f.o.b)	66.8	80.6	92.5	100.8	109.4	119.1	130.3	142.5
Non-oil imports (f.o.b)	-53.4	-57.7	-68.7	-75.7	-84.0	-95.8	-108.8	-123.8
Current account balance	0.3	9.9	8.0	6.8	5.0	1.6	-3.3	-9.7
Direct foreign investment	5.3	3.3	2.8	4.0	4.9	6.2	6.6	7.8
Overall balance	-0.5	15.9	12.4	6.8	7.0	6.4	7.3	8.0
Gross reserves								
In billions of US dollars (end period)	34.7	42.6	55.0	61.8	68.8	75.2	82.5	90.5
In months of imports	4.4	4.8	5.7	5.8	5.8	5.7	5.6	5.5
As a percent of short-term debt 3/	103.0	153.7	187.8	197.8	209.2	216.4	224.5	232.7
Total external debt								
In billions of US dollars	133.8	133.4	130.5	132.1	133.1	132.8	131.7	129.4
In percent of GDP	46.6	36.6	31.2	28.6	26.2	23.9	21.5	19.3
<u>Memorandum items:</u>								
Oil production (000bcpd)	999	956	956	956	1,004	1,104	1,104	1,104
Indonesian oil price (US\$/bbl)	51.8	63.9	60.3	64.3	64.1	63.8	63.3	62.8
Nominal GDP (in billions of US\$)	287	364	418	462	507	556	612	672

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

1/ Contribution to GDP growth (percentage points).

2/ Includes changes in stocks. Computed on real basis.

3/ Short-term debt on a remaining maturity basis.

**Table 9. Indonesia: Progress on the Government's Structural Policy Agenda**

<b>Area</b>	<b>Measure</b>	<b>Status</b>
Investment climate	New Investment Law (equal treatment of foreign and domestic investors, streamlining procedures for starting business)	Approved by Parliament (March 2007). Regulation which include a "negative list" are currently under preparation.
	Improve customs	Customs Law (combating smuggling, strengthening audit functions, and stronger penalties) was approved by Parliament in October 2006. Simplification of procedures ongoing.
	Modifications to the Labor Law	Stalled after labor protests; instead government is preparing regulations aimed at changing severance pay to ease the burden on employers while providing cushion to those unemployed.
Financial sector	Facilitate resolution of non-performing loans at state-owned banks	Presidential decree allowing haircuts issued (October 2006); oversight committee established (February 2007).
	Financial Safety Net	Gradual shift from blanket guarantee to limited deposit insurance completed (March 2007).
	Development of securities markets	Primary dealer system for government securities introduced (December 2006). First T-Bill issuance in June 2007.
Infrastructure	PPP framework and risk management unit	Risk Management Unit (RMU) set up at MoF and PPP framework in place.
Fiscal reforms	Tax Laws (Tax Administration; Income Tax; VAT)	Law on General Tax Rules and Procedures approved (June 2007). Other laws submitted to Parliament and expected to be passed later this year.
	Improving tax administration	New organizational structure for headquarters; modernization of medium tax payer office completed. Work ongoing regarding small tax payer offices, audits, and VAT streamlining.
	Reorganization of MoF	Fiscal policy office, debt unit, and directorates for monitoring regional governments and public enterprises have been set up.
	Treasury reforms	Regulations to implement State Treasury Law under discussions between MoF and BI. Outstanding issues are: completion of the BI-MOF negotiations on remuneration of treasury deposits and effective coordination of BI and treasury operations, and achieving a rapid consolidation of all government funds under treasury oversight.
	Budget reforms	A medium-term fiscal framework (MTFF) and a fiscal risk statement to be introduced with the 2008 budget. Procurement procedures are being reviewed.

## **APPENDIX I. INDONESIA: MEDIUM-TERM OUTLOOK UNDER ALTERNATIVE ASSUMPTIONS AND PUBLIC AND EXTERNAL DEBT SUSTAINABILITY**

*This annex compares the medium-term outlook under the baseline with three alternative scenarios based on: (i) a tightening of global liquidity conditions; (ii) stalled structural reforms; and (iii) a global economic slowdown. It also analyzes the impact of several exogenous shocks on the sustainability of public sector debt and external debt.*

### **I. ALTERNATIVE SCENARIOS**

**A: Tightening of global liquidity conditions**, reflected in a widening of bond spreads and a net outflow of portfolio capital of around US\$10 billion during 2008.

**Policy response:** BI is assumed to increase the policy rate by around 300bps relative to the baseline to stem the capital outflow, stabilize the exchange rate, and limit the impact on inflation.

**Projections:** Reserves decline to around 150 percent of short-term debt in 2008 (below the baseline, but comfortably above conventional reserves adequacy measures; see Chart), while the exchange rate depreciates by about 15 percent. With demand hit by higher interest rates and depressed sentiment, GDP growth declines to 4.8 percent. The nominal depreciation boosts inflation to 7 percent, although higher interest rates contain the increase. The current account surplus is higher than under the baseline (Figure 1).

### **B. Lack of progress on the structural agenda**

**Policy response:** The authorities are assumed to relax fiscal and monetary policies to support growth.

**Projections:** In the absence of continued reforms, output growth gradually falls back to 5.0 percent over the medium term, as low investment slows productivity gains. Macroeconomic policy implementation also weakens, as the authorities relax monetary and fiscal policy to stimulate growth. On the fiscal side, the overall central government deficit increases to 3.2 percent of GDP in 2008. However, this expansion still allows the ratio of public debt to GDP to decline. Interest rates are also lower than under the baseline. With a more expansionary monetary and fiscal stance, inflation increases to a little under 7 percent, outside BI's target range for 2008.

**C. Global growth slowdown.** Driven by a sharp slowdown in the US economy, global economic growth declines by just over 2 percentage points relative to the baseline in 2008, while oil and other commodities decline in price, as do both the value and volume of Indonesian exports. Spreads increase modestly due to heightened risk perceptions.

**Policy response:** Interest rates are unchanged relative to the baseline, as output and inflation concerns broadly offset each other. The fiscal deficit narrows slightly as the net effect of the oil price decline is positive (via lower subsidies and transfers to subnational governments as domestic energy prices are assumed unchanged).

**Projections:** Lower exports plus multiplier effects on domestic demand affect GDP growth. With the exchange rate depreciating, inflation picks up to around 6.3 percent, outside BI's target range for 2008. The current account surplus narrows due to lower export receipts. Combined with a modest decline in portfolio inflows, the lower current account surplus leads to a slowdown in reserves accumulation.

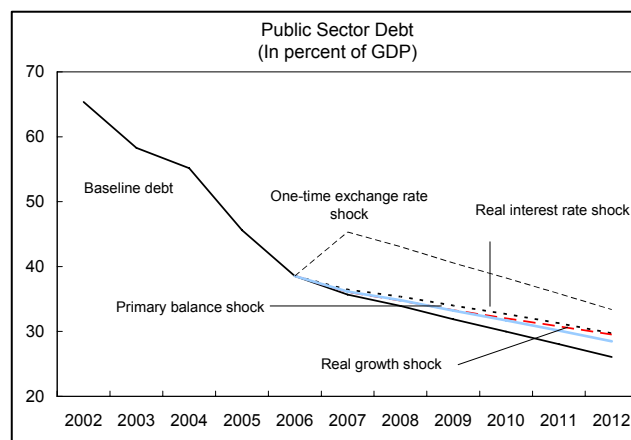
## II. DEBT SUSTAINABILITY ANALYSIS UNDER THE BASELINE SCENARIO

### A. Public Debt

1. **The public sector debt ratio has declined steadily from 65 percent of GDP at end-2002 to an estimated 39 percent at end-2006** (Figure 2). This reflects the government's fiscal consolidation policy, declining interest rates, and growth in real GDP. The share of debt held by foreign creditors (mostly multilateral institutions) has declined to less than 50 percent. This trend is likely to continue as the authorities increasingly tap the domestic bond market.

2. **Under the baseline scenario, public sector debt is expected to decline to around 26 percent of GDP by 2012.** In terms of government revenues, public sector debt will decline from 203 percent to 157 percent over the 2006-12 period. These results are based on the key assumptions underlying the baseline projections for 2007-12, specifically that: (1) real GDP growth rebounds to 6-7 percent; (2) the primary surplus averages around 0.2 percent of GDP; and (3) average nominal interest rates on public debt gradually decline to around 3 percent by the end of the period.

3. **The standard sensitivity analysis shows that the trajectory of the debt ratio is most sensitive to changes in exchange rates or contingent liabilities** (Figure 2). A one-time 30 percent real depreciation of the exchange rate or a 10 percent increase in contingent liabilities immediately raise the debt ratio by around 10 percentage points of GDP, with the impact falling to 7-8 percentage points by 2012. Other macroeconomic shocks have a more limited impact.



## B. External Debt

4. Indonesia's external debt has also declined steadily since the crisis, from over 150 percent of GDP in 1998 to around 37 percent in 2006 (Figure 3). External debt as a percentage of exports has also declined, from 288 percent to 116 percent, over the same period.

5. **External debt dynamics are sustainable under the baseline scenario, with the debt to GDP ratio declining to less than 20 percent by 2012.** The main factors driving these favorable dynamics are: (1) real GDP growth projected to increase to 6-7 percent over the medium term; (2) a projected positive growth-interest rate differential; and (3) an expected increase in non-debt-creating capital inflows.

6. **External debt sustainability is most vulnerable to shocks to the exchange rate.** A one-time 30 percent real exchange rate depreciation would raise the debt ratio by around 20 percentage points in 2007, with the impact declining to around 15 percentage points over the baseline by 2012.

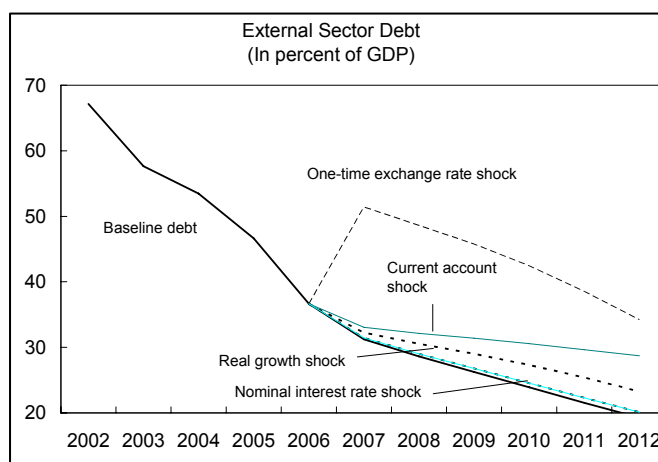
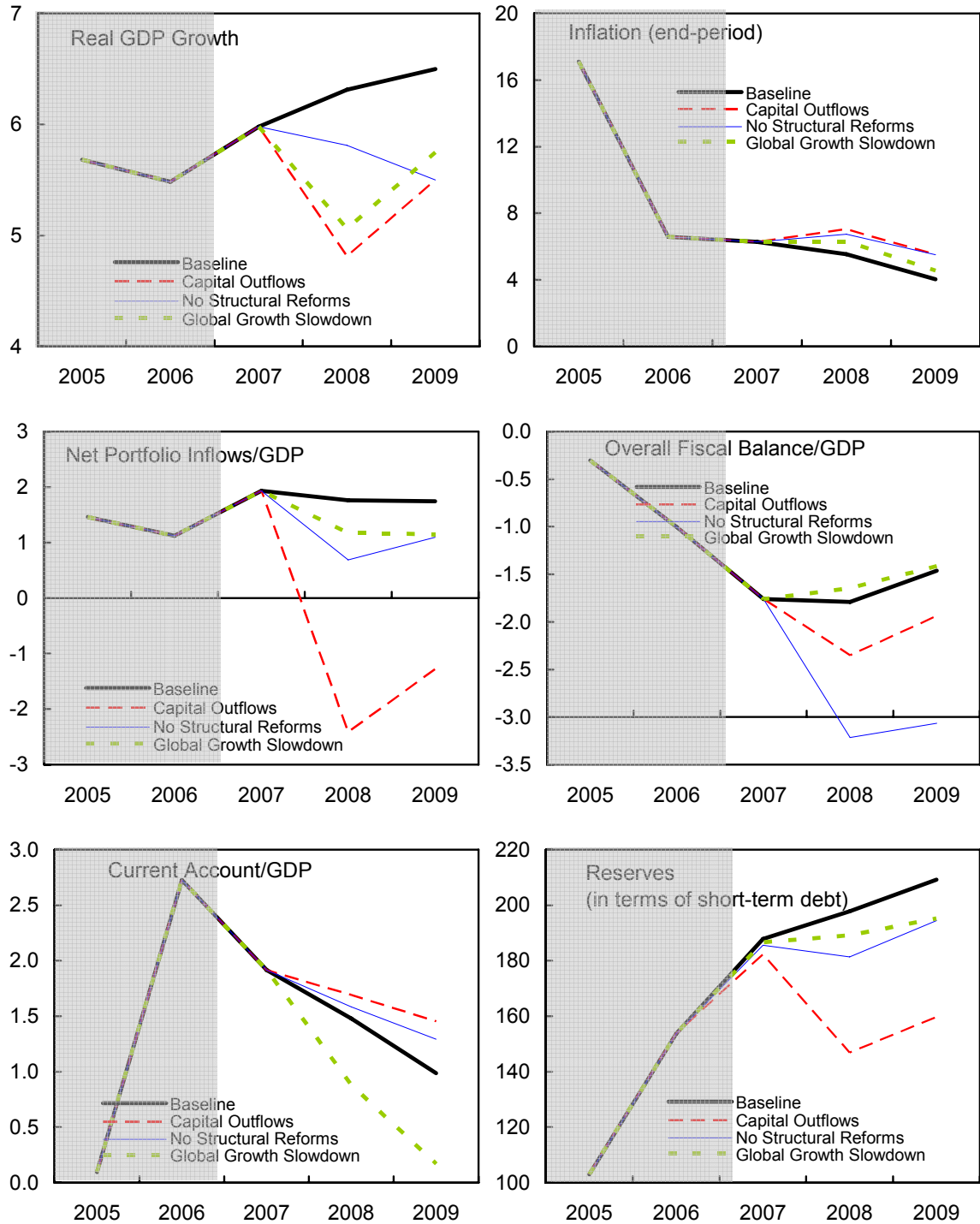
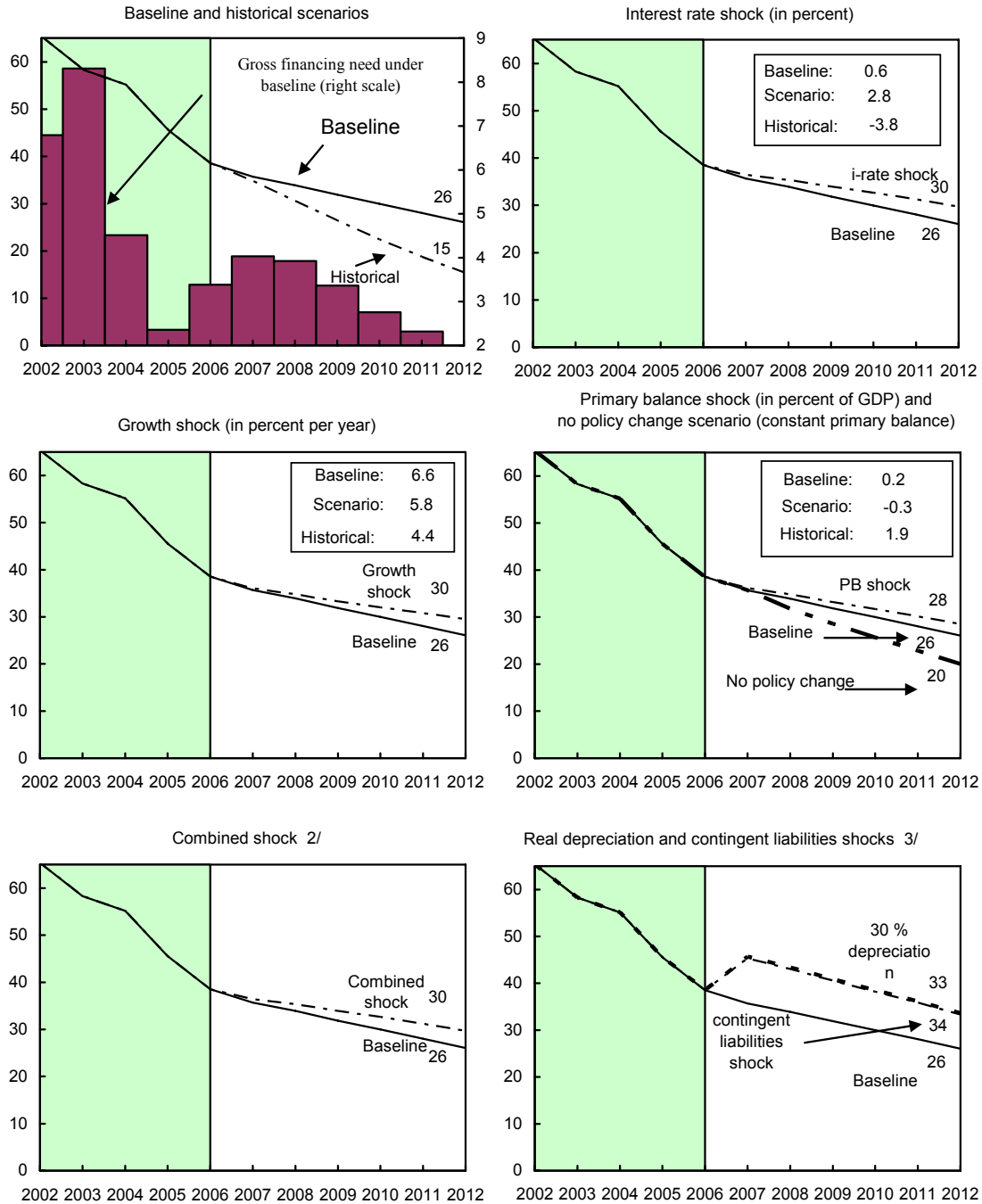


Figure 1. Alternative Scenarios  
(In percent)



Source: CEIC Database and Fund staff estimates.

Figure 2. Indonesia: Public Debt Sustainability: Bound Tests 1/  
(Public debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

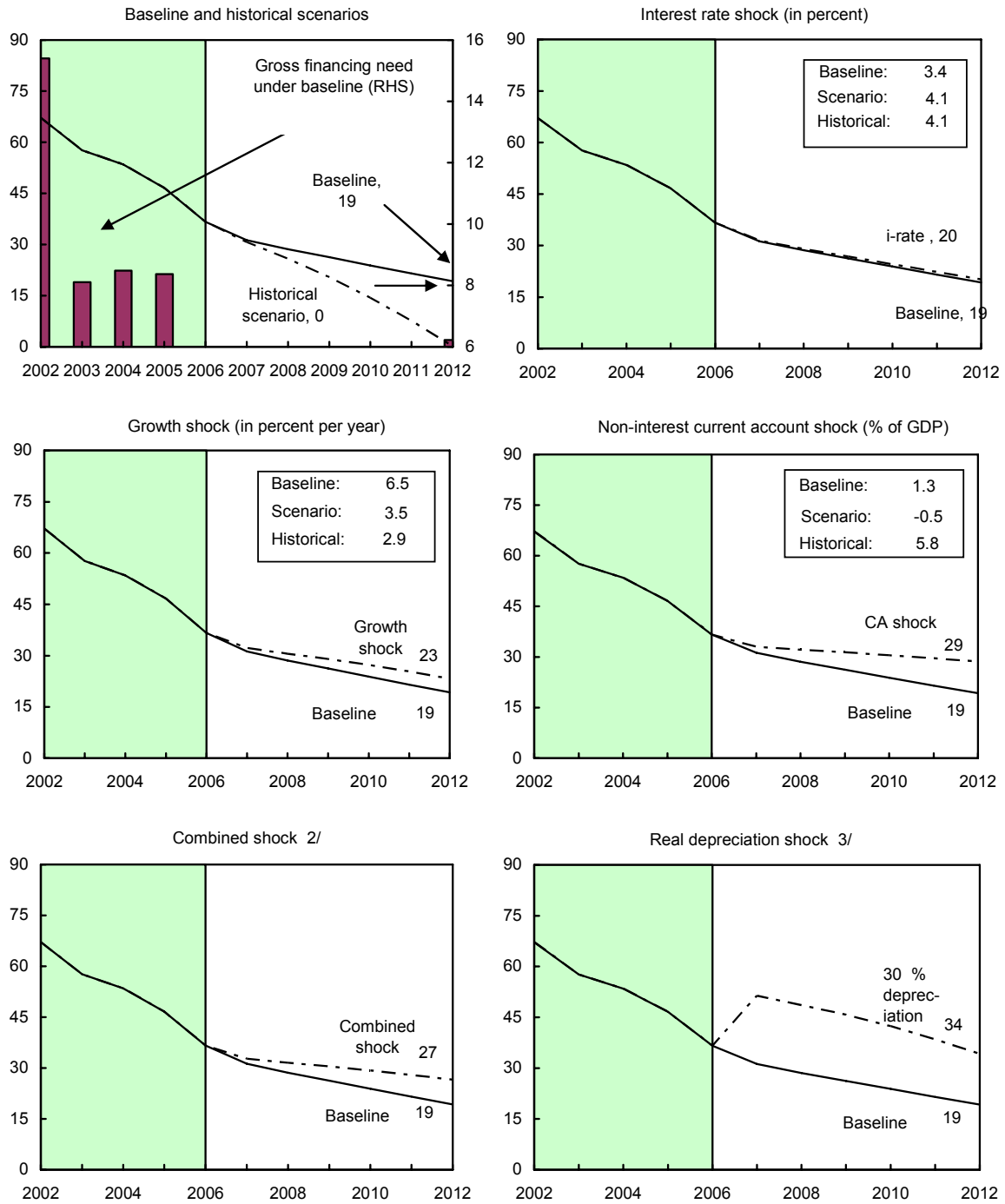
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2007, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

4/ 1998 values for GDP growth and inflation during the crisis are omitted.

Figure 3. Indonesia: External Debt Sustainability: Bound Tests 1/  
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account.

3/ One-time real depreciation of 30 percent occurs in 2007.



Table 1. Indonesia: Public Sector Debt Sustainability Framework, 2002-2012  
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					Debt-stabilizing primary balance 9/	
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011		2012
<b>Baseline: Public sector debt 1/ o/w foreign-currency denominated</b>	65.4	58.3	55.2	45.6	38.6	35.7	33.9	31.9	30.0	28.1	26.1	-1.6
Change in public sector debt	-11.6	-7.1	-3.1	-9.6	-7.0	-2.9	-1.8	-2.0	-1.9	-1.9	-2.0	-2.0
Identified debt-creating flows (4+7+12)	-16.9	-8.3	-2.7	-6.3	-8.2	-2.6	-2.1	-2.1	-1.9	-1.9	-2.0	-2.0
Primary deficit	-3.4	-1.6	-1.3	-2.1	-1.4	-0.5	0.0	-0.1	-0.2	-0.2	-0.3	-0.3
Revenue and grants	16.5	16.7	17.8	17.8	19.0	17.7	17.1	17.0	17.1	16.9	16.6	16.6
Primary (noninterest) expenditure	13.1	15.1	16.4	15.7	17.6	17.2	17.1	16.9	17.0	16.7	16.4	16.4
Automatic debt dynamics 2/	-10.8	-5.0	-0.5	-3.9	-6.7	-2.1	-2.0	-2.0	-1.6	-1.6	-1.7	-1.7
Contribution from interest rate/growth differential 3/	-6.4	-3.4	-3.2	-5.4	-5.0	-2.1	-2.0	-2.0	-1.6	-1.7	-1.7	-1.7
Of which contribution from real interest rate	-3.5	-0.6	-0.6	-2.7	-2.9	0.0	0.0	0.0	0.3	0.2	0.0	0.0
Of which contribution from real GDP growth	-3.0	-2.8	-2.6	-2.7	-2.1	-2.0	-2.0	-2.0	-1.9	-1.8	-1.7	-1.7
Contribution from exchange rate depreciation 4/	-4.4	-1.6	2.6	1.5	-1.7	...	...	...	...	...	...	...
Other identified debt-creating flows	-2.8	-1.7	-0.8	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	-2.8	-1.7	-0.8	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
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	0.0	0.0
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	0.0	0.0
Residual, including asset changes (2-3) 5/	5.3	1.3	-0.4	-3.3	1.2	-0.3	0.3	0.1	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	396.8	349.0	310.5	256.2	203.0	201.6	198.2	187.6	175.1	166.1	156.5	
<b>Gross financing need 6/ in billions of U.S. dollars</b>	6.8	8.3	4.5	2.4	3.4	4.0	3.9	3.4	2.8	2.3	1.7	
Real GDP growth (in percent)	4.5	4.8	5.0	5.7	5.5	6.0	6.3	6.5	6.7	6.7	6.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	-17.3	19.5	16.9	4.7	19.3	3.7	5.2	5.5	7.0	4.9	4.9	
Primary deficit	-3.4	-1.6	-1.3	-2.1	-1.4	-0.5	0.0	-0.1	-0.2	-0.2	-0.3	
<b>A. Alternative scenarios</b>												
A1. No policy change (constant primary balance) in 2005-09						35.7	31.7	28.6	25.6	22.8	20.0	-1.3
A. 2. Scenario with key variables at their historical averages 7/						34.8	30.6	26.4	22.4	18.8	15.4	-1.2
<b>B. Bound Tests</b>												
B1. Real interest rate is at historical average plus one standard deviation						36.4	35.4	34.0	32.7	31.3	29.7	-1.2
B2. Real GDP growth is at historical average minus one standard deviation						36.1	34.8	33.3	32.0	30.8	29.5	-1.6
B3. Primary balance is at historical average minus one standard deviation						36.1	34.8	33.2	31.7	30.1	28.5	-1.8
B4. Combination of B1-B3 using 1/4 standard deviation shocks						36.4	35.3	34.0	32.6	31.2	29.7	-1.4
B5. One time 30 percent real depreciation in 2006 10/						45.3	43.1	40.6	38.2	35.8	33.4	-2.1
B6. 10 percent of GDP increase in other debt-creating flows in 2006						45.7	43.4	40.9	38.5	36.1	33.6	-2.1

1/central government debt (gross debt).

2/ Derived as  $[(r - \pi(1+g) - g + \alpha\epsilon(1+r))/(1+g+\pi+gr)]$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $\alpha$  = share of foreign-currency denominated debt; and  $\epsilon$  = 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  $\alpha\epsilon(1+r)$ .

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/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP. 1998 values for GDP growth and inflation during the crisis are omitted.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ 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.



INTERNATIONAL MONETARY FUND

INDONESIA

**Staff report for the 2007 Article IV Consultation—Informational Annexes**

Prepared by Asia and Pacific Department

June 26, 2007

	Contents	Page
I.	Fund Relations .....	2
II.	Relations with the World Bank Group.....	6
III.	Relations with the Asian Development Bank .....	8
IV.	Statistical Issues.....	9

**ANNEX I. INDONESIA: FUND RELATIONS**  
(As of May 31, 2007)

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

<b>II. General Resources Account</b>	<u>SDR Millions</u>	<u>Percent of Quota</u>
Quota	2,079.30	100.00
Fund holdings of currency	1933.80	93.00
Reserve position in Fund	145.50	7.00

<b>III. SDR Department</b>	<u>SDR Millions</u>	<u>Percent of Allocation</u>
Net cumulative allocation	238.96	100.00
Holdings	9.05	3.79

**IV. Outstanding Purchases and Loans** None

**V. Financial Arrangements**

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved</u> (SDR Millions)	<u>Amount Drawn</u> (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

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Principal					
Charges/Interest	<u>4.93</u>	<u>9.81</u>	<u>9.80</u>	<u>9.81</u>	<u>9.81</u>
Total	<u>4.93</u>	<u>9.81</u>	<u>9.80</u>	<u>9.81</u>	<u>9.81</u>

**VII. Exchange Arrangements**

The rupiah has floated since August 14, 1997. The market exchange rate was Rp **9,080** per U.S. dollar on **June 26, 2007**. 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 (IMF Country Report No. 06/319) was discussed by the Executive Board on July 31, 2006.

**ANNEX II. INDONESIA: WORLD BANK RELATIONS**  
(As of June 18, 2007)

*For questions relating to this annex, contact Bill Wallace, at (+62-21) 5299-3000 or Preeti Ahuja at 202 473-1657*

**Indonesia Country Assistance Strategy (CAS)**

**The World Bank's CAS** for Indonesia was extended by one year to FY08 (from July 2007 to June 2008) to coincide with Indonesia's scheduled graduation from IDA funding. The Bank Group's strategy remains strongly aligned to that of the government and the CAS program remains relevant. The CAS continues to address the two fundamental problems impeding rapid poverty reduction: (i) a weak investment climate and (ii) the lack of quality service delivery to the poor. Both of these challenges, in turn, arise from the same fundamental cause—weak governance, which is the overarching focus of the CAS. In addition, the significant expansion of the Bank program and quick redeployment of resources to post-disaster efforts (notably in Aceh and Yogyakarta/Central Java) in the context of perennial natural disasters call for a greater emphasis on natural disaster management within the CAS. Lastly, given the good track record of reform, continued financing need, strong macroeconomic indicators, and improved creditworthiness, the CAS supports the request by government to recalibrate assistance toward more program lending vis-à-vis the on-going Development Policy Lending (DPL) program and the Infrastructure DPL currently under preparation. Moving forward, as the Bank commences preparation of the next CAS, close coordination with the IMF is expected across key areas of the policy dialogue.

**World Bank Engagement: Selected Highlights**

**Improving the climate for high quality investment:** The DPL program, coupled with targeted projects, a large Analytic and Advisory Activities (AAA) program, and International Finance Corporation (IFC) interventions are supporting policy and institutional reforms for higher growth. Reforms supported by DPLs have helped consolidate macroeconomic stability, a key concern among investors; enhanced competitiveness of the financial sector; streamlined procedures for business start-up, trade, and customs; improved tax administration; and promoted small- and medium-scale enterprises (SMEs). A robust dialogue on infrastructure provision is addressing a key constraint to growth. Key issues being addressed through technical assistance (TA) include regulatory reforms, new legislation, risk management, and public private partnerships (PPP). A strategy to mobilize long-term private financing through nonbank financial institutions (NBFIs) has been developed and a project establishing infrastructure and guarantee funds is currently under preparation. The IFC has complemented Bank work in several of these areas, including local financing of infrastructure, business licensing, and SME development. Bank Group activities have focused on the rural investment climate, with a set of projects to help modernize services to farmers and fishing communities and to address related issues on water management, agricultural services, agribusiness, land titling, irrigation, and coral reef protection.

**Making Service Delivery Responsive to the Poor:** Bank efforts have strongly supported improvements in quality and relevance of, and equitable access to education, water and sanitation (WSS), and health services. Activities have focused on strengthening capacity and systems, and changing the way services are managed and delivered top-to-bottom to improve results. Financial support in education targets the full range of issues from early childhood development (ECD) to tertiary education. The Bank has supported an education sector review and the development of a comprehensive national medium-term strategy (RENSTRA) covering all levels of education, formal and non-formal. A series of Provincial Health Projects (PHPs) were designed to help clarify the roles of different levels of government. Interventions have also aimed at district health administrations' capacities and making service planning and delivery more participatory and accountable. The focus is on areas where indicators lag behind neighboring countries: maternal and child health, and nutrition. CDD approaches in WSS and the GEG program seek to inculcate a more sanitary and healthier environment. The Bank is currently involved in the government's National Program of Community Empowerment (PNPM) and a Conditional Cash Transfer Program. Several of these service delivery efforts are supported by a new policy pillar within the DPL program, including teacher certification, program assessments, and multi-year careover of community spending.

**Addressing the Core Issue of Governance:** The World Bank recognizes governance as the most critical cross-sectoral issue and, hence, has positioned it at the core of the Bank's work program. The DPL program and particularly the Government Financial Management and Revenue Administration Program (GFMRAP) are designed to improve public administration, particularly in the area of public financial management. Along with well targeted interventions, such as Public Expenditure Reviews, trust funded programs supporting corruption prevention and civil service reform, the relatively large CDD portfolio are resulting in progress toward strengthening accountability, functional streamlining and modernization of processes both at the national, subnational, and community levels. Via the multi-donor Decentralization Support Facility (DSF), the Bank works with other donors to improved decentralization and donor effectiveness.

**Program for the Recovery of Aceh and Nias:** The Bank is deeply engaged in the recovery of Aceh and Nias, with a focus on post-tsunami reconstruction, institution building, analytical support and monitoring of progress. Using all its available instruments over the past two and half years, the Bank mobilized an Aceh reconstruction program substantial in scope and objectives. The Bank has played a vital role in putting in place key elements for the management of the reconstruction effort and coordinating the response of the international community. Immediately after the tsunami in partnership with the Netherlands, the Bank established a multi-donor office in Banda Aceh, and made the facilities available to all donors working in Aceh. With a relatively modest Bank contribution of US\$25 million in grant resources from IBRD net income, the Bank's country team has leveraged and mobilized significant donor support. The Bank has mobilized over US\$660 million (commitment) for reconstruction, including the Multi-Donor Fund (MDF) with 15 donors (in

the amount of some US\$547 million in grants), restructured ongoing community driven (CDD) operations and added Aceh focused activities in new IDA projects, donor co-financing of IDA projects and JSDF grants. The community based housing approach deployed by the Bank in Aceh under the MDF housing project, has been indicated by the Government of Indonesia as the model for the massive housing reconstruction program in Yogyakarta and Central Java, following the May 2006 earthquake. At government's request, the Bank has established the Multi-donor Java reconstruction Fund (JRF), primarily supporting housing reconstruction with total value of pledge US\$79 million. Given Indonesia's geographic location and vulnerability to natural disasters, Disaster Management has become an important component of the Bank's country strategy.

**New Lending Operations:** As of March 2007, the Bank's active portfolio comprised 31 projects with a total net commitment of US\$2.6 billion. In FY07, in total, 6 projects are likely to be delivered with total lending volume at US\$1.2 billion. A third Development Policy Loan (DPL3) was approved for a loan amount of US\$600 million in December 2006. DPL3 also enjoyed financial support from Japan and AsDB. Others include Strategic Roads Infrastructure (US\$208 million), FEATA (US\$92 million), KDP additional financing (US\$123 million), UPP additional financing (US\$136 million) and Better Employment and Redeployment (BERMUTU)(US\$86 million). In addition, 5 Aceh and Nias MDF projects (US\$197 million) and 3 projects under JRF (US\$67 million) were approved.

### **Analytic and Advisory Activities**

There is sustained Bank engagement in policy dialogue with GOI, on the direction and substance of its economic, structural, and institutional reform agenda. The AAA program has been organized around five "breakthrough" themes: (1) investment climate, (2) reducing poverty, (3) improving decentralized service delivery, (4) improving governance and the more recently introduced, and (5) progress and constraints in the recovery of Aceh and Nias. The "flagship reports" in related areas, the stand-alone policy notes and think pieces, and day to day informal dialogue between Bank staff and government counterparts, are providing support to GOI in making informed policy choices and in defining the shape of supporting Bank programs. In FY07, as of end-April, 7 reports were delivered and a few more reports are expected by end of June. These include, for example, Poverty Assessment, Public Expenditure Reviews and NBFI Study.

**ANNEX III. INDONESIA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK<sup>1</sup>**  
**(As of June 20, 2007)**

**Asian Development Bank (ADB) cumulative loans to Indonesia exceeded \$21.5 billion at end-December 2006.** In 2006, the ADB approved a total of \$784.8 million or 10.2 percent of the total loans approved by the institution for the year. The assistance provided financing mainly for two programs to strengthen macroeconomic management, governance and investment climate and to accelerate infrastructure development in Indonesia. It also covered project loans for aquaculture development for food security, private and public madrasah education at the primary, junior and secondary levels, the setting up an infrastructure project development facility, and a \$75 million loan through ADB's private sector window for the South Sumatra to West Java (SSWJ) Phase II Gas Pipeline project as part of a larger \$652.5 million project. ADB also arranged a \$125 million B loan from commercial lenders for the SSWJ Project. ADB also approved a \$10 million grant to Indonesia following the devastating earthquake in Central Java and Yogyakarta. During 2006, the ADB continued its support for the post-tsunami reconstruction in Aceh and Nias through its grant-financed Earthquake and Tsunami Emergency Support Project.

In 2006 the ADB Board endorsed the Indonesia Country Strategy and Program (CSP) 2006–09. The CSP aims to help the government achieve higher levels of pro-poor sustainable growth and to enhance social development, with a key thematic focus on governance and capacity development in all operations. Five areas of engagement were derived to address the main constraints to development: improved infrastructure and infrastructure services, deepened financial sector, improved decentralization, accelerated MDG achievement, and strengthened environment and natural resources management. A public sector lending and non-lending program has been agreed round these areas of engagement.

Between 1967 and 2006, ADB also provided 484 Technical Assistance grants to Indonesia amounting to \$247.5 million, or 8.2 percent of the total number of TA grants approved during this period. The TA grants were financed from ADB's Technical Assistance Special Fund, the Japan Special Fund, and other sources. In 2006, seven TA grants amounting to \$7.1 million was approved, and represented 2.9 percent of total TA grants approved by ADB during the year.

Table 1. Loan Approvals and Disbursements to Indonesia<sup>1</sup>  
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Loan approvals	1,108.8	1,836.0	1,020.0	800.0	500.0	767.2	261.6	225.0	1,145.69	784.8
Loan disbursement	676.6	1,079.0	1,329.4	748.4	686.0	1,000.5	442.9	593.5	1,014.99	1,025.88

Source: Asian Development Bank, *2006 Annual Report*, and ADB staff.

<sup>1</sup>Include loans to private sector without government guarantee but excludes equity investments.

<sup>1</sup> Prepared by ADB staff.



Table 2. Cumulative Lending to Indonesia  
(As of December 31, 2006)

<b>Sector</b>	<b>No of Loans</b>	<b>\$ Million</b>	<b>In percent</b>
Social infrastructure	41	3,225.4	15.0
Agriculture and natural resources	101	4,189.9	19.5
Energy	32	3,856.1	17.9
Transport and communication	33	2,713.9	12.6
Finance	17	3,261.1	15.2
Multisector	35	2,372.1	11.0
Industry	14	665.7	3.1
Others	8	1,229.2	5.7
<b>Total</b>	<b>285</b>	<b>21,513.3</b>	<b>100.0</b>

Source: Asian Development Bank, *2006 Annual Report*, and ADB staff.

## ANNEX IV. INDONESIA: STATISTICAL ISSUES<sup>2</sup>

1. Indonesia has been a subscriber to the Special Data Dissemination Standard (SDDS) since September 1996, observing most of the SDDS requirements. Exceptions include the currency composition in the reserve template in the first quarter of 2007, 2005 general government operation data, and timeliness in the production index data due to short delays. Indonesia's macroeconomic statistics and statistical base are broadly adequate to conduct effective surveillance.

### Real Sector

2. Annual national accounts data are based on a 2000 base year. Quarterly GDP data are published in a timely manner for both expenditure and production sides. 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. There are inconsistencies with Bank Indonesia (BI) in imports and exports; and, possibly with the Ministry of Finance (MoF) with regard to local government figures. The five-yearly input-output tables remove the statistical discrepancy, but there are large discrepancies in the intervening years. 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; (v) expedited conversion to the *1993 System of National Accounts*; and (vi) enhancing the convergence exercise on trade data with BI.

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. Available government finance data suffer from a number of weaknesses, in terms of classification, coverage, and timeliness. Data on budgetary central government were available until recently with a one-month lag, but subnational (provincial and local) government data are available only with a lag of two years, and the quality of this data is variable. Problems in budget and accounting systems have been compounded by the recent decentralization initiatives, which have shifted substantial resources to the subnational

---

<sup>2</sup> 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.

governments. At the same time, substantial efforts are in train, and significant progress has been made, on a wide front, to overcome these problems, ranging from the planned adoption of advanced accounting and statistical standards, to the introduction of best practice budget management processes, and development of computerized financial management information systems.

5. Against this background, the MoF and the Ministry of Home Affairs are committed to keeping the requirements of fiscal statistics at the forefront of ongoing fiscal reforms, so as to make better statistical monitoring one of the deliverables of the current efforts. Reflecting the close link between this major reform process and its impact on data reporting, it should be noted that the one-month lag on central government reporting lengthened significantly, but temporarily, in the course of 2007 as a new treasury system was put in place; this should reverse itself as the reform is fully implemented. The coverage and timeliness of public debt statistics is generally adequate; however, only limited information on contingent liabilities is available. The new expenditure classification introduced in the 2005 budget, is generally consistent with the *Government Finance Statistics Manual 2001 (GFSM 2001)* on functional codes and classification, although the data are compiled on a cash basis.

6. The authorities have committed to full adoption of the *GFSM 2001* standards. To this end, the Fund staff has recommended in the short term: (i) establishment of a register of all extrabudgetary units to improve the coverage of central government activity; and (ii) inclusion of the economic codes consistent with the *GFSM 2001* in the chart of account to ensure that general government units report in a statistically meaningful way all transactions and balances over which they exert control. Over the medium-term, priority should be given to (i) seizing the opportunity offered by the two new subnational fiscal reform efforts<sup>3</sup> to simultaneously establish the underlying reporting arrangements to obtain timely preliminary data for local government statistics; and (ii) to develop *GFSM 2001* operating statements, statements of sources and uses of cash, and partial balance sheets, all of which should be published on the MoF websites. The latter should facilitate to the adoption of a full accrual accounting basis for all budget transactions.

### **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—an agency that supervises some of the nonbank financial institutions. 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.

---

<sup>3</sup> Government Financial Management and Revenue Administration (GRMRAP) and Local Government Finance and Governance Reform (LGFR) projects.

8. To strengthen monetary statistics, STA missions have recommended: (i) collection of source data on mutual funds in a format that meets statistical requirements; (ii) expansion of the coverage of the monetary statistics to include mutual funds; and (iii) harmonization of the reported interbank positions between the BI and commercial banks

### **Balance of Payments**

9. Trade data are affected by shortcomings. While customs sources utilized by BI are considered generally reliable, coverage of merchandise trade flows is insufficient. Also, 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. Data on services suffer from outdated surveys and weak methodology. 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.

10. 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 companies that have foreign equity 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).

11. 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, 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.

### **International Investment Position**

12. 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 an 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 received by the private sector from external creditors.

**Indonesia: Table of Common Indicators Required for Surveillance**  
(As of June 19, 2007)

	Date of latest observation	Date received	Frequency of Data <sup>5</sup>	Frequency of Reporting <sup>5</sup>	Frequency of publication <sup>5</sup>	Memo Items:	
						Data Quality – Methodological soundness <sup>7</sup>	Data Quality Accuracy and reliability <sup>8</sup>
Exchange Rates	6/19/07	6/19/07	D	D	W/M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	6/18/07	6/19/07	D	D	W/M		
Reserve/Base Money	6/14/07	6/15/07	D	D	W/M	O, LO, O, O,	LO, O, O, LO, O
Broad Money	4/07	6/07	M	M	M		
Central Bank Balance Sheet	4/07	6/07	M	M	M		
Consolidated Balance Sheet of the Banking System	4/07	6/07	M	M	M		
Interest Rates <sup>2</sup>	6/14/07	6/15/07	D	D	W/M		
Consumer Price Index	5/07	6/07	M	M	M		
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central; Government	3/07	5/07	M	M	...	LNO, LNO, LO, LNO	LNO, LO, LO, LO, LNO
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	3/07	5/07	M	M	...		
Stocks of Central Government and Central Government-Guaranteed Debt	3/07	5/07	...	...	...		
External Current Account Balance	1/07	6/07	Q	Q	Q	LO, LO, LO, LO	LO, O, LO, O, O
Exports and Imports of Goods and Services	05/07	6/07	M	M	M		
GDP/GNP	2007Q1	6/07	Q	Q	Q	LO, LO, O, LO	LO, LO, LO, LO, LNO
Gross External Debt <sup>4</sup>	2007Q1	3/06	Q	Q	A		

<sup>1</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

<sup>7</sup> Reflects the assessment provided in the data ROSC (published on July 28, 2005, and based on the findings of the mission that took place during March 28-April 11, 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

<sup>8</sup> Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

**Statement by the IMF Staff Representative**  
**July 18, 2007**

1. This statement provides an update on recent economic developments based on information received after the staff report was issued. The new information does not alter the thrust of the staff appraisal.
2. **Inflation has fallen further in June and high frequency indicators suggest that the recent robust pace of economic growth is being maintained.** CPI inflation declined to 5.8 percent y/y in June (compared with 6.0 percent in May). Meanwhile, core inflation eased to 5.4 percent. Bank Indonesia cut its policy interest rate by another 25 bps to 8.25 percent at its July 5 Board meeting. Latest short-term indicators suggest that the economy continues to expand at an annual rate of about 6 percent, in line with staff's projections. Exports continue to perform well, in line with staff projections. The trade surplus narrowed slightly as a result of rising imports in recent months, in particular non-oil and gas exports. The trade balance remained broadly unchanged as a reflecting rising imports in recent months.
3. **Rupiah appreciation pressures have eased as the strong portfolio inflows during April/May subsided in June.** Foreign investors reduced their positions in fixed income securities, although moderate inflows into the stock market continued. As a result, the rupiah weakened in June to about 9,000 Rp/US\$, reversing some of the appreciation observed in May, but the stock market continues to reach new highs.
4. **The latest estimate of the poverty rate has been released, indicating a decline to 16.6 percent as of March 2007** (compared to 17.8 percent in March 2006), despite significantly higher food prices. While the rate still remains higher than in 2005 (16.0 percent), when food prices were much lower, the new data suggest that strong growth is beginning to have an effect on poverty, as well as on unemployment, as noted in the staff report.
5. **Important progress has been achieved toward implementing the structural reform agenda in the fiscal area.** Parliament passed on June 19 amendments to the Law on General Tax Rules and Procedure. This amended law, which will take effect as of 1 January 2008, improves legal certainty and achieves a better balance between taxpayers' rights and tax agency's powers. In particular, it makes the appeal process less onerous to the taxpayer. Two more tax law amendments (VAT and income tax) are scheduled for deliberation by Parliament during the remainder of the year and are expected to also take effect by 2008.

6. **The government is in the process of finalizing a set of implementing regulations for the investment law.** A negative list relating to foreign investment has already been issued. It retains a broadly open investment regime and clarifies existing ownership limits, which were previously opaque. The vast majority of business sectors will remain as open, or even more so, than previously, with only a handful of sectors subject to lower foreign ownership limits. While the negative list has raised some concerns in the foreign business community, in recent days the authorities have been meeting with concerned investors to explain the rationale for the list, and to address concerns about how it will be applied.





INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 07/91  
FOR IMMEDIATE RELEASE  
July 31, 2007

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2007 Article IV Consultation with Indonesia**

On July 18, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the 2007 Article IV consultation with Indonesia.<sup>1</sup>

### **Background**

Indonesia's economic performance has been strong since the last Article IV consultation. Supported by sound policies and a favorable external environment, output has grown strongly, inflation has stabilized, and international reserves have risen to an all time high. The government, banking, and corporate sectors continued to reduce balance sheet vulnerabilities. Indonesia's financial markets have rallied in line with global trends and perceptions that risks have been reduced. A strong external position enabled Indonesia to complete the early repayment of its remaining obligations to the Fund in October last year.

This robust economic performance is starting to be reflected in unemployment and poverty indicators, where progress to date had been sluggish. The official unemployment rate dipped below 10 percent in 2007, although formal sector employment opportunities remain limited. Meanwhile, the poverty rate fell back to 16.6 percent in March 2007, having increased sharply to 17.8 percent a year earlier on the back of increased prices for some household staples. However, despite this recent progress, the authorities' focus remains on further accelerating economic growth to improve social conditions and ensure that the benefits of growth are felt across society.

---

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

Economic growth reached 5½ percent in 2006 as the dip in activity following the late 2005 fuel price and interest rate hikes proved shallow. Strong exports compensated for weak domestic demand. Staff projects growth at 6 percent in 2007—the pace maintained since the third quarter in 2006—with some shift from external to domestic demand. Inflation has stabilized at around 6 percent, allowing Bank Indonesia (BI) to lower its policy rate more than 400 basis points since May 2006 as the inflation rate remains on track to end 2007 inside its target range of 5–7 percent. The external current account surplus is projected to decline from 2¾ percent of GDP to 2 percent in 2007 as lower global growth and commodity prices reduce export values. The central government deficit increased modestly to 1.0 percent of GDP in 2006. For 2007, staff projects a somewhat higher deficit at about 1.8 percent of GDP, a level consistent with further reductions in the debt burden.

Equity and bond markets remain buoyant. In addition to increased global risk appetite, the rise in asset prices also reflected Indonesia-specific factors, such as lower domestic interest rates and perceptions of reduced vulnerability. Portfolio capital flows mirrored these developments as foreign investors have been increasing their positions in Indonesian securities. After considerable prior volatility, the exchange rate remained broadly stable during July 2006–April 2007, but appreciated by 3 percent in May vis-à-vis the U.S. dollar, in response to portfolio inflows, although most of this appreciation was reversed in June. Banking sector indicators have also strengthened recently. Banks' profitability has improved, while the system is well capitalized and nonperforming loans remain low for private banks, after falling sharply at the end of 2006 for state banks.

However, volatile portfolio flows are posing additional challenges for the authorities. These include avoiding new external vulnerabilities (e.g., to a sudden reversal of inflows) and minimizing the erosion of competitiveness in labor-intensive manufacturing resulting from real exchange rate appreciation. Meanwhile, a slowdown in domestic credit growth in 2006 has triggered pressure on the central bank and state-owned banks to ensure accelerated lending.

The government continues to implement its comprehensive reform agenda to boost growth over the medium term. Key elements of the strategy include policies to strengthen financial intermediation, improve the business climate, and increase infrastructure investment. While substantial progress has been achieved, including passing of a new investment law and several fiscal reforms, other measures, particularly with respect to the labor market, have encountered resistance.

### **Executive Board Assessment**

The Executive Directors commended the authorities on Indonesia's strong growth, as well as success in reducing inflation and balance sheet vulnerabilities. Further progress has also been made in institution-building, especially in the fiscal area. Improved fundamentals, including lower debt and higher reserves, have increased the resilience of Indonesia's economy. The banking system is well capitalized, profitability has improved, and stress tests suggest it is capable of withstanding reasonable adverse shocks. The recent decline in poverty and unemployment is encouraging, but continued economic growth will be needed to improve social conditions.

Looking forward, Directors noted that Indonesia is well positioned to take advantage of continued favorable global conditions. With stronger financial intermediation, especially better availability of long-term financing, additional investment in infrastructure, and an improved investment climate, growth could be sustained in at least the 6–7 percent range needed to alleviate poverty and unemployment.

Directors noted that capital inflows have moderated recently, but acknowledged the authorities' concern about volatile portfolio capital flows and the challenges they pose to macroeconomic management. They emphasized that possible future surges in inflows should be addressed through allowing further rupiah appreciation, intervention to limit excessive exchange rate movements, and additional interest rate cuts, provided that exchange rate appreciation improves the inflation outlook. Directors welcomed a modest further increase in reserves. Directors recognized that, while some estimates of equilibrium exchange rates suggest a modest undervaluation and although the performance of manufacturing exports has been moderate relative to many competitors, the real effective exchange rate is broadly in line with fundamentals. On balance, Directors endorsed the flexible exchange rate policy and current macroeconomic policy mix. Directors emphasized that continued focus on structural reforms would help to enhance external competitiveness.

Directors commended Bank Indonesia (BI) for its cautious monetary stance and emphasized that convergence of inflation and interest rates with major trading partners would help to reduce capital account volatility. With the 2007 inflation target well within reach, monetary policy should now focus on achieving the 2008 target. While the rupiah appreciation and moderating core inflation have opened room for limited interest rate cuts, the BI needs to exercise caution, keeping in mind the lags in monetary policy transmission.

Directors felt that the recent relaxation in prudential regulations to encourage lending is not likely to have much of an impact, as demand constraints are mostly at play, but were concerned that the departure from international standards could risk sending an adverse signal to supervisors and banks alike. They, therefore, encouraged BI to reconsider the measures as soon as possible. Directors also noted that moral suasion to encourage banks to lend to specific sectors could result in credit misallocation. Instead, steps to promote the development of capital markets and longer-term financing instruments would be more effective in expanding lending while helping to preserve the soundness of the financial sector. In addition, a strategy on the future role of state banks is needed. Directors encouraged the authorities to undertake a Financial Sector Assessment Program.

Directors supported the authorities' fiscal stance and felt that the modest relaxation in deficit targets for 2007 and 2008 would give the authorities some room for additional development spending. However, they viewed that the authorities should not go beyond the deficit levels currently envisaged for 2007–08, given the potential negative consequences of higher debt financing. Further improvements in tax administration, some new tax measures, and the streamlining of expenditures, including through greater flexibility of energy prices, could create additional space for priority spending. Enhancing the implementation capacity of local government would also contribute to this effort.

Directors commended the authorities on the good progress made in fiscal reform. They welcomed the completion of the restructuring of the tax agency and the recent adoption of a key tax reform bill. Directors welcomed the planned introduction of a fiscal risk statement and the medium-term fiscal framework in the 2008 budget and urged early passage of tax bills still in Parliament.

Directors commended the authorities on the passage of the investment law. They encouraged the authorities to focus on increased infrastructure spending, both through direct budget spending to the extent possible and by facilitating public-private partnerships in infrastructure. The authorities should also alleviate the burden of severance payments on employment generation.

**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.

## Indonesia: Selected Economic Indicators, 2002–08

	2002	2003	2004	2005	2006	2007	2008
			Act.			Proj.	
Real GDP (percent change)	4.5	4.8	5.0	5.7	5.5	6.0	6.3
Domestic demand	2.4	6.0	5.4	5.3	3.3	5.2	7.5
<i>Of which:</i>							
Private consumption	3.8	3.9	5.0	4.0	3.2	4.6	4.6
Gross fixed investment	4.7	0.6	14.7	10.8	2.9	9.0	11.9
Change in stocks 1/	-2.0	2.2	-1.3	-0.4	-0.3	-0.8	0.7
Net exports 1/	0.8	1.8	-2.1	1.1	1.4	1.3	-0.3
Statistical discrepancy 1/	1.5	-2.4	2.3	-0.3	1.1	0.0	0.0
Saving and investment (in percent of GDP)							
Gross investment 2/	21.3	22.5	22.9	23.5	22.6	22.5	24.3
Gross national saving	25.3	26.0	23.5	23.6	25.3	24.4	25.8
Foreign saving	-4.0	-3.5	-0.6	-0.1	-2.7	-1.9	-1.5
Prices (12-month percent change)							
Consumer prices (end period)	9.9	5.2	6.4	17.1	6.6	6.3	5.5
Consumer prices (period average)	11.8	6.8	6.1	10.5	13.1	6.2	5.4
Public finances (in percent of GDP)							
Central government revenue	16.5	16.7	17.8	17.8	19.0	17.7	17.1
Central government expenditure	18.0	18.7	19.1	18.1	20.0	19.5	18.9
Central government balance	-1.6	-2.0	-1.4	-0.3	-1.0	-1.8	-1.8
Primary balance	3.4	1.6	1.3	2.1	1.4	0.5	0.0
Central government debt	65.4	58.3	55.2	45.6	38.6	35.7	33.9
Money and credit (12-month percent change; end of period)							
Rupiah M2	7.9	9.8	10.0	13.0	18.1	18.0	...
Base money	8.3	19.8	20.4	21.9	22.2	17.8	...
Private sector credit	25.1	22.1	30.4	19.7	14.4	16.5	...
One-month SBI rate (period average)	15.1	10.1	7.5	9.1	11.9	...	...
Balance of Payments (in billions of US\$)							
Oil and gas (net)	6.2	7.4	5.1	4.2	6.8	6.4	4.3
Non-oil exports (f.o.b)	46.3	48.9	54.5	66.8	80.6	92.5	100.8
Non-oil imports (f.o.b)	-29.0	-31.7	-39.5	-53.4	-57.7	-68.7	-75.7
Current account balance	7.8	8.1	1.6	0.3	9.9	8.0	6.8
Foreign direct investment	0.1	-0.6	-1.5	5.3	3.3	2.8	4.0
Overall balance	5.0	3.7	1.0	-0.5	15.9	12.4	6.8
Gross reserves							
In billions of US dollars (end period)	32.0	36.3	36.3	34.7	42.6	55.0	61.8
In months of imports	6.8	6.1	4.8	4.4	4.8	5.7	5.8
As a percent of short-term debt 3/	117.3	134.5	137.4	103.0	153.7	187.8	197.8
Total external debt							
In billions of US dollars	131.3	135.4	137.4	133.8	133.4	130.5	132.1
In percent of GDP	67.2	57.7	53.5	46.6	36.6	31.2	28.6
Exchange rate (period average)							
Rupiah per US\$	9,314	8,575	8,933	9,705	9,165	...	...
Nominal effective exchange rate (Jan. 2000=100)	94.2	95.0	87.0	79.3	83.7	...	...
<b>Memorandum items:</b>							
Oil production (000bcpd)	1,260	1,200	1,040	999	956	956	956
Indonesian oil price (US\$/bbl)	23.5	28.8	37.2	51.8	63.9	60.3	64.3
Nominal GDP (in trillions of Rupiah)	1,822	2,014	2,296	2,785	3,338	3,756	4,211
Nominal GDP (in billions of US\$)	196	235	257	287	364	418	462

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

1/ Contribution to GDP growth (percentage points).

2/ Includes changes in stocks. Computed on real basis.

3/ Short-term debt on a remaining maturity basis.

**Statement by Perry Warjiyo, Executive Director for Indonesia,  
and Juda Agung, Advisor to Executive Director  
July 18, 2007**

1. On behalf of the Indonesian authorities, we would like to express our sincere appreciation to the staff for the candid and constructive policy dialogue during the 2007 Article IV Consultation and for their balanced report as well as an excellent and relevant Selected Issues paper. The consultation has provided valuable venues to discuss the many progress of home-grown policies and institutional reforms that Indonesia is undertaking, updates the recent achievements on overall economic performance, and exchange views on the best ways to move forward for the sustained growth and stronger macroeconomic and financial stability of the Indonesian economy in the aftermath of a post-monitoring IMF program.

**Progress and Challenges**

2. **The Indonesian economy has secured a path of high and sustained growth, as evidenced in continued stronger growth and sound macroeconomic stability.** Supported by our authorities' continued sound macroeconomic policies and broad-based reforms in the areas of investment climate, financial sector and public administration, the Indonesian economy has been enjoying the highest growth performance since the Asian crisis. Macroeconomic stability strengthened and Indonesia's vulnerabilities have also substantially subsided. With these strong fundamentals, the economy has been witnessing a dramatic recovery from financial market turbulence, largely due to external shocks, in 2005 and early last year. Our authorities believe that this recovery also reflects a growing market confidence over the sound policy and reforms that are taking place, as well as the expectation for a stronger outlook of economic performance this year and next.

3. **With growth momentum and macroeconomic stability underway, the next challenge for our authorities is how to sustain high growth needed for poverty reduction and employment creation.** Our authorities are fully aware that addressing these challenges requires an agenda with clear priorities. While sound macroeconomic policies continue to be of high importance to strengthen the economy against external shocks, further reforms are underway to increase economic productivity and competitiveness as they are necessary for expanding growth potential. And most important for sustaining growth is to capitalize on the current momentum of increasing confidence to boost private investment. In this context, reforms for improving the investment climate are the government's top priorities. The notable progress made in this area is the recent parliamentary approval on the investment law and the taxation law. In order to further improve the business climate, a new policy package on investment climate, acceleration of infrastructure development, empowerment of small medium enterprises, and financial sector development was also recently issued. Institutional reforms are underway. The bureaucracy reform, including improving public services at the Ministry of Finance, is a notable step toward strong and efficient public institutions. In the

financial sector, deep-rooted institutional reforms have resulted in a financial system with better governance and risk management, allowing them the strong capability of weathering potential shocks. The ongoing initiatives on institutional development in various sectors are now progressing and will be continued. In this regard, we believe that the Fund's role and contribution in this process, through continuous policy dialogue and advices as well as training and technical assistance are important.

## **Recent Updates and Outlook**

### **4. Indonesia's recent economic performance has regained strong growth momentum.**

Real GDP growth continued to pickup, the unemployment rate declined, and inflation decelerated. After a slowdown in the last quarter of 2005 and the first half of 2006 following the removal of fuel subsidies and a sharp increase in interest rates, growth has been recovering. For the last three quarters, economic growth has been around 6 percent, allowing the unemployment rate and poverty rate to fall. At the same time, the overall macroeconomic stability has strengthened. Inflation fell from its peak of 17.4 percent in 2005 to 6.6 percent at the end of 2006—well below the inflation target range of 7-9 percent—and it declined further to 5.8 percent in June 2007. In the external side, a robust growth in exports, together with large surge of capital inflows have significantly improved the surplus of the balance of payments, strengthened the Rupiah, and bolstered international reserves. These sound external positions have reinforced confidence and determination of the authorities to expedite the servicing of all remaining debt to the IMF that totaled US\$7.6 billion in June and October 2006, resulting in Indonesia's early completion of its Post-Program Monitoring. At the end of June 2007, international reserves continued to rise and reached US\$50.9 billion.

### **5. Looking ahead, the authorities are strongly confident that economic growth is to gather added momentum during 2007-2008, outperforming previous projections.**

Key to the strengthened optimism for growth is improved performance in consumption and exports, leading to increased investment demand. The lower interest rates are seen as creating greater opportunity for business to take advantage of lower cost financing for investment. At the same time, a higher budget execution and authorities' continuing efforts to improve the investment climate and enhancing infrastructures further boost the economy for the rest of this year, with the annual GDP growth projected to achieve 6.3 percent in 2007. The upward growth trend is also expected to continue in 2008, with growth at around 6.7 percent. A better investment condition following implementation of the new laws on investment and on taxation and the recent policy package to boost private investment, infrastructure, and small medium enterprises (SMEs) are expected to further strengthen private investment and growth in the next year. With the projected growth, unemployment is expected to further decline to 8-9 percent, while poverty at the range of 15-16.8 percent in 2008. Meanwhile, inflation in 2007 and 2008 is forecasted within the target range of  $6\pm 1$  percent and  $5\pm 1$  percent, respectively. On the external front, the balance of payments is likely to outperform earlier forecasts with an expanding surplus and increasing international reserves alongside a stable

Rupiah exchange rate. These developments are expected to underpin stronger and more balanced economic growth in 2007 and 2008.

### **Fiscal Policies and Reforms**

**6. The fiscal policy is designed to support a higher economic growth path, while ensuring fiscal sustainability.** To this end, the authorities are focusing expenditure to areas that will enhance infrastructure and alleviate poverty, including the health sector and education, infrastructure and energy projects, and natural disaster mitigation. In this regard, the government submitted a revised budget to the parliament comprising an increase in the central government deficit from the initial target of 1.1 percent to 1.6 percent of GDP for 2007. The budget deficit is financed by domestic sources, mainly through a bond issuance, while foreign sources are expected from program loans. With the current structure of the government budget, the public debt to GDP ratio is expected to decline further to around 36 percent by the end of 2007. Looking ahead, the 2008 budget will remain prudent with a deficit expected around 1.7 percent of GDP, which is consistent with the declining path of public debt and growth target of 6.7 percent.

**7. Continuous efforts are also underway to strengthen the management of public finance.** On the revenue side, the authorities are committed to strengthening tax administration, including the improvement of tax services and the modernization of the supporting function. Efforts have also been made to simplify the procedures and facilities for exports and imports, and harmonizing import duty tariffs. More importantly, in order to carry out a more comprehensive tax reform, deliberations over the tax reform package are expected to be concluded by the parliament by the end of this year. The General Administrative Rules for Taxation was recently passed by the parliament, while the other two bills (Income Tax and Value Added Tax for Goods and Services, and Sales Tax on Luxury Items) are currently being reviewed by the parliament. The approved bill is designed to create a balanced position between taxpayer rights and the power of the tax authority. The revised tax law would serve to give taxpayers greater legal standing by creating a regulatory framework to make it easier for taxpayers to appeal official rulings, and to reduce incidences of arbitrary detention of taxpayers. It also contains provisions under which taxpayers will not be obliged to pay disputed taxes until a court ruling has been made. On the expenditure side, the authorities have made further progress to address the obstacles of budget execution by streamlining procedures and improving the capacity of local government.

**8. The government is also in the process of reforming the budget and public financial management system and governance.** The publication of ROSCs - Fiscal Transparency Module for Indonesia in September 2006 earmarked Indonesia's effort in this area. The Module provides a comprehensive and reliable assessment of fiscal transparency practices in Indonesia relative to the requirements under the Code of Good Practices on Fiscal Transparency developed by the IMF. In relation with this, the government pursues a cash



management reform (by implementing a Treasury Single Account) and budget reform (through the implementation of a unified budget since 2005), improvement of fiscal analysis and forecasting, establishing the Medium Term Expenditure Framework (MTEF), improving revenue projections, forward estimates of government expenditures and transfers to local government. Meanwhile, in the aspect of good governance, the government had issued Government Regulation Number 8/2006 concerning Government Agencies' Performance and Financial Reporting, as well as Law Number 7/2006 concerning the ratification of UN Convention Against Corruption, 2003. The government is also embarking on the bureaucracy reform, focusing mainly on improving the public service at the Ministry of Finance (including Tax Office, Custom Office, and Treasury Office) and designing the remuneration system consistent with the level and the risk and competency. The establishment of Risk Management Unit in the Ministry of Finance is also a key move to strengthen public financial management.

## **Monetary and Exchange Rate Policies**

**9. On the monetary policy, Bank Indonesia (BI) remains committed to focusing on achievement of the medium-term inflation target of low inflation.** To this end, under the inflation targeting framework, the central bank consistently sets its interest rate policy in line with underlying macroeconomic conditions so as to ensure maintaining price stability which is necessary for sustainable economic growth. BI is confident that the inflation target of  $6\pm 1$  percent for 2007 and  $5\pm 1$  percent for 2008 will be achieved. From an operational perspective, the central bank continues its efforts to improve monetary policy efficacy by strengthening the monetary policy operational framework, including infrastructure developments to enhance the effectiveness of open market operations. Efforts have been made to enrich monetary instruments and improve liquidity forecasting and management. Progress toward implementing Treasury Single Account (TSA) would facilitate liquidity management of the central bank.

**10. To further strengthen monetary policy credibility, the central bank continues to improve monetary policy communication and transparency.** To this end, policy communication and dissemination through press releases and the issuance of monthly, quarterly and annual economic reports complimented by a number of outreach programs through seminars, discussion groups and other venues will be continued. In this regard, further improvements have been adopted in the Monetary Policy Report, including a more forward-looking discussion and a more detailed treatment of risks, and publication of quantitative inflation forecasts is under consideration. At the same time, monetary policy effectiveness has been strengthened through closer coordination with the government and other economic agents, particularly coordination of monetary policy and fiscal policy to support overall macroeconomic objectives. The establishment of a joint team for monitoring and controlling inflation is a good example of this closer coordination.

**11. Indonesia's economic performance with continued stronger growth and sound macroeconomic stability has strengthened its external stability.** Over the past years, the external position has been sound and its external vulnerabilities have declined. For 2007, current account surplus is projected to record a surplus of US\$8.9 billion and, with financial account surpluses of US\$4.9 billion, lead to overall balance of position to record a surplus of US\$13.4 billion and an increase in international reserves to US\$56.2 billion. External vulnerabilities have also subsided, as a result of continued sound macroeconomic policies, a stronger financial and corporate sector condition, and major institutional reforms particularly in the areas of governance and financial supervision. Nonetheless, the authorities are cognizant of possible risks that may emanate from external shocks, such as a capital account shock or a global growth slowdown. In particular, with fully free capital mobility, reversals of short-term portfolio flows may arise in response to shifting in relative yields and a global risk appetite. To mitigate these risks, the authorities share the staff's recommendation for a combination of policies including intervention to limit excessive exchange rate movements, allowing further Rupiah appreciation and appropriate adjustments in interest rate.

**12. With regard to exchange rate policy, our authorities remain committed to a flexible exchange rate regime.** In this regard, exchange rate movements are mainly determined through market mechanisms. As such, the current level of exchange rate is considered appropriate and relatively consistent with the fundamentals. Interventions in the foreign exchange market are confined to smoothing abrupt movements in the exchange rate without targeting any specific exchange rate level. At the same time, adequate accumulation of international reserves is also necessary to safeguard the external stability, including reducing vulnerability to "hot money" outflows.

### **Structural Reforms**

**13. Reforms for improving the investment climate are the government's top priorities. In this respect, a notable step is the parliamentary approval on the Investment Law in March 2007.** The new investment law is expected to have a significant impact on the investment climate and reduce the costs of doing business. Key features of this new investment law includes: providing equal legal status for local and international investors, strengthening investor's protection and property rights, simplifying immigration procedures, dispute resolution using international laws, and tax incentives.

**14. In order to further improve the investment climate, our authorities recently issued a policy package on investment climate, acceleration of infrastructure development, empowerment of small medium enterprises, and financial sector development.** In the area of investment climate, some significant progress has been made in the past year, including simplification of procedures for granting investment approval and establishing a

new company and revocation of unfriendly regional regulations. The new reform package of investment climate is aimed at strengthening investment service institutions, further synchronizing of regional and central government's regulations, improving custom and tax services, and protecting the rights of taxpayers. In order to boost domestic capital market, the government intends to formulate tax policies by introducing incentives for listed companies.

**15. Meanwhile, infrastructure acceleration programs set out in the new reform package continued to focus on the regulatory reform of infrastructure development; institutional developments, including establishment of a non-bank financial institution for infrastructure; and improvement in management of infrastructure development, including acceleration of land acquisition process for public infrastructure.** In the area of empowerment of small and medium enterprises (SMEs), the main objective is to enhance the productivity of SMEs by enhancing their access to financial resources, developing entrepreneurship and human resources, and promoting markets for SMEs. On the labor reform, our authorities are well aware that steps are needed to reduce the costs of severance provided by employers. A new scheme by transferring the obligation to pay severance payments to pension funds is now being considered to find a compromise between interests of employers and workers.

### **Financial Sector Development and Reforms**

**16. In the financial sector, banks continued to be well capitalized and profitable, but loan growth slowed.** The capital adequacy ratio rose to over 20 percent, while net interest margin remained at about 0.5 percent. Non-performing loans have been relatively stable at around 6.6 percent of credit outstanding. However, lending growth slowed with loans outstanding increasing by only 14.1 percent in 2006 and then accelerated to 15.8 percent (y.o.y) for the first five months of 2007, compared to growths of 24.7 percent and 22.7 percent in 2004 and 2005, respectively. In this regard, we appreciate the staff's Selected Issues Paper on the sources of credit slowdown. The authorities are of the view that the credit slowdown is a complex issue involving both supply and demand factors. From the demand side, the authorities concur with the staff's assessment that the lack of demand associated with the overall investment condition and financing needs from creditworthy borrowers is one of the reasons for low credit expansion. Moreover, the lower-than-expected credit growth may also be due to substitution effect, in which businesses seek a non-bank financing for capital accumulation. This is indicated by an increase in new IPOs in capital market and new corporate bond issuance recently. While acknowledging the importance of these demand factors, which are being addressed by appropriate macroeconomic policies and continued structural reforms, authorities are of the view that the supply factors should also be addressed simultaneously, including encouraging lending from banks with strong risk management practices, while retaining bank prudential practices.

**17. Further measures were taken to reinforce the banking industry consolidation program to create a strong and sound banking industry as envisaged in the Indonesian Banking Architecture.** These measures included the incentive for merger and consolidation process, new regulation on corporate governance of banks, and bank risk-management certification. Meanwhile, in order to implement Basel II, the risk-based supervision was implemented last year. The authorities have also made progress to improve the banking infrastructure by operationalization of the Credit Information Bureau, covering all borrowers of commercial banks, credit unions, and non-bank financial institutions. As suggested by staff, the Bureau envisages inclusion of utility companies in its database, although a prior step to create a reliable unified consumers database is a challenging task. In order to facilitate long-term financing, the authorities concur with the staff's recommendation to consider transforming a state-owned bank into a new development bank, as part of the overall reform strategy for state-owned banks.

**18. Our authorities are also committed to further strengthening the stability of the financial system.** A notable progress made in this area includes the establishment of the Financial Sector Stability Forum, which provides a mechanism for discussing the role of the government and the central bank in dealing with a crisis. Other important measures include the drafting of a bill on a financial safety-net program for the financial sector and a blueprint for development of the financial system, to be known as the Indonesian Financial System Architecture (IFSA). Progress has been made by the authorities to strengthen financial sector stability as envisaged in the previous financial reforms, including the settlement of non-performing loans of state owned banks and the treatment of ailing insurance companies. Furthermore, efforts have also been made to strengthen capacity of the Deposit Insurance Corporation. In order to diversify the sources of financing for the real sector economy through capital market and non-bank financial institutions, the authorities have facilitated development of the bond repo market and prepared the regulatory framework of the Islamic capital markets, including Shukuk.

## **Conclusion**

19. The Indonesian economy has regained its strong momentum with high growth and sound macroeconomic stability. While this remarkable performance has been attributed to sound macroeconomic policies and continued reforms over the past years, the authorities are determined that further broad based reforms are needed to secure the high and sustainable growth path over the medium term. The goal is to enhance the country's international competitiveness through improvements in efficiency and economic productivity, which are essential for private sector-led growth, ultimately leading to a reduction in unemployment and poverty. Finally, the Indonesian authorities remain committed to transparency and consent to the publication of all staff reports, with necessary deletions of market sensitive information.