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# INTERNATIONAL MONETARY FUND

## Minutes of Executive Board Meeting 83/6

10:00 a.m., January 7, 1983

W. B. Dale, Acting Chairman

| Executive Directors | Alternate Executive Directors |
|---|---|
| | A. B. Diao, Temporary |
| | C. Taylor |
| | H. G. Schneider |
| | P. D. Péroz, Temporary |
| | M. Teijeiro |
| R. D. Erb | C. Dallara |
| M. Finaish | M. A. Janjua, Temporary |
| A. H. Habib | Jaafar A. |
| T. Hirao | T. Yamashita |
| R. K. Joyce | M. Casey |
| | J. R. N. Almeida, Temporary |
| G. Laske | |
| | C. P. Caranicas |
| R. N. Malhotra | |
| | J. E. Suraisry |
| J. J. Polak | T. de Vries |
| A. R. G. Prowse | |
| | O. Kabbaj |
| | J. M. Jones, Temporary |
| M. A. Senior | |
| | L. Vidvei |
| Zhang Z. | Wang E. |

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

Asian Department: B. B. Aghevli, W. J. L. Evers, N. L. Happe, G. R. Kincaid, I. S. Kim, R. J. Niebuhr, M. R. P. Salgado, B. J. Smith. European Department: K.-W. Riechel, H. Ungerer. Exchange and Trade Relations Department: M. Guitian, E. J. Zervoudakis. Legal Department: Ph. Lachman. Research Department: G. I. Brown, N. M. Kaibni, P. R. Menon, A. Muttardy, A. Salehizadeh. Advisors to Executive Directors: J. Delgadillo, P. Kohnert, I. R. Panday. Assistants to Executive Directors: H. Arias, R. Bernardo, M. Camara, L. E. J. Coene, G. Ercel, I. Fridriksson, M. Hull, P. Leeahtam, W. Moerke, V. K. S. Nair, J. G. Pedersen, G. W. K. Pickering, J. Reddy, D. I. S. Shaw, H. Suzuki, P. S. Tjokronegoro, J. C. Williams, A. Yasseri, Zhang X.

1. INDONESIA - 1982 ARTICLE IV CONSULTATION, AND PURCHASE TRANSACTIONS - BUFFER STOCK FINANCING FACILITY - SIXTH INTERNATIONAL TIN AGREEMENT, AND INTERNATIONAL NATURAL RUBBER AGREEMENT

The Executive Directors considered the staff report for the 1982 Article IV consultation with Indonesia (SM/82/224, 12/1/82; and Cor. 1, 1/5/83), together with Indonesia's request for purchases under the buffer stock financing facility in connection with Indonesia's compulsory contributions to the Sixth International Tin Agreement (EBS/82/234, 12/20/82; Sup. 1, 1/5/83; and Sup. 2, 1/6/83) and the International Natural Rubber Agreement (EBS/82/235, 12/20/82; and Sup. 1, 1/4/83). They also had before them a report on recent economic developments in Indonesia (SM/82/233, 12/20/82).

The staff representative from the Asian Department made the following statement:

> The draft state budget for FY 1983/84 and an economic statement will be presented by the President to the House of People's Representatives on January 6, 1983. The staff has obtained data that outline the budget proposal (see Appendix). The details of the budgetary items are not yet available, but the broad aggregates suggest that the authorities are continuing their policy of seeking adjustment through limits on budgetary expenditure and substantial increases in revenue. Budgeted routine expenditure for 1983/84 is only marginally above that for 1982/83. Total expenditure is about 5 per cent over the previous year's budgeted level. Domestic revenue for 1983/84 is projected to be virtually the same as the 1982/83 budget estimate, but 27 per cent greater than staff estimates of the actual outcome for the year--21 per cent for oil revenue and 38 per cent for non-oil revenue. A shortfall in revenue from the budget target will not necessarily raise the overall deficit, because actual development expenditures are generally below appropriated levels. The overall deficit of Rp 2 trillion would be about 3 per cent of GDP, compared with the 4 per cent estimated by the staff for 1982/83.

Mr. Habib made the following statement:

> On behalf of my Indonesian authorities, I would like to thank the staff for its thorough, comprehensive, and balanced paper on the Indonesian economy. In broad terms, the Indonesian authorities are in agreement with the staff assessment of developments of the Indonesian economy in the past year and of the prospects of future development.
>
> The Board might recall that the previous Article IV consultation on Indonesia was held at a time when the economic situation was much better. The economic performance of Indonesia over the past five years was indeed impressive, with an average growth in real terms of about 8.1 per cent, which was comparable with that

of some other rapidly developing countries in the region. Substantial progress was achieved in agriculture, reflecting intensified efforts by the authorities to increase production. In rice, Indonesia had achieved the long-sought objective of self-sufficiency. Rice supply improved markedly, with a 10.5 per cent production increase in 1981. The record for 1980 was equally impressive, at 13 per cent. The favorable situation was also reflected in other sectors.

The external sector strengthened markedly, with a better performance of exports, mainly due to the effect of high oil prices, but also due to the better performance of non-oil export commodities. Consequently, a substantial surplus was achieved for the current and overall balance of payments. The net foreign assets position was at an unprecedented level of $7.9 billion in April 1981, compared with $4.6 billion in March 1980. Inflation moderated from 21 per cent to 17 per cent over the same period. This was due mainly to the authorities' cautious and prudent demand management policies. The authorities, however, considered the level of inflation still to be high and took steps to bring it down to a more sustainable level. This policy of moderation has contributed to the present inflation rate of 9.6 per cent.

Reflecting the worsening world economic situation, economic activity in Indonesia slowed in 1981 to 7.8 per cent, which, however, can still be considered relatively high compared with the growth in other countries. The slowdown affected the Indonesian economy across the board in terms of major export commodities. The situation was particularly pronounced in the oil sector as well as in other major commodities, such as timber, rubber, coffee, palm oil, and tin.

Net earnings from oil, a major foreign exchange earner for Indonesia, declined markedly in 1981/82. The depressed oil sector affected sharply the financing of development expenditure. Consequently, the overall fiscal balance was in deficit on the order of 2 per cent of GDP in 1981/82, compared with a surplus of 1.3 per cent in 1980/81.

The reduction in timber exports was a reflection mainly of two factors: first, the weakening demand for timber products in the international market; and second, and more important, the Government's policy of restricting exports of unprocessed timber. It has been the authorities' objective to promote exports of processed commodities. For timber, this has taken the form of substituting the exports of logs with exports of processed timber, such as plywood, sawn timber, and related materials. The shift in favor of processed timber reflected the Indonesian objective of maximizing the value-added content of exports from Indonesia and of creating more jobs for the ever-increasing labor force, in addition to the desire to conserve timber resources. The outcome of this po'icy over the past two years has been reflected in lower exports of logs and an increase in plywood and sawn timber. Similarly, the number of timber processing units has also increased from 10 units in 1979, before the announcement of the policy, to 39 units in 1982. Forty-six additional processing units are under construction.

Low rubber prices had an adverse impact on the production and income of the rubber sector, which consists mainly of smallholders. The prospect for recovery in this sector continues to be bleak with the continued weakening in demand by the industrial countries. Depressed rubber prices have affected the livelihood of a significant number of Indonesian people in the rural areas. The role of the International Rubber Agreement in stabilizing prices, and the role of the Fund in providing financial facilities, are welcome in these difficult times.

The situation for other commodities was no better. The volume of exports of coffee declined from 238,000 tons in 1980 to 232,000 tons in 1981, in spite of successful efforts by the authorities to market coffee to non-ICO (International Coffee Organization) member countries. The decline in earnings was due partly to low prices in the world market and, more significantly, to the low export quota introduced by the ICO on the basis of the low production figures of 1975. In the assessment of my authorities, coffee exports are unlikely to recover in the immediate future.

Developments in the palm oil market were also unfavorable. Low palm oil prices in the world market, accompanied by the rapid rise in domestic consumption for cooking oil, contributed to the fall in palm oil exports in 1981/82. The outlook for 1982 continues to be the same as in 1981.

Tin exports similarly suffered from the adverse turn in the world economy. Demand for this commodity continued to weaken. Tin exports from Indonesia fell significantly, from 31,000 tons in 1981/82 to 27,000 tons in 1982/83.

All these developments contributed to the substantial decline in export earnings in 1981. These factors, combined with the continued strong imports, reversed the Indonesian current account surplus, which in the two previous years had averaged \$2.2 billion, to a deficit of \$2.4 billion in 1981/82. Consequently, the overall balance of payments was also adversely affected, and the surplus position that had been recorded for a number of years turned to a deficit of \$139 million.

The prospect for growth--and, therefore, government revenues--is expected to be weaker in 1982/83, against a background of continued deterioration in all categories of exports. Measures have been taken by the authorities to contain the fiscal deficit for 1982/83. Tax collection machinery has been strengthened in an effort to increase revenue from non-oil sectors. A wage freeze was set on salaries for all civil servants and the military early in the year, while a 60 per cent increase in domestic petroleum prices came into effect in January 1982. In addition, the authorities intend to make a further upward adjustment in domestic oil prices in the immediate future.

In a related move to limit the fiscal deficit and increase government revenue, prices of fertilizers, which had previously been kept low in order to provide an incentive to farmers to improve productivity, were also raised by 30 per cent. A study on a further upward adjustment in fertilizer prices will be made in due course.

My authorities are concerned about the external weakness of the economy. The Board may recall that the Indonesian rupiah was devalued in 1978. A managed floating of the exchange rate was subsequently adopted, with the rupiah tied to a basket of currencies of the major trading partners. The authorities have been keeping exchange rate developments under constant review since the devaluation. We are concerned that, given recent developments and especially in view of the exchange competitiveness of Indonesia's exports, any move to hasten adjustment of the rupiah might generate unwanted speculation.

We are also concerned that any abrupt changes in the exchange rate might again trigger inflationary expectations, which have now been successfully contained. Furthermore, an abrupt exchange rate change would also affect seriously the economy as a whole, and in partiuclar the large number of people belonging to the fixed-income group.

In view of the situation, the authorities have to move carefully in taking any measure affecting exchange rate policy. My authorities recognize the dilemma that they face. On the one hand, we need to restore competitiveness, and, on the other, we are apprehensive that a faster adjustment than at present might trigger speculation and a flight of capital from Indonesia. My authorities believe that the adjustment being carried out is adequate. My authorities are keeping this under review and would respond flexibly in the light of further developments.

Early in the year, a package of other policies was introduced to stimulate exports. Some of the principal elements of these measures are the provision of concessionary export credit facilities, export insurance and guarantee facilities, and improved documentation and handling procedures. Two measures that were considered necessary owing to the very difficult circumstances that Indonesia is experiencing were also introduced: the counterpurchase policy on certain government imports, and a shipping policy for handling shipments of public sector goods.

The counterpurchase measure was intended to promote non-oil exports by requiring suppliers to match government imports by an equal amount of exports. The measure is applicable only to imports financed through the budget. The authorities felt that Indonesia's exports are increasingly hampered by protectionistic devices, such as safeguard clauses, voluntary restraints, orderly marketing arrangements, trigger price mechanisms, tariff increases, and quotas. The Government had to do something, particularly in the commodities sector, which supports an enormous rural population. This policy, however, will be implemented flexibly and reasonably, on a case-by-case basis. Similarly, the new shipping policy, which only applies to exports and imports by the public sector, will be implemented in a flexible manner.

Several measures have also been introduced to the liberalized trade and payments system. These cover abolishing the opening letter of credit for imports, requiring advance payment for imports, and obligating exporters to surrender the proceeds of non-oil exports.

On the issue of collection procedures for export taxes, additional export tax and the MPO withholding tax on exports, the authorities concur with the staff findings. These procedures, which in fact were adopted for administrative reasons, are under review with a view to their early replacement with better procedures in such a way as to avoid multiple currency practices. The authorities also concur with the staff finding that the 6 per cent share in GDP of non-oil tax revenue can be improved further. On this matter, the authorities have taken steps to make a comprehensive review of the tax system in preparation for the next Indonesian Five-Year Development Plan (1984/85-1988/89).

I wish to thank the staff for its analysis and findings that the Indonesian economy needs to make structural adjustments in its pattern of production by moving away from its dependence on oil to other sectors. The lesson of the virtue of diversification has already been reflected in areas such as agriculture, mining, and manufacturing. We are concerned, however, about the extent of the benefits and effectiveness of diversification in the light of our recent experience, when the performance of economic activities in all sectors has been adversely affected by the current recession in industrial countries.

As a reflection of the authorities' deep awareness of the serious and difficult conditions that still lie ahead and their general concurrence with the staff's analysis and recommendations, the budget for fiscal year 1983/84 reflects the continuation of the austerity drive begun last year. The growth in the total budget, which includes routine and development budgets, is only 6.1 per cent over 1982/83, which in real terms is about 3.5 per cent less than the budget for last year. Routine expenditure will increase by only 3 per cent.

In conclusion, on account of the adverse balance of payments position of Indonesia, with the attendant decline in its reserve position, my authorities have submitted requests for financing Indonesia's compulsory contributions to the Sixth International Tin Agreement (ITA) and to the International Natural Rubber Agreement (INRA) in conformity with the decision taken at EBM/82/147 on November 12, 1982.

He had just been informed, Mr. Habib added, that, effective January 7, 1983, the Government was increasing domestic oil prices by about 45 per cent on the average, thereby reducing the subsidies on domestic oil products from about $3.1 billion that would have to be provided for in the 1983/84 budget, to approximately $1.02 billion. Moreover, the price increase meant that the subsidies for oil products in the 1982/83 budget year would fall from approximately $1.8 billion to about $1.5 billion.

The 1983/84 budget, Mr. Habib continued, made no provision for either food subsidies or salary increases for government officials and military personnel. In addition, no new vehicles for government officials were to be purchased, the existing ones were to be sold to the officials themselves, and control on official travel within and beyond Indonesia was to be increased. The development budget contained no provision for new government building construction, and priority under the budget was to be given to education, agriculture--including irrigation to boost food production--communications, tourism, mining, and energy. Rice production in 1982 was estimated at more than 23 million tons, despite the drought, and the rate of inflation was estimated at 9.7 per cent.

Mr. Hirao stated that the proposed decisions were acceptable. The Indonesian economy had recorded impressive economic growth over a long period until 1981/82, when major sectors of the economy had been adversely affected by the stagnation of oil and non-oil exports. The growth rate of real GDP had fallen from 9.6 per cent in 1980/81 to 7.8 per cent in 1981/82, the Central Government's overall balance had deteriorated from a surplus of 1.3 per cent of GDP to a deficit of 2 per cent of GDP, and the external current account had shifted from a surplus of 2.8 per cent of GDP to a deficit of 2.7 per cent of GDP. Moreover, net international reserves had declined by nearly $1 billion, mainly because of valuation changes.

The situation was likely to worsen in 1982-83, Mr. Hirao remarked. Oil and natural gas export earnings were projected to decline by 27 per cent and non-oil exports by 10 per cent, while the external current account deficit was projected to rise to $7.2 billion, the equivalent of

7.6 per cent of GDP. Current account deficits of that magnitude would not be easy to sustain, although financing the deficit in the immediate future was unlikely to cause a major problem. The authorities expected that $1.5 billion of the current account deficit in 1982/83 would be financed through the repatriation of the state commercial banks' foreign assets, but the inflow had amounted to only $0.3 billion in the first half of fiscal 1982/83, and he wondered whether the authorities still believed that the projected level would be reached.

Budget revenues in 1982/83 were expected to fall short of the target because of the slowdown in trade and domestic economic activity, Mr. Hirao noted. In order to keep the overall deficit moderate, the authorities had already made commendable efforts to reduce budgeted expenditure and to raise non-oil revenue through fertilizer price adjustments. As a result, the overall deficit in 1982/83 should be equivalent to no more than 4.2 per cent of GDP, and the figure could be lower if the trends evident in the first half of 1982/83 continued through the rest of the year. Nevertheless, the budget deficit remained a cause for concern.

The growth in the external current account and overall government deficits clearly suggested the need for medium-term adjustment, Mr. Hirao said. In recent years, oil revenue had been a major source of foreign exchange earnings and had contributed to public sector savings, but the present prospects for oil exports seemed to be less promising, mainly because of the constraints on oil production capacity and the volume of domestic oil consumption. Hence, the staff had correctly concluded that it would not be wise for the authorities to rely on substantial increases in oil revenues in the future. Alternative sources of foreign exchange earnings and domestic savings would have to be developed to keep the external current account deficit at a sustainable level and to keep the share of investment in GDP sufficiently large to ensure a reasonable growth of output and employment.

On the external side, Mr. Hirao continued, priority should be given to promoting non-oil exports, the volume of which had declined from 8 per cent of GDP in 1972 to 5 per cent in 1981. The authorities had already introduced a number of measures, including the establishment of export insurance and guarantee facilities, and improvements in port and customs procedures; but further reforms in the tariff structure--which had favored import substituting industries--would be welcome. The effort to improve the external balance should be based on measures designed to liberalize the economy, but the authorities had recently introduced an export counter-purchase requirement on certain public sector imports and had given Indonesian companies exclusive rights to ship public sector exports and imports. The negative effects of such measures on the flow of trade and on costs were likely to exceed the potential benefits.

The increased flexibility in the management of the exchange rate was welcome, Mr. Hirao said. A further depreciation of the rupiah was needed to make a significant improvement in competitiveness, but the authorities were understandably concerned that an excessively rapid rate of depreciation could cause speculative capital outflows. Their policy of gradually depreciating the currency while constantly reviewing the exchange rate in the light of balance of payments developments was appropriate.

On the domestic side, Mr. Hirao went on, the authorities should continue their effort to increase non-oil revenues and to reduce subsidies. The staff had wisely concluded that the rates and coverage of the existing taxes needed to be adjusted in order to increase the buoyancy of nontax revenues. The 60 per cent increase in domestic petroleum prices in January 1982 had helped to restrain the growth of domestic oil consumption, but the oil subsidy was likely to continue to be substantial, and the further adjustment mentioned by Mr. Habib at the end of his opening statement was certainly welcome.

He was pleased, Mr. Hirao continued, that the draft budget for 1983/84 was designed to increase budgetary savings and to reduce the overall fiscal deficit through a number of new measures. The medium-term adjustment scenario described by the staff assumed that private savings would remain at about 13 per cent of personal disposable income and 10 per cent of GDP. He wondered whether the recent increase in deposit rates in real terms, due to the drop in the rate of inflation, or an extension of the banking system would contribute to an increase in the savings ratio. On the investment side, the staff had said that it favored a switch from import-intensive and capital-intensive projects to labor-intensive activities, and it would be useful to know what conclusions the World Bank had drawn. The Fund staff had suggested that private investment would be encouraged by an improvement in both the allocative function and the efficiency of the banking system. The present complex system of credit ceilings, and the rediscount mechanism--which was designed to provide subsidized credit to priority sectors--were likely to have an adverse effect on the allocation of credit to the relatively productive sectors. A regular review of the appropriate coverage of the priority sectors would make a useful contribution to the effort to reduce the credit subsidy gradually.

Mr. Polak said that he had found much to agree with in the staff analysis both of the problems facing Indonesia and of the opportunities for improvement in the coming period. The abrupt change in oil market conditions had reduced the possibilities for rapid economic development, forced the authorities to concentrate their development efforts on high-priority activities, and caused the balance of payments to move from a large surplus to a large deficit in a single year. He agreed with the staff that there was an urgent need for internal and external adjustment, and that any delay would only make the adjustments more painful when they were finally undertaken.

The unexpectedly large budget deficit in 1982/83 was evidence of the clear need for budgetary adjustment, Mr. Polak went on. Non-oil tax revenue accounted for only a small proportion of total revenue, and it was discouraging to learn that an effort to change that situation would not be made until 1984/85, under the next five-year plan. Meanwhile, other measures would have to be introduced, and he was pleased that the authorities had taken the major step of reducing the petroleum subsidy by the equivalent of about $2 billion.

The tightening of fiscal policy would have to be accompanied by increased encouragement to private domestic and foreign investment, Mr. Polak considered. The authorities were wisely making the best use of Indonesia's comparative advantage by emphasizing labor-intensive investment. In that connection, an important role could be played by the Indonesian banking system, the efficiency of which could well be improved. For instance, a more flexible interest rate policy would encourage better use of available resources and would support the exchange rate policy.

The authorities were understandably worried that large discrete adjustments of the exchange rate would encourage speculative capital movements, Mr. Polak remarked, but their fear should not keep them from making needed adjustments. A flexible interest rate policy and gradual exchange rate adjustments could help to contain anticipatory capital movements. In December 1978, when Indonesia had devalued the rupiah by one third to improve the competitiveness of the country, which was experiencing an oil boom, he had doubted that it would prove possible to lower the real effective exchange rate. Indonesia had taken appropriate steps since end-1980 to give strong support to the exchange rate; in the second half of 1979 in particular, and in 1981, the authorities had maintained counterinflationary demand policies, the implementation of which had been aided by the world demand situation. Nevertheless, by mid-1981 the positive effect of the large devaluation of December 1978 on relative prices had disappeared. That experience confirmed his belief that countries that had a single strong export product naturally encountered considerable difficulty in pushing other tradables through general measures, particularly through a single massive adjustment of the exchange rate. In such countries, there was considerable risk that the pressure coming from the single strong sector would produce inflation that would quickly offset the positive results of any general measure.

Indonesia clearly needed to expand its non-oil exports, Mr. Polak continued. The country was not totally dependent on oil. A large proportion of the people was engaged in activities outside the oil sector, and the Government had to maintain an active development policy that covered a wide range of activities. Although single large changes in the exchange rate could not solve all the development problems, there was of course no reason to allow the exchange rate to become a barrier to the development of the non-oil export sector, especially at a time when oil revenues were falling, and the continued real appreciation of the rupiah that the staff had described was therefore a cause for concern. The best solution seemed to be to move the peg of the rupiah in slow steps in order to maintain the improved competitiveness that could be gained from a gradual approach.

The restrictive counterpurchase measure was harmful for both the Indonesian and world trade systems, Mr. Polak stated. It was inconsistent with Indonesia's liberal trade policy trend of the previous decade, which had, among its other beneficial effects, removed the opportunities for personal enrichment that had been characteristic of the older, restrictive system. Mr. Habib's statement that the counterpurchase policy would be applied case by case was not reassuring. In general, however, the Government's policy stance in the present difficult circumstances was clearly constructive, and the proposed decisions should be approved.

Mr. Péroz said that the draft decisions were acceptable. The proposed purchases, equivalent to 9.1 per cent of quota, would provide a minimal level of assistance in financing the external imbalance expected in the present financial year, but they were useful in helping to focus attention on the crucial problem facing the economy: the dismal outlook for traditional non-oil exports. The estimated sharp deterioration in both the trade balance and the current account in the present financial year called for prompt remedial action to maintain Indonesia's remarkable growth rate and its successful effort to contain the inflationary pressures.

Given the reserve position of Indonesia, its external debt position, and its credit standing, the financing of the current account deficit in the immediate future should be manageable, Mr. Péroz considered. However, maintaining a current account deficit equivalent to 7 per cent of GDP would certainly not be feasible in the medium term. The medium-term adjustment scenario developed by the staff was welcome; it indicated that a gradual improvement of the fundamentals together with a continued highly satisfactory rate of growth was a realistic goal. It could not be achieved, however, without a decisive move in the direction of fiscal adjustment supported by an appropriate monetary policy and a sharp improvement in competitiveness.

The staff had concluded, Mr. Péroz went on, that the needed degree of adjustment could be achieved only if the authorities acted on a broad front to cope with the decline in oil tax revenues. In the longer run, the new measures should be designed to increase non-oil revenues. In the short run, they should slow the rate of increase in expenditures in a number of areas in order to keep overall expenditure consistent with appropriate monetary and balance of payments objectives. The new information on the budget for the coming fiscal year, which reflected the willingness of the authorities to keep budgetary policy in line with their continued effort to make needed adjustments, was welcome; but it was unclear whether the present fiscal system was capable of sustaining the pace of increase in revenues needed to improve the financial balance quickly.

The lack of buoyancy of certain tax revenues--which probably accounted for the divergence between the official and staff estimates of revenues in 1983/84--seemed to indicate that at least some measure of tax reform would be essential, Mr. Péroz considered. The authorities had stated their intention of proceeding with such a reform, but the status of the relevant ongoing study seemed to preclude taking any decisive action before 1984/85, somewhat later than seemed desirable. Meanwhile, the authorities should not be made until 1984/85, under the next five-year plan. Meanwhile, other measures would have to be introduced, and he was pleased that the authorities had taken the major step of reducing the petroleum subsidy by the equivalent of about $2 billion.

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Priority should also be given to the need to maintain, and even improve, external competitiveness, Mr. Péroz remarked. The authorities were clearly aware of the dimension of the problem, but the staff report contained little information on the strategy that they intended to use; it merely noted that they intended to keep the exchange rate policy under review and to reassess various options as necessary. The staff's analysis of the evolution of non-oil exports clearly indicated that close monitoring of the competitiveness of the country would be desirable. He fully agreed with the thrust of the staff appraisals.

Mr. Kabbaj remarked that in Indonesia, as in other oil exporting countries, a considerable upward surge in oil exports in 1979 had given the authorities ample opportunity to maintain liberal investment policies and to increase expenditure. Realizing that the greatly increased government expenditure would boost final demand and fan inflation, the authorities had wisely decided to save a considerable portion of the increase in earnings and to channel investment and expenditure into the key sectors of the economy. As a result, gross fixed investment had risen by 19 per cent in FY 1980 and by 16 per cent in FY 1981, and output had grown considerably, although it had declined somewhat from the peak of 1980. At the same time, real GDP had grown rapidly, while the rate of inflation had decreased to 10 per cent.

Indonesia, like nearly all non-oil developing countries, Mr. Kabbaj remarked, had experienced a decline in absolute terms in non-oil exports--which had equaled oil exports in 1978/79--because of the recession in industrial countries and, to some extent, because of the reduction in export quotas. The weakening of the oil markets in 1981 and 1982 had brought the current account under pressure. In 1982/83, oil export earnings were estimated to fall by nearly 30 per cent; non-oil exports were also estimated to decline as a result of weak rubber and coffee markets. Consequently, the current account deficit was expected to increase to more than $7 billion. The Government had responded to the changed international economic environment by slowing the growth of imports and by ensuring that the 1982/83 budget reflected the increase in resource stringency.

The authorities had issued various decrees tightening control over a broad spectrum of imported goods, including food and other agricultural products as well as machinery and heavy equipment, Mr. Kabbaj went on; recent press reports suggested that further cuts might well be made in the near future. Page 10 of the staff report contained a description of the measures that the authorities had introduced to increase non-oil exports. The staff had expressed its reservations about the wisdom both of the so-called export counterpurchase requirements and of the exclusive right granted to some countries to ship public sector exports and imports. Did the latter signal a change in the distribution procedure already in effect, or was it a further step in the direction of greater specialization in the export and import distribution system? The question was important because of the crucial role of non-oil exports in the recovery of the economy and in the restoration of external balance. In that connection, the recent elimination of the additional export tax on a number of items was encouraging. The high tax on non-oil exports in 1980 had yielded revenues of Rp 305 billion, the equivalent of some $500 million, and he wondered whether the tax had had a disincentive effect on non-oil exports.

The authorities had taken steps to curtail the real growth of expenditure, Mr. Kabbaj remarked, and, as a result, the rate of increase in 1982/83 would be minimal. They had substantially raised domestic petroleum and fertilizer prices, frozen civil service wages, and significantly improved tax administration. The restraint had included expenditures on development and capital investment.

In the monetary sector, Mr. Kabbaj commented, the authorities were fully aware of the need to control the growth of liquidity, which had slowed to 28 per cent in 1981/82 and, they hoped, would slow further in 1982/83. The balance of payments deficit had had a marked contractionary effect on monetary growth, as net foreign assets of the banking system had declined. The staff was understandably concerned about the need to limit further the rise in liquidity to a level consistent with the economic growth target, but the authorities' credit priorities were appropriate, and the liquidity situation was not a major destabilizing factor at the present stage.

The medium-term scenario, Mr. Kabbaj continued, clearly showed that, assuming a 5 per cent growth in output--a rate that, given the size of the population, was not large--and growth in debt service payments that was commensurate with export earnings, both budgetary savings and non-oil exports would have to grow much faster than their historical rates. The staff had recommended an increase in the share of non-oil revenues in GDP, which, at 6 per cent, was small by Asian standards. The authorities had agreed with that assessment, but he wondered how Indonesia's ratio compared with that of other oil producing countries, particularly those whose economies were similar to Indonesia's. At present, non-oil revenues constituted some 30 per cent of Indonesia's total consolidated revenues, a figure that was not small by OPEC standards.

The staff, Mr. Kabbaj noted, had strongly recommended that the authorities should switch the emphasis of capital expenditure from import substitution toward labor-intensive, quick-yielding projects--such as wood products, leather, fishing, and textiles--mainly because the development of such industries would contribute both to creating employment and to increasing foreign exchange earnings. The need for export promotion was beyond challenge, but it was difficult to see how the desired change in the traditional export pattern could cause an increase in foreign exchange earnings. Nearly half of Indonesia's total exports went to Japan, and 80 per cent went to Japan, Singapore, and the United States together. As a result, any attempt to diversify the foreign exchange earnings base would require an international marketing strategy, something that might not be either easy to implement in present highly competitive market conditions, or consistent with the austerity measures that would have to be implemented for several years to come. The analysis of the staff recommendations would have been easier if the staff had been able to identify the commodity composition of nonprogram imports, 70 per cent of which consisted of manufactured products.

The staff's analysis of the impact of the 1978 devaluation was useful, Mr. Kabbaj remarked, but, as the staff itself had said, its conclusions should be approached with caution. A persistently overvalued currency would adversely affect competitiveness in the tradable goods sector, and the main question was not whether a correction of the value of the currency was required, but rather what means should be used to accomplish that objective. The advantages of a devaluation had to be compared with the economic and social costs and benefits of alternative measures. The present flexible exchange rate policy, which was designed to remove gradually the imbalances in the external economy, was appropriate.

On the whole, Mr. Kabbaj stated, the staff's recommendations were appropriate. Austerity measures taken at present would lessen the need to take more painful steps in the future. Many investment projects, some still ongoing, would be affected by the adjustment efforts. Some of the projects were being carried out with the assistance of the World Bank, and it would be useful to know the World Bank's policy recommendations, particularly with respect to the need to curtail investment expenditure. Finally, the decision concluding the Article XIV consultation should be approved; the proposed purchases were straightforward and clearly met all the requirements.

Mr. Senior said that the proposed decisions were acceptable. The two requests to use the buffer stock financing facility met all the relevant criteria.

Indonesia was one of the few developing countries that had been able to combine a remarkable rate of economic growth with a favorable price performance in the previous two years, Mr. Senior continued. Real GDP was estimated to have grown by 7.6 per cent in 1981, while the rate of domestic inflation had declined from 17 per cent to 7 per cent in 1981 and had remained low in 1982. Oil revenues had clearly provided the stimulus for the remarkable growth rates, and a proper combination of monetary and fiscal policies had helped to contain price pressures. The authorities were to be commended for their prudent management of oil revenues and for their appropriate expenditure policies, which had removed the foreign exchange constraint and had diversified the economic structure, thereby increasing the productive potential of the economy. The attainment of self-sufficiency in rice in 1981 as a result of rising productivity under the Government's rice intensification program was an example of the improved potential of the economy.

On the other hand, Mr. Senior continued, the weakness of the oil market and the recession in industrial countries in 1981 had negatively affected Indonesia's balance of payments position. The current account deficit was projected to rise sharply, from $2.4 billion in 1981/82 to $7.2 billion in 1982/83. The continued decline in oil and gas export earnings and the low prices and volumes of Indonesia's main non-oil primary commodity exports could reduce the chances for further economic growth. The authorities were to be commended for having anticipated the slowdown in the rise in revenues and for having already adopted measures to avoid a further weakening of the external position. Their firm determination was reflected in the 1983 budget, which included only a small increase in expenditure growth in real terms, a substantial rise in domestic petroleum prices, and a freeze on the wages of civil servants. Apparently the authorities intended to maintain their prudent fiscal policy; as a result, the overall fiscal deficit was projected to decline from 4 per cent of GDP in 1982/83 to 3 per cent in 1983/84.

The staff's analysis, Mr. Senior remarked, suggested that in the medium term the authorities had room for maneuver to continue achieving high rates of economic growth and employment. Their intention to improve the administration of the tax system was particularly welcome, although he agreed with the staff that, in view of the small share of non-oil revenues in GDP, a comprehensive tax reform was needed. It was difficult to know for certain whether or not the less favorable resource prospects called for a slowdown in the rate of increase in public investment, but an increase in private investment would clearly be appropriate. The staff had correctly concluded that several sectors of the economy had significant potential for further growth and development, as reflected in private investment in the mining sector in 1981.

Mr. Laske commented that Indonesia's external position had deteriorated during the previous two years, mainly because of the continued weakness in world markets. Export revenues had declined dramatically and were expected to continue to decline in 1982/83. As a result, the external current account deficit was expected to triple in 1982/83, while the government budget, heavily dependent on revenues from oil exports, would probably record a deficit twice as large as that of 1981/82. At present, Indonesia continued to enjoy a comfortable reserve position--about $4 billion--and a high international credit standing, so that financing a large balance of payments deficit should pose no insurmountable problems in 1983. However, increasingly large external deficits would make Indonesia's balance of payments position unsustainable.

The staff's medium-term analysis, Mr. Laske continued, showed that the current account deficit would increase substantially in the coming several years if the growth objectives were not revised downward in response to the changed external environment. Immediate policy action to reduce domestic absorption was clearly required. In the longer run, the development strategy would probably have to be changed to reduce Indonesia's dependence on oil and gas exports, to strengthen the manufacturing sector, and to improve the economy's competitiveness. The authorities had already adopted corrective measures--including increases in domestic petroleum prices, a wage freeze for public employees, and a reduction in the rate of growth of development expenditure--but they would have to be reinforced and supplemented to arrest the clearly rising trend of the public sector deficit. He agreed with the staff that public revenues should be strengthened through an increase in indirect taxes and an improvement in tax administration. The latter was particularly important because of the widespread tax evasion in Indonesia.

Reducing subsidies and increasing energy prices would benefit the fiscal and external sectors in the longer run, Mr. Laske considered. The authorities should give priority to preventing a further slippage in the current account, and he was pleased that they intended to maintain an appropriate combination of domestic demand management and a flexible exchange rate policy. However, he was not fully convinced that that approach would be sufficient, especially as the prospects for an early pickup in demand for Indonesia's traditional export commodities were not bright. Moreover, the precise objective of exchange rate policy was unclear to him. According to press reports of August 1982, the President of Indonesia had announced that the rupiah would not be devalued, but Chart II showed that the real effective exchange rate of the rupiah had depreciated to the level of 1978 after the large one-step devaluation. The resultant apparent loss of competitiveness could not be offset by the kind of crawling peg that the authorities seemed to favor. A more vigorous exchange rate policy seemed to be needed to give the economy, and particularly the nontraditional export sector, a head start in its effort to regain and maintain an adequate level of competitiveness.

In 1982, Mr. Laske remarked, the authorities had introduced the so-called counterpurchase policy in an attempt to promote exports. He wished to associate himself with Mr. Polak's comments on that policy.

In the coming period, Mr. Laske said, the authorities should attach the greatest importance to establishing and maintaining a realistic exchange rate. Diversifying production would play a crucial role in restoring stability to the domestic and external economy in the near future. The Indonesian economy had a substantial potential for the production of manufactured exports, and a realistic exchange rate would help to meet that potential more fully than had been possible thus far.

The apparent shift in demand away from traditional exports as a result of the prolonged global recession, Mr. Laske went on, meant that Indonesia would have to re-examine its long-term investment strategy with the view to bringing overall demand and the external debt situation in line with the country's absorptive capacity. Infrastructure development was an important aspect of Indonesia's overall investment effort, in which the World Bank had played a significant role. It would be useful to know the World Bank's latest views on the Government's investment policy.

The proposed purchases under the buffer stock financing facility were fully appropriate, Mr. Laske considered. The proposed decision on the present multicurrency practice was acceptable; presumably the practice could be eliminated in the near future.

Mr. Suraisry said that he agreed with the thrust of the staff appraisals and accepted the proposed decisions. After years of successful economic development, Indonesia faced a number of serious difficulties. The unfavorable conditions in the international economy had adversely affected Indonesia's oil sector, which had been, and still was, the engine of growth. At the same time, the contribution of the non-oil sector had declined, making it difficult for the economy to maintain the economic growth rate of previous years. The authorities were to be commended for the revenue and expenditure measures adopted as part of the difficult task of minimizing the adverse effects of international economic conditions on the development process in Indonesia.

He agreed with the staff, Mr. Suraisry continued, that, in general, conditions in Indonesia were more suitable to labor-intensive development than capital-intensive projects. On the other hand, some of the country's natural resources, such as oil and natural gas, could be exploited only with capital-intensive projects. The country should of course avoid undertaking capital-intensive projects that were not economically feasible, but Indonesia, unlike many other heavily populated countries, had good reason to implement some capital-intensive projects.

The staff had concluded, Mr. Suraisry noted, that, "over the medium term, the world recovery is likely to result in some improvement in non-oil exports, but the outlook for oil exports is less promising." That conclusion differed from the assessment of economists in many oil economies. Why did the staff feel that the world recovery would not lead to an improvement in oil exports?

He agreed with the staff, Mr. Suraisry said, that restoring the competitiveness of the economy was of fundamental importance if the contribution of the non-oil sector to GDP was to be substantially increased. However, he also agreed with the authorities that any abrupt changes in the exchange rate could hamper the adjustment process.

Mr. Malhotra stated that he fully supported the proposed decisions. Indonesia had achieved high rates of growth over several years as a result of good economic management. In the recent past, the external account had abruptly deteriorated, mainly because the harsh external environment had harmed Indonesia's oil and non-oil exports. Any economy, no matter how well managed, would find it difficult to adjust to such a deterioration in trading conditions. The Indonesian authorities had already taken steps toward adjustment: domestic prices of oil products and fertilizers had been increased; public sector wages had been frozen; investment expenditure had been curtailed; and the rate of inflation had been considerably reduced, though a fairly high rate of growth was being maintained.

The authorities were aware of the need for action on the exchange rate front, Mr. Malhotra remarked, but they felt that, given the depressed demand for oil and Indonesia's other commodity exports, a large discrete devaluation would not be appropriate at present, particularly in view of its likely adverse effect on prices. He sympathized with the authorities' view that the exchange rate should be adjusted gradually.

The authorities were also cognizant of the need for keeping monetary growth under control, Mr. Malhotra went on. He hoped that, with the fall in the rate of inflation, the rate of increase in the supply of money would also decline.

Fertilizer prices had recently been raised by 30 per cent, Mr. Malhotra noted, and further increases were being considered. Developing countries had to approach fertilizer prices with great caution. Large investments in irrigation that were characteristic of many developing countries could be worthwhile only if there was, at the same time, widespread use of fertilizer. Therefore, it was important to ensure that the growing use of fertilizer was not discouraged. It was true that, in the long run, promotion of fertilizer use should not remain dependent on unduly low prices of fertilizer. But it was also true that steep increases in fertilizer prices could have an adverse effect on agricultural output. In India, for instance, increases in fertilizer prices in two consecutive years were followed by a period of reduced rates of increase in the consumption of fertilizer. The demand for fertilizer was of course influenced by a number of factors, including weather conditions. While the Indian authorities had resisted demands for reducing fertilizer prices, the decline in the growth rate of fertilizer use had been a cause for concern in India. In Indonesia, as in many other developing countries making large investments in irrigation, an increasing application of fertilizer had to be encouraged. In any event, there was a considerable lag between the creation of irrigation facilities and their optimal use. Furthermore, new technologies being developed would make it feasible to apply fertilizer in unirrigated areas, thereby increasing the need for promotional efforts.

Keeping the prices of important agricultural inputs at an excessively low level would obviously have an adverse effect on the budget, Mr. Malhotra commented. On the other hand, the price policy for agricultural inputs in developing countries could have important implications for food production and the optimization of investment, especially in irrigation. A large proportion of the development budget in Indonesia was devoted to the development of irrigation facilities, and adequate attention should be paid to the best ways of using them, especially as inadequate agricultural production hurt the balance of payments. Indonesia had reached self-sufficiency in rice, but the population continued to grow rapidly, and food imports might well have to be increased in the future, thereby weakening the balance of payments position and underscoring the need for a comprehensive approach to fertilizer prices.

Mr. Janjua remarked that the performance of the economy in recent years had been quite good. The rate of growth had been high, and the authorities had maintained prudent financial policies, including restrained demand management in the period after the large devaluation in 1978. Fiscal and monetary policy had been designed to prevent the emergence of inflationary pressures, and the oil revenues had been used to promote development and equity. The recent pressures on the balance of payments and the budget were traceable primarily to the recession in the world economy and to the developments in the oil market. The staff had concluded that the balance of payments and the budget were likely to come under increasing pressure in the near future, and that financial stability and the growth momentum could be adversely affected in both the short and medium term if the authorities failed to adopt corrective measures.

The authorities were to be commended for having avoided inappropriate countercyclical policies and for having attempted to deal with the consequences of the recession largely through effective demand management policies, Mr. Janjua continued. The austere budget introduced at the beginning of 1982 had included a wage freeze in the public sector and a drastic reduction in oil subsidies, and subsidies on fertilizers and pesticides had been cut on November 15, 1982. An additional adjustment in fertilizer prices was to be studied in due course, and Mr. Malhotra's comments on fertilizer prices were particularly useful. Any increase in the domestic price of fertilizer should be seen in the light of its possible adverse effect on the Government's rice intensification program. The price adjustments, together with the effort to improve revenues and to save on expenditures, were expected to reduce to a minimum the Government's recourse to its deposits with the banking system, which, at about Rp 4 trillion, represented past savings accumulated through the sterilization of budget surpluses and could provide a cushion for budget deficits in coming years. The staff had highlighted the need for an increase in budgetary savings to support the growth objectives. The authorities seemed to be aware of the need to improve the availability of resources, and a review of the tax system was planned in the next five-year plan.

The present budgetary position and the immediate prospects for it would have a bearing on the size and composition of the development program in the coming years, Mr. Janjua remarked. Development under the present budget was already behind schedule. Recent information on the 1983/84 budget suggested that the authorities were determined to maintain their austere policies for both current and development expenditures. The exclusion of any major new project in the 1983/84 budget was probably appropriate, but it would be unfortunate to postpone or abandon any important ongoing project, especially as most of the large capital-intensive projects were supported by foreign aid. The authorities had reportedly approached some of the aid donors about the possibility of receiving local currency funding in order to avoid losing the development momentum.

The Intergovernmental Group on Indonesia, which consisted of representatives of 12 industrial countries and 5 international agencies, had recently shown its confidence in Indonesia by agreeing to extend nearly \$2 billion in development loans in 1982/83, Mr. Janjua noted. Their confidence stemmed from, inter alia, the fact that Indonesia had made effective use of its oil revenues and had increased per capita GNP from

$370 in 1979 to $521 in 1981. The country was endowed with a rich natural resource base and needed to maintain the development momentum, particularly the development of the non-oil sector in general and the diversification of non-oil exports in particular. In recent years, the capital/output ratio in Indonesia had been quite low.

The staff's views on the investment strategy, and particularly its suggestion for shifting the emphasis to labor-intensive products, were of crucial importance, Mr. Janjua commented. What were the World Bank's views on the Government's strategy?

The staff had also suggested, Mr. Janjua noted, that the authorities should introduce flexible interest rates and strengthen their control of reserve money to improve the allocative function and efficiency of the banking system. The present system of credit ceilings had first been recommended by the Fund when demand for credit had risen despite the reserve requirements and high interest rates. The ceilings had helped to meet the credit needs of priority and disadvantaged sectors, and it would be useful to have a further comment on the staff's latest recommendations concerning the monetary sector.

The medium-term prospects for the external sector would depend largely on the developments in the world economy, Mr. Janjua remarked. Indonesia's reserve position would likely remain comfortable in the immediate future, and the country enjoyed a good credit rating. Foreign borrowing had not been excessive, and Indonesia's obligations were well within its debt servicing capacity.

The authorities had adopted a pragmatic approach to the exchange rate, Mr. Janjua observed. In the past, they had demonstrated their awareness of the need to maintain the competitiveness of Indonesia's exports. The large devaluation in 1978 had been decided in the absence of an obviously difficult balance of payments position. During the previous discussion on Indonesia, in April 1981, Executive Directors had generally felt that Indonesia had succeeded in retaining a significant part of the gains in competitiveness in the traded goods sector. Since then, prudent demand management policies had been maintained and inflation had been moderate; the problem with non-oil exports had been due to the depressed demand--rather than to export prices--and to another factor not mentioned by the staff, namely, the protection in industrial countries. Indonesia's recent major crops, with the exception of logs, had benefited from increases in productivity, and the supply position of non-oil exports had been comfortable. The present flexible exchange rate arrangement adequately met the country's needs, and, as Mr. Habib had stated, the authorities were keeping the exchange rate under review and would respond flexibly to developments. Finally, the proposed decisions were acceptable. The request to use the buffer stock financing facility met all the relevant requirements.

Mr. Zhang considered that Indonesia's economic growth rates during the previous five years were impressive. However, as in many other oil exporting countries, the favorable trends in Indonesia's economy had been abruptly interrupted by the decline in oil exports. At the same time, the world recession had caused the exports of other primary products to decline as well. The authorities had already adopted adjustment measures to deal with the present difficulties and had already decided to undertake longer-term measures to diversify the economy. The proposed decisions should be approved.

Mr. Erb said that he agreed with the thrust of the staff analysis and accepted the proposed decisions. The medium-term adjustment scenario provided by the staff was particularly helpful. In addition to the projections on outstanding debt, it would be useful to have an indication of Indonesia's gross foreign asset position or some other measure of the foreign asset position. Presumably the position had weakened in the recent past.

Indonesia had saved a large proportion of its oil revenues, Mr. Erb noted. Some of the savings had been held abroad directly by the Government in the form of foreign financial assets, and some had been held by the Government in the banking system, which held foreign financial assets of its own. The policy of saving a portion of the oil revenues was certainly a sound one, but further thought should be given to the estimation of the savings rate. In that connection, it might be appropriate explicitly to treat oil revenues as an asset, rather than as a contribution to budget revenues, and to think of the portion of oil revenue that was spent as, in effect, a reduction in total assets. Under that approach, the decision to use the oil revenue "assets" would depend in part on the relative rates of return of domestic investment compared with foreign investment. On the basis of that kind of decision making, and given the pressures on the absorptive capacity of the Indonesian economy, the savings rate in the country might have been even higher, the domestic liquidity pressures might have been less intensive, and the pressure on the exchange rate would have been weaker than had been suggested. The approach that he had in mind would help to separate oil revenues from the other major economic factors and would discourage distortions in the structure of the economy caused by the traditional treatment of oil revenues as one of the sources of government revenues.

Mr. Casey said that he generally agreed with the staff appraisals and accepted the proposed decisions. Indonesia clearly met all the requirements for using the buffer stock financing facility.

The overall fiscal deficit in 1982/83 was substantial by Indonesian standards at 4.2 per cent of GDP but was not alarming by international standards, Mr. Casey commented. It had occurred despite the 60 per cent increase in domestic petroleum prices, the freeze on public sector wages, and the improvements in tax administration, and it had been caused mainly by the near collapse of oil revenues and the serious decline in non-oil revenues. Central government revenue had been equivalent to only about 17 per cent of GDP in 1982/83, a very low figure by international standards. The revenue side of the budget, particularly non-oil revenue sources, required close examination, and the authorities had hired consultants from

Harvard University to assist them. Why did the authorities not prefer Fund technical assistance? The fiscal deficit had been financed by money creation, partly because of the underdeveloped state of the domestic capital market, which in turn was traceable to the Government's credit policies. The financing of the fiscal deficit had significant implications for the balance of payments and the domestic inflation rate. The concept of the domestic budget balance might be usefully applied in Indonesia. It had been mentioned in the discussion for the 1982 Article IV consultation with Trinidad and Tobago (EBM/82/126, 9/14/82), and it might meet Mr. Erb's concern about treating oil revenues as an asset.

The growth of the monetary aggregates in relation to nominal GDP seemed somewhat excessive, partly because of the financing of inventories, Mr. Casey remarked. Had the level of inventories been below normal in the recent past? Excessive stockbuilding was not a good rationalization for a rapid increase in the supply of money. Apparently a substantial part of the economy was nonmonetized, and the rapid growth in the monetary aggregates might well be explained by an acceleration of the process of monetization.

He agreed with Mr. Polak, Mr. Casey said, that a more flexible interest rate policy would lessen the likelihood of capital flight. Given the sizable debt service ratio and the growing balance of payments deficit, the authorities were undoubtedly feeling a significant external constraint. He agreed with the staff that the medium-term growth target of 6.5 per cent per year was rather optimistic. Much would depend on the quality of the investment that took place in the coming period and on more liberal export arrangements. Like previous speakers, he would welcome a comment on the World Bank's opinion of the Government's investment stategy. Much would also depend on the pace of the diversification of manufacturing. The share of manufacturing in GDP in the previous 20 years had increased only slightly, to about 9 per cent. The staff had wisely noted the need to re-examine the system of industrial licensing, which had greatly increased the cost of entering the manufacturing sector. Manufacturing apparently had not been given a high priority in the 1983/84 budget, perhaps because the Government traditionally was not greatly involved in that sector. A more flexible exchange rate would probably help the manufacturing sector and the basic process of diversification.

Indonesia's enviable record of growth and development had raised expectations, thereby increasing the difficulties the authorities faced in restoring financial stability, Mr. Casey considered. However, he had been confident that the authorities would be able to handle the emerging problems, and the preliminary information on the 1983/84 budget had reinforced his confidence. The budget contained a number of courageous measures, particularly the elimination of subsidies and the wage freeze; such measures were especially difficult to introduce in an election year.

Mr. Prowse stated that the proposed decisions were acceptable. Indonesia had played an important role in the operation of the International Tin and Natural Rubber Stock Agreements, and Indonesia was the first country to take advantage of the Rubber Agreement.

The performance of the Indonesian economy, and particularly the 8 per cent growth rate in 1981, was impressive even in the context of the region, which was broadly speaking the most successful in the world. There was a natural tendency to believe that the achievements of the Indonesian economy had been made possible primarily by the growth in the value of oil and liquefied natural gas (LNG) exports until 1981, but they were also traceable to the improved productivity in agriculture--especially in rice production--and to the effective fiscal and monetary policies. The authorities were to be commended for their management of the economy both in recent months and earlier. The quality of their management had been captured by the following statement in April 1981 by Mr. Kharmawan:

> It would be contrary to the Government's prudent stance if it would be carried away by the present favorable situation of the economy. It realizes that the strenuous and difficult task of major structural adjustment lies ahead. Indonesia, like many other oil exporting countries, cannot rely on a continuation of a strong oil sector. It is mandatory that the present favorable conditions be used to prepare the ground for an economy less dependent on oil, which means other exports have to be promoted based on agriculture, mining other than oil, and, in particular, manufacturing.

The authorities had had even less time to make the needed adjustments than they had hoped, Mr. Prowse continued. The rapidly deteriorating foreign markets, falling foreign oil prices, and declining reserves together with the uncertain international capital market conditions meant that the pace of adjustment had to be accelerated. The authorities' recognition of that need was reflected in the vigorous adjustment policies that they had recently adopted. Their strong stance was encouraging, but was the need for significant adjustment as fully understood by the Indonesian public? Was public opinion prepared for the effects of the policies that the Government was implementing? The likelihood of success would of course be increased if the community at large understood and supported the need for change.

While the authorities' policy actions were commendable, the staff had made a number of important recommendations, Mr. Prowse remarked. The tax system should be revitalized and restructured, and the capital markets further developed. The recent Executive Board seminar on interest rates and interest rate policy in developing countries had shown the importance of encouraging the development of an efficient banking system. The present system of credit ceilings and the rediscount mechanism in Indonesia were complex, and apparently credit allocation involved a significant degree of arbitrary, slow, and costly decision making.

As a result of the decline in inflation, Mr. Prowse noted, the interest rates on loans and deposits had gradually increased in real terms. That the rate for the largest categories of deposits had become positive by mid-1981 was certainly welcome.

The authorities' approach to structural adjustment and the exchange rate was appropriate, Mr. Prowse considered. They had considered various options for restoring competitiveness and, for the time being, had decided on a combination of demand management and continued gradual adjustment of the exchange rate. The staff felt that such a policy mix was desirable and, like the authorities, attached importance to keeping the exchange rate policy under review. He himself attached particular importance to maintaining flexibility in the exchange rate policy. A good case could not be made for a significant discrete adjustment of the exchange rate at the present stage.

He agreed with the staff, Mr. Prowse said, that the significant counterpurchase requirement and the exclusive right granted to Indonesian companies to ship public sector exports were likely to impede trade and to increase costs in excess of the potential benefits. Had an attempt been made to quantify the costs and benefits of the measures?

Mr. Jones stated that the proposed decisions should be approved. The performance of the economy in recent years had been satisfactory. Real output had grown by 9.6 per cent and 7.8 per cent in 1980/81 and 1981/82, respectively, and the projected rate of 4 per cent for 1982/83 was favorable, especially given the harsh external environment. The dramatic increase in rice output and the achievement of self-sufficiency in rice were particularly notable. The authorities had also succeeded in reducing the rate of inflation from 20.8 per cent in 1979/80 to 10.2 per cent in 1981/82 and an estimated 9 per cent in 1982/83.

Government revenue had declined markedly as a result of the softening of world demand for Indonesia's major export commodities, including petroleum, rubber, timber, and coffee, Mr. Jones continued. Hence, despite the efforts to curtail expenditure, the overall budget deficit in 1982/83 had widened, domestic bank financing of the deficit had risen, and the external payments position had weakened. He agreed with the staff that the strong adjustment measures contained in the 1982/83 budget, including the sizable increase in the domestic prices of petroleum products and the austere government wage policy, were entirely appropriate and should go a long way toward solving the country's economic problems.

The request to use the buffer stock financing facility met all the relevant criteria, Mr. Jones considered. The balance of payments need was clear, and the authorities were continuing to cooperate with the Fund to find solutions to the payments problems.

Mr. Caranicas remarked that, like some other countries in the region, Indonesia had performed remarkably well in the previous few years. In particular, the rates of growth in real terms had been high, and inflation had been reduced.

He was in broad agreement with the staff's appraisal, Mr. Caranicas went on. Indonesia's counterpurchase requirement seemed inconsistent with international efforts to reduce protectionism. That point should be underlined because Indonesia's own exports had been increasingly hampered by protectionist measures in other countries. The staff report had wisely stressed that Indonesia's restrictive measure was unlikely to bring the benefits that the authorities had assumed it would. It was unclear to him what was meant by the authorities' statement that they would be flexible and reasonable in implementing the restriction and would apply it on a case-by-case basis. Similarly, it was unclear to him how the new policy on shipping goods traded in the public sector could be applied flexibly, as the authorities intended. Furthermore, such restrictions seemed inconsistent with Mr. Habib's comment in his opening statement concerning measures introduced to liberalize the trade and payments system. The Indonesian authorities had a remarkable record of sound economic management and would certainly wish to continue avoiding measures that were likely to impede trade and increase costs in excess of the potential benefits of the measures.

The staff had concluded that the present system of trade protection should be reformed to remove the bias in favor of import substitution and against exports, Mr. Caranicas noted. The system had certainly caused distortions, including the development of a number of inefficient capital-intensive industries, and the staff's point was therefore well taken. However, he wondered how, in the present circumstances, Indonesia could eliminate the protection of import-substitution industries that were labor intensive.

The authorities' policy of gradualism in structural adjustment and the exchange rate was appropriate, Mr. Caranicas considered. As the staff had concluded, the authorities should not rely on demand management alone; the exchange rate should play an appropriate role. He was confident that after the strong adjustment measures in the 1982-83 budget, the Government would continue to maintain the proper policy mix. The proposed decisions should be approved.

The staff representative from the Asian Department explained that the revaluation of the net foreign assets in 1981/82 largely reflected the losses associated with the adjustment of gold reserves following the change in the price of gold. The authorities had recently introduced a policy to encourage the repatriation of net foreign assets held by commercial banks. Accordingly, the commercial banks were encouraged to deposit their foreign assets at Bank Indonesia at an interest rate that was half a percentage point below LIBOR. The elimination of the extension of credit to state banks for working capital loans at an interest rate of 13.5 per cent had also been designed to induce the commercial banks to repatriate their net foreign assets. The staff felt that the volume of assets that the authorities hoped to see repatriated was realistic.

There was a clear need for an increase in savings in the coming several years, the staff representative said, but interest rates were already reasonably high, and there was limited scope for improving private savings. The desired increase in savings would have to come basically from the public sector.

With regard to the World Bank and Fund staff views on the public investment program, the staff representative remarked, when the World Bank staff had written its assessment of the program in early 1982, it had had a more positive view than the staff on the external outlook for the country and, therefore, had been quite positive about the public investment program. The World Bank staff then had recommended an increase in the ratio of government gross domestic investment to GDP from 22 per cent to 27 per cent by 1985, but had subsequently revised its estimates. There had been close contact between the World Bank and Fund staff; indeed, the Fund and World Bank missions had visited Indonesia at the same time and had worked closely together. The assessment of the public investment program in the staff report fully incorporated the views of the World Bank staff, whose revised investment estimates were close to those of the Fund staff. The World Bank staff believed that the share of investment in GDP should remain at about 22 per cent--about the same figure recommended by the Fund staff--and that the growth target should be adjusted downward, to 4.7 per cent, compared with the Fund staff's figure of 5 per cent.

The Fund and World Bank staff were in full agreement on the specifics of the investment strategy, the staff representative continued. It was clear that, in the light of the foreign exchange constraint, emphasis would have to be placed on projects that were labor intensive and had a relatively high domestic content. At the same time, Indonesia enjoyed a comparative advantage in certain resource-based industries, such as petrochemicals and fertilizers, and investment in those industries should certainly continue. Indeed, the present public investment program had a number of lumpy multiyear projects in those areas; over half of the investment program for the coming two years was centered on investments in three refineries and LNG projects, which could not be adjusted downward without subtantial economic cost.

The main issue with respect to the public investment program was the marginal projects, which required more comprehensive cost-benefit analysis, the staff representative went on. The emphasis on agricultural investment should be maintained, but there were two main obstacles to the encouragement of more labor-intensive projects in the private sector. First, in Indonesia, as in many other developing countries, the trade system was biased in favor of import substitution, and some time would be needed to remove the bias against exports. Second, the investment environment had been undermined by the complicated system of licensing and other regulations. The authorities were fully aware of the need to simplify the system and were taking steps to do so. The issue in that area was the appropriate pace at which the reform should take place.

The economic situation in 1978, when the authorities had devalued by 33 per cent, the staff representative said, had been similar to the present one in some respects: oil revenues had not been expected to continue to rise, and the Government had wished to shift resources to the non-oil sector. The 1978 devaluation had been supported by strong financial policies, the rate of domestic inflation had been reduced and, within a year, there had been a significant improvement in the real exchange rate.

The sharp increase in oil prices in 1979 and 1980 had intensified the pressure on the Government to increase spending. The authorities had recognized that oil revenues should not be treated like any other revenue flows but should be spent in a manner consistent with domestic absorptive capacity. However, it was difficult to sterilize oil revenues in a country like Indonesia, where there was still considerable political pressure to reduce poverty. It was difficult to answer the question whether Indonesia could have saved an even larger portion of the oil revenues in the two years following the second round of price increases in 1979, thereby avoiding the appreciation of the real exchange rate. Unlike other oil exporting countries, Indonesia had been able to save a large portion of the oil revenues. Indeed, the reserves that it had built up were a crucial factor in allowing the authorities some flexibility in their approach to adjustment.

The annex to SM/82/233 provided the kind of economic analysis that Mr. Casey had mentioned, the staff representative remarked, as it focused on domestic expenditure and revenue separately in examining the impact of the 1978 exchange rate adjustment on the non-oil trade account. The analysis was particularly difficult in Indonesia because of the so-called balanced budget policy, which had been implemented before the oil price increases and was designed to halt excessive expenditure. The large increase in expenditure that had actually occurred had been unexpected and was explained in part by the considerable political pressure on the Government.

It was of course difficult to predict future developments in the oil markets, the staff representative commented, but it did not seem prudent to count on the recurrence of the kind of price increases that occurred in 1979 and 1980. The medium-term projections included some improvement in prices beginning in 1984-85, but not on the same scale as in previous years.

With respect to comments on recent exchange rate developments and policies, the staff representative noted that the strengthening of the dollar in the first part of 1982 had caused the real exchange rate of the rupiah to continue to rise. Since then, the trend had been reversed; in December 1982 there had been a significant decline--about 5-6 per cent--in the real exchange rate. The need for an improvement in competitiveness was not an issue. The authorities clearly recognized it. The main point of contention was the appropriate pace of the adjustment. A large portion of total revenues was derived from the oil sector, and a sharp depreciation would immediately increase oil revenues, thereby intensifying the pressure on the authorities to step up expenditure. At the same time, a rapid rate of depreciation could cause an increase in capital outflows. Indeed, there was some indication that such outflows were already occurring. On the other hand, if the rate of depreciation was not sufficiently rapid, the needed improvement in competitiveness would not be achieved. In the circumstances, the authorities felt that continuing the depreciation in the coming year at about the same rate as that in recent months would be appropriate. They intended to keep the exchange rate under review and realized that much would depend on external developments. If external developments deteriorated more quickly than expected, the authorities intended to take the necessary steps to deal with the problem.

The question had been raised, the staff representative recalled, whether the authorities should undertake a short-term adjustment in the fiscal sector in order to achieve a rapid increase in revenues, rather than wait for a comprehensive study to be completed. A thorough examination of the tax system was clearly needed but would take some time. Meanwhile, the authorities intended to make some of the clearly required improvements in the tax administration. The Fund staff had conducted a technical assistance study of the tax system in 1979.

The authorities' target for the increase in revenues in the coming year was ambitious, the staff representative commented, and the staff was not fully convinced that it could be achieved. Still, the staff was not greatly concerned about likely budgetary developments, as considerable expenditure constraint was being exercised, and the authorities had recently taken the important decision to increase petroleum prices further, as the staff had recommended. That adjustment had been made even sooner than the staff had expected and was encouraging. The forecast increase in development expenditures actually covered appropriations only, and the figures for final expenditure would probably be significantly smaller.

In response to questions on trade policy, the staff representative explained that effective protection in Indonesia had averaged about 60 per cent for imports and some -6 per cent for exports. The diversity of the effective protection of the trade regime was especially worrying, as it ranged from 4,000 per cent for some items to -35 per cent for others. There was obviously a great deal of room for improvement in the trade regime.

Regarding Mr. Janjua's query on the desirability of credit ceilings, the staff representative noted that the ceilings had been established in the early 1970s on the advice of the Fund, and there was now no objection to the ceilings themselves. The problem was that the credit system had subsequently become much too complex. There were a large number of credit categories, each having its own system of lending rates, most of which were relatively low. At the same time, deposit rates were relatively high. The rediscount system had become so complicated that it interfered with the allocation of credit to the most productive sectors. The World Bank staff, which had also studied the matter, agreed with the Fund staff that there was considerable room for improvement in the credit system.

With respect to price adjustments to reduce subsidies, the staff representative noted that there was less scope for an increase in fertilizer and rice prices than in petroleum prices. The prices obviously affected output, and the staff had recommended that further price increases should be phased in over the coming six years or so. Fertilizer prices in Indonesia were fairly low, partly because the cost of inputs--particularly gas--in the production of fertilizer was moderate.

The difference between rice prices in Indonesia and those in international markets was now small, the staff representative explained, a feature that would facilitate the phased adjustment of input price increases. Net foreign assets of the banking system were projected to fall gradually before leveling out at the equivalent of about four months' imports. The actual figure might well be different, but the main picture drawn by the staff of the trend of net foreign asset positions in future years still seemed correct.

The share of manufacturing in GDP in the previous decade indeed had risen only from 8 per cent to 12 per cent, the staff representative from the Asian Department noted. The point made by Executive Directors was well taken; the manufacturing sector had not developed rapidly, mainly because of the growing role of oil in the economy.

The staff representative from the Exchange and Trade Relations Department remarked that the staff had clearly indicated its strong reservation about the appropriateness of the counterpurchase requirement. It was difficult to quantify with any degree of precision the costs and benefits of that kind of requirement, which represented a form of countertrade or barter. Reliable estimates of trade effected under countertrade arrangements were not available, but Directors might recall that the staff report on bilateral payments arrangements (SM/82/169, 8/17/82) indicated that global countertrade might be of the order of 1 per cent of world trade.

He agreed with Mr. Erb, the staff representative from the Exchange and Trade Relations Department continued, that oil revenues could be seen from the standpoint of an asset rather than as a form of revenue. In other words, oil was an exhaustible stock of wealth, and it was crucial to ensure that other permanent sources of revenue were developed while the stock of oil was run down. However, in many oil exporting countries it was not always easy to ensure the existence of a general perception that oil was a depletable asset. The public usually expected oil revenues to continue increasing so that government activities could be enhanced as a way of solving the problems facing the economy.

Mr. Erb remarked that the problem of the public's perception of oil revenues as an immediate source of financing for expenditures rather than as depletable assets could be dealt with by explicitly treating oil in the way that he had suggested.

The staff representative from the Asian Department noted that although it was not possible to quantify the cost of the counterpart measure in general, there was some evidence that in the specific case of coal mining and electric power projects, the cost of the delays in completing the projects would be about $60 million.

Mr. Suraisry remarked that he had not meant to suggest that the expected recovery in the world economy would cause oil prices to increase to the same extent as in 1979 and 1980. He had been concerned that the staff's discussion on the matter gave the impression that the recovery might not cause an increase in the demand for oil.

The staff representative from the Research Department commented that the decisions on the tin and rubber agreements adopted by the Executive Board on November 12, 1982 stipulated time limits within which requests for Fund financing could be considered by the Fund. Both decisions provided that the Fund would accept a member's request for a purchase in connection with the financing of its contribution to the buffer stock if the request was received in the Fund not later than six months after the date of the contribution or, in respect of contributions made before the date of the decisions, not later than 90 days after that date. The 90-day limit would expire in about mid-February 1983. Both of Indonesia's requests related to contributions that had been made before the adoption of the two decisions on November 12, 1982. All the contributions made thus far by members of the International Rubber Agreement had taken place before November 12, 1982. Hence, the 90-day limit would apply to requests by other members of the International Rubber Agreement in respect of those contributions. The contributions by some other tin exporting countries had also been made before November 12, 1982.

Mr. Habib said that the authorities were discussing among themselves the best ways to maintain the development effort, which had been started only some 14 years earlier but had already significantly benefited the majority of the people. Most Indonesians continued to live in rural areas, and a growing number of them had entered the monetized sectors of the economy. The very success of the national development effort had raised expectations and made the development program one of the most sensitive issues facing the authorities. Any abrupt halt to the development process or any sudden decline in the rate of economic growth could have serious social and political consequences, and the authorities' overriding concern was to avoid losing the momentum of development. Managing the development process was particularly difficult in Indonesia, which consisted of more than 13,600 islands.

The staff had described the background to the adoption of the countertrade policy, Mr. Habib commented. Given the deteriorating export position, the authorities had faced the choice of either drastically reducing imports or tying procurement contracts to exports. Almost 90 per cent of Indonesia's imports consisted of capital goods needed to maintain the momentum of development; hence, the authorities obviously did not wish to make a sharp reduction in imports. They were willing to reduce the imports that did not make a direct contribution to the development process, but the main solution had been to tie government procurement contracts to exports; indeed, in the circumstances, the authorities had had no alternative. It was estimated that countertrade accounted for nearly 30 per cent of world trade and 40 per cent of East-West trade. The authorities did not intend to maintain the countertrade policy indefinitely; it was an emergency policy that would be implemented flexibly and on a case-by-case basis, which meant that, after undertaking bilateral negotiations, the authorities would determine whether countertrade could be arranged. They would not insist on countertrade in each and every case. Nor was countertrade applied to all of the Government's purchases; procurements financed by concessional loans from the World Bank, and the domestic components of foreign contracts, such as professional services and specialized technology, were excluded. It was too soon to know how beneficial the countertrade requirement was. Thus far, only about $400-500 million had been involved, but Indonesia's foreign sector was not expected to strengthen significantly in the coming period, and the countertrade policy might well have to be maintained for at least several years.

The authorities were keenly aware that the countertrade policy would not be effective unless the Government was able to make available export commodities for which there was a market in the countries that exported goods and services to Indonesia, Mr. Habib said. Most of the producers of Indonesia's major exports were smallholders in rural areas. For instance, 60 per cent of the producers of rubber were smallholders, as were 80 per cent of the producers of coffee and nearly 100 per cent of the producers of tobacco and cassava. The authorities obviously preferred to maintain the countertrade policy rather than to threaten the livelihoods of such producers. Furthermore, at present, the Government's development program emphasized agricultural development. Over time the authorities hoped to broaden the productive base, thereby reducing the dependency on the oil sector.

A number of members, many of them major countries, had maintained a cargo preference policy for a number of years, Mr. Habib observed. His authorities intended to implement the policy in a flexible and reasonable manner and, in any event, it was not the kind of action that could negatively affect the world trade system. Furthermore, Indonesia's shipping share in total crosstrading, including bulk cargo such as oil, was negligible, and the national shipping fleet accounted for only about one third of the total tonnage involved in external trade. The main objective of the shipping policy was to encourage the development of a more viable and effective merchant marine, something that was crucial in a country that consisted of a large number of islands. Of course, no attempt was made to apply the shipping policy if the needed cargo space was unavailable on Indonesian ships.

The authorities were worried that abrupt changes in the value of the rupiah could rekindle inflation, Mr. Habib explained. It had taken a great deal of effort to increase the confidence of the monetized sector in the rupiah and in government policy in general, and the recurrence of a high rate of inflation would obviously be counterproductive; the most recent round of such inflation was still fresh in everyone's memory. Prior to the introduction of the development program, the rate of inflation had been as high as 640 per cent. The authorities were also worried about possible capital outflows, especially as there were virtually no controls on capital movements in Indonesia.

The targeted rate of liquidity expansion was closely linked to the rate of economic growth that was thought to be needed to maintain the development momentum, Mr. Habib commented. The rate of liquidity expansion in April-November 1982 was estimated at 14 per cent, and the rate in fiscal year 1982/83 was estimated at about 22 per cent, 2 per cent higher than the staff had estimated. The authorities were fully aware of the role of the control of liquidity expansion in the effort to stabilize economic conditions, and they intended to pay close attention to the matter in the coming period.

The authorities felt that investment should be concentrated on labor-intensive activities and quick-yielding projects, Mr. Habib remarked, but the ongoing capital-intensive projects, especially those involving the resource base, would have to be continued. Any abrupt decline in expenditure on ongoing capital-intensive projects would be costly.

The Harvard Study Group was expected to make final recommendations for improving the tax structure under the Fourth Five-Year Development Plan (beginning in 1984-85), Mr. Habib explained. For the moment, the authorities' main concern was to raise the level of revenues by improving the administration of non-oil taxes. To that end, a computerized taxpayer numbering system had been developed and was expected to be fully operational in 1983.

The concept of treating oil revenues as assets was certainly interesting, Mr. Habib remarked. As the staff had mentioned in its report, 20 per cent of Indonesia's oil revenues had not been treated as budgetary revenue, while the remaining 80 per cent of oil revenues had been managed as budgetary revenues. In a sense, therefore, the authorities' approach to the oil revenues had paralleled that of Mr. Erb. However, the staff had clearly noted that the public strongly favored using the oil revenues as quickly as possible to broaden the productive base of the economy, thereby lessening the dependency on the oil sector. The authorities were aware of the need to strike an appropriate balance between the treatment of oil revenues as budgetary revenues and as assets.

Development of the manufacturing sector was not one of the authorities' high priorities for the immediate future, Mr. Habib said. Still, manufacturing's share of GDP had risen from 8.8 per cent in 1971 to 15.9 per cent in 1981, while the share of agriculture had fallen from 44 per cent to 29.5 per cent. The main thrust of the development effort had been in agriculture because it employed most of the people. The authorities were of course fully aware of the difficulties facing the agricultural sector, and they were paying adequate attention to the growth of the share of manufacturing in GDP.

The initial major increase in domestic petroleum product prices had occurred just two months before the general elections of March 1982, Mr. Habib recalled. The public had been fully informed in advance by the authorities at all levels. The more recent increase in domestic fuel oil prices and the reduction of food subsidies had also been preceded by warnings to the public. The presidential decree raising fuel oil prices on January 7, 1983 had been preceded by the President's submission of the draft 1983/84 budget to parliament.

Negative real interest rates, about 6 per cent, Mr. Habib said, were maintained in certain priority areas to boost production for exports, food production, and the procurement of food by the Government as a buffer stock in the event of natural disasters. In all other sectors, interest rates in real terms were positive.

The Acting Chairman made the following summing up:

Directors commended the Indonesian authorities for the rapid rate of growth and the favorable price performance of the economy in 1981-82 as well as for attaining their goal of self-sufficiency in rice. They also noted the past policy of saving a significant portion of oil earnings, which put Indonesia in a better position to weather the worsening of the external environment. Directors observed that weakened demand for oil and other traditional exports in 1982-83 was likely to result in a current account deficit equivalent to about 8 per cent of GDP and in a substantial reduction in the international reserves accumulated over previous years.

Directors commended the authorities on the fiscal adjustment effort, including the new and substantial increases in domestic petroleum and fertilizer prices, the austere government wage policy, the strict economies on other items of recurrent expenditure, and the concentration of development outlays in main priority areas. They welcomed the fiscal restraint envisaged in the 1983-84 budget, which provides for a small increase in total expenditures and a significant reduction in the overall deficit as a percentage of GDP, compared with the revised estimates for the preceding fiscal year. They stressed the importance of raising fiscal revenues through improved tax administration and through appropriate tax reform.

Directors also noted that monetary growth has continued to decline in 1982, mainly reflecting the large balance of payments deficit. In this context, they questioned whether the acceleration in credit to the private sector and public enterprises was consistent with long-term financial stability and suggested that greater credit stringency may be required to reduce the balance of payments deficit to a sustainable level and to prevent a resurgence of inflation. Directors also called for measures to improve the efficiency of the banking system and for a more flexible interest rate policy. Such measures would also help to improve financial savings. While Directors expressed approval of the measures the authorities had undertaken so far, they were seriously concerned about the size of the deficit in the current account of the balance of payments in prospect for 1982-83 and about the envisaged pace of adjustment.

Indonesia's external borrowing capacity and its relatively high level of international reserves were considered to be sufficient to finance the external deficit without undue difficulty this year, but, without timely adjustment measures, the deficit could widen substantially over the medium term. A number of Directors noted that even with significant adjustment efforts to reduce the current account deficit in relation to GDP, the external debt burden would still rise over the next five years. There was general agreement with the staff's assessment that a broad range of adjustment measures was needed now, including those relating to the mobilization of budgetary savings, the efficiency of public and private investment, the allocation of financial resources, and the improvement of competitiveness. Many Directors argued that Indonesia should urgently strengthen the non-oil export sector for both traditional and non-traditional products and review the trade policy, which was in favor of import substitution and had led to the establishment of inefficient and capital-intensive enterprises.

Directors stressed that the maintenance of competitiveness was essential for attaining long-term balance of payments and growth objectives. They noted the loss in competitiveness since the 1978 devaluation and underscored the importance of appropriate relative prices for the development of non-oil exports and containment of import growth. They welcomed the greater flexibility in exchange rate policy evident during the past year, and they supported the approach of gradual depreciation. But a number of Directors believed that a faster pace of action in that area may well be required than currently envisaged by the authorities.

Questions were raised about certain trade policies being followed by the authorities. A few Directors questioned the likely benefits of the recently imposed measure involving a counterpurchase requirement on certain public sector imports and certain provisions in shipping services. Finally, Directors noted the abolition of the import deposit scheme and welcomed the authorities' intention to review and eliminate the remaining minor multiple currency practices in an otherwise free exchange system.

The Executive Board then took the following decisions:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision relating to Indonesia's exchange measures subject to Article VIII, Section 3, and in concluding the 1982 Article XIV consultation with Indonesia, in the light of the 1982 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 with satisfaction the recent elimination of the advance deposit requirement for imports. However, 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 April 1, 1984.

Decision No. 7292-(83/6), adopted
January 7, 1983

Purchase Transaction - Buffer Stock Financing Facility - Sixth International Tin Agreement

1. The Fund has received a request by the Government of Indonesia for a purchase of SDR 27.7 million (the equivalent of $71.6 million) under the Decision on Buffer Stock Financing Facility: The Problem of Stabilization of Prices of Primary Products, Decision No. 2772-(69/47), June 25, 1969, as amended by Decision No. 4913-(75/207), December 24, 1975, and the Decision on Buffer Stock Financing Facility: Sixth International Tin Agreement, Decision No. 7247-(82/147), November 12, 1982.

2. The Fund determines that this purchase would be consistent with the decisions referred to in (1) above, notes the representations of Indonesia, and approves the purchase in accordance with the request.

Decision No. 7293-(83/6), adopted
January 7, 1983

Purchase Transaction - Buffer Stock Financing Facility - International Natural Rubber Agreement

1. The Fund has received a request by the Government of Indonesia for a purchase of SDR 37.4 million under the Decision on Buffer Stock Financing: The Problem of Stabilization of Prices of Primary Products, Decision No. 2772-(69/47), June 25, 1969, as amended by Decision No. 4913-(75/207), December 24, 1975 and the Decision on Buffer Stock Financing Facility: International Natural Rubber Agreement, Decision No. 7246-(82/147), November 12, 1982.

2. The Fund determines that this purchase would be consistent with the decisions referred to in (1) above, notes the representations of Indonesia, and approves the purchase in accordance with the request.

Decision No. 7294-(83/6), adopted
January 7, 1983

## DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/5 (1/5/83) and EBM/83/6 (1/7/83).

### 2. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/2 (1/4/83), EBAP/83/3 (1/4/83), EBAP/83/4 (1/5/83), and EBAP/83/5 (1/4/83) is approved.

APPROVED: June 14, 1983

LEO VAN HOUTVEN
Secretary