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Indonesia: 2006 Article IV Consultation and Fifth Post-Program Monitoring Discussions—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Indonesia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2006 Article IV consultation with Indonesia and the fifth post-program monitoring discussions, the following documents have been released and are included in this package:

- the staff report for the combined 2006 Article IV consultation and Fifth Post-Program Monitoring Discussions, prepared by a staff team of the IMF, following discussions that ended on May 19, 2006, 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 July 10, 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 supplement of July 27, 2006 updating information on recent economic developments.

- a Public Information Notice (PIN), summarizing the views of the Executive Board as expressed during its July 31, 2006 discussion of the staff report on issues related to the Article IV consultation and the post-program monitoring discussions.

- a statement by the Executive Director for Indonesia.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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INDONESIA

Staff Report for the 2006 Article IV Consultation and Fifth Post-Program Monitoring Discussions

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

Approved by Daniel Citrin and Adnan Mazarei

July 10, 2006

- **A staff team visited Jakarta during May 8–19 to conduct the 2006 Article IV Consultation and Fifth Post-Program Monitoring discussions.** The team comprised Milan Zavadjil (head), Nita Thacker, Geremia Palomba, Hiroko Oura (all APD), Amine Mati (FAD), Steven Seelig and Andre Santos (MFD), and Matthew Jones (PDR). Stephen Schwartz, Senior Resident Representative, and R. Armando Morales, Deputy Resident Representative, participated in the mission. Made Sukada (Alternate Executive Director) attended the meetings. The mission also liaised with the World Bank and key donors.

- The mission met with Vice President Jusuf Kalla, Coordinating Minister for Economic Affairs Boediono, Coordinating Minister for Social Affairs Aburizal Bakrie, Minister of Finance Sri Mulyani Indrawati, Bank Indonesia Governor Burhanuddin Abdullah, Minister of Planning Paskah Suzetta, Minister of Trade Mari Pangestu, Minister of Labor Suparno, Minister of Energy Purnomo Yusgiantoro, Minister of State-owned Enterprises Sugiharto, and other senior officials, parliamentarians, and private sector representatives.

- Indonesia's extended Fund arrangement expired on December 31, 2003. Following early repayment of one-half of its obligations at end-June 2006, Indonesia's outstanding obligations to the Fund were reduced to SDR 2.47 billion (119 percent of quota). Indonesia's outstanding credit would remain above 100 percent of quota until November 2006.

- The authorities and the Fund have continued to work closely following the expiration of the Fund arrangement. The staff has been supportive of the authorities policy priorities and strategies in most areas, and the majority of recent Fund policy recommendations have been implemented (Table 1).

- Indonesia has accepted the obligations under Article VIII, and maintains an exchange system free of restrictions on payments and transfers for current international transactions. Indonesia's exchange rate regime is a managed float with no pre-announced path for the exchange rate.

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Executive Summary

- **Macroeconomic vulnerabilities have been reduced and growth reached its highest level in nine years in 2005.** Public finances have been placed on a sustainable path, with the debt-to-GDP ratio halved during 2000–05 and projected to decline further over the medium term. Banking sector performance has improved and corporate vulnerabilities have been reduced. Gross international reserves have increased to record levels, enabling Indonesia to make early repayments to the Fund.

- **However, Indonesia has lagged Asia's most dynamic economies** and unemployment has risen. Foreign direct investment remains low compared with other Asian countries.

- **Moreover, the economy remains susceptible to shifts in investor sentiment** and occasional asset market volatility, triggered by concerns about domestic policy slippages or developments in global financial markets.

- **In 2006, inflationary pressures are receding, but growth has slowed** as a result of the fuel price and interest rate adjustments implemented last fall to restore market confidence. Growth is expected to pick up in the second half of the year, though there are downside risks, notably if the tightening in global financial markets continues or international oil prices increase further.

Key Issues and Policy Recommendations

- **Fiscal policy is appropriately geared to further reducing the public debt burden, while supporting activity in 2006.** To avoid a repeat of the spending shortfalls of 2005, the authorities need to address spending bottlenecks and are considering extending the fuel price cash compensation program. The implementation of a mechanism for automatic adjustments of energy prices would depoliticize price adjustments and remove the risk of higher subsidies.

- **Further interest rate reductions should be possible in 2006,** but the pace and timing will need to be cautious and take into account global financial market conditions.

- **Nonperforming loan problems at state banks need to be resolved quickly.** A medium-term privatization strategy should be adopted for public banks that do not have a public policy objective.

- **The early approval of one or two key economic laws should be pursued to remove skepticism** about the implementation of the government's impressive structural agenda.

I. Introduction

1. **The 2006 Article IV consultation mission coincided with the first week of the global financial market turmoil that started in mid-May.** The sell-off in emerging markets was felt significantly in Indonesia, and illustrated the country's continued susceptibility to shifts in investor sentiment. The authorities were concerned that despite sound macroeconomic policies, the strong capital inflows of early 2006 might be reversed, with implications for growth and inflation.

2. **The other main concern of the authorities was that improving macroeconomic fundamentals were not being translated into higher living standards**. Growth has slowed in early 2006 and unemployment has been edging up. Recognizing the need to improve the business climate and boost growth, the economic team that took office in December 2005 has announced a comprehensive reform package, and is now focusing on implementation.

3. **But building political consensus for reforms remains a challenge**. The segmented nature of the governing coalition suggests that strong political leadership will be needed to ensure approval of key economic laws. Efforts to combat corruption, the signing of the peace accord in Aceh, and the effective response to natural disasters have all enhanced President Yudhoyono's popularity. However, approval of the government's handling of the economy has been adversely affected by the sharp October 2005 domestic fuel price increase despite the adoption of a comprehensive cash compensation scheme (see Box 1 in IMF Country Report 06/85, February 2006) and efforts to reform the labor law.

4. **The authorities have recently had to deal with the consequences of the tragic earthquake in Yogyakarta and Central Java**. The earthquake has caused substantial damage and the government is gearing up for a large-scale reconstruction effort with assistance from donors (Box 1). Meanwhile, the reconstruction of Aceh following the tsunami in December 2004 is proceeding, with the pace picking up in 2006.

5. **In light of the concerns raised by the authorities, the discussions focused on:**

- Macroeconomic risks stemming from the recent tightening of global liquidity and high international oil prices, and the appropriate stance of monetary and fiscal policy in light of these risks.

- Policies to address the recent weakening of growth and reduce unemployment and poverty over the medium term, in particular, the government's efforts to strengthen financial intermediation, fiscal management, and the investment climate.

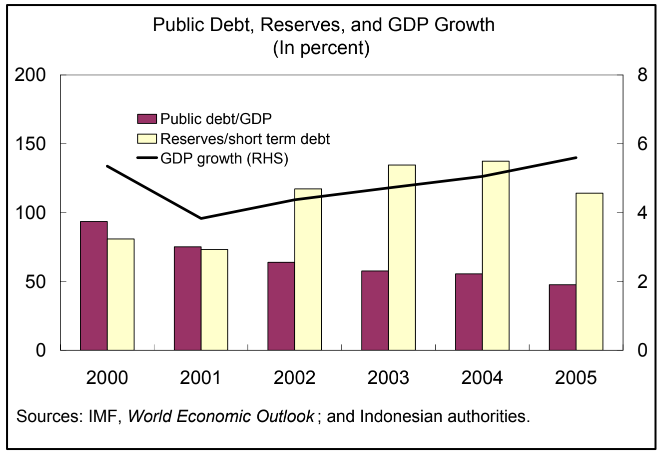
II. Background

Over the past few years, macroeconomic indicators have improved substantially, but Indonesia has not fully benefited from the investment and export boom experienced by some of the region's fastest growing economies.

6. **Activity, macroeconomic fundamentals, and sovereign credit ratings have strengthened** (see Chart, Box 2, Tables 2 and 3).

- Growth has recovered gradually and reached its highest rate in nine years in 2005.

- Public finances have been placed on a sustainable path, with the debt-to-GDP ratio halved during 2000–05. Non-oil revenues, though still low by regional standards, have increased by 2 percent of GDP during the same period as a result of tax administration reforms and a broadening of the tax base (Table 4).



- Corporate profitability has improved, accompanied by a reduction in leverage and other vulnerabilities (Box 3).

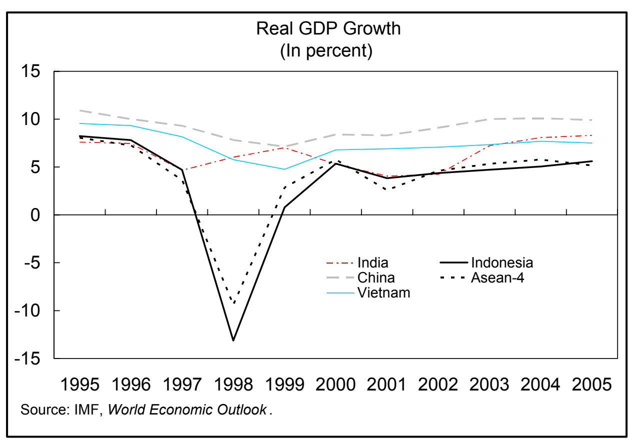
- Bank profitability and financial soundness indicators suggest that the health of the overall banking system has improved considerably since the crisis, though intermediation is still lower than in other major Asian countries.

- Following years of current account surpluses, mainly as a result of the sharp drop in investment following the crisis, external viability has been restored. Reserves reached record levels in mid-2006, enabling early repayments to the Fund.

7. **Notwithstanding these achievements, major challenges remain**.

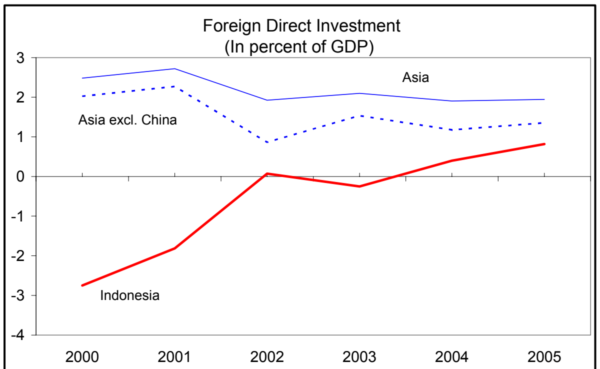
- While output growth has been about 5 percent over the past 2–3 years (in line with other ASEAN-4 countries), it has been considerably lower than in Asia's most dynamic economies, notably the People's Republic of China, India, and Vietnam (see Chart), as well as in Indonesia before the Asian financial crisis.

- Unemployment has risen to over 10 percent in 2005, though there has been some improvement in poverty indicators (Table 5).

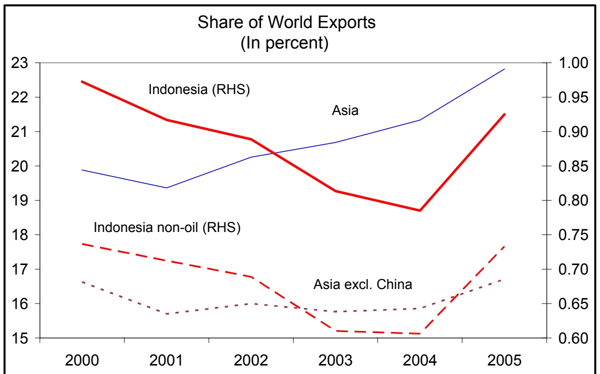


- Foreign investment, though rising, remains low compared with regional averages (see Chart).

- Indonesia's share in both world exports and intra-Asian trade remains below the 2000 level, although there was a modest improvement in 2005 driven largely by commodity prices (see Chart). Despite an open trade regime, the share of foreign trade in the economy declined by 9 percentage points during 2000–05 to 63 percent of GDP, in contrast to the rising trend in most Asian countries.



Source: IMF, *World Economic Outlook*.



Source: IMF, *Direction of Trade Statistics* database.

8. **As discussed in earlier Article IV consultations, some key impediments to accelerating growth need—and have started—to be addressed**.

- Long-standing weaknesses in tax and customs administration and the regulatory environment, as well as labor market inflexibilities, which have discouraged job-creation. *The government has recently approved and begun to implement an ambitious reform agenda to address these issues*.

- Legal uncertainty and a multitude of often conflicting regulations between central and local governments. *Efforts are underway to reform the legal system and resolve the conflicts in regulations*.

- Aging infrastructure, partly reflecting the lack of public investment. *Steps are being taken to address this through public-private partnership projects, and an increase in development spending is targeted*.

- Several business disputes, mostly with foreign investors, have added to the uncertainties. *The recent resolution of the dispute between ExxonMobil and Pertamina over the Cepu oilfield has been a positive step and efforts to resolve other disputes are continuing*.

9. **Sustained implementation of sound macroeconomic policies is also needed to further reduce vulnerability and limit asset market volatility**:

- The experience of last August–September 2005, when investors cashed out from local bond and equity markets, bond yields rose substantially, and the rupiah dropped sharply, illustrated Indonesia's susceptibility to changes in investor sentiment, caused in this case by concerns about delays in tightening monetary policy and adjusting fuel prices. (Figure 1). In Indonesia's shallow asset markets, relatively modest shifts in capital flows can generate large swings in asset prices (Figure 2).

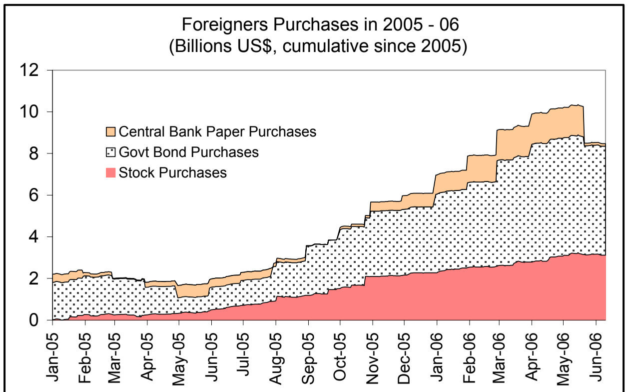
- More recently, the surge in portfolio inflows during October–April and their modest reversal in May–June demonstrated Indonesia's susceptibility to global financial developments, as discussed in the next section.

III. Recent Economic Developments

Volatility in capital flows, and the impact of international oil prices on the macroeconomy, have dominated economic developments in Indonesia over the past year.

- **Financial markets have been on a roller-coaster:**

  - Against a background of ample global liquidity and "search for yield," capital inflows surged from late-2005, after strong policy actions last fall—an increase of 425 basis points in Bank Indonesia's (BI's) benchmark policy rate and a more than doubling in domestic fuel prices—together with the appointment of the new economic team in December restored market confidence.[1] Cumulative inflows into the local bond and equity markets and central bank paper exceeded $6.4 billion during September–April (see Chart), with Indonesian corporations issuing another $1.2 billion in foreign currency bonds. Foreign exchange reserves rose by $12 billion during this period to $44 billion and the rupiah strengthened against the dollar by 11 percent from January to mid-May.



Sources: Bloomberg; and Fund staff calculations.

  - However, Indonesia did not escape the emerging market sell-off in May and June, triggered by expectations of interest rate increases in major industrial countries. The impact of the market correction on Indonesia was somewhat larger than in other countries in the region, but was broadly in line with the relatively larger losses in other markets that had seen higher run-ups in prices. Moreover, the modest widening of spreads on Indonesian foreign currency debt compared with other emerging markets reinforces the view that global rather than Indonesia

[1] See IMF Country Report 06/85, February 2006 for details about last year's financial market turbulence.

specific factors were at play. The authorities responded to the pressures by not reducing interest rates in June (a decrease had been expected before the turmoil started) and intervening, on a very limited scale, in the foreign exchange market to smooth intra-day volatility—foreign exchange reserves remained broadly unchanged between mid-May and late June (before the early repayment to the Fund).

- **An inevitable side effect of the policy actions taken last fall to restore market confidence has been a slowdown in economic activity**.

  - Although real GDP growth reached a nine-year high of 5.6 percent in 2005, the economy had already started to slow in the second half of the year. Growth slowed further to 4.6 percent (y/y) in the first quarter of 2006, down from 4.9 percent in the last quarter of 2005, as domestic demand decelerated further due to rises in interest rates and domestic fuel prices.

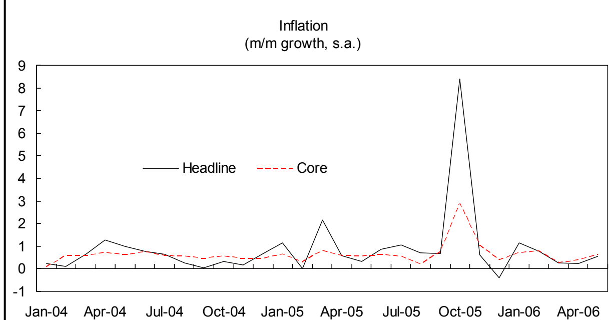
  - Net exports helped offset some of the decline in private demand in the last quarter of 2005, as oil imports plummeted by over one-quarter in value terms. However, the deceleration in exports in early 2006 weakened this effect. That said, the current account remained in surplus in the first quarter of 2006 and the surplus is expected to remain at the 2005 level of 0.3 percent of GDP for the year as a whole (Table 6).

  - Accelerated fiscal spending in the last quarter of 2005 also helped prop up domestic demand, although for the year as a whole spending fell well short of the budget, with the overall deficit at only 0.3 percent of GDP. Data through May 2006 suggest that while spending has accelerated somewhat in 2006 from the very low 2005 level, the intended frontloading of expenditures to boost domestic demand has not been achieved.

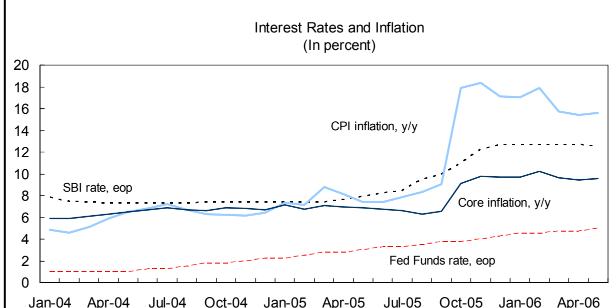
- **Inflationary pressures have been easing**.

  - After peaking at 18 percent in October 2005 because of the fuel price hike, inflation has moderated, as the tighter monetary stance slowed domestic demand (see Chart). Core inflation is currently about 5 percent (three-month annualized basis) although year-on-year it remains high.

Interest Rates and Inflation



Source: CEIC Database



Sources: Indonesian authorities;CEIC database; and Fund staff calculations.

Headline inflation is even lower and well below BI's end-year target of 7–9 percent.

- With inflationary pressures continuing to abate, BI reduced its policy rate (SBI) by 25 basis points in both May and July to 12¼ percent. BI had refrained from lowering the rate further in June because of heightened market volatility and concerns about the inflationary impact of the rupiah depreciation in May.

IV. Policy Discussions

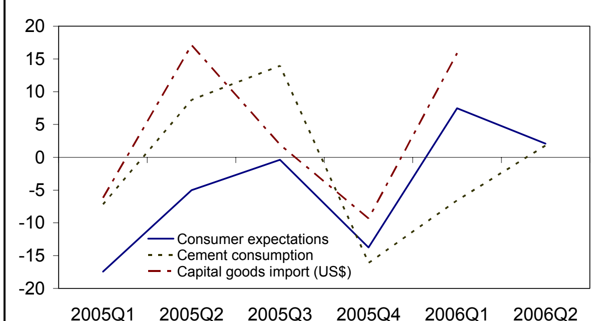
In light of weakening inflationary pressures and slowing growth, the discussions focused on the scope for an easing in monetary and fiscal policies, and the risks from developments in international financial and oil markets. The discussions also focused on structural policies which could enable Indonesia to attract longer-term capital inflows, boost export and GDP growth rates to match those achieved by Asia's most dynamic economies, and reduce unemployment.

Overall Macroeconomic Outlook and Risks

Outlook: The authorities' medium-term strategy aims to accelerate growth and reduce vulnerabilities through prudent macroeconomic policies and the implementation of a reform agenda.

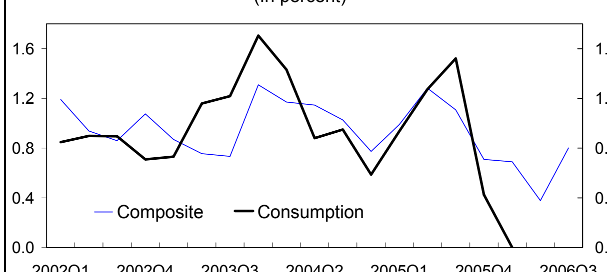
- **Growth** is projected to reach 5.2 percent in 2006 as the effects of the domestic fuel price increase wear off, interest rates decline, and budget execution picks up. A number of indicators, including capital goods imports and construction activity, as well as composite indicators constructed in the context of a staff study (see Charts and Chapter V of Selected Issues paper) suggest that a recovery in growth should begin in the second half of the year. Over the medium term, productivity gains from improvements in infrastructure and increased investment could generate growth rates in the range of 6–7 percent as increased domestic demand is reinforced by improved competitiveness and export growth (Table 8).

Selected Economic Activity Indicators
(QoQ growth, in percent)



Source: CEIC

Consumption Leading Indicator 1/
(In percent)



1/ QoQ growth, seasonally adjusted. Composite index is a simple average of standarlized growth rates for cretail sales index, consumer confidence present index, and real 1-month SBI rate.
Source: CEIC database and Fund staff estimates.

- **Inflation** is projected at 7 percent at end-2006, as the recovery in demand is expected to be gradual (see also section on monetary policy). Given inflation inertia (see Chapter VI of Selected Issues paper), BI intends to reduce inflation gradually over time, to 6 percent in 2007, and over the medium term to about 3 percent, close to the rate prevailing in many trading partner countries.

- Under the medium-term fiscal framework, **public debt** is targeted to decline to about 30 percent of GDP by 2010, accompanied by improvements in other debt sustainability indicators (see also Annex V for details). This would imply keeping the overall budget deficit at under 1 percent of GDP in the medium term, underpinned by: (i) improvements in tax administration that help compensate for lower oil and gas revenues; and (ii) lower interest and subsidy costs, that would allow increased resources to be channeled toward social and development spending.

- The **current account** is expected to be broadly in balance in the next few years, with a deficit projected thereafter as strong domestic demand, including investment-related spending, leads to higher imports. However, the deficit is expected to remain modest at around 1 percent of GDP. On the capital account, it is assumed that the market turmoil experienced in May–June is temporary and that moderate inflows resume in the second half of the year, though at a rate far lower than in the first quarter (the impact of possible lower capital inflows is discussed below). Encouraged by improvements in the investment climate, capital inflows would pick up over the medium term. With the recent early repayments to the Fund, international reserves are expected to end the year at just over $40 billion, and rise moderately over the medium term.

Risks: Downside risks relate to the possible further tightening in global liquidity conditions and an increase in oil prices, as well as the lack of progress in implementing structural reforms. The risks were discussed with the authorities in the context of illustrative scenarios, as described below.

- **Possible further tightening of global liquidity conditions with a reversal of recent capital inflows** (about $8 billion during September–April): while such outflows should be manageable given the recent accumulation of foreign exchange reserves, the reduced scope for lowering domestic interest rates and some associated rupiah depreciation could lower growth (by 0.6 percentage points compared with the baseline in 2007) and raise inflation (by 1 percentage point). Reserves would decline to about $34 billion at end 2006 (equivalent to 110 percent of short-term debt).

- **Possible further large increase in international oil prices:** given the government's intention to keep administered fuel prices unchanged for the time being in order not to further undermine domestic demand, a jump in oil prices to, for example, $100 a barrel would substantially increase fuel subsidy costs. Not only would subsidies increase as a direct result of the increased price differential, but the larger gap between domestic fuel prices and international oil prices could make smuggling profitable again, and raise sales of subsidized products in Indonesia; such smuggling was widespread prior to the October

2005 domestic price increase. Staff estimates suggest that the overall deficit and associated financing requirements would rise by 2 percent of GDP in 2007 compared to the baseline;[2] interest rates and inflation are projected to increase by 1 percentage point each in 2007; and growth would be reduced by 1 percentage point.

- **Structural reforms proceed slowly:** delays in implementation of the government's key structural measures, including approval of customs, tax and investment laws, would further undermine investor confidence. Under this scenario, growth is projected to remain in the 5 percent range (similar to that seen in the last few years), with unemployment continuing to trend upward. Pressure to pursue more accommodative monetary and fiscal policies to sustain this growth would lead to higher deficits of between 1½–2 percent of GDP and inflation is likely to accelerate over the medium term, reflecting a slower growth in potential output. The debt-to-GDP ratio would be modestly higher under this scenario than in the baseline and foreign reserves would be significantly lower at about $35 billion, making Indonesia more vulnerable to shocks. Vulnerability would increase if the rupiah were to depreciate significantly, as both public and external debt indicators are sensitive to changes in the exchange rate.

Authorities' Views: The authorities broadly agreed with the staff projections for the medium term, but they are more optimistic on near-term growth.

- For 2006, they project growth at 5.9 percent as private demand recovers due to lower interest rates in the second half of the year, complemented by increased fiscal spending (see below). For 2007, growth is projected at 6.4 percent with lower interest rates and structural reforms delivering a stronger recovery in investment and exports.

- On the risks from possible global liquidity tightening and market volatility, the authorities stressed that the best response was to maintain the current macroeconomic policy mix which was geared toward further reducing vulnerabilities, together with timely policy responses to external developments. The authorities agreed that a large increase in international oil prices (to say $100 per barrel) could have a substantial fiscal impact if not accompanied by domestic price increases, especially given possible increases in domestic purchases of subsidized products as a result of smuggling. However, they felt that increases (from current levels) in the range of $5 or $10 per barrel—which were more likely—would not lead to an increase in smuggling and would be manageable.

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[2] If no change in domestic fuel sales as a result of smuggling is assumed, a $10 per barrel increase in international oil prices would only raise the overall deficit by 0.2 percent of GDP.

Macroeconomic Policy Challenges

Fiscal Policy

Outlook: Fiscal policy is expected to be suitably balanced between continued reduction of the public debt burden over the medium term and providing support to aggregate demand in 2006.

- The deficit target for 2006 is set at 1.2 percent of GDP to help boost domestic demand by accommodating carryover spending from 2005, higher electricity subsidies due to the postponement of the earlier planned tariff increase, and spending on rehabilitation of the Yogyakarta region (Text Table).[3] Budget resources are also expected to help finance infrastructure under the public-private partnership framework and as a start Rp 3 trillion (0.1 percent of GDP) has been set aside in the 2006 budget for such spending. Despite the rise in the deficit, the public debt ratio will be reduced by another 6 percentage points to about 41 percent of GDP.

Central Government Fiscal Aggregates

	2005	2006	2007
	Prel. Act.	Proj.	Proj.
	(In percent of GDP)		
Revenues and grants	18.1	19.1	18.8
Of which: Oil and gas revenues	5.1	5.7	5.5
Non-oil and gas revenues	13.0	13.2	13.2
Expenditure and net lending	18.5	20.3	19.7
Of which: Subsidies	4.4	3.3	2.3
Of which: Fuel	3.5	2.0	0.9
Of which: Development expenditures	2.3	2.4	3.3
Of which: Transfers to regions	5.5	6.9	6.6
Overall balance	-0.3	-1.2	-0.9

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

- For 2007, the authorities are targeting a budget deficit of 0.9 percent of GDP. The target takes into account planned reductions in corporate and personal income tax rates, and further improvement in tax administration through the roll-out of the medium-size taxpayers' offices, along with a higher budget execution rate.

Risks: The government's capacity to implement the budget and possible financing constraints, if the external environment worsens, are the main risks.

- In the short run, the planned fiscal stimulus may not materialize. Continued delays due to lengthy procurement procedures, slow project implementation, and caution by managers resulting from the government's anti-corruption campaign have resulted in less than 15 percent of the budgeted capital spending being spent in the first five months of 2006. Moreover, large transfers to sub-national governments, resulting from higher oil prices, are not being spent, reflecting mostly capacity constraints, and this could further frustrate the central government's efforts to support growth.[4]

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[3] The deficit target of the central government is taken to represent the fiscal stance. Fiscal planning on a general government level is impossible because of long delays in reporting by subnational governments.

[4] Rp 20 trillion in deposits have been accumulated in regional development banks in the first two months of the year with the local government surplus expected to reach 1.6 percent of GDP in 2006.

- At the same time, although a large part of the financing requirement for 2006 has already been met, the budget could face financing constraints (or at least higher funding costs) if the current market turmoil continues and domestic bond yields continue to rise. Moreover, further increases in international oil prices would raise financing requirements to meet increased fuel subsidy costs, as discussed above.

Authorities' views: Steps are being taken for fiscal policy to support growth.

- The authorities agreed that so far this year fiscal policy had not been supportive of growth and that efforts to provide a stimulus had not been successful. Efforts are underway to address spending bottlenecks by simplifying procurement guidelines and budget execution procedures.

- In addition, measures to prevent the further erosion of consumer purchasing power are being taken. First, subsidized fuel and electricity prices will not be adjusted in 2006, as increases could further undermine weak demand and the inflation outlook. Second, the extension of the fuel cash compensation program (that is set to expire in the third quarter) to more low-income families by expanding eligibility for cash transfers, as well as linking transfers to education and health indicators, is being considered.

- The authorities did not see a problem in financing the budget, short of major changes in investors' risk appetite, given that recent bond issues have been oversubscribed.

Monetary policy

Outlook: With inflationary pressures subdued, further cuts in interest rates should be possible.

- Inflation at the end of 2006 is projected to be near the lower end of BI's 7–9 percent target range. The depreciation of the rupiah in May/June will put some upward pressure on prices, but these pressures should not raise underlying inflation substantially, given still weak domestic demand and the delay in the planned increase in domestic electricity prices.

- The downward trend in inflation has created room for reducing the policy rate. A cautious approach to further reduction will help maintain BI's credibility, especially given the recent shift out of emerging market assets.

Risks: Downside risks relate to unfavorable global liquidity and oil price developments, as noted above.

- Higher international interest rates and/or an excessively rapid decline of domestic rates, would put additional pressure on the rupiah, and given the importance of the exchange rate as a channel of transmission, undermine the achievement of the inflation target.

- If a substantial increase in international oil prices were to occur, it may at least partly need to be passed on to the consumer.

Authorities' views: BI is committed to maintaining price stability in the context of the inflation-targeting framework.

- BI reiterated its commitment to meeting the inflation target in 2006 and gradually reducing inflation thereafter. BI officials agreed that any further reduction in interest rates would have to take into account developments in international financial markets, as an excessively rapid decline in domestic rates could exacerbate pressures on financial markets and undermine the credibility of monetary policy.

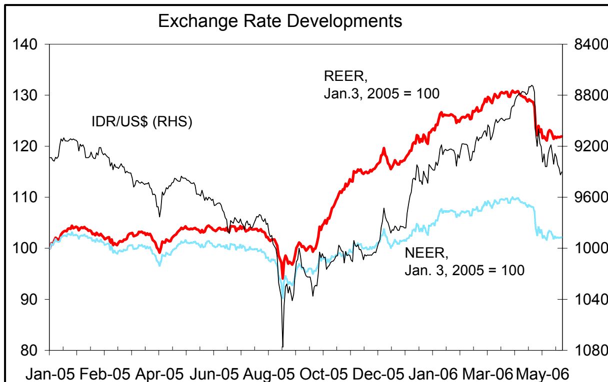
- The authorities were pleased that, following the adoption of the new inflation-targeting framework and the switch from base money to the 30-day SBI rate as the key intermediate target, markets have gradually focused on this rate to assess the monetary policy stance. BI has been making efforts to improve clarity and consistency in statements by its officials when signaling its policy intentions.

External Competitiveness and Exchange Rate Policy

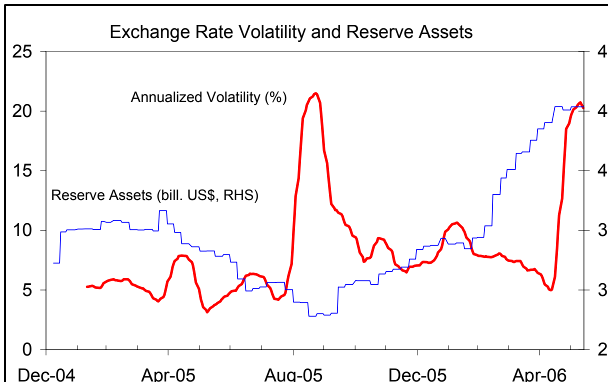
Background: The rupiah has shown considerable volatility in both nominal and real terms over the past year.

- After coming under pressure in August (volatility peaked at 22 percent),[5] the rupiah appreciated strongly in the wake of higher domestic interest rates and resulting capital inflows (see Chart). By early May 2006, the real effective exchange rate (REER) had reached its strongest level in five years, which gave rise to concerns about competitiveness, before the global market correction caused it to depreciate and volatility to again increase.

- Reserves have increased steadily since their low point in September, reflecting stronger oil and gas receipts, an international bond issue, and some foreign exchange intervention.



Sources: Bloomberg and Fund staff calculations.



Sources: Bloommberg and Fund staff calculations.

[5] Defined as the standard deviation of daily percentage (log) changes, annualized.

Risks: Export performance has been modest, but the rupiah does not appear to be out of line with its estimated equilibrium value.

- Moderately declining export shares in recent years, decelerating exports in early 2006, and the cumulative lack of investment in the export sector suggest that, in the absence of significant improvements in structural policies, Indonesia may face competitiveness challenges going forward.

- Real effective exchange rate indicators give a mixed picture, but econometric analysis of Indonesia's equilibrium exchange rate suggests that the rupiah may still be somewhat undervalued (Box 4).

- As noted in earlier Article IV reports, the apparent conflict between the results of the econometric analysis and modest export performance may arise because Indonesia's equilibrium exchange rate moves in line with commodity prices, which have recently risen and helped to maintain favorable macroeconomic balances.

Authorities' views: There was limited scope for enhancing competitiveness through macroeconomic policies.

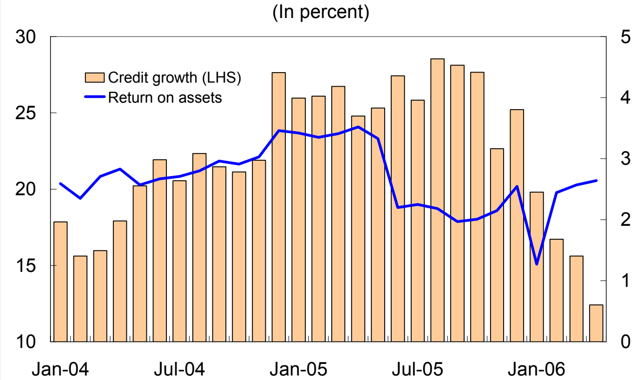
- Some leaders of the business community were concerned that the recent real appreciation of the rupiah, as well as its volatility, had adversely affected exports, especially in the manufacturing sector. These concerns have eased with the rupiah's recent depreciation. While mindful of competitiveness issues, BI officials felt that even at its peak in mid-May, the rupiah had not reached the point of becoming overvalued.

- BI officials also noted that there is limited scope for macroeconomic policy to address the level of the real exchange rate in the context of the inflation-targeting framework. BI's policy is to intervene only to smooth fluctuations and limit volatility in the rupiah. Structural reforms are needed to improve competitiveness.

Financial Sector Vulnerabilities and Policies

Background: Since the crisis, Indonesia has made progress toward establishing a strong and competitive private banking sector, although the two largest state banks have still weak governance and large nonperforming loans (NPLs).

Banking Indicators
(In percent)



Source: Bank Indonesia.

- Banking sector performance improved steadily through 2004 when profitability peaked and NPLs were at their lowest level. However, banks' return on assets declined from 3.3 percent in 2004 to 2.7 percent in 2005, reflecting largely reduced net interest margins, though returns recovered again in early 2006 despite slowing credit growth. The average capital adequacy ratio stood at about 20 percent at end-2005. Strengthened corporate sector balance sheets, including reduced reliance on external financing, have also reduced risks to banks (see Chapter II of Selected Issues paper).

- NPLs at the two largest state-owned banks rose to an average of over 20 percent of assets, respectively, at end-2005. This compares with an average of 3.4 percent for private banks. As a result, lending and profitability at these two banks has declined sharply. On July 5, the authorities released a financial sector package that, among other things, allows state banks to give haircuts on loan principal.[6] In addition, governance and internal controls are weak at these banks, and private shareholders do not have voting rights.

- On the institutional side, bank supervision has improved to bring it closer to Basle standards, and risk-based supervision has been introduced. The blanket guarantee scheme, introduced in the aftermath of the crisis, has been replaced by a financial safety net and a limited deposit guarantee scheme.

Risks: The overall banking sector is resilient to most risks, but NPLs at state banks and the slowing economy pose challenges going forward.

- Stress tests indicate that the overall banking sector is resilient to interest rate, exchange rate, liquidity, and credit risks.[7]

- The increase in NPLs at the two largest state-owned banks, if left unresolved, could pose problems, especially as these two banks constitute almost one-third of the banking sector.

- At private banks, risks are more limited, though aggressive competition for consumer and business lending may have led to weaker underwriting standards (albeit accompanied by higher interest rates charged on riskier loans). The increase in restructured loans at private banks suggests that some consumer loans already have had to be restructured.

Authorities' views: Problems at state banks need to be addressed, while supervision continues to be strengthened.

- The seriousness of the NPL problems at the two largest state-owned banks was recognized. A number of options to resolve these loans will be considered. The privatization of the two major state banks is not politically feasible at this stage. The authorities noted that a third state bank had played a useful public policy role by providing microfinance in remote areas.

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[6] Details will be provided in a forthcoming Staff Supplement.

[7] Sensitivity analysis performed by staff on the 15 largest banks individually and collectively (63 percent of system assets) suggest that most of the banks could readily withstand shocks arising from a 40 percent depreciation of the rupiah, a 400 basis point parallel shift in the yield curve, a downgrading of 50 percent of the loan portfolio, and a withdrawal of 15 percent of deposits.

- In addition, BI is continuing to enhance bank supervision, including through the further development of a risk-based approach and improving coordination between on-site and off-site supervision.

Enhancing Growth Prospects and Strengthening Institutions

The new economic team has stepped up efforts to improve the business climate and is taking a comprehensive approach to address long-standing structural problems and strengthen public institutions.

Fiscal Reforms

Background: A key element of the reform agenda is the development of fiscal institutions that will improve governance and support private sector development.

- Pilot tax offices have been set up for large, medium, and small tax payers over the past few years but continued inefficiency and governance problems at the tax collection department are seen as a major impediment to doing business.

- A sound legal and administrative framework to improve transparency (as noted in the accompanying findings of the ROSC mission) has been established but reporting is weak. Improvements are needed in the following areas to assess fiscal risks: (i) monitoring of State-Owned Enterprises (SOEs) operations,[8] (ii) reporting of quasi-fiscal and extra budgetary activities, such as foundations; and (iii) monitoring contingent liabilities.

- The existing fiscal decentralization framework makes fiscal management difficult due to a number of factors, including: (i) increased revenue-shares for local governments have not been accompanied by higher expenditure responsibilities; (ii) expenditure assignments remain vague; and (iii) subnational fiscal reporting is incomplete and untimely.

- Public expenditure management has improved following the restructuring of the Ministry of Finance and the adoption of the laws on state finances, treasury, and audit. However, the absence of a Single Treasury Account and the existence of a multitude of bank accounts outside the control of the Ministry of Finance undermines fiscal management.

Recent progress:

- A revised tax package aimed at addressing the business community's concerns has been submitted to Parliament. While some provisions are still missing,[9] the most recent proposals improve taxpayers' safeguards by: (i) restricting the rules on arrests/detainment of taxpayers, and (ii) modifying the procedures on the objection process. At the same

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[8] See also Chapter IV of Selected Issues paper and Box 5 for a discussion of fiscal risks related to public enterprises.
[9] Notably those granting standard enforcement powers to the tax agency.

time, a new management team at the tax department is pushing for quick implementation of the modernization strategy, including an evaluation of existing pilot tax offices.

- The Ministry of Finance is introducing a fiscal policy office with the principal task of assessing fiscal risks, including those stemming from SOEs (Box 5), and a risk management unit has been established to monitor contingent liabilities, including those arising from public-private partnerships.

- In late 2005, a number of regulations aimed at improving revenue-sharing mechanisms and financial reporting by regional governments were issued. A revised regulation on expenditure assignments is expected to be issued in 2006.

- A census of commercial bank accounts has been conducted and a new regulation on cash management, which would help in establishing a Single Treasury Account, is expected to be approved soon.

Authorities' views:

- The authorities are hopeful that the tax package will be approved by Parliament by end-year.

- They also expect the implementation of revised decentralization regulations to improve the regional reporting system, including by applying sanctions to non-compliant regions.

- A comprehensive census of all military foundations will be conducted, with a view toward expanding it to other off-budget foundations.

Other Investment Climate Reforms

Background: The government has adopted a time-bound plan to address weaknesses in the business climate (Figure 3), several of which have been on the policy agenda for some time but have been either delayed or implemented in a way that has not fully resolved the underlying problems.

- The new economic team unveiled a package of reforms, developed in consultation with local and foreign investors—the *Policy Package for Improvement in the Investment Climate targets*—which sets out a list of time-bound measures to remove obstacles to investment and boost growth, with clear delineation of responsibility between different ministries to establish accountability. Key areas are:

    - Facilitating investment by streamlining procedures to issue new business licenses and giving equal treatment to foreign and domestic investors.

    - Simplifying customs procedures.

- Revising the Labor Law to increase the role of employer-employee negotiations in wage-setting; modify severance pay and outsourcing regulations; and ease procedures for foreigners to work in Indonesia.

Recent Progress:

- A draft Investment Law has been submitted to Parliament and implementing regulations are being prepared.

- A draft Labor Law modifying several provisions, most notably those relating to severance pay, outsourcing, and minimum wage-setting, was prepared by the Ministry of Labor. However, it has had to be put on hold due to widespread protests by labor unions in early 2006 ahead of its submission to Parliament.

Authorities' views:

- Preliminary indications suggest that there is support in Parliament for the draft Investment Law. The authorities are optimistic that it will be approved by year-end.

- With regard to the labor issues, the President has asked the business community and labor unions to discuss directly possible changes to the framework for business-labor relations, and make recommendations. The authorities are hopeful that some progress toward reaching an agreement can be made before the end of the year, and have noted that some changes could be made through revisions in regulations.

V. Other Issues

- **Capacity to Repay the Fund:** With the early repayment of SDR 2.55 billion completed at end-June, prospective debt service to the Fund has dropped significantly, and is projected to amount to less than 1.5 percent of exports of goods and services over the next two years (Table 9). Under the revised schedule, Indonesia will complete repayment by 2008, two years ahead of schedule, though payments may be accelerated further, if circumstances permit.

- **FSAP:** The authorities reiterated their interest in an FSAP, but did not want to commit to a specific timetable, indicating that this would depend on completion of the ongoing reforms aimed at strengthening the banking system.

- **Data Issues:** Indonesia subscribes to the SDDS, although data weaknesses remain, especially in national accounts and sub-national government statistics. The authorities are making efforts to implement the recommendations provided in the context of the statistics ROSC last year.

VI. Staff Appraisal

10. **Despite security risks and some major natural disasters, Indonesia has continued to make steady economic progress in recent years.** Growth has recovered and sovereign creditworthiness has improved. Strides have been made in establishing a competitive banking system. The current government is making a serious attempt to tackle corruption and improve governance. The authorities have a sound medium-term macroeconomic policy framework in place, as well as an impressive reform agenda, that should help to accelerate growth and reduce vulnerabilities.

11. **Recent sound macroeconomic management has calmed inflationary pressures, though financial markets remain volatile.** Sharp increases in domestic fuel prices and interest rates in the fall of 2005 to address rising subsidy costs and inflationary pressures restored market confidence and triggered large portfolio inflows. However, these inflows also made Indonesia more vulnerable to global financial developments. Indeed, expectations of further interest rate rises in major industrial countries in May 2006 triggered a limited reversal of the inflows and considerable market volatility.

12. **In the short term, activity should regain momentum but there are downside risks.** A recovery in activity depends on global growth not being affected substantially by recent financial market turmoil and interest rate increases, and that the latter do not prevent a further easing in domestic interest rates. The projected recovery also assumes that the government succeeds in accelerating spending and that implementation of structural reforms begins to restore investor confidence.

13. **There is scope for fiscal policy to support activity in 2006, while still firmly pursuing reduction of the public debt burden over the medium term.** In this context, overall deficit targets of 1.2 percent and 0.9 percent of GDP in 2006 and 2007, respectively, are appropriate. To avoid the spending shortfalls of 2005, staff supports the government's intention to remove spending bottlenecks and to extend the fuel price cash compensation program. While recognizing the difficulties of raising energy prices at a time of weak demand, staff recommends the implementation of a mechanism for automatic adjustments of energy prices to depoliticize fuel price adjustments and remove the risk of higher subsidies. Indonesia's 2006 financing requirements are being successfully met so far, but the current financial turmoil calls for domestic and international bond markets to be monitored closely to ensure that the remaining financing requirements can be met.

14. **Further interest rate reductions should be possible in 2006, though the pace and timing will need to be cautious and take into account global market conditions.** Inflation has been trending down and still weak demand should limit the impact of the recent depreciation of the rupiah on price pressures. However, BI needs to be careful that rate decreases do not undermine its credibility, all the more given the recent volatility and possible further interest rate increases abroad. The clarity and consistency of statements by BI officials when signaling the central bank's policy intentions has improved and is essential to maintaining credibility.

15. **Standard real exchange rate indicators and econometric analysis do not suggest that the rupiah is significantly out of line with fundamentals.** While export performance has been modest, this problem needs to be addressed through structural measures that reduce costs and enhance productivity. BI appropriately took advantage of the rupiah appreciation earlier in the year to enhance reserve coverage. Staff supports BI's policy of intervening symmetrically to smooth fluctuations in the exchange market and limit volatility in the rupiah, which tends to undermine investor confidence.

16. **The authorities have done much to reduce macroeconomic vulnerabilities in recent years.** Most vulnerability indicators show improvements. Nevertheless, financial markets continue to experience bouts of volatility, triggered by either global developments or policy slippages, and exacerbated by the shallowness of domestic markets. The strong capital inflows experienced in early 2006 have heightened the risk of a sudden reversal, as demonstrated by market turmoil in May/June. Increased foreign exchange reserves should help the authorities to cope with any additional outflows and volatility in the foreign exchange market. Timely policy responses are also essential. Implementation of the policies envisaged under the authorities' medium-term macroeconomic framework should help reduce vulnerabilities further, as will the reform of state banks and the improvement of the business climate to encourage investment.

17. **The two largest state banks represent the major vulnerability in the banking sector.** In these banks, NPLs are high and governance is weak. On the other hand, private banks are well capitalized, and seem to have weathered well the recent weakness in the economy and rising interest rates. Staff welcomes that state banks will be provided authority to undertake haircuts and recommends that the NPL problem be resolved promptly, as delays could further erode bank capital. Medium-term privatization strategies should be adopted for public banks that do not have a clear public policy objective. In the meantime, governance could be improved by allowing private shareholders to participate in their management. As regards private banks, supervisors will need to remain vigilant to a deterioration in credit quality. Staff encourages the authorities to participate in an FSAP, as this could help to identify areas for further improvement in the financial system.

18. **The government is proceeding on a broad range of fiscal reforms.** Adoption of the tax package now before Parliament, along with modernization of the tax department, will help enhance revenue collection while restoring investor confidence. Staff supports the government's recent agreement with the business community on amending the tax law and making it more taxpayer friendly. The government's intention to better manage potential risks stemming from the operations of public enterprise and private-public partnerships is welcome.

19. **To improve the business climate and boost growth, the government has prepared an impressive reform agenda.** Given the business community's concerns about implementation, some major early reform successes are needed to increase confidence that the entire package will be implemented. For example, the customs, investment, and tax laws should not be too contentious and early approval of at least one or two of them should be pursued, which apart from the signaling effect would also bring immediate benefits for trade and investment.

20. **Staff supports the authorities' intention to press ahead with the preparation of a balanced framework for labor-business relations, despite the political difficulties.** The new framework needs to protect the rights of workers and be more business friendly. More flexible labor markets will help Indonesia become more competitive vis-à-vis neighboring countries and should encourage employers to make hiring decisions more freely.

21. **In sum, the authorities need to maintain sound macroeconomic policies, while implementing more forcefully structural reforms.** Without this, Indonesia could be caught in a circle of faltering growth and macroeconomic volatility, with pressures for more populist economic policies becoming more difficult to resist. Strong political leadership is now needed to implement structural reforms promptly, especially to guide key laws through Parliament. With elections still three years away, and relatively favorable short-term economic prospects, this is an opportune time to press ahead with reforms.

22. **It is recommended that the next Article IV Consultation with Indonesia take place on the standard 12-month cycle.**

Box 1. Tsunami Reconstruction Effort and the 2006 Yogyakarta Earthquake

Tsunami Reconstruction Effort

The pace of reconstruction in the tsunami-affected areas has picked up markedly in recent months. The government's reconstruction agency estimates that, as of February 2006, $4.7 billion has been allocated to specific projects (covering 80 percent of estimated needs) and $1.5 billion disbursed, with the rate of disbursement increasing substantially, to about $200 million per month in early 2006. The bulk of the funds has gone towards housing and the health and education sectors. One third of the destroyed houses and 90 percent of damaged health facilities have been rebuilt. If momentum continues, more than half of reconstruction needs could be met by the end of the year.

Selected Progress Indicators (April 2006)

Indicator	Needs	Recovery	Progress
Housing	120,000 units	42,000 units	35%
Schools	2,006 units	524 units	26%
Teachers	2,500 died	2,430 replacements	96%
Health facilities	127 units	113 unit	89%
Roads	3,000 Km	490 Km	16%
Bridges	120	41	34%
Fishing boats	7,000 units	6,160 units	88%

Source: Aceh and Nias Rehabilitation and Reconstruction Agency.

The 2006 Yogyakarta Earthquake

The earthquake in Yogyakarta and Central Java inflicted a huge death toll and significant damage, but is likely to have limited economic and fiscal impact at the national level. The death toll has reached about 5,700 with another 38,000 people injured. Preliminary estimates put reconstruction costs at about $2.8 billion (0.7 percent of GDP), about one third of the Tsunami reconstruction costs, with damage concentrated in private housing and with comparably smaller damage in the social and infrastructure sectors. Despite the magnitude of the human toll and the economic damage, the economic and fiscal impact at the national level is likely to be modest. The Yogyakarta region accounts for a little more than 1 percent of the country's GDP and most of the infrastructure of the region has remained intact. On the fiscal side, the government has committed Rp 8 trillion (about 0.3 percent of GDP), including immediate cash transfers to the affected population. The authorities expect to receive another $300 million from donors.

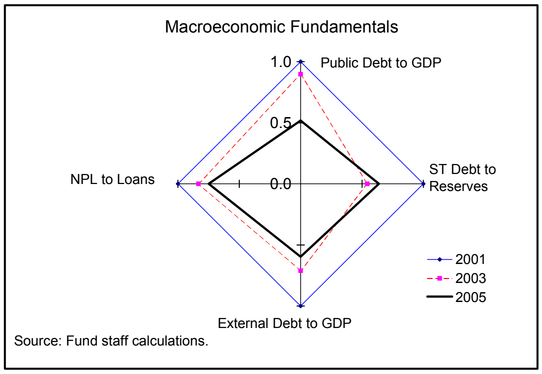
Yogyakarta Earthquake Damages
(as of June 12, 2006)

Dead	5,722
Injured	37,924
Homes heavily damaged or destroyed	294,425

Source: Provincial Coordinating Body for Disaster Management.

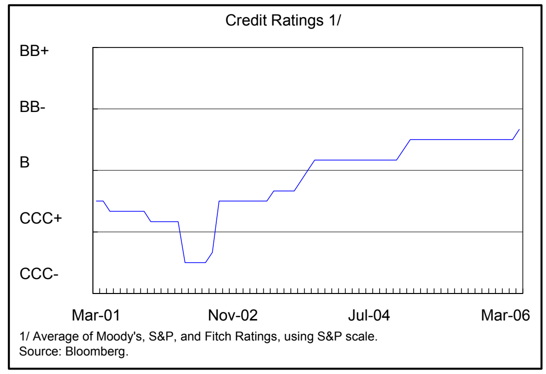
Box 2. Contingent Claims Estimates and Evolution of Indonesia's Sovereign Credit Risk

Indonesia's sovereign credit risk has improved markedly over the past five years, in line with improving fundamentals and favorable market conditions. Declining debt levels, higher reserve coverage, improvements in financial sector health, and favorable balance of payments developments have all contributed to a reduction in spreads on Indonesian debt (see Chart). Rating agencies have all upgraded Indonesian debt (see Chart), in line with declining spreads on emerging market debt more generally (see Chart).



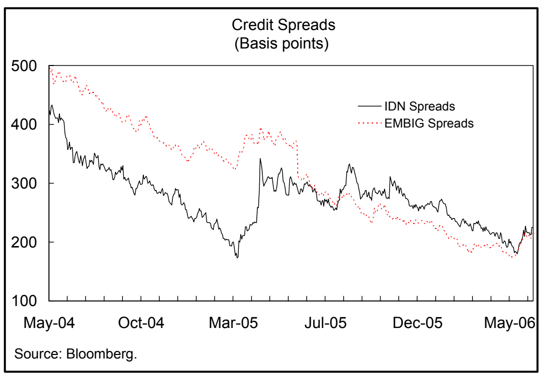
Macroeconomic Fundamentals

Source: Fund staff calculations.



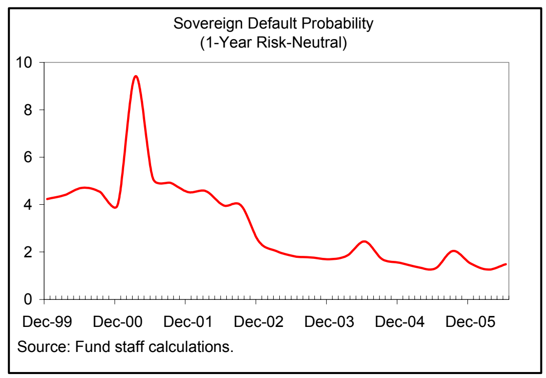
Credit Ratings 1/

1/ Average of Moody's, S&P, and Fitch Ratings, using S&P scale.
Source: Bloomberg.



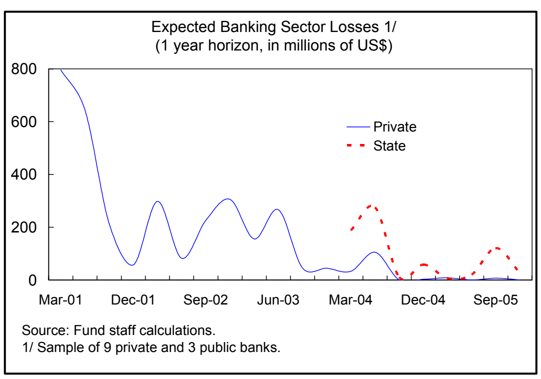
Credit Spreads
(Basis points)

Source: Bloomberg.



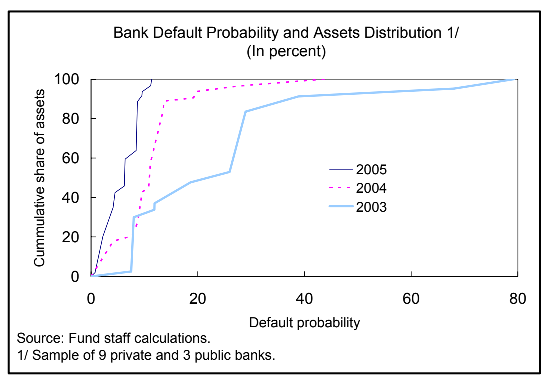
Sovereign Default Probability
(1-Year Risk-Neutral)

Source: Fund staff calculations.



Expected Banking Sector Losses 1/
(1 year horizon, in millions of US$)

Source: Fund staff calculations.
1/ Sample of 9 private and 3 public banks.



Bank Default Probability and Assets Distribution 1/
(In percent)

Source: Fund staff calculations.
1/ Sample of 9 private and 3 public banks.

A variety of risk-adjusted balance sheet indicators, compiled using the contingent claims approach,[1] confirm the improving outlook for sovereign credit risk. Default probabilities for the sovereign have declined steadily since 2001, leading to a decline in spreads (see Chart). For the banking system, default probabilities for 12 of the largest banks have all declined steadily since 2001, leading to a reduction in expected losses (see Chart). The distribution of risks in the banking system has also improved steadily since 2003, with the riskiest banks accounting for a progressively smaller share of banking assets (see Chart).

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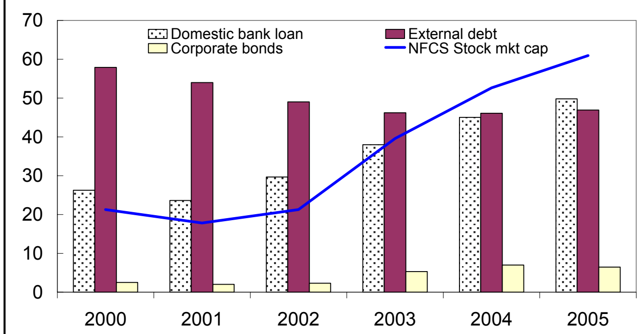
[1] The contingent claims approach uses option pricing formulae to infer asset values and probabilities of default. See Chapter III of Selected Issues paper for further details.

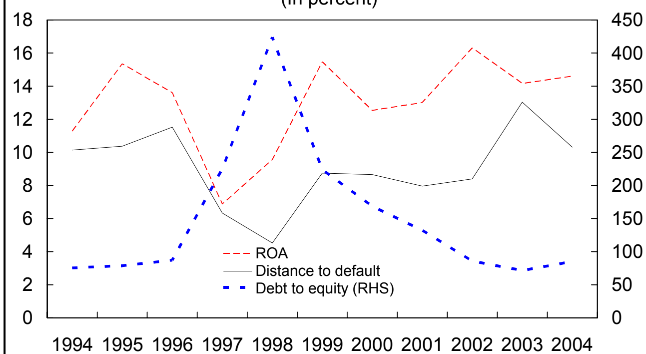
Box 3. Corporate Sector: Financial Performance and Underlying Vulnerabilities

The corporate sector in Indonesia has been recovering from its weak financial situation following the financial crisis of 1997–98. Based on a sample of nonfinancial listed companies, indicators show declining leverage; strengthened capacity to repay obligations, especially for larger firms; and improved profitability accompanying the overall improvement in macroeconomic conditions of recent years (see Chart). The decline in leverage through 2004 is broadly in line with regional standards. Currency mismatches on bank lending to the corporate sector have also declined substantially. Corporate bond financing, although still moderate, has doubled in the last four years, reaching $6 billion in 2005.



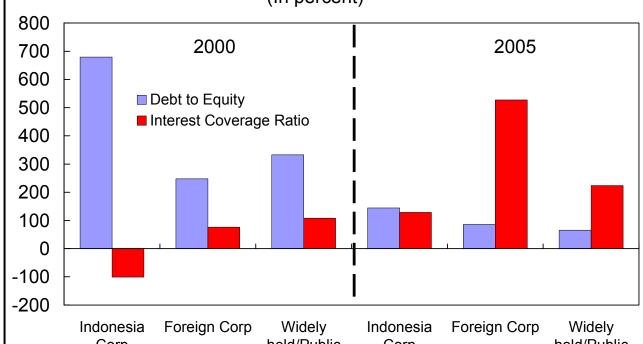
Sources: Indonesian authorities; CEIC Database; and Fund staff calculations.

The recent improvement in corporate financial indicators has taken place in the context of improved corporate governance regulations and practices (see Chart). Widespread bank-corporate ownership ties that had undermined governance were broken after the crisis as a result of bank restructuring and the removal of restrictions to bank ownership structure. Financial reporting has become more transparent following the adoption of basic international financial reporting standards. The excessive degree of ownership concentration observed prior to the crisis—when 10 families controlled more than 50 percent of large firm assets—has moderated significantly. Improvements in the corporate governance environment have also been helped by better banking regulation and supervision and by the government's ongoing anti-corruption drive.



Sources: IMF, *Corporate Vulnerability* database and Fund staff calculations.

At the same time, however, the composition of corporate financing also reflects underlying vulnerabilities. First, the number of listed companies has increased very slowly from 269 to 279 between 2001–05, partly explained by the reluctance of non-listed firms to comply with more stringent governance requirements. Second, bank lending has again become the main source of corporate financing in 2005, for the first time since the crisis, in the face of modest stock market capitalization, a reduction of external borrowing, and still limited resort to corporate bond financing. Third, the availability of bank financing to the domestic traditional corporate sector—defined as those companies that survived the 1997–98 crisis—has remained limited, since increased caution in bank lending decisions following improvements in banking regulation and supervision and increased risk aversion has become incompatible with uncertainties regarding the effectiveness of domestic courts to ensure the full exercise of creditor rights if need arises.



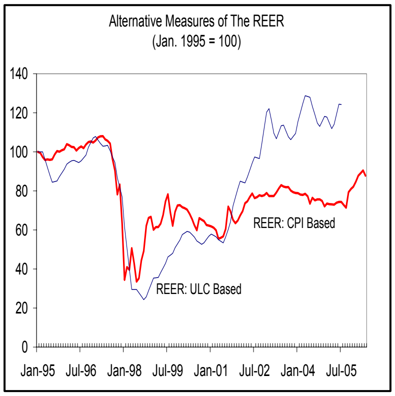
Source: Worldscope database.

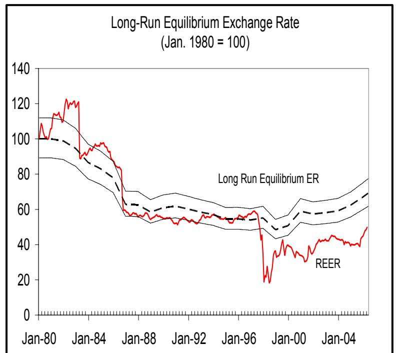
Partly as a result of the above developments, traditional corporate groups appear to be in a relatively more difficult financial situation to face the ongoing slowdown in economic activity. Recent information for the top 100 listed companies through 2005 show the less benign financial situation of domestic traditional corporate groups relative to the rest of the corporate sector. While for the sample as a whole, financial trends show continuous de-leveraging, higher preference for liquidity and declining profitability, firms belonging to traditional corporate groups show higher-than-average leveraging (due to long-unsettled obligations); lower liquidity, and slightly lower profitability (see Chart).

Box 4. Exchange Rate Developments and Competitiveness

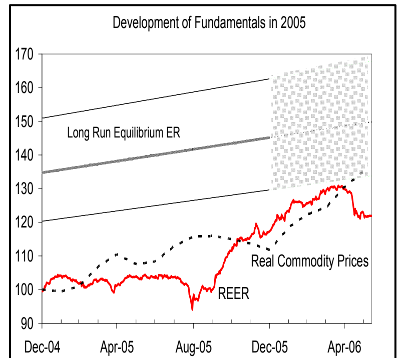
Developments in Fundamentals: Measures of competitiveness based on the CPI and unit labor costs (ULC) both show continued real appreciation since early 2001, with ULC rising more rapidly than the CPI-based measure (see Chart).[1] The REER (CPI-based) is still around 5 percent below its pre-crisis levels.

Fund staff estimates using the adjusted PPP approach suggest that the appreciation of the REER in 2005 has brought it close to its estimated long-run equilibrium value (see Chart). This method relates the REER to productivity developments, commodity terms of trade, and net foreign assets for a panel of 39 countries. At the end of 2005, the REER was estimated to be between 13 percent and 42 percent below its long-run equilibrium value (27 percent ± 1 standard deviation). Since then the REER and the equilibrium exchange rate have continued to appreciate, supported by stronger commodity prices, current account surpluses, and continuing high domestic interest rates (see Chart). Sustainability of the external position does not appear to be a problem, with small but declining current account surpluses likely to give way to moderate but sustainable deficits over the medium term, as external debt ratios continue to improve.

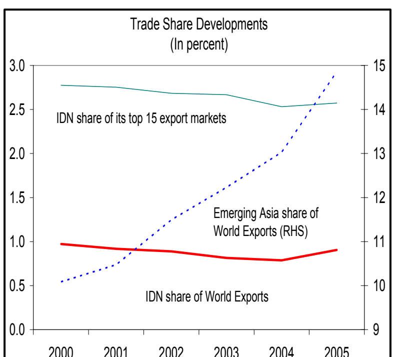




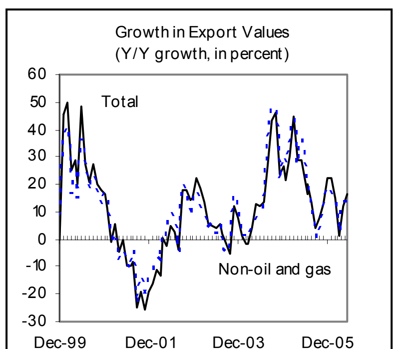
Source: Fund staff calculations.



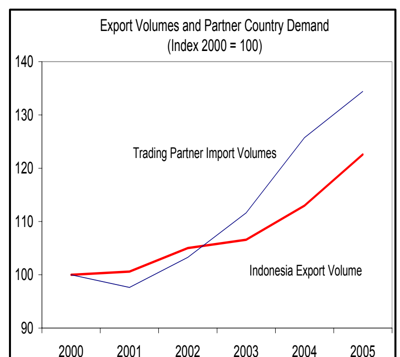
Source: Fund staff calculations.



Source: Direction of Trade database.



Source: CEIC database.



Sources: Direction of Trade database and Fund staff calculations.

Trade performance: Indonesia's declining trade shares were reversed modestly in 2005 on the strength of surging commodity prices and stronger export volumes (see Chart). The modest export performance through 2004 reflects the dearth of investment in export-oriented industries since the crisis, with cumulative investment during 2000–05 at around half of the level prior to the crisis, concentrated in industries with the lowest share of overall exports. As a result, Indonesia's export volumes have remained weak, and have not fully capitalized on surging import demand from its main trading partners. Recent data show steadily decelerating export growth rates (see Chart).

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[1]ULC is based on manufactured output of the small formal sector, so it is a partial indicator that may not be representative of broader trends in labor costs.

Box 5. Indonesia's Public Enterprises and Fiscal Risks[1]

A preliminary assessment of fiscal risks for Indonesia's public enterprises, with a particular emphasis on the largest State Owned Enterprises (SOEs), was undertaken using the criteria developed by the Fund's Fiscal Affairs Department (see Public Investment and Fiscal Policy – Lessons from the Pilot Country Studies, www.imf.org). The five areas of risk examined are as follows:

- **Managerial independence:** While Boards of Directors are largely free to define employment and compensation policies, the government sets prices in the energy and transport sectors.

- **Relations with the government:** All SOEs are subject to the same taxes as private firms. Delays and shortfalls in subsidy payments to state-owned oil and electricity companies have led to some inter-enterprise arrears and quasi-fiscal operations.

- **Transparency and governance:** Law 19/2003 provides regulations on audit committees and compulsory audits of financial statements. However, annual reports are not available for all companies (24 out of 151 SOEs still have not had their 2004 financial accounts audited).

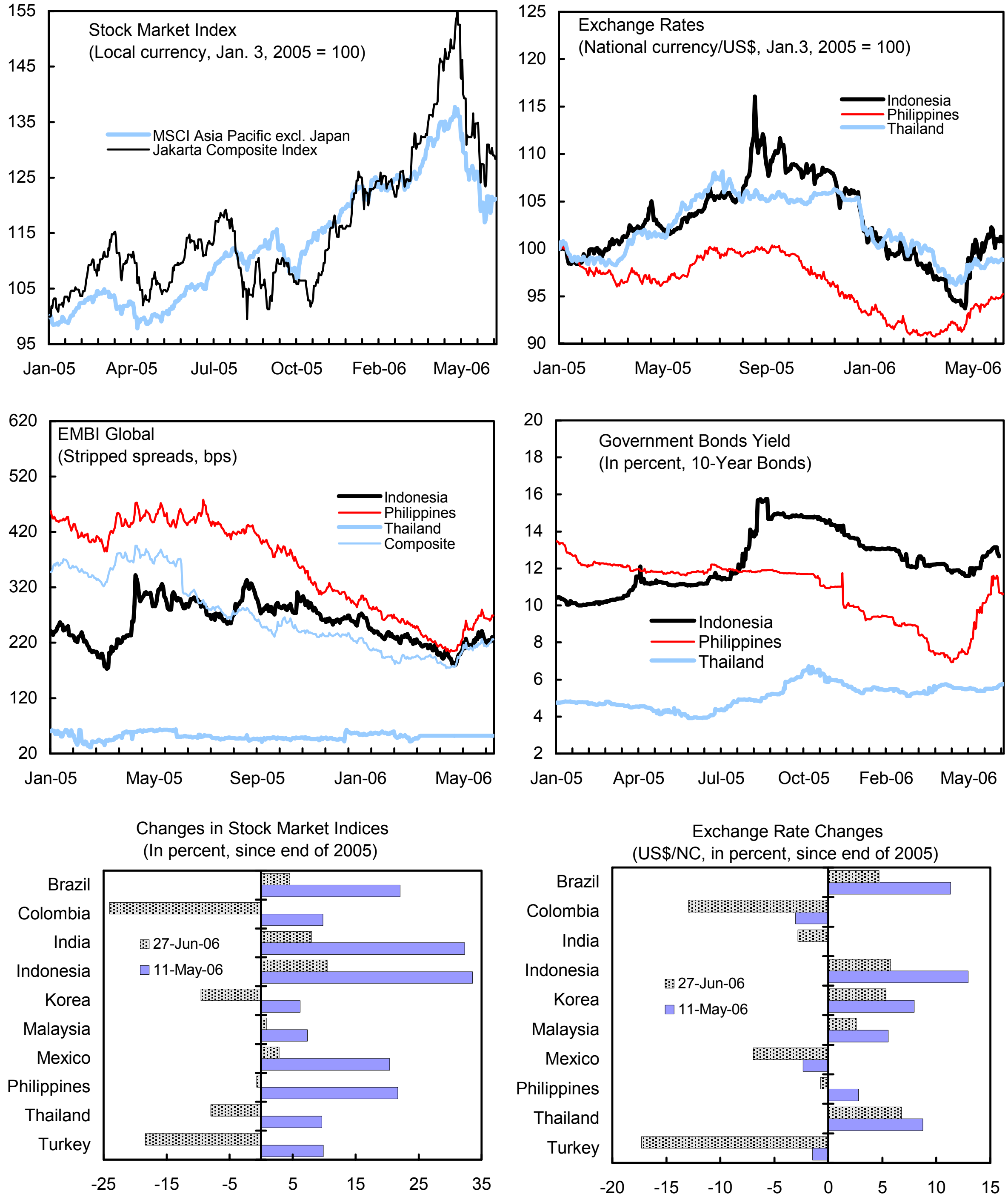
- **Financial conditions and sustainability:** While financial conditions of SOEs vary by sector, overall profit transfers to the central government have been about 0.3 percent of GDP in the last four years and income tax payments have been rising. Most SOEs are not leveraged, as reflected in relatively low debt ratios.

- **Other factors affecting risks:** Some SOEs need to introduce a foreign risk management strategy to hedge currency fluctuations, as a large part of input costs are in foreign exchange.

Overall, the solid financial health of the public enterprise sector and the sound corporate governance framework limit short-run fiscal risks. However, continuing losses in some enterprises (such as the electricity company) will have to be addressed to avoid draining SOE reserves, allow investment plans to go ahead as scheduled, and increase profit transfers to the government.

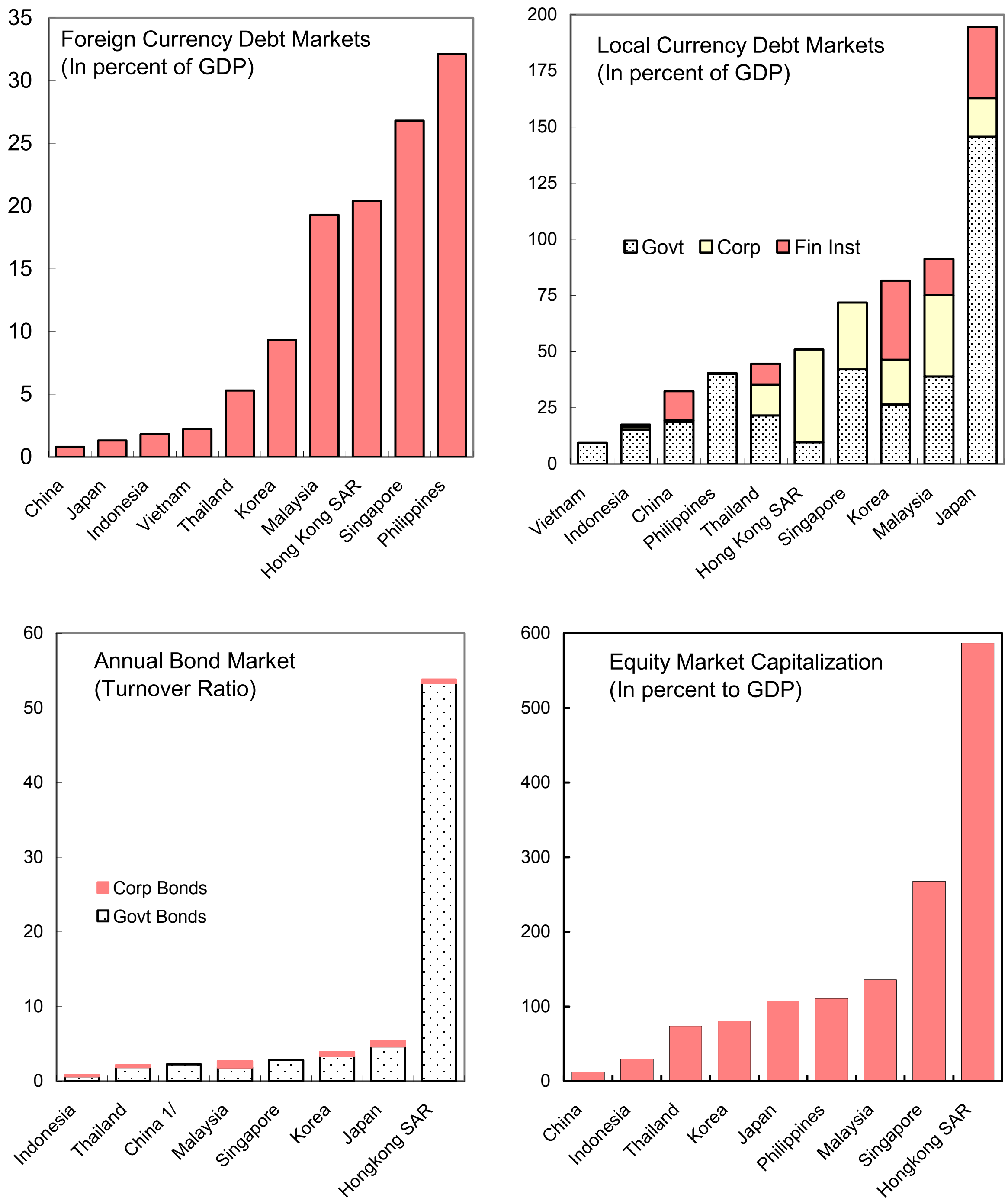
[1] See Chapter IV of Selected Issues paper for more details.

Figure 1. Recent Financial Market Developments



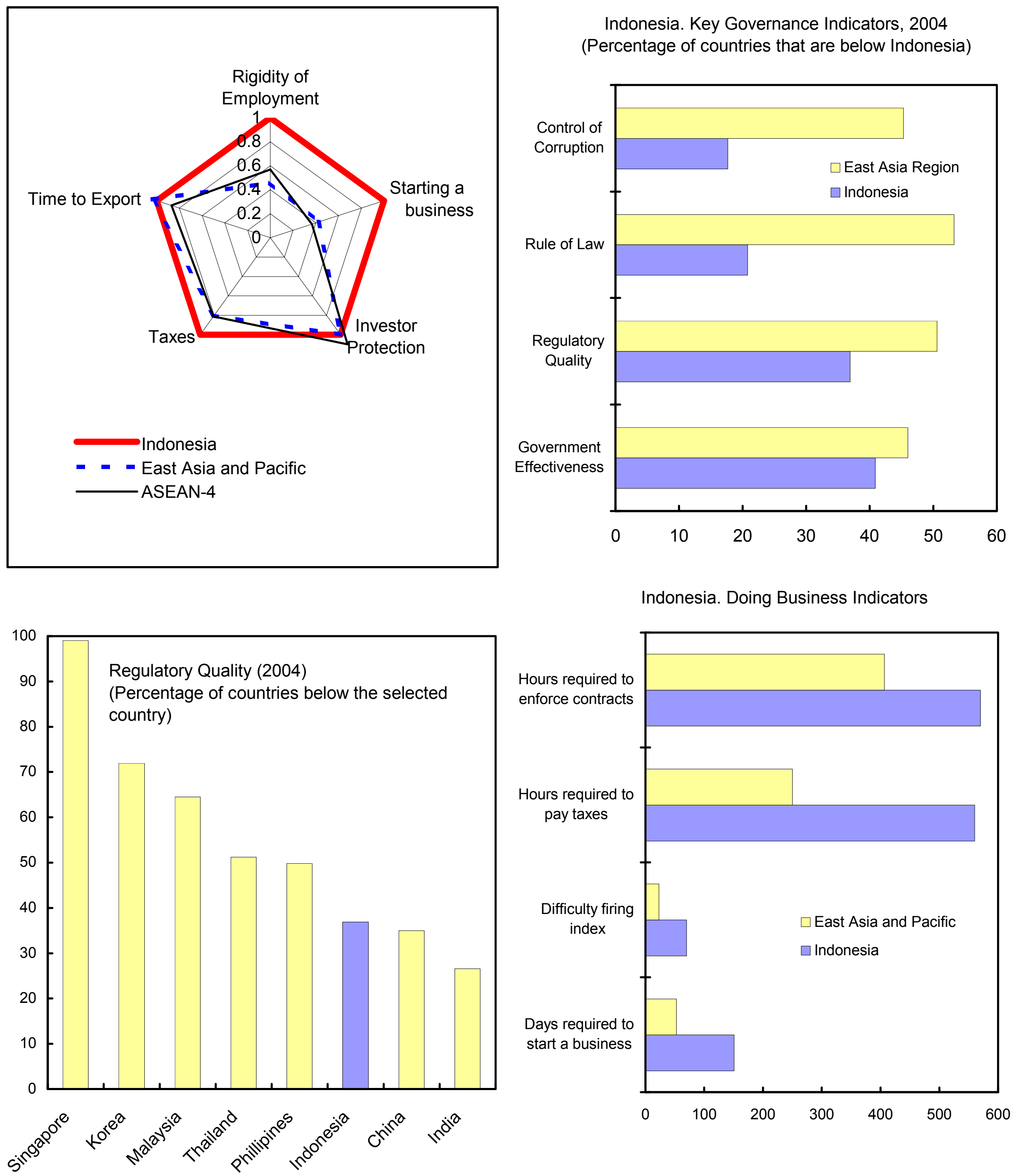
Source: Bloomberg.

Figure 2. Financial Market Shallowness



1/ 2004 data.
Sources: CEIC Database; Asian Bond Online; IMF, *World Economic Outlook*; and Fund staff calculations.

Figure 3. Doing Business



Source: World Bank, *Cost of Doing Business* , 2005

Table 1. The Authorities' Response to Recent Fund Policy Advice

Advice from the 2005 Article IV Discussions	Actions Taken
Monetary and Fiscal policy	
Increase interest rates as inflationary pressure rises	BI increased its policy rate by 450 percentage points in the last 12 months to counteract inflationary pressures.
Move toward a full-fledged inflation-targeting framework	In July 2005, BI moved to formal inflation targeting and adopted the one-month interest rate as an intermediate target.
Maintain prudent fiscal policy to reduce debt	In 2005, the primary surplus increased to 2.2 percent of GDP (1.3 percent of GDP in 2004), largely because of spending delays Debt to GDP ratio decreased by 8 percentage points of GDP to 47 percent of GDP.
Strengthen tax administration and preserve non-oil revenue	A tax administration reform program has been designed and new management has been appointed at the collection agency. A tax bill to balance taxpayers' rights and tax authorities' powers is in Congress. However, it includes reductions in income tax rates.
Reduce fuel subsidies and increase social spending	Domestic fuel prices were more than doubled.
Introduce treasury and debt management reforms	A new cash management system has been designed and is ready for implementation. The creation of a single debt unit is in the pipeline.
Ensure that decentralization reforms do not weaken fiscal discipline	Little progress has been made in clarifying expenditure assignments and the borrowing framework for sub-national governments. Some implementing regulations to the decentralization law have been issued.
Financial sector	
Development of a medium-term strategy for state-owned banks	No progress has been made.
Support the consolidation process in the banking sector with appropriate legal framework	BI has issued regulations on minimum capital requirements and corporate governance, and started implementing risk-based supervision.
Implement a financial sector safety net	The financial sector safety net is operational and the blanket guarantee has been replaced by a deposit insurance scheme.
Structural reforms	
Resolve outstanding investor disputes	The standoff with Exxon on developing the Cepu oil fields has been solved with presidential intervention, but other cases remain.
Improve flexibility in the labor market	A reform bill opposed by unions was recently withdrawn before submission to Parliament.

Table 2. Indonesia: Selected Economic Indicators, 2002–06

	2002	2003	2004	2005	2006
		Act.			Proj.
Real GDP (percent change)	4.5	4.8	5.1	5.6	5.2
Domestic demand	2.4	6.0	5.2	4.4	5.2
Of which:					
Private consumption	3.8	3.9	5.0	4.0	3.0
Gross fixed investment	4.7	0.6	14.6	9.9	6.0
Change in stocks 1/	-2.0	2.2	-1.4	-1.2	0.4
Net exports 1/	0.8	1.8	-2.2	-0.5	0.8
Statistical discrepancy 1/	1.5	-2.4	2.5	2.1	-0.3
Saving and investment (in percent of GDP)					
Gross investment 2/	21.3	22.5	22.8	22.5	23.1
Gross national saving	25.3	26.0	23.4	22.9	23.4
Foreign saving	-4.0	-3.5	-0.6	-0.3	-0.3
Prices (12-month percent change)					
Consumer prices (end period)	9.9	5.2	6.4	17.1	7.0
Consumer prices (period average)	11.8	6.8	6.1	10.5	13.3
Public finances (in percent of GDP)					
Central government revenue	16.5	16.7	17.9	18.1	19.1
Central government expenditure	18.0	18.7	19.3	18.5	20.3
Central government balance	-1.6	-2.0	-1.4	-0.3	-1.2
Primary balance	3.4	1.6	1.4	2.2	1.4
Central government debt	65.4	58.3	55.7	46.5	40.9
Money and credit (12-month percent change; end of period)					
Rupiah M2	7.9	9.8	10.0	13.0	17.9
Base money	8.3	19.8	20.4	21.9	15.8
Private sector credit	25.1	22.1	30.4	19.7	15.9
One-month SBI rate (period average)	15.1	10.1	7.5	9.1	12.1
Balance of Payments (in billions of US$)					
Oil and gas (net)	6.2	7.4	5.1	4.0	6.8
Non-oil exports (f.o.b)	46.3	48.9	54.5	66.2	74.9
Non-oil imports (f.o.b)	-29.0	-31.7	-39.5	-47.9	-54.8
Current account balance	7.8	8.1	1.6	0.9	1.0
Foreign direct investment	0.1	-0.6	-1.5	1.8	2.1
Overall balance	5.0	3.7	1.0	-0.5	11.1
Gross reserves					
In billions of US dollars (end period)	32.0	36.3	36.3	34.7	40.8
In months of imports	6.8	6.1	5.0	4.1	4.4
As a percent of short-term debt 3/	117.3	134.5	137.4	113.7	138.7
Total external debt					
In billions of US dollars	131.3	135.4	137.4	133.8	136.9
In percent of GDP	67.2	57.7	54.0	47.6	39.0
Exchange rate (period average)					
Rupiah per US$	9,314	8,575	8,933	9,705	...
Nominal effective exchange rate (Jan. 2000=100)	94.2	95.0	87.0	79.3	...
Memorandum items:					
Oil production (000bcpd)	1,260	1,200	1,040	999	1,000
Indonesian oil price (US$/bbl)	24.1	28.8	37.8	50.8	64.0
Nominal GDP (in trillions of Rupiah)	1,822	2,014	2,273	2,730	3,253
Nominal GDP (in billions of US$)	196	235	254	281	351

Sources: Indonesian authorities; and Fund staff estimates.

1/ Contribution to GDP growth (percentage points).

2/ Includes changes in stocks. Computed on real basis.

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

Table 3. Indonesia: Selected Vulnerability Indicators, 2002–06

	2002	**2003**	**2004**	**2005** 1/	**2006** 1/	**Latest observation**
Key Economic and Market Indicators						
Real GDP growth (in percent)	4.4	4.8	5.1	5.6	4.6	Mar-06
CPI inflation (in percent)	11.8	6.8	6.1	10.5	15.5	Jun-06
Short-term (ST) interest rate (in percent, end of period)	12.9	8.3	7.4	12.8	12.5	Jun-06
EMBI secondary market spread (bps, end of period)			244	269	220	Jun-06
Exchange rate NC/US$ (end of period)	8,950	8,425	9,285	9,830	9,263	Jun-06
External Sector						
Exchange rate regime			Managed Float			
Current account balance (percent of GDP)	3.9	3.4	0.6	0.3	0.3	Proj.
Net FDI inflows (percent of GDP)	0.1	-0.3	-0.6	0.7	0.6	Proj.
Exports (percentage change of US$ value, GNFS)	4.6	5.3	19.7	19.7	14.9	Proj.
Real effective exchange rate (End, period; Jan. 2000=100)	119.9	120.0	109.4	124.8	132.8	May-06
Gross international reserves (GIR) in US$ billion	32.0	36.3	36.3	34.7	40.8	Proj.
GIR in percent of ST debt at remaining maturity (RM)	117.3	134.5	137.4	113.7	138.7	Proj.
Total gross external debt (ED) in percent of GDP	65.7	56.8	54.0	47.6	39.0	Proj.
o/w ST external debt (original maturity, in percent of total ED)	1.1	1.7	3.0	5.9	5.2	Proj.
ED of domestic private sector (in percent of total ED)	43.3	40.2	41.0	43.8	48.7	Proj.
ED to foreign official sector (in percent of total ED)	54.7	57.8	55.3	51.5	45.9	Proj.
Total gross external debt in percent of exports of GNFS	200.1	195.8	166.0	135.1	120.3	Proj.
Gross external financing requirement (in US$ billion) 2/	30.8	19.8	22.1	23.7	25.0	Proj.
Public Sector (PS) 3/						
Overall balance (percent of GDP)	-1.6	-2.0	-1.4	-0.3	0.2	Apr-06
Primary balance (percent of GDP)	3.4	1.6	1.4	2.2	1.0	Apr-06
Gross PS financing requirement (in percent of GDP) 4/	6.7	8.4	5.5	3.0	...	Dec-05
Public sector gross debt (PSGD, in percent of GDP)	65.4	58.3	55.7	46.5	...	Dec-05
Of which : Exposed to rollover risk (in percent of total PSGD) 5/	3.7	7.0	3.9	6.0	...	Dec-05
Exposed to exchange rate risk (in percent of total PSGD) 6/	45.9	44.0	50.8	51.1	...	Dec-05
Exposed to interest rate risk (in percent of total PSGD) 7/	18.9	18.6	17.0	15.9	...	Dec-05
Financial Sector (FS) 8/						
Capital adequacy ratio (in percent)	20.1	22.3	20.6	19.6	...	Dec-05
NPLs in percent of total loans 9/	6.8	6.3	4.5	10.3	...	Dec-05
Provisions in percent of NPLs	130.0	137.5	138.1	60.1	...	Dec-05
Return on equity (in percent)	19.0	19.2	25.4	17.5	...	Dec-05
FX deposits (in percent of total deposits)	18.2	16.6	11.5	13.1	13.6	Mar-06
FX loans (in percent of total loans)	24.0	20.4	18.7	16.0	...	Dec-05
Government debt held by FS (percent of total FS assets)	43.4	35.9	29.7	26.4	...	Dec-05
Credit to private sector (percent change)	25.1	22.1	30.4	19.7	15.6	Mar-06

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 12 banks by assets.
9/ Loans are gross of any allowance for losses.

Table 4. Indonesia: Summary of Central Government Operations, 2004–07

	2004	2005		2006		2007
	Act.	Revised Budget	Est.	Budget	IMF Staff Proj.	IMF Staff Proj.
			(In trillions of rupiah)			
Revenues and grants	407.8	540.2	495.4	625.2	620.0	687.1
Oil and gas revenues	108.2	175.8	138.7	183.8	186.2	201.8
Non-oil and gas revenues	299.3	356.9	355.4	437.9	430.4	482.7
Tax revenues	257.9	314.8	311.8	378.8	378.0	430.5
Nontax revenues 1/	41.4	42.1	43.6	59.1	52.3	52.2
Grants	0.3	7.5	1.3	3.6	3.4	2.6
Expenditure and net lending	439.4	575.0	503.8	647.7	659.6	719.9
Central government expenditure	309.7	421.6	369.0	427.6	436.6	476.9
Current expenditure	245.0	336.9	306.6	327.7	357.1	356.2
Personnel	54.2	61.1	55.6	79.9	79.6	94.0
Subsidies	85.5	119.1	120.7	79.5	108.6	84.1
of which fuel subsidies	69.0	89.2	95.7	54.3	63.6	33.5
Interest	62.3	71.0	67.7	76.6	84.8	78.9
External 2/	22.8	28.7	24.2	28.0	23.4	25.5
Domestic	39.6	42.3	43.5	48.6	61.4	53.4
Other	43.0	85.7	62.6	91.7	84.1	99.1
Development expenditure 3/	61.7	84.7	62.4	99.9	79.6	120.7
Transfers to regions	129.7	153.4	150.5	220.1	223.0	243.0
Statistical discrepancy 4/	3.0	0.0	-15.7	0.0	0.0	0.0
Overall balance 3/	-31.6	-34.8	-8.4	-22.4	-39.6	-32.8
Financing	31.6	34.8	8.5	22.4	39.6	32.9
Domestic	46.0	20.4	-17.4	40.6	33.4	38.4
Bank financing	28.5	4.3	-16.2	23.0	4.6	22.6
Net issuance of government securities	-1.7	11.8	-2.1	14.6	27.2	13.8
Recovery of bank assets	15.8	5.1	6.1	2.4	2.4	0.0
Privatization of nonfinancial assets	3.5	3.5	0.0	1.0	1.0	2.0
Other 5/	0.0	-4.2	-5.2	-0.4	-1.8	0.0
External	-14.4	14.4	25.9	-18.2	6.2	-5.5
			(In percent of GDP)			
Revenues and grants	17.9	20.4	18.1	20.6	19.1	18.8
Oil and gas revenues	4.8	6.6	5.1	6.0	5.7	5.5
Non-oil and gas revenues	13.2	13.5	13.0	14.4	13.2	13.2
Tax revenues	11.3	11.9	11.4	12.5	11.6	11.8
Nontax revenues 1/	1.8	1.6	1.6	1.9	1.6	1.4
Grants	0.0	0.3	0.0	0.1	0.1	0.1
Expenditure and net lending	19.3	21.7	18.5	21.3	20.3	19.7
Current expenditure	10.8	12.7	11.2	10.8	11.0	9.7
Personnel	2.4	2.3	2.0	2.6	2.4	2.6
Subsidies	3.8	4.5	4.4	2.6	3.3	2.3
of which fuel subsidies	3.0	3.4	3.5	1.8	2.0	0.9
Interest 2/	2.7	2.7	2.5	2.5	2.6	2.2
Other	1.9	3.2	2.3	3.0	2.6	2.7
Development expenditure 3/	2.7	3.2	2.3	3.3	2.4	3.3
Transfers to regions	5.7	5.8	5.5	7.2	6.9	6.6
Overall balance 3/	-1.4	-1.3	-0.3	-0.7	-1.2	-0.9
Financing	1.4	1.3	0.3	0.7	1.2	0.9
Domestic	2.0	0.8	-0.6	1.3	1.0	1.0
External	-0.6	0.5	0.9	-0.6	0.2	-0.2
Memorandum items:						
Primary balance	1.4	1.4	2.2	1.8	1.4	1.3
General Government balance	-1.1	...	-0.2	...	0.3	-0.6
Crude oil price (US $ per barrel)	37.8	54.0	50.8	57.0	64.0	67.3
Oil production (mbpd)	1.040	1.075	0.999	1.050	1.000	1.000

Sources: Indonesian authorities; and Fund staff estimates.

1/ From 2004 onward, 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/ 2005 monetary and fiscal data are still to be reconciled.
5/ Includes capitalization of deposit insurance fund in 2005.

Table 5. Indonesia: Selected Social Indicators, 2001–04

	2001	2002	2003	2004
Education				
Elementary school net enrollment ratio, percent *of relevant aged group*	92.9	92.6	92.6	93.0
Population > 10 yr old not completed primary school (in percent)	34.4	31.3	30.8	29.4
Population > 10 yr old finished primary and Junior high school (in percent)	47.6	49.2	47.1	49.9
Population > 10 yr old finished high school and college (in percent)	18.0	19.5	11.5	20.7
Adult literacy rate	89.3	90.7	90.9	90.5
Health				
Life expectancy rate	66.2	66.2	66.2	68.6
Fertility rate, *births per woman*	2.3	2.3	2.3	2.3
Children < 5 yr old that have good nutrition (in percent)	69.1	71.9	69.6	74.4
Children < 5 yr old that had been immunized (in percent)	89.9	90.6	..	92.1
Housing and Sanitation				
Household with access to piped water (in percent)	18.3	19.7	18.9	18.0
Household with electricity (in percent)	86.3	87.6	87.9	89.0
Poverty and inequality				
Number of people under poverty line (in millions)	37.1	38.4	37.3	36.1
Population under poverty line (in percent)	18.4	18.2	17.4	16.7
Gini Coefficient	0.32	0.33	0.32	0.33
Employment				
Total labor force (in millions)	99	101	100	104
Labor participation rate	68.6	67.8	65.7	67.6
Unemployment rate	8.1	9.1	9.5	9.9

Sources: World Bank; and CEIC database.

Table 6. Indonesia: Balance of Payments, 2002–06
(In billions of U.S. dollars)

	2002	2003	2004	2005 Est.	2006 Proj.
I. Current Account	7.8	8.1	1.6	0.9	1.0
A. Goods, Net (Trade Balance)	23.5	24.6	20.2	22.3	26.8
1. Exports, f.o.b.	59.2	64.1	70.8	86.2	100.7
Of which: Oil and Gas	12.9	15.2	16.3	20.0	25.8
Non-oil and Gas	46.3	48.9	54.5	66.2	74.9
2. Imports, f.o.b.	-35.7	-39.5	-50.6	-63.9	-73.8
Of which: Oil and Gas	-6.7	-7.8	-11.2	-15.9	-19.0
Non-oil and Gas	-29.0	-31.7	-39.5	-47.9	-54.8
B. Services, Net	-9.9	-11.7	-8.8	-10.8	-14.0
C. Income, Net	-7.0	-6.2	-10.9	-11.8	-13.0
D. Current Transfers, Net	1.3	1.5	1.1	1.3	1.2
II. Capital and Financial Account	-1.1	-0.9	2.5	-2.5	8.9
A. Capital Account	0.0	0.0	0.0	0.3	0.3
B. Financial Account	-1.1	-0.9	2.5	-2.8	8.6
1. Direct Investment, net	0.1	-0.6	-1.5	1.8	2.1
2. Portfolio Investment, net	1.2	2.3	4.4	6.1	8.1
3. Other Investment 1/	-2.5	-2.6	-0.3	-10.7	-1.6
III. Total (I+II)	6.7	7.2	4.1	-1.6	9.9
IV. Errors and Omissions	-1.7	-3.5	-3.1	1.1	1.2
V. Overall Balance (III+IV)	5.0	3.7	1.0	-0.5	11.1
VI. Reserves and Related Items	-5.0	-3.7	-1.0	0.5	-11.1
Changes in Reserve Assets	-4.0	-4.3	0.0	1.6	-6.0
Of which: Transactions	...	...	0.9	1.6	-6.0
Use of Fund Credit and Loans	-1.0	0.6	-1.0	-1.1	-5.1
Purchases	1.4	2.0	0.0	0.0	0.0
Repurchases	-2.4	-1.4	-1.0	-1.1	-5.1
Memorandum items:					
Reserve Assets Position (eop)	32.0	36.3	36.3	34.7	40.8
in months of imports of goods and services	6.8	6.1	5.0	4.1	4.4
in percent of short-term debt	117.3	134.5	137.4	113.7	138.7
Current account (percent of GDP)	3.9	3.4	0.6	0.3	0.3
Non-oil and gas exports, volume growth	0.9	-6.7	0.2	15.5	12.4
Non-oil and gas imports, volume growth	-2.1	-3.4	10.8	15.4	7.1
Terms of trade, percent change (excluding oil)	0.2	-0.1	-0.9	1.1	-3.1

Sources: Bank Indonesia; and Fund staff estimates.

1/ For 2005, includes unrecorded private capital outflows.

Table 7. Indonesia: Monetary Survey, December 2003-December 2006
(In trillions of rupiah, unless otherwise indicated, end of period) 1/

	2003	2004	2005				2006
	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Dec. Proj.
Monetary Survey							
Net foreign assets	218.3	193.1	188.2	179.9	184.3	218.2	318.5
(in US$ billions)	31.2	27.6	26.9	25.7	26.3	31.2	45.5
Net domestic assets	713.8	807.0	796.1	851.2	904.7	930.6	1042.0
Net claims on government	482.0	499.0	462.0	475.0	499.4	501.8	533.6
Claims on business sector	450.6	587.6	609.3	652.3	696.3	703.4	815.3
Rupiah claims	370.9	501.1	521.9	563.3	607.8	615.6	727.6
Foreign exchange claims	79.7	86.4	87.3	89.1	88.4	87.7	87.7
Other items (net)	-218.8	-279.5	-275.2	-276.1	-290.9	-274.5	-306.9
Broad money (M2)	932.2	1000.2	984.2	1031.1	1089.1	1148.8	1360.5
Rupiah M2	816.5	897.9	881.0	922.6	958.4	1014.3	1195.8
Currency in circulation	94.5	109.3	98.6	106.1	115.0	124.3	142.2
Deposits	722.0	788.7	782.5	816.5	843.5	890.0	1053.6
Foreign exchange deposits	115.6	102.2	103.2	108.5	130.6	134.5	164.7
Bank of Indonesia							
Net international reserves	169.4	170.8	173.3	163.8	141.5	173.9	263.5
Net domestic assets 2/ 3/	-3.8	28.6	11.6	34.7	82.9	69.3	18.1
Net claims on government	175.4	226.6	192.2	204.1	219.5	240.9	245.5
Claims on business sector	8.5	39.6	39.0	39.7	39.7	25.9	25.9
Claims on DMBs	-91.1	-101.6	-87.9	-72.5	-19.4	-92.8	-148.6
Open market operations	-136.5	-144.5	-130.8	-115.1	-61.9	-121.2	-177.1
Other items (net)	-96.6	-136.0	-131.7	-136.6	-156.9	-104.7	-104.7
Base money	165.6	199.4	184.9	198.4	224.4	243.2	281.6
Currency in circulation	94.5	109.3	98.6	106.1	115.0	124.3	142.2
DMBs	70.4	89.7	85.6	91.7	109.0	118.5	139.0
Nonbank deposits	0.7	0.5	0.7	0.6	0.5	0.4	0.4
Memorandum items:							
NIR of BI (in billions of US$)	24.2	24.4	24.8	23.4	20.2	24.8	37.6
Money multiplier (rupiah M2)	4.9	4.5	4.8	4.6	4.3	4.2	4.2
Base money velocity 4/	12.2	11.9	13.6	13.3	12.5	12.1	11.6
Rupiah broad money velocity 4/	2.5	2.6	2.9	2.9	2.9	2.9	2.8
Annual percentage change:							
Broad money (constant exchange rate)	9.2	7.3	8.2	10.0	14.2	14.9	18.4
Rupiah broad money	9.8	10.0	11.1	11.5	13.2	13.0	17.9
Base money	19.8	20.4	29.6	27.6	28.0	21.9	15.8
Private sector claims	22.1	30.4	32.6	25.0	26.3	19.7	15.9

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

	2004	2005	2006	2007	2008	2009	2010	2011
	Act.		Proj.					
Real GDP (percent change)	5.1	5.6	5.2	6.0	6.6	6.7	6.7	6.7
Saving and investment (in percent of GDP)								
Gross investment 2/	22.8	22.5	23.1	23.5	24.2	25.1	25.9	26.7
Gross national saving	23.4	22.9	23.4	24.2	24.6	25.3	25.8	26.4
Foreign saving	-0.6	-0.3	-0.3	-0.7	-0.4	-0.2	0.1	0.4
Prices (12-month percent change)								
Consumer prices (end period)	6.4	17.1	7.0	6.0	4.5	3.5	3.0	3.0
Consumer prices (period average)	6.1	10.5	13.3	6.1	4.9	3.6	3.0	3.0
Public finances (in percent of GDP)								
Central government revenue	17.9	18.1	19.1	18.8	18.3	18.1	18.3	18.1
Central government expenditure	19.3	18.5	20.3	19.7	18.9	18.6	18.8	18.5
Central government balance	-1.4	-0.3	-1.2	-0.9	-0.6	-0.5	-0.5	-0.5
Primary balance	1.4	2.2	1.4	1.3	1.1	0.9	0.6	0.5
Central government debt	55.7	46.5	40.9	37.3	34.5	31.9	29.8	27.7
Balance of Payments (in billions of US$)								
Oil and gas (net)	5.1	4.0	6.8	6.0	4.5	3.5	2.4	1.3
Non-oil exports (f.o.b)	54.5	66.2	74.9	82.8	90.3	98.9	109.0	121.8
Non-oil imports (f.o.b)	-39.5	-47.9	-54.8	-59.9	-65.4	-72.3	-81.4	-91.9
Current account balance	1.6	0.9	1.0	2.8	1.6	1.0	-0.5	-2.0
Direct foreign investment	-1.5	1.8	2.1	3.0	3.7	4.3	5.0	6.1
Overall balance	1.0	-0.5	11.1	3.7	3.8	2.7	4.9	3.1
Gross reserves								
In billions of US dollars (end period)	36.3	34.7	40.8	42.9	45.3	48.0	52.8	56.0
In months of imports	5.0	4.1	4.4	4.3	4.2	4.1	4.1	4.1
As a percent of short-term debt 3/	137.4	113.7	138.7	139.2	144.9	146.5	154.4	153.9
Total external debt								
In billions of US dollars	137.4	133.8	136.9	132.1	131.2	130.6	128.2	125.1
In percent of GDP	54.0	47.6	39.0	34.5	31.3	28.5	25.5	22.6
Memorandum items:								
Oil production (000bcpd)	1,040	999	1,000	1,000	1,000	1,050	1,155	1,155
Indonesian oil price (US$/bbl)	37.8	50.8	64.0	67.3	66.0	65.0	64.3	63.5
Nominal GDP (in billions of US$)	254	281	351	383	419	459	504	553

Sources: 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. Computed on real basis.

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

Table 9. 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/	0.8	2.1	5.2	1.7	1.4	0.0	0.0	0.0
Charges	0.2	0.3	0.3	0.1	0.1	0.0	0.0	0.0
Repurchases 2/	0.5	1.8	4.9	1.6	1.4	0.0	0.0	0.0
In percent of exports of goods and nonfactor services	0.9	2.1	4.6	1.4	1.1	0.0	0.0	0.0
In percent of total nonfinancial public sector debt service	8.7	19.5	35.6	15.6	13.3	0.1	0.1	0.1
In percent of reserves of Bank Indonesia 3/	2.1	6.1	12.7	4.0	3.0	0.0	0.0	0.0
Outstanding Fund credit 1/ 2/	9.6	7.8	2.9	1.4	0.0	0.0	0.0	0.0
In percent of GDP	3.8	2.8	0.8	0.4	0.0	0.0	0.0	0.0
In percent of nonfinancial public debt	11.2	10.0	4.0	1.9	0.0	0.0	0.0	0.0
In percent of reserves of Bank Indonesia 3/	26.5	22.5	7.2	3.2	0.0	0.0	0.0	0.0
In percent of quota	300.0	262.7	95.8	44.4	0.0	0.0	0.0	0.0
Total non-financial public sector debt service								
In percent of exports of goods and nonfactor services	10.5	10.9	12.8	8.8	8.1	6.5	5.6	4.6
In percent of GDP	3.4	3.8	4.1	2.9	2.6	2.0	1.7	1.4

Sources: Indonesian authorities; and Fund staff estimates.

1/ Obligations basis.
2/ Using end-period exchange rates.
3/ End of period reserves.

ANNEX I. INDONESIA: FUND RELATIONS
(As of June 30, 2006)

I. Membership Status: Joined February 21, 1967; Article VIII

II. General Resources Account	SDR Millions	Percent of Quota
Quota	2,079.30	100.00
Fund holdings of currency	4,407.01	211.95
Reserve position in Fund	145.50	7.00

III. SDR Department	SDR Millions	Percent of Allocation
Net cumulative allocation	238.96	100.00
Holdings	11.67	4.88

IV. Outstanding Purchases and Loans	SDR Millions	Percent of Quota
Extended arrangements	2,473.21	118.94

V. Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Millions)	Amount Drawn (SDR Millions)
EFF	Feb. 04, 2000	Dec. 31, 2003	3,638.00	3,638.00
EFF	Aug. 25, 1998	Feb. 04, 2000	5,383.10	3,797.70
Stand-by	Nov. 05, 1997	Aug. 25, 1998	8,338.24	3,669.12

VI. Projected Payments to Fund (expectations basis)
(SDR Millions; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	573.63	1,359.70	536.88		
Charges/Interest	84.37	82.53	19.51	8.45	8.45
Total	661.00	1,442.23	556.39	8.45	8.45

VII. Exchange Arrangements

The rupiah has floated since August 14, 1997. The market exchange rate was Rp 9,263 per U.S. dollar on June 30, 2006. Indonesia has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

VIII. Article IV Consultation

The last Article IV Consultation report (IMF Country Report 05/326, September 2005) was discussed by the Executive Board on July 18, 2005.

IX. Safeguards Assessments

Under the Extended Arrangement, BI was subject to the transitional procedures under the Fund's safeguards assessment policy. This required a review of BI's external audit mechanism, which was completed on March 15, 2002. The assessment recommended remedial actions to address a number of vulnerabilities. The main recommendations have been implemented, including the establishment of an independent audit committee at BI and the publication of BI's audited financial statements.

ANNEX II. INDONESIA: WORLD BANK RELATIONS
(As of June 20, 2006)

For questions relating to this annex, contact Bill Wallace, at (+62-21) 5299-3000 or Preeti Ahuja at 202 473-1657

Indonesia Country Assistance Strategy

The World Bank's CAS (FY04-07) for Indonesia is focused on areas most crucial to poverty reduction: (i) a weak investment climate; and (ii) the lack of quality service delivery to the poor. Both of these challenges arise from the same fundamental cause – weak governance. Designed to use all of the Bank's instruments to advance good governance for improved poverty reduction outcomes, the CAS provides a fully relevant strategic framework for the period ahead. In addition to implementation of the two focal areas noted directly above, over the past 18 months there has been a significant redeployment of Bank resources to support the post-tsunami recovery of Aceh. The Bank team is now mobilizing to appropriately support the reconstruction needs in Yogyakarta and Central Java. This adjustment is represented in the CAS framework via the addition of a substantial work program on the enhanced management of disasters. A CAS update extending the present CAS cycle through FY08 is under finalization, and will be presented to the Bank's Board in early FY07. The Bank coordinates the policy dialogue across key areas with the IMF.

World Bank Engagement: Selected Highlights

Improving the climate for high quality investment: The Bank's policy dialogue in this area is buttressed by the on-going Development Policy Lending (DPL) program and were underpinned by analytical and diagnostic work (see below). Now in the last phase of a cycle of three annual operations, the DPL program supports policy and institutional reforms to improve macroeconomic stability and the investment climate, in addition to public financial management and anti-corruption, and improved delivery of public services. The reforms are an integral part of the government's own reform program and selected based on their criticality and potential for achieving the government's medium-term objectives. In the former two areas, reforms supported by the DPL have helped improve Indonesia's creditworthiness; strengthen the country's macroeconomic framework; improve competitiveness, diversification, and efficiency of the financial sector; and create a better business climate.

The World Bank has also supported government efforts to increase and improve investments in infrastructure. Specifically, the Bank has focused on (i) development of a strategic framework for infrastructure; (ii) developing core large-scale infrastructure for growth; and building sub-national and community level infrastructure to support income opportunities for poorer households. Besides the DPL program, which is helping to promote greater public-private partnerships (PPP), the Bank is preparing a dedicated program loan supporting reforms in the infrastructure regulatory framework. The Bank's portfolio also includes an on-going Private Participation in Infrastructure TA loan to leverage private investment in infrastructure; a Java-Bali power sector strengthening project; and several regional transportation and water and sanitation interventions. Complementing these efforts at the community level is a series of Community Driven Development (CDD) programs, which seek to improve access to essential social and economic infrastructure, including tertiary physical infrastructure for targeted communities (including the urban poor). These include the long-running, successful Kecamatan Development (KDP) and Urban Poverty Programs (UPP), as well as the recent Support for Poor and Disadvantaged Areas Program (SPADA).

Making Service Delivery Responsive to the Poor: Bank efforts have strongly supported improvements in quality and relevance of, and equitable access to education, water and sanitation (WSS), and health services. Activities have focused on strengthening capacity and systems, and changing the way services are managed and delivered top-to-bottom to improve results. Financial support in education targets the full range of issues from early childhood development (ECD) to tertiary education. The Bank has supported an education sector review and, more recently, the development of a comprehensive national medium-term strategy (RENSTRA) covering all levels of education, formal and non-formal. A series of Provincial Health Projects (PHPs) were designed to help clarify the roles of different levels of government. Interventions have also aimed at district health administrations' capacities and making service planning and delivery more participatory and accountable. The focus is on areas where indicators lag behind neighboring countries: maternal and child health, and nutrition. CDD approaches in WSS and the GEG program seek to inculcate a more sanitary and healthier environment.

Addressing the Core Issue of Governance: The World Bank recognizes governance as the most critical cross-sectoral issue and, hence, has positioned it at the core of the Bank's work program. The DPL program and particularly the Government Financial Management and Revenue Administration Program (GFMRAP) are designed to improve public administration, particularly in the area of public financial management. Two local government-level projects were approved in 2005: (1) Urban Sector Development and Reform project (USDRP), which seeks to make urban local governments more efficient and effective in meeting the needs of their citizens in the context of the new decentralization laws; and (2) Initiatives for Local Governance Reform project (ILGRIP) that provides pilot support to 40 local governments (LGs) in improving transparency, accountability and public participatory practices and in undertaking reforms in financial management and procurement. In addition, the community-based projects are above all, a vehicle for improving sub-sovereign governance. Bank interventions are underpinned by analytic work which have included a report providing sectoral perspectives on corruption, a study on justice and the poor, as well as the Public Expenditure Review and Report on the Observance of Standards and Codes.

Program for the Recovery of Aceh and Nias: The Bank is deeply engaged in the recovery of Aceh and Nias, with a focus on post-tsunami reconstruction, institution building, analytical support and monitoring of progress. Using all its available instruments, over the past 18 months, the Bank mobilized an Aceh reconstruction program substantial in scope and objectives. The Bank has played a vital role in putting in place key elements for the management of the reconstruction effort and coordinating the response of the international community. Immediately after the tsunami in partnership with the Netherlands, the Bank established a multi-donor office in Banda Aceh, and made the facilities available to all donors working in Aceh. With a relatively modest Bank contribution of $25 million in grant resources from IBRD net income, the Bank's country team has leveraged and mobilized significant donor support. The Bank has mobilized over $600 million for reconstruction, including the Multi-Donor Fund (MDF) with 15 donors (in the amount of some $547 million in grants), restructured ongoing community driven (CDD) operations and added Aceh focused activities in new IDA projects, donor co-financing of IDA projects and JSDF grants. The Bank's CDD platform and facilitators in Aceh have been invaluable in delivering projects and financing for the reconstruction of Aceh. Most Bank and MDF infrastructure projects deliver assistance through an extensive community-based network of facilitators and volunteers reaching every village in Aceh and Nias. An integrated approach that includes land titling, housing, infrastructure, and building social capital is being employed, with a key role played by communities in reconstruction and rehabilitation. The Aceh and Nias Reconstruction Agency (BRR) has recently proposed a comprehensive strategy for utilizing the remaining resources from the MDF to develop a joint BRR-MDF mechanism to plan, design, finance, and oversee the construction of infrastructure by engaging LGs in their own infrastructure needs, within a strong oversight, planning and management framework. The Bank has also delivered a very considerable TA program to the BRR, and supported a large analytical program and monitoring framework for all activities in Aceh. The community based housing approach deployed by the Bank in Aceh under the MDF housing project, has been indicated by the Government of Indonesia as the model for the massive housing reconstruction program in Yogyakarta and Central Java, following the May 27 earthquake.

New Lending Operations: As of June 30, 2006, the Bank's active portfolio comprised 31 projects with a total net commitment of $2.7 billion, including US$ 686 million in loan resources committed this fiscal year. A second Development Policy Loan (DPL2) was approved for a loan amount of US$400 million on December 19, 2005. DPL2 also enjoyed financial support from Japan and AsDB. Second in a series of three annual, single tranche loans, it built on reforms supported by the first DPL—and deepened cross-cutting reforms in the core policy areas of (i) macroeconomic stability and creditworthiness; (ii) improved investment climate; and (iii) improved public financial management and anti-corruption. The operation also marked the starting point for policy dialogue on pro-poor service delivery—a policy area that the government is keen on making an integral part of the DPL program—starting with DPL 3. This new policy area is in line with the government's focus on reducing poverty and reaching ambitious medium-term development goals linked to the MDGs, as articulated in the government's medium-term development plan, or RPJM. Approved in FY06, the Domestic Gas Project aims at expanding the use of natural gas in the West Java market. This project involves expansion of the gas distribution system in West Java and capacity building activities for the utility company, PGN. The proposed Early Childhood Education and Development II, seeks to improve poor children's development and readiness for further education. The proposed Third Water Supply and Sanitation for Low-Income Communities seeks to improve delivery of water supply and sanitation to the eastern kabupatens. These projects will be presented to the Bank's Board on June 27, 2006.

Analytic and Advisory Activities (AAA)

There is sustained Bank engagement in policy dialogue with GOI, on the direction and substance of its economic, structural, and institutional reform agenda. The AAA program has been organized around five “breakthrough” themes: (1) investment climate, (2) reducing poverty, (3) improving decentralized service delivery, (4) improving governance and the more recently introduced, and (5) progress and constraints in the recovery of Aceh and Nias. The “flagship reports” in related areas, the stand-alone policy notes and think pieces, and day to day informal dialogue between Bank staff and government counterparts, are providing support to GOI in making informed policy choices and in defining the shape of supporting Bank programs.

ANNEX III. INDONESIA: RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]
(As of June 20, 2006)

Asian Development Bank (AsDB) cumulative loans to Indonesia reached over $20.7 billion at end-December 2005. In 2005, the AsDB approved a total of $1,145.7 million or 19.8% of the total loans approved by the institution for the year. The assistance provided financing for six projects and two programs in Indonesia. In addition to public sector projects and programs in community water supply and sanitation, rural infrastructure, road rehabilitation, and development policy reforms and local government public financial management reforms, the AsDB also approved its first infrastructure project financed through the private sector window since the Asian financial crisis. The $350 million Tangguh Liquefied Natural Gas Project plays a catalytic role as part of a larger $6.3 billion private sector investment.

During the course of 2005, AsDB has continued to support the post-tsunami reconstruction in Aceh and Nias out of its $290 million Earthquake and Tsunami Emergency Support Project and other support totaling about $43 million including a $10 million contribution to the Multi-Donor Trust Fund. With the second disaster striking in Yogyakarta and Central Java in May 2006, AsDB has committed a new grant of $10 million for the affected regions by way of immediate response, which could be supplemented by up to $50 million through reprogramming of ongoing projects financed under its Asian Development Fund window. The scope of AsDB's assistance and further steps will be based on the recent damage and loss assessment findings and the reconstruction strategy.

Table 1. Loan Approvals and Disbursements to Indonesia[1]
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Loan approvals	1,108.8	1,836.0	1,020.0	800.0	500.0	767.2	261.6	225.0	1,145.69
Loan disbursement	676.6	1,079.0	1,329.4	748.4	686.0	1,000.5	442.9	593.5	1,014.99
Undisbursed balance at the beginning of the year[2]	3,957.3	3,902.0	4,503.4	3.899.3	3.085.6	3,135.6	2,367.2	1,892.8	1,724.0

Source: Asian Development Bank, *2005 Annual Report*, and AsDB staff.
[1]Include loans to private sector without government guarantee but excludes equity investments.
[2]At the end of the year.

Table 2. Cumulative Lending to Indonesia
(As of December 31, 2005)

Sector	No of Loans	$ Million	In percent
Social infrastructure	40	3,175.4	15.3
Agriculture and natural resources	100	4,156.6	20.1
Energy	31	3,781.1	18.2
Transport and communication	33	2,713.9	13.1
Finance	17	3,261.1	15.7
Multisector	33	1,945.6	9.4
Industry	14	665.7	3.2
Others	7	1,029.2	5.0
Total	**279**	**20,728.50**	**100.0**

Source: Asian Development Bank, *2003 Annual Report*, and AsDB staff.

[1] Prepared by AsDB staff.

ANNEX IV. INDONESIA: STATISTICAL ISSUES[1]

1. Indonesia has subscribed to the Special Data Dissemination Standard (SDDS) since September 1996. Indonesia's macroeconomic statistics and statistical base are broadly adequate to conduct effective surveillance.

Real Sector

2. Annual national accounts data are based on a 2000 base year. Quarterly GDP data are published in a timely manner for both expenditure and production sides. The estimates are based on a limited set of indirect indicators of uncertain quality. Although some sectors are influenced strongly by seasonality, seasonally adjusted data are prepared but not published, and no survey of nonfinancial services is conducted. An economic census of businesses is undertaken every 10 years, but not updated in the intervening periods. The household budget survey does not cover higher income households. There are inconsistencies with BI in imports and exports; and, possibly with MoF with regard to local government figures. The five-yearly input-output tables remove the statistical discrepancy, but this is not done for intervening years, creating large discrepancies. The staff have recommended: (i) development of a system to continuously update the census of businesses; (ii) introduction of comprehensive annual establishment surveys for nonfinancial services industries; (iii) publication of annual GDP estimates, including a time series of at least 20 years; (iv) development of a set of annual supply and use tables (SUTS) starting from 2000; (v) expedited conversion to the *1993 System of National Accounts*; and (vi) enhancing the convergence exercise on trade data with BI.

3. Labor market data, including wages and employment, are available, albeit reported with some delay, through the annual labor market survey (Sakernas) published by the Bureau of Statistics. Data are also available on minimum and maximum wages for the formal sector. Quarterly data are available on industrial wages, again with some delay.

Public Finance

4. Comprehensive public sector finance data are generally not available, and the data that are available are of questionable quality in terms of definition, coverage and timeliness. Subnational government fiscal data are available with a lag of two years, and the quality is variable. Data on the central government budget become available with a one month lag.

5. The statistical discrepancy between financing and above the line categories has increased in 2005, reflecting either a double counting of expenditures or additional revenues that have not been accounted for. The coverage and timeliness of public debt statistics is generally adequate; however, only limited information on contingent liabilities is available. There are a large number of extra-budgetary funds, resulting in non-transparent and unaccountable activities not included in budget reports. A new expenditure classification has

[1] The section is based on a Detailed Assessment of Indonesia's observance of the IMF's Data Quality Assessment Framework, prepared by STA in March 2005.

been introduced in the 2005 budget, which is generally consistent with the GFSM 2001 economic codes (but on a cash accounting basis). The authorities are considering the adoption of the GFS standards as their general reporting framework by 2008

6. In this context, the Fund staff have recommended in the short term: (i) establishment of a register of all central government public sector units, classified by sector; and (ii) the amendment of accounting regulations to ensure that general government units report all transactions and balances over which they exert control. Over the medium-term, priority should be given to (i) establishing arrangements to obtain timely preliminary data for local government statistics; and (ii) developing *Government Financial Statistic Manual 2001* operating statements, statements of sources and uses of cash, and partial balance sheets, all of which should be published on the MOF websites. The latter should lead to the adoption of a full accrual accounting basis for all budget transactions. Further TA from the Fund is likely to be provided in this area if there have been tangible signs of progress on implementing short-term recommendations.

Monetary Accounts

7. Good quality monetary statistics are compiled by the BI on a timely basis. With STA assistance BI has developed an integrated database from which alternative presentations of monetary statistics can be drawn to meet the needs of BI and the Fund. Further work, however, is needed to expand the coverage of depository corporations to include mutual funds (REKSA DANA), which report data to BAPEPAM—the supervisory agency over-viewing the nonbank financial institutions. To this end, BI is currently developing institutional data-sharing arrangements that would enable it to access the register of—and data on—mutual funds.

8. In order to strengthen monetary statistics Fund TA missions have recommended to: (i) collect source data on mutual funds in a format that meets statistical requirements; (ii) expand the coverage of the monetary statistics to include mutual funds; and (iii) harmonize reported interbank positions between the BI and commercial banks.

Balance of Payments

9. Indonesia's balance of payments statistics are broadly adequate to conduct effective surveillance, but certain weaknesses remain. In general, there are some deficiencies in the recording of financial transactions of the private sector.

10. With respect to merchandise trade data, while customs sources utilized by BI are considered generally reliable, there is believed to be under-coverage in selected areas. When the online reporting system for exports and imports was introduced in 2004, the historical series were reconstructed only as far back as 2003. Therefore, prior to 2003, balance of payments statistics are not entirely consistent with the national accounts estimates. Data on services suffer from outdated surveys and weak methodologies. BI adjusts the customs data to cover exports and imports of Batam and other bonded zones. Adjustments are also made to

data on compensation of employees and workers remittances to cover professional workers, legal workers not reported to the Ministry of Manpower, and illegal workers.

11. For the capital and financial account, the methodological basis for the compilation of FDI data needs substantial improvement. Inflows are currently calculated based on loan disbursements to companies that have foreign equity and the application of a fixed ratio to the loan disbursements data to estimate equity inflows. Surveys conducted by BI to collect FDI data have a low response rate and the directory of enterprises requires enhancement in terms of its coverage. Other areas that need improvement include the recording of trade credits and the assets data for portfolio investment and other investment transactions. The magnitude of the errors and omissions item has been significant and appears to be related to the methodology used, for instance, for unrecorded assets in the financial account. Financial transactions data have not been reconciled with changes in the International Investment Position (IIP).

12. BI has proposed a range of measures to address these weaknesses. On trade-related data, a working group has been established to reconcile differences between BI and customs data. BI is planning to collect and publish data on goods imported for processing, goods procured in ports by carriers, and transactions with the oil and gas sector. On the financial account, BI is planning to collect and publish data on direct investment abroad, portfolio investment assets, other investment assets, and trade credits, to help address some of the identified shortcomings in the recording of private financial flows.

13. An annual IIP is compiled, but the underlying data are weak in several areas, notably for FDI. External debt statistics have improved considerably with the introduction of a External Debt Information System (EDIS) in 2002. The system records external debt of government and over 800 other entities that report to the BI on a monthly basis. The data that this system generates for public sector external debt and debt service, as well as those for private banks, are considered reliable. However, improvements are still needed with respect to components of private corporate sector data, particularly in distinguishing between scheduled and actual debt service, in estimating the accumulation/reduction of private sector payments arrears, and in estimating rescheduling and debt reductions being received by the private sector from external creditors.

Indonesia: Table of Common Indicators Required for Surveillance

(As of June 20, 2006)

	Date of latest observation	Date received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of publication[5]
Exchange Rates	6/19/06	6/20/06	D	D	W/M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/19/06	6/20/06	D	D	W/M
Reserve/Base Money	6/19/06	6/20/06	D	D	W/M
Broad Money	3/06	5/15/06	M	M	M
Central Bank Balance Sheet	3/06	5/15/06	M	M	M
Consolidated Balance Sheet of the Banking System	3/06	5/06	M	M	M
Interest Rates[2]	5/06	5/06	D	D	W/M
Consumer Price Index	5/06	6/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central; Government	4/06	5/06	M	M	...
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	4/06	5/06	M	M	...
Stocks of Central Government and Central Government-Guaranteed Debt	12/05	5/06	...	...	...
External Current Account Balance	3/06	3/06	Q	Q	Q
Exports and Imports of Goods and Services	4/06	6/05	M	M	M
GDP/GNP	2006Q1	5/06	Q	Q	Q
Gross External Debt[4]	12/05	3/06	Q	Q	A

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] Including currency and maturity composition.
[5] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); NA: Not Available

ANNEX V. INDONESIA: MEDIUM-TERM OUTLOOK UNDER ALTERNATIVE ASSUMPTIONS AND PUBLIC AND EXTERNAL DEBT SUSTAINABILITY

This annex compares the medium-term outlook under the baseline scenario discussed in the staff report text with three alternative scenarios based on: (i) possible further tightening in global liquidity conditions; (ii) a possible further increase in oil prices; and (iii) slower progress on the ambitious structural agenda planned by the authorities. It also analyzes the impact of several exogenous shocks on the sustainability of public sector debt and external debt.

I. ALTERNATIVE SCENARIOS

A: **Possible further tightening of liquidity conditions resulting in the reversal of recent portfolio inflows (about $8 billion is estimated to have come in between September 2005-April 2006)**

Policy response: BI is assumed to keep the policy rate unchanged at its current level in an effort to keep Indonesian assets attractive. In addition, BI is likely to intervene to smooth volatility in the exchange rate, although the rupiah would depreciate as capital flows out.

Projections: The outflows would have a direct impact on reserve holdings as foreign investors withdraw their dollar investments and BI intervenes to smooth volatility. Staff projections indicate that reserves at end-year 2006 would be about $34 billion equivalent to about 110 percent of short-term debt (see Chart). Continued high costs of borrowing would constrain both consumption and investment spending and adversely affect growth. Growth would decline by 0.4 percentage points in 2006 and an additional one percentage point in 2007. The fiscal deficit would increase for two reasons - first, the depreciation in the rupiah would raise subsidy costs and second, interest costs would be higher than in the baseline (spreads on government bonds are assumed to be higher by an additional 200 basis points) – creating additional financing requirements in an already tight environment. The current account surplus would increase as the slowdown in the economy lowers imports.

B. Oil prices increase to $100 per barrel in 2006:Q3 and stays at that level through end-2007

Policy response: Administered prices of subsidized fuel products and electricity tariffs are kept unchanged in line with the government’s current intentions, and the increased cost of fuel subsidies is accommodated by raising the deficit.

Projections: An increase in oil prices will have important implications for the budget given that some domestic fuels are still subsidized. Staff estimates indicate that the jump in oil prices by $30 per barrel would increase the cost of fuel subsidies (including for electricity) to about 5 percent of GDP in 2006, compared to 3.3 percent of GDP in the baseline scenario. For 2007, subsidy costs will be even higher, requiring additional financing of up to 2 percent of GDP.

At the same time, the increase in prices of nonsubsidized fuels (mainly industrial fuels) would rise as these prices are adjusted to market prices, leading to higher inflation, higher production costs and a slowdown in real growth. The jump in international oil prices would also lead to a weakening in external demand (assuming the oil price jump reflects supply side factors) and cause a slowdown in exports. Accounting for these various factors, staff estimates suggest real GDP growth would slow by 0.4 and 0.6 percentage points, respectively, in 2006 and 2007. The current account surplus is expected to increase, reflecting a positive net impact of higher oil prices on the balance of payments (gas prices are assumed to rise in tandem).

C. Lack of progress on the structural agenda

Policy response: Government relaxes fiscal and monetary policies (though modestly so that it does not threaten macroeconomic stability) to support growth.

Projections: Indonesia would be stuck in the 5 percent growth range over the medium-term, even as the region continues to grow, as lack of investment slows productivity gains, including in the oil sector. Macroeconomic policy implementation could also weaken, as the government could relax monetary and fiscal policy to stimulate growth. On the fiscal side, the overall fiscal deficit is expected to go to about 1½ percent of GDP as the government relaxes spending to stimulate growth, only slightly raising the public debt ratio in the medium term. With slower growth and less foreign investment, both the current and capital accounts would be negative over the medium term and reserves lower, which would increase vulnerability.

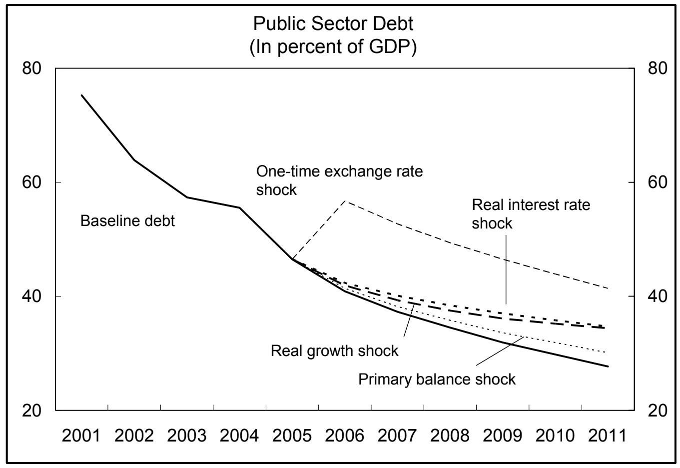
II. Debt Sustainability Analysis Under the Baseline Scenario

A. Public debt

1. **The public sector debt ratio has steadily declined from 75 percent of GDP at end-2001 to an estimated 46.5 percent of GDP at end-2005** (Figure 2). This reflects the government's fiscal consolidation policy, declining interest rates, and sustained growth in real GDP. About half of the total outstanding public debt is owed to foreign creditors, mainly multilateral institutions.

2. **Under the projected baseline scenario, the public sector debt ratio is expected to decline gradually to below 28 percent by 2011.** In terms of public sector revenues, public debt will decline from 256 percent to 153 percent over the 2005-2011 period. These results are based on the assumptions underlying the baseline medium-term scenario in the staff report, specifically that: (1) real GDP growth rebounds to 6–7 percent over the medium term; (2) primary surplus averages 1 percent of GDP over the period; and (3) average nominal interest rates on public debt remain in the 5–7 percent range.

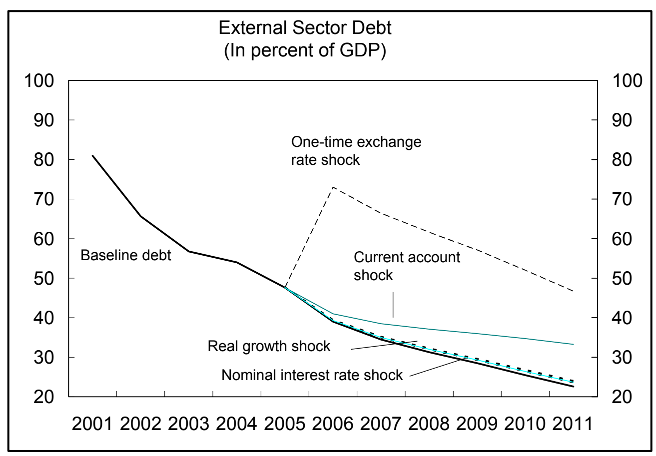
3. **The standard sensitivity analysis shows that the trajectory of the debt ratio is particularly sensitive to changes in real interest rates and exchange rates** (Figure 2). A temporary upward shock in 2006 and 2007, equivalent to one standard deviation in the real interest rate above its historical average raises the debt ratio by about 7 percent of GDP over the medium-term. A one-time 30 percent real depreciation of the exchange rate immediately raises the debt ratio by 16 percentage points of GDP with the impact over the baseline being slightly reduced in the medium term.



External debt

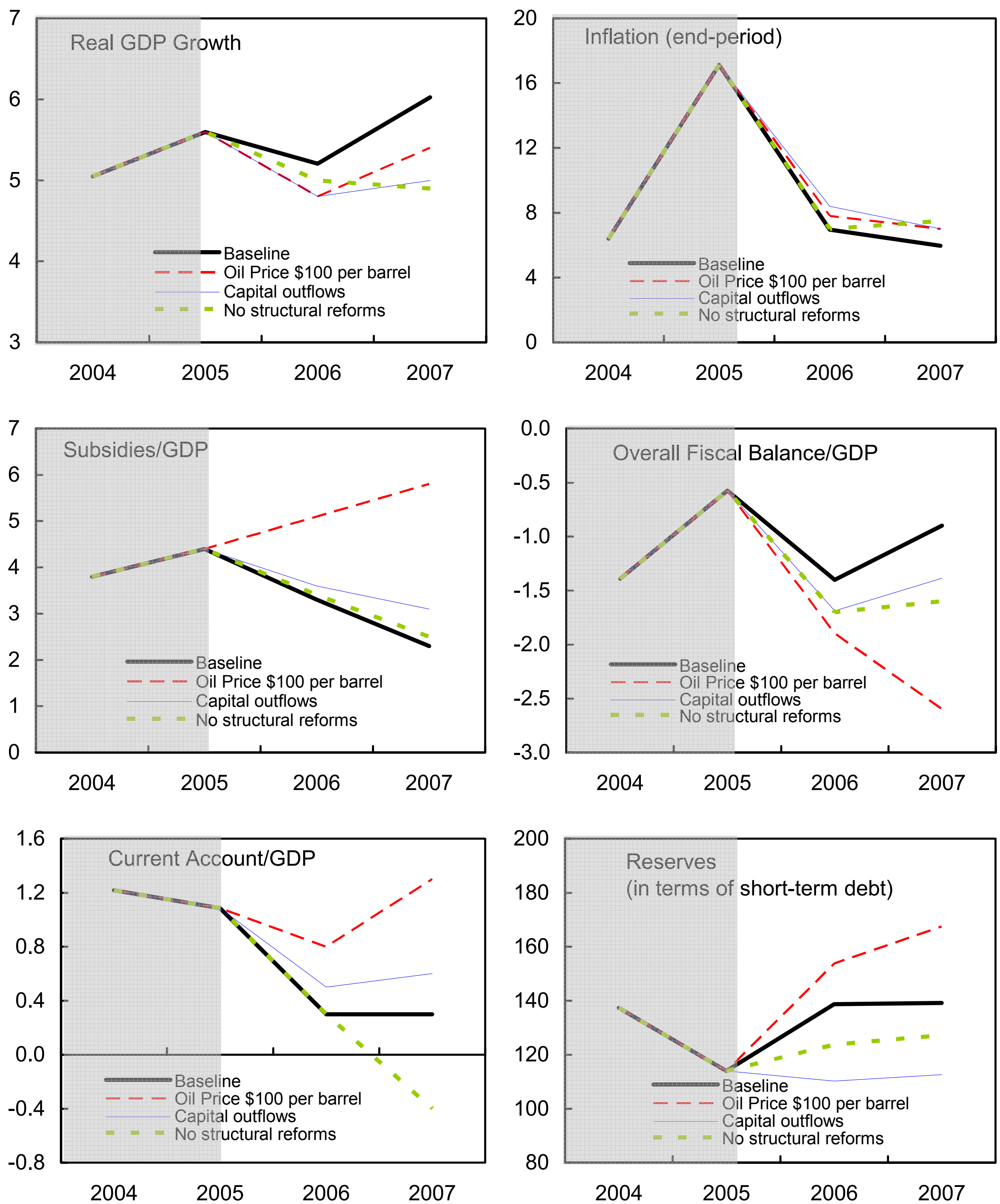
4. **Indonesia's external debt has also declined steadily since the crisis, from over 80 percent of GDP in 2001 to around 48 percent in 2005** (Figure 1). External debt as a percent of exports has also declined from 209 percent in 2001 to 135 percent in 2005.

5. **External debt dynamics are sustainable under the baseline scenario, with the debt-to-GDP ratio declining to less than 25 percent by 2011.** However, the favorable trend in the external debt burden could be reversed if the envisaged foreign direct investment and equity inflows, and growth fail to materialize, or if the associated investment does not generate growing export receipts.



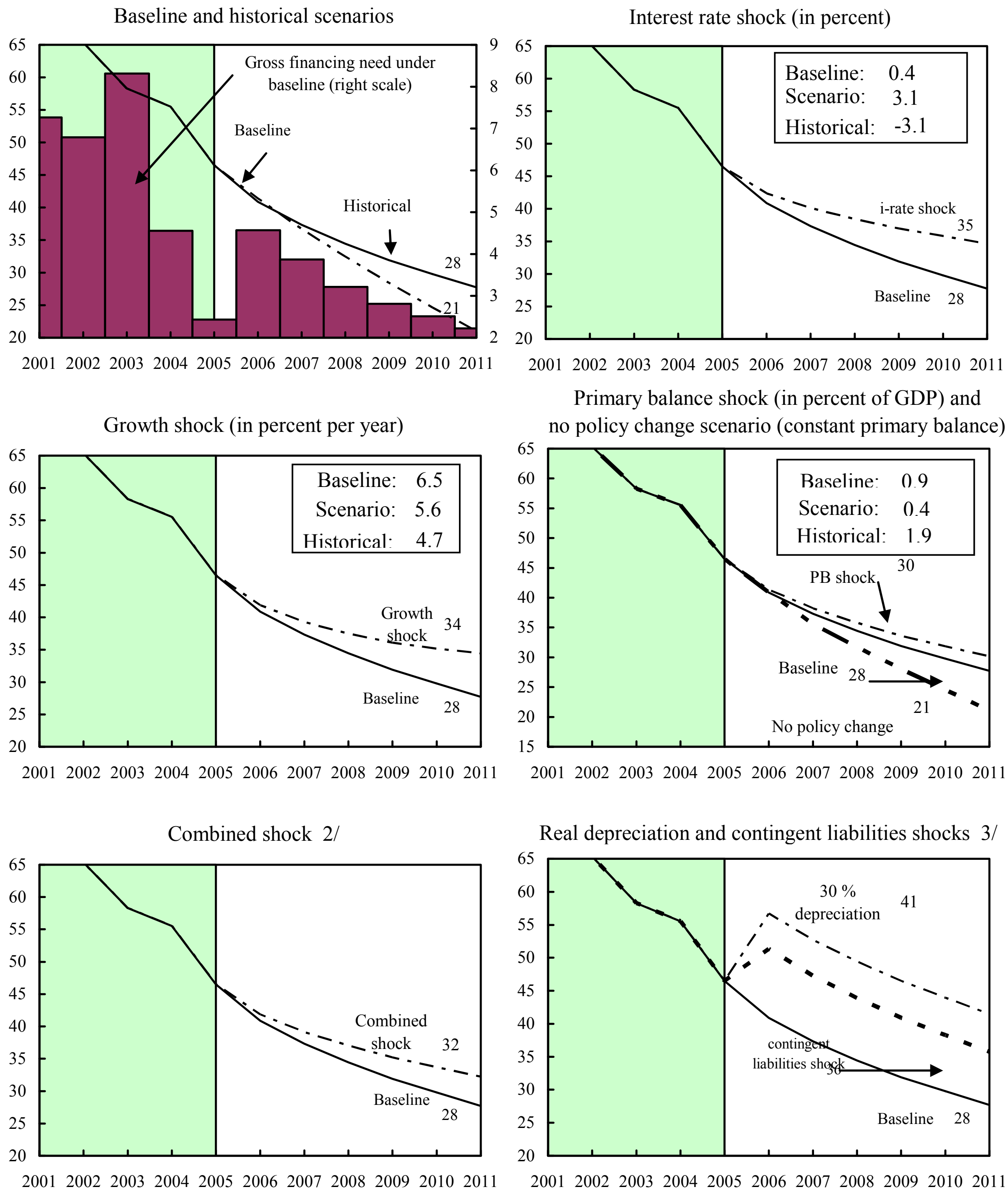
6. **External debt sustainability is most vulnerable to shocks to the exchange rate.** A one-time shock of a 30 percent depreciation of the exchange rate in 2006 raises the debt ratio immediately by about 35 percent of GDP with the impact declining gradually over the medium term to 25 percent of GDP by 2011.

Figure 1. Alternative Scenarios
(In percent)



Source: CEIC Database and Fund staff estimates.

Figure 2. Country: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



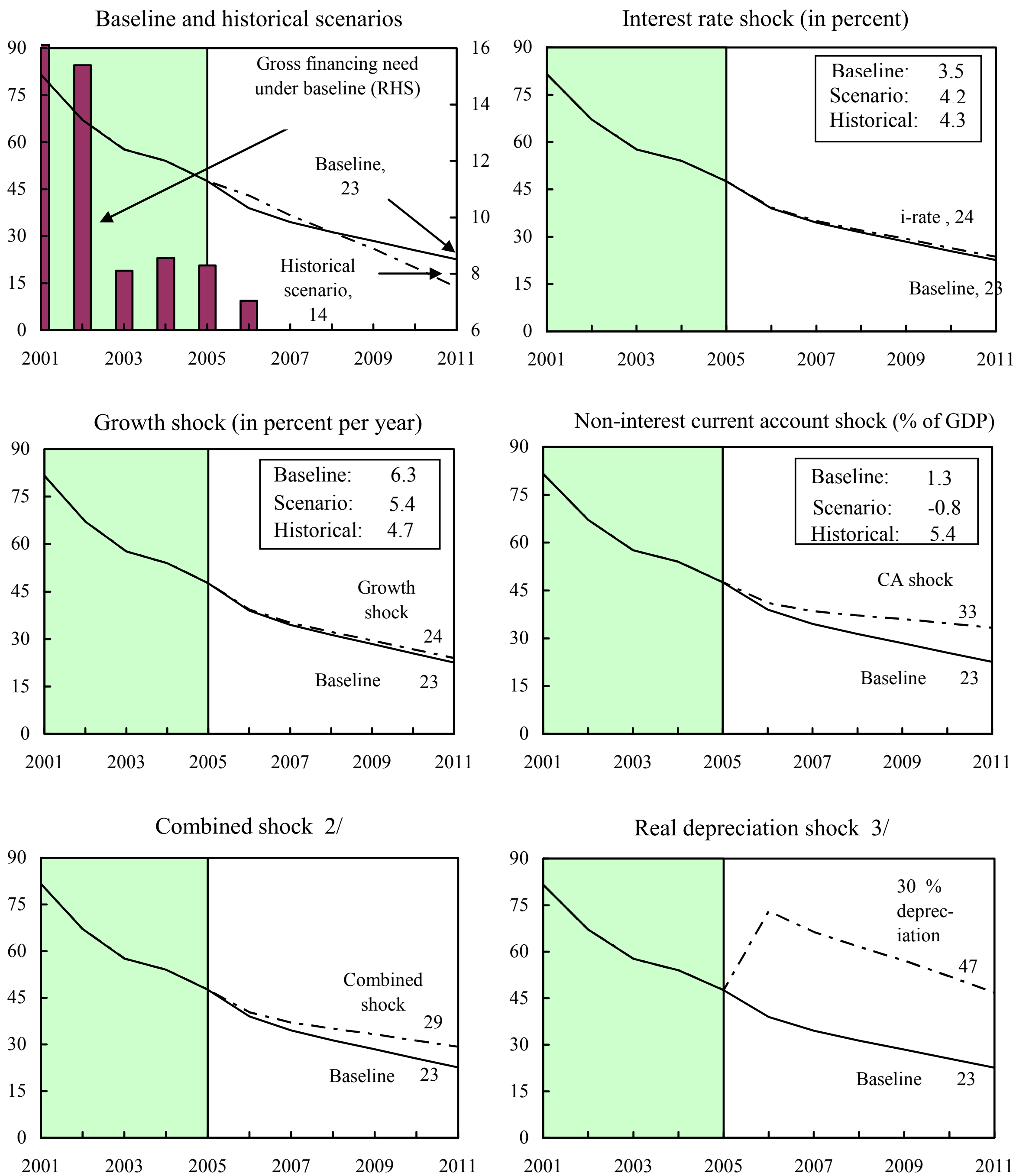
Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 3. Indonesia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account.
3/ One-time real depreciation of 30 percent occurs in 2006.

Table 1. Indonesia: Public Sector Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	77.0	65.4	58.3	55.7	46.5	**40.9**	**37.3**	**34.5**	**31.9**	**29.8**	**27.7**	**-1.6**
o/w foreign-currency denominated	34.9	29.8	27.6	28.2	23.7	19.3	17.5	15.4	13.4	11.4	9.9	
Change in public sector debt	-16.5	-11.6	-7.1	-2.7	-9.0	-5.6	-3.6	-2.9	-2.5	-2.1	-2.1	
Identified debt-creating flows (4+7+12)	-11.8	-13.3	-7.1	-3.3	-7.2	-5.3	-3.9	-3.3	-2.9	-2.4	-2.3	
Primary deficit	-2.5	-3.4	-1.6	-1.4	-2.2	-1.4	-1.3	-1.1	-0.9	-0.6	-0.5	
Revenue and grants	18.2	16.5	16.7	17.9	18.1	19.1	18.8	18.3	18.1	18.3	18.1	
Primary (noninterest) expenditure	15.7	13.1	15.1	16.6	16.0	17.7	17.5	17.1	17.2	17.7	17.6	
Automatic debt dynamics 2/	-7.4	-7.1	-3.8	-1.1	-4.8	-3.8	-2.6	-2.2	-1.9	-1.7	-1.7	
Contribution from interest rate/growth differential 3/	-10.5	-2.5	-2.2	-3.7	-6.3	-3.8	-2.6	-2.2	-1.9	-1.7	-1.7	
Of which contribution from real interest rate	-7.7	0.6	0.7	-1.1	-3.7	-1.8	-0.4	0.0	0.2	0.2	0.1	
Of which contribution from real GDP growth	-2.8	-3.1	-2.8	-2.6	-2.6	-2.1	-2.2	-2.2	-2.1	-1.9	-1.8	
Contribution from exchange rate depreciation 4/	3.2	-4.6	-1.7	2.6	1.4	...	...	...	...	...	...	
Other identified debt-creating flows	-1.9	-2.8	-1.7	-0.8	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-1.9	-2.8	-1.7	-0.8	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-4.7	1.6	0.1	0.6	-1.8	-0.3	0.3	0.5	0.3	0.2	0.2	
Public sector debt-to-revenue ratio 1/	422.8	396.8	349.0	309.5	256.2	214.5	198.8	188.7	176.1	162.8	153.2	
Gross financing need 6/	7.3	6.8	8.3	4.6	2.4	4.6	3.9	3.2	2.8	2.5	2.2	
in billions of U.S. dollars	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Key Macroeconomic and Fiscal Assumptions												
Real GDP growth (in percent)	3.6	4.5	4.8	5.1	5.6	5.2	6.0	6.5	6.7	6.7	6.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	39.7	-12.8	21.8	15.8	2.8	19.2	4.6	4.1	7.2	9.5	6.3	
Primary deficit	-2.5	-3.4	-1.6	-1.4	-2.2	-1.4	-1.3	-1.1	-0.9	-0.6	-0.5	
A. Alternative scenarios												
A1. No policy change (constant primary balance) in 2005-09						**40.9**	**35.6**	**31.7**	**28.0**	**24.5**	**21.1**	**-1.3**
A. 2. Scenario with key variables at their historical averages 7/						**41.4**	**36.7**	**32.5**	**28.4**	**24.6**	**21.0**	**-1.6**
A. 3. Alternative Scenario						**41.3**	**38.9**	**37.1**	**35.5**	**32.1**	**28.9**	
B. Bound Tests												
B1. Real interest rate is at historical average plus one standard deviation						**42.4**	**40.1**	**38.4**	**37.0**	**35.8**	**34.7**	**-1.2**
B2. Real GDP growth is at historical average minus one standard deviation						**41.9**	**39.3**	**37.5**	**36.1**	**35.2**	**34.5**	**-1.7**
B3. Primary balance is at historical average minus one standard deviation						**41.4**	**38.2**	**35.8**	**33.6**	**31.9**	**30.1**	**-1.8**
B4. Combination of B1-B3 using 1/2 standard deviation shocks						**41.8**	**39.1**	**37.0**	**35.2**	**33.7**	**32.2**	**-1.4**
B5. One time 30 percent real depreciation in 2006 10/						**56.7**	**52.7**	**49.4**	**46.5**	**43.9**	**41.4**	**-2.4**
B6. 10 percent of GDP increase in other debt-creating flows in 2006						**51.3**	**47.3**	**43.9**	**40.9**	**38.3**	**35.7**	**-2.1**

1/central government debt (gross debt).
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 2. Indonesia: External Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011	
								I. Baseline Projections						**Debt-stabilizing**
External debt	81.6	67.2	57.7	54.0	47.6			**39.0**	**34.5**	**31.3**	**28.5**	**25.5**	**22.6**	**non-interest**
Change in external debt	-4.0	-14.5	-9.5	-3.6	-6.4			-8.6	-4.5	-3.2	-2.9	-3.0	-2.9	**current account 6/**
Identified external debt-creating flows (4+8+9)	-2.6	-20.3	-15.8	-6.4	-7.0			-10.6	-4.9	-4.4	-4.0	-3.5	-3.1	**-2.6**
Current account deficit, excluding interest payments	-8.5	-5.7	-5.0	-2.0	-2.0			-1.7	-2.0	-1.5	-1.2	-0.8	-0.4	
Deficit in balance of goods and services	-8.0	-7.0	-5.5	-4.5	-4.1			-3.7	-3.7	-3.4	-3.1	-2.6	-2.3	
Exports	39.1	33.6	29.4	32.5	35.2			32.4	32.5	31.6	31.0	30.5	30.3	
Imports	31.1	26.6	24.0	28.1	31.1			28.8	28.8	28.2	27.9	27.9	28.0	
Net non-debt creating capital inflows (negative)	-0.9	-1.8	-1.1	-1.3	-1.5			-0.9	-1.0	-1.0	-1.1	-1.1	-1.2	
Automatic debt dynamics 1/	6.8	-12.9	-9.6	-3.0	-3.5			-8.1	-2.0	-1.9	-1.7	-1.6	-1.5	
Contribution from nominal interest rate	4.2	1.7	1.6	1.4	1.7			1.4	1.3	1.1	1.0	0.9	0.8	
Contribution from real GDP growth	-3.2	-3.0	-2.7	-2.7	-2.7			-2.0	-2.1	-2.1	-1.9	-1.7	-1.6	
Contribution from price and exchange rate changes 2/	5.8	-11.6	-8.5	-1.8	-2.4			-7.5	-1.1	-0.9	-0.8	-0.8	-0.7	
Residual, incl. change in gross foreign assets (2-3)	-1.4	5.9	6.3	2.7	0.6			2.0	0.5	1.2	1.1	0.5	0.3	
External debt-to-exports ratio (in percent)	208.9	200.1	195.8	166.0	135.1			120.3	106.1	98.9	91.8	83.4	74.6	
Gross external financing need (in billions of US dollars) 3/	25.9	30.1	19.0	21.8	23.3			24.7	21.7	24.5	25.8	28.9	32.0	
in percent of GDP	16.1	15.4	8.1	8.6	8.3	10-Year Historical Average	10-Year Standard Deviation	7.0	5.7	5.9	5.6	5.7	5.8	Projected Average
Key Macroeconomic Assumptions														
Real GDP growth (in percent)	3.6	4.5	4.8	5.1	5.6	4.7 7/	1.9 7/	5.2	6.0	6.6	6.7	6.7	6.7	6.3
Exchange rate appreciation (US dollar value of local currency, change in %)	-18.1	10.0	8.6	-4.0	-8.0	-8.5	26.0							
GDP deflator in US dollars (change in percent)	-6.4	16.5	14.6	3.2	4.7	0.6 7/	29.0 7/	18.6	2.9	2.7	2.7	2.8	3.0	5.4
Nominal external interest rate (in percent)	4.7	2.6	2.8	2.7	3.5	4.3	1.3	3.6	3.5	3.6	3.5	3.4	3.4	3.5
Growth of exports (US dollar terms, in percent)	-11.0	4.6	5.3	19.7	19.7	7.2	13.1	14.9	9.4	6.5	7.3	8.0	9.1	9.2
Growth of imports (US dollar terms, in percent)	-9.6	4.1	8.2	26.9	22.5	6.0	18.3	15.3	9.1	7.5	8.3	9.5	10.4	10.0
Current account balance, excluding interest payments	8.5	5.7	5.0	2.0	2.0	5.4	4.1	1.7	2.0	1.5	1.2	0.8	0.4	1.3
Net non-debt creating capital inflows	0.9	1.8	1.1	1.3	1.5	1.1	0.9	0.9	1.0	1.0	1.1	1.1	1.2	1.0
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2006-10 4/								**43.0**	**36.6**	**31.3**	**26.0**	**19.9**	**13.6**	**-1.2**
A2. Alternative Scenario								**40.0**	**35.8**	**32.8**	**30.2**	**27.3**	**24.3**	
B. Bound Tests														
B1. Nominal interest rate is at baseline plus one-half standard deviation								**39.3**	**35.0**	**32.0**	**29.3**	**26.4**	**23.7**	**-2.5**
B2. Real GDP growth is at baseline minus one-half standard deviations 7/								**39.4**	**35.2**	**32.2**	**29.6**	**26.8**	**24.0**	**-2.5**
B3. Non-interest current account is at baseline minus one-half standard deviations								**41.0**	**38.5**	**37.1**	**36.0**	**34.7**	**33.3**	**-3.2**
B4. Combination of B1-B3 using 1/4 standard deviation shocks								**40.3**	**37.1**	**35.0**	**33.3**	**31.3**	**29.3**	**-2.8**
B5. One time 30 percent real depreciation in 2006								**73.0**	**66.4**	**61.6**	**57.1**	**52.0**	**46.7**	**-5.0**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ The implied change in other key variables under this scenario is discussed in the text.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

7/ Excluding 1998, which was an extreme outlier due to the depth of the crisis in Indonesia. Including 1998 reduces average real GDP growth to 3.2 percent with a corresponding standard deviation of 6.1 percent; and the average growth of the GDP deflator in U.S. dollars to 5.4 percent with a standard deviation of 17.7 percent.

INTERNATIONAL MONETARY FUND

INDONESIA

Staff Report for the 2006 Article IV Consultation and Fifth Post-Program Monitoring Discussions

Supplementary Information

Prepared by the Asia and Pacific Department

Approved by Daniel Citrin and Carlo Cottarelli

July 26, 2006

This supplement provides an update on developments since the issuance of the staff report. The thrust of the staff appraisal remains unchanged. Following the earlier release of the infrastructure and investment climate policy packages, the financial sector reform package announced on July 7 represents a useful attempt to consolidate financial sector reform efforts, with a focus on accelerating implementation.

Recent developments

1. After being significantly affected by the global market turmoil in May/June, Indonesia's financial markets have been recovering. In the period since mid-June, which has seen both a rebound and a greater differentiation between emerging markets by investors, capital inflows to Indonesia appear to have resumed. The rupiah has recovered somewhat more strongly than other emerging market currencies, though stock prices have lagged (see Table). Foreign exchange reserves have edged up since end-June, when Indonesia repaid early one-half of its obligations to the Fund, and now amount to about $41 billion.

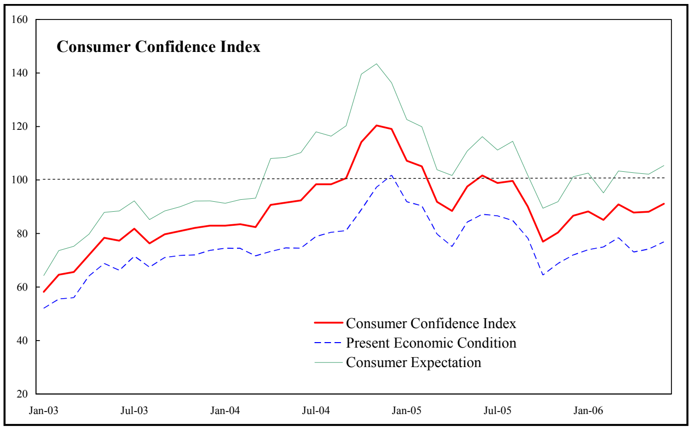
Financial Market Developments
(As of July 25, 2006)

	Change in percent	
	Indonesia	Emerging markets 1/
Foreign Exchange		
Peak to trough	-8.1	-6.2
Trough to today	3.8	2.2
Stocks		
Peak to trough	-20.5	-19.8
Trough to today	6.0	11.4

Sources: Bloomberg; and Fund staff estimates.
1/ Simple average of currencies and stock indices of Brazil, Hungary, Mexico, the Philippines, South Africa, Thailand, and Indonesia.

2. **Some recent indicators suggest that growth could begin to pick up in the second half of 2006.** The consumer confidence index improved further in June reaching its highest

level since September 2005 (see Chart). Motorcycle sales have stabilized in the last three months, albeit at a lower level than last summer, and retail sales also show signs of a recovery in May. After a decelerating trend in the first part of 2006, export growth picked up in May (exports in May were 16 percent higher than a year earlier). However, credit growth remains slow.



3. **Preliminary information through end-June shows a cumulative overall fiscal deficit of about 0.1 percent of GDP**, compared to a surplus of 0.7 percent of GDP for the same period last year. There has been some pickup in spending recently. For example, capital expenditures in January–June reached 20 percent of the amount budgeted for the whole year, compared with only 15 percent in January–May. Current expenditures in January–June reached 34 percent of the amount budgeted for the year. If the current pace of spending continues, staff's projections of spending for 2006 could materialize; a shortfall in spending was seen as a significant risk in the staff report.

Financial sector policy package

4. **As expected, the government unveiled a financial sector policy package** (FSP) on July 7, aimed at strengthening financial intermediation and enhancing stability. To this end, the FSP includes a series of measures to: (i) address nonperforming loans at the state banks; (ii) improve and strengthen management performance at the state banks; (iii) foster the development and deepening of the nonbank financial sector, including the merger of the Jakarta and Surabaya stock exchanges, and encourage the government debt market; (iv) improve banking supervision, in particular with respect to the introduction of risk-based, consolidated supervision; (v) develop a medium-term privatization strategy; (vi) strengthen the financial safety net through the submission of the long-awaited Financial Sector Safety Net Law to parliament; and (vii) improve the functioning of the credit bureau.

5. While details in some areas have yet to be specified, the package addresses a number of long-standing issues, and includes many of the measures that have been recommended by Fund staff in the past. It was drafted with input from several key stakeholders. To ensure accountability, the FSP clearly identifies the different government agencies that will be responsible for each of the measures.

INTERNATIONAL MONETARY FUND
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FOR IMMEDIATE RELEASE
August 7, 2006

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation and Fifth Post-Program Monitoring Discussions with Indonesia

On July 31, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the 2006 Article IV consultation and the fifth post-program monitoring discussions with Indonesia.[1]

Background

Over the last few years, Indonesia has continued to make steady economic progress, despite some major natural disasters. In 2005, growth reached its highest level in nine years while macroeconomic vulnerabilities have been declining. The debt-to-GDP ratio has been halved since 2000, banking sector performance has improved, and corporate vulnerabilities have been reduced. S&P recently upgraded Indonesia’s external and local currency debt ratings up one notch to BB- and BB+, respectively. The government’s key objective is to accelerate growth to 6–7 percent and reverse the rising trend in unemployment.

In early 2006, economic activity slowed as a result of fuel price and interest rate adjustments implemented in the fall of last year in order to restore financial market confidence. After peaking at 18 percent in October 2005, inflation has moderated as the tight monetary stance has constrained domestic demand growth. High interest rates also triggered significant capital

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with all member countries, usually every year. Post-Program Monitoring provides for frequent consultations between the Fund and members whose Fund arrangements have expired but who continue to have substantial Fund credit outstanding. Particular focus is placed on policies that have a bearing on external viability. For both purposes, a staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the July 31, 2006 Executive Board discussion based on the staff report.

inflows in early 2006 leading to substantial accumulation of international reserves and enabling Indonesia to make early repayments to the Fund. While Indonesia was initially hard hit by the turmoil in emerging markets in May/June, the rupiah and stock prices have recently recovered a part of their losses.

Real GDP is projected to pick up in the second half of the year and reach 5.2 percent in 2006, supported by an expected gradual reduction in interest rates and an acceleration in government spending from the very low levels of 2005; the central government's deficit is budgeted to rise by 1 percentage point to 1.2 percent of GDP. At the same time, inflation is on track to reach the lower bound of Bank Indonesia's 7–9 percent target range. The current account is expected to remain in surplus in 2006, partly as a result of lower oil imports following the fuel price increase.

That said, there are some short-term downside risks to this generally favorable outlook. Further tightening in global financial markets could prevent the planned easing in domestic interest rates and the government needs to substantially accelerate spending in support of domestic demand. Higher international oil prices could also have an unfavorable impact on the budget, growth and inflation.

In the banking sector, performance has been on a steadily improving trend and private banks appear to have weathered the recent slowdown in growth and rise in interest rates quite well. Banks are on average well capitalized. However, nonperforming loans (NPLs) at the two largest state-owned banks rose substantially in 2005 and governance remains weak.
To address weaknesses in the financial system, the government released in July a package of financial sector reforms that will help resolve state banks' NPLs, foster improvements in banking supervision, and facilitate the development of the nonbank financial sector.

For the medium term, the government has adopted a comprehensive reform agenda to strengthen public institutions, improve the business climate and boost growth. If implemented, these reforms will remove some of the main obstacles to private investment, and contribute to a more flexible labor market and more efficient public administration, thus contributing to an acceleration in growth.

Executive Board Assessment

Executive Directors expressed their deepest sympathies to the people of Java and Sumatra who have suffered recently from earthquakes and tsunamis.

Directors commended the authorities on Indonesia's considerable achievements since the crisis. They noted that real GDP has returned to pre-crisis levels, public debt is on a declining trend, and creditworthiness has improved. The bold policy actions taken last fall and continued sound macroeconomic management have helped to reestablish policy credibility and resulted in large capital inflows with reserves reaching record highs. While Indonesia did not escape the sell-off in global financial markets in May/June, asset prices have been recovering in recent weeks.

Looking ahead, Directors considered that the key challenge facing the country remains to boost economic growth in order to make further progress in alleviating poverty and reducing unemployment. To this end, they encouraged the authorities to accelerate the implementation of their structural reform agenda that aims to enhance investor confidence and promote private-sector led growth. Directors also noted that continued pursuit of prudent macroeconomic policies will remain essential to further reduce vulnerabilities.

Directors saw some scope for a cautious easing of macroeconomic policies in 2006 to support growth. Accordingly, they noted that, after a slowdown in late 2005 and early 2006, economic activity is expected to regain momentum in the second half of this year, with interest rates likely to decline and government spending likely to accelerate in the coming months. Nevertheless, they drew attention to some downside risks. A tightening in global liquidity conditions and higher international oil prices could prevent the planned easing in domestic interest rates and slow the recovery in domestic demand.

Directors commended Bank Indonesia for its cautious approach in cutting interest rates. They agreed that—while there is scope for further reduction in interest rates in the coming months, given that inflation has been trending down and domestic demand remains relatively subdued—the pace and timing of these cuts would also need to take into account developments in global financial markets. Directors also praised Bank Indonesia for its efforts to improve clarity and consistency in conveying its monetary policy intentions, which have helped to strengthen the credibility of its inflation-targeting framework among market participants.

As regards the exchange rate, Directors noted that, despite some real appreciation recently, the rupiah seems broadly in line with fundamentals. While agreeing that Bank Indonesia had appropriately taken advantage of the rupiah appreciation earlier in the year to enhance reserve coverage, Directors emphasized that intervention should continue to be limited, in a symmetric way, only to smooth fluctuations in the exchange market and thus reduce volatility.

Directors noted that there is scope for fiscal policy to support activity in 2006, while firmly pursuing fiscal prudence. They agreed that the overall deficit targets for 2006 and 2007 are appropriate. Directors welcomed the government's efforts to avoid the spending shortfalls that had occurred in 2005 by simplifying procurement and budget execution procedures. The planned expansion of the fuel cash compensation program should also help support domestic demand. Directors suggested that these actions must be accompanied by improvements in expenditure management and monitoring systems to ensure the quality of outlays and prevent corruption, as well as in project implementation skills at the regional and local levels. They also recommended that, as domestic demand strengthens sufficiently, the authorities should consider reintroducing a mechanism for automatic adjustments of energy prices to depoliticize these adjustments and remove the risk of higher subsidies in the future, while taking into account the need to establish an adequate safety net for vulnerable groups.

Directors welcomed the authorities' intentions to address banking sector vulnerabilities and strengthen financial intermediation in the context of the recently announced financial sector reform package. In particular, they stressed the importance of dealing with the problems at the two largest state banks, where NPLs have risen considerably in the past year and governance remains weak. They commended the authorities on their intention to allow state banks to take haircuts on NPLs, which would give the banks the necessary tool to resolve NPLs, and recommended that this problem be addressed promptly.

Directors supported the medium-term privatization of state banks that do not have a public policy objective. In the meantime, governance could be improved by allowing private shareholders to participate in their management. As regards private banks, Directors were encouraged that these banks have weathered relatively well the current slowdown in activity and the rise in interest rates. Nevertheless, they stressed that bank supervisors will need to remain vigilant to any deterioration in credit quality. Directors encouraged the authorities to participate in a Financial Sector Assessment Program (FSAP), as this could help identify areas for further improvement in the financial system.

Directors commended the authorities for putting together an impressive reform package to improve the business climate and boost growth. However, they emphasized that it is essential to implement these measures in a forceful manner, to jump start investment. In particular, early approval of one or two laws currently under consideration would bring immediate benefits for trade and investment and help restore business confidence. In this context, they also stressed the need to modernize the legal framework.

Directors also underscored the importance of speedy implementation of fiscal reforms currently under consideration. Adoption of the tax package now before parliament, along with modernization of the tax department, will help enhance revenue collection while restoring investor confidence. The government's intention to better manage the potential risks stemming from the operations of public enterprise and private-public partnerships was also welcomed by Directors.

While acknowledging the political difficulties, Directors emphasized that the authorities need to press ahead with establishing a balanced framework for labor-business relations. Such a framework should protect the rights of workers but also be more business-friendly. More flexible labor markets would help Indonesia become more competitive vis-à-vis neighboring countries and should encourage employers to hire new labor more freely.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

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

	2002	2003	2004	2005	2006
	Act.				Proj.
Real GDP (percent change)	4.5	4.8	5.1	5.6	5.2
Domestic demand	2.4	6.0	5.2	4.4	5.2
Of which:					
Private consumption	3.8	3.9	5.0	4.0	3.0
Gross fixed investment	4.7	0.6	14.6	9.9	6.0
Change in stocks 1/	-2.0	2.2	-1.4	-1.2	0.4
Net exports 1/	0.8	1.8	-2.2	-0.5	0.8
Statistical discrepancy 1/	1.5	-2.4	2.5	2.1	-0.3
Saving and investment (in percent of GDP)					
Gross investment 2/	21.3	22.5	22.8	22.5	23.1
Gross national saving	25.3	26.0	23.4	22.9	23.4
Foreign saving	-4.0	-3.5	-0.6	-0.3	-0.3
Prices (12-month percent change)					
Consumer prices (end period)	9.9	5.2	6.4	17.1	7.0
Consumer prices (period average)	11.8	6.8	6.1	10.5	13.3
Public finances (in percent of GDP)					
Central government revenue	16.5	16.7	17.9	18.1	19.1
Central government expenditure	18.0	18.7	19.3	18.5	20.3
Central government balance	-1.6	-2.0	-1.4	-0.3	-1.2
Primary balance	3.4	1.6	1.4	2.2	1.4
Central government debt	65.4	58.3	55.7	46.5	40.9
Money and credit (12-month percent change; end of period)					
Rupiah M2	7.9	9.8	10.0	13.0	17.9
Base money	8.3	19.8	20.4	21.9	15.8
Private sector credit	25.1	22.1	30.4	19.7	15.9
One-month SBI rate (period average)	15.1	10.1	7.5	9.1	12.1
Balance of Payments (in billions of US$)					
Oil and gas (net)	6.2	7.4	5.1	4.0	6.8
Non-oil exports (f.o.b)	46.3	48.9	54.5	66.2	74.9
Non-oil imports (f.o.b)	-29.0	-31.7	-39.5	-47.9	-54.8
Current account balance	7.8	8.1	1.6	0.9	1.0
Foreign direct investment	0.1	-0.6	-1.5	1.8	2.1
Overall balance	5.0	3.7	1.0	-0.5	11.1
Gross reserves					
In billions of US dollars (end period)	32.0	36.3	36.3	34.7	40.8
In months of imports	6.8	6.1	5.0	4.1	4.4
As a percent of short-term debt 3/	117.3	134.5	137.4	113.7	138.7
Total external debt					
In billions of US dollars	131.3	135.4	137.4	133.8	136.9
In percent of GDP	67.2	57.7	54.0	47.6	39.0
Exchange rate (period average)					
Rupiah per US$	9,314	8,575	8,933	9,705	...
Nominal effective exchange rate (Jan. 2000=100)	94.2	95.0	87.0	79.3	...
Memorandum items:					
Oil production (000bcpd)	1,260	1,200	1,040	999	1,000
Indonesian oil price (US$/bbl)	24.1	28.8	37.8	50.8	64.0
Nominal GDP (in trillions of Rupiah)	1,822	2,014	2,273	2,730	3,253
Nominal GDP (in billions of US$)	196	235	254	281	351

Sources: Indonesian authorities; and IMF staff estimates.
1/ Contribution to GDP growth (percentage points).
2/ Includes changes in stocks. Computed on real basis.
3/ Short-term debt on a remaining maturity basis, before rescheduling, and including IMF repurchases.

Statement by Made Sukada, Alternate Executive Director for Indonesia
July 31, 2006

1. On behalf of the Indonesian authorities, we would like to thank Executive Directors and Management for their continued support for Indonesia. The authorities would also like to express their appreciation to staff for the constructive policy discussions in Jakarta during the recent Fund mission and for the balanced report and useful Selected Issues paper.

2. The authorities are in general agreement with the staff's assessment of the challenges faced and the policy initiatives to revive the economy and create job opportunities in the immediate future. They are particularly pleased to note that the staff are supportive of the government's policy priorities and the medium-term economic strategy which is aimed at promoting high and sustainable growth led by the private sector, as well as reducing unemployment and combating poverty in line with the Medium Term National Development Plan (RPJMN 2005-2009).

Recent Developments and Prospects for 2006

3. Despite experiencing several external shocks in 2005, Indonesia's economy recorded its highest growth in 9 years with GDP growth of 5.6 percent, achieving a sustainable path of public finance, a continued current account surplus with a healthy build up in international reserves, and further improvement in the banking sector. Inflation trended downwards, but remains high due to pass-through of the domestic fuel price adjustment last year.

4. Macroeconomic fundamentals continued improving over the first half of 2006, albeit with growth moderating in recent quarters. The recent earthquake and floods in some parts of the country have had minimal impact on the Indonesian economy. Inflationary pressures continued receding while fiscal sustainability has been maintained. The balance of payments has improved, reflecting strong growth in exports as well as a capital account surplus. This has contributed to a significant increase in international reserves and modest exchange rate appreciation which is nevertheless in line with economic fundamentals as reflected in the continued increase in non-oil and gas exports. The banking sector is profitable and well capitalized, and has gradually resumed its financial intermediation role. Although the loan to deposit ratio (LDR) is still low, bank financing to the small and medium scale enterprises, which absorb a large portion of the labor force, has increased steadily in recent years. The authorities are pleased that Indonesia's sovereign as well as banking and corporate sector vulnerabilities have been declining over time as also pointed out in the Selected Issues paper.

5. Going forward, maintaining macroeconomic stability, accelerating the implementation of structural reforms, and improving the investment climate, including concerted efforts against corruption, will continue to be of the highest priorities for the current government. The main goals are to revive and sustain growth, further reduce inflation, expedite budget execution, and strengthen the banking sector while improving its financial intermediation. The authorities, however, recognize the risks and uncertainties surrounding the global financial markets and international oil prices as well as the formidable challenges

ahead in allocating resources for emergency assistance and reconstruction in the aftermath of the tsunami and the recent natural disasters.

6. Against this backdrop and coupled with the authorities' full commitment to implement the reform agenda, growth is expected to accelerate in the second half of the year, resulting in an annual GDP growth forecast close to 6 percent for 2006. This growth forecast is underpinned by a cautious easing of monetary policy, timely budget execution, the dissipating impact of the domestic oil price hikes as well as continued non-oil and gas export growth. This growth outlook is shared by staff, although the authorities are slightly more optimistic. Growth is projected to exceed 6 percent for 2007. As inflationary pressures recede, BI is confident that inflation towards end-2006 will be within the target range of 8 percent (+/- 1 percent) and further reduced to 6 percent (+/- 1 percent) in 2007. The positive prospects for Indonesia's economy are also shared by investors and rating agencies as reflected in the recent improvement of ratings for Indonesia by Moody's and Standard & Poor's. Over the medium term, the economy is expected to achieve its growth potential and be more resilient to external shocks given the structural reforms that have been put in place.

Fiscal Policy

7. The authorities are fully committed to maintaining prudent fiscal policy while recognizing the need for moderate fiscal stimulus in 2006, and increased growth generating expenditures and social spending over the medium term. To this end, the government has recently submitted a revised budget to the Parliament comprising an increase in the central government deficit from the initial target of 0.7 percent to 1.2 percent of GDP for 2006, including the carry over spending of the 2005 unspent budget of about 0.3 percent of GDP. This will enable the government to allocate more resources for education, the reconstruction of places affected by the recent earthquake, floods and tsunami, in addition to the larger expenditures needed for the increase in interest payments and fuel subsidies. Nonetheless, even with the envisaged increase in the deficit, the public debt to GDP ratio is expected to decline further to about 40 percent in 2006 and 30 percent by 2010.

8. The 2006 budget will be financed from domestic sources, mainly through the issuance of government bonds while net-foreign financing is targeted to be negative with debt re-payments exceeding new borrowings so as to reduce external debt vulnerability. The authorities are thankful to the Consultative Group on Indonesia and other development partners for their continued support, including the concessional financing for reconstruction in the hard-hit natural disaster areas. The 2007 budget that is being finalized for submission to the Parliament in August will remain prudent with the central government deficit capped below 1 percent of GDP.

9. On the expenditure side, the government has taken steps to address the obstacles of budget execution, both at the central and local government levels, by streamlining the procurement procedures and improving the capacity of local governments while maintaining proper governance, transparency, and accountability. The existing cash transfer scheme that has successfully targeted the poor is being further improved to sharpen its focus. The new scheme will directly link the cash transfer with the needs of the beneficiary for education and health expenses. As discussed in the staff report on the Observance of Standards and Codes

(ROSC) Fiscal Transparency Module, Indonesia has taken impressive steps in recent years to improve fiscal transparency and further actions in this direction are well underway. The recent establishment of a fiscal policy office and a new debt management unit are expected to further strengthen the assessment of fiscal risks and public debt management. On the revenue side, the implementation of modern tax offices is to be expanded to medium and small tax payers' offices. The tax and customs reforms that are expected to be passed by the Parliament by end-2006, will help expand the tax base and enhance revenue collection over the near-and-medium term.

Monetary and Exchange Rate Policies

10. The overriding objective of BI in the conduct of monetary policy is to contain inflation. Monetary policy was significantly tightened towards end-2005 and remained so until Q1-2006 so as to limit the second-round effects of the sharp increase in domestic fuel prices. As inflationary pressures eased, BI cautiously reduced the SBI rate by 25 bps in May. BI is nevertheless well aware that an excessive decline in the domestic interest rate could undermine the credibility of monetary policy, and in this connection, although inflationary pressures clearly receded in June, BI only cut its rate in early July by another 25 bps to 12.25 percent to take into account the developments in international financial markets. BI will continue to be cautious and interest rates will be reduced only when inflationary pressures show clear signs of abating. Furthermore, BI has intervened in the foreign exchange market to smooth abrupt movements in the exchange rate without targeting any specific exchange rate level. The authorities also concur with the view, as expressed in the Selected Issues paper, that exchange rate stability needs to be maintained in order to support the convergence process of lowering inflation to regional levels.

11. BI has made considerable progress to further strengthen the implementation of the inflation targeting (IT) framework. Its communication strategy and analytical capabilities are being improved, while policy coordination with the government continues to be strengthened. For transparency, the monetary policy stance is announced to the public every month. BI has also strengthened its coordination with the Central Bureau of Statistics to improve the quality of statistics, including the contribution of administered and non-administered commodity prices to inflation, and key inflation indicators like core inflation, so as to enable BI to conduct effective inflation surveillance and monitoring. The authorities concur with the staff that the flexible exchange rate system has served the economy well. They are committed to maintaining the system which is supportive of the IT framework.

Financial Sector Policy

12. BI has made further progress in strengthening banking supervision and prudential regulations to comply with international best practices. Early this year, BI issued a banking regulation package, including the provisions on promoting governance and enhancing customer protection. To facilitate the banking consolidation process in line with the Indonesian Banking Architecture (API), BI plans to introduce a single-presence-policy that will bar a single shareholder from owning a dominant stake in more than one bank. A major shareholder who already has a "controlling interest", as defined by BI, in more than one bank

will be given options to merge the banks, reduce the stake, or set up a special holding company in Indonesia. The policy is expected to encourage mergers and enhance effective banking supervision. While agreeing on the policy to privatize state-owned banks, the authorities, at this time however, attach greater priority on improving the performance of the state banks before contemplating a specific time frame for privatization. To further strengthen the banking infrastructure, BI has improved the existing Debtor Information System (DIS) so that all borrowers of banks as well as a large number of nonbank financial institutions are now covered under the new system. The authorities have also made progress through the introduction of retail bond transactions, beginning this month as part of the overall strategy to develop the domestic bond market.

Structural Reforms

13. The authorities are intensifying their structural reform agenda to further improve the investment climate, increase public infrastructure, and strengthen the financial sector intermediation that are necessary for improving efficiency of the economy and accelerating growth. A time-bound investment policy package was introduced in February this year, which involves a series of measures and actions to improve the investment climate. Key elements of the package include strengthening service institutions, synchronizing regional and central regulations, and improving customs, taxes, and labor regulations. Towards this end, a draft investment law has been submitted to the Parliament in March. Furthermore, there is increasing clarity on the proposed tax law, including key revisions to the initial draft to redress the balance between taxpayer’s rights and the retention of power with the tax officer. The new management teams installed recently in the tax and customs offices, together with the modernization of the tax and customs laws, unequivocally reflect the willingness of the authorities to address private sector concerns. The problem of illegal local tax is also being addressed through a plan to move from an open to a closed system, which will curtail local governments’ imposition of illegal taxes and levies. Steps have also been taken to streamline various regulations on trade licensing, delegating more authority to the regional governments for business licensing, and simplifying the immigration procedures for foreign investors and workers. A preliminary draft of the revised labor law designed to increase labor market flexibility ran into opposition from labor groups and is currently being re-examined in consultation with the business community and labor unions.

14. Two other policy packages covering infrastructure and the financial sector were issued as an integral part of the investment policy package. The authorities are well aware of the need for the smooth implementation of infrastructure projects with active participation from private investors. In this connection, the government has further improved the regulation on the risk sharing mechanism for infrastructure projects under the umbrella of public-private partnerships (PPP). The new regulation clearly specifies the criteria for financial support that can be provided by the government for PPP investment projects while avoiding unfunded liabilities for the budget. The new guidelines complement the existing regulations on electricity toll roads, water piping systems, and land acquisitions for public use issued last year and are expected to provide sufficient incentives for private investors to participate in the PPP schemes.

15. The government and BI has jointly launched a financial sector package early this month aimed at improving policy coordination and advancing the regulation and supervision of both banks and non-bank financial institutions. The policy package covers time-bound initiatives to strengthen financial system stability and banking institutions, including specific action plans to address the NPLs of state-owned banks by allowing these banks to give haircuts on loan principal, reforming the non-bank financial institutions, and improving the efficiency of capital markets.

Regional Cooperation

16. Efforts to strengthen trade and investment cooperation are being intensified. Indonesia has made commitments in the framework of the ASEAN + 3[1] to reduce import tariffs so as to further enhance regional cooperation. In May, Indonesia signed Preferential Trade Agreements (PTAs) with the D-8 member countries[2] aimed at promoting trade through the reduction of tariffs to the predetermined rates within a 4 to 8 year time frame. Indonesia also recently signed a Framework Agreement on Economic Cooperation with Singapore aimed at developing Special Economic Zones (SEZs) in the Indonesian islands of Batam, Bintan, and Karimun. It is expected that the SEZs will facilitate FDI and improve the country's international competitiveness. Intensive bilateral negotiations with major trading partners are also being pursued to revitalize trade activities going forward.

Conclusion

17. Despite experiencing several external shocks in recent years, Indonesia has made significant progress in strengthening its economic fundamentals. The authorities are well aware of the remaining challenges and are strongly committed to intensifying the reform agenda while maintaining macroeconomic stability. The goal is to enhance the country's international competitiveness through improvements in efficiency and economic productivity, which are essential for private sector-led growth, ultimately leading to a reduction in unemployment and poverty. The authorities would also like to thank Management and Executive Directors for the technical assistance provided to Indonesia in various areas that has helped the country make significant progress in recent years. Finally, the Indonesian authorities remain committed to transparency and consent to the publication of all staff reports, with necessary deletions of market sensitive information.

[1] The ASEAN+3 are the 10 ASEAN member countries plus China, Japan, and South Korea.

[2] The D-8 countries are Egypt, Bangladesh, Indonesia, Iran, Malaysia, Nigeria, Pakistan, and Turkey.