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INFORMATION

October 18, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Indonesia - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Indonesia. A draft decision appears on page 27.

This subject has been tentatively scheduled for discussion on Monday, November 14, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Boorman (ext. (5)7311) or Mr. Niebuhr (ext. (5)7315).

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INTERNATIONAL MONETARY FUND

INDONESIA

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Consultation with Indonesia

Approved by Tun Thin and M. Guitian

October 17, 1983

I. Introduction

A staff team comprising Messrs. Boorman (Head, ASD), Niebuhr and Kim (ASD), Abrams (ETRD), McDonald (FAD), and Mrs. Kahoonei (TRE) visited Jakarta from August 1-18, 1983 to hold Article IV consultation discussions. Ms. Happe, the Fund Resident Representative, assisted the team. Several members of the mission remained in Jakarta until August 23 to provide technical assistance on matters related to the recent financial reform measures. The mission met with the Coordinating Minister for the Economy, Finance and Industry and Development Supervision; the Ministers of National Development Planning, Finance, Trade, and Administrative Reform; the Advisor to the Planning Agency; the Governor of the Central Bank; and the Presidents of most of the state banks.

Indonesia continues to avail itself of the transitional arrangements under Article XIV.

II. Economic Background

The improved terms of trade in 1979 and 1980 boosted income dramatically, giving rise to sharp increases in private and government spending, especially on public sector investment projects (Chart 1). An acceleration of domestic growth followed, aided by the coincident favorable performance in agriculture, where rice production increased at annual average rates of nearly 10 percent. Notwithstanding the increased pace of activity, inflation moderated from the high levels recorded immediately following the devaluation in late 1978 (Table 1 and Chart 2). This improved price performance was aided, in part, by the favorable supply response in the agricultural sector, but also by the spillover of increased demand to the external sector. 1/

1/ Inflationary pressures were also reduced by sheltering the domestic economy until early 1982 from the effects of higher crude oil prices on the prices of petroleum products.

Table 1. Indonesia: Selected Economic Indicators, 1978-83

	1978	1979	1980	1981	1982	1983 1/
			Percentage change			
National income						
GDP (in real terms)	7.7	6.3	9.9	7.9	2.2	1.8
GDP adjusted 2/	7.0	18.7	17.0	6.3	-1.7	-2.4
			Percent of GNP			
Savings/investment						
Gross fixed capital formation	21.4	21.9	21.8	23.3	23.3	...
Domestic savings	18.4	23.9	25.9	21.7	15.9	...
Foreign savings	3.0	-2.0	-4.1	1.6	7.4	...
			Percentage change			
Prices						
GDP deflator	11.0	32.5	29.1	10.1	7.9	13.8
CPI	8.1	22.0	18.5	12.2	9.5	13.6 3/
Terms of trade (1973=100)	155	231	310	311	308	265

Source: Data provided by the Indonesian authorities.

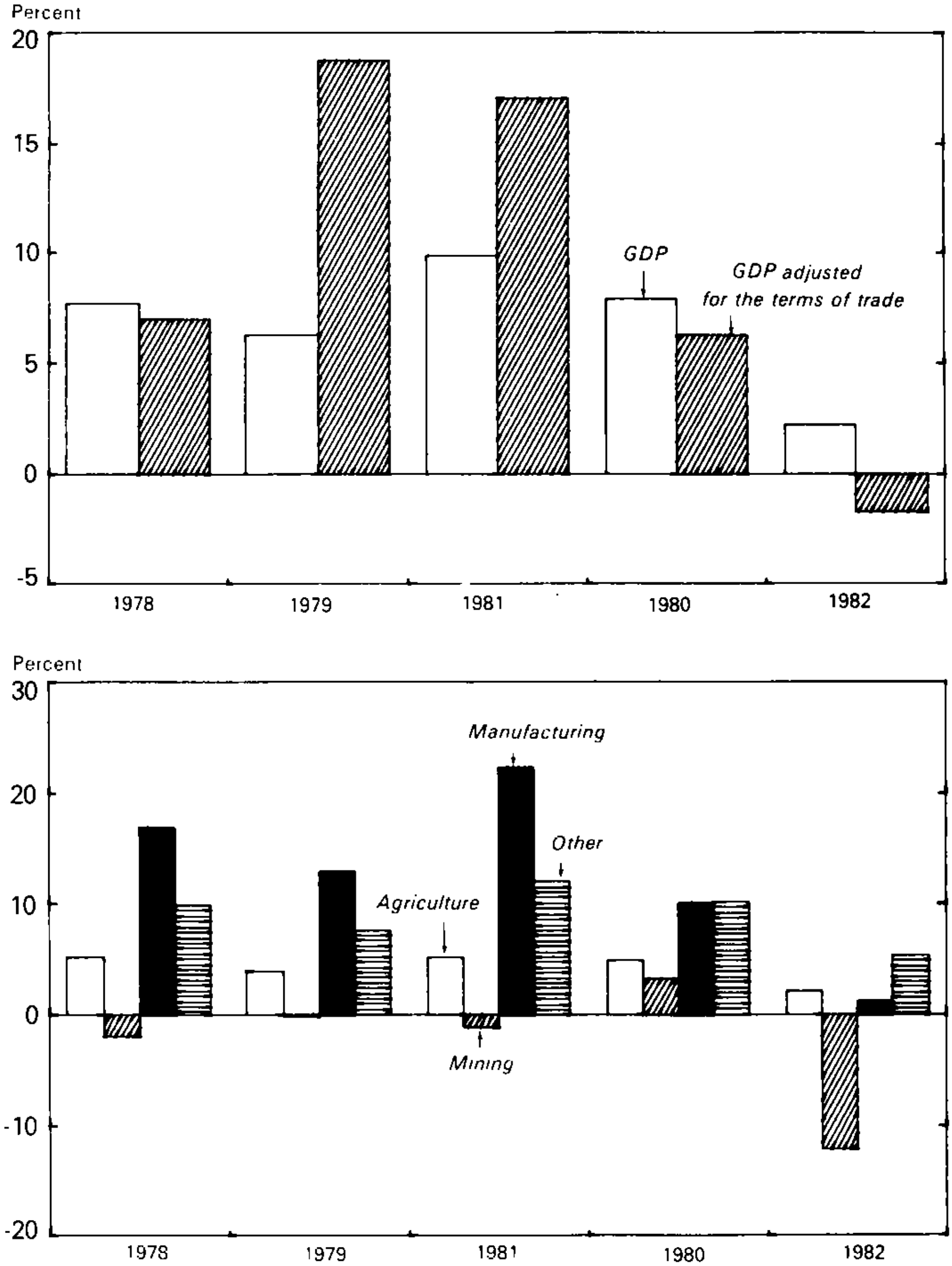
1/ Staff estimates.
2/ Adjusted for the impact of changes in the terms of trade.
3/ July 1983 over year earlier.

With hindsight, it is possible to identify forces that were being set in motion relatively early in this period which would ultimately emerge as unsustainable pressure on the external position. Real exports (national accounts basis) declined almost continuously after 1978, falling by a total of 8 percent over the following three years. Domestic expenditure increases, combined with the effect of an appreciating rupiah, led to a rapid increase in imports, which rose in real terms at a compound average annual rate of over 20 percent from 1979-81. Moreover, in late 1981, the terms of trade began to move against Indonesia as the effects of the protracted world recession began to be felt more severely in commodity markets. In sum, these factors halted the

CHART 1

INDONESIA

ECONOMIC GROWTH AND ITS SOURCES BY SECTOR, 1978-82

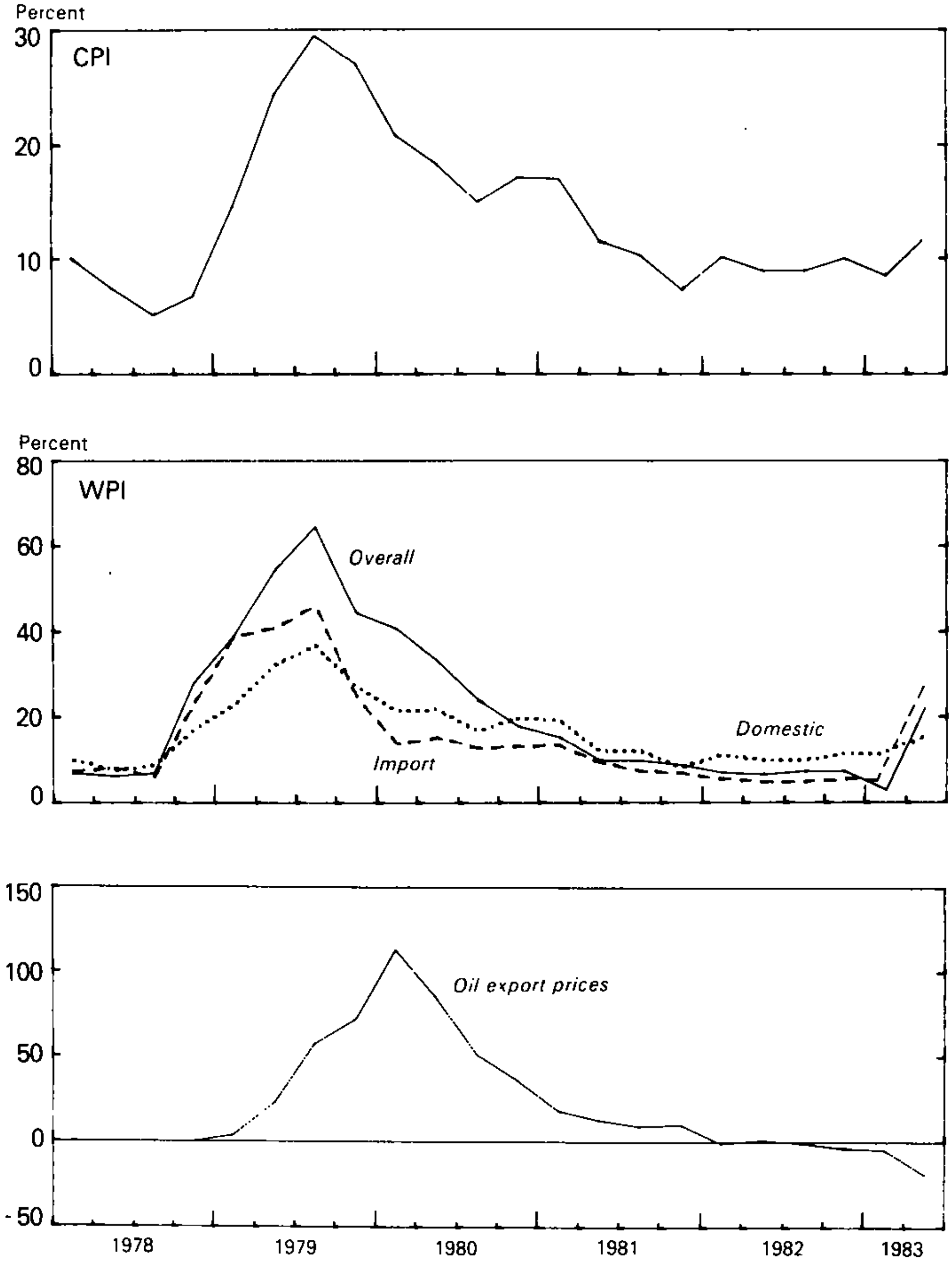


Source: Data provided by the Indonesian authorities.

CHART 2

INDONESIA

PRICE DEVELOPMENTS, Q1 1978 - Q2 1983[1]



Source: Data provided by the Indonesian authorities.
[1]Percentage changes over the same quarter of previous year.

improvement of the current account, and after recording surpluses of $2 billion in 1979 and 1980 (fiscal years), 1/ a deficit of nearly $3 billion (3.4 percent of GDP) emerged in 1981/82 (Table 2 and Chart 3).

Performance during 1982 and early 1983 was aggravated by unforeseen adverse developments in the domestic economy. Drought reduced the growth of rice production to 4 percent in 1982 and is likely to reduce it even further in 1983. Production of other important crops, including corn, cassava, sweet potatoes, and certain nonfood farm products fell sharply on account of adverse weather in 1982, weakening both domestic income and exports.

Nevertheless, the single most important element in the deterioration of the external position since early 1982 was the sharp drop in oil export volumes in 1982 and early 1983 and, finally, the fall in oil prices. The performance of the Indonesian economy is still very much a function of developments in world oil markets. Production and revenues from that sector in recent years have accounted for about 20 percent of GNP, three quarters of gross exports, and almost 70 percent of government revenue. Oil production declined by about 20 percent in 1982/83 to 1.26 million barrels per day and gross oil earnings fell by nearly 20 percent (or $2.8 billion). The effects of these developments in the oil sector, especially on government revenue and spending, combined with the weakening in other sectors noted above, led to a fall in the growth of GDP from an average of 9 percent in 1980 and 1981 to only about 2 percent in 1982. 2/

The decline in oil exports, together with further weakness in the prices of non-oil export commodities and continued, if much slower, growth in imports, contributed to an increase in the current account deficit to $6.9 billion (7.6 percent of GDP) in 1982/83. Capital inflows increased substantially, reflecting primarily larger syndicate borrowings on commercial terms for project finance. Nevertheless, banking system net foreign assets declined by $3.3 billion, with gross official reserves bearing the brunt of the decline, falling by $2.4 billion. As a result of the increased borrowing and the coincident sharp drop in export earnings, the public sector debt service ratio increased rapidly, rising from 12.1 percent in 1979/80 to over 20 percent in 1982/83.

1/ April 1-March 31.

2/ These figures are based on national accounts data using 1973 as a base year. The structural change which has occurred in the economy since then--represented most dramatically by the sharply increased importance of the mining and manufacturing (including LNG) sectors and the decline in importance of agriculture--results in some bias in the official national accounts data. The authorities are considering rebasing these data but have not done so yet. Staff calculations indicate that on the basis of more current structural weights there was virtually no growth in the economy in 1982.

Table 2. Indonesia: Summary Balance of Payments, 1979/80-1983/84

(In millions of U.S. dollars)

	1979/80	1980/81	1981/82	1982/83	1983/84 Staff Est.
Exports, f.o.b.	17,495	21,786	21,145	18,083	17,853
Oil 1/	9,979	14,087	14,632	11,790	10,899
LNG	1,345	2,111	2,343	2,400	2,254
Non-oil	6,171	5,587	4,170	3,893	4,700
Oil sector payments	-4,349	-5,597	-7,214	-6,999	-6,791
Non-oil imports, c.i.f.	-9,028	-11,837	-14,561	-15,490	-14,040
Services (net) 2/	-2,060	-2,343	-2,240	-2,487	-2,731
Current account	2,058	2,008	-2,870	-6,893	-5,709
Oil/LNG (net)	6,975	10,601	9,761	7,191	6,362
Non-oil sector (net)	-4,917	-8,593	-12,631	-14,084	-12,071
Total recorded capital (net)	891	1,898	3,916	5,348	5,118
Official capital (net)	1,998	2,069	2,712	3,772	4,272
Receipts	2,690	2,684	3,521	4,727	5,260
IGGI	2,237	2,406	2,415	2,646	3,542
Non-IGGI (project aid)	453	278	1,106	2,081	1,718
Of which: syndicated loans and bonds	(140)	(146)	(857)	(1,590)	(977) 3/
Amortization	-692	-615	-809	-955	-988
State enterprises (net) (Pertamina & Garuda)	-77	46	658	900	20
Direct investment (net)	217	140	142	311	338
Other	-1,247	-357	404	365	488
Errors and omissions	822	29	-1,383	-1,796	0
Monetary movements (increase in net assets -)	-3,771	-3,935	337	3,341	591
Assets	-3,794	-3,861	307	2,834	...
Liabilities	23	-74	30	507	...
Of which:					
IMF 4/	(--)	(--)	(--)	(71)	(390)
Compensatory borrowing	(--)	(--)	(--)	(--)	(1,133)

Source: Data provided by the Indonesian authorities.

1/ Excludes crude oil sent abroad for processsing for domestic use.

2/ Revised to include state enterprise interest payments in current account.

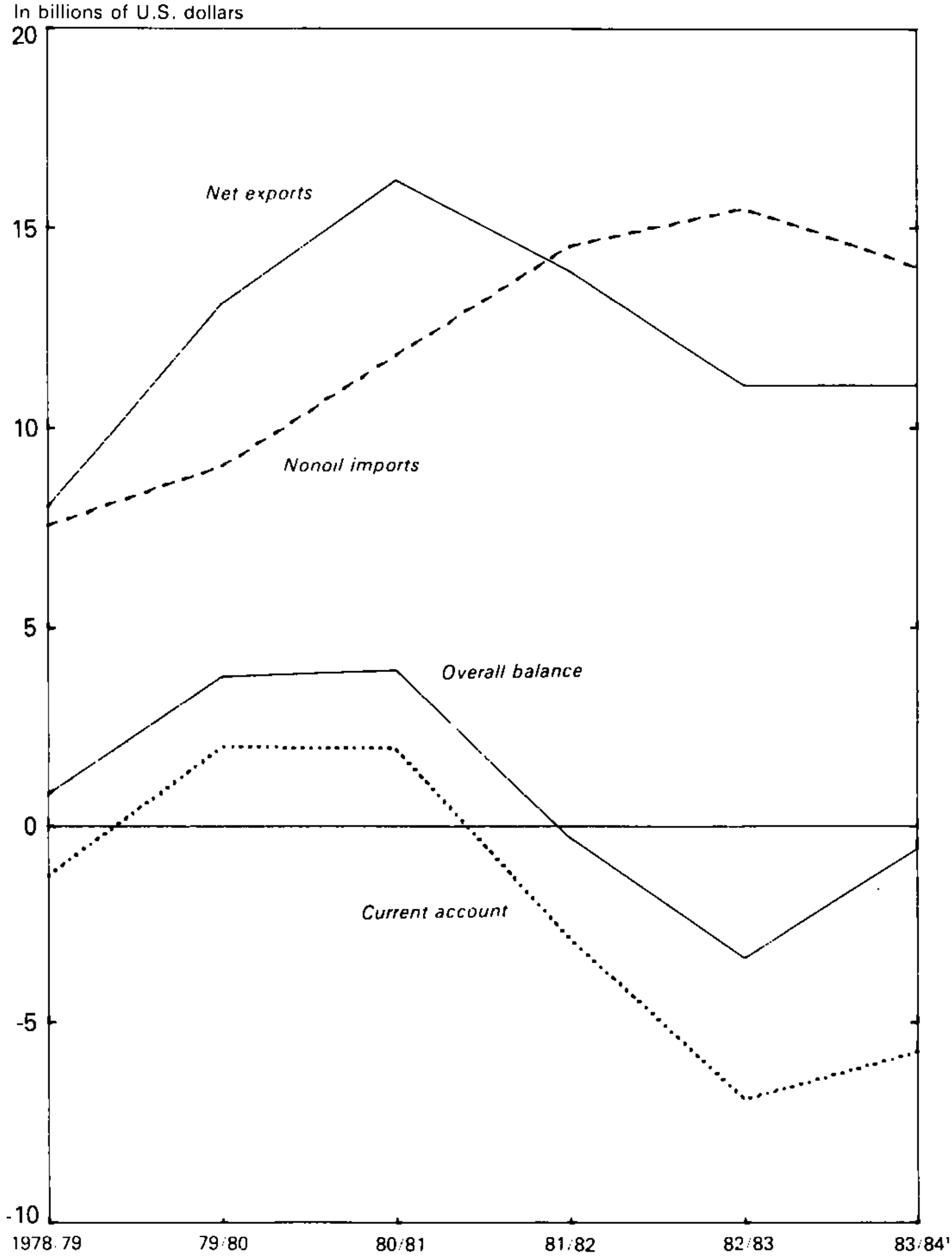
3/ Does not include $1,133 million of such credits classified as compensatory borrowing in monetary movements below.

4/ BSF purchase in 1982/83 and CFF purchase in 1983/84.

CHART 3

INDONESIA

BALANCE OF PAYMENTS DEVELOPMENTS



Source: Data provided by the Indonesian authorities and staff estimates.
[1] Projection

III. The Adjustment Program

1. Policies in 1982 and early 1983

The authorities began to adjust policies in response to the emerging weakness in the external sector in early 1982. In addition to export promotion measures, 1/ additional policies to deal with the projected deceleration in oil revenue were announced with the presentation of the 1982/83 budget. To make the limited projected resource increase available for development spending, current budgetary expenditures were to be held constant in nominal terms, leading to their further decline as a share of GDP. Measures introduced to restrict current spending and subsidies included a 60 percent rise in domestic petroleum prices and a freeze on civil servant salaries. The ratio of non-oil revenue to GDP was to increase through improved tax administration.

Problems in the oil market--reflected in the establishment of an OPEC production quota in March 1982 (at 1.3 mbd. for Indonesia) and an inability to produce at much above that level because of weak demand after the quota lapsed in July--soon made the revenue situation even worse than forecast. Additional measures were taken during the year, including increases in subsidized fertilizer prices and an increased assessment of taxes on the national oil company (Pertamina). Moreover, budget expenditure authorizations for development outlays were held significantly below original estimates. In the end, however, the fiscal deficit widened above planned levels to 5.0 percent of GDP and, for the first time since oil prices began rising in 1979, there was a drawdown of government deposits with the domestic banking system to finance part of this deficit (Table 3 and Chart 4).

The 1983/84 budget was framed against this background. Even on the basis of what now appear to have been optimistic assumptions for oil--an export price of $35/barrel and a production level of 1.4 mbd.--the revenue outlook for 1983/84 was more stringent than had been the case when the budget of the previous year was being formulated. To allow some increase in development spending, current expenditures were to be held at near the level of the previous two years. To accomplish this, food subsidies were to remain negligible, petroleum subsidies were to be further reduced through an additional 52 percent rise in the domestic price of oil products, and wages of civil servants were to remain frozen for the second year. In addition, domestic financing of the deficit was to be eliminated, although foreign financing would increase.

1/ See "Indonesia: Recent Economic Developments," (SM/83/85, 5/16/83).

Table 3. Indonesia: Summary of Central Government Operations, 1979/80-1983/84

(In billions of rupiahs)

	1979/80	1980/81	1981/82	1982/83	Budget 1983/84	Staff Projections 1983/84
Tax revenue	6,886	10,568	11,982	11,465	13,322	13,955
Of which: oil	(4,636)	(7,677)	(8,733)	(7,653)	(8,869)	(9,550)
Nontax revenue	187	316	336	436	502	502
Grants	136	122	99	55	46	65
Total revenue and grants	7,209	11,006	12,417	11,956	13,870	14,512
Current expenditure	4,372	6,361	7,609	7,498	7,748	8,904
Capital expenditure and net lending 1/	3,437	5,040	5,850	6,333	8,128	9,156
Adjustment to expenditure 2/	-1,028	-1,402	311	1,110	...	532
Total expenditure and net lending	6,781	9,999	13,770	14,941	...	18,592
Surplus/deficit (-)	428	1,007	-1,353	-2,985	...	-4,080
(percent of GDP)	(1.3)	(2.2)	(-2.5)	(-5.0)	...	(-5.9)
Financing	-428	-1,007	1,353	2,985	...	4,080
Domestic	-1,175	-1,822	-35	918	...	-41
Monetary authorities	(-966)	(-1,490)	(-184)	(707)	...	...
Commercial banks	(-209)	(-332)	(149)	(211)	...	...
Foreign	747	815	1,388	2,067	...	4,121
Memorandum items:						
Foreign project expenditure (millions of dollars):						
Included above	1,955	1,996	3,080	4,152	...	4,452
Total public sector 3/	2,073	2,380	4,079	5,400	7,854	4,837

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

1/ "Development Expenditure" as defined by the authorities adjusted for certain components classified as current expenditure by the staff.

2/ This adjustment is understood to relate, for the most part, to capital expenditure and net lending. It reflects differences between expenditure authorizations for the current year and actual expenditures (which also include expenditures out of previous years' authorizations) and off-budget lending activities.

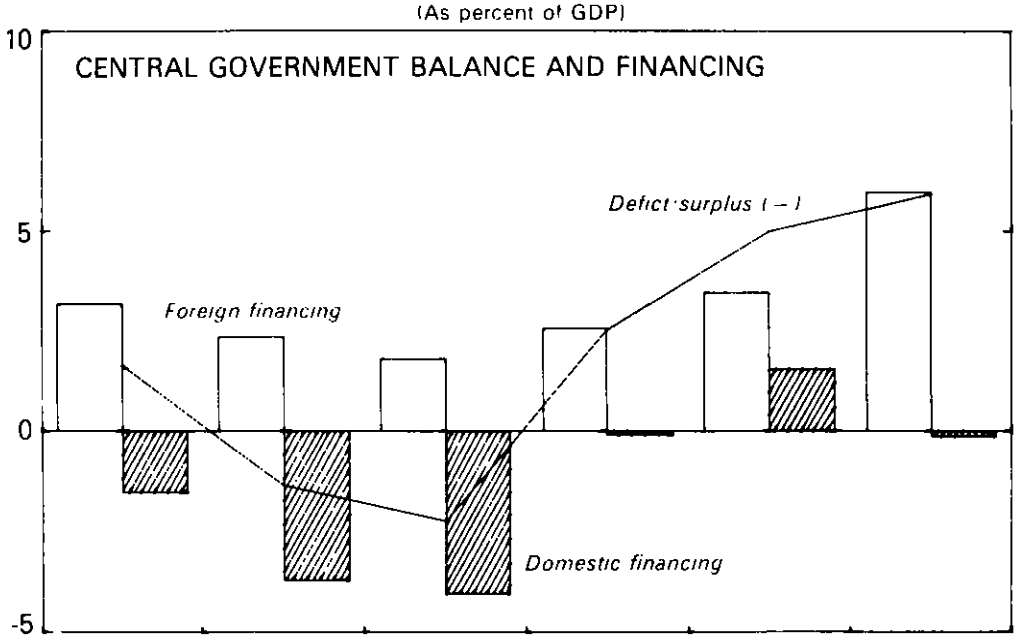
3/ Includes all foreign project expenditures of Pertamina and Garuda. Expenditure and net lending of central government includes only those project expenditures of Pertamina and Garuda which are financed through on-lending of foreign borrowing by the Central Government.

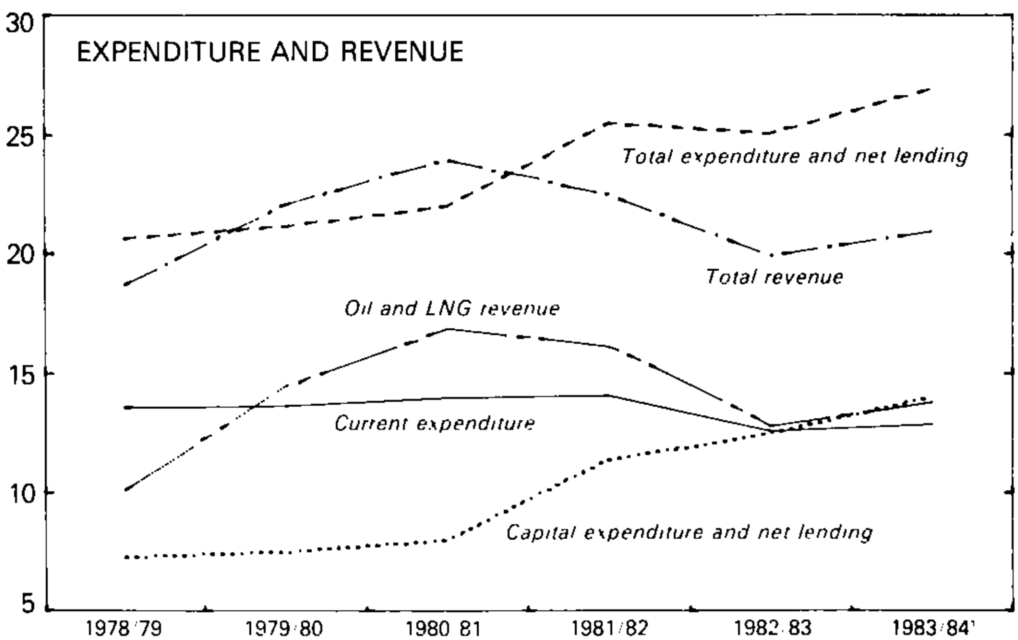
CHART 4

INDONESIA

GOVERNMENT FINANCE DEVELOPMENTS
1978/79-1983/84

(As percent of GDP)





[1] Staff projection.

Other financial policies were also tightened somewhat during the course of 1982 and early 1983 in an effort to slow the expansion of domestic liqudity and halt the deterioration in the external sector (Table 4). Liquidity expansion, which had averaged over 30 percent per annum in the previous three years, declined to an annual rate of 23 percent during April/September 1982 and further to 7 percent during October 1982/March 1983 1/ (Chart 5). While reflecting a sharp decline in net foreign assets--partly resulting from a flight of capital toward the end of the period--depressed domestic economic conditions and some tightening of credit conditions during 1982/83 contributed to this deceleration in monetary growth.

The authorities also employed a greater degree of flexibility in the management of the exchange rate during 1982. The rate of Rp 625/US$1 which had been set in November 1978 had been adjusted only to Rp 650/US$1 by mid-1982, representing an appreciation over the period since late 1978 of 13 percent and 46 percent in nominal effective and real effective terms, respectively (Chart 6). During the remainder of 1982 and the first two months of 1983, however, the exchange rate was adjusted gradually to about Rp 700/US$1. This adjustment, along with some weakening of the U.S. dollar vis-a-vis other major currencies, had the effect of halting the real appreciation of the rupiah and bringing about some reversal in the loss of competitiveness. Nevertheless, the adjustment left the rupiah about 40 percent above the level in real effective terms that had been established in November 1978.

The measures described above had an important impact on the economy and on the external position. The growth of imports slowed substantially and inflation moderated further, despite the large increases in certain administered prices and the depreciation of the rupiah. However, these measures were overtaken by the impact of the protracted world recession, which continued to depress non-oil exports and added to the impact of conservation efforts in depressing the demand for crude oil. By early 1983, crude oil production had fallen to 1.14 mbd., almost 30 percent below the average level recorded during 1978-81, indicating an even more dramatic reduction in exports. These developments threatened to increase the current account deficit further. In light of the decline in reserves and the increase in the debt service ratio and the uncertainties concerning access to commercial borrowing on world markets, such a deficit, even in the short run, would have been difficult to finance. Growing perceptions of the worsening conditions aggravated the situation by encouraging large capital outflows.

2. Adjustment measures of 1983

Following the Presidential elections in March and the installation of the new Cabinet, further action was taken to deal with these

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1/ Excluding the impact on total liquidity of the March 30, 1983 devaluation.

Table 4. Indonesia: Indicators of Monetary Developments, 1979-83

(In billions of rupiah)

	End-March 1979	End-March 1980	End-March 1981	End-March 1982	March 1983	Revaluation Adjustment 1/	August 1983
Monetary developments							
Net foreign assets	1,477	4,017	6,308	6,273	6,227	1,838	6,928
Of which: Monetary authorities	(1,208)	(2,580)	(4,137)	(3,534)	(3,217)	(957)	(3,234)
Domestic credit	4,739	4,366	4,383	6,886	10,681	182	10,771
Government, net	(-918)	(-2,098)	(-3,918)	(-4,021)	(-3,261)	(-112)	(-3,909)
Public enterprises	(2,851)	(3,101)	(3,640)	(4,323)	(4,704)	(146)	(5,180)
Private sector	(2,806)	(3,363)	(4,661)	(6,584)	(9,238)	(148)	(9,500)
Total liquidity	4,155	5,802	7,906	10,151	12,247	620	13,780
Narrow money (percentage change)	(32.8)	(35.6)	(37.3)	(29.9)	(8.9)	...	(18.9) 2/
Quasi-money (percentage change)	(16.4)	(48.0)	(34.2)	(25.4)	(25.8) 3/	...	(55.4) 2/3/
Interest rates 4/							
Rate on 12-month deposit							
At state banks	9.0	9.0	9.0	9.0	9.0	...	18.0 5/
At private banks	17.2	19.5	20.0	19.3	19.3	...	19.6 5/

Source: Data provided by the Indonesian authorities.

1/ Reflects adjustment for the devaluation of rupiah by 27.6 percent on March 30, 1983.

2/ Annual rate of increase during April through August.

3/ Based on level of quasi-money at end-March 1983 adjusted to exclude the impact of the devaluation on foreign exchange denominated deposits.

4/ Average interest rate at selected banks during last month of period.

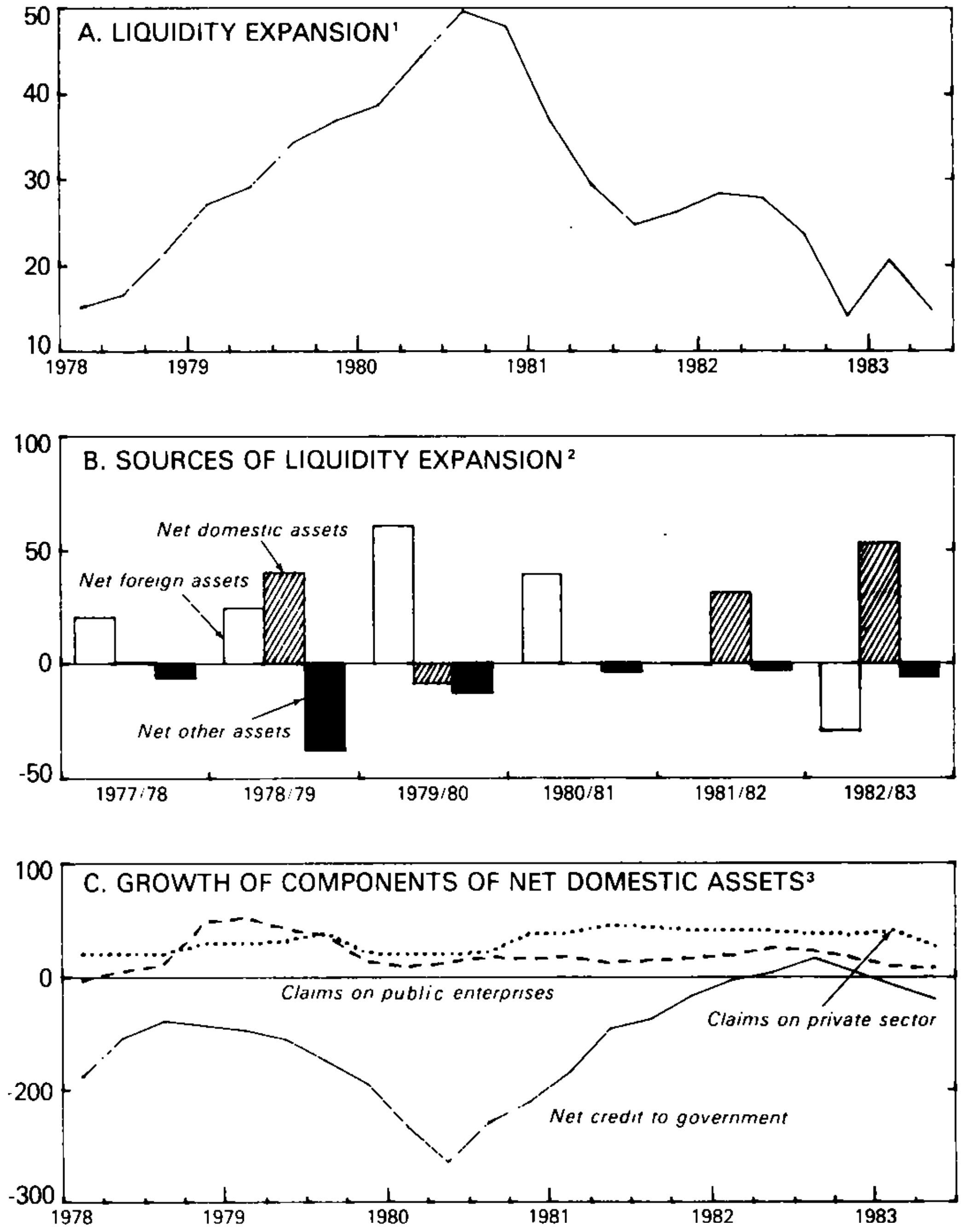
5/ Interest rates prevailing at the end of July.

CHART 5

INDONESIA

LIQUIDITY EXPANSION, 1977/78-1982/83

(In per cent)



Sources: Data provided by Indonesian authorities.

[1]Percentage change in total liquidity (broad money) over the same quarter of the previous year.

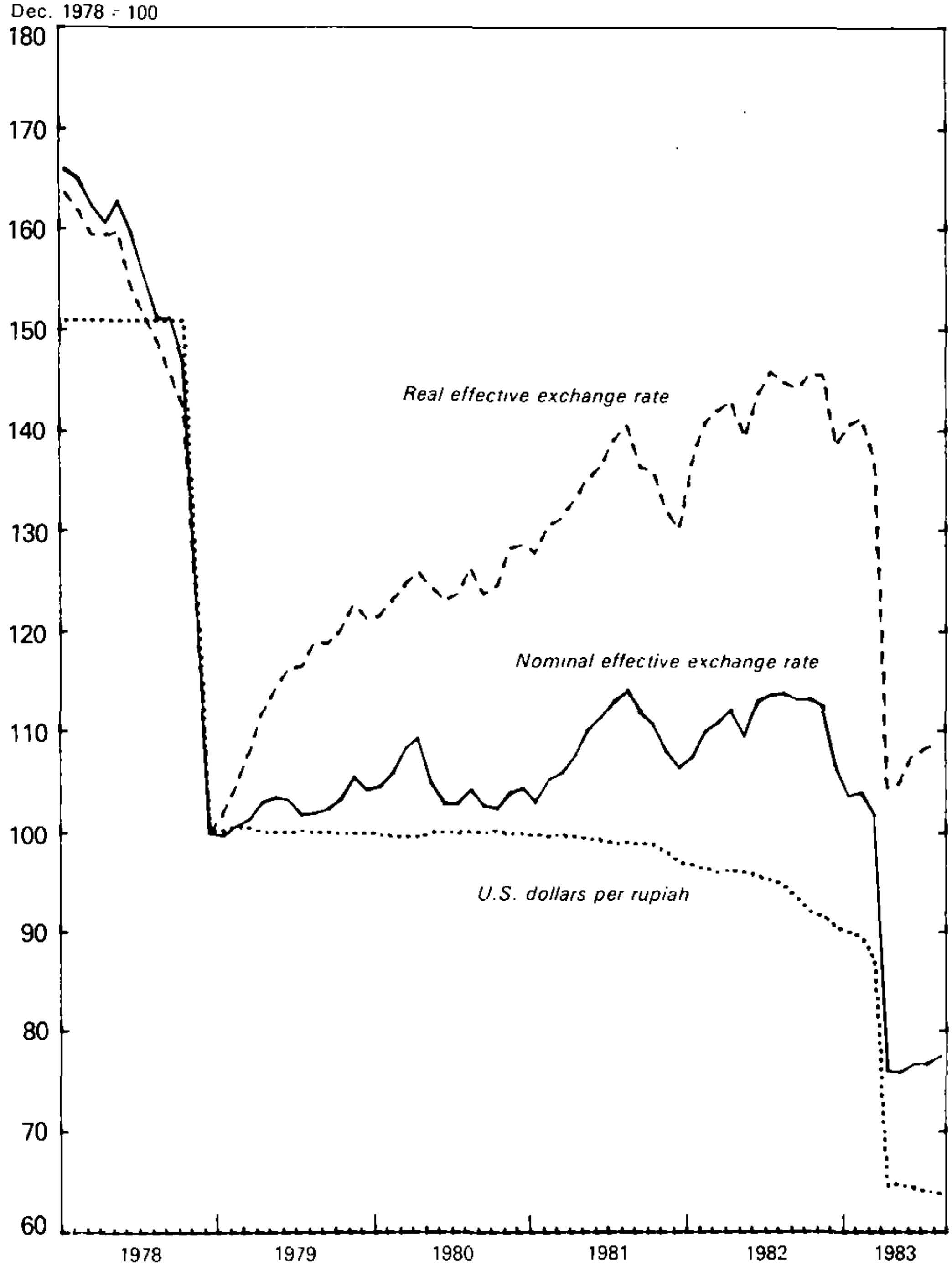
[2]Annual change in asset type divided by total liquidity at end of previous year.

[3]Annual percentage change.

CHART 6

INDONESIA

DEVELOPMENTS IN EXCHANGE RATE INDICES[1], 1978-AUG. 1983



Source: Data provided by the Indonesian authorities and staff estimates.
[1]Indices calculated using monthly average data.

conditions. On March 30, 1983 the rupiah was devalued by a further 28 percent to Rp 970/US$1. In early May, plans were announced to reduce drastically public sector investment expenditures from planned levels over the next several years, with the intention of shifting the savings in local currency to employment-generating activities. On June 1, a substantial reform of the financial sector was introduced. The authorities noted that the aims of these measures were to reduce pressure on external resources; to encourage non-oil exports and import substitution in the medium term; to more fully exploit prospects for increased employment in an environment of slower growth; and to increase the mobilization of domestic savings through the financial system.

a. The devaluation

The adjustment of the exchange rate on March 30, 1983 is estimated to have restored competitiveness of the traded goods sector to about the level prevailing immediately following the previous devaluation in November 1978. In the five months following the devaluation, consumer prices have risen by about 6 percent; at the wholesale level, prices went up by 19 percent in the first two months following the devaluation, with increases in traded goods prices accounting for four fifths of the rise. The passthrough to nontraded goods prices appears to be limited, partly because of the substantial slack in the domestic economy, partly because of the phased passthrough of the required increases in certain administered prices, and partly because of the example set by wage restraint in the public sector. Moreover, the adjustment in the exchange rate appears to have been convincing. Bank Indonesia was a net purchaser of foreign exchange immediately following the devaluation until mid-July, reflecting a substantial inflow of capital. Since mid-July, a pattern of net sales of foreign exchange roughly commensurate with the balance of payments forecast for 1983/84 seems to have been re-established. The adjustment of the exchange rate seems also to have helped relieve inventory problems in certain manufacturing industries, such as textiles, by encouraging increased exports.

b. Review and rephasing of public sector project spending

The rephasing of the public sector investment program was undertaken to conserve foreign exchange resources in light of the weaker prospects for the balance of payments and to halt the sharp rise in the public sector debt service ratio. The rephasing promises to have a substantial impact on reducing imports and moderating overseas borrowing. Projects affected include both those financed through the Central Government budget as well as those executed by public enterprises with approved foreign borrowing. 1/ The authorities reviewed 125 projects in various stages of planning and execution. Foreign exchange expenditures which had been authorized for such projects totalled over $21 billion; the

1/ All foreign borrowing by public enterprises must be approved by the Ministry of Finance.

cancellation, postponement and rephasing of projects reduced such spending to $10.9 billion, against which payments of nearly $3.7 billion had already been disbursed by end-March 1983 (Table 5).

Projects affected ranged from the virtually complete Cilicap, Balikpapan, and Dumai refineries--for which only minor changes were made in the supporting facilities to be completed by Pertamina--to projects such as highway construction, power plants, telecommunications, defense, coal mines, and alumina facilities which were still in the planning or design stages and which were cancelled or indefinitely postponed. Some projects were to be redesigned to employ domestically-produced goods (inter-island vessels and port equipment, for example); others were to be offered to the private sector for implementation. The scope and extent of the revisions to the investment program are evident in Table 5. Foreign exchange savings expected in 1983/84 alone exceed $3 billion; savings in subsequent years will amount to over $7 billion.

The deceleration of public sector investment expenditures may be even larger than indicated by these data which are derived from the rephasing exercise. Garuda's purchase of airplanes was phasing down as the size of the fleet had already expanded substantially and major components of Pertamina's investment in LNG facilities were reaching completion. 1/

c. Financial reform measures

The financial reform measures taken on June 1, represent the most significant change in the monetary system in over a decade. Under the new system, state banks are free to set most deposit and lending rates; the detailed rediscount mechanism has been simplified so as to restrict access to only the highest priority sectors; and credit ceilings are to be replaced by indirect control over the pace of monetary expansion through reserve money management. The authorities hoped that the adoption of indirect mechanisms for monetary control would alleviate some of the adverse side effects associated with the credit ceilings--including what had become unduly selective credit allocation schemes. 2/ They view the reforms generally as an effective means of encouraging the mobilization of domestic financial resources and of promoting efficient use of investment funds.

Within the banking system, the state banks are most directly affected by the new measures, under which their operations are expected to take on more of a commercial orientation. This is expected to be

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1/ See Table 2, Net Capital Inflows on Account of State Enterprises, and Table 3, "Memorandum item," on public sector foreign borrowing.

2/ Credit ceilings were originally established in 1974 as one means to help control the expansionary impact of the sharp increase in oil revenues which occurred at that time.

Table 5. Indonesia: Project Rephasing Program

(In millions of U.S. dollars)

Project or Implementing Agency	Planned Foreign Exchange Expenditure		Disbursements Made Through March 31, 1983	Payments to be Made in 1983/84		Payments to be Made in Subsequent Years	
	Before rephasing	After rephasing		Before rephasing	After rephasing	Before rephasing	After rephasing
Sugar mills, smallholder and nucleus estates 1/	809.9	269.5	69.9	306.0	132.3	433.8	94.7
Dairy industry, plywood, and cement plants 1/	1,139.6	194.6	45.8	424.1	66.2	669.7	82.6
Fertilizer projects	753.1	738.1	132.9	378.5	363.0	242.2	242.2
Aircraft, ship industry, and others	1,701.5	899.8	393.9	511.3	317.3	796.3	188.6
Coal and alumina	828.2	324.6	62.0	333.6	177.6	432.6	111.1
Pertamina 2/	7,023.7	4,479.3	2,450.2	2,585.5	1,610.7	1,988.1	418.5
Garuda	427.0	258.0	207.0	93.3	51.0	126.7	--
Power, transport, navigation, and telecommunications	5,768.2	2,405.6	249.7	1,688.1	752.4	3,830.4	1,398.5
Kraft paper, Cold Rolling Mill, Olefin	2,005.0	805.0	--	243.0	164.2	1,762.0	640.8
Other	842.0	477.1	61.7	257.2	169.0	523.1	246.4
Total	21,298.2	10,871.6	3,673.1	6,820.6	3,803.7	10,804.9	3,423.4

Source: Data provided by the Indonesian authorities.
1/ Efforts will be made to attract private investment to the projects in these sectors.
2/ Including methanol, aromatic, and ethane production facilities, the Cilicap, Dumai, Balikpapan, and Musi refineries, and other projects.

a gradual process, however, as these banks are likely to continue to pursue their historic specialization in certain sectors and will remain subject to central bank guidance in the supply of the appropriate volume of credit to priority sectors.

The most obvious initial effect of the new monetary measures has been the quick alignment of state bank deposit rates with the unregulated rates prevailing at private domestic and foreign banks and the sharp increase in short maturity deposits at these banks (Table 4 and Chart 7). The increase in time and saving deposits may be partly associated with a transfer from current accounts but probably also reflects the continued inflow of speculative funds that left the country prior to the March 30 devaluation. Loan rates at state banks have also been adjusted, with rates on major categories of investment credits increasing from 13.5 percent to 18 percent or higher. Several factors indicate that the initial increase in interest rates after the June 1 measures were announced may have been overdone and deposit rates, at least, have subsequently declined modestly. The current level of interest rates, which are positive in real terms, may be influenced by Bank Indonesia's fixed fee for swaps (forward sales of foreign exchange), which could be holding rates slightly above equilibrium levels.

One result of the new deposit rate structure has been to shorten the maturity of bank time deposits. The authorities expressed some concern that this change, along with the decreased access of banks to central bank liquidity credit to fund investment lending and the much higher interest rates on such credits at state banks, may affect the adequacy of term lending for investment purposes.

IV. Medium-term Prospects

1. Recent policy measures and external adjustment

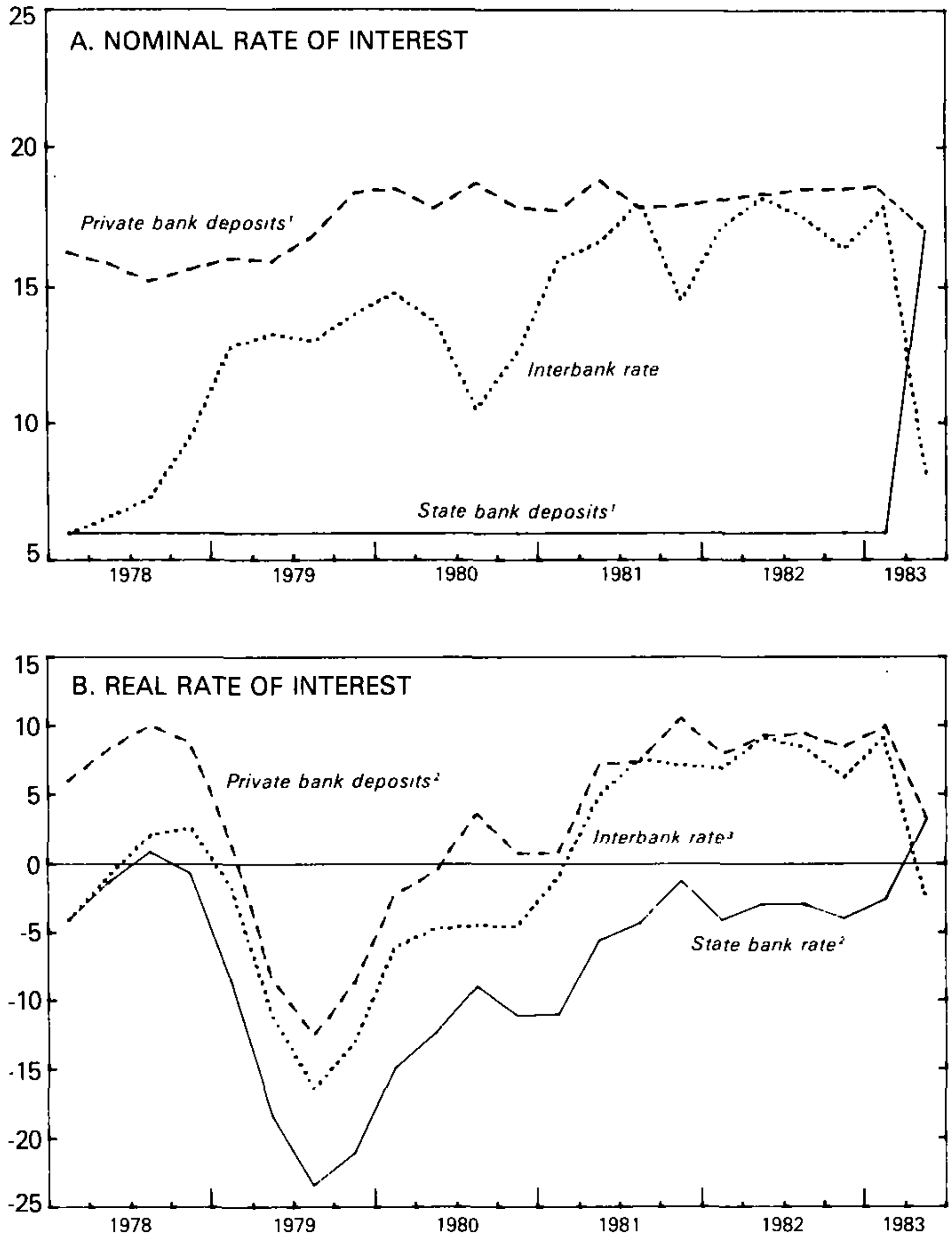
On the basis of relatively cautious assumptions for the world economy, the adjustment measures taken by the authorities appear to be sufficient to substantially reduce the current account deficit in the balance of payments over a relatively short period of time. The current account deficit for 1983/84, which was forecast early in 1983 to be in the range of $9-10 billion, is now estimated at $5.7 billion under current policies. While some of the projected improvement reflects better prospects for commodity prices and for world oil market conditions, the bulk of the adjustment reflects the impact of the investment rephasing exercise on project imports and of the devaluation on other imports. Financing the projected deficit should not present a problem. In fact, borrowings sufficient to fund this deficit--with no accumulation of reserves--have already been arranged.

Balance of payments forecast beyond 1983/84 are fraught with uncertainties. There are the obvious concerns about the sustainability of the current recovery in the industrial world. The full impact on

CHART 7

INDONESIA

NOMINAL AND REAL INTEREST RATES, 1978-83



Source: Data provided by Indonesian authorities and staff estimates.
[1] Six-month rate.
[2] Six month deposit rate less annual percentage change in CPI.
[3] Interbank rate minus LIBOR.

the economy of the recent policy measures--especially the devaluation and the financial reform--will not be known for some time. Moreover, at the time of the consultation discussions, the authorities had not yet fully specified the policy outline for the next Five-Year Plan to commence in April 1984. Therefore, to judge the sufficiency of the adjustment program over the medium term, the staff developed a scenario incorporating certain assumptions for the external conditions likely to confront the economy and postulating as a base-case a policy stance reflective of the authorities' early indications for the new Five-Year Plan. The scenario presumes continuous but moderate growth in the industrial world. Commodity prices are forecast as in the recent WEO exercise, except for oil, which is assumed to increase only to an average level of $31/barrel in 1985/86. 1/ A moderate rebound in non-oil export volume is assumed and oil production is projected to increase from the current level of about 1.4 mbd. to 1.65 mbd. 2/

Project imports are estimated for 1984/85 on the basis of data supplied by the authorities in connection with the rephasing exercise; for 1985/86 and beyond, some rebound in such imports is projected, as disbursements against public sector loans are assumed to increase in accord with forecast requirements to reach the planned official medium-term growth estimate of 5 percent per year. 3/ Nonproject imports are assumed to increase along a devaluation-adjusted trend, assuming maintenance of the current level of competitiveness. Government expenditures, other than for project imports, are assumed to expand at about the same rate as nominal GDP. Government oil revenue is projected on the price and production assumptions noted above. The ratio of domestic revenue to GDP is assumed to remain unchanged.

Balance of payments projections based on this scenario suggest a continued substantial decline in the current account deficit from $5.7 billion (7.5 percent of GDP) this year to below $2.5 billion (2.5 percent of GDP) in 1985/86 4/ (Table 6). Projections beyond

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1/ This assumption was made to tailor the scenario closer to the views of the authorities on the outlook for oil prices. Oil prices were assumed to increase further to $34.50/barrel in 1987/88.

2/ Current production capacity, proven reserves, and a continued high level of exploration and development activity are considered by most observers to make this level of production feasible beyond the scenario period. Substitution of alternative energy sources for oil, aided by increased domestic petroleum prices, is also projected to reduce the growth of domestic consumption of oil products, sustaining exports at near the levels recorded during 1979-81.

3/ These projections for project imports are staff estimates; detailed official projections for the next Five-Year Plan (beginning April 1984) have not yet been finalized.

4/ At the oil production and export levels assumed for 1985/86, a variation in crude oil prices of $1/barrel would alter the oil export projections by about $450 million; a production shortfall of 0.05 mbd. would reduce export receipts by about $560 million.

Table 6. Public Sector Debt and Debt Service Payments on External Debt, 1982/83-1987/88 1/

(In millions of U.S. dollars)

	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88
From existing pipeline as of end-1982/83 2/						
Gross disbursements	5,469	4,838	2,246	1,298	932	905
Debt service payments	2,485	2,673	3,221	3,394	3,754	3,777
Multilateral loans	256	359	460	506	618	715
Bilateral loans	334	467	596	615	725	837
Nationalization debt	9	9	9	9	9	9
Private banks and supplier credits and other 3/	1,886	1,838	2,156	2,264	2,402	2,216
Amortization	1,303	1,353	1,680	1,799	2,211	2,319
Interest	1,182	1,320	1,541	1,595	1,543	1,458
Disbursements and debt service from new commitments 4/						
Gross disbursements	--	2,264	2,354	3,702	4,568	5,095
Debt service payments	--	--	245	517	1,091	1,589
Amortization	--	--	--	44	312	493
Interest	--	--	245	473	779	1,096
Totals and summary data						
Total disbursements	5,469	7,102	4,600	5,000	5,500	6,000
Amortization	1,303	1,353	1,680	1,843	2,523	2,812
Interest	1,182	1,320	1,786	2,068	2,322	2,554
Total debt outstanding	21,213	26,962	29,882	33,039	36,016	39,204
Memorandum items:						
Current account deficit	6,893	5,709	3,155	2,154	2,590	3,002
Debt service/GDP (percent)	2.8	3.5	4.4	4.5	5.0	5.1
Debt/GDP (percent)	23.5	35.4	38.1	38.2	37.7	37.3
Debt service/net exports of goods and services (percent)	20.2	22.3	23.1	21.9	25.0	25.5
Exports of goods and services (gross)	19,294	18,761	20,794	24,842	26,889	29,142
Exports of goods and services (net)	12,295	11,970	14,998	17,882	19,406	21,061

Source: Data provided by the Indonesian authorities.

1/ Excludes nonbank, non-government short-, medium-, and long-term debt to banks estimated to be $5.8 billion at end 1982/83.

2/ Includes drawing, charges, and repurchases associated with IMF buffer stock facility.

3/ LNG-related debt included; this debt is nonguaranteed, project related.

4/ Includes drawing, charges, and repurchases relating to CFF purchase.

1985/86 indicate a modest increase in the current account deficit in U.S. dollar terms more or less in line with the assumed increase in public sector project imports. As a share of GDP, the current account deficit would rise slightly from the level projected for 1985/86.

The evolution of the balance of payments outlined above would substantially slow the deterioration of the public sector debt service ratio but would not be expected to reverse it. After nearly doubling over the past four years to a projected 22 percent in 1983/84, the ratio is expected to increase somewhat further in 1984/85 and then to decline to about this year's level in the following year. 1/ Over subsequent years, however, the ratio would increase somewhat if disbursements for public sector investment projects are programmed to increase slightly in real terms as assumed in the staff's scenario.

2. Growth prospects and policies

Growth in 1983/84 is expected to exceed last year's rate of 2.2 percent by only a small margin. Some rebound in the oil sector is likely, but the rest of the economy, including the agricultural sector, remains weak. The public sector is expected to contribute little to growth, and there could be some adverse effect on private investment of the rephasing of the public sector investment program. Inflation is expected to moderate as the impact of the devaluation dissipates; weak domestic demand and wage restraint are expected to hold down domestic price increases. The domestic employment situation is likely to deteriorate somewhat further in this environment.

The authorities stressed that the economy is undergoing a transition from one driven by rapidly increasing project spending by the Government and public enterprises, supported by increasing oil revenues and subject to no immediate foreign exchange constraint, to one in which the public sector cannot be expected to be a dominant source of growth and foreign exchange has become far more scarce. The scenario reviewed in the previous section reflects that view. That scenario assumes little growth in real public sector project imports from the reduced level resulting from the rephasing exercise and an approximately constant share of government spending and domestic revenue in GDP. It also presumes management of the exchange rate to avoid a loss of competitiveness and success of current policies in boosting non-oil exports. The debt service profile which emerges from that scenario suggests little scope for increasing investment through foreign borrowing above the levels assumed in that exercise.

1/ In this exercise, LIBOR has been assumed to average 10 percent until 1985/86 and then decline to 9 percent in 1986/87 and to 8 percent in 1987/88.

The growth rate assumed in that scenario--5 percent per annum--is the authorities' estimated rate of growth for the period covered by the next Five-Year Plan. In addition to success in increasing non-oil exports, achievement of that rate of growth and the indicated path of external adjustment will require two fundamental changes in the economy: increased mobilization of domestic savings to provide the resources for the implied level of investment; and a substantially increased role for the private sector. The Government is addressing both of these requirements in its current policies and in framing the next Five-Year Plan. The financial reforms introduced in June were aimed at providing a larger flow of investible resources for the private sector and for public enterprises and, at the same time, improving the efficiency of the use of those resources through greater commercialization of the operations of the state banks. Increased savings will also be required in the budget to permit a continued expansion of development expenditures. To achieve this, the authorities intend to continue the austerity in current expenditures that has characterized the last two budgets. Moreover, substantial reform of the domestic tax system is to be introduced in early 1984 in order to increase domestic tax revenue. The staff understands that the reform will involve simplification of the structure of both personal and corporate income taxes and a replacement of the current system of sales taxes by a broad based value-added tax. The changes will be supported by administrative reforms and the introduction of a computer-based information system. The authorities expect the simplicity and certainty of the proposed system, by facilitating assessment and encouraging compliance, to increase significantly the yield of non-oil taxes relative to GDP. However, they do not expect that the revenue benefits will be fully realized until the late 1980s.

The authorities are addressing the second requirement through their continued efforts to promote both domestic and foreign private investment and to create a business climate more conducive to private sector activity. For this purpose, a review is being conducted of all reporting requirements, rules, regulations, levies, and administrative requirements imposed on the private sector by government agencies. This reform effort has been given priority by the Cabinet and has already resulted in the elimination of some local levies and reporting requirements.

V. Current Policies

1. Fiscal policy

The budgetary outlook for 1983/84 discussed in Section III was fundamentally altered by developments in the oil market, the devaluation, and the rephasing of the investment program (Table 3). The price of oil is now expected to average only $29.50/barrel during 1983/84 and production is likely to be somewhat lower than expected. These changes in the prospects for the oil sector have reduced projected dollar receipts from that sector by an estimated 23 percent relative to the budget estimates. However, the impact of the devaluation on oil revenue more than offset this decline in foreign exchange receipts, boosting estimated (rupiah) revenue by almost 8 percent from the budget figure. While many adjustments were made to the original non-oil revenue estimates as a result of the devaluation and other developments since presentation of the budget in early 1983, these changes are almost wholly offsetting, and the increase in oil revenue is reflected fully in increased total receipts.

Expenditure estimates have also been substantially revised. Excluding increases for (foreign) interest payments and increased subsidies on petroleum (due to the devaluation) and on food (due, in part, to the devaluation), current expenditures are estimated to increase by about 5 percent from the budgeted level. This increase reflects, primarily, the impact of the one-month wage bonus given to public sector employees to offset the impact of the devaluation on inflation. Moreover, it suggests a decline in other current expenditures in real terms relative to that planned in the original budget, leaving such expenditures at about the same real level as in 1982/83. The authorities have instructed departments not to exceed original rupiah authorizations despite the prospects for larger-than-projected price increases stemming primarily from the devaluation.

Development spending authorizations were budgeted to increase by 26 percent in 1983/84, including a 42 percent increase in foreign-financed expenditures and a 21 percent increase in locally-financed expenditures. Staff estimates of a somewhat broader measure of capital spending and net lending suggest that an increase of more than one third was in prospect when the budget was formulated. 1/ Revised estimates made since the devaluation and the rephasing of the public sector investment program indicate that capital spending and net lending will increase by almost 30 percent in nominal rupiah terms over the level in 1982/83. Absent the rephasing effort, the increase would have been more than 60 percent. The change in the investment program has reduced planned foreign-financed project expenditures in the budget by over $2 billion to about 10 percent above their level in 1982/83. Rupiah-financed development expenditures will remain at about the same level as projected in the budget, suggesting some increase in real terms over last year's level.

1/ The staff estimate adjusts official budgetary data to take account of certain extrabudgetary expenditure and transfers financed through foreign borrowing (derived from creditor data) and, for years before 1983/84, adjusts for the difference between budget authorizations and cash expenditure (which includes spending against both the current year's authorizations and against unused authorizations from previous years). The staff definition of capital spending excludes some items (subsidies on fertilizers, defense expenditure, and current transfers to enterprises) which the authorities classify as development expenditure.

These revisions to the current year budget suggest that the fiscal deficit will increase to 5.9 percent of GDP from 5.0 percent in 1982/83. Staff estimates suggest, however, that this fiscal stance will provide little impulse to domestic demand, the increase in the deficit relative to 1982/83 resulting from a net increase in public demand for external resources reflected in a deterioration in the Government's foreign balance. Furthermore, these figures do not reflect all of the foreign project expenditures of Pertamina or Garuda, two of the largest public enterprises. The authorities noted the substantial decline in investment by these enterprises reflected in balance of payments data as Pertamina completes a major phase of the LNG expansion and Garuda reduces its aircraft purchases. Incorporating these elements into a broader measure of public sector activity suggests that the foreign balance will remain roughly unchanged in 1983/84 (despite the sharp drop in oil tax revenues), due to a substantial drop in total public sector foreign project expenditures. 1/

2. Monetary policy

Given the official forecast for the budget and balance of payments, the authorities set a target for credit expansion for the current fiscal year of 18 percent, implying domestic liquidity expansion of about 15 percent. This was seen to be consistent with an underlying inflation rate of about 10 percent and real growth at about the same rate as last year (below 3 percent). As the year has progressed, however, the authorities have come to the view that some slight shift in monetary policy would be appropriate. With the apparent progress in the balance of payments--assisted by the rephasing of the public sector investment program--the burden on monetary policy has been somewhat reduced. Moreover, as the price passthrough from the devaluation appears not to have ignited inflation, more weight could be given to depressed domestic economic conditions in the formulation of credit policy. Under these conditions, the authorities indicated that credit expansion at a rate slightly faster than 18 percent would be appropriate. They emphasized, however, that this alone would not revive domestic activity; a revival in the demand for exports was seen as critical to an improvement in the domestic economy.

It is difficult to judge recent monetary developments on the basis of the data available for the first several months of this fiscal year. The financial system has been adjusting to significant changes: first, to the devaluation and, then, to the reform measures introduced on June 1. Outstanding credit to the private sector declined in April coincident with a reflow of capital into the country. Private sector

1/ This broader measure of government activity is useful to provide consistency to the budget data since the percentage of public sector foreign expenditure financed through the Central Government has varied considerably in recent years.

credit expansion over the subsequent few months has been well within the limits deemed appropriate by the authorities and substantially below the rates recorded prior to the devaluation. Net credit to the Government has declined during this period. However, credit to public enterprises other than Pertamina and BULOG has expanded rapidly. After increasing by about 30 percent in 1982/83, such credit is estimated to have accelerated sharply in the April/August period.

The major factor increasing domestic liquidity over the recent period has been the substantial increase in net foreign assets in the banking system (Table 4). Given the reflows of capital evident immediately following the devaluation, the relatively slow expansion of credit to the private sector, and the sharp increase in (short maturity) time deposits in the banking system, this appears to reflect a rebuilding of domestic money balances following the devaluation. Total liquidity has expanded at a compound annual rate of about 33 percent over the period April/August, a rate above the target rate set by the authorities. 1/

The June financial reforms removed the major mechanism of control over domestic credit expansion--credit ceilings--and substantially reduced the potential of central bank rediscounting operations for supplying the banking system with reserve money. Other policy instruments are available--primarily reserve requirements and moral suasion--and a major source of liquidity is available to banks through repatriation of their relatively large holdings of foreign assets. The authorities intend to use moral suasion to maintain an adequate level of lending to priority sectors. Moreover, some guidance is provided to banks to accord the external constraint some priority in their lending operations by restricting loans for import-intensive activities and focussing instead on export credits and credit for more labor-intensive projects.

The authorities are concerned that the instruments currently at their disposal are insufficiently flexible to guide monetary policy as closely as they would like. Consideration is being given to the institution of a more traditional rediscount mechanism directed toward reserve money control and distinct from the central bank's rediscount operations used to influence bank lending to priority sectors. The authorities are also considering issuance of a central bank note or certificate of indebtedness. In the absence of government securities, 2/ such an instrument is seen as one means to develop a capability for open market operations by the central bank to more directly influence bank liquidity. A nonreservable note is also seen as a mechanism for providing commercial banks with a domestic alternative to their substantial holdings of foreign assets. 3/

1/ The official target for monetary expansion does not allow for any significant rebuilding of money balances.

2/ There are no government securities of any maturity issued in Indonesia.

3/ Technical assistance on these issues was provided in conjunction with the recent consultation discussions. Additional assistance is now being arranged through the IMF Central Banking Department.

3. Exchange rate and reserves policy

Since the devaluation on March 30, 1983, the rupiah has gradually depreciated against the U.S. dollar from Rp 970/US$1 to Rp 984/U$1 (about 1.5 percent). Except during August when the strength of the dollar peaked, these adjustments have been generally sufficient to maintain the level of the rupiah relatively stable in nominal effective terms.

The authorities explained that an indicator basket of currencies is used--though not exclusively--to guide day-to-day movements of the exchange rate. The exchange rate would continue to be managed flexibly so as to avoid the situation which developed prior to November 1978 and again between 1979 and mid-1982. The loss of competitiveness which occurred during those periods is viewed by the authorities as having had a detrimental impact on the development of industry and agriculture and on exports from those sectors. At the same time, however, the authorities emphasized that the goals for exchange rate policy could change with circumstances, leading to adjustments in the rate to a greater or lesser degree than indicated by calculations based on a basket of currencies.

Developments in the level of official foreign exchange reserves will continue to play a role in exchange rate management. The authorities indicated that official foreign exchange reserves should provide at least three months cover for non-oil imports. Official reserves as of August 1983 were $4.6 billion, equivalent to 3.9 months of total non-oil imports. An additional $4.6 billion in foreign assets is held by commercial banks against foreign liabilities of $0.8 billion.

The authorities would like to see the banks repatriate more of their holdings of foreign assets. During 1982/83, the central bank induced repatriation of about $1.5 billion through the establishment of a special interest-bearing nonreserve account into which state banks were encouraged to deposit the proceeds of sales of foreign exchange to Bank Indonesia. No target for repatriation has been set for 1983/84, and in August 1983 the special deposits were eliminated and merged with regular reserve deposits of the banks. Recently, the interest rate payable on excess rupiah reserves has been increased (to 13 percent), partly with the intention of encouraging a further inflow of foreign assets to Bank Indonesia.

4. External debt

Total external debt of the public sector rose to over $21 billion (24 percent of GDP) at the end of March 1983. 1/ Original borrowing

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1/ This amount includes about $1.5 billion of debt on account of the LNG expansion facilities. This debt, to be repaid in kind, may not always be included in official debt totals because of certain "limited recourse" features in the loan agreements.

plans for the current year, which would lead to an accumulation of gross reserves of nearly $1 billion under the current forecast for the balance of payments, would raise outstanding public sector debt to nearly $27 billion (35 percent of GDP) (Chart 8). 1/ While public sector debt has expanded rapidly in recent years and the terms on new commitments have hardened somewhat, the overall structure of the debt is not a matter of immediate concern. Debt at floating market interest rates accounts for only 17 percent of the total (including undisbursed debt), and ODA for 35 percent; there is no short-term public debt; and the level of net foreign assets remains relatively high. Moreover, while some projects already underway will require commercial borrowing, the authorities have indicated their intention to restrict new development projects to the extent practical to those that can be financed by ODA or by official export credits.

The debt service ratio, which fell rapidly with the commodity boom and oil price increases of the late 1970s to below 12 percent in 1980/81, has since increased to over 20 percent in 1982/83 and is projected to fluctuate in a range from 22-25 percent over the next five years. Of the increase of 12 percentage points between 1980/81 and 1982/83, about 3.5 percentage points is due to increased debt service and the remainder to the sharp decline in exports which has occurred. Exports, however, are not anticipated to regain the 1980/81 level until 1985/86. The authorities have indicated that in framing the next Five-Year Plan, they intend to limit borrowing so as to prevent a further rise in the debt service ratio by exercising continued restraint over the public sector investment program.

There are no official data on nonbank private sector debt. Staff estimates place private nonbank debt to overseas banks (both short-term and long-term) at nearly $6 billion. 2/ Total private sector external debt is likely to be larger than these estimates. The authorities expressed concern over this situation and indicated that they would attach some urgency to improving and expanding the monitoring systems for such debt. This factor also played an important part in the decision to frame the next Five-Year Plan to prevent further increases in the public sector debt service ratio.

5. Trade policy

Trade policy over the recent period has been influenced by four major factors: the reported increase in dumping by overseas producers as the world recession weakened demand; the perceived need to protect

1/ Much of the rise in the debt/GDP ratio results from the impact of the devaluation on the rupiah equivalent of outstanding debt. Abstracting from that effect, the debt/GDP ratio would rise to 29.9 percent.
2/ Staff estimate based on the IMF Project on International Banking Statistics.

large domestic investments until industries have been able to achieve an economic scale of operations; the desire to increase domestic production in certain areas with the goal of eventual self-sufficiency; and the desire to reduce administrative impediments to trade, especially as they affect exports.

Complaints from domestic producers of sales of imports at prices which could not reflect full costs, along with the perceived ineffectiveness of tariffs in halting such practices, have led to an increase in quantitative restrictions on imports. The authorities indicated that such restrictions were temporary and were in many cases necessary because no formal apparatus has yet been developed to take other effective countermeasures against dumping. Partly to deal with this same problem, most items may no longer be imported under a general import license, but rather must be included within a specific product group for which an importer has secured an import license. The aim of such measures is to encourage import specialization in particular product lines. The authorities explained that, in this way, importers will develop longer term relations with suppliers and domestic distributors and a longer term interest in the sales and service of the products they sell. In most cases, no limits are expected to be placed on the number of licenses to be granted for a specific product group.

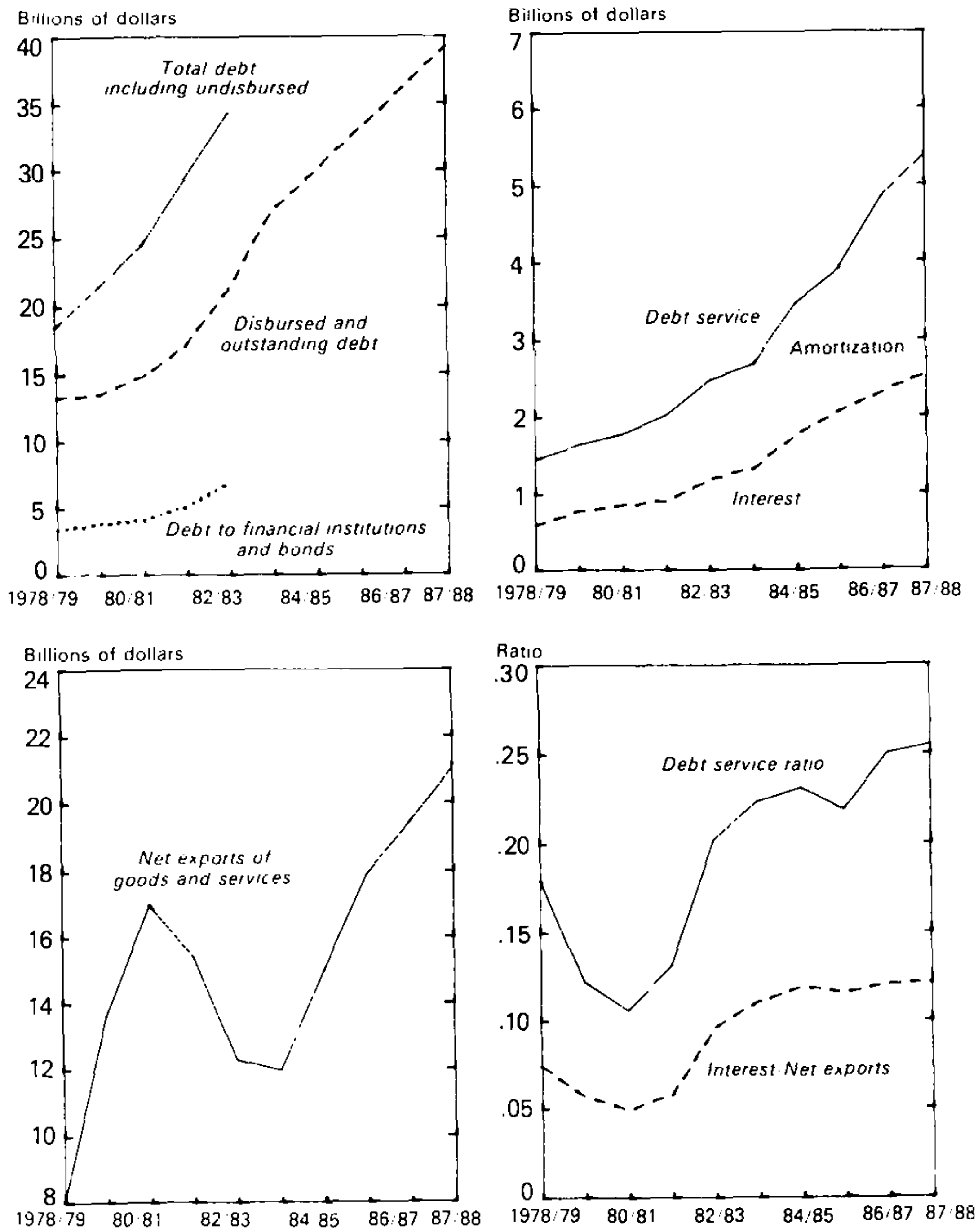
Protection of the domestic steel industry has increased with the granting to Krakatau steel of exclusive import and distribution rights over a wide range of steel products. Similarly, Pertamina has been given exclusive control over imports and domestic production of lubricants. The latter was motivated by the coming onstream of production facilities operated by Pertamina sufficient to supply the domestic market and by consumer complaints about the quality of lubricants supplied by other domestic producers. In all but isolated areas, imports of a large number of food items have been limited to two state trading companies. Importation of a number of other items has also been restricted to selected trading companies. The import levels of these items are not restricted but are subject to review (ex post) by the Ministry of Trade. The authorities noted that in some cases these arrangements are intended to lay the basis for eventual domestic self-sufficiency in certain commodities; in other cases, the justification is that imports of nonessential items needed to be curtailed as the balance of payments had weakened.

Measures have also been taken to stimulate exports. In addition to revised export credit facilities and the general stimulus from the devaluation, the authorities have begun a program to overhaul and simplify export procedures. Single-commodity export teams have been established to examine the problems faced by exporters with an eye to eliminating unduly burdensome levies, duties, taxes, licensing requirements, and other unnecessary administrative impediments to trade. More effective financing and shipping arrangements for exporters will also

CHART 8

INDONESIA

EXTERNAL DEBT INDICATORS, 1978/79-87/88



Source: Data provided by the Indonesian authorities and staff estimates.

be recommended. Notwithstanding this effort, the 1982 decree requiring that all public sector exports and imports use Indonesian transport facilities, has been retained. The authorities reported that no major problems of capacity shortages or otherwise have resulted from this measure.

The counterpurchase requirements established in 1982 have been modified to expand the list of eligible export products (including the export of labor services). The authorities reported that large trading firms and even some international banks have become active in assuming responsibility for counterpurchase arrangements.

The authorities noted the difficult conditions imposed in international markets by the increasingly protectionist stance taken by some industrial countries. Lists of restricted products--subject to quotas--have increased and bilateral consultations under international agreements, such as the MFA, have sometimes been called for involving extremely low values of exports. Some of the measures taken in the domestic market were explained by the authorities as necessary countermeasures to this deteriorating environment.

VI. Staff Appraisal

The viability of the trends established in the economy during the period of rising oil revenue and increasing foreign exchange reserves--especially the acceleration of public sector project spending and the rapid increase in imports was challenged by the onset of the world recession in 1981. The protracted nature and depth of that recession ultimately made these trends unsustainable. The policies introduced during 1982, which were dictated by the weakened external environment, proved insufficient as oil production fell dramatically and, ultimately, crude oil prices declined. At that point, the momentum of development spending planned earlier collided with the realities of a far tighter external resource situation. Under those circumstances, the authorities moved decisively to introduce additional adjustment measures to alter the trends which had been established and to better align demand in the economy with prospective resource availabilities. The measures adopted included a 28 percent devaluation of the rupiah, the rephasing of the public sector investment program, and reform of the financial system.

The implementation of these policies appears to have been well managed and to have convinced the markets. Moreover, these measures have evidently had the desired initial effects on the economy. In combination, the devaluation, the reduction in planned public sector project spending, and the somewhat improved prospects for the world economy have halted the loss of international reserves. Under current prospects for the world economy, these measures also promise to reduce the current account deficit in the balance of payments and return it to a sustainable position over the medium term if the growth of government spending is confined to about the rate of expansion of GDP and if monetary policy remains appropriately restrained. The reduced financing requirement should also slow substantially the rise in the public sector external debt service ratio. Nevertheless, the external debt situation will require constant monitoring, including better surveillance over private sector borrowing.

The measures taken represent only the first--though perhaps the most difficult and dramatic--moves necessary to successfully manage the transition to a new economic environment. That environment dictates a more slowly expanding public sector--and, thereby, increased reliance on the private sector for growth--and will be characterized by a far tighter foreign exchange situation. In adapting the measures already taken to emerging evidence of their impact on the economy, it will be important to gear policies to the extent possible within the new constraints toward a restoration of growth. Some rebound in oil production and further expansion of LNG capacity during this fiscal year should help sustain growth in the face of weakness in other sectors, including agriculture. Further oil sector gains and a recovery of agriculture should bolster growth next year.

During the next Five-Year Plan period, however, growth in non-oil sectors, especially industry, will have to accelerate to meet the authorities' estimate of 5 percent GDP expansion. In the new environment, this will require a more active private sector, employing a higher proportion of domestic resources, including labor; more buoyant growth in domestic tax revenue to provide expanded resources for continued--albeit more modest--increases in development spending; a competitive price structure that provides continuous incentives to use a mix of domestic resources and imported capital appropriate to the reduced availability of foreign exchange; and maintenance of improved incentives for exports. It will also require a stable domestic financial environment. The authorities are addressing these requirements in their current policies and in the formulation of the Five-Year Plan to begin next April.

The measures taken in the financial sector should promote increased domestic saving and, together with the proposed reform of the tax system, should assist the mobilization of domestic resources for investment. Successful management of the financial sector, including monetary policy, will require improved monitoring of developments in the banking system as well as additional instruments for monetary control to supplant the credit ceilings abolished in June. The authorities are considering the institution of various instruments--including a rediscount mechanism and the issuance of a central bank debt instrument--and the staff concurs with the need for and appropriateness of these measures. Other issues in the financial sector need to be addressed as well, including the impact on domestic interest rates of Bank Indonesia's fixed fee for swaps and the potential effect of recent measures on term lending by commercial banks. The latter will require careful monitoring of the response of the several components of the financial system to the new environment.

The tax reform measures proposed are known only in broad outline. The changes represent a fundamental revision of the tax system but a substantial revenue impact cannot be expected for some time. Moreover, continued improvement in tax administration, on which the authorities are also actively working, will be critical to the success of these reform measures. Prospects on the tax side and the already high external debt service ratio suggest the need for continued restraint on current budgetary expenditures and a cautious approach to restoring projects cancelled or postponed in the recent rephasing exercise. For the time being, any restoration of projects--resulting from changes in prospective financing arrangements, including offers of additional aid, for example--may require adjustments elsewhere in the investment program to keep the overall profile of the program more or less unchanged. A further shift in the structure of investment--especially in the public sector--to more labor and domestic resource-intensive production techniques will be necessary in light of the foreign exchange constraint. The authorities have already made this shift one of the criteria in the rephasing of the public sector investment program.

The authorities continue to encourage private investment through tax holidays and other incentives geared to the Government's development objectives. In general, however, the overriding factor in determining incentives for private investment, particularly in the industrial sector, will be projected market growth. In this sense, only an export orientation is likely to provide adequate incentives. This will require constant attention to the factors determining the competitiveness of domestic industry, especially the exchange rate. The recent devaluation has restored competitiveness to the level prevailing immediately after the 1978 adjustment and appears to have been of an appropriate magnitude and convincing. Nevertheless, it will be important to manage the rate flexibly with an eye toward developments in relative prices, so as to prevent an erosion of competitiveness. Moreover, in light of the structural changes that have occurred and will be required, it will be essential to monitor carefully developments in the balance of payments and in international reserves.

The potential impact of certain of the recently adopted trade measures on incentives in the private sector and on the efficiency of investment is of concern. Protection of upstream industries, especially through quantitative import restrictions or exclusive import licensing, may lead to increased costs for downstream manufacturers impairing their competitiveness in export markets and eventually inducing a spread of protectionism. This could have especially damaging effects at a time when the industrial sector is just beginning to expand and is being looked to as a major source of growth and foreign exchange.

Reversal of protectionist actions in developed countries which have accompanied the recessions in those economies would assist development in the industrial sector in Indonesia and provide confidence in the longer-term viability and appropriateness of an export-oriented industrial growth strategy.

At the conclusion of the 1982 Article XIV consultation with Indonesia, procedures involving the withholding tax on exports (MPO), the export tax, and the additional export tax, were observed to constitute multiple currency practices, subject to approval under Article VIII, Section 3. Since these procedures had been adopted for administrative reasons, and because the authorities stated that they would review the procedures with an eye toward eliminating the multiple currency practices, temporary approval for their retention was granted through April 1, 1984. These procedures have not been changed. However, the authorities have stated that, under the envisaged tax reform which is expected to be introduced in early 1984, these taxes could be eliminated. In the meantime, the staff recommends that the Executive Board grant an extension of the approval of these multiple currency practices.

There have been no substantive changes in the operation of the export counterpurchase scheme discussed during the 1982 consultation. However, the staff was informed that, should the counterpurchase requirement not be met, a penalty (equivalent to 50 percent of the amount of the import) could be assessed. The authorities noted that this might be effected by withholding payment to the foreign exporter. Exchange features subject to the Fund's Article VIII may therefore be involved in the counterpurchase scheme, and information will continue to be sought as to its ongoing operation. The staff encourages the Indonesian authorities to dismantle this scheme as soon as possible, noting that the recent amendment to permit assignment under the contracts of imports by third parties will, in any event, make the scheme largely ineffective as a device for export promotion.

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

VII. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Indonesia's exchange measures subject to Article VIII, Section 3, and in concluding the Article XIV consultation with Indonesia, in the light of the 1983 Article IV consultation with Indonesia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

2. The Fund notes that certain export taxes, described in SM/82/233, constitute multiple currency practices. The Fund encourages Indonesia to eliminate these multiple currency practices and, in the meantime, the Fund grants temporary approval for the retention of these practices until December 31, 1984 or the next Article IV consultation, whichever comes first.

Fund Relations with Indonesia

(As of September 30, 1983)

Date of membership:	February 21, 1967
Quota Present: Proposed:	 SDR 720 million SDR 1,009.7 million (Consent received)
Status:	Article XIV
Fund holdings of Indonesian rupiahs:	SDR 1,145.1 million, or 159.0 percent of quota

Use of Fund Credit:

Facility	Amount	Percent of quota
BSF	SDR 65.1 mn.	9.0
CFF	SDR 360.0 mn.	50.0

Holdings of SDRs:	SDR 15,736,389, or 6.59 percent of net cumulative allocation of SDR 238.9 million.
Gold distribution:	222,515.983 fine ounces in four distributions.
Direct distribution of profits from gold sales:	US$41.3 million
Exchange rate system:	On November 15, 1978, the peg of the Indonesian rupiah to the U.S. dollar was severed and Indonesia instituted a managed float under which a basket of trading partner currencies is used as one of the indicators for the determination of the exchange rate. The initial rate established for the rupiah on that date was Rp 625 per US$1. The U.S. dollar is the intervention currency. Effective March 30, 1983, the rupiah was devalued by 27.6 percent. At the same time, Bank Indonesia announced that it would continue to follow a policy of a managed float, but would take into account a somewhat broader set of currencies than was the case prior to this devaluation. The rate established for the rupiah as of March 31, 1983 was Rp 970 per US$1; subsequently, the rate has varied around this value and moved to Rp 980 per US$1 on September 30, 1983.
Exchange practices:	Indonesia maintains three multiple currency practices arising from collection procedures for export taxes. Temporary approval for retention of these multiple currency practices until April 1, 1984 was granted at EBM/83/6, January 7, 1983.
Technical assistance:	In the past the Fund has provided Indonesia with considerable technical assistance in various areas.
Last Article IV consultation:	SM/82/244 was discussed by the Executive Board on January 7, 1983 (EBM/83/6).

Bank Relations with Indonesia 1/

IBRD and IDA Lending

(In millions of U.S. dollars)

	IBRD	IDA	Total
Agriculture, forestry, and fishing	1,830.7	494.4	2,325.1
Energy (including power and coal)	2,003.0	101.0	2,104.0
Industry	660.4	111.5	771.9
Transportation	713.0	84.5	797.5
Education	400.4	73.4	473.8
Population, health, and nutrition	99.5	13.2	112.7
Urban and water supply	278.0	--	278.0
Other	--	53.8	53.8
Total commitments	5,985.0	931.8	6,916.8
Repayments	225.5	8.8	234.3
Debt outstanding (including undisbursed)	5,759.5	923.0	5,582.5
Debt outstanding (disbursed)	1,943.8	739.3	2,683.1

Source: The World Bank.
1/ Covering IBRD, IDA, and IFC.
2/ As of June 30, 1983.

Loans and development credits committed during FY 1983 (ending June 30) amounted to US$1,329.9 million.

IFC activity: As of June 30, 1983, gross commitments totaled $136.8 million for 20 projects. Of this amount, 58 percent was for cement and construction material projects and 14 percent for textile and fiber projects.

Technical assistance: IDA has extended five technical assistance credits to Indonesia totaling $25 million as of June 30, 1983. In addition, significant allocations for technical services have been included in virtually all IBRD/IDA loans.

Recent economic report: The latest economic mission report, "Indonesia--Policies for Growth with Lower Oil Prices" (No. 4279-IND), was issued on May 12, 1983.

Aid group: The most recent (twenty-sixth) meeting of the Inter-Governmental Group on Indonesia (IGGI) was held in Amsterdam during June 12-14, 1983, under the chairmanship of the Minister of Development

INDONESIA

Basic Data 1/

Area:	2,027 million sq. km.
Population:	153 million
Rate of growth of population (1982):	2.0 percent
Gross national product (1982):	$87.2 billion
Gross national product per capita (1982):	$570

	1979/80	1980/81	1981/82	1982/83 2/	1983/84 3/
			(In percent)		
Selected aggregates as ratios to GDP					
Gross investment 4/	20.9	20.9	22.4	22.6	...
National savings 4/	22.8	24.7	20.9	15.4	...
Current account (BOP basis)	4.0	2.8	-3.4	-7.6	-7.5 5/
External debt 6/	26.2	20.5	19.9	23.5	35.4 5/
Debt service/net exports 7/	12.1	10.6	13.1	20.2	22.3
Interest payments	1.5	1.2	1.0	1.3	1.7
Central Government revenue	22.1	23.9	22.8	20.0	20.9
Central Government expenditures	21.2	22.0	25.5	25.1	26.9
Central Government overall balance	1.3	2.2	-2.5	-5.0	-5.9
Domestic bank financing	-3.7	-4.0	-0.1	1.5	-0.1
Foreign financing	2.3	1.8	2.6	3.5	6.0
			(Percentage change)		
National output and prices					
GDP at constant prices 4/	6.3	9.9	7.9	2.2	1.8
GDP at current prices 4/	40.8	41.9	18.9	10.4	15.6
Rice production 4/	2.0	12.8	10.5	4.1	...
Crude oil production	-2.5	0.9	-1.8	-19.5	5.5
Consumer prices 6/	20.8	17.0	10.2	8.6	13.6 8/
Monetary sector 6/					
Money	35.6	37.3	29.9	8.9 9/	18.9 10/11/
Liquidity (money and quasi-money)	39.6	36.3	28.4	14.5 9/	32.7 10/11/
Net domestic credit	-7.9	0.4	57.1	52.5 9/	2.0 10/11/
Net government deposits	128.5	86.7	2.6	-21.7 9/	54.5 10/11/
Credit to public enterprises and private sector	14.3	28.4	31.4	25.1 9/	13.2 10/11/

Indonesia

Basic Data (concluded)

	1979/80	1980/81	1981/82	1982/83 2/	1983/84 3/
			(Percentage change)		
External sector 12/					
Exports, f.o.b.	54.0	24.5	-2.9	-15.5	-1.3
Gross oil/LNG sector exports	53.6	43.1	4.8	-16.4	-7.3
Non-oil exports	54.9	-9.5	-25.4	-6.6	20.7
Non-oil imports	19.7	31.1	23.0	6.4	-9.4
Terms of trade (deterioration -) 4/	49.0	34.2	0.3	-1.0	-14.0
Nominal effective exchange rate 13/	6.8	-2.3	4.7	-8.1	-32.0 11/
Real effective exchange rate 13/	15.6	5.2	8.3	-3.5	-24.8 11/
			(In billions of U.S. dollars)		
Balance of payments and reserves					
Exports, f.o.b.	17.5	21.8	21.1	18.1	17.9
Oil (gross)	(10.0)	(14.1)	(14.6)	(11.8)	(10.9)
LNG (gross)	(1.3)	(2.1)	(2.3)	(2.4)	(2.3)
Non-oil/LNG	(6.2)	(5.6)	(4.2)	(3.9)	(4.7)
Non-oil imports	-9.0	-11.8	-14.6	-15.5	-14.0
Current Account	2.1	2.0	-2.9	-6.9	-5.7
Overall balance	3.8	3.9	-0.3	-3.3	0.6
Gross official reserves 6/	4.9	7.8	6.6	4.3 14/	4.6 11/14/
(In months of next year's non-oil imports)	(5.0)	(6.4)	(5.1)	(3.6)	(3.9)
Banking system, net foreign assets 6/	7.2	11.2	10.8	7.5	8.0 11/
(In months of next year's non-oil imports)	(7.3)	(9.2)	(8.4)	(6.4)	(6.8)

1/ Fiscal year ending March.
2/ Preliminary estimates.
3/ Staff estimates.
4/ On the calendar year basis.
5/ Partly reflects the impact of the 28 percent devaluation of the rupiah vis-a-vis the U.S. dollar on March 30, 1983.
6/ End of period.
7/ Net exports are defined as merchandise exports plus recorded service receipts by oil sector payments.
8/ Through August 1983.
9/ Net of valuation changes due to the March 30 devaluation.
10/ Including valuation changes due to the March 30 devaluation.
11/ Through August 1983. Monetary data are annual rates of changes over the first five months of 1983/84.
12/ On a U.S. dollar basis.
13/ Depreciation is negative. Twelve month percentage change to end of period. Non-oil export weighted.
14/ Excludes contingency reserves against forward liabilities.