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SM/89/64
Correction 1

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INFORMATION

May 8, 1989

To: Members of the Executive Board
From: The Secretary
Subject: Indonesia - Staff Report for the 1989 Article IV Consultation

The following correction has been made in SM/89/64 (4/6/89):

Page 4, para. 2, lines 6 and 7: for "order to...by the Government"
read "line with...the budget"

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

initially were reduced by 1984/85 ^{1/} and, following the further sharp decline in oil prices, again in 1987/88 (Appendix Table 7). Non-oil/LNG exports responded strongly to the exchange rate and deregulation measures, averaging 15 percent per annum growth in volume terms from 1982/83 onward; volume growth of manufactured exports averaged over 30 percent, and was particularly strong in a variety of products for which Indonesia has a small share of world markets and enjoys a favorable cost position vis-a-vis its Asian competitors. Imports also contributed to external adjustment, declining in absolute terms as public investment was sharply cut back and progress was made toward food self-sufficiency.

External deficits led, however, to a steady accumulation of external debt and a sharp rise in debt service payments--both measured in U.S. dollar terms. These developments were compounded after 1985 by valuation effects from the depreciation of the U.S. dollar against other major currencies, in which a substantial proportion of Indonesia's debt is denominated. ^{2/} The impact of exchange rate movements contrasted with the experience in the early 1980s, when the U.S. dollar was appreciating.

During the May 1988 Article IV consultation, Executive Directors observed that Indonesia had weathered major economic challenges in recent years through the adoption of strong adjustment policies and wide-ranging structural reforms. Directors also observed that the economy still faced a heavy debt burden and was vulnerable to adverse oil price developments. Therefore, Directors underscored the importance of further structural reforms coupled with financial restraint, continued flexibility in exchange rate management, and considerable caution in foreign borrowing.

Against this background, the consultation discussions focused on the major policy challenges that face Indonesia in combining faster growth with financial stability and balance of payments viability over the period ahead. In the next five-year plan (Repelita V, beginning in 1989/90), the authorities are aiming to sustain growth at 5 percent per annum, provide productive job opportunities for a rapidly expanding labor force, and alleviate poverty, while substantially reducing the external debt service burden. In pursuit of these objectives, the plan emphasizes a strategy of promoting non-oil exports and efficient import substitution and improving domestic resource mobilization.

^{1/} The fiscal year begins on April 1.

^{2/} These valuation effects were partly offset by lower interest rates on non-U.S. dollar denominated debt. For details and illustrative calculations, see the accompanying paper on recent economic developments.

II. Short-Term Developments and Policies

1. Developments in 1988/89

Despite weak oil prices during much of the year, growth picked up in 1988/89, inflation moderated, and the external position remained manageable. Output expansion rose to over 4 1/2 percent, the highest rate in four years. Growth of the non-oil/LNG sector was maintained at the faster pace (about 5 percent) established the previous year, as export and investment demand continued to respond to adjustment and deregulation measures. Growth of manufacturing output remained strong, buoyed by export demand. Oil output declined owing to production restraints, but LNG output recorded a healthy increase. Consumer price inflation, which had exceeded 9 percent in 1987/88 in the aftermath of the 1986 rupiah depreciation and a drought, declined to about 7 1/2 percent.

Domestic financial policies helped to limit the adverse impact of oil price developments. Despite a decline in oil/LNG revenue equivalent to almost 2 percent of GDP, the rise in the overall fiscal deficit was limited to about 1/2 percent of GDP (Table 2). Non-oil/LNG revenue performance strengthened, while expenditure--which is adjusted in line with available domestic and external resources in line with the longstanding government policy not to resort to domestic borrowing to finance the budget--declined by 3/4 percentage point of GDP. As in earlier years, the burden of fiscal adjustment fell heavily on development expenditure, which was reduced by 1 1/3 percent of GDP. The impact of the weakness in revenue would have been more severe but for the provision of more than \$2 billion (about 3 percent of GDP) in special foreign assistance.

In an exchange system that is free of restrictions, monetary policy has aimed at countering bouts of speculation against the rupiah as well as moderating inflationary pressures. Following a drop in oil prices in October 1988 that induced short-term capital outflows, the authorities allowed a sharp increase in money market interest rates, which rose temporarily to over 30 percent in early November. Open-market operations and moral suasion were also invoked in early November to mop up excess liquidity in the wake of financial sector measures that included a reduction in reserve requirements from 15 percent to 2 percent with a view to reducing intermediation costs.

Growth of narrow money was broadly in line with that of nominal GDP during 1988/89 (Table 3). With interest rates remaining significantly positive in real terms, quasi-money maintained the trend of rapid expansion experienced since the inception of financial reforms in 1983. This expansion, together with the modest credit requirements of the public sector, facilitated further strong growth in private sector credit, demand for which has been boosted by deregulation measures.