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March 30, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Indonesia - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Indonesia, which has been tentatively scheduled for discussion on Wednesday, April 22, 1987.

Ms. Ripley (ext. 6531) or Mr. Marquez-Ruarte (ext. 7180) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

INDONESIA

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the
1986 Consultation with Indonesia

Approved by P. R. Narvekar and Eduard Brau

March 27, 1987

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I. Introduction

The 1986 Article IV consultation discussions were held in Jakarta from October 22 to November 7, 1986 and from January 15 to January 27, 1987. The second visit took place following the presentation of the 1987/88 budget to parliament. 1/ The Indonesian authorities were represented by the Coordinating Minister for Economy, Finance, Industry, and Development; the Ministers of Finance, Trade, and Planning; the Special Advisor to the President; the Governor of Bank Indonesia; and other senior officials of the Government and of Bank Indonesia. The mission also met with officials of private and public sector enterprises, representatives of the foreign economic community, and the IBRD resident mission. Mr. J. E. Ismael, Executive Director for Indonesia, attended the first series of meetings as an observer. The staff team 2/ was assisted by Mr. R. Hides, the Fund's Resident Representative, and staff of the IBRD resident mission were also present during many of the meetings.

Indonesia continues to avail itself of the transitional arrangements under Article XIV. It does not, however, maintain any restrictions on payments and transfers for current international transactions.

II. Retrospective

The oil sector has played a dominant role in Indonesia's economy, accounting in the year of peak oil prices (1981/82) for one fourth of GDP, for over two thirds of government revenues, and for four fifths of gross merchandise exports. Buoyant oil revenues, along with a cautious external debt strategy, made possible the financing of an ambitious development program during the late 1970s, accompanied by only a modest rise in the debt service burden. However, dependent as Indonesia is on oil, its proven oil reserves are less abundant than those of many major exporting countries. At the same time, its growth and employment objectives have also pointed to the need to pursue policies conducive to the expansion of the non-oil/LNG sector.

The situation in 1986/87--characterized by a current account deficit of $4 1/4 billion (5 3/4 percent of GDP) and a budget deficit equivalent to 5 1/2 percent of GDP--was foreshadowed by the imbalances that emerged in 1982/83 (Chart 1 and Table 1). With the fall in the

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1/ The fiscal year ends on March 31.

2/ The team comprised D. Ripley (Head), J. Marquez-Ruarte, S. Itam, J. Schulz (all ASD), and G. R. Kincaid (ETR), with P. Job (ASD) and S. Christian (TRE), as secretaries.

Table 1. Indonesia: Summary Balance of Payments, 1981/82-1986/87 1/

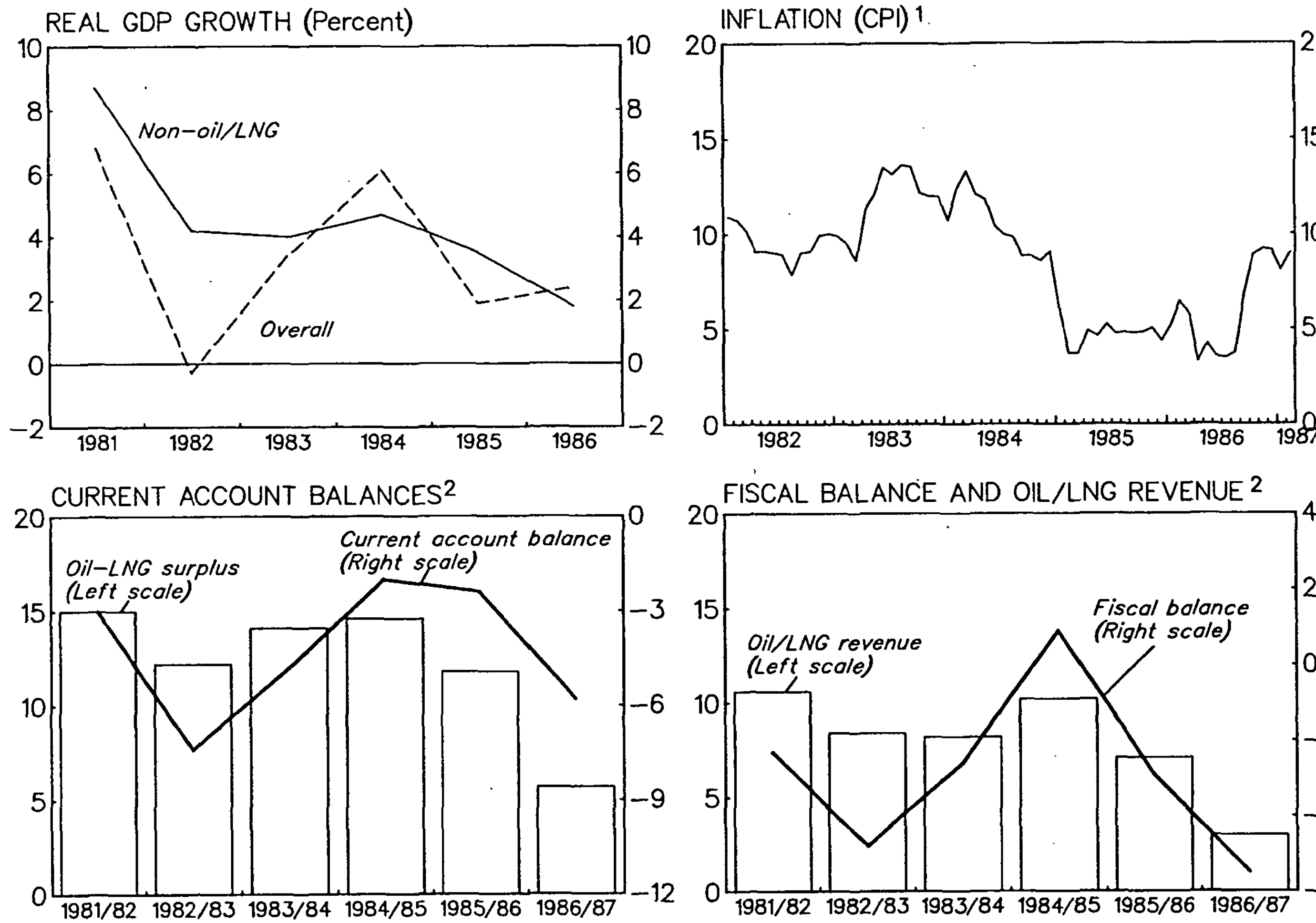
(In billions of U.S. dollars)

	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87 Est.
Exports, f.o.b.	21.1	18.7	19.9	20.9	18.6	13.4
Oil	14.6	12.3	12.1	11.6	8.8	4.7
LNG	2.3	2.5	2.4	3.4	3.6	2.1
Non-oil	4.2	3.9	5.4	5.9	6.2	6.6
Non-oil/LNG imports, c.i.f.	-14.3	-15.8	-14.3	-12.9	-11.2	-9.7
Oil/LNG sector payments (net)	-7.2	-7.1	-7.1	-6.6	-6.5	-4.6
Non-oil/LNG services (net)	-2.6	-2.7	-2.9	-3.2	-3.1	-3.3
Official transfers	0.2	0.1	0.1	0.1	0.1	0.1
Current account	-2.8	-6.8	-4.4	-1.7	-2.0	-4.2
Oil/LNG sector (net)	9.8	7.7	7.4	8.3	6.0	2.2
Non-oil/LNG sector (net)	-12.5	-14.5	-11.8	-10.1	-8.0	-6.3
Capital account	2.9	3.3	6.9	4.1	1.3	1.1
Long-term capital (net)	3.1	4.6	4.0	2.0	1.7	2.0
Official capital (net)	3.0	4.2	3.9	1.7	1.4	1.7
Receipts	4.0	5.3	5.1	3.4	3.4	4.3
Amortization	-1.1	-1.2	-1.3	-1.7	-2.1	-2.6
Direct investment (net)	0.1	0.3	0.2	0.2	0.3	0.3
Oil/LNG sector trade credits (net)	0.4	0.6	0.4	0.2	0.6	0.6
Errors and omissions (net) 2/	-0.6	-1.9	2.5	0.8	-0.7	-1.5
Overall balance	0.1	-3.5	2.6	2.3	-0.5	-3.1
Valuation adjustment	-0.5	0.1	--	-0.6	1.0	0.7
Monetary movements (increase in net assets -) 3/	0.3	3.3	-2.5	-1.7	-0.5	2.4
Assets	0.3	2.4	-2.6	-1.3	-0.3	...
Liabilities	--	0.5	0.1	-0.4	-0.1	...
Memorandum items:						
Current account (in percent of GDP)	-3.0	-7.2	-5.5	-2.1	-2.4	-5.8
Foreign assets 3/	11.4	8.6	11.2	12.5	12.9	10.0
Foreign assets 3/ /imports (in months of next year's non-oil/LNG imports)	8.9	7.2	10.4	13.4	15.9	13.2

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

1/ Component may not add to totals due to rounding.
2/ Includes private capital flows and counterpart to valuation adjustments in foreign assets and liabilities of the domestic money banks.
3/ Monetary authorities and deposit money banks.

CHART 1
INDONESIA
ECONOMIC INDICATORS, 1981-87



Sources: Data provided by the Indonesian authorities; and staff estimates.
1Percentage change over preceding 12 months.
2Percent of GDP.

average oil price of only some $1.50 per barrel--but which was accompanied by an acceleration of government expenditures in the pipeline--the external current account deficit rose by $4 billion to almost $7 billion (7 1/4 percent of GDP) and the budget moved into deficit equivalent to almost 5 percent of GDP. The debt service burden remained moderate at 15 percent of exports of goods and services owing to Indonesia's earlier cautious financial strategy and the grace periods for recent borrowings. As oil prices continued to decline, an integrated policy response evolved to contain internal and external imbalances and address structural impediments to the growth of the non-oil/LNG sector.

The rupiah was devalued by 28 percent in March 1983, and the gains achieved in external competitiveness were subsequently protected by flexible exchange rate management (Chart 2). A concerted effort was made to contain current expenditures, and civil service salaries were frozen for a time. Projects already accepted for the public investment program were subjected to a careful review, resulting in announced cuts of $10 billion in 1983 and the application of much more stringent criteria in the selection of new projects. The tax system was revamped in 1984-85 to enhance the efficiency and the buoyancy of non-oil/LNG revenues. In addition, a wide-ranging liberalization of the financial system was initiated in 1983 to strengthen domestic resource mobilization and enhance the efficient use of scarce capital resources.

Structural measures to encourage the growth of the non-oil/LNG sector included initiatives to simplify procedures for securing investment licenses and to facilitate project implementation. Perhaps most importantly from the point of view of external balance, the very high costs associated with international trade were addressed through a streamlining of customs, shipping, and port procedures, while tariffs were also reduced. However, nontariff trade barriers proliferated, particularly in the form of restrictive import licensing. Further, a lack of competition in the domestic market and the rigidity of industrial regulations continued to contribute to inefficiencies in domestic production and an inward-looking investment strategy.

The authorities achieved considerable success in reducing imbalances through both structural policies and cautious demand management. Oil export prices averaged $10 less in 1985/86 than in 1981/82, and the overall terms of trade deterioration, measured at the level of

1981/82 trade flows, amounted to $3 1/2 billion (Chart 3). 1/ Nevertheless, the current account deficit was contained at some $2 billion (2 1/2 percent of GDP) in 1985/86, while the budget deficit was held to Rp 2 3/4 trillion (3 percent of GDP). 2/ However, Indonesia's external debt rose by 75 percent between March 1982 and March 1986 to $37 billion (to 186 percent of exports), largely as a result of the cumulative current account deficit but also as a result of a depreciation of the U.S. dollar against other major currencies; its debt service ratio doubled to 23 percent (Chart 4). The containment of imbalances over this period was also accompanied by a moderation in the rates of real GDP growth.

At the conclusion of the last Article IV consultation in February 1986, Executive Directors commented favorably on the implementation of adjustment measures since 1983 and welcomed the recently announced austerity budget for 1986/87. Concern was expressed, however, about the possible need for further adaptations in financial policies, were the oil price to continue to decline. 3/ Executive Directors considered that an integrated adjustment strategy was appropriate to Indonesia's circumstances, based on cautious financial policies, flexible exchange rate management, and structural initiatives to enhance efficiency, particularly in the fields of trade and industrial policies.

III. Developments in 1986/87 4/

At the time of the consultation discussions, there was limited evidence on the current level of economic activity. It appeared likely,

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1/ The calculation of movements in terms of trade is subject to a very large margin of error. No official import unit value indices are available, and estimates used here are based on World Economic Outlook aggregations for trade data for other countries. A number of questions also arise in connection with the export unit value data. See Annex IV section 1.(c).(2). However, there is no question but that the deterioration has been large, particularly in 1986/87, and an attempt has been made to quantify its impact on the development of important variables to facilitate analysis.

2/ Staff calculations suggest that about one third of the improvement in the non-oil/LNG current account between 1982/83 and 1985/86 can be attributed to the exchange rate adjustment of March 1983, with the remainder being attributable to, inter alia, the effects of fiscal restraint and the increasing restrictiveness of the import system.

3/ The baseline scenario presented in the staff report (SM/86/11) foresaw an average price per barrel of $20 in 1986/87-1987/88.

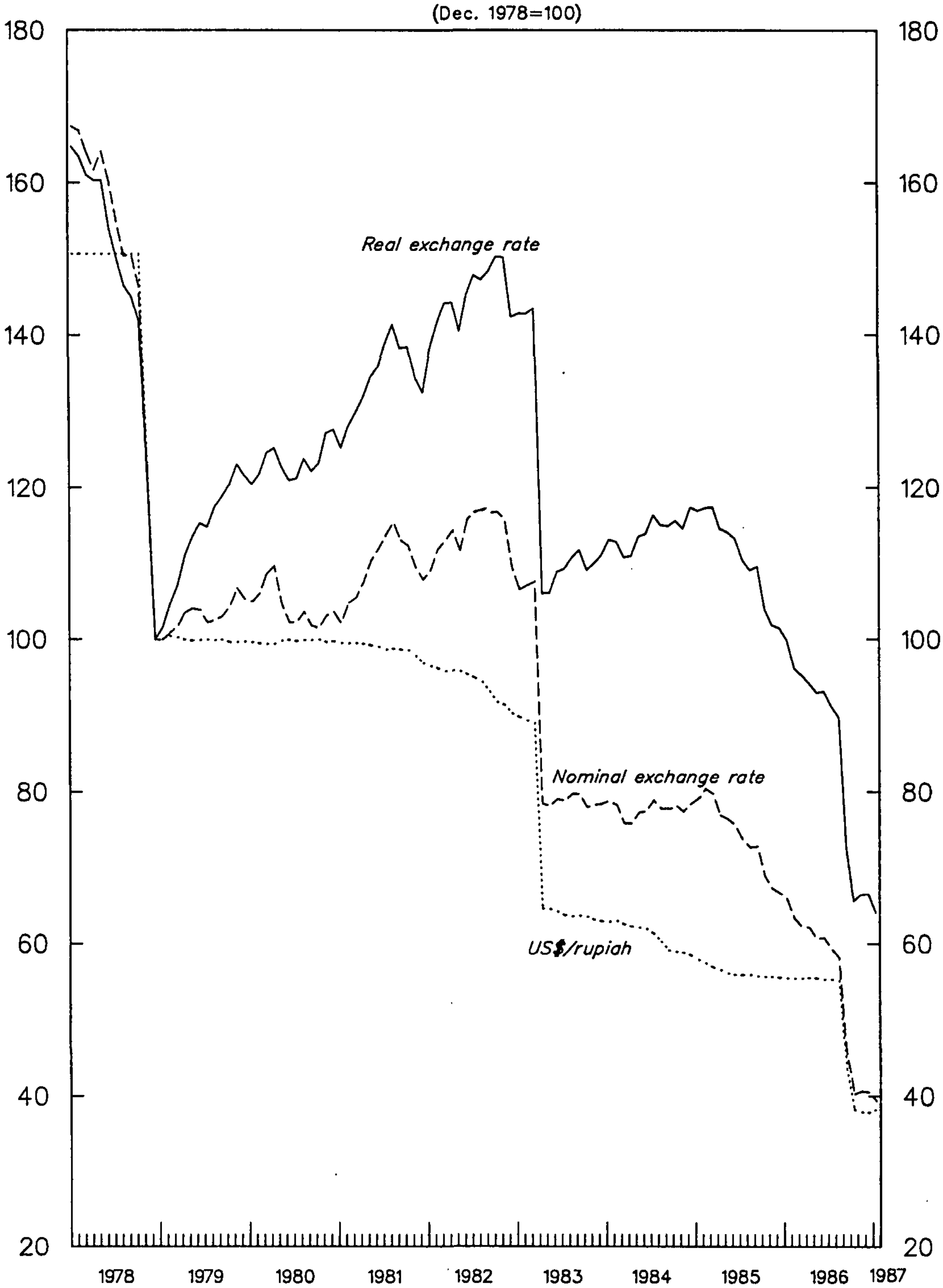
4/ Estimates presented here for 1986 and 1986/87 are those of the staff. They have been discussed with the authorities, and areas where there are major differences of views as to probable outturns are flagged in the text.

CHART 2

INDONESIA

DEVELOPMENTS IN EXCHANGE RATE INDICES, 1978–1987[1]

(Dec. 1978=100)



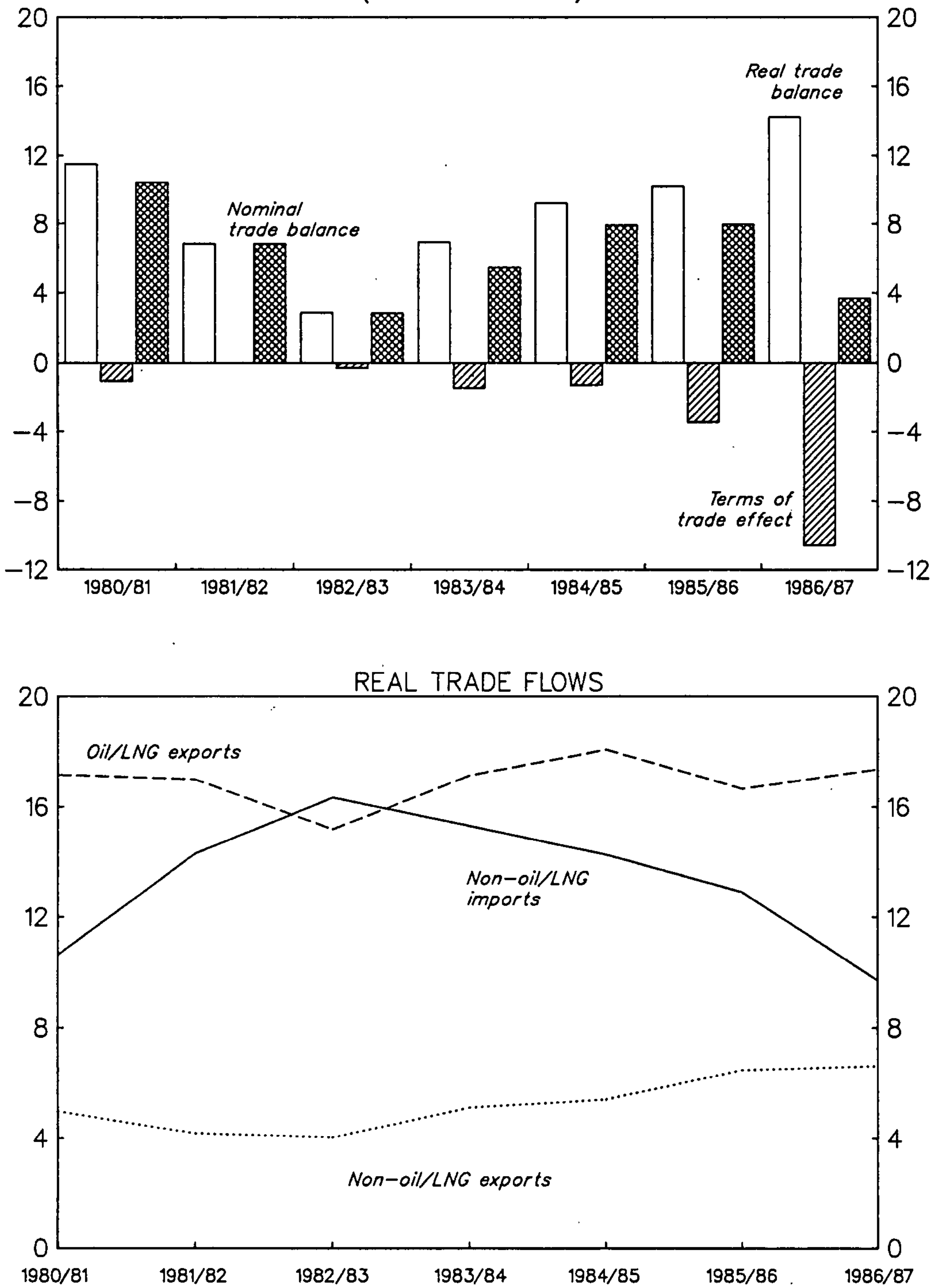
Sources: IMF Data Fund; and staff estimates.

[1] Trade–weighted notification index; indices calculated using monthly average data. Increase indicates an appreciation of the rupiah.

CHART 3
INDONESIA

TRADE BALANCE, 1980/81–1986/87[1]

(In billions of U.S. dollars)

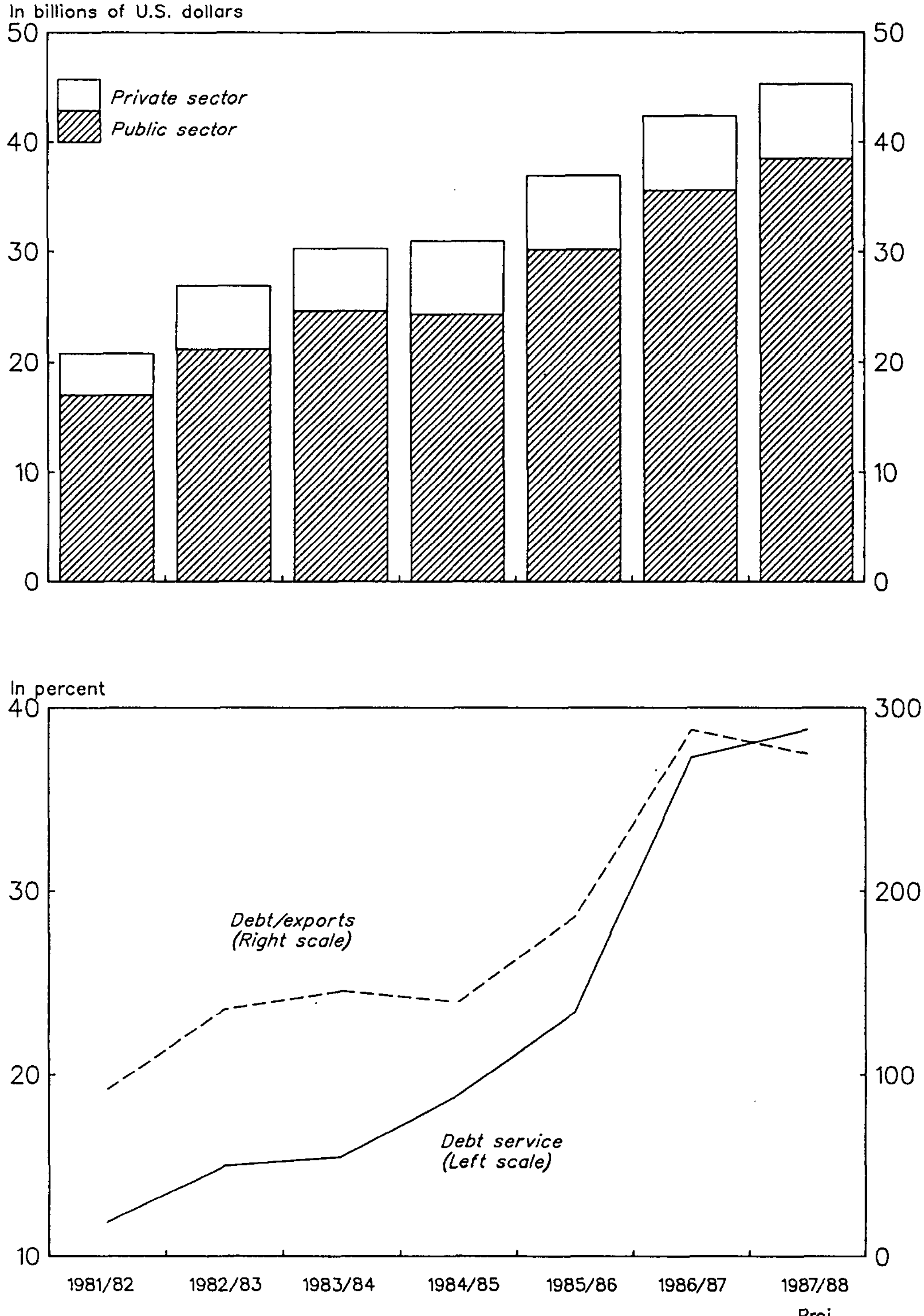


Sources: Data provided by the Indonesian authorities; and staff estimates.
[1] Real trade flows are measured at 1981/82 prices.

CHART 4

INDONESIA

EXTERNAL DEBT, 1981/82–1987/88



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

however, that the rate of growth of real GDP would remain moderate for the second consecutive year (at about 2-3 percent). Real gross national income in 1986 was likely to have fallen by some 6 percent, compared with a small increase in the preceding year. 1/

Growth of the non-oil/LNG sector decelerated to about 2 percent in 1986 from 3 1/2 percent a year earlier, clearly well below the range of 4-5 percent which is viewed as consistent with adequate absorption of the growing labor force. The rate of growth of the agricultural sector declined somewhat; some reduction in financial incentives and damage caused by locusts led to an increase in rice production of less than 1 percent, compared with average gains of 7 percent in previous years. Activity in the small non-oil/LNG mining sector was relatively strong, with significant increases in the production of tin, copper, and coal. On the other hand, the construction sector is estimated to have remained weak on account of depressed domestic investment. 2/ Manufacturing activity has proved relatively buoyant, particularly for cement, plywood, and textiles, which have benefited significantly from gains in external competitiveness and the expansion of foreign markets.

Real GDP in the oil/LNG sector rose by an estimated 4 1/2 percent in 1986, following a 4 percent decline in 1985. After contracting by almost 6 percent in 1985, reflecting in part marketing difficulties, crude oil output is estimated to have increased by 5 percent in 1986. By contrast, LNG output rose by 2 percent in 1986, compared with much larger increases in earlier years which were characterized by a rapid expansion of facilities and markets; at the end of the year a new gas train was brought on stream to produce LNG exports for Korea.

Inflation remained low during the first five months of 1986/87, averaging less than 5 percent at annual rates. Following the 31 percent devaluation of the rupiah on September 12, the rate of rise of the CPI accelerated to 9 percent by February. Some further acceleration was expected in March as the full feed-through of the devaluation to domestic prices was realized, and as additional administered prices were adjusted in line with costs.

The marked deterioration in the external environment in 1986/87 has given rise, as noted, to very large increases in domestic and external imbalances. Other things being equal, the decline in the average oil

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1/ Corrected for the terms of trade.

2/ No analysis of saving and investment in Indonesia is presented here. No current data are available and, more importantly, the large statistical discrepancy and the lack of data on inventory accumulation make very tenuous any analysis of expenditure trends.

price to $12.50 in 1986/87, 1/ from over $25 per barrel a year earlier, would raise the budget deficit by about 6 percent of GDP; would reduce the value of total exports by one third (or by $6 billion); and would increase the debt service ratio by some 11 percentage points. The first round impact of the fall in oil/LNG prices on the budget and the external accounts has, however, been attenuated by policy adaptations.

The staff estimates that the current account deficit will be contained to $4 1/4 billion (5 3/4 percent of GDP) in 1986/87, premised on the effects of slack domestic demand, cautious financial policies, and significant gains in external competitiveness stemming from the devaluation of the rupiah and trade liberalization measures. Thus, non-oil/LNG exports are expected to rise by about 2 percent in real terms, with exports of manufactures increasing by 9 percent; non-oil/LNG imports are projected to decline by one fifth. The rise in the gross borrowing requirement is estimated to exceed the rise in the current account by at least $1 billion to reach $7 1/2 billion, because of an increase in amortization payments of $1/2 billion and sizable capital outflows.

The gross financing includes IGGI 2/ disbursements of $3 billion (including some disbursement of a recently agreed IBRD trade policy adjustment loan for $300 million 3/); the use of net reserves of the banking system (including the valuation adjustment on reserves of Bank Indonesia) of nearly $2 1/2 billion; and drawings by the Government on commercial banks of almost $1 1/2 billion, representing a sizable increase in their exposure. In March 1987, official reserves would be close to their January level of just over $5 billion. The stand-by lines of credit with commercial banks abroad, which have been integral to Indonesia's financing strategy since the early 1980s, would be drawn down from the end-December level of about $2 1/4 billion to just under $2 billion. Were foreign borrowings to prove larger than projected, the overall deficit would be reduced accordingly. Staff estimates of the balance of payments outturn are consistent with a rise in the debt service ratio to 37 percent, and of total external debt to $42 billion (288 percent of exports of goods and services).

1/ Realized prices for Indonesia's oil exports averaged $11.50 per barrel over the first three quarters of 1986/87.

2/ Inter-Governmental Group on Indonesia.

3/ This rapidly disbursing loan, which is available for the financing of a wide range of imports, was approved by the IBRD Executive Board on February 3, 1987. The loan supports the trade liberalization measures undertaken through October 1986 and the authorities' intention to take further measures to liberalize the trade and industrial licensing systems. Indonesia's relations with the World Bank Group are described in Annex III.

IV. Report on the Discussions

The discussions focused on policy developments in 1986/87 and on the stance of policies for 1987/88 and the medium term necessary to contain domestic and external imbalances in an environment conducive to satisfactory growth and employment. The authorities' envisaged policy strategy is based on cautious demand management, flexible exchange rate policy, and structural measures to promote efficiency and an outward-looking investment strategy.

The 1987/88 program is premised on an average oil price of $15 per barrel. On the domestic side, the authorities plan a sharp reduction in the budget deficit to about one third of the estimated outturn for 1986/87. Monetary expansion will also be contained to levels consistent with the targets for growth, inflation, and the management of Indonesia's net foreign assets. On the external side, the authorities intended to reduce the current account deficit by almost half, to about $2 1/2 billion. The gross external borrowing requirement was expected to be held below $6 billion, which, with the exceptional financing foreseen from the Export-Import Bank of Japan, would be consistent with no net increase in lending from banks abroad. In the coming years, the current account and budget deficits were envisaged to move into approximate balance with a reduction in the debt service burden to about 35 percent in 1991/92. Nonetheless, the gross borrowing requirement would remain significant owing to increasing amortization payments and would necessitate the continuing support of the international community for Indonesia's adjustment effort.

Alternative medium-term scenarios were developed during the discussions, based on a firming of the real price of oil to $18 per barrel compared with the baseline scenario premised on $15. They suggested that, even with such a strengthening in Indonesia's external environment, there was little scope for a relaxation in the adjustment effort, given the magnitude of present imbalances and Indonesia's large external borrowing requirement. The uncertainties surrounding revenue projections and the difficulties in cutting expenditures that have already been approved underscored the need for caution.

1. Fiscal policy and the operations of public sector enterprises

a. Fiscal policy in 1986/87 and the expected budget outturn

The 1986/87 budget had been based on an oil price of $25 per barrel. Thus, oil/LNG revenues were projected to decline by 14 percent from the outturn in the preceding year. Much of the offset to the projected fall in revenues was to come from expenditure restraint, as the budget did not incorporate significant new revenue measures. Salaries of government employees were frozen in nominal terms, and other current expenditures (including subsidies) were to be contained as well. Thus, nominal current expenditures (excluding interest) were to rise by 7 percent (Table 2). The budget projected that development expenditures and net lending would be held at 80 percent of the level of the preceding budget, which would imply a reduction of almost 30 percent from the actual outturn. Such expenditure restraint would be brought about by a careful review of projects already in the pipeline and by an especially close scrutiny of prospective projects (Chart 5). The budget deficit was projected to equal 2 percent of GDP, and was expected to be financed fully from foreign sources.

In the event, the fiscal deficit for 1986/87 is now estimated by the staff to be equivalent to 5 1/2 percent of GDP. Nominal oil/LNG tax revenues for 1986/87 (excluding the surplus on domestic oil operations) 1/ are now expected to fall some 50 percent below the 1985/86 outturn, notwithstanding the September devaluation of the rupiah. Thus, for the first time, these revenues would account for significantly less than half of the Government's tax revenues. Non-oil/LNG tax revenues were approximately on target: the yield of the VAT was exceeding budget estimates, while income tax yields from companies were lagging.

The financing constraint was particularly acute for expenditures dependent on domestic resource generation. Efforts had been made to increase the portion of a project's costs that would be covered by external financial assistance and these efforts had met with some success. 2/ The authorities also explained that, for the first time, a large portion of the budget deficit had been financed by nonproject foreign borrowing, including program borrowing and significant recourse to credit from foreign banks. Such borrowings for budgetary support

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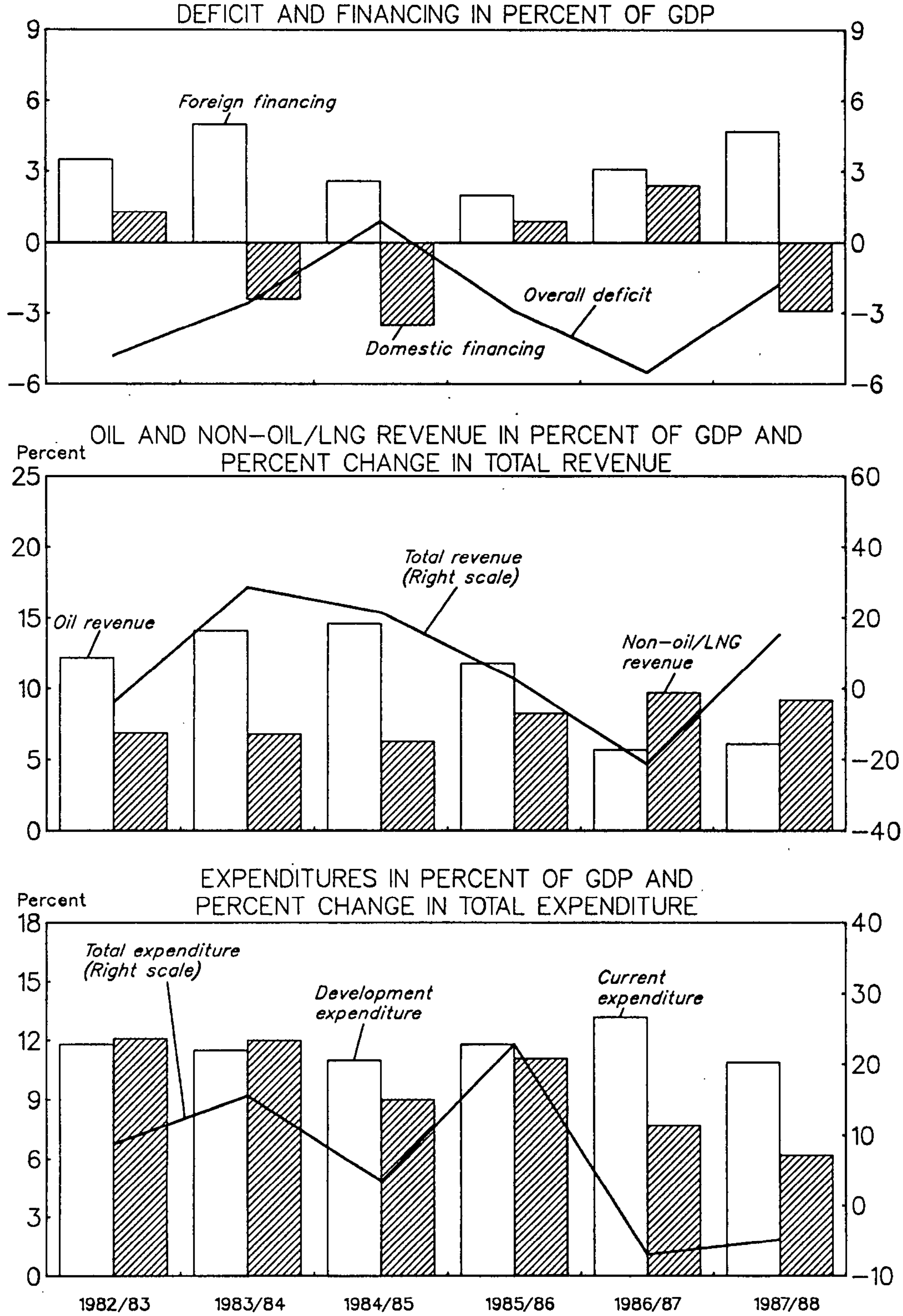
1/ Up to 1985/86 the budget provided a subsidy for the sale of petroleum products in the domestic market (domestic oil operations) at administered prices that were below world prices. In 1986/87, the sharp decline in international oil prices lowered the cost of petroleum products but the administered prices were not reduced commensurately. Consequently, a surplus of almost 1 percent of GDP is estimated to accrue to the Government in 1986/87. It is generally included in nontax revenues in the tabular presentation, but is excluded for certain types of analyses. See the forthcoming report on Recent Economic Developments.

2/ The Asian Development Bank has agreed to provide $30 million to cover local costs of an education project. The IBRD is considering financing local costs, including expenditures for operations and maintenance, under two proposed sector loans. A loan of $900 million was agreed in mid-February 1987 with the Export-Import Bank of Japan to provide counterpart funding for 21 IBRD projects in 1986/87-1987/88; a portion of this funding will be retroactive.

CHART 5
INDONESIA

CENTRAL GOVERNMENT OPERATIONS, 1982/83–1987/88



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

Table 2. Indonesia: Summary of Central Government Operations, 1983/84-1987/88

	1983/84	1984/85	1985/86	1986/87 Budget	1986/87 Prel. Est.	1987/88 Budget	1987/88 Staff Proj.
				(In trillions of rupiah)			
Total revenue and grants	15.4	18.7	19.2	17.9	15.1	17.4	17.6
Tax revenue	14.8	17.9	17.6	16.9	12.9	16.1	15.9
Of which: Oil/LNG 1/	10.4	13.1	11.3	9.7	5.6	6.9	6.9
Nontax revenue and grants 2/	0.6	0.8	1.6	1.1	2.2	1.4	1.7
Total expenditure and net lending	17.3	17.9	22.0	19.9	20.5	19.5	21.0
Current expenditure	8.5	9.8	11.3	12.4	13.0	12.4	13.9
Of which:							
Interest on external debt	1.2	1.5	1.7	2.1	3.0	3.4	3.9
Development expenditure and net lending 3/	8.9	8.1	10.7	7.5	7.5	7.0	7.0
Overall surplus/deficit (-)	-1.9	0.8	-2.8	-2.0	-5.4	-2.0	-3.4
Financing (net)	1.9	-0.8	2.8	2.0	5.4	2.0	3.4
Domestic 4/	-1.8	-3.0	0.9	—	2.4	-3.2	-0.4
Foreign	3.7	2.2	1.9	2.0	3.0	5.3	3.8
				(In percent of GDP)			
Memorandum items:							
Overall surplus/deficit (-)	-2.6	0.9	-2.9	-2.0	-5.5	-1.8	-3.0
Current surplus	9.4	10.4	8.2	5.5	2.1	4.5	3.2
Total revenue and grants	20.9	20.9	20.1	17.8	15.4	15.3	15.5
Of which: Oil/LNG revenue	14.1	14.6	11.8	9.6	5.7	6.1	6.1
Non-oil/LNG revenue 1/	6.8	6.3	8.3	8.2	8.7	9.1	9.3
Total expenditure and net lending	23.5	20.0	23.0	19.7	20.9	17.1	18.5
				(Annual percentage changes)			
Total revenue and grants 2/	28.6	21.5	2.8	-6.7	-21.3	15.3	16.2
Oil/LNG revenue 1/	35.9	26.3	-14.0	-13.8	-50.8	23.8	23.8
Non-oil/LNG revenue 1/	15.8	11.4	42.3	3.4	4.8	20.9	23.2
Total expenditure and net lending	15.5	3.5	22.8	-9.6	-7.0	-4.9	2.6
Current expenditures 5/	8.4	14.0	15.4	6.7	3.5	-9.3	0.1
Interest payments	71.2	28.2	14.2	24.3	75.4	13.2	31.3
Development expenditure and net lending	16.8	-8.5	31.9	-29.6	-29.6	-6.3	-6.3

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

1/ Excluding surplus in domestic oil operations in 1986/87 and 1987/88.
2/ Including surplus in domestic oil operations in 1986/87 and 1987/88.
3/ Derived as current budget surplus plus financing (net).
4/ Corresponds to the change in government net deposits with the banking system adjusted for valuation changes.
5/ Excluding interest payments on external debt.

were to be seen as exceptional, however, and would not be continued in 1987/88.

Guidelines had been issued to at least contain current expenditures (excluding interest) in nominal terms and to severely limit the rise in development expenditures by stretching out disbursements for specific projects and by concentrating expenditures within certain categories on specific projects. In some instances, the financing of outlays of public sector enterprises had been shifted from the budget to the banking system, at least temporarily, and traditional lags in making current payments had increased. The interest burden, in terms of rupiah, was estimated to increase by some 75 percent, to almost one fourth of current expenditures, reflecting largely exchange rate movements. The authorities were not in a position to provide firm expenditure estimates for 1986/87. They felt, however, that the staff estimates were realistic, suggesting that current expenditures (excluding interest) and development expenditures would be in line with the budget projections.

b. Fiscal policy in 1987/88

The budget for 1987/88 assumes an average oil export price of $15 per barrel, and projects that oil/LNG revenues will rise some 1/2 percentage point of GDP in 1987/88 to 6 percent. It envisages significant expenditure restraint, limiting expenditures (including interest payments) and net lending to 17 percent of GDP, and a strengthening in non-oil/LNG revenues (excluding the surplus on domestic oil operations) to 9 percent of GDP, premised on improved administration and some modification in present policies. The budget process had been made particularly difficult by the uncertainties surrounding the oil price, and the parliamentary elections scheduled for mid-April. And although budget targets for revenues and expenditures have been set, specific measures to permit the achievement of these targets will be announced only during the coming months. The budget figures suggest a deficit of some 1 3/4 percent of GDP, but staff estimates indicate a probable outturn of 2 1/2-3 percent. 1/

Real reductions in both current and development expenditure were in prospect. Abstracting from expenditures that were largely outside the Government's control, such as interest payments on external debt, the

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1/ The authorities envisage that commercial borrowing by the Government used exclusively for balance of payments (and not budgetary) support will be serviced by Bank Indonesia, which will also be responsible for reimbursing the Government for earlier interest payments on foreign currency borrowings deposited with Bank Indonesia. In the presentation used in this report, however, estimates of these interest payments on commercial borrowings are included under current expenditures for consistency with past accounting practices.

strategy for current expenditures was one of maintaining a wage freeze and permitting only a limited increase in the salary bill (about 1/2 percent) to cover wage drift and modest increases in employment; of further reducing certain subsidies; and, more generally, of permitting only a very limited increase in nominal terms in most current expenditure categories. Additional measures would be needed to curtail the fertilizer subsidy, though it was likely that even with the adoption of measures, the subsidy would exceed the budget estimate significantly. Current expenditures in real terms (excluding interest payments) were thus likely to decline--according to staff calculations--by as much as 7 1/2 percent, with the ratio of such expenditures to GDP declining by nearly 1 1/2 percentage points.

The authorities saw severe restraint in both foreign-financed and rupiah-financed development expenditure as essential to the containment of domestic and external imbalances, though efforts had been made to moderate the adverse consequences of these expenditure cutbacks on growth. And although substantial progress had been made in facilitating project implementation per se, only highly productive projects were to be pursued. Priority would be accorded to the completion of projects already at an advanced stage of implementation, those that had important externalities but were suited only to public sector implementation, and those that were likely to significantly strengthen employment opportunities. The IBRD felt that these investment priorities were well conceived. 1/ As in 1986/87, new projects would not generally be undertaken, while every effort would be made to increase the foreign-financed share of project costs.

The staff stressed that, even were oil prices to firm modestly, or were additional external assistance to be made available in 1987/88, there would still be little scope for relaxing the stance of fiscal policy. Firstly, the firming of oil prices could prove temporary, and the actual outturn could even fall below initial projections; at the same time, contingent increases in expenditures could prove difficult to reverse. Secondly, Indonesia's external borrowing requirement remains large. Thus, it would be important to use such an opportunity to reduce reliance on foreign bank credit. The staff hoped that contingency plans, for example, to increase salaries or development expenditures, would not be activated.

The authorities acknowledged the need to limit Indonesia's external indebtedness, but felt that, if oil prices were to firm, some acceleration in general project implementation could not be precluded. In the absence of more favorable developments in revenues, however, nominal development expenditures would not be allowed to rise above their 1986/87 level. Taking into account the large increase in the deflator for these expenditures consequent on the September 1986 devaluation,

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1/ See Annex III.

staff calculations suggested that the fall in real terms was likely to reach 20 percent, with the ratio of such expenditures to GDP declining by 1 1/2 percentage points to 6 percent.

Measures to boost non-oil/LNG revenues (excluding the surplus on domestic oil operations) by 23 percent would include improvements in administrative procedures, including an expansion of audits to cover VAT and individual income tax returns, and the vigorous enforcement of penalties. The authorities explained that their preference was, in the first instance, to strengthen tax revenues through improved tax administration, partly because it could prove counterproductive to increase rates until compliance levels had become more satisfactory.

Efforts were being made, with IBRD assistance, to improve the assessment of property tax liabilities. The revenue effects of this effort, however, were not likely to be fully realized in 1987/88. A widening of the tax base was also under consideration, including the elimination of certain exemptions and the extension of VAT to selected services. A major concern with respect to the removal of the exemption from tax of interest earned on bank deposits was the possibility of provoking capital flight. As interest from bonds is taxed, however, such a step would eliminate an important impediment to the development of a domestic securities market. The authorities felt that such a market would contribute importantly to the realization of their investment strategy in the years to come by providing necessary financial support for their privatization effort and more generally, by widening sources of finance available to the private sector.

c. The operations of public sector enterprises 1/

The budget provides only limited coverage of transactions of the central government with public enterprises and of the public sector as a whole with the rest of the economy. Public sector enterprises account for a large share of the revenue from corporate income taxes as well as of nontax revenue. However, public sector enterprises depend to a large extent on the central government for their capital expenditures. Given the continuing constraints on budget outlays, the authorities indicated that the pattern of public sector borrowing already manifest in

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1/ The banking sector is dominated by state-owned banks and the petroleum sector by Pertamina (the state-owned petroleum company), which handles refining and sales in addition to some exploration and production. The sales of other nonfinancial public enterprises in recent years have been estimated to amount to about one fifth of the value of GDP. They are engaged in activities typically reserved for public sector enterprises, such as transportation and telecommunications, and are also dominant in sectors such as steel, fertilizer, and the manufacture of aircraft. There are a number of joint ventures between the public and private sectors.

1986/87--of a shift from reliance on budgetary support to greater dependence on support from the banking sector--was likely to persist in 1987/88.

The authorities are currently concerned with improving efficiency and profitability of public sector enterprises. In the first instance, they were seeking ways to strengthen profits through a reduction in costs. For some enterprises, the traditional cost-plus pricing procedures had been modified--for example, by capping costs identified as controllable--to boost financial incentives for efficiency, and the possibility of extending this approach to other enterprises was being explored. In some instances, prices had been increased in line with increases in justifiable costs, and additional price adjustments were under consideration. More generally, the staff suggested that a thorough review of the pricing policies of public sector enterprises be undertaken to assess existing distortions and to provide the basis for a systematic rationalization of pricing.

The performance of the 158 nonfinancial enterprises that are fully government owned was being reviewed on a case-by-case basis to determine the commercial and/or social value of their operations and to establish guidelines to enhance efficiency and profitability. Consideration would be given to privatizing loss-making operations and to moving to joint ventures or joint operations with the private sector. Changes in the system of supervision and control were envisaged. The authorities indicated that they expected to complete a project to consolidate the accounts of public sector corporations in the coming year. Both the Fund and the IBRD are providing technical assistance for this very welcome initiative.

2. Monetary policy

Reserve money declined by 4 percent during the first half of the fiscal year, but increased by 7 1/2 percent in the third quarter to an annual rate of 21 percent in December. The 12-month rate of growth of broad money declined from 25 percent in March to 16 1/2 percent in August, but accelerated to over 25 percent in October, the last month for which firm data are available, as a result of the effects of the devaluation of the rupiah on the value of foreign currency deposits. The staff noted that, in assessing the stance of monetary policy, the behavior of credit aggregates and developments in the balance of payments played an important role, as did the movement of the broader aggregates.

During the first half of the fiscal year, Bank Indonesia (BI) had absorbed a substantial amount of liquidity through money market transactions. By contrast, in November and especially in December, a substantial amount of liquidity had been injected. This infusion was accompanied by a sharp increase in sales of foreign exchange on the bourse, leading to a marked decline in net foreign assets (Chart 6).

The staff wondered whether a lesser injection of liquidity would have moderated pressures on the exchange market, leading to a smaller drawdown in foreign assets.

The authorities explained that they had decided in December to inject liquidity into the economy through BI's money market facilities in order to offset the outflow of funds owing to speculative and seasonal pressures on the exchange market, and to stabilize interest rates. 1/ They felt that a sharp rise in bank lending rates in December would have unduly penalized productive agents, and it might also have intensified speculative pressures on the rupiah. In any case, interbank rates had been allowed to rise somewhat in late December, though they had subsequently eased. The authorities expected a significant portion of these funds to flow back to Indonesia in the near term.

The authorities agreed that, for the anticipated capital reflow to take place in early 1987, it would be necessary to dampen the growth of credit and to enhance the attractiveness of rupiah-denominated financial assets. Staff calculations suggested that a rate of growth of broad money of about 20 percent would be consistent with the authorities' domestic and external objectives, while a deceleration in the rate of growth of credit to the private sector to about 17 percent would also be necessary. BI had actively absorbed liquidity in January, and pressures on the exchange market had diminished significantly during the month. The staff noted the very large drawdown in net foreign assets that had occurred and suggested that a more active interest rate and exchange rate policy be considered to safeguard these assets.

Bank lending and deposit rates had remained stable during 1986/87, but at high levels. Though one of the medium-term objectives of the authorities was to reduce lending rates, there appeared little scope to do so at present. The margin between deposit and lending rates could not be compressed much further, in view of transaction costs and the necessary provision for risk, and a reduction in deposit rates was also seen to be difficult (Chart 6).

The staff explored with the authorities the reasons for the seemingly strong growth of bank credit to the private sector in a setting of high real lending rates and weak economic activity. The authorities indicated that most bank lending was for purposes of working capital. A task force at Bank Indonesia was also looking into the contribution of the capitalization of interest to credit expansion, although this contribution was thought to be fairly small. The monetary authorities confirmed their intention to provide adequate financial support for the private sector so that it could assume the crucial role foreseen for it

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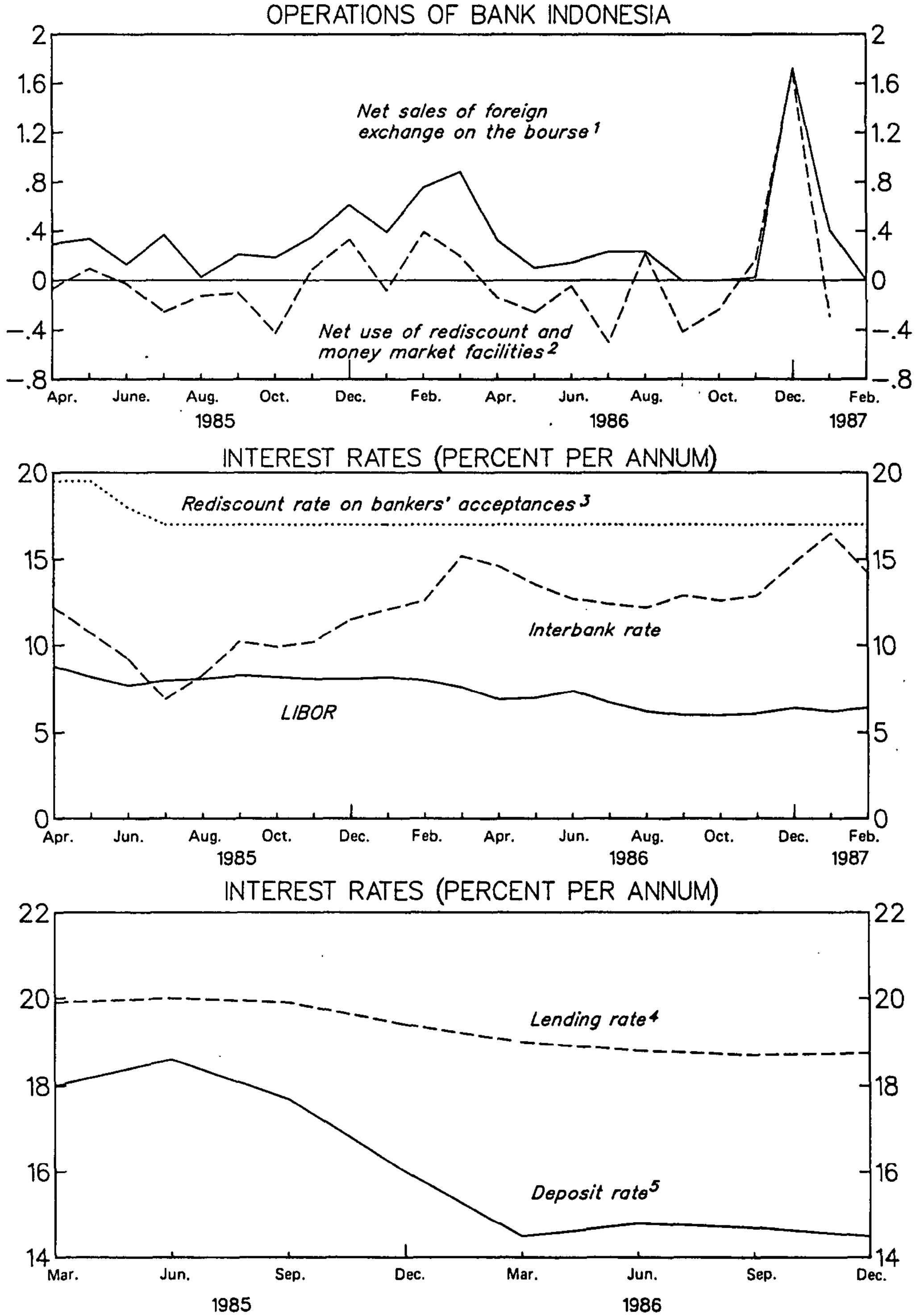
1/ A significant share of the outflow reflected the prepayment of foreign debt. This occurred to permit the realization, in 1986, of tax losses associated with the September 1986 devaluation.

CHART 6
INDONESIA

FINANCIAL INDICATORS, 1985–87



Sources: Data provided by the Indonesian authorities; and staff estimates.
1 In billions of U.S. dollars. Operations in the bourse include almost all private sector transactions in foreign exchange. Excluded are transactions by the Government and public entities, and most transactions relating to the oil sector.
2 In trillions of rupiah.
3 SBPU (Surat Berangka Pasar Uang).
4 Interest rate on nonpriority loans for working capital charged by state banks. Monthly averages. December 1986 figure is staff estimates.
5 Interest rate on six-month time deposits at state banks. Monthly averages.

in Indonesia's development process. The authorities were well aware that, if the overall growth of credit were to be constrained to realistic levels, the growth of credit to public sector enterprises and to the Government would have to be restrained. The implementation of such a policy would not be easy in current circumstances.

The necessary monitoring of the credit aggregates was likely, in the view of the staff, to require a substantial upgrading of the money and banking statistics. 1/ Movements in important credit and monetary aggregates could be tracked only after a considerable lapse of time, and there were significant difficulties in reconciling data from different sources. Furthermore, current information on the operation of nonbank financial institutions was not readily available. Although these institutions were seen to be of limited importance, their activities had reached into the traditional domains of commercial banks.

3. Reserve management and external financing strategy

The authorities have indicated that one objective of Indonesia's external financing strategy has been to maintain official international reserves at a level adequate to instill confidence in the convertibility of the rupiah. The authorities felt that a stock of gross international reserves of close to $5 3/4 billion, the level that had been maintained for the past two fiscal years, was appropriate for this purpose, supported by undrawn lines of credit of about $2 1/4 billion. At the end of February 1987, these reserves stood at just over $5 billion and undrawn lines of credit amounted to almost $2 billion. A marked decline in reserves had taken place in December as a result of large capital outflows. The staff noted that the adequacy of Indonesia's foreign assets had to be viewed together with the foreign exchange obligations of BI of some $3 billion under the swap facility. 2/

The swap facility, through which BI provides forward exchange cover for approved private sector foreign debt obligations, had been modified in October 1986. The previous ceiling on swaps was removed, and the premium for new swaps of one-, three-, and six-month maturities was raised from 6 percent to 8 percent. The authorities explained to the staff that it was their intention to change the swap premium in line with interest rate differentials. Thus far, however, it had not been changed. The staff noted that the swap facility had served to strengthen BI's gross reserve position in recent months. It suggested further that a marked buildup of such liabilities could discourage

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1/ Considerable technical assistance in the design of monetary instruments and in strengthening monetary statistics has been provided by the Fund (see Annex II).

2/ Foreign currency deposits of the banking system, which are not directly BI liabilities, also amounted to about $3 billion at the end of 1986.

active exchange rate management. Thus, consideration might be given to more flexible management of the swap premium, consistent with the development of a forward market by commercial banks. The staff also recommended that measures be taken to contain the growth of BI swaps.

The fall in Indonesia's export receipts, coupled with the large impact of a weaker U.S. dollar on external debt and debt service payments denominated in other major currencies, and an increase in amortization payments, contributed importantly to the rise in its debt service obligations. 1/ Nonetheless, Indonesia continued to enjoy spontaneous access to international capital markets in 1986/87 at attractive rates, and new publicized commitments from commercial banks totaled $1 billion. The authorities indicated, however, that for 1987/88, they did not wish to rely unduly on international capital markets.

The staff observed that there had been a significant shift in the creditor composition of Indonesia's debt portfolio, and that new commitments have effectively been taken up by Japanese banks. Indeed, between 1984 and mid-1986, outstanding claims on Indonesia by U.S. banks were estimated to have declined by almost $1 billion (or by 25 percent).

4. Exchange rate policy

Prior to the devaluation of the rupiah in September, the authorities limited movements of the rupiah vis-a-vis the U.S. dollar. Thus, in the first eight months of 1986, the rupiah depreciated by some 13 percent in nominal effective terms (12 percent in real terms), but by only 1 percent against the U.S. dollar. The weakening in oil prices gave rise to speculative bouts in February/March 1986, but resulted in only a temporary drawdown in reserves.

As previously noted, in September 1986, the authorities devalued the rupiah by 31 percent. The lower real exchange rate was intended to strengthen the growth potential of the non-oil/LNG sector and to facilitate the liberalization of the import system. Such actions took on increasing urgency with the continued weakness of the oil market. The devaluation was followed by an announcement that the authorities intended to monitor exchange rate developments in terms of a basket of currencies of trading partner and competitor countries, taking also into account inflation differentials. The appropriateness of the developments in the real effective exchange rate would also be reviewed from

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1/ About 60 percent of Indonesia's external debt is denominated in currencies other than the U.S. dollar. Of the $11 1/2 billion rise in the stock of external debt estimated to have taken place between March 1985 and March 1987, $8 billion is attributed to exchange rate movements.

time to time based on the performance of non-oil/LNG exports and on balance of payments objectives. The authorities explained that exchange rate policy was designed to safeguard external competitiveness, and that the present level of the exchange rate was thought to be satisfactory. It was intended that the stance of monetary policy would be supportive of exchange rate objectives.

At the time of severe speculative pressures in December 1986, and again in January 1987, when the dollar weakened against other major currencies, the rupiah appreciated modestly against the U.S. dollar. However, in nominal effective terms, it is estimated to have depreciated by some 3 percent in the four months to end-January. Clearly, the full effects of the devaluation on Indonesia's non-oil/LNG sector had yet to be fully realized, and would need to be supported by further structural measures.

5. Structural policies

The Indonesian economy has traditionally been characterized by high production costs and, with a large domestic market, by an inward-looking investment strategy. The trade and industrial licensing systems and cumbersome domestic administrative procedures have contributed importantly to these costs. An increase in protectionist sentiment abroad has also limited the growth potential for exports. Since the last consultation discussions, the authorities had made further progress in bringing about structural reforms. Three important packages of structural reform measures to liberalize trade and industrial licensing policies had been introduced. They had also taken further steps toward streamlining charges and administrative procedures to encourage efficiency in production. 1/

The measures introduced on May 6, 1986 were designed to reduce the anti-export bias stemming from the operation of the trade system by easing access to inputs at international prices for export production. The authorities indicated that the May 6 package was operating well and flexibly. The packages of October 25, 1986 and January 5, 1987 eliminated or eased import license restrictions for important blocks of products and changed tariffs for many goods. In the manufacturing sector, over 25 percent of all import items have been completely liberalized since October 1986, while an additional 18 percent have benefited from a significant relaxation in import procedures. 2/ Tariffs were reduced in October for raw materials that were not produced domestically, but were raised for imports of manufactures to broadly maintain the levels of effective protection offered earlier by the

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1/ The IBRD trade policy adjustment loan reflects the Bank's assessment of the importance of these actions.

2/ In terms of the four-digit classification of the Customs Cooperation Council Nomenclature.

restrictive import licensing system; in January a number of tariffs were reduced.

The authorities explained that the October 1986 and January 1987 packages must be seen as part of a series of measures to liberalize the trade environment and to shift from a system heavily reliant on non-tariff trade barriers to a more transparent system based on lower and more uniform rates of protection. They recognized the partial nature of the recent trade packages and indicated their commitment to gradually eliminate all nontariff restrictions on imports, other than those necessary on the grounds of health, defense, or special social and economic considerations. They indicated, however, that provisions for safeguard procedures against the possibility of dumping would be required. In 1987, further substantial progress was expected in eliminating nontariff barriers, in reducing the highest tariffs to the maximum rate set in the 1985 tariff reform, and, with IBRD assistance, in designing appropriate programs of restructuring and trade reform.

The staff noted the importance of maintaining momentum in the structural reform effort and urged early and comprehensive action in shifting to tariffs, accompanied by the establishment of a timetable for such shifts and for a reduction in the maximum tariff rate. Such a timetable would diminish uncertainty confronting investors regarding the degree of protection to be expected over the medium term. While indicating that new initiatives were under active consideration, the authorities felt that the establishment of a timetable for action was not suited to Indonesia's current circumstances. They agreed that the desired effects of trade liberalization would only be realized if, at the same time, there were supporting liberalization of industrial licensing policy. Additional significant deregulation was seen to be necessary for the mobilization of the entrepreneurial talents and financial resources essential for the satisfactory growth of the non-oil/LNG sector.

As part of the May 6 package, requirements for local participation in joint ventures were relaxed and the validity of investment licenses was extended to 30 years. The number of sectors open to foreign investment had been increased, and the October package permitted, in some instances, foreign joint ventures to be treated as domestically owned firms--thereby gaining certain advantages--and to export products of other companies. The elimination of the ceiling on the BI swap facility also benefited foreign investors, whose investment financing must come largely from abroad.

Licenses have also been used to restrict the use of facilities to the production of specified goods. At times, this has prevented the shift of resources in response to market forces and has been reflected by high levels of unutilized productive capacity. For production facilities of the machinery and electrical machinery industries, these restrictions were eliminated in mid-January 1987.

Efforts to expedite project implementation were furthered through the setting up of a ministerial level committee to resolve identified difficulties. This action was followed in October 1986 by the elimination of many administrative fees at the local government level. The authorities expected that this latter step would reduce significantly the direct and indirect costs of doing business in Indonesia, making it a more attractive venue for investment. The Government was also studying the structure of local government taxes with a view to eliminating taxes with a large nuisance value and which generated little revenue.

6. Economic outlook for 1987/88 and the medium term

The policy adaptations outlined above were designed to secure a reduction in domestic and external imbalances and to establish the preconditions for a resumption of growth. In 1987/88, with the policies envisaged, a projected average price of oil of $15 per barrel, and a very modest strengthening in commodity prices, the current account deficit would decline by more than half to $2 1/4 billion (3 1/4 percent of GDP). The improvement would occur primarily in the non-oil/LNG balance. Non-oil/LNG exports are estimated to rise by 14 percent in volume terms reflecting the stimulus provided by the real depreciation of the rupiah and the impact of partial trade liberalization on exports of textiles and other manufactures. Non-oil/LNG imports are anticipated to decline in real terms by 12 percent, as a result of the devaluation and enhanced financial austerity.

On the domestic side, it is foreseen that in 1987/88 there will be a revival of activity in the non-oil/LNG sector as production increases to satisfy export demand, and as the adverse wealth effects of the deterioration in the terms of trade diminish. Though the rate of inflation, as measured by the CPI, is projected to decline in 1987/88 to about 5 percent by end-year, the increase in the GDP deflator will accelerate to 13 1/2 percent because of developments in oil prices. 1/

The staff discussed with the authorities its economic projections for the medium term (1988/89-1991/92). The baseline projection is premised on the World Economic Outlook (WEO) assumptions for the external environment, in particular, no real increase in oil prices beyond 1987/88 but an increase in real commodity prices of about 3 percent. 2/ It is assumed that the restrictive stance of domestic policies is maintained, reflecting the authorities' awareness of Indonesia's large external financing requirement.

1/ The deflator for oil/LNG GDP will increase markedly in rupiah terms because of the full year effects of the devaluation of the rupiah and some strengthening in world oil prices in dollars.

2/ The assumptions about the external environment and the methodology used in constructing the medium-term scenarios are outlined in Annex V.

The growth of the non-oil/LNG sector was expected to stabilize at some 5 percent with the release of resources by the public sector and the consolidation of gains in competitiveness. This rate of growth was expected to generate employment opportunities in excess of the rate of growth of the labor force, while the rate of inflation would remain at about 5 percent.

The authorities foresaw the need to contain public sector expenditures over the medium term, taking into account the Government's resource constraints and the expanded role envisaged for the private sector in Indonesia's development effort. Increases in current expenditure were to be concentrated on essential operations and maintenance, while efforts to curtail subsidies would continue. Development expenditure would be limited to priority projects that can be accommodated within the general resource constraint. On the receipts side, efforts to expand the non-oil/LNG revenue base would be intensified. Thus, it was envisaged that the overall budget deficit would be gradually reduced to approximate equilibrium by 1991/92.

The policies envisaged would also result in the establishment of balance in the external current account by 1991/92. External debt and debt service would decline markedly in relation to export earnings (Chart 7 and Table 3). Notwithstanding these developments, the gross external financing requirement is projected to decrease by only $1/2 billion, to $5 billion per annum during 1988/89-1991/92, largely because amortization payments are scheduled to rise by $1 3/4 billion to about $5 billion per annum over the same period. These projected levels of gross external borrowing would remain somewhat above the average level of disbursements recorded from both official and bank creditors during 1985/86-1986/87.

External debt is expected to increase by $6 billion over the scenario period, reaching $48 1/4 billion in 1991/92. 1/ The ratio of debt to exports would fall to 200 percent in 1991/92, while the debt service ratio would decline slightly to 35 percent of exports of goods and services.

The staff has also developed an alternative scenario based on oil prices that are 20 percent higher in real terms throughout the scenario period (i.e., $18 per barrel in 1987/88 instead of $15). If the higher budget revenues were passed through in the form of greater budgetary expenditures, then there would be no significant change in the current account and budgetary deficits foreseen for the medium term or in the external financing requirements (Scenario I). External debt indicators

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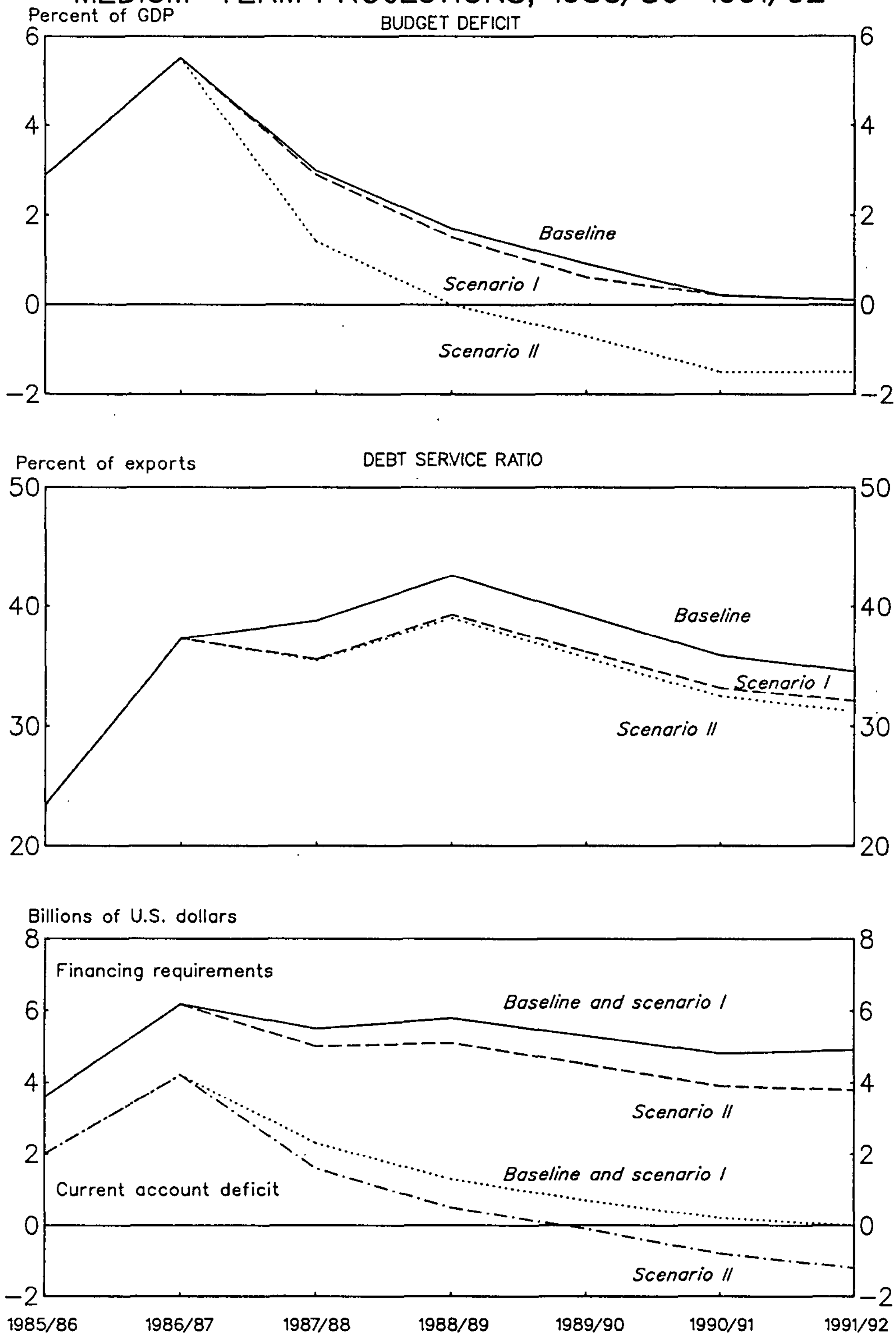
1/ Nearly half of this increase in external debt is attributable to the WEO assumption that the real effective exchange rate of the U.S. dollar will remain constant over the projection period, leading to a nominal depreciation against other major currencies.

CHART 7

INDONESIA

MEDIUM–TERM PROJECTIONS, 1985/86–1991/92



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

Table 3. Indonesia: Medium-Term Projections Under Alternative Assumptions, 1987/88-1991/92 1/

	1987/88	1988/89	1989/90	1990/91	1991/92
	Baseline scenario: oil export price of $15 per barrel in 1987/88				
GDP growth rate	3.4	4.5	4.5	4.5	4.5
Non-oil/LNG GDP	4.5	5.0	5.0	5.0	5.0
Inflation (CPI)	8.4	5.1	5.0	5.0	5.0
Budget surplus/deficit (-)					
(in percent of GDP)	-3.0	-1.7	-0.9	-0.2	-0.1
Foreign sector					
Current account					
(US$ billions)	-2.3	-1.3	-0.7	-0.2	--
(In percent of GDP)	-3.3	-1.8	-0.9	-0.3	--
Financing requirement 2/					
(US$ billions)	5.5	5.8	5.3	4.8	4.9
Debt service ratio 3/	38.8	42.6	39.2	35.9	34.6
Debt/exports 3/	274.7	252.6	231.4	212.5	197.8
	Scenario I: oil export price of $18 per barrel in 1987/88 with the Government spending the additional resources				
GDP growth rate	3.8	4.9	4.9	4.9	4.9
Non-oil/LNG GDP	5.0	5.5	5.5	5.5	5.5
Inflation (CPI)	8.4	5.1	5.0	5.0	5.0
Budget surplus/deficit (-)					
(in percent of GDP)	-2.9	-1.5	-0.6	-0.2	-0.1
Foreign sector					
Current account					
(US$ billions)	-2.3	-1.3	-0.7	-0.2	--
(In percent of GDP)	-3.3	-1.8	-0.9	-0.3	--
Financing requirement 2/					
(US$ billions)	5.5	5.8	5.3	4.8	4.9
Debt service ratio 3/	35.6	39.3	36.2	33.2	32.1
Debt/exports 3/	251.2	232.9	213.9	196.8	183.4
	Scenario II: oil export price of $18 per barrel in 1987/88 with the Government saving the additional resources				
GDP growth rate	3.4	4.5	4.5	4.5	4.5
Non-oil/LNG GDP	4.5	5.0	5.0	5.0	5.0
Inflation (CPI)	8.4	5.1	5.0	5.0	5.0
Budget surplus/deficit (-)					
(in percent of GDP)	-1.4	--	0.7	1.5	1.5
Foreign sector					
Current account					
(US$ billions)	-1.6	-0.5	0.1	0.8	1.2
(In percent of GDP)	-2.3	-0.7	0.2	0.9	1.3
Financing requirement 2/					
(US$ billions)	5.0	5.1	4.5	3.9	3.8
Debt service ratio 3/	35.5	39.0	35.7	32.5	31.2
Debt/exports 3/	248.7	226.2	204.5	184.3	170.5

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

1/ In all scenarios, it is assumed that the oil export price remains constant in real terms at the 1987/88 level.

2/ Sum of the current account deficit, amortization payments, and extension of trade credits.

3/ Percent of exports of goods and services.

would improve moderately, but would still remain high: the ratios of external debt and debt service payments to exports would be smaller by 14 percentage points (183 percent) and 2 1/2 percentage points (32 percent), respectively.

During the discussions, the staff stressed that there were downside risks in the price assumptions used in the baseline scenario. And even were oil prices to firm as indicated in the alternative scenarios, there would be little scope for relaxing the stance of fiscal policy, given the need to contain Indonesia's large external financing requirement and to reduce the debt service burden from the high levels now being experienced. Were government expenditure to remain unchanged in the face of higher revenues, the smaller fiscal deficits would lead to a stronger current account position and smaller external financing requirements (Scenario II). Indeed, a current account surplus of about $1 1/4 billion (1 1/4 percent of GDP) would be projected for 1991/92. The gross external financing requirement would be diminished commensurately, to $3 3/4 billion, a level below recent disbursements from official and bank creditors. External debt would remain virtually unchanged at nearly $45 billion over the period 1987/88-1991/92. The ratio of external debt to exports would fall to about 170 percent (or 15 percentage points below its 1985/86 level), while the debt service ratio would undergo a more rapid decline than in Scenario I. Nonetheless, it would continue to exceed 30 percent in 1991/92.

V. Staff Appraisal

The external environment facing Indonesia has become markedly less favorable during the past year. The sharp fall in the world price of oil, accompanied by low prices of other primary exports, has brought about a dramatic weakening in foreign exchange earnings and in the Government's financial position. Further, the depreciation of the U.S. dollar vis-a-vis other major currencies has led to a substantial increase in the U.S. dollar equivalent of Indonesia's external debt and its debt service obligations. The uncertainties surrounding prospective developments in oil prices and the availability of foreign financing have also complicated the design of an adjustment strategy.

The authorities' response, which has encompassed bold initiatives in all major policy fields, has been well considered. Demand management--and especially budgetary policy--has become more cautious in the face of growing imbalances. But it is recognized by Indonesian policymakers that undue reliance on demand management to contain imbalances would thwart the attainment of acceptable rates of growth and employment. The sharp devaluation of the rupiah in September signaled the authorities' resolve to strengthen the competitiveness of the non-oil/LNG sector and the importance accorded market forces in the adjustment strategy. In recent years, the authorities have also promoted structural reforms in a number of areas in order to enhance efficiency and the role of market forces. The present circumstances have permitted the mobilization of support for an expansion of the reform initiatives to key areas of trade and industrial licensing policy and to the operations of the public enterprise sector.

The authorities' intention to continue to pursue a stringent fiscal policy to bring about a significant reduction in the central government deficit in 1987/88 seems fully appropriate. The pattern projected for expenditures is designed to limit the adverse consequences of expenditure restraint on growth. At the same time, the expenditure level envisaged would be consistent with a reduction in resources made available to the public sector and with the enhanced role foreseen for the private sector in Indonesia's development process. The staff would urge caution in increasing expenditures, should oil/LNG revenues prove somewhat more buoyant than projected. Indeed, the staff projections show that, even with a considerable increase in oil prices and continued expenditure restraint, Indonesia's external borrowing requirements and debt burden would remain at high levels.

The authorities are confident that a significant increase in government revenue will take place in 1987/88 largely through a strengthening in tax administration and in the performance of public sector enterprises, but also through new revenue initiatives. In the staff's view, the realization of the revenue projections will require the timely extension of the tax base for the VAT, unless the envisaged improvements in tax administration are indeed wide ranging and extraordinarily effective. Also, even with the non-oil/LNG revenue performance foreseen for 1987/88, Indonesia's tax effort will remain weak in comparison with those of other countries at similar stages of development. An intensification of Indonesia's tax effort would seem appropriate, both to contain imbalances in the short term and to provide support for the country's development effort.

Given the dramatic fall in government revenues, there may be a temptation to have the domestic banking system finance directly some outlays that, normally, would have been financed through the budget. Such transactions should be kept under close scrutiny, since they could give rise to rapid rates of growth of domestic credit that would offset the gains from fiscal restraint. The staff welcomes the authorities' commitment to containing the growth of credit to the public sector, and also the recent initiative to consolidate the public sector accounts, which will permit a broader assessment of fiscal policy.

The simultaneous pursuit of stability in both interest rates and exchange rates has complicated the formulation of monetary policy in recent months. In December 1986, the potential effects of very large private capital outflows on interest rates were offset by an infusion of liquidity. Interest rates rose only modestly while the exchange rate appreciated vis-a-vis the U.S. dollar. Net foreign assets of the monetary authorities, however, declined considerably. While acknowledging the authorities' concerns about the stability of interest rates and exchange rates, the staff believes that the protection of Indonesia's foreign reserve position could well necessitate the implementation of more active interest rate and exchange rate policies. The staff would also urge the authorities to attach particular importance to the evolution of net foreign assets in assessing the appropriateness of monetary policy. For purposes of tracking monetary developments, a more current and comprehensive data base would be essential.

The depreciation of the rupiah in real terms, also taking into account the unavoidable feed-through of the devaluation to domestic prices, appears broadly appropriate, and the authorities' commitment to pursue a flexible exchange rate policy designed to safeguard gains in competitiveness is to be welcomed. Only with an adequate level of competitiveness, based both on appropriate exchange rate and structural policies, will Indonesia be able to overcome its present external imbalances and to secure the domestic growth necessary for the employment of its growing labor force. The emergence of market expectations of a fixed relationship between the rupiah and another major currency (in the past, the U.S. dollar) would appear undesirable, in that it would limit the flexible management of the exchange rate. Such flexibility could also be jeopardized by the buildup of large contingent foreign currency liabilities. The staff would encourage the authorities to undertake a review of the BI swap facility so as to scale down Bank Indonesia's role and enhance the participation of domestic commercial banks in swap transactions.

Structural measures are essential to Indonesia's adjustment strategy. The changes implemented thus far are important and have already bolstered Indonesia's export potential in important sectors. The staff would urge the authorities to move quickly to realize their objectives of shifting fully from nontariff barriers to tariffs, and to rationalizing tariffs. Timely and comprehensive implementation would be essential to enhance efficiency and to stabilize the decision-making environment so that the desired investment response is not delayed. At the same time, the effectiveness of Indonesia's efforts to strengthen the competitiveness of domestic production by liberalizing its import regime must not be stifled by increasing protectionism abroad.

The structural policies outlined by the authorities, accompanied by cautious demand management, should bring about a marked strengthening in Indonesia's external accounts in the medium term in a setting of noninflationary growth. Nevertheless, Indonesia's external debt position and the prospect that amortization payments will keep gross foreign borrowing requirements high in the next few years underscore the need for perseverance in the implementation of adjustment policies. The recent policy initiatives, coupled with the acknowledged track record of Indonesia's policymakers, clearly demonstrate their commitment to domestic and external adjustment. This commitment must be translated into policy actions to assure the containment of the debt burden to sustainable levels and to elicit the continuing support of the international community.

The staff welcomes the maintenance by Indonesia of an exchange system that is free of restrictions on payments and transfers for current international transactions. It is proposed that the next Article IV consultation with Indonesia be held on the standard 12-month cycle.

Indonesia: Basic Data

Area:	1,900 thousand sq. km.
Population (June 1985):	163 million
Growth of population (1985):	2.2 percent per annum
GDP (1985):	$77 billion
GDP per capita (1985):	$475

	Fiscal Year Ending March					
	1982/83	1983/84	1984/85	1985/86	1986/87 Est.	1987/88 Proj.
	(Percentage change)					
Growth and inflation 1/						
Real GDP	-0.3	3.4	6.1	1.9	2.4	3.0
Of which: Non-oil GDP	(4.2)	(4.0)	(4.7)	(3.5)	(1.8)	(4.4)
GDP deflator	7.8	14.1	11.9	7.7	-3.1	13.5
CPI	8.6	13.3	3.7	5.8	9.0	5.1
Money and credit						
Net domestic credit	71.6	4.3	16.3	42.3	14.3 2/	...
Net Government deposits	-11.6	46.1	50.7	-10.2	24.6 2/	...
Credit to the private sector	36.2	26.5	29.1	24.9	20.7 2/	...
Broad money	20.7	28.7	22.8	24.9	26.0 2/	...
Reserve money	1.7	31.0	9.3	29.7	21.3 3/	...
	(In percent of GDP)					
Central Government budget						
Revenue and grants	19.1	20.9	20.9	20.1	15.4	15.5
Oil/LNG	12.2	14.1	14.6	11.8	5.7	6.1
Non-oil/LNG	6.9	6.8	6.3	8.3	9.7	9.4
Expenditure	23.9	23.5	20.0	23.0	20.9	18.5
Current	11.8	11.5	11.0	11.8	13.2	12.3
Development	12.1	12.0	9.0	11.1	7.7	6.2
Current budgetary surplus	7.2	9.4	10.4	8.2	2.1	3.2
Overall surplus or deficit	-4.8	-2.6	0.9	-2.9	-5.5	-3.0
Borrowing from the banking system	1.4	-2.4	-3.5	0.9	2.4	-0.4
Foreign borrowing (net)	3.5	5.0	2.6	2.0	3.1	3.4
	(In billions of U.S. dollars)					
Balance of payments						
Exports	18.7	19.8	20.9	18.6	13.4	15.2
Oil and LNG	14.7	14.4	14.9	12.4	6.8	7.5
Non-oil	3.9	5.4	5.9	6.2	6.6	7.7
Imports (non-oil sector)	-15.8	-14.3	-12.9	-11.2	-9.7	-9.1
Oil/LNG service payments (net)	-7.1	-7.1	-6.6	-6.5	-4.6	-4.9
Non-oil/LNG service payments (net)	-2.7	-2.9	-3.2	-3.1	-3.3	-3.6
Current account	-6.8	-4.4	-1.7	-2.0	-4.2	-2.3
(As percent of GDP)	(-7.2)	(-5.5)	(-2.1)	(-2.4)	(-5.8)	(-3.3)
Overall balance	-3.5	2.6	2.3	-0.5	-3.0 4/	-0.1
	(Percentage change unless otherwise specified)					
Terms of trade	0.3	-5.3	3.1	-11.4	-35.7	1.6
Real effective exchange rate 5/	1.2	-21.6	4.5	-17.2	-34.4 6/	...
Average crude oil price ($/barrel)	33.48	29.45	28.77	25.12	12.50	15.00
	(In billions of U.S. dollars)					
Reserves (end of period)						
Gross official assets	4.3	6.7	7.4	7.2	5.1 7/	...
(In months of non-oil imports)	(3.5)	(5.8)	(6.9)	(7.8)	(6.1)	...
Foreign assets of the banking system	8.6	11.2	12.5	12.9	10.0 7/	...
External debt (end of period)						
Public medium- and long-term debt	21.2	24.6	24.4	30.2	35.6	38.5
Total external debt	26.8	30.3	31.0	37.1	42.4	45.3
Debt service	3.0	3.2	4.2	4.7	5.5	6.4
In percent of exports of goods and services:						
Total external debt	(135.4)	(145.2)	(139.3)	(185.6)	(287.7)	(274.7)
Debt service	(15.0)	(15.5)	(18.9)	(23.4)	(37.3)	(38.8)

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

1/ On a calendar year basis, except for the CPI figures. For 1986/87, the CPI figure is for February; for other years, March figures are used.

2/ October 1986 data. Rates of change include the effect of the September 1986 devaluation on the rupiah value of domestic and foreign assets and liabilities denominated in foreign currencies. The valuation adjustment on foreign currency deposits accounted for about 6 percentage points of the increase shown for broad money.

3/ December 1986 data.

4/ These figures presuppose that drawings on lines of credit will be used to achieve a stock of official reserves of $5.1 billion at the end of March 1987.

5/ End-period. Depreciation is negative. Non-oil export trade-weighted.

6/ December to December.

7/ January 1987 data.

Indonesia: Fund Relations
(As of February 28, 1987)

I. Membership status

(a)	Date of membership:	February 21, 1967
(b)	Status:	Article XIV

A. Financial Relations

(Amounts in millions of SDRs, unless otherwise specified)

II. General Department (General Resources Account)

(a)	Quota:	1,009.7
(b)	Total Fund holdings of rupiah:	979.2
	(As percent of quota):	(97.0)
(c)	Fund credit:	42.0
	(As percent of quota):	(4.2)
(d)	Reserve tranche position:	72.4
(e)	Lending to the Fund:	(--)

III. Stand-by and extended arrangements and special facilities

(a)	Current stand-by or extended arrangement:	None
(b)	Special facilities CFF (August 1983):	360.0

IV. SDR Department

(a)	Net cumulative allocation:	239.0
(b)	Holdings:	35.5
	(As percent of net cumulative allocations)	(14.9)

V. Administered accounts

(a)	Trust Fund loans:	Not eligible
(b)	SFF subsidy account:	None

VI. Financial obligations to the Fund:

	Overdue Financial Obligations	Principal and Interest Due 1987	1988	1989	1990
Principal	--	--	42.0	--	--
Repurchases	--	--	42.0	--	--
Charges and interest including SDR (provisional)	--	15.4	14.8	12.7	12.7
Total	--	15.4	56.8	12.7	12.7

B. Nonfinancial Relations

VII. Exchange rate arrangement

On November 15, 1978, the peg of the Indonesian rupiah to the U.S. dollar was severed and Indonesia instituted a managed float under which a basket of trading partner currencies was used as one of the indicators for the determination of the exchange rate. The initial rate established for the rupiah on that date was Rp 625 per US$1. The U.S. dollar is the intervention currency. Effective March 30, 1983, the rupiah was devalued by 27.6 percent to Rp 970 per US$1. At the same time, Bank Indonesia announced that it would continue to follow a policy of a managed float, but would take into account a broader set of currencies than was the case prior to this devaluation. On September 12, 1986 the rupiah was devalued by 31 percent, moving from Rp 1,134 per US$1 to Rp 1,644; subsequently, the rupiah has fluctuated against the U.S. dollar and on February 28, 1987 the rate was Rp 1,644 per US$1.

VIII. Last Article IV consultation

The last Article IV consultation report (SM/86/11) was discussed by the Executive Board on February 14, 1986 (EBM/86/28). The following decision was adopted:

> The Fund takes this decision in concluding the 1985 Article XIV consultation with Indonesia in light of the 1985 Article IV consultation with Indonesia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).
>
> The Fund notes with satisfaction that Indonesia maintains an exchange system which is free of restrictions on payments and transfers for current international transactions.

Indonesia is on the standard 12-month cycle for Article IV consultations.

IX. Technical assistance

(a) CBD: In November 1983, CBD advised on the design of monetary instruments to improve the control of liquidity; in 1985, advice was given on techniques of money market management. In February 1986, a follow-up mission visited Jakarta for two weeks to prepare a report reviewing the financial reforms in monetary control and deregulation.

(b) FAD: In 1986, FAD continued to advise on the administration of the value-added tax (VAT). In early 1987, FAD provided technical assistance to review the enterprise accounting systems and to consolidate the accounts of the public enterprises.

(c) STA: In 1985-86, STA missions visited Jakarta to review progress in implementing recommendations to broaden the coverage of nonmonetary financial institutions in IFS, and in strengthening the compilation techniques for monetary and balance of payments statistics. In 1987, an STA mission visited Jakarta to discuss with the authorities Indonesia's participation in the Fund's International Banking Statistics Project.

X. Resident representative: Mr. Richard Hides completed his first year in mid-August 1986 and his assignment has been extended for a second year at the authorities' request.

Indonesia: Relations with the World Bank Group 1/

1. As of February 28, 1987, Indonesia had received 48 IDA credits totaling $895.55 million (less cancellations) and 117 IBRD loans totaling $9,394.03 million (less cancellations). IFC commitments totaled $163.20 million. From 1968 until 1974, all lending to Indonesia was made through IDA. Owing to the country's improved creditworthiness following the oil and commodity price boom in 1973/74, the bulk of the Bank's lending during the remainder of the 1970s was through IBRD loans. However, a modest amount of IDA lending continued until 1979/80.

2. The Government's major development objectives are to sustain a reasonable rate of economic growth and employment generation, diversify the base for non-oil exports and public revenues, and improve the efficiency of resource use. For the current Five-Year Plan period, 1984/85-1988/89, the Government has projected a growth rate of 5 percent per annum for real GDP. However, given the recent decline in and uncertain outlook for foreign exchange earnings, especially with respect to oil, this projection is seen by the World Bank staff as optimistic. In the view of the staff, investment levels are also likely to fall significantly short of those planned. Even so, the broad priorities for public investment outlined in the Plan are seen to remain appropriate. In particular, as compared with actual trends over the last five years, the Plan proposes a reallocation of development expenditure away from the industrial sectors (manufacturing, mining, and petroleum) and toward economic infrastructure (water resources and power) and social services (education and health). Such a reallocation is justified by: (a) the relatively limited development of economic and social infrastructure in Indonesia compared with other countries in the region; and (b) the Government's objective to give an expanded role to private investment in the directly productive sectors.

3. The World Bank has geared its lending and economic work to support the Government's objectives (as indicated above) and to address emerging development issues. The approach is to continue emphasizing the ongoing dialogue on economic policy that has been a cornerstone of the Bank's relationship with Indonesia for many years. This dialogue on macroeconomics will continue to be coordinated with advice on institutional and policy issues in important sectors, together with related lending operations and technical assistance. The major vehicle for this dialogue is the annual economic report on Indonesia prepared by the IBRD. Other recently completed or ongoing studies focus on issues of financial sector development, trade/industrial policy, public resource management, agricultural incentives, the government

1/ Prepared by the staff of the IBRD.

transmigration program, power investment, energy options, and transport sector strategy. In the lending program, agricultural projects, especially for tree crops and irrigation, still receive the highest priority. However, the program is broadly based, and includes increasing emphasis on efficiency improvements in the infrastructure sectors and on education and human resource development. Continued attention will be given to power and energy, where the Bank is concentrating on policies to diversify the country's energy base and to improve sector planning. In transportation, the Bank is focusing on efficiency improvements in the maritime subsector and on improving the national network of highways and rural roads. In urban development and water supply, lending is being directed toward establishment of appropriate sector policies and institutional development aimed at strengthening local government and regional enterprises, in order to minimize demands on the central government budget and decentralize the responsibility for addressing basic needs. Wherever possible, the impact of Bank lending is to be widened through technical assistance, as well as complementary investments and coordinated policy dialogue with other donors.

4. As with many of the World Bank's borrowing countries, Indonesia suffers from weaknesses in project implementation capabilities. These weaknesses reflect a range of factors, including the shortage of trained manpower, regulatory and procedural bottlenecks, and the rapid increase in development expenditure (and aid commitments) over the past decade. Implementation, as reflected by disbursements, has been steadily improving over the past three years. The disbursement ratio 1/ has risen from 15 percent 2/ in FY 1984 to about 18.5 percent in FY 1986. Although this is not yet a satisfactory level, this improvement reflects the results of efforts which the Government and the Bank have been making to address key implementation problem areas. These include budgeting and disbursement procedures, procurement procedures, managerial capacity, limited capacity in the local consulting and contracting industries, and land acquisition. Several special Bank missions and reports have broadly addressed various aspects of these problems and made recommendations, many of which have been adopted by the Government. Seminars on procurement and disbursement procedures as well as others which have more broadly addressed implementation problems of specific sectors have been held, in addition to regular formal meetings between the Bank and the Government to review implementation and disbursement performance and project- and sector-specific problems. As a consequence of these joint initiatives, the Government has acted to streamline some complex budgetary and financial procedures, improved its information system, and instituted training programs in procedures and project management. In addition, a ministerial level

1/ The ratio of actual disbursements during the Bank's fiscal year to the cumulative undisbursed amount at the beginning of the fiscal year.

2/ Excluding the Special Assistance Program (SAP)--related disbursements that added 2.8 percent.

committee responsible to the President has been established to monitor implementation performance, as well as a ministerial committee on land acquisition. To continue to assist in alleviating the problems that persist, the Bank has been, and will be in future, working with the implementation monitoring committee as well as on specific problem areas agreed with the Government. Programs are already under way in the following areas: developing the local consulting and contracting industries; improving budgeting and financial procedures, management development and training; simplifying reimbursement procedures and strengthening management information systems for procurement and post-contract implementation monitoring.

Relations with the World Bank Group

Table 1. Indonesia: IBRD and IDA Commitments and Disbursements, FY 1975-87 1/

(In millions of U.S. dollars)

Bank Fiscal Years	IBRD Commit-ments	IBRD Disburse-ments	IDA Commit-ments	IDA Disburse-ments	Total Commit-ments	Total Disburse-ments
1975	332.0	56.8	--	106.9	332.0	163.7
1976	517.0	157.2	--	99.4	517.0	256.6
1977	440.0	190.6	--	49.0	440.0	239.6
1978	435.0	167.9	70.0	29.5	505.0	197.4
1979	704.0	176.2	126.0	29.8	830.0	206.0
1980	580.0	236.3	174.0	41.7	754.0	278.0
1981	673.0	304.9	--	68.6	673.0	373.5
1982	926.1	423.1	--	78.2	926.1	501.3
1983	1,329.9	523.2	--	59.6	1,329.9	582.8
1984	1,033.4	711.9	--	52.6	1,033.4	764.5
1985	1,068.1	679.2	--	49.1	1,068.1	728.3
1986	1,132.3	788.3	--	29.8	1,132.3	818.1
1987 2/	635.0	427.3	--	5.5	635.0	432.8

Source: The World Bank.
1/ Bank fiscal year--July 1-June 30.
2/ As of February 28, 1987.

Table 2. IBRD and IDA Commitments and Disbursements as of February 28, 1987

(In millions of U.S. dollars)

	IBRD	IDA	Total
Agriculture, forestry, and fishing	2,878.1	494.4	3,372.5
Energy (including power and coal)	2,523.0	101.0	2,624.0
Industry, development finance	929.5	111.5	1,041.0
Transportation	1,364.0	84.5	1,448.5
Education	882.8	73.4	956.2
Population, health, and nutrition	217.9	13.2	231.1
Urban development and water supply	635.5	--	635.5
Other	327.5	53.8	381.3
Total commitments	9,758.3	931.8	10,690.1
Repayments	702.4	27.6	730.0
Debt outstanding 1/	4,944.7	856.8	5,801.5

Source: The World Bank.
1/ Net of valuation adjustments and repayments.

New commitments: Loans committed during FY 1987 (ending February 28, 1987) amounted to $635.0 million ($1,132.3 million in FY 1986).

IFC activity: As of February 28, 1987, gross commitments totaled $163.2 million for 22 projects. Of this amount, 65 percent was for cement and construction material projects and 12 percent for textile and fiber projects.

Technical assistance: IDA has extended six technical assistance credits to Indonesia totaling $39.5 million as of February 28, 1987. In addition, significant allocations for technical services have been included in virtually all IBRD/IDA loans.

Recent economic report: The latest economic mission report, Indonesia--Adjusting to Lower Oil Revenues (No. 6201-IND), was issued on May 27, 1986.

Aid Group: The most recent (twenty-ninth) meeting of the Inter-Governmental Group on Indonesia (IGGI) was held in The Hague during June 18-19, 1986, under the chairmanship of the Minister of Development Cooperation, Government of the Netherlands.

Indonesia--Statistical Issues

1. Outstanding statistical issues

a. Monetary accounts

In light of the report on the September 1985 technical assistance mission in money and banking statistics, various changes were implemented in the *IFS* data beginning with the February 1987 issue of *IFS*.

b. Government finance

The 1986 issue of the *Government Finance Statistics Yearbook* includes data in the statistical and derivation tables for the consolidated central and provincial governments through 1984. However, no data have been supplied on the operations of local governments. Efforts are reportedly under way to collect such data.

c. External sector

(1) Balance of payments

A follow-up technical assistance mission in balance of payments statistics took place in November 1985. The mission report, which was transmitted to the authorities in February 1986, recommended, inter alia, the need for effecting improvements in the compilation of data on transactions relating to the oil sector, non-oil imports, private unrequited transfers, direct investment income, and direct investment capital.

(2) External trade

Data on the volume of non-oil exports are deficient; consequently, it is not possible to derive reliable data on unit values. In addition, an import unit value index is not compiled nor are separate data available on either project or private sector imports.

d. International banking

Indonesia has agreed, in principle, to participate in the Fund's international banking statistics project but very little progress has been made toward implementing a reporting system apparently owing to the authorities' lack of familiarity with the project. A mission took place in early 1987 to assist the authorities in implementing the required reporting system. The mission also reviewed Indonesia's statistics on external debt as part of the effort to produce a comprehensive coverage of debt statistics with an appropriate creditor/debtor classification.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Indonesia in the March 1987 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by Bank Indonesia, which during the past year, have been provided on a timely basis.

Status of IFS Data

		Latest Data in March 1987 IFS
Real sector	- National Accounts	1985
	- Prices: Consumer	December 1986
	Wholesale	April 1986
	- Production: crude petroleum	August 1986
	- Employment	n.a.
	- Earnings	n.a.
Government finance	- Deficit/surplus	August 1986
	- Financing	August 1986
	- Debt	n.a.
Monetary accounts	- Monetary Authorities	October 1986
	- Deposit money banks	July 1986
	- Other financial institutions	August 1986
Interest rates	- Discount rate	n.a.
	- Bank lending/deposit rate	December 1985
	- Bond yield	n.a.
External sector	- Merchandise trade: Values	April 1986
	Unit value (exports)	April 1986
	- Balance of payments	Q4 1985
	- International reserves	December 1986
	- Exchange rates	January 1987

Indonesia--Medium-Term Projections

1. Introduction

The staff has prepared economic projections for the period to 1991/92, which focus on the evolution of domestic and external balances, the external debt burden, and real GDP growth. The exercise involved the formulation of different scenarios in order to explore the economic implications of alternative sets of assumptions about external factors and the stance of policies. For the external environment, the staff has drawn heavily on the global assumptions underlying the February 1987 World Economic Outlook exercise. Assumptions for the domestic policy environment--in particular for the baseline scenario--reflect the discussions with the authorities.

2. Assumptions

The principal assumptions about the external environment in 1988-92 used for the baseline projections are the following (Table 1): price increases for manufactured exports from industrial countries of 3 percent per annum; foreign market growth for non-oil exports of about 5 percent per annum; a modest improvement in the terms of trade for non-oil primary products; stability in real terms of the realized export price for Indonesian oil, as explained below; LIBOR of 6 1/2 percent; no change in the protectionist environment abroad; and a constant real level of foreign aid.

Consumer prices in Indonesia are assumed to increase over the medium term by 5 percent per annum, a rate of inflation that would be in line with past experience. Non-oil/LNG exports are projected to grow, on average, 4-5 percentage points faster than the rate of growth of foreign markets. Non-oil export growth is anticipated to be highest in 1987/88 and to decelerate to the rate of market growth by 1991/92. This pattern of non-oil export growth reflects the response to the September 1986 devaluation and to the packages of trade liberalization measures introduced in 1986/87. It is also premised on the maintenance of an appropriate level of external competitiveness and the continuing adoption of measures designed to enhance efficiency and reduce the anti-export bias of the trade system.

The growth of imports, as well, is constrained by developments in external competitiveness and the innovations in the trade system. Other major factors affecting imports are the level of government expenditure and domestic economic activity. These factors are incorporated in an iterative process, which tracks the implications of different levels of government expenditure for real GDP growth, imports, foreign borrowing requirements, and the debt service burden.

Table 1. Indonesia: Global Assumptions and Domestic Targets

Scenario Based on February 1987 World Economic Outlook Assumptions, 1986-1992

(Changes in percent per annum, unless otherwise specified)

	1986	1987	1988	1989-1991 Annual Average
Foreign market growth (export weighted)				
Imports, in volume				
Oil imports	4.7	4.7	3.5	2.7
Non-oil imports	7.8	4.4	5.3	4.7
Foreign prices 1/ and interest rates				
World prices of manufactures	17.5	6.5	3.0	3.0
World oil prices	-47.6	7.1	3.0	3.0
World non-oil commodity prices	-1.4	-2.3	3.0	6.0
LIBOR (six-month U.S. dollar deposits)	6.8	6.5	6.5	6.5

	1986/87	1987/88	1988/89-1991/92 Annual Average
Indonesia--output and prices			
Real GDP	2.4	3.4	4.5
Non-oil/LNG GDP	1.8	4.5	5.0
Consumer prices	9.2	5.1	5.0
Export prices 1/	-29.0	10.5	3.8
Oil export prices	-50.2	20.0	3.0
Non-oil export prices	6.8	1.4	4.7
Of which:			
Non-fuel commodities	3.0	0.8	5.2
Manufactures	6.5	3.0	3.0
Import prices 1/	6.5	3.0	3.0
Terms of trade	-39.5	7.3	0.8
Real effective exchange rate (end fiscal year)	-40.0	--	--

Sources: Indonesian authorities; World Economic Outlook assumptions of February 1987; and Fund staff estimates.

1/ In U.S. dollars. Commodity price developments for Indonesia may differ from world market assumptions because of commodity composition effects and timing differences arising from the use of Indonesian fiscal year data.

For 1987/88, a substantial decrease (6 1/2 percent) in oil export volumes is assumed from the level of 377 million barrels per year estimated for 1986/87; thereafter, oil export volumes are projected to grow in line with the expansion of oil imports by industrial countries (about 2 1/2 percent). Oil prices are assumed to average $15 per barrel in 1987/88 and to rise by 3 percent per annum in nominal terms--the rate of inflation for manufactured exports--to $16.88 in 1991/92. LNG exports are projected to expand somewhat faster than oil imports of industrial countries, on the basis of existing contracts and plans for the expansion of productive capacity. LNG prices are envisaged to move in line with oil prices.

The financing of the current account deficit is derived residually by setting a target for the net foreign assets of the banking system. The ratio of net foreign assets to the next year's non-oil/LNG imports is permitted to decline to the equivalent of about ten months, which is similar to the level recorded in the period 1980/81-1983/84. The average interest rate on new disbursements of external debt is assumed to be LIBOR (six-month U.S. dollar deposits) plus a spread of 1 percent. This interest rate closely approximates the average interest rates on external debt in the years 1985/86-1986/87. Disbursements are assumed to have a 5-year grace period, with a 10-year repayment period for loans from commercial banks and a 20-year repayment period for loans from official sources. These assumptions are consistent with recent data on new loan commitments to Indonesia.

3. Baseline projections

The projections are based on a static accounting framework incorporating macroeconomic identities, which ensures the consistency of the projections with the assumptions and targets. The required fiscal adjustment is derived on the basis of the target for the current account balance, and the rate of growth of real GDP is adjusted to be consistent with the level of investment. These projections should not be interpreted as forecasts. Rather, they give an indication of the domestic and external consequences of certain developments, so that a view can be formed as to whether these developments are acceptable and what types of adjustment measures might be sought. Tables 2-4 summarize the outcome of the baseline scenario, while Table 3 in the main text presents two alternative scenarios based on a higher oil price assumption.

Table 2. Indonesia: Medium-Term Summary of Central Government Operations, 1986/87-1991/92

(In trillions of rupiah)

	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92
Total revenue and grants	15.1	17.6	20.4	22.6	25.0	27.7
Tax revenue	12.9	15.9	18.7	20.6	22.8	25.2
Of which: Oil/LNG 1/	5.6	6.9	8.2	8.7	9.3	9.9
Nontax revenue and grants 2/	2.2	1.7	1.7	1.9	2.1	2.4
Total expenditure and net lending	20.5	21.0	22.6	23.8	25.2	27.9
Current expenditure	13.0	13.9	15.1	16.0	17.0	18.1
Of which:						
Interest on external debt 3/	3.0	3.9	4.3	4.5	4.6	4.7
Development expenditure and net lending 4/	7.5	7.0	7.5	7.8	8.2	9.8
Overall surplus/deficit (-)	-5.4	-3.4	-2.2	-1.3	-0.2	-0.2
Financing (net)	5.4	3.4	2.2	1.3	0.2	0.2
Domestic 5/	2.4	-0.4	0.3	0.5	—	—
Foreign (net)	3.0	3.8	1.9	0.8	0.2	0.2
			(In percent of GDP)			
Memorandum items:						
Overall surplus/deficit (-)	-5.5	-3.0	-1.7	-0.9	-0.2	-0.1
Current surplus	2.1	3.2	4.2	4.6	6.6	5.9
Total revenue and grants	15.4	15.5	16.4	16.5	16.6	16.8
Of which: Oil/LNG	5.7	6.1	6.6	6.4	6.2	6.0
Total expenditure and net lending	20.9	18.5	18.1	17.5	16.8	16.9
Of which: Development expenditure and net lending	7.7	6.2	6.0	5.7	5.4	5.9

Sources: Data provided by the Indonesian authorities; and staff estimates.
1/ Excluding surplus in domestic oil operations in 1986/87 and 1987/88.
2/ Including surplus in domestic oil operations in 1986/87 and 1987/88.
3/ Including interest charges on foreign borrowing for balance of payments purposes.
4/ Defined as current budget surplus plus financing (net).
5/ Excluding valuation adjustments in 1986/87 amounting to a gain of about Rp 1.8 trillion.

Table 3. Indonesia: Summary Balance of Payments, 1986/87-1991/92

(In billions of U.S. dollars)

	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92
Exports	13.4	15.2	16.9	18.9	20.8	22.6
Oil	4.7	5.3	5.6	6.0	6.3	6.7
LNG	2.1	2.2	2.4	2.6	2.8	3.0
Non-oil	6.6	7.7	8.9	10.3	11.7	12.9
Non-oil imports	-9.7	-9.1	-9.4	-10.3	-11.3	-12.4
Oil/LNG sector payments (net)	-4.6	-4.9	-5.2	-5.6	-5.9	-6.3
Non-oil/LNG services (net)	-3.3	-3.6	-3.7	-3.8	-3.9	-4.0
Official transfers	0.1	0.1	0.1	0.1	0.1	0.1
Current account	-4.2	-2.3	-1.3	-0.7	-0.2	—
Oil/LNG sector	2.2	2.6	2.8	2.9	3.1	3.4
Non-oil/LNG	-6.3	-4.9	-4.1	-3.7	-3.4	-3.3
Capital account	1.3	2.1	1.3	0.6	0.4	0.4
Long-term capital (net)	2.0	2.2	1.4	0.7	0.5	0.5
Official capital (net)	1.7	1.9	1.0	0.3	—	—
Receipts	4.3	5.1	5.4	4.8	4.5	4.9
Amortization	-2.6	-3.2	-4.4	-4.5	-4.5	-4.9
Direct investment	0.3	0.3	0.4	0.4	0.5	0.5
Oil/LNG sector trade credits	0.6	-0.1	—	—	—	—
Errors and omissions	-1.5	—	—	—	—	—
Overall balance	-3.0	-0.1	-0.1	-0.1	0.1	0.4
Valuation adjustment	0.7	0.1	0.1	0.1	0.1	0.1
Monetary movements (net) (increase -)	2.4	—	—	—	-0.2	-0.5
Foreign assets	10.0	10.0	10.0	10.0	10.2	10.7
(In months of next year's non-oil/LNG imports)	13.2	12.8	11.7	10.6	9.9	9.6
Memorandum item:						
Current account (as percentage of GDP)	-5.8	-3.3	-1.8	-0.9	-0.3	—

Sources: Bank Indonesia; and staff estimates.

Table 4. Indonesia: Baseline Medium Term External Debt, 1986/87-1991/92

(In billions of U.S. dollars) 1/

	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92
Total	42.4	45.3	46.7	47.4	47.9	48.3
Public sector	35.6	38.5	39.9	40.6	41.1	41.5
Private sector	6.8	6.8	6.8	6.8	6.8	6.8
Net change from previous year	5.3	2.9	1.4	0.8	0.5	0.5
Drawings	4.2	5.1	5.4	4.8	4.5	4.9
Amortization	-2.6	-3.2	-4.4	-4.5	-4.5	-4.9
Valuation adjustment	3.6	0.9	0.5	0.5	0.5	0.5
Debt service payments	5.5	6.4	7.9	8.0	8.1	8.5
Interest	2.9	3.2	3.4	3.5	3.6	3.6
Public sector	2.4	2.7	2.9	3.0	3.1	3.1
Private sector	0.5	0.5	0.5	0.5	0.5	0.5
Amortization	2.6	3.2	4.4	4.5	4.5	4.9
Exports of goods and services	14.7	16.5	18.5	20.5	22.5	24.4
In percent of exports of goods and services:						
Total debt	288	275	253	231	213	198
Debt service 2/	37.5	39.0	42.5	39.0	36.0	34.5

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

1/ Partials may not add up to totals because of rounding.
2/ Rounded to the nearest 1/2 percentage point.