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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/67

10:00 a.m., May 4, 1987

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	Yang W., Temporary
C. H. Dallara	
	L. K. Hubloue, Temporary
	M. Hepp, Temporary
M. Finaish	T. Alhaimus
	B. Goos
J. E. Ismael	
	J. R. N. Almeida, Temporary
	M. Foot
H. Lundstrom	
	G. D. Hodgson, Temporary
Mawakani Samba	
	I. A. Al-Assaf
	C. Noriega, Temporary
	G. Pineau, Temporary
G. A. Posthumus	J. de Beaufort Wijnholds
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
B. J. Owen, Assistant

Also Present

IBRD: A. Hamilton, East Asia and Pacific Regional Office. African Department: G. E. Gondwe, Deputy Director; E. A. Calamitsis. Asian Department: H. Neiss, Deputy Director; U. Baumgartner, S. P. O. Itam, J. R. Márquez-Ruarte, R. J. Niebuhr, D. M. Ripley, W. M. Tilakaratna. European Department: N. Happe. Exchange and Trade Relations Department: E. H. Brau. Legal Department: P. L. Francotte, J. M. Ogoola. Research Department: M. Goldstein, Deputy Director; R. R. Rhomberg, Deputy Director; N. M. Kaibni, I.-S. Kim, A. Muttardy, R. Pownall, J. J. Soladay. Secretary's Department: C. Brachet, Deputy Secretary. Western Hemisphere Department: L. R. Kenward. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: E. Ayales, A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, S. M. Hassan, K. Murakami, I. Puro, A. Vasudevan. Assistants to Executive Directors: R. Comotto, F. Di Mauro, S. K. Fayyad, A. Iljas, S. King, M. A. Kyhlberg, M. Lundsager, T. Morita, A. H. Mustafa, D. V. Nhien, S. Rebecchini, V. Rousset, G. Schurr, B. Tamami.

1. INDONESIA - 1986 ARTICLE IV CONSULTATION; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the staff report for the 1986 Article IV consultation with Indonesia (SM/87/76, 3/30/87; Sup. 1, 4/27/87), together with a request for a purchase in an amount equivalent to SDR 462.9 million under the decision on the compensatory financing of export fluctuations (EBS/87/77, 4/13/87; Sup. 1, 4/29/87). They also had before them a background paper on recent economic developments in Indonesia (SM/87/79, 4/3/87).

Mr. Ismael made the following statement:

Policy developments

1986 was one of the most difficult years Indonesia has ever experienced. The steep decline in oil prices, continued low prices of other primary exports, and the sharp depreciation of the U.S. dollar vis-â-vis other major currencies brought about major new problems after the economy had already responded well to the various adjustment measures introduced from 1983 to 1985. As a result of these adverse developments, foreign exchange earnings and government revenues were significantly weakened, and Indonesia's external debt and debt service obligations increased substantially.

In order to reduce or to do away with restrictive trade regulations governing certain industries that are generally seen as important factors in high production costs, three packages of similarly oriented measures were consecutively introduced in May 1986, October 1986, and January 1987. In May 1986, new regulations relaxing import restrictions for export production were announced, and restrictions affecting inward investment flows were substantially reduced. These were followed in October 1986 by a package of measures in which tariffs were reduced on over 150 items, import monopolies for 165 products were abolished, and licensing restrictions on 110 items were relaxed, as part of a policy to move from nontariff to tariff barriers. Moreover, the ceiling on the foreign exchange-rupiah swap facility was lifted as part of the move to stimulate foreign investment and non-oil exports. In January 1987, import duties were lowered on an additional 55 items. At the same time, nontariff barriers to imports were removed on more than 100 items, while quota restrictions were abolished on approximately 140 categories of textile and steel products. The measures also amended industrial regulations to permit the use of excess capacity to diversify product lines.

To further improve Indonesia's competitiveness in international markets, thereby improving the current account of the balance of payments, the rupiah was devalued by 31 percent against the U.S. dollar in September 1986.

In March 1985, Indonesia signed the Code on Subsidies and Countervailing Duties of the GATT. As a consequence, the export certificate scheme was changed in April 1986 into a pure duty drawback scheme (or pure restitution of duties paid by producers/ exporters for imported materials processed into export goods). This was followed in April 1987 by an increase in interest rates on export credits from 9 percent to 11.5 percent a year. In this way, the export credit subsidy was reduced to 50 percent, to be cut further by another 25 percent in 1988, followed by an additional 15 percent in 1989, and finally by still another 10 percent in 1990, when all subsidies will be done away with.

Economic performance

The broad-ranging adjustment measures undertaken in 1986 and early 1987, together with the continued commitment to a stance of restraint in demand management and a flexible foreign exchange rate policy, helped contain the internal and external imbalances. GDP (expressed in constant 1983 prices) increased sufficiently well, by about 2.5 percent in 1986 compared to about 2 percent in 1985. Although agriculture continued to be the dominant contributor of GDP, its growth declined somewhat due to damage caused by brown grasshoppers. However, it was possible to maintain self-sufficiency in sugar and rice, which was achieved in 1983 and 1984 respectively, and self-sufficiency in soybeans is expected to be attained by the end of 1987, following an increase in production of 35 percent in 1986. The increased rate of growth of GDP was mainly attributable to growth in the non-oil/LNG mining sector (e.g., tin, copper, and coal), manufacturing (particularly cement, plywood, and textiles), and the oil/LNG sector.

Notwithstanding the large devaluation of the rupiah in September 1986, from 4.3 percent in 1985, inflation increased to only 8.8 percent in 1986. This relatively low inflation rate was not only due to effective monetary management, but to proper functioning of the existing system for providing basic necessities as well.

The current account deficit amounted to $4.1 billion in 1986 (or 5.4 percent of GDP) compared with $1.9 billion (or 2.2 percent of GDP) in the preceding year. Had it not been for the devaluation of September 1986, the deficit would have been much higher.

While large purchases of foreign exchange took place in December 1986--to finance imports and for speculative purposes out of concern about possible drastic monetary measures in response to uncertainties in the oil market--there were sizable capital inflows for the year as a whole. However, total capital inflows were not sufficient to cover the current account deficit, debt repayment, and a large part of the foreign exchange purchases mentioned above, so that an overall balance of payments deficit occurred amounting to $2.1 billion. As a result, foreign exchange reserves declined from $12.2 billion at the end of 1985 to $10.1 billion at the end of 1986.

The difficulties in the balance of payments constituted an important contractionary factor affecting the money supply in 1986. However, the efforts by banks to sustain business activities resulted in a substantial rise in credit extended, which thus became a major expansionary factor. Bank credits showed an increase of 18.1 percent in 1986 compared with 17.8 percent in 1985. In the event, narrow money rose by 17.4 percent in 1986 compared with 17.7 percent in 1985, broad money increased by 21.2 percent in 1986 compared with 29.1 percent in the preceding year, and reserve money grew by 21.3 percent compared to 30 percent in 1985.

The budget outturn for 1986/87 was adversely affected by a 44 percent decline in oil/LNG revenues, which undermined a 29 percent improvement in non-oil/LNG revenues achieved as a result of tax reforms, intensification of tax collection, and larger profit transfers from public enterprises. Domestic revenues were estimated to decline by 14 percent compared with the 1985/86 outturn, while current expenditures were estimated to increase by 12 percent, largely due to an increase in interest payments on external debt. As a consequence, public savings were estimated to fall by 50 percent. However, it was expected that the overall budget deficit could be contained at about 4.8 percent of GDP, largely owing to a reduction of development expenditures by almost 21 percent.

Meanwhile, public external debt increased markedly from $30.2 billion in FY 1985/86 to $35.6 billion in FY 1986/87, in large part due to the weakness of the U.S. dollar against certain of the currencies in which the debt is denominated. At the same time, debt service obligations increased from $4 billion to $5 billion, an increase that, coupled with a significant decline in export earnings, resulted in a substantial rise in the debt service ratio from 20.3 percent in FY 1985/86 to 33.7 percent in 1986/87.

Economic outlook

As part of the continuing efforts to adjust the economy, the budget for 1987/88 continues to be austere, amounting to Rp 22,783 billion, representing a 6.4 percent nominal increase over budgeted revenue and expenditure for 1986/87. Current expenditure, excluding interest payments on external debt, is projected to decline by 16 percent in real terms, representing a further freeze on wages and salaries, a cutback in material expenditure, and a sharp reduction in fertilizer subsidy. Development expenditure is projected to fall by 20 percent in real terms. Therefore, priority will be given to completion of projects at advanced stages of implementation and to small-scale projects.

In view of decreased government revenues from oil and gas, efforts will be intensified to increase revenues from non-oil and gas sources by 27 percent. In particular, revenues from sales and value-added taxes are anticipated to rise by 65 percent to account for 38 percent of fiscal revenues. Development funds from foreign sources are expected to increase by 55 percent, partly as a consequence of the September 1986 devaluation. In addition, special efforts to mobilize foreign assistance to finance the local cost of certain projects were to be made in 1987/88.

It is expected that the budget will record an overall deficit of 2.2 percent of GDP at the end of 1987/88 compared to a deficit of 4.8 percent at the end of 1986/87.

It is also expected that the balance of payments will show a substantial improvement as well. The current account deficit is estimated to amount to $2.3 billion at the end of 1987 compared with one of $4.1 billion at the end of the preceding year.

To improve the efficiency and performance of public enterprises, a commission was formed in February 1987 with the task of looking into the possibility of selling unprofitable state-owned enterprises. Four possible solutions are now being considered by the commission: (1) outright liquidation; (2) mergers with other more profitable state-owned enterprises; (3) joint ventures with private partners; and (4) sale to the private sector.

Conclusion

The adjustment measures that have been undertaken since the 1985 Article IV consultation not only show Indonesia's firm determination and ability to adjust to an adverse economic environment, but also reflect Indonesia's ongoing resolve to create a stable and sustainable outward-looking economy with minimal government interference, where continued attention to its competitive position is clearly important. Therefore, if further adjustments turn out to be warranted, they will certainly be made.

In the meantime, however, Indonesia has experienced a substantial shortfall of SDR 3.4 billion in total export earnings for 1986/87, consisting of an oil shortfall of SDR 2.2 billion, a gas shortfall of SDR 0.56 billion, and a nonenergy shortfall of SDR 0.44 billion. To help smoothen the adjustment process, the Indonesian authorities have requested a purchase equivalent to SDR 462.9 million under the decision on compensatory financing of export fluctuations. This proposed purchase would raise Indonesia's outstanding purchases under that facility from 4.2 percent of quota to 50 percent of quota. My authorities firmly believe that their request has met all the requirements set forth in the compensatory financing decision. They would appreciate receiving the Board's approval of their request.

In conclusion, I join my Indonesian authorities in expressing deep appreciation to the staff for producing excellent reports and for the valuable exchange of views throughout the consultation visits.

Mr. Yamazaki made the following statement:

As Mr. Ismael has stated, 1986 was a difficult year for the Indonesian economy in terms of the external environment, which was characterized by the sharp fall in oil prices. The progress achieved through the adjustment measures taken since 1983, however, has enabled the authorities to make a response to the problem already. Particularly noteworthy in this context is the continuation of the structural adjustment measures to remove the basic impediments to the growth of the economy and to improve external competitiveness. In May and October 1986 and in January 1987, the authorities adopted measures to liberalize the trade, investment, and industrial licensing systems. Likewise, the rupiah was devalued in September 1986.

Owing to the impact of the sharp fall in the price of oil, both the external current account deficit and the fiscal deficit in 1986/87 would have widened even more than the estimated figures, in the absence of the policy responses by the authorities. It should also be noted that, despite the unfavorable external environment, the economy is expected to record positive growth of above 2 percent in real terms in 1986/87, with only a modest acceleration in inflation. Having said this, however, the magnitude of the current account deficit of 5 3/4 percent of GDP for 1986/87 and the schedule of debt service payments over the medium term point to the need for perseverance in the adjustment effort. It is encouraging to note that, based on the assumption that the structural policies envisaged by the authorities will be accompanied by cautious demand management, the staff's medium-term scenario draws a picture of a substantially strengthened external position.

Let me touch briefly on specific policy areas. First, on fiscal policy, I welcome the authorities' stringent budget target for 1987/88, calling for a reduction in the budget deficit to a little above 2 percent of GDP. While specific, detailed measures have not been announced yet, I note in the staff paper that, on the expenditure side, a real reduction in the Government's discretionary expenditure is inevitable. On the revenue side, while fully endorsing the authorities' efforts to improve tax administration, I have some doubts as to the effectiveness of the envisaged improvements in tax administration as a reliable revenue source. In this respect, the widening of the tax base would have to be carefully articulated.

Second, on monetary policy, and according to the supplement to the staff paper, the growth of both broad money and reserve money seems to have slowed down moderately in 1986. However, taking into account the rapid growth of monetary aggregates in Indonesia in previous years, monetary policy should continue to be conducted cautiously. In December 1986, when a large capital outflow occurred, a more flexible interest rate might have prevented a large drawdown of reserves. While acknowledging that the stability of the interest rate is an important concern for the authorities, there are circumstances in which an active and flexible interest policy can be pursued.

Third, on exchange rate policy, I welcome the devaluation of the rupiah of September 1986 under the existing circumstances. I also welcome the authorities' commitment to pursue a flexible exchange rate policy to maintain the competitiveness of Indonesian exports.

Fourth, on structural policies, the problems of the so-called "high-cost" economy make structural adjustment measures an essential element of the authorities' policy efforts. On the immediate agenda are early and comprehensive implementation of the tariff reform and further liberalization of Indonesia's import regime with a view to improving the competitiveness and the efficiency of domestic production.

Finally, with respect to Indonesia's request for the use of the resources of the compensatory financing facility, I note in the staff report that all the requirements under the relevant Executive Board decision are satisfied. In this connection, I am thankful to the staff for its detailed analysis. Therefore, I have no difficulty in supporting the proposed decision.

Before concluding, I would like to offer a small footnote to the reference on page 8 of the staff report to the loan of $900 million from the Export-Import Bank of Japan. The loan is provided in the form of an untied cofinancing arrangement with the World Bank in support of the timely completion of 21 World Bank projects in Indonesia, which are mainly export-oriented or power-sector projects. My authorities strongly hope that this loan will contribute effectively to the economy and the welfare of the people in Indonesia.

Mr. Al-Assaf made the following statement:

Economic policy management in Indonesia over the past few years has in many respects been very successful, particularly as the task facing the Indonesian authorities was that of adjusting to an external environment which had become increasingly less favorable. This adjustment has had two components--namely, to reduce aggregate demand imbalances and to diversify the production base of the economy to reduce the dependence on oil. The second component involves establishing an environment which will encourage the private sector to adopt an outward-looking investment strategy. As Mr. Ismael's comprehensive statement indicates, the Indonesian authorities have been pursuing policies with both components in mind, and these policies are beginning to meet with considerable success. I warmly commend them for their comprehensive and responsible approach to economic policymaking.

I believe that the main point to emphasize at this stage is that it is important for the authorities to persevere with their adjustment efforts. This will allow them to capitalize on all they have achieved and, in particular, will ensure that the economy will now return to a path of sustained growth. Since I agree with the thrust of the staff report, I will limit myself to a few brief observations.

On monetary policy, the rapid increase in broad money in the latter part of 1986 could be viewed with concern. It is, therefore, most encouraging to read in the staff supplement that the growth in reserve money has, more recently, decelerated sharply. More generally, I believe that the lesson to be learned from the volatile financial conditions experienced in the latter part of 1986 is that it is necessary for the authorities to stand ready to react quickly and flexibly to circumstances. By doing so, the authorities will bolster confidence and reduce the likelihood of speculation. In this connection, the authorities should also continue their flexible management of the exchange rate.

As for fiscal policy, I might comment first that if the price of oil should turn out to be higher than anticipated, I would urge the authorities to be cautious before increasing expenditure. Indonesia's external debt and amortization demands are relatively high and therefore a high priority should be assigned to reducing the country's external borrowing requirements where possible.

Second, it has been two years since Indonesia implemented a major tax reform which involved, among other things, a reduction in marginal income tax rates and a simplification of income tax schedules. I judge from the staff supplement that we are beginning to see some of the benefits of this reform.

Specifically, tax revenues are turning out to be more buoyant than anticipated, suggesting that simplified tax administration can yield significant dividends. If so, I think that future revenue increases should be sought, as much as possible, from further tax administration improvements rather than from tax rate increases. Staff comment on this would be appreciated as well as on whether the Indonesian experience with tax reform could usefully be transferred to other countries.

On a related matter, I note that, in some instances, the financing of some public sector enterprises has been shifted from the budget to the banking system. While there is nothing basically wrong with such a shift, it is important that it does not affect the measurement of the fiscal deficit and that the public enterprises in question compete for bank credit on competitive terms.

My comments have been more in the nature of words of caution. They should be seen against the background of an economy that has benefited from bold initiatives in all major policy fields, for which the authorities should be warmly commended. To repeat what I have already said, it remains for them to persist with their efforts to restore economic balance, and to reorient the economy by moving from an inward-looking to an outward-looking strategy.

Turning to the specific matter of the request for a drawing under the compensatory financing facility, Indonesia clearly satisfies all the conditions for such a request. In particular, there is clear evidence of their willingness to cooperate with the Fund, as is evidenced by their maintenance of an active policy dialogue with the Fund, as well as of the fact that the shortfall of more than SDR 3 billion was largely outside the control of the authorities. I therefore support the proposed decision and wish the authorities well.

Mr. Posthumus made the following statement:

At the outset I should like to state that I agree with the staff appraisal in the Article IV consultation report and that I can approve the Indonesian request to make a purchase in an amount equivalent to SDR 462.9 million under the compensatory financing facility.

For more than two decades now, the Indonesian authorities have followed strong macroeconomic adjustment policies, usually well timed and well measured. These policies have helped the country through some exceptionally serious external disturbances. Thus the stage was set for economic growth which, as the Indonesian experience shows, is not an alternative to adjustment but which accompanies and follows adjustment. Even in economic policy, fashion is apparently sometimes preceded by the avant garde. There are three subjects which I would like to discuss: structural or supply-side policies, budget policy, and exchange rate policy.

On the first of those subjects, while the stage has been set for economic growth, the question is whether the opportunities that exist are being fully exploited. One may even wonder whether rigidities on the supply side in the Indonesian economy are not becoming more and more of a hindrance to further growth. This is of course difficult to measure. Import regulation through licenses, certain monopoly situations, an extensive system of public enterprises, restrictive licensing on private investment, both national and foreign, are all issues which have long been recognized in Indonesia. In fact, the balance between regulation and deregulation has had to be reconsidered time and again. Considering the measures taken recently by the authorities, this apparently is a time of reconsideration. But I would like to urge them to continue to implement structural policies, and even to accelerate the process insofar as the necessary consensus permits. More foreign investment can play an important role in this respect. I note that net private investment in Indonesia represents 8 percent of other net capital inflows in the period 1980-85, whereas it was 11 percent for Nigeria and 25 percent for Mexico. Net private investment flows into Malaysia actually were higher than other net capital inflows. Thus, there certainly appears to be room for more foreign investment financing in Indonesia. Such financing of course also means a diminished fixed-debt burden over time, which seems better than the debt-equity operations to which some countries have to resort to solve an unbearable debt burden.

Budget policy, the second subject, corrected for the effects of lower revenue from the oil sector, has been tightened considerably. The brunt has been borne by expenditure restraint. Like the staff, I feel that continuous caution is needed with respect to the public finances in view of the heavy debt service burden. Nevertheless, I wonder whether continued restraint in expenditure is feasible or warranted, after the significant cuts that have taken place, notably in development expenditure, and in view also of the continued freeze in civil sector wages that ultimately will give rise to tensions. I also note that Indonesia has for many years had a problem with providing sufficient rupiah counterpart funds for foreign-aid projects because donors usually insist on financing only the foreign exchange part. Understandably, ahead of this month's elections, revenue-raising measures were difficult. I do feel, however, that in the future a greater effort to raise revenue is warranted. In this respect, strengthening of the tax administration is crucial, but enlarging the tax base and increasing tariffs should also be contemplated. After all, as the staff notes, Indonesia's tax effort is weak compared to that of other countries.

The third subject is exchange rate policy. I share the staff's support for the measures taken in September 1986. I might also be able to support the staff's remarks about the authorities' commitment to pursue a flexible exchange rate policy designed to safeguard gains in competitiveness, depending on a clarification from the staff. In the appraisal the staff remarks that the emergence of market expectations of a fixed relationship between the rupiah and another major currency would appear undesirable in that it would limit the flexible management of the exchange rate. If that major currency is itself rather unstable--and that may now be the case--then there is indeed a problem. If that major currency was stable, then a certain stability of the rupiah would have advantages. It is an advantage for both exporters and importers to be reasonably certain about the exchange rate; in addition, commitment to a stable rate is a disciplinary element because it is a commitment to a stable internal economy.

If flexible management of the exchange rate means that an adjustment of an overvalued or undervalued currency to fundamental underlying changes should remain a possibility, then I would agree. If a flexible exchange rate means that the exchange rate is just another policy instrument to be used as an alternative, for instance to monetary policy, or fiscal policy, in maintaining or improving a country's competitive position, then I would disagree. Am I right that the policy of aiming for a stable real exchange rate is supported by the staff?

Mr. Hodgson made the following statement:

The last four years have seen Indonesia challenged by difficult external circumstances. For the most part, the authorities have been equal to this challenge. Further necessary efforts were undertaken during 1986 to strengthen both macroeconomic and structural policies. Although the economy continues to grow slowly by Indonesian standards, and both the fiscal and external current account deficits have increased, the situation could have been far more difficult if the appropriate policy reforms had not been implemented. The fact that we are holding only an Article IV consultation today, and not discussing a stand-by arrangement for Indonesia, is testimony to the cautious and correct fiscal, monetary, and exchange rate policies which have been implemented.

I shall begin my more specific comments with fiscal policy, where Indonesia has demonstrated continuing efforts to limit the fiscal impact of lower oil revenues. The revised numbers in the supplement to the staff paper, which show stronger revenue performance leading to a lower than anticipated overall deficit in 1986/87, are welcome. Looking ahead, it is imperative that Indonesia continue to implement measures to strengthen revenues from outside the energy sector, and thereby reduce the extent to which the deficit reduction exercise will have to rely over the medium-term on reducing development expenditures, including reductions in counterpart funds, as just noted by Mr. Posthumus.

The authorities' intention to increase revenues during 1987/88 through improved tax administration and larger transfers from public enterprises seems ambitious on the surface. However, the stronger than expected revenue performance during 1986/87 suggests that the authorities' fiscal goals in terms of revenues, expenditures, and the overall deficit can be realized. We welcome the plans to strengthen coverage of the parastatal sector, as well as Fund and Bank efforts to provide technical assistance on consolidation of the public sector accounts. One final specific comment on the fiscal area: implementation of the tax on interest-bearing accounts might be one means of simultaneously broadening financial markets and increasing revenues, but changes will need to be introduced carefully to avoid encouraging capital flight.

Briefly, on monetary policy, I would tend to support the staff view that current circumstances require as strong a foreign reserve position as possible, which might therefore require more active interest rate and exchange rate policies. Certainly, I understand the authorities' desire to have a stable environment for interest rates and exchange rates, but that stability should not be gained at the expense of depleted foreign exchange reserves. Similarly, I agree with the staff that the authorities' commitment to contain the growth of credit for the public sector is welcome and necessary.

Another impressive element of the authorities' strong adjustment policies during the last year has been the depreciation of the rupiah in real terms. I fully welcome the commitment to pursue a flexible exchange rate policy, which is imperative if the export base is to be diversified and if import demand is to be contained. However, other structural changes will be needed to buttress the exchange rate action. To that end, some progress has already been made toward reorienting the traditional inward-looking investment strategy, and Mr. Ismael has outlined a number of measures taken during the last year to reduce the anti-export bias inherent in the trade and licensing systems. However, I would like to ask Mr. Ismael whether the authorities might reconsider establishing a timetable for the implementation of new structural initiatives, particularly in the area of tariff reform. As the staff points out, such a timetable would help to diminish the uncertainty confronting investors regarding the degree of protection they can expect over the medium term.

One theme running through the staff paper is Indonesia's increased reliance upon external financing, and its increasing debt service burden. While the increase in external liabilities during the past few years was probably unavoidable if Indonesia was to grow and adjust simultaneously, Indonesia has now reached the upper limit of a manageable external debt burden. The debt service ratio is approaching 40 percent of exports, and in the staff's medium-term projections, the debt service ratio declines, but only to 35 percent in 1991/92. In fact, even in the more favorable scenarios with higher oil prices and a tighter fiscal position, the debt service ratio is projected still to exceed 30 percent five years from now. These projections simply reinforce the staff view that the Indonesian authorities will need to persevere in the implementation of adjustment policies, even if the external circumstances improve. The authorities have a solid track record for adjustment and for good policies, a record which needs to be maintained.

Turning now to the request for compensatory financing, I can support the proposed purchase of SDR 462.9 million. We are satisfied that the criterion with respect to cooperation with the Fund has been met, and have no trouble with the shortfall calculation. As for the criterion of the shortfall being beyond the control of the authorities, Indonesia's share of world petroleum exports, at about 5 percent, and its participation in OPEC suggest that Indonesia can, to some extent, influence petroleum market behavior and thus influence a large share of its export earnings. However, the proposed purchase under the compensatory financing facility is very small relative to the calculated shortfall, and is in fact even smaller than the calculated shortfall arising from liquid natural gas exports and other nonenergy exports. I also note that Indonesia has increased its volume production of crude oil, and is now producing at a high rate relative to available capacity, which in effect has lowered the potential size of the calculated shortfall. Taking all these factors into consideration, we feel that Indonesia qualifies for the proposed purchase.

Mr. Pineau made the following statement:

At this stage of the discussion, I shall be brief as I mostly share the opinions already expressed. In the face of a serious deterioration in the external environment, the Indonesian authorities have reacted promptly and convincingly. This willingness to come to grips with adverse effects associated with exogenous shocks is acknowledged by the staff; the various remedial actions initiated by the authorities are very well expressed in Mr. Ismael's statement; their scope is impressive.

The general lines along which the ongoing economic adjustment is being carried out appears appropriate. I would just like to make a few remarks on some aspects of this policy.

Regarding public finance, the steps already taken to trim the deficit were necessary. However, on the expenditure side one could have the impression that the burden of adjustment placed on development expenditure is excessive. In a country where the population increases at a rate of 2.2 percent a year, the preservation of development potential would seem a high priority. It might prove possible, while keeping downward pressure on current expenditures, to take a less restrictive approach to development outlays by enhancing revenues from indirect taxes. The relatively small economic size of the general government could in fact allow for fiscal consolidation based more widely on revenue measures. The most recent indications in the supplement to the staff paper are welcome, since they appear to go in this direction.

With respect to monetary policy, as implied in the staff report, a more active if not restrictive approach seems warranted. In 1986 the contractionary impact of the loss of external reserves was offset by an expansion of internal credit. A flexible exchange rate policy is certainly helpful in easing the pressures on external assets, but it should be accompanied by stricter control over domestic monetary sources. As for the more active interest rate policy called for by the staff, I wonder whether the temporary firmness of short-term interest rates witnessed last December does not offer conclusive evidence of the authorities' determination in this area. Yet another consideration which may point to a relative tightening of the monetary stance has to do with the potential inflationary impact of the recent and substantial depreciation of the rupiah. In such circumstances, a closer monitoring of liquidity can be of some significance.

On the external front, allow me to touch upon the request for compensatory financing, a noteworthy feature of which is the marked discrepancy between the estimated shortfall and the proposed amount of the drawing. In any case, it would seem to have been difficult to offset completely such a large shortfall, and I note that the purchase will only cover, more or less, the shortfall experienced by Indonesia on its nonenergy exports.

In our opinion, the various requirements for a compensatory financing purchase are clearly met, particularly as regards cooperation with the Fund. I thus have no difficulties in supporting the proposed decision.

Mr. Noriega made the following statement:

Indonesia's adjustment to the fall of international oil prices in the early 1980s was in general terms remarkable, leading as it did to the attainment of domestic and external equilibria. However, the measures taken during those years were not able to reduce the dependence of foreign exchange earnings and government revenue on oil exports. The oil price fall at the outset of 1986 therefore constituted a major drawback to the country's economic policy. It is, nevertheless, encouraging to see how the authorities quickened the pace of adjustment. As a result, inflation was reduced by more than half between the fiscal years ending in 1984 and 1986, non-oil GDP has sustained a positive rate of growth since 1982, and non-oil exports have continuously increased while imports have been simultaneously curtailed. The most important measures that brought about these results were a very active exchange rate policy, which was geared to stimulating export competitiveness; an austere fiscal policy, which was able to maintain current expenditures relatively constant as a proportion of GDP; a significant liberalization of the financial system, which enabled Indonesia to retain and efficiently allocate domestic savings; and, finally, incentives to promote investment, particularly in the export sector.

We are of the view, however, that the adjustment proceeded at a pace slower than warranted by circumstances, and that it has been insufficient. What seems to be more worrisome is that the economic targets for the near future may be similarly characterized. The insufficiency of the adjustment has rendered the economic fabric more vulnerable to external shocks, and its slowness has resulted in a substantial accumulation of external debt that further complicates the adjustment process.

Before I address some issues which might have a bearing on the policies to be pursued during 1987, let me recall that in two previous instances when the terms of trade deteriorated abruptly, the authorities embarked on comprehensive adjustment programs. This time, Mr. Ismael's statement indicates once again the willingness of the Indonesian Government to adopt appropriate policies.

Regarding fiscal policy, the first issue that may become a source of concern is the apparent slackening in revenue. According to the figures provided in Annex I to the staff report, non-oil related revenue is estimated to increase by an amount equivalent to 1.8 percentage points of GDP between the fiscal years ending in 1983 and 1987. However, the share of this item is projected to decline in the next fiscal year, despite the fact that the rate of growth of non-oil output will accelerate significantly. We would like to hear from the staff what could cause the income elasticity of revenue to fall.

The slight increase projected in the share of overall revenue in GDP rests on an increase of oil-related revenue deriving mostly from a firming of international oil prices, an outcome that would further increase reliance on the oil sector. We believe that the expected dynamic growth of output in the non-oil sector must provide an opportunity to strengthen the tax effort.

The overall fiscal deficit is expected to be reduced by 2.5 percent of GDP as a result of a decline of close to one point in current expenditures and one and a half points in investment expenditure. Notwithstanding these measures, current expenditures will still remain above the level in any of the previous four years, and investment at a level close to one half the average in the same period. These results, moreover, are dependent on measures which have yet to be announced.

The second issue that may deserve further analysis refers to some of the financial targets. In the staff report it is stated that an effort will be made to increase the foreign-financed share of investment projects. Mr. Ismael's statement confirms this intention. In fact, for the fiscal year ending in 1988, foreign financing to the public sector will exceed the overall budget deficit. This source of finance may be reflected in an expansion of domestic liquidity unless the monetary authorities sterilize the inflows, or unless the resources flow out via the current or capital accounts of the balance of payments. However, the scenario for the coming year does not envisage an accumulation of foreign exchange; moreover, concern is expressed in the report on the need to contain domestic credit expansion. I would like to learn from the staff if it expects money demand to grow sufficiently fast to avoid pressures on the balance of payments.

Despite these two caveats on policies for next year, we recognize the earnest and in general adequate effort made by the authorities to adjust to worsened terms of trade. The test of cooperation also having been met satisfactorily, we are prepared to endorse their request for the use of resources under the compensatory financing facility.

Mr. Sliper made the following statement:

In our view 1986 marked a good year for Indonesia in terms of economic policymaking. As the appraisal in the staff report together with Mr. Ismael's statement make clear, Indonesia suffered from a substantial decline in oil revenues plus a very large increase in debt servicing costs due to exchange rate changes. However, the authorities have reacted very positively to these adversities. The packages that were introduced in May and October 1986 and in January 1987 were comprehensive and were mutually reinforcing in encouraging a more outward-looking policy stance.

We were particularly pleased with the moves to dismantle many of the licensing restrictions surrounding the industrial sector and also the moves to improve the performance of the public enterprises. I am aware of foreign firms engaged in joint ventures in Indonesia that have been frustrated at the amount of red tape surrounding Indonesia's industry. The moves to simplify the licensing and administrative framework will be most welcome. It is hoped that the authorities will press ahead with the more outward-looking policies that have been adopted. Still, much remains to be done in this area.

Similarly, the public enterprise sector has been a weak area of economic performance in recent years and improvements are required. Big efficiency gains can be expected as these public enterprises accounted for about 10 percent of gross investment in Indonesia over the past year.

In short, there is much encouraging news in the adjustment measures that have been introduced in the last year, and these should enhance the growth prospects of the economy in the medium term.

We support the proposed decision to provide Indonesia with the use of Fund resources under the compensatory financing facility. We are satisfied that the Indonesian case does meet the criteria which have been established, although the criterion of balance of payments need would not seem to be strongly met. However, the justification that has been provided of cooperation with the Fund and the calculations on the nature of the export shortfall are convincing. In our view, the provision of finance will assist in reinforcing the close dialogue that has built up between the Fund and the World Bank and Indonesia at the present time. It should provide a spur to the authorities to continue with the policy reform program that Indonesia has embarked upon over the last year. We support the proposed decision.

Mr. Foot said that he could be brief as the staff report for the Article IV consultation was comprehensive and well focused. As Mr. Ismael's statement made clear, there were no substantive points of disagreement between the staff and the authorities. Another justification for brevity was the point made by several previous speakers that, although Indonesia's external circumstances were difficult and sizable imbalances were currently evident in the economy, the authorities had a good record of careful and well-aimed responses to their problems.

He could strongly endorse the need for caution in and close monitoring of both fiscal and monetary policy, Mr. Foot remarked. That was all the more important because of the vulnerability of the rupiah to speculative pressure, as had been seen in December and January. He also joined those who had urged the authorities to press on as fast as circumstances allowed with opening up their economy to foreign investment and with the measures that they recognized would be needed to reap the benefits of trade liberalization and to permit the development of a more effective domestic capital market. Despite the measures taken so far, there still appeared to be effective monopolies or oligopolies on the importation of a number of essential goods. There was in addition, as had already been pointed out, a good deal more to be done in opening up the country to foreign investment.

His remarks on the request for compensatory financing could also be brief, Mr. Foot said. Indonesia clearly met the necessary test of cooperation with the Fund and that of balance of payments need. The fact that Indonesia had sizable gross foreign exchange reserves was not, in his view, a relevant factor, because on a net basis, the figures were not inappropriate for a country of Indonesia's size and indebtedness. So far as the details of the request for compensatory financing were concerned, the calculated shortfall was so large and so well spread between exports that, following the case-by-case approach that he had consistently endorsed, he had no difficulty supporting the proposed decision.

Mr. Goos commented that he was in full agreement with the staff appraisal and with the views expressed in Mr. Ismael's statement. He joined previous speakers in explicitly welcoming the encouraging results the authorities had achieved so far with their adjustment strategy. Like others, he found it particularly noteworthy that notwithstanding the remarkable success in containing financial imbalances and inflationary pressures, economic activity had continued to expand at considerable rates of real growth--an achievement that undoubtedly had to be attributed to the ongoing structural reform measures, including the 1986 currency devaluation. Against that background, the authorities' determination to continue their adjustment effort, as highlighted by the commendable targets set for the fiscal and current account deficits, was most encouraging and, he believed, commensurate with the difficult external situation of the country. The paramount importance of a continued restrictive stance of domestic financial policies was clearly underlined by the medium-term scenarios discussed in the paper. In that respect, it was somewhat puzzling, if not disappointing, to him that the better than expected budgetary performance reported in the supplementary paper for the past year could not be translated into a similar improvement in the external current account, beyond the original staff estimates presented in the staff report. While the upward revision in economic growth, which in itself was of course welcome, might be partly responsible, the monetary policy stance in the past year might also not have been sufficiently restrictive. Another indicator pointing in that direction was the unexpected substantial widening of the errors and omissions item, suggesting--inasmuch as it reflected private sector capital outflows--that domestic financial assets were not sufficiently competitive with external investment opportunities. Although he recognized the desirability of providing adequate financial support to the private sector, in particular in view of the increasing role being assigned to it by the authorities, he believed that the development he had mentioned underlined the importance of both maintaining adequate monetary restraint and further curtailing credit demand of the public sector. In turn, the arguments in favor of a forceful reform of public sector enterprises were also reinforced.

To conclude his remarks on the adjustment strategy of the authorities, Mr. Goos said that he stressed, like Mr. Posthumus, the potentially important contribution that foreign direct investment could make toward easing the existing external constraints. Therefore, he encouraged the authorities to further enhance the attractiveness of their economy to such investment. To be sure, the ongoing efforts of structural reform and liberalization should go a long way toward achieving that objective. But, as the staff report clearly indicated, there was still a considerable distance to go before the objective of a truly market-oriented and outward-looking economy would be achieved. At the same time, the stagnant inflow of direct investment projected by the staff for the current year led him to wonder whether the authorities should not engage in more specific efforts to stimulate stronger growth of such inflows by reducing existing impediments and perhaps providing more explicit incentives.

Finally, as regards the requested drawing under the compensatory financing facility, Mr. Goos considered that as all the requirements for such a drawing were met, he could support the proposed decision. In doing so, he wished to express admiration for the continued adjustment efforts of the Indonesian authorities and for the fact that those efforts were being pursued in close cooperation with the Fund. The issue of whether compensatory financing would be justified for members of commodity cartels was of little practical relevance in the case of Indonesia since the requested drawing was considerably lower than the shortfall calculated for non-oil exports.

Mr. Finaish made the following statement:

> The sharp decline in oil prices, the continued weakening in the prices of other primary exports, and the substantial depreciation of the U.S. dollar against currencies in which part of its external debt is denominated, have all combined to adversely affect Indonesia's economic performance in 1986. These adverse developments have considerably impeded Indonesia's adjustment strategy, in place since 1983. Indeed, the economic outturn for 1986 undoubtedly would have been worse had it not been for the broad range of adjustment measures undertaken by the authorities during the year.

The thrust of the recent shift in fiscal policy toward further expenditure restraint and revenue enhancement is broadly consistent with the financing constraints facing Indonesia. However, efforts should be made to moderate cutbacks in development outlays and to mitigate their adverse consequences on future growth. Therefore, greater emphasis should be placed on cutbacks in current expenditures, and on domestic resource mobilization. Of particular importance for strengthening the fiscal position is also the continuation of the ongoing quest for increased economic efficiency through structural reforms.

Notwithstanding the shift toward monetary restraint, the authorities continue to face difficulties in limiting domestic credit expansion, partly out of the desire to promote private sector activity. Needless to say, however, restraint in credit expansion, in support of fiscal retrenchment, will be crucial for combating inflation, alleviating downward pressures on the exchange rate, and containing external imbalances. Regarding the interest rate, both lending and deposit rates are significantly high in real terms, suggesting perhaps excessive reliance on the interest rate mechanism to compensate for other policy measures. In this connection, the staff may wish to elaborate on the factors underlying the large spread between deposit and lending rates that is mentioned on page 14 of the staff report.

In addition to measures of financial austerity, we have noted the steps taken in the areas of the exchange rate and structural reform, which are expected to promote growth of the nonenergy sector as well as strengthen the external sector. In addition to a large exchange rate devaluation, three reform packages to liberalize external trade and industrial policies have been introduced in 1986 and early 1987. We welcome the fact that the reform process is to be continued in the period ahead and is being supported by other measures to encourage efficiency in production and improve external competitiveness of the economy, as explained in Mr. Ismael's helpful statement. In order for these efforts to succeed, however, it is essential that Indonesia's exports do not face an intensification of protectionism abroad, particularly at a time when Indonesia is undertaking substantial liberalization of its import system.

The authorities are to be commended for their prompt policy response to cope with the emerging economic difficulties. Although difficulties still lie ahead, the authorities' strong policy response as well as the broad resource base of the economy are sources of optimism in Indonesia's economic outlook. As pointed out by the staff, however, there are downward risks regarding the achievement of the medium-term targets, including, in particular, the uncertainty surrounding price assumptions.

Turning to Indonesia's request for a purchase under the compensatory financing facility, and the amount being only one seventh of the total shortfall, the detailed analysis of the staff shows that the request meets all the relevant requirements, and we, therefore, lend it our full support. I hope that wide support for this request will demonstrate the Fund's intention to apply the compensatory financing facility's rules with respect to oil exporting countries in an evenhanded fashion in full conformity with the case-by-case approach adopted by the Board in 1983.

I wish to add, however, a couple of observations on some aspects of the staff's analysis of oil production policies. The first is related to the staff's emphasis on the high capacity utilization in Indonesia's oil sector. It may be recalled that this point was brought up for the first time last year in connection with Ecuador's request for a compensatory financing purchase. Since this point is coming up again, I am concerned about the evolution of capacity utilization as a criterion for whether or not a given export shortfall is beyond the control of the member. The staff has underlined in several places in its paper, as it did in the paper on Ecuador's request in 1986, the fact that capacity utilization in Indonesia has been relatively high. This, of course, is a statement of fact and it is not at all surprising given that Indonesia's maximum production capacity is declining. I hope, however, that the emphasis on this aspect in the paper is not intended to mean that high capacity utilization is necessarily a condition for fulfilling the beyond-the-control criterion. Obviously, if high capacity utilization is expected of members requesting compensatory financing purchases, the implications for exporters of depletable natural resources could be quite serious. The rate of depletion that a country considers optimal depends on a whole set of factors, including, among other things, its stage of development and the availability of other resources.

A related point that the paper also mentions in more than one place is that the increase in the volume of exported oil during the shortfall year has reduced the size of the potential shortfall. This may be the case when a higher export volume by one producer does not also reduce prices, either as a direct result of that exporter's action or because of the reaction of other exporters. In this particular instance, it may well be the case that a lower export volume would have resulted in a larger shortfall. It does not follow, however, that a lower export volume will in all cases lead to lower export incomes and larger shortfalls. This is particularly so when a production agreement is in place. To argue otherwise would be to ignore the interrelatedness of producers' actions, which exemplifies a fallacy of composition, perhaps even a strong version of it. What appears to be true for an individual producer when considered in isolation may turn out to be otherwise as a result of the likely reaction of other producers.

Mr. Dallara made the following statement:

When the Board reviewed Indonesia's economic situation in February of last year, it was already clear that the decline in the world price of oil would have severe effects on Indonesia's fiscal and external positions. These, of course, have materialized, perhaps to a degree not fully anticipated, and yet the response of the authorities has generally been commendable: notably, the devaluation of the exchange rate, the constraint imposed on certain areas of public expenditures, and the continued forward progress in key areas of structural reform, particularly trade liberalization.

With regard to fiscal policy, fiscal deficits have not been the problem in Indonesia that they have been in other major debtor countries. Nevertheless, the sharp drop in oil revenues last year and the uncertain prospects for such revenues in the future have added a degree of urgency to the need to deal in a lasting way with fiscal problems. The reaction of the authorities has generally been encouraging, but additional efforts to consolidate the gains achieved and ensure that they will be lasting are clearly needed. On the revenue side, some progress has apparently been achieved in stricter tax compliance, but additional efforts may be required, such as a broadening of the value-added tax base, and the possibility of removing the tax exempt status of interest on bank deposits. On the expenditure side, the freeze of government salaries, and the sharp cutbacks in development expenditures that have been imposed, can have a prompt and substantial effect in reducing the deficit. But, clearly there are limits to the extent to which these areas can serve as the principal source or the centerpiece of fiscal containment. And, depending on revenue developments in the period ahead, we would encourage the authorities to focus closely on other areas of current expenditures that might help take up part of the fiscal adjustment effort. We strongly support the assistance being provided to the authorities by the World Bank and the efforts of the authorities in assessing and determining public investment priorities. We also would endorse the technical assistance being given by the Fund and the Bank in improving fiscal accounting.

In the monetary area, the attempt late last year to stabilize interest rates and the exchange rate in order to promote confidence and support economic activity does raise some difficult policy questions. While we can understand the motivations which lay behind the efforts of the authorities, on balance, we are rather persuaded by the staff's urging that in the future both interest rates and exchange rate policy be employed more actively to defend reserves, should that prove necessary.

Certainly the substantial devaluation last September was a bold move, and the chart provided to us demonstrates a very clear and substantial drop in the real exchange rate since early 1985. This should be very helpful in creating an incentive for non-oil exports and, in particular, in facilitating the ongoing process of trade liberalization. We would also encourage further efforts in this area, as well as in liberalizing further the foreign investment regime where progress, while notable, is perhaps not quite as advanced as in the trade area.

Over the medium term, Indonesia's balance of payments and foreign debt prospects appear to be moderately optimistic. Nonetheless, the level of foreign debt is expected to remain quite high, and the annual gross borrowing requirement will still average around $5 billion a year in the next few years. The second scenario developed by the staff, which assumes an oil price of $18 per barrel, with the additional revenues not being spent, does clearly present a somewhat more comfortable medium-term outlook. Whatever the price of oil, however, it is clear that Indonesia's foreign debt position will require continued careful and cautious management in light of the recent substantial deterioration in the external accounts. We would support staff's cautionary comments and recommendations concerning debt management and, in that connection, their recommendations concerning central bank swap activities.

Turning to the request for compensatory financing, I will briefly review our assessment of how this request meets each of the criteria for use of the facility. First, there is no doubt in our minds that Indonesia meets the balance of payments needs test. Second, on balance, we would agree with the staff that the export shortfall is of a temporary nature, although we do have some concerns about certain components of the shortfall that appear to derive from a secular decline in exports. Third, we believe that Indonesia has had a good record of cooperation with the Fund and its recent policy efforts demonstrate clearly its continued strong cooperation. As with a number of compensatory financing cases, however, the question of whether or not the shortfall is due to circumstances largely beyond the control of the authorities is, in our view, a somewhat more difficult one, particularly with regard to the oil component of that shortfall. The recent volatility in the oil market does make it difficult to make judgments, particularly considering that the shortfall calculation, as usual, covers a five-year period and in this case involves projected data. While it is true that the Indonesian authorities have historically produced quite close to capacity, being well above the average of OPEC members during the period 1983 to 1986, the existence of unused capacity averaging nearly 20 percent of the total in this period does, in our view, raise some questions. Indonesia is a significant player in the international oil markets and has played an active role in support of periodic efforts by OPEC to control or influence oil production and pricing. It is not, however, in our view so difficult to reach judgments on other components of the shortfall, and clearly the non-oil components of the total shortfall substantially exceed the size of the requested drawing under the compensatory financing facility. We are, therefore, able to conclude that the shortfall is due to circumstances largely beyond the control of the authorities, without having to reach a judgment on any particular component of the shortfall.

In conclusion, Indonesia has been hard hit by the decline in world oil prices. The impact of this development added to an already rather difficult balance of payments and foreign debt problem. Nevertheless, Indonesia has responded effectively and in a timely fashion to the difficult circumstances which have developed in the last year or so. We look forward to its continued impressive economic adjustment efforts and are certainly happy to support the compensatory financing facility request before the Board as part of the Fund's continuing cooperative support of those efforts.

Mr. Hubloue made the following statement:

It is most encouraging to learn from the staff and from Mr. Ismael's statement that the Indonesian Government has promptly responded to last year's sharp shortfall of export revenues by initiating comprehensive adjustment policies aimed at improving the efficiency of the economy and reversing the weakening of the current account. The chances that these policies will succeed in reorienting the Indonesian economy are strengthened both because the policies were implemented before the external situation got completely out of hand, and because Indonesia's past record of cooperation assures us that the operation of the adjustment policies will be monitored in close collaboration with the Fund. I therefore fully support the requested purchase under the compensatory financing facility, not only because this request satisfies all the legal conditions for its approval, but also because the assistance is symbolic of the close cooperation between the Fund and Indonesia and will, we hope, have a positive effect on the confidence of the international banking community. Since I am in broad agreement with the staff's assessment of Indonesia's economic prospects and adjustment policies, I will comment only briefly on a few issues which seem to be of special importance to the structural improvement of the economy, notably, investment and public enterprises, tax administration, and exchange rate and trade policies.

The existence of a large and cost-inefficient public enterprise sector has long been a problem for the Indonesian economy, and I welcome the Government's present concern for improving the efficiency and profitability of public enterprises. This concern should in time be translated into clear and firm principles imposing on the enterprises the necessity of arriving at pricing and production decisions on the basis of market signals. The staff's suggestion for a comprehensive review of pricing policies to improve their transparency and detect distortions deserves all our support; such a review should begin without delay.

An even more radical reorientation of Indonesia's production system could be initiated through the privatization of enterprises. And although any initiative of the authorities in this direction is to be supported, I would add that such a policy can succeed only if it is implemented in combination with a far-reaching liberalization of the present system of investment licensing and of the restrictions on the use of facilities for the production of specified goods. Such administrative schemes represent a strong and permanent barrier to the productive allocation of domestic resources. Moreover, they also encourage the outflow of domestic capital and discourage foreign direct investment. The steps recently taken to liberalize the investment and production system are therefore extremely important, and I join other speakers in encouraging the authorities to take further actions in this area, since it is precisely to foreign direct investment that a country like Indonesia should look for long-term solutions to its debt and growth problems.

On fiscal and tax policy, the current shift of the structure of government revenues from oil and gas to general tax income and the intention of holding the budget deficit to sustainable levels provide clear evidence that Indonesia is on the right track. In this context, the improvement of yields from the value-added tax is a most encouraging sign. This unexpected success indicates that the base of economic activity from which taxes can be generated may well be considerably larger than currently acknowledged and should encourage the authorities to intensify their efforts to achieve a broader based tax structure. Continuation of Fund and World Bank technical assistance in this area would be desirable.

The exchange and trade systems represent a third area where reform is a critical ingredient of progress with structural adjustment. The authorities' commitment to conduct a more flexible exchange rate policy than in the past is a central element of their adjustment strategy and should be supported by thorough liberalization of their trade system to enable the new exchange rate policy to exert its full effects in terms of efficient resource allocation, external competitiveness, and diversification of trade. Welcome steps have already been taken toward liberalizing Indonesia's complex and pervasive system of import restrictions, but I agree with the staff that if the momentum of the present reform effort is to be maintained, further liberalization and streamlining is urgently needed. Only when a firm stance has been established with respect to systematically reducing protection in the economy can the other major reforms which are planned in the areas of investment and the public enterprises yield their expected benefits in terms of improved internal efficiency and international competitiveness.

In conclusion, the policy path to which the Indonesian authorities have been guided by last year's adverse balance of payments developments combines all the elements necessary to support expectations of durable adjustment and growth. I have the impression, however, that in a number of important areas, such as the reform of the investment and production systems and the liberalization of trade, the adopted policies will need to be embodied in still more comprehensive and perhaps more explicit reform schemes if lasting success is to be achieved.

I am confident that the authorities are fully aware of the need for additional measures, and I encourage them to do all in their power to keep the present momentum toward reform alive.

Mr. Lundstrom made the following statement:

The year 1986 was an extremely difficult one for the Indonesian economy. As oil prices collapsed, the authorities realized that it would not be possible or prudent to continue financing large deficits in the medium term. Additional comprehensive adjustment became a necessity. With a record of rather successful adjustment in recent years, it is not surprising that Indonesia has addressed its present problems resolutely. The strategy chosen and the measures taken are commendable.

Preliminary evidence suggests that some measures have already had a positive effect. The widening of the current account deficit was contained and the outlook is for a clear improvement. The provisional estimates of the 1986/87 budgetary outturn are somewhat better than was foreseen, and the deficit may be expected to narrow, thanks to the austerity measures taken. However, the economy has also paid a price in terms of slower economic growth. Unfortunately, the projected adjustment of the Indonesian economy will require continued restraint over the next couple of years.

In the area of fiscal policy, there will be no scope for a relaxed stance in 1987/88, even if oil prices are firming somewhat. Thus, the authorities' commitment to continuing the tight policy stance is welcome and their intention to reduce current expenditures is well founded. If effectively directed, this reduction can serve to correct distortions in areas where subsidies are excessive. The effects of budgetary austerity on development expenditures, as indicated in Mr. Ismael's interesting statement, are deplorably severe. Hopefully, by setting carefully considered investment priorities, it will be possible to mitigate the repercussions on future growth of declining development expenditures. On the revenue side, I hope the success experienced in mobilizing revenues for the previous budget will persist, but further progress should be sought along the lines indicated in the staff paper.

The authorities' flexible exchange rate policy seems well designed to safeguard gains in competitiveness. I am somewhat puzzled, however, by the way monetary and exchange rate policies were interacting in the speculative situation late last year. In an attempt to maintain the prevailing domestic interest rate level, the authorities had to inject liquidity into the economy. This may have further fueled speculation and led to an increased drawdown in foreign assets. Another route might have been to make a quick decision to allow the rupiah to depreciate, thereby saving foreign assets and avoiding the injection of liquidity.

Indonesia's medium-term prospects will be tightly constrained by its balance of payments. The authorities have not only responded promptly on the demand-management side to the sharp fall in oil prices, but they have also initiated structural measures, in particular to redress the long-standing distortions in the trade and investment incentive regime. The measures taken in the form of three similarly oriented packages in 1986-87 have reduced the scope of import license restrictions and signaled the authorities' intention to move to tariffs as the primary instrument of import policy.

I also note with satisfaction the changes in the export certificate scheme and the accompanying increases in the interest rates on export credits. The schedule for reducing the export subsidies seems to be a reasonable one, and appears to provide sufficient room for exporters to adapt to the situation.

However, in spite of the measures taken, trade practices still remain restrictive in a number of areas. Therefore, further liberalization measures are desirable. To realize the full potential of the trade reforms, complementary actions will also be required to relax restrictive licensing arrangements on private investment and domestic trade. In order to prevent excess capacity in domestic industry and to avoid monopolistic or oligopolistic market structures, the emphasis of licensing policy needs to be further shifted from investment regulation to investment promotion.

The request for compensatory financing is for only about 45.8 percent of quota, a figure arrived at, as I see it, to be within the 50 percent limit and in the lower tranche. The estimated shortfall is almost seven times as large as the proposed purchase of SDR 463 million. The export shortfalls are in respect of both oil and non-oil products and are mainly due to the sharp decline in prices of exportable commodities, which is clearly outside the authorities' control. In fact, the proposed purchase is also well below the shortfall in exports of non-oil commodities. The authorities' track record in respect of cooperation with the Fund and adjustment policy stances are, as everyone has stressed, commendable. In the circumstances, I wonder whether Indonesia could not have been allowed larger access than provided for. This is one of the few cases where the traditional link-up with a stand-by arrangmeent would not have been necessary, even if the access had been raised to the maximum permissible level.

Mr. Zecchini made the following statement:

Unfavorable external developments hit the Indonesian economy last year, leading to a reduction of foreign exchange earnings, a deterioration of the current account balance, and an increase in the debt service burden. Several significant corrective measures have been taken by the authorities, as indicated in Mr. Ismael's helpful statement, and, notwithstanding the adverse circumstances, the country was able to raise its rate of GDP growth to 2.5 percent. In spite of the output expansion in the nontraditional sectors, Indonesia's economy continues to depend to a large extent on oil output and exports. In such a context there is no doubt that in order to achieve sustained and stable growth the authorities need to persevere in their efforts to diversify the economy. In the light of this overall objective, we will comment briefly on macroeconomic and structural policies.

As to fiscal policy, further efforts should be made to reduce the budget deficit in the coming year. To this end the authorities should strictly adhere to their commitment to cut significantly current expenditures, which have been increasing during the past year, and to take a more cautious attitude with respect to capital expenditures. The public investment plan should be re-examined with a view to concentrating resources on the most valuable projects from the point of view of production diversification and export enhancement. In order to reduce the dependence of budget revenues on the performance of the oil sector, it is necessary that further improvements be sought in the collection of non-oil taxes. In this respect there is room for maneuver to strengthen tax administration. Overall, the authorities expect that the fiscal measures envisaged for 1987/88 would help reduce the budget deficit to 2.2 percent of GDP. In spite of this improvement, we believe that the fiscal stance should not be relaxed in case oil prices turn out to be more favorable. We share the staff's view that given the magnitude of the country's foreign debt, any "degree of freedom" made available by external circumstances should be utilized to reduce the debt burden.

In the coming fiscal year, monetary policy will have to aim at fostering the output diversification process by providing a stable price environment, notwithstanding the flexible exchange rate policy recently adopted. Monetary management will also have to take into account the need to induce capital inflows and to safeguard the level of net foreign assets in order to avoid the losses that have occurred in the past year. A more active interest rate policy will therefore be necessary. It is also necessary that the authorities improve the monitoring of credit aggregates by upgrading money and banking statistics. To this end, we support the continued collaboration with the Fund in the context of the technical assistance program.

As we have already mentioned in the case of other economies highly dependent on the export of one single commodity, exchange rate policy can play a key role in the output and export diversification strategy. Through the expenditure switching effect, a depreciation of the domestic currency could boost profitability and output in the "traded goods" sectors and particularly in the "non-oil" sectors. Therefore, we welcome the recent devaluation of the rupiah and the authorities' decision to monitor exchange rate developments more actively, on the basis of a basket of currencies, in order to preserve external competitiveness. At the same time, we share the view that this devaluation, in order to be effective, has to be supported by structural measures aimed at enhancing the role of price signals and removing price distortions and supply bottlenecks.

Last year, further progress in key structural reforms had been made. Trade liberalization has been progressing as a result of the three packages of measures taken to ease access of domestic producers to external inputs, thereby improving their export performance. While the authorities' commitment to eliminate all nontariff restrictions on imports is important, it should also be emphasized that such a first step needs to be followed by a reduction of tariff rates. The revision of the industrial licensing policy, which the authorities have already undertaken, would also need to be accelerated. Finally, in order to foster the mobilization of financial and entrepreneurial resources for the output diversification process, we consider essential the development of a broad capital market. In Indonesia this market is still relatively small although it has expanded in recent years, especially in the bond sector. Its development seems to be hampered by tax treatment that discriminates in favor of bank deposits, which are tax exempt. In this respect, we would be interested in hearing from the staff whether room for maneuver exists for modifying the tax legislation to improve the relative returns on capital market instruments compared to those on deposits by reducing the tax rate on the former and/or the exemptions for the latter.

Turning now to the authorities' request for compensatory financing, we can endorse it since it is in line with the criteria of an export shortfall and of cooperation with the Fund. The export shortfall has been caused by a reduction of receipts from oil exports as well as from other exports. In the current period, it is particularly difficult to calculate the size of this shortfall because of the volatility of world market prices of primary and energy products and because of the increased uncertainty about their market trends. In such a situation the conservative assumptions utilized by the staff in projecting Indonesia's oil prices and export volumes in the coming years seem appropriate. Specifically, the assumptions that oil prices would average about $15 per barrel in the two postshortfall years and that production will be in line with the quota established in September 1986 seem reasonable.

Compliance with the requirement that the shortfall be largely attributable to factors beyond the country's control also seems to be present although it is not fully apparent. It has been a long-standing position of this chair that this assessment should be based on the analysis of the actual behavior of the country rather than on the application of a priori definitions based on the country's membership of specific groups. In the case under examination, the fall in oil prices that occurred in 1986 can be partly attributed to the policy shift of some OPEC members, as documented in EBS/87/77. Although Indonesia is a member of the OPEC group, we can agree that the shortfall is largely beyond the country's control. Moreover, apart from the shortfall in oil revenues, the authorities' request for a purchase equivalent to SDR 462.9 million under the compensatory financing facility can be justified on the basis of the shortfalls that have occurred in exports of liquid natural gas and in nonenergy products amounting altogether to almost SDR 1 billion.

Mrs. Hepp made the following statement:

Indonesia had to face during 1986 a difficult external environment. The sharp decline in oil prices and the weak export prices for other primary products resulted in a substantial fall in export earnings and in the Government's revenues. Furthermore, the depreciation of the U.S. dollar vis-à-vis other major currencies resulted in an increase in the dollar value of Indonesia's external debt and its debt service obligations. The authorities' response was the adoption of a series of adjustment measures, in all major policy fields, in order to contain the internal and external imbalances without substantially affecting economic activity.

Real GDP growth was about 2.5 percent during 1986, compared with 2.0 percent in the previous year, while inflation reached only 9 percent, even after the devaluation of the rupiah by 31 percent in September 1986.

In the external sector, the current account deficit widened in 1986/87 to $4.2 billion compared with $2.0 billion in the previous year, much less than the decline in exports of $5.2 billion during the same period. This outcome reflects the effectiveness of the structural and adjustment measures adopted in this area to improve Indonesia's competitiveness in international markets.

The external debt position of Indonesia, the uncertainties surrounding oil prices, and the prospects for the medium term presented in the staff report reaffirm the need for continued adjustment efforts. We would like to encourage the authorities to continue in their efforts to pursue a flexible and realistic exchange rate policy, and further liberalize the trade system.

In the public sector, provisional estimates indicate an overall deficit equivalent to 4.8 percent of GDP in 1986/87, compared with 2.9 percent in the previous year. Again, the widening in the fiscal deficit is much less than the shortfall in oil and LNG revenues in the same period, reflecting the efforts to restrain total expenditures. The projections for 1987/88 indicate that the overall deficit will fall to about 2 percent of GDP. The budget presented to parliament provides for significant expenditure restraint and for strengthening non-oil and LNG revenues, and suggests the intention of the authorities to further eliminate its internal and external imbalances.

Monetary policy seems to be the most complicated area, given the speculative pressures against the rupiah which occurred during the year, the need to support the September devaluation, and the need to stabilize interest rates in order to promote economic activity. The opportune intervention of the Bank of Indonesia in absorbing and injecting liquidity through money market operations seems to have achieved its objectives. We agree with the staff that consideration might be given to a swap premium and to the growth of those swaps, and that given the developments of the recent period, more active interest and exchange rate policies might be implemented.

In sum, during 1986 Indonesia faced a difficult situation. The appropriate measures adopted in all major policy fields reflect the authorities' intention and ability to face adverse circumstances, and we commend them for their achievements.

With respect to the request for the use of Fund resources under the compensatory financing facility, we fully endorse the proposed decision. We agree that for the reasons presented by the staff, the request satisfies all the requirements of the facility.

Mr. Salehkhou made the following statement:

The sharp fall in oil prices in 1986 did not spare the Indonesian economy which, like that of many other oil producers, depends heavily on revenues from oil exports. The situation was aggravated by the continued weak prices in other primary commodity markets and lower LNG revenues. Furthermore, the sizable depreciation of the U.S. dollar vis-à-vis other major currencies resulted in a dramatic increase in the dollar value of Indonesia's external debt and a substantial rise in debt service obligations. The authorities were therefore forced to undertake a comprehensive set of adjustment measures in all major policy areas to deal with the resulting lower foreign exchange earnings and the heavier debt service obligations. The staff reports, as well as Mr. Ismael's candid and helpful statement, have provided us with details on the extent of these adverse developments as well as the authorities' response. I would like to comment only on a few major areas.

On the fiscal front, the 1986/87 budget had not envisaged significant new revenue measures. The substantial fall in oil/LGN revenues therefore had to be compensated for by demand management policies and expenditure restraint. Civil servants' salaries were frozen in nominal terms and certain subsidies were further reduced. Development projects came under close scrutiny and priority was given to those projects that were highly productive, or would significantly improve employment opportunities, and/or were near completion. Financing of some outlays that would normally be made in the context of the budget was shifted to the banking system. In this connection, I note the staff's caution regarding the adverse inflationary consequences of such a shift and the possibility of offsetting some of the gains already made in this area. I also note the authorities' successful efforts in obtaining additional external foreign financing to cover an increasing portion of project costs.

The authorities' pragmatic attitude toward improving the efficiency and performance of public enterprises by the recent formation of a commission to look into several possibilities to that end is encouraging. I welcome their consideration of the various options as enumerated by Mr. Ismael even as I continue to maintain that privatization does not constitute a panacea and does not necessarily guarantee improved performance and increased efficiency.

The budgetary situation was further aggravated by the substantial increased burden of interest payments on external debt as a result of the increased dollar value of Indonesia's external debt by $5.4 billion and debt service obligations by $1 billion in FY 1986/87. Notwithstanding and largely due to a reduction in development expenditures of about 21 percent, the overall budget deficit could be contained at 4.8 percent of GDP, according to the latest available figures.

I welcome the authorities' resolve to continue the policy of fiscal restraint aimed at a significant reduction of the central government deficit in FY 1987/88 while trying to minimize the adverse consequences of expenditure restraint. Given a more stable oil market in recent months and the authorities' effort to improve tax administration and expand the tax base, I am confident that there could be more room for maneuver. Given the high level of external debt and the heavy burden of debt service obligations I caution against any major new borrowings, especially on commercial terms, and urge the international financial community to continue its support through the Inter-Governmental Group on Indonesia or other channels.

The authorities are to be commended for their effective monetary management which, despite a large devaluation of the rupiah in September 1986, has resulted in only a modest increase in the inflation rate. The devaluation also appears responsible for the lower than expected current account deficit, which according to the latest estimates for 1986/87 amounted to $4.5 billion (5 3/4 percent of GDP). The overall balance of payments deficit is estimated by the staff to be some $3 billion.

The series of adjustment measures that Indonesia has undertaken since 1985 is a clear indication of the country's ability and willingness to create and promote a stable and sustainable environment for an outward-oriented and growing economy. The authorities' stated commitment to take additional adjustment measures should they become necessary is indeed welcome.

As for Indonesia's request to purchase under the compensatory financing facility, I am of the opinion that the request is justified in view of Indonesia's balance of payments need. The test of cooperation is met in view of Indonesia's good track record of cooperation with the Fund, and the shortfall in export earnings has been beyond the control of the authorities and is of a temporary nature. I can therefore support the proposed decision.

Before closing, I wish to associate myself with the two points made by Mr. Finaish regarding the relationship between "high capacity utilization" and the test of "beyond the authorities' control" as well as the "high volume of exports" and "the extent of the shortfall."

Mr. Almeida said that he was in broad agreement with the staff appraisal. He was particularly happy to note from Mr. Ismael's statement the determination of the authorities to adjust in face of a very adverse economic environment without sacrificing a moderate but healthy rate of economic growth.

On the request for compensatory financing, it was clear that the events of the past two years had confirmed the view that OPEC did not currently control either prices or even world oil production. Certainly, membership in OPEC did not by itself carry with it any restrictions on access to compensatory financing. In addition, Indonesia was not an important producer, even inside OPEC, and had generally been second only to Ecuador in producing crude oil up to its production capacity. For all those reasons, he was fully satisfied that the shortfall was temporary and beyond the control of the authorities. As the staff pointed out, there was no doubt that the authorities had been in close collaboration with the Fund for many years, and there was a clear balance of payments need.

Even if Indonesia were to ask for a compensatory drawing of SDR 796 million, Mr. Almeida noted, which would represent access of 83 percent of quota, the drawing would cover less than one quarter of the shortfall. That was yet another example of the inadequacies of the compensatory financing facility and an indication that the rules on access to the facility should be changed. He warmly supported the proposed decision on the request for a compensatory financing purchase transaction.

Mr. Mawakani made the following statement:

The commendable progress achieved by the Indonesian authorities until 1985 has been impeded in 1986 mainly by the dramatic fall in oil and liquefied natural gas prices. As indicated in the staff report, other things being equal, this would raise the 1986/87 budget deficit by about 6 percent of GDP, reduce the total value of exports by one third, and increase the debt service ratio by some 11 percentage points. It is all the more encouraging to note that in response to these adverse developments, the authorities have taken measures to strengthen their fiscal and monetary policies in order partially to mitigate their effects on the economy. Since the staff report and Mr. Ismael's statement have well described the challenges facing Indonesia and the remedial measures to tackle them, I will comment briefly on the fiscal and the external sectors and on the request for a drawing under the compensatory financing facility.

In the fiscal sector, the swift response of the Indonesian authorities to adjust their economy to the changing environment is noteworthy. Faced with the sharp fall in the prices of oil and liquefied natural gas on central government revenue, the authorities appropriately implemented an austerity budget in 1986/87 that placed emphasis on expenditure reduction. Indeed, while priority projects were accommodated, development expenditures and net lending were substantially reduced, and positive steps were taken to restrain current expenditures, particularly by freezing wages and salaries and by reducing subsidies. These measures, together with the improvements in tax administration and the positive effects of the value-added tax on revenue, enabled the authorities to contain the overall budget deficit to 5.5 percent of GDP. For 1987/88, I note that the authorities have adopted a more stringent fiscal policy. Development and current expenditures, excluding interest payments, are to be further reduced. On the revenue side, I welcome the efforts made in many areas to improve and broaden the nonenergy tax base.

In the external sector, I note that Indonesia has followed a flexible exchange rate policy to strengthen the competitiveness of the nonenergy sector. As mentioned by the staff in its report, this policy will have to be supported by appropriate credit and further structural adjustment measures. In this context, I welcome the package of structural measures implemented since the last Article IV consultation with a view to liberalizing the trade system and the industrial environment, and streamlining administrative procedures in order to reduce business costs.

The Indonesian request for compensatory financing appears justified, according to the staff's analysis, and I fully support it.

To sum up, the Indonesian economy has experienced large imbalances in 1986/87 as a consequence of external factors beyond the control of the authorities. By the measures they have taken, the authorities have demonstrated their commitment to tackle them. The proposed drawing, as well as other international financial assistance, could help them to smooth the adjustment process.

Mr. Al-Assaf said that he had two additional points to make that he had at first elected not to make--although they were analyzed at length in the staff paper--until other Directors addressed them during the discussions.

First, on the oil shortfall, Mr. Al-Assaf remarked that it was true, as some Directors had mentioned, that the oil shortfall was not needed to justify the compensatory financing purchase. But it was also true that none of the other components, on their own, were needed to justify a purchase under the compensatory financing facility. His point was that it was not appropriate to single out oil for special mention. Oil shortfalls should be treated just like any other revenue shortfall within the context of a case-by-case approach to compensatory financing requests, as Mr. Foot had mentioned, and as the Board had already decided in its 1983 discussion on the use of the facility by oil exporting countries. Indonesia's oil revenue shortfall had been included because the staff believed, and he agreed, that it justified a compensatory financing drawing as much as any other component.

His second point concerned capacity utilization, Mr. Al-Assaf said. The use of capacity utilization data as an indicator of whether or not a country's shortfall was largely outside that country's control, was he believed, and as Mr. Finaish had mentioned, highly suspect. Capacity utilization was not a matter of supply decisions alone. Demand conditions were also of crucial importance, as any industrial country could attest--no doubt Mr. Dallara would agree. Further, how was capacity to be measured? It was not a technologically given constant, but was itself determined by wear and tear, and economic conditions.

Finally, Mr. Al-Assaf posed three questions. First, if capacity utilization estimates were presented, why only for oil? Why not for all other exports, and for all requests for compensatory financing? That would be in the spirit of uniformity of treatment by the Fund of all its members, exporters of oil or not. Another question related to what level of capacity utilization was acceptable to the Fund for oil and other exports. The third question related to policy advice advocated by the Fund in general. If the Board asked an oil exporting country with low oil reserves, like Gabon, to exhaust its oil revenues in six years instead of ten years just to meet the capacity utilization criteria, then the credibility of the Fund's advice would be placed in question.

The staff representative from the Asian Department noted that the magnitude of the adjustment problems that Indonesia had faced, and the success of its efforts to combat them could be illustrated in terms of certain figures. The debt service burden had risen by 15 percentage points in 1986/87, compared with the previous year, and largely for reasons outside Indonesia's immediate control, including movements in exchange rates, which gave rise to about 40 percent of that increase. The collapse in oil prices by itself would have given rise to an increase in the current account deficit to about $4 billion, but the deficit had been contained at $2 3/4 billion. The fiscal deficit would have risen to 6 percent in terms of GDP, but it had been kept at about 4 3/4 percent of GDP. The outlook for 1987/88 was for a continuing reduction in imbalances. In addition to the policy measures that had been initiated, the authorities had indicated their flexibility and willingness to take further action if it should prove necessary.

Several Directors had wondered whether expenditure restraint might not be at the cost of growth, the staff representative continued. In fact, Indonesia was perhaps one of the few countries that had maintained a reasonable rate of growth together with adjustment. The authorities had done what they could in terms of offsetting the effects on growth of severe restrictions on development expenditures. For instance, efforts had been made to increase the efficiency of the Government's investment plan, to introduce structural reform, and to give further indications of an export-oriented growth strategy by means of a large exchange rate adjustment.

There was considerable scope in Indonesia for improved administration to strengthen government revenues, the staff representative added, and efforts were being made in that area. The staff understood the view that had been expressed on the need to strengthen administration before new tax measures were introduced. Nonetheless, given the continued weakness in oil revenues and delays in full implementation, it seemed prudent to introduce additional measures. In that connection, the staff foresaw a broadening of the value-added tax (VAT) base. The considerable scope for improving revenues from the property tax was being explored, with the assistance of the World Bank.

Indonesia's experience with the tax reform measures introduced in 1984/85, in terms of streamlining and ease of implementation, certainly had relevance for other countries attempting to improve their own tax performance, the staff representative considered. In assessing whether the registered levels of current expenditure indicated a significant degree of expenditure restraint, it was necessary to correct for the large increase in interest payments; once adjusted for these payments, which had risen dramatically, the degree of restraint was very significant.

It would be possible to subject interest on bank deposits to income tax as a way of both increasing tax revenues and of according equal treatment to yields on other financial investments in Indonesia, the staff representative remarked. The timing of the removal of the exemption would pose problems, given the open capital account. Another possibility would be to introduce exemptions for other forms of income from financial assets, but that might go against the lines of the tax reform, under which the authorities had tried to limit exemptions severely.

In connection with the structural reforms implemented by Indonesia, and especially the need to enhance the country's ability to attract foreign direct investment, the staff representative noted that impediments to such investment still existed, for instance, in the form of licensing requirements and restrictions on ownership. The authorities were fully aware of the various structural impediments to the growth of non-oil exports, and acknowledged that they were being addressed only partially. A trade policy adjustment loan recently agreed with the World Bank, and the policy statement in support of it, indicated that further actions could be anticipated in the near to medium term in three further areas--a deepening of the trade reform; a review of industrial licensing; and a strengthening of efficiency in public sector enterprises with the consolidation of public sector accounts.

As for monetary policy, the staff agreed that it should be cautious, particularly in view of the drawdown in reserves that occurred in the third quarter of 1986/87, the staff representative said. The evidence of some tightening in the policy stance was welcome, as was the deceleration of the growth of monetary aggregates, which should not however come about as a result of a weakening in the external position.

The staff had discussed the possibility of narrowing the spread between lending and deposit rates with the authorities, but there seemed to be little scope for a reduction in lending rates.

On exchange rate policy, the authorities were monitoring the appropriateness of the exchange rate in terms of the real effective rate and balance of payments developments, the staff representative from the Asian Department stated. What the staff had in mind in its appraisal was that if no expectations of a fixed relationship between the rupiah and another currency were built up, then the possibilities for flexible management would be enhanced, including gradual adjustment of the rate or small discrete adjustments. Otherwise, should adjustment prove necessary, it might be delayed and would tend to be a large discrete one. In the light of past experience in Indonesia, the staff considered that it would be prudent to safeguard the possibility for more flexibility in exchange rate management.

The staff representative from the Research Department explained that the reference in EBS/87/77 to capacity utilization was not intended to suggest that a high rate of capacity utilization was a prerequisite for use of the compensatory financing facility. What was relevant as one element in the staff's analysis of whether or not the shortfall was within or outside the control of the member was an assessment of the impact of policies on changes in the rate of capacity utilization and thus on exports during the shortfall year in relation to the other years of the period covered by the calculations. In that respect, the rate of capacity utilization was obviously a matter for the authorities, and in making their choices about the specific rate, several factors were taken into consideration, including the stage of development of the economy, the availability of other resources, and short-term versus long-term considerations.

The statement on page 10 of EBS/87/77 relating to the fact that the shortfall on account of oil exports would have been even larger without the sharp increase in oil exports in the shortfall year, was meant to refer only to the action taken by Indonesia in the year under consideration, the staff representative from the Research Department explained. In other words, had Indonesia not raised the volume of its oil exports in the circumstances of the market during that year, it was the staff's judgment that the shortfall in Indonesia's exports would have been larger and export earnings lower than indicated in the staff paper.

The Chairman then made the following summing up:

Executive Directors were in broad agreement with the thrust of the appraisal in the staff report for the 1986 Article IV consultation with Indonesia.

Directors noted the severe deterioration in Indonesia's external environment that had taken place since the last consultation and welcomed the prompt and well-conceived response of policymakers. During 1986/87 Indonesia's terms of trade worsened dramatically, as the price of its dominant export commodity declined by more than half, and an important weakening in other export prices occurred as well. At the same time, Indonesia's debt service burden in U.S. dollar terms rose markedly, owing to the effects of the depreciation of the dollar against other major currencies and increasing amortization payments. Faced with large domestic and external imbalances, the authorities quickly implemented an integrated adjustment strategy. Cautious demand management policies were accompanied by a major exchange rate adjustment, and structural measures were also taken in the fields of trade, industrial policies, and in the public enterprise sector to strengthen the supply response of the economy.

Directors commended the authorities on the well-considered and timely exchange rate action taken in September to pre-empt speculative pressures and to enhance the competitiveness of Indonesia's non-oil exports. They also noted the considerable success that had been achieved in safeguarding the gains in competitiveness and in limiting the feedthrough of the devaluation to domestic prices. The current level of competitiveness, supported by cautious demand management and more determined efforts to liberalize the trade and industrial licensing systems, appeared broadly appropriate. Indeed, many--if not all--speakers stressed the benefits to Indonesia in terms of growth of deregulation and the abolition of widespread rigidities on the supply side. The beneficial role that foreign direct investment can play in Indonesia and the importance of abolishing impediments to such capital flows was also emphasized by many Directors.

Directors noted the very large and adverse effects on the fiscal balance in 1986/87 of the fall in the prices of oil and gas and the rise in interest payments. They observed, however, that these effects had been mitigated, in large part, by expenditure restraint and by an intensification of efforts to mobilize revenues from other sources. The strengthening in tax administration was particularly welcome.

Directors welcomed also the deceleration in the rate of growth of reserve money and the firming of interest rates in the first calendar quarter of 1987, taking into account Indonesia's vulnerability to speculative capital outflows. In addition to the pursuit of adequate restraint on the growth of domestic credit, Directors urged the authorities to follow a policy of greater interest rate and exchange rate flexibility in order to ensure the maintenance of competitiveness and the strengthening of the external reserves position. Directors commended the authorities for the austere budget introduced for 1987/88. This budget was based on a cautious assessment of the external environment. And it called both for additional domestic resource mobilization and severe expenditure restraint. Cautious budgetary policy was seen to be essential to reducing foreign and domestic imbalances. A number of Directors noted, however, that additional tax measures and expenditure adjustments were in prospect, and urged that they be quickly implemented so that the projected budgetary effects would be fully realized. Several Directors regretted the large cuts in development expenditures and observed that Indonesia's tax effort remained comparatively weak. Directors observed that demand management would have to remain very cautious, even if export prices were to strengthen.

The fiscal policy envisaged would, in itself, be expected to dampen domestic demand. However, important counterweights would be provided by enhanced efficiency in the use of scarce public sector resources and by the cumulative effects of structural reform measures. Thus a revival of growth and employment was foreseen. Directors urged the authorities, however, to move decisively in the areas of structural and regulatory reform and with respect to the operations of the public sector enterprises in order to help secure satisfactory rates of growth.

Although Indonesia's domestic and external imbalances had been contained by major initiatives in most policy areas, its external debt service burden had risen markedly and its gross borrowing requirement would remain high over the medium term. Directors considered that continued access to bank financing and to foreign markets was essential to the success of Indonesia's adjustment efforts, but speakers generally urged the Indonesian authorities to exercise considerable caution with regard to foreign borrowing in order to keep the external debt burden within manageable proportions.

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

Mr. Ismael said that with respect to the need for further measures, it should be noted that the policy measures and adjustments undertaken in 1986 and 1987 could be said to represent a partial restructuring of the Indonesian economy. Therefore, it was understandable that the President, in delivering the 1987/88 proposed budget to Parliament in January 1987, had revealed that further policy adjustments might have to be made in the future. Viewed differently, it could also be said that with the constraints on the role of the budget in the economy, a greater role would be required of the monetary sector. However, the fiscal and monetary sectors constituted only one factor in determining the course of the economy. Of equal importance was the flow of goods, the smooth flow of which might best be realized through further deregulation in trade and investment. In addition, the reduced role of the budget in the economy would necessitate greater growth in the activities of the private sector. That development would emphasize the need to undertake deregulation in an effective and consistent manner. As to whether Indonesia should not set a timetable for further liberalization of the trade system, it should be recognized that the problem was a political one and the timing and extent of the measures would depend on the political opportunities that opened up at a given point of time.

The Central Bureau of Statistics estimated a GDP growth rate of 3.03 percent in 1987, which compared with an estimated 2.2 percent increase in the total population and a 2.8 percent increase in the labor force, Mr. Ismael observed. The GDP growth estimate was based on the sum of positive growth rates for agricultural and industrial sectors of 3.8 percent and 7 percent, respectively. With the proper political will indicated in the President's speech, and supported by the positive impact of the September 1986 devaluation and the deregulation introduced in 1986 and 1987, there were sufficient signs that recent growth in the prices of oil and other primary commodities would in fact result in the expected GDP growth rate of 3.03 percent. Rough estimates for growth in 1988 put the rate at almost 4 percent, contingent however upon the achievement of the 3.03 percent rate of growth for 1987.

It should be recognized that reform of the state enterprises was a complex and sensitive issue, Mr. Ismael said. To mention only a few of the numerous factors that had to be taken into consideration, an accurate estimate would first have to be made of the current market value of the enterprises and not of their book value. Second, the enterprises must be seen in terms of the social benefits they provided. The social loss resulting from a shift from government to private hands might not be offset by the profits gained under private ownership. Third, it was necessary to consider who the potential buyers would be, especially as the sale of a state enterprise would more than likely require a large amount of capital. That being the case, there was a good possibility that the enterprises would be purchased by those same financially strong people who in the past had greatly benefited from privileges granted them by the Government. The sociopolitical consequences of such an outcome would not be favorable. If, therefore, the Government attempted to sell state enterprises to small indigenous groups, the buyers would probably have to seek credit assistance from the state banks. Furthermore, it was an open question whether potential buyers would even be interested in purchasing state enterprises that were currently operating at a loss.

In sum, no quick decisions could be expected by the Commission, Mr. Ismael remarked. However, the fact that the Government was willing to look at the matter and not retreat from the possibility of selling state-owned enterprises as a means of stimulating improvement in the overall economy was a sign of progress and courage.

As noted during the discussion, in light of the current developments in the economy and the vigorous adjustment measures that had been taken, Indonesia would qualify for a compensatory financing purchase of more than 50 percent of quota, Mr. Ismael said. However, the Indonesian authorities were of the opinion that a purchase of 50 percent of quota, in combination with their ongoing cautious program of commercial market borrowing and the expected inflow of official capital, was sufficient at the present stage. Moreover, since the request had been under discussion since mid-1986, a purchase of 50 percent of quota was considered to be a surer way of attaining smooth and prompt approval of the request.

In conclusion, Mr. Ismael thanked Executive Directors for their unanimous support for Indonesia's request to use the resources of the compensatory financing facility, and assured them that their comments would be conveyed to his Indonesian authorities.

The Executive Board then took the following decision:

1. The Fund has received a request by Indonesia for a purchase of SDR 462.9 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979, as amended).

2. The Fund notes the representations of Indonesia and approves the purchase in accordance with the request.

Decision No. 8577-(87/67), adopted
May 4, 1987

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/66 (5/1/87) and EBM/87/67 (5/4/87).

2. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/87/98 (4/30/87) is approved.

APPROVED: November 12, 1987

LEO VAN HOUTVEN
Secretary