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INFORMATION

January 18, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Indonesia - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Indonesia. A draft decision appears on page 33.

This subject has been tentatively scheduled for discussion on Friday, February 8, 1985.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. R. Williams (ext. 7610) or Mr. Niebuhr (ext. 7315).

Att: (1)

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INTERNATIONAL MONETARY FUND

INDONESIA

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with Indonesia

Approved by P.R. Narvekar and S. Kanesa-Thasan

January 17, 1985

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I. Introduction

A staff team comprising Richard C. Williams (Head), Richard J. Niebuhr, Emine Gurgen, (all ASD), Reinold H. van Til (FAD), Tomas Jose T. Balino (CBD), and Lilian Knauseder (secretary, ASD) visited Jakarta from October 22-November 7, 1984 to conduct the 1984 Article IV consultation discussions. Ms. Happe, the Fund Resident Representative, assisted the team. The mission met with the Coordinating Minister for Economy, Finance, and Industry and Development; the Ministers of Finance and Administrative Reform; the Advisor to the Planning Agency; the Governor of the Central Bank; senior staff of the Ministries of Agriculture, Industry, Mining and Gas, and Trade; officials of the Investment Board, National Logistics Board (BULOG), and several state banks. Mr. Ismael, Executive Director for Indonesia, attended some of the 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. Indonesia's relations with the Fund are summarized in Appendix II and with the World Bank in Appendix III.

II. Background and Recent Economic Developments

1. Initiation of adjustment and developments in 1983/84

The strong growth in domestic expenditure and the appreciation of the rupiah in real effective terms led to rapid import growth from 1979/80, while non-oil exports declined. With the marked decline in the volume of oil exports in 1982 and again in early 1983, the latter accompanied by a sharp decline in oil prices, the underlying weakness of Indonesia's non-oil accounts also became manifest. In 1982/83, 1/ the current account deficit rose to almost $7 billion (7.5 percent of GDP), and the overall deficit exceeded $3 billion (Table 1). Pressures on the balance of payments were further aggravated by a weakening in confidence in the rupiah, reflected in large-scale capital outflows. By early 1983, the scale of the prospective foreign exchange gap appeared well beyond the range of orderly financing even in the short run; with likely continued weakness in the world oil market, Indonesia faced the prospect of severe constraints on foreign exchange and budgetary resources for the coming Five-Year Plan (1984/85-1988/89).

Beginning in March 1983 the Government adopted a series of far-reaching measures designed to achieve rapid correction in the balance of payments and to initiate structural adjustment in the economy: a 28 percent devaluation of the rupiah and adoption of a policy of flexible exchange rate management to maintain external competitiveness; a rephasing of the public sector investment program resulting in a

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1/ The fiscal year runs from April 1 through March 31.

Table 1. Indonesia: Summary Balance of Payments, 1980/81-1984/85

(In millions of U.S. dollars)

	1980/81	1981/82	1982/83	1983/84	1984/85 (Staff est.)
Exports, f.o.b.	21,786	21,145	18,152	19,817	19,744
Oil 1/	14,088	14,633	11,763	12,050	10,787
LNG	2,111	2,342	2,461	2,399	2,972
Non-oil	5,587	4,170	3,928	5,368	5,985
Oil LNG sector payments 1/	-5,598	-7,219	-7,049	-7,079	-6,432
Non-oil/LNG imports, c.i.f.	-11,344	-14,305	-15,140	-13,823	-13,085
Non-oil/LNG services, net	-2,220	-2,540	-2,863	-3,237	-3,586
Official transfers	195	185	108	113	100
Current account	2,819	-2,734	-6,792	-4,209	-3,259
Oil/LNG sector (net)	10,601	9,756	7,175	7,370	7,327
Non-oil/LNG sector (net)	-7,782	-12,490	-13,967	-11,579	-10,586
Long-term capital (net)	1,570	3,096	4,556	4,083	2,099
Official capital (net)	1,381	2,271	3,228	3,773	2,387
Receipts	1,996	3,080	4,154	4,783	3,896
Project aid	(1,850)	(2,223)	(2,564)	(3,439)	(2,856)
Syndicated loans and bonds	(146)	(857)	(1,590)	(1,344)	(1,040)
Amortization	-615	-809	-926	-1,010	-1,509
State enterprises (net)	49	683	1,017	117	-528
Receipts	384	999	1,294	377	52
Amortization	-335	-316	-277	-260	-580
Direct investment (net)	140	142	311	193	240
Oil/LNG sector trade credits (net)	-419	404	634	359	100
SDR allocations	62	—	—	—	—
Errors and omissions 2/	-97	-1,103	-1,739	2,170	1,684
Monetary movements (increase in assets -) 3/	-3,935	337	3,341	-2,403	-624
Assets	-3,861	307	2,834	-2,520	...
Liabilities	-74	30	507	117	...
Memorandum items:					
Current account (percent of GDP)	3.9	-3.2	-7.5	-5.3	-4.1
Total debt service/gross exports 4/	11.5	10.1	11.7	17.0	24.6
Public debt service/net exports 5/	12.1	10.7	13.1	20.4	29.9

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

1/ Excludes oil exported under "cross purchase" and other arrangements for processing or exchange of products to re-import.
2/ Includes private capital flows.
3/ Monetary authorities and deposit money banks.
4/ Total debt service includes estimated interest on private debt.
5/ Net exports are defined as gross exports of goods and services less oil/LNG sector imports.

reduction in planned expenditure in foreign exchange by about $10 billion, of which about $3 billion would be realized in 1983/84; an extensive financial sector reform which included a freeing of most domestic interest rates; a major reform of the tax system, including passage of laws greatly simplifying the income tax and providing for the introduction of a new value added tax (VAT); 1/ and a review of, and initial action to eliminate, government regulations that hamper private sector economic activities. The structural adjustment measures were to be supported by a tightening of demand management policies. The fiscal stance reflected expenditure restraint, including smaller petroleum and fertilizer subsidies and the continuation of the freeze on civil servants' salaries. Nevertheless, it appeared that the 1983/84 budget deficit might exceed that of the previous year.

At the time the Staff Report for the 1983 Article IV Consultation was prepared, the prospective budget deficit was large, the adjustment measures taken during the previous few months had not achieved full impact, and some elements of macroeconomic policy for 1983/84 (e.g., monetary policy) were still under review by the authorities. 2/ Accordingly, at the Board discussion of the Staff Report in November 1983, Executive Directors urged further action to reduce the fiscal deficit and suggested that additional monetary restraint was warranted. More broadly, while commending the authorities on the decisive and timely implementation of adjustment measures, Directors noted several areas where policies needed to be kept under review: alternative mechanisms for monetary control should be instituted promptly; developments in the real effective exchange rate should be monitored closely to preserve the gains in competitiveness; caution must be exercised in restoring public sector projects cancelled or postponed in the rephasing exercise, and there was scope for improvement in the monitoring of the activities of state enterprises; projected developments in the external debt burden should be monitored closely and, in this regard, improvements were needed in the surveillance of private sector external borrowing; priority had to be given to the promotion of an active and competitive private sector, particularly through a more export-oriented trade regime.

In the event, domestic demand management was more restrained in 1983/84 than was apparent at mid-year, and the response to the adjustment initiatives exceeded staff expectations at the time of the consultation discussions. 3/ The overall budget deficit in relation to GDP declined to 2.4 percent, from 5.1 percent in 1982/83. Total budget expenditure declined in relation to GDP (by about 1.5 percentage points) and net domestic expenditure increased by less than 1 percent, thus

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1/ The introduction of the VAT was subsequently postponed; it is now expected to be introduced with the 1985/86 budget.
2/ IMF, EBM/83/154; SUR/83/35, 11/16/83; and SM/83/208, 10/18/83.
3/ Held in August 1983.

declining significantly in real terms (Table 2). 1/ Availability of foreign project financing for the budget exceeded the overall budget deficit and a sizable buildup of government deposits with the Central Bank (Bank Indonesia) occurred. This factor, together with the small increase in banking system credit to the public enterprises, led to a decline in banking system credit to the public sector. The expansion of bank credit to the private sector moderated considerably (26 percent growth, compared with 40 percent in the previous year), so that total domestic credit extended by the banking system grew by only about 8 percent, compared with 56 percent in 1982/83 (Table 3). Flexible exchange rate management in the fiscal year essentially maintained the improvement in external competitiveness from the March 1983 devaluation. 2/

The external current account deficit narrowed in 1983/84 by the equivalent of 2.2 percent of GDP, reflecting both the impact of demand restraint and the supply response of the traded goods sector to the devaluation; non-oil exports rose by about 37 percent, while non-oil imports declined by almost 9 percent (Table 1). The overall balance of payments recorded a surplus of about $2.4 billion. The sharp reversal (by close to $4 billion) of private short-term capital outflows indicated that the adjustment policies, including the exchange rate adjustment, restored confidence in the rupiah. This factor, coupled with the stimulus to financial saving attendant on the deregulation of deposit rates (Chart 1), led to an expansion in rupiah-denominated time and savings deposits of almost 90 percent (Table 3).

Real GDP increased by 5.1 percent in CY 1983, following the 0.4 percent decline in 1982 3/, although performance was uneven; petroleum output recovered partially and growth in non-oil GDP accelerated slightly, but was low relative to previous years (Table 4). Real gross fixed investment declined about 1 percent after increasing by over 10 percent in 1982. Some parts of the non-oil/LNG sector, especially domestic food crops and goods destined for export, showed significant gains. Reflecting both tight financial policies and an improved food supply situation, inflation was contained at 12 percent despite cost-push pressures emanating from the devaluation and the sharp increases in domestic petroleum and other administered prices.

1/ Net government domestic expenditure is defined as: total expenditure net of foreign financed project expenditure less domestic non-oil revenues. It is taken as an approximation of the direct, first round impact of the budget on domestic demand.

2/ In real effective terms, the rupiah appreciated by about 3 percent by March 1984, reflecting the immediate pass-through effect of the devaluation on domestic prices, which had been expected at the time of devaluation.

3/ Using 1981 sectoral weights. Using 1973 sectoral weights, real GDP increased by 2.2 percent in 1982, following a 7.9 percent growth in 1981. The authorities intend to revise the national accounts using 1983 sectoral weights and to publish the data in the latter part of 1985.

Table 2. Indonesia: Summary of Central Government Operations, 1979/80-1985/86

(In billions of rupiah)

	1979/80	1980/81	1981/82	1982/83	1983/84	Budget 1984/85	Est. 1984/85	Provisional Budget 1985/86
Tax revenue	6,885	10,567	11,981	11,475	14,785	15,533	16,693	17,946
Of which: Oil/LNG	4,635	7,676	8,732	7,663	10,398	10,367	11,857	11,160
Nontax revenue	187	316	336	436	520	615	639	732
Grants	137	122	118	71	93	100	100	100
Total revenue and grants	7,209	11,005	12,435	11,982	15,398	16,248	17,432	18,778
Recurrent expenditure	4,239	6,169	7,383	7,281	8,441	10,002	9,432	11,853
Of which: Petroleum subsidies	535	1,021	1,316	962	925	1,147	577	532
Fertilizer subsidies	125	284	371	420	324	459	459	558
Development expenditure and net lending	2,545	3,828	6,409	7,730	8,697	9,324	7,924	9,359
Of which: Foreign-financed project expenditure	983	1,301	1,959	2,713	4,106	4,200	2,800	3,965
Total expenditure and net lending	6,784	9,997	13,792	15,011	17,138	19,326	17,356	21,212
Surplus/deficit (-)	425	1,008	-1,357	-3,029	-1,740	-3,078	76	-2,434
(Percent of GDP)	1.3	2.2	-2.5	-5.1	-2.4	-3.8	0.1	-2.05
Financing (net)	-425	-1,008	1,357	3,029	1,740	3,078	-76	2,434
Domestic	-1,216	-1,874	-88	854	-1,765	—	-2,571	-30
Monetary authorities	(-1,007)	(-1,542)	(-237)	(643)	(-1,645)	—	...	...
Commercial banks	(-209)	(-332)	(149)	(211)	(-120)	—	...	...
Foreign (net)	791	866	1,445	2,175	3,496	3,078	2,495	2,464
Memorandum items:								
Net domestic expenditure 1/	3,364	5,489	8,248	8,050	8,125	9,343	9,081	9,729
(percent of GDP)	10.3	12.0	15.2	13.6	11.2	11.2	10.9	10.2
Foreign-financed project expenditure 2/3/ (US$ mn.)								
Included above	1,815	1,989	3,079	4,017	4,210	...	3,046	...
Total for public sector 4/	1,928	2,373	4,078	5,311	4,599	...	3,098	...

Sources: Ministry of Finance; and Fund staff estimates.

1/ Net government domestic expenditure is defined as: total expenditure net of foreign-financed project expenditure less domestic non-oil revenues. It is taken as an approximation of the direct, first round impact of the budget on domestic demand.
2/ Includes defense expenditures, which are classified as current expenditure above.
3/ In this table, as different from the balance of payments table, only syndicated loans used for project spending are considered part of foreign project expenditure.
4/ Includes direct borrowing by public corporations (Pertamina and Garuda).

Table 3. Indonesia: Indicators of Monetary Developments, 1980/81-1984/85

(In billions of rupiah)

	End-March			Revaluation Adjustment	March 1984	October (Prelim.) 1984	Staff Projection March 1985
	1981	1982	1983				
Monetary developments							
Net foreign assets	6,913	6,833	7,016	1,823	9,849	11,281	11,900
Of which: Monetary authorities	(4,668)	(4,094)	(4,006)	(1,066)	(6,244)	(7,297)	...
Domestic credit	3,778	6,326	9,892	196	10,659	10,172	11,480
Government, net	(-4,523)	(-4,581)	(-4,050)	(-98)	(-5,917)	(-8,522)	(-9,150)
Public enterprises	(3,640)	(4,323)	(4,704)	(146)	(4,982)	(5,192)	(5,390)
Private sector	(4,661)	(6,584)	(9,238)	(148)	(11,594)	(13,502)	(15,240)
Total liquidity	7,906	10,151	12,247	620	15,758	17,104	18,450
Narrow money 1/	(37.3)	(29.9)	(8.9)		(9.2)	(5.0)	(7.3)
Rupiah broad money 1/	(36.6)	(30.6)	(13.4)		(30.9)	(17.1)	(17.6)
Rupiah quasi-money 1/	(34.5)	(32.5)	(27.3)		(89.5)	(36.0)	(33.6)
Foreign currency deposits 1/	(33.8)	(14.6)	(23.2) 2/		(17.9)	(16.7)	(14.2)
Interest rates (in percent)							
Rate on 12-month deposits							
At state banks	9.0	9.0	9.0		17.8	17.9	...
At national private banks	20.0	19.3	19.3		20.2	20.0	...

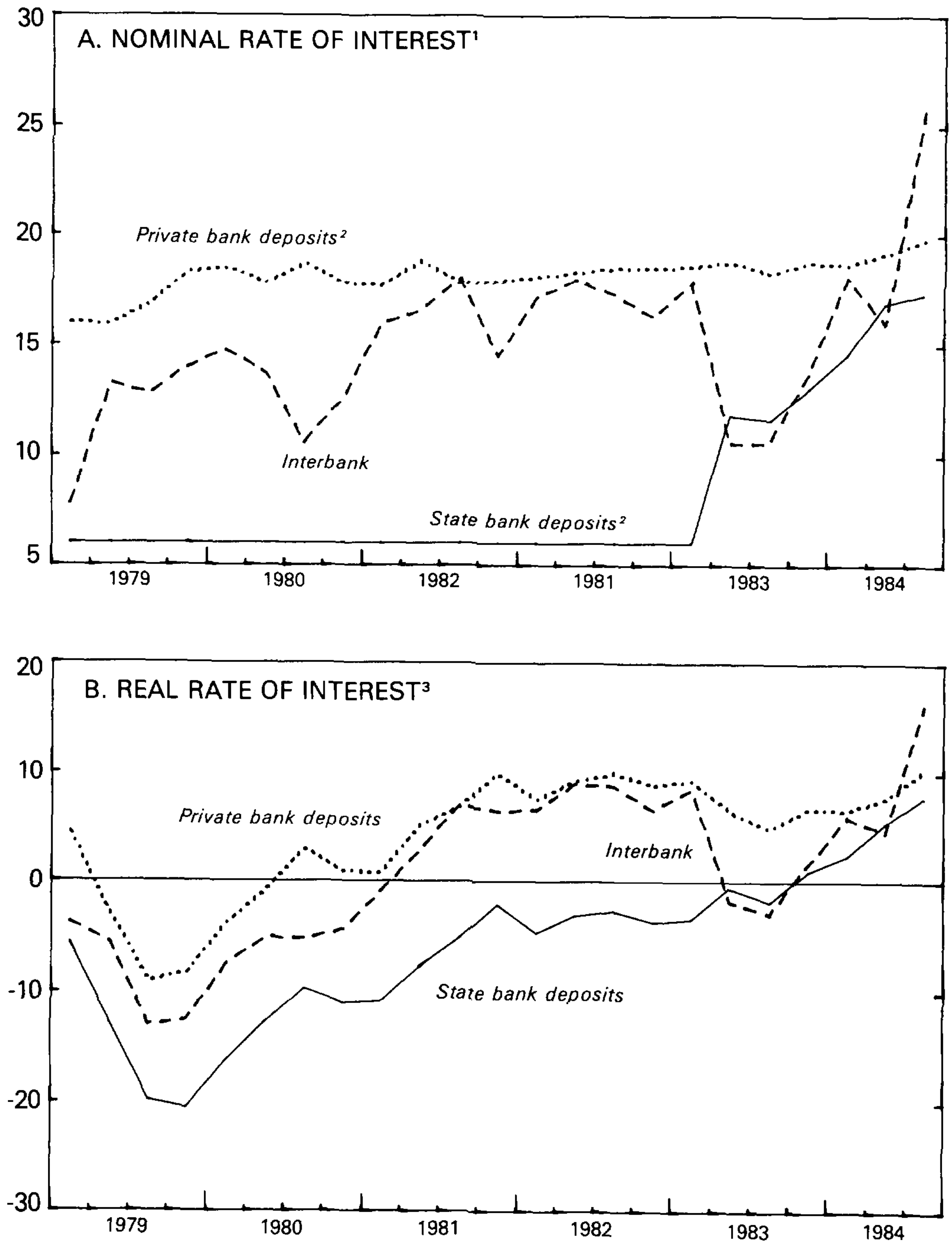
Sources: Bank Indonesia, and Fund staff estimates.

1/ Annual percentage change.
2/ Excluding the revaluation effect of the March 30, 1983 devaluation.

CHART 1

INDONESIA

NOMINAL AND REAL INTEREST RATES, 1979-84



Source: Bank Indonesia.

[1] Quarterly averages.

[2] Average rate paid on outstanding six month deposits.

[3] Nominal rate minus annual rate of change in CPI.

Table 4. Indonesia: Selected Economic Indicators, 1979-84

	1979	1980	1981	1982	1983	1984
			(Percentage change)			
Gross domestic product 1/	5.1	7.6	7.1	-0.4	5.1	6.0
Oil sector 2/	(0.7)	(1.2)	(5.7)	(-13.1)	(6.4)	(12.4)
Non-oil sector	(6.9)	(10.0)	(7.6)	(4.1)	(4.7)	(4.1)
Real gross domestic income 3/	25.1	16.6	6.5	-1.0	4.4	5.8
Total consumption	12.3	12.9	11.4	3.8	3.8	3.8
Private 4/	(12.7)	(13.2)	(11.6)	(4.1)	(3.9)	(3.9)
Government	(9.5)	(10.8)	(10.2)	(1.9)	(3.0)	(3.1)
Gross fixed investment	4.4	18.9	16.7	10.5	-1.0	-3.0
Domestic demand	10.5	14.1	12.5	5.4	3.1	2.2
Exports of goods and services	-0.1	-5.6	-2.4	-14.1	6.2	12.0
Aggregate demand	7.4	8.8	9.0	1.3	3.7	4.7
Imports of goods and services	22.6	15.1	18.4	8.5	-1.7	-4.7
Gross domestic product 1/	5.1	7.6	7.1	-0.4	5.1	6.0
			(Percent of GNP)			
Gross national savings/GNP	23.9	25.8	22.3	16.3	17.7	19.7
Central Government 5/	9.7	10.1	9.9	8.3	9.2	9.6
Private sector 6/	14.2	15.7	12.4	8.0	8.5	10.1
Gross domestic investment/GNP	22.0	21.8	23.3	23.3	24.9	23.6
Current account/GNP	1.9	4.0	-1.0	-7.0	-7.2	-3.9
			(Percentage change)			
GDP deflator						
Overall	34.0	31.9	11.0	10.8	14.9	11.0
Non-oil	25.4	19.2	13.9	8.2	14.5	11.0
CPI	24.5	18.1	12.2	9.5	11.8	10.4
Terms of trade (1981 = 100)	63.4	102.0	100.0	97.3	94.6	94.1

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

1/ Using 1981 value weights.
2/ Includes value-added in production of crude oil and natural gas (mining sector) and value-added in domestic refining and production of LNG (manufacturing sector).
3/ Real GDP adjusted for the impact of changes in the terms of trade.
4/ Residual.
5/ Staff estimates.
6/ Residual; includes public enterprises and state and local governments.

2. Developments and prospects for 1984/85

a. Growth and inflation

Manufacturing activity increased in the first half of 1984 and was accompanied by volume increases in agricultural output, a sharp increase in LNG production, and strong construction activity in the Jakarta area. The staff estimated an increase in real GDP of about 6 percent in CY 1984. However, the estimated increase in the growth rate in 1984 entirely reflects a 50 percent increase in LNG production resulting from completion of large expansion in plant capacity. The estimated growth in non-oil/LNG sector output is somewhat below the gains recorded in 1983, but with some encouraging signs: growth in agriculture is estimated to have declined slightly (to 4 percent) from last year's recovery growth rate, but has remained high by historical standards; a record rice harvest was achieved which brought the domestic stocks of BULOG to three million tons; 1/ growth of manufacturing output (excluding LNG and oil refining) is estimated to increase to 4.8 percent, from 2.6 percent in 1983. Sizable underutilization of capacity, however, prevails in many parts of the manufacturing sector, in construction, and in the services sector. New investment activity continues to be depressed, with fixed investment falling for the second consecutive year (Table 4).

Reflecting both financial restraint and the favorable supply response in agriculture, inflation moderated further. On an end-year basis, the CPI is estimated to rise by 8.5 percent, compared to almost 12 percent in 1983. Moreover, much of the price increase in 1984 took place in the first quarter (of the calendar year), reflecting a substantial (37 percent) increase in domestic oil prices; during April-November 1984, the first eight months of 1984/85, the CPI rose at an annual rate of only 3.7 percent. For fiscal year 1984/85, the staff expects the CPI to increase by only about 4 percent. 2/

b. Balance of payments and external debt 3/

The current account deficit in 1984/85 is expected to decline further to approximately $3 billion. The authorities estimate that the overall balance of payments will show a surplus of about $0.6 billion, all of which was achieved in the first half of the fiscal year (April-September 1984). The overall projections involve, in particular, uncertainty in respect of oil exports in the last few months of the fiscal

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1/ With the surplus in excess of domestic requirements, consideration is being given to exporting some of the surplus. However, relatively high costs and lower quality than internationally traded rice militate against Indonesia becoming a regular rice exporter.

2/ On a period average basis, the increase is estimated at 8.5 percent in 1984/85, compared with 12.6 percent in 1983/84.

3/ Unless otherwise stated, the discussion in this section relates to figures expressed in current U.S. dollar terms.

year. The projected decrease in oil export receipts for the year as a whole of $1.3 billion, or 9 percent, is heavily influenced by the production cuts agreed by OPEC in October 1984, 1/ as well as a weakening in the demand for oil. LNG exports, in contrast, are projected to rise by about 24 percent, due to an increase in production and export volume, and in addition, payments abroad by the oil/LNG sector are expected to decline by almost $650 million. When these factors are taken together, net oil/LNG exports are estimated to be approximately unchanged in 1984/85. This may prove to be somewhat pessimistic and, accordingly, the overall balance of payments surplus may be larger than now estimated. Thus, all of the currently estimated $1 billion reduction in the current account deficit relates to the non-oil trade account, with exports increasing by close to 12 percent and imports declining by 5 percent. The increase in non-oil export volume is estimated at around 8 percent and export prices are estimated to increase by about 3 percent; the overall external terms of trade would remain approximately stable after deteriorating by 4.4 percent in 1983/84 (Table 4).

The decline in non-oil imports reflects the continued impact of the adjustment measures, as well as difficulties encountered in implementing foreign-financed development projects; non-oil import volume is estimated to decline by about 6 percent, following a 5 percent decline in 1983/84. The shortfall from the budgeted level of foreign-financed project expenditure is estimated to have reduced the level of non-oil imports by about $1.2 billion, an amount equivalent to about 1.5 percent of GDP; this can be considered as "unplanned adjustment".

Reflecting the slowdown in foreign-financed public sector investment projects, gross disbursements of long-term public capital are estimated to decline by close to $900 million to $3.9 billion. Amortization payments will rise sharply (by about $800 million, or 64 percent), in part reflecting initiation of repayment on an LNG expansion loan. The long-term net capital inflow is thus estimated to decline by about $2 billion, or 50 percent. Public external debt is estimated to rise to $26.4 billion (34 percent of GDP), and total external debt to $33.5 billion (Table 5). Public sector debt service (including repayment to the Fund) is estimated to rise to almost 30 percent of net

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1/ The OPEC quota for Indonesia's crude oil production is 1.3 million barrels per day, excluding production of condensates which are not subject to quota and amount to about 0.1 billion barrels a day. The OPEC cuts were in the amount of 110,000 barrels per day for November-December 1984. However, oil export projections assume continuation of the cuts through the fiscal year (March 1985).

Table 5. Indonesia: External Debt and Debt Service, 1983/84-1988/89

(In millions of U.S. dollars)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
Total external debt (end of period)						
Including monetary liabilities	31,827	33,535	36,160	39,068	41,746	44,165
Excluding monetary liabilities	30,596	32,455	35,380	38,288	40,966	43,385
Public external debt 1/	24,596	26,455	29,380	32,288	34,966	37,385
Private external debt	6,000	6,000	6,000	6,000	6,000	6,000
Banks foreign liabilities	1,231	1,080	780	780	780	780
Bank Indonesia	(452)	(300)	(—)	(—)	(—)	(—)
commercial banks	(779)	(780)	(780)	(780)	(780)	(780)
Net disbursements of external debt	3,890	1,859	2,925	2,908	2,678	2,419
Gross disbursements	5,160	3,948	5,051	5,109	5,187	5,655
Pipeline disbursements	(...)	(...)	(2,230)	(1,674)	(1,175)	(963)
Disbursements out of new commitments	(...)	(...)	(2,821)	(3,435)	(4,012)	(4,692)
Total amortization	-1,270	-2,089	-2,126	-2,201	-2,509	-3,236
Public debt service	2,817	4,426	4,699	4,636	5,207	6,008
Amortization 1/ 2/	1,270	2,089	2,126	2,201	2,509	3,236
Interest 2/	1,547	2,185	2,273	2,435	2,698	2,772
IMF repurchases	—	152	300	—	—	—
Interest on private debt	730	800	800	700	700	700
			(In percent of GDP)			
Memorandum items:						
Total external debt						
Including monetary liabilities	40.3	43.0	42.0	41.3	40.1	38.6
Excluding monetary liabilities	38.7	41.6	41.1	40.5	39.4	37.9
Public external debt	31.1	33.9	34.2	34.1	33.6	32.7
Current account deficit	-5.3	-4.1	-3.2	-3.0	-3.0	-2.8
			(In millions of U.S. dollars)			
Net exports of goods and services 3/	13,836	14,790	16,795	18,424	20,321	22,345
Gross exports of goods and services	20,915	21,222	22,715	24,289	26,719	28,786
Total debt service	3,547	5,226	5,499	5,336	5,907	6,708
Current account deficit	-4,209	-3,259	-2,778	-2,882	-3,091	-3,180
			(In percent)			
Total debt service/gross exports	17.0	24.6	24.2	22.0	22.1	23.3
Public debt service/net exports	20.4	29.9	28.0	25.2	25.6	26.9

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

1/ Includes LNG expansion loan and amortization of this loan beginning in 1984/85.
2/ Includes amortization and interest payments on disbursements out of new commitments; also includes interest on LNG expansion loan.
3/ Net of oil/LNG sector imports.

exports of goods and services in 1984/85, compared to 20 percent in 1983/84. 1/

During the period April 1983 to March 1984, the real effective exchange rate had remained near the post-devaluation level after some moderate and planned pass-through of the devaluation to domestic prices had occurred. From March 1984 to July 1984, however, the real effective rate appreciated by 5.3 percent, due largely to the strengthening of the U.S. dollar vis-a-vis other major currencies. The authorities' response was to accelerate temporarily the crawl of the rupiah against the U.S. dollar in August and early September, particularly as the dollar continued to reach record levels against other currencies. While the rupiah depreciation resulted in some improvement in external competitiveness, it was misinterpreted by the domestic financial market as signaling the beginning of continued rapid depreciation and, hence, appears to have contributed to domestic money market difficulties. During August-November 1984 the real effective exchange rate depreciated by about 1.8 percent; compared to June 1983, when the pass-through of the devaluation on domestic prices was more or less completed, the real effective exchange rate had appreciated by 3.9 percent by November 1984.

c. Domestic finances

In contrast to the budget deficit in 1983/84 (2.4 percent of GDP) and the deficit implicit in the 1984/85 budget document (3.8 percent of GDP), it is estimated that the budgetary outcome for 1984/85 is approximate balance. With a projected net inflow of foreign financing totaling the equivalent of Rp 2.5 trillion, an equivalent increase is expected in government deposits with Bank Indonesia. The overall outcome is expected to show both higher revenue and lower expenditure than budgeted. On the revenue side, receipts are estimated to increase by about 13 percent. The unanticipated revenue buoyancy reflects an increase (14 percent) in oil/LNG tax receipts, which were forecast at the same level as in 1983/84. Partially offsetting this was a lower than forecast increase in non-oil/LNG tax receipts (12 percent instead of 18 percent).

Total expenditure was budgeted to increase by about 13 percent, but it is estimated that the actual increase will be marginal (1.3 percent), indicating a sharp decline in real terms. The overall shortfall in Central Government expenditure is estimated to be about Rp 2 trillion,

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1/ The Indonesian authorities have adopted the convention of monitoring developments in the public sector debt service ratio, oil/LNG exports being netted for external payments by that sector in the denominator. The more conventional debt service ratio, in which private sector debt service is included in the numerator and total gross exports of goods and services comprise the denominator, is lower. The debt service ratio on this standard basis is estimated at about 25 percent in 1984/85, up from 17 percent in 1983/84.

equivalent to 2.4 percent of GDP. About 30 percent of the expenditure shortfall is in the recurrent expenditure category and is entirely the result of a sharp (50 percent) reduction below the budgeted level in petroleum subsidy payments to the state oil company Pertamina, related to improved efficiency in refining operations. The larger portion of the estimated shortfall is in development expenditure, all in the category of foreign-financed project expenditure, which is estimated to decline by about one third over 1983/84, as a result of delays in project implementation.

Fiscal 1984/85 is again characterized by a large-scale flow of government resources to the banking system. Budgetary operations are estimated to increase the Government's deposits with the banking system by an amount equivalent to about 16 percent of the stock of broad money at the outset of the fiscal year. This development, plus the modest expansion in bank credit to the public enterprises, has provided scope for significant expansion of banking credit to the private sector without undermining domestic macroeconomic objectives. Banking system credit to the private sector and public enterprises together is estimated to expand by 24 percent, somewhat above the rate in 1983/84 (19 percent). However, estimated private sector credit expansion (32 percent) is considerably higher than the rate of increase of bank credit to public enterprises (8 percent). Total liquidity is estimated to expand by about 17 percent, a little above the estimated increase in nominal GDP (15 percent).

The authorities made further progress in adapting their monetary control instruments to the new environment following the June 1, 1983 financial liberalization. In February 1984, two new rediscount facilities--one for short-term liquidity management and the other of facilitating maturity transformation--were introduced. In addition, Bank Indonesia issued a debt certificate (SBI) to initiate open market operations. In response to interbank market problems in September 1984, a limit was set on interbank borrowing and a special credit facility was created at Bank Indonesia to accommodate temporarily the financing needs of the banks whose interbank borrowing exceeded the limit. These measures succeeded in calming the interbank market where interest rates had reached unprecedented levels as a result of the growing tightness in banks' reserve position compounded by the speculative pressure on the rupiah in August and September. By October, Bank Indonesia had extended about Rp 300 billion (equivalent to about 5 percent of the stock of reserve money) to banks through the new credit facility. Half of this amount is scheduled to be repaid by end-March, and the remainder, by end-September 1985. With the injection of liquidity from the new facility, plus some transfers of budgetary funds to one of the state banks, the banking system became reasonably liquid from late September, 1/ as evidenced by interbank interest rates which declined to an average of

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1/ Reserve money nevertheless was still slightly below the end-March 1984 level because the latter had included substantial excess reserves due to special year-end fiscal transactions.

around 12 percent in October and November. 1/ This permitted, as part of the authorities' program to develop and strengthen the instruments of monetary policy, buildup of an outstanding stock of Bank Indonesia certificates (of Rp 225 billion equivalent to about 13 percent of banks' liquid reserves) as of mid-November 1984.

III. Policy Discussions

The discussions focused on the current policy stance and recent experience with implementation of adjustment/reform measures, including operational issues that had emerged in the use and coordination of policy instruments. While there was an exchange of views with the authorities on the broad parameters of financial policy for 1985/86, the staff team did not have the opportunity to discuss the details of fiscal projections, which were made available subsequent to the mission.

1. Fiscal policy and budget execution

Following two budgets which, as executed, involved a notable reduction in the ratio of net domestic expenditure to GDP, the 1984/85 budget as presented implied modest fiscal stimulus. 2/ The staff estimates indicate that actual budgetary operations in 1984/85 will make a smaller contribution to domestic demand than planned, 3/ but the extent of the shortfall is difficult to quantify. Central Government budget data indicate that domestically financed development expenditure is approximately on target, and on that basis the estimated increase in total net domestic expenditure is 12 percent, compared with the 15 percent planned increase. However, a sizable amount of these funds have been utilized only in the sense of being transferred to disbursement accounts of ministries and regional government, and thus have not yet resulted in actual expenditure on goods and services. Thus, it appears that total development expenditure in rupiah at all levels of government was below the level planned for 1984/85.

The authorities attribute the large shortfall in rupiah as well as foreign-financed development expenditure in part to a number of changes in procedures for project and expenditure approval and new project

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1/ Interbank overnight rates had risen to an average of 30-40 percent during a period in August and early September, and were very volatile--the overnight rate reached 80-90 percent on some days.

2/ Net domestic expenditure declined by over 2 percent in 1982/83 and rose by less than 1 percent in nominal terms in 1983/84. Thus, the ratio of net domestic expenditure to GDP declined from the peak of 15.2 percent in 1981/82 to 13.6 percent and 11.2 percent in 1982/83 and 1983/84, respectively. The 1984/85 budget implied no change in the ratio.

3/ Net domestic expenditure in the Central Government budget is estimated to increase by just under 12 percent.

documentation requirements. Many of these were designed to strengthen the process of project selection and appraisal and to improve project administration, while some others, such as domestic use requirements, were introduced to increase the role of the Indonesian private sector in the development process. Other factors included institutional and legal impediments affecting land acquisition for projects, and a shortage of experienced personnel in project administration. In addition to the adverse implications for achievement of longer-term developmental objectives, the authorities were concerned that the outturn of fiscal operations was not contributing to shorter-term economic recovery and that additional fiscal stimulus is needed. Actions to redress the problems with project implementation were under way, and the authorities were hopeful that the disbursement rate would pick up in the coming months, although a quick solution to the problem was not foreseen. A Presidential ruling aimed at speeding up the governmental approval process was announced in December 1984.

The staff team agreed that slow absorption of foreign savings may have adverse longer-term growth implications and welcomed the efforts to reduce the bottlenecks, although the initial levels may have been somewhat ambitious. It was also noted, however, that strictly from the point of view of short-term domestic demand considerations, a shortfall in foreign-financed project expenditure, accompanied by an equivalent decline in imports and in payments abroad, should not involve a significant withdrawal of fiscal stimulus. On the other hand, to the extent that this expenditure would be associated with private activity or was accompanied by a significant shortfall (at all levels) in government rupiah development expenditure, there may have been more "fiscal drag" than apparent from the data on the execution of the Central Government budget. Nevertheless, given the oil export uncertainties, the good prospects for consolidating the gains in reducing inflation, and the need to contain the balance of payments current deficit, the staff team urged caution in considering major countercyclical fiscal measures at this juncture--the rate of increase in net domestic expenditure should not exceed the planned growth of nominal GDP.

In this regard, the staff team also cautioned against the adoption of a large-scale program of interest subsidies to private investment credits extended through the banking system, which was being discussed at the technical level while the mission was in Jakarta. Such a scheme would build a structural element into the budget which could absorb a significant amount of scarce resources from a domestic revenue base which itself needed to be strengthened. More broadly, such a scheme could have potentially serious adverse resource allocation consequences and would run counter to the thrust of the financial sector reform and the objectives of the Development Plan. These views were received sympathetically by the authorities.

Recurrent expenditure was budgeted to increase by about 18 percent in 1984/85, in reflection of a 15 percent salary increase to government employees; 1/ an increase in expenditure on goods and services broadly in line with the expected increase in nominal GDP; a 24 percent increase in the budgeted subsidy on domestic sales of oil products. It is estimated that for most categories of recurrent expenditures, the budget will be executed about as planned. One notable exception is the petroleum subsidy, which is estimated to be 50 percent below the budget level, reflecting a significant reduction in costs related to increased efficiency in Pertamina's refining operations. The fertilizer subsidy is expected to increase sharply in 1984/85, after declining last year. The staff team suggested, that with self-sufficiency achieved in rice production, and taking into account the high costs of storage, consideration be given to a modest increase in the distribution price for fertilizer relative to rice (as was done in late 1982). However, it seemed unlikely that the Government would change the rice/fertilizer price ratio until rice reserve stocks are higher than at present. 2/

Government revenue is estimated to exceed the budgeted level due to a higher level of oil/LNG revenues, while a 5 percent shortfall is estimated for non-oil tax revenue. The authorities acknowledged that during the first several months of 1984/85 both sales and income tax receipts were running below projected levels and that a shortfall for the year was probable. With respect to sales tax receipts, some loss could be expected as a result of the delay in implementing the new value-added tax from July 1984. 3/ The authorities noted that there were several other factors underlying the shortfall, e.g., the depressed level of consumer expenditure, the lower-than-projected imports, and the lower-than-expected rate of inflation in the period. The authorities attributed the relative lack of buoyancy in non-oil income tax receipts to problems associated with administration and collections under the new, substantially modified system, including the abolishment of the withholding tax on certain transactions. These problems, however, were viewed as temporary, and did not call into question the potential longer-term buoyancy of the income tax as modified last year. 4/ The work on tax administration has been proceeding on an accelerated basis with the help of outside consultants, including continued technical assistance from the Fund.

1/ This increase became effective in February 1984 and, with the exception of an extra month's salary granted in 1983, was the first increase in two years. It was expected that the net budgetary impact of the increase would be fairly modest, because government employees would now be subject to the income tax under the new law.

2/ The distribution price of fertilizer was raised by 11 percent in November 1984, and a similar increase in the acquisition price of rice is to come into effect in February 1985.

3/ It was noted that the resulting revenue loss probably was modest since the turnover tax, which would be replaced by the VAT, remained in effect.

4/ The Development Plan target is for an increase in the ratio of non-oil tax revenues to non-oil GDP to 12 percent by the final year (compared to 8 percent in 1983/84).

The 1985/86 budget, which was announced on January 7, 1985, thus was framed against the background of a perceived need to stimulate a sluggish economy, while maintaining the gains of the past two years with regard to inflation and balance of payments objectives. A more specific concern was that merely allocating sizable additional funds to the development budget would not assure additional stimulus, due to likely continuing problems with project disbursements. The budget outline, therefore, proposes to increase recurrent expenditure by about 25 percent (compared to the staff's estimate for the 1984/85 outcome), whereas development expenditure would rise by about 18 percent. 1/ The authorities stressed that the budget shows a relative shift toward greater reliance on domestic revenue, particularly non-oil revenue, rather than foreign borrowing. The ratio of net foreign financing to total expenditure and net lending would decline to 11.6 percent, from an estimated 14.4 percent in 1984/85 and 20.4 percent in 1983/84. The overall budget deficit would approximate 2.5 percent of GDP and would be covered by net foreign project loans, implying an unchanged position vis-a-vis the domestic banking system. The staff believes that, in spite of concerted efforts to greatly accelerate project implementation, the budgeted figure for project expenditure is probably on the high side, so that the overall budget deficit probably will be less than projected.

The proposed budget includes a sharp increase in personnel expenditures, reflecting a further 20 percent increase in (net) civil servants' salaries, a major increase in government pension benefits, and a hike in teachers' salaries. 2/ Taken together, these adjustments explain about 70 percent of the increase in recurrent expenditure; all other items together would grow by some 15 percent (including a 20 percent increase in interest payments, a 21 percent increase in the fertilizer subsidy, and an 8 percent further reduction in the petroleum subsidy). The decision on the salary increase took into account the historically low level of civil servants' salaries, exacerbated by decreases in real terms in recent years, 3/ and was combined with a simplification of the salary structure.

While the budget proposal as formulated implies an overall fiscal deficit, the absence of domestic bank financing and the projected increase of net domestic expenditure of 7 percent above the staff estimate for 1984/85 would suggest a modest impact on domestic demand.

1/ The level of development expenditure in the 1985/86 budget is roughly unchanged from the level budgeted for 1984/85.

2/ The World Bank has found that the low level of teachers' salaries in Indonesia has been a major reason for multi-jobbing by school teachers, and an important factor explaining the current relatively low quality of education, particularly at the secondary school level. See, General Secondary Education in Indonesia: Issues and Programs for Action, IBRD, No. 4954 IND (7/26/84).

3/ It is estimated that the increase in civil servants' salaries would approximately restore the level in real terms in 1985/86 to that prevailing in 1982/83.

In the staff's view it is unlikely that non-oil revenue will be as buoyant as projected (35 percent increase), even with the application of the income tax to government workers and assuming full collection of the new VAT right from the outset; a more cautious appraisal of non-oil revenue prospects would suggest an increase of about 25 percent. On this basis, the increase in net domestic expenditure would be about 13 percent, broadly in line with the expected increase in GDP. At the same time, however, the projection of tax revenue from the oil/LNG sector appears on the low side, so that the increase in total revenue may be approximately as envisaged (a rise of about 8 percent) . On balance, the parameters of the proposed budget would appear to be broadly in line with the macroeconomic objectives underlying the adjustment effort.

2. Monetary and credit policy and instruments

The conduct of monetary and credit policy in 1984/85, the operational issues that emerged, and the challenges to policymakers in the period ahead must be viewed against the profound changes in the policy instruments and the credit funding and allocation system following the sweeping financial sector reform initiated in mid-1983. The broad lines of policy for 1984/85 thus had to be developed against the background of significant uncertainty about the continued impact of the reform on asset preference and credit demand of the public and the behavior of commercial banks in respect of reserve and liability management. The authorities' financial plan for 1984/85 assumed growth in liquidity of between 17 and 20 percent which, given the parameter estimates, suggested an expansion in demand for reserve money of 13-18 percent. 1/ The relatively lower growth expected in demand for reserve money primarily reflected the continued low growth in demand for currency following the increase in state bank interest rates in June 1983, as well as greater efficiency by the commercial banks in their management of excess reserves. However, actual reserve money growth was expected to be much less than projected demand because it was assumed that more than half of this would be accommodated by a drawdown of the temporarily high level of excess reserves at the outset of the fiscal year. Given developments up to now and the current policy stance, the staff team estimates growth in demand for liquidity in 1984/85 to be at the lower end of the range.

Indonesia has followed a cautious monetary policy which the staff believes has been consistent with adjustment objectives, although in some periods monetary conditions were tighter than the authorities would have wished. The large increase in the deposits with the banking system, and the estimated expansion of bank credit to public enterprises at a rate somewhat below nominal GDP growth, have allowed room for credit to the private sector to expand at about twice the growth in GDP without impairing achievement of broad domestic and external objectives

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1/ The wide range on the reserve money growth target reflected the difficulty in predicting the relative growth rates in the components of liquidity.

in the period. The authorities and the staff shared a concern that, based on the authorities' projection of no further increase in the net foreign assets of Bank Indonesia in the second half of the fiscal year while government deposits are expected to continue to rise, excessive tightness in the banks' reserve position might again develop. This would be exacerbated by the scheduled repayment by commercial banks of the first half of the special credit facility by March 1985. The staff views it as likely that the overall balance of payments surplus will turn out to be significantly higher than the authorities' forecast, which is traditionally conservative. However, if this is not the case, other means will have to be used for maintaining adequate growth in reserve money; the authorities are currently reviewing their existing monetary policy instruments and considering development of additional instruments that could be used to increase bank liquidity if and as needed.

It would be expected that the broad policy stance will again be appropriately cautious in 1985/86, although the quantitative parameters had not been established at the time of the staff team's visit. On the basis of its understanding of macroeconomic objectives and broad budget planning parameters, the mission indicated that a target for expansion of rupiah broad money of about 15 percent would appear appropriate. In view of the continued adaptation of banks' liquidity management and the public's asset preference, the target for reserve money should give due weight to developments in the latter part of the current fiscal year and be implemented flexibly in light of shorter-term changes in market conditions. The scenario for monetary/credit management likely will change significantly next year if, as expected, the sharp upward trend in Government deposits with Bank Indonesia is greatly moderated--or even halted--next year. The rate of expansion of bank credit to the private sector and public enterprises together would have to be reduced (to about 15 percent), if inflation and balance of payments objectives are not to be jeopardized. A somewhat faster growth for the private sector than for the public enterprises would appear appropriate in view of growth/developmental objectives.

The challenge to monetary/credit management in the period ahead is to maintain the momentum toward greater reliance on the markets for interest rate determination and credit allocation in order to achieve broad domestic and external objectives. A key element of the reform, which would permit flexible asset management by the central bank in managing reserve money, was the marked reduction of the scope of subsidized liquidity credits 1/ and direct credits to nonbanks. In this regard, the mission noted that demand for credits by BULOG for

1/ These are Bank Indonesia refinancing advances to commercial banks through which the latter had funded a significant portion of their credits (mainly longer term) to final borrowers on a subsidized basis.

stockpiling rice, 1/ which was an important source of Bank Indonesia reserve money expansion this year, would likely be strong again next year, and that there appeared to be some pressure to add new categories of subsidized credits--e.g., for investment. 2/ The staff urged caution in this area, on grounds that a new expansion of these facilities would undermine the thrust of the financial reform and could complicate and possibly jeopardize the process of flexible monetary management. Moreover, there is no clear link between the interest subsidy granted and the quantity of additional private investment. The authorities indicated that it had been decided not to expand the scope of liquidity credit operations and if, in response to continuing weak demand for investment credits, further action were to be taken, it probably would be in the form of interest rate subsidies directly from the budget; however, no decision had been taken.

Part of the reason why the demand for investment credits was unusually weak, in the mission's view, was the excess capacity in industry and weak consumer demand. Another problem, which should be resolved over time, was that banks, in particular the large state banks, still had limited experience in funding and liability management in the new environment and were preceding very cautiously in extending term credits to avoid excessive maturity mismatch. Granting of longer-term credits should be facilitated as the market makes greater use of floating interest rate credits, a prospect that might be enhanced were Bank Indonesia to formulate and publish a market-guided, reference interest rate.

Aside from questions of Bank Indonesia's asset management, there is the operational issue of the sufficiency of monetary policy instruments. When the Bank Indonesia certificate (SBI) was introduced in February 1984, it appeared that there would be a tendency toward excess liquidity creation over the coming few years. It was expected that with ample demand for the certificate, the authorities could build up a large enough stock so that the SBI could soon be actively used for two-way open market operations. In order to make the SBI relatively more attractive, the rate of interest paid by Bank Indonesia on the banks' excess reserves was reduced to zero by May 1. However, because of the tight monetary conditions during much of the past year, the outstanding stock of SBIs has generally been small. Although the stock of SBIs increased to a peak of Rp 300 billion in mid-October, this was largely due to the temporary liquidity injection of the special Bank Indonesia credit facility and to transfers of budgetary funds to one of the state

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1/ Until this year, such credits were classified as direct credits but are now considered as liquidity credits, as credits are advanced to BULOG by the state bank, BRI--the interest rate is 6 percent--but funded through refinancing advances from Bank Indonesia.

2/ Three new categories of credits eligible for refinancing through Bank Indonesia liquidity credit advances were added in the course of 1984: working capital credits for small business, credits for certain government suppliers, and a new rural credit program (Kupedes).

banks. If a tendency for reserve money to contract develops during the remainder of the fiscal year, a modest amount of liquidity could be injected through a rundown of the relatively small outstanding stock of SBIs. Thereafter, at least for the time being, the instrument would have potential only as a means of contracting liquidity. Should the monetary impact of budgetary developments prove to be expansionary in 1985/86 and/or the balance of payments surplus increases significantly, the SBI could have a significant role to play in monetary policy in the period ahead.

Use of the two new discount facilities introduced in February 1984 was very limited until September when, with the advent of money market difficulties, Bank Indonesia actively encouraged the banks to borrow under the first window and, for a short time, 36 banks made use of the window for a total of Rp 125 billion. Prior to this, the banks apparently had been concerned that use of the window would be perceived as implying that the bank was in financial difficulty. The third facility, introduced in September 1984, was designed to provide temporary funding to banks that were above the new limits established on interbank borrowing. In the staff's view this was appropriate and timely action, and order was quickly restored to the interbank market. Nevertheless, the authorities are aware that the restriction on interbank borrowing may create inefficiencies in the money market and they are reviewing the regulation. In this regard, the mission suggested that, at a minimum, longer maturities of interbank placements might be left outside the ceiling and that the authorities might consider eliminating the ceiling entirely and use bank supervision instead to ensure that banks maintain prudent positions.

The requirements for reserve money management in the period ahead also suggest the need for review of Bank Indonesia's foreign exchange swap facility, established after the 1978 devaluation to encourage capital inflows at the time. The fact that the swap rate is fixed over long periods of time introduces an element of potential rigidity in domestic interest rates and at times has resulted in substantial subsidies to those who can obtain access to the facility. 1/ This implicit subsidy could have adverse implications for resource allocation, complicates effective domestic monetary/credit management, and could raise issues with respect to the coordination of monetary policy and exchange rate management. During periods when the rupiah depreciates vis-a-vis the U.S. dollar at a rate (annualized) higher than the swap fee, the facility results in (potentially significant) losses to Bank Indonesia (tantamount to primary monetary expansion)--which may be the wrong way for monetary policy to be moving at the time. The

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1/ The swap fee has been about 6 percent per annum since February 1983. Thus, an implicit subsidy arises when, as at present, the (annualized) swap rate is below the interest rate differential between the domestic and foreign markets. In such circumstances, the cost of borrowing abroad and swapping the foreign exchange for rupiah funds is below the cost of borrowing in the domestic market.

mission, therefore, urged that the facility be phased out; the authorities listened sympathetically, but were noncommital.

3. External policies

a. Exchange rate management

Faced with a marked strengthening of the U.S. dollar against most of the currencies in the indicator basket last summer, the rupiah's downward crawl against the U.S. dollar was temporarily accelerated; the rupiah depreciated against the dollar by close to 2 percent in August 1984 and at a similar rate in early September (Chart 2). Substantial conversion of rupiah-denominated assets into foreign exchange ensued, and the authorities believed that the exchange rate uncertainty was an important cause of the upheaval in the interbank money market in September. To dispel devaluation fears, the rupiah was slightly appreciated for a few days, and new measures (discussed above) were introduced to restore order in the interbank market. At the time of the mission's visit, discussions were underway with OPEC with regard to possible oil production cuts, and the authorities were concerned about the impact of this uncertainty on exchange market expectations. Under these circumstances, they believed it appropriate for the rupiah/U.S. dollar rate to be stabilized; moreover, domestic prices were almost stable during the July-October period. Noting the continued stability of the rate throughout its visit, the staff team inquired whether the basic policy stance on flexible rate management might have been changed. The authorities said that they remained fully committed to preserving the gain in competitiveness from the March 1983 devaluation.

The staff team agreed that exchange rate management had to be crafted carefully to avoid unwarranted speculation. In view of recent balance of payments developments and the modest size of the appreciation of the real effective exchange rate, the staff team's view was that the objective indicators did not suggest the need for an immediate, significant depreciation of the rate. However, it stressed the importance of allowing the rate to move flexibly. The present stability of the rate could create a false impression in the market about the underlying policy, and the rate could become "institutionalized" fairly quickly. Thus, adjustment, when it became necessary, might be interpreted as a shift in policy and create undue uncertainty. Soon after the oil production cuts agreed within OPEC were announced, the rupiah began to move downward slowly against the U.S. dollar, and during the six weeks through mid-December the rupiah depreciated vis-a-vis the U.S. dollar at an annual rate of about 7.5 percent.

At its meeting on November 14, 1983, the Executive Board noted that certain taxes on export receipts constitute multiple currency practices subject to approval under Article VIII, Section 3; these were granted temporary approval until December 31, 1984. On January 1, 1984, the MPO withholding tax on export receipts, considered by the Fund to constitute a multiple currency practice, was abolished. On May 4, 1984, the collection procedures for the export surcharge and the additional export surcharge, which gave rise to a multiple currency practice, were modified and the incidence of these taxes was shifted from the movement of funds to the physical movement of the goods being exported. Previously the taxes were collected by the foreign exchange banks at the time the exporter received payments. Under present procedures, the surcharges are collected by the Customs.

b. External debt management

External debt service has risen much more rapidly than debt in recent years, reflecting a relative shift toward medium-term credits at market-related interest rates. 1/ With net exports still below the peak levels of the early 1980s, the public debt service ratio has risen sharply, to close to 30 percent in 1984/85. 2/ In the discussions, the authorities agreed that the debt service burden should be reduced from current levels and that the degree of success will reside basically in the sustained implementation of policies to reduce the relative size of the current account deficit, including avoidance of large-scale restoration of public investment projects already rephased. In conjunction with those policies, an important step had been taken in October 1984 to strengthen external public debt management. A Presidential Decree was issued instructing the ministries that all use of foreign finance in the form of "export credits" would henceforth be subject to an aggregate annual ceiling, and that each project utilizing such financing would be subject to the approval of the Coordinating Minister for Economy, Finance, Industry and Development Supervision. The aggregate limit was set at $1.5 billion for 1984/85, against total requests for approval during the course of the year amounting to about three times that amount. For this purpose the term "export credit" is interpreted broadly to include all "nonconcessional" trade-related credits. 3/

With respect to private sector external debt, other than the external liabilities of the banking system, comprehensive data are

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1/ Such credits (e.g., suppliers credits, LNG expansion loans, syndicated bank credits and purchases from the Fund) represented 37 percent of the stock of public external debt in March 1981. During the subsequent three years, net disbursements of these loans represented 73 percent of net inflows to the public sector; such loans rose to 53 percent of the total outstanding in March 1984.

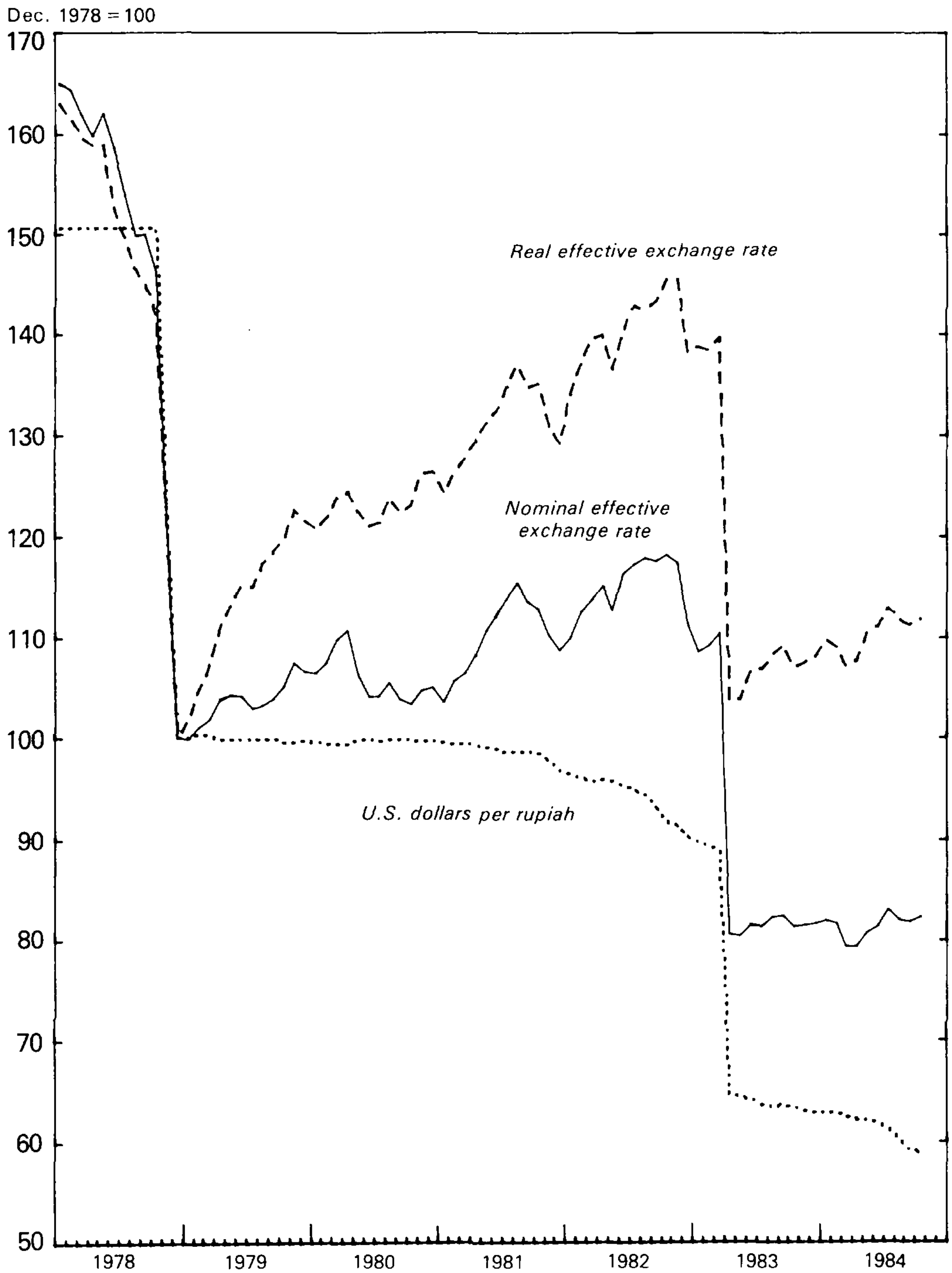
2/ The ratio of public debt service to net exports rose from 12.1 percent in 1980/81 to 20.4 percent in 1983/84 and then jumped to an estimated 29.9 percent in 1984/85; using a more conventional measure, with the gross receipts of goods and services in the denominator, the estimated ratio in 1984/85 is 20.8 percent. Inclusion of a rough estimate of debt service on purely private debt yields a ratio of 24-25 percent of gross exports (Table 1).

3/ All trade-related credits, the terms of which are less favorable than the following are included: interest rate, no more than 3.5 percent; grace period, at least 7-10 years; maturity, at least 25 years.

CHART 2

INDONESIA

DEVELOPMENTS IN EXCHANGE RATE INDICES[1], JAN. 1978-OCT. 1984



Source: IMF Datafund.

[1]Trade weighted norification index, indices calculated using monthly average data.

unavailable. Staff estimates derived from creditor source data indicate that the total debt to foreign banks may be around $6 billion, while data reported directly to the authorities by banks with offices in Indonesia indicate a total of $3-4 billion. Nevertheless, the authorities agreed that monitoring procedures at present were not sufficient to permit clarification. To this end, they have requested technical assistance from the Fund to improve the monitoring of private external debt. It was noted that the new system of taxpayer identification numbers, as well as the new provisions for limiting deductions of interest payments as a business expense, 1/ might improve the information available on private debt.

The authorities referred to the increase in the withholding tax from 10 percent to 20 percent on interest payments made abroad and noted that the resulting increase in borrowing costs might provide some disincentives to private external borrowing. In this regard, the staff team pointed out that another reason to consider adapting or (preferably) phasing out the swap facility offered by Bank Indonesia was that it provided an inducement to private short-term borrowing abroad. The authorities generally agreed with this assessment but emphasized that an increase in the swap rate could tend to push up domestic interest rates and/or create undesirable market expectations about official views on the exchange rate. The alternative of phasing out the facility would have to be examined in light of balance of payments conditions at the time, and would have to take into account the likely impact on private capital flows and investment activity.

c. Foreign trade policy

During the past two years there has been a trend towards increased import protection--already at a significant level--including quantitative restrictions that risk serious distortions and increases in the domestic cost structure. 2/ There has been a proliferation of quantitative restrictions, domestic use requirements, special import licenses, and exclusive import authorization, or even arrangements covering production and distribution as well as importation. Some relatively inefficient industries have been created in various sectors in Indonesia, and for many of them future growth prospects are limited, as most import substitution possibilities have essentially been

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1/ A stipulated maximum debt-equity ratio cannot be exceeded for tax purposes; greater documentation of claims for interest payments (domestic and foreign) will be required.

2/ In its report for the 1984 IGGI meeting, the World Bank indicated that the implicit subsidy to producers in many protected industries in Indonesia is very high. Giving broad orders of magnitude, the implicit subsidy per worker (i.e., higher domestic costs to consumers in relation to imported costs of comparable items) is as high as about $18,000 for cement and $36,000 for steel billets in any given year, for example, see, "Indonesia: Policies and Prospects for Growth and Transformation," (IBRD, No. 5066-IND, 4/26/84) pp. 98-102.

exhausted. 1/ The IBRD gave significant attention in its latest report to the IGGI to the problems posed for growth and non-oil export prospects by the level and structure of protection, and is undertaking further studies in this area. 2/ The Bank has recommended a rollback of import bans and a gradual reduction of tariffs, while advocating adjustment assistance and anti-dumping legislation to assist affected industries. The staff team was in close contact with the Bank's resident staff in Jakarta on this (as well as other) issues.

The mission expressed concern about the adverse impact of the existing trade policy stance on prospects for sustained growth in non-oil exports, which is the strategy of the Plan for structural strengthening of the balance of payments. Although protection is not an explicitly stated element of the policy, there is always a risk that once it is granted to industries or increased, it will become a permanent feature of the system. When heavy protection is offered to basic, "up-stream" industry (e.g., steel), for example, it gives rise to a body of high-cost "down-stream" industry, and the system tends to be self-perpetuating. The authorities indicated that the current policy was designed to accommodate reduction of protection for specific industries when justified. There were procedures for reducing the scope of protection when complaints from users of the protected inputs warranted redress--such a reduction had been made recently for polyster fabric used in the textile industry, for example. The mission noted that it had not received comprehensive information on import regulations and administration, but that qualitatively the import system appeared somewhat more protective than at the time of the previous consultation discussions.

The counterpurchase scheme had been modified (September 1983) to permit assignment of the countertrade obligation to third parties, including those currently importing from Indonesia. This adaptation of the regulations would seem to reduce whatever had been the initially assumed effectiveness of the scheme as a tool of non-oil export promotion. Moreover, when the measure was introduced (1982), exporters were penalized by an overvalued exchange rate, which was no longer the case. The staff team therefore suggested that consideration be given to eliminating this scheme, which seemed to serve mainly to complicate the trade process. The authorities, however, did not believe that the scheme had become ineffective in promoting exports to new markets, because an arrangement is subject to official review and approval when the counterpurchase obligation is transferred to third parties. Such

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1/ The World Bank report (op. cit., p. 100) indicates that more than 95 percent of consumer goods and 65 percent of producer goods (largely intermediates) consumed in Indonesia were produced domestically.

2/ The IGGI, at its June 1984 meeting, requested that for the next meeting an account be given to them of the impact of protectionism policy, both in Indonesia and among Indonesia's trading partners, on Indonesia's growth and balance of payments prospects.

arrangements include a condition of "additionality"--i.e., counterpurchases by the third party have to be in addition to "regular" imports from Indonesia. If that condition is not observed, the liability for fulfilling the counterpurchase requirement reverts to the original importer. 1/

On the subject of protection abroad faced by Indonesia's non-oil exports, the authorities indicated that textile and plywood exports had been particularly hard hit. The United States had recently notified Indonesia of an additional list of textiles that would be subject to import restrictions and this action, which the Indonesian authorities believed to be at odds with the Multifiber Agreement, was expected to have a quantitatively significant impact on Indonesia's textile exports. The authorities also explained that Indonesia's plywood exports to Japan were adversely affected by the large tariff differential (approximately 18 percent versus 8 percent) between imports of softwood and hardwood plywood, which Indonesia exports. In addition, tariff quotas (i.e., quotas for which low tariffs applied) for plywood in Europe were quite small. Moreover, there were a number of proposals currently under consideration in Europe which, if put into effect, would have a detrimental impact on a range of Indonesia's exports.

d. Foreign investment policy

During the discussions, the authorities stressed that encouraging private investment, both domestic and foreign, remains one of the Government's top economic priorities and is key to meeting the development goals of Repelita IV. Recent steps to reform the tax system and simplify and reduce regulations affecting business were aimed at stimulating investment and economic efficiency. Industrial growth has been accorded increased emphasis in the new development plan, and direct investment is to be encouraged. Foreign capital is especially welcomed in industries that contribute to the expansion of exports and also in those which require large amounts of capital investment and high technology. In the past year, the Investment Coordinating Board (BKPM) has stepped up its efforts to inform foreign investors of specific project opportunities, while the number of Minister-led investment missions abroad was increased. Also, foreign investment procedures have recently been simplified by BKPM which is in the process of setting up one-stop offices in regional centers to assist new ventures locating outside the Jakarta area. Further, business travelers from 28 countries can now obtain visas upon arrival at ports of entry.

1/ At the time of the discussions, there had been no cases where such a problem had risen. Moreover, there have been no cases in which penalties had been assesed because the terms of any countertrade agreements had not been fulfilled.

The authorities stressed that while the reform of the tax system may have created temporary uncertainty on the part of some investors, the new laws provide enhanced incentives: although tax holidays of 3-5 years had been eliminated, these had been replaced by what should be a more attractive incentive--lower tax rates. For the typical investment, it was observed that tax obligations will be lower or unchanged under the new law. The lower rates are applicable uniformly for the life of the project, and apply to all areas, not just to those selected by the Government for promotion as in the past. Further, the new laws have been designed to reduce irregularities in administration which can be particularly troublesome to investors. While implementation of foreign investment projects fell somewhat in 1984 and investment applications declined (though this was affected by a bunching of approvals at the end of 1983 so as to qualify for the tax holiday as well as the beneficial treatment of the new law), the authorities believe this to be temporary and associated with less buoyant economic conditions. 1/ For the long run, they stressed the strong attractions of Indonesia to foreign investors. These included a large domestic market of 160 million people, a vast store of untapped mineral and agricultural resources, a willing labor force, a strategic location, political stability, a free foreign exchange system, and an established record of prudent economic management.

IV. Medium-Term Prospects

1. The Five-Year Development Plan

The Fourth Plan (Repelita IV) covers the period 1984/85 through 1988/89. In recognition of the less favorable external environment and the additional constraint imposed by the substantial increase in external debt and debt service in recent years, the Plan envisages a lower average annual growth rate (5 percent) than the Second and Third Plans (7.5 percent and 6.5 percent, respectively). Industrial growth is to become increasingly important to Indonesia's development. Industrial output is expected to grow at an average annual rate of 9.5 percent and to become increasingly externally oriented; manufactured exports are to increase by over 21 percent per annum and contribute to raising the growth of non-oil/LNG exports to 15 percent per year. With a more conservative outlook for oil production and oil prices, the mining sector is expected to grow at an average annual rate of only 2.5 percent, and oil and LNG exports, by just 6 percent. Non-oil/LNG imports

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1/ The petroleum sector is governed separately from general foreign investment. It should be noted that expenditures by foreign petroleum companies for exploration, development, and production amounted to about $4 billion in the 1982-84 period. A similar level of such spending in 1985 is expected by companies.

are projected to rise by just under 10 percent annually, broadly in line with the growth of GDP in U.S. dollar terms. 1/

On this basis, the Plan's balance of payments current account deficit (originally projected to be $4.7 billion for 1984/85) would approximate $4.6 billion in 1985/86, then decline steadily to just over $3 billion in 1988/89; in relation to GDP the deficit would decline from 5.3 percent of GDP in 1985/86 to 2.8 percent in the final year of the Plan. The cumulative current account deficit in the Plan of about $20 billion would be associated with a similar increase in external public debt (mostly on concessional or quasi-concessional terms), which would reach $45 billion by 1988/89. External public debt would grow by about 13 percent per annum on average, somewhat faster than the growth of either GDP or net exports in U.S. dollar terms and, although not explicit in the Plan document, it appears that in these circumstances the public sector debt service ratio would not decline below the fairly high level the staff has estimated for 1984/85.

While the authorities see the Plan as a guide to policy, they realize fully the necessity of continually assessing developments and modifying policies as needed in the light of circumstances, as has been done in the past.

2. A revised medium-term scenario

The Plan was formulated more than a year ago, well before the full impact on the economy of the wide-ranging adjustment and structural reform measures of 1983 was felt. For example, non-oil imports during the two-year period 1983/84-1984/85 (which includes the first year of the Fourth Plan) are now estimated to have remained significantly below the earlier projections, although the economy grew somewhat faster than expected. Moreover, recent developments in the world oil market have added to the uncertainties about the period ahead. Finally, in a number of areas--e.g., strengthening and re-orientation of the industrial sector--structural adjustment policy measures have not yet been fully specified. In light of these considerations, the staff has developed a medium-term scenario incorporating assumptions about external conditions likely to face Indonesia and postulating continuation of current policies to assess the sustainability of the balance of payments through 1988/89. The scenario presumes continuous but moderate growth in the industrial world and in commodity prices. The assumptions about developments in the oil sector are somewhat more conservative than in the

1/ Under the staff's assumptions, GDP in current U.S. dollar terms would increase at an annual average rate of about 9.7 percent, or by 5 percent in real dollar terms--i.e., deflating by projected world inflation.

Plan 1/, while its assumptions about agriculture and service sectors are somewhat more optimistic; the average annual growth target is maintained in the staff projections.

Non-oil/LNG imports are projected under broad categories: Capital goods imports consist mainly of foreign-financed project imports, the growth of which fell sharply short of expectations in 1984/85. Under the staff's scenario, a recovery in project aid-financed imports from the very low level estimated for 1984/85 is foreseen for 1985/86. Thereafter, these imports are projected to rise by 9-10 percent yearly, broadly in line with the projected growth in GDP in U.S. dollar terms, while general imports are projected to grow by about 11 percent annually through the four-year period. 2/ Total non-oil/LNG imports thus are projected to grow by about 10 percent annually during the period; this is similar to the Plan projection, but starting from a much lower base.

Current account projections under this scenario suggest a modest decline in the deficit from an estimated $3.2 billion (4.1 percent of GDP) in 1984/85 to about $2.8 billion (3.2 percent of GDP) in 1985/86 (Table 5). Projections beyond 1985/86 indicate a gradual reduction in the current account deficit to 2.8 percent of GDP by the end of the period (1988/89). The ratio of public external debt to GDP and to net exports would decline only marginally, and the sharp upward trend in the public sector debt service ratio noted in recent years would only be modestly reversed; the ratio would begin to decline in 1985/86 (to 28 percent from 30 percent in 1984/85) and be reduced substantially further in the following year, before slowly increasing back to about 27 percent by 1988/89. 3/

The policy course to achieve certain Plan objectives has not yet been fully mapped out, particularly with regard to the promotion of large-scale private sector investment in manufacturing. If the basic incentives for development of a dynamic, internationally competitive industrial sector are to be sufficient, the external trade regime would need to be reviewed and certain policy adjustments undertaken. In the

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1/ Crude oil production and export volume are projected by the staff to recover in 1985/86 to approximately the levels achieved in 1983/84. Production would grow by 2.7 percent, while export volume would grow by 11.6 percent on the strength of the recovery in output, a sharp decline in product exports, and roughly stable domestic consumption. Both crude oil and product prices (at $29.50 and $27.00 per barrel, respectively) are assumed to be unchanged in nominal terms through 1986/87 and then to increase by 4.5 percent annually through 1988/89--i.e., unchanged in real terms according to WEO assumptions of world inflation.

2/ On the basis of an assumed elasticity of 1.2 with respect to real GDP and an annual increase in import prices of 4.5 percent.

3/ On the more conventional basis in which total service and gross exports of goods and services would enter the equation, the ratio would decline from close to 25 percent in 1984/85 to about 23 percent in 1988/89.

absence of early action in this area, the staff has doubts that the Plan projections for non-oil/LNG exports could be achieved; even the lower growth rates embodied in the foregoing scenario might be on the high side. On the other hand, the current account outcome is very sensitive to volume/price assumptions for oil/LNG exports, and in this regard it is possible that the projections in the scenario could prove to be somewhat conservative. A combination of price/volume changes which would raise the average annual growth rate of gross oil/LNG export receipts by only 2 percentage points above that assumed would, for example, yield $2 billion cumulative additional net export receipts and lower the current account deficit to about 2 percent of GDP by 1988/89. In contrast, a 2 percentage-point reduction in the average oil/LNG growth rate would reduce cumulative net export receipts by a similar amount and increase the 1988/89 current deficit to 3.6 percent of GDP, which clearly would be unsustainable. These alternative scenarios serve, inter alia, to underscore the highly tentative nature of the projections, even for a fairly short period.

It appears that the external borrowing needed to finance the current account deficits projected under the staff's scenario would not create financing problems in the Plan period. Conceivably, deficits of such magnitude could begin to strain external debt management in subsequent years, unless the non-oil export sector strengthens more rapidly and/or world oil markets are stronger than assumed. The World Bank staff generally concurs with this judgment. Moreover, the present scenario already implies borrowing at the upper level of what could be considered prudent, with not much progress in reducing the debt servicing burden over the next few years. If exports were to develop more favorably than foreseen in the scenario, it would seem prudent to reduce external borrowing below the levels projected above. A deterioration in oil market conditions from those assumed by the staff, on the other hand, would require an immediate policy response to ensure that the current deficit continues on a path toward longer-term sustainability.

V. Staff Appraisal

For some years the structural growth pattern of the Indonesian economy reflected strong increases in government spending and ample foreign exchange to accommodate the Government's investment program and the private sector's response to the stimulus thus provided. The external constraint on this process was manifest in 1982/83 after oil production and, ultimately prices, had declined sharply, yielding an external gap that appeared beyond the range of orderly financing even in the short run. In response, the Government introduced a series of far-reaching adjustment/reform measures carefully crafted both to achieve rapid correction in the balance of payments and to lay the foundation for a sustainable growth path in an environment in which the private sector would have to generate much of its own momentum and earn an increasing portion of its own foreign exchange requirements. The 1983 measures, in conjunction with strong demand management policies, have yielded impressive adjustment. In particular, the current account deficit has been reduced substantially, with progress toward a sustainable longer-term path, as the non-oil balance of payments has strengthened. Significant progress has been made also in resource mobilization and improved allocation, and inflation has moderated notably. On the other hand, the pace of underlying economic recovery remains slow and uneven, substantial excess capacity exists in manufacturing and other parts of the nonagricultural private sector, and fixed investment remains depressed. Given the substantial annual increases in the work force, there is some concern among policymakers about the relative lack of momentum in the economy.

The policy response to the perceived need for some additional stimulus to the economy is reflected in the proposed budget for 1985/86--more in the distribution of expenditure rather than the aggregate level. Even after adjustment for what in the staff view is a somewhat optimistic assessment of non-oil revenue prospects, full expenditure implementation would involve an overall outcome reflective of a fairly cautious fiscal stance, which appears broadly consistent with macroeconomic objectives. The proposed budget reflects a desire to attain the modest fiscal stimulus planned for in 1984/85 but effectively withdrawn through serious delays in project implementation. The shift in the budget structure toward recurrent expenditure reflects the authorities' view that these problems cannot be resolved quickly, so that merely allocating additional expenditure to the development category would not provide assurances of adequate support to domestic demand. While understandable in current circumstances, the relative shift toward recurrent expenditure should be considered an exceptional, interim solution, and should not detract the policymakers' attention from the sustained action required to resolve the problems with execution of development projects. In this regard, the staff welcomes the efforts under way to redress these problems and hopes they will be pursued vigorously.

The budget strategy involves a significant increase in civil servants' (and teachers') salaries which have tended to be compressed in real terms from a base the authorities have considered inadequate for some time; this is being combined with a simplification of the salary structure. The challenge to policymakers will be to ensure that these actions are accompanied by efficiency gains, in order that the budget does not become overburdened, and to help avoid perceptions by the private sector that the salary action signals an easing of adjustment requirements. The staff is encouraged that the budget provides for some further reduction in the petroleum subsidy--following the very sharp cut this year--and would hope that similar action in respect of the fertilizer subsidy will be kept under consideration.

In framing policies for the coming year, the authorities have reviewed a range of possible options to provide additional stimulus without undermining adjustment achieved and interrupting progress toward longer-term balance of payments sustainability. The range of options is, however, rather narrowly circumscribed by the external resource constraints. One possible option which has been under discussion would be to rechannel to the private sector--directly through the budget or through Bank Indonesia--part of the large buildup of government deposits in the form of interest subsidies on "investment credits" extended to the private sector from the banking system. The staff would urge considerable caution in considering such action, as it would reverse progress achieved in reducing loan subsidies, with potentially the same adverse effect on resource allocation that the authorities sought to eliminate with the major financial sector reform. Moreover, the link between the subsidy and investment would be tenuous, as investment additionality could neither be assured nor monitored in a large-scale program. The authorities are aware of the need to weigh carefully the drawbacks of such a scheme; no action in this area has been incorporated in the budget proposal.

The fiscal projections 1985/86 suggest a changed environment for the conduct of monetary policy. The potential elimination of the sharp monetary contraction emanating from the budget indicates that the recent pace of expansion of bank credit to the private sector may need to be dampened. However, in some ways strains in monetary management may be eased. The increase in government deposits and the marked seasonal variation have complicated monetary management this year and, at times, kept market conditions tighter than the authorities would have desired. The magnitude of downward pressure on bank reserves during the summer was a factor underlying the disruptions in the interbank market. The measures taken by the monetary authorities in response, which the staff views as timely and appropriate, quickly restored order to the market. The interbank measures included a direct limitation on interbank funding which should be further reviewed to determine whether in its present form it could lead to excessive market segmentation, and possibly constrain longer-term financial market development.

Prospects for the remainder of this year, when pressure on bank reserves could again appear, and for 1985/86 indicate the need to monitor closely overall monetary conditions and to ensure that the policy instruments are available and used flexibly. In this regard, the authorities intend to review the scope, terms and coordination of existing rediscount facilities. The staff believes that a further examination of ways to enlarge the role of Bank Indonesia certificates (SBIs) as an instrument for open market operations would also be useful. The marked reduction in the scope of Bank Indonesia subsidized liquidity credits in 1983 greatly enhanced the prospects for flexible monetary/credit management, and the staff would urge great caution in adding further to the list of credits eligible for this facility, as was done to some extent this year. Some further flexibility could be achieved were consideration also given to phasing out the Bank Indonesia foreign exchange swap facility, use of which expanded considerably over the past year. Under certain circumstances, this facility can complicate monetary management and, moreover, it has tended to provide an incentive to private short-term external borrowing, at odds with the general objectives of external debt management.

Present oil export uncertainties, in combination with the recent sharp increase in the debt service burden, highlight the need for careful attention to external debt management. In this regard, the recent measure to strengthen the review and authorization procedures for public sector projects to be financed on nonconcessional terms is to be welcomed, as is the intention to develop more effective mechanisms for monitoring developments in private foreign debt. The extent to which the external resource and debt management constraints facing Indonesia may be eased over time will depend in large part on success in stimulating and reorienting growth in the non-oil industrial sector, and the key determinant of private investment incentives probably will be projected market growth. While some stimulus to domestic demand may be useful in the short run, over a longer period only strengthened export orientation is likely to provide adequate market incentives. Thus, it will be important that the exchange rate continue to be managed flexibly to avoid an erosion of the gains in external competitiveness already achieved. The circumstances also suggest the need for careful review of the existing foreign trade regime to determine what actions can be initiated to reduce the excessive and costly protection afforded to some sectors. The general trend of trade policy in recent years appears to run counter to the non-oil export-led growth strategy of the Development Plan, and in this regard, the potential adverse impact on export incentives and on efficient resource allocation of quantitative trade measures introduced over the past two years is of particular concern. A reversal of protectionist actions in industrial countries, some of which have directly and seriously impaired Indonesia's export prospects, also would improve Indonesia's growth and balance of payments prospects, in part by validating the appropriateness and realism of an export-oriented industrial growth strategy. In this context, the staff considers that the counterpurchase scheme operated by Indonesia unduly complicates the foreign trade system, and would encourage the authorities to dismantle it as soon as possible.

At the conclusion of the 1983 Article IV consultation with Indonesia, temporary approval was granted for the retention of multiple currency practices which arose from the procedures for three export taxes. These procedures were changed in two steps, in January and May 1984, in a manner that eliminated the features giving rise to the multiple currency practices. The staff welcomes these actions and the maintenance by Indonesia of an exchange system that is free of restrictions on payments and transfers for current international transactions.

It is recommended 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 1984 Article XIV consultation with Indonesia in the 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).

2. 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.

INDONESIA

Basic Data 1/

Area:	2,027 million sq. km.
Population (1983):	156.4 million
Rate of growth of population (1983):	2.2 percent per annum
Gross national product (1983):	$75.0 billion
Gross national product per capita (1983):	$480

	1979/80	1980/81	1981/82	1982/83	1983/84 2/	1984/85 3/
			(In percent)			
Selected aggregates as ratios to GDP						
Gross investment 4/	20.9	20.9	22.4	22.6	23.9	22.5
National savings 4/	22.8	24.7	21.4	15.8	17.0	18.8
Current account (BOP basis)	5.3	3.9	-3.2	-7.5	-5.3	-4.1
External debt 5/	26.2	20.5	19.9	23.5	31.7	34.1
Debt service/net exports 6/	12.1	10.6	13.1	19.2	20.4	29.9
Interest payments	1.5	1.2	1.0	1.3	1.9	2.7
Central Government revenue	22.1	23.9	22.8	20.1	21.4	20.6
Central Government expenditures	21.2	22.0	25.5	25.2	23.8	20.5
Central Government overall balance	1.3	2.2	-2.5	-5.1	-2.4	0.1
Domestic bank financing	-3.7	-4.0	-0.2	1.4	-3.1	-3.0
Foreign financing	2.3	1.9	2.7	3.6	5.5	2.9
			(Percentage change)			
National output and prices						
GDP at constant prices 4/	5.1	7.6	7.1	-0.4	5.1	6.0
GDP at current prices 4/	40.8	41.9	18.9	10.4	20.7	17.6
Rice production 4/	2.0	12.8	10.5	2.5	4.9	6.4
Crude oil production 4/	-2.7	-0.6	1.4	-16.5	0.5	...
Consumer prices 5/	20.8	17.0	10.2	8.6	13.3	4.2
Monetary sector 5/						
Money	35.6	37.3	29.9	8.9 7/	9.2	7.3
Liquidity (money and quasi-money)	39.6	36.3	28.4	20.6 7/	28.7	17.1
Net domestic credit	-7.9	0.4	57.1	56.4 7/	8.0	7.7
Net government deposits	128.5	86.7	2.6	-11.6 7/	45.4	54.6
Credit to public enterprises and private sector	14.3	28.4	31.4	27.8 7/	18.9	24.4
External sector 8/						
Exports, f.o.b.	54.0	24.5	-2.9	-14.2	9.2	-0.4
Gross oil/LNG sector exports	53.6	43.0	4.8	-16.2	1.6	-4.8
Non-oil exports	54.9	-9.5	-25.4	-5.8	36.6	11.5
Non-oil imports	19.7	33.2	26.1	5.8	-8.7	-5.3
Terms of trade (deterioration -)	42.6	21.1	8.7	0.6	-4.4	-0.5
Nominal effective exchange rate 9/	7.8	-3.1	6.8	-3.0	-28.0	...
Real effective exchange rate 9/	15.9	3.3	9.4	0.1	-23.2	...
			(In billions of U.S. dollars)			
Balance of payments and reserves						
Exports, f.o.b.	17.5	21.8	21.1	18.1	19.8	19.7
Oil (gross)	(10.0)	(14.1)	(14.6)	(11.8)	(12.1)	(10.8)
LNG (gross)	(1.3)	(2.1)	(2.3)	(2.4)	(2.4)	(3.0)
Non-oil/LNG	(6.2)	(5.6)	(4.2)	(3.9)	(5.3)	(5.9)
Non-oil imports	-9.0	-11.8	-14.6	-15.1	-13.8	-13.1
Oil/LNG sector payments	-4.3	-5.6	-7.2	-7.0	-7.1	-6.4
Current account	2.1	2.0	-2.9	-6.8	-4.2	-3.2
Overall balance	3.8	3.9	-0.3	-3.3	2.4	0.6
Gross official reserves 5/10/	4.9	7.8	6.6	4.3	6.7	6.8 11/
(In months of next year's non-oil imports)	(5.0)	(6.4)	(5.1)	(3.7)	(6.1)	(...)
Banking system, net foreign assets 5/	7.2	11.2	10.8	7.5	10.0	10.5 11/
(In months of next year's non-oil imports)	(7.3)	(9.2)	(8.4)	(6.50	(9.2)	(...)

1/ Fiscal year ending March.
2/ Preliminary estimates.
3/ Staff estimates.
4/ On the calendar year basis.
5/ End of period.
6/ Net exports are defined as merchandise exports plus recorded service receipts by oil sector payments.
7/ Including valuation changes due to the March 30 devaluation.
8/ On a U.S. dollar basis.
9/ Depreciation is negative. Twelve-month percentage change to end of period. Trade-weighted notification index.
10/ Includes contingency reserves against forward liabilities.
11/ September 1984.

Indonesia - Fund Relations
(As of December 31, 1984)

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:	1,358.7
	(As percent of quota)	134.6
(c)	Fund credit:	421.5
	(As percent of quota:	(41.7)
(d)	Reserve tranche position:	72.4
(e)	Current operational budget	(114.6)
(f)	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 (the current and past two years):	BSF (1/1983):	65.1
		CFF (8/1983):	360.0

IV. SDR Department

(a)	Net cumulative allocation:	238.9
(b)	Holdings:	0.5
	(As percent of net cumulative allocations)	(0.2)
(c)	Current Designation Plan	58.6

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 varied and has moved to Rp 1,069 per US$1 on December 17, 1984.

VIII. Last Article IV consultation

The last Article IV consultation report (SM/83/208) was discussed by the Executive Board on November 14, 1983 (EBM/83/154). The following decision (Decision No. 7555-(83/154)) was adopted:

1. The Fund takes this decision relating to Indonesia's exchange measures subject to Article VIII, Section 3, and in concluding the Article XIV consultation with Indonesia, in the light of the 1983 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 that certain export taxes, described in SM/82/233, constitute multiple currency practices. The Fund encourages Indonesia to eliminate these multiple currency practices and, in the meantime, the Fund grants temporary approval for the retention of these practices until December 31, 1984 or the next Article IV consultation, whichever comes first.

IX. Consultation cycle

A consultation cycle of 12 months was indicated in the Summing Up of the 1983 Article IV consultation.

X. Technical assistance

(a) CBD: A CBD mission visited Jakarta during November/December 1983 to advise on introduction of monetary policy instruments. A report, "Instruments of Monetary Policy in Indonesia: Problems of Coordination and Monetary Control," was sent to the Government in April 1984.

(b) FAD: During 1983 and 1984, there were several FAD missions to advise on tax administration matters, including computerization, in connection with the reform of the income tax and the introduction of a VAT. A panel expert was resident in Jakarta during April-September 1984 to advise on introduction of the VAT. Continued assistance in tax administration is planned for 1985.

XII. Resident Representative: Ms. Nancy Happe

Relations with World Bank Group

IBRD and IDA Lending 1/

(In millions of U.S. dollars)

	IBRD	IDA	Total
Agriculture, forestry, and fishing	2,063.9	494.4	2,558.3
Energy (including power and coal)	2,213.0	101.0	2,314.0
Industry	865.0	111.5	976.5
Transportation	953.0	84.5	1,037.5
Education	506.7	73.4	580.1
Population, health, and nutrition	99.5	13.2	112.7
Urban development and water supply	317.3	--	317.3
Other	--	53.8	53.8
Total commitments	7,018.4	931.8	7,950.2
Repayments	325.3	13.9	339.2
Debt outstanding 2/	2,306.5	786.8	3,093.3

Source: The World Bank.
1/ As of June 30, 1984.
2/ Net of valuation adjustments and repayments.

New commitments: Loans and development credits committed during FY 1984 (ending June 30) amounted to US$1,033.4 million ($1,329.9 million in FY 1983).

IFC activity: As of June 30, 1984, gross commitments totaled $162.6 million for 21 projects. Of this amount, 65 percent was for cement and construction material projects and 11 percent for textile and fiber projects.

Technical assistance: IDA has extended five technical assistance credits to Indonesia totaling $25 million as of June 30, 1984. 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 and Prospects for Economic Growth and Transformation" (No. 5066-IND), was issued on April 26, 1984.

Aid Group: The most recent (twenty-seventh) meeting of the Inter-Governmental Group on Indonesia (IGGI) was held in the Hague during June 4-5, 1984, under the chairmanship of the Minister of Development Cooperation, Government of the Netherlands.

Indonesia--Statistical Issues

1. Coverage, Currentness, and Reporting of Data in IFS

			Latest Data in January 1985 IFS
Real Sector	- National Accounts		1983
	- Prices:	Consumer	September 1984
		Wholesale	March 1984
	- Production		October 1984
	- Employment		n.a.
	- Earnings		n.a.
Government Finance	- Deficit/Surplus		September 1984
	- Financing		September 1984
	- Debt		n.a.
Monetary Accounts	- Monetary Authorities		September 1984
	- Deposit Money Banks		July 1984
	- Other Financial Institutions		July 1984
External Sector	- Merchandise Trade:	Values	
		(exports)	March 1984
		(imports)	May 1984
	- Merchandise Trade:	Prices	March 1984
	- Balance of Payments		Q4 1983
	- International Reserves		October 1984
	- Exchange Rates		November 1984

During the past year, the reporting of data for inclusion in IFS has been satisfactory.

2. Outstanding Statistical Issues

a. Government Finance

The 1984 issue of the Government Finance Statistics Yearbook will include the statistical and derivation tables for the consolidated Central Government and will provide data on provincial governments through fiscal year 1982/83. However, data are not available on the operations of local governments. The statistical presentation for Indonesia in the GFS Yearbook would be improved through the inclusion of these data.

The coverage of IFS data is limited to the budgetary Central Government. For this reason, they differ from the corresponding data in the GFS Yearbook.

b. Monetary Accounts

Money and banking data are sometimes inconsistent and incomplete in the monthly report forms. There is also a regular discrepancy between banks' external accounts as reported in U.S. dollars (on Report Form 07R) and those reported in national currency on Report Form 20R. A broader coverage of nonmonetary financial institutions and the introduction of a financial survey were recommended in the report of a technical assistance mission in 1981, but no action has yet been taken.

c. Balance of Payments

While there are no outstanding statistical issues at present, there have been delays in the reporting of balance of payments data to the Bureau of Statistics. In February 1983, a Bureau of Statistics staff member visited Indonesia on a balance of payments technical assistance mission. Recommendations for the improvement of balance of payments statistics were sent to the authorities in June 1983. In a letter dated May 28, 1984 Bank Indonesia indicated that although steps have been taken to implement some of the mission's recommendations, more substantial changes in the compilation of the balance of payments would have to be postponed for the time being.

d. International Banking Statistics

In May 1983, Bank Indonesia agreed to participate in the Fund's international banking statistics project. During a technical assistance mission in April 1984, it was learned that progress in implementing an appropriate reporting system has been slow, and contrary to the Bureau of Statistics' expectation, Bank Indonesia is pessimistic on the prospect of supplying data in the near future.

e. STAT

During 1983, a technical assistance mission was undertaken in the field of balance of payments. In addition, during April 1984, a Bureau of Statistics staff member visited Indonesia to advise on matters pertaining to the compilation of international banking and external debt statistics.