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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/19

10:00 a.m., February 8, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	D. C. Templeman, Temporary
	G. Ercel, Temporary
	X. Blandin
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	Jaafar A.
	L. Leonard
	C. Robalino
	A. Lindø
	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
	A. S. Jayawardena
	T. A. Clark
S. Zecchini	
Zhang Z.	

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

Asian Department: E. Gurgen, S. Kohsaka, R. J. Niebuhr, R. C. Williams. Exchange and Trade Relations Department: E. H. Brau. Fiscal Affairs Department: D. C. McDonald. IMF Institute: R. C. Barth; A. Karim, Participant. Legal Department: Ph. Lachman. Advisors to Executive Directors: H. A. Arias, D. Hammann, S. M. Hassan, G. W. K. Pickering, T. Sirivedhin, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. Bulloch, J. de la Herrán, J. J. Dreizzen, V. Govindarajan, G. D. Hodgson, Z. b. Ismail, A. K. Juusela, H. Kobayashi, S. Kolb, M. Lundsager, R. Msadek, A. Mustafa, W. K. Parmena, M. Rasyid, J. Reddy, J. E. Rodríguez, A. A. Scholten, Wang C. Y.

1. INDONESIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Indonesia (SM/85/20, 1/18/85; and Cor. 1, 2/7/85). They also had before them a report on recent economic developments in Indonesia (SM/85/25, 1/24/85; and Cor. 1, 2/7/85).

Mr. Ismael made the following statement:

My authorities would like to express their appreciation for the thorough analysis of the Indonesian economy that the staff has presented to the Board. My authorities consider the appraisal fair and well balanced. My comments would therefore merely serve to emphasize or supplement the points raised in the papers.

In the first half of 1983, the Indonesian authorities took a number of measures to counteract the effects of the world economic recession and to lay the foundation for long-term structural economic adjustment. These measures, together with the improvement in the world economy, the stabilization in the volume of Indonesia's oil exports, and the increase in non-oil exports following the downward adjustment of the rupiah in March 1983, enabled Indonesia to achieve satisfactory results in 1983.

The past year was marked by further adjustment efforts and by strengthening of Indonesia's economic conditions. Real GDP is estimated to have risen by about 4.6 percent in 1984, slightly higher than the 4.2 percent attained in 1983. The consumer price index increased by only 8.76 percent in 1984, an improvement over the 11.46 percent rise in the preceding year. One factor helping to moderate last year's level of inflation was the relatively low aggregate demand, partially a result of slower than expected government expenditures.

Preliminary data indicate a favorable fiscal outcome. Based on figures available for the first half of fiscal year 1984/85, routine expenditures by the Government were about 42.5 percent of the total expenditures budgeted for the entire fiscal year. Due mainly to slower than expected foreign aid disbursements, actual development expenditures were also less than expected, amounting to 40.6 percent of the projected outlays for the full fiscal year.

Early in November 1983, the authorities presented to Parliament recommendations for a major tax reform designed to simplify the tax structure and to broaden the tax base. The principal features of the new tax reform are, first, the introduction of a graduated scale of personal and corporate income taxes, with a new top marginal tax rate of 35 percent, compared with a previous maximum rate of 45 percent on corporate incomes and 50 percent on personal incomes; second, the introduction of

a value-added tax to replace a variety of sales taxes; and third, improvements in administration and collection methods. The new laws became effective Junuary 1, 1984, except for the provisions relating to the value-added tax, which will become effective April 1, 1985.

Provisional estimates show that M-1, consisting of currency and demand deposits, has risen by 10 percent in 1984, compared with an increase of 6 percent in 1983. In addition to the balance of payments surplus, the large increase in bank credits constituted the most significant element in increasing the money supply last year. Bank credits in 1984 rose by about 24 percent, compared with 18 percent in 1983. This substantial growth in bank credits was made possible by an impressive volume of funds mobilized by the banking system, particularly in the form of time deposits, as a result of interest rate decontrol since June 1983. Economic activities could therefore be financed without a concomitant rise in liquidity credits from the central bank without creating pressure on prices or the balance of payments.

The gradual process of reducing the dependence of both the private and state-owned commercial banks on the central bank resulted in certain difficulties as well. In August and September 1984, speculation in foreign exchange disrupted the interbank market, leading to a rapid rise in rupiah interest rates. To prevent a recurrence of such a disruption while the interbank money market remains unbalanced and therefore potentially fragile, the central bank responded by restricting interbank funding to 7.5 percent of a bank's total funding.

In the area of monetary management, in addition to the use of reserve requirements, the central bank introduced two new instruments in February 1984, namely, discount facilities and the SBI, or Bank Indonesia Certificate. These new facilities have gradually become accepted, with 42 banks using the discount facility last year and the market bearing an average weekly volume of Rp 16.2 billion in SBIs, which the central bank has issued in two-week, one-month, and three-month maturities.

The overall balance of payments continued to show improvement, with a recorded surplus of $943 million in 1984, compared with a surplus of $654 million in 1983. As a result, foreign exchange reserves held by the central bank increased to $5.7 billion at the end of December 1984, compared with $4.8 billion at the end of 1983. Taking into account the net foreign assets held by the commercial banks, which amounted to approximately $4.3 billion, the country's total foreign exchange reserves at the end of 1984 equaled about $10 billion, compared with $8.6 billion at the end of 1983.

Performance in the trade account of the balance of payments was most impressive. For calendar year 1984, it registered a surplus of $4.8 billion, compared with only $0.9 billion in 1983. This improvement was due to a 3 percent rise in exports of oil to $11.7 billion in 1984, a rather significant increase in the exports of liquefied natural gas (LNG) by 31.8 percent to $3 billion, and a particularly encouraging increase in exports of non-oil commodities, by 19 percent, to $5.9 billion. By contrast, non-oil imports showed a 10.1 percent decline, from $13.8 billion to $12.4 billion. As a result, the current account deficit declined sharply in 1984, from $6.4 billion to $3 billion.

A number of factors helped to strengthen Indonesia's balance of payments over last year, in particular measures taken by the Government to encourage non-oil exports and the continuing impact of the decision taken in 1983 to rephase a number of large public sector projects involving significant foreign expenditures. Renewed growth in the world economy and the realistic rupiah exchange rate within the system of a managed float also contributed to the improving balance of payments. Determination of a realistic exchange rate for the rupiah during 1984 was strongly influenced by the movements of the U.S. dollar. During calendar year 1984, the rupiah depreciated by 8.05 percent vis-à-vis the U.S. dollar. However, it should be noted that in the same period the rupiah appreciated against other major currencies.

The Government has continued to follow a conservative path in foreign borrowing. Borrowing has been carefully limited to amounts considered prudent, and every attempt has been made to rely on concessional and semiconcessional external fundings. In this regard, of the $23.2 billion in outstanding external borrowings of the public sector at the end of June 1984, about 75 percent was on concessional and semiconcessional terms, with the remainder coming from commercial lenders. As of the beginning of January 1985, the Government had about $1.7 billion in undrawn committed commercial credits, which again reflected the positive developments in the country's balance of payments.

The ratio of total debt service to total gross exports of goods and services is expected to increase sharply, from 17 percent in 1983/84 to 24.6 percent in 1984/85. In October 1984, an additional debt management step was announced, namely, that export credits denominated in foreign currencies would be subject to an annual ceiling of $1.5 billion and that they must be utilized to finance only those development projects designated as priority projects by the Government. Projects not included on the Government's priority list may be authorized only if concessional financing can be obtained. Furthermore, the Government has raised the withholding tax on interest payments made abroad

from 10 percent to 20 percent in an attempt to discourage private external borrowing. The Government is also exploring ways to enhance its monitoring of developments in private external debt.

While progress in adjustment has been substantial, the authorities are fully aware of the long and bumpy road ahead. Structural weaknesses remain in some sectors, and many of these can only be removed in a gradual manner due to the political, social, and institutional factors involved.

On the external side, the present uncertainty in the world oil market and the rather sharp increase in the debt service burden have been officially acknowledged as real challenges calling for a strengthening of the present adjustment policies.

On the domestic front, however, there has been general concern over the slow pace and the uneven nature of the economic recovery. Depressed fixed investment in the last two years and substantial excess capacity in manufacturing and other parts of the nonagricultural sector are threatening the medium-term growth prospects of the economy and aggravating the unemployment situation. Confronted with this dilemma, the authorities recognize that the design of the program will have to be adapted accordingly and implemented with care to ensure that adjustment can proceed in a smooth and orderly fashion.

The 1985/86 budget submitted to Parliament on January 7, 1985 remains an austerity budget with no domestic financing required. Total outlays are projected to increase by only 12 percent in nominal terms (with respect to the previous year's budget), amounting to approximately Rp 23,000 billion. While the growth of the budget reflects the Government's firm commitment to continue and maintain the momentum of the adjustment process, the structure of expenditures has been designed to address some urgent short-term problems confronting the economy, notably the increasingly depressed domestic activities.

Three striking features of the budget are worth mentioning. First, an ambitious target of a 30 percent increase in non-oil and gas revenues has been set, reflecting the implementation of new income and value-added taxes. Second, total fuel subsidies are budgeted to decline to about half the amount in the previous year's budget. Third, development spending is budgeted to increase by only 1.8 percent in nominal terms, to equal 46.2 percent of total outlays, whereas routine expenditures are budgeted to increase by 22.7 percent, accounting for 53.8 percent of total outlays.

Since the initiation of the June 1983 monetary policy changes, it has been considered important to develop further the instruments for monetary policy that can be used for open market

operations and to foster the development of a healthy money market, including secondary markets for securities. To this end, the central bank will soon introduce new money market securities of 30-90 day maturities, which in the initial stage will include promissory notes based on bank credits or interbank borrowings, and trade bills accepted by a customer of a bank or a nonbank financial institution. In this connection, new securities houses will be established, with the primary function of trading these instruments.

My authorities believe that the series of adjustment measures introduced in the last two years and those contemplated for 1985 are adequate to achieve viable economic growth in the medium term. Domestic economic activity, particularly agricultural output, is expected to remain strong in 1985. Real GDP growth, although much lower than the rate for the past decade, is expected to continue to be satisfactory without causing inflationary pressures. However, there are a number of uncertainties, particularly those related to the oil market, which remain a cause for serious concern. My authorities are fully aware that the country has to thread its way between constraints of a vulnerable balance of payments situation and a pressing need to provide meaningful employment opportunities to a rapidly growing labor force. Continued commitment to a stance of restraint in demand management to help control the external deficit and continued attention to the country's competitive position are therefore considered of utmost importance.

Mr. Abdallah said that he broadly agreed with the staff appraisal, which the Indonesian authorities considered fair and well balanced. The staff report clearly showed that the authorities had maintained prudent policies in response to adverse external developments. In particular, they had moved quickly to make timely adjustments in the exchange rate, to control expenditure, and to stimulate the private sector. The economy had responded favorably to the adjustment measures, and the budget had recorded a surplus in 1983/84, after a substantial deficit in 1982/83. The devaluation and the increase in non-oil exports had had a positive effect on the balance of payments.

After the balance of payments had registered a deficit in 1982, the authorities had introduced several corrective measures, Mr. Abdallah remarked. However, the authorities also had had to postpone most of the foreign-financed public projects, thereby seriously limiting the employment prospects for the country's rapidly growing labor force. Member countries typically found it easier to reduce capital expenditure than recurrent expenditure, but the Indonesian authorities should resist that temptation to the extent possible to keep the present problems facing the economy from becoming even more serious.

The authorities' various policy actions had increased the room in which to mobilize domestic resources, Mr. Abdallah considered. In 1983, they had removed the credit ceilings--which had outlived their usefulness--freed interest rates, and eliminated Bank Indonesia's subsidies to state banks that had been a disincentive to resource mobilization by the banks. As a result, the commercial banks had begun to compete for domestic funds, and real interest rates on deposits had become positive. The liberalization of interest rates should help to encourage a reflow to Indonesia of the short-term funds that had been placed abroad. Bank Indonesia had introduced new instruments to control bank liquidity, but much more should be done to develop a domestic capital market; the basic infrastructure for such a market already existed. Singapore's market was a good model for Indonesia.

Further information on the mobilization and use of public funds in Indonesia would be helpful, Mr. Abdallah said. The Central Government provided considerable financial support to the provincial governments, while the parastatal bodies financed their investment programs mainly with foreign funds transferred to them by the Central Government. He wondered to what extent that financing pattern strained the budget of the Central Government. Indonesia had recorded a substantial budget deficit in 1982/83, but the deficit had been reduced in 1983/84 and would probably be eliminated in 1984/85, mainly because of reductions in capital expenditure and subsidies, particularly on fertilizers. In 1985/86, however, the budget was expected to register another deficit, owing mainly to the increase in the salaries of civil servants and teachers; that increase was intended to encourage economic efficiency and productivity and therefore seemed justified.

The frequent budget deficits in recent years were due to a basic imbalance in the fiscal sector, Mr. Abdallah considered. In earlier years, the deficits had been offset by ad hoc cuts in public capital expenditure and by the limited capital absorptive capacity of the private sector. The long-term solution to the fiscal imbalance would have to involve new revenue measures as well as stronger expenditure control. The authorities had adopted new tax measures, and they planned to introduce a value-added tax as part of their effort to broaden the tax base and improve tax collection. Hence, even without an increase in tax rates, non-oil revenues were expected to rise to 12 percent of non-oil GDP by 1988/89. All those measures were welcome, but the tax effort was still rather limited; Indonesia could raise the tax ratio substantially to increase its self-reliance and reduce its vulnerability to external shocks. Finally, he supported the proposed decision.

Mr. Fujino commended the authorities for the generally successful implementation of far-reaching adjustment measures since March 1983, when the external position had deteriorated because of the sharp reduction in oil export receipts and rapid growth of imports. The authorities had devalued the currency, frozen civil servants' wages, rephased expenditures under public investment programs, and introduced reforms in taxes and in

the financial sector. Taken together, those measures had adequately tightened domestic demand, reduced the rate of inflation, and strengthened the non-oil balance of payments position.

While substantial progress in adjusting the economy had been made, structural imbalances remained in some areas, Mr. Fujino continued. Future economic growth was threatened by weak private investment and large excess capacity in the manufacturing sector, and domestic demand was curbed by the growing external debt service burden. The Indonesian economy was apparently in a period of transition: the phase of growing oil revenues and accelerating project spending was giving way to a period of constraint due mainly to the weak oil export performance. The authorities' medium-run and long-run growth strategy was based on private initiatives; accordingly, the highest priority should be given to promoting non-oil exports and strengthening international competitiveness through strong private investment. However, the recent adjustment measures had narrowed the scope for private credit and virtually eliminated the special tax incentives for private investment, although the corporate tax rate had been somewhat reduced. The staff opposed budgetary subsidies for investment credit but did not clearly show how adequate private investment in strategic sectors in the longer run could be achieved, particularly in the light of the substantial excess capacity in manufacturing.

The fiscal balance had improved significantly, from a deficit of 5 percent of GDP in 1982/83 to a small surplus in 1984/85, Mr. Fujino observed. The improvement had been due partly to delays in implementing public investment programs and to higher than expected oil and liquefied natural gas revenues, but various adjustment measures had also played a role. Moreover, the overall fiscal stance for the coming year was broadly consistent with the medium-term adjustment effort. The authorities intended to grant a 20 percent increase in civil servants' wages in 1985/86, following a 15 percent rise in the current fiscal year. While that approach might be appropriate, given the historically low level of civil servants' wages, a fuller discussion in the staff report on the development of real wages in the public and private sectors would have been useful. Creating a sufficient number of jobs for the growing labor force--despite a relatively slow rate of economic growth--was an important task, and further comment on it, too, would have been helpful. Future staff reports should contain more detailed information on the labor situation in Indonesia.

He welcomed the recent reduction in petroleum subsidies resulting from price increases and following the improvement in the efficiency of refining operations, Mr. Fujino went on. The authorities should consider taking similar steps to reduce other subsidies as well.

The continued delay in project implementation would adversely affect growth in the long run, Mr. Fujino commented. The delay apparently was attributable to various administrative problems, including a scarcity of experienced personnel. Such bottlenecks probably could not be eliminated quickly, but continued efforts to reduce them should certainly be made.

The authorities' various steps to increase non-oil tax revenues, including the introduction of a value-added tax and the widening of the non-oil tax base, were welcome, Mr. Fujino said. Accelerating the effort to strengthen tax administration would further increase the buoyancy of the new tax system.

The results of the 1983 financial reform had been encouraging, Mr. Fujino remarked. The sharp rise in interest rates had led to a substantial increase in state banks' time and savings deposits. Both the authorities and the financial markets seemed to have adapted gradually to the new environment created by the 1983 reform. The authorities had acted promptly and appropriately to restore order in the financial market following the emergence of problems in the interbank market in September 1984. Further progress could be made in using the new instruments of monetary control, such as the central bank certificates. The authorities' efforts to enhance the attractiveness of those certificates and to encourage borrowing under the new discount facilities were clearly steps in the right direction.

Medium-term debt management was one of the most important policy issues, Mr. Fujino commented. The overall debt structure was not a cause for immediate concern, but caution was called for in the light of the recent rapid increase in outstanding debt--particularly medium-term debt--and the rise in the debt service ratio. Despite the reduction in project-related imports as a result of rephasing of, and delays in, project implementation, the external debt had steadily increased, owing partly to the continued weakness in oil export receipts. The authorities faced the difficult task of restoring canceled or postponed public investments while maintaining a sound external debt structure. The recently adopted policy of scrutinizing each project supported by nonconcessional external credit and the efforts to strengthen the monitoring of private debt were welcome, but persistent efforts to promote non-oil exports would be crucial, and to that end the flexible exchange rate policy should be maintained.

He agreed with the staff that the rising trend toward import protection in Indonesia might adversely affect Indonesia's prospects for non-oil export growth by increasing domestic costs in Indonesia and reducing the efficiency of domestic industries, Mr. Fujino went on. He also agreed that the counterpurchase scheme was an inefficient means of promoting non-oil exports, and he welcomed the authorities' decision to eliminate it. The recent tax reform and reduction of regulations in order to increase incentives for foreign direct investment were also welcome. Given the strong attraction of Indonesia to foreign investors and the present moderate level of investment flows, the potential for increasing foreign investment seemed considerable. Finally, Indonesia was an important example of a member country's ability to implement a comprehensive adjustment program without financial assistance from the Fund.

Mr. Grosche remarked that just two years previously, the economic situation in Indonesia had been serious: the high level of government spending and the shrinking oil revenues had caused a sizable and

unsustainable external financing gap. The authorities had reacted with determination and vigor, keeping domestic demand management on a restrictive course and devaluing the exchange rate. As a result, there had been a remarkable turnaround in the economy: positive real growth rates had been recorded, inflation had remained subdued, and the improvement in the external accounts had enabled the authorities to increase international reserves. Those achievements were particularly remarkable in the light of the continued deterioration in the terms of trade. The authorities were to be commended for having taken the initiative to introduce a bold and courageous adjustment program.

However, Mr. Grosche went on, the picture of the economy was blurred by a number of less positive developments. Economic growth in 1984 had been due to a significant extent to the increase in liquefied natural gas production and had occurred despite the underutilized capacity in other sectors of the economy. In addition, monetary policy had not fully met the needs of the economy. Moreover, the authorities regrettably had tended to yield to pressures to add new categories of subsidized credit and to introduce import restrictions and other administrative barriers.

The achievement of near balance in the fiscal accounts was traceable to the slow absorption of foreign savings and to delays in project implementation, Mr. Grosche noted. The staff shared the authorities' concern that the delays could create bottlenecks that would hamper future development. In that connection, further comment by the staff on the sectors that had been particularly affected by the bottlenecks would be helpful.

The staff seemed somewhat concerned about the reduction in the stimulus from the budget and the accompanying decline in domestic demand, Mr. Grosche commented. In his view, it was important to bear in mind that the increase in government deposits in the banking sector would give more room for private sector investment credit that would encourage overall private sector activity. Of course, that outcome ideally should be the result of a deliberate policy stance rather than of accidental factors.

The shortfall in non-oil government revenue was significant, although it had been offset by increased revenue from oil and liquefied natural gas, Mr. Grosche observed. He hoped that the problems in administering the new income tax system would be solved quickly, and that the value-added tax could be introduced without much difficulty.

As to current expenditure, Mr. Grosche went on, some additional fiscal stimulus seemed warranted in the light of the reduced level of development expenditure. However, the increase in the share of current expenditure in total expenditure should be exceptional and should not be taken as a sign that basic economic conditions had changed and that the Government could therefore introduce more expansionary policies. He was pleased that the 1985/86 budget was an austerity budget and would require no domestic financing.

That total fuel subsidies in 1985/86 were expected to be about half the amount in the 1984/85 budget was encouraging, Mr. Grosche said. The authorities should consider phasing out progressively the fertilizer subsidies, particularly in view of the objective of achieving self-sufficiency in the rice supply.

The authorities had clearly attempted to have monetary policy make a valuable contribution to the adjustment effort, Mr. Grosche commented, and the positive real interest rates were an indication of the authorities' commitment. However, the implementation of monetary policy seemed hampered by the inadequacy of the monetary instruments. The staff report gave the impression that the existing discount and foreign exchange swap facilities should be re-examined with a view to their simplification. Similarly, the management of domestic monetary and credit aggregates could usefully be made less complicated. At the same time, the authorities should resist any pressure to add new categories of subsidized credit; to do so would hinder the needed financial reform and could complicate and possibly jeopardize the process of flexible monetary management. He doubted whether interest rate subsidies would actually generate new private investment.

The authorities' commitment to maintain external competitiveness was welcome, Mr. Grosche said. In the light of recent developments in the oil sector and the appreciation of the U.S. dollar, the exchange rate would have to be managed with great skill and care. In the medium run, the economy would have to be more clearly oriented toward exports if sustained economic growth were to be achieved. In that connection, the trend toward rising import restrictions was worrying, particularly in view of the heavy costs involved. For instance, as both the Fund and World Bank staff had noted, some relatively inefficient industries with limited growth prospects had been developed in various sectors, and the room for import substitution had been virtually exhausted. The authorities should be encouraged to take bold steps to reduce import restrictions; a gradual approach to the elimination of such restrictions would run the risk of delaying and eventually reversing progress in that area.

At the same time, Mr. Grosche continued, the protection in industrial countries had clearly hurt Indonesia's exports. The Fund had been preoccupied with protection in those countries in keeping with its strategy for dealing with the international debt situation. Still, it was important not to lose sight of the protection in developing countries. In that context, he regretted that the mission had not received comprehensive information on Indonesia's import regulations. Finally, the proposed decision was acceptable.

Mr. Leonard said that he agreed with the thrust of the staff appraisal. Since the deterioration of the economy in 1982 and early 1983, the authorities had introduced a range of measures to restore economic growth and to correct rapidly the balance of payments. Their approach had been both equable and comprehensive, and they had been willing to adopt firm measures

whenever necessary. As a result, strong economic growth had been regained, the rate of inflation had been reduced, and the external balance had become more sustainable.

The recovery was not even, and difficulties in the management of development project expenditures, in the financial markets, and in the external sector had significant implications for future economic performance, Mr. Leonard continued. Because the basic policy course was correct, additional modifications and fine-tuning, rather than a major overhaul of present policies, would suffice.

The 6 percent rate of economic growth in 1984 was impressive, particularly as it had occurred together with a dramatic decline in the rate of inflation and a considerable strengthening of the balance of payments, Mr. Leonard commented. However, much of the growth had been accounted for by an increase in liquefied natural gas production rather than by the achievement of the main structural policy objective of diversifying the economic base. In addition, much of the apparent improvement in the external and fiscal accounts in 1984/85 was explained by what the staff called "unplanned adjustment" owing to difficulties in implementing foreign-financed development projects. Those problems would have to be solved if the implementation of the development program were to progress more smoothly. Some steps in that direction had been taken, and a further comment on the authorities' plans for improving project management would be helpful.

The domestic money markets had had some difficulty in handling the effects of the exchange rate adjustments in August and September 1984, Mr. Leonard went on. Additional monetary management instruments were needed to settle the markets and help them to adjust to earlier reforms. The detailed discussion in the staff reports on the banking and credit system was particularly valuable.

He agreed with the staff that the authorities should move cautiously in using expansionary fiscal policy as a major countercyclical measure in 1985/86, Mr. Leonard said. There might well be some room for stimulus in carefully chosen areas, but it would have to be managed cautiously if a re-emergence of the earlier tendency toward fiscal imbalance were to be avoided. However, the authorities should not introduce new subsidies for interest rates in the private sector or for fertilizers. The relatively strong fiscal position gave the authorities room to increase income transfers, but additional subsidies would have the usual undesirable effects on resource allocation, particularly in the medium term. Interest subsidies for private investment could have particularly adverse consequences by providing inappropriate short-term price signals. It would be undesirable for the government in a low-income country with a large and growing population to encourage a bias toward greater use of capital--rather than labor--in production processes. The recent reduction in the petroleum subsidy was timely, given the weakening international oil prices. If the authorities wished to redistribute income through the budget, they could increase expenditures on social infrastructure rather than on subsidies, which were difficult to eliminate after they were no longer required.

The proposed expenditures during 1985/86 on public sector salaries and pensions seemed appropriate, since real wages would be merely restored, rather than increased, and since the priority being given to education and training was consistent with the country's development needs, Mr. Leonard said. However, the impact of those increases on private sector pay should be monitored, and any suggestion that those adjustments were meant to set an example for the private sector should be avoided.

The effort to shift the tax burden gradually to non-oil sectors of the domestic economy should help to prevent unpredictable variations in revenue, Mr. Leonard commented. Meanwhile, the likelihood that the deficit expected in 1985/86 would be financed entirely by foreign loans was not unwelcome; the availability of those loans would leave more room within the credit targets to finance private sector activity.

The ceilings on growth in liquidity and reserve money seemed consistent with the authorities' macroeconomic objectives, Mr. Leonard remarked. However, he agreed with the staff that the monetary system should be more flexible and efficient, and that the financial markets would be strengthened if Bank Indonesia were to formulate and publicize market-oriented reference interest rates. Moreover, the development of other financial instruments suggested by the staff would help to deepen the financial system.

The staff wished to see the swap market phased out, Mr. Leonard noted. He wondered whether the authorities could not find some means of encouraging a futures foreign exchange market that could perform the swap market's functions without requiring Bank Indonesia to play such a central role in the foreign exchange market. If that were not possible, the swap market should be eliminated, or, at the least, the price for foreign exchange should be opened to bidding and interest rates should be adjusted to better reflect market conditions. Such matters might appropriately be examined by the proposed technical assistance mission to Indonesia. He wondered whether the same mission could respond to the authorities' request for techncial assistance in improving their debt monitoring.

The medium-term scenario was plausible, Mr. Leonard said. He agreed with the staff that the deteriorating oil markets were the greatest risk to the economy in the medium run. If excessive external borrowing in response to the weak oil markets were to be avoided, the authorities would have to persevere in their efforts to diversify nonenergy exports and to maintain close control over aggregate demand.

He was pleased by the cooperation between the Fund and the World Bank on Indonesia reflected in the staff report, Mr. Leonard commented. He hoped that it would continue, and that the focus on Indonesia's medium-term development strategy would be sharpened. The staff's conclusion that most import substitution possibilities in Indonesia had been exhausted was supported by the figures in footnote 1 on page 24 of the staff report. However, in the light of the reference on page 26 to Indonesia's development potential, it seemed that substantial domestic markets would open up over time as the potential was realized, thereby presenting a tremendous

opportunity for domestic enterprise. More information was needed on the authorities' views on how that opportunity should be grasped. Such information would help Executive Directors in assessing matters such as protectionist tendencies and the aims of interest rate subsidization in Indonesia.

The authorities had shown great ability to adopt and maintain appropriate macroeconomic policies, Mr. Leonard concluded. He was confident that they would show the same pragmatism, prudence, and balance in their future policy choices. Finally, the proposed decision was acceptable.

Mr. Pérez said that the authorities' substantial adjustment efforts had yielded positive results. Those efforts had been required when adverse external economic conditions had posed a threat to the economy, which had become vulnerable to oil market developments.

The main problems facing Indonesia were in the external sector, Mr. Pérez considered. Export data clearly reflected the unfavorable effects of the reduction in oil prices and the expansionary policies based on prospective oil revenues. The drop in non-oil exports in 1981-83 had been dramatic, but the external current account had greatly improved in 1983/84, and the estimated deficit for 1984/85 was roughly only half that of 1982/83. The adverse trend in the oil sector had continued in 1984, but the trend in non-oil exports had apparently been reversed and should lead to a sustained recovery of the external sector if adequate policies were maintained. The effort to improve non-oil export performance should certainly be continued, since, despite the positive results thus far, those exports were still small in dollar terms and their value was not expected to regain the $5.5 billion reached in 1981 for some time.

The protection of local industry in the form of import tariffs and quotas, together with the policy measures designed to stimulate export-oriented industries, should have a measurable impact on Indonesia's balance of payments, Mr. Pérez remarked. The staff had criticized the Government's protectionist policies and had concluded that recent measures constituted an intensification of the protection. He agreed that protectionist policies were incompatible with an export-led growth strategy. Moreover, protectionist measures that had been in place for some time became increasingly difficult to eliminate; accordingly, measures that had been meant to be temporary could easily become permanent. However, Indonesia's trade barriers need not be eliminated as promptly as the staff suggested. The industries created under protectionist policies should be given the chance to become competitive. That approach, which underscored the temporary nature of those policies, allowed the authorities to lower tariffs gradually, thereby minimizing the cost of reducing protection while stressing the unacceptability of inefficiency associated with excessive protection. The industries that would benefit from temporary protection should be selected carefully, and clear timetables for phasing out the protection should be established.

The effort to promote foreign investment in export-oriented industries was welcome, Mr. Pérez said, but the relevant policies would be ineffective if industrial countries' protectionist measures, such as those affecting garments and textiles, were maintained.

Recent developments in fiscal policy were positive, Mr. Pérez considered. The substantial reduction in subsidies for the petroleum sector, made possible by Pertamina's increase in production, was particularly significant. Another encouraging sign was the sizable reduction in external financing of the budget. The increase in the wages of teachers and civil servants was appropriate; additional reductions in their real wages and relative income position would have caused a further deterioration in the quality of public services, including education. Current expenditures should be monitored carefully, but the improved civil service pay should help to deal with some of the difficulties in project administration.

Indonesia's debt problem was still manageable, and the authorities' present policies in that area were appropriate and timely, Mr. Pérez said. Their awareness of the need to improve the management of private external debt was reflected in their recent request for technical assistance.

Indonesia had made great strides in the fiscal and monetary areas, thereby reducing the economy's vulnerability to external shocks, Mr. Pérez concluded. The authorities should continue their adjustment efforts, and he hoped that industrial countries would help to solve Indonesia's economic problems by eliminating protection and providing a stable environment for trade.

Mr. Clark said that the authorities should be commended for the continued success of their adjustment efforts. Their timely and determined implementation of adjustment policies in 1983 had yielded substantial results. In the present fiscal year, the authorities expected to achieve marked reductions in the rate of inflation and the external current account deficit, together with a broadly balanced fiscal outturn. In addition, the non-oil trade balance had been strengthened. However, as Mr. Ismael had stated, the road ahead was "long and bumpy." The authorities' conservative fiscal and external debt policies should enable the economy to weather any transitory deterioration in the balance of payments, but success in the medium term would depend importantly on the authorities' ability to promote adequate investment and to stimulate non-oil exports, thereby making the economy less vulnerable to unexpected developments in the oil market. The outcome in those areas would in turn depend significantly on the authorities' determination to implement appropriate trade and tax reforms and to strengthen the private sector.

The authorities should implement a number of measures to boost both domestic and foreign investment, Mr. Clark continued. They should be especially encouraged to persevere in reducing the burden of regulations affecting investment decisions. The staff had attributed the decline in foreign investment to adjustments of previously approved plans in response

to the slowdown in economic growth since 1981. That had undoubtedly been an important factor in the investment performance, but the staff could have usefully analyzed the role of the regulatory climate, and he would appreciate more information on the conditions for foreign investment in the next staff report for Indonesia.

Deregulation had proceeded quickly in the banking sector, Mr. Clark noted. He hoped that it would help to increase the efficiency with which funds were channeled to meet the economy's investment needs. In the aftermath of deregulation, the banks faced new challenges in managing their business. The authorities should therefore be encouraged to ensure effective supervision of the banking sector in the coming period and should be prepared to take early action to deal with any problems that might emerge.

Further progress in deregulation would also help the authorities to meet their external goals under the five-year plan, and particularly the doubling of exports other than oil and liquefied natural gas, Mr. Clark remarked. It was therefore disappointing that there would apparently be some intensification of trade restrictions under the 1985/86 budget. Such restrictions would likely delay the restructuring of inefficient industries and in the long run would impose an additional burden on the economy. Similarly, although the policy of countertrade had provided some short-term benefits, they would be reduced as import-intensive projects were cut back. The authorities could consider whether a preferable long-term strategy for export promotion might not be to remove trade barriers and improve the climate for direct investment while maintaining a flexible exchange rate policy.

The Indonesian authorities had maintained responsible and effective policies, Mr. Clark concluded. He agreed with the staff appraisal and accepted the proposed decision.

Mr. Suraisry said that he endorsed the thrust of the staff appraisal and accepted the proposed decision. In response to external constraints evident in 1982/83, the authorities had adopted an effective combination of demand management and structural adjustment measures. The results were impressive: the fiscal position, the rate of inflation, and the balance of payments had improved considerably. The authorities should therefore maintain their present policies, and he was pleased that they intended to do so.

The increase in recurrent expenditure under the 1985/86 budget would not undermine the authorities' adjustment effort, Mr. Suraisry considered. Most of the increase would cover higher civil servants' salaries after several years of restraint; those adjustments were not expected to affect private sector wages, but an assessment of the matter in the staff report would have been helpful. It was sensible to stimulate aggregate demand moderately, particularly as project implementation had been slow, owing to various bottlenecks. In addition, the comprehensive tax reform, including the introduction of a value-added tax in April 1985, should

enable the authorities to finance the increase in current spending without weakening the public finances. In the longer run, however, current spending could not replace development expenditure if the economy's full potential were to be realized. The authorities' efforts to improve project implementation was a welcome step in the right direction.

The cautious monetary and credit policies were generally appropriate and supportive of the adjustment effort, Mr. Suraisry remarked. The active role of monetary policy and the recent initiatives to develop the domestic money markets were particularly impressive. However, there was room for improvement, and he fully supported Indonesia's request for technical assistance in the management and operation of the money market.

The exchange rate was managed flexibly, and the authorities remained committed to preserving the gain in competitiveness achieved through the March 1983 devaluation, Mr. Suraisry said. Their external policy stance was commendable, as it had proved essential both for the growth strategy--which was based on the promotion of non-oil exports--and for the adjustment process in general. The elimination of multiple currency practices was also commendable.

The total debt service ratio had risen substantially in the previous several years, Mr. Suraisry observed. The authorities recognized that containing the ratio was essential and would be consistent with the desired adjustment in the external sector. The steps taken in late 1984 to strengthen external public debt management were welcome, as they were needed to contain the demand for external borrowing by the public sector. However, more attention should be paid to private external debt. The first step should be the determination of the size of the debt; there was a large difference between the staff estimates, based upon creditor source data, and the information provided by Indonesian banks. Additional information on the maturity structure of private external debt, particularly short-term debt, would be helpful, and the authorities' request for technical assistance in that area was acceptable.

The staff had noted the unfortunate trend toward excessive import protection in Indonesia, Mr. Suraisry remarked, and he was confident that the authorities would make every effort to reverse it. At the same time, the country's industrial trading partners should reduce their restrictions on Indonesia's exports; Indonesia would then be better placed to reverse its trend toward import protection. The situation underscored the fact that free trade was a two-way street.

The authorities had adjusted well to the lower foreign exchange earnings by implementing commendable and far-reaching reform and adjustment measures, Mr. Suraisry said. The economy had responded favorably, and the authorities remained committed to economic adjustment and were clearly on the right track.

Mr. Polak commented that the results of the adjustment measures introduced in the spring of 1983 were even more impressive than expected at the time of the consultation discussions in November 1983. The balance of payments had improved sharply, the rate of inflation had declined rapidly, the fiscal balance had improved, and GDP growth had been in the range of 5-6 percent. That outcome underscored the correctness of the basic principle that when adjustment measures were introduced early and were firmly sustained, they could be very successful.

He supported the staff appraisal and welcomed the absence of major disagreements on short-term policy issues between the authorities and the staff, Mr. Polak commented. The staff correctly emphasized the importance of regulatory reform for investment performance and export growth.

The government budget had recently recorded a surplus because of the difficulties in implementing public development programs, Mr. Polak observed. The authorities' actual goal had been a moderate fiscal deficit matched by foreign financing for development projects. In the coming period, achievement of that aim, together with growing non-oil domestic revenue, would permit some increase in recurrent expenditure and substantially larger development expenditure. However, the new budget provided for a low level of development expenditure and a sharp increase in recurrent expenditure of about 20 percent in real terms. The authorities' wish to increase salaries in some sectors of the civil service--in line with the World Bank's analysis--was understandable, but the large increase in recurrent expenditure might leave little room for development expenditure once the bottlenecks were eliminated. There was some risk that, while the bottlenecks persisted, symptoms of fiscal drag would be evident. The proper response to those symptoms was to use a more expeditious approach to development expenditure rather than to increase recurrent expenditure excessively or reintroduce interest rate subsidies for development financing.

The staff report did not clearly show whether the 1985/86 budget was expansionary, Mr. Polak commented. He wondered which measures the staff had had in mind in concluding that the new budget provided the stimulus that had been envisaged, but not actually realized, in the budget for 1984/85. After all, Table 2 (SM/85/20) showed that the growth of net domestic expenditure in 1985/86 would slow, and that the ratio of net domestic expenditure to GDP would decline. Hence, it seemed unlikely that the 1985/86 budget would provide a stronger stimulus to the economy than the 1984/85 budget.

The features of the new income tax were interesting, particularly the simplified tax structure consisting of three tax brackets of 15 percent, 25 percent, and 35 percent and the greatly reduced exemptions from taxation, Mr. Polak remarked. The new tax plan together with the improved tax administration promised to provide significant benefits; indeed, the simplified tax structure might well serve as a model for other economies.

The staff had recommended a prudent monetary policy but had not spelled out the precise practical measures involved, Mr. Polak noted. The staff understandably seemed confident that the authorities would make the right choices. That confidence had been bolstered by the significant contribution the authorities had permitted monetary policy to make in the adjustment program initiated in 1983. Although fiscal and exchange rate measures had constituted the core of the overall adjustment effort, monetary policy had played an important role in reversing short-term capital outflows. Since the 1983 devaluation, the balance of payments entry "errors and omissions," which included all private capital flows, was estimated at $3.8 billion, compared with the outflow in the two preceding years of $2.8 billion. The new monetary policy had provided a quick and efficient defense--mainly through the interest rate mechanism--against the speculative attacks to which the rupiah was occasionally subject. It was also making a significant long-term contribution to more efficient credit allocation. In sum, the bold shift away from a bureaucratic to a market-oriented approach to monetary policy had apparently been advantageous.

He fully agreed with the staff's comments on the fixed fee swap facility of Bank Indonesia, Mr. Polak said. However, the staff had given the impression that the facility imposed an exchange risk on Bank Indonesia and had concluded that important losses on those accounts had occurred at the time of the devaluation. A more accurate description was that Bank Indonesia had failed to make devaluation profits on the foreign exchange it had bought in the spot market and sold in the forward market. If the facility had not existed, Bank Indonesia would not have had the foreign exchange in question. The facility encouraged the private sector--particularly foreign investors who did not have access to rupiah credit on favorable terms--to borrow abroad and to swap the foreign exchange proceeds with Bank Indonesia. A better arrangement would be to give foreign direct investors comparable access to domestic credit and/or provide for cover through a new market mechanism. The swap technique had adverse implications for reserve money management, and better techniques for supplying the needed liquidity were undoubtedly available. In that connection, technical assistance would be useful.

The revised medium-term scenario showed that, on the basis of present policies, a sustainable balance of payments position was within reach, Mr. Polak remarked. There were considerable uncertainties--for instance, the future price of oil--and the authorities would have to be flexible, adjusting their policies as necessary. Another major uncertainty was whether the administrative rigidities in general, and the level and structure of protection in particular, would permit the envisaged rapid growth in non-oil output and non-oil exports.

The authorities had shown an admirable capacity to make short-term adjustments in recent years, but they had not been as successful in eliminating the rigidities in the economy, Mr. Polak went on. The economy suffered from excessive regulation that discouraged and misdirected investment, a problem that the authorities themselves clearly recognized. In that context, the World Bank had usefully noted that "upstream" protection

caused "downstream" uncompetitiveness. At the same time, the problems in implementing the development budget were traceable to the stifling effects of regulation. There was difficulty in finding enough personnel to perform all the various regulatory tasks; as a result, development project implementation was invariably delayed. In the regulation area, Indonesia was clearly heading down a dead-end street, and radical changes in policy were obviously required.

The authorities had made some progress in deregulating the credit markets, and they should persevere in that area in the coming period, Mr. Polak commented. Moreover, the tax system had been improved, and some subsidies--particularly on oil--had been reduced substantially, although the fertilizer subsidy remained. The reform of investment and trade regulations should be stepped up. In particular, the countertrade requirements served no useful purpose, and the staff's analysis in that respect was fully appropriate. Furthermore, it would be disappointing if the authorities were to conclude that a further real effective depreciation of the rupiah was necessary as a substitute for productivity gains from new export-oriented investment. It was true that Indonesia's exports suffered from protection abroad, but the country could only gain by opening up its economy through rapid and efficient investment in export-oriented industries.

Mr. Templeman said that he agreed with the staff's assessment of the far-reaching adjustment and reform measures introduced in 1983; those measures had had positive effects on growth, inflation, the external current account deficit, the budget deficit, tax reform, the ratio of public expenditure to GDP, deregulation of interest rates, the mobilization of domestic financial resources, and the restoration of Indonesia's international competitive position. However, he harbored some doubts about the duration and composition of the economic recovery, particularly the decline in gross fixed investment, the high foreign debt, the possible inadequacy of the range and effectiveness of monetary tools, the recent real effective appreciation of the rupiah, and growing protectionist tendencies.

Progress in the fiscal area was reflected in the apparent elimination of the central government deficit in 1984/85, the decline in the ratio of expenditures to GDP, and the sharp cut in current subsidy payments, Mr. Templeman remarked. In addition, the large-scale foreign borrowing by the Government for developmental purposes had often exceeded the budget deficit, resulting in an accumulation of government deposits in the banking system and permitting domestic credit expansion to be directed principally toward the private sector. Unfortunately, the counterpart to that development had been a rapid buildup of public sector external debt. Moreover, the shortfall in expected revenues since the tax reform suggested that the broadening of the revenue base might not have been sufficient. Given those developments, together with the continuing difficulty in implementing foreign-financed development projects, future developments in those areas should be closely monitored.

He wondered how the recent world oil price developments were likely to affect the budget and the balance of payments, Mr. Templeman went on. He shared the staff's reluctance to recommend fiscal stimulus through the 1985/86 budget. The authorities' wish to correct for the unexpectedly contractionary effect of the 1984/85 budget was understandable, and the proposed stimulus seemed relatively moderate, but care must be taken to avoid the perception that the authorities were significantly easing their adjustment efforts. In addition, the authorities should avoid large-scale interest subsidies to stimulate private investment, as they would adversely affect the budget and the efficiency of resource allocation.

There were encouraging signs that the extensive monetary reforms in 1983 had had beneficial effects, Mr. Templeman stated. For example, the growth of rupiah-denominated bank deposits had accelerated both in absolute terms and in comparison with the growth of foreign currency deposits. However, despite the authorities' success in calming the domestic money markets, there was some doubt whether the available monetary policy tools were adequate for the more open financial markets that were evolving in Indonesia. The possible shift in the financial market environment, due to the somewhat more stimulative fiscal stance in 1985/86 and to the need to moderate the growth of foreign debt, might leave the authorities less room for maneuver in the monetary area. He wondered whether the banks would be able to meet their repayment obligations to Bank Indonesia under the special rediscounting facilities even with the help of the new money market instruments Mr. Ismael had mentioned in his opening statement. The authorities should review their experience with the various monetary tools, such as Bank Indonesia's new certificates, the swap arrangements with the banks, the ceilings on interbank credit, and the special rediscount facilities.

Exchange rate policy would have to play a significant role--especially in stimulating the growth of nonenergy exports--if the authorities were to arrest the growth of foreign debt and continue to reduce the external current account deficit, Mr. Templeman said. The restoration of Indonesia's international competitiveness following the 1983 devaluation was a notable achievement, but the chart on page 22a of the staff report showed that there had subsequently been a steady appreciation through late 1984. He wondered what had happened to the exchange rate since then. The authorities' renewed commitment to exchange rate flexibility was welcome. The exchange market was sensitive to speculative forces, and it would be important to be able to change the pace of exchange rate adjustment if necessary.

The foreign debt--particularly public sector debt--had increased rapidly in recent years, Mr. Templeman noted. The public sector debt had risen from some 20 percent of GDP in 1980/81 to approximately 34 percent in 1984/85, and the ratio of public debt service to net exports had increased from less than 11 percent in 1980/81 to nearly 30 percent in 1984/85. The medium-term balance of payments scenario showed little reduction in the debt and debt service ratios, and he agreed with the staff that the level of foreign borrowing had reached the upper limit of

the prudent range. In the circumstances, the authorities' efforts to slow the growth of foreign debt and improve both the management of the public debt and the monitoring of the evolution of private sector foreign debt were welcome.

The authorities were to be commended for eliminating multiple currency practices, Mr. Templeman remarked. The exchange system was completely free of payments restrictions on current transactions. However, there was evidence of increasing use of protectionist trade measures. In that connection, the World Bank estimates of the implicit costs per worker of subsidies in some industries were striking, and the Fund staff had noted the proliferation of quantitative restrictions, domestic use requirements, special import licensing requirements, countertrade requirements, and exclusive import authorizations. Those developments were inconsistent with the authorities' overall economic strategy and would inevitably affect adversely resource allocation and the difficult worldwide struggle against protection.

The strong economic adjustment effort had enabled Indonesia to avoid the backlash of the world debt problem of recent years, Mr. Templeman commented. The authorities' general progress had been good, but it was easy for a country to slip backward and he urged the authorities to avoid doing so.

Mr. Alfidja noted that the economic and financial upturn in 1983 had been sustained in 1984, as real GDP growth had increased to 6 percent, owing mainly to the expansion of oil output and the increased supply of liquefied natural gas. A number of non-oil economic activities, such as the manufacturing of basic consumer goods, had also expanded. At the same time, inflation had moderated significantly and the external current account deficit had declined, owing largely to the restrained fiscal and monetary policies. The authorities were to be commended for engineering and maintaining the economic recovery through skillfully crafted policies.

The growth of agricultural output had been sustained in 1983 by the abundant rice harvest, and the yield of almost all the major food crops had increased, Mr. Alfidja observed. The staff had stated that the quality of Indonesia's rice should be substantially enhanced. With that improvement and additional bumper harvests, the country's foreign exchange resources might be further diversified through rice exports.

The index of production of consumer and intermediate goods had recovered in 1983, but that of transport equipment--especially motor vehicles and cycles--had fallen sharply, Mr. Alfidja continued. He hoped that the downturn would be short-lived and would not undermine the efforts to diversify the productive base. Unlike many oil producing countries, Indonesia had several attractive features that should contribute to the successful implementation of a well-designed economic diversification policy. For instance, the country had vast agricultural and mineral resources, a sizable population, a relatively inexpensive labor force, and experienced economic managers. Furthermore, the exchange system was

essentially free of restrictions, and the exchange rate policy was applied flexibly in order to preserve export competitiveness while containing domestic inflation. The combination of those factors with the authorities' generally pragmatic approach to the optimal mix of private and public sector shares in economic activity should attract both domestic and foreign investors. Although the domestic market was large enough to support an expanded manufacturing sector, investors should be export-minded as well. The effort to increase Indonesia's exports would certainly be helped by dismantling the protection in many of Indonesia's actual and potential trading partners. In any event, economic diversification was required not only because of the need to create additional employment and income but also because of the uncertainties about oil reserves and foreign demand.

The important fiscal adjustment effort begun in 1983/84 would be maintained in 1984/85, Mr. Alfidja noted. The estimated near balance between receipts and expenditures in 1984/85 was an impressive achievement, particularly in comparison with the large deficit that had been forecast. Although that outcome was due in part to the underestimation of revenues and overstatement of outlays, the authorities were to be commended for exercising considerable restraint and prudence in managing the country's finances. Their cautious approach was reflected in the freeze on government workers' wages, the reduction of subsidies to Pertamina, and the Government's comfortable creditor position with the banks. However, the Government's overall financial operations were estimated to have deteriorated in 1984/85, owing to the substantial rise in both recurrent and capital expenditures. He agreed with the staff that actual capital outlays might fall short of the projection, due to administrative and other constraints. The deterioration in real wages during the previous two years justified the recent decision to raise the salaries of civil servants and teachers, but the authorities should make such adjustments cautiously because new wage levels tended to become the firm floor for those outlays.

The pragmatic fiscal policy during the previous two years, together with the March 1983 exchange rate adjustment, had bolstered the economy, Mr. Alfidja remarked. The authorities should make every effort to strike a judicious balance between short-term objectives and the longer-term goals of achieving a sustainable external position, strong economic growth, and price stability. Prudent fiscal and monetary policies would be crucial to attaining the longer-run objectives.

The economic and financial performance of Indonesia in 1984 had been satisfactory, Mr. Alfidja said. The authorities should maintain the policies that had caused the impressive growth in economic activity in 1984 and the remarkable reduction in inflationary pressures. The proposed decision was acceptable.

Mr. Salehkhou remarked that the performance of the economy during the previous several years had been largely satisfactory, despite the continuing unsettling pressures in the world oil markets that had affected most oil exporting countries and had increased the uncertainties in the international economic environment. Economic policy had played a major

role in the favorable performance of Indonesia's economy; the authorities had acted promptly to offset the effects of the marked decline in the volume of oil exports, the growing external deficits, and the large capital outflows that had seriously constrained international reserves and budgetary resources, thereby undermining the long-term growth prospects.

The adjustment program implemented by Indonesia in early 1983 had been timely and comprehensive, Mr. Salehkhou commented. It had included measures aimed at correcting the external and domestic imbalances as well as at addressing underlying structural weaknesses. The improvement in the economy during the previous two years had admittedly been due partly to the serious difficulties in implementing foreign-financed development projects, as a result of which the growth in output had been very uneven. However, the 1983 adjustment program had clearly succeeded in restoring external confidence, thereby enabling the authorities to bring the external and budgetary positions back to sustainable levels, resume real economic growth, and reduce the rate of inflation from 12 percent in 1983 to only 4 percent in 1984/85. The improvement in the central government budget--which was expected to record a small overall surplus in the current fiscal year--was particularly impressive and should permit a further increase in the Government's deposits with the banking system and an expansion of credit to the private sector.

Despite the adjustment made thus far, Indonesia still faced a number of problems, some of which were related to the uncertainties in the world oil market and others to structural problems that clearly underscored the need for the authorities to maintain and strengthen their adjustment policies, Mr. Salehkhou said. The fact that the authorities' fiscal, monetary, and external policies remained cautious, despite the perceived need for some economic stimulus to broaden the recovery and strengthen the balance of payments, was encouraging.

The authorities' cautious fiscal stance was confirmed by the austerity budget proposed for the coming fiscal year, Mr. Salehkhou remarked. The new budget would provide only a moderate fiscal stimulus. Continued austerity should consolidate the gains in reducing inflation and in containing the external current account deficit, as called for by the unsettled conditions in the oil sector. Efforts to eliminate the bottlenecks in project implementation should also broaden the economic recovery and strengthen the adjustment process. The structure of the new budget constituted a shift toward recurrent expenditure, including a large increase in civil servants' salaries to restore them in real terms to the level before the freeze and to support domestic demand. Many adjustment programs, including those supported by the Fund, tended to underplay the importance of sustaining recurrent expenditure in ensuring the success of the programs.

The authorities' cautious fiscal stance and the improved balance of payments position had permitted an expansion of credit to the private sector within the broad domestic and external objectives, Mr. Salehkhou noted. At the same time, the authorities were maintaining their effort to adapt policy instruments in the wake of the extensive financial reform

in mid-1983. Monetary policy was considered to be generally appropriate by the staff, but there was some concern about possible interest subsidies to stimulate the weak demand for investment. The fluid situation in the oil market, which affected Indonesia's oil receipts, had given the authorities an added incentive to promote the non-oil sector. To that end, and in the light of the fairly comfortable budgetary position, interest subsidization might well be seen as an appropriate monetary instrument. However, he wondered whether excess capacity had not played a more important role than high interest rates in the weak demand for investment. Fertilizer subsidies also had been instrumental in helping to develop the agricultural sector and to achieve food self-sufficiency without placing undue pressure on fiscal resources.

Responding both to short-term conditions in the exchange market and to the need to maintain competitiveness, the authorities' exchange rate management had enabled them to contain the impact on the rupiah of the uncertainties in the oil market and of the unsettling behavior of major currencies, Mr. Salehkhou commented. Indonesia's foreign debt was relatively small in relation to GDP, and he was pleased that the authorities had shown an increased concern about the expansion of the debt and were moving to bring it under control by enforcing a ceiling on export credits and by requesting Fund technical assistance to improve the monitoring of private external debt. All the measures the authorities had implemented to improve external debt management and the staff's proposal to phase out the swap facility offered by Bank Indonesia were appropriate, but a further comment on the authorities' policy of avoiding any recourse to domestic credit for fiscal financing would be helpful. Given the rapidly increasing debt service ratio and the uncertain oil market prospects, a reappraisal of that policy might be warranted. The proposed decision was acceptable.

Mr. Alhaimus said that he too believed that the authorities should be commended for the strong measures adopted since early 1983 in response to the prospective foreign exchange gap that had become increasingly alarming as the oil market prospects had changed. The demand management policies introduced since then had contributed to the notable improvements over the previous two years in the fiscal and external balances. The overall budget deficit, which had amounted to more than 5 percent of GDP in 1982/83, had been sharply curtailed in 1983/84, and a small surplus--albeit an involuntary one--was expected in 1984/85. The external current account deficit had been markedly reduced, by 3.4 percent of GDP, in the previous two years. Those achievements had been accompanied by a fairly rapid rate of output growth--owing to the expansion of liquefied natural gas production capacity--and by a more moderate rate of inflation. The main concern of economic policymakers was the sizable underutilization of capacity in the non-oil sector and the depressed investment activity, which had fallen sharply in contrast to preceding years.

The authorities understandably wished to attempt a shift under the 1984/85 budget toward some fiscal stimulus to the economy, Mr. Alhaimus continued. The various difficulties hampering a sufficient rise in

actual project expenditures had led the authorities to seek to stimulate the economy through recurrent expenditure under the 1985/86 budget. He agreed with the staff that the recourse to recurrent expenditure should not detract attention from solving the problems in the area of project execution. The staff had noted that steps were being taken to solve those problems, and that the authorities expected the project financing disbursement rate to pick up in coming months. Given the budgetary policies as a whole and the uncertainties still facing the economy, it was encouraging to note that fiscal restraint was still the basic policy theme and that no domestic financing would be required for the 1985/86 budget.

Monetary policy had been appropriately cautious, in line with the overall adjustment strategy, Mr. Alhaimus commented. However, the authorities still faced the task of avoiding undue monetary contraction resulting from the fiscal retrenchment without unnecessary easing of monetary policy. In 1984, the large increase in deposits with the banking system had made possible a significant rise in bank credit--by about 24 percent--without an increase in credit from Bank Indonesia and the attendant adverse effects on inflation and the external balance. The original concern of the authorities and the staff about the possible excessive tightness in Bank Indonesia's reserve position seemed to be receding in the light of the unexpectedly large overall balance of payments surplus and the central bank's intention to introduce new money market securities.

The external balance in 1984 had been characterized by a considerable improvement in the current account over 1982/83, a sharp reversal in private short-term capital outflows, and an unexpectedly large overall surplus, Mr. Alhaimus noted. An encouraging aspect of the trade balance was the contribution of non-oil exports. However, there were considerable uncertainties about the prospects for the external balance, given the weak oil market on which Indonesia's exports remained dependent. In that connection, the sharp rise in the public sector debt service ratio was a cause for concern. The recent measures to control the use of export credit and the intention to improve monitoring of private sector external debt were steps in the right direction. A more fundamental approach to improving the external position was the effort to improve the competitiveness of non-oil exports. Although the authorities had taken commendable steps in that direction, the prospects for key non-oil exports unfortunately would remain uncertain as long as protectionist measures persisted in Indonesia's large trade partners; and the staff had indicated that further intensification of protection abroad was expected. Indonesia's difficulties in diversifying its economy by expanding the non-oil sector were similar to those facing other major oil exporters. Finally, the proposed decision was acceptable.

Mr. Zecchini considered that Indonesia's performance over the previous several years had been impressive. Indonesia's dual economy--a large oil sector and significant agricultural and manufacturing sectors--had been able to maintain remarkably persistent economic growth compared with other countries in similar circumstances and despite the sharp swings in oil

sector production, ranging from minus 13.1 percent in 1982 to 12.4 percent in 1984. In addition, although Indonesia had required foreign savings to accelerate its economic development, it had thus far been able to maintain a relatively manageable debt position. In 1983, the authorities had adopted stringent adjustment measures, and Indonesia's debt service ratio was among the lowest of the major borrowing countries. Moreover, the authorities had introduced far-reaching structural measures to modernize the financial markets and the fiscal system within a framework of substantial integration with the international financial community.

Those developments suggested the vitality that was characteristic of the economy and the authorities' policy management, but a deeper analysis of Indonesia's development process revealed a number of problems that required comprehensive policy action, Mr. Zecchini commented. The most crucial problem was the weak investment demand that had plagued the country for some two years and was of the utmost concern to the authorities. The employment situation was also a cause for concern, although the data needed to evaluate it in detail were lacking.

Total fixed investment had been falling in real terms for two consecutive years in both the public and private sectors, Mr. Zecchini continued. The decline in public sector investment was due partly to the authorities' decision to curtail capital formation. The causes of the stagnation of private investment demand were less apparent, and a more detailed discussion of the matter in the staff report would have been welcome. One possible cause mentioned by the staff was the sluggishness of consumer spending, but that argument was not fully convincing, since there was no apparent reason why consumer expenditure alone should be the main driving factor of investment on the demand side. Indeed, there was no apparent correlation between aggregate demand and private investment when the latter was roughly measured as the difference between total fixed investment and public sector development expenditure. One reason for the lack of correlation might be the substantial unused productive capacity, but no explanation had been given of why an economy whose growth had consistently exceeded 5 percent--except for the stagnation in 1982--should have such excess capacity.

In assessing the weak investment demand, it was helpful to examine the effects of the fiscal reform of 1984, Mr. Zecchini went on. Although the reform had included measures favoring private investors, such as the simplification of the tax rate, the reduction of the maximum rate for the corporate income tax, and the new accelerated depreciation schedule, it had also eliminated a number of deductions and allowances previously enjoyed by private companies. The simplification of tax procedures had certainly had a positive effect on efficiency and resource allocation, but its net effect as a stimulus to investment was unclear. According to rough estimates, private investment in real terms had apparently increased somewhat in 1983 and declined in 1984, while total investment had fallen in both years. Moreover, the data on approvals of domestic investment by economic sector in Table 36 of SM/85/25 also pointed to a strong decline in investment demand after the various new rules he had mentioned had

come into effect. Private investors might have felt that the new legislation would unfavorably affect their investment projects, or they might have adopted a wait-and-see attitude pending their careful assessment of the new taxes. A further comment by the staff on the likely impact of the tax reform on aggregate investment in the medium run would be helpful.

Monetary policy also might have been a disincentive to capital formation, Mr. Zecchini remarked. Lending rates had tended to rise since mid-1983, and the present rates were nearly 20 percent, compared with an estimated quarterly rate of inflation of 4 percent. Although interest payments were tax deductible, after-tax rates had apparently been very high in real terms.

Stagnation in investment would undermine the capacity of the economy to generate sufficient jobs to absorb the rapidly growing labor force, Mr. Zecchini said. Indeed, the World Bank had recently stated that employment creation was the most pressing development issue in Indonesia. Unfortunately, the authorities had not provided employment data, and the matter was not discussed in the staff report. According to the World Bank, as much as 27 percent of the rural labor force and 17 percent of the urban labor force had been either unemployed or underemployed in 1980, and there was reason to believe that current rates were higher. Given those facts, the downgrading of the capital formation process by both the authorities and the private sector was particularly worrying.

The staff had correctly stressed the need for flexibility in the management of the exchange rate, particularly in view of the close integration of Indonesia with foreign financial markets, Mr. Zecchini remarked. The liquidity crisis of September 1984 had shown that a decline in confidence in the rupiah could be quickly translated into a liquidity squeeze and a rise in domestic interest rates. Although the likelihood of that outcome had been increased by the 1983 reform of the financial system, the charts in the staff report showed a strong correlation between real interest rates and the real exchange rate. It was interesting to note that the authorities believed that they could restore confidence in the rupiah by inducing an appreciation; presumably they believed that market operators formulated their exchange rate expectations by extrapolating past trends. While the authorities' conclusion might be applicable in the short run, it was clear that, in the medium run, confidence in the rupiah could be preserved only by maintaining the currency's real foreign value at a stable and sustainable level. The staff should comment on whether the trend in the real exchange rate since mid-1983 was consistent with that principle.

Future staff reports on recent economic developments in Indonesia could usefully contain additional information on such relevant variables as private investment expenditure and capacity utilization, Mr. Zecchini said. The various tables in the present report did not by themselves help Executive Directors to focus clearly on the most significant issues.

Mr. Ercel considered that the authorities were to be commended for their impressive adjustment efforts in 1983/84, which had led to a significant improvement in the economy following a period of serious external imbalances due largely to exogenous factors. Those results were particularly encouraging because they had been accompanied by improved resource allocation and sustainable economic growth. The authorities' reaction in 1983 and 1984 to the sharp decline in oil revenues had set the stage for a more balanced approach to maintaining growth in the long run.

The ratio of national savings to GNP had declined sharply in 1982 and 1983 but had recovered by 2 percentage points in 1984, Mr. Ercel noted. That development was especially encouraging because it had been made possible by contributions from both the public and private sectors. However, the investment data were puzzling. Despite the rephasing of the public sector investment program and the decline in real investment in 1983 and 1984 by about 1 percent and 3 percent, respectively, the ratio of domestic investment to GNP was higher in 1984 than in 1981 and 1982. Moreover, despite the relatively high economic growth rates during the previous two years, the ratio of investment to GNP had risen only slightly, from 23.3 percent in 1981 and 1982 to 23.5 percent in 1984. The staff had commented briefly on the investment data in a footnote on page 12 of SM/85/25, but the matter should be explored more fully during the next consultation.

Using the balanced-budget approach seemed to be a precondition for achieving the adjustment objectives in the fiscal area, Mr. Ercel remarked. The adjustment policies had been cautious, and he was pleased that the balanced-budget approach had contributed to solving some of the fiscal problems. However, the authorities' conclusion that additional fiscal stimulus was needed to support the short-term economic recovery should be carefully examined. Slow project implementation had limited development expenditures' capacity to stimulate the economy. At the same time, increasing subsidies for private investment had created certain problems. In the circumstances, the staff had wisely counseled the authorities to take a cautious approach to speeding up project implementation and adopting a large-scale program of interest subsidies for private investment credit. It was useful to note that most countries preferred to introduce several investment incentives in the framework of tax legislation. Indonesia, too, had introduced various tax incentives for investment. Could the staff comment on the different economic effects on private investment of tax incentives and subsidies financed by the budget?

The financial reform of June 1983 and the accompanying supportive measures had improved the management of money and credit, Mr. Ercel commented. Despite the difficulties the authorities had encountered in reducing the dependence of commercial banks on the central bank, the outlook for maintaining a sound financial system in the long run was encouraging. The authorities should also pay sufficient attention to the capital market and the deposit insurance scheme. The development of the institutional framework of the capital market since its introduction in

1977 had been slow. A well-designed deposit insurance scheme would help to attract additional financial savings and to increase the competition among public, private, and foreign banks.

Because of the uncertainties about future developments in the oil markets and the impact of the structural adjustment measures, the medium-term prospects for the economy were particularly difficult to assess, Mr. Ercel remarked. However, it was clear that the authorities should strengthen the management of the external debt, including private sector debt. In addition, the exchange rate policy should be more flexible, not only to avoid an erosion of the gains in external competitiveness but also to reallocate the non-oil resources of the economy. He was pleased that the authorities were well aware of those requirements.

It would be difficult for the authorities to eliminate the structural weaknesses in the economy and to reallocate domestic resources in the short run, but their intention to introduce and maintain the necessary sound economic policies was welcome, Mr. Ercel concluded. The new measures should result in both a better balance in the development of the various productive sectors and a viable balance of payments position. The authorities' present policies were clearly in the right direction.

Mr. Jayawardena remarked that Indonesia was an important Asian economy; it was well endowed with natural resources, had a large population, and had recently emerged as a major energy producer. The windfall nature of the energy income had created imbalances in the economic structures of many major energy producing countries, and his authorities had observed with interest the way in which the Indonesian authorities had come to grips with the problem in their country. The imbalances registered in 1983 had been a cause for concern, but the manner in which the authorities had addressed them was encouraging; the authorities had apparently dealt successfully with a difficult situation caused by external factors.

In 1983/84 and 1984/85--a period of adjustment in Indonesia--real GDP had risen, inflation had moderated, and the external current account deficit had declined significantly, Mr. Jayawardena noted. In addition, the fiscal position had improved substantially in 1983/84 and had recorded a surplus in 1984/85. The deregulation of interest rates had caused time deposits to grow, thereby contributing to a large increase in broad money. Narrow money had grown by 10 percent in 1984, compared with 6 percent in 1983, owing mainly to a rise in bank credit and an improvement in the balance of payments. The devaluation of the rupiah in March 1983 and the adjustment measures subsequently adopted had promoted confidence in the currency and had led to private capital inflows. In 1984, the rupiah had depreciated by more than 8 percent vis-à-vis the U.S. dollar, and the present total debt service ratio was manageable. All those positive aspects of Indonesia's adjustment were evidence of the economy's capacity to adapt quickly to policy changes.

The authorities' adjustment measures had been fully appropriate; they had undoubtedly contributed to the turnaround in the external position, Mr. Jayawardena said. However, he felt less strongly than the staff that the turnaround was attributable largely to the adjustment measures. The recovery had been helped by the sharp expansion in exports of liquefied natural gas, the coming on stream of large past investments, the substantial recovery of agriculture due to favorable weather conditions, and the strong growth in capital inflows. The prospects of the non-oil sector had been improved by the exchange system, but the sector had yet to regain the dynamism of the past, and it would have to do so if the economy were to become more diversified and its dependency on the energy sector were to be moderated. The tight demand management policies introduced after 1983--including credit restraint, the maintenance of highly positive interest rates, and the rephasing of the budget--might also have contributed to the turnaround in the external position. Given the close relationship between public and private investment, he was of the view that the slowing of investment had resulted from the strong fiscal adjustment. Accordingly, the authorities' decision to provide slight stimulation under the 1985/86 budget while continuing to give the adjustment objectives the highest priority was welcome. Reducing the regulations on economic activity would also help to promote economic activity in general and investment in particular.

He hoped that the expected strong rise in current expenditure together with a moderate increase in development outlays would be temporary, Mr. Jayawardena remarked. The authorities should be encouraged to avoid delays in project implementation, so that the pace of development expenditure could be resumed and accelerated. Those steps were essential to increasing the rate of economic growth in the medium term and to diversifying the economic base. At the same time, the authorities were to be commended for their intention to increase non-oil and gas revenues by implementing new income and value-added taxes and by sharply reducing the fuel subsidies. The fertilizer subsidies would have to be eliminated cautiously, as poor farmers benefiting from them were the least able to bear strong price shocks.

It would be useful to have a further comment on the likely impact of the 1985/86 budget on monetary management, Mr. Jayawardena continued. Given the uncertainty about the disbursement of development expenditure in the coming period, it was not clear to him whether the expected decline in accumulated government deposits with the banks would actually occur. The central bank's room to use the refinancing and reserve ratio instruments would depend upon the level of government deposits with banks. Apparently the authorities and the staff considered that the pace of credit expansion to the private sector would have to be dampened. Mr. Ismael had mentioned that the central bank would soon introduce new money market securities and trade bills to foster the development of the money market and open market operations as instruments of monetary policy. While open market operations could conceivably constitute an additional policy

instrument, he wondered whether they would be as effective in the short run as access limits and reserve ratios. Moreover, the introduction of a number of money market instruments in a short period might create problems.

The non-oil sector and non-oil exports had grown over time, although the pace had slowed in the recent past, Mr. Jayawardena remarked. The considerable uncertainty about the external demand for oil and non-oil products added to the difficulty in diversifying the economy. The non-oil sector should be export oriented, particularly in the light of the uncertainty about the demand for oil exports reflected in the medium-term scenario. The authorities should be encouraged to review regularly their trade and exchange rate policies, making appropriate alterations in response to changing circumstances. Their stance on foreign borrowing was welcome, and the measures they had adopted in October 1984 to improve external debt management were commendable.

Indonesia was endowed with ample natural resources, and the economy's potential was considerable, Mr. Jayawardena commented. If Indonesia's abundant resources were fully developed, the country could conceivably become the world's sixth richest country. With the benefit of improved health and education, the large population could be a considerable asset. Prudent economic policies would also be required, and he was pleased that the authorities' policy stance was on the right course. Their reaction to the imbalances recorded in 1983 was evidence of their strong management of the economy and of their determination to persevere in maintaining appropriate policies. The reduction in the role of the state, the development of financial institutions and instruments, the reform of the tax system, the improvement in tax administration, the adoption of a flexible exchange rate policy, and the restoration of market incentives augured well for the future. The Indonesian authorities should be mindful of the distributive aspects of economic policies, something that the authorities in many other countries had ignored to their eventual regret. As Mr. Ismael had stated, the road ahead for Indonesia would be long and bumpy. Prudent economic and financial policies would provide the country with the best means of navigating that course, and he hoped that there would not be many roadblocks, such as protection by Indonesia's trading partners, that would make the policy effort more complicated, if not impossible. Finally, the proposed decision was acceptable.

Mr. Zhang noted that in early 1983 the authorities had adopted a series of far-reaching structural adjustment measures that, together with strong demand management policies, had yielded impressive results. Unlike most developing countries that had undertaken adjustment programs, Indonesia had been able to maintain a continuous, substantial increase in GDP during the adjustment period. Between 1982 and 1984, GDP had grown by more than 11 percent, with manufacturing, mining, construction, and utilities making important contributions. The increase in output had been accompanied by changes in the pattern of demand and resource allocation owing to government policies. In 1982-84, both real private and public consumption had risen, although much more slowly than GDP, as the main burden of adjustment had been borne by real gross investment, which had fallen substantially.

At the same time, the authorities had been able to increase the proportion of exports in total output. Non-oil exports had increased, and the growth of total exports, together with a significant decline in imports, had helped to reduce the external current account deficit in 1984/85 to half the deficit recorded in 1982/83. Hence, it appeared that adjustment in Indonesia had been easier than it would have been in the absence of continued economic growth.

The adjustments had been made, and resource allocation had been programmed, within the broad framework of the Five-Year Development Plan, Mr. Zhang observed. The staff had concluded that the authorities recognized the need to modify their development policies in the light of changed circumstances. As was apparent from Mr. Ismael's opening statement, additional adjustment measures in the fiscal, monetary, trade, and price fields were contemplated for 1985 to strengthen further economic growth in the medium term.

The staff report included an interesting and thorough analysis of various aspects of the economy, but a fuller discussion of the development strategy and the medium-term prospects for the real sectors other than oil would have been welcome, Mr. Zhang remarked. In that connection, the staff should comment on the level and pattern of investment originally envisaged under the development plan. Was the decline in investment likely to continue in the coming period? If so, how would the planned growth of GDP be realized? He wondered whether the new strategy for promoting manufactured exports would entail significant changes in the pattern of investment. He also wondered whether the importance of the public sector would be greatly reduced in the coming period, as the staff seemed to have implied, and if so, in what direction. Did the adjustment program include measures to improve the organization and management of public enterprises as well as their production and price policies? A comment on the specific measures the authorities intended to adopt to increase the competitiveness of manufactured exports in the coming years under the new export-oriented development strategy would also be helpful, particularly as the staff's views on that matter were rather pessimistic. Finally, he wondered whether the authorities had introduced programs to deal with unemployment.

Mr. Nebbia said that basically he agreed with the staff appraisal. The authorities' policies showed that their assessment of the economic situation was realistic and that they had decided to act vigorously to handle the various problems. He agreed with the staff and the authorities that export-led growth and economic diversification were the best ways to solve the problems caused by the unfavorable external conditions.

The economy had grown steadily over the previous decade, and the rate of inflation had declined, Mr. Nebbia noted. The authorities were to be commended for the prompt implementation of appropriate adjustment policies in response to the weakening of the external accounts owing to the deterioration in the international economic environment. After the devaluation of March 1983, the performance of non-oil exports had improved

and the current account deficit had steadily decreased. In addition, the debt service burden seemed under control; a significant portion of total foreign debt had been contracted on concessional and semiconcessional terms.

The outlook for the oil market was uncertain, Mr. Nebbia remarked. OPEC had announced a cut in oil prices on January 29, 1985, and Indonesia's Oil Minister, the current president of OPEC, had stated that in future OPEC would permit market conditions to determine the price of oil. Oil exports accounted for more than half of projected exports and tax revenues, and the staff had assumed that the price of crude oil in nominal terms would remain unchanged at $29.50 in 1986/87 and would then increase by 4.5 percent annually through 1988/89. Those assumptions seemed inconsistent with the expectations of other oil exporters.

The increase in the trade surplus during the previous two years had been accompanied by a decline in investment, Mr. Nebbia continued, and he wondered how the authorities planned to tackle that problem, which undermined medium-term growth prospects. Moreover, the central government budget for 1985/86 would continue the unfavorable investment trend by reducing the share of development expenditure in total expenditure. The emphasis on non-oil exports required the adoption of appropriate supply-side policies and critical investments to restructure the industrial sector.

The staff should comment on the extent to which private companies had adjusted to the financial reform of June 1983, Mr. Nebbia said. In particular, he wondered how the higher, volatile interest rates had affected private investment and non-oil exports. The reform might have resulted in more stringent financial conditions for industrial firms, which in turn might have contributed to the poor investment performance during the previous two years.

Chart 2 (SM/85/20) showed that, as a result of the increased value of the U.S. dollar, Indonesia's rupiah had appreciated in real terms against the currencies of its major commercial partners since March 1983, Mr. Nebbia noted. Given the urgent need to increase non-oil export revenues, the authorities should avoid the erosion of competitiveness caused by the movement of the exchange rate. The high elasticity of exports to movements in the real exchange rate had been evident following the March 1983 devaluation; the value of non-oil exports had risen by more than 50 percent during the previous two years, although the value of oil exports had fallen.

The introduction of travel restrictions was regrettable, particularly as they would be difficult to remove, Mr. Nebbia said. He fully agreed with the staff that reversing the protection in developed countries was a necessary condition for instilling confidence in the long-term viability of the export-oriented industrial growth strategy of developing countries like Indonesia. But countries that were advocating a reduction in protection should make certain that they themselves were eliminating trade barriers.

The future performance of the Indonesian economy would depend on the authorities' willingness to maintain strong structural and other adjustment policies and on the availability of external markets for Indonesia's exports, Mr. Nebbia considered. The authorities' determination to maintain the appropriate policies was commendable, and the elimination of all the remaining multiple currency practices was welcome. The proposed decision should be approved.

Mr. Blandin stated that he broadly agreed with the staff's appraisal. The authorities were to be commended for their skillful and prudent management of the adjustment process. They had already achieved impressive results, although structural weaknesses remained in some sectors.

Some stimulus to domestic demand might be useful at the present stage, Mr. Blandin remarked. However, it should not keep the authorities from introducing structural and other far-reaching measures to strengthen the balance of payments--and stimulate non-oil exports in particular--thereby providing needed employment opportunities over the medium term.

The staff representative from the Asian Department said that the staff had noted Executive Directors' requests for future staff reports to contain a more detailed discussion of the development strategy and the employment situation. The present report reflected the subjects that the authorities had wished to take up with the staff. A number of the other matters that Executive Directors had noted had been dealt with in detail in various World Bank reports, including the latest report to the Intergovernmental Group on Indonesia (IGGI), and the Fund staff had not attempted to duplicate those efforts.

The World Bank was in the process of conducting a number of sector studies in Indonesia in cooperation with the Central Government, and the findings would be summarized by the staff in future reports, the staff representative said. The U.S. Agency for International Development and the World Bank were studying possible means of promoting employment in Indonesia. The World Bank study was to be presented to the next IGGI meeting, probably in June 1985.

The staff's conclusion that the budget might have recorded a moderate surplus in 1984/85 was not meant to suggest that that was necessarily the most desirable outcome for the budget, the staff representative remarked. In fact, the staff had hoped that the authorities would make more effective use of available resources in implementing development projects. The staff had meant to suggest that it would have been comfortable with a budget outcome for 1984/85 similar to the one projected for 1985/86, namely, a budget deficit equivalent to approximately 2.5 percent of GDP and financed fully by foreign funds.

The April 1984 World Bank report to the IGGI dealt with the appropriate policies to support the medium-term growth strategy, the staff representative noted. The broad policy lines had been set out in the development plan, but many of the details--for instance, the precise

means of encouraging private investment--had not yet been formulated. The World Bank staff had identified employment creation as the most pressing developmental issue in Indonesia. The World Bank staff had noted that planned employment opportunities could be created if GDP were to grow and if changes in the structure of the economy were made. The main question was whether economic growth of approximately 5 percent a year, as assumed under the development plan, would be sufficient to absorb a labor force that was growing by approximately 2.7 percent a year, or 1.8 million workers over the plan period. In its report to the IGGI, the World Bank staff had correctly concluded that the economic activities generating the projected economic growth would have to become increasingly labor intensive, and it had proposed a number of microeconomic policy measures designed to encourage more labor-intensive production while maintaining efficiency. For example, the World Bank staff had recommended specific policies designed to increase crop output in irrigated areas, to diversify crop production in rain-fed areas, and to expand tree crop output in the outer islands. The World Bank staff had also discussed those matters in the context of the transmigration program. In the industrial sector, the World Bank staff had underscored the need to stimulate export-oriented industries; that emphasis was consistent with the objective of restructuring the balance of payments to reduce the country's dependence on oil receipts.

The opportunities for large-scale import substitution in Indonesia, particularly of consumer goods, had been virtually exhausted, the staff representative said. The remaining import substitution possibilities probably were more capital intensive than the remaining options to diversify and increase non-oil exports. Accordingly, the promotion of those exports was consistent with the overall objective of restructuring the economy in favor of labor-intensive production. However, the pattern of protection in Indonesia seemed to favor relatively capital-intensive sectors. Rather than roll back all the various forms of protection at once, the Fund and World Bank staffs had suggested making an effort to catalogue the various practices to learn how each segment of industry was being protected. Conclusions about appropriate liberalization steps could then be drawn. The staff was concerned about the apparent recent shift toward quantitative restrictions, which seemed undesirable at the present stage, although the staff had not meant to imply that it expected additional protection under the 1985/86 budget; the staff had merely meant to describe developments to date.

With the exception of trade policy, the authorities were addressing the main aspects of the medium-term growth strategy, the staff representative noted. The staff hoped that the authorities would clearly stipulate the areas where the private sector would be permitted to invest, and that that sector would be allowed to exercise considerable initiative. Significant progress had been made at the central government level in simplifying the regulatory framework and in making useful administrative reforms, but those efforts would have to be pursued in an aggressive manner. In addition, the medium-term strategy should certainly include a continuation of the basic financial market reforms and other steps to develop Indonesia's domestic capital markets.

Available information suggested that the delays in project implementation had been particularly evident in foreign-financed projects, many of which were large scale, the staff representative commented. While information on the budget suggested that better progress had been made on the implementation of projects financed in local currency out of the budget, qualitative information and analysis suggested that significant delays had affected those projects as well. Those delays apparently had been particularly significant when legal problems, such as land acquisition, had been encountered, but delays across-the-board had been in evidence.

The authorities had recognized the need to strengthen bank supervision after the deregulation of the financial market, the staff representative said. Indeed, Bank Indonesia had intensified its efforts in that area.

Labor market conditions were apparently easy for nonskilled categories and not as easy for some skilled categories, the staff representative went on. Real wages in the nonagricultural private sector had increased fairly rapidly for some time until approximately two years previously. The authorities had concluded that, given current labor market conditions, restoring real wages of public sector employees and teachers to the level of approximately two years previously would not lead to sharp wage increases in the private sector.

The question had been raised, the staff representative recalled, whether the new budget was more or less expansionary than the previous budget. Table 2 in the staff report showed Rp 9,729 billion in net domestic expenditure under the provisional budget for 1985/86. However, the staff believed that the prospects for non-oil revenue had been overstated. While the provisional budget provided for an increase in net domestic expenditure of about 7 percent, the staff expected that such expenditure would actually increase by 12-13 percent, somewhat faster than in 1984/85. It should also be noted that the staff estimate of net domestic expenditure in 1984/85 assumed that all the budgeted rupiah-financed development expenditure had actually been made; in fact, some of the "expenditures" had merely been transfers to the spending ministries and other levels of government, and there was no certainty that the transfers had actually been spent on goods and services. In any event, the 12-13 percent increase in net domestic expenditure in 1985/86 expected by the staff was approximately in line with the expected increase in GDP, a pattern the staff considered appropriate. A similar pattern had been assumed a year previously; that assumption had not been borne out because of the delays in development project implementation.

The staff and the authorities had similar views on the appropriate level of demand for liquid assets, given the goal of continuing to moderate the rate of inflation, the staff representative remarked. The staff was confident that monetary policy would be consistent with the major assumptions underlying the new budget.

The reference price of oil exported by Indonesia had recently been reduced by $1 a barrel, the staff representative noted. The staff had assumed that the price reduction would reduce net oil revenues by approximately $250 million in 1985/86, and that, ceteris paribus, the current account deficit as a proportion of GDP would now be about 0.2-0.3 percentage point of GDP higher than expected before the oil price reduction.

The staff did not have the data on inflation differentials needed to compute the recent movement in the real effective exchange rate, the staff representative explained. However, the rate of inflation over the previous four weeks had been fairly low, and there was no reason to believe that the real effective exchange rate had moved sharply in one direction or the other.

One speaker seemed to have implied that, given the constraint on foreign borrowing, the authorities might wish to increase the Government's recourse to domestic credit, the staff representative noted. However, the staff and the authorities themselves would not find that option attractive. Excessive recourse to bank credit had created difficulties--including an increase in balance of payments problems--in many countries, including Indonesia, in the past. In any event, given the authorities' development objectives and their efforts to revitalize the credit markets, the authorities would not wish to see the Government compete with the private sector for the available domestic credit.

As to aggregate investment in the medium run, the staff representative said, much would depend on the incentives in the private sector and the increase in the public revenue base. The Government would be in a better position to implement its investment program once the public revenue base had been broadened. The tax reform had led to the removal of certain tax incentives, for instance, the tax holiday, but new incentives for foreign and domestic investment also had been provided. Many observers had concluded that the considerable decline in the marginal tax rates and the much more generous depreciation allowances would provide adequate incentives. The fall in investment in 1983 and 1984 had been due only in part to the uncertainty about the shape of the tax system.

In many countries, there had been periods in which the real effective exchange rate had been appreciating while real domestic interest rates had been declining, eventually becoming negative in real terms, thereby creating serious domestic and external problems for the countries concerned, the staff representative remarked. In the case of Indonesia, the real exchange rate and real domestic interest rates had also been negatively correlated for some time following the devaluation and financial sector liberalization, as there had been a significant real depreciation of the exchange rate and an increase in real interest rates. He agreed with Mr. Zecchini that in recent months there had been some positive correlation of those factors, with both real interest rates and the real exchange rate rising. However, the econometric evidence was weak, and certainly one would not expect, for example, that a reduction in the real exchange

rate would lead to a reduction in real interest rates, although an acceleration of inflation likely would work in the same direction on both variables.

The real effective exchange rate index was approximately 4 percent higher in November 1984 than in mid-1983, the staff representative stated. The staff hoped that the rate would not continue to appreciate in the comming period, but he sympathized with the authorities, who had encountered a number of operational difficulties in managing the exchange rate. They took a number of factors into account in managing the rate, and those indicators had not suggested that the real effective exchange rate index should be restored to precisely the level of mid-1983. The considerable strengthening of the U.S. dollar since mid-1983 had made it difficult for the authorities to reduce or even maintain the real effective exchange rate. The staff was confident that the authorities would make an appropriate adjustment in the exchange rate when market conditions permitted, but the staff did not believe that the present exchange rate was out of line with balance of payments developments and prospects.

The staff suspected that the authorities' estimates of the overall balance of payments outcome for 1984/85 would prove to be somewhat conservative and that the overall balance of payments surplus would be significantly larger--perhaps by $500-600 million--than the $600 million surplus recorded in the first half of 1984/85, the staff representative remarked. As a result, the balance of payments would still be generating liquidity in the second half of 1984/85. In its report, the staff had expressed its concern that, should the external accounts not generate liquidity toward the end of 1984/85, the interbank market would again be squeezed as a result of the required repayment under the special rediscount facility. There seemed to be some feeling among Executive Directors that the banks that had used that facility might not be able to make the required repayments easily. The authorities could choose to reschedule those obligations, but there was considerable liquidity in the country's money market at present, the balance of payments surplus had continued to be another source, and the authorities were considering new monetary policy instruments to add to liquidity. The Governor of the central bank had recently stated that enough liquidity would be injected into the market to offset the required repayments under the special rediscount facility in March 1985, and the staff saw no reason why that should not be possible.

The authorities would of course wish to carefully consider new short-term monetary policy instruments, and the staff was therefore pleased that they had requested technical assistance in that area, the staff representative said. The financial market had experienced a major reform and restructuring over the previous two years and should not be subjected to major shocks. Still, strengthening the monetary policy instruments and improving the prospects for more effective growth of the money market were clearly desirable. The staff would know more about the prospects for doing so once it had begun providing technical assistance.

The authorities were paying considerable attention to developments in the capital market, the staff representative commented. A World Bank staff mission had visited Indonesia in early 1984 and was preparing broad policy recommendations. The authorities were aware that some of their policies were not consistent with their goal of rapidly broadening and deepening the capital market. For example, at least for the time being, interest paid on time deposits was exempt from income taxes while bond interest earnings were not. In addition, the yield curve was essentially flat. There had been a shift in asset holdings away from one- and two-year deposits and toward six-month deposits. At the same time, in order to meet the demand for long-term investment credit and, in some cases, to encourage such demand, the banks had been lending medium-term funds at rates below those for short-term commercial loans. The staff wondered whether, in those circumstances, there would be adequate incentives for banks to make medium-term investment loans. However, the reform and liberalization of the financial market had been introduced fairly recently and bankers were still adjusting to them; the problems in connection with medium-term investment would probably ease over time.

Much of the investment credits extended by banks in the past--particularly the state banks, which accounted for some 80 percent of total credit--had been refinanced or rediscounted through Bank Indonesia, the staff representative from the Asian Department noted; therefore, the credit extension had not created funding problems for the banks concerned. However, approximately 60 percent of the credits that had previously qualified for refinancing or rediscounting through Bank Indonesia no longer qualified; as a result, a larger proportion of such credits would have to be funded entirely by the banks. That decision had created some uncertainty among bankers, and the authorities had responded by creating a second rediscount facility to give banks the assurance that they could receive temporary assistance if they experienced deposit withdrawals or shifting deposit maturities.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/18 (2/4/85) and EBM/85/19 (2/8/85).

2. APPROVAL OF MINUTES

a. The minutes of Executive Board Meeting 84/99 are approved. (EBD/85/39, 1/29/85)

Adopted February 4, 1985

b. The minutes of Executive Board Meeting 84/100 are approved. (EBD/85/41, 1/31/85)

Adopted February 6, 1985

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/27 (2/1/85), EBAP/85/28 (2/4/85), and EBAP/85/32 (2/5/85) and by Advisors to Executive Directors as set forth in EBAP/85/27 (2/1/85) and EBAP/85/28 is approved.

4. STAFF TRAVEL

Travel by the Deputy Managing Director as set forth in EBAP/85/31 (2/5/85) is approved.

APPROVED: November 1, 1985

LEO VAN HOUTVEN
Secretary