

**FOR
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To: Members of the Executive Board

From: The Secretary

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Indonesia—Assessment Letter for the Asian Infrastructure Investment Bank

April 24, 2020

I. RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

Recent Developments

The Indonesian economy performed well in recent years. Growth was robust at about 5 percent between 2013 and 2019 and inflation was contained. Fiscal deficits were low, and Indonesia's external and public debt are moderate and sustainable. At around US\$121 billion or 111 percent of the IMF's reserve adequacy metric (as of end-March 2020), gross international reserves are deemed adequate. Banks are well-capitalized.

The COVID-19 pandemic and associated financial market pressures are putting significant strain on the economy. With more than 3,200 confirmed COVID-19 cases and 280 deaths as of April 9, 2020, the Indonesian government has adopted various containment measures, including travel bans on foreign nationals, screening at ports of entry, school closures, and other restrictions on public events. As COVID-19 spreads worldwide, external financial conditions have tightened sharply amid exchange rate pressures and capital outflows from emerging markets, including Indonesia. Year-to-date the rupiah depreciated by 14.5 percent vis-à-vis the U.S. dollar, the yield on rupiah-denominated 10-year government bonds increased by 98 bps to 8 percent, equity prices dropped by 26 percent, and portfolio outflows exceeded US\$9 billion. The impact on Indonesia in part reflects its reliance on portfolio inflows to finance the current account and fiscal deficits. Nonresident investors held about 40 percent of local currency government bonds and about a third of nonfinancial corporate debt at end-2019.

Outlook and Risks

The relatively bright outlook for Indonesia's economy at the beginning of the year has dimmed significantly with the drag from the COVID-19 pandemic. Growth is now expected to slow sharply to 0.5 percent in 2020, reflecting supply disruptions from containment measures; weaker consumer and business confidence; reduced net external demand, especially from tourism; and tighter external financial conditions. These are expected to weigh heavily on private consumption and investment during the second quarter of 2020. The slowdown in output growth in 2020 is expected to be temporary, with growth projected to rebound as the economy emerges from the COVID-19 shock, reaching 8.2 percent in 2021. Inflation is expected to remain close to the center of the target band (3 ± 1 percent), as downward price pressures from the slowing economy are expected to offset upward price pressures from supply disruptions. The current account deficit is projected to widen to 3.2 percent of GDP, driven by weaker tourism and lower commodity prices, more than offsetting reduced imports.

Downside risks are large. The uncertainty around the near-term outlook is greater than usual. The main risk is a prolonged COVID-19 outbreak and associated disruptions, which could extend the domestic demand shortfall and weigh on private and public sector balance sheets. Under such a scenario, growth would be materially lower in 2020, mostly driven by a larger contraction in private consumption, and the recovery in 2021 would be delayed. Other risks include persistent capital flow reversals, tighter financial conditions and financing challenges, protracted pandemic-prompted protectionist actions globally that could re-ignite broader international protectionist measures, and commodity prices remaining low for longer than expected. A deterioration in financial institutions' asset quality and funding positions could impair credit flows, further constraining investment and productivity.

II. POLICY FRAMEWORK AND SETTINGS

Fiscal Policy

In response to the COVID-19 pandemic, the government announced major fiscal support, with measures that are appropriately targeted towards strengthening health care and mitigating economic and social hardship. In addition to the first two packages amounting to IDR 33.2 trillion (0.2 percent of GDP), which include tax relief for the tourism and manufacturing sectors, and food aid to low-income households, the government announced a third sizeable stimulus package of IDR 405 trillion (2.6 percent of GDP) on March 31, 2020. The third package includes IDR 255 trillion (1.6 percent of GDP) in additional spending and tax relief, covering (i) support to the health care sector to boost testing and treatment capability for COVID-19 cases; (ii) increased benefits and broader coverage of existing social assistance schemes to low-income households such as food aid, conditional cash transfers, and electricity subsidy; (iii) expanded unemployment benefits, including for workers in the informal sector; (iv) tax relief for individuals (with an income ceiling); and (v) permanent reductions of the corporate income tax rate from 25 percent to 22 percent in 2020–21 and 20 percent starting in 2022. In addition to tax and spending measures, the last stimulus package includes IDR 150 trillion (0.9 percent of GDP) financing for a national economic program, including to support credit guarantees for the private sector. The stimulus packages also include measures to lift restrictions on imports and exports, aiming to ease global supply-chain disruptions caused by the virus. Reflecting mainly revenue shortfall, higher interest payments, and announced tax and spending measures in the stimulus packages, the fiscal deficit would widen from 2.2 percent of GDP in 2019 to 5.0 percent in 2020. Automatic stabilizers are expected to fully operate, amounting to about 0.3 percent of GDP, mostly from the tax side.

Considering the sizeable economic downturn, temporary deviation from the 3 percent fiscal deficit ceiling is appropriate to accommodate needed fiscal support. The authorities announced a temporary suspension of the 3 percent fiscal deficit ceiling for 3 years to accommodate the fiscal stimulus packages and lower fiscal revenues. Making the deviation from the fiscal rule temporary improves its countercyclical properties while preserving the institutional foundation for Indonesia's track record of prudent fiscal policy conduct. Early communication of specific tax policy and spending reduction measures to support the planned return to a 3 percent deficit ceiling by 2023 would further support market confidence. In that context, implementing a medium-term revenue strategy (MTRS), aiming to raise 5 percent of GDP in additional revenue over five years, could help rebuild fiscal buffers and finance permanently higher priority spending in health, education, infrastructure, and social safety nets (see also section on *Macrostructural issues*). A timely unwinding of the emergency fiscal measures post-virus while maintaining overall stimulus would help ensure that the economy reaches potential, taking into account implications for debt sustainability.

Monetary Policy

Faced with the COVID-19 shock, Bank Indonesia (BI) has appropriately eased monetary policy and intervened to maintain orderly market conditions while allowing exchange rate flexibility. BI reduced the policy rate by 25 bps to 4.75 percent on February 20, 2020, and by another 25 bps to 4.5 percent on March 19. BI intervened in the spot and domestic non-deliverable foreign exchange markets, and in the domestic government bond market to maintain orderly market conditions while allowing the exchange rate to depreciate. BI also announced measures to ease liquidity conditions, including: (i) lowering reserve requirement ratios for banks; (ii) increasing the maximum duration for repo and reverse repo operations (up to 12 months); (iii) introducing daily repo auctions; (iv) increasing the frequency of FX swap auctions for 1, 3, 6 and 12-month tenors from three times per week to daily auctions; and (v) increasing the size of the main weekly refinancing operations as needed.

Further monetary policy easing would be appropriate, given the deterioration in the near-term outlook, but its impact on capital outflow risks should be monitored. Against the backdrop of contained inflation risks, the widening of the expected output gap in 2020, and downside risks to the growth outlook, BI could use its policy space for a few additional rate cuts, while closely monitoring the impact on capital inflows, the exchange rate, and bank and corporate balance sheets. If needed, foreign exchange intervention should continue to maintain orderly market conditions, while allowing the exchange rate to move with underlying market forces. Prudent use of reserve buffers could help in preserving a backstop for local U.S. dollar funding liquidity. Clear and focused communication of objectives and policies should remain an integral part of the monetary policy framework.

Financial Sector

While the banking system is sound overall, the weakening outlook calls for close monitoring to prevent an adverse macro-financial feedback loop. The banking system is well capitalized, and profitability is high, with the return on assets at 2.5 percent. System-wide liquidity remains adequate, although some small non-systemic banks are vulnerable to liquidity shocks, including FX liquidity shortfalls. Nonperforming loans (NPLs) reached 2.8 percent in January 2020, up from 2.5 percent in December 2019. The share of problem loans (the sum of NPLs, special mention, and restructured loans) remains high and further increased from 9 percent to 10.5 percent of total loans over the same time horizon, driven by worsened profitability on the back of weaker domestic and external demand. Despite large capital buffers and strong profitability, banks' high exposure to the corporate sector is an important source of risk. While corporate FX regulations has helped nonfinancial corporates to increase the share of hedged FX loans, their elevated foreign-currency debt levels (close to 45 percent of total nonfinancial corporate debt) leaves them exposed to FX volatility.

Financial sector measures to address the credit and funding implications of temporary cash flow constraints would complement fiscal and monetary policies. To ease stock market volatility and facilitate loan restructuring, the Financial Services Authority (OJK) has relaxed share buyback policy by allowing listed companies to repurchase their shares without a prior shareholders' meeting; introduced limits on stock price declines; and relaxed loan classification and restructuring procedures for banks, also allowing banks to extend additional financing to impacted borrowers. Banks' existing capital buffers should be available to meet the financial costs of the restructuring and temporary losses due to deterioration in banks asset quality. However, some small and medium-sized banks could face capital shortfalls if the impact of the outbreak is longer lasting.

Preserving banks' lending capacity and easing liquidity (cash flow) constraints for affected corporates and households will be critical for "keeping the lights on" in this downturn and facilitate a rapid recovery afterwards. To support affected borrowers, a range of targeted measures, implemented in collaboration with the government, could be considered: (i) temporary forbearance; (ii) lending schemes and credit guarantee programs for borrowers in the most affected sectors; and (iii) debt service moratorium/repayment holidays. When implementing such measures, avoiding blanket relaxations of loan classifications and provisioning rules would be paramount. Banks that do not have adequate buffers or capital to fully absorb the losses from the virus outbreak without temporarily breaching regulatory minima, should work closely with OJK for a capital restoration plan to increase their capital back to the required levels. For such measures to work effectively without hampering financial stability, supervision should be intensified, especially for medium and small banks with high liquidity risks and weak balance sheets and for nonbank financial institutions. Efforts to strengthen financial oversight and crisis management frameworks, such as the ELA and resolution frameworks should also continue. The corporate prudential FX regulation should be further improved by extending its coverage to all FX liabilities of systemic corporates, which could reduce enforcement and compliance costs.

Macrostructural Issues

Achieving higher potential growth and harnessing the young and growing labor force will require ambitious reforms, which should be synchronized with the expected economic recovery. The timing of reforms should be carefully considered in light of the economic cycle. For instance, implementing reforms with potential short-term cost to output, such as labor reforms, would be more appropriate when the recovery is well underway. The reform priorities are (i) revenue mobilization to finance increased development spending (infrastructure, health, education, and social safety nets); (ii) financial deepening to lessen reliance on volatile capital inflows and promote financial inclusion; and (iii) streamlining of regulation and improving of labor and product markets. Early implementation of an MTRS that centers on tax policy reforms and improved tax administration is critical. In addition to raising revenue for higher development spending, an MTRS would also help improve business conditions and boost productivity, including by streamlining tax regimes, removing distortions, and improving the efficiency of tax filling and collection.

IMF Relations

Indonesia is on a standard 12-month Article IV consultation cycle. The 2019 Article IV consultation was concluded by the IMF's Executive Board on July 3, 2019.

Table 1. Indonesia: Selected Economic Indicators

Nominal GDP (2019): Rp 15,924 trillion or US\$1,126 billion

Population (2019): 266.9 million

Main exports (percent of total, 2019): coal (12.9), palm oil (8.8), oil and gas (7.5), textile & textile products (7.7)

GDP per capita (2019): US\$4,219

Unemployment rate (2019): 5.28 percent

Poverty headcount ratio at national poverty line (Sep. 2019): 9.22 percent of population

	2016	2017	2018	2019	2020 Proj.	2021 Proj.
Real GDP (percent change)	5.0	5.1	5.2	5.0	0.5	8.2
Domestic demand	4.6	5.0	6.1	4.0	0.5	7.9
<i>Of which:</i>						
Private consumption 1/	5.0	5.0	5.0	5.2	0.5	8.5
Government consumption	-0.1	2.1	4.8	3.2	14.0	-5.1
Gross fixed investment	4.5	6.2	7.9	4.4	-2.0	10.0
Change in stocks 2/	0.2	-0.1	0.4	-0.6	-0.2	0.3
Net exports 2/	0.1	0.3	-1.2	1.4	0.0	0.5
Saving and investment (in percent of GDP)						
Gross investment 3/	33.9	33.7	34.6	33.8	32.7	33.5
Gross national saving	32.0	32.1	31.6	31.1	29.6	30.8
Prices (12-month percent change)						
Consumer prices (end period)	3.0	3.6	3.2	2.6	3.1	3.0
Consumer prices (period average)	3.5	3.8	3.3	2.8	2.9	2.9
Public finances (in percent of GDP)						
General government revenue	14.3	14.1	14.9	14.2	12.4	12.5
General government expenditure	16.8	16.6	16.6	16.4	17.4	16.5
<i>Of which : Energy subsidies</i>	0.9	0.7	1.0	0.9	0.5	0.6
General government balance	-2.5	-2.5	-1.8	-2.2	-5.0	-4.0
Primary balance	-1.0	-0.9	0.0	-0.5	-3.2	-2.2
General government debt	28.0	29.4	30.1	30.4	36.9	37.6
Money and credit (12-month percent change; end of period)						
Rupiah M2	11.7	9.6	5.8	6.8	...	...
Base money	4.6	9.7	-1.5	3.9	...	...
Balance of payments (in billions of U.S. dollars, unless otherwise indicated)						
Current account balance	-17.0	-16.2	-30.6	-30.4	-32.7	-29.5
In percent of GDP	-1.8	-1.6	-2.9	-2.7	-3.2	-2.7
Trade balance	15.3	18.8	-0.2	3.5	0.5	2.8
<i>Of which : Oil and gas (net)</i>	-4.8	-7.3	-11.4	-10.3	-7.9	-10.1
Inward direct investment	3.9	20.6	20.6	23.4	15.9	18.2
Overall balance	12.1	11.6	-7.1	4.9	-13.3	14.7
Terms of trade, percent change (excluding oil)	0.4	1.3	0.4	-3.1	-9.0	1.7
Gross reserves						
In billions of U.S. dollars (end period)	116.4	130.2	120.7	129.2	115.9	130.6
In months of prospective imports of goods and services	7.6	7.1	7.1	9.5	7.8	8.2
As a percent of short-term debt 4/	213	237	201	205	173	176
Total external debt 5/						
In billions of U.S. dollars	320.0	352.5	375.4	404.3	427.4	474.4
In percent of GDP	34.3	34.7	36.0	36.1	41.4	43.2
Exchange rate						
Rupiah per U.S. dollar (period average)	13,306	13,383	14,231	14,140	...	...
Rupiah per U.S. dollar (end of period)	13,473	13,568	14,390	13,866	...	...
Memorandum items:						
Jakarta Stock Exchange (12-month percentage change, composite index)	15.3	20.0	-2.5	1.7	...	...
Oil production (thousands of barrels per day)	820	815	810	805	710	707
Nominal GDP (in trillions of rupiah)	12,402	13,590	14,838	15,834	16,369	18,232

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

1/ Includes NPISH consumption.

2/ Contribution to GDP growth (percentage points).

3/ Includes changes in stocks.

4/ Short-term debt on a remaining maturity basis.

5/ Public and private external debt.