

SM/08/237  
Correction 2

September 3, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Indonesia—Staff Report for the 2008 Article IV Consultation**

The attached corrections to SM/08/237 (7/11/08) have been provided by the staff.

**Factual Errors Not Affecting the Presentation of Staff's Analysis or Views**

**Page 11, paragraph 12, first bullet, line 4:** for “Staff analysis suggests that, within Asia, Indonesia remains among the most sensitive countries to risk aversion” read “Staff analysis suggests that, within Asia, Indonesia’s financial markets remain relatively sensitive to spillovers from short-term shocks to risk aversion.”

**Page 11, paragraph 12, second bullet, line 1:** for “Indonesia could be vulnerable to a sharp reversal of the rise in commodity prices” read “A sharp reversal of the rise in commodity prices could pose downside risks to growth.”

**Page 12, Box 1, second paragraph, line 1:** for “Within Asia, Indonesia remains among the most sensitive countries to such spillover” read “Within Asia, Indonesia’s financial markets remain relatively sensitive to such short-term spillovers.”

Questions may be referred to Mr. Zavadjil (ext. 38730), Mr. Reichold (ext. 39974), and Ms. Ruiz-Arranz (ext. 38564) in APD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (2)

Other Distribution:  
Department Heads



12. At the same time, there are significant external downside risks to growth, and Indonesia could be strongly affected by a deterioration in economic and financial conditions beyond the WEO baseline.

- **While relatively less vulnerable to slower U.S. growth, shifts in investor sentiment and financial contagion could be disruptive.** Increased global risk aversion, involving substantial deleveraging and repricing of risk, could trigger capital outflows from high-beta and more volatile emerging markets. Staff analysis suggests that, within Asia, Indonesia's financial markets remains relatively among the most sensitive countries to spillovers from short-term shocks to risk aversion (Box 1).
- **A sharp reversal of the rise in commodity prices could pose downside risks to growth**~~Indonesia could be vulnerable to a sharp reversal of the rise in commodity prices.~~ Commodities account for more than half of total exports in Indonesia. Therefore, declines in commodity prices would undermine export revenue, as well as profits and valuations of many commodity producers on the Jakarta stock market. This could also trigger capital outflows, put pressures on the rupiah, and reverse the recent increase in FDI to these sectors. On the positive side, declines in food and oil prices would help ease inflationary pressures and reduce budget subsidies.<sup>1</sup>

13. **A continued rise in global oil and food prices, on the other hand, pose a significant risk for the inflation outlook.** Food price pressures are expected to ease with an expected strong rice harvest and international prices of many food commodities leveling off. However, price pressures could mount later in the year, especially if the strong rice harvest fails to materialize.<sup>2</sup>

## I. DISCUSSIONS OF KEY POLICY CHALLENGES

### A. Monetary and Exchange Rate Policies: Responding to Rising Inflation

14. **As in many other countries, inflationary pressures have intensified since the beginning of the year** (Figure 4). Headline inflation is expected to reach 12 percent by the end of the year, reflecting the effect of the fuel price adjustment, high food prices, as well as demand pressures.

15. **Rising commodity prices have contributed disproportionately to the increase in inflation in Indonesia.** Food prices accounted for 49 percent of y/y inflation as of June, compared with a CPI weight of 36 percent. Similarly, the 29 percent fuel price adjustment also significantly raised the headline inflation rate, as did some other commodity prices, such as gold, although to a lesser extent.

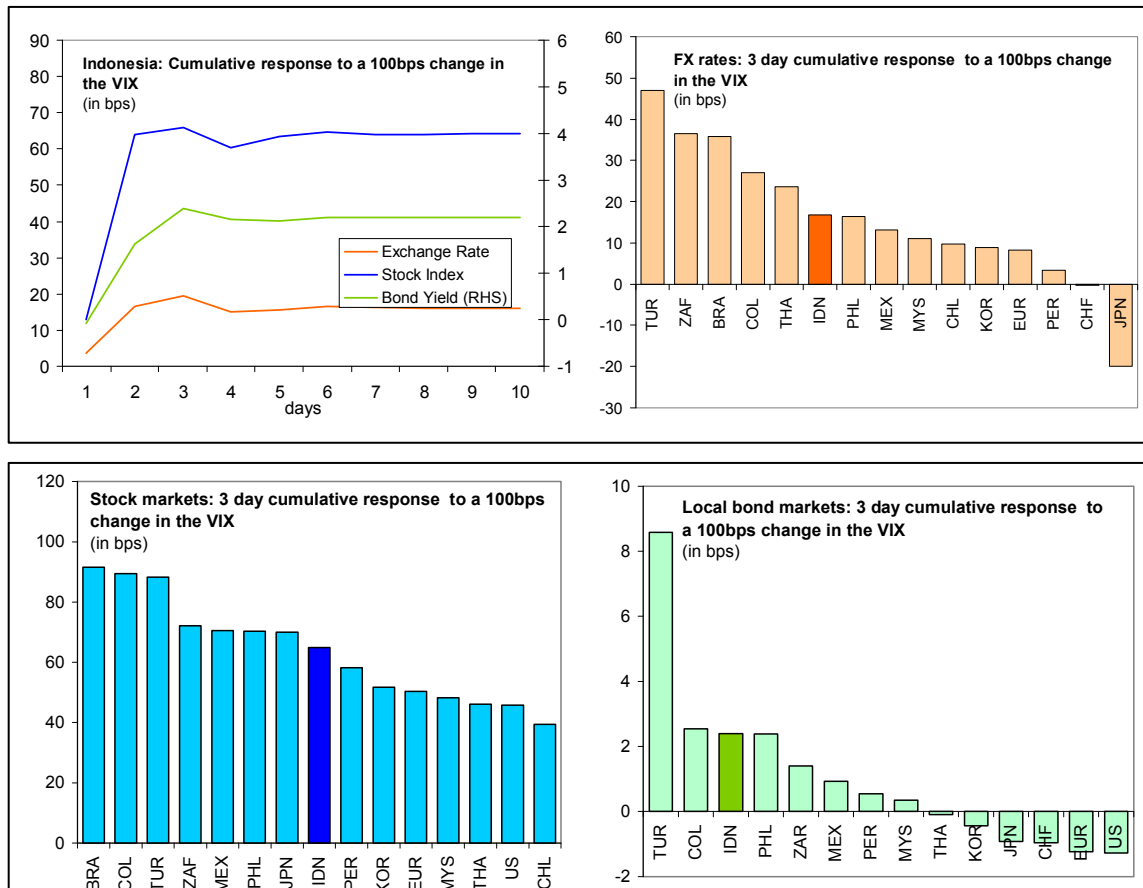
<sup>1</sup> Annex I describes in more detail the medium-term impact of a possible adverse shock scenario, assuming a stronger global slowdown, a sharp drop in commodity prices, and a surge in risk aversion.

<sup>2</sup> Such a scenario is explored in the accompanying Selected Issues Paper: Inflation Outlook and Monetary Policy Challenges.

### BOX 1. FINANCIAL MARKET SPILLOVERS: EVIDENCE FROM RECENT DATA 1/

**Global shocks to risk aversion have a significant impact on Indonesian financial markets.** Shocks to the VIX index tend to spill over into Indonesian financial markets within 2–3 days. As expected, the largest impact is on equities, the most risky asset class.

**Within Asia, Indonesia's financial markets remains relatively among the most sensitive to such short-term countries to such spillovers.** Compared to some important emerging market countries outside the region (e.g., Turkey, South Africa, and Brazil) Indonesian markets appears to be somewhat more stable. Nevertheless, the analysis suggests that Indonesia could be significantly affected by another episode of flight from emerging market assets.



1/ Based on daily data from January 2006 through February 2008. Impulse responses are based on VARs with 2 lags and generalized impulses that are robust the ordering of shocks.