

Indonesia: Eighth Review Under the Extended Arrangement and Request for Waiver of Performance Criteria—Staff Report; Staff Supplement; and Press Release on the Executive Board Discussion

In the context of the eighth review under the extended arrangement and request for waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the eighth review under the extended arrangement and request for waiver of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **January 29, 2003**, 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 March 18, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of **March 27, 2003** updating information on recent developments.
- a Press Release summarizing the **views of the Executive Board as expressed during its March 28, 2003 discussion** of the staff report that completed the request and review.

The document(s) listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Indonesia*
Memorandum of Economic and Financial Policies by the authorities of Indonesia*
Technical Memorandum of Understanding*

*May also be included in Staff Report

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: <http://www.imf.org>

Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

INDONESIA

**Eighth Review Under the Extended Arrangement and
Request for Waiver of Performance Criterion**

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

Approved by David Burton and Leslie Lipschitz

March 18, 2003

- Discussions were held in Jakarta during January 9–29. The mission met with Coordinating Ministers Dorodjatun Kuntjoro-Jakti (Economic Affairs) and Yusef Kalla (Peoples' Welfare), Minister of Finance Boediono, Minister of State-Owned Enterprises Laksamana Sukardi, Minister of Labor Jacob Nuwa Wea; Bank Indonesia Governor Syahril Sabirin; other senior officials; and representatives of NGOs and the private sector.
- The staff team comprised Messrs. Citrin (head), Schwartz, Bingham, and Wolfson, Ms. Richter Hume (all APD), Messrs. Baldacci (FAD), Forget (LEG), and Tadesse (PDR), and Ms. Aquino (assistant, APD), and was assisted by Messrs. Nellor, Heytens, and Taylor of the Fund's Jakarta office. The mission worked closely with an overlapping FAD technical assistance team, and with the World Bank and AsDB.
- The present extended arrangement (SDR 3.6 billion) was approved on February 4, 2000, and was extended on January 28, 2002 by an additional year, through end-2003. To date, seven reviews have been completed (the last on December 5, 2002) and a total of SDR 2.3 billion has been purchased, bringing Indonesia's outstanding obligations to the Fund to SDR 6.3 billion (Annex I and Table 1). A purchase of SDR 344 million will become available on completion of the review.
- In completing the last review, Directors welcomed that macroeconomic policies remained on track, and that corrective actions had been taken to restore the momentum of reform. They stressed the importance of advancing the structural reform agenda, particularly through actions to bolster the investment climate. Bank divestment, legal and judicial reform, and privatization were viewed as priorities; Directors also stressed the importance of strengthening the revenue base through improved tax administration.
- As described in the LOI and MEFP (circulated separately), all end-December quantitative performance criteria and indicative targets were met (MEFP, Table 2). The authorities are requesting a waiver for the nonobservance of the structural performance criterion concerning financial issues related to the BLBI liquidity credits, whose implementation awaits completion of parliamentary discussion.
- The authorities' program for 2003 aims to consolidate recent gains in macroeconomic stability, and strengthen growth and employment prospects through reforms to improve the investment climate. New quantitative performance criteria and indicative targets, and structural benchmarks are proposed for the year (MEFP, Tables 2 and 3). In view of the recent record of policy implementation and the strength of the 2003 program, the staff supports the authorities' request for completion of the review.

	Page
Executive Summary	4
I. Background and Performance Under the Program	5
A. Background	5
B. Recent Developments and Performance Under the Program.....	5
II. Policy Discussions and the 2003 Program	7
A. Macroeconomic Framework	8
B. Macroeconomic Policies	8
C. Structural Reforms	12
III. Program Monitoring and Financing	19
Text Figures	
1. Stock Market and Exchange Rate Developments	6
2. Public Debt Dynamics	10
3. Monetary Conditions Index	11
4. Banking Indicators	12
Text Tables	
1. External Financing in 2003	12
Boxes	
1. Status of Economy Recovery	22
2. External Vulnerability.....	23
3. Corporate Sector Developments	24
Tables	
1. Schedule of Reviews and Purchases	25
2. Selected Economic Indicators, 1996/97–2003	26
3. Balance of Payments, 2000–03	27
4. Monetary Survey, December 2000–December 2003	28
5. Summary of Central Government Operations, 2001–03.....	29
6. Structural Benchmarks for the Eighth Review	30
7. Indicators of External Vulnerability, 1996/97–2003	31
8. External Sustainability Framework, 1997–2010.....	32
9. Medium-Term Fiscal Projection, 2001–05	33
10. IBRA Asset Recovery and Official Targets, 2002–03	34
11. Indicators of Debt Service to the Fund, 2001–10	35

Figures

1.	Recent Macroeconomic Developments	36
2.	Market Sentiment and Financial Indicators	37
3.	Monetary and Inflation Developments.....	38

Annexes

I.	Fund Relations	39
II.	World Bank—IMF Relations.....	41

EXECUTIVE SUMMARY

Background

- **Economic developments have evolved broadly in line with projections**, with indications that the adverse impact of the Bali terrorist attack may be less severe than initially feared. GDP grew by 3.7 percent in 2002, and inflation declined to 7.3 percent (12-month basis) as of February. Financial markets rebounded quickly after the attack, and the exchange rate has stabilized below Rp 9,000 per dollar.
- **Policy implementation against end-December program targets and benchmarks was favorable.** All quantitative performance criteria and targets were met, and good progress was made in advancing the structural reform agenda.
- **Nevertheless, there are signs that domestic support for reforms could weaken**, with political maneuvering on the rise in advance of the 2004 elections. This was evident in January when the government responded to protests by rolling back a scheduled fuel price increase that was part of a broader effort to eliminate poorly targeted subsidies. The authorities have emphasized that the rollback is temporary, and that they remain committed to the original 2003 fiscal deficit target.

The 2003 Program

- **The program is based on GDP growth of 3½–4 percent, and inflation of 9 percent.** Gross reserves are projected to increase by \$0.6 billion, sufficient to raise short-term debt coverage to about 150 percent, and to maintain import cover at close to seven months. These objectives are supported by a fiscal deficit target of 1.8 percent of GDP, and a monetary program centered on base money growth of 13–14 percent.
- **The policy focus is on advancing the unfinished reform agenda and strengthening the investment climate.** Key structural elements of the program include:
 - **Fiscal reforms:** a detailed plan for further reforms in tax administration and customs, and measures to strengthen the decentralization process.
 - **Financial sector reforms:** an elaboration of IBRA's plans to sell its remaining banks, steps to restructure and strengthen the governance of state banks, and measures to ensure an orderly reform of the financial safety net.
 - **IBRA asset recoveries and privatization:** a strategy to maximize the recovery from IBRA's remaining assets, and an elaboration of the authorities' privatization plans.
 - **Improvement of the investment climate:** continuation of judicial and legal reforms, measures to improve labor relations, and steps to strengthen public sector governance.

The staff supports the request for completion of the eighth review, as well as the request for a waiver of the nonobservance of the end-December performance criterion on the BLBI burden-sharing agreement, which is nearing completion.

I. BACKGROUND AND PERFORMANCE UNDER THE PROGRAM

A. Background

1. **Much has been achieved over the past three years under Indonesia's extended arrangement.** Macroeconomic stability has been restored, international reserves have been rebuilt to a more comfortable level, the banking system has been strengthened, IBRA asset recoveries have advanced, and steps have been taken to enhance governance. Nevertheless, the investment climate remains weak and economic growth has been disappointing relative to original program targets (which had envisaged growth of 5–6 percent by now).
2. **As Indonesia enters the final year of the EFF arrangement, the priority has shifted from macroeconomic stabilization to advancing the unfinished structural reform agenda.** In addition to ensuring the maintenance of macroeconomic stability and further steps to enhance debt sustainability, the 2003 program focuses on strengthening the banking system, and legal and other reforms to enhance the investment climate.
3. **While recent policy implementation has been generally favorable, there is a risk that support for reforms could diminish as the year unfolds.** Political maneuvering is rising in advance of the 2004 elections, and President Megawati's government has already come under pressure this year. This was apparent in January, when the government reacted to street protests by rolling back a scheduled increase in fuel prices that was intended to eliminate poorly targeted subsidies, and which had received parliamentary approval. Observers have noted that the protests were mainly politically motivated, with the aim of destabilizing the government. They have also emphasized that the authorities' policy agenda is not well understood by the general public, suggesting that to ensure its credibility, the government will need to spare no effort in explaining its program to civil society as well as forcefully pressing ahead with policy implementation.
4. **Indonesia's post-2003 relationship with the Fund following the expiration of the extended arrangement has also become the focus of domestic political debate.** A team has been commissioned by the President to study post-2003 strategic and financing options. The authorities have stated publicly their desire to graduate from exceptional financing when the extended arrangement expires at the end of the year.

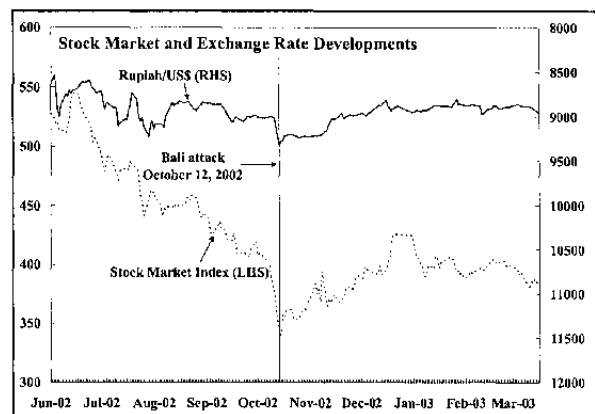
B. Recent Developments and Performance Under the Program

5. **Macroeconomic developments have evolved broadly as projected, and performance against end-2002 quantitative program targets was favorable** (Table 2, MEFP Table 2, and Figure 1). While the October Bali attack has undoubtedly had an effect on tourism, indicators related to private consumption have held up better than expected, and the impact of the attack now appears less severe than originally feared:

- **The preliminary outturn for real GDP growth in 2002 was 3.7 percent, above the 3¼ percent projected at the last review, and within the original 2002 program range.** However, investment has remained weak, and demand was led by private consumption (Box 1).

- **Inflation has continued to moderate, to 7.3 percent (12-month basis) in February** (Figure 2). The recent decline has been somewhat steeper than expected, due to a fall in food prices. Still, core inflation continues to trend down, and now stands at about 8 percent.

- **The preliminary balance of payments outturn for 2002 is also somewhat more favorable than projected at the last review** (Table 3). The current account surplus amounted to over \$7 billion (4.2 percent of GDP), reflecting continued sluggishness in imports, and a better-than-expected services balance notwithstanding the sharp decline in fourth-quarter tourism receipts. On the capital account, official financing in 2002 was substantially lower than expected (mainly reflecting slow disbursement of project loans) and FDI inflows declined slightly; but this was offset by an improvement in portfolio flows. As a result, the end-December NIR target was met with a large margin, and reserves accumulation for the year amounted to \$3½ billion, bringing gross reserves to \$32 billion (equivalent to seven months of imports and sufficient to more than fully cover short-term debt).



- **Financial markets have maintained the positive trends recorded through much of 2002, rebounding from the effects of the Bali attack and so far being relatively unscathed by the ongoing geopolitical tensions** (Figure 3). The rupiah has stabilized at below Rp 9,000 per dollar, and stock prices have recovered. Indonesia's sovereign credit ratings have also been maintained, following the third quarter upgrade.

6. **Base money has remained well within the program path, and the end-December performance criterion on NDA was met with a significant margin** (Table 4). Following cuts totaling 300 basis points from April to November, BI's overnight deposit facility rate (previously known as the rupiah intervention rate) was reduced by about 60 basis points in early March, and now stands at 11.5 percent; the one-month SBI rate has continued to ease, reaching 11.6 percent in mid-March.

7. **The 2002 budget deficit outturn was also well within the program target** (Table 5). The full-year deficit was only Rp 26.3 trillion (1.6 percent of GDP), compared with the program ceiling of Rp 42.1 trillion (2.5 percent of GDP). Overall revenues were broadly in line with expectations. Encouragingly, non-oil tax collections (mainly VAT and

excise receipts) exceeded expectations in the fourth quarter, due in part to improvements in tax administration implemented during the year.¹ Expenditure was significantly lower than expected, owing to a combination of factors, including savings on current expenditures (including lower external interest payments) and some lags in implementation of development projects.

8. **Performance against the November and December structural benchmarks was satisfactory** (Table 6). IBRA exceeded its annual cash recoveries target; enforcement actions were initiated against noncompliant former bank owners under their shareholder settlement agreements (see ¶33 below); further progress was made in the bank divestment program, with the launching of the sale of a majority stake of Bank Danamon in early December; the Anti-Corruption Commission (ACC) was established with the passage of its enabling legislation; and the government conducted a successful auction of government securities. However, the structural performance criterion on the implementation of the burden sharing agreement on Bank Indonesia liquidity credits (BLBI) between BI and the government was again not met. Implementation of the agreement awaits completion of parliamentary discussion, which was initiated in January (¶30). The benchmarks on the completion of the third round of audits of state enterprises and the quarterly reporting of local government finances were also not fully met. The former is now expected to be completed in July (¶43), and the latter (for which the reporting coverage was only 65 percent of regions, compared to the benchmark of 85 percent) is expected to be completed shortly.

9. **Satisfactory progress was also made in other areas of the structural reform agenda.** The annual privatization receipts target (Rp 6.5 trillion) was exceeded with the successful sale of the telecommunications company Indosat. As already noted, good progress was also made in implementing tax administration reforms, particularly with respect to arrears collections and the expansion of tax audits.

II. POLICY DISCUSSIONS AND THE 2003 PROGRAM

10. **The discussions focused on advancing the unfinished reform agenda, and strengthening the investment climate.** Recent economic developments provided some indication that implementation of the government's overall strategy was bearing fruit. Both economic activity and financial markets had shown an impressive resilience to the Bali attack. The staff therefore stressed the importance of adhering to the program, particularly given that the political environment for reform was becoming more difficult and in view of Indonesia's desire to graduate successfully in 2004 from exceptional financing.

¹ Despite higher oil prices, oil and gas receipts were below expectations, as some overseas revenue was frozen pending resolution of a commercial dispute.

A. Macroeconomic Framework

11. **The macroeconomic objectives for 2003 remain broadly unchanged from those presented at the seventh review.** GDP growth is projected in the 3½–4 percent range, and inflation is expected to run at 9 percent.² The program targets an increase in gross reserves of \$1 billion, sufficient to raise the coverage of short-term debt to about 150 percent while keeping import cover broadly unchanged.

12. **The main risks to the outlook stem from a slowdown in policy implementation and from exogenous shocks related to a war in the Middle East or global weakness.** On the domestic front, a slowdown in policy implementation, combined with investor uncertainty ahead of the 2004 elections, could threaten the recovery. The risks of an external crisis, however, are relatively low given the flexible exchange rate regime and comfortable level of reserves (Box 2, and Tables 7 and 8). Moreover, the effects of a sharp rise in oil prices would be mitigated given Indonesia's status as an oil exporter. A relatively low dependence on market financing would also act to limit vulnerability to global credit market events.

B. Macroeconomic Policies

Fiscal Policy

13. **The authorities emphasized that they remain committed to their 2003 budget deficit target of 1.8 percent of GDP (MEFP, ¶7).** The budget places an emphasis on raising non-oil tax revenues (from gains in tax administration and a broadening of the tax base) to finance an increase in priority development spending. Faced with popular pressure in January, the government introduced two temporary initiatives which, while being accommodated within the overall fiscal envelope, represent a departure from the original budget. These comprise: (i) tax relief measures, amounting to 0.3 percent of GDP;³ and (ii) a temporary rollback of the planned increase in fuel prices that would have eliminated subsidies (except on household consumption of kerosene) that are poorly targeted on the

² While the authorities have maintained a target for GDP growth of 4 percent, as a safeguard against downside risks to the outlook, the program's quantitative targets have been based on a point estimate consistent with the staff's 3½ percent growth projection (at the upper end of the 3–3½ percent range forecast at the seventh review, owing to the smaller-than-feared impact of the Bali attack). Inflation is currently below the end-year target, due in part to base effects and other temporary factors.

³ The tax package included an exemption from income tax for minimum wage workers and a reduction in the rates of luxury tax on selected consumer items (largely to reduce smuggling). The package also reintroduced an exemption from VAT for capital goods, and postponed the removal of exemptions of a number of other items (electricity and toll roads).

poor, and a suspension of the automatic fuel price adjustment mechanism. The rollback led to the increases being scaled back from 21 percent to 12 percent (on a weighted average basis).

14. **The mission reviewed the budgetary impact of the tax relief and partial reintroduction of fuel subsidies.** The mission agreed that these measures could be financed from additional oil revenues associated with the recent run-up in oil prices, and that even after the rollback, the fuel subsidy rate had been reduced from its level at end-2002. (Nevertheless, as a result of the measures the non-oil deficit is now projected to widen by an additional 0.6 percent of GDP compared to the original budget.) The mission expressed serious concern about the damage to the government's credibility that such a reversal of policy might have (all the more so as scheduled increases in electricity and phone tariffs were also delayed.) The authorities stated that their decision was unavoidable given the widespread level of opposition, and emphasized that the price freezes were temporary, and that the monthly price adjustment mechanism—and elimination of fuel subsidies—would resume once international benchmark prices fell to more normal levels, which they anticipated would occur around mid-year.⁴ (Subsidies would fall automatically under such a scenario, bringing the non-oil primary balance back toward the original budget target.) Even if oil prices remained high, the overall budget target would be protected, as the net impact (on revenues and subsidies) would be positive.

15. **The mission also expressed reservations about the composition of the tax package introduced in January.** The staff noted that even though the budgetary impact of the reversal of the elimination of the VAT exemption on capital goods was small, it would weaken the overall structure of the VAT. The authorities explained that the decision was a temporary measure adopted in response to complaints from businesses about inefficiencies in the VAT refund system (particularly in the mining and gas sectors), and agreed to reevaluate this decision in the context of the next review.

16. **The latest financing outlook for the budget is broadly in line with that envisaged at the last review.** The outlook is for net domestic financing of 1.4 percent of GDP, and net external financing of 0.4 percent of GDP, compared to 1.2 percent of GDP and 0.6 percent of GDP, respectively, at the last review. The change is due to the impact on foreign financing of the recent decision by Paris Club creditors to reschedule only 50 percent of interest falling due in 2003.⁵

⁴ For the purposes of this review, it was assumed that Indonesian oil prices would decline gradually to \$24 per barrel by mid-year, compared with a price of \$22 per barrel in the budget.

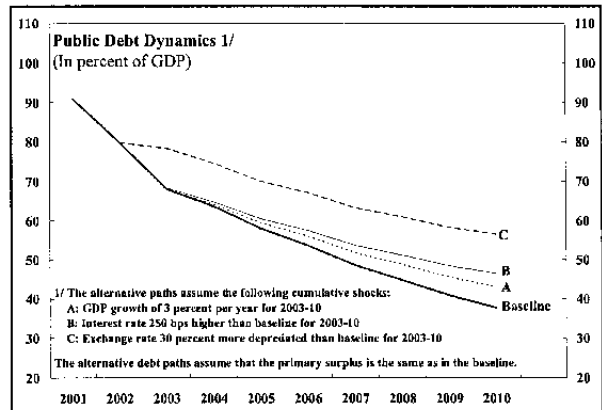
⁵ When Paris Club creditors agreed last April to reschedule eligible interest and principal falling due in 2003, they deferred a decision on the precise amount of interest rescheduling until the 2003 balance of payments need could be established. In the event, the amount

(continued...)

17. **The program also includes fiscal reforms in the following areas:**

- **Tax administration** (MEFP, ¶8 and Annex A). The measures encompass revenue generation (intensifying tax payer registration, tax audits, and arrears collection), modernization, and governance initiatives (expanding the large taxpayer offices and the new electronic tax payment system, strengthening the VAT refund system, and advancing customs reform).
- **Public expenditure management** (MEFP, ¶10). Plans are underway for an internal reorganization of the Ministry of Finance. The priorities include a restructuring of the budget preparation process and a strengthening of the government's payment and receipts systems.
- **Fiscal decentralization** (MEFP, ¶13–15). The program includes measures to: (i) strengthen the reporting of fiscal outturns from the regions; (ii) enhance central oversight of regional regulations; and (iii) improve the framework for regional borrowing (in the meantime, as noted at the last review, the government has extended the moratorium on local government borrowing for another year, covering all borrowing other than through the center).⁶ The government is also working with donors to develop a framework to enable on-lending of donor funds to regions through the central government (this issue has become a priority for donors with the devolution of expenditure responsibilities to the regions).

18. **The mission updated its assessment of Indonesia's medium-term fiscal sustainability** (Table 9). This assessment continues to show that with further progress in fiscal consolidation, the public debt-to-GDP ratio should remain on a declining path, a conclusion that is robust to a variety of shocks (Text Figure). In addition, the short-term financing outlook has improved considerably following the successful reprofiling of the government's domestic debt last year.



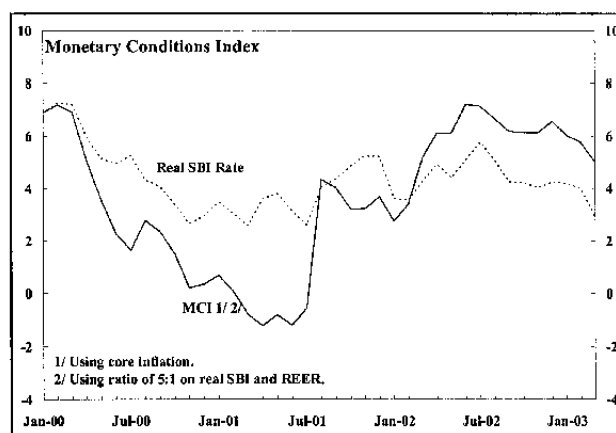
granted—100 percent of principal and 50 percent of interest—was a little below the authorities' request on which the budget was formulated.

⁶ The moratorium provides additional time to strengthen the budget reporting system and address weaknesses in the legal framework governing regional borrowing. Although the framework establishes a ceiling on the debt of local governments, it does not specify sanctions against regions which breach their debt limits. There is also a need to develop a resolution framework for regions that default on their debt.

19. **Discussions on the 2004 financing outlook focused on the implications of the authorities' intention at this stage not to seek recourse to exceptional financing** (including from the Paris Club). The authorities explained that they are considering a number of financing options in view of the substantial domestic and external amortization falling due. In addition to the issuance of domestic bonds, they are examining the scope for drawing down deposits at BI.⁷ From a macroeconomic perspective, the risk of crowding out is small given banks' substantial liquidity position, but the feasibility of a potentially significant increase in bond sales would depend on the success of the government's plans to foster the development of an active debt market.⁸ As for the option of using domestic deposits to repay external debt, the authorities would need to ensure that this did not lead to undue pressure on foreign reserves. The authorities plan to continue monitoring the 2004 financing outlook in close consultation with the staff as the year evolves.

Monetary and Exchange Rate Policy

20. **The mission agreed with the authorities that the recent conduct of monetary policy had been appropriate, but urged caution with respect to the pace of further interest rate cuts.** In recent months, interest rates had been reduced modestly, while the rupiah had remained stable. Indeed, with the appreciation of the rupiah, monetary conditions remained relatively tight (Text Figure). Thus, a further reduction in interest rates could be warranted, so long as inflation continued to decline in line with the program's target. Consistent with this approach, interest rates were eased in early March. While the monetary program is consistent with the year-end inflation target of 9 percent, the authorities were optimistic that the inflation outcome could well be lower, if the rupiah continues to trade in a range of Rp 8,800–9,000 per dollar, as they expect.



⁷ The government holds substantial deposits (around Rp 80 trillion), partly reflecting earnings from “investment funds” that are generated by interest and principal payments received on donor (and other) funds previously on-lent to local governments. The balances on these funds are integrated into the budget.

⁸ The results of the government's placement of domestic securities (Rp 2 trillion in 8-year bonds) in December were promising. The auction was 3½ times oversubscribed, with the bond yielding 14½ percent (the prevailing yield for 1-month SBIs was 13 percent).

Balance of Payments and External Financing

21. **The balance of payments outlook has been updated to take into account the prospects of higher oil revenues but still weak external demand conditions.** The current account surplus is expected to narrow in 2003, as higher export receipts are offset by weak tourism receipts (due to the Bali attack), and a rebound in imports from their currently compressed levels. Despite higher official disbursements, the capital account is also expected to show a modest deterioration reflecting higher payments falling due by the banking sector and lower expected net portfolio inflows. On this basis, NIR is projected to remain broadly unchanged. Gross external financing needs for 2003 are estimated at \$5.3 billion (Text Table). In addition to Fund purchases, this is to be covered by official financing secured at the meeting of the Consultative Group on Indonesia (CGI) meeting (held last January in Bali) and rescheduling from the Paris Club.

External Financing in 2003 (In billions of U.S. dollars)	
Gross financing needs	5.3
Current account deficit	-4.7
Debt amortization	8.1
IMF repayments	1.3
Reserves accumulation	0.6
Available financing	5.3
Foreign direct investment	2.2
Loan disbursements	4.4
IMF purchases	1.8
Other flows, net	-6.1
Rescheduling	3.1

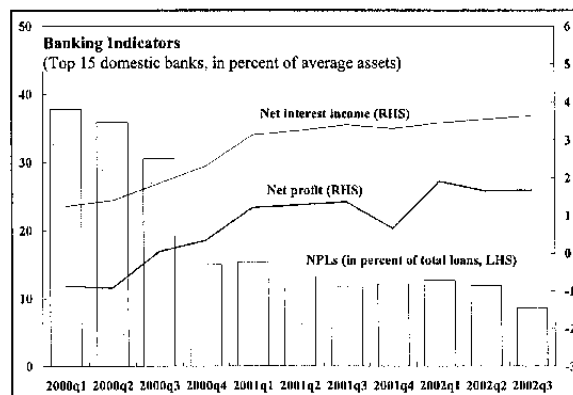
C. Structural Reforms

22. **The authorities agreed with the importance of maintaining momentum and forcefully addressing the unfinished structural reform agenda.** In that regard, there is a need to advance reforms in the areas of bank divestment and restructuring, to continue the asset recovery process through further IBRA asset sales and privatization, and to improve the investment climate through legal, judicial, and other reforms. The staff stressed that the authorities' commitment in these areas would be especially important for maintaining confidence as the Fund arrangement winds down, in the pre-election period.

Financial Sector Reforms

23. **While the condition of Indonesian banks has stabilized, further progress is required to restore them to full health.**

Indicators of banking system soundness generally improved in 2002, with profitability rising and nonperforming loans continuing to decline (Text Figure). Nonetheless, the system remains vulnerable, especially as there are concerns that the quality of restructured loans—and hence part of the improvement in these indicators—may be overstated. Banks have resumed lending to the private sector, especially to consumers. However, despite the pickup in credit growth in 2002 (to 24 percent in nominal terms), bank credit to the private



sector as a share of GDP remains low, and recapitalization bonds continue to represent almost one-half of banking system assets. Against this background, the discussions focused on measures to conclude the process of bank restructuring and improve the institutional framework for the financial sector.

24. **Ensuring the return of banks taken over during the crisis to private ownership is central to the strategy to revitalize the banking sector** (MEFP, ¶23). The four banks still under IBRA's control represent almost 15 percent of banking system assets. The immediate priority is to conclude the divestment of Bank Danamon, expected by end-April. This would be followed by the launch of the divestment of the government's remaining majority stake in Bank Lippo.⁹ The sales of IBRA's other banks, BII and Permata (formed through the merger of five smaller banks in October 2002), will be launched later in the year, with a view to completing the divestment process by the end of IBRA's mandate in early 2004.

25. **The program includes measures to strengthen state bank governance** (MEFP ¶24). Progress in this area has lagged, with the government continuing to exercise weak control over the state banks (which together account for about 45 percent of banking system assets). With a view to improving oversight of the sector, the government is taking a number of measures to strengthen the monitoring and accountability of state bank activities.

26. **The mission also agreed on the next steps in the restructuring and divestment of the state banks** (MEFP, ¶25). The conditions for the sale of a stake in the largest state bank, Bank Mandiri, have been met, and the IPO of a minority stake is now envisaged to be concluded by June. The government then intends to develop a plan for the next phase of its divestment strategy. With respect to the other state banks, an IPO of a minority stake in BRI is to be launched in the second half of the year, and BNI will be reviewed as part of the fourth round of performance audits of state enterprises, with a view to strengthening its operations ahead of its eventual divestment. As for BTN, a restructuring plan is being developed, with a specific implementation schedule.

27. **The authorities' plans for the reform of the financial sector safety net are advancing** (MEFP, ¶26–28; ¶30). A comprehensive plan is expected by end-March to ensure the coordination and proper sequencing of a number of new institutions and policies needed to safeguard the stability of the financial system. The first priority will be to establish a deposit insurance agency with powers to manage bank closures, with a view to having the agency in place when IBRA's mandate expires. In addition, BI's lender of last resort (LOLR)

⁹ Bank Lippo was jointly recapitalized in 1999 by the government and the original owners. A controversy has surfaced in recent weeks regarding the financial statements for the bank, linked to allegations that the former owners have been seeking to manipulate the reported value of the bank's assets and share price to enable them to regain control. The government, as majority shareholder, is considering steps to address the situation, including changing the bank's management.

function needs to be strengthened to ensure that it has the capability to provide emergency liquidity support to banks encountering difficulties. The strategy also incorporates the development of the independent Financial Supervisory Agency (OJK). In order to ensure a smooth transition to the new agency, supervisory and regulatory functions will be transferred to it gradually, over a number of years. In the first stage, the OJK is expected to be responsible for supervising the nonbank sector, with bank supervision remaining at BI. In order to improve the efficiency and accountability of bank supervision ahead of the eventual transfer of these duties to the OJK, by end-September BI will complete a restructuring of its operations in this area.

28. **The blanket deposit guarantee will be phased out gradually.** The mission advised delaying its removal until the health of the banking system has improved further, and the major elements of the financial safety net described above are in place (in particular, the deposit insurance agency and BI's enhanced LOLR function). The authorities agreed to move cautiously, and it is expected that the guarantee will be removed progressively.

29. **The mission discussed a number of issues related to the reform of BI** (MEFP, ¶29). Parliamentary discussions of amendments to the BI Law, designed to improve the oversight and accountability of the central bank while safeguarding its operational independence, have not yet concluded. However, the divestment of BI's overseas subsidiary is advancing. Following the transfer of its impaired assets to a special purpose vehicle, the subsidiary (Bank Indover) will be offered for sale.

30. **The resolution of the BLBI liquidity credit issue is nearing completion.** A major concern in the program was a potential deadlock between the government and BI on their financial relations linked to this issue. Following the landmark agreement between the two parties in June 2002 based on the report of the independent panel of experts, the government in January took the important step of forwarding the proposed agreement to Parliament for its review. The discussion so far, as well as informal consultations with the Supreme Audit Agency, has not indicated any problems with the basic elements of the financial agreement. However, the discussion in Parliament is touching upon the broader issue of assigning responsibility for the decision to provide the liquidity credits during the crisis. The authorities are working to ensure the agreement's expeditious approval, but the deliberations are yet to be completed. Given the sensitive nature of the discussions, the staff agreed with the authorities that it would be counter-productive to pressure Parliament to reach a quick conclusion on this matter, and concluded that a further rescheduling of the performance criterion would not be warranted. In the meantime, the financial operations of the budget and the central bank in 2003 are being conducted on the basis of the agreement; therefore the delay is not having a macroeconomic impact.

IBRA Asset Recovery

31. **IBRA cash recoveries in 2002 amounted to Rp 38.1 trillion, exceeding the target of Rp 36.1 trillion** (total asset recoveries, including bonds, amounted to Rp 45.6 trillion).

Proceeds from the sale of loans accounted for nearly two-thirds of cash receipts (Rp 21.7 trillion), while divestment of government holdings in banks BCA and Niaga brought in a further 18 percent (Rp 6.7 trillion). (The remaining recoveries were under the shareholder settlement agreements with former bank owners.) To date, IBRA has disposed of over half of its total loan book.

32. **The program for 2003 aims to maximize recovery from the remaining stock of assets ahead of the winding down of IBRA's operations by February 2004** (MEFP, ¶31 and ¶34 and Table 10). IBRA's Rp 26 trillion (1.4 percent of GDP) recovery target for 2003 is expected to be met primarily from sales of its remaining NPLs. While the majority of these loans are to be offered using IBRA's well-tested auction mechanism, loans related to the Top 5 debtors will be offered on an individual basis in strategic sales (combining equity and debt positions). To ensure transparency, IBRA's Oversight Committee is vetting the proposed sales mechanisms.

33. **The authorities are strengthening their strategy for asset recoveries under the settlement agreements with former bank shareholders** (MEFP, ¶32–33). IBRA has launched formal enforcement actions against the shareholders who remained noncompliant with their agreements at the end-February deadline.¹⁰ For the 4 shareholders who have fulfilled their obligations under the agreements, the government is ceasing further legal actions. All industrial and other assets that had been pledged in settlement of outstanding claims are being transferred to IBRA; these assets will be offered for sale over the course of 2003. IBRA will also undertake forensic audits to identify any additional shareholder assets that could be used to meet outstanding obligations in cases (under the so-called MRNIAs) where the assessed value of the assets pledged initially was insufficient to meet the full obligation amount.

Legal Reforms

34. **The mission reviewed the strategy and priorities for legal reform in 2003** (MEFP, ¶38–39). It was agreed that the key program objective in this area is to further the development of the commercial court system, as weaknesses in the implementation of the bankruptcy framework remained a significant impediment to enhancing the investment climate. The authorities noted that ongoing work to strengthen the operations of the Commercial Court would continue, and that an update of the blueprint for the associated reforms would be finalized by the middle of the year. Steps are also being taken to expedite the passage of (largely procedural) amendments to the bankruptcy law and to strengthen the

¹⁰ Criminal cases have been launched against 5 shareholders, and are under preparation for a further 12. To strengthen this approach, IBRA will now include the original Directors and Commissioners of the banks, who in many cases are closely related to the noncooperative shareholders, in their legal actions.

Court by increasing the number of ad hoc judges. The authorities are complementing the work in this area with two new initiatives:

- A financial needs assessment of the Commercial Court to place its finances on a sounder basis. The assessment will provide a comprehensive review of the facilities (and personnel) needed to operate an effective commercial court system.
- The establishment of an independent Judicial Commission to strengthen the governance and administration of the judiciary. The government is working with the Supreme Court and the relevant parliamentary committees to finalize the enabling legislation for the commission by the end of the year.

35. **The mission assessed progress in other areas of the legal reform agenda** (MEFP, ¶40–41). The government is working to ensure that the Anti-Corruption Commission (ACC) starts work by end-2003, as required by the Anti-Corruption Law. The next step in this process will be to appoint the chairman and the four deputies for the Commission by July this year. Steps are also being taken to ensure that the wealth declaration process is not weakened once this function is taken over by the ACC.

36. **Progress is being made in strengthening Indonesia's anti-money laundering (AML) framework.** The senior management of the financial intelligence unit, which has primary responsibility for administering the AML framework, has been appointed, and the unit now has 23 staff (including 2 international advisers). The government will also shortly table amendments to the AML law, to bring it into conformity with FATF requirements. Passage of these amendments is expected to pave the way to removing Indonesia from FATF's list of non-cooperating countries.

Other Structural Reforms

Privatization

37. **The government has approved a privatization program for 2003 designed to achieve the budget target of Rp 8 trillion** (MEFP, ¶35). In order to ensure broader support for its program, the government will present its program to Parliament and seek approval for the larger divestments on an individual basis.¹¹

Corporate debt restructuring

38. **After several years of stagnation, financial restructuring of Indonesia's heavily indebted corporate sector is advancing** (Box 3 and MEFP, ¶36). IBRA's sale of over

¹¹ A draft privatization law is currently before Parliament. The draft seeks to consolidate the legal basis for privatization into a single law, and thereby facilitate the privatization process.

Rp 100 trillion in NPLs in 2002 has significantly boosted the secondary market for distressed corporate debt, thus encouraging market-based restructuring, and further NPL sales this year are likely to provide an additional stimulus. With better prospects for market-based restructurings, the role of official intermediation in restructuring negotiations is likely to wane. As the Jakarta Initiative Task Force's (JITF's) mandate is set to expire at end-2003, the JITF will prioritize its mediation efforts on its remaining cases with the greatest chance of reaching resolution in 2003, while those unlikely to be resolved will be dismissed.¹²

Labor policies

39. **The mission reviewed the status of the government's strategy to modernize labor relations** (MEFP, ¶42). This process, which was initiated in 1998 with the ratification of ILO conventions on worker rights and was followed in 2000 by a major reform of legislation governing rights of association and union activity, had stalled in the absence of a consensus on complementary legislation on labor protection and industrial dispute settlement, leaving investors uncertain about the shape of the key elements of the industrial relations framework (retrenchment, severance pay, dispute resolution). The government reported that good progress had been made in recent months. The legislation relating to labor protection has now been passed by Parliament, and the bill on industrial dispute settlement is expected to be enacted by the middle of the year.

40. **The government also informed the mission that it intended to strengthen the framework for setting minimum wages** (MEFP, ¶43). This has been another area of concern to investors, as minimum wages had been rising rapidly since being devolved to the regions in 2001. While the central government has only limited direct influence in this area, it had decided to convene a national tripartite council (comprising government, labor, and employers) to establish national standards to guide the minimum wage setting process in the regions. Such standards would be intended to foster a minimum wage setting process that was more orderly and predictable, and took into account the broader national interest.

Trade

41. **Indonesia continues to maintain a relatively open trade regime** (MEFP, ¶21). The simple average tariff (7 percent) compares favorably to other countries in the region, and trade barriers are relatively low.¹³ In response to concerns expressed by the mission about recent protectionist actions (with respect to sugar, steel, and textiles), the authorities

¹² To date, the JITF has mediated \$19.4 billion in external debt restructuring; its remaining stock amounts to \$10.4 billion.

¹³ Indonesia has been replacing nontariff barriers with tariffs since the mid-1990s; while licensing requirements exist for some sensitive goods (e.g., steel and textiles), they are implemented liberally, without quantitative restrictions.

reaffirmed their commitment to a liberal regime, and pointed out that such actions had been narrow in scope, and were consistent with Indonesia's WTO commitments.¹⁴ The government is an ongoing participant of the Doha round of WTO negotiations, and will also take part in future trade negotiations under the ASEAN.

Public sector governance

42. **The authorities intend to advance ongoing efforts to improve fiscal transparency** (MEFP, ¶16). The priority in this area will be to continue the process of auditing and consolidating off-budget funds. Audits of the largest of the remaining funds—the Reforestation Fund and the two investment funds (RDI and RDA)—have been completed and their findings presented to Parliament. The focus going forward will be on ensuring that these funds are consolidated into the budget and brought fully under the control of the Ministry of Finance. Routine audits of government agencies will continue to prevent the emergence of new off-budget funds and all balances from previously identified off-budget funds will be transferred to the Treasury by June this year.

43. **The mission also discussed measures to improve governance of the wider public sector** (MEFP, ¶17–19). The program of performance audits of state enterprises has played a major role in strengthening the public sector. The first two rounds of performance audits uncovered sizeable efficiency losses (currently being addressed through corrective action plans).¹⁵ The third round of audits covering an additional five companies will be completed by July and a fourth round, which will start the process of auditing state banks, will be launched in June. Oversight of military and other foundations linked to public agencies will also be strengthened. To this end, the authorities are drafting amendments to the Foundations Law to ensure that the Supreme Audit Agency has clear powers to audit the activities of such foundations.

III. PROGRAM MONITORING AND FINANCING

44. **Quantitative program targets have been established through end-2003, consistent with quarterly purchases and reviews** (MEFP Table 2). Performance criteria for end-March and end-June are proposed for NDA, NIR, the central government balance, and external debt, and indicative targets are proposed for end-September and end-December for these variables. The definitions and coverage of all program variables are unchanged from those set out in the technical memorandum for the 2002 program, except for the definition of

¹⁴ Recent actions include an increase in steel tariffs (of 10–15 percentage points) and imposition of a licensing requirement for textile imports (mainly woven cloth). The authorities explained that the former is a temporary measure to address anti-dumping concerns, while the latter is narrow in scope, and does not impose quantitative restrictions.

¹⁵ The first two rounds covered major agencies such as the national oil company (Pertamina), the electricity company (PLN), and the rice procurement board (Bulog).

reserves (including NIR), which has been clarified to be consistent with the general ledger concept (following the safeguard assessment's recommendations).

45. **New structural benchmarks have also been set through December 2003** (MEFP Table 3). These relate to key financial sector reforms, tax administration initiatives, IBRA asset sales and privatization, governance of state-owned enterprises and banks, financial reporting of local governments, and BI reforms. The authorities have requested a waiver for the nonobservance of the end-2002 structural performance criterion related to the resolution of the BLBI credit issue, which is expected to be implemented soon. The end-2002 structural benchmarks that were not met on time—relating to the completion of the third round of special audits of state enterprises and the reporting of local government finances—are not being reset, as the former is underway, and the latter is close to completion.

46. **The authorities have made good progress toward finalizing their recent bilateral rescheduling agreements.** Of the 18 bilateral agreements to be signed with Paris Club creditors eight have been concluded, and the others are being finalized. The authorities have requested an extension of the deadline for concluding agreements to end-May. Negotiations with non-Paris Club official creditors are ongoing, although some difficulties in securing comparable treatment have been encountered (in two of the five cases).

47. **The mission discussed measures being implemented under the Fund's safeguard assessments policy.** The authorities agreed to follow up on the recommendations endorsed by the Board at the seventh review concerning the mid-term review of BI's reserves. In particular, (i) BI agreed to base its future reporting of NIR to the Fund on the general ledger concept; and (ii) BI is undertaking measures to address control weaknesses in its foreign reserves operations, and the Supreme Audit Agency will conduct an implementation review in the context of its annual 2002 audit. Discussions are underway with respect to the continued involvement of an independent accounting firm in BI's external audit mechanism, and the staff will report on further developments as warranted.

IV. STAFF APPRAISAL

48. **Overall, good progress has been made over the past year in policy implementation under the program.** Prudent fiscal and monetary policies have contributed to a reduction in inflation and an appreciation of the rupiah, which have facilitated a decline in interest rates in support of the economic recovery. At the same time, structural reforms have advanced in key areas, including bank divestment, IBRA asset recoveries, and privatization. The improvement in economic conditions and resilience of the economy to recent shocks, including from the tragic events in Bali last year, are indications that the program has been working to restore confidence and promote a durable recovery.

49. **Notwithstanding these achievements, the reform agenda remains unfinished, and it is likely that program implementation will become more difficult in 2003.** As Indonesia enters the final year of the extended arrangement, the authorities should make every effort to

consolidate recent gains made under the program and address remaining reforms. The authorities' program for 2003 appropriately focuses on maintaining macroeconomic stability, ensuring debt sustainability through further fiscal prudence and continued asset recoveries and privatization, strengthening the banking system, and enhancing the still-weak investment climate. Sustaining the pace of reform will be important for maintaining market confidence in the lead-up to the 2004 general elections, and will be crucial if Indonesia is to graduate successfully from exceptional financial support.

50. The 2002 fiscal deficit outturn was well within the program's 2½ percent of GDP target. As overall revenues were broadly in line with expectations at the last review, this outcome was achieved primarily through lower than expected expenditure, on both current and development spending items. Encouragingly, tax collections picked up in the fourth quarter, with indications that the tax administration measures implemented earlier in the year are yielding results.

51. For 2003, the staff welcomes the authorities' commitment to maintain their 1.8 percent of GDP budget deficit target. As noted at the last review, the target strikes an appropriate balance between ensuring consolidation to reduce public debt, and providing support for the economy. While the temporary rollback in January of the planned elimination of fuel subsidies (except on household kerosene) is regrettable, the authorities' desire to smooth the domestic pass-through of the recent sharp increase in international oil prices is understandable. The staff welcomes the authorities' intention to reintroduce the fuel price adjustment mechanism and eliminate subsidies once oil prices return to more normal levels. The staff also commends the authorities' ongoing efforts to strengthen tax administration, improve public expenditure management, and implement a sound decentralization framework.

52. Bank Indonesia has continued to maintain a prudent monetary stance. In the period ahead, the authorities should proceed cautiously with respect to further easing of monetary conditions, to ensure that inflation remains in line with the program's target, and that the rupiah's stability is not compromised as investors assess the outlook ahead of the 2004 elections.

53. In 2002, IBRA made important strides in returning assets taken over during the crisis to the private sector, and recovering funds for the budget. For 2003, IBRA's strategy is to maximize recoveries from loan sales and to complete the divestment of IBRA banks, in advance of its winding down early next year. In this regard, the staff welcomes IBRA's detailed asset disposal plan, which contains important steps to enhance transparency and governance in the sales process, as well as the bank divestment schedule. Recent efforts to better enforce the shareholder settlement agreements are also welcome, in conjunction with steps to initiate legal actions against noncompliant former bank owners, and to discharge those who have fulfilled their obligations from further liability. It will be essential for the government to play an active coordinating role with the Attorney General's Office and police to ensure that the enforcement actions are effectively implemented.

54. **Financial sector reforms and the strengthening of the financial safety net remain core areas of the program.** The staff urges the authorities to ensure close coordination among relevant agencies to ensure the development of a sound and comprehensive plan for the reform of the financial safety net. Key elements of the plan include the creation of a deposit insurance agency, the adoption of a strengthened lender of last resort function at BI, and the transition to an independent Financial Supervisory Agency. These reforms should be carefully sequenced, with a gradual removal of the blanket guarantee linked to the implementation of key elements of the financial safety net. The staff welcomes steps in the program to strengthen state bank governance through improved monitoring and accountability, as they are prepared for divestment. This is a priority given the state banks' large size in the overall banking system.

55. **Efforts in recent months to advance the structural reform agenda in other important areas have also met with some success.** The 2002 target for privatization receipts was exceeded with the successful sale of Indosat. The authorities have made good progress to deepen the market for public debt, with the initiation of domestic bond placements. And steps have been taken to further judicial and legal reform, as well as to strengthen the governance of state enterprises; it will be critical to maintain progress in these areas under the 2003 program, in order to strengthen the investment climate.

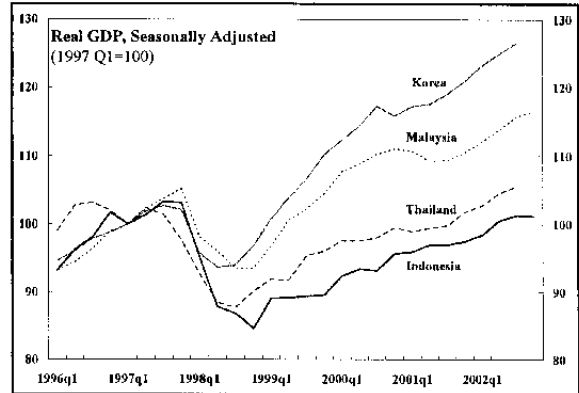
56. **The 2003 program is appropriately ambitious and, if fully implemented, should go a long way toward consolidating recent gains in Indonesia's economic performance.** The challenge moving forward will be to build on the progress made in policy implementation over the past year. As recent events have illustrated, this will not be an easy task, in what is likely to become an increasingly difficult environment for policy implementation ahead of the 2004 elections. Nevertheless, recent policy actions and the intentions outlined in the MEFP are an indication of the government's commitment to meeting this challenge. The staff therefore supports the authorities' request for a waiver for the nonobservance of the structural performance criterion on the end-December BLBI burden-sharing agreement, and the completion of the eighth review.

Box 1. Status of Economic Recovery

Indonesia's GDP has finally recovered to its precrisis level. While GDP growth in recent years has been steady, in a range of 3–4 percent, it remains below the level required to absorb new entrants into the labor market and achieve a sustained reduction in poverty.

According to newly released GDP data, growth in 2002 rose to 3.7 percent, up from 3.4 percent in 2001.

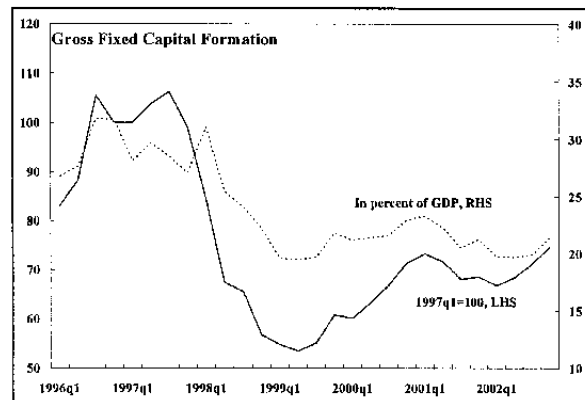
Despite this modest pickup, the recovery in Indonesia continues to lag other regional economies (Text Figure). Growth in 2002 was driven primarily by consumption, with net exports also contributing somewhat, due mainly to sluggish import growth. However, investment remains slack, and this remains a constraint on Indonesia's growth prospects.



The impact of the terrorist attack in Bali was relatively mild, with a fourth quarter decline in output that was only slightly steeper than the usual seasonal pattern. Tourism has clearly been affected (arrivals in Bali were down 30 percent in the fourth quarter from the previous year), but other indicators of consumer and business confidence have held up well.

There has been a sustained strengthening of private consumption in recent years. Consumption growth is largely related to nonfood expenditures including durables (motorcycle sales have recorded strong increases in recent years). Household spending has been supported by an expansion of consumer credit, which banks considered to be relatively less risky than the corporate sector. This process is likely to continue, as household indebtedness remains relatively low—the ratio of such credit to GDP remains below 8 percent, compared with above 13 percent before the crisis.

Investment remains weak. After a strong recovery in 2000 and 2001 (following a precipitous decline after the crisis), investment has remained flat. The share of investment in GDP remains at about 20 percent in 2002, from above 30 percent before the crisis (Text Figure). The investment outlook in the near term remains poor, with foreign investment approvals in 2002 registering a 35 percent drop from the previous year. In 2002, some high-profile foreign investors wound down their operations in Indonesia, citing concerns over the legal environment and labor framework.



Some progress has been made in reducing unemployment, but the overall pace of poverty reduction slowed in 2002. Open unemployment declined from above 6 percent in 1999 to 5½ percent in 2001 (based on a consistent methodology).¹ Underemployment experienced a similar decline, but remains very high at 28 percent in 2001. While formal wages have increased sharply in recent years, real wages in the informal sector remain depressed at below precrisis levels. In real terms, by mid-2002 formal sector wages were 35 percent higher than in 1996, while agricultural wages (a proxy for informal wages) remained 12 percent lower. As a result, improvements in poverty indicators have stalled. The core poverty headcount index, which had improved sharply through end-2000, recorded a small increase in early 2002.

¹ Official data report open unemployment of 8 percent in 2001, but this is based on an expanded definition of unemployment.

Box 2. External Vulnerability

Large current account surpluses and prudent macroeconomic policies have helped to reduce Indonesia's vulnerability to external shocks. By end-2002, external reserves had risen to \$32 billion, sufficient to cover seven months of imports and over 125 percent of short-term debt. External debt has also declined sharply, falling from a peak of 167 percent of GDP in 1998 to 75 percent in 2002, reflecting the return of output to its precrisis levels, as well as the recovery of the exchange rate. Nevertheless, Indonesia's external debt remains comparatively high, as does its debt-service burden, which is running at around 30 percent of exports of goods and services.

Provided the economic recovery continues, Indonesia's external vulnerability should continue to decline over the medium term. Under the staff's baseline scenario, the external debt-to-GDP ratio is projected to decline to around 47 percent by 2005 (Text Table). External reserves are also expected to remain at a comfortable level (6–7 months of imports), with an improvement in the coverage of short-term debt. A simulation of various macroeconomic shocks (through setting key parameters at their historical averages) still shows a declining trend in debt ratios over the medium term, although at a somewhat slower pace than under the baseline scenario.

	Projections									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	
Baseline debt-to-GDP ratio	75	60	53	47	42	38	36	34	33	
Higher interest rate 1/		62	55	49	44	40	38	36	35	
Lower real GDP growth 1/		62	58	52	46	43	40	39	38	
Lower USD GDP deflator 1/		95	88	82	76	72	70	68	67	
Weaker current account 1/		70	73	66	61	57	55	53	52	
Combined shock 2/		84	84	77	72	68	65	63	62	

1/ Shocks represent two standard deviations from 1992–2002 average (excluding 1997–98).
2/ The combined shock (all of the above) is based on one standard deviation.

The Indonesian government is relatively insulated from some of the external financing concerns that are prevalent in other emerging markets. Most of its debt is on concessional terms and only a negligible portion is short term. Government external debt-service payments are projected to average \$8 billion per annum (20 percent of government revenues) over the next five years, which is expected to be manageable provided that there is a continued fiscal consolidation effort and a deepening of the domestic bond market.

This relatively benign outlook is dependent on a number of important assumptions, most notably exchange rate stability and a policy framework geared toward promoting exports and investment:

- **Stability in the real exchange rate.** By way of example, if growth of the nominal GDP deflator were two standard deviations lower than its historical average (due to a sharp depreciation), debt ratios would increase by over 30 percentage points. For the private sector, an exchange rate shock would prolong its reliance on arrears accumulation, as it already faces a difficult debt-service burden.
- **Export growth.** The baseline scenario envisages export growth of around 5 percent per annum over the medium term (somewhat more conservative than Indonesia's past experience). Although such growth may not be realized in all products (the largest non-oil export sector, textiles, is for instance facing pressures from competitors), prospects for other key manufacturing sectors such as electrical appliances, machinery, and chemicals are promising; moreover, several major commodity exports (palm oil, rubber, copper) are expected to benefit from rising prices over the medium term.
- **Investment flows.** The tentative recovery seen in 2002 for some components of the capital account (equity FDI, bond issues) will need to continue in the coming years. In fact, the medium-term projections assume a gradual recovery of FDI and a restoration of the private sector's access to external loans and bond markets. Besides external factors, policy measures that improve the investment climate and strengthen the domestic financial sector will be critical for Indonesia's success in this endeavor.

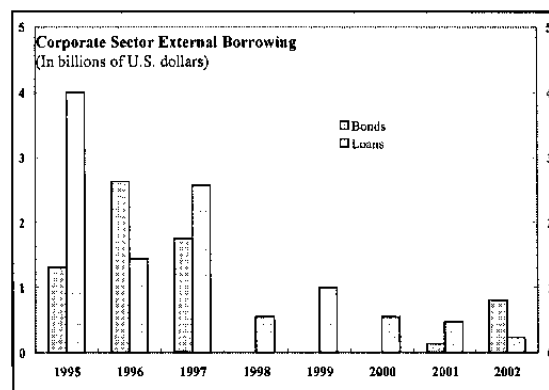
Box 3. Corporate Sector Developments

An assessment of corporate sector developments in Indonesia is impaired by data limitations.

As relatively few Indonesian companies are publicly owned (at end-2002, only 257 nonfinancial companies were listed on the Jakarta Stock Exchange), financial indicators are available for a relatively small share of the corporate sector, thus making it difficult to draw conclusions regarding the performance of the sector as a whole. In addition, a quantitative assessment of the corporate sector's financial condition is hindered by the fact that debt restructuring activity may not be fully captured by the official data on corporate debt.

Nevertheless, available indicators suggest that the financial health of the corporate sector has improved in recent years. The average debt-to-equity ratio (weighted by company equity) has fallen from roughly 6 at the end of 1998, to about 2 in early 2002.¹ This decline in corporate sector leverage has resulted in part from the implementation of restructuring agreements for Rp 54 trillion in IBRA-held debt, involving 156 companies. A further \$19.4 billion in external debt has been restructured through JITF mediation, involving 91 companies. IBRA's loan sales should provide an additional stimulus to financial restructuring, by bolstering the development of the secondary distressed-debt market and thereby promoting market-based debt restructuring. Nevertheless, firms remain vulnerable to exchange rate risk due to the sizeable remaining stock of foreign exchange-denominated debt.

Although corporate financial restructuring should continue to accelerate with further IBRA loan sales during 2003, a more sustainable recovery of the corporate sector may be constrained by firms' limited access to new financing. Foreign debt financing remains very low compared to precrisis levels (Text Figure). Indonesian issuers returned to the international bond market only in December 2001, when Bank Mandiri placed a \$125 million Eurobond, and only a handful of corporate borrowers were able to follow suit in 2002 (total issuance of \$800 million). Although access to external loan finance has become available to high-grade corporate borrowers, it remains severely limited (only \$200 million last year). FDI flows to Indonesia, estimated at \$2.4 billion in 2002, are still well below their pre-crisis peak of over \$9 billion in 1997/98.



Access to domestic financing also remains limited. Bank credit to the corporate sector increased by only 7 percent in 2002 and 8 percent in 2001 (in nominal terms), as banks remain reluctant to lend to heavily-indebted corporates. Although activity in the corporate bond market picked up sharply in 2002, with Rp 7.6 trillion in new issuance (compared with a cumulative total of Rp 11.1 trillion during 1998–2001), access remains limited to the top corporate names. However, market analysts expect activity in this market to continue to increase this year, as it has in other Asian crisis countries, as corporate health improves and yields on other investments (notably government and central bank debt) fall. Issuance of new equity has remained very low, due to both low investor interest and shareholders' reluctance to dilute corporate control.

¹ These data are for positive-equity companies continuously listed on the JSX between 1998 and 2002.

Table 1. Indonesia: Schedule of Reviews and Purchases

Date	Purchases		Conditions
	In Millions of SDR	In Percent of Quota	
Completed purchases			
February 4, 2000	260.00	12.5	Approval of extended arrangement
June 2, 2000	281.50	13.5	First review completed by the Board
September 10, 2000	309.65	14.9	Second review completed by the Board
September 10, 2001	309.65	14.9	Third review completed by the Board
January 28, 2002	275.24	13.2	Fourth review completed by the Board
April 26, 2002	275.24	13.2	Fifth review completed by the Board
June 21, 2002	275.24	13.2	Sixth review completed by the Board
December 5, 2002	275.24	13.2	Seventh review completed by the Board
Total	2,261.76	108.8	
Remaining purchases			
March 24, 2003	344.06	16.5	Eighth review and end-December 2002 performance criteria
May 15, 2003	344.06	16.5	Ninth review and end-March 2003 performance criteria
August 15, 2003	344.06	16.5	Tenth review and end-June 2003 performance criteria
November 15, 2003	344.06	16.5	Eleventh review and end-September 2003 performance criteria
Total	1,376.24	66.2	
Total	3,638.00	175.0	

Table 2. Indonesia: Selected Economic Indicators, 1996/97–2003 1/

	1996/97	1997/98	1998/99	1999	2000	2001	2002 Est.	2003 Proj.
Real GDP (percent change)	8.2	1.7	-13.6	0.8	4.9	3.4	3.7	3.5-4
Domestic demand	9.5	1.2	-17.2	-2.1	4.0	5.1	1.9	4.2
<i>Of which:</i>								
Private consumption	8.0	6.5	-5.5	4.6	1.6	4.4	4.7	4.1
Gross fixed investment	17.6	-0.1	-37.9	-18.2	16.7	7.7	-0.2	2.5
Net exports 2/	-1.5	0.5	4.0	2.9	1.0	-1.5	1.8	-0.5
Errors and omissions 2/	-0.5	-2.4	-1.5	-0.9	-1.1	-0.5	-2.4	0.0
Savings and investment (in percent of GDP)								
Gross fixed capital investment	29.8	29.2	22.7	20.1	21.8	21.8	20.2	20.0
Gross national savings	26.4	28.0	27.1	24.2	27.2	26.7	24.4	22.2
Foreign savings	3.4	1.1	-4.5	-4.1	-5.3	-4.9	-4.2	-2.2
Prices (12-month percent change)								
Consumer prices (end period)	4.7	35.8	46.5	2.0	9.3	12.5	10.0	9.0
Consumer prices (period average)	5.7	11.9	64.8	20.7	3.8	11.5	11.9	9.0
Public finances (in percent of GDP)								
Central government revenue 3/	14.9	15.4	14.9	16.8	20.0	20.8	18.6	17.9
Central government expenditure	13.8	16.7	17.2	18.3	21.1	24.5	20.3	19.7
Central government balance	1.1	-1.3	-2.3	-1.5	-1.1	-3.7	-1.6	-1.8
Central government debt	22.9	61.5	66.6	88.6	100.3	90.9	79.3	64.1
Money and credit (end of period)								
Rupiah M2	27.4	39.4	39.9	17.0	13.8	13.6	7.9	12.7
Base money	13.9	68.1	32.5	35.5	22.8	2.1	8.3	13.0
One-month SBI rate (period average)	12.1	15.0	48.2	22.7	12.4	16.5	14.9	12.3
Balance of payments (in billions of U.S. dollars)								
Oil and gas (net)	7.6	5.7	4.2	5.9	8.6	6.4	5.1	5.5
Non-oil exports (f.o.b)	39.3	45.9	41.1	41.0	50.3	44.8	45.3	48.1
Non-oil imports (c.i.f)	-45.7	-42.9	-30.7	-29.0	-37.1	-31.3	-29.8	-33.5
Current account balance	-8.1	-1.7	4.6	5.8	8.0	6.9	7.2	4.7
Overall balance	6.1	-13.4	0.9	0.0	1.2	-2.9	1.0	-3.0
Gross reserves								
In billions of U.S. dollars (end period) 4/	25.8	10.7	20.3	24.3	29.4	28.0	32.0	33.0
In months of imports	5.4	3.1	5.3	5.3	7.1	6.9	7.1	6.9
As a percent of short-term debt 5/	77.1	24.4	60.3	78.1	84.3	92.6	126.3	155.5
External debt (medium- and long-term)								
In billions of U.S. dollars	127.4	138.0	149.9	148.7	141.7	131.2	128.1	126.3
(In percent of GDP)	54.2	92.9	144.9	94.9	94.3	92.7	74.0	59.3
Exchange rate								
Rupiah per U.S. dollar (period average)	2,364	4,667	9,849	7,855	8,422	10,246	9,295	9,000
Nominal effective exchange rate 6/	99.3	71.6	28.0	33.7	32.3	28.0	30.6	29.8
Real effective exchange rate 6/	97.8	74.6	49.5	63.9	62.7	59.7	72.6	75.1
Memorandum items:								
Indonesia oil production (000 bcpd)	1,523	1,501	1,476	1,471	1,388	1,320	1,260	1,200
Indonesian oil price (US\$/bbl)	20.7	16.9	11.9	17.4	28.1	23.6	23.5	24.1
Nominal GDP in trillions of rupiah	556	693	1,019	1,100	1,265	1,449	1,610	1,916
Nominal GDP in billions of U.S. dollars	235	149	104	140	150	141	173	213

1/ Fiscal years from 1996/97 to 1998/99 (fiscal year starts April 1). Calendar years from 1999 onward, with the exception of public finances for 1999 and 2000 which are based on fiscal year 1999/00 and the 9-month fiscal year from April to December, respectively.

2/ Contribution to GDP growth. Errors and omissions includes stockbuilding.

3/ Includes grants.

4/ From 2002 onward reflects higher reserves reported in general ledger.

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

6/ Period average (June 1997=100).

Table 3. Indonesia: Balance of Payments, 2000–03
(In billions of U.S. dollars)

	2000	2001	2002		2003
	Actual	Actual	7th Review	Estimate	Projection
Current account	8.0	6.9	5.5	7.2	4.7
Trade balance	21.8	19.8	20.5	20.6	20.1
Exports (fob)	65.4	57.4	57.3	57.3	61.0
Oil and gas	15.1	12.6	12.2	12.1	12.9
Non-oil and gas	50.3	44.8	45.2	45.3	48.1
Imports (cif)	-43.6	-37.5	-36.8	-36.7	-40.9
Oil and gas	-6.5	-6.2	-6.4	-7.0	-7.4
Non-oil and gas	-37.1	-31.3	-30.5	-29.8	-33.5
Services (net)	-13.8	-12.9	-15.0	-13.4	-15.4
Nonfactor services (net)	-6.5	-7.1	-7.9	-7.3	-9.1
Factor services	-7.2	-5.8	-7.1	-6.1	-6.3
Capital account	-6.9	-9.8	-6.0	-6.2	-7.7
Nonfinancial public sector	-0.9	-2.7	-3.0	-3.7	-3.2
Disbursements	4.0	2.9	3.2	2.4	3.4
Amortization	-4.9	-5.6	-6.3	-6.1	-6.6
Banking sector (net)	-1.7	0.1	0.5	0.2	-0.5
Disbursements	1.3	2.0	1.6	1.4	1.0
Amortization	-3.0	-1.9	-1.1	-1.1	-1.4
Private sector (net)	-4.3	-7.2	-3.5	-2.8	-4.0
FDI	2.8	2.6	2.6	2.4	2.2
Other	-7.0	-9.8	-6.1	-5.1	-6.1
Portfolio investment	-1.9	-0.2	0.9	1.1	0.0
Other private sector (net)	-5.1	-9.5	-7.0	-6.2	-6.1
Overall balance	1.2	-2.9	-0.5	1.0	-3.0
Financing	-1.2	2.9	0.5	-1.0	3.0
NIR	-3.5	0.0	-3.0	-4.5	-0.5
Gross reserves	-5.0	1.4	-2.1	-3.5	-1.0
Reserve liabilities	1.5	-1.4	-0.9	-0.9	0.5
Public sector rescheduling 1/	2.4	2.9	3.5	3.5	3.5
Memorandum items:					
Gross reserves (e.o.p.) 2/	29.4	28.0	30.1	32.0	33.0
In months of imports of goods and nonfactor services	7.1	6.9	6.8	7.1	6.9
As a ratio to short-term debt	0.84	0.93	1.01	1.27	1.56
Non-oil and gas exports, volume growth (percent)	17.6	-7.9	-1.3	-1.2	1.0
Non-oil and gas imports, volume growth (percent)	28.9	-13.1	-4.3	-6.5	7.8
Terms of trade, percent change	10.0	-1.4	0.2	0.2	0.6
Current account (in percent of GDP)	5.3	4.7	3.0	4.2	2.2
Stock of public sector external debt (excluding state-owned banks)	80.0	74.1	73.6	76.3	76.0
(In percent of GDP)	53.2	52.4	40.1	44.0	35.7
Nonfinancial public sector debt service/XGNFS 3/	12.4	17.6	19.6	18.6	16.7
Indonesian oil price	28.1	23.6	23.5	23.5	24.1
GDP (in billions of U.S. dollars)	150	141	184	173	213

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

1/ For 2003, debt relief of \$3.1 billion has already been committed. Full interest rescheduling would provide an extra \$0.4 billion of financing.

2/ Projections from 2002 onward reflect higher reserves reported in BI's general ledger.

3/ Before rescheduling and including IMF repurchases.

Table 4. Indonesia: Monetary Survey, December 2000–December 2003
(In trillions of rupiah, unless otherwise indicated) 1/

	2000	2001	2002		2003				
	Dec.	Dec.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	
		Actual	Actual	Program	Actual	Projected			
(End-of-period)									
Monetary Survey									
Net foreign assets	119.0	141.9	164.2	163.0	178.8	186.7	189.4	192.1	194.9
(In billions of U.S. dollars)	17.0	20.3	23.5	23.3	25.5	26.7	27.1	27.4	27.8
Net domestic assets	590.1	651.6	663.5	734.1	674.6	686.8	710.2	734.0	766.3
Net claims on government	526.5	539.3	536.4	569.7	515.2	519.3	521.7	511.8	507.4
Claims on private sector	263.4	294.8	343.3	377.4	369.0	373.8	391.9	419.8	454.9
Rupiah claims	178.4	224.2	272.6	306.7	295.7	301.2	317.8	344.3	377.9
Foreign exchange claims	85.0	70.7	70.7	70.7	73.3	72.6	74.1	75.5	77.0
Other items (net)	-199.9	-182.6	-216.2	-213.1	-209.6	-206.4	-203.4	-197.6	-196.0
Broad money (M2)	709.1	793.5	827.7	897.0	853.4	873.4	899.6	926.1	961.2
Rupiah broad money	606.8	689.3	716.6	779.3	743.4	760.2	783.1	806.2	837.8
Currency	72.4	76.3	72.8	85.2	80.7	78.1	81.1	83.7	94.2
Deposits 2/	534.5	612.9	643.8	694.0	662.8	682.1	702.0	722.5	743.6
Foreign exchange deposits	102.3	104.2	111.2	117.8	110.0	113.2	116.5	119.9	123.4
Bank of Indonesia									
Net international reserves 3/	124.5	128.1	145.1	138.3	155.1	155.3	155.4	155.5	155.6
Net domestic assets	0.4	-0.5	-21.3	3.9	-16.8	-24.5	-19.4	-15.6	0.6
Net claims on government	136.1	166.8	176.2	197.3	172.0	189.0	198.1	195.9	193.1
Claims on private sector	7.7	7.8	8.3	7.8	8.3	8.3	8.3	8.3	8.3
Claims on DMBs	-44.6	-69.6	-83.3	-65.2	-80.9	-105.6	-109.6	-103.6	-84.6
Open market operations	-78.0	-102.6	-115.9	-98.2	-113.3	-138.1	-142.1	-136.0	-117.0
Other items (net)	-98.7	-105.5	-122.4	-135.9	-116.3	-116.3	-116.3	-116.3	-116.3
Base money 4/	125.0	127.7	123.9	142.2	138.2	130.7	136.0	139.9	156.2
Currency outside banks	72.4	76.3	72.8	85.2	80.7	78.1	81.1	83.7	94.2
DMBs	50.7	49.6	49.6	53.9	55.9	51.0	53.2	54.5	60.4
Nonbank deposits	2.0	1.7	1.5	3.0	1.6	1.6	1.6	1.6	1.6
Memorandum items:									
Base Money test date 5/	118.1	124.7	120.8	138.2	132.2	129.3	134.5	138.1	150.4
NIR of BI (billions USD)	17.8	18.3	20.7	19.8	22.2	22.2	22.2	22.2	22.2
Money multiplier (rupiah broad money)	4.9	5.4	5.8	5.5	5.4	5.8	5.8	5.8	5.4
Base money velocity 6/	10.8	11.4	13.2	12.2	11.7	14.3	14.0	14.0	12.5
Rupiah broad money velocity 6/	2.2	2.1	2.3	2.2	2.2	2.4	2.4	2.4	2.3
Annual percentage change:									
Broad money (constant exchange rate)	10.0	11.9	11.2	13.1	7.6	10.5	10.9	11.9	12.6
Rupiah broad money	13.8	13.6	11.4	13.1	7.9	11.6	11.9	12.5	12.7
Base money	22.8	2.1	7.6	11.4	8.3	11.8	13.4	12.9	13.0
Private sector claims 7/	5.2	17.9	20.2	28.0	23.6	24.5	22.6	22.3	23.3

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

1/ All foreign currency denominated components are valued at the program exchange rate.

2/ Includes nonbank private sector deposits held at BI (Rp 1.6 trillion at December 2002).

3/ From December 2002 (actual) based on general ledger.

4/ Data on base money differ from those presented in Table 2 of the MEFP, which are based on period averages rather than end point values.

5/ Test date outcome based on 10-day average centered at end-month for 2000; 30-day average centered at end-month from 2001.

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

7/ Adjusted for transfers to and from IBRA. Projections make allowance for credit growth associated with IBRA bond-for-loan swaps, IBRA loan and asset sales, and privatization.

Table 5. Indonesia: Summary of Central Government Operations, 2001–03

	2001	2002			2003	
		Budget	7th Review	Actual	Budget	Proj.
(In trillions of rupiah)						
Revenues and grants	301.1	301.9	300.6	300.2	336.2	344.0
Oil and gas revenues	104.1	74.2	84.3	77.2	71.0	81.1
Non-oil and gas revenues	196.5	227.7	216.3	223.0	265.2	262.9
Tax revenues	162.4	203.9	189.9	193.7	239.4	237.1
Nontax revenues 1/	34.5	23.7	26.4	29.2	25.8	25.8
Expenditure and net lending	354.4	344.0	342.7	326.5	370.6	378.4
Central government expenditure	273.3	246.0	244.9	228.0	253.7	260.0
Current expenditure	226.1	197.1	205.0	192.7	195.8	202.1
Personnel	38.7	41.8	42.2	39.8	50.2	50.2
Subsidies	77.4	41.6	43.8	40.0	25.5	32.8
Interest	94.9	88.5	91.5	89.9	82.0	81.2
External	28.9	29.0	27.7	25.4	26.8	26.0
Domestic	66.0	59.5	63.8	64.5	55.2	55.2
Other	15.0	25.2	27.5	23.1	38.1	37.9
Development expenditure 2/	41.6	48.9	39.9	36.9	57.9	57.9
Statistical discrepancy	5.6	0.0	0.0	-1.6	0.0	0.0
Transfers to regions	81.1	98.0	97.8	98.5	116.9	118.4
Overall balance	-53.3	-42.1	-42.1	-26.3	-34.4	-34.4
Financing	53.3	42.1	42.1	26.3	34.4	34.4
Domestic	46.5	26.0	31.6	24.0	22.5	22.5
Bank financing 3/	7.2	0.0	0.0	-21.8	-11.5	-11.6
Cash recovery of bank assets 4/	28.0	43.6	43.6	43.3	26.0	26.0
Privatization of nonfinancial assets	3.5	6.5	6.5	7.6	8.0	8.0
Other	7.8	-24.1	-18.5	-5.1	0.0	0.0
External	6.8	16.1	10.5	2.4	12.0	12.0
(In percent of GDP)						
Revenues and grants	20.8	17.9	17.5	18.6	17.3	17.9
Oil and gas revenues	7.2	4.4	4.9	4.8	3.7	4.2
Non-oil and gas revenues	13.6	13.5	12.6	13.8	13.7	13.7
Tax revenues	11.2	12.1	11.1	12.0	12.3	12.4
Nontax revenues 1/	2.3	1.4	1.5	1.8	1.3	1.3
Expenditure and net lending	24.5	20.4	20.0	20.3	19.1	19.7
Central government expenditure	18.9	14.6	14.3	14.2	13.1	13.6
Current expenditure	15.6	11.7	11.9	12.0	10.1	10.5
Personnel	2.7	2.5	2.5	2.5	2.6	2.6
Subsidies	5.3	2.5	2.6	2.5	1.3	1.7
Interest	6.6	5.3	5.3	5.6	4.2	4.2
External	2.0	1.7	1.6	1.6	1.4	1.4
Domestic	4.6	3.5	3.7	4.0	2.8	2.9
Other	1.0	1.5	1.6	1.4	2.0	2.0
Development expenditure 2/	2.9	2.9	2.3	2.3	3.0	3.0
Statistical discrepancy	0.4	0.0	0.0	-0.1	0.0	0.0
Transfers to regions	5.6	5.8	5.7	6.1	6.0	6.2
Overall balance	-3.7	-2.5	-2.5	-1.6	-1.8	-1.8
Financing	3.7	2.5	2.5	1.6	1.8	1.8
Domestic	3.2	1.5	1.8	1.5	1.2	1.2
Bank financing 3/	0.5	0.0	0.0	-1.4	-0.6	-0.6
Cash recovery of bank assets 4/	1.9	2.6	2.5	2.7	1.3	1.4
Privatization of nonfinancial assets	0.2	0.4	0.4	0.5	0.4	0.4
Other	0.5	-1.4	-1.1	-0.3	0.0	0.0
External	0.5	1.0	0.6	0.1	0.6	0.6
Memorandum items:						
Primary balance	2.9	2.8	2.9	3.9	2.5	2.4
Non-oil primary balance	-4.3	-1.7	-2.0	-0.9	-1.2	-1.8
Non-oil overall balance	-10.9	-6.9	-7.4	-6.4	-5.4	-6.0
GDP (in trillions of rupiah)	1,449	1,685	1,716	1,610	1,940	1,916

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

1/ Includes Rp 0.5 trillion in grants in 2001, and Rp 0.3 trillion in grants in 2002.

2/ Excludes military expenditures, which are included in other current expenditure.

3/ In 2003, includes Rp 7.7 trillion for issuance of government debt, Rp 21.5 trillion in domestic debt amortization, and Rp 15 trillion in debt buy-backs.

4/ For 2002 and 2003, includes total IBRA receipts (rather than only the amount needed to finance the deficit).

Table 6. Indonesia: Structural Benchmarks for the Eighth Review

Measures	Status ¹
<p>November 2002</p> <ul style="list-style-type: none"> • Initiate legal and other enforcement actions against former bank owners issued final determination of noncompliance in relation to the shareholder settlement agreements. • Launch sale of a majority stake in Bank Danamon. 	<p style="text-align: center;">✓</p> <p style="text-align: center;">Completed in early December.</p>
<p>December 2002</p> <ul style="list-style-type: none"> • Implement burden sharing agreement on BLBI between BI and government.² • Complete third round of special audits of state enterprises and adopt corrective actions. • Collect at least Rp 36.1 trillion in cash by IBRA (net of expenses). • Establish Anti-Corruption Commission. • Begin primary auctions of government securities. • Produce quarterly report on local government finances through June 2002 with coverage of at least 85 percent of jurisdictions. 	<p style="text-align: center;">Pending.</p> <p style="text-align: center;">Expected in July.</p> <p style="text-align: center;">✓</p> <p style="text-align: center;">✓</p> <p style="text-align: center;">✓</p> <p style="text-align: center;">Report prepared covering 65 percent of regions; actions underway to increase coverage to 85 percent by end-April.</p>

¹ A ✓ indicates that the structural benchmark was met on time.

² Performance criterion.

Table 7. Indonesia: Indicators of External Vulnerability, 1996/97–2003

	1996/97	1997/98	1998/99	1999	2000	2001	2002	2003
Key economic and market indicators								
Real GDP growth (in percent)	8.2	1.7	-13.6	0.8	4.9	3.4	3.7	3.5
CPI inflation (period average, in percent)	5.7	11.9	64.8	20.7	3.8	11.5	11.9	9.0
Short-term (ST) interest rate (in percent)	12.1	15	48.2	22.7	12.4	16.5	14.9	12.3
EMBI plus secondary market spread (bps, end of period)	114	508	839	458	677	479	347	...
Exchange rate NC/US\$ (end of period)	2,419	8,325	8,685	7,085	9,595	10,400	8,950	9,200
External sector								
Current account balance (percent of GDP)	-3.4	-1.1	4.5	4.1	5.3	4.9	4.2	2.2
Net FDI inflows (percent of GDP)	3.7	6.3	5.5	2.4	1.8	1.8	1.4	1.0
Export growth (US\$ value, GNFS)	9.7	6.8	-15.4	1.8	26.5	-10.9	-0.5	4.8
Real effective exchange rate (1995 = 100)	106.6	81.3	53.9	69.7	68.3	65.1	79.1	81.9
Gross international reserves (GIR) (in billions of U.S. dollars)	25.8	10.7	20.3	24.3	29.4	28.0	32.0	32.6
GIR in percent of short-term debt at remaining maturity	84.1	30.3	66.4	73.8	84.3	92.6	126.3	153.7
Net international reserves (NIR) (in billions of U.S. dollars)	26.7	13.3	15.9	16.0	17.8	18.3	22.2	22.2
Total gross external debt in percent of GDP	60.3	99.4	156.9	113.2	99.6	97.5	75.1	60.3
Of which: Short-term debt (original maturity in percent of GDP)	6.1	6.5	12.1	6.9	5.3	4.7	1.2	0.9
Private sector debt (in percent of GDP)	22.9	46.1	66.7	43.0	43.5	42.3	32.0	25.7
Total gross external debt in percent of exports of GNFS	243.2	237.1	308.0	285.0	212.7	220.2	208.8	196.6
Public sector 1/								
Overall balance (percent of GDP)	0.8	-1.6	-2.2	-1.5	-1.1	-3.7	-1.6	-1.8
Primary balance (percent of GDP)	2.0	0.0	0.9	2.4	4.0	2.9	3.9	2.4
Debt-stabilizing primary balance (percent of GDP) 2/	...	...	...	...	2.3	2.5	2.3	...
Public sector gross debt (in percent of GDP) 3/	24.5	66.1	70.1	92.1	104.1	94.2	81.5	65.5
External debt from official creditors (in percent of total)	65.3	63.4	49.3	34.0	44.4	43.8	41.7	45.3
External debt from private creditors (in percent of total)	28.2	29.6	22.6	13.3	0.6	0.5	0.1	0.0
Domestic debt linked to foreign currency (in percent of total)	0.0	0.0	0.0	2.8	2.6	2.9	2.0	1.0
Domestic debt linked to ST interest rate or inflation (in percent of total)	0.0	0.0	0.0	19.8	16.7	16.1	18.1	18.1
Public sector net debt (in percent of GDP)	...	...	...	...	...	...	...	...
Financial sector								
Capital adequacy ratio (in percent) 4/ 5/ 6/	11.8	9.2	-52.2	-8.1	21.7	18.5	23.4	...
NPLs in percent of total loans 4/ 6/	...	11.3	50.9	32.9	15.0	12.1	8.7	...
Provisions in percent of NPLs 4/ 6/	36.4	34.4	34.5	87.0	95.0	96.4	113.1	...
Return on average assets (in percent) 4/ 6/	...	...	...	-8.7	0.3	0.7	1.7	...
FX deposits (in percent of total deposits)	22.2	31.5	25.9	19.2	20.8	20.2	18.2	...
FX deposits (in percent of gross international reserves)	82.0	123.7	72.9	65.6	30.8	52.5	49.0	...
FX loans (in percent of total loans)	20.0	39.8	36.9	37.6	39.8	32.6	28.9	...
Financing requirements								
Gross external financing requirement (GEFR) (in billions of U.S. dollars)	25.3	40.4	29.7	22.7	14.8	18.9	9.5	12.8
Of which: Amortization of MLT debt, public (in percent of total GEFR) 7/	40.8	20.1	42.4	43.8	53.3	49.6	101.2	73.2
Amortization of MLT debt, private (in percent of total GEFR) 8/	-29.4	51.7	31.2	38.7	47.5	51.5	54.2	47.9
Maturing ST debt (in percent of total GEFR)	56.8	24.0	42.0	42.9	53.5	35.5	21.1	15.6
Current account balance (in percent of total GEFR)	31.8	4.2	-15.5	-25.4	-54.4	-36.6	-76.5	-36.7
Gross public sector financing requirements (GPSFR) (in billions of U.S. dollars) 9/	4.3	6.3	5.3	4.9	5.2	11.8	9.8	12.4
Of which: Amortization of MLT debt (in percent of total GPSFR) 10/	143.9	62.4	56.6	55.2	17.3	30.1	47.7	38.9
Maturing ST debt (in percent of total GPSFR)	...	...	...	...	3.2	1.4	1.7	1.3
Overall public sector deficit (in percent of total GPSFR)	-43.9	37.6	43.4	44.8	24.7	43.9	29.0	30.8

1/ Nonfinancial public sector (including state-owned enterprises). For 1999 and 2000, data are for FY 1999/00 and FY 2000, respectively.

2/ Based on GDP growth of 2.4 percent (annual average for 1995/96-2002) and a real interest rate of 5 percent.

3/ Medium- and long-term debt. Excludes IMF outstanding purchases.

4/ From 1999 onward, top 15 banks only (which account for over 80 percent of total deposits).

5/ Data for 1995/96, 1996/97 and 1997/98 are for December 1995, December 1996 and December 1997, respectively.

6/ 2002 column refers to end-September.

7/ Includes banking sector amortizations and IMF repurchases.

8/ Due to data deficiencies, this item represents net MLT capital flows to the corporate sector (which were positive prior to 1997/98) and net portfolio investment flows.

9/ Includes ST debt (all external).

10/ Based on fiscal data for external MLT amortization (net of rescheduling), domestic debt amortization, and IMF repurchases.

Table 8. Indonesia: External Sustainability Framework, 1997–2010

	Actual						Projections								
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	
I. Baseline Medium-Term Projections															
External debt/Exports of goods and services	229	282	285	213	220	209	197	175	158	144	134	127	124	122	
External debt/GDP	68	167	112	100	98	75	60	53	47	42	38	36	34	33	
II. Sensitivity Analysis for External Debt-to-GDP Ratio															
1. If interest rate, real GDP growth rate, U.S. dollar GDP deflator growth, non-interest current account, and nondebt flows (in percent of GDP) are at average of past 10 years							64	51	45	40	35	31	28	25	
2. If interest rate in 2003 and 2004 is average plus two standard deviations, others at baseline							62	55	49	44	40	38	36	35	
3. If real GDP growth rate in 2003 and 2004 is average minus two standard deviations, others at baseline							62	58	52	46	43	40	39	38	
4. If U.S. dollar GDP deflator in 2003 is average minus two standard deviations, others at baseline							95	88	82	76	72	70	68	67	
5. If non-interest current account (in percent of GDP) in 2003 and 2004 is average minus two s.d.s, others at baseline							70	73	66	61	57	55	53	52	
6. Combination of 2–5 using one standard deviation shocks							84	84	77	72	68	65	63	62	
7. One time 30 percent depreciation in year 2003 (-30% GDP deflator shock), others at baseline							105	97	91	85	81	78	77	76	
Memorandum items: Key macro and external assumptions															
Nominal GDP (rupiah trillion)	628	956	1,110	1,265	1,449	1,610	1,916	2,156	2,414	2,686	2,990	3,328	3,704	4,122	
Nominal GDP (U.S. dollar billions)	216	95	141	150	141	173	213	226	241	259	277	297	319	341	
Real GDP growth (in percent per year)	4.5	-13.1	0.8	4.9	3.4	3.7	3.5	4.0	5.0	5.0	5.0	5.0	5.0	5.0	
Nominal GDP deflator (in U.S. dollars, change in percent per year)	-9.1	-49.1	46.8	2.8	-8.9	18.2	18.8	2.0	1.8	2.2	2.1	2.0	2.1	2.0	
External interest rate (percent per year)	6.0	6.0	4.4	4.4	4.7	3.9	4.0	5.6	6.0	6.0	6.3	6.6	6.7	6.9	
Growth of exports of goods and services (U.S. dollar terms, in percent per year)	15.1	-11.7	-1.8	26.5	-10.9	-0.5	4.8	5.1	4.9	4.7	5.4	5.4	5.4	5.5	
Growth of imports of goods and services (U.S. dollar terms, in percent per year)	7.6	-21.9	-19.8	29.5	-9.3	-1.8	10.8	5.5	7.0	7.0	7.4	7.2	7.6	7.2	
Historical values for macroeconomic variables 1/															
							(Excluding 1997–98)		(Including 1997–98)						
Current account deficit, excluding interest payments (percent of GDP, average of past 10 years)							-4.7		-5.2						
Current account deficit, excluding interest payments (percent of GDP, standard deviation of past 10 years)							4.7		5.2						
Net nondebt creating capital inflows (percent of GDP, average of past 10 years)							1.8		1.3						
Interest rate (average of past 10 years)							4.9		5.1						
Interest rate (standard deviation of past 10 years)							0.7		0.8						
Real GDP growth rate (average of past 10 years)							5.5		3.5						
Real GDP growth rate (standard deviation of past 10 years)							2.7		6.3						
GDP deflator, U.S. dollar terms (average of past 10 years)							9.8		2.0						
GDP deflator, U.S. dollar terms (standard deviation of past 10 years)							16.6		23.9						

1/ Historical values are based on the ten year (1992–2002) average excluding 1997–98, as those two years represented extreme outliers. The averages including 1997–98 are presented for information.

Table 9. Indonesia: Medium-Term Fiscal Projection, 2001–05

	2001	2002	2003	2004	2005
	(In percent of GDP)				
Fiscal accounts					
Primary balance	2.9	4.0	2.5	2.9	3.2
Interest 1/	6.5	5.6	4.2	3.9	3.7
Overall balance	-3.7	-1.6	-1.8	-1.0	-0.5
Financing					
Gross requirements	8.3	5.4	6.2	4.7	7.0
Deficit	3.7	1.6	1.8	1.0	0.5
Amortization	4.6	3.8	4.4	3.7	6.5
External	3.3	3.1	2.5	2.3	2.2
Domestic 2/	1.2	0.7	1.9	1.4	4.3
Sources	8.3	5.4	6.2	4.7	7.0
External disbursements	3.8	3.2	3.2	1.6	1.4
Privatization and asset recoveries	2.1	3.2	1.8	0.6	0.4
Other domestic financing 3/	2.4	-1.0	1.3	2.5	5.2
Public debt					
Total	90.9	79.8	64.7	60.4	54.9
External 4/	41.8	34.6	30.3	28.3	25.0
Domestic 5/	49.1	45.2	34.4	32.1	29.9
Memorandum items:					
Other domestic financing (in trillions of rupiah)	34.0	-15.5	24.9	54.3	125.1
Deficit financing	3.7	1.6	1.8	1.0	0.5
Net domestic financing	3.2	1.5	1.2	1.8	1.3
Net external financing	0.5	0.1	0.6	-0.7	-0.8
Key assumptions					
Real GDP growth (annual rate)	3.4	3.7	3.5	4.0	5.0
Domestic interest rate (short-term real)	4.5	2.6	4.0	4.2	4.5

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

1/ Includes interest assumed on a new BLBI-related note, estimated at Rp 2 trillion (0.1 percent of GDP) in 2004, and Rp 5.2 trillion (0.2 percent of GDP) in 2005.

2/ Excludes amortization on the stock of hedge bonds and BI indexed bonds, which are to be rolled over. In 2003, includes debt buy back of Rp 15 trillion; and IBRA debt redemption of Rp 8 trillion.

3/ Includes domestic debt issuance.

4/ Includes short-term debt.

5/ In 2003 includes Rp 66.7 trillion for debt write-off related to BLBI resolution.

Table 10. IBRA Asset Recovery and Official Targets, 2002–03
(In trillions of rupiah)

	2002		2003				Total
	Annual Actual	Target	Q1	Q2	Q3 Target 1/	Q4	
Total <i>cash</i> receipts (net of expenses)	38.1	36.1	3.4	7.5	13.2	1.9	26.0
+ AMC (loans and non-core assets)	26.8	24.5	3.0	3.2	9.3	0.1	15.6
<i>of which loan sales</i>	21.7	15.5	...	...	...	...	...
+ AMI (industrial and other assets)	5.0	9.7	0.4	1.3	2.9	1.9	6.4
+ BRU (bank equity)	6.7	4.3	0.0	3.0	1.0	0.0	4.0
+ Other Income 2/	0.7	...	...	...	...	...	...
- Total expenses	1.1	2.4	...	...	...	...	...
Total <i>bond</i> receipts 3/	7.5	7.5	...	...	...	...	...

Source: Finance and Accounting (IBRA).

1/ Net of investment income and operational expenses. May also include receipts in the form of bonds, for which no separate target has been set for 2003.

2/ Comprises investment income.

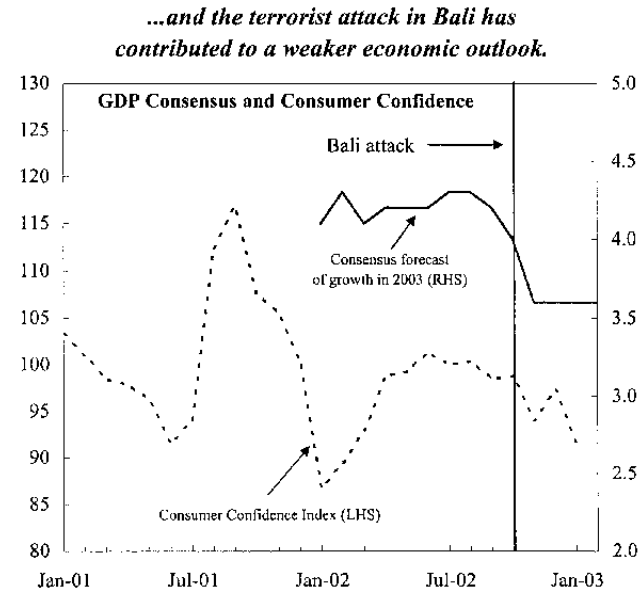
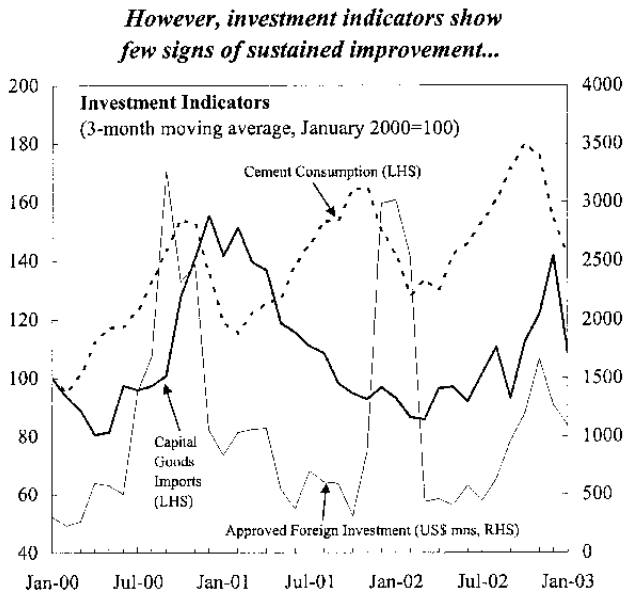
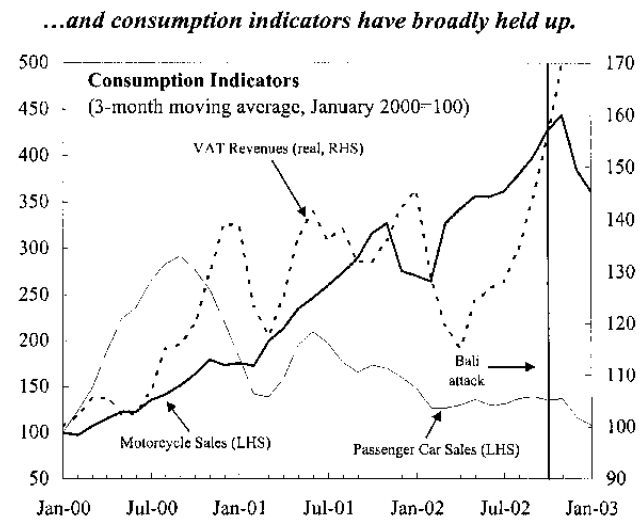
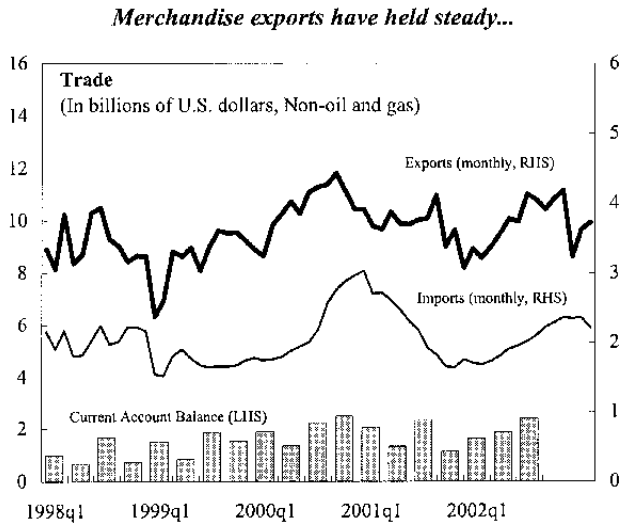
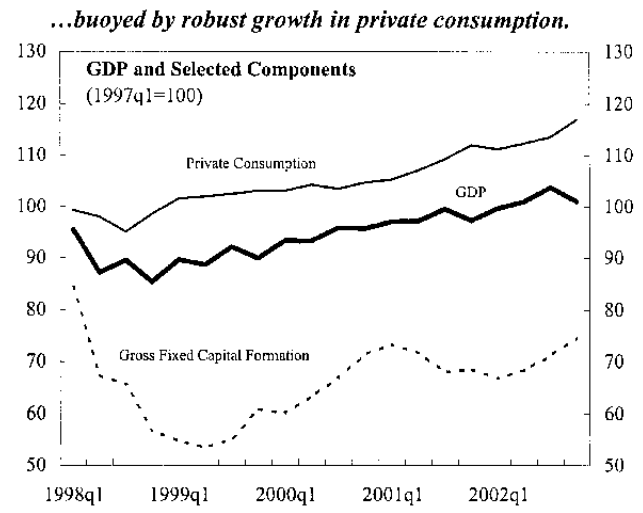
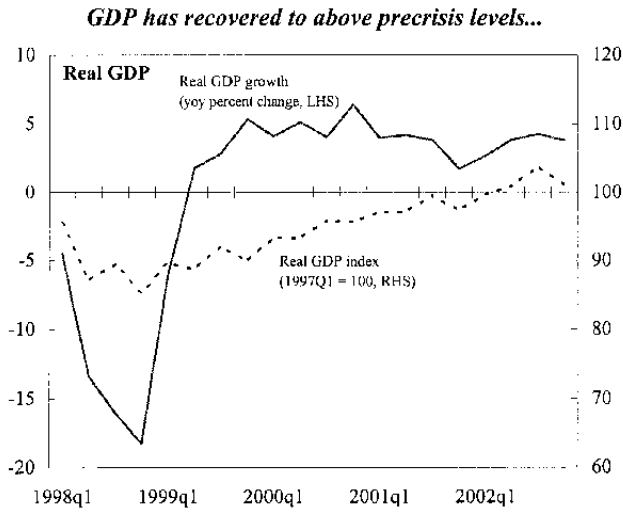
3/ Received as payment in loan sales.

Table 11. Indonesia: Indicators of Debt Service to the Fund, 2001–10
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Debt service to the Fund										
Charges	0.48	0.27	0.26	0.26	0.23	0.20	0.17	0.12	0.08	0.06
Repurchases	1.75	2.34	1.30	0.91	1.04	1.20	1.43	1.66	0.96	0.75
In percent of exports of goods and nonfactor services	3.6	4.2	2.4	1.7	1.8	1.9	2.0	2.1	1.2	0.9
In percent of total nonfinancial public sector debt service	20.3	22.5	14.4	11.4	11.5	11.9	14.5	15.5	9.8	7.6
In percent of reserves of Bank Indonesia 1/	8.0	8.1	4.8	3.5	3.6	3.8	4.0	4.1	2.2	1.5
Outstanding Fund credit										
In percent of GDP	6.5	4.9	4.6	3.9	3.2	2.5	1.8	1.1	0.7	0.4
In percent of nonfinancial public debt	12.4	11.0	12.1	11.4	10.5	9.3	7.5	5.1	3.6	2.4
In percent of reserves of Bank Indonesia 1/	32.9	26.3	27.9	25.0	20.6	16.5	11.7	7.0	4.3	2.4
In percent of quota	348.8	313.5	332.6	300.0	262.7	219.6	168.3	73.4	37.8	19.3
Total nonfinancial public sector debt service										
In percent of exports of goods and nonfactor services	17.6	18.6	16.7	14.8	15.3	15.6	13.8	13.8	12.1	11.4
In percent of GDP	7.8	6.7	5.4	4.7	4.8	4.8	4.2	4.1	3.5	3.3

1/ End of period reserves.

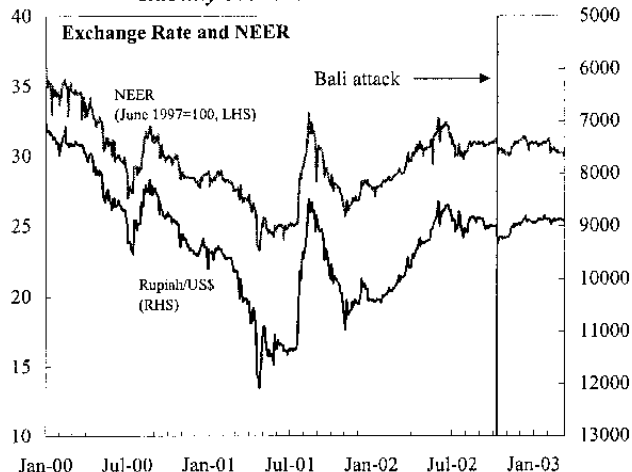
Figure 1. Recent Macroeconomic Developments



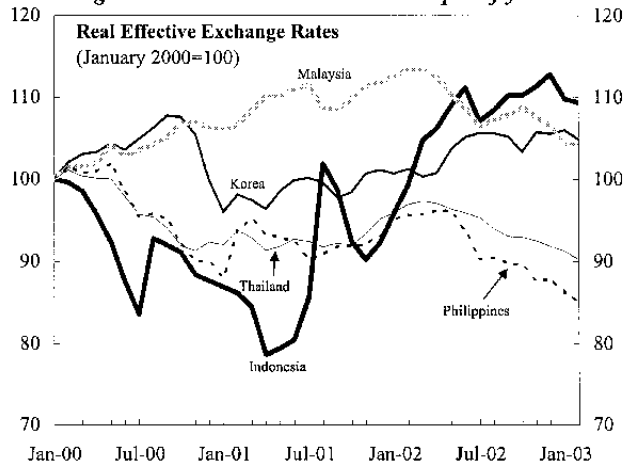
Sources: Data provided by the Indonesian authorities; CEIC; Danareksa Research Institute; and Fund staff estimates.

Figure 2. Market Sentiment and Financial Indicators

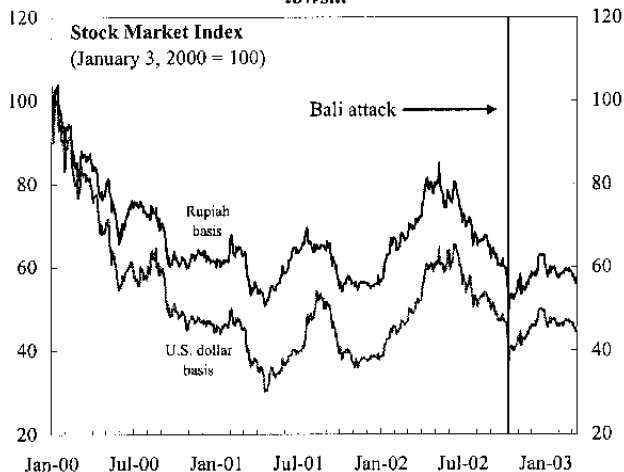
The rupiah has exhibited considerable stability over the last six months...



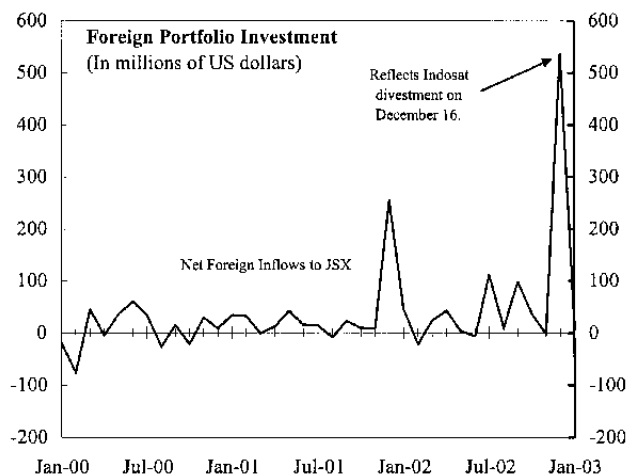
...and has appreciated significantly relative to other regional currencies over the last couple of years.



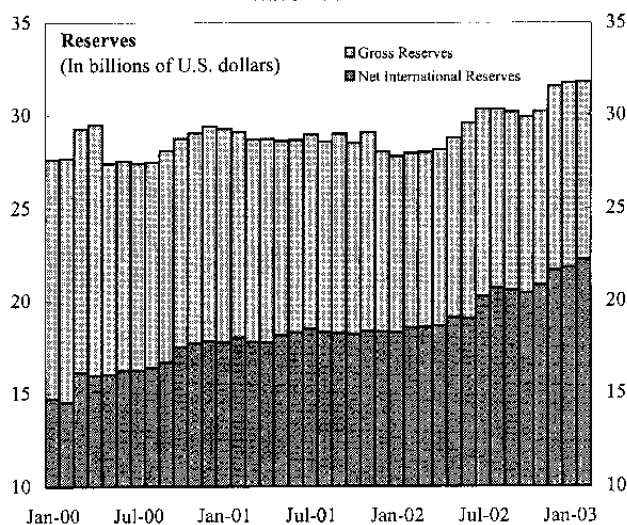
The stock market is recovering from its post-Bali attack lows...



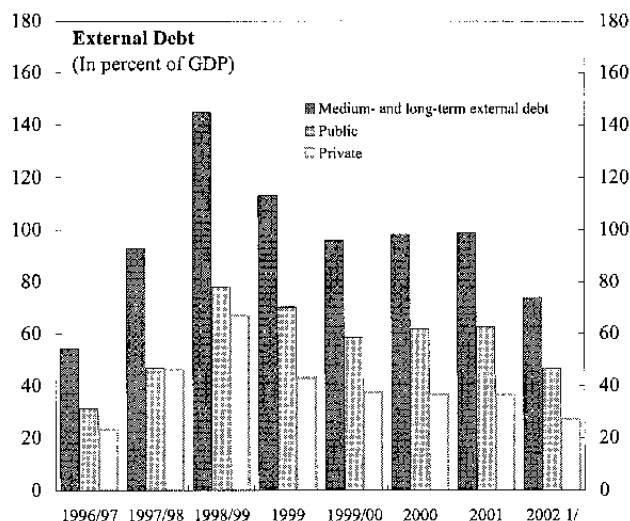
...and net foreign inflows have remained positive.



External vulnerability has been reduced as reserves have risen...



...and external debt has been reduced.

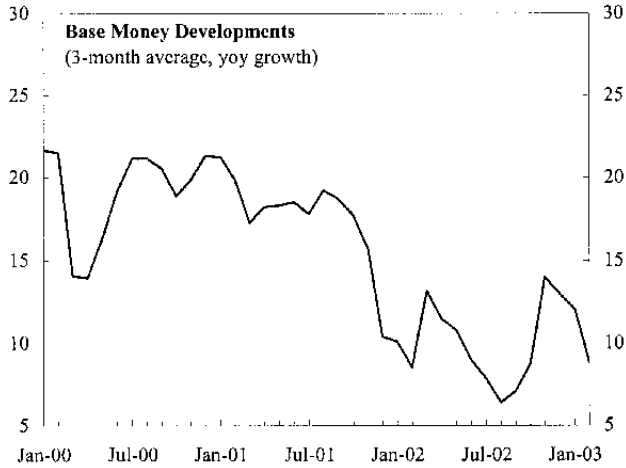


Sources: Data provided by the Indonesian authorities; and Fund staff estimates.

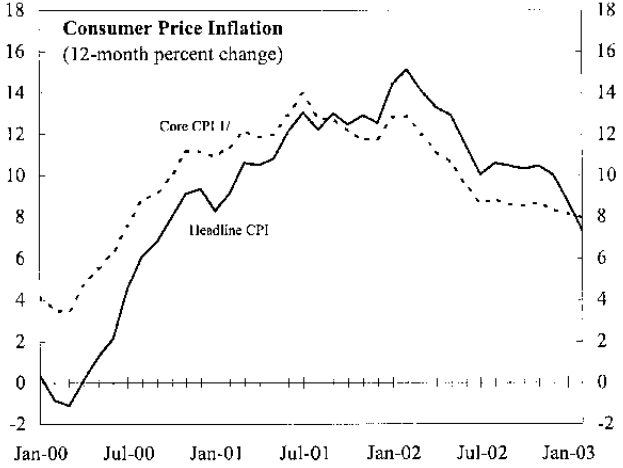
1/ As of November 2002.

Figure 3. Monetary and Inflation Developments

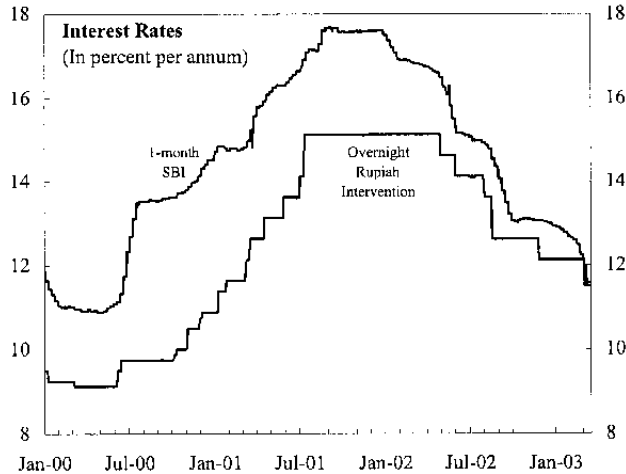
Base money growth has picked up moderately.



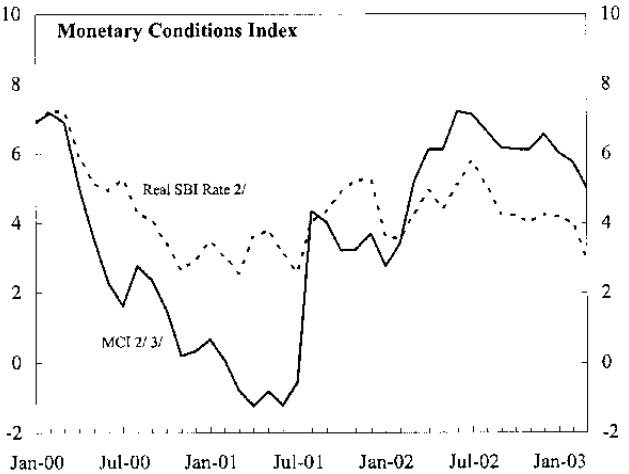
Inflation has continued to fall...



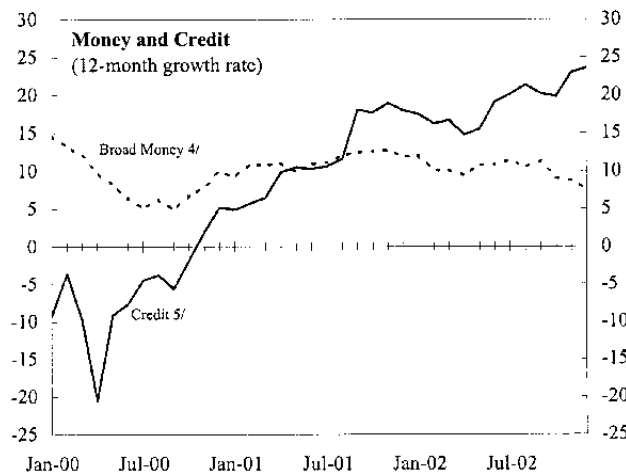
...which has enabled policy rates to be lowered.



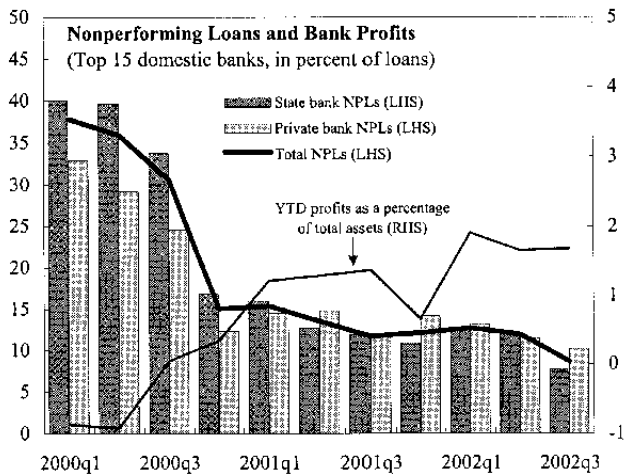
However, monetary conditions remain relatively tight.



Broad money growth has been sluggish, even though credit growth has accelerated...



...while bank financial indicators have improved.



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

1/ Nonfood, excluding administered prices.

2/ Using core inflation.

3/ Using ratio of 5:1 on real SBI and REER.

4/ At constant exchange rate.

5/ Data adjusted to account for loan transfers to and from IBRA.

INDONESIA: FUND RELATIONS
As of February 28, 2003

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

II. General Resources Account	<u>SDR Millions</u>	<u>Percent of Quota</u>
Quota	2,079.30	100.00
Fund holdings of currency	8,207.3	394.71
Reserve position in Fund	145.50	7.00

III. SDR Department	<u>SDR Millions</u>	<u>Percent of Allocation</u>
Net cumulative allocation	238.96	100.00
Holdings	5.96	2.49

IV. Outstanding Purchases and Loans	<u>SDR Millions</u>	<u>Percent of Quota</u>
Stand-by arrangements	275.18	13.23
Extended arrangements	5,998.31	288.48

V. Financial Arrangements			<u>Amount</u>	<u>Amount Drawn</u>
<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Approved</u>	<u>(SDR Millions)</u>
			<u>(SDR Millions)</u>	
EFF	Feb. 04, 2000	Dec. 31, 2003	3,638.00	2,261.76
EFF	Aug. 25, 1998	Feb. 04, 2000	5,383.10	3,797.70
Stand-by	Nov. 05, 1997	Aug. 25, 1998	8,338.24	3,669.12

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

	<u>Forthcoming</u>				
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Principal	734.7	678.1	774.8	1,015.6	1,245.0
Charges/Interest	<u>111.2</u>	<u>133.2</u>	<u>115.7</u>	<u>95.8</u>	<u>69.3</u>
Total	845.9	811.3	890.5	1,111.5	1,314.3

VII. Exchange Arrangements

The rupiah has floated since August 14, 1997. The market exchange rate was Rp 8,881 per U.S. dollar on February 28, 2003. 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. A multiple currency practice arising from the foreign exchange subsidy for food imports was abolished on December 31, 1998.

VIII. Article IV Consultation

Indonesia is on the standard 12-month consultation cycle. The last Article IV consultation report (EBS/02/65) was discussed by the Executive Board on April 26, 2002.

IX. Safeguards Assessments

Under the Fund's safeguards assessment policy, Bank Indonesia (BI) is subject to the transitional procedures with respect to the EFF arrangement, approved on February 4, 2000 and scheduled to expire on December 31, 2003. The transitional procedures require a review of only BI's external audit mechanism. This assessment determines whether BI publishes annual financial statements that are independently audited in accordance with internationally accepted standards. The assessment of BI's external audit mechanism completed on March 15, 2002, revealed significant weaknesses and recommended remedial actions to address identified vulnerabilities. The recommendation concerning BI's publication of audited financial statements has been implemented. A mid-year audit of BI's foreign exchange reserves (conducted by the independent accounting firm of PricewaterhouseCoopers) was completed in late October. The report indicated that international reserves data reported to the Fund had been underestimated at June 30, 2002, due to timing issues and other compilation discrepancies. The audit also found control weaknesses in BI's foreign reserves operations. The staff is continuing to discuss follow-up recommendations with the authorities.

INDONESIA: WORLD BANK—IMF RELATIONS¹

The World Bank has a wide-ranging policy dialogue in Indonesia, covering traditional areas such as poverty reduction, fiscal and structural reforms, and extending to new areas such as corruption, justice reform, postconflict assistance, and social empowerment. This Annex focuses on topics that are pertinent to the Fund's activities in Indonesia.

World Bank Policy Dialogue

Poverty alleviation and PRSP. After declining markedly since the crisis, poverty increased between 2001 and 2002 mainly as a result of a hike in rice price. Rice remains a very important determining factor for poverty. Adopting a strategy for future rice policy, including price and trade policy and productivity enhancing measures for farmers, is a trigger to achieve the high case lending in the Bank's current Country Assistance Strategy (CAS). Such a rice policy strategy should avoid increases in rice tariffs and expansion in public marketing policies. Moreover, building human assets is essential in breaking the vicious cycle of poverty. An enabling environment that deals with corruption, conflict resolution, and access to justice is also required for poverty alleviation. The government has recently completed a draft interim poverty reduction strategy which lays out a roadmap for developing a national poverty reduction strategy paper (PRSP) by 2004. The Bank will continue to actively support this process, through analytical work aimed to help the government formulate policy options for poverty reduction.

Fiscal issues. While the Fund is in the lead in developing fiscal policy and overall fiscal targets, as well as on taxation issues, the Bank takes the lead in policy dialogue on: the development budget and sectoral allocation, fiscal decentralization, and civil service reform. The Bank also plays a significant role in capacity building for long-term debt management and public expenditure management.

Development budget and sectoral allocations. The postcrisis deficit reduction entailed cuts in operation and maintenance and development spending, especially in infrastructure where roads have deteriorated and the threat of power shortage is looming. These sectoral spendings are now largely responsibilities assigned to subnational entities; their implementation depends on putting in place adequate mechanisms to foster decentralization in each sector and redefining a new role for the center.

Decentralization. The 2001 *Big Bang* decentralization was successfully implemented with smooth transfer of civil service to the regions, adequate safeguards on aggregate local budgets, and improved perception of service delivery. However, the regions have inherited a social service delivery system suffering from years of under-investment and lack of clarity in tasks and responsibilities. The decentralization process is far from finalized as the government continues to struggle with the issue of devolution of responsibilities, regional imbalance, and revenue sharing. The ongoing debate on regional

¹ Prepared by World Bank staff.

autonomy needs to clarify the functions of regional governments and the center, provide a stronger intergovernmental fiscal framework, and reinforce accountability at the local level. The Bank is closely monitoring the decentralization process through analytical work and is advising government on coherent implementation of decentralization laws 22 and 25. The Bank is also supporting the regions through its projects, such as governance at the kabupaten level and health services at the provincial level.

Civil service reform. Indonesia's civil service size is at par with countries of similar per capita income. But there is an ongoing debate about whether civil service pay is appropriate, and whether it is linked to corruption in the public sector. The political will to embark on a major reform of the civil service has been lacking. The Bank is facilitating a process by which the central government develops and adopts an appropriate civil service model for a decentralized Indonesia, which is then implemented at the subnational level. The legal and institutional basis for greater flexibility to reforming regional governments will need to be put in place. In the medium term, a civil service reform agenda would need to comprise core elements such as a review of the administrative structures at the central and subnational levels based on the new role of the state.

Long-term debt management capacity building. Despite the progress achieved, the public debt remains high at 85 percent of GDP and requires careful management of both its level and vulnerability to shocks. Along with AusAID, the Bank is providing technical assistance and advice on building debt management capacity, including setting up an integrated debt management unit to establish a debt strategy and manage risk, implement an integrated debt reporting and risk management system that assesses vulnerability, risk, and cost in a sovereign liabilities portfolio, improve the "front, back, and middle-office" functions for public debt management, and monitor fiscal risks associated with the government's contingent liabilities and incorporate them into debt management policy decisions. A new law on Government Securities was passed in September 2002, allowing the government to issue bonds and reprofile the existing bonds to smooth associated debt service payments. The Center for Government Bond Management within the Ministry of Finance has subsequently been established with the mandate to manage the country's domestic debt, and eventually the entire public debt.

Public expenditure management. New legislation for budget formulation, treasury management, and auditing to increase transparency and accountability in budget preparation and execution was submitted to Parliament a year ago. In their current form, these draft laws are not adequate to meet the triggers on public financial management for the Bank's high case lending. The Bank is providing advice on how to revise the three draft laws and how to improve government financial management—including strengthening linkages between planning and budgeting, and improving reporting to Parliament and financial accountability. The draft law on budget formulation is being revised and will be re-submitted to Parliament.

Financial Sector. Collaboration between the Fund and the Bank in the financial sector has been intense, given the extent of financial sector problems in Indonesia resulting from the crisis and its importance in the IMF program and the Bank's CAS.

Division of labor between the Fund and the Bank. Early in the crisis, the Bank agreed with the IMF and AsDB to a division of labor wherein the Bank assumed primary or lead responsibility for the oversight of IBRA and three of the four state-owned banks; the IMF assumed oversight responsibility for the central bank and Bank Mandiri; and the AsDB for the pension, insurance, SME, capital market sectors, and more recently for the support of the introduction of the Financial Supervisory Authority (FSA) legislation. Bank staff have participated in many joint missions with the IMF, providing regular inputs to the authorities and frequent written contributions to the IMF Letter of Intent drafting process. Overall, the five-year old division of labor has remained in place.

Current situation in the financial sector. The banking sector is now in considerably better condition than it was at end-1997 as deposits, interest margins, earnings, and capital have all markedly increased, while the number of banks has decreased to 141 from 238. However, the four government-owned banks, comprising 45 percent of the sector, remain subject to the weak shareholder oversight and governance controls. Moreover, these banks remain vulnerable to external shocks, increased competition from foreign banks, or, in the case of the two largest state-owned banks, defaults from large domestic borrowers. In 2002, IBRA finally began in earnest to sell down its large NPLs and bank holdings: more than \$10 billion equivalent (nominal value) of NPLs were sold, as were majority stakes in two nationalized banks.

World Bank financial sector program. Overall, the Bank's financial sector assistance program will continue to aim at helping government improve the overall investment climate whilst supporting the authorities' efforts to ensure that the poor and vulnerable share in the benefits of economic recovery and renewed growth. In particular, three remaining tasks are foreseen as Indonesia moves beyond the financial crisis.

First, the Bank will continue its *policy dialogue with IBRA*, aiming to largely and transparently dissolve the agency by early 2004 through sale of the agency's remaining NPLs, bank and enterprise equity holdings, and resolution of the 39 shareholder settlement agreements. As a significant portion of IBRA's assets may be unsold at the end of its mandate, the ownership, transfer, and management of the unsold asset stock remains a serious concern. To outline these issues and further a dialogue, a summary of possible disposition alternatives was recently provided to the authorities during the recent Bank-IMF mission. Regarding shareholder settlements, to minimize the effects of moral hazard, it is incumbent upon government to promptly exercise all available legal and administrative remedies toward recalcitrant former bank shareholders; vigorous prosecutions would serve as a deterrent to those prepared to honor their shareholder settlement agreements.

Second, regarding the *three state-owned banks* overseen by the Bank, the Bank is of the view that so long as these banks remain in the government's control, neither corporate

governance nor capital will be substantively improved. The best means of improving governance is to divest these banks, though state-owned asset sales of all types have proven to be amongst the most contentious public policy issues for successive governments. The Bank thus envisages supporting MoSOE in the near term through putting forward capacity and transparency strengthening measures to mitigate banking risks, and in the longer term through providing analytical work to enable government to reap the benefits of state banks divestment.

Third, following on from the paper on “Financial Sector Strategy: Issues and Options” delivered to government in September 2001, the Bank intends to continue to encourage government’s development of a comprehensive, *medium-term Financial Sector Strategy* which includes, *inter alia*: (i) development of a micro-finance institutional framework to increase access to finance for the poor; (ii) continuing public and private banks’ consolidation; (iii) sequenced establishment of a Financial Supervisory Authority; (iv) transition to a deposit insurance protection scheme; and (v) further capacity building for public debt management within government. A follow-up Bank paper, reflecting recent progress on the above components and providing further suggestions on the development of a financial sector strategy, will be prepared prior to end-April.

Private Sector. Both the Bank and the Fund have been heavily involved in voluntary debt workout through the Jakarta Initiative Task Force (JITF), with the Bank taking the lead. Working closely with the Fund, the Bank played a key role in the creation and fine tuning of the JITF mechanism and provided most of the financing for JITF through its Corporate Restructuring Technical Assistance Project, two Bank-executed technical assistance grants, and policy conditionality in two adjustment loans (PRSL I and II). Since JITF corporate restructuring was redesigned in 1999, corporate debt resolution accelerated and JITF targets have been consistently met. Restructurings through the JITF to date amount to more than \$17 billion, accounting for almost one-third of Indonesia’s nonperforming corporate loans. Incentive measures to maintain the momentum of corporate debt restructuring until JITF’s closure in end-2003 were discussed recently between the government, the Bank, and the Fund.

Moreover, the Bank continues to support other reforms for the corporate sector, notably in the areas of corporate governance, competition policy, promotion of foreign direct investment, SME development policy, and legal and judicial reforms. The Bank is placing increasing emphasis on improving the investment climate, at the national and local level, particularly in simplifying regulations and levies, improving access to finance for investment and working capital, reducing corruption and improving local public sector governance, and developing business management skills and service for SMEs.

Trade. The trade agenda is becoming highly topical in Indonesia and the region. While Indonesia has a very open trade regime, it has recently issued some trade restrictions on the import of textiles, sugar, and steel. A recent increase in the rice tariff has been modest, but further increases are likely to be damaging for the poor. At the same time, agricultural exports, a potential growth market for Indonesia, are hampered by developed country trade restrictions and subsidies, but also by the lack of capacity of Indonesia to

meet standards in health and quality. Moreover, infrastructure bottlenecks, ports and customs handling, and corruption are hampering better export performance. In addition, manufacturing industries, and textiles in particular, are suffering from increased competition notably from China. The Bank is collaborating with the Ministry of Trade and Industry on trade policy, trade performance, and export competitiveness.

Corruption, justice and legal reforms. The Bank and the Fund have been active in providing support to the legal and justice sector. The authorities realize that progress in this area is important, particularly as the investment climate continues to suffer from widespread recognition of judicial corruption and weaknesses in the legal framework. The Fund is providing technical assistance to the Supreme Court and, together with the Bank, is assisting in the reform of the commercial courts. For the Bank, justice sector reforms are an important part of a broader program of governance reforms. The Bank's strategy in this area has three components: (i) leading the CGI members' dialogue on justice sector reforms at the national level through support to the Governance Partnership's efforts at enhancing dialogue within the justice sector and to the work of the National Law Commission which is now finalizing its recommendations for a long-term reform agenda for the sector; (ii) contributing to effective aid coordination; and (iii) supporting civil society reform efforts, both through the Partnership and through the Bank's own project mechanisms, such as the Justice for the Poor program.

While the government has initiated a number of anticorruption measures, including passage of an anticorruption law, the establishment of the office of the Ombudsman, and the creation of a commission to audit the wealth of state officials, these efforts have been undermined by weak enforcement. The Bank has been working with the Governance Partnership in undertaking corruption diagnostic work (including an anticorruption survey) that led to a number of civil society initiatives to fight corruption and raised public awareness of the underlying policy issues. The Bank's planned operations in subnational regions to improve governance have a strong anticorruption focus. Finally, the Bank is working with the government to reform key budgetary processes relating to procurement and financial management. Progress in these areas are triggers for Indonesia accessing the high case lending in the current CAS.

World Bank-Fund Overall Collaboration

Bank-Fund collaboration in Indonesia takes place at two levels: (i) through the lending program and conditionalities; and (ii) through analytical and advisory services.

Lending programs and macroeconomic issues. The Fund has taken the lead in assisting the government in maintaining macroeconomic stability and fiscal sustainability. There is a close link between the Fund program and the CAS triggers for the high case lending of the Bank. On the one hand, structural measures in the current Fund program are closely coordinated with the Bank, especially relating to IBRA, privatization, bank and corporate restructuring, and other financial sector reforms. On the other hand, compliance with appropriate policies and targets in the LOI, including macroeconomic stability, is one of

the Bank's triggers in the current CAS to reach the high case lending. Coordination between the two institutions has thus been crucial.

Analytical and advisory activities. Over the CAS period, the Bank's analytical and advisory services have shifted from crisis response to longer-term development concerns, including work on governance, decentralization, financial sector development, and long-term development prospects. At the same time, the Bank continues its assistance in the development and implementation of the government's broad-based poverty strategy.

Main World Bank's Nonlending Services
(Recently completed or ongoing)

Issue	Instrument
Poverty alleviation	Poverty report (2001); PRSP (ongoing)
Development spending and sector issues	Health Strategy in a Post-Decentralizing Indonesia (2000); Education Sector Review; Infrastructure Strategy for Decentralized Indonesia; Public Expenditure Review
Long-term debt management	ASEM trust fund on Building Debt Management Capacity
Public expenditure management	Public Expenditure Review; Advice on three laws (CAS trigger); Country Financial Accountability Assessment (2001); and Country Procurement Assessment Review (2001)
Decentralization	Regional Public Expenditure Reviews
Civil service reform	ASEM trust fund on Civil Service Reform in Decentralized Indonesia
Financial sector	Advice on IBRA and three state banks; Financial Sector Strategy
Corporate sector	Special Miyazawa technical assistance grants; Corporate Restructuring Technical Assistance project; Policy dialogue; Investment Climate Survey and Assessment
Trade	ASEM trust fund on Trade Performance and Competitiveness; Trade Diagnostics Study
Corruption, justice, and legal reforms	Support for Governance Partnership; Justice for the Poor program; Advice on procurement (CAS trigger)

Note: Services without a date are ongoing and will be completed in 2003.

Lending Operations

The main goal of the World Bank in Indonesia is to support efforts in reducing poverty and vulnerability in an open and decentralized environment. FY01 and FY02 achieved base case lending expectations averaging \$400 million a year, and a similar trend is expected for FY03. But project implementation is slowing down due to changes arising from decentralization and, in particular, the lack of on-lending guidelines. Corruption continues to limit the effectiveness of development expenditures in Indonesia. The Bank is working with government to address corruption in Bank-financed projects and has outlined a strategy to help ensure that Bank funds are used for intended purposes. The Bank's projects over the past three years fell into five categories: community development, infrastructure, human development, decentralization/governance reform, and environment.

COORDINATING MINISTER OF ECONOMIC AFFAIRS
REPUBLIC OF INDONESIA

Jakarta, Indonesia
March 18, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Köhler:

We have continued to make progress in implementing our economic program, with increasing signs that our efforts are laying the basis for a durable recovery. Over the past year, the rupiah has strengthened, interest rates have fallen along with inflation, and our balance of payments position has improved with a further build-up in international reserves. Notwithstanding the tragic events in Bali last October, economic growth has been sustained. These positive developments were facilitated by a cautious monetary policy and continued fiscal consolidation, as well as further advances in structural reforms.

Our program for 2003 aims to strengthen growth and employment prospects by enhancing competitiveness and fostering a more attractive investment climate. As described in the attached Memorandum of Economic Policies (MEFP), our strategy rests on the continuation of prudent fiscal and monetary policies, with an emphasis on sound debt management in support of fiscal sustainability, and the vigorous implementation of the structural reform agenda.

With respect to the monitoring of the 2002 program, we are pleased to report that all end-December quantitative performance criteria were met, and that good progress was made against the structural benchmarks for November and December. We request a waiver for the nonobservance of the end-December structural performance criterion concerning financial issues related to the BLBI, whose implementation awaits completion of ongoing parliamentary consultations. In view of our performance under the program, we request completion of the eighth review under the Extended Arrangement.

We will continue to consult with the Fund on economic policies during the remaining period of the arrangement. The next review of the program is to be completed by June 2003, at which time we will reassess the 2003 program in light of developments in the first quarter, in particular budget prospects and tax and spending policies, and will identify additional structural benchmarks for the second half of 2003, as needed, to ensure that the objectives of the program are achieved.

Sincerely yours,

/sd/

Dorodjatun Kuntjoro-Jakti
Coordinating Minister for
Economic Affairs

/sd/

Boediono
Minister of Finance

/sd/

Syahril Sabirin
Governor
Bank Indonesia

March 18, 2003

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

Government of Indonesia and Bank Indonesia

1. We have made significant progress over the past year in implementing our economic program. Despite the setback from the tragic events in Bali last October, the economic recovery continues and macroeconomic stability has been maintained. Economic growth in 2002 was positive for the fourth consecutive year, and real GDP has now recovered to its pre-crisis level. At the same time, the balance of payments has strengthened, with a further build-up in international reserves.
2. These positive developments were facilitated through sound macroeconomic management and further advances in structural reforms. The fiscal deficit outturn was well within the government's 2002 budget target, contributing to a reduction in public debt. Important strides were also made in improving tax administration and debt management. Bank Indonesia's (BI's) prudent monetary policy stance led to a decline in inflation which, together with the rupiah's stability, allowed interest rates to decline in support of the recovery. In the financial sector, bank divestment gained momentum with the sale of two banks taken over during the crisis and the launching of the sale of a third. IBRA asset recoveries and privatization receipts exceeded expectations. In the legal sphere, the Anti-Corruption Commission (ACC) was established.
3. This Memorandum of Economic and Financial Policies (MEFP) lays out our economic strategy for 2003, the final year of the Extended Fund Facility (EFF) launched in January 2000. While much has been achieved under the EFF, strengthening growth and employment prospects by enhancing business competitiveness and fostering a more attractive investment climate remains a key challenge. Our strategy for 2003 rests on the vigorous implementation of the reform agenda, with special emphasis on increasing non-oil exports and investment, sound debt management in support of fiscal sustainability, and the rehabilitation and development of vital infrastructure. Against this background, our program for 2003 is framed around the following objectives:
 - consolidation of recent gains on the macroeconomic front through the continued implementation of prudent fiscal and monetary policies;
 - enhancement of financial system stability by further strengthening the banking system, state bank governance, and the regulatory framework; and
 - improvement of the investment climate through legal and other structural reforms.
4. In addition to the policies outlined in this memorandum, we will continue our efforts in other areas, including rice policies, state-owned enterprise reform, natural resource management, civil service reform, and poverty reduction.

I. MACROECONOMIC FRAMEWORK AND POLICIES

5. The basic macroeconomic objectives for 2003 are as reflected in the assumptions for the budget approved by Parliament in November 2002. The framework targets GDP growth of 4 percent, and aims to reduce inflation to 9 percent by year-end (Table 1).

Monetary Policy

6. Monetary policy will be geared toward maintaining a downward trend in inflation and preserving broad exchange rate stability. Consistent with this, and the need to support the economic recovery, BI has designed a monetary program around a target range for base money growth of 13–14 percent for end-2003. We will review the monetary stance throughout the year to ensure that monetary policy remains consistent with the program's inflation objective.

Fiscal Policy

7. The government is firmly committed to further fiscal consolidation to reduce public debt to more manageable levels, while maintaining spending on infrastructure and boosting the provision of key social services. In 2003, we are targeting a budget deficit of 1.8 percent of GDP, as approved by Parliament in November. We are aiming for a significant increase in non-oil tax revenues and higher outlays on priority social and development programs. In January, we also adopted a package of tax measures to further stimulate economic activity, that comprised a reduction in luxury taxes on consumer goods, interim relief from the VAT for businesses, and an elimination of income taxes for minimum wage workers.

8. The strategy to mobilize non-oil tax revenues centers on a continuation of tax administration reforms initiated in 2002. In this connection, the initial operations of the Large Tax Payer Offices (LTOs), now under way since last September, have been promising. We will expand operations of the LTO in Jakarta to more taxpayers while we evaluate an expansion to other regions at a future date. The new electronic payment system will be extended nationwide in 2003. In addition, we plan to expand the coverage of corporate tax audits, intensify the collection of arrears, enhance control of nonfiling taxpayers, and take steps to increase the taxpayer population. The governance framework of Directorate General of Taxation (DGT) will also be strengthened and extended to all tax offices nationwide in 2003. The action plan for 2003 is shown in Annex A; a medium-term reform plan is also under preparation. We have also initiated a comprehensive strategy to reform customs administration, focusing on strengthening governance, facilitating trade, and combating smuggling and tax evasion. Detailed plans for the 2003 reform agenda will be ready for implementation by June.

9. Our aim remains to further reduce fuel subsidies, which are not well-suited to helping the poor, and to shift our assistance to more targeted schemes. The approved budget for 2003 had planned for the elimination of fuel subsidies with the exception of those on kerosene consumed by households. However, in view of the spike in international oil prices resulting from the prevailing abnormal world market conditions, the government has decided to

smooth the adjustment of domestic fuel prices and temporarily restore some subsidies until market conditions stabilize. Our deficit target for 2003, as well as spending in priority areas, will not be affected. At the same time, we have expanded programs to improve the welfare of low-income groups, and are examining ways to improve their targeting on the poor.

10. To enhance the efficient use of public funds, the government intends to take a number of steps to strengthen expenditure management. The initial focus will be on strengthening the treasury and budget functions of the Ministry of Finance. A blueprint for this reform, along with the timetable for its implementation, is expected to be finalized in April. Once the blueprint is in place, the government intends to establish dedicated task forces by July to review the reform of the government's payment and receipts system, consolidation of bank accounts, and the restructuring of budget preparation procedures.

Financing and Debt Management

11. With regard to financing of the budget, we expect domestic sources, consisting of receipts from IBRA asset sales and privatization, to provide 1.4 percent of GDP. This leaves a net external financing need of 0.4 percent of GDP to be met by commitments from official creditors received at the recent meeting of the CGI, from Paris Club rescheduling, and by other official loans.

12. Our public debt management strategy aims to lower the budget's debt service costs, and to minimize refinancing risk by improving the maturity profile of our debt. The Government Debt Securities Law has been enacted, and an interdealer market has been established to provide transparent price discovery for market players. We are strengthening the regulatory framework and developing the market infrastructure needed to enhance the liquidity of the secondary market for government securities. We have also issued decrees setting out the procedures for issuing government securities, enabling auctions to begin on a regular basis. Moreover, the structure of our debt has been significantly improved by the reprofiling of government recapitalization bonds held by state banks, and the debt stock has been reduced by using asset recoveries to redeem bonds. We intend to take further steps to reduce the burden of the public debt through exchange offers and debt buybacks. The agreement between the government and BI concerning financial issues related to the BLBI has been presented to Parliament. We will work closely with Parliament to ensure its timely implementation, which will reduce the public debt burden while preserving the financial soundness of the central bank.

Decentralization

13. While significant progress has been made, further work is needed to strengthen the fiscal, legal, and administrative framework for decentralization. A priority will be to strengthen the procedures governing the issuance of regional regulations that have the potential to conflict with the national interest. To this end, we intend to continue our efforts to enforce existing reporting requirements and ensure compliance with government directives canceling problematic regulations.

14. The development of an effective regional budget reporting system also remains a priority. While some progress toward this objective was made in 2002, with the finalization of the regions' 2001 accounts, further efforts will be necessary in the coming year to establish a comprehensive quarterly reporting system. The strategic aim remains to produce regular quarterly budget reports within six months of the end of each quarter. To ensure timely data submission, sanctions such as postponement of transfers will be imposed on regions that fail to comply with the reporting requirements. We have prepared a preliminary report on the regional budget outturn for the first half of 2002, and aim to complete a report with coverage of at least 85 percent of the regions by end-April; we also aim to produce the full year report by June 2003. During the first half of the year, the government will issue generally accepted government accounting standards to ensure uniform reporting standards across regions. Existing regulations on local government financial management will be modified in line with these standards. New government accounting systems are being developed to support the implementation of the forthcoming standards, and will be introduced on a gradual basis over the course of the year.

15. A ministerial decree has been issued extending the existing moratorium on local government borrowing (except through the center) until end-2003. This is needed to provide additional time for the reporting system to become fully operational. In the meantime, we are working to strengthen the borrowing framework for regional governments. We are also putting in place a framework to enable regions to borrow from external sources through the central government.

Fiscal Transparency and Public Sector Governance

16. Improving fiscal transparency and public sector governance remain priorities in 2003. We will continue our efforts at budget consolidation. All remaining funds not previously consolidated will be brought under the control of the central government by June 2003. The State Audit Agency (BPKP) will continue its routine audits of government agencies with a view to identifying any additional nonconsolidated funds. The main findings of the audit of the Reforestation Fund completed last year have been submitted to Parliament, and corrective action plans adopted. The primary actions are to integrate its bank accounts into the Treasury and bring their use under the control of the Ministry of Finance. The first progress report on the implementation of the corrective action plans will be published by September 2003. In addition, the main findings of the audits of the two investment funds (RDI and RDA) completed last year have been submitted to Parliament. Necessary corrective action plans will be developed by the government in consultation with Parliament.

17. The performance of the public sector is also being strengthened through the ongoing program of performance audits of state enterprises: (i) corrective actions identified under the second round-audits are being carried out (for Garuda, Pelindo II, Jasa Marga, Telkom, PT PN-IV), and a progress report on their implementation has just been published; (ii) the third-round audits (for PT Dirgantara, PT Kereta Api, PT Taspen, Semen Gresik, and PT Pusri) are underway, and are expected to be completed by July, with corrective actions beginning in August; and (iii) a fourth round of audits, covering state enterprises in the banking,

transportation, tourism, and basic industry sectors, will be launched by June 2003, for completion in early 2004.

18. The legal framework for public sector financial management is in the process of being updated. The recently approved law on state finances, which covers all state funds in all state institutions, and the draft laws on state treasury and state audit, aim to improve accountability and transparency in government financial management. We have asked Parliament to prioritize the finalization of these laws. On our part, we are in the process of revising the drafts in light of comments received from Parliament, and intend to strengthen the drafts further to bring the legislation into line with international best practice. Specifically, we would like to ensure that the draft state audit law, which complements Law 5/1973, does not undermine the constitutional authority of the Supreme Audit Agency (BPK).

19. The government will also take steps to strengthen the framework for auditing military and other foundations receiving state funds or financing state activities. The government is preparing amendments to the Foundations Law, to be presented to Parliament in its next session, to clarify the legal basis for the BPK to undertake such audits.

Balance of Payments and External Policies

20. The external current account recorded another sizeable surplus in 2002, estimated at \$7.2 billion (4.2 percent of GDP), facilitating a further build-up in international reserves. The surplus, however, is expected to narrow in 2003, as imports rebound and tourism receipts recover only gradually in the aftermath of the Bali incident. The capital account is also expected to remain in deficit. Even still, gross international reserves are targeted to rise by \$0.6 billion, sufficient to maintain import coverage at current levels and to increase the coverage of short-term debt.

21. The government remains committed to a liberal and open trade regime, and will continue to honor its WTO and AFTA commitments. We will maintain our dialogue with concerned IFIs on a regular basis to review our overall trade strategy.

II. STRUCTURAL REFORMS

Financial Sector

22. A core objective of our economic strategy in 2003 is to further advance the process of bank restructuring and to restore a strong, private sector-led banking system essential for establishing efficient credit flows and reviving investment. Accordingly, the 2003 program includes further significant progress in the bank divestment program, and improving the governance of state banks.

Bank Divestment and Restructuring

23. With regard to IBRA bank divestment, the sale of Bank Danamon has been launched, and is expected to be completed by April. We also plan to launch the sale of Bank Lippo in

the second quarter, with a view to completing its sale by end-September. The government remains committed to selling the remaining IBRA banks by the time IBRA winds down in early 2004.

24. Our efforts to strengthen state bank governance center on steps to improve oversight and accountability. First, we are strengthening the capacity of the Ministry of State-Owned Enterprises to monitor state bank performance, and additional staffing resources are being provided to the Ministry for this purpose. Second, additional independent, qualified commissioners will be appointed, with a view to ensuring that each state bank has four to five commissioners by mid-year. Third, new annual performance contracts will be prepared by April, which will contain benchmarks developed from their annual business plans. And finally, the external audit mechanism of state banks will be strengthened in the first half of the year, through the development of follow-on external audit corrective action plans.

25. With respect to the restructuring and divestment of state banks, the initial public offering (IPO) of Bank Mandiri is expected to be listed in the second quarter, following the issuance of the final prospectus in April. We intend to announce a strategic plan for the future of the bank in the second half of the year. We also expect to launch an IPO of shares in BRI during the second half of 2003. The strategy for BNI is to implement its approved business plan that sets forth action items designed to strengthen the bank, such as improving the quality of assets, developing the information technology network, and continuing further divestment efforts. We will develop, during the second quarter, a time-bound action plan to resolve its impaired assets. With respect to BTN, external consultants have been engaged to develop a restructuring plan, based on which we will adopt a specific implementation schedule based on the plan by end-March 2003.

Financial Sector Safety Net

26. The Ministry of Finance, with inputs from Bank Indonesia, is developing a comprehensive plan for a sound financial sector safety net, expected to be completed by end-March 2003. The key elements of the plan are to create a limited coverage deposit insurance scheme (LPS), an enhanced lender of last resort function for BI, a framework for bank resolution, and an agency that integrates supervision and regulation of the financial sector (OJK). The plan will also set out criteria and procedures for bank resolution through a Committee chaired by the Ministry of Finance with representatives of OJK, BI, and LPS.

27. The plan will contain detailed proposals on the institutional structure of the financial safety net and on sequencing and transitioning arrangements, including measures for an orderly phase-out of the blanket guarantee. In this regard, the first task will be to establish a deposit insurance agency to administer a deposit insurance fund financed by premiums paid by the banking sector, and with a role in bank resolution. We will also give priority to a review of BI's lender of last resort function, including any needed changes to the BI law, to ensure that it will be adequate to provide emergency liquidity support to the banking sector once the blanket guarantee is removed.

28. We are also preparing the groundwork for the new Financial Supervisory Agency (OJK). Safeguards will be put in place to ensure the independence of the new agency and that its funding arrangements provide it with adequate resources to attract and retain staff with appropriate skills and experience. The transition to the OJK will be managed carefully to ensure that financial system stability and effective supervision are not undermined. We will utilize an independent assessment of the supervision of the nonbank financial sector against the relevant international standards, and will prepare action plans to remedy any identified deficiencies prior to the transfer of these functions to the new agency.

Bank Indonesia

29. We remain committed to improving the oversight and accountability of the central bank, in a manner that preserves its operational independence. In line with this objective, we intend to work with Parliament to enact amendments to the central bank law that are fully consistent with the recommendations of the independent panel of experts published in April 2001. In line with international practice, BI will also establish an audit committee, whose membership will include outside experts, to subject its internal financial policies and procedures to regular independent review. As a follow-up to the recommendations from the mid-year review of its foreign exchange operations, BI is taking steps to strengthen its control and accounting procedures. Progress in this regard will be reviewed in the context of BI's forthcoming 2002 annual audit, conducted by its constitutionally appointed auditor. The process of restructuring BI's overseas subsidiary is proceeding and its sale will be completed in the first half of 2003. Assets removed in the restructuring process will be sold by the end of the year.

30. As part of ongoing efforts to bring the banking supervision function, currently located in BI, into line with international best practice, we will reform the organization of this function to improve its efficiency, accountability and internal coordination. This is expected to be completed by September. Also, BI will establish by June a dedicated financial stability unit to monitor the soundness of the overall financial system.

IBRA Asset Recoveries

31. The strategy remains to maximize recoveries from IBRA's remaining assets, in advance of its scheduled winding-down. In this regard, IBRA has announced a detailed plan for asset recovery, with quarterly targets, to meet its annual asset recovery target of Rp 26 trillion. To ensure transparency, the Oversight Committee (OC) is reviewing the proposed asset sales mechanisms, and will provide any recommendations regarding their strengthening to IBRA and the FSPC. The FSPC will publish its decisions regarding the mechanisms chosen for these sales, as well as its responses to OC recommendations.

32. We are nearing final resolution of the bank shareholder settlement agreements. We aim to collect Rp 6-7 trillion from these agreements in 2003. All noncash assets pledged or that have fallen due under agreements with cooperative shareholders are being transferred to IBRA; this process is planned for completion by May. We have collected the initial

30 percent cash payment due from 9 out of 30 shareholders of banks closed in 1999 and 2000 (so-called APU cases) under the revised settlement terms set out in the October 2002 FSPC decision. With regard to shareholders of banks closed in 1998 who issued personal guarantees toward settling their obligations (under the so-called MRNIAs), we will conduct forensic audits to identify any additional shareholder assets that may be needed to settle outstanding obligations under existing agreements. Full settlement of the commercial terms stipulated under all the bank shareholder agreements is due by June 2003.

33. As set out in Presidential Instruction No. 8 signed on December 30, 2002, the government remains committed to taking strong legal and other enforcement actions against former bank shareholders who fail to meet their obligations under their settlement agreements. We are increasing the effectiveness of our enforcement strategy by including the original Directors and Commissioners of noncompliant shareholders' banks in our legal actions. The cases of five noncompliant shareholders were transferred to the police and AGO in February, and IBRA is preparing to forward 12 additional cases to the legal authorities, thereby covering all shareholders who failed to make the initial payment under the revised settlement agreements for banks closed in 1999 and 2000, as well as two other noncompliant shareholders. To those who have fulfilled their obligations under the shareholder settlement agreements, the government is ceasing legal actions relating to any criminal charges or other irregularities that gave rise to the agreements.

34. IBRA is finalizing its plans for the winding down of its operations. Administrative preparations are well advanced and a strategy for the resolution of any assets that may remain unsold at the end of IBRA's mandate will be finalized and published by September 2003. The strategy will ensure that adequate recoveries will be maintained, on the basis of full transparency and accountability, after IBRA is closed.

Privatization

35. The government remains committed to its privatization program, which is critical for improving economic performance and strengthening the public finances. The divestment plan for 2003, which builds on the progress generated in 2002, is designed to achieve the budget target of Rp 8 trillion. The plan has been approved by the Privatization Committee chaired by the Coordinating Minister for Economic Affairs.

Corporate Debt Restructuring

36. With the Jakarta Initiative Task Force's (JITF) mandate set to expire on December 31, 2003, the strategic objective now is to process the remaining 40 cases in its docket (total debt of \$10.1 billion), through either mediated resolution or dismissal. In 2002, the JITF met its targets for debt restructurings, and by end-December the cumulative total for JITF-mediated debt reaching the MOU stage amounted to \$18.9 billion, representing the debt of 86 companies. Going forward, the JITF aims to process half of its remaining cases by July, and by November it will issue a final report, setting forth its assessment of corporate debt

restructuring, and outlining the disposition of all major cases during the course of its operations.

III. POLICIES TO IMPROVE THE INVESTMENT CLIMATE

37. While significant progress has been made under the program to restore macroeconomic stability and advance the structural reform agenda, investment—the engine of long-term growth and employment generation—remains weak. A number of the policies described above will contribute to an improvement in the investment climate. These include improvements to the decentralization framework, strengthened tax and customs administration, improved public sector governance, and maintenance of a liberal trade regime. In addition, establishing certainty for investors with respect to the application of commercial and bankruptcy laws, and improving the industrial relations framework are also important for improving the investment climate.

Legal and Judicial Reform

38. The emphasis in 2003 will be on the further development of the Commercial Court, which has jurisdiction over bankruptcy and intellectual property rights cases. A number of steps have already been taken to strengthen the administration and procedures of the Court, and to enhance the transparency of the Court's decisions. The Blueprint formulated in 2001 for the development of the Commercial Court has been key to this effort and an updated version will be issued in May 2003. Going forward, emphasis will also be placed on setting the Court's finances on a sounder basis. To maintain the capacity of the Court and the transparency of its decisions, we will work with the Supreme Court to restore the number of qualified ad hoc judges to an adequate level.

39. With respect to other judicial reforms, the government intends to work closely with the Supreme Court and other concerned parties to facilitate the establishment of a Judicial Commission, an initiative central to strengthening the governance and administration of the judiciary. The Supreme Court is currently finalizing its proposals in this area, and the law establishing the Commission is expected to be adopted by end-2003. Steps will also be taken to ensure that the Anti-Corruption Commission (ACC) is fully operational by no later than December 2003, as required by the Anti-Corruption law. In this regard, the government intends to submit names of candidates for the five positions of members of the ACC to Parliament by July 2003.

40. We intend to integrate the functions of the Independent Commission for the Audit of the Wealth of State Officials (KPKPN) into the ACC, as required by the Anti-Corruption law, in a manner that preserves the integrity of the wealth declaration process. To this end, the government will issue a decree by August 2003 that will ensure that the capacity to obtain and analyze wealth declarations is maintained, and that the ACC has the powers to enforce the wealth declaration requirements.

41. The government is working with Parliament to expedite passage of amendments to the bankruptcy law, which is expected in the second quarter of 2003. The amendments

improve the existing law by adding definitions and clarifications on a number of points that will make the law easier to apply in practice.

Labor Policies

42. Establishing a sound framework for labor relations is central to generating employment, improving the welfare and skills of workers, and providing a stable environment for business. Following the major reform of the rights of association and union activity in 2000, modernization of complementary labor legislation relating to industrial relations has become a priority. A bill relating to labor protection has now been passed, and we are working closely with Parliament to ensure that the other bill in this area, on industrial dispute resolution, is enacted during the first half of 2003. We are working with labor and business to ensure that the laws strike an appropriate balance between protecting the rights of workers, including freedom of association, and preserving a flexible labor market.

43. With the devolution of minimum wage setting to the regions, it has become increasingly important to provide standards to guide the minimum wage setting process to ensure that it is in accordance with the national interest. To this end, we have recently reconvened the national tripartite council comprising government, labor groups, and employers to consider options for developing national guidelines in this area. The council will be a regular vehicle to facilitate a national dialogue on broader labor policy issues.

Table 1. Indonesia: Macroeconomic Framework, 2002–03

	2002 Prel.	2003
Real GDP growth	3.7	4.0
Inflation (end of period)	10.0	9.0
Current account balance		
In billions of U.S. dollars	7.2	4.7
In percent of GDP	4.2	2.2
Gross reserves (in billions of U.S. dollars)	32.0	32.6
Central government balance (in percent of GDP)	-1.6	-1.8
Revenues and grants	18.6	17.3
Expenditures and net lending	20.3	19.1
Base money growth (end of period)	8.3	13–14

Table 2. Indonesia: Quantitative Performance Criteria (PC) and Indicative Targets (IT)
Under the Extended Arrangement, 2002–03 1/

	2002		2003			
	Dec.		Mar.	Jun.	Sep.	Dec.
	PC 2/	Actual	PC	PC	IT	IT
Monetary and fiscal targets						
Net domestic assets (NDA) of Bank Indonesia	10.9	-16.8	-24.5	-19.4	-15.6	0.6
Base money (indicative target) 3/	138.2	132.2	129.3	134.5	138.1	150.4
Overall central government balance 4/	-42.1	-26.3	-7.6	-15.6	-25.6	-34.4
External targets (in billions of U.S. dollars)						
Net international reserves (NIR) of Bank Indonesia 5/	18.8	22.2	22.2	22.2	22.2	22.2
Contracting or guaranteeing of new noncessional external debt 6/	1.5	0.8	0.3	0.6	1.0	1.5
<i>Of which: Government debt to commercial creditors</i>	0.2	0.1	0.2	0.2	0.2	0.2
Stock of short-term external debt outstanding	2.5	0.5	2.5	2.5	2.5	2.5

1/ Definitions are contained in the attached Technical Memorandum of Understanding. Continuous performance criteria are: the nonaccumulation of public external arrears and no securitization or forward sale of receipts from natural resources.

2/ Adjusted program targets for NDA and NIR.

3/ Base money targets are one-month averages centered on end-month.

4/ Cumulative balances from beginning of fiscal year (floor). Central government bonds issued to district and provincial government are included as financing of the central government deficit.

5/ Outstanding stocks (floor).

6/ Cumulative amounts from beginning of fiscal year (ceilings).

Table 3. Indonesia: Structural Benchmarks

March 2003

- Finalize comprehensive plan for financial sector safety net.
- Formulate plans and targets for audits, tax arrears collection, and registration of taxpayers.
- Collect at least Rp 3 trillion in cash by IBRA (net of expenses).
- Adopt implementation schedule for the restructuring of BTN.

April 2003

- Conclude majority divestment of Bank Danamon.
- Launch majority divestment of Bank Lippo.
- Finalize blueprint for strengthening the treasury and budget functions of the Ministry of Finance.
- Issue ministerial decree liberalizing conditions under which VAT refund claims may be approved.

June 2003

- Collect at least Rp 7 trillion in cash by IBRA (net of expenses).
- List IPO for Bank Mandiri on the stock exchange.
- Appoint additional commissioners to ensure each state bank has four to five commissioners in place.
- Launch a fourth round of performance audits of state enterprises.
- Produce report on 2002 local government finances, with coverage of at least 85 percent of jurisdictions.
- Complete sale of BI's overseas subsidiary.

September 2003

- Collect at least Rp 18 trillion in cash by IBRA (net of expenses).
- Launch IPO for BRI.
- Finalize strategy for the resolution of assets that may remain unsold at the end of IBRA's mandate.

December 2003

- Launch majority divestment of remaining two IBRA banks.
- Announce strategic plan for future of Bank Mandiri.
- Complete the expansion of large taxpayers' offices to increase coverage to 35 percent of the tax collections of the Directorate General of Taxation.
- Ensure that the Anti-Corruption Commission is fully operational.
- Achieve budget privatization target of Rp 8 trillion.

REVENUE ADMINISTRATION INITIATIVES FOR 2003

Key initiatives for strengthening revenue administration are set out below.

March 2003, Directorate General of Taxation approves an **“extensification” program** that will register 60,000 companies and 50,000 individuals. Ten percent of the individual registrants will have income of at least Rp 100 million. A tax return for 2002 income and profits taxes will be secured from 60 percent of the new registrants.

March 2003, Directorate General of Taxation formulates a **national audit plan for 2003** that provides for (nonrefund) audits of 1,250 “large” taxpayers and 12,600 “medium-sized” taxpayers.

March 2003, Directorate General of Taxation formulates a **national arrears collection plan for 2003** aimed at: (1) keeping the stock of tax arrears deemed to be collectible at a level no higher than that at the end of 2002, and (2) resolving 5 of the largest 10 arrears cases deemed to be uncollectible.

March 2003, Directorate General of Taxation formulates a **plan to control registered taxpayers** who fail to file tax returns.

March 2003, Directorate General of Taxation prepares a plan to further **modernize the large taxpayer offices’** taxpayer services, audit, arrears collection, and information technology programs during 2003.

March 2003, Directorate General of Taxation and Directorates General of Customs and Excises (DGCE) will reach agreement on a program of **cooperation with the National Ombudsman Commission (NOC)** to publicize the existence of the NOC, establish time standards for responding to NOC recommendations on specific cases, and make summary information available to the public two times per year on the actions taken by DGT and DGCE in implementing NOC recommendations.

April 2003, the Ministry of Finance’s Inspector General submits to the Minister of Finance the first of four quarterly reports detailing **violations of the tax and customs codes of conduct**, the number of investigations initiated and completed, and the number and types of sanctions imposed. Within two weeks of receipt by the Minister, summary statistics from the report will be made available to the public.

April, 2003, Ministerial Decree issued that liberalizes the conditions under which claims for **VAT refunds** may be approved without requiring a pre-refund audit (but continuing to allow post-refund audits on a selective basis), with a view to increasing the coverage of nonrefund audits.

April 2003, Director General of Customs and Excises implements the first phase of the **customs administration modernization strategy** involving trade facilitation, combating undervaluation, and promoting governance, and approves a detailed work plan for the balance of 2003 and 2004.

May 2003, the Minister of Finance will appoint a task force (comprising private sector representatives and public sector officials) to **review all aspects of the value-added tax**—including its policy features, administrative provisions, information reporting requirements—with a view to proposing ways to reduce the cost of compliance to taxpayers and cost of administration to the government. A draft report will be submitted to the Minister of Finance by September 2003 and final report by December 2003.

June 2003, the **electronic tax filing and payment system** will be expanded to process 75 percent of DGT tax collections. The electronic payment system will also be introduced at one large customs office and one large budget office to process the remittance of import duties and taxes collected or withheld by these offices.

June 2003, the inter-ministerial task force will prepare a **government-wide anti-smuggling strategy**. The strategy is to be approved by the government and begin to be implemented by end-June 2003.

June 2003, Directorate General of Taxation prepares a **plan to expand the large taxpayer offices** by December 2003 to administer those taxpayers who collectively account for 35 percent of total DGT tax collections.

June 2003, the government will allocate sufficient resources to the National Ombudsman Commission to establish 5 regional offices and create a telephone hotline by end of December 2003.

June 2003, the Ministry of Finance will streamline the procedures by which it requests from BI access to a taxpayer's banking information in cases where a bonafide tax audit has been initiated. The new procedures will include appropriate safeguards to protect confidentiality and taxpayers' rights.

July 2003, Directorate General of Taxation will instruct tax offices to conduct **tax audits of companies in the oil and gas sector**.

July 2003, Directorate General of Taxation and the MOF Inspector General's office will **extend the governance framework for tax officers**—including the code of conduct, hotline for taxpayers to report misconduct by tax officers, code of conduct committee, and special team of inspectors at the Inspectorate General—at all DGT tax offices. A "Taxpayer Bill of Rights" will also be introduced.

December 2003, Directorate General of Taxation will **complete the expansion of the large taxpayers' offices** to administer those taxpayers who collectively account for 35 percent of total DGT tax collections.

December 2003, revise the Law on General Rules and Procedures of Taxation and the Law Concerning Tax Collection and present to Parliament for approval.

INDONESIA: TECHNICAL MEMORANDUM OF UNDERSTANDING
March 18, 2003

A. Monetary Targets

1. Performance Criterion on Net Domestic Assets

Outstanding Stock As Of:	Program Limit (In trillions of rupiah)
End-December 2002 (actual)	-16.8
End-March 2003 (performance criterion)	-24.5
End-June 2003 (performance criterion)	-19.4
End-September 2003 (indicative target)	-15.6
End-December 2003 (indicative target)	0.6

Net domestic assets (NDA) of BI are defined as the difference between base money and net international reserves (NIR) of BI as defined in Section D, converted into rupiah at an accounting exchange rate of Rp 7,000 per U.S. dollar. Base money is defined as currency in circulation, bank deposits at BI in rupiah, private sector demand deposits at BI, and the aggregate reserve deficiency. The aggregate reserve deficiency is defined as the amount by which aggregate statutory reserves against rupiah third-party liabilities exceed bank deposits at BI.

The NDA targets will be subject to the following adjustors:

(i) In the event of shortfalls of balance of payments support from that assumed in Section E, the ceiling on NDA will be adjusted upward by the rupiah equivalent of the shortfall, up to a maximum of US\$1.0 billion.¹ The ceiling on NDA will be adjusted downward by the rupiah equivalent of any excess of balance of payments support over that set out in Section E.

(ii) Changes in reserve requirements will modify the NDA ceiling according to the formula:

$$\Delta NDA = (\Delta r B_0 + r_0 \Delta B + \Delta r \Delta B)$$

where ΔNDA denotes the change in the ceiling on NDA of BI; r_0 denotes the reserve requirement prior to any change; B_0 denotes the rupiah reservable base in the period prior to

¹Converted at the accounting exchange rate of Rp 7,000 per U.S. dollar.

any change; Δr is the change in the reserve requirement ratio; and ΔB denotes the immediate change in the rupiah reservable base as a result of changes in its definition.

2. Indicative Targets on Base Money

Outstanding Stock of Base Money As Of:	Indicative Limit (In trillions of rupiah)
End-December 2002 (actual)	132.2
End-March 2003 (indicative target)	129.3
End-June 2003 (indicative target)	134.5
End-September 2003 (indicative target)	138.1
End-December 2003 (indicative target)	150.4

The indicative target on base money at the test date will be measured as the average of its value from the first business day after the fifteenth day of the month up to (and including) the fifteenth day of the following month (or the last business day preceding the sixteenth day, if the fifteenth day is not a business day). The target on base money will also be adjusted by changes in reserve requirements according to the same adjustor applied to NDA in the previous section.

B. Fiscal Targets

1. Performance Criterion on the Overall Central Government Balance (Financing Side)

Cumulative Balance	Floor (In trillions of rupiah)
From January 1, 2003 to:	
End-March 2003 (performance criterion)	-7.6
End-June 2003 (performance criterion)	-15.6
End-September 2003 (indicative target)	-25.6
End-December 2003 (indicative target)	-34.4

For the purposes of the program, all interest payable, including the interest costs associated with bonds and other debt issued by the government to cover the costs of bank restructuring will be placed above the line. The fiscal balance is therefore defined as the negative of the sum of: (i) net foreign borrowing; (ii) the change in net credit to the central government from the banking system, excluding the amount of government bonds, and excluding changes in the balances on the Haj account and the deposit guarantee accounts (accounts 502 and 519); (iii) the change in the stock of government bonds (excluding new issues of bonds to cover the

cost of bank restructuring); and (iv) net financing from all other sources to the government, including receipts from privatization and divestiture.

Net foreign financing is defined as government foreign borrowing less amortization payments (including debt prepayments) of foreign debt, with transactions converted into rupiah each month at the average exchange rates for that month. Net credit from the banking system is defined as the change in net credit to government (including commercial loans and the extrabudgetary funds), as reported in the central government accounts in the monetary survey. Net financing from all other sources includes receipts from the sale of government assets and recoveries of assets held by IBRA, including any sale or swap of IBRA (or other government) assets for government securities.

Monthly changes in government foreign currency balances will be converted into rupiah at the average exchange rate (based on the rates reported to IFS) prevailing for that month.

C. IBRA Asset Recovery

The target for IBRA's net cash recovery is defined as the sum of all cash receipts stemming from transactions related to IBRA assets (including but not limited to the sale of assets, debt service on loans, dividend payments, and shareholder settlement payments) minus IBRA operating expenses. Income from recapitalization bond interest and payments of deposit guarantee premia are excluded.

D. External Sector Targets

1. Performance Criterion on Net International Reserves of Bank Indonesia

Outstanding Stock As Of:	Floor (In billions of U.S. dollars)
End-December 2002 (actual)	22.2
End-March 2003 (performance criterion)	22.2
End-June 2003 (performance criterion)	22.2
End-September 2003 (indicative target)	22.2
End-December 2003 (indicative target)	22.2

For monitoring purposes, net international reserves of BI (NIR) are defined as (i)+(ii)-(iii): (i) the U.S. dollar value of gross foreign exchange assets in foreign currencies minus gross liabilities in foreign currencies; (ii) the net forward position of BI; and (iii) reserves against foreign currency deposits.

NIR is based on the SDDS concept of gross reserves based on data from the general ledger of BI. Accordingly, foreign exchange assets are defined as those assets that are in convertible

currencies, are under the direct effective control of BI, and are readily available for such purposes of BI as intervention or the direct financing of payment imbalances. Such assets may be in any of the following forms, provided that they meet the test of effective control and ready availability for use: currency, bank deposits in nonresident institutions and government securities and other bonds and notes issued by nonresidents (with a rating not below “A” in the classification of Fitch IBCA and Standard and Poor’s or “A2” in the classification of Moody’s). In addition, holdings of SDRs and of monetary gold are included (provided that they too meet the test of effective control and ready availability for use), as is the reserve position in the IMF.

Excluded from the definition of gross foreign exchange assets are all foreign currency claims arising from off-balance sheet transactions, claims on residents, capital subscriptions in international financial institutions, any assets in nonconvertible currencies, claims on any nonresident Indonesian-owned institutions, or any amounts (in all components of assets, including gold) that have been pledged in a direct or contingent way.

Gross foreign liabilities are all foreign currency-denominated liabilities of contracted maturity up to and including one year plus the use of Fund credit. Foreign currency liabilities to the central government are excluded. All assets and liabilities will be valued using the exchange rates and gold price shown in Section E.

The net forward position is defined as the difference between the face value of foreign currency-denominated BI off-balance sheet claims on nonresidents (forwards, swaps, options, and any futures market contracts) and foreign currency obligations to both residents and nonresidents.

The NIR floors will be subject to the following adjustors:

- (i) In the event of shortfalls of balance of payments support from those assumed in Section E, the NIR floor will be adjusted downward by the amount of the shortfall, up to a maximum of US\$1.0 billion. The NIR floor will be adjusted upward by the amount of any excess of balance of payments support over that set out in Section E.

The adjustors and definition of NIR will be subject to review to take account of new sources of financing not anticipated under the program.

2. Performance Criterion on Contracting or Guaranteeing of New Nonconcessional External Debt

Cumulative Change in Stock	Limit (In billions of U.S. dollars)
From end-December 2002 to:	
End-March 2003 (performance criterion)	0.3
End-June 2003 (performance criterion)	0.6
End-September 2003 (indicative target)	1.0
End-December 2003 (indicative target)	1.5

The limit applies to the contracting or guaranteeing by the nonfinancial public sector of new nonconcessional external debt² with an original maturity of more than one year, which is defined as loans containing a grant element of less than 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates.³ Excluded from the limits are credits extended by the IMF and balance of payments support loans extended by multilateral and bilateral creditors. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee is issued.

² The term "debt" has the meaning set forth in point number 9 of the Guidelines on Performance Criteria with respect to Foreign Debt (Decision No. 12274-00/85, August 24, 2000).

³ For loans with a maturity of at least 15 years, the 10-year average commercial interest reference rates (CIRRs) published by the OECD should be used as the discount rate for assessing the level of concessionality, while the 6-month average CIRRs should be used for the loans with shorter maturities. To both the 10-year and the 6-month averages, the following margins for differing repayment periods should be added: 0.75 percent to repayment periods of less than 15 years; 1 percent for 15–19 years; 1.15 percent for 20–29 years; and 1.25 percent for 30 years or more.

3. Performance Criterion on Contracting or Guaranteeing Debt to Commercial Creditors

Cumulative Change in Stock	Limit (In billions of U.S. dollars)
From end-December 2002 to:	
End-March 2003 (performance criterion)	0.2
End-June 2003 (performance criterion)	0.2
End-September 2003 (indicative target)	0.2
End-December 2003 (indicative target)	0.2

The limit applies to the contracting or guaranteeing by the central government or Bank Indonesia of new debt to commercial creditors. Excluded from this limit are export credits extended or guaranteed by official creditors.

4. Performance Criterion on the Stock of Short-Term Debt Outstanding

Outstanding Stock As Of:	Limit (In billions of U.S. dollars)
End-December 2002 (actual)	0.5
End-March 2003 (performance criterion)	2.5
End-June 2003 (performance criterion)	2.5
End-September 2003 (indicative target)	2.5
End-December 2003 (indicative target)	2.5

The limits apply to the stock of debt of original maturity of one year or less, contracted or guaranteed by the nonfinancial public sector. Excluded are normal import-related credits, reserve liabilities of Bank Indonesia, forward contracts, swaps, and other futures market contracts.

5. The non-accumulation of public external arrears during the program period is a performance criterion and will apply on a continuous basis. The program contains a continuous performance criterion that there will be no securitization or forward sales of receipts from natural resources.

E. Program Assumptions and Reporting

1. Program Baselines for Balance of Payments Financing Package

Cumulative Amounts From	Floors (In billions of U.S. dollars)
	BOP Support 1/
From end-December 2002:	
End-March 2003	0.7
End-June 2003	2.0
End-September 2003	2.9
End-December 2003	4.2

1/ Includes all quick-disbursing balance of payments support loans from multilateral and bilateral sources, including similar loans channeled to the government budget and rescheduling of government or Bank Indonesia debt-service falling due, but excluding short-term loans that are reserve liabilities of BI as well as IMF purchases.

2. Exchange Rates and Gold Price to be Used Under the Program 1/

	Foreign Currency per U.S. dollar
Japanese yen	104.85
Deutsche mark 2/	1.8711
Pound sterling	0.61177
French franc 2/	6.2753
Swiss franc	1.5339
SDR	0.72426
Euro	0.9567
Gold price (U.S. dollars per ounce)	299.10

1/ Currencies not shown here will be converted using the official rate for October 31, 1999 used by IMF's Treasurer's Department.

2/ Deutsche mark and French franc are converted against the euro based on fixed conversion rates as of December 31, 1998.

3. Reporting

Monitoring the program requires accurate and timely data. All information on performance criteria, indicative targets, and balance of payments support loans will be reported to Fund staff within two weeks of the reference date with the exception of data on the central

government balance, which will be provided within one month. In addition, detailed data on government revenues and expenditures, costs of financial sector restructuring, and the monetary survey will be provided monthly within 30 days of the reference date. Monetary statistics covering developments in the banking system, including third-party liabilities, monetary accounts, and deposit and lending rates will be provided monthly (with a five-week lag). Data on base money (showing all the factors affecting reserve money), foreign exchange intervention in both the spot and forward markets, as well as use of reserves for financing and liquidity support will be provided daily (with a 2-day lag). The net forward position, net foreign assets, liquidity support to banks under various facilities, and open market operations (including the stocks of SBIs and SBPUs) will be provided daily (with a 2-day lag). Information on access by individual banks and nonbanks to BI credit (either in rupiah or foreign currency) will be provided on request. Debt stocks and associated flows broken down by both creditor and debtor types and maturity will be provided on a quarterly basis.

BI will publish weekly, with 3-day lag, key monetary data, (which may be subject to revision) including base money, gross international reserves of BI, NDA of BI, and NIR of BI (the information could be made available through special press releases and/or by updating BI's web site).

Within three weeks of the end of each month, IBRA will provide to Fund staff its financial results of the most recent month and of the year-to-date, as prepared by its Finance and Accounting Division. These data will be broken down as follows: (i) AMC (receipts from loan work out, outsourcing, core asset sales, noncore assets, and litigation); (ii) AMI (receipts detailed by individual asset sales and/or dividends); (iii) BRU (receipts detailed by individual asset sales and/or dividends); (iv) other income (receipts detailed by investment income, guarantee premia, and other); and (v) operating expenses.

INTERNATIONAL MONETARY FUND

INDONESIA

**Eighth Review Under the Extended Arrangement and
Request for Waiver of Performance Criterion**

Supplementary Information

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

Approved by Wanda Tseng and Michael Hadjimichael

March 27, 2003

1. **This supplement provides an update on economic and policy developments** since the staff report was issued on March 18, 2003. The staff appraisal remains valid.
2. **Financial markets remain resilient in the face of hostilities in Iraq.** The rupiah has continued to trade in a narrow range and, after a modest decline last week, has strengthened back to below Rp 9,000 per U.S. dollar. Central bank intervention has been small, and the end-March target for NIR should be met with a margin. Equity prices have also remained stable.
3. **The staff's growth forecast for 2003 (3½ percent) remains unchanged.** However, the outlook is subject to increased uncertainty and will depend on the reaction of consumer and investor sentiment to both world events and domestic developments. Recent macroeconomic indicators are broadly positive. The decline in tourist arrivals has been less than anticipated, with arrivals in January down 9 percent from the previous year (although arrivals in Bali were down 28 percent). Foreign investment approvals for the first two months of 2003 were \$2.3 billion, up sharply from \$1.0 billion in the same period last year.
4. **IBRA continues to make progress on its 2003 asset recovery program.** Notably, on March 21 IBRA announced that three bidders for Bank Danamon (one foreign-led and two local consortia) had been shortlisted. Final bids are due in mid-April, with the winning bid expected to be announced shortly thereafter.
5. **With respect to the safeguards process, discussions have continued with the authorities on steps to strengthen BI's external audit mechanism.** In particular, the staff is continuing to encourage the involvement of an independent accounting firm in BI's external audit mechanism for its 2002 financial accounts. The involvement of such a firm in the review of BI's foreign exchange reserves at end-2002 identified a series of control weaknesses, as well as data discrepancies that gave rise to an upward revision to NIR and a change in the reporting methodology of NIR data to the Fund. BI's auditor, the Supreme Audit Agency, acknowledges the need for further capacity building, but has indicated a preference to work with other state audit agencies, which it believes have relevant expertise, rather than to engage an independent firm. The staff believes that the involvement of an independent firm is necessary at the present time to provide assurances of the quality of BI's financial statements. The staff will maintain a dialogue with the authorities on this issue, with a view to achieving a solution consistent with the Fund's safeguards policy, and will provide an update at the next review.



Press Release No. 03/43
FOR IMMEDIATE RELEASE
March 28, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Eighth Review of Indonesia Program, Approves US\$469 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) completed today its eighth review of Indonesia's performance under a SDR 3.6 billion (about US\$5 billion) Extended Fund Facility arrangement (see Press Release No. 00/4). This opens the way for release of a further SDR 344 million (about US\$469 million), bringing the total amount drawn under the arrangement to SDR 2.6 billion (about US\$3.6 billion).

At the conclusion of the Executive Board's discussion on Indonesia's economic and structural reform program, Anne Krueger, First Deputy Managing Director and Acting Chair, stated:

“Indonesia has continued to make good progress in implementing economic reforms under the program. Economic growth has been sustained, inflation has declined, the banking system has been strengthened, and asset recoveries have advanced. Nevertheless, weaknesses in the investment climate continue to hold back a more robust economic recovery. Sustained efforts for further reform will be necessary in the context of the 2003 program, to lay the basis for more rapid economic growth.

“Indonesia achieved a significant fiscal consolidation in 2002, with the budget deficit outturn well below the target of 2.5 percent of GDP. The 2003 budget builds on this accomplishment, and is expected to contribute to a further decline in public debt levels, while preserving key development expenditures. The sharp rise in oil prices led to a partial re-introduction of fuel subsidies. It will be important to reduce these subsidies as soon as possible, to enable a reorientation of expenditure priorities toward key social and development needs.

“Inflation has declined steadily in recent months and the rupiah has remained stable, allowing monetary policy to be more supportive of economic recovery. Looking ahead, monetary policy will need to continue to strike an appropriate balance between supporting the economy and contributing to a further reduction in inflation risks.

“Strengthening the financial sector is a central element of the program. With the launch of the sale of Bank Danamon, further progress continues to be made toward the goal of returning to private ownership banks that were taken over during the crisis. Further steps are required to

strengthen the monitoring, governance, and accountability of state banks as they are prepared for divestment. Over the longer term, a key step will be the development of a comprehensive plan for the reform of the financial sector safety net, including the creation of a deposit insurance agency and the transition to an independent financial sector supervisory agency.

“The increased momentum of recoveries from IBRA loan sales and state enterprise divestment should be maintained. A key element of the strategy to maximize IBRA recoveries is the strict enforcement of shareholder settlement agreements, along with the initiation of legal actions against noncompliant former bank owners. In general, further progress in privatization is encouraged.

“Further progress in implementing legal and judicial reforms is critical to strengthen governance and improve the investment climate. Key steps will include operationalizing the Anti-Corruption Commission, strengthening the commercial court, and adopting amendments to the bankruptcy law,” Ms. Krueger said.