February 2006
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Indonesia: Fourth Post-Program Monitoring Discussions—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Indonesia

In the context of the Fourth Post-Program Monitoring Discussions with Indonesia, the following documents have been released and are included in this package:

- the staff report for the Fourth Post-Program Monitoring Discussions, prepared by a staff team of the IMF, following discussions that ended on December 9, 2005, with the officials of Indonesia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 23, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of February 3, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 6, 2006 discussion of the staff report that completed the review.

- a statement by the Executive Director for Indonesia.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

INDONESIA

Fourth Post-Program Monitoring Discussions

Prepared by the Asia and Pacific Department
(in consultation with other departments)

Approved by Daniel Citrin and Carlo Cottarelli

January 23, 2006

- **A staff team visited Jakarta during December 1-9, 2005, to conduct the fourth Post-Program Monitoring discussions**. The team comprised Daniel Citrin (head), Milan Zavadjil (Assistant Director), Nita Thacker, Ashok Bhundia, Geremia Palomba, Hiroko Oura (all APD), Amine Mati (FAD), and Matthew Jones (PDR). Stephen Schwartz, Senior Resident Representative, Yougesh Khatri, Deputy Resident Representative (outgoing), and Armando Morales, Deputy Resident Representative (incoming) also participated in the mission. Mr. Sukada (Alternate Executive Director) attended the meetings. The mission also liaised with the World Bank, the AsDB and key donors.

- **The mission met** with the previous and new Coordinating Ministers for Economic Affairs, Aburizal Bakrie and Boediono, respectively (a change in the economic team took place on December 7); previous and new Ministers of Finance, Jusuf Anwar and Sri Mulyani Indrawati, respectively; Bank Indonesia Governor Burhanuddin Abdullah, Minister of Trade Mari Pangestu, Minister of Energy Purnomo Yusgiantoro, Minister of State Enterprises Sugiharto, Chairman of the Capital Markets Supervisory Agency Darmin Nasution, other senior officials, parliamentarians, and private sector representatives.

- **Indonesia's extended Fund arrangement expired on December 31, 2003**. As of December 31, 2005, outstanding obligations to the Fund amounted to SDR 5.462 billion (263 percent of quota), and would remain above 100 percent of quota until 2008 (expectations basis).

- **The last Article IV Consultation and third post-program monitoring discussions were concluded with Indonesia on July 18, 2005**.

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Executive Summary

Background

After substantial pressures in August/September, the sharp increases in interest rates and the decision to raise fuel prices helped calm financial markets and revive confidence. However, short-term macroeconomic indicators and near-term prospects deteriorated. Growth slowed to 4½ percent (seasonally adjusted) in the first three quarters of 2005, with poor execution of government spending contributing to the weakness in growth. Inflation ended the year at 17.1 percent, up from 6½ percent in 2004. Looking ahead, growth is expected to remain sluggish in the first half of 2006 and inflation in the double digits through much of the year. Financial sector vulnerabilities have increased in the face of rising interest rates and a slowing economy, but the overall banking sector remains resilient to moderate credit, interest and depreciation risks.

Prospects, Staff Recommendations, and Authorities' Views

Staff recommended the continuation of monetary restraint for the next few months, improvement in budget execution, addressing vulnerabilities at state banks, and accelerating structural reforms. With such a mix, growth should strengthen in the second half of 2006, as inflation and interest rates decline. Furthermore, this will also help to reinforce the medium term outlook to achieve the 6-7 percent growth target, while preserving balance of payments and fiscal sustainability.

- **To meet its end-year inflation target of 7-9 percent, Bank Indonesia (BI) should maintain a tightening bias until inflation shows clear signs of abating.** The current strength of the rupiah and weakening activity will help BI to meet its target, despite quite high minimum wage increases in some regions.
- **Improved budget execution could help cushion the downturn**. Reducing delays in disbursing funds to executing agencies and better project implementation would help offset the expected decline in private consumption.
- **The recent increase in NPLs underscores the need to further strengthen state bank management and credit practices, as well as to deal with their compromised assets in line with international best practices**. Completion of the remaining steps on the financial sector safety net will help to further enhance banking system resilience. Over the medium-term, strategic privatization of state banks should be considered.

The government currently has an excellent opportunity to reinvigorate structural reforms, and thus bolster investor confidence. As regards the tax administration reform proposal currently before parliament, a solution that balances taxpayers rights with the powers of tax collectors needs to be reached as soon as possible, especially in view of the issue's visibility. The intention to formulate a time-bound structural matrix to guide and monitor progress in structural reform is welcome.

I. INTRODUCTION

1. **Despite a challenging first year in office, President Yudhoyono and his government continue to enjoy broad popular support**. They have had to face a number of shocks, including the tragic tsunami, the second Bali bombing, avian flu, and the rise in international oil prices and interest rates. Amongst other things, the President's swift response to natural disasters, the signing of the peace deal with the Free Aceh Movement in August (ending a 30-year conflict in the region), and the President's personal commitment to anti-corruption policies, have helped maintain his public support.

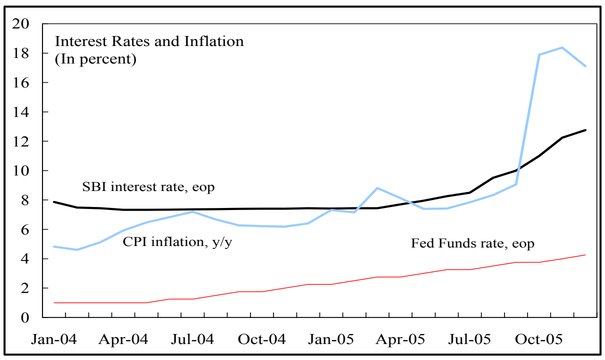
2. **Tsunami related reconstruction is proceeding**. One year after the tsunami, the emphasis has now moved from emergency assistance to reconstruction and rehabilitation of Aceh and Nias. As is often the case after natural disasters, implementation of projects has been slower than expected. The government's reconstruction agency estimates that of the total of US$4.4 billion allocated to specific projects by the government and donors, US$775 million had been disbursed as of November 2005, including by NGOs. The bulk of the funds have gone toward reinstating housing, followed by transport, education and health. In an effort to expedite implementation, the authorities have given the agency the added responsibility of directly executing many of the government reconstruction projects, in addition to its coordinating function.

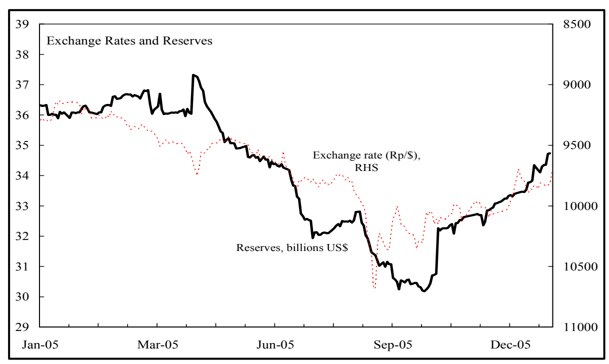
3. **In early December, the President announced a cabinet reshuffle centering on the economic team**. The reshuffle was widely perceived as reflecting the President's dissatisfaction with economic management, following the financial market turbulence of last August/September, and was reported to be aimed at enhancing coordination in economic policy making and implementation. Key changes were the appointment of ex-Finance Minister Boediono (under the Megawati government) as Coordinating Minister for Economic Affairs, Sri Mulyani Indrawati (previously Minister of Planning), as Finance Minister, and Paskah Suzetta (previously Chairman of the Budget Committee in Parliament) as the new Planning Minister. As the new team took office in the midst of the mission, views expressed to the staff regarding policy priorities were preliminary.

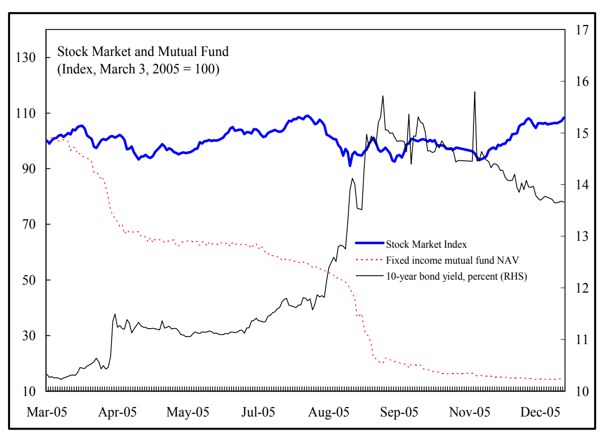
4. **With heightened uncertainty about near-term inflation and growth prospects, the mission focused on the 2006 macroeconomic outlook and the key policy implications**. Decisive actions on interest rates and fuel prices have restored market stability following the turbulence of last August/September, and the cuts in fuel subsidies have enhanced economic efficiency and fiscal and balance of payments sustainability. Nevertheless, near-term costs are evident in terms of both inflation and growth. The challenge now is for the authorities to dampen inflationary expectations through continued monetary restraint while supporting economic activity through better budget execution and an acceleration of structural reforms.

II. Economic Conjuncture and Authorities' Views on Key Issues

5. **Following delays in needed adjustments, strong policy actions have been taken to reestablish credibility**. Financial markets came under pressure in the second quarter of 2005 on concerns about BI's modest response to rising inflationary pressures and higher international interest rates (see Chart). Market pressures intensified in August with the hike in international oil prices causing worries about the sustainability of the budget (because of rising costs of fuel subsidies) and the balance of payments. Despite substantial foreign exchange intervention starting in April, the rupiah hit a four-year low against the dollar in late-August (see Chart). The stock market dipped to below end-2004 levels, and bond yields shot up as investors pulled out of fixed income (government bond) mutual funds (see Chart). To reestablish investor confidence and macroeconomic stability, Bank Indonesia (BI) tightened monetary policy aggressively from late-August—one-month policy rates were increased by a cumulative 425 basis points to 12¾ percent by December (their current level) and reserve requirements on banks were raised. In addition, the government raised domestic fuel prices sharply in October (Box 1). Once these measures were implemented, financial markets stabilized quickly, with the rupiah appreciating quite significantly. Equity markets have recently reached record levels and bond yields have declined.







6. **Mission discussions are reported below:**

Growth

- **Developments to date:** Growth momentum since the beginning of 2005 has moderated with seasonally adjusted data (annualized quarter-on-quarter) showing a slowdown to the 4½ percent range in the first three quarters of last year. The slowing reflects a confluence of several

Box 1. Fuel Subsidies in Indonesia

After no adjustment since 2002, domestic fuel prices were increased substantially in March and October 2005. The October increases were especially sharp, with gasoline prices raised by 88 percent, diesel by 105 percent and kerosene by 186 percent. As a result, average domestic fuel prices reached about 75 percent of the international level. This resulted in budgetary savings of about 0.5 percent of GDP in 2005 and an estimated 2.5 percent of GDP in 2006.

Percent increase in domestic fuel retail prices

Fuel type	Consumption use	Mar.05 1/	Aug.05 1/ 2/	Oct.05 1/	Oct. price in percent of international price 3/
Gasoline	Premium (17.4 %)	33	0	88	72
Kerosene	Household (10%)	0	0	186	31
	Industry (2 %)	22	150	17	100
Automotive Diesel	Transportation (14.5 %)	27	0	105	72
	Industry (16.5 %)	33	149	9	100
Industrial Diesel	Transportation (0.6 %)	39	128	10	100
Fuel Oil	Transportation (5.1%)	31	46	21	100
Weighted average fuel price 4/		29	51	48	75

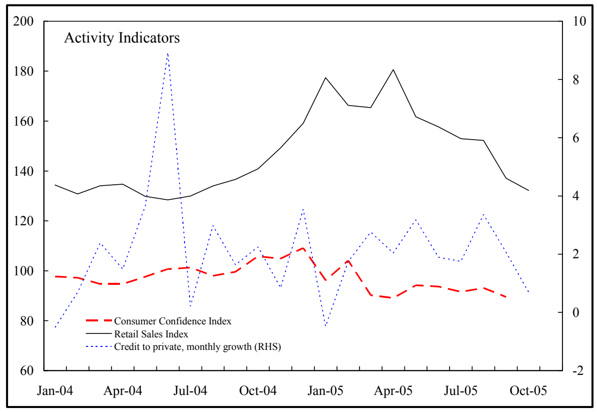
1/ Increases in March are with respect to previous month, those in August are with respect to. end March prices and October ones are with respect of end-August.
2/ Pertamina brought fuel prices for industry to market levels during July and August.
3/ Calculated using industry October prices as market prices.
4/ Using consumption shares of each type of fuel. Total annual consumption was projected at 66.2 million kl for 2005.

A substantial compensation package, coupled with the realization that the subsidies were poorly targeted and fiscally very burdensome, helped limit protests. Budgetary savings from the fuel price increase were set aside to finance an unprecedented cash transfer program to 15.5 million poor families, equivalent to some 60 million people (about one-fourth of the population). Under the program, each family receives Rp. 300,000 per quarter, with the annual program expected to last until November 2006 and cost about Rp. 20 trillion (0.6 percent of GDP). About 70 percent of the first quarterly tranche was already disbursed by end-October with beneficiary cards and receipt coupons printed and delivered by the post-office. An additional "incentive package"(costing about 0.25 percent of GDP) was announced for other groups including: (i) a 10 percent increase in the personal income tax threshold; (ii) a reduction in tariffs on sugar and public transport; and (iii) VAT exemption of agricultural products.

Fuel subsidies for 2005 are estimated at 3.7 percent of GDP, and projected to fall to 1.7 percent of GDP in 2006. The authorities have also announced that they intend to adjust fuel prices further so as to eliminate all fuel subsidies over time. In this context, introducing an automatic adjustment mechanism could help to eliminate uncertainty and increase the transparency of how prices evolve in line with the movement in international oil prices.

factors, amongst others: (i) following the surge in the second half of 2004, investment decelerated reflecting higher interest rates; (ii) under-execution of government spending; and (iii) negative market sentiment during the summer affected activity in the third quarter.

- **Outlook**: Activity in the fourth quarter of 2005 and prospects for the first half of 2006 were further undermined by the short-term fallout of the fuel price increase on production costs and purchasing power, and the recent Bali bombings which have resulted in a sharp downturn in tourist arrivals. Government plans to expedite budget execution in early 2006 and the recent recovery in market sentiment are likely to partially offset this weakening. Thus, activity is expected to gradually strengthen over the course of 2006 as inflation and interest rates come down and the near-term impact of the fuel price increase wears off (see below). All in all, in the staff's view, while growth in the 5 percent range in 2006 is still possible, risks are biased downwards. Indeed, the most likely outcome would appear to be 4½-5 percent growth, even with a strong rebound in the second half of 2006 (Table 1).[1]

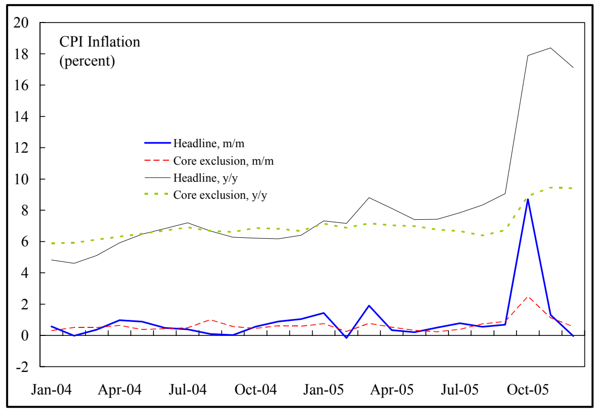


- **Authorities' Views**: The authorities agreed that growth was slowing. However, they were optimistic that increased central and regional government spending in early 2006 (see below) would help offset weaknesses in private consumption, so that the slowdown would be less marked than projected by the staff. They believed that growth in the 5½-6 percent range would still be achievable in 2006 (as compared with the original budget assumption of 6.2 percent).

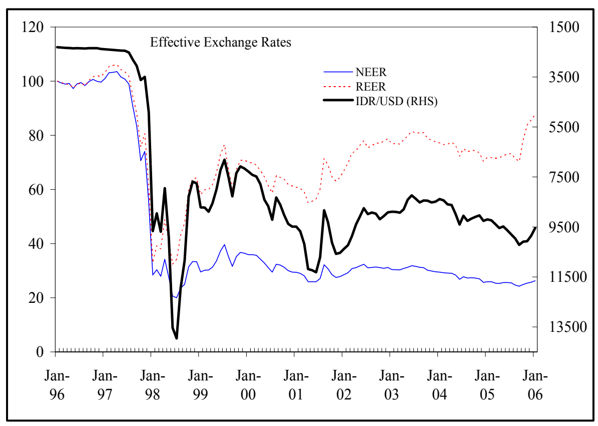
[1] The most recent consensus forecasts project an average growth of 5 percent this year, and range from 4 percent to 6.2 percent.

Inflation, Monetary Policy and the Exchange Rate

- **Developments to date:** Headline inflation ended 2005 at 17.1 percent, up from 6.4 percent in 2004, reflecting largely the adjustment in fuel prices during the year. At the same time, core inflation, which had been trending up since late 2004 ended 2005 at 9½ percent, up from 6 percent a year earlier. However, month-on-month inflation has moderated with both headline and core inflation down in December, reflecting a reversal of earlier overshooting in food prices and the weakening indirect effects of the fuel price increase. The rupiah has also appreciated in real and nominal effective terms in recent weeks, suggesting that BI's decisive action on interest rates has helped to reestablish it's credibility.



- **Outlook**: Headline inflation is likely to remain high on a year-on-year basis for the next several months, until the base effects fall out. Some further increase in interest rates may be necessary if there is a further uptick in underlying inflation or if it does not come down in the next few months. But assuming that BI maintains an appropriately restrained monetary policy, both headline and core inflation should begin to moderate in view of the weakness in activity, recently positive real interest rates and the current appreciation trend in the rupiah, despite quite high minimum wage increases in some areas.[2] In addition, it seems that the



[2] The minimum wage in the critical Jakarta area was raised by 15 percent. In other regions, the minimum wage increases range from a low of 9.7 percent in West Java, to 32 percent in Aceh (with most falling in the 15–20 percent range). Minimum wage increases are determined on the basis of tripartite discussions between trade unions, employers, and regional governments.

second round effects of the fuel price increase have been contained so far by the monetary policy response. Such a moderation could allow BI to begin to lower interest rates in the second half of the year. With the real effective exchange rate still some 10-20 percent below its pre-crisis level, external competitiveness should not yet be a concern with the rupiah in its current range (see Chart).[3]

- **Authorities' views**: To achieve its' end-year inflation target of 7-9 percent, BI is committed to a restrained monetary policy. BI agreed that a clear communication of it's policy intentions and decisions on the one-month interest rate following regular Board meetings could help to contain inflation expectations. BI also plans to further develop and monitor forward looking indicators of inflation to help guide monetary policy in the context of its inflation targeting framework.[4] In this context, BI also remains committed to maintaining a flexible exchange rate system.

Fiscal Policy

- **Developments to date:** The introduction of new budget procedures for disbursing funds to executing agencies, slow project implementation, and the late adoption of the revised 2005 budget resulted in significant delays in spending, including spending for Aceh reconstruction. At the same time, the large increase in domestic fuel prices helped limit fuel subsidies to 3.7 percent of GDP and thus contain expenditures. As a result, based on data through November, the 2005 overall fiscal deficit was estimated

Summary of Central Government Operations, 2004–2006

	2004	2005		2006	
	Prel. Act.	Second Revised Budget	Staff projections	Adopted Budget	Staff projections
	(In percent of GDP)				
Revenues and grants	17.7	20.4	18.8	20.6	19.5
Oil and gas revenues	4.7	6.6	5.5	6.0	5.8
Non-oil and gas revenues	13.0	13.5	13.2	14.4	13.6
Grants	0.0	0.3	0.1	0.1	0.1
Expenditure and net lending	19.1	21.7	19.4	21.3	20.5
Current expenditure	10.6	12.7	11.6	10.9	10.4
Fuel subsidies	3.0	3.4	3.7	1.8	1.7
Development expenditure	2.7	3.2	2.1	3.2	2.8
Transfers to regions	5.6	5.8	5.6	7.2	7.0
Carry-over spending	...	...	...	...	0.3
Overall balance	-1.4	-1.3	-0.6	-0.7	-1.0

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

[3] See Indonesia: IMF Country Report 05/327 http://www.imf.org/external/pubs/ft/scr/2005/cr05327.pdf

[4] MFD is providing technical assistance on this issue as well as in other areas, including monetary operations and bank supervision.

to amount to about 0.6 percent of GDP, significantly below the budget limit (see also Table 2).[5]

- **Outlook:** For 2006, the authorities are targeting an overall budget deficit of 1 percent of GDP, including 0.3 percent of GDP in expenditures carried over from 2005. Although higher than parliament's approved deficit target, such an outcome would still lead to a significant decline in the public debt ratio. If growth were to slow significantly below 5 percent, consideration could be given to a further modest increase in the deficit to allow automatic stabilizers to work, given the strong medium-term outlook. However, the feasibility of this will depend on the financing outlook and the strength of market confidence.[6] It should also be noted that in addition there are some risks to achieving the budget target linked to the interest bill, progress in improving tax administration, and successfully capping subsidies, which will require increases in electricity and possibly fuel prices.

Central Government Financing

	2004	2005		2006	
	Act.	Rev. budget	Proj.	Budget	Proj.
	(In percent of GDP)				
Financing	1.4	1.3	0.6	0.7	1.0
Domestic financing	2.0	0.8	-0.4	1.3	1.5
Bank	1.2	0.2	-0.2	0.8	1.0
Nonbank	0.8	0.3	0.2	0.1	0.1
Net bonds issuance 1/	-0.1	0.4	-0.2	0.5	0.5
Others 2/	0.0	-0.2	-0.2	0.0	0.0
External financing	-0.6	0.5	1.0	-0.6	-0.5
Gross drawings	1.4	1.7	1.9	1.5	1.4
Net amortization	-2.0	-1.1	-0.9	-2.1	-1.9
Financing gap	0.0	0.0	0.0	0.0	0.0

Sources: Data provided by the Indonesian authorities; and Fund staff estimates.
1/ Rp 10 trillion amortization amount for the SU bonds is not included in 2006.
2/ This includes recapitalization of the deposit insurance company

- **Authorities' views**: The authorities intend to front-load the spending of the authorized carryover amounts from 2005 and to improve budget procedures to provide fiscal stimulus early in 2006. They did not consider it necessary to plan any additional stimulus at this juncture, particularly in view of the already large financing needs and the desirability of avoiding further pressures on domestic interest rates. In this context, the authorities are planning to issue sovereign bonds to meet part of the financing requirement for 2006.

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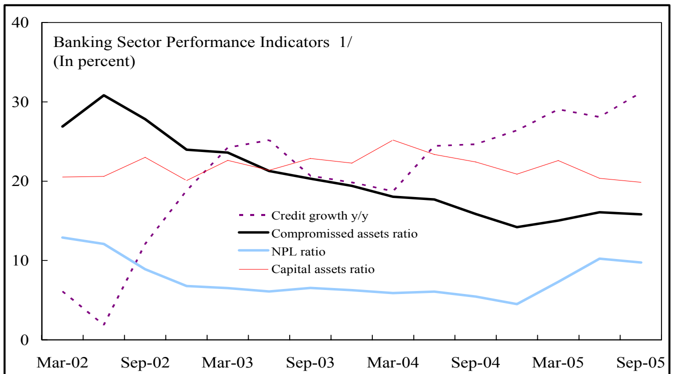
[5] Preliminary data provided more recently by the authorities suggests that the deficit could be somewhat higher because of delays in the transfer of oil company profits to the government.

[6] Large external amortizations are due in 2006.

- ***Banking***

  - **Developments to date**: After a year of high profits in 2004, which helped improve banks' capital positions, banking sector performance deteriorated in 2005, especially at state banks (Table 6). Nonperforming loans (NPLs) at state banks rose three-fold to 15.1 percent at end-September. Although over 70 percent of this increase is estimated by BI to reflect tighter nonperforming loans (NPL) classification rules, there was some deterioration in the quality of the loan portfolio at these banks. With respect to the financial sector safety net, recent steps include the establishment of the deposit insurance agency with an initial capital of Rp 4 trillion (about $0.4 billion) and completion of the initial phase of withdrawal of the full deposit guarantee (interbank funds are no longer covered). Also, a new emergency lending facility has been put in place.



1/ Using revised series.

Banking Indicators, 2003-05

	2003		2004		2005 2/	
	Private Banks	State Banks	Private Banks	State Banks	Private Banks	State Banks
Capital adequacy ratio	22.4	22.2	21.2	20.6	20.6	19.2
Loan growth (q/q)	24.6	17.8	28.6	24.4	35.9	23.6
Equity/assets	9.5	8.1	10.0	10.1	10.2	6.4
Core earnings/ average assets	2.6	2.4	2.9	3.3	2.8	2.9
NPLs/total loans	5.2	7.0	3.1	5.5	3.4	15.1
Compromised assets/total loans 1/	11.5	25.4	7.2	19.6	6.9	23.4
Net compromised assets/Tier 1 capital	19.8	89.0	17.2	62.3	27.0	84.7
Loan-loss reserves/compromised assets	66.8	35.3	54.6	39.8	44.6	38.3
Liquid assets/total assets	25.8	11.1	20.5	11.1	13.1	10.8

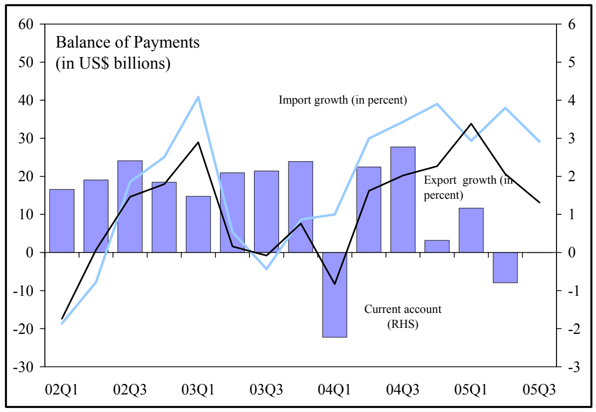
1/ Compromised assets includes NPLs, restructured loans, and foreclosed real estate and equities.
2/ Based on preliminary data of the top 15 banks as of September 2005

  - **Issues:** Vulnerabilities have increased as a result of rising interest rates and a slowing economy. Nevertheless, stress tests suggest that the overall banking sector remains resilient to moderate credit, interest and depreciation risks. However, asset quality at the largest state banks remains weak. In this context, Bank Mandiri is making efforts to clean its balance sheet by transferring some of the NPLs to the State Receivable Agency and through efforts to set up an asset management company (AMC) (with private capital) to further expedite resolution of NPLs. However, the inability of state banks to take haircuts on their NPLs–according to current legal requirements NPLs transferred to third parties must be compensated by full payment at face value–has limited the speed at which these NPLs can be resolved.

- **Authorities' views**: The authorities acknowledged the risks stemming from higher interest rates and said that the key to strengthening the financial sector will be addressing NPLs and weak risk-management and governance at state banks. To this end, BI has intensified supervision of these banks. While the authorities agreed in principle that allowing state banks to take haircuts could expedite NPL resolution, they also indicated that this requires changing legislation. On the financial sector safety net, the authorities intend to expedite submission to parliament of the financial sector safety net law (this has been pending for more than a year).

- ***External Sector***

- **Developments to date:** Data for the third quarter indicate that the current account surplus has narrowed, largely reflecting the surge in oil imports (see Chart and Table 3). However, with the domestic fuel price increase in October, oil import volumes declined by 7½ percent in November compared with the previous month. Capital inflows, which declined sharply during the summer, have resumed with improved investor sentiment.



- **Outlook**: After narrowing in 2005, the current account is expected to stay in surplus next year as imports continue to slow because of weakening economic activity and as the negative impact of the Bali bombing on the tourist industry wanes. Capital inflows are expected to remain strong as investor confidence returns. Under a strong policy scenario, the current account should move into a deficit over the medium-term as strong domestic growth leads to higher imports. Consistent macroeconomic management and an acceleration of structural reforms could attract capital inflows to finance this deficit (Table 7).[7] The capacity to repay the Fund remains strong with debt service to the Fund amounting to some 2 percent (peaking in 2008, and falling below 1 percent after that) in relation to exports of goods and services (Table 8).

[7] The assessment of medium-term prospects remains broadly unchanged from EBS/05/94. A more comprehensive reassessment of the medium-term prospects will be done at the next Article IV consultation scheduled for mid-year (Table 5).

Reforms to improve the investment climate

- **Tax reforms**

    - **Progress to date and issues**: A tax reform package was submitted to Parliament in September. However, implementation has been delayed, likely to 2007, as some key issues, most notably on the balance between tax payer rights and powers granted to tax collectors, are in dispute (Box 2 for further details).

    - **Authorities views**: They are mindful of the concerns raised by the business community, as well as of the need to strengthen tax collection. The new economic team will reassess the proposals before deciding how to proceed (in particular, whether to pull the draft back from Parliament, or allow debate to proceed). Even more importantly, the authorities stressed that they intend to focus on strengthening governance at the tax office and customs—to improve business confidence in the tax system. The Fund will continue to provide technical assistance in these areas, as requested.

- **Other structural reforms**

    - **Progress to date and issues**: The government has made some encouraging initial progress in combating corruption. However, on most other fronts, progress has been slower than expected (Tables 9 and 10). While the government remains strongly committed to structural reforms, the complex nature of the governing coalition, bureaucratic resistance, and a lack of coordination have acted as constraints.

    - **Authorities' views and outlook**: The authorities agreed that accelerating structural reforms is key to attracting much-needed investment and generating employment. They intend to give high priority to reforms on tax and labor issues, and are considering formulating a time-bound schedule for all sectors with clear lines of responsibility to ensure that progress is made.

Box 2. Tax Package

Following an extensive consultation process, revisions to the income tax and VAT law, as well as to the Law on General Provisions and Procedures for Taxation, were submitted to Parliament last August. However, the package faces strong opposition from the business community and it is not clear that it will be approved. The mission discussed the current draft with government officials and parliamentarians and repeated some prior technical assistance recommendations in this area:

- The introduction of a single corporate income tax and a reduction in corporate and income tax rates to 25 and 30 percent respectively simplifies the income tax structure, but is expected to result in an annual revenue loss of about 0.5 percent of GDP. Recommended measures to maintain the package revenue neutral include: (i) taxing fringe benefits; (ii) raising the lower Personal Income Tax bracket rate (5 percent) to comparable levels in neighbor countries (10 percent); and (iii) removing VAT exemptions.

- Some of the current tax administration shortcomings are remedied in the current proposal by: (i) introducing electronic submission of tax returns; (ii) allowing some refunds without a priori audit; and (iii) requiring tax officers to comply with a code of ethics. However, the business community remains concerned about additional powers being granted to the tax agency, such as: (i) access to taxpayer bank information; (ii) authority to block/seize bank accounts; (iii) the power to arrest and detain a person; and (iv) the requirement of full settlement of a tax obligation before completion of the appeals process. While the last two provisions are unusual by international standards, the others represent good practice. Nevertheless, the protection of taxpayers' rights could be further strengthened by: (i) allowing the Tax Department access to bank information only in the case of a bona fide audit and subjecting it to judicial review; and (ii) requiring that staff of the Directorate General of Taxes (DGT) report instances of misconduct to the Inspectorate General and establishing sanctions for failure to do so.

III. Staff Appraisal

7. **After some delay, the authorities dealt forcefully with the main causes of financial market volatility in August/September**. However, they are now having to address the short-term consequences of the sharp policy adjustments—substantially higher than projected inflation and slowing growth—in spite of a strong medium-term outlook. The lesson from this episode of financial market volatility is that market confidence can be fragile, and that prompt policy responses are required to changes in the economic environment to avoid more painful adjustments at a later stage.

8. **With year-on-year inflation still at 17 percent, BI should maintain a tightening bias until inflation shows clear signs of abating**. That is, it should monitor price and other inflation indicators carefully and be ready to raise interest rates if there are signs that inflation is not coming down. Once inflation pressures ebb in the months ahead, interest rates could begin to be reduced. In this context, clear communication of BI's policy stance to markets will enhance the effectiveness of monetary policy.

9. **Given the current weakening of economic activity and pressing spending needs on infrastructure and the social sectors, staff supports the somewhat higher fiscal deficit for 2006**. In fact, in the event of a stronger than projected slowdown, a further modest increase in the deficit reflecting the working of the automatic stabilizers would still be consistent with medium-term fiscal sustainability, although use of this option would ultimately have to depend on the availability of financing and the strength of market confidence. That said, there are some risks to the fiscal outlook but the recent track record in meeting fiscal targets suggests they can be managed. With respect to energy prices, one lesson from the past is that timely adjustments are essential to avoid sharp—but ultimately necessary—realignments later on that are both costly and disruptive.

10. **In the financial system, while banks capital positions are strong, downside risks have increased due to recent interest rate hikes**. The recent increase in NPLs at state banks underscores the need to further strengthen oversight of state bank management and credit practices. In this context, while staff supports Bank Mandiri's efforts to form an AMC to restructure its NPLs, this should be done transparently and in line with international best practices. An even better solution to the problem of state bank NPLs would be to modify legislation to allow them to take haircuts. Over the medium-term, strategic privatization of state banks should be considered. Completion of the remaining steps on the financial sector safety net will help to further enhance banking system resilience.

11. **The government's continued popularity and recent enthusiasm in the market for the new economic team provide an excellent opportunity to reinvigorate structural reforms**. This would help to bolster investor confidence and cushion the economic downturn. In terms of priorities, the staff supports indications of the new

team's emphasis on tax and labor reform, as well as infrastructure development, while noting also the importance of resolving investor disputes, and enhancing legal certainty. With regard to the much-disputed tax administration reform proposal currently before parliament, it will be crucial to reach closure as soon as possible in view of the visibility of the issue, while balancing taxpayer rights and the powers of tax collectors. Staff welcomes government's plans to formulate a time-bound structural matrix to guide and monitor progress in structural reform.

12. **In sum, staff believe that despite the current weakening of macroeconomic indicators, Indonesia continues to have strong medium-term prospects, assuming policy slippages of the type that occurred in 2005 are avoided**. The continuation of monetary restraint until inflation shows clear signs of coming down, better budget execution, and the acceleration of structural reforms should see Indonesia through the current soft patch. Such an approach would alleviate risks of populist pressures and the temptation of quick-fix remedies which could possibly boost short-term growth, but undermine the medium-term outlook.

Table 1. Indonesia: Selected Economic Indicators, 2002–06

	2002	2003	2004	2005	2006
		Act		Proj.	Proj.
Real GDP (percent change)	4.4	4.9	5.1	5.3	4½-5
Domestic demand	2.4	2.4	10.3	5.3	4.4
Of which:					
Private consumption	3.8	3.9	4.9	3.5	2.5
Gross fixed investment	4.7	1.0	15.7	11.2	6.2
Change in stocks 1/	-2.0	-1.2	2.8	0.0	0.1
Net exports 1/	0.8	2.3	-3.6	-0.9	0.6
Statistical discrepancy 1/	1.4	0.4	-0.4	1.4	-0.1
Saving and investment (in percent of GDP)					
Gross investment 2/	21.3	19.4	24.1	25.2	25.5
Gross national saving	25.2	22.8	25.3	25.4	26.0
Foreign saving	-3.9	-3.4	-1.2	-0.2	-0.5
Prices (12-month percent change)					
Consumer prices (end period)	10.0	5.2	6.4	17.1	8.0
Consumer prices (period average)	11.9	6.8	6.1	10.4	14.5
Public finances (in percent of GDP)					
Central government revenue	16.1	16.4	17.7	18.8	19.5
Central government expenditure	17.6	18.4	19.1	19.4	20.5
Central government balance 3/	-1.5	-1.9	-1.4	-0.6	-1.0
Primary balance	3.3	1.6	1.3	1.9	1.5
Central government debt	63.9	57.4	54.8	47.8	41.0
Money and credit (12-month percent change; end of period)					
Rupiah M2	7.9	9.8	10.0	15.0	15.8
Base money	8.3	19.1	21.1	20.2	17.1
Private sector credit	25.1	22.1	30.4	26.7	15.1
One-month SBI rate (period average)	14.9	10.0	7.4	9.0	12.5
Balance of Payments (in billions of US$)					
Oil and gas (net)	6.2	7.4	6.5	4.9	5.4
Non-oil exports (f.o.b)	46.3	48.9	54.5	65.7	71.2
Non-oil imports (f.o.b)	-29.0	-31.7	-39.5	-48.4	-51.4
Current account balance	7.8	8.1	3.1	0.6	1.4
Foreign direct investment	0.1	-0.6	1.0	2.3	3.8
Gross reserves					
In billions of US dollars (end period)	32.0	36.3	36.3	34.7	36.7
In months of imports	6.8	5.5	4.6	4.1	4.1
As a percent of short-term debt 4/	130.8	155.5	200.4	150.1	154.9
Total external debt					
In billions of US dollars	131.3	135.4	137.5	132.8	131.0
In percent of GDP	65.7	56.8	53.3	48.2	41.6
Exchange rate (period average)					
Rupiah per US$	9,314	8,575	8,933	9,705	...
Nominal effective exchange rate (Jan. 2000=100)	86.0	85.6	77.6	...	...
Memorandum items:					
Oil production (000bcpd)	1,260	1,200	1,040	1,010	1,010
Indonesian oil price (US$/bbl)	24.1	28.8	37.8	50.8	57.5
Nominal GDP (in trillions of Rupiah)	1,863	2,046	2,303	2,679	3,205
Nominal GDP (in billions of US$)	200	239	258	276	315

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

1/ Contribution to GDP growth (percentage points).

2/ Includes changes in stocks.

3/ Based on Fund definition.

4/ Short-term debt on a remaining maturity basis, before rescheduling, and including IMF repurchases.

Table 2. Indonesia: Summary of Central Government Operations, 2004–06

	2004	2005		2006	
	Act.	Revised Budget	December Projections	Adopted Budget	Staff Projections
			(In trillions of rupiah)		
Revenues and grants	407.8	540.2	503.0	625.2	624.8
Oil and gas revenues	108.2	175.8	148.1	183.8	186.3
Non-oil and gas revenues	299.3	356.9	352.9	437.9	434.7
Tax revenues	257.9	314.8	309.7	378.8	378.7
Nontax revenues 1/	41.4	42.1	43.2	59.1	56.1
Grants	0.3	7.5	2.0	3.6	3.7
Expenditure and net lending	439.4	575.0	518.3	647.7	658.2
Central government expenditure	309.7	421.6	367.0	427.6	424.4
Current expenditure	245.0	336.9	312.0	331.0	333.5
of which Personnel	54.2	61.1	59.7	77.8	77.8
of which Subsidies	85.5	119.1	128.5	79.5	79.5
of which Fuel Subsidies	69.0	89.2	99.0	54.3	54.3
of which Interest	62.3	71.0	65.1	76.6	80.1
External 2/	22.8	28.7	23.1	28.0	24.4
Domestic	39.6	42.3	42.0	48.6	55.7
Development expenditure 3/	61.7	84.7	55.1	96.6	90.9
Transfers to regions	129.7	153.4	151.3	220.1	222.8
Carry-over spending 4/	...	...	...	...	11.0
Overall balance	-31.6	-34.8	-15.3	-22.4	-33.4
Financing Gap	0.0	0.0	0.0	0.0	0.0
Financing	31.6	34.8	15.3	22.4	33.4
Domestic	46.0	20.4	-10.5	40.6	49.1
External	-14.4	14.4	25.8	-18.2	-15.7
			(In percent of GDP)		
Revenues and grants	17.7	20.4	18.8	20.6	19.5
Oil and gas revenues	4.7	6.6	5.5	6.0	5.8
Non-oil and gas revenues	13.0	13.5	13.2	14.4	13.6
Tax revenues	11.2	11.9	11.6	12.5	11.8
Nontax revenues 1/	1.8	1.6	1.6	1.9	1.7
Grants	0.0	0.3	0.1	0.1	0.1
Expenditure and net lending	19.1	21.7	19.4	21.3	20.5
Central government expenditure	13.4	15.9	13.7	14.1	13.2
Current expenditure	10.6	12.7	11.6	10.9	10.4
of which Personnel	2.4	2.3	2.2	2.6	2.4
of which Subsidies	3.7	4.5	4.8	2.6	2.5
of which Fuel Subsidies	3.0	3.4	3.7	1.8	1.7
of which Interest	2.7	2.7	2.4	2.5	2.5
Other	1.9	3.2	2.2	3.2	3.0
Development expenditure 3/	2.7	3.2	2.1	3.2	2.8
Transfers to regions	5.6	5.8	5.6	7.2	7.0
Carry-over spending 4/	...	...	...	...	0.3
Overall balance 5/	-1.4	-1.3	-0.6	-0.7	-1.0
Financing	1.4	1.3	0.6	0.7	1.0
Domestic	2.0	0.8	-0.4	1.3	1.5
External	-0.6	0.5	1.0	-0.6	-0.5
Memorandum items:					
Primary balance	1.3	1.4	1.9	1.8	1.5
Indonesian oil price (US $ per barrel)	37.8	54.0	50.8	57.0	57.5
Oil production (mbpd)	1.040	1.075	1.010	1.050	1.010
GDP growth rate	5.1	6.0	5.3	6.2	4.5
Exchange rate (Rupiah per US$)	8,933	9,800	...	9,900	...
GDP (in trillions of rupiah)	2,303	2,649	2,679	3,041	3,205

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

1/ From 2004 onwards, deposit insurance premia are treated as nontax revenues.
2/ Interest on a due basis (Paris Club moratoria is shown as a financing item)
3/ In 2005, comprises capital spending and social assistance spending.
4/ These will mostly be projects already started by November 22nd and carried over to the 2006 budget.
5/ Based on Fund definition.

Table 3. Indonesia: Balance of Payments, 2002-06
(In billions of U.S. dollars)

	2002	2003	2004	2005 Proj.	2006 Proj.
I. Current Account	7.8	8.1	3.1	0.6	1.4
A. Goods, Net (Trade Balance)	23.5	24.6	21.5	22.3	25.1
1. Exports, f.o.b.	59.2	64.1	72.2	86.7	94.0
Of which: Oil and Gas	12.9	15.2	17.7	21.0	22.8
Non-oil and Gas	46.3	48.9	54.5	65.7	71.2
2. Imports, f.o.b.	-35.7	-39.5	-50.6	-64.4	-68.8
Of which: Oil and Gas	-6.7	-7.8	-11.2	-16.0	-17.4
Non-oil and Gas	-29.0	-31.7	-39.5	-48.4	-51.4
B. Services, Net	-9.9	-11.7	-10.9	-13.2	-15.3
C. Income, Net	-7.0	-6.2	-8.7	-9.7	-10.3
D. Current Transfers, Net	1.3	1.5	1.1	1.3	1.9
II. Capital and Financial Account	-1.1	-0.9	3.3	3.9	1.8
A. Capital Account	0.0	0.0	0.0	0.0	0.0
B. Financial Account	-1.1	-0.9	3.3	3.9	1.8
1. Direct Investment, net	0.1	-0.6	1.0	2.3	3.8
Equity Capital	2.6	1.5	1.3	1.9	3.0
Others	-2.4	-2.1	-0.2	0.4	0.8
2. Portfolio Investment, net	1.2	2.3	3.2	3.1	3.2
Equity Securities	0.9	1.1	2.0	2.3	2.0
Debt Securities	0.3	1.1	1.1	0.8	1.2
3. Other Investment	-2.5	-2.6	-0.9	-1.5	-5.2
Non-financial Public Sector	-3.8	-3.9	-1.9	-1.2	-2.5
Banking Sector	0.8	2.7	4.6	0.3	0.8
Other	0.6	-1.4	-3.6	-0.5	-3.5
III. Total (I+II)	6.7	7.2	6.4	4.5	3.2
IV. Errors and Omissions	-1.7	-3.5	-5.4	-4.9	0.0
V. Overall Balance (III+IV)	5.0	3.7	1.0	-0.5	3.2
VI. Reserves and Related Items	-5.0	-3.7	-1.0	0.5	-3.2
Changes in Reserve Assets	-4.0	-4.3	0.0	1.6	-2.0
Use of Fund Credit and Loans	-1.0	0.6	-1.0	-1.1	-1.3
Purchases	1.4	2.0	0.0	0.0	0.0
Repurchases	-2.4	-1.4	-1.0	-1.1	-1.3
Memorandum items:					
Reserve Assets Position (end-of-period)	32.0	36.3	36.3	34.7	36.7
in months of imports of goods and services	6.8	5.5	4.6	4.1	4.1
in percent of short-term debt	130.8	155.5	200.4	150.1	154.9
Current account (percent of GDP)	3.9	3.4	1.2	0.2	0.5
Non-oil and gas exports, volume growth	0.9	-6.7	0.3	14.4	7.0
Non-oil and gas imports, volume growth	-2.1	-3.4	10.8	16.4	9.0
Terms of trade, percent change (excluding oil)	0.2	-0.1	-0.9	0.1	-2.7
Non-fin public sector debt service (percent of exports)	18.0	15.0	10.9	10.0	10.2

Sources: Bank Indonesia, Fund staff estimates.

Table 4. Indonesia: Monetary Survey, December 2003 to December 2005
(In trillions of rupiah, unless otherwise indicated, end of period) 1/

	2003	2004	2005			
	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.
Monetary Survey		Act.	Act.	Act.	Act.	Proj.
Net foreign assets	218.3	193.1	188.2	179.9	184.3	207.3
(in USD billions)	31.2	27.6	26.9	25.7	26.3	29.6
Net domestic assets	713.8	807.0	796.1	851.2	904.7	943.2
Net claims on government	482.0	498.1	461.1	474.1	499.5	486.7
Claims on business sector	450.6	587.6	609.3	652.3	696.3	744.4
Rupiah claims	370.9	501.1	521.9	563.3	607.8	657.9
Foreign exchange claims	79.7	86.4	87.3	89.1	88.4	86.4
Other items (net)	-218.8	-278.6	-274.3	-275.2	-291.0	-287.9
Broad money (M2)	932.2	1000.2	984.2	1031.1	1089.1	1150.5
Rupiah M2	816.5	897.9	881.0	922.6	958.4	1032.9
Currency in circulation	94.5	109.3	98.6	106.1	115.0	126.1
Deposits	722.0	788.7	782.5	816.5	843.5	906.8
Foreign exchange deposits	115.6	102.2	103.2	108.5	130.6	117.6
Bank of Indonesia						
Net international reserves	169.4	170.8	173.3	163.8	141.5	188.0
Net domestic assets 2/ 3/	-4.7	28.6	11.5	35.9	78.1	51.8
Net claims on government	175.4	225.7	191.2	203.1	219.6	219.2
Claims on business sector	8.5	39.6	39.0	39.7	39.7	39.6
Claims on DMBs	-91.1	-101.6	-87.9	-72.5	-19.4	-72.0
Open market operations	-136.5	-144.5	-130.8	-115.1	-61.9	-129.5
Other items (net)	-97.5	-135.0	-130.8	-134.4	-161.7	-135.0
Base money	164.7	199.4	184.8	199.6	219.7	239.8
Currency in circulation	94.5	109.3	98.6	106.1	115.0	126.1
DMBs	69.5	89.7	85.5	93.0	104.2	113.3
Nonbank deposits	0.7	0.5	0.7	0.6	0.5	0.4
Memorandum items:						
NIR of BI (in billions of US$)	24.2	24.4	24.8	23.4	20.2	26.9
Money multiplier (rupiah M2)	5.0	4.5	4.8	4.6	4.4	4.3
Base money velocity 4/	12.5	12.0	13.8	13.4	12.9	11.1
Rupiah broad money velocity 4/	2.5	2.7	2.9	2.9	3.0	2.6
Annual percentage change:						
Broad money (constant exchange rate)	9.2	7.3	8.2	10.0	14.2	15.0
Rupiah broad money	9.8	10.0	11.1	11.5	13.2	15.0
Base money	19.1	21.1	29.6	28.4	24.1	20.2
Private sector claims	22.1	30.4	32.6	25.0	26.3	26.7

Sources: Bank Indonesia; and Fund staff estimates.

1/ All foreign currency denominated components are valued at a constant exchange rate.
2/ The introduction of a 9-digit system of accounts at BI in May 2004 resulted in a reclassification of some government accounts from other items net to net claims on government.
3/ As part of the BLBI resolution, BI's net claims on government were reduced by Rp 20.2 trillion (reflected in the figure for 2003). BI's capital reserves (under other items net) have been reduced by a corresponding amount.
4/ Calculated using end-period quarterly GDP, annualized.

Table 5. Indonesia: Medium-Term Macroeconomic Framework, 2004–11 1/

	2004	2005	2006	2007	2008	2009	2010	2011
	Act.				Proj.			
Real GDP (percent change)	5.1	5.3	4½-5	6.0	6.5	6.7	7.0	7.0
Saving and investment (in percent of GDP)								
Gross investment 2/	24.1	25.2	25.5	25.8	26.1	26.4	26.6	26.8
Gross national saving	25.3	25.4	26.0	25.9	25.9	26.1	26.2	26.4
Foreign saving	-1.2	-0.2	-0.5	-0.1	0.2	0.3	0.3	0.4
Prices (12-month percent change)								
Consumer prices (end period)	6.4	17.1	8.0	6.0	4.5	3.5	3.0	3.0
Consumer prices (period average)	6.1	10.4	14.5	6.6	4.5	3.5	3.0	3.0
Public finances (in percent of GDP)								
Central government revenue	17.7	18.8	19.5	19.1	19.0	19.1	19.3	19.5
Central government expenditure	19.1	19.4	20.5	19.6	19.1	18.9	18.8	18.8
Central government balance	-1.4	-0.6	-1.0	-0.5	0.0	0.2	0.5	0.7
Primary balance	1.3	1.9	1.5	1.5	1.5	1.5	1.5	1.5
Central government debt	54.8	47.8	41.0	37.9	33.9	30.3	27.2	24.5
Balance of Payments (in billions of US$)								
Oil and gas (net)	6.5	4.9	5.4	4.0	3.2	2.4	1.2	0.5
Non-oil exports (f.o.b)	54.5	65.7	71.2	75.5	79.6	85.0	91.6	98.8
Non-oil imports (f.o.b)	-39.5	-48.4	-51.4	-55.0	-58.7	-62.9	-67.6	-72.6
Current account balance	3.1	0.6	1.4	0.4	-0.7	-1.3	-1.6	-1.9
Direct foreign investment	1.0	2.3	3.8	4.5	5.3	5.8	6.3	7.0
Gross reserves								
In billions of US dollars (end period)	36.3	34.7	36.7	39.5	42.5	45.8	49.8	55.2
In months of imports	4.6	4.1	4.1	4.2	4.3	4.3	4.4	4.6
As a percent of short-term debt 3/	200.4	150.1	154.9	154.7	156.9	159.2	165.8	175.5
Total external debt								
In billions of US dollars	137.5	132.8	131.0	128.1	125.2	122.2	119.1	114.2
In percent of GDP	53.3	48.2	41.6	37.1	33.2	29.7	26.3	22.9
Memorandum items:								
Oil production (000bcpd)	1,040	1,010	1,010	1,040	1,072	1,104	1,137	1,171
Indonesian oil price (US$/bbl)	37.2	50.8	57.5	58.3	56.3	55.3	54.5	54.0
Nominal GDP (in billions of US$)	258	276	315	345	377	412	453	499

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

1/ National accounts figures (and ratios to GDP) are based on the revised national accounts (2000 prices).

2/ Includes changes in stocks.

3/ Short-term debt on a remaining maturity basis, before rescheduling, and including IMF repurchases.

Table 6. Indonesia: Selected Vulnerability Indicators, 2002–05

	2002	2003	2004	2005 1/	Latest observation
Key Economic and Market Indicators					
Real GDP growth (in percent)	4.4	4.9	5.1	5.3	2005Q3
CPI inflation (in percent)	11.9	6.8	6.1	10.5	Dec-05
Short-term (ST) interest rate (in percent)	12.9	8.3	7.4	12.8	30-Dec-05
EMBI secondary market spread (bps, end of period)			244	269	30-Dec-05
Exchange rate NC/US$ (end of period)	8,950	8,425	9,285	9,830	30-Dec-05
External Sector					
Exchange rate regime		Managed Float			
Current account balance (percent of GDP)	3.9	3.4	1.2	0.2	Proj.
Net FDI inflows (percent of GDP)	0.1	-0.3	0.4	0.8	Proj.
Exports (percentage change of US$ value, GNFS)	4.6	5.3	29.8	16.5	Proj.
Real effective exchange rate (End, period; Jan. 2000=100)	112.5	110.8	100.6	112.3	Oct-05
Gross international reserves (GIR) in US$ billion	32.0	36.3	36.3	34.7	Dec-05
GIR in percent of ST debt at remaining maturity (RM)	130.8	155.5	200.4	150.1	Proj.
Total gross external debt (ED) in percent of GDP	65.7	56.8	53.3	48.2	Proj.
o/w ST external debt (original maturity, in percent of total ED)	1.1	1.7	3.0	4.1	Proj.
ED of domestic private sector (in percent of total ED)	43.3	40.2	40.9	38.0	Proj.
ED to foreign official sector (in percent of total ED)	54.7	57.8	54.8	57.2	Proj.
Total gross external debt in percent of exports of GNFS	200.1	195.8	153.1	127.0	Proj.
Gross external financing requirement (in US$ billion) 2/	30.8	19.8	20.6	19.4	Proj.
Public Sector (PS) 3/					
Overall balance (percent of GDP)	-1.5	-1.9	-1.4	-0.6	Proj.
Primary balance (percent of GDP)	3.3	1.6	1.3	1.9	Proj.
Gross PS financing requirement (in percent of GDP) 4/	6.6	8.2	5.5	3.0	Proj.
Public sector gross debt (PSGD, in percent of GDP)	68.0	59.3	56.4	47.8	Proj.
o/w Exposed to rollover risk (in percent of total PSGD) 5/	3.7	7.0	3.9	3.6	Proj.
Exposed to exchange rate risk (in percent of total PSGD) 6/	45.9	44.0	50.8	52.1	Proj.
Exposed to interest rate risk (in percent of total PSGD) 7/	18.9	18.6	17.0	17.2	Proj.
Financial Sector (FS) 8/					
Capital adequacy ratio (in percent)	20.1	22.3	20.9	19.9	Sep-05
NPLs in percent of total loans 9/	6.8	6.3	4.5	9.7	Sep-05
Provisions in percent of NPLs	130.0	137.5	138.1	64.9	Sep-05
Return on average assets (in percent)	1.3	1.7	2.6	1.7	Sep-05
Return on equity (in percent)	19.0	19.2	25.4	20.6	Sep-05
FX deposits (in percent of total deposits)	18.2	16.6	11.5	13.4	Nov-05
FX loans (in percent of total loans)	24.0	20.4	18.7	17.2	Sep-05
Government debt held by FS (percent of total FS assets)	43.4	35.9	29.7	26.4	Sep-04
Credit to private sector (percent change)	25.1	22.1	30.4	23.4	Nov-05

Sources: Indonesian authorities; and Fund staff estimates.

1/ Staff estimates, projections, or latest available observations as indicated in the last column.
2/ Current account deficit plus amortization of external debt.
3/ Public sector covers central government.
4/ Overall balance plus debt amortization.
5/ Short-term debt and maturing medium- and long-term debt, domestic and external, excluding external debt to official creditors.
6/ Debt in foreign currency or linked to the exchange rate, domestic and external, excluding external debt on concessional terms.
7/ Short-term debt and maturing medium- and long-term debt at variable interest rates, domestic and external.
8/ Financial sector includes largest 15 banks by assets. September 2005 banking data are preliminary.
9/ Loans are gross of any allowance for losses.

Table 7. Indonesia: External Financing Requirements and Sources, 2004-06
(In billions of U.S. dollars)

	2004	2005 Est.	2006 Proj.
Total requirements	14.4	14.0	17.6
Current account deficit (if surplus = -)	-3.1	-0.6	-1.4
o/w: net interest payments (if net receipts = -)	4.7	4.3	4.3
Maturing short-term (ST) debt, orig. mat. (=debt stock at end of previous year)	2.3	4.1	5.5
Amortization of medium and long-term (MLT) debt	15.1	10.6	13.6
MLT to external private creditors	8.9	5.7	7.0
MLT to external official creditors	6.3	4.9	6.6
of which: IMF	1.0	1.1	1.3
Total sources	14.4	14.0	17.6
Net FDI (inflows=+)	1.0	2.3	3.8
Roll-over of short-term debt (= debt stock at end of current year)	4.1	5.5	5.5
Medium- and long-term borrowing (gross)	14.9	14.8	15.8
From private creditors	12.5	12.2	12.3
From official creditors	2.4	2.6	3.5
Other net capital inflows (net inflows = +)	-5.6	-12.7	-5.5
Exceptional financing and arrears (increase in arrears = +)	0.0	2.6	0.0
Change in reserves (decrease = +)	0.0	1.6	-2.0
Financing gap	0.0	0.0	0.0
External Stock Variables (end of period)			
Gross international reserves (GIR) in US$ billion	36.3	34.7	36.7
Total gross external debt (ED) in percent of GDP	53.3	48.2	41.6
By maturity			
Short-term (ST) external debt (original maturity, in percent of total ED)	3.0	4.1	4.2
Medium- and long-term (MLT) external debt (in percent of total ED)	97.0	95.9	95.8
By creditor			
ED to foreign official sector (in percent of total ED)	54.8	57.2	55.2
ED to foreign private sector (in percent of total ED)	45.2	42.8	44.8

Sources: Bank Indonesia, Fund staff estimates.

Table 8. Indonesia: Indicators of Debt Service to the Fund, 2004-11
(In billions of U.S. dollars)

	2004	2005	2006	2007	2008	2009	2010	2011
Debt service to the Fund 1/	1.224	1.457	1.602	1.793	1.973	1.162	0.896	0.726
Charges	0.219	0.312	0.323	0.267	0.200	0.134	0.094	0.062
Repurchases	1.004	1.145	1.279	1.526	1.773	1.028	0.802	0.664
In percent of exports of goods and nonfactor services	1.4	1.4	1.4	1.5	1.6	0.9	0.7	0.5
In percent of total non-financial public sector debt service	12.8	14.3	14.5	18.2	19.8	12.1	9.8	8.9
In percent of reserves of Bank Indonesia 2/	3.4	4.2	4.4	4.5	4.6	2.5	1.8	1.3
Outstanding Fund credit 1/	9.2	7.9	6.5	5.0	3.2	2.2	1.4	0.7
In percent of GDP	3.6	2.9	2.1	1.4	0.9	0.5	0.3	0.1
In percent of non-financial public debt	10.8	9.1	7.8	6.3	4.3	3.1	2.1	1.2
In percent of reserves of Bank Indonesia 2/	25.4	22.7	17.8	12.7	7.6	4.8	2.8	1.3
In percent of quota	300.0	262.7	219.6	168.3	108.7	74.2	47.2	24.8
Total non-financial public sector debt service								
In percent of exports of goods and nonfactor services	10.6	9.7	9.9	8.4	8.2	7.5	6.7	5.6
In percent of GDP	3.7	3.7	3.5	2.9	2.6	2.3	2.0	1.6

Sources: Indonesian authorities, and Fund staff estimates.

1/ Obligations basis.
2/ End of period reserves.

Table 9. Indonesia: Structural Reforms to Improve the Investment Climate

Area	Progress and outstanding issues
1. Resolving investor disputes	Despite commitment to resolve 3 high-profile investor disputes within its first 100 days in office, none have been resolved so far. Discussions on the operating agreement between ExxonMobil and Pertamina on the Cepu oilfield have not been concluded.
2. Reduce corruption	Progress is being made in this area with the Anti-Corruption Commission (KPK), the Attorney-Generals' office and the Judicial Commission (JC) working together. Examples are recent prosecution of some high profile cases, including at banks. Most recently, the KPK and JC have been working together to investigate claims that judges have traded favorable rulings for bribes. However, governance problems at tax offices, including at customs, are a major concern, both for domestic and foreign investors.
3. Infrastructure development and public private partnerships (PPPs)	In consultation with the World Bank, a framework for PPPs, including risk-management under such agreements has now been completed. However, it would be useful to further clarify accounting and disclosure requirements under such agreements. The government also recently passed regulations that would allow land acquisition for public sector projects in return for appropriate compensation to the owner. It has also issued regulations specifying the manner in which toll roads are to be planned, developed, built and managed. An Infrastructure Summit, planned for February to generate investor participation in this sector, has been delayed to the second half of 2006.
4. Labor market reforms	The Ministry of Manpower is revising the Labor Law but progress has been slow. Minimum wages have been increased by an average of 15-20 percent starting January. Improving labor market flexibility through revisions in severance pay and outsourcing regulations will be key to ensuring that jobs continue to be created.
5. Legal reforms	Developing a coherent strategy to effectively use available donor resources to build the capacity of the judiciary along with improved accountability and governance will help improve the legal environment.

Table 10. Indonesia: Fiscal Structural Reforms	
Area	Progress and outstanding issues
1. Tax policy	The reform package has been submitted to Parliament but does not fully address deficiencies, such as the inefficient luxury tax and VAT exemptions.
2. Tax administration	Progress on this area is ongoing as: (i) model tax offices have been established for administering large and medium taxpayers at a few pilot regions in Jakarta and (ii) reform of the Inspectorate General is ongoing with help from a Fund expert on the conduct of investigations. However, in addition to the new tax package's shortcomings (see box), major weaknesses remain such as: (i) a weak audit program and governance framework; (ii) inappropriate human resources regime in DGT; (iii) lack of a short term revenue generation program, to set up targets for new taxpayer registration, tax arrears collection and audit collection; and (iv) plans for a tax amnesty to be implemented by 2007, which would present risks for future compliance and collections.
3. Treasury Management	Progress has been made in rationalizating government bank accounts under the control of the Treasury. This is a first stage for improving cash management, which also require bringing all government bank accounts under treasury control and remunerating banks for providing services to the treasury. The simplification of the budget execution process remains a priority. Reform in this area entails expediting the submission of line ministries' working plans, reforming budget allocation procedures, and simplifying complex procedures and regulations.
4. Fiscal decentralization	Regulations, such as the ones on revenue sharing and regional borrowing, have been submitted for Presidential approval while the draft regional taxation law now limits taxes that can be created by local government. However, weaknesses still remain as: (i) expenditure assignments are still not clearly defined, while revenue sharing resources have been increased; (ii) the subnational borrowing regulation does not allow for effective sanctions for non-compliant provincial governments and a definite limit on subnational borrowing; and (iii) subnational fiscal reporting is still incomplete and untimely.

Statement by IMF Staff Representative
February 6, 2006

This statement provides an update of developments since the issuance of the staff report. The thrust of the staff appraisal remains unchanged. Inflation (year-on-year) was unchanged in January and the central bank is maintaining a tight bias pending clear signs that inflation is on a downward trend.

1. Recent indicators confirm that economic activity weakened further in the fourth quarter of 2005. Retail sales softened in December, though motor vehicle and motor cycle sales recovered partially from their earlier drops. Consumer confidence also recovered slightly in December, but remained well below its levels earlier in the year.

2. The latest trade figures are also consistent with a softening in domestic demand in the fourth quarter, with non-oil imports declining by about 3 percent (quarter-on-quarter). Also, following the increase in domestic fuel prices, oil imports were down by 23 percent (quarter-on-quarter). However, exports rose strongly in December, increasing by 6 percent.

3. Headline inflation remained at 17 percent in January, in part reflecting restrictions and uncertainties over rice imports. Seasonally adjusted inflation in January was close to zero. Core inflation remained unchanged in January at 9.4 percent (y/y).

4. The exchange rate is currently trading in the Rupiah 9,300-9,400 per U.S. dollar range, appreciating some 5 percent since end-December. Equity prices have remained buoyant, with the stock market up by 7 percent this year. Bond yields have remained fairly flat since the issuance of the staff report.

5. The final outcome on the budget for 2005 is not yet available as the authorities still have to reconcile monetary and fiscal data. However, preliminary information suggests that budget execution accelerated significantly in December, especially capital expenditures. In addition, all 2006 budget allocation documents have been issued which should help avoid spending delays of the kind seen last year.

6. Bank Indonesia announced some modifications in the classification rules for non-performing loans. Most notably, the requirement that if one bank downgrades the credit quality of any single debtor, all banks in the system must classify the loans accordingly, will be phased in gradually. While this represents a certain weakening of the regulations passed in July, BI is committed to fully implement this requirements once credit bureaus (that provide information on credit quality) are strengthened and become equipped to provide the requisite information.

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Washington, D. C. 20431 USA

IMF Concludes Fourth Post-Program Monitoring Discussion with Indonesia

On February 6, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Fourth Post-Program Monitoring Discussions with Indonesia.[1]

Background

The Indonesian authorities took strong policy actions in the fall to calm financial markets and reestablish policy credibility. After the rupiah hit a four-year low in late-August, Bank Indonesia (BI) tightened monetary policy aggressively—one-month policy rates were increased by a cumulative 425 basis points to 12¾ percent by December (their current level). In addition, the government raised domestic fuel prices sharply in October. Following these steps, financial markets stabilized quickly, with the rupiah appreciating significantly. Equity markets have recently reached record levels and bond yields have declined.

However, macroeconomic indicators and near-term prospects have weakened somewhat. Growth momentum has been moderating since the beginning of 2005 with staff estimates showing that seasonally adjusted growth (annualized quarter-on-quarter) slowed to the 4½ percent range in the first three quarters of the year. The slowing reflects several factors, amongst others, interest rates edging up since early 2005 and the under-execution of government spending. Headline and core inflation increased in 2005, ending the year at 17.1 percent and 9.5 percent, respectively, up from 6.4 percent and 6 percent, respectively, in 2004.

Looking ahead, the unavoidable near-term fallout of the fuel price increase and high interest rates on purchasing power and production costs are likely to limit growth in the first half of 2006. Government plans to expedite budget execution in early 2006 and the recent recovery in market

[1] Post-Program Monitoring provides for semi-annual consultations between the Fund and members whose Fund arrangements have expired but who continue to have substantial Fund credit outstanding.

sentiment should help to partially offset the weakening, and activity is expected to gradually strengthen over the course of 2006 as inflation and interest rates come down.

The 2005 overall fiscal deficit is estimated to have declined to 0.6 percent of GDP from 1.4 percent in 2004. The introduction of new budget procedures for disbursing funds to executing agencies, slow project implementation, and the late adoption of the revised 2005 budget resulted in significant delays in spending. Part of the unspent amounts (0.3 percent of GDP) are being carried over and will be spent as part of the 2006 budget.

After a year of high profits in 2004, which helped improve banks' capital positions, banking sector performance weakened in 2005, in part reflecting higher interest rates. Nonperforming loans (NPLs) at state banks rose three-fold to 15 percent at end-September. Although most of the increase was related to tighter NPL classification rules, there are signs that the underlying loan portfolio also deteriorated. Nevertheless, stress tests suggest that the overall banking sector remains resilient to moderate credit, interest and depreciation risks. On the financial sector safety net, the deposit insurance agency has been set up and the initial phase of withdrawal of the full deposit guarantee (interbank funds are no longer covered) has been completed.

As regards the external sector, the current account surplus has narrowed, largely reflecting the surge in oil imports (before the October fuel price increase) and weaker export volumes. Capital inflows, which declined sharply during the summer, have resumed as investor sentiment has improved. Gross international reserves stand at about $35 billion at end-December (about 150 percent of short-term debt).

The government has made some encouraging initial progress in combating corruption. However, progress has been slower than expected in other areas, including resolving investor disputes and improving labor market flexibility and the legal environment. The new economic team intends to give high priority to reforms on tax and labor issues, and is formulating a time-bound schedule for all sectors with clear lines of responsibility to ensure that progress is made.

Executive Board Assessment

Executive Directors commended the authorities on the bold policy measures taken to address the causes of financial market volatility during the summer. They noted that, while these measures have resulted in unavoidable adverse effects on the near-term outlook, with a slowdown in economic activity and high inflation and interest rates, medium-term prospects had strengthened. The outlook should remain favorable, provided the authorities continue to implement policies consistent with macroeconomic stability and accelerate structural reforms.

Directors agreed that the priority for monetary policy is to ensure that inflation comes down. In this context, most Directors considered Bank Indonesia's commitment to maintain a tightening bias until inflation shows clear signs of abating as appropriate. They also agreed with staff that Bank Indonesia should stand ready to raise interest rates further in coming months if inflation does not show signs of declining. That said, once inflation pressures subside, interest rates could be reduced. Directors also emphasized that a clear communication of the authorities' policy stance to the public will be critical in enhancing the effectiveness of monetary policy and promoting policy credibility. Directors observed that the flexible exchange rate regime has served Indonesia well, supporting the inflation-targeting framework, and helping to cushion exogenous shocks.

Directors commended the authorities for their continued emphasis on limiting the budget deficit, which has helped to reduce the public debt burden further. In view of this and given the current slowdown in economic activity and the pressing infrastructure and social needs, the somewhat higher deficit for 2006 is warranted. A number of Directors were of the view that if the slowdown in economic activity proves to be sharper-than-projected, the authorities could allow for a mild fiscal stimulus through automatic stabilizers and permit the budget deficit to be a little higher, subject to the availability of financing and the strength of market confidence. Most Directors welcomed the adjustment of domestic fuel prices as a positive step to fiscal sustainability, and supported the authorities' intention to eliminate them over time. At the same time, they stressed the importance of well-targeted and effective safety nets to protect the poor.

Directors emphasized the need to address banking sector vulnerabilities, especially at state banks, given the downside risks due to high interest rates and a slowing economy. In this context, they underscored the need for further strengthening the oversight of state banks' management and credit practices. While supporting the formation of an asset management company to restructure the non-performing loans of a state-owned bank, Directors noted that consideration should be given to amending legislation that prevents state banks from taking hair cuts on these loans. Such an approach would remove an important obstacle to the restructuring of non-performing loans and help in their speedier resolution. Directors also urged the authorities to complete the remaining steps on the financial sector safety net to improve banking system resilience. Some Directors noted that strategic privatization of state banks over the medium-term should be considered.

Directors underscored the critical importance of structural reforms to help boost investor confidence. This will not only provide an important stimulus in the current economic environment but also ensure sustained growth over the medium term. In this context, they welcomed the authorities' emphasis on tax and labor market reforms, as well as on improving infrastructure and enhancing legal certainty. In particular, with respect to tax reforms, Directors emphasized the importance of ensuring a proper balance between taxpayer rights and the powers of tax collectors. Directors also welcomed the government's plans to formulate a time-bound schedule for implementing reforms, as this would allow for a transparent monitoring of the progress achieved.

In sum, Directors agreed that despite the current weakening in economic activity, prospects for the medium-term remain strong, as long as the authorities continue to implement policies consistent with macroeconomic stability and push ahead with the structural reforms needed to attract investment and generate growth and employment.

Indonesia: Selected Economic Indicators, 2002–06

	2002	2003	2004	2005	2006
		Act		Proj.	Proj.
Real GDP (percent change)	4.4	4.9	5.1	5.3	4½-5
Domestic demand	2.4	2.4	10.3	5.3	4.4
Of which:					
Private consumption	3.8	3.9	4.9	3.5	2.5
Gross fixed investment	4.7	1.0	15.7	11.2	6.2
Change in stocks 1/	-2.0	-1.2	2.8	0.0	0.1
Net exports 1/	0.8	2.3	-3.6	-0.9	0.6
Statistical discrepancy 1/	1.4	0.4	-0.4	1.4	-0.1
Saving and investment (in percent of GDP)					
Gross investment 2/	21.3	19.4	24.1	25.2	25.5
Gross national saving	25.2	22.8	25.3	25.4	26.0
Foreign saving	-3.9	-3.4	-1.2	-0.2	-0.5
Prices (12-month percent change)					
Consumer prices (end period)	10.0	5.2	6.4	17.1	8.0
Consumer prices (period average)	11.9	6.8	6.1	10.4	14.5
Public finances (in percent of GDP)					
Central government revenue	16.1	16.4	17.7	18.8	19.5
Central government expenditure	17.6	18.4	19.1	19.4	20.5
Central government balance 3/	-1.5	-1.9	-1.4	-0.6	-1.0
Primary balance	3.3	1.6	1.3	1.9	1.5
Central government debt	63.9	57.4	54.8	47.8	41.0
Money and credit (12-month percent change; end of period)					
Rupiah M2	7.9	9.8	10.0	15.0	15.8
Base money	8.3	19.1	21.1	20.2	17.1
Private sector credit	25.1	22.1	30.4	26.7	15.1
One-month SBI rate (period average)	14.9	10.0	7.4	9.0	12.5

Balance of Payments (in billions of US$)					
Oil and gas (net)	6.2	7.4	6.5	4.9	5.4
Non-oil exports (f.o.b)	46.3	48.9	54.5	65.7	71.2
Non-oil imports (f.o.b)	-29.0	-31.7	-39.5	-48.4	-51.4
Current account balance	7.8	8.1	3.1	0.6	1.4
Foreign direct investment	0.1	-0.6	1.0	2.3	3.8
Gross reserves					
In billions of US dollars (end period)	32.0	36.3	36.3	34.7	36.7
In months of imports	6.8	5.5	4.6	4.1	4.1
As a percent of short-term debt 4/	130.8	155.5	200.4	150.1	154.9
Total external debt					
In billions of US dollars	131.3	135.4	137.5	132.8	131.0
In percent of GDP	65.7	56.8	53.3	48.2	41.6
Exchange rate (period average)					
Rupiah per US$	9,314	8,575	8,933	9,705	...
Nominal effective exchange rate (Jan. 2000=100)	86.0	85.6	77.6	...	...
Memorandum items:					
Oil production (000bcpd)	1,260	1,200	1,040	1,010	1,010
Indonesian oil price (US$/bbl)	24.1	28.8	37.8	50.8	57.5
Nominal GDP (in trillions of Rupiah)	1,863	2,046	2,303	2,679	3,205
Nominal GDP (in billions of US$)	200	239	258	276	315

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

1/ Contribution to GDP growth (percentage points).
2/ Includes changes in stocks.
3/ Based on Fund definition.
4/ Short-term debt on a remaining maturity basis, before rescheduling, and including IMF repurchases.

Statement by Hooi Eng Phang, Executive Director for Indonesia and Made Sukada, Alternate Executive Director February 6, 2006

1. On behalf of our Indonesian authorities, we thank staff for the concise report and the constructive policy dialogue during the recent Post Program Monitoring mission. Our authorities appreciate the staff's balanced and fair assessment of the economic and financial developments in Indonesia. They concur with the staff's appraisal of the challenges faced by the Indonesian economy as well as staff's policy recommendations. The authorities would also like to reiterate their appreciation to donors and the international community for their continued support for the Indonesian economy, including the reconstruction efforts in the tsunami-hit areas of Aceh and Nias.

Recent Macroeconomic Developments

2. In 2005, the authorities have skillfully steered the economy through several external shocks, particularly the aftermath of the tsunami tragedy, the second Bali bombing, the steep rise in international oil prices, and the increase in global interest rates. After registering a strong growth of 6.1 percent in Q1-2005, growth moderated beginning Q2 as a temporary consequence of the series of bold policy adjustments undertaken to sustain macroeconomic stability, maintain fiscal sustainability, enhance efficiency, and improve prospects for the balance of payments in light of high world oil prices and rising global interest rates. Growth for 2005, estimated to be in the 5.3-5.6 percent range, is higher than the previous year (5.1 percent) but is lower compared to the initial projection of 6.0 percent. Growth was driven mainly by the private sector, as the public sector continued on the path of fiscal consolidation.

3. The sharp fuel price adjustments in 2005 resulted in budget savings of about 0.5 percent of GDP, thus lowering the overall budget deficit to 0.7 percent of GDP compared to the target, 0.9 percent of GDP. A much slower budget execution and good performance on non-oil and gas tax collections also contributed to the low budget deficit. The former was the result of an unintended effect of the new budget procedures that were implemented beginning 2005, the reorganization of the Ministry of Finance, and late adoption of the revised budget, as noted by the staff. Fiscal consolidation contributed to a continued decline in external debt to 48.2 percent of GDP from 53.3 percent in 2004.

4. Headline inflation for 2005 rose to 17.1 percent, reflecting largely the hike in domestic fuel prices. Subsequently, with the revival of market confidence, inflation moderated in the last two months of 2005 whilst the pressure on the Rupiah exchange rate that was evident in Q3 has also eased. While inflation in January 2006 is still high largely due to the increase in food prices, it has nevertheless moderated to 17.0 percent (yoy).

5. The current account position remained in surplus despite a faster increase in non-oil and gas imports (20 percent), compared to exports (17 percent). Imports were higher reflecting higher imports of capital goods and raw materials in tandem with higher economic

activity. Exports are estimated to have reached a record high of US$86.9 billion in 2005 while export proceeds from tourism significantly declined following the second Bali bombing. Nevertheless, the foreign exchange reserves were maintained at a comfortable level that was sufficient to cover 4.3 months of imports and official debt repayment.

6. Indonesia's financial sector has performed well during the past year. The performance of the banking sector has been favorable as reflected in the profitability, liquidity, and capital ratios, but NPLs remained high attributable primarily to the large amount of impaired loans in two state banks, as noted by staff. Credit extended by the banking sector expanded in line with the target set while the loan to deposit ratio rose significantly as bank deposits experienced a moderate increase. Notably, 35 percent of the total credit expansion went to SMEs thus raising the proportion of SME loan to 51 percent of total bank loan. Meanwhile, with the rise in investor confidence, the Jakarta Stock Index (JSI) gained 16.2 percentage points, among the highest market performers in the region.

Outlook for 2006

7. The government's top priorities in 2006 are to restore macroeconomic stability, promote growth, improve the investment climate, and provide a competitive and transparent framework for infrastructure development. Growth is expected to be sustained at the 2005 level in the first half of 2006 but is expected to accelerate in the second half, supported by stronger investment and more robust growth in exports and consumption. The new economic team of President Susilo Bambang Yudhoyono has indicated its strong commitment to strengthening structural reforms in accordance with the Medium Term National Development Plan (RPJMN) for the period 2005-2009, and reviving the economy through a policy mix featuring a fiscal stimulus in the first half of 2006 and an acceleration of investment in the second half, while monetary policy could gradually be eased with lower inflation.

8. The authorities agree with the staff that accelerating structural reforms is critical for sustaining growth and reducing unemployment and poverty. They recognize that growth was on a downward trend during the last three quarters of 2005 but the rate of moderation would be less than projected by the staff on account of the following:

- The authorities believe that moderate inflation coupled with the strengthening rupiah exchange rate will continue and the banking sector is in a good position to support and finance growth given its current sound position in terms of capital adequacy and liquidity condition, thus providing a more conducive environment for growth before the second half of 2006.

- The government's decision to carry-over part of the unspent 2005 budget allocation, including the budget for the Aceh and Nias reconstruction program, to the first four months of 2006 and the increase in regional government spending will also contribute to the growth prospects for 2006; and

- Forward-looking investment indicators signal an upward trend in investment activities, as reflected in the increase in FDI approvals by the Investment

Coordinating Board (BKPM) to US$13.57 billion for 1,648 projects in 2005 from US$10.41 billion for 1,226 projects in 2004. Construction activities for some of these FDI projects have been scheduled to begin in 2006.

The authorities are therefore more optimistic than the staff and they believe that the economy could grow in the range of 5.0–5.7 percent (compared to the staff's projection of 4 ½ -5 percent) in 2006. Inflation is projected to decline further to 7-9 percent, while the overall budget deficit is expected to be maintained below 1 percent of GDP and the current account is expected to remain in surplus.

Fiscal Policy

9. Fiscal consolidation, which was a key priority in 2005, will be maintained as reflected in the 2006 overall fiscal deficit which is targeted at 0.7 percent of GDP, excluding 0.3 percent of GDP in expenditures carried over from 2005. As noted by the staff, the budget strategy is aimed at providing fiscal stimulus early in 2006 by front-loading spending of the carryover amount from the 2005 budget allocation while maintaining the fiscal deficit at a manageable and sustainable level. In this regard, the MOF has coordinated with the line ministries and regional governments to accelerate the budgeting process. DIPAs, the main documents of the new budget procedure for disbursing funds that caused significant delays in spending last year, have been distributed, as scheduled, to the regional governments at the beginning of 2006. The government has also streamlined the administrative procedure related to the reconstruction of Aceh and Nias by giving additional powers to BRR (Rehabilitation and Reconstruction Agency for Aceh and Nias) to implement housing reconstruction projects through direct contracting for the Aceh and Nias reconstruction program. These efforts are expected to help cushion the economy against a further downward path. In addition, the government has improved the efficiency and effectiveness of the fuel subsidy system by replacing the product based scheme with a cash compensation scheme (the SLT) for well-targeted vulnerable groups.

10. On the revenue side, the authorities have maintained their strong commitment to strengthen the tax and customs administration, including through the expansion of modern tax offices which were introduced in 2001 to widen the tax base and improve tax collection. The 2006 budget will be financed largely from domestic sources, primarily by issuing government bonds while the contribution from privatization is expected to be minimal. On a net basis, external financing is negative, as debt payments are expected to be larger than the new borrowings.

11. Looking forward to the medium term, a comprehensive tax reform package was submitted to the Parliament in September 2005. The tax package includes the revisions to the law on General Provisions and Procedures for Taxation, as well as the income tax, VAT and luxury sales tax laws. The tax reform is expected to strike a balance between enhancing fiscal sustainability and improving the investment climate for private sector-led growth in the medium term. The government is garnering political support to speed up the parliamentary approval of the tax reform. Reforms within the Ministry of Finance to improve public expenditure and debt management are also underway.

Monetary and Exchange Rate Policy

12. Monetary policy is aimed at reducing inflation to between 7-9 percent in 2006 and geared towards achieving a low medium-term target. As indicated in the staff report, the second round effects of the fuel price increase have been contained by the monetary policy response as reflected in the slowing down of inflation following the price adjustments. Bank Indonesia (BI) will continue to closely monitor the developments and review the situation if there is a timely opportunity to gradually reduce the BI policy rate and lower the statutory reserve requirement provision without jeopardizing monetary stability. To strengthen the inflation targeting framework and enhance transparency, BI has strengthened its communication strategy by announcing the BI indicative policy rate three months in advance, with effect from July 2005.

13. With regard to the exchange rate policy, the authorities agree with staff that the flexible exchange rate system has provided flexibility to the economy in absorbing shocks and they are committed to maintaining the system.

Financial Policy

14. As highlighted in the staff report, the overall banking sector remains resilient to moderate credit, interest rate and depreciation risks. The overall performance of the banking sector in 2005 was favorable. However, authorities are well aware that two large state banks have large compromised assets and high NPLs. In this respect, BI has placed them under tight supervision. In addition, the authorities have continued to make efforts to find the best solution for the NPLs of these two states banks, including reviewing the existing legislations that do not allow state-owned companies, including banks, to take haircuts.

15. BI has continued to strengthen banking supervision and prudential regulations to comply with international standards. In this respect, on January 30, 2006 BI introduced a package of banking regulations, including the provisions on good corporate governance and consolidated risk management. A Memorandum of Understanding between the Governor of Bank Indonesia, the Finance Minister, and the Chairman of the Indonesian Deposit Insurance Agency was also signed in December 2005 to strengthen coordination among the institutions in dealing with banking matters. With the Fund's technical assistance, a framework for a financial sector safety net (FSN) has been put in place to replace the blanket guarantee scheme. The required regulations for a full functioning of the FSN have been issued, including 5 regulations from the LPS (the Deposit Insurance Agency), the BI regulation on the lender of last resort provision and the MOF decree on emergency lending assistance. The LPS has become fully operational, with effect from September 22, 2005 and the insurance coverage is being reduced in stages. In the first six months following the establishment of LPS, the full value of eligible deposits will be insured; in the second six months, only deposits up to a maximum of Rp. 5 billion will be insured; in the third six months the insurance coverage falls to Rp. 1 billion; and from March 22, 2007 onwards it will be reduced to a maximum of Rp. 100 million.

16. Meanwhile, BI is fully cognizant of the heavy burden faced by the banking industry owing to prolonged high interest rates. In this regard, BI is closely monitoring the situation and will consider a downward adjustment of the statutory reserves requirement when macroeconomic conditions permit. In addition, a number of banking regulations are being improved to allow for greater provision of Islamic banking services and to reduce the risk weighted assets provisioning requirement for certain retail businesses, including for micro, small, and medium enterprises (MSME). BI will expand the coverage of the current mapping survey to identify MSME sectors that have potential. The results of the survey will then be synchronized with the Basel II concepts to reduce the provisioning requirement for the MSME sectors. These efforts are aimed at strengthening intermediation to support the economy while preserving soundness of the banking system.

Structural Reforms

17. Although building the right and good institutions for supporting economic development is a long and difficult process, the government has demonstrated its strong commitment to continue the ambitious and multi-faceted reform program aimed at improving the investment climate and encouraging private sector growth. In this regard, the Corruption Eradication Commission (KPK), which was established as part of the efforts to establish a clean and efficient government, has recorded significant progress in the fight against corruption. Further efforts towards the promotion of a more conducive investment climate include equal treatment for foreign and domestic investors, streamlining procedures for investment approvals, reducing the existing rigidities in the labor market, improving tax and customs services and governance, and further synchronization of central and regional government regulations. The government has also strengthened its effort to enhance bilateral and regional cooperation and to reduce export and import impediments. Import duties on additional groups of products have been reduced or eliminated, effective February 1, 2006. A number of new regulations either have been completed or are being finalized to improve the regulatory framework for the infrastructure sector. For example, the regulations on electricity, toll roads, and water supply provisions have been completed while major amendments to the Investment Law are expected to be submitted to Parliament in the near future.

Conclusion

18. We thank management and the Executive Board for their continued support for the Indonesian economy. The Indonesian authorities are committed to making all possible efforts towards ensuring macroeconomic stability and improving the investment climate, in order to achieve high and sustainable economic growth, generate employment opportunities and reduce poverty. The authorities are confident that the policy mix that is being implemented would facilitate higher growth in 2006 and improve prospects for the medium term.

19. We are pleased to inform the Board that in line with the authorities' commitment to transparency, they consent to the publication of the staff report, with necessary deletions of market sensitive information.