Office Memorandum

To: Members of the Executive Board July 25, 2014

From: The Secretary

Subject: **Indonesia—Assessment Letter for the Asian Development Bank**

Attached for the **information** of Executive Directors is the Fund's assessment letter on the macroeconomic conditions in Indonesia, which was requested by the Asian Development Bank (AsDB).

If the authorities of Indonesia consent to the publication of this assessment, it may be published by the AsDB.

Questions may be referred to Mr. Cowen (ext. 37207) and Mr. Toh (ext. 34697) in APD.

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

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Indonesia—Assessment Letter for the Asian Development Bank
July 25, 2014

Overview

Recent developments have been broadly in line with those envisaged during the 2013 Article IV consultation, which concluded in November 2013. The near-term outlook and balance of risks for Indonesia are also largely unchanged, although the reserve build up has been stronger than expected, helping reduce external vulnerability.

Macroeconomic developments and outlook. Growth in Indonesia was 5.8 percent in 2013, which was better than expected mainly because of a stronger contribution from net exports. It is projected to slow to 5.2 percent in 2014 due to moderating domestic demand and supply side factors in the resource sector. Inflation has been declining since early 2014 and is expected to be within the upper limit of the Bank Indonesia's (BI) target band (4.5±1 percent) by end 2014. The current account deficit is projected at 3.2 percent of GDP in 2014—approximately the same level as in 2013—with adjustment tempered by soft nonoil commodity prices, the partial ban on mineral ore exports implemented in January 2014, and projected lower oil output. The deficit is expected to be financed mainly by FDI and portfolio inflows, which have resulted in a balance of payments (BOP) surplus in 2013:Q4 and 2014:Q1 (latest available data) and supported a recovery in gross reserves from mid-2013 lows by US$15.0 billion to US$107.7 billion at end-June 2014 (6 months of imports). Public debt and external debt remain sustainable.

Policy developments. Monetary policy has been tightened since June 2013, mainly through policy rate increases by BI, and bond yields have been allowed to rise, with tighter financial conditions helping contain inflation and external pressures. Macroprudential measures have also been used selectively to contain financial stability risks. Credit growth, in turn, has moderated. Bank Indonesia has also shifted to a more flexible exchange rate policy framework to reduce external pressures. Fiscal policy has been moderately expansionary on slow revenue growth and large energy subsidies, with the central government deficit expected to be 2.5 percent of GDP in 2014 (compared to 2.3 percent in 2013) based on performance through June and the government's revised budget for this year.

Main risks are surges in global financial market volatility brought on by geopolitical tensions and/or revised expectations on the exit from unconventional monetary policies, which could trigger a sustained reversal in capital flows from emerging markets. A protracted period of slower growth among major trade partners and, related to this, a sustained decline in commodity prices, as well as geopolitically-driven oil price shocks, could intensify external and fiscal pressures faced by Indonesia.

Policy Framework

The current policy framework is appropriately geared toward ensuring a stable macroeconomic environment. To buttress stability, reduce vulnerabilities, and adapt to tightening global financial conditions, the framework should continue to aim at reducing external imbalances, keeping the fiscal deficit in check, and maintaining financial stability. The recent election outcome suggests an opportunity to advance structural reforms in support of higher, more inclusive growth. Clear communication and coordination will continue to aid policy effectiveness.

Monetary policy is expected to remain focused on anchoring inflation expectations and reducing BOP pressures, with BI's current stance broadly appropriate. To facilitate adjustment, the exchange rate and bond yields are expected to continue to move flexibly to reflect market conditions.

Fiscal policy should support monetary policy in this effort, with a moderate consolidation desirable in the period ahead to avoid funding pressures. Efforts will be needed to bolster tax collection and press ahead on energy subsidy reform, with well-targeted safety nets. These moves would open up fiscal space to ensure adequate spending on infrastructure projects and new social protections.

Financial sector policies should be geared toward strengthening the financial stability architecture by closing gaps in laws and protocols governing liquidity provision and bank resolution. Banks' asset quality and capital positions are generally sound, but financial indicators bear close watch given earlier credit expansion, slower economic activity, and liquidity needs. Private external borrowing will also need to be watched closely to ensure it is adequately hedged.

Structural reforms should focus on export diversification through addressing infrastructure and logistics bottlenecks and improving the trade and investment climate; financial deepening through strengthening intermediation capacity and the domestic investor base; and employment generation, supported by education reform and flexible labor markets.

IMF Relations

The 2013 IMF Article IV consultation was concluded by the IMF's Executive Board in November 2013. A joint IMF-World Bank FSAP was completed in 2010.