DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/86/11

CONTAINS CONFIDENTIAL
INFORMATION

January 14, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Indonesia - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Indonesia. A draft decision appears on page 26.

It is proposed to bring this subject to the agenda for discussion on Friday, February 14, 1986.

Ms. Ripley (ext. 6531) or Ms. McGuirk (ext. 7338) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

INDONESIA

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the 1985 Consultation with Indonesia

Approved by P. R. Narvekar and Eduard Brau

January 13, 1986

Contents

Charts

I. Introduction

The 1985 Article IV consultation discussions were held in Jakarta from October 23 to November 8, 1985. The Indonesian authorities were represented by the Coordinating Minister for Economy, Finance, and Industry and Development; the Ministers of Finance and Trade, and the Advisor to the Planning Agency; the Governor of Bank Indonesia; and other senior officials from ministries and Bank Indonesia. The mission also met with officials of public sector enterprises and with representatives of the domestic banking community and the foreign economic community. Mr. J. E. Ismael, Executive Director for Indonesia, attended the meetings as observer. The staff team 1/ was assisted by Mr. R. Hides, the Fund Resident Representative, while Mr. S. M. P. Suriyaarachchi of the IBRD resident mission also attended many of the policy meetings.

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

II. Economic Setting and Overview

Since 1983, when a number of wide-ranging reforms were introduced, the Indonesian authorities have been pursuing an active adjustment policy focused on the correction of imbalances in the fiscal and external accounts (Chart 1). Cautious demand management has been accompanied by structural adjustment policies designed to reduce the susceptibility of the economy to fluctuations in the oil market. While the oil/LNG 2/ sector accounts for some 20 percent of GDP, its contributions to both merchandise exports and the revenues of the central government exceed 60 percent. The importance of strengthening the performance of the non-oil/LNG sector has long been recognized as essential for the attainment of Indonesia's objectives of growth, stability, and equity. The short-term prospect of continued weakness in the oil market has underscored the importance of firm and timely action.

The rupiah was devalued by 28 percent in March 1983, approximately restoring the competitiveness of Indonesia's non-oil/LNG exports to the level attained in late 1978 (Chart 2). Within the constraints imposed by unrestricted capital movements, the authorities have subsequently pursued a flexible exchange rate policy that has generally safeguarded this gain in competitiveness.

1/ Members of the team included: D. Ripley (Head), L. De Wulf, A. McGuirk (all ASD), G. Hacche (CBD), and S. Richupan (FAD), with A. Martini (ASD) as secretary.

2/ Liquefied natural gas.

Major changes were also introduced in the monetary field in the first half of 1983 to encourage resource mobilization through the growth of the deposit base and to enhance efficiency in the allocation of capital. State banks were allowed at that time to set their own deposit rates to permit them to compete effectively for savings, while credit ceilings were abolished. New monetary policy instruments were introduced to provide for the absorption or injection of liquidity by Bank Indonesia (BI). 1/ Greater reliance was to be placed on market forces in the allocation of credit, in place of the earmarking of credit for specific purposes, generally at preferential rates. The monetary reform has been accompanied by a marked rise in the level of nominal interest rates and the rapid growth of time deposits.

A massive rephasing of the public sector investment program was initiated in the spring of 1983 with a view to eliminating projects that could no longer be justified in the light of changed circumstances, and to containing the buildup in external indebtedness. Foreign exchange savings associated with rephased projects were broadly estimated at over $10 billion, and most of the projects suspended at that time remain in abeyance. The authorities took measures to restrain public sector pay, to promote efficiency in public enterprises, permitting inter alia a reduction in subsidies, and also to strengthen the non-oil/LNG revenue base of the Government. A streamlined income tax system came into effect in January 1984, while in April 1985 the value-added tax was implemented after some delay.

In the field of industrial and trade policy, changes have been introduced to simplify licensing procedures, to facilitate disbursements for investment projects, and to reduce costs associated with transportation. However, some of the measures designed to enhance the role of the private sector in the development process and accountability in public sector disbursements have tended to delay disbursements. In addition, the general weakness of the bureaucratic structure continues to impede rapid administrative processing. Notwithstanding recognition by the authorities of the need to liberalize the trade system, dependence on licensed importers and on quantitative restrictions has increased.

The authorities met with considerable success in reducing fiscal and external imbalances, controlling inflationary pressures, and

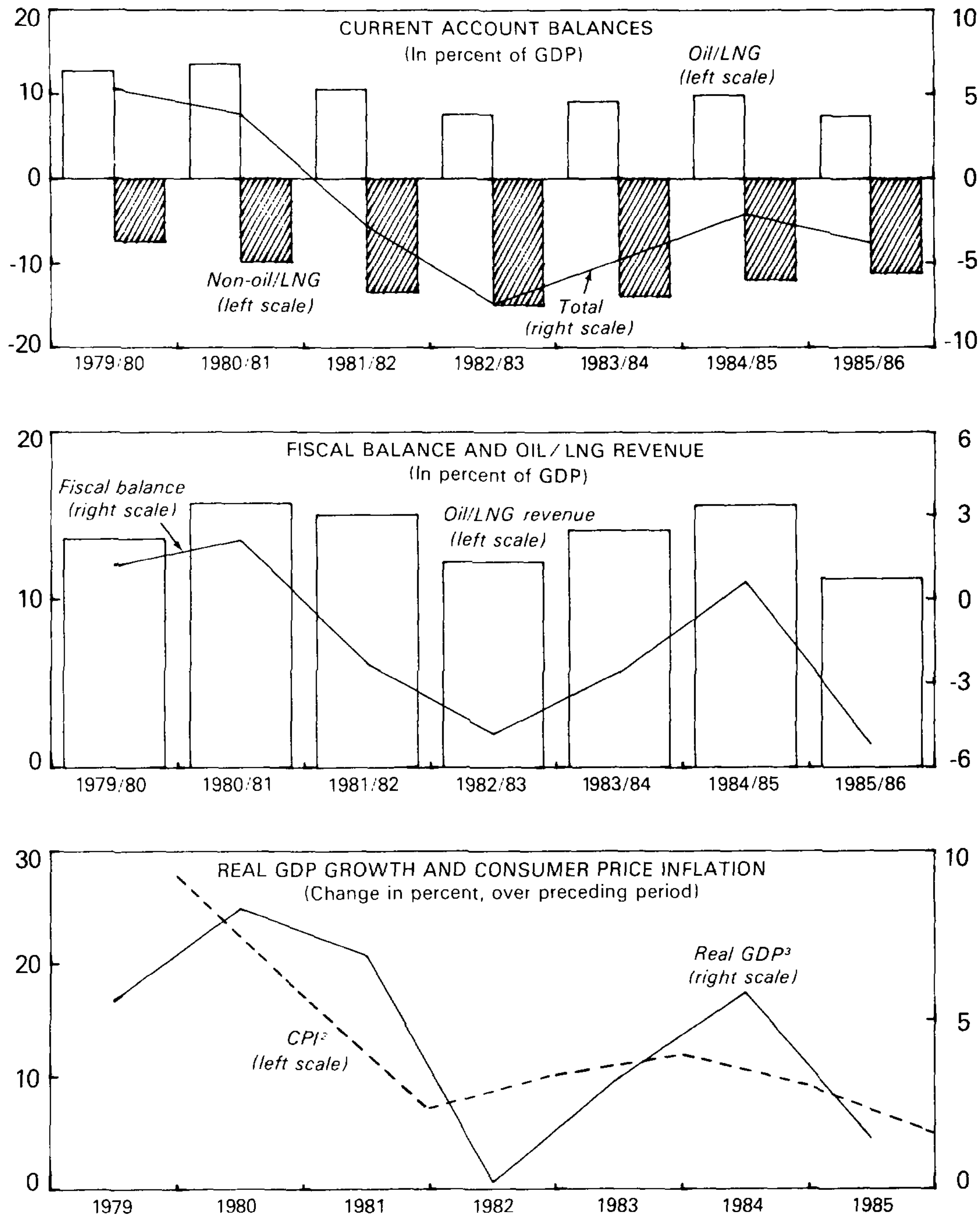
---

1/ In February 1984, BI began offering short-term debt instruments (SBIs) for sale to banks and other financial institutions and, at the same time, established two new rediscount facilities. A third, temporary, rediscount facility was added in September 1984. In February 1985, BI introduced a permanent third rediscount facility based on newly established money market instruments (SBPUs). Under this facility, short-term financing backed by commercial paper can be obtained from BI, through FICORINVEST. See the forthcoming report on recent economic developments.

CHART 1

INDONESIA

ECONOMIC INDICATORS, 1979/80-1985/86[1]



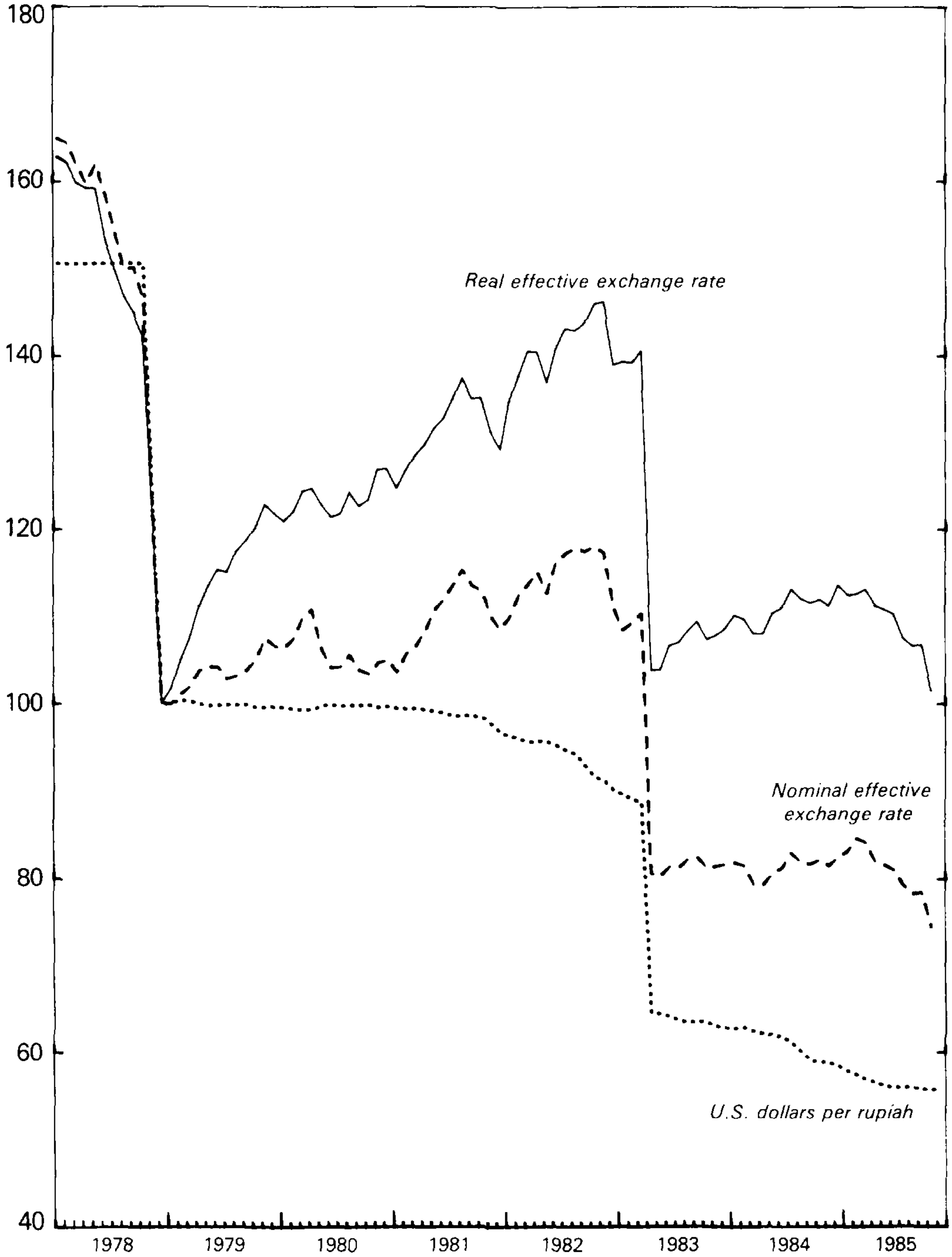
Sources: Data provided by Indonesian authorities; and Fund staff estimates.
[1]Fiscal year, April/March, unless otherwise specified.
[2]December.
[3]Calendar year.

CHART 2

INDONESIA

DEVELOPMENTS IN EXCHANGE RATE INDICES,[1] JANUARY 1978-NOVEMBER 1985

(Dec. 1978=100)



Source: IMF Data Fund

[1] Trade weighted notification index; indices calculated using monthly average data.

reviving growth, while at the same time bringing about structural adjustments. Notwithstanding a decline in the official price of oil, from $35 per barrel in March 1982 to $28.50 per barrel in March 1985, the current account deficit was reduced from the equivalent of 7 1/2 percent of GDP in 1982/83 (fiscal year ending March 31) to some 2 percent of GDP in 1984/85. The budget of the central government moved from a deficit of almost 5 percent of GDP to a modest surplus over the same period. The rate of inflation as measured by the CPI fell from 13 percent in the summer of 1983 to 4 percent in March 1985, although important administered prices were increased markedly over this period, and the nominal exchange rate depreciated to offset inflation differentials.

Real growth, after being close to zero in 1982, revived in the following two years and averaged some 4 1/2 percent per annum (Chart 1). In 1984, investment activity fell by 7 percent in real terms. By contrast, the strengthening in the external balance in that year amounted to 6 1/2 percent of GDP. 1/ Imports declined in part on account of the rephasing of public investment outlays and the attainment of rice self-sufficiency, while the coming on-stream of new LNG production facilities was reflected in a rise in exports (Chart 3). The improvement in Indonesia's competitiveness as a result of the exchange rate adjustment of March 1983 also contributed to the strengthening of its current account balance, as did the pickup in foreign demand. Although there was a marked increase in non-oil/LNG exports, from the low levels to which they had declined in 1981/82, they did not regain the market shares registered in the late 1970s. Manufactured exports as a subgroup grew rapidly, albeit from a small base (Chart 3), but the increase in traditional non-oil/LNG exports did not keep up with market growth. 2/ The need to strengthen Indonesia's non-oil/LNG exports, and the perceptible slackening in activity that occurred during the course of 1984/85 were reflected in the policies for 1985/86.

III. Report on the Discussions

At the time of the last consultation (EBM/85/19-20, 2/8/85) Executive Directors commended the Indonesian authorities for their continued strong adjustment efforts, though they noted that prospective developments in the world oil market posed a continuing challenge. The

---

1/ A significant offset was provided by the estimate of the change in stocks and statistical discrepancy (minus 2 1/2 percent of GDP); the statistical discrepancy would now seem to be at a more realistic level than in the early 1980s when it reached 12 percent of GDP.

2/ There is a marked discrepancy between the movements in export prices for primary commodities provided by the Indonesian authorities, and those published in IFS. A reconciliation of these differences would facilitate the analysis of Indonesia's export performance.

importance of policies to encourage productive investment in the non-oil/LNG sector was noted. In this connection, Executive Directors pointed to the need to strengthen resource mobilization in the public sector by increasing the buoyancy of non-oil/LNG revenue, by constraining the growth of current expenditures, and by enhancing the efficiency of public enterprises. The continued pursuit of a flexible exchange rate policy, a vigorous attack on administrative controls inimical to entrepreneurial activity, and a more liberal trade policy were also endorsed. A number of Directors expressed concern at that time, however, about the weakness of investment and the prospects for a sustained revival of growth. Several Directors hoped that the renewed rapid growth of preferential credit earmarked for specific uses (liquidity credits) would prove transitory.

The discussions in Jakarta focused on a review of the current economic situation and the stance of policies. The seriousness of the challenges facing the Indonesian authorities, both in the coming year and in the medium term, and the time available for implementing adjustment measures, depend crucially on the evolution of the oil market. A medium-term scenario was developed for discussion with the authorities, based on the August 1985 world economic outlook projections for world trade and for oil and commodity prices. Calculations were made to determine the sensitivity of Indonesia's external position to changes in assumptions, for example, about the development of oil prices, LIBOR, or activity abroad.

The policy discussion focused on the principal elements of the integrated adjustment strategy thought necessary at that time to secure Indonesia's development objectives. The baseline scenario has subsequently been recalculated to reflect the WEO working assumptions of December 1985. The revised projections underscore the need for a further intensification of Indonesia's adjustment effort.

1. Developments in 1985/86

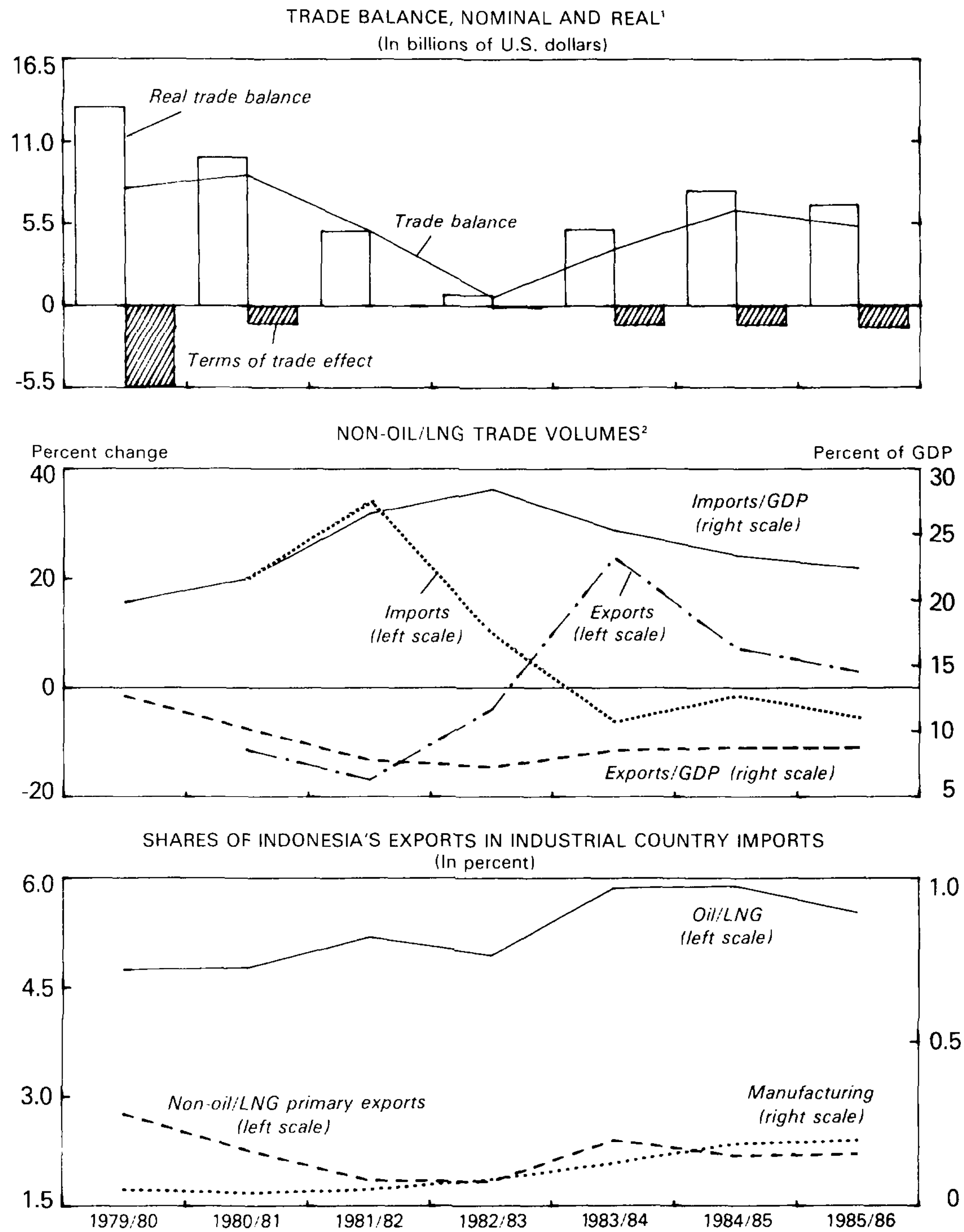
a. Domestic economy

Economic activity in Indonesia was sluggish on account of weak domestic and foreign demand. Based on sectoral data provided by the authorities, the staff estimated that real GDP growth for 1985 would not exceed 1 1/2 percent, compared with 3 1/2 percent in 1983 and almost 6 percent in 1984 (Chart 4). Real oil/LNG GDP was expected to fall by 6 percent. Oil output had been constrained by the reduction of Indonesia's production quota, from 1.3 million to 1.189 million barrels per day, effective November 1984, coupled with a weakness in markets abroad of particular importance for Indonesia's oil/LNG exports. New LNG capacity, which contributed importantly to growth in 1984, was not expected to increase significantly until 1987-88.

CHART 3

INDONESIA

TRADE PERFORMANCE, 1979/80-1985/86



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

[1] The real trade balance and terms of trade effect are calculated on the basis of 1981/82 prices.

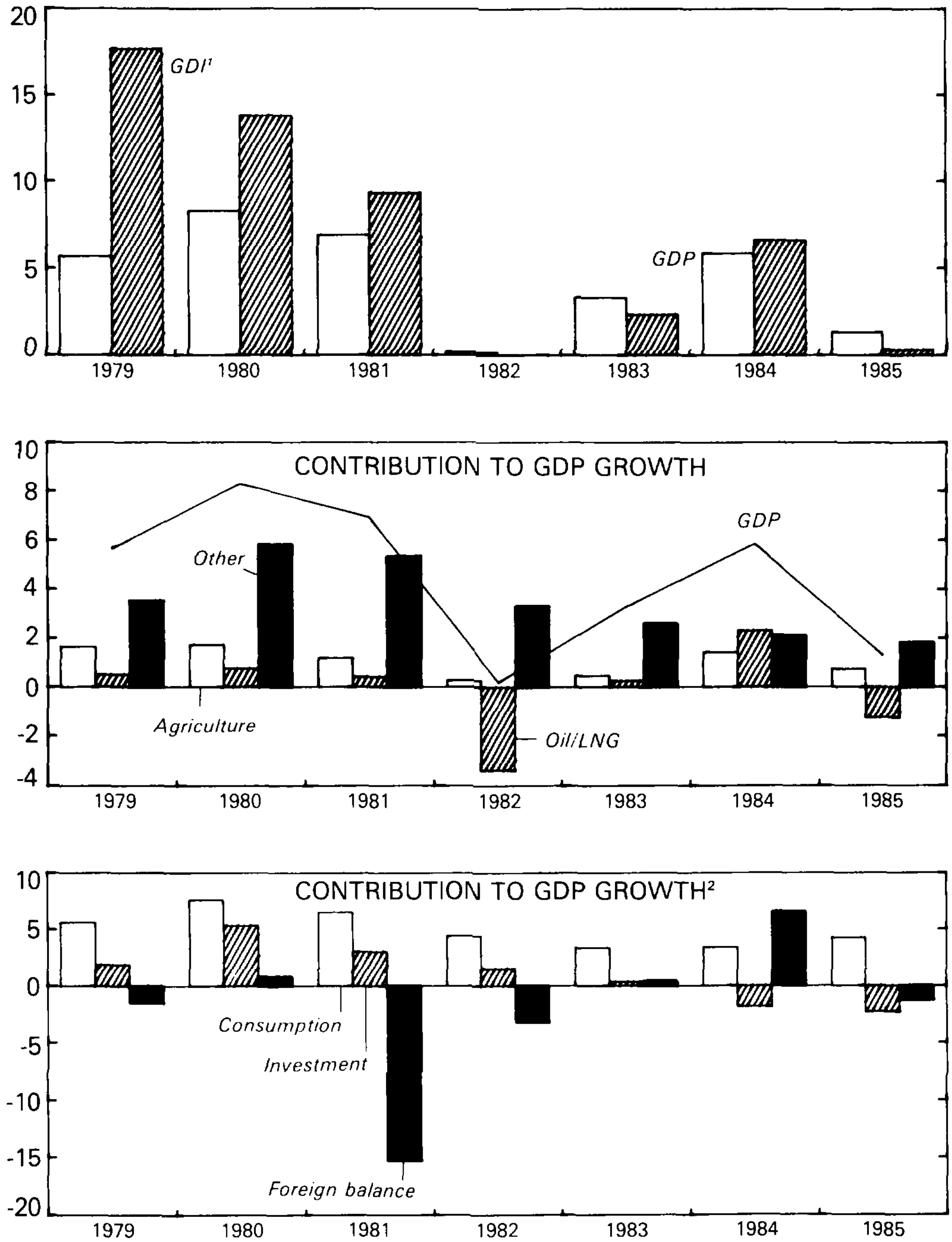
[2] Non-oil LNG imports and exports relative to non-oil/LNG GDP in 1981/82 prices and import and export volumes in percent change

CHART 4

INDONESIA

INCOME GROWTH: SOURCES AND USES, 1979-85

(In percent)



Sources: Data provided by Indonesian authorities, and Fund staff estimates.

[1]Gross domestic income (GDI) is obtained by correcting GDP for terms of trade effects: the methodology of this correction is given in the statistical appendix of the forthcoming report on Recent Economic Developments.

[2]Contributions listed here do not add to totals as changes in stocks (which include the statistical discrepancy) were omitted

Non-oil/LNG growth was expected to amount to 3 percent in 1985, largely because of a continued rise in agricultural output, though after two successive years of bumper rice crops, the rate of rise had slackened. The output of other commodities had been adversely affected by depressed prices--for example, for tree crop products. In addition, in an effort to improve quality and limit accumulation of excess stocks, the effective support price had been reduced below the announced price for rice falling short of established quality standards. 1/ The weakness in agricultural incomes contributed to the sluggishness of domestic demand.

The Government continued to pursue a cautious public investment policy, but measures had been taken to speed disbursements so that the budgeted rise in investment expenditures could be realized. The first semester results (April-October 1985) suggested that a very marked acceleration in expenditures in the second half year would be necessary for this increase to be realized. Investment outlays had been depressed by excess capacity in many sectors, reflecting, in part, demand conditions, but also a misestimation of the longer-term growth potential for these sectors. 2/ A sectoral approach to the rationalization of excess capacity was not, however, being actively pursued. 3/ Looking ahead, the weakness of investment intentions was also a source of considerable concern. In addition to cyclical and structural factors, the very high level of real interest rates--with lending rates for nonconcessional credits being of the order of 17-18 percent, against an estimated annual inflation rate of some 5 percent--was pointed to as a deterent to investment and a source of financial difficulty for heavily leveraged enterprises.

With the slowing of activity in the industrial sectors, the number of urban unemployed had risen noticeably in recent months. To be sure, the rise had been small in relation to the size of the labor force. However, the authorities expressed concern about the labor market situation. The financial difficulties still to be resolved in important industrial sectors and the limited prospects for growth in the near term

---

1/ The reduction was estimated to have amounted to as much as 30 percent.

2/ Sectors particuarly affected by excess capacity include cement, car tires, electronics, paper, steel, plywood, fertilizer and transportation equipment. The Ministry of Industry estimates excess capacity in the first two industries at about 40 percent, whereas for automobiles it may reach 70 percent. High costs of domestic production have also limited the export potential of some of these sectors. For a fuller discussion, see the forthcoming report on recent economic developments; and IBRD, Indonesia--Policies for Growth and Employment (No. 5597-IND), April 23, 1985.

3/ State banks were encouraged to support the restructuring of firms in difficulties on a case-by-case basis. See Section III.2.b.

could endanger their employment objectives. Indeed, World Bank estimates suggest that real GDP growth of some 4-5 percent per annum is needed to absorb new entrants into the labor force. 1/

Price pressures have eased considerably in recent years, and the deceleration of inflation continued during 1985 (Chart 5). A number of administered price adjustments necessary to rationalize the price structure and to provide a more adequate offset to costs had been introduced in earlier years. Factors also contributing to the deceleration included a dampening of food price increases as a result of good harvests, only a modest rise in import prices expressed in rupiah, and generally weak domestic and external demand. 2/ In October 1985, the year-on-year rise in consumer prices amounted to less than 5 percent.

Wages in the industrial sector had generally moved in line with the consumer price index. Wage adjustments in the public sector had been very uneven in recent years. The catch-up in 1985 restored the salaries in real effective terms to the levels generally prevailing in 1982.

b. Exchange rate developments, the balance of payments, and external debt

Between June 1983, when the feed-through to domestic prices of the March 1983 devaluation is estimated to have been largely realized, and December 1984, the rupiah appreciated by 7 percent in real effective terms. During 1985, however, this appreciation was more than offset by the nominal effective depreciation of the rupiah combined with the deceleration of domestic inflation (Chart 2). Thus, by end-October 1985, the real effective rate of the rupiah was 6 percent below its June 1983 level. The rupiah depreciated against the U.S. dollar at an annual rate of some 7 percent in the 18 months to July 1985, but the rate of depreciation declined to less than 2 percent, at annual rates, in the July-October period.

Expectations remained for a widening of Indonesia's current account deficit in 1985/86 to some $3 billion, from about $2 billion in 1984/85. 3/ Staff projections are for a weakening in the oil/LNG

1/ Indonesia's labor force is estimated to increase at 2 1/4 percent per annum or by almost 2 million persons a year. See IBRD, Wages and Employment in Indonesia (July 19, 1983); and IBRD, Indonesia--Policies for Growth and Employment (No. 5597-IND, April 23, 1985).

2/ In April 1985, a flat 10 percent value-added tax, with added coverage of petroleum products, was substituted for a multitiered sales tax. In the three months following the introduction of this tax, the CPI rose by less than 5 percent at an annual rate.

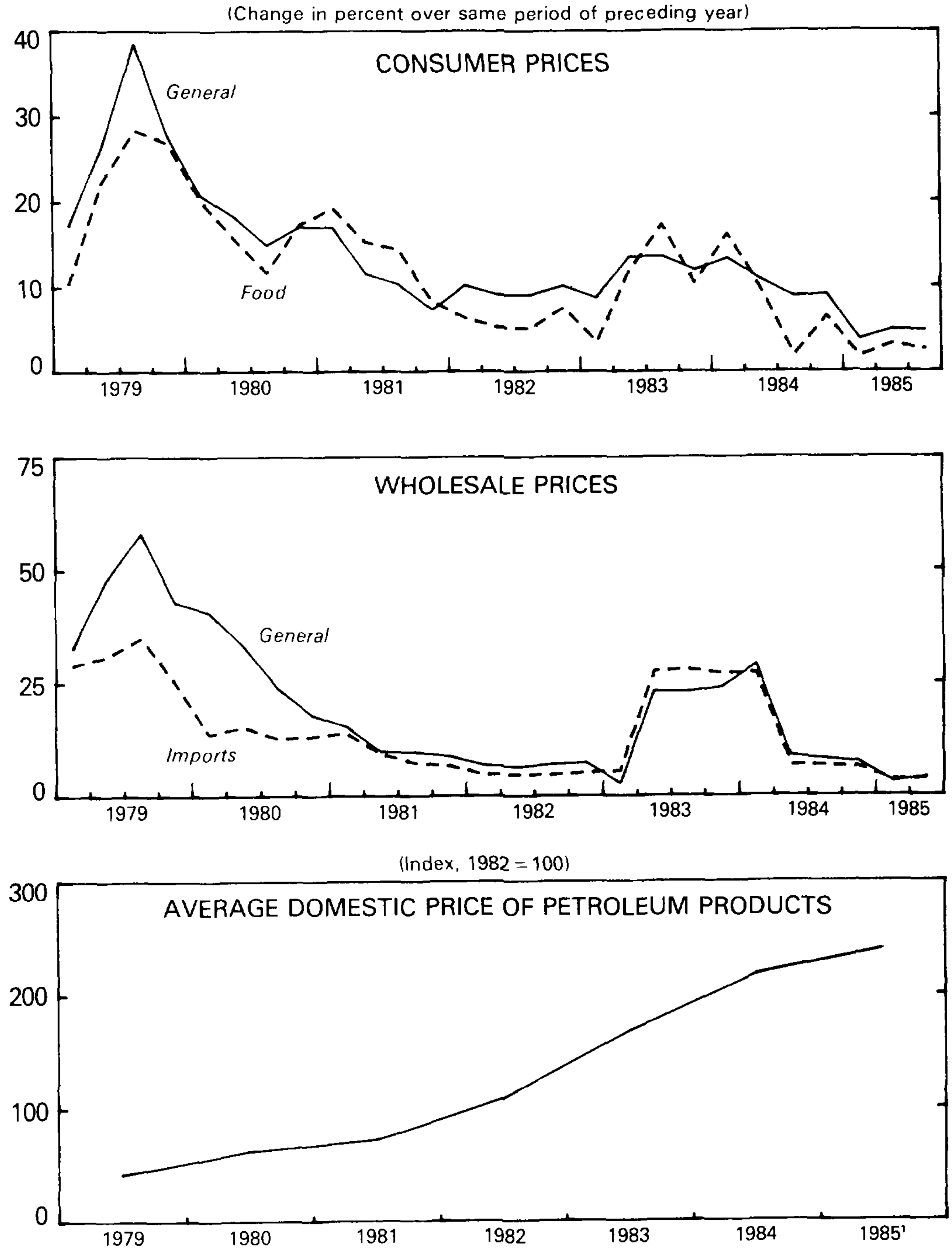
3/ Official projections were for a current account deficit of $2.8 billion in 1985/86 whereas staff projections foresaw a deficit of $3.1 billion at the time of the discussions. Staff projections for 1985/86 have not been significantly affected by the change in WEO assumptions subsequent to the discussions.

CHART 5

INDONESIA

PRICE DEVELOPMENTS, 1979-85

(Change in percent over same period of preceding year)



Source: Data provided by the Indonesian authorities.
[1] Includes the 10 percent value added tax.

balance of more than $2 billion. 1/ Oil export receipts (including condensates and products) are projected to fall by some 20 percent, representing a 15 percent decline in real terms and about a 5 1/2 percent decline in the average export price denominated in U.S. dollars. In contrast to 1984/85, when a sharp rise in LNG exports offset the decline in oil export receipts, LNG exports are projected to show little growth in 1985/86. Indeed, based on first semester results, Indonesia's oil/LNG exports, expressed as a percent of oil/LNG imports of industrial countries, are expected to decline modestly (see Chart 3). As much as half of the decline in the oil/LNG balance is projected to be offset by an improvement in the non-oil/LNG balance. Data for the first half of 1985/86 suggest a decline of up to 20 percent in non-oil/LNG imports valued in U.S. dollars; however, only a 3 percent decline is projected for the full year, consistent with the fiscal projection of a pickup in foreign-financed project expenditures in the second semester. The ratio of imports to GDP is expected to decline for the third year in a row. Because of the slowdown in foreign demand and the weakness in commodity prices, non-oil/LNG export growth in value terms is projected to decline to about 3 percent in 1985/86, from an average annual rate of growth of 23 percent in 1983/84-1984/85. The uncertainties surrounding the projected pickup in commodity prices in the second semester raise questions as to whether even this increase is attainable.

Notwithstanding the marked strengthening of the current account between 1982/83 and 1984/85, public sector external debt increased by $3 billion to $24 1/2 billion in March 1985 (29 percent of GDP) while total external debt rose to $32 billion (38 percent of GDP). The debt service ratio for medium- and long-term publicly guaranteed debt rose from 12 percent to 15 1/2 percent, with the total debt service ratio rising from 16 percent to 20 percent. In addition to the rise in the level of debt, the increase in the debt service ratio reflected a continuing reduction in the share of concessional credit in total credit, and a fall in export earnings. 2/

In the first half of 1985/86, the maturity profile of public sector external debt was strengthened by early repayments and by the taking up of new loans with longer maturities and more favorable spreads. Net reserve holdings of the banking system increased modestly. They remain comfortable at almost $12 billion or 11 months of non-oil/LNG imports. Nonetheless, with an acceleration in project

---

1/ Defined as gross oil/LNG export receipts less production-related imports of goods and services and remittances of profits of foreign-owned oil companies.

2/ Concessional credit is defined as credit for which the grant element exceeds 25 percent. It is estimated that in 1985, concessional credit accounted for 35 percent of outstanding public sector debt, down from 37 percent a year earlier and 43 percent in 1983.

disbursements, the level of public debt outstanding is expected to rise to \$26 1/2 billion (32 1/2 percent of GDP) and the debt service ratio for this sector to 17 1/2 percent; the ratios for total debt are estimated at 42 percent and 22 percent, respectively.

2. The stance of policies

a. Exchange rate policy and the management of external assets and liabilities

The Indonesian authorities noted that since the 1983 devaluation, exchange rate policy had focused on strengthening confidence in the rupiah, by avoiding large discrete adjustments in the rupiah/U.S. dollar rate, while, at the same time, seeking to maintain the price competitiveness of Indonesia's non-oil/LNG exports. The recent depreciation of the U.S. dollar against other major currencies had made possible some strengthening in Indonesia's competitive position beyond that achieved in the spring of 1983 (Chart 2).

While recognizing the need for exchange rate flexibility, the authorities stressed that such flexibility had to be carefully managed. Market participants were seen by the authorities to be extremely sensitive to the pace of change in the rupiah/U.S. dollar exchange rate. Instead of viewing a discrete adjustment as leading to a more stable relationship over the longer term, in which case a compression of interest rate differentials would be possible without adverse consequences for the external balance, there was a chance that such an adjustment would be extrapolated into the future, necessitating even higher domestic interest rates. It was hoped by the authorities that, as confidence in the rupiah continued to build, some further reduction in domestic interest rates might be possible. Should temporary pressures on the capital account emerge, the first line of response would be a drawing on foreign exchange credits; but increases in interest rates would be considered if necessary.

Consistent with the pursuit of prudent domestic policies, the authorities had sought to strengthen their external position by the building up of a significant stock of reserves. Lines of credit had also been expanded to \$2 billion. An annual ceiling imposed on the taking up of trade credits on nonconcessional terms by state enterprises continued to be observed. 1/ Borrowing by the private nonbank sector was not controlled, however, in line with Indonesia's system of free capital movements.

1/ For purposes of this ceiling only credits carrying interest rates of, at most, 3 1/2 percent with maturities of 25 years or longer are considered concessional.

b. Monetary policy

The main features of recent monetary developments in Indonesia have included a very modest decline in nominal interest rates--contrasting with a much larger decline in the rate of inflation and in interest rates abroad (Chart 6)--and continued rapid growth of broad money (Chart 7). The marked acceleration in the growth of total domestic credit, which was foreseen at the time of the last Board discussion, has occurred: the offset to the growth of credit to the private and public enterprise sectors that was earlier provided by the buildup of government balances is no longer being realized, and indeed the weakness of oil/LNG revenues is expected to necessitate a drawdown of these balances in the second half of 1985/86.

The authorities expressed concern about the high level of interest rates in Indonesia and its adverse consequences for activity and investment. A reduction in deposit rates of about 4 percentage points had been brought about since April 1985, and prime lending rates had eased somewhat. The authorities continued to urge the banks to use what further scope might still be available to reduce interest rates. However, they were mindful that a rapid reduction could prove counterproductive if it had soon to be reversed. Though the attractions of interest rate subsidies to be provided through the budget in support of productive investment were noted, such subsidies were not under active consideration. To be sure, credits carrying preferential interest rates of some 12 percent to the borrower--by comparison with prime lending rates of 17-18 percent--accounted for about one sixth of bank lending.

Movements in the monetary aggregates in Indonesia have been particularly difficult to interpret in recent years because of the changes in the structure of the monetary system, accompanying shifts in the demand for assets, and a reflow of funds from abroad. Thus, the exceptionally rapid rise in rupiah time and savings deposits in 1983/84--of some 90 percent--moderated in 1984/85 to 35 percent, suggesting that much of the portfolio adjustment had taken place. However, growth of these deposits accelerated in 1985/86, reaching 57 percent in the year ending September 1985. One explanation offered by the authorities for the rapid growth of time deposits was the availability of very attractive real effective yields (Chart 6). 1/ Indeed, staff calculations show that the real rate of return on deposits is high by historical standards, while the spread over LIBOR has also increased. Over this

---

1/ Interest paid on bank deposits is not taxable.

same period, broad money increased by 29 percent, and narrow money by 18 percent. 1/ 2/

On the asset side, total domestic credit in the year to September 1985 rose by 31 percent, and credit to the private and public enterprise sectors by 20 percent. This contrasts with the outturn for 1984/85 when credit to the private and public enterprise sectors rose by 21 percent, compared with a total domestic credit expansion of only 4 percent, and a buildup of government sector claims on the banking system of about Rp 3 trillion. The authorities explained that credit policy was being actively used to support domestic activity.

There has been significant expansion since 1984 in credits refinanced by BI (liquidity credits) for on-lending by commercial banks. 3/ Thus, although in 1983/84 such credits (excluding those for BULOG) 4/ had risen by only 4 percent, in line with the intention of the authorities to reduce the role of such credits, their growth had accelerated to about 20 percent per annum in the subsequent 18 months. It remained the intention of the authorities to reduce the role of liquidity credits in the medium term--an intention that had found strong endorsement in the Executive Board.

One explanation for the strong growth of liquidity credits in recent years was the addition of four new eligible categories during the course of 1984. 5/ While efforts were being made to limit further expansion, liquidity credits for additional support to the agricultural sector were foreseen, particularly since budgetary resources were expected to be limited in the coming year.

The authorities explained that the extension of the payment period from three to six months for accounts receivable in some sectors--for

---

1/ The marked acceleration in the year-on-year growth of narrow money between July and August 1985, from 13 percent to 17 percent, stems, in part, from the unusually low level of August 1984, but also perhaps from the relatively attractive real rates of return on current deposits. Interest on current deposits is negotiable for large deposits and may amount to as much as 8 percent.

2/ The target for broad money growth for 1985/86 was 23 percent, but was premised on much higher rates of nominal GDP growth than are likely to be realized.

3/ Liquidity credits amount to about one third of total bank credit. About half of these credits currently are "priority" credits carrying interest rates of the order of 12 percent.

4/ BULOG, which is the National Logistical Agency, is responsible for the stabilization of prices of important agricultural commodities.

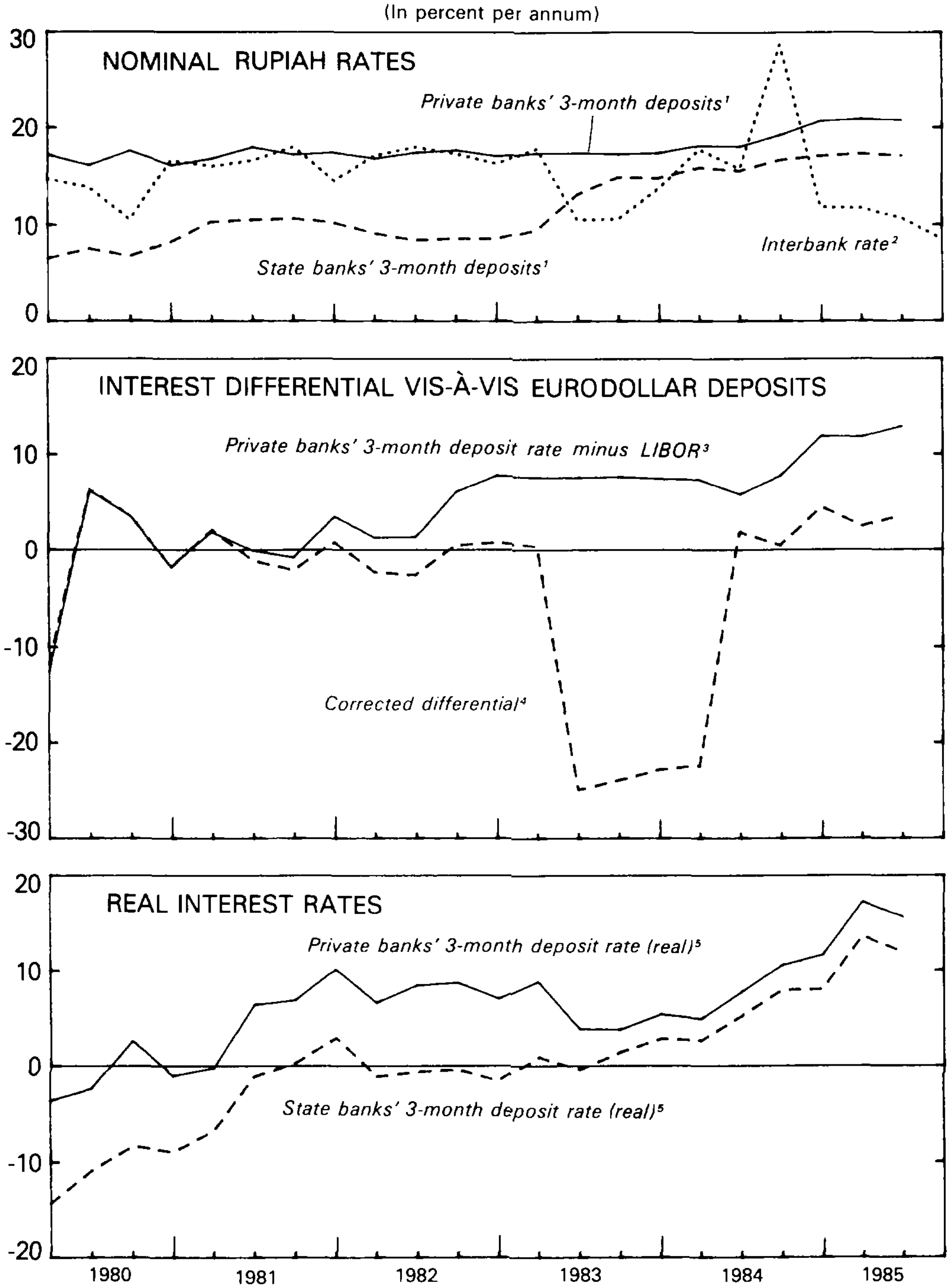
5/ These were working capital credits for small businesses, credits for certain government suppliers, a new government project, and a new rural credit program (Kupedes).

CHART 6

INDONESIA

DOMESTIC INTEREST RATES IN RELATION TO EURODOLLAR RATES AND DOMESTIC INFLATION, 1980-85

(In percent per annum)



Source: Bank Indonesia and A.P. Dow-Jones Tape.

[1] At end of quarter; weighted average of rates at individual banks, with current weights based on deposits.

[2] Average for quarter, using weights based on size of transactions.

[3] LIBOR is London interbank offered rate on 3-month U.S. dollar deposits at end of quarter.

[4] Private banks' 3-month deposit rate minus LIBOR minus percentage appreciation of U.S. dollar in terms of rupiah over previous year

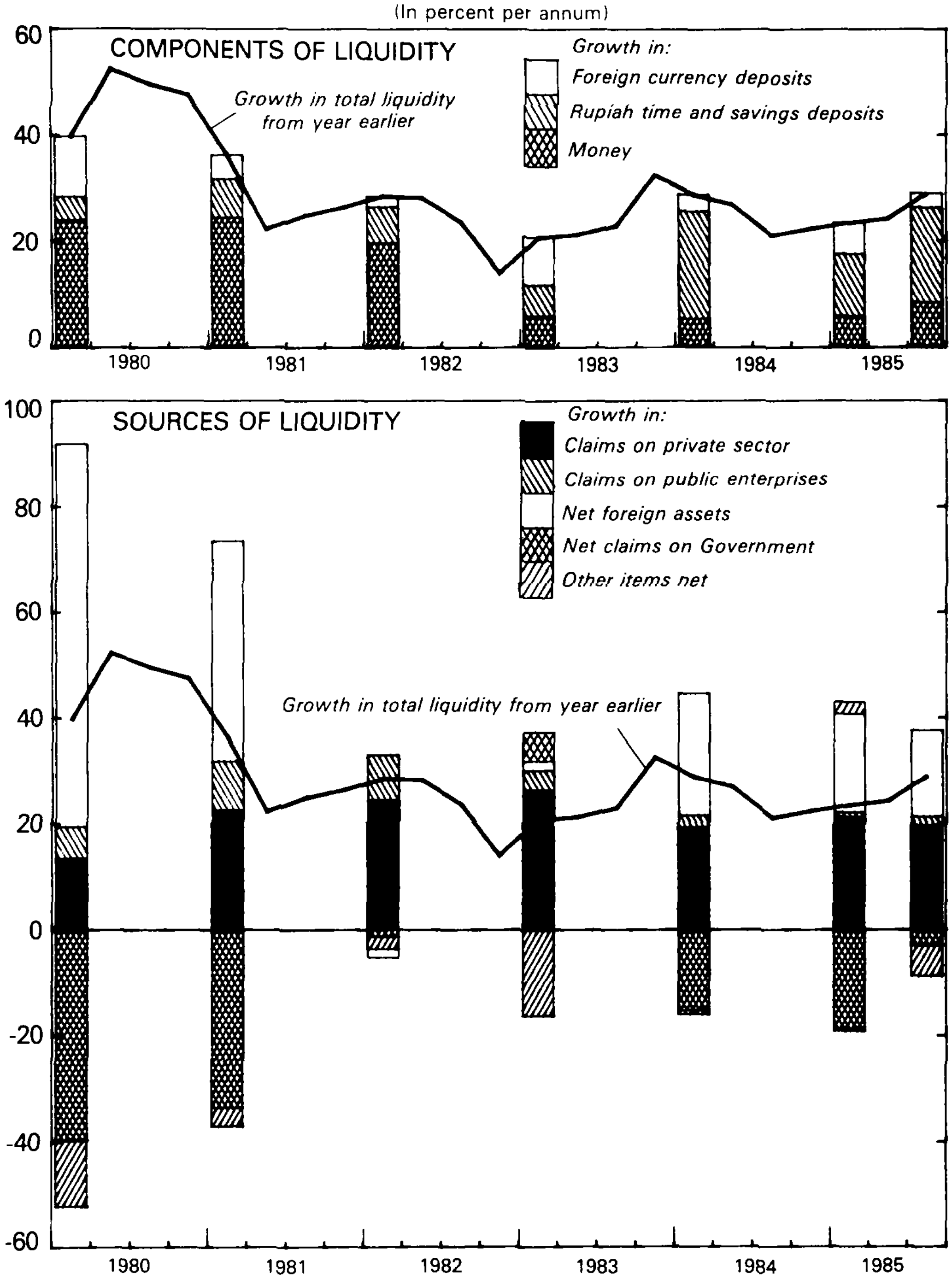
[5] Net of inflation in previous year (measured by CPI)

CHART 7

INDONESIA

CONTRIBUTIONS TO THE GROWTH OF TOTAL LIQUIDITY, 1980-85[1]

(In percent per annum)



Source: *Bank Indonesia*

[1] The source data are end quarter. Each bar refers to the growth of total liquidity over the year ending in the quarter in which the bar is shown, except that the bar shown for the third quarter of 1985 refers to the year ending in August. Each bar shown other than the last refers in fact to liquidity growth over a fiscal year.

example, in connection with the provision of consumer credit--had given rise to an increased need for credit in 1985/86. The authorities also noted that the banking system had an obligation to extend credit to firms facing financial difficulties of a cyclical nature, while the state banks had also been encouraged to involve themselves in the restructuring of firms whose weaknesses appeared less transitory. Equity participation by the banks, at least for a time, was considered a necessary part of the restructuring process. At the time of the discussions, it was difficult to assess the importance of nonperforming loans in the portfolio of the banking sector as a whole, but a study of the quality of the major development bank's loan portfolio was being conducted in conjunction with the World Bank. It was expected, however, that a number of small banks would register losses in 1985/86, and, in the absence of a pickup in activity, possibly also in 1986/87.

The authorities were not concerned by the rapid growth of the monetary aggregates. They pointed to the sluggishness of activity, unutilized capacity, and low price pressures as indicative of the absence of inflationary pressures. Should inflationary pressures emerge, they felt confident that the instruments at hand to absorb excess liquidity--in particular, the sale of Bank Indonesia certificates (SBIs) to banks--would be adequate. 1/ In this context, they pointed to the recent significant increase in the stock of SBIs held by the banking system as indicative of both the liquidity of the banking system and the ability of BI to absorb liquidity, should the need arise. They also noted that the SBPU facility 2/ could provide temporary funds to the banking system, should that be required. At present, little use was being made of this facility. The recent increase in the limit on interbank borrowing, from 7 1/2 percent to 15 percent of third party liabilities, and the increased scope for credit through the SBPU facility were designed to assure banks of the adequacy of their access to reserve assets, should the easing of interest rates that was being urged give rise to a fall in deposits. There was no intention of removing the ceiling on borrowing from the interbank market.

c. Fiscal policy

To facilitate staff analysis, a number of adjustments have been made to the official budget figures to permit a better assessment of the overall balance. Nonetheless, the budget figures presented here may still not be fully reflective of the magnitude of net lending and expenditures of the central government, or of the revenues accruing to it, since the financial transactions between the central government and state enterprises are only partly captured. The staff team commended

---

1/ A follow-up technical assistance mission from the Central Banking Department is scheduled for February 1986 to review the monetary reform and the adequacy of policy instruments.

2/ See footnote 1, page 2.

the authorities for their intention to make the costs of certain policies more transparent (for example by moving a portion of the costs of preferential credits to BULOG to the budget) so that the outlays could be reviewed more readily.

This being said, the 1984/85 budget outturn differed considerably from what was projected in the budget document. Reflecting a much larger increase in oil/LNG revenues than originally foreseen, coupled with shortfalls in project disbursements, a modest overall surplus was registered, against a projected deficit of over 3 percent of GDP; net domestic expenditures declined to 9.4 percent of GDP, against 9.6 percent a year earlier. 1/ The modest surplus was accompanied by a marked buildup in the Government's balances with Bank Indonesia (Chart 8). Indeed, between 1978/79 and 1984/85, the Government's deposits with the domestic banking system increased in every year other than 1982/83.

(1) Budget for 1985/86

The 1985/86 budget was formulated within a framework of prudent financial policies. As in earlier budgets, the aim was generally to restrain expenditures to the level consistent with government revenues and borrowing from abroad associated with project finance. Within this framework, the authorities took account of the sluggishness of activity and the weakening of price pressures, while at the same time, recognizing financing constraints and the difficulties of accelerating development expenditure. Thus, the budget strategy was to offer some stimulus to domestic activity through a 20 percent increase in current expenditures. However, with the foreseen strengthening of non-oil/LNG revenues by one third, net domestic expenditures would fall from 9.4 percent of GDP in 1984/85 to about 8 percent in 1985/86. The overall balance would register a deficit of 2 1/2 percent of GDP, however, on account of an acceleration in foreign-financed project expenditure--brought about in part by measures to facilitate implementation--and a weakening in oil/LNG revenues.

Government wages were to increase by 20 percent, to promote efficiency and to restore salaries to the real levels of 1982, while

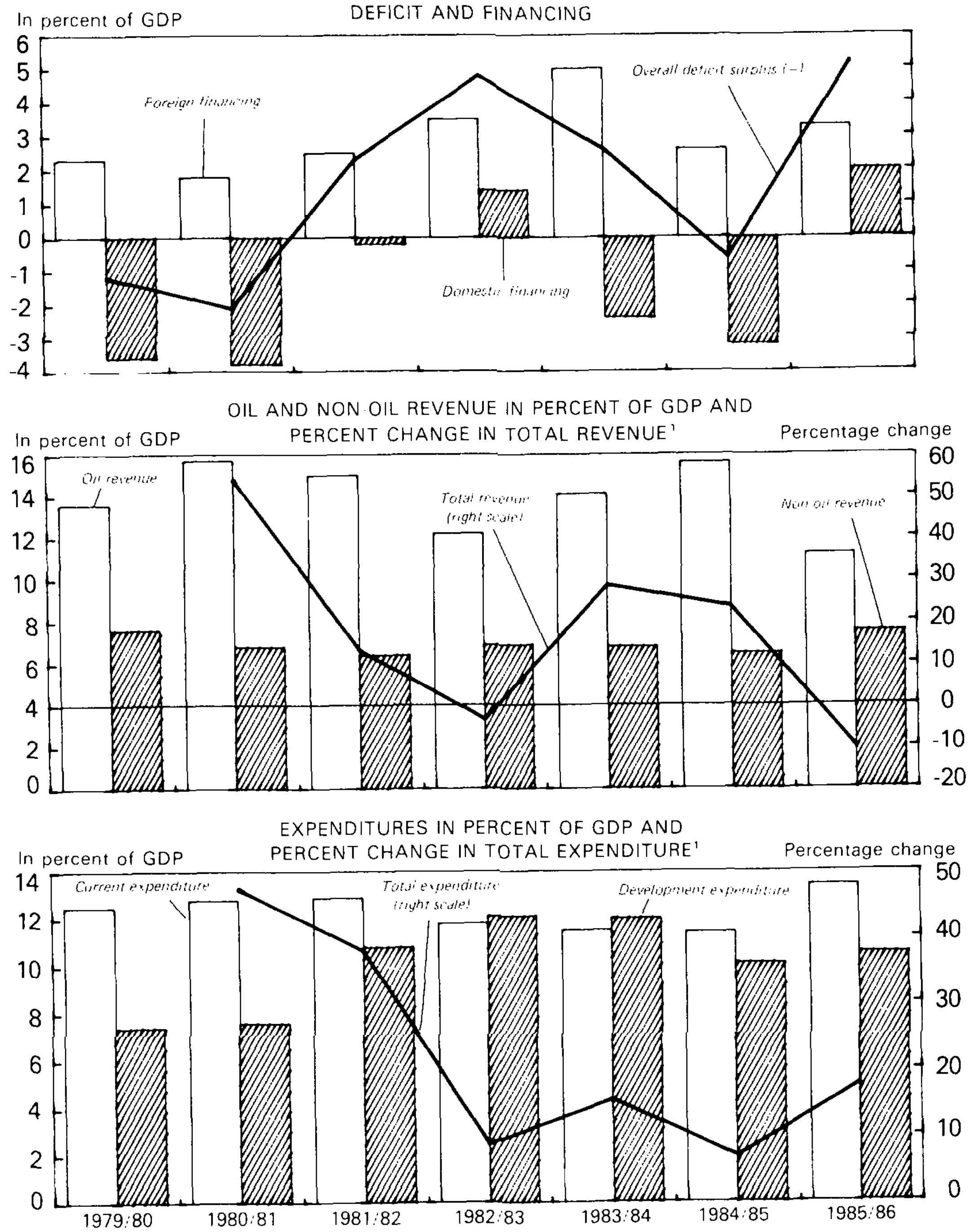
---

1/ Net domestic expenditures are defined as domestic expenditures (expenditures exclusive of government imports of goods and services and foreign debt servicing) less domestically generated revenues (largely non-oil/LNG tax revenues and domestic nontax revenues). They may be taken as a first approximation of the impact of fiscal policy on domestic economic activity, though measurement is subject to a wide margin of error, if only because of the difficulties in distinguishing between expenditures on imports and domestically produced goods.

CHART 8

INDONESIA

CENTRAL GOVERNMENT OPERATIONS, 1979/80-1985/86



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

[1] Discontinuities in the data preclude the calculation of percent changes between 1978/79 and 1979/80 for revenue and expenditure.

employment would also rise. 1/ Transfers to regions, largely to cover personnel costs, were to increase by 38 percent. By contrast, the budget foresaw a 12 percent decline in subsidies, from 12 1/2 percent of current outlays to just over 9 percent, because of a 24 percent decline in the fertilizer subsidy.

The revenue estimates were surrounded by substantial uncertainty. Projections of oil/LNG revenues, accounting for some two thirds of government revenues, were based on an oil price assumption of $29 per barrel. Thus, oil/LNG revenues were expected to decline by some 17 percent to some 60 percent of total revenues. Non-oil/LNG tax revenues were projected to rise by 42 percent, to 36 percent of total revenues, with the coming into effect of the VAT and a strengthening in revenues from the new income tax. The reduction in import tariffs, effective April 1, 1985 had not been foreseen at the time of budget preparation.

(2) Outturn for the first half year and prospects for 1985/86

The first semester results show a deficit of 1 1/2 percent of GDP at annual rates. However, the authorities felt that there would be a significant rise in outlays in the second half year, which, coupled with continued weak oil/LNG revenues, could result in a deficit of some 5 percent of GDP for the year as a whole. The fiscal developments foreseen for the second half year would necessitate a drawing down in government deposits of Rp 1.8 trillion (almost 2 percent of GDP). No drawdown had yet taken place.

Both current and development expenditures--namely foreign-financed project expenditure--fell well short of half the budgeted amount during the first six months of the fiscal year. 2/ However, the traditional seasonal pattern for current expenditures would result in a full catch-up in the second half year for most items; an overshooting was to be expected for fertilizer subsidies. The authorities were also confident that measures to speed disbursements would be effective in the second half year, keeping development outlays in line with budget projections.

For 1985/86 as a whole, a shortfall of an additional Rp 1 trillion in oil/LNG revenues (to a level 9 percent below the 1985/86 budget estimate and almost 25 percent below the 1984/85 outturn) was expected, roughly in line with oil price developments. (The decline in oil/LNG revenues in 1985/86 from the 1984/85 budget outturn was equivalent to 3 1/2 percent of GDP.) This shortfall in itself would increase the

---

1/ Budget figures for 1985/86 would seem to imply a rise in employment of about 6-7 percent, in line with the growth of employment of the central government since 1978.

2/ Foreign-financed project expenditure for the first six months amounted to about one third of the budgeted amount.

overall deficit by 1 percentage point of GDP. The foreseen shortfall of non-oil/LNG revenues from budget estimates and an overshooting of current and development expenditures were expected to account equally for the remainder.

Non-oil/LNG tax revenues were expected to fall short of estimates by about 11 percent: value-added tax receipts had been buoyant despite a compliance rate of only some 35 percent, but income tax receipts had fallen substantially short of the budget target despite a 50 percent compliance rate. Revenues from international trade taxes were significantly below projections, partly because of the unanticipated reduction in tariff rates, but also because of the sluggishness of imports.

The ratio of net domestic expenditures to GDP was likely to remain roughly constant at 9 1/2 percent in 1985/86, against a budgeted decline to 8 percent. Current expenditures--and with them, gross domestic expenditures--were expected to exceed the budgeted total as a result of a rise in the fertilizer subsidy. This subsidy was expected to increase by 5 percent above the budgeted outturn for 1984/85 (rather than fall by 24 percent), thus moderating the decline in the share of subsidies in current expenditures to 10 1/2 percent. The revised estimate reflected undue optimism in the initial budget, coupled with continued strong demand for fertilizer for rice production. Rupiah-financed project expenditure would be roughly equal to the budget estimate, notwithstanding greater-than-expected government equity investment in the first six months of 1985/86.

Outlays for interest payments on foreign debt were to rise by 15 percent. With an annual rate of rise of 36 percent since 1982/83, the share of interest payments in current expenditures would increase from 9 percent to 14 percent.

Though foreign-financed development outlays were running behind schedule, the authorities were optimistic that new measures to speed disbursements would prove effective and would permit a full catch-up in the second half year. This, coupled with an adjustment for exchange rate movements, would be reflected in foreign-financed project expenditures 6 percent above the budgeted level.

(3) Budget for 1986/87 and recent fiscal initiatives

The budget process for 1986/87 had just been initiated at the time of the consultation discussions in Jakarta, and the authorities were reviewing alternative scenarios for oil production and price developments on which to base their calculations. Public statements by high-level officials made clear, nonetheless, that the Government's revenue projections for 1986/87 would be lower than those for 1985/86, and that they would need to trim expenditures.

The Ministry of Finance and the Planning Agency were actively seeking to identify possible cuts in current and capital expenditures. Cuts in nonproductive current expenditures would first be introduced, while there was also a strong possibility that, for a time, there would be no further wage increases.

The review of project expenditures was to take into account the impact of projects on the growth of domestic employment and the balance of payments. World Bank staff have encouraged the authorities to finish productive projects close to completion but, more generally, to concentrate their investment efforts on the development of social and economic infrastructure, because of Indonesia's relatively weak infrastructure, the important externalities of such investment, and the objective of promoting growth of the private sector in productive activities (see Annex III).

Recognizing the weakness of economic activity and the financial difficulties faced by a number of firms, and also wishing to encourage compliance with the new income tax law, the Government announced in October 1985 that it would immediately refund to businesses upon application any excess payment of income tax. 1/ A penalty would be imposed, however, on those whose claims for refund proved unjustified. It was also the intention of the authorities to initiate tax audits in November and to strengthen compliance with income tax laws and with the VAT.

A further important change in the tax system, which had just been submitted to Parliament, was the consolidation and simplification of the wealth and land taxes. A multiple rate structure was to be converted to a single rate of 0.5 percent of assessed value, and only land and buildings were to be subject to this tax. Hitherto, the capital value of all real and financial assets (excluding bank deposits) had been subject to taxation, though the effective implementation of this policy had proved difficult. It was hoped that this tax reform would reduce some of the impediments to the development of the market for financial assets.

d. Agricultural, industrial, and trade policies

Indonesia's rice policy has led to the attainment of self-sufficiency in recent years, which has significantly reduced the country's reliance on food imports. However, at the same time, large stocks of rice, subject to high rates of spoilage, have been accumulated by BULOG under its rice stabilization program. The costs of stockpiling are considerable, and liquidity credits extended for BULOG have increased rapidly. As noted, efforts were made in 1985 to encourage rice growers to improve the quality of rice through the enforcement of previously set standards, and this had reduced the effective price paid to farmers. The authorities explained that they wished to reduce the relative

1/ Total refunds were expected to reach Rp 225 billion.

incentives for rice production, but the change in the incentives structure should not be so abrupt as to damage the confidence of the farming community in the Government's agricultural policies, or to hold the growth of rice production below that of demand in the longer term. In the event, support prices for the 1986 crop year are to remain unchanged in nominal terms, in contrast to the usual increase; it was also announced that there would be no increase in the price of fertilizer sold to farmers.

The general structure of agricultural incentives was under review. Consideration was being given to shifting a portion of the cost of BULOG's support operations from Bank Indonesia to the Government so that the actual costs of the rice program would be more readily apparent, and so that support for a rationalization of the agricultural strategy could be mobilized. Soybeans at present are largely imported, but measures to encourage production had been officially endorsed. Preferential financial support (under the liquidity credit scheme) would be provided to encourage the shifting of acreage from rice to soybean production and the opening of new acreage for soybeans, though the operational details had yet to be worked out.

In addition, programs for tree crop support would be accelerated. The tree crop sector (for example, palm oil, rubber, coffee and tea) which already accounted for one eighth of employment and one third of non-oil/LNG exports, would thus increase further in importance as a result of extensive planting and rehabilitation schemes.

Major administrative reforms related to the simplification of the approvals procedure for granting investment licenses--reducing the number of documented steps from 35 to 13--and further measures to facilitate project disbursements through the streamlining of approval procedures. 1/ The latter included the waiving of certain complex approval procedures for small disbursements (in rupiah terms) and minor acquisitions of land (in terms of hectares). A new secretariat was also being set up to identify and resolve systemic implementation problems. No change in the requirement that a certain share of inputs in investment or production had to be produced locally (domestic content requirement) was foreseen, though at times this requirement could give rise to high downstream costs of production and a loss of competitiveness. In some cases, the dampening of competitiveness stemming from high costs had been addressed by less-than-full cost pricing by important state enterprises, but in others, the pricing policies of such enterprises continue to be based on cost-plus principles. No plans for restructuring sectors suffering from chronic excess capacity were pointed to in the discussions.

1/ For a description of impediments to disbursements, see Annex III, Section 4, and the forthcoming report on recent economic developments.

There had been some expansion of the annual list of sectors open to investment by joint ventures. However, foreign investors in such instances could be required to form partnerships with groups that were economically disadvantaged, such as cooperative groups. In general, foreign investments were permitted if they were fully export oriented, involved high technology, or required very large capital outlays. The operation of joint ventures, which has traditionally been geared to production for the domestic market, continued to be affected by guidelines governing the level and growth of the share of domestic value-added in production and by a timetable for the transfer of majority ownership to Indonesian partners. At the same time, land ownership by nonresidents was precluded and land leases, held by Indonesian partners, could not exceed 30 years. Although the length of leases was seen to limit investment in the plantation sector, there was no intention of extending the lease period.

The Government has been pursuing an active promotional policy to attract foreign investment in joint ventures, and has also indicated a willingness to implement certain rules in a flexible manner--for example, adherence to the timetable on the transfer of majority ownership to Indonesian residents, should difficulties arise or the early renewal of leases. Because of restrictions on borrowing from domestic banks in rupiah, the financial position of joint ventures suffered particularly from the effects of the 1983 rupiah devaluation on their external liabilities. Joint ventures have, however, recently been allowed access to preferential export credits. Foreign banks have also been allowed to extend such credits to firms headquartered outside Jakarta.

Action has been taken recently to address the high costs of transportation in Indonesia. Measures were introduced in April 1985 to reduce both the explicit and implicit costs of port and shipping services, including prolonged delays and administrative costs associated with the use of Indonesian ports. These measures were supplemented in July by reforms designed to reduce the costs of domestic road transportation. The authorities expressed satisfaction with the effect of these efforts.

In conjunction with the port and shipping reforms associated with Presidential Regulation No. 4, the Societe Generale de Surveillance (SGS, a private Swiss-based firm) was given the major responsibility for customs inspection. Inspection takes place primarily in ports of origin for Indonesia's imports, or of destination for Indonesia's exports. Documentation from the SGS is typically necessary to obtain customs clearance for imports, and also to obtain the rebate available under the export certificate system. The authorities reported satisfaction with the operation of the new system, which was expected to work more smoothly as the trading community gained further experience.

At the same time that the SGS started operations, the maximum tariff rate was reduced from 200 percent to 60 percent, and the schedule of tariffs was simplified. The authorities confirmed, however, that the trade system had become more restrictive in recent years. Tariffs were perceived to be ineffective in controlling imports priced at or below the foreign producer's marginal costs of production, and this was particularly worrisome for domestic industries suffering from low levels of capacity utilization. Questions were also raised about the effectiveness of anti-dumping legislation in the Indonesian setting. Thus, there had been increasing reliance on the channeling of particular imports through licensed importers who could assess the desirability of such imports from the perspective of the domestic economy. The designation of licensed importers was also thought to be beneficial in that it would give rise to a specialized body of knowledge about the availability of goods and to a stronger relationship with potential suppliers. The recent customs reform could enhance the effectiveness of tariffs and permit a shift to greater reliance on tariffs in lieu of quantitative restrictions and licensed import channels. The authorities indicated that it was their intention to strengthen the efficiency of domestic production by shifting to a more liberal trade system. However, it was difficult to foresee when such a shift might take place.

The importance of encouraging non-oil/LNG exports continued to be very much in the minds of policymakers, and the adequacy of export incentives was under review. The policy of limiting particular exports in order to stabilize domestic prices had been eased for important commodities; it had been accepted that, at times, domestic demand might have to be satisfied by imports in order to secure export markets for domestic products over the longer term. Although the availability of export credits on favorable terms was extended to joint ventures, there remained the commitment under the GATT to phase out all preferential export credits by 1990 and to replace the Export Certificate Scheme by April 1986 with a yet-to-be announced duty drawback system. These changes would make essential a marked increase in the efficiency of domestic producers, if these producers were to maintain their markets abroad.

The authorities noted the adverse effects on Indonesia's exports of sluggish growth in partner countries, as well as protectionist tendencies abroad. One strategy that was being actively pursued with respect to oil/LNG exports was the diversification of markets and products; significant sales of LNG to new markets were in prospect, while exports of liquefied petroleum gas (LPG) were also expected to grow in importance. The countertrade initiative, under which foreign suppliers were to balance certain public sector imports with purchases of additional exports from Indonesia, continued to be pursued. Further, private market participants were being encouraged to expand markets by arranging balancing export and import contracts with state-trading countries. The authorities felt that, even though such bilateral arrangements might not strengthen the trade balance significantly, they might boost activity in

Indonesia. The staff pointed to the practical difficulties of arriving at bilateral trade arrangements, not least for Indonesian private sector participants, and questioned whether any net benefit would arise from such transactions.

IV. Medium-Term Prospects for Growth and the Balance of Payments

Medium-term projections for Indonesia's external balance and budgetary position were developed by the staff at the time of the discussions, assuming the pursuit of present policies and using the assumptions for growth in partner countries' imports and for oil and non-oil commodity price developments incorporated in the August world economic outlook exercise (WEO). Annex V provides a more detailed description of the procedures and assumptions used by the staff to derive these projections. The base scenario assumed that Indonesia's oil export price measured in U.S. dollars would decline by 2 percent in 1986/87 and remain constant in nominal terms in the following two years. Thereafter, it would rise with world inflation. The results of this projection are described in the text below, and summarized in Table 3 of Annex V. The text and Chart 9 also indicate how the results are affected by the shift to the December WEO working assumptions, suggesting inter alia a 12 percent decline in 1986, on average, in the world oil export price expressed in U.S. dollars. 1/

The base scenario developed at the time of the discussions illustrates that with a weakening in oil prices, and thus in the resources available to support investment and service debt, a continuation of prudent financial policies necessitates further import restraint and a lower rate of capital formation, with attendant consequences for growth. Such adjustments would be necessary, notwithstanding the developments described above: the mobilization of non-oil/LNG based resources within the government sector, the mobilization of resources within the private sector and from abroad; the completion of capital-intensive infrastructure projects; and enhanced efficiency in the use of capital. The constraints on investible resources and the lack of dynamism in non-oil/LNG export performance were seen to limit growth over the five years to 1990 to about 3 1/2 percent per annum, compared with population growth of 2 1/4 percent.

1/ The assumptions incorporated in the WEO to be presented for Board discussion in March may differ somewhat because further consistency checks may call for a modification of trade flow projections. However, the changes are not expected to be large. The global assumptions for foreign direct investment and aid flows are somewhat more buoyant than those used in constructing the revised scenario for Indonesia, reflecting a modification of these projections for Indonesia's specific circumstances.

Substantial fiscal adjustment was incorporated into the baseline projection; the overall budget deficit was reduced from 5 percent of GDP in 1985/86 to 1 percent of GDP by 1990/91. A broadening of the non-oil/LNG tax base and an increased rate of compliance were projected to raise non-oil/LNG revenues from 6 1/2 percent of GDP in 1984/85 to 9 1/2 percent of GDP by 1990/91, while the petroleum and fertilizer subsidies were gradually reduced in real terms. Government investment declined from 10 1/2 percent of GDP in 1985/86 to about 8 percent of GDP by 1990/91.

Turning to the balance of payments, the current account deficit would remain in the range of 3 1/2 percent of GDP until 1987/88, but would decline to 2 percent of GDP by 1990/91. Excluding major changes in industrial and trade policies, non-oil/LNG exports were only expected to rise in line with demand in foreign markets. Aid commitments were expected to remain roughly constant in real terms over this period, and were used to finance project imports. Nonproject imports were expected to rise with income.

The financing of the current account was reflected in the buildup of external debt and debt service over the projection period. Total public external debt rose to $37 billion by 1990/91, from $24 1/2 billion in 1984/85; after rising to almost 33 percent of GDP in 1987/88, the ratio of public sector debt to GDP declined to some 30 percent in 1990/91 (Annex V, Table 3). The public sector debt service ratio increased from 17 1/2 percentage points in 1985/86 to 22 percent by 1988/89 before declining to 19 percent in 1990/91 (the ratio for total debt service rose to 25 percent in 1988/89 but fell somewhat below 22 percent in 1990/91) (Chart 9).

If the balance of payments aggregates developed as foreseen above, the external balance could prove sustainable for some years; however, the implications of such a scenario for domestic activity provided clear evidence that more active policies to support growth of the non-oil/LNG sector were needed. The timely implementation of such policies was seen to be important, because of the length of time required to bring about significant structural adjustments.

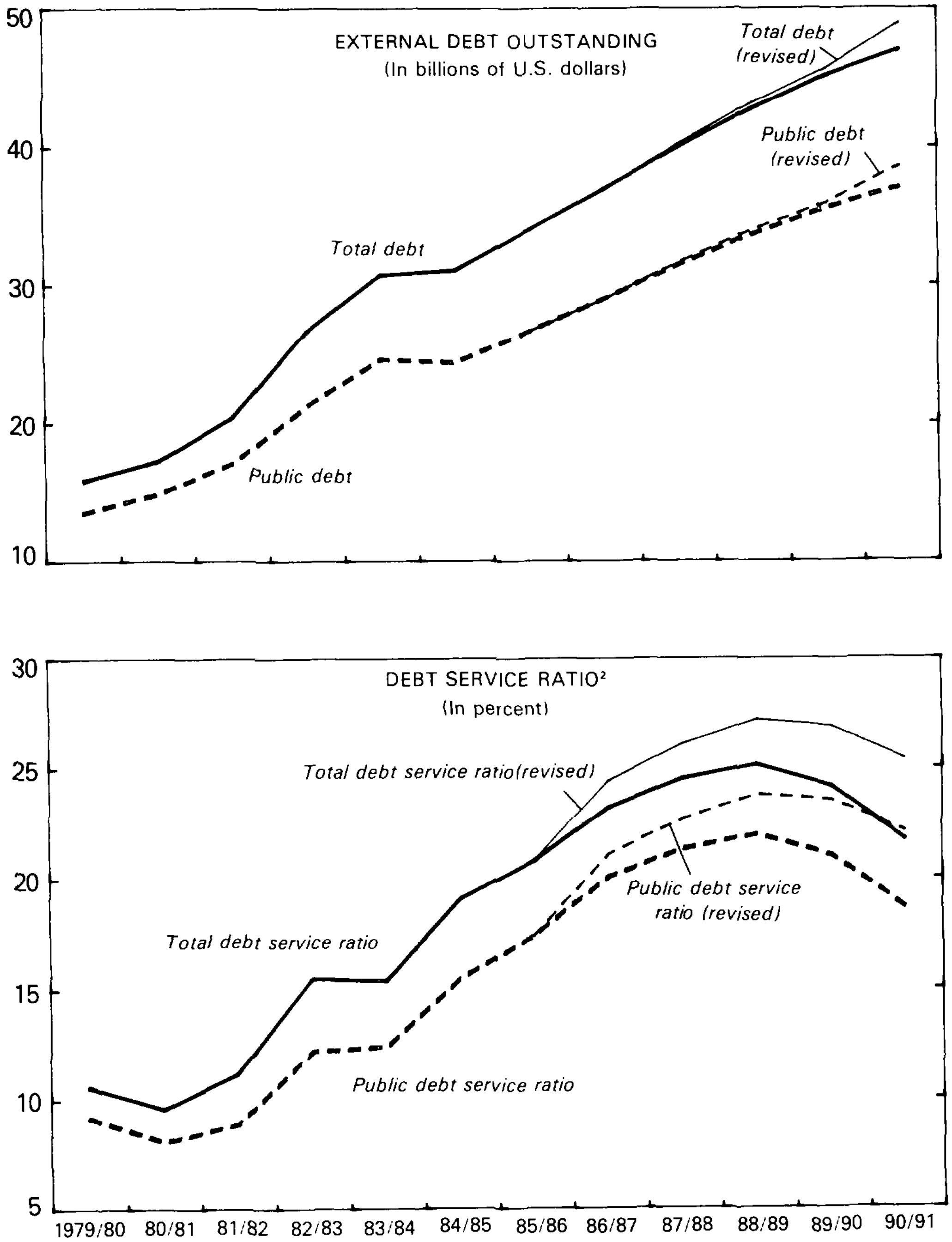
In the staff's view, the revised baseline projection underscores the need for more active adjustment policies. It incorporates the December WEO assumptions but, at the same time, assumes that the authorities intensify their efforts to promote non-oil/LNG exports. Thus, some gain in market shares is realized. Project and general imports are even more restrained than foreseen earlier. Subsidies are also projected to be reduced significantly. The budget deficit in the revised scenario declines from 5 percent of GDP to below 2 percent over the forecast period, reflecting the staff's view that further increases in non-oil/LNG revenues beyond those foreseen in the first scenario will be difficult to achieve in the medium term. Notwithstanding these policy initiatives, the current account deficit is expected to rise to

CHART 9

INDONESIA

EXTERNAL DEBT AND DEBT SERVICE,[1]

1979/80-1990/91



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

[1] Data for 1986/87 1990/91 are projections.

[2] Debt service in percent of exports of goods and services.

some 4 1/2 percent of GDP in 1986/87-1987/88, before declining to 2 1/2 percent by 1990/91 (Annex V, Table 4).

The projections for external debt and its servicing are illustrated in Chart 9 for both scenarios. The rise in the stock of debt in the revised scenario is contained in the short term by an assumed decline in foreign exchange reserves; however, by the end of the projection period, official external debt is estimated at $38 1/2 billion with total external debt of almost $50 billion (40 percent of GDP). The debt service ratios are about 3 percentage points higher by 1990/91 in the revised scenario (at 22 percent and 25 percent for public and total external debt, respectively), owing to higher service payments and lower export receipts. The domestic rate of growth for the period 1986/87-1990/91, associated with the revised scenario, is some 3 1/4 percent per annum.

V. Staff Appraisal

The prudent financial policies pursued by the Indonesian authorities in recent years have found strong support in the international community. During a period of rapidly growing foreign exchange earnings following the oil price increases of 1979 and 1980, policymakers were under pressure to quickly spend the incoming revenues; this could have resulted in a wastage of resources, and a very marked rise in domestic inflationary pressures. In the event, many of the dangers of an overly rapid development effort were avoided, while the Government built up its foreign exchange reserves. Consequently, when the oil markets weakened in the early 1980s, the authorities were better able to respond. Specific investment projects were reviewed against the changed world environment and a diminished resource base. More generally, steps were taken to enhance the efficiency of resource use. A number of bold initiatives have been taken since early 1983 to strengthen the growth potential of the non-oil/LNG sector, encompassing an exchange rate devaluation, and monetary, fiscal, and administrative reforms.

The success of the authorities in eliminating impediments to the growth of the non-oil/LNG sector has been incomplete in certain areas, while other basic impediments to this endeavor, such as the high level of effective protection offered by the trade system, have not yet been addressed. At this time, however, new initiatives are essential because of the substantial level of external debt outstanding, estimated to reach almost $35 billion by March 1986 (42 percent of GDP), an aggregate debt service ratio of 22 percent, and the medium-term prospects for growth and the balance of payments. Admittedly, new initiatives are made more difficult by the sluggishness of activity at home and abroad.

Medium-term projections, based on a further weakening of oil/LNG and commodity prices in the near term, 1/ point to a further nominal rise in total external debt (but a decline to 40 percent of GDP by 1990/91), with the public debt service ratio peaking at 24 percent in 1988/89 before declining to 22 percent by 1990/91 (Chart 9). (Some pickup in the debt service ratio in the early 1990s would be likely to occur as the grace periods for the borrowing foreseen in the second half of the 1980s elapse.) These projections are premised on a marked intensification of the adjustment policies presently pursued by the authorities: within the limits imposed by greater resource constraints, efforts are continued to further increase the efficient use of capital in the public sector and to encourage private sector investment. Nevertheless, real GDP growth is limited to some 3 1/4 percent over the coming five years. This rate of growth contrasts with the estimated increase in the labor force of some 2 1/4 percent per annum, and the real rise of GDP of 4-5 percent that is seen necessary by the World Bank if employment opportunities are to expand in line with the labor force.

Though the imbalances now foreseen might be financed for a time, both the external and domestic implications of the medium-term scenario would suggest that even more active policies of structural adjustment than those envisaged in the scenario, supported by cautious financial policies, are necessary. Given the need to establish a stable environment for decision making, and the long response times that must be expected, the timely implementation of adjustment measures is called for. A strengthening of the data base, particularly for trade flows and the transactions of the central government and of public sector enterprises, would facilitate the tasks of economic analysis and the monitoring of policy implementation.

Of immediate concern to the staff is the recent rapid growth of liquidity, notwithstanding sluggish economic activity, and, related to it, the sharp swing in the budget balance (to a deficit of 1 1/2 percent of GDP at annual rates during the first semester); if the projected drawdown in government balances is realized, liquidity growth could accelerate further. In the staff's view, excess liquidity may not prove as easy to absorb as the authorities believe. It could affect domestic prices with a lag, but the greater danger would seem to lie in its potential impact on the balance of payments.

The staff understands the importance attached by the authorities to supporting activity through the extension of credit, and in this connection, notes the growth of credit to the private and public enterprise sectors of some 20 percent per annum despite a depressed investment

1/ The specific assumptions underlying the medium-term projections presented here are the working assumptions developed for the world economic outlook exercise in December 1985. Thus, they became available after the discussions in Jakarta had been completed.

environment. The growth of preferential credits has played an important role in the current credit expansion. Reliance on preferential credits is made all the more attractive by budgetary constraint, and by the high level of real interest rates charged on banks' own resources. Such credits may impair, however, the effectiveness of traditional instruments for controlling the growth of liquidity. Further, the monitoring of their potential costs to the economy if, for example, they foster distortions in the allocation of resources, is difficult. The implications of bank lending for nonproductive purposes should also be carefully monitored so that adjustment is not unduly delayed and the soundness of banks' financial positions is not impaired. In the staff's view, it would seem particularly important, in a setting of resource scarcity, for the authorities to renew their commitment to placing greater reliance on markets in the allocation of capital.

The budget for 1985/86 called for a shift in the overall balance from a modest surplus to a deficit of some 2 1/2 percent of GDP. This was judged in the last Article IV consultation as appropriate to the circumstances, and the authorities were encouraged not to trim current expenditures if revenues proved somewhat weaker than foreseen. But Executive Directors also urged the authorities to reduce impediments to project implementation and thus to reverse the projected rise in the share of current expenditures in total outlays. In the event, revenues have proved substantially weaker than expected. If significant progress in project implementation does occur in the second semester, and with the seasonal upturn in current expenditures also expected by the authorities, the deficit could rise from 1 1/2 percent of GDP (at annual rates) in the first semester to over 5 percent for the year as a whole. However, the staff doubts that such a large deficit will be realized, given the results thus far in project implementation. And, although progress in strengthening project disbursements is to be welcomed, such a sharp rise in the deficit, and attendant consequences for liquidity growth, would not be supportive of growth over the medium term or of stability.

The deviations from budget projections, on account of a rise in fertilizer subsidies and weak compliance with the new income tax law, are important sources of concern. They suggest that renewed efforts to strengthen Indonesia's non-oil/LNG revenue base and to contain subsidies will be needed if the policy projections underlying the medium-term scenario are to be realized. In line with the recommendations of the World Bank, the staff would urge the authorities to reduce fertilizer subsidies over time by increasing the price to the consumer; in addition to constraining budget outlays, this would encourage the sought-for diversification in agricultural production. Further, full weight must be given in the budgetary process to the longer-term prospects for oil/LNG revenues for financing rupiah development expenditure, and to the credit needed by the private sector if it is to play an enhanced role. The staff would urge the pursuit of cautious financial policies, taking fully into account the resource constraints that are likely to continue to be faced in 1986/87 and beyond.

The suggestion that public sector salaries should remain unchanged in 1986/87 is understandable as a signal of budgetary stringency, though it may be possible to control the growth of current expenditures also, for example, by a careful review of increases in public sector employment. The authorities are fully aware of the scope for increasing efficiency and the covering of costs in the public enterprise sector, and thus increasing internally generated resources for investment. In the view of the staff, however, it would be unwise to try to contain the budget deficit through increased reliance on off-budget channels of support for activity, for example, by the substitution of preferential credits for subsidies, since the direct and indirect costs of such decisions are difficult to monitor. Further, capital expenditures must again be reviewed as well as the effectiveness of measures to facilitate project disbursements. On the revenue side, the steps already taken to improve administration and strengthen the tax base are appropriate, and should continue to be pursued.

The authorities have adopted a number of measures to address important aspects of the high-cost economy--most recently in the fields of administrative and transportation costs. A flexible exchange rate policy has also been pursued and has resulted in some gain in competitiveness beyond that achieved following the devaluation in the spring of 1983. Such policies are to be welcomed. The staff foresees, however, an urgent need to enhance the growth potential of the non-oil/LNG sector, and especially of non-oil/LNG exports. An integrated approach is called for, based on initiatives in the fields of industrial and trade policies, and a continuous review of exchange rate policy, designed to strengthen the competitiveness of Indonesian products at home and abroad. Deregulation in the decision-making framework, permitting the private sector to assume a larger role, more adequate financial incentives for investment in the non-oil/LNG sector, and increased efficiency through fostering greater competition would be part of this approach.

A shift from reliance on quantitative restrictions to tariffs would play an important role in the integrated strategy, and it is to be hoped that the increased efficiency resulting from the measures announced in the spring of 1985 will be sufficient to permit such a shift. Although quantitative restrictions may be particularly suited to containing imports priced below production costs, the wider implications of a restrictive system for the economy--in terms of a loss of competitiveness and a reduction in the potential rate of growth--must also be borne in mind. It is important that the export orientation of production be strengthened by an improvement in the relative financial incentives for exports, and by the provision of adequate export support facilities, such as financing, marketing, and insurance.

It is fully appropriate that the promotion of joint ventures is actively being pursued. The staff would urge the authorities to review carefully the incentives for and impediments to joint ventures in Indonesia, comparing them, in particular, with those in neighboring countries. Such a review may suggest concrete measures that would encourage inflows from abroad. The offer of flexible application of rules that appear unattractive is less likely to encourage inflows, in the view of the staff, than concrete measures that can be understood by decision makers abroad.

The authorities have also noted the need to develop a private capital market, particularly if they are to meet with success in diversifying the equity base of certain public sector enterprises and in strengthening the capital base for private sector investment. At present, a major impediment to the development of such a market lies in the preferential tax treatment accorded interest income from bank deposits. While the revised wealth tax should eliminate some of the disincentives for the development of a market for financial assets, efforts to eliminate the discrimination in favor of bank deposits would also be essential in the longer term.

Finally, the authorities have taken a number of measures to reduce delays in project disbursement, both in support of investment activity and to encourage the inflow of aid commitments. To safeguard Indonesia's financial resources, and to strengthen its growth potential, it is important that impediments to disbursements continue to be addressed. At the same time, it is essential that the Indonesian Government continue to receive the financial support of the international community for its adjustment efforts, and that markets abroad remain open for the growth of its exports.

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

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Indonesia in the light of the 1985 Article IV consultation with Indonesia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Indonesia maintains an exchange system which is free of restrictions on payments and transfers for current international transactions.

ANNEX I

INDONESIA

Basic Data

Area:	1,900 thousand sq. km.
Population (June 1984):	160 million
Growth of population (1984):	2.2 percent per annum
GDP (1984):	$84 billion
GDP per capita (1984):	$520

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86 Proj. 1/
			(Percentage change)				
Growth and inflation (calendar year)							
Real GDP	5.7	8.3	6.9	0.2	3.3	5.8	1.5
Oil/LNG GDP	1.8	2.8	1.5	-13.7	1.2	11.1	-6.0
Non-oil/LNG GDP	7.2	10.4	8.8	4.7	3.9	4.5	3.0
GDP deflator	35.3	32.6	11.4	7.5	13.7	10.2	5.0
CPI--end of year	14.9	17.1	7.3	10.1	11.9	9.1	4.4
Money and credit							
Total domestic credit	-8.3	-2.9	67.4	56.4	7.8	4.3	31.0
Claims on private sector	14.0	38.6	41.3	40.3	25.5	28.7	25.1
Claims on public enterprises	...	17.4	18.8	8.8	5.9	2.8	6.6
Liquidity credits 2/	...	35.5	57.3	42.3	3.7	22.4	19.6
Total liquidity	39.6	36.3	28.4	20.6	28.7	23.4	29.3
Money	35.6	37.3	29.9	8.9	9.2	11.6	18.3
Quasi-money	48.0	34.2	25.4	44.2	58.3	35.8	39.3
Rupiah deposits	17.2	34.5	32.5	27.3	89.5	35.3	57.2
Foreign currency deposits	146.4	33.8	14.6	74.0	17.9	36.7	4.9
Rupiah broad money	...	36.6	30.6	13.4	30.9	20.9	34.6
Three-month deposit rate 3/	6.5	10.3	9.1	9.5	15.9	17.3	16.4

INDONESIA

Basic Data (Cont'd)

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86 Proj. 1/
				(Percentage change)			
Central government budget							
Total revenue and grants	...	52.7	13.0	-3.7	28.6	23.4	-10.2
Oil/LNG	...	65.6	13.8	-12.4	35.9	29.1	-24.0
Non-oil/LNG	...	29.3	11.2	16.7	15.8	11.5	23.1
Total expenditure	...	47.4	38.0	8.8	15.5	6.9	17.9
Current	...	46.9	19.3	-0.8	14.1	15.9	24.5
Development	...	48.1	69.4	20.3	16.8	-1.9	10.5
				(In percent of GDP)			
Current budgetary surplus	8.6	9.7	8.5	7.2	9.4	10.7	5.3
Overall surplus or deficit (-)	1.2	2.1	-2.3	-4.8	-2.6	0.6	-5.2
Borrowing from the banking sector	-3.6	-3.8	-0.2	1.4	-2.4	-3.2	2[illegible]
Foreign borrowing (net)	2.3	1.8	2.5	3.5	5.0	2.6	3.3
Net domestic expenditures 4/	8.1	10.3	13.3	11.6	9.6	9.4	9.6
				(In billions of U.S. dollars)			
Balance of payments							
Exports	17.5	21.8	21.1	18.2	19.8	20.8	18.9
Oil and LNG	11.3	16.2	17.0	14.2	14.5	14.9	12.8
Non-oil/LNG	6.2	5.6	4.2	3.9	5.4	5.9	6.1
Imports (non-oil/LNG)	-8.5	-11.3	-14.3	-15.4	-13.8	-12.9	-12.5
Oil sector payments (net)	-4.3	-5.6	-7.2	-7.1	-7.1	-6.6	-6.8
Non-oil sector services	-2.1	-2.2	-2.6	-2.9	-3.0	-3.2	-2.9
Receipts	0.6	1.1	1.5	1.1	1.1	1.4	1.5
Payments	-2.7	-3.4	-4.1	-4.0	-4.0	-4.6	-4.4
Official transfers	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Current account	2.7	2.8	-2.8	-7.1	-3.9	-1.8	-3.1
Of which: Oil/LNG	7.0	10.6	9.8	7.2	7.4	8.3	6.1
Long-term capital	1.5	1.6	3.1	4.6	4.0	2.0	2.5
Of which: Direct investment	0.2	0.1	0.1	0.3	0.2	0.2	0.3
Overall balance	3.8	3.9	-0.3	-3.3	2.5	1.6	0.4
Current account/GDP (in percent)	5.0	3.6	-3.0	-7.5	-4.9	-2.2	-3.8

INDONESIA

Basic Data (concluded)

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86 Proj. 1/
Terms of trade (1983/84 = 100)	80.6	97.0	105.3	105.6	100.0	104.8	99.1
Nominal effective exchange rate index 5/ (Dec. 1978 = 100)	105.4	105.3	111.8	114.4	81.4	82.3	77.4
Real effective exchange rate index 5/ (Dec. 1978 = 100)	118.6	124.6	134.3	141.6	107.7	111.9	105.2
Average Rp/$ rate	626.6	627.0	636.5	674.2	983.4	1,049.5	1,119.1
			(In billions of U.S. dollars)				
Reserves (end of year)							
Gross official reserves	4.9	7.8	6.6	4.3	6.7	7.3	7.2
(months of non-oil/LNG imports)	6.9	8.3	5.5	3.3	5.8	6.8	6.9
Net foreign assets of the banking system	7.2	11.2	10.8	7.5	10.0	11.6	11.8
Total external debt (end of year)	17.4	18.8	21.8	28.2	32.4	32.2	34.6
Medium- and long-term	15.1	16.5	19.1	24.2	27.9	27.9	30.4
Public	13.5	14.9	17.0	21.2	24.6	24.4	26.6
Private 6/	1.6	1.6	2.1	3.0	3.3	3.5	3.7
Short-term nonmonetary 6/	1.7	1.7	2.1	3.0	3.3	3.5	3.7
Fund credit outstanding	--	--	--	--	0.4	0.3	0.1
DMB's foreign liabilities	0.6	0.6	0.6	1.0	0.8	0.5	0.5
				(In percent)			
Public external debt/GDP	24.7	19.1	18.5	22.3	30.4	29.1	32.3
Total external debt/GDP	31.9	24.0	23.7	29.9	40.0	38.4	41.9
Public debt service ratio	9.2	8.1	8.9	12.2	12.4	15.5	17.4
Total debt service ratio	11.5	10.2	11.9	16.1	15.8	19.8	21.9

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

1/ Data for money and credit are annual changes to September 1985; interest rate data are for September; the exchange rate data assume that exchange rates are frozen as of October.

2/ Excludes BULOG. Liquidity credits are extended by Bank Indonesia to commercial banks at subsidized rates to support bank lending to selected sectors.

3/ Average for state banks for the last quarter of the fiscal year.

4/ Net domestic expenditures are defined as domestic expenditures (expenditures exclusive of government imports of goods and services and foreign debt servicing) less domestically generated revenue (largely non-oil/LNG tax revenues and domestic nontax revenues).

5/ Notification basket, based on consumer price indices and average exchange rates.

6/ Fund staff estimates.

Indonesia: Fund Relations
(As of December 31, 1985)

I. Membership status

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

A. Financial Relations

(Amounts in millions of SDRs, unless otherwise indicated)

II. General Department (General Resources Account)

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

III. Stand-By and Extended Arrangements

(a)	Current stand-by or extended arrangement:	None
(b)	Previous stand-by or extended arrangement:	1973
(c)	Special facilities: CFF (8/1983):	360.0

IV. SDR Department

(a)	Net cumulative allocation:	238.9
(b)	Holdings:	51.2
	(As percent of net cumulative allocations)	(21.4)

V. Administered accounts

(a)	Trust Fund loans:	Not eligible
(b)	SFF Subsidy Account:	None

VI. Overdue Obligations to the Fund — None

B. Nonfinancial Relations

VII. Exchange rate arrangement:

On November 15, 1978, the peg of the Indonesian rupiah to the U.S. dollar was severed and Indonesia instituted a managed float under which a basket of trading partner currencies was used as one of the indicators for the determination of the exchange rate. The initial rate established for the rupiah on that date was Rp 625 per US$1. The U.S. dollar is the intervention currency. Effective March 30, 1983, the rupiah was devalued by 27.6 percent. At the same time, Bank Indonesia announced that it would continue to follow a policy of a managed float, but would take into account a broader set of currencies than was the case prior to this devaluation. The rate established for the rupiah as of March 31, 1983 was Rp 970 per US$1; subsequently, the rate has tended to depreciate against the U.S. dollar and on December 31, 1985 was Rp 1,125 per US$1.

VIII. Last Article IV consultation

The last Article IV consultation report (SM/85/20) was discussed by the Executive Board on February 8, 1985 (EBM/85/20). The following decision was adopted:

> The Fund takes this decision in concluding the 1984 Article XIV consultation with Indonesia in light of the 1984 Article IV consultation with Indonesia conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).
>
> The Fund welcomes the elimination in May 1984 of multiple currency practices which had arisen from certain export taxes, and notes with satisfaction that Indonesia maintains an exchange system which is free of restrictions on payments and transfers for current international transactions.

IX. Consultation cycle

A consultation cycle of 12 months was indicated in the Summing Up of the 1984 Article IV consultation.

X. Technical assistance

(a) CBD: In November 1983, CBD advised on the design of monetary instruments to improve the control of liquidity; in 1985, advice was given on techniques of money market management. A follow-up mission on the design and control of monetary policy instruments is scheduled for February 1986.

(b) FAD: In 1984 and 1985 FAD continued to advise the tax administration authorities on the implementation of the value-added tax and on computer technology to facilitate the implementation of the new income tax. A panel expert with specialization in value-added tax administration is presently residing in Jakarta.

(c) STA: In the fourth quarter of 1985, STA missions visited Jakarta to review progress in implementing recommendations to broaden the coverage of nonmonetary financial institutions in IFS, and in strengthening the compilation techniques for balance of payments statistics (see Annex IV).

XI. Resident Representative: Mr. Richard Hides.

Indonesia: Relations with the World Bank Group

1. As of September 30, 1985, Indonesia had received 48 IDA credits totaling $910.08 million (less cancellations) and 101 IBRD loans totaling $7,859.57 million (less cancellations). IFC commitments totaled $163.20 million. From 1968 until 1974, all lending to Indonesia was made through IDA. Owing to the country's improved creditworthiness following the oil and commodity price boom in 1973-74, the bulk of the Bank Group's lending during the remainder of the 1970s was through IBRD loans. However, a modest amount of IDA lending continued to be provided until 1979-80. Given the critical importance of agriculture (including transmigration) for employment, food security, and exports, over one third of Bank Group projects have been in this sector. In addition, loans and credits have been extended to virtually all other sectors of the economy.

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

3. The World Bank has geared its lending and economic work to support the Government's objectives (as indicated above) and to address emerging development issues. The approach is to continue emphasizing the ongoing dialogue on economic policy that has been a cornerstone of the Bank's relationship with Indonesia for many years. This macroeconomic dialogue will be coordinated with advice on institutional and policy issues in important sectors, together with related lending operations and technical assistance. The major vehicle for macroeconomic dialogue is the

annual economic report prepared by the IBRD. Other recently completed or ongoing studies focus on issues of financial sector development, trade/industrial policy, public resource management, agricultural incentives, the government tree crop and transmigration programs, power investment, and transport sector strategy. In the lending program, agricultural projects, especially for tree crops and irrigation, still receive the highest priority. However, the program is broadly based, and includes increasing emphasis on social infrastructure: education and human resource development, urban services, and water supply. Continued attention will also be given to power and energy, where the Bank is concentrating on policies to diversify the country's energy base and to improve sector planning. In transportation, the Bank is focusing on efficiency improvements in the maritime subsector and on improving the national network of highways and rural roads. Wherever possible, the impact of Bank lending is to be widened through technical assistance, as well as complementary investments and coordinated policy dialogue with other donors.

4. As with many of the World Bank's borrowing countries, Indonesia suffers from weaknesses in project implementation capabilities. These weaknesses reflect a range of factors, including the shortage of trained manpower, a range of regulatory and procedural bottlenecks, and the rapid increase in development expenditure (and aid commitments) over the past decade. Implementation capacity has been particularly strained in recent years, as the Government has reallocated expenditures from large turnkey-style operations toward social investments, which require substantially more locally trained workers and effective decentralized administration. Recognizing these problems, the Government has recently streamlined some of the complex budgetary and financial procedures affecting project implementation. Other initiatives are under way to strengthen the local construction industry, to standardize tender documents, and to improve project monitoring and land acquisition procedures. In addition, to reduce disbursement delays, the World Bank is now presenting projects for Board consideration later in the project cycle. Partly in response to these actions, the ratio of disbursements to the opening and undisbursed balance for World Bank projects has risen from a low of 13 percent in 1979/80 to more than 17 percent in 1984/85. However, this ratio is still significantly lower than the Bank-wide average of 22 percent (excluding program loans). Accordingly, both the Bank and the Indonesian Government intend to devote continued attention to project implementation issues over the coming year, in order to ensure that Indonesia realizes the maximum benefit from World Bank-assisted and other investments.

Relations with the World Bank Group

Table 1. Indonesia: IBRD and IDA Commitments and Disbursements, 1975-84

(In millions of U.S. dollars)

Calendar Years	IBRD Commit-ments	IBRD Disburse-ments	IDA Commit-ments	IDA Disburse-ments	Total Commit-ments	Total Disburse-ments
1975	310.5	56.8	--	106.9	310.5	163.7
1976	563.7	157.2	--	99.4	563.7	256.6
1977	405.5	190.6	--	49.0	405.5	239.6
1978	432.0	167.9	119.0	29.5	551.0	197.4
1979	726.0	198.9	89.0	29.8	815.0	228.7
1980	572.0	331.2	162.0	41.7	734.0	372.9
1981	837.0	314.2	--	68.6	837.0	382.8
1982	976.6	504.6	--	78.2	976.6	582.8
1983	1,209.9	489.2	--	59.6	1,209.9	548.8
1984	987.2	772.2	--	54.4	987.2	826.6

Source: The World Bank.

Table 2. IBRD and IDA Commitments and Disbursements as of September 30, 1985

(In millions of U.S. dollars)

	IBRD	IDA	Total
Agriculture, forestry, and fishing	2,509.6	494.4	3,004.0
Energy (including power and coal)	2,263.0	101.0	2,364.0
Industry	865.1	111.5	976.6
Transportation	1,064.0	84.5	1,148.5
Education	824.7	73.4	898.1
Population, health, and nutrition	184.5	13.2	197.7
Urban development and water supply	360.2	--	360.2
Other	13.0	53.8	66.8
Total commitments	8,084.1	931.8	9,015.9
Change from June 30, 1985	93.0	--	93.0
Repayments	481.49	20.54	502.03
Debt outstanding 1/	3,246.45	837.42	4,083.87

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

New commitments: Loans committed during FY 1985 (ending June 30) amounted to $972.7 million ($1,033.4 million in FY 1984). IDA lending to Indonesia was discontinued in FY 1980.

IFC activity: As of September 30, 1985, gross commitments totaled $163.2 million for 22 projects. Of this amount, 65 percent was for cement and construction material projects and 12 percent for textile and fiber projects.

Technical assistance: IDA has extended five technical assistance credits to Indonesia totaling $25 million as of September 30, 1985. In addition, significant allocations for technical services have been included in virtually all IBRD/IDA loans.

Recent economic report: The latest economic mission report, Indonesia--Policies for Growth and Employment (No. 5597-IND), was issued on April 23, 1985.

Aid Group: The most recent (twenty-eighth) meeting of the Inter-Governmental Group on Indonesia (IGGI) was held in Amsterdam during June 4-5, 1985, under the chairmanship of the Minister of Development Cooperation, Government of the Netherlands.

Indonesia--Statistical Issues

1. Outstanding statistical issues

a. Financial statistics

A broader coverage of nonmonetary financial institutions in IFS was recommended in the report of a technical assistance mission in 1981. In September 1985, a Bureau mission visited Jakarta to assess progress made in the implementation of these recommendations and to discuss the feasibility of extending the coverage of financial statistics on the Indonesian country page of IFS. Classification difficulties were resolved, and this will soon be reflected in IFS. However, some additional data will need to be collected by the Indonesian authorities before a broader coverage of financial institutions can be published.

b. Government finance

The 1985 issue of the Government Finance Statistics Yearbook includes data in the statistical and derivation tables for the consolidated central government through fiscal year 1983. Data on the operations of local governments have not been submitted so that the data presented on general government in the GFS Yearbook are limited to central and provincial governments only. The presentation for Indonesia in the GFS Yearbook would be improved by the inclusion of data for local governments.

IFS includes monthly, quarterly, and annual data for the central government through July 1985. The annual time series will be changed to correspond with the data in the GFS Yearbook.

c. Merchandise trade

Detailed trade-by-country data have been provided to the Bureau of Statistics on an annual basis and less detailed data are published on a monthly basis. The Article IV consultation mission was informed that, owing to incomplete monthly data, the authorities would not be able to provide detailed monthly data to the Bureau in the near future. There are significant discrepancies between Indonesian estimates of movements in export unit values of non-oil commodities and estimates based on observations of world market commodity prices published in IFS.

d. Balance of payments

A balance of payments technical assistance mission to Indonesia took place in February 1983; the mission report, containing recommendations for improving the compilation of balance of payments statistics, was sent to the authorities in June 1983. A follow-up balance of payments mission took place in November 1985 to assess the progress in the implementation of the recommendations made in the 1983 mission report and to provide further advice in this area.

e. International banking statistics

In May 1983, Bank Indonesia agreed to participate in the Fund's international banking statistics (IBS) project. However, Bank Indonesia has not yet provided a bank/nonbank disaggregation of the external positions of deposit money banks, and little progress has been made in preparing the geographical breakdown requested for the IBS project.

2. Coverage, currentness, and reporting of data

The table below shows the currentness and coverage of data published in the country page for Indonesia in the December 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by Bank Indonesia, which during the past year have, on the whole, been provided on a timely basis.

Status of IFS Data

		Latest Data in December 1985 IFS
Real Sector	- National accounts	1984, partial
	- Prices: CPI	Sept. 1985
	WPI	April 1985
	- Production: Petroleum	August 1985
	- Employment	...
	- Earnings	...
Government Finance	- Deficit/surplus	July 1985
	- Financing	July 1985
	- Debt	...
Monetary Accounts	- Monetary authorities	Sept. 1985
	- Deposit money banks	July 1985
	- Other financial institutions	July 1985
External Sector	- Merchandise trade:	
	Value: Exports	June 1985
	Imports	June 1985
	Unit values: (Exports)	June 1985
	- Balance of Payments	Qtr. 4 1984
	- International reserves	Sept. 1985
	- Exchange rates	Oct. 1985

Indonesia: Medium-Term Projections

1. Introduction

This annex describes the medium-term projections worked out by the staff to illustrate the implications of developments in foreign and domestic factors for internal and external balance, the external debt burden, and domestic growth. The projections developed in the field were based on the August 1985 WEO assumptions for the global environment; these projections have been revised, using the December 1985 working assumptions for the WEO. The most important change in the baseline assumptions is the substantial decline in oil prices now projected for calendar year 1986. The results for both scenarios are presented below along with an analysis of the sensitivity of the outcomes to changes in interest rates, foreign demand, and the growth of imports. The various medium-term scenarios incorporate the actual outturn for 1984/85 (fiscal year ending March 31) and the projections for 1985/86 based on the results of the discussions held in Jakarta in October-November 1985.

2. Assumptions

Many of the principal assumptions regarding the external environment used for the baseline projections at the time of the discussions are shown in Table 1. Briefly, the external assumptions include: economic growth of 3 percent per annum in the industrial countries and inflation of 4 percent; approximate stability from 1987 onward in the terms of trade of primary producers; stable oil prices at $26.50 per barrel from 1986/87 until the end of 1987/88, 1/ and stable real prices thereafter; a LIBOR rate of 8 percent; no change in protectionist measures; and a constant real level of foreign aid. The assumptions used for the revised baseline scenario are shown in Table 2. As noted above, the most significant change is the 12 percent decline in oil prices in 1986, compared with the 1 percent decline projected in August.

For Indonesia, it is assumed that government expenditures, in particular, investment expenditures, adjust to the level of available resources. Because of the resource constraints for the economy imposed by lower oil prices, this implies only moderate rates of growth in the baseline scenario; real GDP is projected to grow by about 3 percent per annum in 1986/87-1987/88 and by 4 percent per annum in the period 1988/89-1990/91. In the revised baseline scenario, real GDP growth

---

1/ For the August WEO it was assumed that oil prices would be indexed to inflation beginning in 1987. In the staff projections for Indonesia, the indexing of oil prices was delayed until 1988/89.

Table 1. Indonesia: Global Assumptions and Domestic Targets

Scenario Based on August 1985 World Economic Outlook Assumptions 1/, 1985-1990/91

(Changes in percent per annum, unless otherwise specified)

	1985	1986	1987	1988-90 annual average
Foreign market growth (export weighted)				
Imports, in volume				
Oil imports	-5.5	2.5	2.0	2.0
Non-oil imports	7.5	5.3	5.5	5.5
Foreign prices 2/ and interest rates				
World price of manufactures	-2.0	6.0	5.0	5.0
World oil prices	-4.0	-1.0	5.0	5.0
World non-oil commodity prices	-11.1	1.5	5.0	5.0
LIBOR (six-month U.S. dollar deposits)	8.5	8.0	8.0	8.0

	1985/86	1986/87	1987/88	1988/89-1990/91 annual average
Indonesia--output and prices				
Real GDP	1.5	2.5	3.5	4.0
Oil/LNG GDP	-6.0	1.0	2.0	1.0
Consumer prices (end fiscal year)	5.0	5.0	5.0	5.0
Export prices 2/	-4.0	0.9	1.5	5.0
Oil export prices	-5.6	-1.9	--	5.0
Non-oil export prices	--	5.2	5.0	5.0
Of which:				
Non-fuel commodities	0.7	5.0	5.0	5.0
Manufactures	-2.0	6.0	5.0	5.0
Import prices 2/	-2.0	6.0	5.0	5.0
Terms of trade	-2.0	-5.1	-3.5	--
Nominal exchange rate (Rp/US$) 3/	6.7	0.5	--	--

Sources: Indonesian authorities, world economic outlook assumptions; and Fund staff estimates.

1/ In the period 1987/88-1990/91, the rate of inflation of traded goods prices measured in U.S. dollars was reduced from 7.5 percent per annum to 5 percent per annum in light of the substantial depreciation of the U.S. dollar that occurred from August to October 1985.

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

3/ Assumes that the nominal rate is fixed at the average level of October 1985 for the projection period.

Table 2. Indonesia: Global Assumptions and Domestic Targets

Scenario Based on December 1985 World Economic Outlook Assumptions, 1985-1990/91

(Changes in percent per annum, unless otherwise indicated)

	1985	1986	1987	1988-90 annual average
Foreign market growth (export weighted)				
Imports, in volume				
Oil imports	-2.5	1.9	3.7	...
Non-oil imports	6.3	4.3	5.0	...
Foreign prices 1/ and interest rates				
World price of manufactures	-0.5	9.5	4.0	4.5
World oil prices	-4.1	-11.8	--	4.5
World non-oil commodity prices	-12.6	1.1	4.0	5.2
LIBOR (six-month U.S. dollar deposits)	8.7	8.3	8.0	8.0

	1985/86	1986/87	1987/88	1988/89-1990/91 annual average
Indonesia--output and prices				
Real GDP	1.5	1.5	3.0	4.0
Oil/LNG GDP	-6.0	1.0	2.0	2.0
Consumer prices (end fiscal year)	5.0	5.0	5.0	5.0
Export prices 1/	-3.9	-7.4	1.0	5.0
Oil export prices	-5.6	-10.0	--	4.5
Non-oil export prices	0.4	-0.6	3.5	5.5
Of which:				
Non-fuel commodities	0.7	-3.9	3.3	5.7
Manufactures	-0.5	9.5	4.0	4.5
Import prices (U.S. dollars) 1/	-0.5	9.5	4.0	4.5
Terms of trade	-3.4	-16.9	-3.0	0.5
Nominal exchange rate (Rp/US$) 2/	6.7	0.5	--	--

Sources: Indonesian authorities, world economic outlook assumptions; and Fund staff estimates.

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

2/ Assumes that the nominal rate is fixed at the average level of October 1985 for the projection period.

4. Sensitivity analysis

To assess the sensitivity of the baseline scenario to changes in the assumptions, several alternative simulations were conducted in which each variable was shocked separately. The sensitivity of the projections to increased non-oil/LNG export growth, which could arise from stronger foreign demand or improved profitability, to lower non-oil/LNG import growth, and to lower interest rates was calculated. The differences in the outcomes of the alternative simulations from the baseline projections are summarized in Table 5.

Table 2. Indonesia: Global Assumptions and Domestic Targets

Scenario Based on December 1985 World Economic Outlook Assumptions, 1985-1990/91

(Changes in percent per annum, unless otherwise indicated)

	1985	1986	1987	1988-90 annual average
Foreign market growth (export weighted)				
Imports, in volume				
Oil imports	-2.5	1.9	3.7	...
Non-oil imports	6.3	4.3	5.0	...
Foreign prices 1/ and interest rates				
World price of manufactures	-0.5	9.5	4.0	4.5
World oil prices	-4.1	-11.8	--	4.5
World non-oil commodity prices	-12.6	1.1	4.0	5.2
LIBOR (six-month U.S. dollar deposits)	8.7	8.3	8.0	8.0

	1985/86	1986/87	1987/88	1988/89-1990/91 annual average
Indonesia--output and prices				
Real GDP	1.5	1.5	3.0	4.0
Oil/LNG GDP	-6.0	1.0	2.0	2.0
Consumer prices (end fiscal year)	5.0	5.0	5.0	5.0
Export prices 1/	-3.9	-7.4	1.0	5.0
Oil export prices	-5.6	-10.0	--	4.5
Non-oil export prices	0.4	-0.6	3.5	5.5
Of which:				
Non-fuel commodities	0.7	-3.9	3.3	5.7
Manufactures	-0.5	9.5	4.0	4.5
Import prices (U.S. dollars) 1/	-0.5	9.5	4.0	4.5
Terms of trade	-3.4	-16.9	-3.0	0.5
Nominal exchange rate (Rp/US$) 2/	6.7	0.5	--	--

Sources: Indonesian authorities, world economic outlook assumptions; and Fund staff estimates.

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

2/ Assumes that the nominal rate is fixed at the average level of October 1985 for the projection period.

declines to 2 1/4 percent per annum in 1986/87-1987/88 and then rises to 4 percent per annum in 1988/89-1990/91. The target for consumer price inflation in both scenarios is to keep domestic inflation broadly in line with world price developments. In order to bring government expenditures into line with available resources, the fiscal deficit is reduced from 5 percent of GDP in 1985/86 to 1 percent of GDP by 1990/91 in the baseline scenario; for the revised scenario, the fiscal deficit is reduced to less than 2 percent of GDP by 1990/91, which is consistent with the larger current account deficit. 1/ Fiscal adjustment is achieved by increasing revenues from non-oil/LNG income taxes and the VAT, the cutting back of fertilizer and petroleum subsidies, and the efficient pruning of public sector investment to match available resources. Revenue items, except for non-oil/LNG income and value-added taxes, are estimated based on buoyancy relationships and the growth of their respective tax bases. Recurrent expenditures are linked to nominal GDP, while foreign financed development expenditures are consistent with the balance of payments outcome.

In the areas of industrial and trade policy, the baseline assumes that the authorities continue their efforts to promote efficiency and investment in the non-oil/LNG sector; however, without new initiatives, non-oil/LNG exports are only projected to keep pace with market growth. For the revised baseline scenario, it is assumed that the authorities intensify their efforts to promote non-oil/LNG exports and encourage foreign direct investment. As a result, in the revised scenario, non-oil/LNG exports grow 1-2 percent faster per annum than the growth of demand in foreign markets. In both scenarios, the growth of project imports is constrained by the outlook for aid commitments, which are expected to remain roughly constant in real terms over the projection period. 2/ Program imports, which have declined sharply during the past few years owing to improved agricultural output, are projected to remain constant in nominal terms, while general imports, in volume terms, are projected to increase in line with real GDP.

1/ If a smaller fiscal deficit were realized in 1985/86, due to a lesser acceleration in foreign financed development expenditures in the second semester, the base values of the current account deficit, the level of external indebtedness at end-year, and the debt service ratio would have to be revised downward somewhat, all other things being equal. The scenarios focus, however, on the need to constrain the build-up in external indebtedness beyond that stemming from inflows of project assistance at current levels, and to tailor domestically financed development expenditures to the revenues available to the government. These constraints would not be fundamentally altered by the realization of a lower overall budget deficit for 1985/86. Thus the medium-term projections would not differ substantially, though some modification in levels, and a lowering of the growth rate, could result.

2/ In the revised baseline projection, project imports are held constant in nominal terms in 1986/87, the year of the oil price decline, and thereafter remain constant in real terms.

For 1986/87, a substantial increase (10 percent) in oil export volumes from the low level of 343 millions of barrels per day in 1985/86 is assumed; thereafter, oil export volumes are projected to grow by 1 percent per annum in the baseline scenario. In the revised scenario, oil export volumes grow by 2 percent per annum and, by 1990/91, the volume of oil exports would reach the peak levels attained in 1983/84-1984/85, prior to the reduction in Indonesia's output quota.

The financing of the current account is derived residually by setting a target for the net foreign assets of the banking system. In both scenarios, the ratio of net foreign assets declines to about seven months of non-oil/LNG imports by 1990/91; however, in the case of the revised baseline scenario, net foreign assets decline to that level more rapidly. Eighty percent of financing that is not already in the pipeline is allocated to the public sector and 20 percent to the private sector. The average interest rate on new disbursements of public sector debt 1/ is assumed to be LIBOR (six-month U.S. dollar deposits), while that on private sector debt is assumed to be LIBOR plus 1 percentage point. Disbursements out of new commitments of public sector debt are assumed to have a 4-year grace period and a maturity of 15 years. Private sector debt is treated as short term, that is, only interest is paid on outstanding private sector debt.

3. Baseline projections

The projections are calculated using a static accounting framework based on national accounts and balance of payments identities which ensures the consistency of the projections with the assumptions and targets set out above. The required fiscal adjustment is derived on the basis of the target for the fiscal balance, and the rate of growth of real GDP is adjusted to be consistent with the level of investment. The projections for each exercise should not be interpreted as forecasts. Rather, they give an indication of the domestic and external consequences of certain developments, so that a view can be formed as to whether these developments are acceptable and what types of adjustment measures might be sought.

Tables 3 and 4 and Chart 9 in the main text summarize the outcome for the baseline scenario and the revised baseline scenario.

1/ Interest rates on new commitments of public sector debt in the first half of 1985 were in the range of 3 1/2 percent on concessional loans, 6 1/2 percent on export credits, and 9 1/2-10 percent for commercial credits. The weighted average of interest rates was 8.2 percent, while LIBOR for six-month U.S. dollar deposits averaged 9 percent in the first half of 1985. The interest rate assumption used in the projections takes into account the fact the borrowings over and above the $2.5 billion per annum expected from IGGI countries will be primarily at commercial rates.

Table 3. Indonesia: Summary of Medium-Term Projections Based on August 1985 World Economic Outlook Assumptions, 1/ 1984/85-1990/91

(In percent of GDP)

	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
Current account deficit	2.2	3.8	3.6	3.5	2.9	2.4	1.8
Gross domestic investment	22.5	18.8	18.2	19.2	19.2	19.4	19.6
Public investment	10.1	10.5	8.9	8.6	8.5	8.3	8.2
Private investment	12.4	8.3	9.3	10.6	10.8	11.1	11.3
Gross national savings	20.3	15.0	14.6	15.7	16.3	17.0	17.8
Private national savings	9.8	9.8	9.5	10.5	10.5	10.5	10.5
Government national savings	10.5	5.2	5.1	5.2	5.8	6.5	7.3
Oil/LNG revenues	15.6	11.2	10.3	9.7	9.4	9.1	8.8
Non-oil/LNG revenues	6.4	7.4	7.8	8.2	8.7	9.1	9.6
Current expenditures	11.4	13.4	13.1	12.7	12.2	11.7	11.1
Memorandum items:							
Real GDP growth	5.8	1.5	2.5	3.5	4.0	4.0	4.0
Fiscal balance/GDP	0.6	-5.2	-3.7	-3.3	-2.6	-1.7	-0.9
Public debt/GDP	29.1	32.3	32.9	32.8	32.2	31.3	29.9
Public debt service ratio	15.5	17.4	20.1	21.3	22.0	21.0	18.7
Total debt/GDP	38.4	41.9	42.4	42.3	41.4	40.1	38.3
Total debt service ratio	19.8	21.9	23.2	24.5	25.1	24.2	21.7
Net foreign assets/ imports 2/	10.8	11.5	10.7	9.9	9.1	8.4	7.8

Sources: Indonesian authorities; world economic outlook assumptions; and staff estimates.

1/ Projections begin in 1986/87.
2/ Net foreign assets of the banking system in months of current year's non-oil/LNG imports.

Table 4. Indonesia: Summary of Medium-Term Projections Based on December 1985 World Economic Outlook Assumptions, 1/ 1984/85-1990/91

(In percent of GDP)

	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
Current account deficit	2.2	3.8	4.7	4.4	3.7	3.1	2.5
Gross domestic investment	22.5	18.8	18.5	19.6	19.5	19.5	19.5
Public investment	10.1	10.5	8.9	9.0	8.7	8.2	8.1
Private investment	12.4	8.3	9.6	10.6	10.8	11.3	11.3
Gross national savings	20.3	15.0	13.8	15.2	15.8	16.4	17.0
Private national savings	9.8	9.8	9.5	10.5	10.5	10.5	10.5
Government national savings	10.5	5.2	4.3	4.7	5.3	5.9	6.5
Oil/LNG revenues	15.6	11.2	9.6	9.0	8.8	8.6	8.5
Non-oil/LNG revenues	6.4	7.4	7.8	8.2	8.6	9.0	9.4
Current expenditures	11.4	13.4	13.0	12.6	12.2	11.8	11.3
Memorandum items:							
Real GDP growth	5.8	1.5	1.5	3.0	4.0	4.0	4.0
Fiscal balance/GDP	0.6	-5.2	-4.5	-4.2	-3.3	-2.2	-1.6
Public debt/GDP	29.1	32.3	33.1	33.4	33.0	32.0	31.5
Public debt service ratio	15.5	17.4	21.2	22.7	23.8	23.6	22.1
Total debt/GDP	38.4	41.9	42.8	43.1	42.5	41.1	40.4
Total debt service ratio	19.8	21.9	24.6	26.2	27.2	27.0	25.4
Net foreign assets/imports 2/	10.8	11.5	10.0	9.0	8.0	7.0	7.0

Sources: Indonesian authorities; world economic outlook assumptions; and Fund staff estimates.

1/ Projections begin in 1986/87.
2/ Net foreign assets of the banking system in months of current year's non-oil/LNG imports.

4. Sensitivity analysis

To assess the sensitivity of the baseline scenario to changes in the assumptions, several alternative simulations were conducted in which each variable was shocked separately. The sensitivity of the projections to increased non-oil/LNG export growth, which could arise from stronger foreign demand or improved profitability, to lower non-oil/LNG import growth, and to lower interest rates was calculated. The differences in the outcomes of the alternative simulations from the baseline projections are summarized in Table 5.

Table 5. Indonesia: Sensitivity of Medium-Term Projections to Alternative Assumptions

	1986/87	1987/88	1988/89	1989/90	1990/91
Baseline Scenario: August 1985 World Economic Outlook Assumptions					
Current account/GDP (in percent)	3.63	3.50	2.93	2.39	1.78
Debt service ratio (in percent)	23.20	24.52	25.14	24.15	21.72
Public debt service ratio (in percent)	20.07	21.32	21.96	21.01	18.65
Gross public disbursements (millions of US$)	4,616	5,101	5,322	5,247	4,757
Alternative Scenario: Interest Rates 1 Percent Lower Each Year					
(Difference between alternative and baseline)					
Current account/GDP (in percent)	-0.17	-0.19	-0.20	-0.21	-0.20
Debt service ratio (in percent)	-0.79	-0.87	-0.93	-0.97	-1.01
Public debt service ratio (in percent)	-0.11	-0.15	-0.20	-0.23	-0.26
Gross public disbursements (millions of US$)	-130	-161	-185	-207	-232
Alternative Scenario: Non-oil/LNG Export Growth 1 Percent Higher Each Year					
(Difference between alternative and baseline)					
Current account/GDP (in percent)	-0.07	-0.15	-0.23	-0.32	-0.41
Debt service ratio (in percent)	-0.10	-0.23	-0.37	-0.51	-0.66
Public debt service ratio (in percent)	-0.08	-0.18	-0.29	-0.38	-0.47
Gross public disbursements (millions of US$)	-57	-128	-214	-322	-456
Alternative Scenario: Non-oil/LNG Import Growth 1 Percent Lower Each Year					
(Difference between alternative and baseline)					
Current account/GDP (in percent)	-0.15	-0.30	-0.45	-0.61	-0.77
Debt service ratio (in percent)	-0.06	-0.14	-0.24	-0.34	-0.51
Public debt service ratio (in percent)	-0.05	-0.10	-0.15	-0.21	-0.30
Gross public disbursements (millions of US$)	-119	-258	-423	-620	-859

Source: Fund staff estimates.