September 2010
IMF Country Report No. 10/284

Indonesia: 2010 Article IV Consultation—Staff Report; Staff Statement; 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 the 2010 Article IV consultation with Indonesia, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 9, 2010, 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 August 2, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement.

- A Public Information Notice (PIN).

- 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 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Consultation with Indonesia

Approved by Mahmood Pradhan and Aasim Husain

August 2, 2010

Mission. A staff team—T. Rumbaugh (head), L. Lipscomb, U. Ramakrishnan (all APD), N. Budina (FAD), X. Li (MCM), and G. Adler (SPR)—visited Jakarta during May31-June 9, 2010. Mr. Ferhani (MCM) joined the discussions on the Financial Sector Assessment Program (FSAP), and Mr. Zavadjil (Senior Resident Representative) also participated in the discussions. Ms. Vongpradhip (Executive Director) and Mr. Kartikoyono (Advisor, OED) attended the meetings. The team met with Finance Minister Agus Martowardojo, Bank Indonesia Governor Darmin Nasution, other senior officials, and private sector representatives.

Past surveillance. In concluding the 2009 Article IV consultation (July 13, 2009), the Fund praised the authorities' policies to maintain stability and support growth in response to the global crisis. Directors recommended enhancing budget flexibility and improving public resource management. Directors also encouraged the authorities to continue strengthening the monetary policy framework, including strong commitment to the inflation target to help guide inflation expectations and enhance policy credibility. Significant technical assistance is ongoing in the fiscal, financial, monetary, and statistical spheres to help build a stronger institutional framework.

Analytical work. Background studies assess Indonesia's export performance, inflation volatility, priorities for strengthening the financial sector, and managing fiscal policy under uncertainty.

Exchange rate regime. The exchange rate regime is classified as floating. Indonesia has also accepted the obligations under Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

Economic statistics are adequate for surveillance purposes, although they could be improved in some areas (Annex IV).

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EXECUTIVE SUMMARY

Current setting: Benefiting from strong initial conditions and robust domestic consumption, the authorities successfully steered the economy out of the crisis with appropriate policy responses, while even lowering public debt. Key challenges are to maintain the appropriate policy mix in a volatile external environment while fostering sustained high growth. Enhancing financial sector resilience and development based on the FSAP findings is also a top priority.

Outlook and risks: Supported by a recovery in investment, growth is likely to be 6 percent in 2010, rising to 7 percent in the medium term as infrastructure development takes hold. Inflation is likely to be higher than in 2009, but still within Bank Indonesia's (BI's) target range. Near-term risks would rise if there was a sustained increase in global risk aversion, which could trigger capital outflows and dampen growth momentum. In the medium term, stronger external demand could boost growth, but delays in implementing the planned infrastructure program are a downside risk.

Managing capital flows: Attaining the appropriate policy mix to manage volatile capital inflows is an ongoing challenge. The exchange rate is broadly in equilibrium and its continued flexibility in both directions remains an important part of the policy toolkit. Rising sterilization costs are a concern, underscoring the need to strengthen BI's balance sheet and operational toolkit. In this respect, the package of measures announced on June 16 could help improve monetary operations and lower volatility of short-term capital flows.

Monetary policy: Bank Indonesia's holding stance is appropriate for now, but signaling a proactive stance is needed to anchor inflation expectations in the target range. Expectations for 2011 are at the top end of the target range and several risk factors could push it higher. Thus, unwinding monetary accommodation may need to start in the second half of 2010. Administrative measures to fuel credit growth should be avoided since such actions could conflict with banks' prudential policies and risk management practices.

Financial sector stability: The joint IMF-World Bank FSAP confirms the sustained progress in financial sector stability and identifies further reform priorities. Some banks are vulnerable to credit and liquidity risks, which could be addressed by enhanced regulations. Stability could be strengthened by addressing weaknesses in the legal framework, bolstering coordination of macro and micro prudential supervision, and developing a deeper capital market to deliver a more diverse funding base.

Fiscal policy: Better budget execution is critical for a more effective fiscal policy. Also, phasing out energy subsidies, combined with expanding transfer programs and social services for the poor, and increasing non-commodity based revenues are key to create added space for infrastructure development.

I. CONTEXT

1. **Indonesia's growth in 2009 was the third highest among the G-20 group of countries**. Several factors contributed to this resilience: strong initial conditions (including low debt levels), greater dependence on domestic demand, a diversified export base, and appropriate policy responses.

2. **Reflecting this economic strength, capital inflows have been surging, posing policy challenges**. Large portfolio inflows since the second half of 2009 have complicated macroeconomic management and raised questions about the most suitable policy response. Against this background, the Article IV Consultation focused on (i) achieving the appropriate policy mix under a volatile external environment; (ii) enhancing systemic stability of the financial sector based on key FSAP recommendations; and (iii) harnessing recent performance to achieve sustained high growth.

II. ECONOMIC DEVELOPMENTS

3. **Growth has been resilient and inflation subdued**.

- Real GDP growth in Q1 of 2010 was 5.7 percent (y/y), the fastest pace since Q3 of 2008, and comes at the back of 4½ percent growth in 2009. Domestic demand continues to be a strong contributor, with a shift from consumption to investment occurring in 2010, reflected by the rising imports of raw materials and capital goods, as well as cement consumption (Figures 1 and 2). On the supply side, the service sector—notably transport and communication—has anchored growth, with manufacturing showing signs of recovery after slowing in 2009.

- Inflation has remained relatively low in 2010, following a sharp deceleration in 2009. With declining food and commodity prices and excess capacity in the economy, average inflation slowed to 2.8 percent (y/y) in 2009, well below the 3½–5½ percent target range (Figure 3). Average annual inflation through June 2010 has increased to 4 percent, mostly driven by higher food prices. Administered prices—which were reduced in late 2008 and early 2009, partly reversing the increase that took effect in June 2008—have increased broadly in line with headline inflation.

4. **Financial markets have responded positively to the economic developments and market sentiment remains broadly upbeat** (Figure 4). Fitch upgraded Indonesia's sovereign rating in January this year to BB+ (one notch below investment grade), and S&P and Moody's upgraded their ratings to two notches below investment grade. Reflecting global financial market conditions and consistent with other emerging markets, external spreads declined. The government's US$2 billion 10-year global bond issue in January was

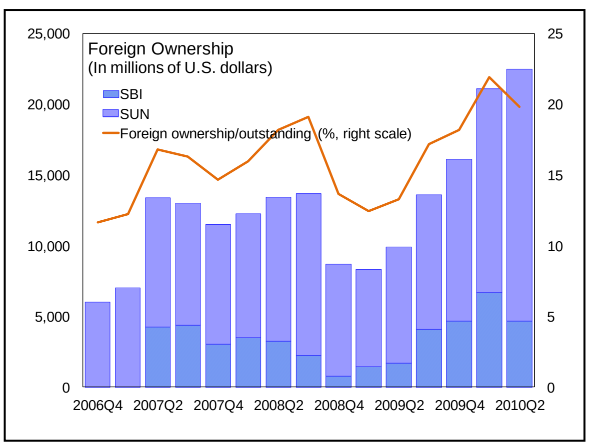
heavily oversubscribed, ending with a 6 percent yield, about 575 bps lower than a similar issue in March 2009 and only 278 bps higher than comparable U.S. treasuries. Indonesia has so far withstood well swings in global risk aversion in May, following Europe's problems, with only temporary and limited volatility in domestic yields and external spreads.

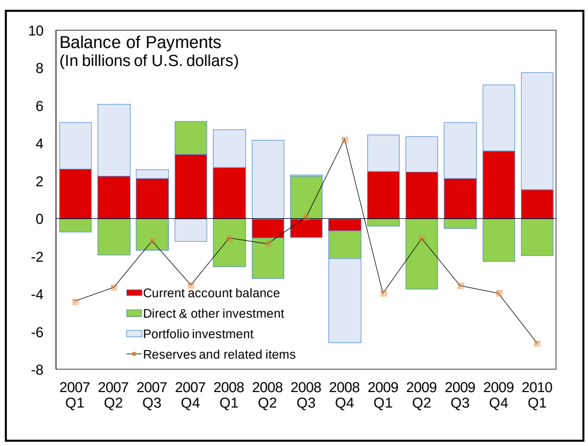
Comparison of Sovereign Ratings						
Moody's	S&P	Fitch	Moody's	S&P	Fitch	Definitions
Baa1	BBB+	BBB+	THA	THA		Investment grade
Baa2	BBB	BBB			THA	
Baa3	BBB-	BBB-	IND	IND	IND	
Ba1	BB+	BB+			IDN	Noninvestment grade
Ba2	BB	BB	IDN	IDN	PHL	Speculative
Ba3	BB-	BB-	PHL	PHL		
IND=India; IDN=Indonesia; PHL=Philippines; THA=Thailand						

5. **Notwithstanding some turbulence in May from the European crisis, strong capital inflows combined with small external current account surpluses have led to rupiah appreciation and reserve accumulation**.

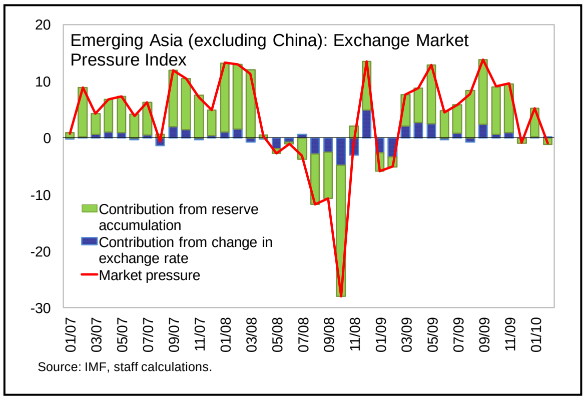
- Foreign capital has been pouring into Indonesia—net flows have been positive since Q3 of 2009, and the pace accelerated in Q1 of 2010. Both push (global liquidity and higher risk appetite) and pull (growth and yield differentials) factors have led to large portfolio inflows, particularly into government bonds (SUNs) and short-term BI certificates (SBIs), with foreign ownership at over 20 percent of the outstanding stock. Meanwhile, the stock market reached an all time high in April this year. In May, however, volatility increased following the European crisis, with US$5¾ billion of capital outflows, about US$5 billion of which were SBIs which has historically been the most volatile asset class in terms of foreign holdings. Strong inflows resumed in June. Foreign direct investment jumped in Q1 of 2010 to US$2½ billion—compared with only about US$5 billion in 2009—largely reflecting investments in the power sector.

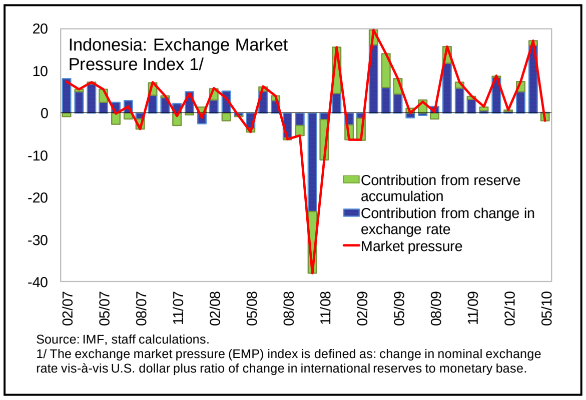
- On the trade side, surpluses continued in Q1 of 2010, despite fast growing imports. In 2009, weak exports were more than offset by the decline in imports—especially investment-related imports—resulting in persistent current account surpluses. Indonesia also benefited from higher commodity prices and China's increased demand for coal and copper.





- Indonesia has relied more on exchange rate flexibility than many other emerging markets. The Rp/US$ exchange rate appreciated nearly 35 percent from the trough in March 2009 through April 2010, undoing the depreciation during the crisis. International reserve accumulation has been relatively modest—about US$15 billion in 2009 and US$12 billion through April 2010. Some of these gains were partially reversed in May as the currency modestly depreciated due to the impact of the European crisis. Reserves also dropped by about US$4 billion to US$74½ billion in May, but recovered by nearly US$2 billion in June.





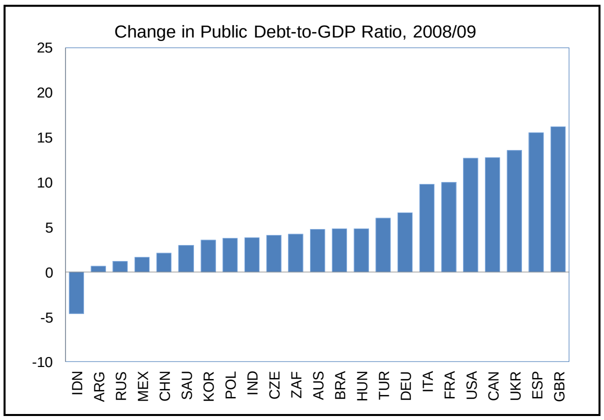
- On June 16, BI introduced a package of measures to address money market volatility and enhance its liquidity management toolkit. Specifically, to curtail short-term volatility of capital flows, BI introduced a one-month holding period for SBIs, whether purchased in the primary or secondary market by domestic or foreign investors. Market reaction to the measures has been positive, with net foreign buying of US$ 1 billion in both SUNs and SBIs since the announcement. In addition, to further encourage financial deepening, BI also plans to introduce 9- and 12-month tenor SBIs later this year in addition to the existing shorter tenors.

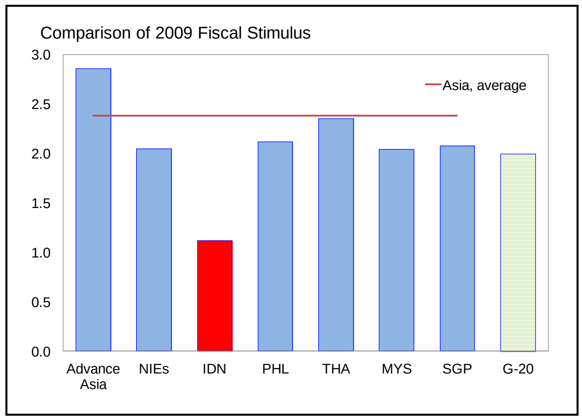
6. **Monetary operations have been complicated by the large inflows, and BI has responded by introducing measures to strengthen its liquidity management**. Reserve accumulation has added to the need for large draining operations, and BI has stepped up SBI issuance since 2009. However, to deter banks from relying on SBI's for short-term cash management and onshore/offshore arbitrage activities, BI began in March 2010 to shift the maturity structure of SBIs from one-month to 3- and 6-month tenors, and from weekly to monthly auctions. Also, in the June 16 measures, BI widened the corridor between its overnight deposit facility (FASBI) rate and the overnight BI repo rate by 100 bps to 5.5 percent to 7.5 percent, respectively. The wider corridor increases the borrowing cost from BI and lowers returns on its deposits, encouraging banks to trade in the interbank market.

7. **Additionally, Bank Indonesia has kept the policy rate unchanged since September 2009**. After easing the policy rate by 300 bps during the crisis, BI has left the rate at an historic low of 6½ percent. Interbank and SBI rates declined in line with the policy rate, but a similar reduction in deposit and lending rates has not occurred. To facilitate a reduction

in deposit rates, with the expectation that such a move will also lower lending rates, BI guided 14 banks in August 2009 to gradually reduce their deposit rates to no more than 50 bps above the policy rate by December 2009. Banks complied with the deposit rate reduction, but lending rates have remained mostly sticky downward, resulting in wider spreads between deposit and lending rates.[1] Still, credit growth in 2009 was 10 percent—markedly lower than in previous years, but consistent with the economic conditions in a crisis year as demand for working capital and investment funding had declined—but is gaining strong momentum in 2010 (annual growth of 18½ percent in June).[2]

8. **Despite expanded fiscal space for countercyclical policy, support was modest by international standards**. Public finance improvements prior to 2009—average primary surpluses of 2 percent of GDP during 2005−08—created ample room for countercyclical fiscal policy to respond to the global shock. However, the fiscal stimulus— mostly corporate and income tax cuts planned before the crisis—was only 1.1 percent of GDP or about half the G-20 average, which was appropriate given Indonesia's resilience to the shock. As a result, there was a primary surplus of 0.1 percent of GDP in 2009, and public debt declined to about 29 percent of GDP—the only country in the G-20 with a *declining* debt ratio in 2009.





9. **Financial soundness indicators remain strong**. Banks were generally resilient to the crisis as evidenced by their capital adequacy ratio (CAR) of 17½ percent at end-2009, above the regulatory minimum of 8 percent and BI's informal target of 12 percent (Figure 5).[3] Gross nonperforming loans (NPLs) increased by 14 percent in 2009, but the NPL

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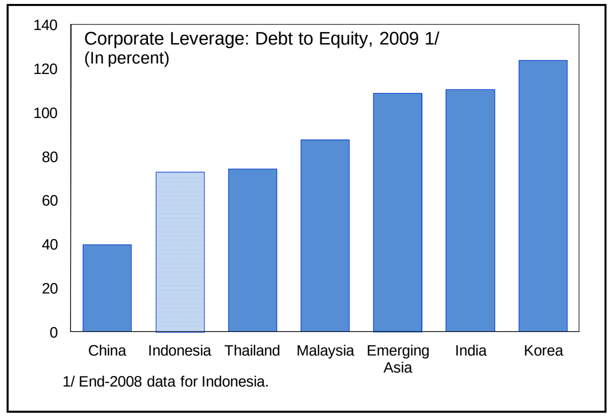
[1] Anecdotal evidence suggests that banks, particularly those with lower liquidity, are giving vouchers to attract more deposits, raising their effective deposit rate to more than 7 percent.

[2] Compared with the period 2004−08, when loan growth was accelerating rapidly, total credit growth in 2009 was relatively weaker than nominal GDP. However, such an outcome is consistent with the sharp increase in credit risk aversion and liquidity shortage in 2009.

[3] There were two bank failures during the crisis: Bank Century was taken over by the deposit insurance agency in November 2008 and Bank IFI was closed and liquidated in March 2009.

ratio was broadly unchanged at 3.2 percent of total loans, and loan loss coverage increased. Despite the difficult operating environment, profitability remained high with net interest income driven by higher interest rate spreads and loan growth, and banking sector liquidity conditions improved during the year.

10. **Overall, the corporate sector also weathered the crisis well**. Balance sheets were relatively more liquid compared with other countries in the region and were able to withstand reduced access to foreign funding. There has been a general shift in bank lending from corporate loans to retail and SME lending over the last few years, with a modest comeback in corporate lending during 2007−08 to support infrastructure spending (Figure 6). After a decline in bond issuance during the crisis, large corporations have returned to local debt markets since mid-2009, though issuance remains sporadic.



III. Macroeconomic Outlook and Risks

11. **Growth is expected to accelerate with rising contributions from investment**. Real GDP is projected to grow by 6 percent in 2010, as private investment recovers. Robust export and import growth are also likely, albeit from a low base. Medium-term growth is projected to be about 7 percent as investment grows in line with the planned infrastructure development.[4] Inflation is expected to be higher in 2010, but within BI's target range of 4−6 percent.

Indonesia: Medium-Term Macroeconomic Framework, 2008–15

	2008	2009	2010	2011	2012	2013	2014	2015
	(Percentage change)							
Real GDP growth	6.1	4.5	6.0	6.2	6.5	6.7	7.0	7.0
Domestic demand	7.6	5.3	5.8	6.3	6.6	6.7	7.0	7.2
Net exports 1/	0.7	1.2	0.8	0.6	0.6	0.7	0.7	0.5
CPI inflation (end period)	11.1	2.8	5.7	5.6	4.9	4.3	4.0	3.6
Saving and investment	(In percent of GDP)							
Gross investment	27.7	31.1	32.0	32.8	33.9	35.5	37.0	38.6
Gross national saving	27.7	33.0	32.9	32.8	33.4	34.6	36.0	37.5
Current account balance	0.0	2.0	0.8	0.0	-0.6	-0.9	-1.0	-1.1
Central government balance	-0.1	-1.6	-1.9	-1.7	-1.6	-1.6	-1.6	-1.5
Central government debt	33.2	28.6	27.0	26.3	25.5	24.7	24.0	23.3

1/ Contribution to GDP growth (percentage points).

12. **An external current account surplus is expected in 2010, but smaller than in 2009**. Exports are expected to recover from the sharp decline in 2009 as growth in trading partners recovers from the low base. Moreover, higher prices and demand for commodities—primarily from China—are also expected to contribute to export growth.[5] Growth in imports,

[4] While a robust measure of potential growth is not available given large structural shifts in the economy, staff estimates that the output gap is likely to close in the second half of 2011.

[5] Chapter I of the selected issues examines the evolution of Indonesia's exports in recent years.

mainly capital goods and raw materials, is expected to be driven by accelerated investment. In line with the economic cycle, the current account is projected to move to a slight deficit over the medium term.

13. **Risks to the outlook are broadly balanced**. Direct spillovers from the European crisis are likely to be limited given low dependence of Indonesian banks on foreign funding and modest trade exposure to the region. However, an increase in global risk aversion creates near-term risks because it could trigger capital outflows and squeeze liquidity, dampening growth momentum. In the medium term, the possibility of sustained and stronger external recovery combined with larger foreign direct investment, as the investment climate improves, could further boost growth potential. Downside risks to growth could stem from weak implementation of the government's infrastructure development program. Inflationary risks in 2010/11 arise from rising commodity prices and supply-side constraints (see also ¶19).

14. **Authorities' views**: There was broad agreement with the growth outlook, and the authorities remain cautious about global economic conditions and spillovers to Indonesia. The government considers medium-term growth of about 7¾ percent as feasible with the implementation of its infrastructure program that will help expand capacity and boost productivity. In this regard, the authorities also noted that the recent signing of a decree easing foreign investment restrictions in over 40 industries, including healthcare and agriculture, is likely to increase foreign investment.

IV. Main Policy Discussions

A. Managing Volatile Capital Flows

15. **Recent growth performance, combined with recent and prospective ratings upgrades, have made Indonesia an attractive investment destination, albeit posing policy challenges**. The authorities' policy response has focused on exchange rate flexibility, supplemented by modest reserve accumulation aimed at reducing the short-term volatility of the exchange rate. More recently, a one-month holding period on all SBI holdings has been introduced (see ¶5). Despite the lack of evidence of emerging asset bubbles, continued large inflows are worrisome because additional upward pressure on the rupiah could weaken competitiveness, and further increase sterilization costs. In addition, given the short-term nature of the inflows, there are also concerns about the risk of a sudden reversal arising from renewed global risk aversion.

16. **Staff supported the authorities' policy response to manage the inflows, including measures to deepen the capital market, and discussed the pros and cons of imposing administrative measures to manage volatility**.

- Exchange rate flexibility has served Indonesia well in absorbing external shocks during the 2008/09 global financial crisis, and should remain a significant part of the policy response to volatile capital flows. Staff's assessment is that the current exchange rate level is broadly in equilibrium (Box 1), allowing room for some further appreciation in response to continued capital inflows. While sustained appreciation could affect competitiveness, implementing measures to remove supply constraints, including developing infrastructure and improving the investment climate, would help ease the stress. Moreover, anecdotal evidence suggests that some industries (e.g., footwear and garments) are relocating to Indonesia from other Asian countries due to its relatively lower labor costs.

- Further modest strengthening of reserve buffers may be justified given Indonesia's sensitivity to global risk aversion, evidenced even as recently as 2008/09, despite some standard metrics indicating adequacy of the current reserve level (Appendix I). Mounting sterilization costs, however, are a concern. This situation highlights the need to address the long-standing issue of nonmarketable government securities on the central bank's balance sheet.[6] An agreement with the government to make this debt marketable would expand BI's operational toolkit for liquidity management. Securing a firmer financial footing for BI would better align its incentive structure with its mandate.

- The one-month holding period on domestic and foreign investors could be effective in deterring short-term inflows since offshore investors cannot use onshore banks to invest in SBIs to circumvent the regulation. If the measure works, less BI intervention may be needed to stem rupiah appreciation, lowering its sterilization costs. But staff also cautioned that rolling over the existing stock of SBIs could become more costly as SBI yields rise to compensate for lower liquidity, potentially increasing overall sterilization costs. In the short-term, the measures may also complicate cash management for banks and longer-term investors, given relatively weak repo and interbank market trading.

17. **Authorities' views**: The authorities agreed with staff analysis of policy options, including addressing supply constraints to relieve potential competitiveness pressures triggered by rupiah appreciation. They also agreed that making the nonmarketable government securities marketable could improve monetary management, and discussions between the government and BI are underway. On the one-month holding period requirement for SBIs, the authorities noted that it was meant to curb volatility and applies equally to domestic and foreign investors, and, therefore, should not adversely affect foreign investor sentiment.

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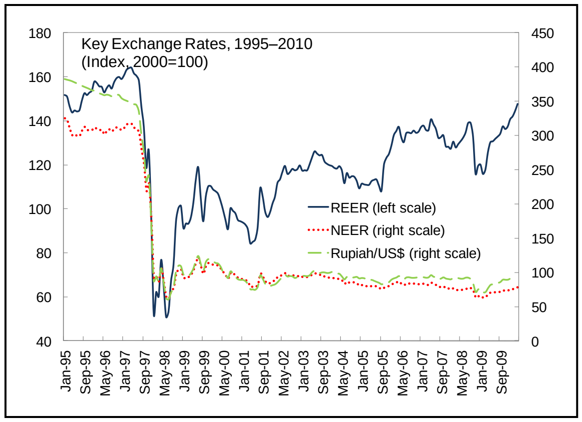
[6] The notional amount of nonmarketable and noninterest earning government securities on BI's balance sheet is roughly equal to the outstanding amount of SBI's issued to drain liquidity. If a portion of these securities were replaced by interest bearing marketable instruments, BI could sell them to replace maturing SBI's to drain liquidity, without incurring losses.

Box 1. Indonesia: Exchange Rate Assessment

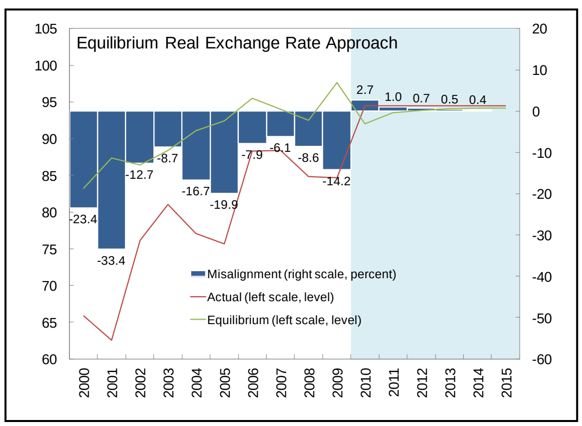
Indonesia's real effective exchange rate (REER) fluctuated significantly during the 2008 crisis, due to sharp moves in the nominal exchange rate. It fell nearly 20 percent from its peak in August 2008, before turning around in February 2009 to surpass pre-crisis levels by April 2010.



Strong real appreciation has been accompanied by a marked pick up in imports after the crisis—reflecting robust domestic demand—but exports have also performed remarkably, mostly reflecting booming commodity prices and volumes. Strong export performance has allowed the trade balance and the current account (CA) to remain positive, although there are some signs of modest weakening. There is also evidence of some key manufacturing sectors (e.g., textiles, electric machinery, furniture, paper) being sluggish, suggesting that competitiveness may have eroded somewhat in recent years, although other manufacturing sectors are growing robustly *(e.g., road vehicles, industrial machinery)* (see Chapter I of the selected issues).

Different CGER methodologies deliver somewhat different results, but all of them suggest the exchange rate is close to the equilibrium value:

- The external stability (ES) approach points to a 9 percent undervaluation, with a gap of 1.3 percentage points of GDP between the NFA-stabilizing CA (−2.4) and the underlying CA (−1.1). The result mainly reflects a baseline projection with a yet-to-materialize pick up in real GDP growth (averaging 7 percent over the medium term, against an average of 5.5 percent for the period 2003−07) which would allow a higher-than projected current account deficit while maintaining the NFA position stable at the estimated end-2009 level (−34.5).



- The macroeconomic balance (MB) approach points to an overvaluation of 5 percent, resulting from a gap of 0.9 percentage points of GDP between the underlying CA (−1.1) and the CA norm (−0.2).

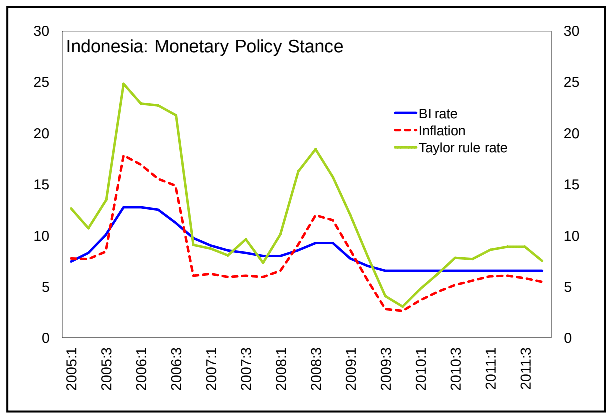
- Finally, the equilibrium real exchange rate (ERER) approach suggests that, under the projected path, the exchange rate would converge to its equilibrium value (zero misalignment) in 2010, after several years of undervaluation. This result mainly reflects significant real appreciation in recent years, while the equilibrium REER has remained broadly constant, as improving terms-of-trade have been offset by reduced government spending (relative to trading partners).

Overall, close-to-equilibrium CGER estimates (from both sides) and a positive but weakening trade balance and CA, suggest that there is no clear evidence of misalignment at this point.

B. Monetary Policy: Managing Inflation Expectations

18. **BI has signaled its intent to maintain its current stance until inflation climbs outside the 4−6 percent target range**. While some tightening was implemented through the increase in reserve requirements announced last year,[7] the immediate need to raise interest rates is mitigated by the rupiah appreciation and the delay in administered price increases.[8]

19. **BI's holding stance is appropriate for now, but signaling a proactive stance is necessary to anchor inflation expectations within the target range**. BI's current stance is justified as inflation expectations for 2010 are well within the 4−6 percent target range, and given the risk that hiking rates now could attract even more volatile portfolio capital. Looking ahead, however, inflation expectations for 2011 are at the top end of the range (5.9 percent, June Consensus Survey forecasts). Various risk factors could push expectations higher, including a narrowing output gap, recovering credit growth, excess liquidity, commodity price fluctuations, and potential administered price hikes. Given limited scope for a countercyclical fiscal policy response (see ¶27), the near-term burden falls on monetary policy to respond to economic and financial developments. Based on the current inflation and growth projections, an estimated Taylor rule indicates that unwinding may need to start in the second half of 2010, broadly consistent with market expectations. Also, continued efforts by BI to communicate its strategy to anchor inflation expectations will help signal commitment to lower the level and volatility of inflation in line with trading partners, helping lower Indonesia's term premium and boosting medium-term growth potential.[9]



20. **Staff supported recent measures to develop the money market as they broadly complement each other, encouraging development of the interbank market and enhancing BI's liquidity management**. A lower FASBI rate gives banks an incentive to trade in the interbank market, rather than park cash in BI deposits when short-term investments in SBIs are no longer available for cash management. However, staff also

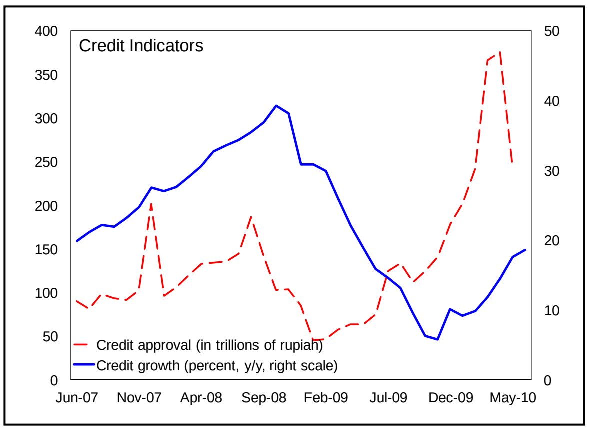
[7] BI increased banks' minimum reserve requirement (RR) from 5 percent to 7.5 percent in October 2009. BI had reduced RR from 9 percent to 5 percent during the liquidity squeeze at the peak of the 2008 crisis, at which time BI also announced that the 2.5 percent secondary reserve requirement would take effect a year later.

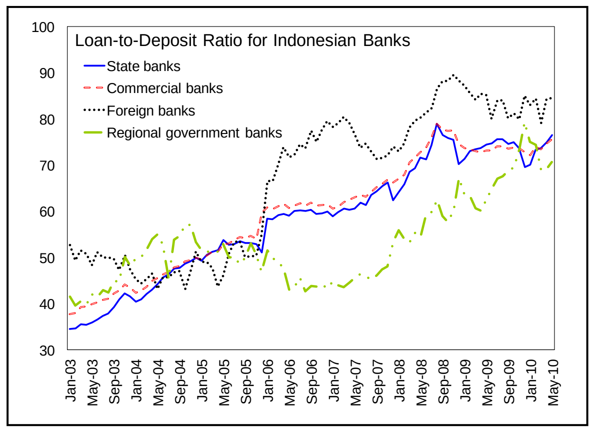
[8] The 10 percent electricity tariff hike from July is likely to have only a relatively small inflationary impact.

[9] Chapter II of the selected issues shows that Indonesia's borrowing costs have been higher than peer countries over the last few years due to elevated local currency term premia.

cautioned that managing market interest rates close to the policy rate would be needed to maintain policy credibility. Regarding the planned issuance of the 12-month SBI from September, close coordination with the government—which also issues one-year treasuries—will be necessary to manage the yield curve.

21. **Staff advised against introducing administrative measures to boost credit growth**. Given BI's concerns that the current credit recovery is weaker than would be expected with the prevailing economic and liquidity conditions, it is considering changing the regulation on the reserve requirement by linking it to each banks' loan-to-deposit ratio (LDR).[10] Under the measure, any deviation in banks' LDR from a certain threshold would require banks to hold additional reserves at BI. Staff believes that credit growth is gaining momentum in line with the economic recovery cycle and the sharp rise in credit approvals foreshadows even stronger credit growth. Most importantly, BI's planned action could conflict with sound prudential policies and banks' own credit risk management measures.





22. **Authorities' views**: BI observed that with inflation expected below target this year, the current policy stance was likely to be maintained unless global developments warrant action or if there was a major administered price adjustment. On linking reserve requirements to the LDR, BI disagreed with staff that credit momentum is picking up sharply. They instead attributed the recent increase in credit growth to low base effects, and feared that credit growth would slow again as the year progresses. In their view, creating symmetric incentives for achieving an appropriate LDR will facilitate better financial intermediation.

C. FSAP and Financial Sector Stability

23. **Indonesia has made great strides over the last decade to improve financial sector stability**. Progress has been made in bank regulation and supervision, including stricter loan

[10] A similar measure was in place for some years, including prior to the 2008 crisis, at which time credit grew rapidly. However, at that time, banks had to meet the higher RR only if their LDR fell below the threshold.

classification and provisioning, tightened related-party lending limits, higher capital adequacy requirement, and tightened foreign exchange open position limits. BI has also increased transparency and corporate governance, enhanced on- and off-site supervision, and instituted fit-and-proper tests for controlling shareholders and bank management. More recently, BI introduced individual bank risk assessments, enhanced consolidated supervision, and is moving progressively toward Basel II.

24. **The joint IMF-World Bank FSAP finds overall resilience of the banking sector**. The banking system has a large capital buffer and ample liquidity. Banks were profitable in 2009 despite the economic slowdown, and are expected to improve further as growth picks up. Stress testing under the FSAP finds that only under extreme shocks some banks become vulnerable to liquidity shocks and a few large banks susceptible to concentration risk. Exchange rate and contagion risks were not major concerns (Box 2).

25. **The FSAP also identifies further reform areas to enhance financial sector resilience**. The FSAP's key reform priorities—the legal and governance framework, coordination of macro-micro prudential supervision and crisis management, securing BI's financial independence, and developing capital markets—are further enumerated below.[11]

- *A sound legal framework is vital for financial stability and development of the financial sector*. Addressing weaknesses in the legal and institutional framework, governance, and protection for supervisors is needed to improve financial stability. To provide a legal foundation for crisis management, it is crucial to adopt the revised Financial System Safety Net Law, which should also help clarify the responsibilities of the various financial safety net participants (i.e., BI, Financial Services Authority (OJK), LPS, and Ministry of Finance). In addition, introducing a legally mandated, prompt corrective action regime that makes required actions explicit (e.g., a time limit for problem banks to remain under intensive supervision) would help speedy resolution of problem banks. Going forward, strengthened enforcement of creditors' rights will be important to reduce the cost of lending and promote financial intermediation.

- *While revising the financial supervisory framework, it is important to ensure the coordination of macro-micro prudential supervision*. The new framework should include a financial stability mandate, which BI is in a position to assume given its expertise in macro oversight. For this, BI must be able to continuously monitor systemically important banks and financial conglomerates. BI also needs full and timely access to the latest individual bank supervisory information, especially to perform its lender of last resort function. If bank supervision is transferred out of BI, it needs to be managed carefully to avoid losing already established capacity.

[11] More details on FSAP-related issues are in the companion paper *Financial System Stability Assessment*.

Box 2. Indonesia: Banking Sector Stress Test Results

The banking sector was stress tested during the FSAP to assess the impact of a range of tail risks. Both scenario and sensitivity analyses were applied. For the scenario analysis, the impact of a severe recession on the banking system—whereby the economy contracts by 5 percent, in sharp contrast to an average actual growth rate of about 5 percent during 2001−09—was assessed based on a macro credit risk model. The sensitivity analysis comprised market risk (e.g., interest rate, exchange rate, liquidity and interbank contagion risks) and concentration risk (collective default of the 10 largest system-wide borrowers) shocks and also a multifactor shock (exchange and interest rates).[1/] Both top down (TD) and bottom up approaches (BU) were used. In the TD, the balance sheet for each of the 121 banks was stress tested using common assumptions. In the BU, the 12 largest banks conducted stress tests.

The stress tests highlight the relative import of potential vulnerabilities to guide efforts to further strengthening financial stability, while the probability of the outcomes are very small by design. In sum, the sensitivity analysis showed that Indonesian banks are relatively resilient to market shocks. This is largely due to banks' small proprietary trading positions; tight management of the net open foreign currency positions (NOP); the use of plain vanilla interest rate and foreign currency hedging instruments; and the regulatory restrictions on banks' risk exposure to equities and structured products. The most vulnerability is to credit risk, followed by interest rate risk. Some banks are vulnerable to liquidity shocks while exchange rate and contagion risks are negligible. Specifically:

- Under the extreme macroeconomic shock to analyze credit risk, a third of the banks become undercapitalized with capital adequacy ratios (CARs) falling below the 8 percent regulatory minimum in the TD analysis, and three out of eight banks participating in the BU scenario analysis become undercapitalized when banks take into account their profit projections and using their own models to map macro shocks to credit performance. Non-performing loans would increase significantly. State-owned banks are most vulnerable, while small banks, with significant capital and liquidity buffers, weather the stress scenarios better than large and mid-sized banks.
- Sensitivity analysis to market shocks indicated that banks are most vulnerable to interest rate shocks. A 10 percentage point hike in interest rates would cause a 2½−3 percentage point drop in system-wide CAR, with close to one out of five banks becoming undercapitalized. Domestic private banks are the most vulnerable with one quarter reporting CAR below 8 percent, followed by state-owned banks. This vulnerability is ascribed to banks' short-term funding, with over 90 percent of deposits having maturities of less than one month and at call.
- Some second-tier large and medium-sized banks are vulnerable to liquidity shocks. About one out of five of these banks would run out of liquidity at the end of a five-day deposit run. Most of the banks that become illiquid have high loan to deposit ratios, averaging 89 percent in contrast to 74 percent for the group that stays liquid.
- A few large banks are vulnerable to concentration risks. These banks have large exposures to state-owned enterprises, which enjoy a single borrower-lending limit of 30 percent. If their ten largest borrowers default, five large banks would become undercapitalized, and one would become insolvent.
- Banks exposure to exchange rate and contagion risks are negligible. Given tight rules on managing banks' NOP, a 50 percent depreciation would reduce the system-wide CAR by only 0.1 percentage point. Banks' interbank exposures are limited; only four small banks are at risk of becoming undercapitalized if one of their large borrowers fails.

The stress tests underscore the importance of prudent banking regulations and supervision. Given susceptibility to credit risk, applying international best practices in asset classification and provisioning will help ensure the quality of banks' capital. Banks' vulnerability to interest rate risks highlights the importance of introducing regulations and enhancing supervision of interest rate risk. Above all, it is important to enact the financial safety net law to deal with any unexpected shocks timely and effectively.

1/ Shocks to interest and exchange rate were set at two standard deviations from the mean during 2001−2009. A liquidity shock is simulated by a daily deposit withdrawal calibrated to the pattern of the short-lived liquidity stress during the fall of 2008 and a shock to haircut of collaterals used for borrowing.

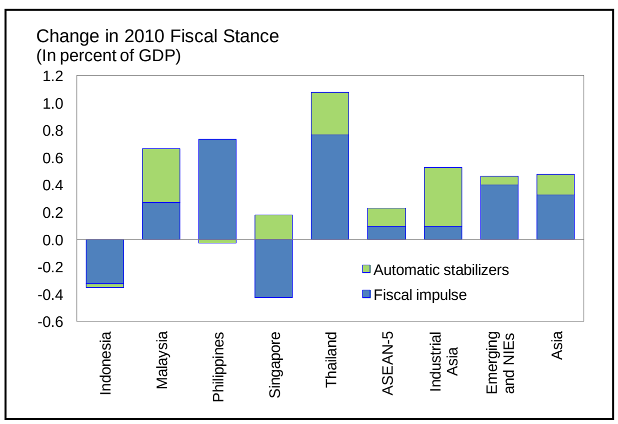
- *Capital market development is needed to diversify funding sources*. This initiative would be supported by strengthening legal and accounting standards (including augmenting the Capital Markets Law), encouraging state-owned enterprises to list on the domestic exchange, and expanding the institutional investor base by supporting development of the pension fund industry.

- *Strengthening BI's balance sheet would increase financial independence and enhance monetary management*. (As described in ¶16, bullet 2).

26. **Authorities' views**: The authorities were in broad agreement with the main conclusions of the FSAP. They are in the process of preparing an action plan to address the key priorities, and requested IMF technical assistance in a number of areas to help build capacity and guide the necessary reforms. They noted that three pieces of legislation are under consideration to reform the legal and governance framework of the financial system, i.e., creation of the OJK, the Financial Safety Net law, and revising the BI Act in the area of appointment of BI's top management. They recognized the importance of coordination between micro and macro prudential supervision and noted that the FSAP's recommendation will be considered in the current policy debate on the OJK. The government and BI both recognize the need for capital market development, and they welcomed further guidance on setting priorities.

D. Fiscal Policy: Supporting Sustained Growth

27. **Indonesia's 2010 budget is modestly expansionary unlike the rest of Asia, but remains consistent with macroeconomic stability**. The 2010 budget envisages a deficit expansion to 2.1 percent of GDP, with the bulk of the expansion stemming from implementation of the second round of corporate tax cuts planned before the crisis (Rp 30 trillion or 0.5 percent of GDP).[12] Staff estimates that the deficit could be slightly lower (1.9 percent of GDP) largely based on the historical pattern of under spending, While a stronger countercyclical fiscal policy stance would have been desirable, the room for such a stance is constrained by the permanent tax measures implemented, structural rigidities in

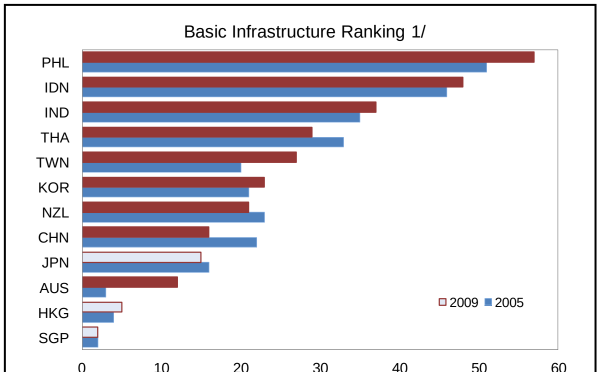


[12] Tax amendments passed in 2008 have been implemented in stages since January 2009 and as part of the stimulus packages. In 2009, the corporate income tax (CIT) rate was cut from 30 percent to 28 percent with a 5 percent discount for listed companies; personal income tax was reduced from 35 percent to 30 percent. In 2010, the CIT rate was reduced further to 25 percent with the 5 percent discount for listed companies.

spending, and a higher subsidy bill due to deferment of domestic fuel price increases. Even as estimated, however, the net fiscal impulse amounts to only 0.3 percent of GDP, posing no threat to debt sustainability as public debt is likely to remain below 30 percent of GDP and risks are manageable under all adverse scenarios.[13] Financing risks in 2010 are very low, given that two-thirds of the financing need has already been met.

28. **Further fiscal consolidation is expected from 2011, but will need to be supplemented by fiscal reforms to support sustained high growth**. Fiscal consolidation is planned from 2011, with a fiscal target of 1.7 percent of GDP, implying a stimulus withdrawal of 0.2 percent of GDP relative to 2010. While supporting the strategy, staff also stressed that achieving the medium-term growth targets would require redirection of spending priorities, better budget execution, and improving tax revenue ratios. Specifically:

- Improving both the quality and quantity of Indonesia's publicly provided infrastructure services, which currently has a relatively low international ranking, requires creating fiscal space for more capital spending, especially for the power sector and inter-island connectivity. In its absence, supply-side bottlenecks would constrain achieving sustained high growth. Phasing out energy subsidies, combined with expanding transfer programs and social services for the poor, will help create additional fiscal space for public investment with little impact on fiscal sustainability. In this regard, the increase in the electricity tariff by 10 percent from July is a step in the right direction, despite its small fiscal impact (0.1 percent of GDP compared with the budgeted subsidy of 3.2 percent of GDP). However, postponement of the increase in administered fuel prices in 2010 is a setback to subsidy reforms. With rising fuel consumption, volatile oil prices, and oil production uncertainties, delaying subsidy reforms could increase fiscal vulnerabilities over the medium term. Moreover, past ad hoc administered price adjustments have spurred substantial inflation volatility, complicating monetary policy implementation (Box 3).



Source: IMD, *World Competitiveness Yearbook1995–2009*.
1/ Total number of countries: 51 in 2005, 57 in 2009.

[13] Chapter IV of the selected issues examines public debt sustainability under various economic shocks (the exchange rate, borrowing costs, real GDP growth, and oil/gas volatility).

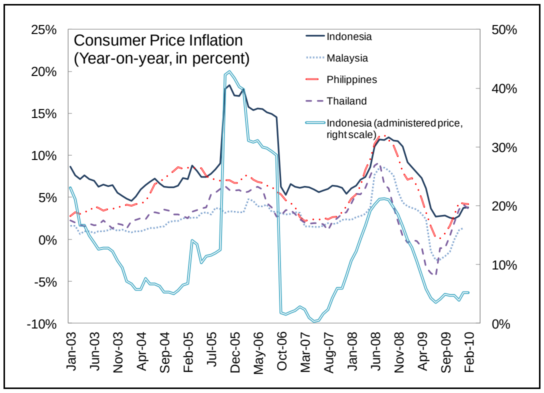
Box 3. Indonesia: Administered Price Adjustments and Inflation Volatility

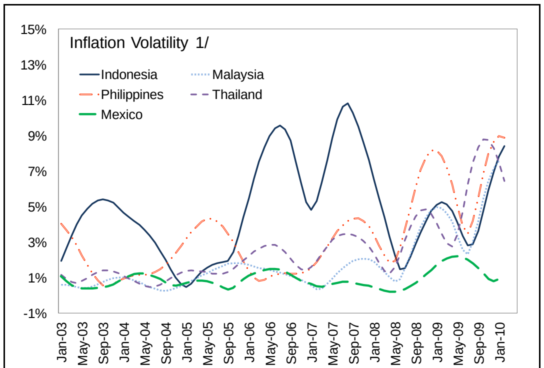
The inflation level and its volatility have been higher in Indonesia than some of its peer countries.

- Indonesia's consumer price inflation has averaged 12 percent since 1997 and 8½ percent since the formal adoption of inflation targeting in July 2005. By comparison, some of its Asian comparators have averaged about 3−6 percent inflation since July 2005, while Mexico and Brazil have averaged about 4−5 percent inflation in this period.
- Indonesia's inflation volatility also has been, on average, sharply higher than its peers, and the volatility in Indonesia is highly correlated with administered price adjustments. In the two most recent episodes of price hikes—in 2005 and 2008—volatility spiked significantly.[1/] Moreover, energy price adjustments and core inflation are also highly correlated because of second-round effects from the adjustment.

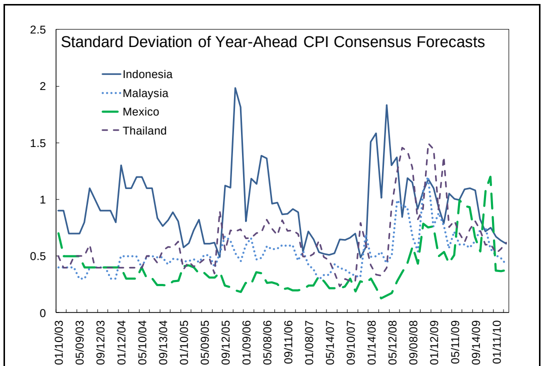
The high volatility has also contributed to uncertainty over estimates of Indonesia's future inflation rates. The dispersion of inflation survey forecasts (Consensus Forecasts)—which is used in the literature as a proxy for market uncertainty about the future inflation rate—shows that Indonesia has the highest standard deviation among forecasts for one-year ahead inflation.[2/]

Thus, ad hoc adjustments to administered prices create uncertainty over inflationary expectations, affecting monetary policy. When the central bank is unable to anchor inflation expectations due to inflation volatility, its policy credibility is undermined, leading to higher inflationary risk premium—i.e., additional cost of borrowing and lower growth.[3/]



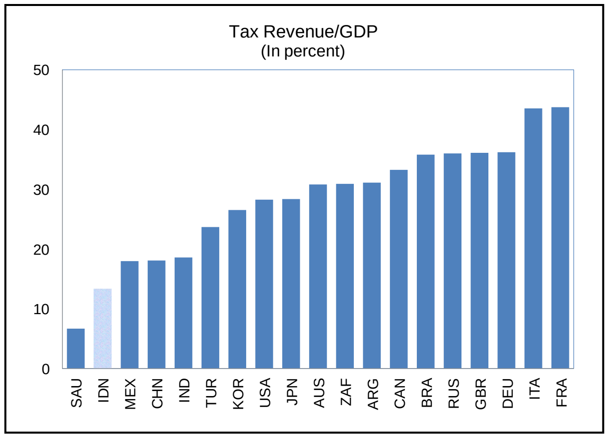


1/ Twelve-month rolling volatility based on annual average inflation.



1/ Fuel price adjustments were also made in 1998, 2000, and 2002, which also resulted in high volatility.
2/ Wright, J., "Term Premiums and Inflation Uncertainty: Empirical Evidence from an International Panel Dataset," Finance and Economics Discussion Series 2008−25, Board of Governors of the Federal Reserve System.
3/ See Chapter II of the selected issues.

- Sustained fiscal reforms to improve the quality and efficiency of fiscal institutions are also necessary to support long term growth. In particular, improved budget execution, including better coordination with line ministries, is critical to strengthen fiscal policy effectiveness. To raise tax revenue ratios from the current level, which is one of the lowest in the G-20, continued efforts are needed to broaden the tax base and improve tax administration, including improving arrears collection, taxpayer registration, and audit functions.



29. **Authorities' views**: There was broad agreement with staff, especially on raising revenue ratios, broadening the tax base, and improving budget execution, particularly relating to spending by line ministries. The authorities also noted ongoing efforts to enforce compliance and reduce tax fraud. The authorities stressed their commitment to reduce subsidies, but were not in a position to specify a timeframe for action.

V. Staff Appraisal

30. **Indonesia has shown resilience during shifts in external conditions**. Strong balance sheets, relatively low dependence on external demand, and appropriate policy responses helped support domestic demand through the crisis. Indeed, Indonesia was the only country in the G-20 to lower its public debt-to-GDP ratio in 2009. This strong performance, combined with higher global risk appetite, has contributed to large portfolio inflows from the second half of 2009. While market turbulence in May prompted some pullout of foreign investment, inflows have since returned.

31. **Continuing to achieve the appropriate policy mix through the ongoing volatile external conditions, while supporting sustained high growth, are the main policy challenges**. Despite the strong ongoing recovery in growth, volatile capital flows are complicating monetary management and the timing of removal of policy accommodation in the near term. In addition, for achieving sustained high growth and macroeconomic stability, enhancing financial sector resilience and development based on the FSAP findings is a top priority. Fiscal reforms to support medium-term investment and growth are also necessary.

32. **Unstable movements in foreign capital flows complicate policy management**. Conventional measures to manage the surge in inflows—allowing rupiah appreciation and modest international reserve accumulation—have worked well. Continued exchange rate flexibility in both directions will continue to be an important tool to manage volatility.

Concerns about competitiveness in the manufacturing sector due to rupiah appreciation could be addressed by removing supply constraints. Rising sterilization costs are a concern, underscoring the need to make the nonmarketable government bonds in BI's balance sheet marketable, which would help expand BI's operational toolkit. In this regard, the recent measures introduced by BI could improve monetary management and help lower volatility in short-term capital flows.

33. **BI's holding stance is appropriate for now, but looking forward, signaling readiness to respond to inflationary pressures is necessary to anchor expectations within the target range**. Expectations for 2011 are at the top end of the target range of 4–6 percent, and several risk factors could push it higher. Taking into account an estimated Taylor rule, unwinding may need to start in the second half of 2010, broadly consistent with market expectations. Moreover, continued effective communication of a proactive stance would signal BI's commitment to lower inflation and reduce its volatility to trading partner levels. Avoiding administrative measures to fuel credit growth is important to avert conflicts with banks' prudential policies and risk management practices.

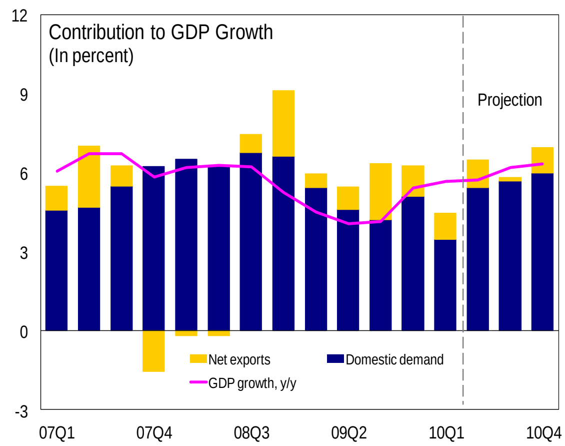
34. **The FSAP confirms the sustained improvements in financial sector stability and identifies additional reform priorities**. Some banks remain vulnerable to credit and liquidity risks. This highlights the need to improve coordination of macro and micro prudential supervision, and develop a crisis management framework for quick resolution of problem banks, including adoption of the Financial Safety Net law. Addressing weaknesses in the legal mandate for supervision and governance structures in financial institutions are also essential to further enhance stability. More generally, strengthening enforcement of creditors' rights and developing a deeper capital market will help improve financial intermediation and deliver a more diverse funding base to promote long-term investment.

35. **Fiscal reforms are necessary to enhance policy effectiveness and support sustained high growth**. Improved budget execution of development spending is critical for a more effective fiscal policy. Also, increasing non-commodity based revenues and phasing out energy subsidies, combined with expanding transfer programs and social services for the poor, are important to create additional fiscal space for infrastructure development.

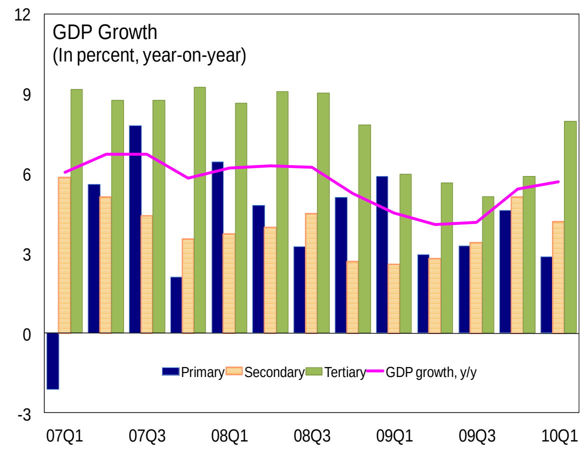
36. It is proposed that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Indonesia: Macroeconomic Developments and Outlook

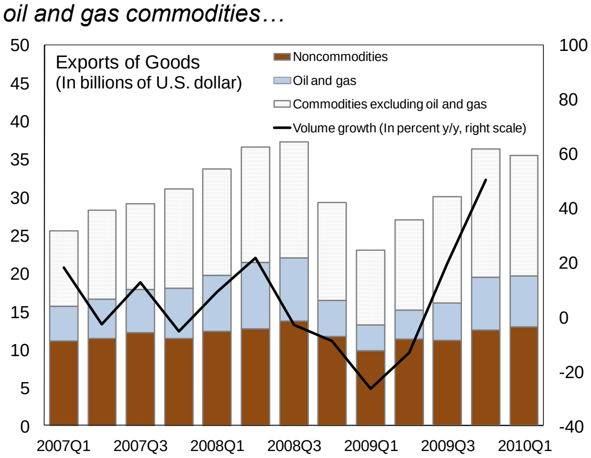
GDP growth was resilient in 2009, with strong growth projected in 2010…



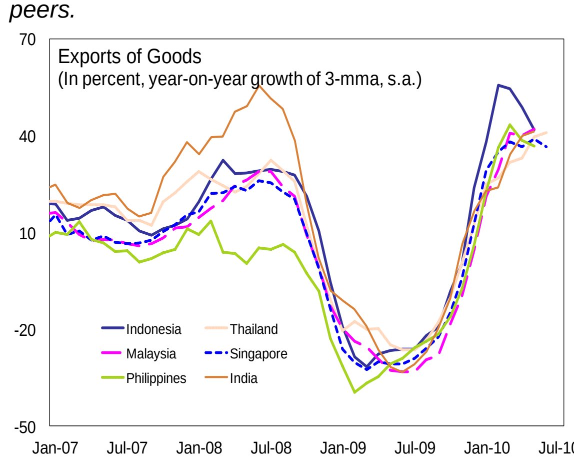
…amid broad-based growth across sectors.



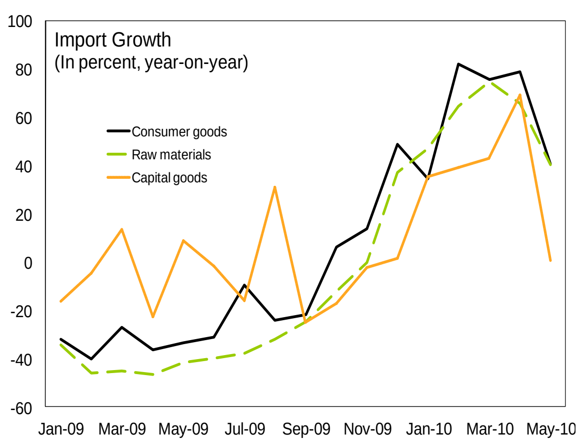
The recovery in exports has been supported by non-oil and gas commodities…



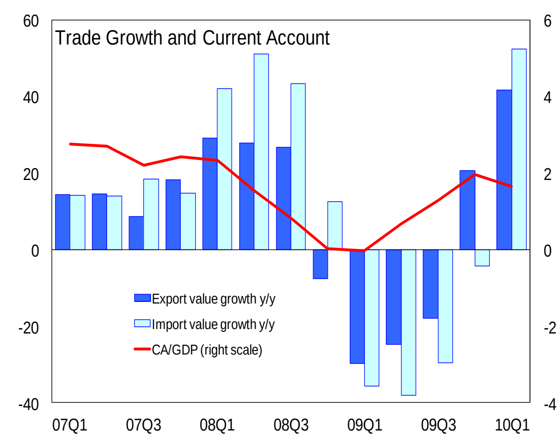
… driving export growth to exceed that of regional peers.



Domestic demand is supporting a pickup in imports…



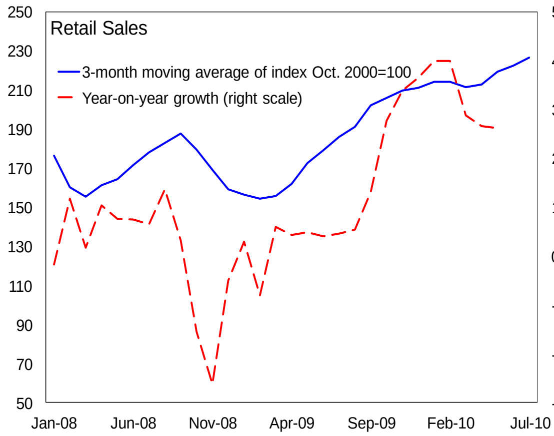
…however, the current account has remained in surplus.



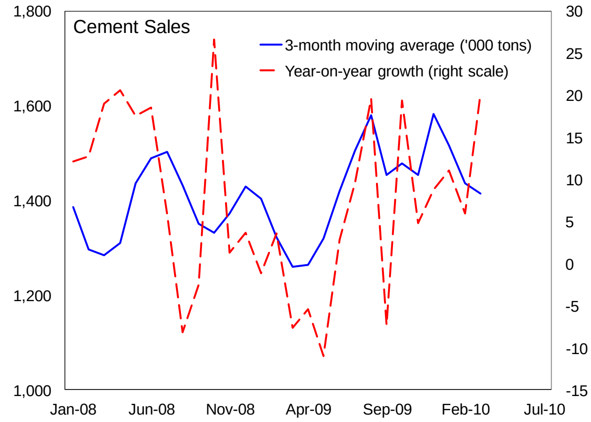
Source: CEIC Data Co., Ltd.; and IMF staff calculations and estimates.

Figure 2. Indonesia: Business Activity Indicators

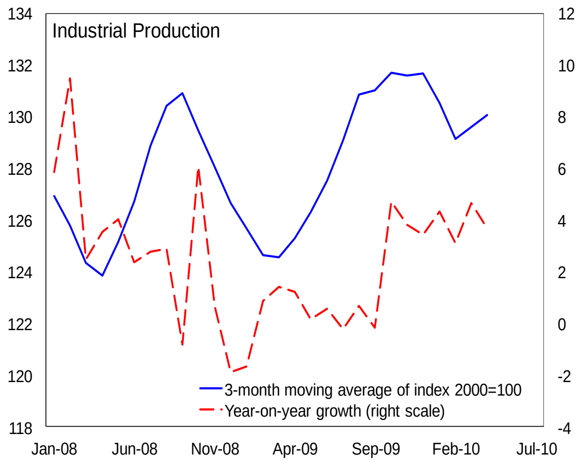
High frequency indicators show a rebound in business activity, with retail sales rising,…



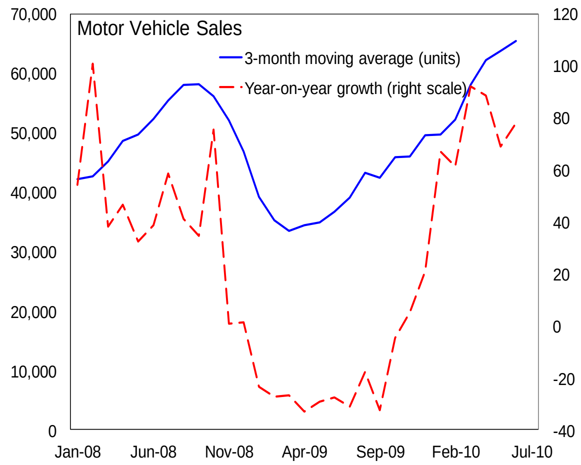
…cement sales picking up,…



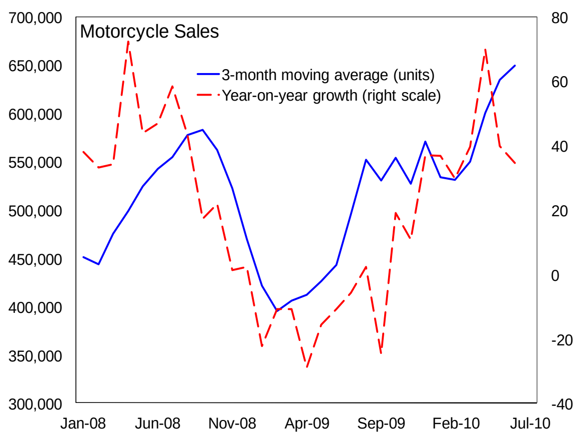
…industrial production surging since the start of last year…



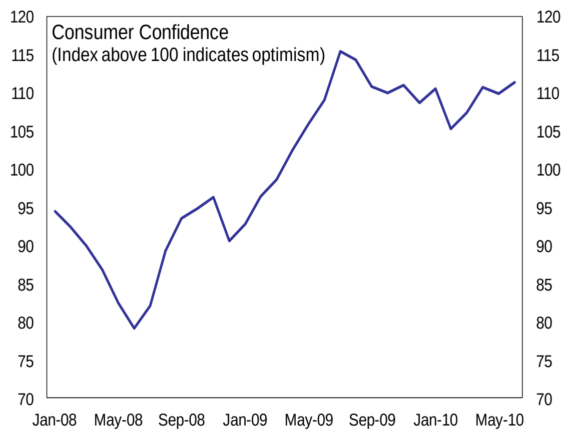
…and motor vehicle sales on a steady upward trend.



Motor cycle sales also rebounded from post-crisis lows…



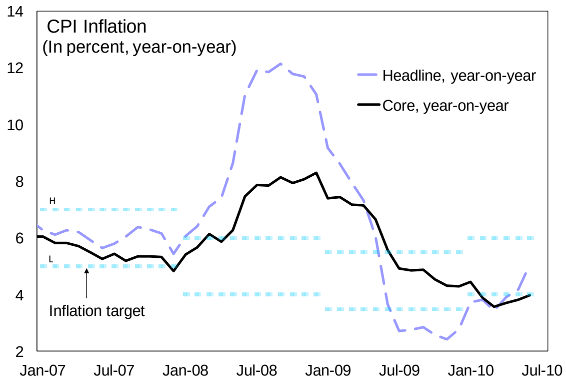
…as consumer confidence has remained buoyant.



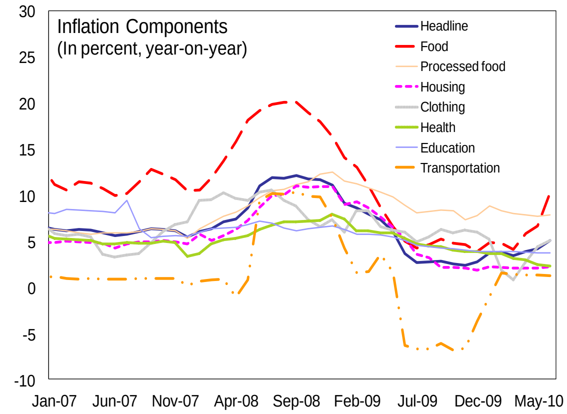
Source: CEIC Data Co., Ltd.; and IMF staff calculations.

Figure 3. Indonesia: Inflation and Monetary Developments

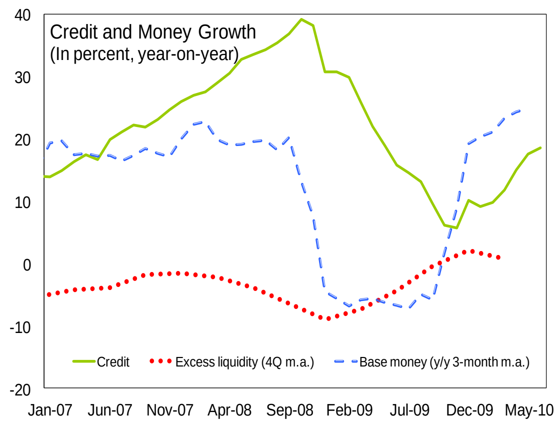
Inflation started to decelerate in October 2008…



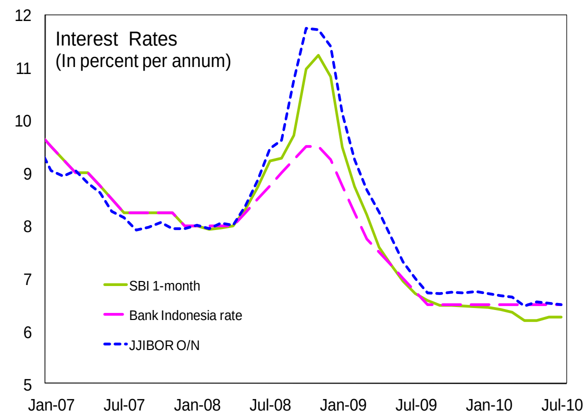
…as a result of food and commodity price declines and slower domestic demand.



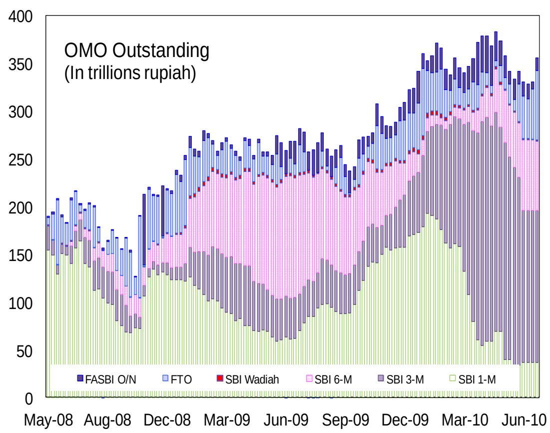
Credit growth declined during the crisis, but has started to recover as money growth has risen…



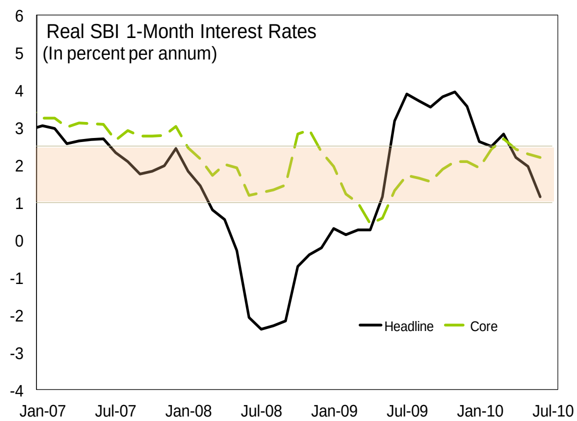
…along with aggressive monetary policy easing.



After supporting the market with liquidity during the crisis, BI has since increased draining operations,



…and real short-term interest rates are near the top of the estimated neutral window.

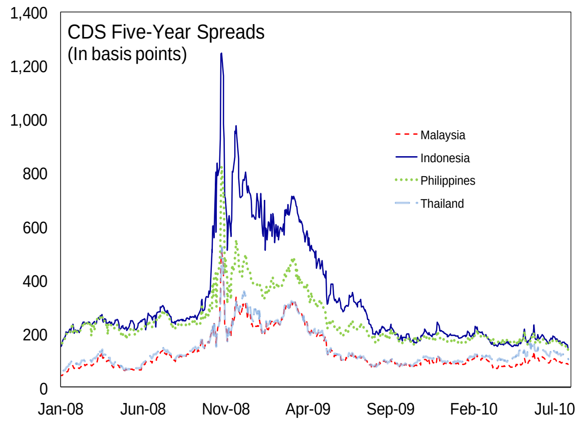


Source: CEIC Data Co., Ltd.; Country authorities; and IMF staff calculations.

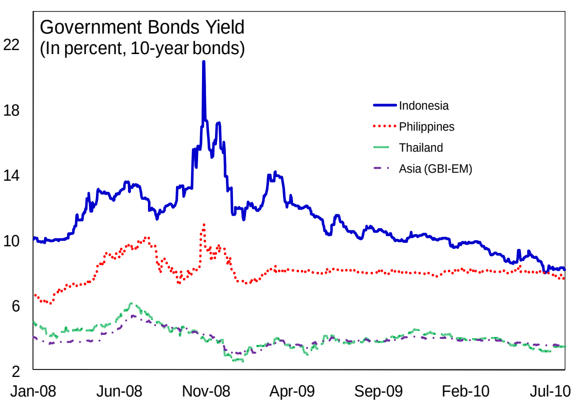
Figure 4. Indonesia: Financial Market Performance

The stock market has surged past pre-crisis levels, with effects from European debt crisis short lived…

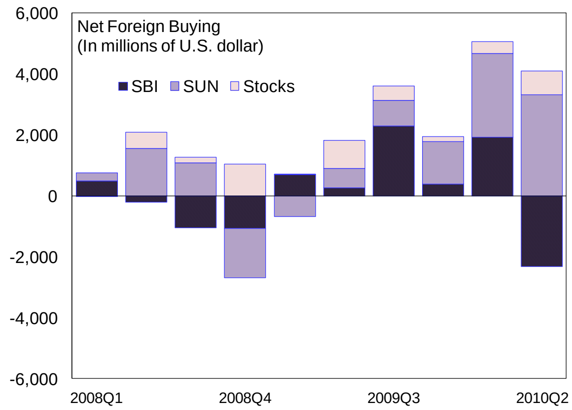
…while sovereign external debt spreads have also recovered.



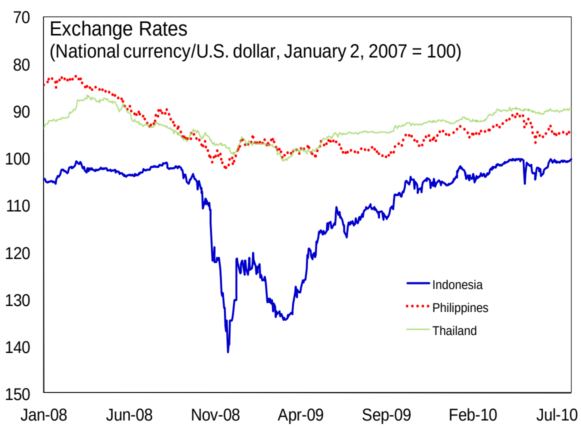
Though still higher than peers, local currency debt yields have also fallen to pre-crisis levels.



Foreign demand for SUNs has been steady, despite outflows from SBI's during the European debt crisis.



Indonesia's degree of exchange rate flexibility during the crisis and post-crisis has been high…

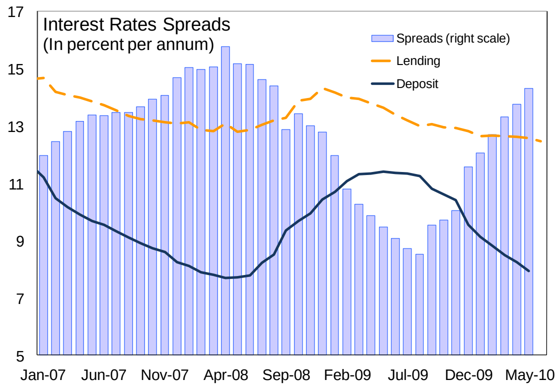


…even amid the increase in foreign exchange reserve in response to recent inflows.

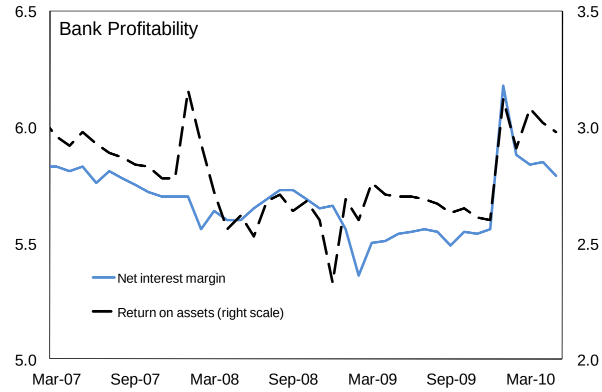
Source: CEIC Data Co., Ltd.; Bloomberg L.P.; Country authorities; and IMF staff calculations.

Figure 5. Indonesia: Banking Sector Indicators

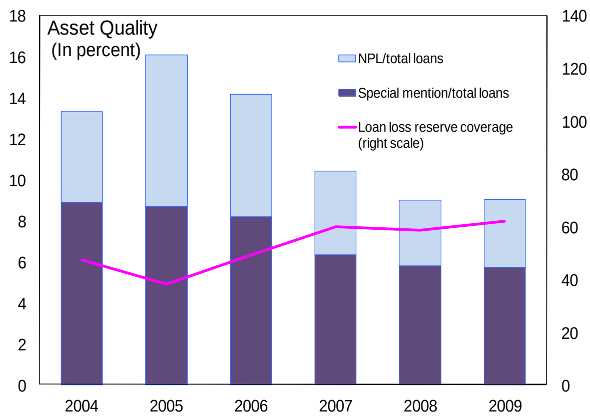
Banks lowered retail lending rates only slightly in response to their lower funding costs...



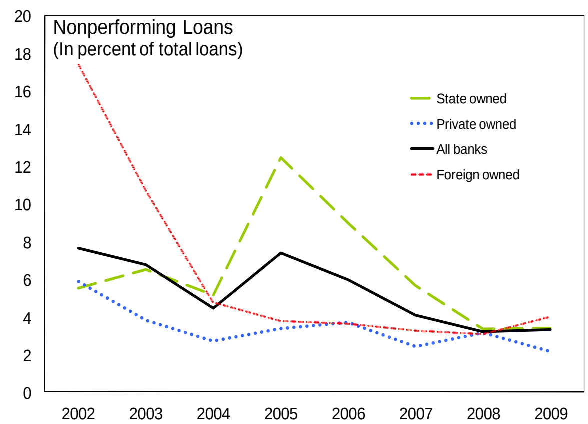
...supporting a high interest margin.



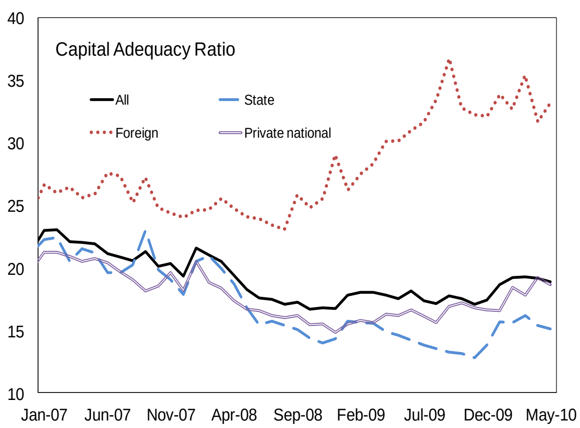
Loan loss reserve coverage remains ample...



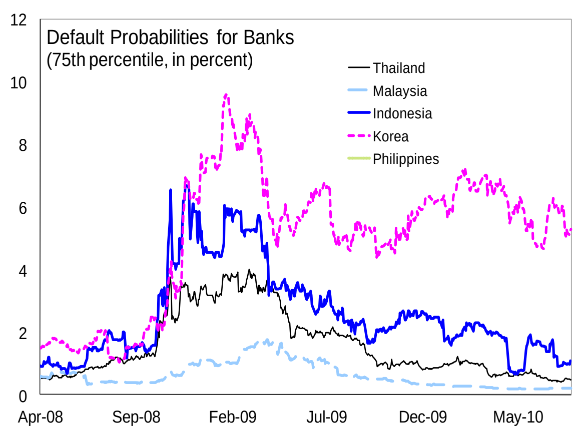
…with asset quality remaining relatively robust.



Capital asset ratios of banks have improved recently…



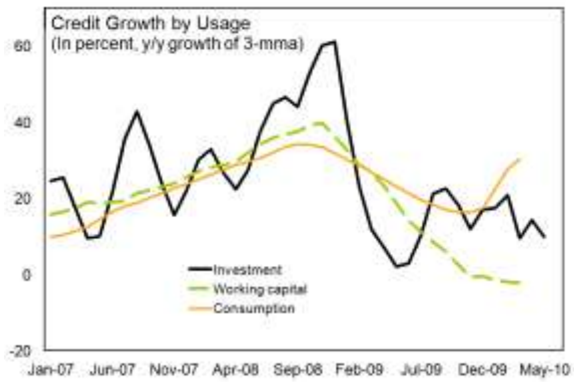
…and default probabilities have fallen in line with the recovery in the stock market.



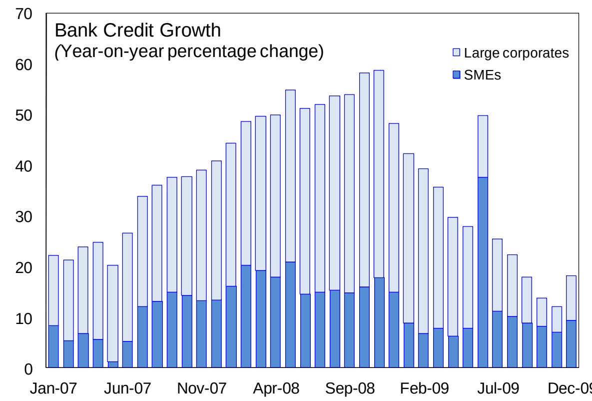
Source: CEIC Data Co., Ltd.; Country authorities; Moody's KMV; and IMF staff calculations.

Figure 6. Indonesia: Corporate Sector Indicators

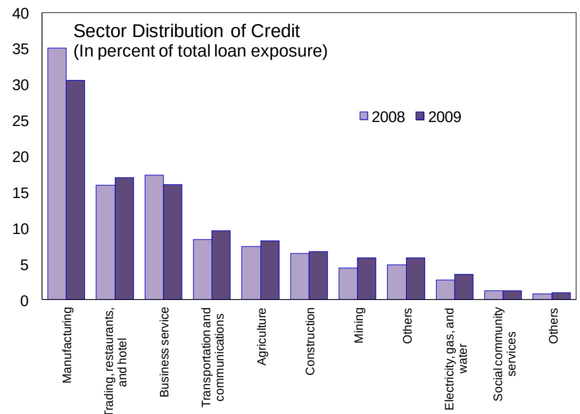
Investment credit growth has picked up, though working capital credit has so far remained sluggish.



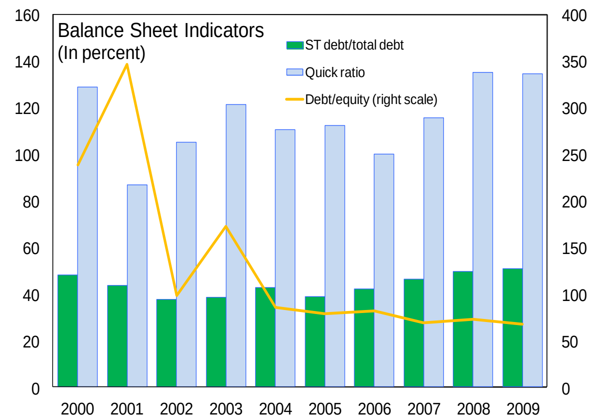
The recovery in credit is benefiting both large and smaller firms.



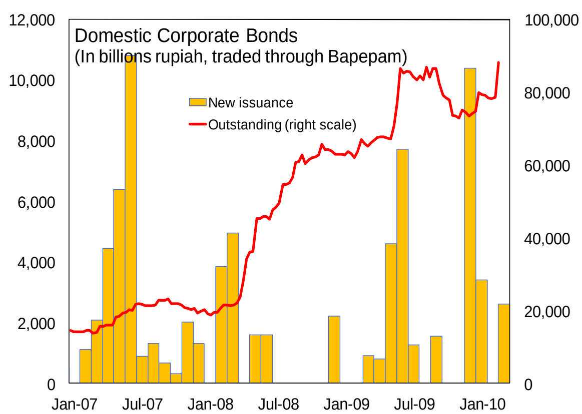
Sectors related to infrastructure investment are gaining a greater share of credit distribution…



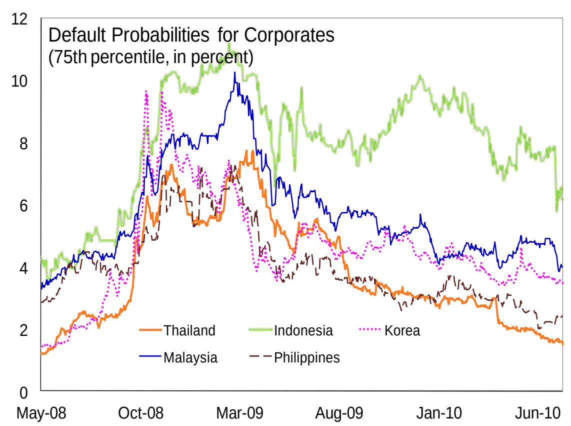
…and corporate balance sheets are relatively liquid in aggregate…



Though still patchy, domestic corporate bond issuance has picked up...



…as default probabilities have declined with the surge in the equity market.



Source: CEIC Data Co., Ltd.; Country authorities; and Moody's KMV; and IMF staff calculations.

Table 1. Indonesia: Selected Economic Indicators, 2007–11

Nominal GDP (2009): Rp 5,613 trillion or US$539 billion
Main exports (percent of total, 2009): mineral fuels (30), manufactured goods (16), machinery and transport equipment (15)
GDP per capita (2009): US$2,330
Unemployment rate (2009): 7.9
Poverty headcount ratio at national poverty line (2009): 14.1 percent of population

	2007	2008	2009	2010	2011
		Actual		Proj.	
Real GDP (percent change)	6.3	6.1	4.5	6.0	6.2
Domestic demand	4.1	7.6	5.3	5.8	6.3
Of which:					
Private consumption	5.0	5.3	4.9	5.5	5.5
Gross fixed investment	9.4	11.9	3.3	7.9	8.5
Change in stocks 1/	-1.6	0.1	-0.1	0.0	0.0
Net exports 1/	0.6	0.7	1.2	0.8	0.6
Statistical discrepancy 1/	1.9	-1.4	-1.4	0.0	0.0
Saving and investment (in percent of GDP)					
Gross investment 2/	25.0	27.7	31.1	32.0	32.8
Gross national saving	27.4	27.7	33.0	32.9	32.8
Foreign saving (external current account balance)	-2.4	0.0	-2.0	-0.8	0.0
Prices (12-month percent change)					
Consumer prices (end period)	5.6	11.1	2.8	5.7	5.6
Consumer prices (period average)	6.2	9.8	4.8	4.7	5.7
Public finances (in percent of GDP)					
Central government revenue	17.9	19.8	15.5	15.1	15.3
Central government expenditure	19.1	19.9	17.1	17.0	17.0
Central government balance	-1.2	-0.1	-1.6	-1.9	-1.7
Primary balance	0.8	1.7	0.1	-0.2	-0.1
Central government debt	36.9	33.2	28.6	27.0	26.3
Money and credit (12-month percent change; end of period)					
Rupiah M2	19.5	12.6	13.9	…	…
Base money	26.5	-2.9	17.2	…	…
Total credit	27.5	30.8	10.1	…	…
One-month SBI rate (period average)	8.6	9.1	7.4	…	…
Balance of payments (in billions of U.S. dollars)					
Oil and gas (net)	5.7	7.8	8.3	6.3	5.1
Non-oil exports (f.o.b)	93.1	107.9	99.1	121.6	127.2
Non-oil imports (f.o.b)	-66.1	-92.8	-72.2	-94.0	-102.5
Current account balance	10.5	0.1	10.6	5.8	0.2
Foreign direct investment	2.3	3.4	1.9	4.5	6.2
Overall balance	12.7	-1.9	12.4	14.4	7.5
Gross reserves					
In billions of U.S. dollars (end period)	54.1	52.1	66.1	80.5	87.9
In months of imports	4.5	5.6	5.5	6.2	6.3
As a percent of short-term debt 3/	157.4	141.5	203.7	220.6	218.2
Total external debt					
In billions of U.S. dollars	137.4	149.7	172.8	187.7	196.0
In percent of GDP	31.8	29.3	32.0	27.3	25.7
Exchange rate (period average)					
Rupiah per U.S. dollar	9,141	9,439	10,354	…	…
Nominal effective exchange rate (Jan. 2000=100)	80.9	73.6	69.7	…	…
Memorandum items:					
Oil production (000bcpd)	899	927	960	965	970
Indonesian oil price (US$/bbl)	70.7	96.6	61.4	74.9	77.1
Nominal GDP (in trillions of rupiah)	3,957	4,954	5,613	6,288	7,061
Nominal GDP (in billions of U.S. dollars)	433	512	539	689	761

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

1/ Contribution to GDP growth (percentage points).
2/ Includes changes in stocks.
3/ Short-term debt on a remaining maturity basis.

Table 2. Indonesia: Balance of Payments, 2006–11

(In billions of U.S. dollars)

	2006 Act.	2007 Act.	2008 Act.	2009 Act.	2010 Proj.	2011 Proj.
Current account	10.9	10.5	0.1	10.6	5.8	0.2
Goods, net (trade balance)	29.7	32.8	22.9	35.2	34.0	29.8
Exports, f.o.b.	103.5	118.0	139.6	119.5	146.4	153.0
Of which: Oil and gas	23.0	24.9	31.7	20.5	24.8	25.9
Non-oil and gas	80.6	93.1	107.9	99.1	121.6	127.2
Imports, f.o.b.	-73.9	-85.3	-116.7	-84.3	-112.4	-123.2
Of which: Oil and gas	-16.2	-19.2	-23.9	-12.1	-18.5	-20.7
Non-oil and gas	-57.7	-66.1	-92.8	-72.2	-94.0	-102.5
Services, net	-9.9	-11.8	-13.0	-14.2	-15.9	-16.5
Income, net	-13.8	-15.5	-15.2	-15.3	-17.2	-18.2
Current transfers, net	4.9	5.1	5.4	4.9	4.9	5.1
Capital and financial account	2.8	3.6	-1.9	3.5	8.6	7.3
Capital account	0.4	0.5	0.3	0.1	0.1	0.1
Financial account	2.4	3.0	-2.2	3.5	8.5	7.2
Direct investment, net	2.2	2.3	3.4	1.9	4.5	6.2
Abroad, net	-2.7	-4.7	-5.9	-2.9	-4.0	-4.0
In Indonesia (FDI), net	4.9	6.9	9.3	4.9	8.5	10.1
Portfolio investment, net	4.3	5.6	1.7	10.3	10.1	6.2
Other investment	-4.1	-4.8	-7.3	-8.8	-6.0	-5.2
Nonfinancial public sector	-2.8	-2.4	-1.4	-1.2	0.8	0.3
Banking sector	0.4	0.1	1.4	0.7	0.7	0.4
Corporate sector	-0.8	1.1	2.8	2.4	2.2	2.1
Disbursements	6.0	8.1	10.9	11.3	12.2	12.9
Repayments	-6.8	-7.0	-8.1	-8.8	-10.1	-10.7
Other 1/	-0.9	-3.6	-10.1	-10.7	-9.7	-8.0
Total	13.6	14.1	-1.8	14.1	14.4	7.5
Errors and omissions	0.6	-1.4	-0.2	-1.7	0.0	0.0
Overall balance	14.2	12.7	-1.9	12.4	14.4	7.5
Reserves and related items	-14.5	-12.7	1.9	-12.4	-14.4	-7.5
Memorandum items:						
Reserve assets position (eop)	42.6	56.9	51.6	66.1	80.5	87.9
in months of imports of goods and services	4.7	4.7	5.5	5.5	6.2	6.3
in percent of short-term debt at remaining maturity	200	197	177	204	221	218
Current account (percent of GDP)	3.0	2.4	0.0	2.0	0.8	0.0
Non-oil and gas exports, volume growth	5.2	-0.3	2.1	7.9	6.8	7.5
Non-oil and gas imports, volume growth	2.1	4.5	28.3	-14.7	18.5	9.2
Terms of trade, percent change (excluding oil)	8.5	5.8	3.6	-6.8	1.3	-1.3
Terms of trade, percent change (including oil)	5.2	3.8	2.5	-5.2	-0.7	-0.8
Stock of nonfinancial public sector external debt 2/	76.7	81.0	89.5	105.5	117.8	123.2
in percent of GDP	21.0	18.7	17.5	19.6	17.1	16.2
Nonfinancial public sector debt service (percent of exports)	12.1	6.9	6.5	8.0	5.9	5.8
Indonesian oil price	63.9	70.7	96.6	61.4	74.9	77.1

Sources: Data provided by Bank Indonesia; and Fund staff estimates.

1/ Includes unrecorded capital flows and exceptional financing.
2/ Includes non-financial state-owned enterprises.

Table 3. Indonesia: Monetary Survey, 2005–09

(In trillions of rupiah, unless otherwise indicated, end of period)

	2005 Dec	2006 Dec	2007 Dec	2008 Dec	2009 Dec
Bank Indonesia					
Net foreign assets	255.7	380.9	534.1	561.8	618.2
Net domestic assets	14.2	-34.4	-95.6	-136.0	-119.2
Net claims on government	249.5	274.2	264.5	191.2	225.7
Net claims on financial corporations	-74.4	-165.4	-192.4	-151.2	-169.6
Others	-160.8	-143.2	-167.8	-176.0	-175.3
Base money	270.0	346.5	438.5	425.8	499.0
Monetary survey					
Net foreign assets	307.4	405.2	513.9	596.8	807.4
Net domestic assets	895.4	977.3	1135.7	1299.0	941.1
Net claims on nonfinancial public sector	520.8	539.6	558.4	450.3	505.9
Total credit outstanding	733.2	821.6	1005.7	1314.0	1408.7
Others	-358.6	-383.9	-428.4	-465.3	-973.6
Broad money	1202.8	1382.5	1649.7	1895.8	2141.4
Rupiah, M2	1016.8	1199.8	1433.9	1614.9	1838.8
Currency in circulation	124.0	150.7	183.0	209.7	226.0
Deposits	892.9	1049.2	1250.9	1405.1	1612.8
Foreign exchange	185.9	182.7	215.8	281.0	302.6
Memorandum items:					
NIR of BI (US$ billions)	26.8	42.3	56.5	51.1	56.4
Money multiplier (rupiah M2)	3.8	3.5	3.3	3.8	3.7
Base money velocity 1/	11.2	10.1	9.4	12.1	11.6
Rupiah broad money velocity 1/	2.5	2.5	2.5	2.7	2.7
Annual percentage change:					
Broad money	16.3	14.9	19.3	14.9	13.0
Rupiah broad money	13.1	18.0	19.5	12.6	13.9
Base money	30.9	28.3	26.5	-2.9	17.2
Total credit outstanding	28.4	12.7	27.5	30.8	10.1

Sources: IMF, International Financial Statistics; and IMF staff estimates.

1/ Calculated using end-period quarterly GDP, annualized.

Table 4. Indonesia: Summary of Central Government Operations, 2006–11

	2006	2007	2008	2009			2010		2011
	Act.	Act.	Act.	Revised Budget	Prel. Outturn	Staff est.	Approved budget	Staff proj.	Staff proj.
				(In trillions of rupiah)					
Revenues and grants	627	706	982	871	870	870	992	951	1080
Oil and gas revenues	201	168	289	177	176	176	207	202	213
Tax revenues	43	44	77	49	50	50	55	54	57
Nontax revenues	158	124	210	128	126	126	152	148	156
Non-oil and gas revenues	424	536	691	693	693	693	783	747	866
Tax revenues	366	447	582	603	591	591	688	651	758
Nontax revenues	58	88	109	90	101	101	95	95	108
Grants	2	2	2	1	1	1	2	2	1
Expenditure and net lending	659	754	986	1001	957	957	1126	1070	1200
Current expenditure	338	385	563	540	500	500	624	575	623
Personnel	73	90	113	134	128	128	162	154	175
Subsidies	107	150	275	158	160	160	201	183	178
Of which: energy subsidies	64	117	223	100	95	95	144	126	117
Interest	79	80	88	110	94	94	106	103	116
Other	79	65	86	139	119	119	154	135	154
Development expenditure 1/	102	115	131	151	148	148	158	155	205
Transfers to regions	226	253	292	309	309	309	345	339	372
				(In percent of GDP)					
Revenues and grants	18.8	17.9	19.8	16.1	16.1	15.5	15.9	15.1	15.3
Oil and gas revenues	6.0	4.3	5.8	3.3	3.3	3.1	3.3	3.2	3.0
Non-oil and gas revenues	12.7	13.6	13.9	12.8	12.8	12.3	12.5	11.9	12.3
Tax revenues	11.0	11.3	11.7	11.2	10.9	10.5	11.0	10.4	10.7
Nontax revenues	1.7	2.2	2.2	1.7	1.9	1.8	1.5	1.5	1.5
Grants	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	19.7	19.1	19.9	18.5	17.7	17.1	18.0	17.0	17.0
Current expenditure	10.1	9.7	11.4	10.0	9.3	8.9	10.0	9.1	8.8
Personnel	2.2	2.3	2.3	2.5	2.4	2.3	2.6	2.5	2.5
Subsidies	3.2	3.8	5.6	2.9	3.0	2.8	3.2	2.9	2.5
Of which: energy subsidies	1.9	3.0	4.5	1.9	1.8	1.7	2.3	2.0	1.7
Interest	2.4	2.0	1.8	2.0	1.7	1.7	1.7	1.6	1.6
Other	2.4	1.7	1.7	2.6	2.2	2.1	2.5	2.1	2.2
Development expenditure 1/	3.1	2.9	2.6	2.8	2.7	2.6	2.5	2.5	2.9
Transfers to regions	6.8	6.4	5.9	5.7	5.7	5.5	5.5	5.4	5.3
Overall balance	-1.0	-1.2	-0.1	-2.4	-1.6	-1.6	-2.1	-1.9	-1.7
Financing	1.0	1.2	0.1	2.5	2.1	1.6	2.1	1.9	1.7
Domestic	1.0	1.5	-0.4	2.7	2.4	1.2	2.1	1.3	1.5
External	0.0	-0.3	0.5	-0.2	-0.3	0.3	0.0	0.6	0.2
Memorandum items:									
Primary balance	1.4	0.8	1.7	-0.4	0.1	0.1	-0.4	-0.2	-0.1
Public debt to GDP	40.4	36.9	33.2	…	…	28.6		27.0	26.3

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

1/ Comprises capital spending and social assistance spending.

Table 5. Indonesia: Selected Vulnerability Indicators, 2005–10

	2005	2006	2007	2008	2009	2010 1/	Latest Observation
Key economic and market indicators							
Real GDP growth (in percent)	5.7	5.5	6.3	6.1	4.5	6.0	Proj.
CPI inflation (in percent)	17.1	6.6	5.6	11.1	2.8	5.7	Proj.
Short-term (ST) interest rate (in percent)	12.8	9.8	8.0	11.0	6.5	6.5	Jun-10
EMBI spread (bps, end of period)	269	153	275	381	230	328	Jun-10
Exchange rate NC/US$ (end of period)	9,830	8,990	9,395	10,900	9,457	9,008	Jun-10
External sector							
Exchange rate regime				(Float)			
Current account balance (percent of GDP)	0.1	3.0	2.4	0.0	2.0	0.8	Proj.
Net FDI inflows (percent of GDP)	1.8	0.6	0.5	0.7	0.4	0.6	Proj.
Exports (percentage change of US$ value, GNFS)	20.7	15.1	13.4	18.7	-14.0	20.8	Proj.
Real effective exchange rate (end period; Jan. 2000=100)	125.0	135.2	128.3	119.5	137.5	148.6	May-10
Gross international reserves (GIR) in US$ billion	34.7	42.6	56.9	51.6	66.1	74.6	May-10
GIR in percent of ST debt at remaining maturity (RM)	145.7	200.4	196.7	176.7	203.7	220.6	Proj.
Total gross external debt in percent of exports of GNFS	133.0	113.5	105.9	100.1	129.7	116.6	Proj.
Gross external financing requirement (US$ billion) 2/	26.7	32.8	33.6	59.1	47.2	54.0	Proj.
Public sector (PS) 3/							
Overall balance (percent of GDP)	-0.3	-1.0	-1.2	-0.2	-1.6	-1.9	Proj.
Primary balance (percent of GDP)	2.1	1.4	0.8	1.6	0.1	-0.2	Proj.
Gross PS financing requirement (in percent of GDP) 4/	3.2	3.4	3.6	2.1	3.6	3.1	Proj.
Public sector gross debt (PSGD, in percent of GDP)	45.8	39.0	35.1	33.2	28.6	27.0	Proj.
Of which : Exposed to rollover risk (in percent of total PSGD) 5/	4.3	6.0	2.4	1.9	2.0	1.2	Proj.
Exposed to exchange rate risk (in percent of total PSGD) 6/	51.1	46.1	47.0	51.6	46.4	45.4	Proj.
Exposed to interest rate risk (in percent of total PSGD) 7/	16.6	15.7	12.4	9.2	9.4	8.7	Proj.
Financial sector (FS)							
Capital adequacy ratio (in percent)	19.3	21.3	19.3	16.8	17.4	19.3	Mar-10
NPLs in percent of total loans	7.4	6.0	4.1	3.2	3.3	3.2	Apr-10
Provisions in percent of NPLs 8/	38.1	49.1	59.8	58.5	62.0	NA	
FX deposits (in percent of total deposits)	13.1	15.5	14.6	16.6	15.7	15.8	May-10
FX loans (in percent of total loans)	16.0	18.8	20.1	18.5	13.9	12.9	Apr-10
Government debt held by FS (percent of total FS assets)	21.9	18.5	13.0	9.3	9.0	10.6	Apr-10
Total credit outstanding (percent change)	19.7	12.8	26.0	30.8	10.1	18.6	Jun-10

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 for domestic debt. Information on external debt is not available.
8/ Data compiled in conjunction with the FSAP.

Table 6. Indonesia: Medium-Term Macroeconomic Framework, 2008–15

	2008	2009	2010	2011	2012	2013	2014	2015
	Act.		Proj.					
Real GDP (percent change)	6.1	4.5	6.0	6.2	6.5	6.7	7.0	7.0
Domestic demand	7.6	5.3	5.8	6.3	6.6	6.7	7.0	7.2
Of which:								
Private consumption	5.3	4.9	5.5	5.5	5.7	5.8	5.8	5.9
Gross fixed investment	11.9	3.3	7.9	8.5	9.8	10.1	10.6	11.4
Change in stocks 1/	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 1/	0.7	1.2	0.8	0.6	0.6	0.7	0.7	0.5
Statistical discrepancy 1/	-1.4	-1.4	0.0	0.0	0.0	0.0	0.0	0.0
Saving and investment (in percent of GDP)								
Gross investment 2/	27.7	31.1	32.0	32.8	33.9	35.5	37.0	38.6
Gross national saving	27.7	33.0	32.9	32.8	33.4	34.6	36.0	37.5
Foreign saving (external current account balance)	0.0	-2.0	-0.8	0.0	0.6	0.9	1.0	1.1
Prices (12-month percent change)								
Consumer prices (end period)	11.1	2.8	5.7	5.6	4.9	4.3	4.0	3.6
Consumer prices (period average)	9.8	4.8	4.7	5.7	5.2	4.5	4.2	3.8
Public finances (in percent of GDP)								
Central government revenue	19.8	15.5	15.1	15.3	15.5	15.7	15.9	16.2
Central government expenditure	19.9	17.1	17.0	17.0	17.1	17.3	17.5	17.8
Central government balance	-0.1	-1.6	-1.9	-1.7	-1.6	-1.6	-1.6	-1.5
Primary balance	1.7	0.1	-0.2	-0.1	-0.1	0.0	0.0	-0.1
Central government debt	33.2	28.6	27.0	26.3	25.5	24.7	24.0	23.3
Balance of payments (US$ billions)								
Oil and gas (net)	7.8	8.3	6.3	5.1	3.9	2.0	0.3	-1.4
Non-oil exports (f.o.b)	107.9	99.1	121.6	127.2	132.7	141.4	152.4	162.7
Non-oil imports (f.o.b)	-92.8	-72.2	-94.0	-102.5	-110.0	-119.2	-128.6	-137.1
Current account balance	0.1	10.6	5.8	0.2	-4.7	-8.6	-10.4	-12.2
Direct foreign investment	3.4	1.9	4.5	6.2	7.4	8.2	9.4	10.8
Overall balance	-1.9	12.4	14.4	7.5	6.1	3.7	3.4	3.7
Gross reserves								
In billions of U.S. dollars (end period)	52.1	66.1	80.5	87.9	94.0	97.8	101.2	104.9
In months of imports	5.6	5.5	6.2	6.3	6.2	6.0	5.8	5.8
As a percent of short-term debt 3/	141.5	203.7	220.6	218.2	211.9	204.4	189.4	182.8
Total external debt								
In billions of U.S. dollars	149.7	172.8	187.7	196.0	205.3	214.6	225.7	238.2
In percent of GDP	29.3	32.0	27.3	25.7	24.5	23.2	22.0	21.0
Memorandum items:								
Oil production (000bcpd)	927	960	965	970	970	974	979	994
Indonesian oil price (US$/bbl)	96.6	61.4	74.9	77.1	79.9	81.6	83.1	85.1
Nominal GDP (US$ billions)	512	539	689	761	839	925	1,025	1,133

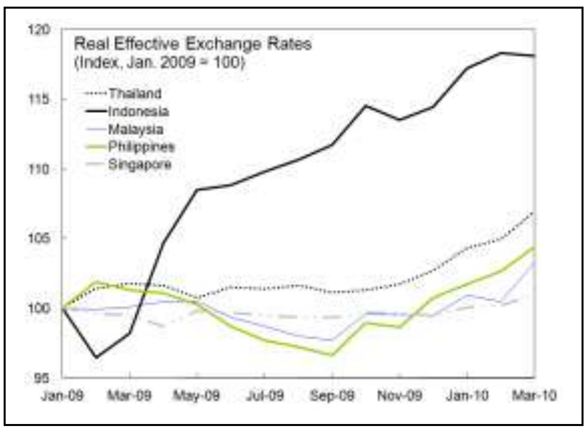
Sources: Data provided by the Indonesian authorities; and Fund staff estimates.

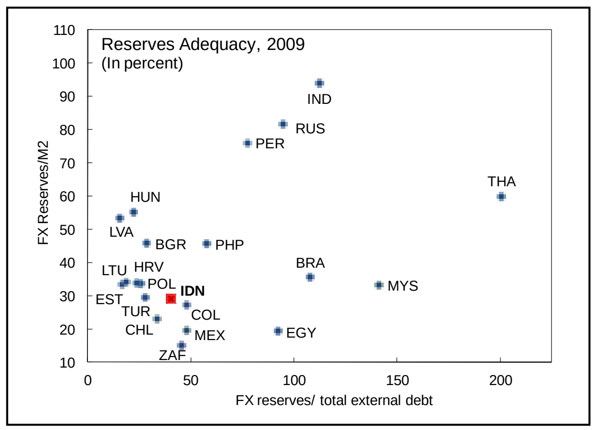
1/ Contribution to GDP growth.
2/ Includes changes in stocks.
3/ Short-term debt on a remaining maturity basis.

APPENDIX I: INDONESIA—CAPITAL INFLOWS AND POLICY RESPONSE

Indonesia's strong growth trajectory and high interest rate environment have attracted capital inflows over the last few quarters. The rapidity of the inflows complicates economic management and also raises susceptibility to sharp outflows when investor risk appetite declines, as seen in May amid concerns about the European debt situation.

Indonesia has followed an appropriate policy response to capital inflows, allowing sharp rupiah appreciation, with real appreciation far exceeding that of regional peers. Reserve accumulation has also increased, with the stock of net international reserves at US$75 billion in May 2010 compared with US$57 billion as of June 2009. According to some standard metrics of minimum reserve adequacy, Indonesia appears to have adequate buffers (with gross reserves as a percent of short-term debt at remaining maturity at about 200 percent, coverage of imports of goods and services at 5.5 months, and coverage of M2 at 28 percent as of end 2009.[1] However, Indonesia's continued vulnerability to shifts in external sentiment, most recently evidenced by the sharp loss of reserves during the 2008 crisis, suggests some scope remains for incremental reserve accumulation.[2] The most recent measure introducing a one-month holding period on all BI certificates (SBIs) is expected to reduce short-term volatility in capital flows.





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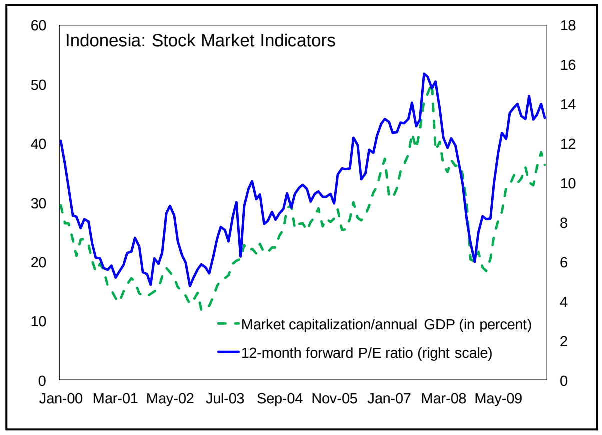
[1] Standard reserves benchmarks include: coverage of 100 percent of short-term debt at remaining maturity, 20 percent of M2, and four months of imports.

[2] Staff analysis in "Adequacy of Indonesia's Foreign Exchange Reserves," *Indonesia—Selected Issue* (IMF Country Report No. 08/298) developed thresholds of reserve adequacy based on standard metrics and found these to be higher for Indonesia than traditional benchmarks. However, based on alternative metrics, Indonesia was found to have below optimal reserves.

Staff analysis indicates that periods of capital inflows coupled with reserve accumulation and excess liquidity may contribute to asset boom/bust cycles.[3] So far, inflows into Indonesia have come primarily through portfolio flows rather than the banking sector and are not directly contributing to credit growth. However, valuation levels in the equity market have risen sharply, which though having little impact on the wider economy, could be a harbinger of building asset price pressures.

Going forward, any mix of policy measures to deal with continued inflows involves trade offs (Table I.1). Policy measures taken in the region to deal with capital inflows have focused primarily on macroprudential measures to reign in credit growth, particularly to real estate. These types of measures may be less relevant for Indonesia given relatively subdued credit growth. A tax on inflows, such as imposed by Brazil last fall, or even an outright ban on foreign purchases of SBIs would be administratively cumbersome.[4] In addition, such measures could be counter to the goals of deepening the fixed income market and lowering the cost of local currency borrowing, should foreign investor interest in longer term government securities be deterred.



[3] "Lessons from Past Episodes of Large Capital Inflows in Asia," Box 1.4, *Asia and Pacific Regional Economic Outlook, April 2010*.

[4] Indonesia has a reporting regime in place for foreign ownership of fixed income investments, which is administered through onshore custodians. Reporting requirements were strengthened effective January 1, 2010 such that nonresident investors are required to periodically supply verified documentation to be granted the lower withholding tax specified under double taxation treaty agreements.

Table I.1. Measures to Manage Capital Flow Volatility

Policy Tool	Recent Country Examples (2006–2010)	Pros	Cons	Specific Operational Considerations
		A. Macro		
Foreign exchange intervention	Many: China, Thailand, Taiw an POC, Malaysia, Philippines, Russia, Turkey etc.	Indonesia has some scope to expand reserve cushion.	Sterilization costs on erode central bank capital. Limiting rupiah appreciation could cause build up of bubble /one-w ay bet. Less appreciation w ould push forw ard need for monetary tightening.	
Monetary easing	Russia, Turkey, Poland, Czech Republic, Hungary, Serbia 1/	Low ering rates w ould decrease OMO costs.	May erode credibility and raise LT borrow ing costs.	
Fiscal tightening		Low er domestic issuance might low er onshore interest rates.	Limited room for any fiscal tightening. Interest rate response uncertain.	
		B. Macroprudential		
Restrictions on mortgage lending	Hong Kong SAR: mortgages for luxury property capped at 60 percent LVR. Max. loan amt for non-luxury property capped at US$1.5 billion, stamp duty on sales increased. Guidance on mortgage rates. Korea: ceiling on LTV ratios increased in Seoul. Singapore: Interest-only loans banned. China: Taxes on resale of properties w ithin five years increased.		Maybe not so relevant for Indonesia. Affects only real estate transactions.	
Higher reserve requirement on FX liabilities than on local currency liabilities	Many countries.Thailand (2006–2008), Croatia: An effective unremunerated reserve requirement of 55 percent applied until 2009 to increases in banks' foreign liabilities. Romania: Reserve requirements ratios differ according to the currency and residual maturity.	Prudential measures are not capital controls, hence their implementation does not result in negative investor sentiment.	Inflow s to Indonesia are through portfolio investment rather than banks. May lead to disinternediation via direct offshore borrow ing by the nonfinancial private sector or through institutions not subject to reserve requirements.	Does not require additional administrative resources, the requirement can be administered w ith the existing framew ork for reserve requirements.
Limits to direct and indirect FX exposure	Korea (2010): caps FX forw ard positions of banks relative to their equity capital. Restricts corporate FX hedging to 100% of export reciepts. Romania: The provisioning costs for foreign exchange credits to unhedged borrow ers are higher than for local currency lending.	Prudential measures are not capital controls, hence their implementation does not alw ays involve negative investor sentiment.	Indonesia already has FX NOP limits of 20 percent of regulatory capital, and banks maintain even smaller ratios. Inflow s are now through portfolio investment rather than banks. FX loans have fallen to 15–16 percent of total loans. May lead to disinternediation.	Does not require additional administrative resources, the requirement can be administered w ith the existing framew ork for reserve requirements.
		C. Administrative		
Liberalization of controls on residents' outw ard investments	Thailand ended restrictions on the amount and firms are permitted to invest abroad and raised outw ard foreign investment limit for mutual funds. China canceled the review and approval requirement for outw ard direct investment.	View ed as improving the investment environment.		Preconditions for liberalization must be in place. For example, liberalization of the controls on Indonesian institutional investors' investments abroad requires that prudential ratios for exchange rate risk management are in place.
Tax on portfolio inflow s	Brazil (2 percent tax on portfolio inflow s imposed in October 2009 may have slow ed inflow s modestly), currently discussed by Russia. Thailand (2006).	Some studies show that these types of controls might serve to lengthen maturity of inflow s modestly, but such effects may be due to misreporting of inflow s. 2/	Could reverse positive sentiment and raise local currency borrow ing costs. Could create market dislocations or misreporting as investors attempt to go around regulations.	Requires effective tax collection system and imposes additional burden on the financial institutions intermediating the portfolio transactions, since they have to assist in administering the control. Rate of tax should be carefully calibrated to avoid a collapse of the stock exchange. May be circumvented if not broad based.
Ban on foreigners buying central bank bills	Iceland currently	Affects only a relatively minor segment of investments.	Creating a w edge betw een SBI's and SUN's might further impede deepening of yield curve.	Relatively easy to administer, but additional provisions are needed to minimize circumvention.
Minimum maturity requirements for certain types of inflow s	Thailand, Colombia	Distorts investment decisions, destroys secondary market liquidity, may raise cost of borrow ing.	Administratively cumbersome.	Requires cooperation of the securities depository, banks and security brokers.
Other bans on foreign access	Taiw an POC: Financial Supervisory Commission barred access to time deposit accounts for foreign investors.			Local banks need to participate in the administration of the control. Compliance needs to be monitored

Sources: IMF, Spring 2010, *Asia and Pacific Regional Economic Outlook; and IMF, Spring 2010* Global Financial Stability Report*, Chapter 4.*

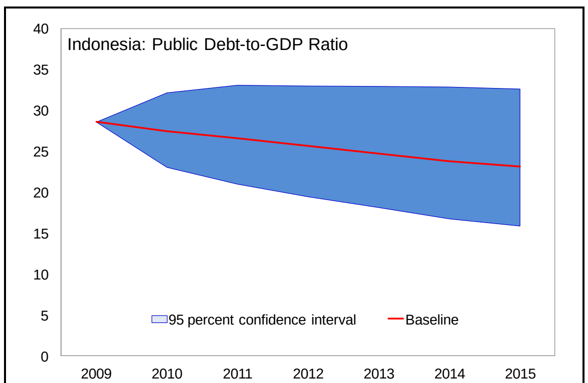
Appendix II: Indonesia—Public and External Debt Sustainability in the Baseline Scenario

A. Public Debt

1. **Public sector debt is low and declining despite the global shock in 2009**. The ratio fell to a record-low level of 29 percent in 2009 (Figure II.1) owing to prudent fiscal management, which led to primary fiscal surpluses averaging almost 1.6 percent of GDP per year in the last decade and a modest fiscal stimulus in response to the global shock in 2009. Reduced inflation, lower interest rates, and high real GDP growth also contributed to debt consolidation. Foreign-currency debt (mostly due to multilateral institutions) has fallen markedly to less than half of total debt, as the improved fiscal position facilitated government access to the domestic capital market.

2. **The baseline scenario projects a further moderate decline in public sector debt**. Despite a larger fiscal deficit, public debt is likely to fall to about 27 percent of GDP in 2010, reflecting rupiah appreciation and robust economic growth. In the medium term, gradual fiscal consolidation—starting in 2011, based on subsidy reduction and tax administration reforms and continued strong economic growth—will support a further decline in public debt to 23 percent of GDP by 2015. Such a strategy will ensure a primary balance near zero, but also accommodate extra resources for development spending.

3. **Public debt is sustainable and robust to macroeconomic and oil price shocks**. All the standard stress tests suggest that the debt ratio is likely to remain modest even under shocks from contingent liabilities, sharp exchange rate movements, and higher interest rates (Figure II.1). Fiscal contingent liabilities amounting to 10 percent of GDP could raise the public sector debt to 32 percent of GDP by 2015, while currency depreciation of 30 percent would raise the debt ratio to about 29 percent of GDP. An increase in real interest rates would have a smaller, but still sizeable, effect with the debt ratio reaching 26 percent by 2015. Other macroeconomic shocks have even more limited impact. Furthermore, stochastic simulations show that the maximum likely debt level under macroeconomic and oil price shocks is also relatively moderate at about 35 percent of GDP in the 95 percent confidence interval.



Source: IMF staff calculations.

B. External Debt

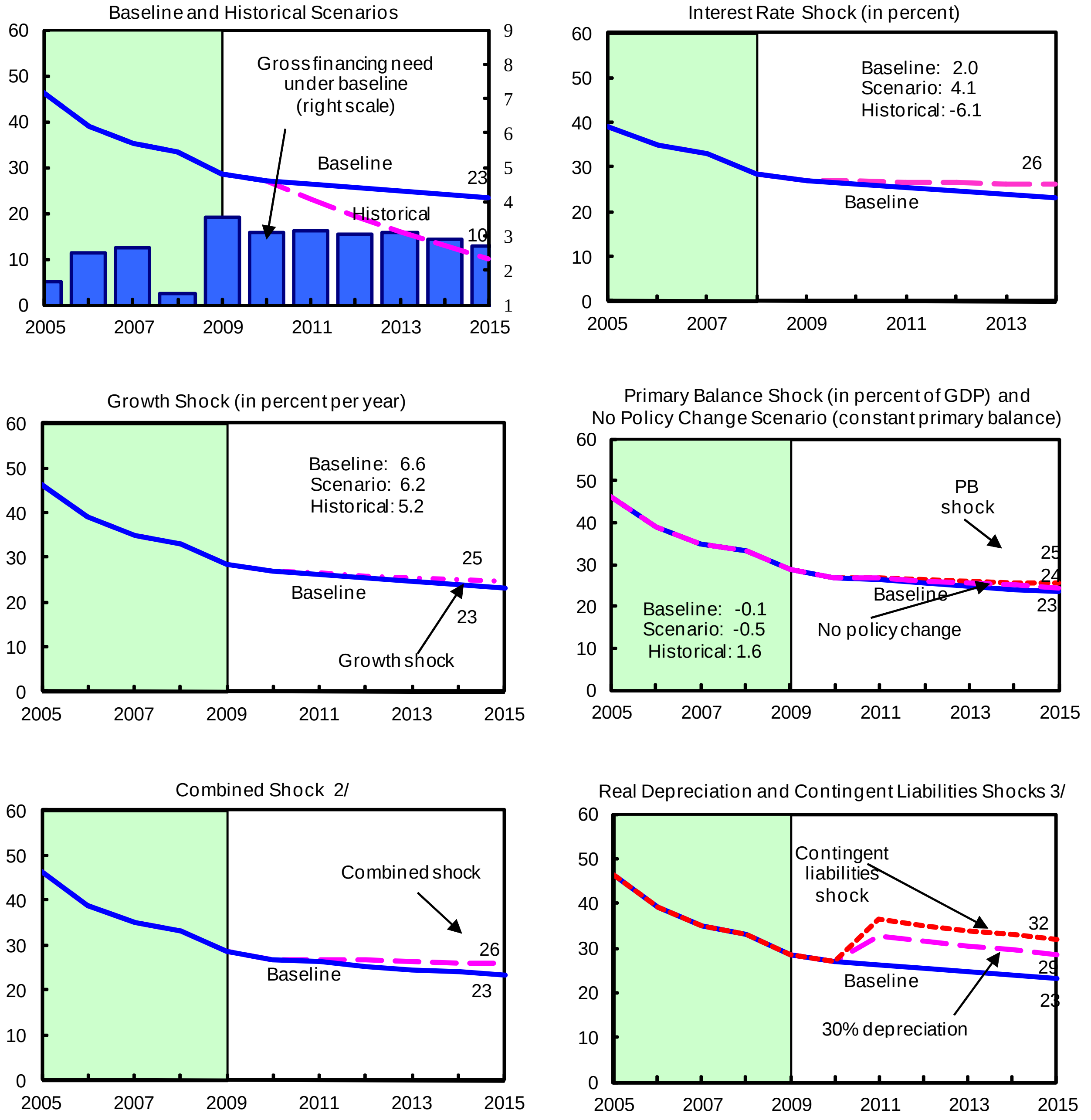
4. **Indonesia's external debt continues on a steady downward trend, after a temporary spike in 2009**. Following a decade of a continuously improving external position, the sharp nominal depreciation of late 2008 and early 2009 temporarily led to an increase in the external debt-to-GDP ratio from 30 percent to 32 percent. However, strong growth and the rapid turnaround in the exchange rate are quickly reversing this increase, with the ratio projected to reach 27 percent of GDP as early as end 2010 (Figure II.2).

5. **The baseline scenario projects external debt to continue on a declining path over the medium-term, reaching 20 percent of GDP by 2015**. A weakening current account balance—projected to reach -1 percent of GDP by 2015—is expected to be more than offset by: (i) sustained high real GDP growth in the range of 6.5−7.0 percent per year; (ii) increasing non-debt creating (i.e., FDI) flows; and (iii) some further real appreciation. At -0.4 percent of GDP, the medium-term non-interest current account balance would remain comfortably above the debt-stabilizing level (−2.5 percent of GDP).

6. **External sustainability is robust to most shocks**. The external debt ratio is expected to follow a declining path, and remain at manageable levels, under all standardized-shock scenarios. A one-time 30 percent real exchange rate depreciation would have the largest impact, raising the debt ratio by 14 percentage points in 2011, and 11 percentage points over the baseline by 2015.

Figure II.1. Indonesia: 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 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table II.1. Indonesia: Public Sector Debt Sustainability Framework, 2004–2014

(In percent of GDP, unless otherwise indicated)

	Actual						Projections							
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Debt-stabilizing primary balance 9/
1 Baseline: Public sector debt 1/	55.8	46.3	39.0	35.1	33.2	28.6	27.0	26.3	25.5	24.7	24.0	23.3		-0.7
Of which: foreign-currency denominated	28.7	24.0	18.2	16.5	17.1	13.3	12.3	11.6	10.8	9.8	9.0	8.2		
2 Change in public sector debt	-4.7	-9.5	-7.4	-3.9	-1.9	-4.6	-1.6	-0.6	-0.9	-0.8	-0.7	-0.7		
3 Identified debt-creating flows (4+7+12)	-4.8	-7.7	-8.8	-4.1	-4.8	-4.2	-0.7	-1.1	-1.0	-0.9	-0.8	-0.7		
4 Primary deficit	-1.3	-2.1	-1.6	-0.8	-1.7	-0.1	0.2	0.1	0.1	0.0	0.0	0.1		
5 Revenue and grants	17.8	17.9	18.9	17.9	19.8	15.5	15.1	15.3	15.5	15.7	15.9	16.2		
6 Primary (noninterest) expenditure	16.4	15.7	17.4	17.1	18.1	15.4	15.4	15.4	15.5	15.7	15.9	16.3		
7 Automatic debt dynamics 2/	-2.0	-5.7	-7.2	-3.3	-3.1	-4.4	-1.4	-1.3	-1.3	-1.0	-0.9	-0.9		
8 Contribution from interest rate/growth differential 3/	-4.7	-7.2	-5.5	-4.0	-5.3	-2.2	-1.4	-1.3	-1.3	-1.0	-0.9	-0.9		
9 *Of which*: contribution from real interest rate	-2.1	-4.6	-3.4	-1.9	-3.6	-0.9	0.1	0.2	0.3	0.5	0.6	0.6		
10 *Of which*: contribution from real GDP growth	-2.7	-2.6	-2.1	-2.1	-1.7	-1.3	-1.5	-1.5	-1.5	-1.5	-1.6	-1.5		
11 Contribution from exchange rate depreciation 4/	2.8	1.4	-1.8	0.7	2.2	-2.2	...	...	...	...	...	...		
12 Other identified debt-creating flows	-1.5	0.2	0.0	0.0	0.0	0.3	0.4	0.2	0.2	0.1	0.2	0.2		
13 Privatization receipts (negative)	-1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
14 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	0.0		
15 Other (specify, e.g., bank recapitalization)	0.0	0.2	0.1	0.1	0.1	0.3	0.4	0.2	0.2	0.1	0.2	0.2		
16 Residual, including asset changes (2–3) 5/	0.1	-1.8	1.4	0.1	2.9	-0.4	-0.9	0.4	0.2	0.1	0.1	0.0		
Public sector debt-to-revenue ratio 1/	314.3	259.5	205.8	196.2	167.6	184.6	178.2	172.1	164.7	157.3	150.8	143.8		
Gross financing need 6/	3.4	1.7	2.5	2.7	1.3	3.5	3.1	3.2	3.1	3.1	2.9	2.7		
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	0.0		
Scenario with key variables at their historical averages 7/							27.0	22.9	19.3	15.9	12.8	10.0		-0.9
Scenario with no policy change (constant primary balance) in 2009–2014							27.0	26.7	26.0	25.5	25.0	24.4		-0.8
Key macroeconomic and fiscal assumptions underlying baseline														
Real GDP growth (in percent)	5.0	5.7	5.5	6.3	6.1	4.6	6.0	6.2	6.5	6.7	7.0	7.0		
Average nominal interest rate on public debt (in percent) 8/	5.1	5.3	6.1	6.1	6.4	5.7	6.4	6.8	6.7	7.2	7.2	6.7		
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-3.4	-9.1	-7.9	-5.2	-11.9	-2.7	0.8	1.1	1.4	2.6	3.0	3.0		
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-9.3	-5.5	9.3	-4.3	-13.8	16.1	...	...	...	...	...	...		
Inflation rate (GDP deflator, in percent)	8.6	14.3	14.1	11.3	18.3	8.4	5.7	5.7	5.2	4.5	4.2	3.8		
Growth of real primary spending (deflated by GDP deflator, in percent)	14.2	1.2	16.6	4.3	12.6	-11.2	5.9	6.1	7.5	7.9	8.7	9.5		
Primary deficit	-1.3	-2.1	-1.6	-0.8	-1.7	-0.1	0.2	0.1	0.1	0.0	0.0	0.1		

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

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 e = 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.

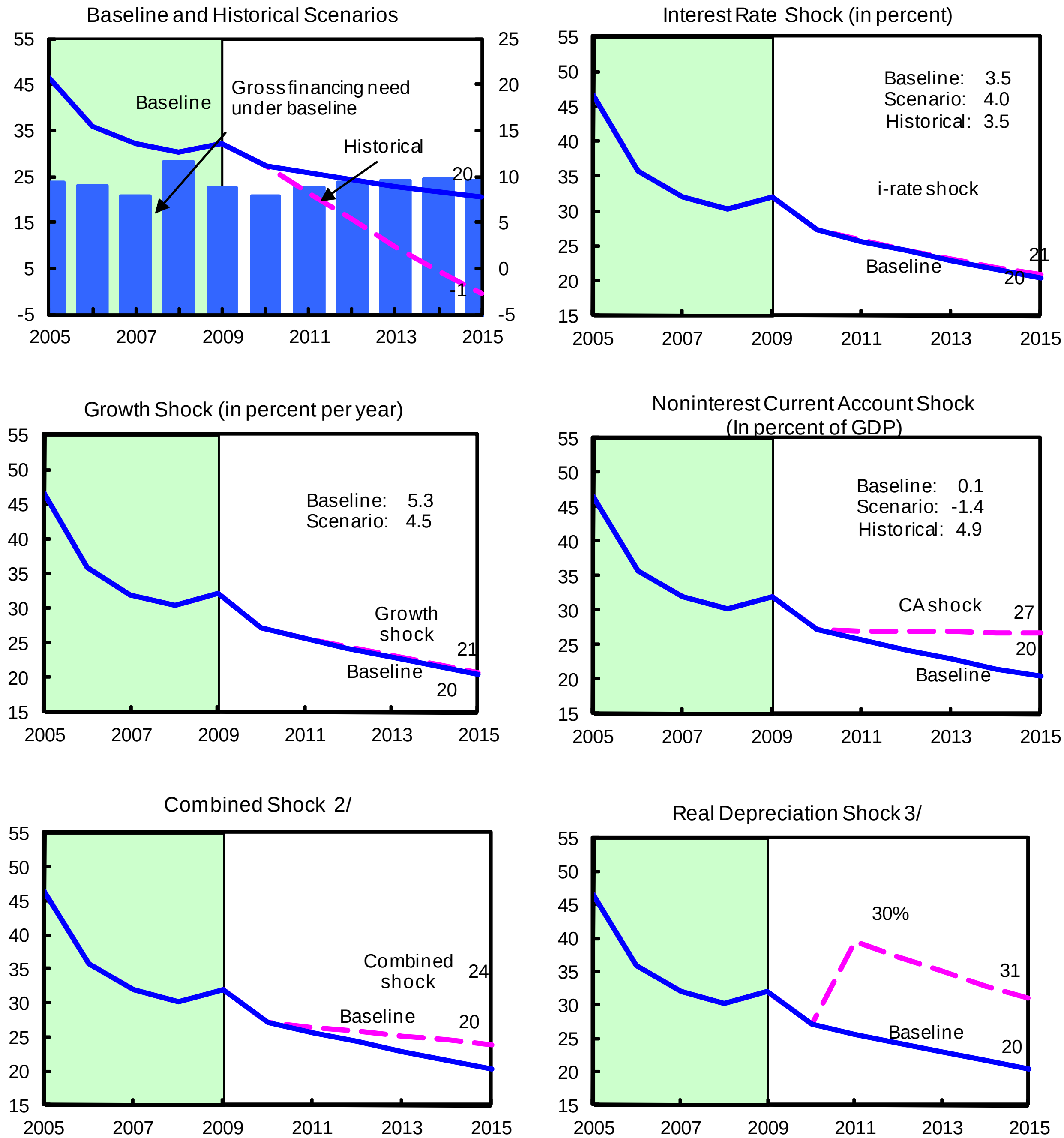
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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.

Figure II.2. 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 balance.

3/ One-time real depreciation of 30 percent occurs in 2009.

Table II.2. Indonesia: External Debt Sustainability Framework, 2004–14

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Debt-stabilizing noninterest current account 6/
1 Baseline: External debt	46.5	35.8	32.0	30.3	32.0	27.3	25.7	24.3	22.9	21.6	20.4	-2.5
2 Change in external debt	-6.9	-10.6	-3.9	-1.7	1.7	-4.8	-1.6	-1.4	-1.4	-1.3	-1.2	
3 Identified external debt-creating flows (4+8+9)	-7.1	-14.0	-9.5	-5.7	-4.1	-2.9	-2.5	-2.0	-1.6	-1.6	-1.5	
4 Current account deficit, excluding interest payments	-1.8	-4.3	-3.5	-0.9	-2.7	-1.4	-0.6	-0.1	0.2	0.3	0.4	
5 Deficit in balance of goods and services	-2.9	-5.4	-51.9	-52.0	-41.7	-40.2	-38.0	-35.9	-34.4	-33.2	-31.9	
6 Exports	35.0	31.6	30.2	30.3	24.7	23.4	22.1	21.0	20.1	19.4	18.6	
7 Imports	32.0	26.1	-21.7	-21.8	-17.0	-16.8	-15.8	-15.0	-14.3	-13.9	-13.3	
8 Net nondebt creating capital inflows (negative)	-1.6	-1.0	-1.5	-0.7	-0.5	-0.6	-1.0	-1.1	-1.1	-1.1	-1.2	
9 Automatic debt dynamics 1/	-3.7	-8.7	-4.6	-4.1	-0.8	-0.9	-1.0	-0.9	-0.8	-0.8	-0.7	
10 Contribution from nominal interest rate	1.7	1.3	1.0	0.9	0.8	0.6	0.6	0.6	0.7	0.7	0.7	
11 Contribution from real GDP growth	-2.7	-2.0	-1.9	-1.6	-1.3	-1.5	-1.5	-1.5	-1.5	-1.4	-1.4	
12 Contribution from price and exchange rate changes 2/	-2.7	-8.0	-3.7	-3.3	-0.3	…	…	…	…	…	…	
13 Residual, including change in gross foreign assets (2–3) 3/	0.1	3.4	5.7	4.0	5.8	-1.8	1.0	0.6	0.2	0.3	0.3	
External debt-to-exports ratio (in percent)	133.0	113.5	105.9	100.1	129.7	116.6	116.1	115.9	114.1	111.6	110.0	
Gross external financing need (in billions of U.S. dollars) 4/	26.7	32.8	33.6	59.1	47.2	54.0	66.5	78.4	88.8	99.0	109.0	
In percent of GDP	9.3	9.0	7.8	11.6	8.8	7.8	8.7	9.3	9.6	9.7	9.6	
Scenario with key variables at their historical averages 5/						27.3	21.4	15.5	9.7	4.3	-0.6	-0.9
Key macroeconomic assumptions underlying baseline												
Real GDP growth (in percent)	5.7	5.5	6.3	6.0	4.5	6.0	6.2	6.5	6.7	7.0	7.0	
GDP deflator in U.S. dollars (change in percent)	5.2	20.8	11.6	11.6	0.9	20.5	4.1	3.5	3.4	3.5	3.4	
Nominal external interest rate (in percent)	3.5	3.7	3.4	3.2	2.6	2.3	2.2	2.6	3.2	3.4	3.3	
Growth of exports (U.S. dollar terms, in percent)	20.7	15.1	13.4	18.7	-14.0	20.8	4.6	4.4	5.7	6.8	6.0	
Growth of imports (U.S. dollar terms, in percent)	28.0	4.1	-198.3	18.9	-17.7	26.3	4.2	4.1	5.7	7.1	6.3	
Current account balance, excluding interest payments	1.8	4.3	3.5	0.9	2.7	1.4	0.6	0.1	-0.2	-0.3	-0.4	
Net non-debt creating capital inflows	1.6	1.0	1.5	0.7	0.5	0.6	1.0	1.1	1.1	1.1	1.2	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. 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

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

3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ 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.

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.

INTERNATIONAL MONETARY FUND

INDONESIA

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department

August 2, 2010

Contents Page

ANNEX I: INDONESIA—FUND RELATIONS

(As of June 30, 2010)

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	1,933.80	93.00
Reserve position in Fund	145.50	7.00

III. SDR Department	**SDR Millions**	**Percent of Allocation**
Net cumulative allocation	1,980.44	100.00
Holdings	1,762.40	88.99

IV. Outstanding Purchases and Loans	None

V. Financial Arrangements

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR millions)**	**Amount Drawn (SDR millions)**
EFF	2/04/2000	12/31/2003	3,638.00	3,638.00
EFF	8/25/1998	2/04/2000	5,383.10	3,797.70
Stand-by	11/05/1997	8/25/1998	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				
	2010	**2011**	**2012**	**2013**	**2014**
Principal					
Charges/Interest	0.29	0.60	0.61	0.60	0.60
Total	0.29	0.60	0.61	0.60	0.60

VII. Exchange Arrangements

The rupiah has floated since August 14, 1997. The market exchange rate was Rp 9,053 per U.S. dollar on June 30, 2010. 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 No. 09/230) was discussed by the Executive Board on July 13, 2009.

ANNEX II: INDONESIA—RELATIONS WITH THE WORLD BANK GROUP[1]

(As of June 9, 2010)

Indonesia Country Partnership Strategy

The World Bank Group's (WBG) Country Partnership Strategy (CPS) for Indonesia for FY 2009−12, which marked Indonesia's emergence as a strong middle income country, was approved by the WBG Board in September 2008. The CPS focuses on improving Indonesia's institutions, both at the central and sub-national level, through five core areas of engagement: private sector development, infrastructure, community development, education, environmental sustainability, and disaster mitigation. A full Progress Report on the CPS will be undertaken in FY 11.

The CPS implementation is marked by strong dialogue and solid partnership with the Indonesia's core economic ministries and several line ministries and agencies, including education, public works, people's welfare, anti-corruption commission (KPK), supreme and state audit agencies (BPK and BPKP), and regional/local governments. Partnerships with the key bilateral and multilaterals, including EC, Japan, Australia, Netherlands, ADB, UNDP and IMF remain robust.

World Bank Engagement: Selected Highlights

Improving the Climate for High Quality Investment and Growth. The WBG, with the support of trust funds, is involved in several key areas to promote the private sector. The WBG works closely with the government to develop investment policies that are conducive to private sector business including regulatory reform and business licensing. In addition to improving the investment climate, the WBG is also involved in creating a better trade environment—both domestically and internationally. On the domestic side, work on logistics has become a top priority for improving Indonesia's connectivity and competitiveness. On the international side, the WBG team is working on implementation of the National Single Window, analysis of non-tariff barriers, and port and customs bottlenecks. On the finance side, the WBG is also involved in improving access to financial services, infrastructure financing, and developing non-bank financial institutions.

In response to the global financial crisis, the Government of Indonesia (GOI) took precautionary and preemptive actions to address financial and fiscal concerns including approaching the WBG and other development partners for contingent financing support. The WBG assisted the Government to mobilize from bilateral, multilateral and other sources US$5.5 billion, of which US$2 billion was a WBG-supported Development Policy Loan with

[1] Prepared by the World Bank staff. For questions relating to this annex, contact Shubham Chaudhuri at (+62 21) 5299 3076 or schaudhuri@worldbank.org.

a Deferred Drawdown Option (DPL-DDO), enabling Indonesia to successfully weather the crisis and emerge as one of the more robust economies in the region.

Strengthening the Governance Agenda. The WBG is supporting the strengthening of Indonesia's country systems. The fight against corruption is central to the Government's program and relevant institutions continue to be strengthened. The CPS seeks to move away from a WBG focused approach of "ring-fencing projects" to one designed to strengthen and build upon Indonesia's own systems, policies and procedures. This approach focuses on policy formulation, policy and program implementation, financial management, procurement, budget implementation, audit, social and environmental safeguards, monitoring and evaluation, and supports Indonesia's priority budget programs to enhance the quality of overall public spending. In addition, funding in several projects (e.g., PNPM, BOS and DAK) puts more focus on utilizing and strengthening existing government programs, with better monitoring and oversight of results. To strengthen governance, work is also expanding in improving the effectiveness of the government via bureaucratic reform—first at the Ministry of Finance, and more recently with the Ministry of Trade.

Deepening Indonesia's Decentralization. The decentralization and empowerment of local governments has been one of Indonesia's most remarkable achievements in the past 10 years. As a result, Indonesia's almost 500 sub-national governments now manage close to 40 percent of all public spending. Many of elected heads of provinces and districts/cities are implementing innovative reforms, although challenges are considerable. Needs, opportunities and the WBG's capacity to respond to the demand vary greatly across the archipelago. Over the CPS period, the WBG will seek to engage with a limited number of sub-national governments that demonstrate a clear commitment to reforms. One means is through our sub-national public expenditure reviews, tailored to the needs of local governments. Another project will increase the accountability of local governments in their use of Specific Purpose Grants (DAK). DAK grants come from the national budget (APBN) and are generally used to support regions that lack the fiscal capacity to provide physical infrastructure for basic public service delivery. Lastly, the WBG-administered Decentralization Support Facility brings together a number of development partners with a broad mandate to engage Indonesian institutions essential to the local accountability framework.

Enhancing Poverty Reduction and Service Delivery. The GOI aims to lower the poverty rate from 14.1 percent in 2009 to 8−10 percent by 2014 by strengthening economic growth and job creation, as well as continuing its poverty reduction strategy. To this end, the WBG is providing technical assistance to the government in coordinating and integrating poverty reduction programs. Analytical and advisory services are supporting the reform of household-based assistance programs, the establishment of cross-cutting targeting and M&E systems, and the strengthening of local capacities for poverty analysis. Key reforms in these areas are included among the triggers for a series of development program loans that also support reforms in investment climate, public financial management, public service delivery and infrastructure. In addition, WBG is supporting the implementation and consolidation of community-based programs through the National Community Empowerment Program (PNPM Mandiri) Support Facility. The WBG also supports the development of local water utilities to improve delivery of water and sanitation services. On health, there has been recent work on maternal health, HIV, and health insurance. On education, the WBG is involved in improving the quality of teacher management, early childhood development, youth skills and competitiveness.

Supporting Indonesia on Environmental Sustainability and Climate Change. Indonesia emits significant levels of greenhouse gases, mainly from deforestation and land use change. The GOI recognizes this issue and is developing an initiative on Reduced Emissions from Deforestation and Degradation (REDD) supported by the WBG. The GOI is pursuing an innovative and potentially path-breaking engagement with the WBG on geothermal energy. The WBG is also deepening the relationships established with the National Planning Agency (Bappenas) and the local governments of Aceh, Nias and Jogjakarta in supporting selected elements of the Government's actions to strengthen natural disaster resiliency. In addition to investment operations, the WBG is supporting the GOI with background studies and other analytical work and technical assistance provided to the Government agencies at the central and local levels. The WBG has also supported GOI's initiatives through the recent climate change development policy loan.

Support for Sustainable Recovery in Disaster Areas. Reconstruction efforts after the tsunami in Aceh and the series of earthquakes devastating Nias, Central Java, and Jogyakarta, have become a key element of the WBG's response program, anchored around two substantial multi-donor trust funds. The Multi-Donor Fund (MDF) for Aceh and Nias brings together some 15 partners and is providing nearly US$700 million in resources, while Java Reconstruction Fund (JRF), supported by six partners, brings in over US$90 million. Post-disaster reconstruction and recovery are progressing well. In the wake of the recent West Sumatra earthquake, the WBG took a leading role in the damage and loss assessment and has an on-going program to train other institutions to conduct such assessments in the future.

Bank Operations in FY 10 and FY 11

Lending. As of April 30, 2010, there are 46 active IBRD/IDA investment projects and project-type grants in the Indonesia Portfolio, including a DPL with a Deferred Draw Down Option (DDO). For FY 10, the World Bank expects to deliver 8 projects and 2 additional financing operations, worth $3.2 billion. These include three development policy loans (DPL, Infrastructure DPL, Climate Change DPL), and lending in rural and urban community programs (PNPM), local government (DAK), urban water, health education quality, and power transmission.

In FY 11−12, there is a strong pipeline of about $1.0 billion a year each for DPLs, country programs and projects, including significant infrastructure investments. In addition to the development policies series, other deliveries planned for FY 11 are projects to strengthen statistical capacity of the Government, electric transmission, an infrastructure guarantee fund, and road preservation.

Analytical and Advisory Services. In addition to the lending program, the WBG is delivering to the Government of Indonesia policy notes and just-in-time advice, technical assistance, as well as reports including Papua Infrastructure Strategy, Labor Report, Health workforce, Agriculture Research and Development PER, Access to Finance for Migrant Workers.

In the year ahead, the WBG expects to deliver continuing analytical and advisory support, including policy notes for the new Government and reports including on Social Protection, Public Spending, Urbanization and Maternal Health.

Trust Funds. Trust funds (TF) and grant financing are an integral part of the WBG program. The Indonesian TF portfolio is around US$1 billion at present.

ANNEX III: INDONESIA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

(As of June 9, 2010)

Asian Development Bank (ADB) cumulative loans to Indonesia reached $25.7 billion as of end-December 2009. In 2009, the ADB approved a total of $2,184 million or 16.5 percent of the total loans approved by the institution for the year. More than 90 percent of the loans approved in 2009 were provided through four policy-based operations. Two loans supported the Government's efforts to mitigate the effects of the global economic crisis. The remaining two continued to support the Government's medium-term term reform agenda in capital market development, investment climate, public financial management, and poverty alleviation.

ADB is preparing a Country Partnership Strategy with the Government of Indonesia to cover the period 2011−2015. The strategy will be aligned with the Government's medium-term development plan (RPJM) for 2010−2014. It will support the government's objectives to achieve higher levels of sustainable growth and to foster social development. It is anticipated that assistance will be provided in the core areas—transport, energy, financial sector, natural resource management, water supply and sanitation, and education—identified in ADB's Long-Term Strategic Framework. Support for good governance, gender equality, environmental sustainability and regional cooperation will be encouraged in all sectors where relevant. Special emphasis will be provided to assist the Government to implement its Climate Change action plan.

Between 1967 and 2009, ADB provided 504 Technical Assistance grants to Indonesia amounting to $282.9 million. The TA grants were financed from ADB's Technical Assistance Special Fund, the Japan Special Fund, and other sources. Measured by cumulative TA approvals, Indonesia is the second largest recipient of TA support from the ADB.

Table 1. Sovereign and Nonsovereign Loan Approvals and Disbursements to Indonesia

(In millions of U.S. dollars)

	2004	2005	2006	2007	2008	2009
Loan approvals	225.0	1,145.69	784.8	1,187.1	1,085	2,184.2
Loan disbursement	593.5	1,014.99	1,025.88	1,136.3	949.6	739.3

Sources: Asian Development Bank, *Annual Report (various editions)*, and ADB staff.

[1] Prepared by ADB staff.

Table 2. Cumulative Lending to Indonesia

(As of December 31, 2009)

Sector	Loans (No.)	Amount ($ million)	Percent 1/
Agriculture and Natural Resources	99	4,047.00	15.74
Education	32	2,222.35	8.64
Energy	31	3,781.05	14. 71
Finance	20	3,526.10	13. 72
Health and Social Protection	13	1,068.30	4.16
Industry and Trade	12	645.70	2.51
Public Sector Management	16	4,167.22	16.21
Multisector	16	1,586.22	6.17
Transport and ICT	33	2,713.86	10.56
Water Supply and Other Municipal Infrastructure and Services	31	1,949.74	7.58
Total	303	25,707.54	100.00

Sources: Asian Development Bank, *Indonesia Fact Sheet 2010;* and ADB staff.

1/ Total may not add up because of rounding.

ANNEX IV: INDONESIA—STATISTICAL ISSUES

As of June 22, 2010

I. Assessment of Data Adequacy for Surveillance

General: Indonesia's macroeconomic statistics are broadly adequate to conduct effective surveillance.

National accounts: Quarterly GDP data are published in a timely manner for both expenditure and production sides. The annual national accounts have 2000 as the base year. The estimates are based on a limited set of indirect indicators of uncertain quality. Some sectors are influenced strongly by seasonality, and seasonally adjusted data are prepared but not published. In addition, no survey of nonfinancial services is prepared. The Fund has 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; and (v) enhancing the convergence exercise on trade data between Bank Indonesia (BI) and Ministry of Finance (MoF).

Price statistics: Price statistics are broadly adequate for surveillance.

Government finance statistics: Available government finance data suffer from a number of weaknesses, in terms of classification, coverage, and timeliness. Data on the budget of the central government are available with a one-month lag, but subnational (provincial and local) government data are available only with a lag of two years, and the quality of this data is variable. Problems in budget and accounting systems have been compounded by the recent decentralization initiatives, which have shifted substantial resources to the subnational governments. Substantial efforts are in train, and significant progress has been made to overcome these problems, ranging from the planned adoption of advanced accounting and statistical standards, to the introduction of best practice budget management processes, and the development of computerized financial management information systems.

Against this background, the MoF and the Ministry of Home Affairs are committed to keeping the requirements of fiscal statistics at the forefront of ongoing fiscal reforms, so as to make better statistical monitoring one of the goals of the current efforts. The coverage and timeliness of public debt statistics is generally adequate. The new expenditure classification introduced in the 2005 budget, is generally consistent with the Government Finance Statistics Manual 2001 (GFSM 2001) on functional codes and classification, although the data are compiled on a cash basis.

The authorities have committed to adopting GFSM 2001 standards. To this end, the Fund staff has recommended in the short term: (i) establishment of a register of all extrabudgetary units; and (ii) inclusion of the economic codes consistent with the GFSM 2001 in the chart of accounts 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) establish the underlying reporting arrangements necessary to obtain timely preliminary data for local government statistics; and (ii) to develop GFSM 2001 operating statements, statements of sources and uses of cash, and partial balance sheets, all of which should be published on the MoF websites. Currently a system has been set up to allow for an automatic conversion of budget files to GFSM 2001 data; however, these data are yet to be published on the MoF website.

Monetary statistics: Good quality monetary statistics are compiled by 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. To strengthen monetary statistics, STA missions have also recommended the expansion of the coverage of monetary statistics to include mutual funds. Additional challenges include timely revisions of published banking sector data after supervisory verification.
Balance of payments: Trade data are affected by some significant shortcomings. While customs sources utilized by the BI are considered generally reliable, coverage of merchandise trade flows is insufficient. Also, when the online reporting system for exports and imports was introduced in 2004, the historical series were reconstructed only as far back as 2003. As a result, prior to 2003, balance of payments statistics are not entirely consistent with the national accounts estimates. Exports and imports volume data, and consequently trade deflator data, is incorrectly computed as aggregate indexes that do not weight sub-category volumes by their economic value. 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 using a fixed ratio to estimate equity inflows. Surveys conducted by BI to collect FDI data have a low response rate and the coverage of the directory of enterprises should be improved. Other areas that need improvement include the recording of trade credits and the asset data for portfolio investment and other investment transactions. The magnitude of the errors and omissions item has been significant at times 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). An annual IIP is compiled, but the underlying data are weak in several areas, notably for FDI, and published data should include a higher degree of disaggregation (only main items are reported). External debt statistics have improved considerably with the introduction of an External Debt Information System (EDIS) in 2002 and the recent initiative to publish monthly indicators. 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 received by the private sector from external creditors.

II. Data Standards and Quality	
Subscriber to the Special Data Dissemination Standard (SDDS) since September 1996, observing most of the SDDS requirements.	Data ROSC completed in 2005.

Indonesia: Table of Common Indicators Required for Surveillance

(As of June 30, 2010)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memorandum Items:	
						Data Quality – Methodological soundness[7]	Data Quality - Accuracy and Reliability[8]
Exchange rates	6/30/10	6/30/10	D	D	W/M		
International reserve assets and reserve liabilities of the monetary authorities[1]	6/30/10	7/23/10	D	M	M		
Reserve/base money	6/10	7/28/10	D	D	W/M	O, LO, O, O	LO, O, O, LO, O
Broad money	5/10	7/28/10	M	M	M		
Central bank balance sheet	4/10	6/21/10	M	M	M		
Consolidated balance sheet of the banking system	5/20/10	6/8/10	M	M	M		
Interest rates[2]	6/30/10	6/30/10	D	D	W/M		
Consumer price index	6/10	7/10	M	M	M		
Revenue, expenditure, balance and composition of financing[3]–central government	2010	6/21/10	M	M	Mid-year	LNO, LNO, LO, LNO	LNO, LO, LO, LO, LNO
Stocks of central government and central government–guaranteed debt	3/10	6/10	M	Q	A		
External current account balance	3/10	5/24/10	Q	Q	Q	LO, LO, LO, LO	LO, O, LO, O, O
Exports and imports of goods and services	3/10	7/13/10	M	M	M		
GDP/GNP	3/10	7/13/10	Q	Q	Q	LO, LO, O, LO	LO, LO, LO, LO, LNO
Gross external debt[4]	3/10	6/21/10	Q	Q	A		
International investment position[5]	2008	5/24/10	A	A	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] Includes external gross financial assets and liability positions vis-à-vis non residents.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); NA: Not Available.
[7] Reflects the assessment provided in the data ROSC published on July 20, 2005 (based on the findings of the mission that took place during March 28-April 11, 2005), for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative on Indonesia
August 27, 2010

The information below has become available following the issuance of the staff report. It does not alter the thrust of the staff appraisal.

1. Economic recovery continued in Q2 of 2010 as indicated by the 6.2 percent annual real GDP growth. While private consumption continues to drive economic growth, the contribution from investment—including from rebounding FDI inflows—was significant. The recovery in credit growth has continued with July numbers showing an increase of 19½ percent (y/y). Despite continued export growth, the contribution of net exports declined somewhat with the acceleration of investment-related imports, but remained positive. The balance of payments surplus narrowed somewhat in Q2, primarily due to a slowdown in portfolio inflows driven by global turbulence related to the European debt crisis, and a marginally weaker current account amid strong imports. These developments are consistent with the projections for 2010 in the staff report.

2. Staff revised the 2010 inflation outlook upward by a ¼ percentage point to 5 percent for the annual average and 6 percent at year end—the upper end of Bank Indonesia’s (BI) target range—reinforcing the case made in the staff report for the authorities to respond to inflationary pressures to keep expectations within the target range. Inflation has been driven by persistent increases in food prices, with annual headline inflation rising to 6¼ percent in July. Core inflation also increased in July to near 4 percent. While earlier signaling that the holding stance was consistent with the inflation target, BI’s August policy statement signaled some concern over price pressures.

3. Market sentiment remains upbeat and strong capital inflows continue. During July and August, the rupiah has been trading at about Rp 9,000 per U.S. dollar. Local government debt yields have continued to fall despite the uptick in inflation. Net foreign purchases of BI certificates (SBIs) kept pace with those of government notes at US$2 billion since the beginning of July, indicating continued appetite for SBIs despite the one-month holding period requirement announced on June 16.

4. The government revised down its estimate for the overall 2010 budget deficit to 1½ percent of GDP from 2 percent, largely reflecting higher projected revenue as well as slower capital spending. The preliminary 2011 budget framework released on August 17 projects an overall deficit of 1¾ percent of GDP, reflecting a planned increase in capital spending and improved revenue collections (in line with staff projections).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 10/130
FOR IMMEDIATE RELEASE
September 16, 2010

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation with Indonesia

On August 27, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Indonesia.[1]

Background

Indonesia's growth in 2009 was 4½ percent, the third highest in the G-20 group of countries, and the pace is accelerating in 2010. Several factors contributed to this resilience during the crisis, including strong initial conditions, which resulted from prudent macroeconomic management, greater dependence on domestic demand, a diversified export base, and appropriate policy responses to support domestic demand. High frequency indicators for both consumption and investment indicate strong growth momentum in 2010. Inflation decelerated to 2.8 percent in 2009 (year-on-year) but is increasing slightly in 2010.

Capital flows into Indonesia have been buoyant, driven in part by ratings upgrades. Both push and pull factors have attracted large portfolio inflows, particularly into government bonds and short-term Bank Indonesia certificates (SBIs). While volatility increased in May following the European crisis, with about US$5.75 billion of capital outflows—mostly SBIs—inflows have since returned. Meanwhile, the stock market, the rupiah exchange rate, and the level of international reserves are at or above pre-crisis levels.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Bank Indonesia (BI) has left the policy rate unchanged since September 2009. After easing the policy rate by 300 bps during the crisis, BI has left the rate at a historic low of 6½ percent. Meanwhile, to enhance its liquidity management, BI recently introduced a series of measures. In particular, to discourage the use of SBIs for short-term cash management, BI has been shifting the maturity structure of SBIs from one month to 3- and 6-months, and it plans to introduce 9- and 12-month bills later this year. In addition, to encourage interbank market development, BI widened its policy rate corridor by 100 basis points to 5.5 percent to 7.5 percent. A one-month holding period on SBIs across the board was also introduced to help reduce money market volatility.

Fiscal support during the crisis was modest by international standards. Despite having room for undertaking countercyclical fiscal measures, owing to consistent prudent fiscal management in previous years, Indonesia's fiscal stimulus was about 1.1 percent of GDP or half the average stimulus in the G-20 group. In fact, Indonesia had a primary surplus of 0.1 percent of GDP in 2009, and public debt declined to about 29 percent of GDP—the only country in the G-20 with *declining* debt in 2009.

The financial and corporate sectors were resilient to the crisis. Banks maintained high capital adequacy ratios and remained profitable despite the difficult operating environment. Although gross nonperforming loans increased, the ratio of nonperforming loans to total loans remained low at 3.2 percent. Banking sector liquidity improved throughout the year. Credit growth was 10 percent in 2009 and is gaining momentum in 2010, with 19½ percent growth in the year to July. Corporate balance sheets were relatively more liquid than other Asian economies. Corporate bond issuance declined during the crisis, but large corporations have returned to local debt markets since mid-2009.

The Article IV consultation also included discussions on the findings of the recently concluded joint IMF/World Bank Financial Sector Assessment Program (FSAP).

Executive Board Assessment

Executive Directors commended the Indonesian authorities for their impressive policy performance which successfully steered the economy through the global financial crisis. Its favorable public debt dynamics, sovereign ratings upgrades and higher global risk appetite provide an opportunity for Indonesia to sustain, and even accelerate, economic growth and development. Going forward, maintaining an appropriate policy mix is an important challenge in the current volatile external environment. Over the medium term, efforts should continue to improve public infrastructure and the business climate.

Directors considered that maintaining exchange rate flexibility is an important part of the toolkit to manage the volatility of capital flows. They supported the introduction of a one-month holding period for Bank Indonesia (BI) certificates to help thwart short-term volatility. Directors encouraged the authorities to address potential competitiveness pressures from further rupiah appreciation by removing supply constraints. To lower sterilization costs, Directors recommended the gradual conversion of the nonmarketable government bonds in BI's balance sheet to marketable bonds, thereby also expanding BI's operational toolkit.

Directors considered BI's current monetary policy stance to be appropriate given that core inflation is within the target range. Looking ahead, they advised that BI should signal its readiness to respond to rising inflationary pressures to anchor inflation expectations within the 4–6 percent target range. Continued effective communication of a proactive policy would also signal BI's commitment to lower the level and volatility of inflation in line with trading partners. Directors generally cautioned against introducing administrative measures to fuel credit growth.

Directors commended Indonesia's progress over the last decade in improving financial stability. They welcomed the steps being taken by the authorities to further strengthen the resilience of the financial sector in line with the recommendations of the recent FSAP, including enactment of the Financial System Safety Net Law, introducing a prompt corrective action regime to deal with problem banks, and enforcement of creditors' rights. Proper coordination of macro and micro prudential supervision and developing capital markets to diversify the funding base are also important.

Directors endorsed the overall fiscal stance for 2010 and noted that further fiscal reforms will be necessary to support sustained high growth. Specifically, reducing energy subsidies would create additional fiscal space for much needed infrastructure spending and transfer programs for the poor, with little impact on debt sustainability. They stressed the importance of better budget execution for strengthening fiscal policy effectiveness and of efforts to expand the tax base and raise revenue ratios.

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. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with Indonesia is also available.

Indonesia: Selected Economic Indicators, 2007–11

	2007	2008	2009	2010	2011
				Proj.1/	
Real GDP (percent change)	6.3	6.1	4.5	6.0	6.2
Private consumption	5.0	5.3	4.9	5.3	5.5
Gross fixed investment	9.4	11.9	3.3	7.9	8.2
Net exports 2/	0.6	0.7	1.2	0.5	0.6
Saving and investment (in percent of GDP)					
Gross investment 3/	25.0	27.7	31.1	31.9	32.6
Gross national saving	27.4	27.7	33.0	32.8	32.7
Prices (12-month percent change)					
Consumer prices (end period)	5.6	11.1	2.8	5.9	5.8
Public finances (in percent of GDP) 4/					
Central government revenue	17.9	19.8	15.1	15.4	15.4
Central government expenditure	19.1	19.9	16.7	16.8	17.2
Central government balance	-1.2	-0.1	-1.6	-1.5	-1.7
Primary balance	0.8	1.7	0.1	0.1	-0.1
Central government debt	36.9	33.2	28.6	26.7	26.3
Money and credit (12-month percent change; end of period)					
Rupiah M2	19.5	12.6	13.9	...	...
Total credit	27.5	30.8	10.1	...	...
One-month SBI rate (period average)	8.6	9.1	7.4	...	...
Balance of payments (in billions of U.S. dollars)					
Non-oil exports (f.o.b)	93.1	107.9	99.1	123.3	129.2
Non-oil imports (f.o.b)	-66.1	-92.8	-72.2	-94.7	-103.7
Current account balance	10.5	0.1	10.6	6.4	0.5
Overall balance	12.7	-1.9	12.4	16.4	7.5
Gross reserves					
In billions of U.S. dollars (end period)	54.1	52.1	66.1	82.5	90.0
In months of imports	4.5	5.6	5.5	6.3	6.3
As a percent of short-term debt 5/	157.4	141.5	203.7	226.4	223.5
Total external debt					
In billions of U.S. dollars	137.4	149.7	172.8	187.7	195.5
In percent of GDP	31.8	29.3	32.0	27.0	25.2
Exchange rate (period average)					
Rupiah per U.S. dollar	9,141	9,439	10,354	...	...
Nominal effective exchange rate (Jan. 2000=100)	80.9	73.6	69.7	...	...
Memorandum items:					
Nominal GDP (in trillions of rupiah)	3,957	4,954	5,613	6,311	7,071

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

1/ Projections reflect data available since the issuance of the staff report.
2/ Contribution to GDP growth (percentage points).
3/ Includes changes in stocks.
4/ 2009 data have been revised to reflect the audited 2009 budget.
5/ Short-term debt on a remaining maturity basis.

Statement by Duangmanee Vongpradhip, Executive Director for Indonesia and Dicky Kartikoyono, Senior Advisor to Executive Director

Introduction

1. The Indonesian authorities would like to thank the IMF and the World Bank team for fruitful and candid dialogue during this year's Article IV consultation and the first joint IMF/World Bank's FSAP. The authorities broadly agree with their appraisal of the Indonesian economy and continue to value their constructive policy recommendations. They would also like to communicate their appreciation to the Fund's management, particularly Deputy Managing Director, Mr. Shinohara, for his visit to Indonesia that coincided with the end of this year's mission. During the occasion, he shared his strategic and valuable views with the authorities on the issues of recent global economic development, the outlook of Asian economy, and ongoing reforms of the Fund. The authorities welcomed and commended the Fund's sensible initiative to enhance its useful engagement to its members in the region, including Indonesia.

Recent Economic Development

2. Despite the challenging external environment, the Indonesian authorities have persevered with prudent macroeconomic and financial policies, as well as intensified structural reforms to further unlock its growth potential. Their earlier economic programs aimed at maintaining fiscal sustainability and safeguarding monetary and financial stability have been able to deliver a remarkable outcome. Considerable debt reduction, rising investment, marked fiscal primary surplus, subdued inflation, less volatile exchange rates, a stronger banking system and healthy corporate balance sheets were amongst the indicators marking Indonesia's resilience to withstand the economy from the lingering impact of global economic crisis and uncertainty in the global financial market. Such achievements have been able to buttress strong prevailing domestic demand during the crisis, which led Indonesia to register a fairly high growth reaching 4.5 percent in 2009. With acceleration in investment and a strong recovery of exports, this growth momentum would be accelerated in 2010 and 2011 to reach around 6.0 percent and 6.5 percent, respectively.

3. In the aftermath of the crisis, Bank Indonesia (BI), the central bank, adopted a loose monetary stance by cutting aggressively its BI rate, the policy rate, as well as extending liquidity to the banking system so as to provide monetary stimulus aimed at preventing further decline in economic growth. On account of decreasing commodity prices, favorable domestic supply conditions and weak monetary growth, average inflation during 2009 declined significantly to a historical low of 2.8 percent (y/y).

4. Into 2010, food prices have started to be volatile and shown unexpectedly strong growth lifting the headline rate in July to 6.2 percent (y/y), while inflationary pressure from fundamentals, reflected in core inflation, has held at a modest 4.2 percent (y/y). In response to renewed inflationary pressures, since September 2009 Bank Indonesia (BI), the central bank, decided to keep its policy rate steady at 6.5 percent. It viewed that the earlier easing stance to combat the crisis could not be continued. While observing that this interest rate level is adequate to anchor inflation expectations, consistent with the inflation target of

5−6 percent in 2010 and allowing room for financing activities to further expand and boost economic growth, they have noted there was some uncertainty on the path of inflationary developments in the months ahead. In their last monetary policy statement on August 4, 2010, BI's Board of Governors continued to believe that Indonesia hitherto did not have a strong case to raise the policy rate, as the inflation outlook remains benign. Nonetheless, they have also indicated that they are standing ready to reverse the policy direction as needed to maintain inflation within the target range.

5. While private consumption maintains brisk growth in 2009 and 2010, exports have mounted steadily on the performance of manufacturing industries. The recovery in the world economy and commodity prices is also in support of continued growth in Indonesia's exports. Driven by vibrant dynamics of regional economies, up until June 2010 the current account posted staggeringly a surplus with exports surpassing imports. Following the ongoing improvement in domestic economic performance and outlook, large capital inflows and some return of foreign direct investment will continue to bring positive impact on Indonesia's balance of payments. In Q2-2010, investment growth reached 8 percent (y/y) in response to strengthening domestic and external demand. The more favorable investment climate also received a boost from the upgrading of Indonesia's sovereign credit rating following improvements in economic fundamentals. Earlier this year, Fitch, S & P and Moody's upgraded Indonesia sovereign ratings which have been expected to reach the investment grade in the near future, whenever the investment growth could reach a higher level.

6. While various macroeconomic indicators are kept in check, increasingly rapid flow of overseas capital into emerging countries has indeed exposed the Indonesian economy to greater risks and added complexity to the authorities in managing their macroeconomic policies. This concern once again became evident in May 2010, when the global economy faced mounting pressures from financial distress in Europe. This event had made a clear showcase of how the global economic uncertainty posts grave risks to a small open economy like Indonesia.

7. In the first four months of 2010, alongside a sizeable capital account surplus, foreign investors poured money into Indonesia's financial market, causing a significant surging of the Indonesian Rupiah of more than 4 percent and allowing BI to accumulate the country's foreign exchange reserves to reach a comfortable level of nearly USD79 billion. Growing investors' risk aversion due to accelerating adverse development of Greece sovereign debt crisis triggered a huge reversal of capital flows from Indonesia. The sell-off in Indonesian financial instruments amounted to USD5.7 billion over the course of a month, particularly central bank certificates (SBI), put severe pressures on the Rupiah. It was weakened nearly 2 percent and in fact, could have been much larger if the central bank had not intervened actively. As a consequence, the country's foreign exchange reserves dropped swiftly by USD4 billion.

8. In support of such a vigilant intervention in the foreign exchange market, Bank Indonesia also launched policy packages designed to curb exchange rate volatility. Without being intended as a capital control, in mid June 2010, BI introduced the regulations around SBI and money market to generally improve the monetary policy transmission mechanism. BI

specifically reduced the attractiveness of SBI for carry trade transactions, managed volatility in portfolio flows and encouraged longer-term investments, and raised the liquidity of the local interbank market. These measures included requiring a minimum 1-month holding of SBIs, introducing 9- and 12-month SBIs, doubling the interest margin to 100 bps from the policy rate on overnight borrowings and deposits with the central bank, and creating a term-deposit facility. As a result, since the end of June 2010, the volatility has been subdued, the level of exchange rate has been stable and under control, and the foreign exchange reserves stood steadily around USD77 billion, as the capital inflows have started to flow back to the Indonesian financial assets in more orderly fashion. Market players rated the June 2010's policy packages as positive, as it does not essentially restrain the timely and wide-ranging financial flow in and out of the country. They are in agreement with the authorities' view that these measures are contributing to a more robust monetary management and the authorities' need for financial market deepening.

9. The Indonesia banking sector showed remarkable resilience to the crisis, thanks to earlier restructuring, prudent regulation and enhanced supervisory framework. Robust capitalization, low NPL, minimal derivative and foreign exchange exposure, and ample liquidity suggest the health of the overall banking sector remains protected and solid to weather the financial pressures. After experiencing growth slowdown in 2009 and Q1-2010, bank credit to private sector started to pick up, as economic activities gain traction and more confidence in growing certainty and optimism. In June 2010, the industry's average CAR reached a high level of 17.4 percent and NPL hovered only around 3.3 percent. Their profit would remain relatively high, as their loan growth in the last two months is back to pre-crisis level of 18 percent, and over 50 percent of banks financial products are in the form of Micro, Small and Medium Enterprises (MSME) loan, which is particularly insensitive to interest rates.

Policy Discussions

<u>Monetary policy</u>

10. As monetary policy in Indonesia remains to face challenges from distorted transmission mechanism of sticky downward bank interest rates and prevailing supply side constraints, the Inflation Targeting Framework (ITF) has served the country relatively well to anchor inflation expectation and to prevent excessive CPI pressures. The central bank's judicious monetary measures by managing liquidity and controlling money supply have also been effective in containing the demand-pull inflationary pressures. Against this background, the authorities noted that key challenges going forward are to implement appropriate policy mix and improve further the effectiveness of communication in the ITF. They acknowledged that efforts to help achieve the inflation target rely on improved cross-institutional coordination and the industrial structure reinforcement. Commitment to improve coordination, and intensify communication strategy and efforts was reinvigorated by establishing the Inflation Monitoring and Control Team, both in the central and regional governments. Meanwhile, the issues of high cost of banking fund, excess liquidity in financial market, lack of adequate infrastructure, inefficiency of distribution channel, and imperfect market structure have always been priority in the authorities' agenda. They have put a greater emphasis to

strengthen economic institution and accelerate infrastructure development related with the efforts to expand production capacity and economic capacity in general.

11. Building Indonesia's economic momentum into sustained, higher growth in the last decade is remarkably challenging for the authorities. The uncertainty of global development followed by massive foreign capital inflow in the recent episodes owing to Indonesia's open capital account has left its financial markets vulnerable to the risk of sudden reversal or capital flight. Even though foreign exchange reserves have increased around USD 18 billion since September 2008, a huge sell-off in foreign holdings of financial assets could reduce reserves quickly if BI has to defend Rupiah from a potential steep fall. This heightened vulnerability to capital flows therefore makes it important for the country to have a deep enough reserves cushion to be able to stem excessive currency volatility that can destabilize other segments of the economy. While believing such policy is needed to preserve macroeconomic and financial stability, the authorities are aware of the consequence to the central bank's balance sheet. They acknowledged the growing cost incurred by BI, as it has to pay relatively high interest rates on the domestic money, compared to its reserves assets earning in the current low interest rate environment. In view of this development, since a few months ago, the government and the central bank have initiated discussions aimed to make the non-marketable government securities held by BI become sellable to the market as it could improve monetary management and help to strengthen the health of BI's balance sheet.

Fiscal Policy

12. Last year, the government with the approval of parliament implemented a substantial fiscal stimulus, involving tax relief and measures to safeguard public purchasing power. Fiscal policy was focused on delivering a stimulus to the economy during the period of the global economic downturn, while simultaneously maintaining the fiscal sustainability. Given Indonesia's characteristic of budget execution, this stimulus was specially designed with heavy allocation to tax savings and tax subsidies for business accounted for 77 percent of the stimulus package, and the remaining was delivered through infrastructure spending. This uniquely designed stimulus was effectively delivered to support the impact of other stimulus on the economy. While relatively modest yet appropriate to support Indonesia's resilience, the size of this package around 1.3 percent of GDP slightly increased the budget deficit in 2009 by 1.6 percent of GDP higher than the original target at 1 percent of GDP.

13. While lowering the magnitude of 2010 fiscal stimulus to 0.8 percent of GDP, the authorities have decided to keep the countercyclical policy. Judging from Indonesia's recent condition, the entire package of stimulus is in the form of tax incentives rather than directly stimulating demand, which tended to drive the economy to heat up easily and thus vulnerable to inflationary pressure. Earlier this year, they have decreased corporate income tax by 5 percent for companies listed on the Indonesian stock exchange and 3 percent for non–listed companies, and abolished luxury tax for some high-tech industries. With such policy option, they recognize that tax policy reforms kept on a mainstay of fiscal consolidation to maintain adequate flow of revenues. The shortfall of tax revenues is expected to be offset by the better collection efforts owing to improved administration and taxpayer compliance. In this regard,

the authorities are very much concerned on the need of raising tax revenue ratios by broadening the tax base and improving the tax administration effectiveness.

14. In the context of budget spending, the authorities acknowledge the importance of energy price reforms to support fiscal sustainability over the medium term, and share the same view as staff's on the downside risks of delaying the reforms. They closely and continuously monitor the development in this area. They observed that this year's purchasing power of corporate and households, particularly the neediest, remain vulnerable to the price shocks and needed to be strengthened prior to significant upsurge of fuel price. The authorities therefore favor a gradual approach to take this difficult decision. In July 2010, they have begun to lower electricity subsidy by increasing tariffs around 10 to 15 percent on average (18 percent maximum) with the exclusion of small customers to allow further flexibility for budgetary maneuver. In the mean time, administered fuel price will be adjusted whenever world oil price rises deviating more than10 percent from the assumption. They remain committed to undertake the fuel price reforms as the economy and social condition allow.

15. In light of these policies, the government has reduced its projected budget deficit to 1.5 percent of GDP. To finance this lower budget deficit, the government has cut its plan on spending the 2009 financing surplus and decreased the bond issuance. With strong fiscal position, low Debt to GDP ratio recorded 26 percent and robust growth outlook, by early August 2010 it was already well advanced on filing its market sourced financing plan, having sold IDR132 trillions of conventional and sharia bonds, in addition to USD2 billion global bonds with considerable lower yield compared to the previous year's issuance. The Government has projected the 2011 budget deficit to be 1.7 percent of GDP, slightly higher than that of 2010. This slight increase was attributable to higher increase in government spending vis a vis increase in revenue.

Banking Policy

16. Indonesia's financial system is far stronger than a decade ago in the aftermath of 1997/1998 Asian crisis. Since then, the authorities undertook, ad infinitum, a major overhaul in the financial system, a series of far-reaching policy reforms, and a range of bold and painstaking measures to strengthen financial system stability. The recent episodes of the global financial crisis have well tested the resilience of the Indonesian financial system. The FSAP stress test results also suggested that the Indonesian banking sector representing 80 percent of the overall financial sector assets is resilient to various shock scenarios and in robust condition to support higher economic growth.

17. Following the significant retrenchment of credit growth due to the crisis, BI's policies have been focused on improving banking industry resilience through further actions to strengthen the banking intermediation function. It has recently contemplated to adjust the existing macro prudential measure with the aim of reducing excessive pro-cyclicality of bank lending behavior. The measure is essentially designed for encouraging bank lending in the recession and discouraging it in a boom period by linking the reserve requirement to banks' Loan to Deposit Ratio. This measure has been implemented since a few years ago and works effectively to balance the need for stimulating bank intermediation and better liquidity

management. In the past, the policy however did not have an automatic brake when banks' credit growth has been relatively high. The new LDR-linked reserve requirement is revised in order to incorporate this critical feature.

18. In the regulatory and supervisory framework, the authorities have also made tremendous progress, but more remains to be done to further solidify financial sector resilience. As an integral part of global community, particularly through its active roles in G-20, Financial Stability Board (FSB), and the Basel Committee on Banking Supervision (BCBS), Indonesia is committed to rebuild a healthier global financial system and move together in a transparent and coordinated way on national implementation of internationally agreed rules, followed by robust supervision frameworks. By having the joint IMF-WB FSAP for the very first time in Indonesia, the authorities expect that they will receive a balanced and valuable feedback for continued improvements of structure and various domestic financial system policies. Indonesia has also prepared action plans to respond to the FSAP findings, as part of its commitments to strengthen their compliance to international standards. Priorities are being made to bolster compliance to standards in the banking sector and Basel Core Principles for Effective Banking Supervision (BCP).

19. As suggested by staff, Indonesia needs to have a sound legal framework for financial stability and development of financial sector. Last month, as a preliminary step to enhance the effectiveness of crisis management, Minister of Finance, BI Governor and Chairman of Deposit Insurance Company have signed MOU aimed at elucidating the roles and responsibilities of each financial safety nets participant on the eve of crisis. They are committed to adopt the revised Financial System Net Law as the draft Law that has already been submitted for Parliamentary approval. Meanwhile, with a view to improving financial regulation and supervision, the authorities just re-embarked a deferred initiative to integrate banks and all others financial institutions including capital market supervision into a new unified supervisory body. They are now in the process of identifying, outlining and defining the macro-micro supervisory responsibilities between the central bank and a newly proposed agency. The authorities recognize that the central bank needs to continue its own analysis of macro-prudential regulation tailored to the Indonesian banking system and economy. Preventing systemic risks in the near future needs a comprehensive role of the central bank in macro-prudential surveillance.

Final Remarks

20. Despite subject to prevailing problems and susceptible to external and internal shocks, the Indonesian authorities have successfully overcome the difficult year of 2009 with a number of achievements. The authorities' perseverant efforts to maintain macroeconomic and financial stability, while continuing structural reforms, succeeded in navigating the economy through various shocks. Looking forward, as the global economic recovery chart further progresses, domestic demand grows persistently strong and capital inflows remain on the rising trend, key challenges are effective implementation to the most appropriate policy mix in a wide-ranging global uncertainty, while advancing sustained high growth. The Indonesian authorities welcome and look forward to a strengthened relationship with the Fund that could facilitate Indonesia success in overriding the challenges and achieving its prosperous future.