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May 18, 2023

**Statement by Mr. Palotai, Mr. Mert, and Mr. Hagara on Indonesia
(Preliminary)
Executive Board Meeting
May 22, 2023**

We thank staff for the helpful reports and Ms. Lim and Messrs. Hendrayadi and Kurniawan for their informative Buff statement. We broadly concur with the staff appraisal and add the following comments.

Indonesia's recovery from the 2020 pandemic-induced recession continued strongly in 2022, supported by favorable global commodity prices, and the medium-term growth projections remain favorable, at close to 5 percent. We note that staff assess risks to the outlook as broadly balanced, as negative global risks are offset by upside risks from a stronger recovery in China, a stronger boost from pent-up demand and a faster decline in inflation. *Can ask staff expand on the reasoning behind the upside risks.*

Keeping the fiscal deficit below 3 percent of GDP, while maintaining a broadly neutral fiscal policy stance in 2023, seem appropriate at the current stage. While public debt remains relatively low and on a declining path, the swift shift in the investors base from non-resident holdings more towards local banks should be monitored to limit the risks stemming from the high interdependence of banks and the government. Keeping the fiscal deficit below 3 percent target and creating room for development expenditures, will require the authorities to set concrete fiscal measures and *we wonder about their intended steps should adherence to the target prove difficult.* With a low tax-to-GDP ratio, further revenue mobilization seems warranted, while the energy subsidy reform would help improve cost recovery in the fuel and electricity sectors, as also suggested by staff. At the same time, the negative impacts on the most vulnerable should be addressed by strengthening the social safety net. *We note the authorities' steps to improve the social registry database and accelerate compensation payments to SOEs and wonder about any plans towards a subsidy reform accompanied by a strengthened social safety net.*

Monetary policy has been tightened, but the BI should continue monitoring inflation risks and react if needed. Inflation is projected to return to the BI's target range in the second half of this year, but risks are skewed to the upside. In that context, the end of

monetary financing is welcome, and we encourage the authorities to reinstate an inflation expectations survey to better guide monetary policy-making. At the same time, the exchange rate should continue to act as a primary shock absorber, while FX interventions should be limited to smoothing excessive volatility.

Indonesia's financial system appears resilient, with a well capitalized and liquid banking sector. Nevertheless, banks should be monitored for risks emanating from those sectors hit hardest by the pandemic and sensitive to interest rate increases. We note the narrowed scope of the relaxation of loan classification standards, but it should be discontinued. *Can staff comment on why the authorities opted to extend the relaxed standards for another year.* As credit growth is recovering to pre-pandemic pace, the authorities may consider tightening macroprudential policies.

We encourage the authorities to prioritize addressing structural policy gaps, promoting the business and investment climate, to support the long-term growth potential and diversification of the economy. The informality in the labor market has increased since the pandemic, hence the labor market reform and measures to reduce the regulatory burden of doing business, decreed by the President, should be implemented swiftly, while also strengthening legal certainty and removing non-tariff trade barriers. Furthermore, investment in human capital and infrastructure should be improved. We are not convinced that focus on addressing structural policy gaps can be replaced by down-streaming policies. We thank staff for their analysis which shows that the climate strategy based on forestry and land use (FOLU) measures would be less costly in the initial phase but needs to be complemented by an energy subsidy reform and carbon pricing to achieve the net-zero emission goal by 2060. *We wonder how the authorities plan to monitor the implementation of the FOLU measures.* Related to sustainability challenges of Jakarta as the capital city and the authorities' plans to build a new capital city, *we wonder what the estimated burden of this move is on the budget, and which instruments the authorities intend to seek as funding sources. We would also appreciate staff's comments on the environmental impact of this move.*