

Indonesia: Ninth Review Under the Extended Arrangement—Staff Report; and Press Release on the Executive Board Discussion

In the context of the ninth review under the extended arrangement, the following documents have been released and are included in this package:

- the staff report for the ninth review under the extended arrangement, prepared by a staff team of the IMF, following discussions that ended on **May 8, 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 June 11, 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 Press Release summarizing the **views of the Executive Board as expressed during its June 25, 2003 discussion** of the staff report that completed the 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*

*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.

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INTERNATIONAL MONETARY FUND

INDONESIA

Ninth Review Under the Extended Arrangement

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

Approved by Wanda Tseng and Leslie Lipschitz

June 11, 2003

- Discussions were held in Jakarta during April 28–May 8. 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, Bank Indonesia Governor Syahril Sabirin (whose term expired on May 17), other senior officials, and parliamentarians. The mission also had discussions with academics, journalists, and representatives of the private sector.
- The staff team comprised Messrs. Citrin (head), Schwartz, Bingham, and Wolfson (all APD), Messrs. Baldacci (FAD), Ogada (LEG), and Tadesse (PDR), and Ms. Danklou (assistant, APD), and was assisted by Messrs. Nellor, Khatri, and Taylor of the Fund's Jakarta office. The mission worked closely with an overlapping MFD 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, eight reviews have been completed and a total of SDR 2.6 billion has been purchased, bringing Indonesia's obligations to the Fund to SDR 6.3 billion (Annex and Table 1). A purchase of SDR 344 million will become available on completion of the review.
- In completing the last review (March 28, 2003), Directors welcomed Indonesia's continued progress in policy implementation and were encouraged by signs that a durable economic recovery was taking hold. They stressed, however, that the recovery was still fragile, and that a successful graduation from exceptional balance of payments support when the Fund arrangement expires at end-2003 would require completion of the remaining reform agenda. They highlighted the need to improve the investment climate through legal and other structural reforms.
- As described in the attached supplementary LOI, all end-March quantitative performance criteria and indicative targets were met (LOI, Table 1). Good progress has also been made against the March and April structural benchmarks (Table 2). In view of the continued progress in policy implementation, the staff supports the authorities' request for completion of the review.

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EXECUTIVE SUMMARY

Background

- **Macroeconomic performance and financial market sentiment continue to improve.** The 2003 outlook for GDP growth remains at 3½ percent. Inflation has continued to trend down (to 7 percent at present), and is likely to come in below the program's year-end target of 9 percent. Boosted by private portfolio inflows, the exchange rate has appreciated significantly (to well below Rp 8,500 per dollar), the stock market is up sharply, and there has been a further build-up in reserves.
- **With the EFF scheduled to expire at year-end, a vocal domestic debate has arisen about Indonesia's post-2003 relationship with the IMF.** There is strong popular sentiment for Indonesia to graduate from the Fund arrangement. Nevertheless, the authorities are still weighing their options, and a number of observers view a new arrangement (precautionary or otherwise) as desirable to provide a framework and discipline for policies during the forthcoming election year.
- **The staff's baseline scenario suggests that the 2004 financing outlook could be manageable without recourse to exceptional financing.** However, this assessment assumes the continued maintenance of market confidence, without which the exchange rate, interest rates, and reserves could come under pressure.

Policy implementation

- **Macroeconomic policies are on track, and all end-March quantitative and indicative targets were met with margins:**
 - Falling inflation and the strength of the rupiah have facilitated further reductions in interest rates. In response to recent capital inflows, the mission encouraged the authorities to take advantage of upward currency pressures to build reserves, with interest rate reductions continuing to be based on inflation prospects.
 - Fiscal policy is well on track to meet the full-year deficit target, with the first quarter outcome registering an unexpected surplus.
- **Performance against the program's structural benchmarks has been broadly satisfactory.** All but one of the March/April benchmarks have now been implemented (albeit with some delays):
 - IBRA asset recoveries are on track to meet the mid-year target, the bank divestment program is proceeding, steps have been taken to strengthen the performance of state banks, and progress has been made to develop a comprehensive plan to strengthen the financial safety net.
 - However, progress has been more limited in enforcing shareholder settlement agreements with former bank owners, in sustaining the privatization program, and in establishing the Anti-Corruption Commission.

I. BACKGROUND AND RECENT PERFORMANCE UNDER THE PROGRAM

A. Background

1. **The mission took place against the backdrop of an ongoing improvement in macroeconomic performance and financial market sentiment.** Indonesia's economy has shown resilience to recent external and domestic shocks, including the war in Iraq, the SARS outbreak (which has so far had only a very limited direct impact on Indonesia), and the renewed conflict in Aceh. Financial market sentiment—manifested in a strengthening of the rupiah and sharp rise in the stock market—has been buoyed by continued political stability and the authorities' strong track record of policy implementation. Market reaction to the appointment in mid-May of Bank Indonesia's (BI's) new Governor, Mr. Burhanuddin Abdullah, has been generally positive.¹

2. **While the political environment is becoming more active in advance of next year's elections, the reform program has to date not been significantly impeded.**² President Megawati continues to enjoy relatively broad support for her government's handling of the security situation post-Bali, and for having delivered political and economic stability. Nevertheless, the political situation remains fluid, and the climate for structural reforms is likely to become more challenging as the year progresses.

3. **There has been an increasingly vocal domestic debate about Indonesia's post-2003 relationship with the IMF.** Almost five years of Fund arrangements have given rise to a strong popular sentiment for Indonesia to "graduate" from the Fund's assistance upon expiration of the program. There are, however, a number of officials, as well as academics, business leaders, and analysts who view a new arrangement (including possibly a precautionary one) as desirable to provide a framework and discipline for sound policies, particularly during the 2004 election period. While continuing to express their desire to graduate from exceptional financing, the authorities are still weighing their strategic options; the government plans to formulate its "exit strategy" shortly, ahead of the annual session of the People's Consultative Assembly (MPR) in August. The staff has assured the authorities that the Fund will continue to cooperate closely whichever course is ultimately chosen, and that at a minimum post-program monitoring should provide a vehicle for maintaining a close policy dialogue following the expiration of the current arrangement.

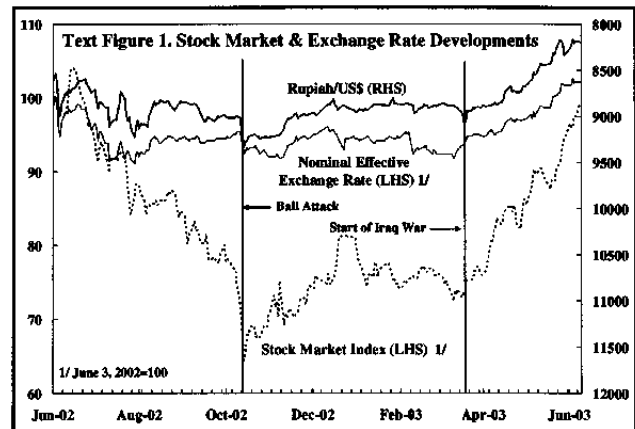
¹ Mr. Abdullah is a career central banker, and served as a Deputy Governor of BI during 2000–01; he also served briefly as Coordinating Minister of Economic Affairs at the end of the administration of President Wahid in 2001.

² Parliamentary elections are scheduled for April 5, 2004, with the Presidential election to follow within two months.

B. Recent Developments, Outlook, and Performance Under the Program

4. Macroeconomic performance and financial market sentiment have continued to improve (Table 3 and Figure 1):

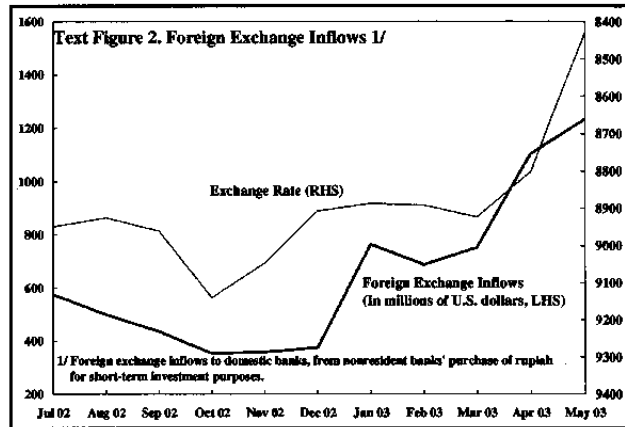
- **The GDP growth projection of 3½ percent for the year appears achievable.** Growth slowed slightly in the first quarter (3.4 percent, year-on-year), as consumer and investor confidence were weighed down by uncertainties ahead of the Iraq war. However, the slowdown was more modest than expected, and despite the regional impact of SARS (particularly on tourism), activity appears to be rebounding, with recent indicators of consumer confidence on the rise. Nevertheless, investment remains sluggish.
- **Inflation continues to decline, and on present trends is likely to come in lower than the government's year-end target of 9 percent.** Headline inflation (12-month) was 6.9 percent in May reflecting declines in food prices and continued exchange rate appreciation. Core inflation has remained broadly stable in recent months, and currently stands at 8.2 percent.
- **External developments have evolved more favorably than anticipated, and reserves are running well ahead of previous projections.** Higher-than-expected oil receipts and improved private capital inflows during the first quarter contributed to a stronger build-up of international reserves, with NIR at end-March running \$1 billion above the corresponding target. Gross reserves are projected at \$34.3 billion at year-end, almost \$2 billion higher than previously expected (Table 4).³
- **Financial market sentiment has improved markedly in recent months, with Indonesia's market performance among the strongest in the region** (Text Figure 1 and Figure 2). The rupiah has strengthened to well below Rp 8,500 per dollar, and the stock market is up by around 20 percent for the year. Financial markets have responded favorably to the decline in uncertainty related to the Iraq war, as well as the continued



³ With respect to the bilateral agreements to be signed with Paris Club creditors, 11 of 18 agreements have now been concluded, with the remainder in process.

implementation of the authorities' reform program (particularly the successful sale of Bank Danamon). Further lifting sentiment was an upgrade by Standard & Poor's in early May of Indonesia's long-term foreign and domestic currency ratings.⁴

- **A significant revival of private portfolio inflows has occurred in recent weeks** (Text Figure 2). Data are still sketchy, but there has been a discernable inflow into the stock market, mutual funds, and corporate and government bonds, reflecting improved market confidence in Indonesia, as well as the recent broad rally in emerging market debt.⁵



- **Indicators of banking system soundness also continue to improve.** Bank profitability and return on assets achieved postcrisis highs in 2002, reflecting in part large foreign exchange gains from the appreciation of the rupiah. Reported NPLs also declined to 6 percent (from a peak of 16 percent at end-2000). However, this latter measure likely overstates the underlying improvement in the banking system in light of poor asset quality, exacerbated by banks' purchase, albeit at a discount, of NPLs from IBRA and the restructuring of their own NPLs.

Recent program performance and monitoring

5. **All end-March quantitative performance criteria were met, and the structural reform agenda is broadly on track.** No changes are being proposed to the quantitative targets and structural benchmarks for the remainder of the year. It is proposed to convert the September indicative targets on NDA, NIR, the central government balance, and external debt into performance criteria.

⁴ As the basis for its upgrade (the first in well over six months) S&P cited Indonesia's improving fiscal and external positions.

⁵ The most recent auction of government bonds, in early April, was highly successful, with the government placing Rp 2.7 trillion in eight-year bonds, yielding 12.2 percent; the auction was three times oversubscribed. In addition, Indonesian's top-tier companies have seen an improvement in their market access in recent months, with external bond issuance of the nonfinancial corporate sector amounting to \$500 million so far in 2003, the same level as recorded for all of 2002.

6. **Base money has remained well below the program path, and the end-March NDA performance criterion was met with a margin** (Table 5 and Figure 3). BI has continued to ease interest rates, cutting its key policy rate (the overnight deposit facility rate) by a further 125 basis points since March, to 10¼ percent, bringing the cumulative reduction so far this year to 190 basis points. The one-month SBI rate has fallen in tandem, and now stands at 10.1 percent.

7. **In the area of fiscal policy, performance also remains well within the program targets.** In the first quarter the budget registered a surplus of Rp 10.1 trillion, against the program's deficit ceiling of Rp 7.6 trillion (Table 6). Revenues were broadly on target, but expenditure was significantly lower than expected, due mainly to delays in wage and subsidy payments and lower-than-expected disbursements for development expenditure and transfers to regions; even excluding these temporary factors, however, the first quarter outcome would have been well within the program target.⁶

8. **Performance against the program's March and April structural benchmarks has been broadly satisfactory.** All of the pending benchmarks have now been met, with the exception of that relating to finalization of the blueprint for the reorganization of the Ministry of Finance. Completion of this benchmark is now expected by the end of June, pending a review of the draft blueprint by an independent consultant (the review was commissioned by the Minister of Finance in light of the sensitivities surrounding these reforms). Although the March benchmark relating to IBRA cash recoveries was not met (due to a delay in the completion of an NPL sales program), collections are now back on track.

II. POLICY DISCUSSIONS

9. **The discussions focused on sustaining the momentum of policy implementation in the period ahead.** The authorities agreed that this would be important during the remainder of the program, all the more so given the need to maintain market confidence to sustain the recovery and achieve their objective of a smooth graduation from exceptional financing at the end of the year. With respect to the latter, the discussions also focused on the 2004 financing outlook.

A. Macroeconomic Policies

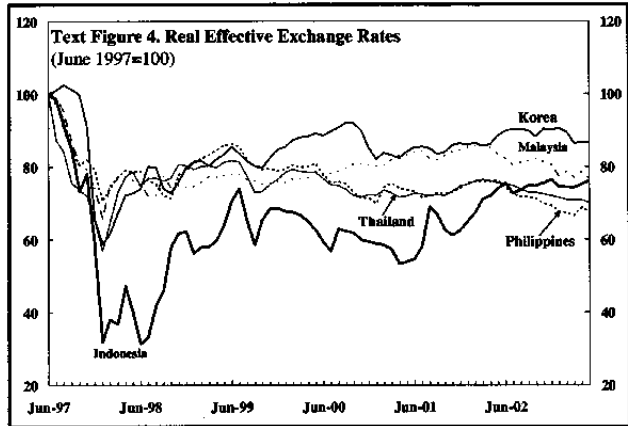
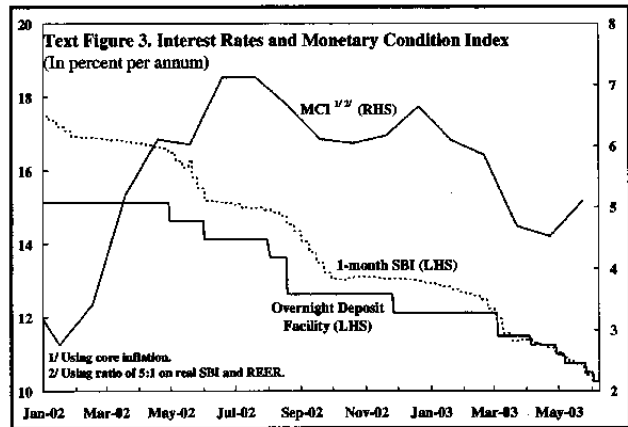
10. **The authorities were in broad agreement with the staff's assessment of the economic outlook.** The main risk stemmed from the still evolving regional impact of SARS, even though so far there had been little direct effect in Indonesia. The authorities were also

⁶ Payment of the 2003 salary increase was delayed by a month due to technical difficulties, which also affected transfers to regions. The delay in oil subsidy payments partially reflected the late transfer of oil revenues from Pertamina.

concerned that the recent strength of the rupiah and private portfolio inflows, while an encouraging sign of confidence, could leave the economy vulnerable to a sudden shift in sentiment later in the year, particularly as the elections approached. Thus, while it was likely they would overperform on the program's monetary, NIR, and inflation targets, the authorities preferred to maintain the program's existing targets in order to allow room for maneuver in the event of unanticipated shocks.

Monetary and exchange rate policy

11. **With the monetary program well on track and inflation continuing to fall, the mission agreed that BI's approach to gradual interest rate cuts remained appropriate** (Text Figure 3). The discussions centered on the appropriate response to the recent strong upward pressure on the rupiah, which the authorities attributed to short-term portfolio inflows attracted by positive interest rate differentials. BI had responded mainly by lowering interest rates and allowing the rupiah to appreciate. The staff noted that the authorities should also take advantage of the upward currency pressures to build reserves further through purchases in the foreign exchange market, and emphasized that interest rate reductions should continue to be guided by inflation prospects. The authorities agreed that a reserve build-up in 2003 of around \$2 billion higher than initially envisaged appeared feasible. Although it is not proposed to modify the program's formal targets, as noted above, the authorities intend to aim to at least maintain the existing margins in the monetary program through the remainder of the year.



12. **With the rupiah having strengthened to well below Rp 8,500 per dollar, the scope for further appreciation without compromising competitiveness has become limited.** At its current level, the rupiah is some 25 percent more depreciated in real terms than its precrisis level, and now lies within the middle of the group of regional

comparator currencies (Text Figure 4).⁷ The present level of the exchange rate does not appear to be problematic (staff calculations of the equilibrium real exchange rate continue to suggest scope for some further appreciation), especially as recent export performance has been encouraging.

Fiscal policy

13. **The mission agreed that fiscal policy is on track to achieve the program's annual deficit target** (Rp 34.4 trillion, or 1.9 percent of GDP).⁸ Both revenues and expenditures are expected to undershoot previous projections—the former due largely to lower projected oil receipts, and the latter due to lower projected fuel subsidies and interest payments.⁹ With respect to the financing of the budget, the outlook is broadly unchanged from that envisaged at the last review. External financing is on track, while privatization receipts are projected to be somewhat lower (Rp 5 trillion, against the program target of Rp 8 trillion), resulting in a slight increase in bank financing.

14. **The discussions consequently focused on the agenda for fiscal reforms under the 2003 program.** Key items include the elimination of fuel subsidies, and measures to strengthen tax and customs administration and the decentralization framework. The planned elimination of fuel subsidies was partially reversed last January in response to popular protest. In view of declining international oil prices the authorities reiterated their intention to return to the automatic fuel price adjustment mechanism during the second half of the year, and to eliminate subsidies on all items except household kerosene. The precise timing and mechanics were under review. The authorities also reiterated that they plan to eliminate the VAT exemption on capital goods in 2004 (this measure was temporarily introduced last January in response to complaints from businesses about inefficiencies in the VAT refund system). With respect to tax and customs administration, good progress continues to be made in line with plans set out at the last review.

15. **Progress in strengthening the decentralization process is proceeding, albeit more slowly than expected** (it took until April for regional reporting of the outturn for the first half of 2002 to reach close to 85 percent, an end-December structural benchmark). The

⁷ This assessment uses the CPI-based measure of the real effective exchange rate. While data to calculate a unit labor cost-based (ULC) measure of the real effective exchange rate are not available, recent wage trends suggest that the ULC-based real exchange has also appreciated significantly.

⁸ The official target referred to in the LOI remains at 1.8 percent of GDP based on the budget's original nominal GDP assumption, which has yet to be formally revised.

⁹ The updated projection assumes an average annual oil price for Indonesia of \$23.5 per barrel, consistent with the WEO, compared to \$24.3 per barrel at the time of the last review.

priority going forward is to improve the timeliness of regional reporting (reporting of the 2002 local government finances is an end-June structural benchmark). To this end, the authorities plan to initiate sanctions shortly, including the withholding of grants, against non-complying regions. The authorities also plan to advance the remaining reform agenda in this area, including measures to ensure the consistency of national and regional regulations and the design and implementation of uniform accounting standards for the regions.

2004 financing outlook

16. **The mission reviewed macroeconomic scenarios with the authorities to assess likely financing needs in 2004.** The staff's baseline scenario indicates that Indonesia's external financing needs next year should be manageable without recourse to exceptional financing (Text Table 1). Importantly, the baseline assumes that the current program continues to be implemented successfully, and that the confidence of both domestic and international investors, and political stability, are maintained as the Fund arrangement expires and the elections draw near. In such a scenario, reserves would remain comfortable, and Indonesia would be positioned to benefit from reasonable medium-term economic growth prospects with external viability. However, there are a number of downside risks to the outlook, including with respect to oil prices and a deterioration of market confidence in an election year. In an adverse scenario, there would be pressures on the exchange rate, interest rates, and reserves. To reduce these risks, the mission stressed the need for the government to do all in its power—through good policy performance and consistent communications—to maintain its credibility with markets.

Text Table 1. External Financing (In billions of U.S. dollars)			
	2003	2004	
		Baseline	Adverse
Gross financing needs	9.9	8.9	11.4
Current account deficit	-4.5	-4.1	-3.6
Debt amortization	7.8	7.1	7.1
Other flows (net)	5.3	5.0	7.0
IMF repayments	1.3	0.9	0.9
Available financing	9.9	8.9	11.4
Foreign direct investment	2.4	2.6	2.6
Loan disbursements	4.9	5.2	4.7
IMF purchases	1.9	0.0	0.0
Rescheduling	3.1	0.0	0.0
Use of reserves	-2.3	1.1	4.1
Memorandum items:			
GDP growth	3.5	4.0	3.0
Exchange rate (average)	9,000	9,000	12,000
Interest rate (average)	11.2	10.5	14.0
Indonesian oil price	23.5	22.6	17.0

Text Table 2. Budget Financing (In percent of GDP)			
	2003	2004	
		Baseline	Adverse
Budget deficit	1.9	1.1	2.3
Amortization	3.4	3.4	4.1
Domestic 1/	0.7	1.2	1.2
External	2.7	2.2	2.9
Gross financing	5.3	4.5	6.4
External	3.1	1.5	1.7
Of which: Rescheduling	1.4	0.0	0.0
Privatization	0.3	0.1	0.0
IBRA	1.4	0.2	0.2
Other domestic 2/	0.9	2.0	2.6
Unidentified	0.0	0.0	1.9

1/ Excludes debt-buybacks and IBRA bond redemptions.
2/ Deposit withdrawals and issuance of government bonds.

17. **The mission also evaluated the preliminary 2004 fiscal outlook** (Text Table 2 and Table 7).¹⁰ At this stage, the authorities are aiming for a deficit of about 1.1 percent of GDP,

¹⁰ The authorities plan to begin preparation of the 2004 budget in June/July, for presentation to Parliament in August.

implying a small (0.2 percent of GDP) increase in the primary surplus.¹¹ The baseline scenario indicates that the budget's financing needs also can be satisfied without further debt rescheduling (including from the Paris Club), although it will require a large step-up in domestic financing.¹² (Given the high level of liquidity in the banking system, there appears to be adequate scope for increased domestic debt issuance without crowding out private sector credit.) As noted above, however, this assessment is sensitive to the maintenance of market confidence.

B. Structural Reforms

18. Given the satisfactory progress since the last review, the discussions mainly focused on the reform agenda for the remainder of the year. The priorities include IBRA asset recoveries, bank divestment and restructuring, and strengthening of banking supervision and the regulatory framework.

IBRA asset recovery

19. After falling short of its first quarter cash target, IBRA's recoveries are back on track, and the end-June target of Rp 7 trillion should be met (Table 8).¹³ Going forward, achievement of the full-year target will depend on the successful disposition of loans related to IBRA's largest debtors. In mid-May, IBRA launched the sale of "strategic positions" comprising debt and equity of these debtors.¹⁴

20. Progress in enhancing recoveries under the shareholder-settlement agreements has been limited so far. Only some small additional payments have been made by

¹¹ With oil revenues projected to decline by 0.9 percent of GDP, the adjustment in the primary surplus would result from reductions in fuel subsidies, associated lower transfers to regions, and other expenditure savings (together amounting to 0.9 percent of GDP), and from an increase in non-oil revenues of 0.2 percent of GDP, including from ongoing efforts to strengthen tax administration. The staff's assessment of medium-term fiscal sustainability remains as presented in the staff report for the eighth review (EBS/03/35).

¹² The scenario also incorporates some modest access to official commercial borrowing on the order of \$500 million, possibly in the form of sovereign bond issues.

¹³ Cash recoveries through April amounted to Rp 5 trillion (with a further Rp 2.9 trillion collected in bonds), and the most recent NPL sale program is expected to raise at least another Rp 3 trillion.

¹⁴ These large debtors, which in several cases are holding companies with assets in diverse economic sectors, are the so-called "Top 7" obligors. The first tranche of the sale includes assets with a book value of around \$4.5 billion.

cooperative debtors since the last review, and it is possible that many of the debtors may not fully meet their final obligations under the revised settlement agreements (which are due at end-June). IBRA continues to seek full compliance, and the government intends to use its nonjudicial enforcement powers (including seizure of assets, imposition of travel bans, and civil detention)—the legal basis of which is being strengthened for this purpose.

21. IBRA-mediated efforts to restructure the debt of Asia Pulp and Paper (APP) appear to be nearing completion.¹⁵ The main remaining stumbling block in negotiations with APP's official creditors—export credit agencies (ECAs)—has been the mechanism through which creditors could take control of the company in the event of another default. ECAs have been concerned that the terms originally proposed by APP would not be effective in that regard. Positive progress is being made in the negotiations, and on June 10, a group of creditors, including IBRA and the majority of the ECAs, signed a preliminary restructuring agreement. Efforts are now underway to encourage the remaining creditors to sign the agreement.

Bank divestment and restructuring

22. The bank divestment program is proceeding well. The majority stake sale of Bank Danamon has been concluded, following the awarding of the winning bid in early May to a consortium consisting of Singapore's government-owned Temasek Holdings and Deutsche Bank. The authorities have now announced their plan for the sale of the next IBRA bank (Lippo); the sale is expected to be completed in September. Thereafter, as previously envisaged, IBRA plans to proceed with the sale of its two remaining banks (BII and Permata) prior to its winding down in early 2004.

23. The mission also reviewed progress under the program to improve the performance of the state banks:

- The initial public offerings (IPOs) for Bank Mandiri and BRI are under preparation (the IPO for Bank Mandiri is planned for end-June and BRI's for end-September).
- The process of restructuring the other state banks is underway. The restructuring plan for BTN—which seeks to transform the bank into a sustainable mortgage lender—has been adopted. The 2002 audit for BNI, which will serve as a basis for resolving the bank's impaired assets, has also been completed.
- With a view to strengthening oversight, additional commissioners are being appointed to the Boards of the state banks. Bank Mandiri and BNI each now have four commissioners, and the process of appointing the outstanding commissioners at BRI (2) and BTN (1) is well underway.

¹⁵ In March 2001, Singapore-based APP defaulted on over \$13 billion in debt, of which the Indonesian subsidiaries owed about \$6.4 billion, to IBRA (\$1 billion) and export credit agencies (\$900 million), and the remainder to bondholders and suppliers.

24. **Nevertheless, the mission expressed concerns about recent developments at the state banks.** Drawing on the work of the overlapping MFD mission, the staff noted that the state bank sector is heavily reliant on high-cost funding, and that high-growth strategies in the sector could compromise asset quality. The authorities indicated that they shared these concerns, and had responded recently with steps to strengthen the management of these banks including through the appointment of new Directors. In addition to pressing ahead with plans to divest the banks—which would enhance market discipline—the mission urged BI, as supervisor, to establish benchmarks to strengthen their financial position; the mission also encouraged the government, as shareholder, to ensure that the banks adopt operating plans to achieve the benchmarks.

25. **The mission reviewed progress in a number of areas related to reforms of BI's operations.** The financial agreement on the resolution of the BLBI issue has been endorsed by the Supreme Audit Agency and is expected to be ratified by Parliament during the current legislative session (as noted in the staff report for the eighth review, the financial operations of the budget and the central bank in 2003 are already being conducted on the basis of the agreement).¹⁶ Preparations to divest BI's overseas subsidiary (Bank Indover) are proceeding, with the sale of the bank now expected in the third quarter of the year (rather than by mid-year as previously envisaged), due to additional time needed to transfer the bank's impaired assets and appoint financial advisors for the sale.

Bank supervision and financial sector regulatory framework

26. **After extensive internal discussions, a comprehensive plan to strengthen the financial sector safety net was completed in June.** In light of the experience with extension of BLBI liquidity credits during the crisis, the most sensitive issue was the nature of BI's lender of last resort facility (LOLR). The plan includes a delineation of the roles of the different financial sector agencies in the LOLR process, in line with MFD recommendations. The key next steps in the process are to adopt legislation establishing a deposit insurance scheme, and to amend the BI Law to reflect the agreed procedures for LOLR support.

27. **The mission discussed the implications for the financial system of the sharp growth in mutual funds invested in recapitalization bonds** (over the last nine months these funds have quadrupled, to stand at about Rp 45 trillion at end-March). With the decline in

¹⁶ To ensure consistency with Indonesian accounting standards and the existing BI Law, the final resolution may differ slightly from the original agreement reached between the government and BI in June 2002. In particular, the new promissory note will bear a miniscule but positive interest rate and have a finite maturity. In addition, pending amendment of the BI Law, the central bank will continue to retain 30 percent of its profits in a special reserve. These adjustments should not materially affect the financial aspects of the original agreement.

interest rates, such funds, sponsored largely by banks, have become an increasingly attractive retail investment.¹⁷ The mission's primary concern was that a number of these funds provide a guaranteed return to investors, thus exposing sponsoring banks to increased risks of capital losses and liquidity pressures. In addition, there was a perception among investors that these funds are covered by the blanket deposit guarantee. On the advice of the overlapping MFD mission, the authorities are taking steps to address these risks. The securities regulator has publicly clarified that mutual fund investments are not covered by the blanket guarantee, and BI is intensifying its scrutiny of the links between banks and mutual funds.

Other structural reforms

28. **In the legal reform area, the priorities are to strengthen the Commercial Court and establish the Anti-Corruption Commission (ACC).** An updated version of the 2001 blueprint for the development of the Court is being prepared, with assistance from LEG. With regard to the ACC, the authorities are continuing to work toward its establishment by year-end, as required by the enabling law. However, work in this regard has proceeded more slowly than expected (in particular there has been a delay in appointing members of the nomination committee, which is responsible for selecting candidates to serve as commissioners on the ACC). Further amendments to the Foundations Law, to clarify the legal basis for the Supreme Audit Agency to audit military and other foundations, will be presented to Parliament during the debate on the law.

29. **The emphasis on labor policy has now turned to formulation of the implementing regulations relating to the Manpower Act** (which was passed by Parliament last March). The authorities are hopeful that the complementary bill on industrial dispute settlement, which builds on the Manpower Act by establishing new institutions for the industrial relations framework, will be enacted in the current session of Parliament. The authorities are also giving high priority to establishing national guidelines on wage policy (including the setting of minimum wages) through implementation of regulations governing the new National Wage Council.

30. **Progress is also being made under the program to strengthen public sector governance.** Corrective action plans are being formulated in response to the audits of the two off-budget investment funds (RDI and RDA, which together have assets of Rp 85 trillion). (The assets and income of the other major remaining off-budget fund, the Reforestation Fund, are now consolidated into the main Treasury account.) The third round of performance audits of state-owned enterprises is expected to be completed on schedule in July, with the launch of the fourth round expected to follow.

¹⁷ In addition, mutual fund earnings are exempt from withholding tax.

31. **While the authorities remain committed to privatization, they noted that the target for receipts for 2003 (Rp 8 trillion) would now be difficult to achieve.** The privatization of two pharmaceuticals companies, that had been slated for this year, is likely to be delayed, pending their restructuring to improve profitability. As noted above, the authorities saw reasonable prospects for completing the envisaged IPOs of the two state banks (Mandiri and BRI), and also hoped to launch the sale of a major natural gas company. They were hopeful that these sales would raise close to Rp 5 trillion by the end of the year.

III. SAFEGUARDS ISSUES

32. **The mission assessed progress in implementing measures under the Fund's safeguards assessment policy.** In line with staff recommendations, BI has established an independent audit committee. In addition, almost all of the control and accounting weaknesses identified in last year's mid-term review of BI's foreign exchange reserves have been addressed. Following up on previous recommendations, the mission proposed the continued involvement of an independent accounting firm in BI's external audit mechanism, through the engagement of an independent firm to undertake a mid-year review of BI's balance sheet. The Supreme Audit Agency, BI's independent and constitutionally appointed auditor, has taken this recommendation under consideration, and discussions are continuing on the modalities of the possible involvement of an external party.

IV. STAFF APPRAISAL

33. **Good progress continues to be made in policy implementation under the program.** Monetary and fiscal policies remain on track, and the authorities have pressed ahead with structural reforms. At this review, there are now further indications that the program is working to lay the basis for enhanced growth and external viability, with financial conditions improving further, and the economic recovery continuing to advance. These positive trends have occurred in the face of a number of unfavorable domestic and external developments.

34. **The first quarter budget outcome was well within the program's deficit ceiling.** Looking ahead, fiscal policy is on track to achieve the program's annual deficit target (1.9 percent of GDP, based on an updated nominal GDP projection). With oil prices having now returned to more normal levels, the staff welcomes the authorities' intention to revert to the automatic fuel price adjustment and eliminate fuel subsidies (except on household kerosene) during the second half of the year. The staff also commends the authorities' continued efforts to improve tax and customs administration. Efforts to strengthen the decentralization framework would also be welcome through planned steps to improve the timeliness of regional budget reporting.

35. **The ongoing decline in inflation and strength of the rupiah have facilitated further welcome reductions in interest rates.** The recent strength of the rupiah appears to have been driven in part by short-term portfolio inflows, which pose new challenges for

monetary policy. While there is scope for some further currency appreciation, the staff encourages the authorities to take advantage of upward pressures on the rupiah to build reserves. In the period ahead, further interest rate reductions may also be appropriate, as long as inflation continues on a downward trend. The staff commends the authorities for their prudent approach to monetary policy, and for their intention to seek to maintain the margins in the program's monetary and reserves targets during the remainder of the year.

36. **IBRA's cash recoveries are back on track after a shortfall at end-March.** IBRA has now launched its latest asset sale, consisting of debt and equity of its largest debtors. It will be important for the authorities to ensure transparency in the process by involving IBRA's Oversight Committee in reviews of these sales. With respect to the settlement of obligations due under the shareholder-settlement agreements of former bank owners, collections to date have been somewhat disappointing; the staff encourages the government to do all it can to enhance compliance, including through the use of nonjudicial enforcement powers. The continued implementation of the bank divestment program is encouraging, and has facilitated a further strengthening of market confidence. The staff commends the authorities for the recent successful conclusion of the sale of Bank Danamon and announcement of their timetable for the sale of Bank Lippo.

37. **Other areas of the structural reform program are, for the most part, proceeding on schedule.** A comprehensive plan to strengthen the financial safety net and the financial system has been completed. While legal and judicial reforms to enhance the investment climate are proceeding, the staff urges the authorities to move forcefully in this area, in particular to ensure the establishment of the ACC by year-end. In that connection, the staff is encouraged that the authorities expect to complete the process of appointing the nomination committee for selecting the commissioners of the ACC by the third quarter of the year. With respect to privatization, while it now appears unlikely that the original Rp 8 trillion annual recoveries target will be achieved, the staff urges the authorities to press ahead with the program during the remainder of the year so as to ensure that momentum in this area is not lost.

38. **The staff's baseline scenario for 2004 suggests that the financing outlook should be manageable without recourse to exceptional financing.** This assessment, however, depends on a maintenance of market confidence and sound policies, without which new pressures on interest rates and exchange rates could emerge, resulting in a loss of reserves. The financing of the budget in such a case would also become more difficult.

39. **Continued sound policy implementation will therefore be needed to meet the significant challenges that lie ahead.** The recovery is still fragile, and recent indications of portfolio inflows, while encouraging, could leave the economy vulnerable to external shocks or a sudden shift in market sentiment. To minimize these risks, it will be important to maintain market confidence through good policy performance, all the more so in light of investor uncertainty that could increase in advance of next year's general elections.

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
March 28, 2003	344.06	16.5	Eighth review completed by the Board
Total	2,605.82	125.4	
Remaining purchases			
June 25, 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	1,032.18	49.6	
Total	3,638.00	175.0	

Table 2. Indonesia: Structural Benchmarks for the Ninth Review

Measures	Status ¹
<p>March 2003</p> <ul style="list-style-type: none"> • 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. 	<p>Finalized in June.</p> <p style="text-align: center;">✓</p> <p>Total collections of Rp 4.1 trillion, of which Rp 1.2 trillion in cash.</p> <p>Implementation schedule adopted in May.</p>
<p>April 2003</p> <ul style="list-style-type: none"> • 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. 	<p>Completed in May.</p> <p>Divestment plan announced in May; launch expected in June.</p> <p>Awaiting completion of consultant's report; blueprint to be finalized by mid-year.</p> <p>Completed in June.</p>

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

Table 3. Indonesia: Selected Economic Indicators, 1997/98–2004 1/

	1997/98	1998/99	1999	2000	2001	2002 Est.	2003 Proj.	2004 Proj.
Real GDP (percent change)	1.7	-13.6	0.8	4.9	3.4	3.7	3.5	4.0
Domestic demand	1.2	-17.2	-2.1	4.0	5.1	1.9	4.2	4.2
<i>Of which:</i>								
Private consumption	6.5	-5.5	4.6	1.6	4.4	4.7	4.1	3.8
Gross fixed investment	-0.1	-37.9	-18.2	16.7	7.7	-0.2	2.5	5.0
Net exports 2/	0.5	4.0	2.9	1.0	-1.5	1.8	-0.5	0.0
Errors and omissions 2/	-2.4	-1.5	-0.9	-1.1	-0.5	-2.4	0.0	0.0
Savings and investment (in percent of GDP)								
Gross fixed capital investment	29.2	22.7	20.1	21.8	21.8	20.2	21.0	21.3
Gross national savings	28.0	27.1	24.2	27.2	26.7	24.4	23.2	23.5
Foreign savings	1.1	-4.5	-4.1	-5.3	-4.9	-4.2	-2.2	-2.2
Prices (12-month percent change)								
Consumer prices (end period)	35.8	46.5	2.0	9.3	12.5	10.0	8.0	6.5
Consumer prices (period average)	11.9	64.8	20.7	3.8	11.5	11.9	8.1	7.4
Public finances (in percent of GDP)								
Central government revenue 3/	15.4	14.9	16.8	20.0	20.8	18.6	18.3	17.5
Central government expenditure	16.7	17.2	18.3	21.1	24.5	20.4	20.2	18.6
Central government balance	-1.3	-2.3	-1.5	-1.1	-3.7	-1.8	-1.9	-1.1
Central government debt	61.5	66.6	88.6	100.3	90.9	80.6	67.9	62.7
Money and credit (end of period)								
Rupiah M2	39.4	39.9	17.0	13.8	13.6	7.9	11.0	13.0
Base money	68.1	32.5	35.5	22.8	2.1	8.3	10.8	13.0
One-month SBI rate (period average)	15.0	48.2	22.7	12.4	16.5	14.9	11.2	10.5
Balance of payments (in billions of U.S. dollars)								
Oil and gas (net)	5.7	4.2	5.9	8.6	6.4	5.3	4.8	5.1
Non-oil exports (f.o.b)	45.9	41.1	41.0	50.3	44.8	46.3	48.9	51.7
Non-oil imports (c.i.f)	-42.9	-30.7	-29.0	-37.1	-31.3	-31.1	-34.9	-38.2
Current account balance	-1.7	4.6	5.8	8.0	6.9	7.4	4.5	4.1
Overall balance	-13.4	0.9	0.0	1.2	-2.9	0.9	-1.3	-0.2
Gross reserves								
In billions of U.S. dollars (end period) 4/	10.7	20.3	24.3	29.4	28.0	32.0	34.3	33.2
In months of imports	3.1	5.3	5.3	7.1	6.9	7.0	7.1	6.4
As a percent of short-term debt 5/	24.4	60.3	78.1	84.3	93.0	131.3	150.1	151.1
External debt (medium- and long-term)								
In billions of U.S. dollars	138.0	149.9	148.7	141.7	131.2	129.8	126.9	121.2
(In percent of GDP)	92.9	144.9	94.9	94.3	92.7	75.0	62.7	56.2
Exchange rate								
Rupiah per U.S. dollar (period average)	4,667	9,849	7,855	8,422	10,246	9,295	9,000	...
Nominal effective exchange rate 6/	71.6	28.0	33.7	32.3	28.0	30.6	29.9	29.6
Real effective exchange rate 6/	74.6	49.5	63.9	62.7	59.7	72.7	74.4	77.7
Memorandum items:								
Indonesia oil production (000 bopd)	1,501	1,476	1,471	1,388	1,320	1,260	1,200	1,150
Indonesian oil price (US\$/bbl)	16.9	11.9	17.4	28.1	23.6	23.5	23.5	22.6
Nominal GDP (in trillions of rupiah)	693	1,019	1,100	1,265	1,449	1,610	1,825	2,044
Nominal GDP (in billions of U.S. dollars)	149	104	140	150	141	173	203	227

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

1/ Fiscal years from 1997/98 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 4. Indonesia: Balance of Payments, 2000–04
(In billions of U.S. dollars)

	2000	2001	2002	2003		2004
	Actual	Actual	Estimate	8th Review	Projection	Projection
Current account	8.0	6.9	7.4	4.7	4.5	4.1
Trade balance	21.8	19.8	20.6	20.1	18.8	18.6
Exports (fob)	65.4	57.4	58.8	61.0	60.9	63.3
Oil and gas	15.1	12.6	12.5	12.9	12.0	11.6
Non-oil and gas	50.3	44.8	46.3	48.1	48.9	51.7
Imports (cif)	-43.6	-37.5	-38.3	-40.9	-42.1	-44.7
Oil and gas	-6.5	-6.2	-7.2	-7.4	-7.2	-6.5
Non-oil and gas	-37.1	-31.3	-31.1	-33.5	-34.9	-38.2
Services (net)	-13.8	-12.9	-13.2	-15.4	-14.3	-14.4
Nonfactor services (net)	-6.5	-7.1	-7.4	-9.1	-8.2	-8.3
Factor services	-7.2	-5.8	-5.8	-6.3	-6.1	-6.2
Capital account	-6.9	-9.8	-6.5	-7.7	-5.7	-4.3
Nonfinancial public sector	-0.9	-2.7	-3.8	-3.2	-3.0	-2.1
Disbursements	4.0	2.9	2.3	3.4	3.4	3.7
Amortization	-4.9	-5.6	-6.1	-6.6	-6.4	-5.8
Banking sector (net)	-1.7	0.1	0.8	-0.5	0.1	0.2
Disbursements	1.3	2.0	2.4	1.0	1.5	1.5
Amortization	-3.0	-1.9	-1.6	-1.4	-1.4	-1.3
Private sector (net)	-4.3	-7.2	-3.6	-4.0	-2.9	-2.5
FDI	2.8	2.6	2.3	2.2	2.4	2.6
Other	-7.0	-9.8	-5.9	-6.1	-5.2	-5.0
Portfolio investment	-1.9	-0.2	1.2	0.0	1.4	1.5
Other private sector (net)	-5.1	-9.5	-7.1	-6.1	-6.6	-6.6
Overall balance	1.2	-2.9	0.9	-3.0	-1.3	-0.2
Financing	-1.2	2.9	-0.9	3.0	1.3	0.2
NIR	-3.5	0.0	-4.5	-0.1	-1.8	0.2
Gross reserves	-5.0	1.4	-3.6	-0.6	-2.3	1.1
Reserve liabilities	1.5	-1.4	-0.9	0.5	0.5	-0.9
Public sector rescheduling 1/	2.4	2.9	3.6	3.1	3.1	0.0
Memorandum items:						
Gross reserves (e.o.p.) 2/	29.4	28.0	32.0	32.6	34.3	33.2
In months of imports of goods and nonfactor services	7.1	6.9	7.0	6.8	7.1	6.4
As a ratio to short-term debt	0.84	0.93	1.31	1.54	1.50	1.51
Non-oil and gas exports, volume growth (percent)	17.6	-7.9	-1.2	1.0	1.0	4.0
Non-oil and gas imports, volume growth (percent)	28.9	-13.1	-6.5	7.8	6.0	8.0
Terms of trade, percent change	10.0	-1.4	0.2	0.6	-1.7	0.0
Current account (in percent of GDP)	5.3	4.9	4.3	2.2	2.2	1.8
Stock of public sector external debt (excluding state-owned banks)	80.0	75.8	78.4	76.0	78.4	75.4
(In percent of GDP)	53.3	53.6	45.3	38.7	38.7	33.2
Nonfinancial public sector debt service/XGNFS 3/	12.2	17.2	18.3	16.9	16.7	14.5
Indonesian oil price	27.4	23.3	24.2	24.1	23.5	22.6
GDP (in billions of U.S. dollars)	150	141	173	213	203	227

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

1/ For 2003, consists of debt relief amounting to \$3.0 billion from Paris Club creditors and \$0.1 billion from other creditors.

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

3/ Before rescheduling and including IMF repurchases.

Table 5. Indonesia: Monetary Survey, December 2000–December 2003
(In trillions of rupiah, unless otherwise indicated) 1/

	2000	2001	2002	2003		Jun.	Sep.	Dec.
	Dec.	Dec.	Dec. Actual	Mar. Prog.	Est.				Program
(End-of-period)								
Monetary Survey								
Net foreign assets	119.0	141.9	178.8	186.7	181.1	189.4	192.1	194.9
(In billions of U.S. dollars)	17.0	20.3	25.5	26.7	25.9	27.1	27.4	27.8
Net domestic assets	590.1	651.6	674.6	686.8	667.3	710.2	734.0	766.3
Net claims on government	526.5	539.3	515.2	519.3	518.6	521.7	511.8	507.4
Claims on private sector	263.4	294.8	369.0	373.8	380.0	391.9	419.8	454.9
Rupiah claims	178.4	224.2	295.7	301.2	305.0	317.8	344.3	377.9
Foreign exchange claims	85.0	70.7	73.3	72.6	75.0	74.1	75.5	77.0
Other items (net)	-199.9	-182.6	-209.6	-206.4	-231.3	-203.4	-197.6	-196.0
Broad money (M2)	709.1	793.5	853.4	873.4	848.4	899.6	926.1	961.2
Rupiah broad money	606.8	689.3	743.4	760.2	740.2	783.1	806.2	837.8
Currency	72.4	76.3	80.7	78.1	72.3	81.1	83.7	94.2
Deposits 2/	534.5	612.9	662.8	682.1	667.9	702.0	722.5	743.6
Foreign exchange deposits	102.3	104.2	110.0	113.2	108.2	116.5	119.9	123.4
Bank of Indonesia								
Net international reserves 3/	124.5	128.1	155.1	155.3	162.1	155.4	155.5	155.6
Net domestic assets	0.4	-0.5	-16.8	-24.5	-36.9	-19.4	-15.6	0.6
Net claims on government	136.1	166.8	172.0	189.0	175.9	198.1	195.9	193.1
Claims on private sector	7.7	7.8	8.3	8.3	8.4	8.3	8.3	8.3
Claims on DMBs	-44.6	-69.6	-80.9	-105.6	-96.2	-109.6	-103.6	-84.6
Open market operations	-78.0	-102.6	-113.3	-138.1	-127.9	-142.1	-136.0	117.0
Other items (net)	-98.7	-105.5	-116.3	-116.3	-125.1	-116.3	-116.3	-116.3
Base money 4/	125.0	127.7	138.3	130.7	125.2	136.0	139.9	156.2
Currency outside banks	72.4	76.3	80.7	78.1	72.3	81.1	83.7	94.2
DMBs	50.7	49.6	56.0	51.0	51.0	53.2	54.5	60.4
Nonbank deposits	2.0	1.7	1.6	1.6	1.9	1.6	1.6	1.6
Memorandum items:								
Base Money test date 5/	118.1	124.7	132.2	129.3	123.0	134.5	138.1	150.4
NIR of BI (billions USD)	17.8	18.3	22.2	22.2	23.2	22.2	22.2	22.2
Money multiplier (rupiah broad money)	4.9	5.4	5.4	5.8	5.9	5.8	5.8	5.4
Base money velocity 6/	10.8	11.4	11.7	14.3	14.2	14.0	14.0	12.5
Rupiah broad money velocity 6/	2.2	2.1	2.2	2.4	2.4	2.4	2.4	2.3
Annual percentage change:								
Broad money (constant exchange rate)	10.0	11.9	7.6	10.5	7.4	10.9	11.9	12.6
Rupiah broad money	13.8	13.6	7.9	11.6	8.6	11.9	12.5	12.7
Base money	22.8	2.1	8.3	11.8	7.1	13.4	12.9	13.0
Private sector claims 7/	5.2	17.9	23.6	24.5	26.6	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 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 6. Indonesia: Summary of Central Government Operations, 2001–03

	2001	2002	2003			Proj.
			Q1 Program	Q1 Preliminary	8th Review	
(In trillions of rupiah)						
Revenues and grants	301.1	300.1	73.3	70.2	344.0	333.4
Oil and gas revenues	104.1	77.2	12.4	12.8	81.1	73.9
Non-oil and gas revenues	196.5	222.9	60.9	57.4	262.9	259.5
Tax revenues	162.4	193.7	56.5	53.6	237.1	233.7
Nontax revenues 1/	34.5	29.1	4.4	3.7	25.8	25.8
Expenditure and net lending	354.4	328.4	80.9	60.1	378.4	367.8
Central government expenditure	273.3	229.8	49.1	31.1	260.0	249.6
Current expenditure	226.1	192.8	43.8	34.1	202.1	193.2
Personnel	38.7	39.8	13.7	12.0	50.2	50.2
Subsidies	77.4	40.0	5.8	1.3	32.8	28.0
Interest	94.9	89.9	18.3	16.9	81.2	77.4
External	28.9	25.4	5.5	4.8	26.0	25.5
Domestic	66.0	64.5	12.8	12.1	55.2	51.9
Other	15.0	23.1	6.0	3.9	37.9	37.6
Development expenditure 2/	41.6	37.1	5.3	2.1	57.9	56.4
Statistical discrepancy	5.6	0.0	0.0	-5.1	0.0	0.0
Transfers to regions	81.1	98.5	31.8	29.0	118.4	118.2
Overall balance	-53.3	-28.3	-7.6	10.1	-34.4	-34.4
Financing	53.3	28.3	7.6	-10.1	34.4	34.4
Domestic	46.5	24.0	8.4	-9.0	26.1	26.1
Bank financing 3/	7.2	-21.8	4.0	-14.0	-7.9	-5.4
Cash recovery of bank assets 4/	28.0	43.3	4.3	4.6	26.0	26.0
Privatization of nonfinancial assets	3.5	7.6	0.0	0.0	8.0	5.0
Other	7.8	-5.1	0.0	0.4	0.0	0.5
External	6.8	4.3	-0.8	-1.1	8.3	8.3
(In percent of GDP)						
Revenues and grants	20.8	18.6	3.8	3.8	17.9	18.3
Oil and gas revenues	7.2	4.8	0.6	0.7	4.2	4.0
Non-oil and gas revenues	13.6	13.8	3.2	3.1	13.7	14.2
Tax revenues	11.2	12.0	2.9	2.9	12.4	12.8
Nontax revenues 1/	2.3	1.8	0.2	0.2	1.3	1.4
Expenditure and net lending	24.5	20.4	4.2	3.3	19.7	20.2
Central government expenditure	18.9	14.3	2.6	1.7	13.6	13.7
Current expenditure	15.6	12.0	2.3	1.9	10.5	10.6
Personnel	2.7	2.5	0.7	0.7	2.6	2.8
Subsidies	5.3	2.5	0.3	0.1	1.7	1.5
Interest	6.6	5.6	1.0	0.9	4.2	4.2
External	2.0	1.6	0.3	0.3	1.4	1.4
Domestic	4.6	4.0	0.7	0.7	2.9	2.8
Other	1.0	1.4	0.3	0.2	2.0	2.1
Development expenditure 2/	2.9	2.3	0.3	0.1	3.0	3.1
Statistical discrepancy	0.4	0.0	0.0	-0.3	0.0	0.0
Transfers to regions	5.6	6.1	1.7	1.6	6.2	6.5
Overall balance	-3.7	-1.8	-0.4	0.6	-1.8	-1.9
Financing	3.7	1.8	0.4	-0.6	1.8	1.9
Domestic	3.2	1.5	0.4	-0.5	1.4	1.4
Bank financing 3/	0.5	-1.4	0.2	-0.8	-0.4	-0.4
Cash recovery of bank assets 4/	1.9	2.7	0.2	0.2	1.4	1.4
Privatization of nonfinancial assets	0.2	0.5	0.0	0.0	0.4	0.4
Other	0.5	-0.3	0.0	0.0	0.0	0.0
External	0.5	0.3	0.0	-0.1	0.4	0.5
Memorandum items:						
Primary balance	2.9	3.8	0.6	1.5	2.4	2.4
Non-oil primary balance	-4.3	-1.0	-0.1	0.8	-1.8	-1.7
Non-oil overall balance	-10.9	-6.6	-1.0	-0.1	-6.0	-5.9
GDP (in trillions of rupiah)	1,449	1,610	1,916	1,825	1,916	1,825

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 net issuance of domestic debt.

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

Table 7. Indonesia: Medium-Term Fiscal Projections, 2001–05

	2001	2002	2003	2004	2005
	(In percent of GDP)				
Fiscal accounts					
Primary balance	2.9	3.8	2.4	2.6	2.9
Interest 1/	6.5	5.6	4.2	3.7	3.6
Overall balance	-3.7	-1.8	-1.9	-1.1	-0.7
Financing					
Gross requirements	8.3	5.5	5.7	4.5	4.7
Deficit	3.7	1.8	1.9	1.1	0.7
Amortization	4.6	3.8	3.8	3.4	4.0
External	3.3	3.1	2.7	2.2	2.1
Domestic 2/	1.2	0.7	1.2	1.2	1.9
Sources	8.3	5.5	5.7	4.5	4.7
External disbursements (including rescheduling)	3.8	3.3	3.1	1.5	1.4
Privatization and asset recoveries	2.1	3.2	1.7	0.3	0.4
Other domestic financing 3/	2.4	-1.0	0.9	2.6	2.9
Public debt					
Total	90.9	86.4	69.0	64.0	58.5
External 4/	41.8	41.1	32.3	30.1	26.8
Domestic 5/	49.1	45.3	36.6	33.9	31.7
Memorandum items:					
Other domestic financing (in trillions of rupiah)	34.0	-15.5	16.6	52.8	65.1
Deficit financing	3.7	1.8	1.9	1.1	0.7
Net domestic financing	3.2	1.5	1.4	1.7	1.4
Net external financing	0.5	0.3	0.5	-0.6	-0.7
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	2.9	3.0	3.5	4.0

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 1 trillion (0.05 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. Includes 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 8. IBRA Asset Recovery and Official Targets, 2002–03
(In trillions of rupiah)

	2002		2003		2003		Q4	Total
	Annual		Q1	Actual	Q2	Q3		
	Actual	Target	Target 1/		Target 1/			
Total cash receipts (net of expenses)	38.1	36.1	3.4	1.2	7.5	13.2	1.9	26.0
+ AMC (loans and noncore assets)	26.8	24.5	3.0	0.8	3.2	9.3	0.1	15.6
Of which: Loan sales	21.7	15.5	...	-0.2	...	...	...	...
+ AMI (industrial and other assets)	5.0	9.7	0.4	0.5	1.3	2.9	1.9	6.4
+ BRU (bank equity)	6.7	4.3	0.0	0.0	3.0	1.0	0.0	4.0
+ Other income 2/	0.7	...	...	0.1	...	...	...	...
- Total expenses	1.1	2.4	...	0.2	...	...	...	...
Total bond receipts 3/	7.5	7.5	...	2.9	...	...	...	...
Total receipts (cash and bonds)	45.6	43.6	3.4	4.1	7.5	13.2	1.9	26.0

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. Under the program, structural benchmarks for cumulative IBRA cash recoveries have been set as follows: Rp 3 trillion by end-March, Rp 7 trillion by end-June, and Rp 18 trillion by end-September.

2/ Comprises investment income.

3/ Received as payment in loan sales.

Table 9. 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	8.1
Short-term (ST) interest rate (in percent)	12.1	15	48.2	22.7	12.4	16.5	14.9	11.2
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	...
External sector								
Current account balance (in percent of GDP)	-3.4	-1.1	4.5	4.1	5.3	4.9	4.3	2.2
Net FDI inflows (in percent of GDP)	3.7	6.3	5.5	2.4	1.8	1.8	1.3	1.2
Export growth (U.S. dollar value, GNFS)	9.7	6.8	-15.4	1.8	26.5	-10.9	1.8	2.2
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	34.3
GIR in percent of short-term debt at remaining maturity	84.1	30.3	66.4	73.8	84.3	89.6	131.3	150.1
Net international reserves (NIR) (in billions of U.S. dollars)	26.7	13.3	15.9	16.0	17.8	18.3	22.2	24.0
Total gross external debt (in percent of GDP)	60.3	99.4	156.9	113.2	99.6	97.5	75.8	63.0
Of which: Short-term debt (original maturity in percent of GDP)	6.1	6.5	12.1	6.9	5.3	4.7	0.9	0.7
Private sector debt (in percent of GDP)	22.9	46.1	66.7	43.0	43.5	42.3	32.0	25.8
Total gross external debt in percent of exports of GNFS	243.2	237.1	308.0	285.0	212.7	220.2	205.9	197.1
Public sector 1/								
Overall balance (in percent of GDP)	0.8	-1.6	-2.2	-1.5	-1.1	-3.7	-1.8	-1.9
Primary balance (in percent of GDP)	2.0	0.0	0.9	2.4	4.0	2.9	3.8	2.4
Debt-stabilizing primary balance (in percent of GDP) 2/	...	...	...	...	2.3	2.5	2.3	2.1
Public sector gross debt (in percent of GDP) 3/	24.5	66.1	70.1	92.1	104.1	94.2	82.7	69.3
External debt from official creditors (in percent of total)	65.3	63.4	49.3	34.0	44.4	43.8	42.4	44.9
External debt from private creditors (in percent of total)	28.2	29.6	22.6	13.3	0.6	0.5	0.4	0.3
Domestic debt linked to foreign currency (in percent of total)	0.0	0.0	0.0	2.8	2.6	2.9	1.9	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	17.8	17.9
Public sector net debt (in percent of GDP)	...	...	...	...	...	...	...	...
Financial sector								
Capital adequacy ratio (in percent) 4/ 5/	11.8	9.2	-52.2	-8.1	21.6	18.2	19.6	...
NPLs in percent of total loans 4/	...	11.3	50.9	32.9	16.3	12.3	5.8	...
Provisions in percent of NPLs 4/	36.4	34.4	34.5	87.0	88.8	94.0	125.7	...
Return on average assets (in percent) 4/	...	...	...	-8.7	0.3	0.6	1.3	...
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	10.0	11.3
Of which: Amortization of MLT debt, public (in percent of total GEFR) 6/	40.8	20.1	42.4	43.8	53.3	49.6	100.0	80.1
Amortization of MLT debt, private (in percent of total GEFR) 7/	-29.4	51.7	31.2	38.7	47.5	51.5	58.6	45.9
Maturing ST debt (in percent of total GEFR)	56.8	24.0	42.0	42.9	53.5	35.5	15.0	13.3
Current account balance (in percent of total GEFR)	31.8	4.2	-15.5	-25.4	-54.4	-36.6	-73.6	-39.3
Gross public sector financing requirements (GPSFR) (in billions of U.S. dollars) 8/	4.3	6.3	5.3	4.9	2.4	8.9	7.7	8.8
Of which: Amortization of MLT debt (in percent of total GPSFR) 9/	143.9	62.4	56.6	55.2	38.3	39.9	60.8	54.8
Maturing short-term debt (in percent of total GPSFR)	...	...	...	...	7.0	1.8	2.2	1.9
Overall public sector deficit (in percent of total GPSFR)	-43.9	37.6	43.4	44.8	54.7	58.2	37.0	43.3

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 outstanding IMF purchases.

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

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

6/ Includes banking sector amortizations and IMF repurchases.

7/ 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.

8/ Includes short-term debt (all external).

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

Table 10. Indonesia: External Debt Sustainability Framework, 1997–2007 (Sensitivity Analysis excluding 1998 and 1999)
(In percent of GDP, unless otherwise indicated)

	Actual						Projections				
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline medium-term projections											
External debt	67.9	167.4	112.1	94.3	94.2	75.8	63.3	54.0	48.0	42.8	37.9
External debt-to-exports ratio (in percent)	228.6	282.3	285.0	201.3	212.6	205.9	197.1	179.6	163.7	147.2	132.7
Gross external financing need (in billions of U.S. dollars) 1/	40.6	32.7	23.1	24.8	26.7	31.5	23.7	14.0	13.8	13.6	12.4
In percent of GDP	18.8	34.2	16.3	16.5	18.9	18.2	11.7	6.2	5.7	5.3	4.5
Key macroeconomic and external assumptions											
Nominal GDP (U.S. dollars)	216	95	141	150	141	173	203	227	243	258	278
Real GDP growth (in percent)	4.5	-13.1	0.8	4.9	3.4	3.7	3.5	4.0	5.0	5.0	5.0
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-19.3	-70.9	27.5	-6.7	-17.8	10.2	3.3	0.0	-3.7	-3.1	-1.0
GDP deflator in U.S. dollars (change in percent)	-9.1	-49.1	46.8	2.8	-8.9	18.2	13.1	7.7	1.8	1.3	2.4
Nominal external interest rate (in percent)	6.0	6.0	4.4	4.8	4.1	3.1	3.3	3.6	3.7	3.7	3.7
Growth of exports (U.S. dollar terms, in percent)	15.1	-11.7	-1.8	26.6	-11.0	1.8	2.2	4.8	4.3	5.3	5.8
Growth of imports (U.S. dollar terms, in percent)	7.6	-21.9	-19.8	29.8	-9.6	1.6	7.8	6.2	7.4	7.1	7.4
II. Stress tests for external debt ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and nondebt inflows are at historical average in 2003-						75.8	76.5	75.6	74.2	72.7	71.6
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						75.8	65.5	57.8	51.7	46.3	41.4
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						75.8	63.8	55.2	49.2	43.9	39.0
4. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						75.8	82.1	87.9	80.9	74.8	68.8
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						75.8	73.4	72.9	66.3	60.6	55.1
6. Combination of 2–5 using one standard deviation shocks						75.8	83.5	90.2	83.1	77.0	70.9
7. One-time 30 percent nominal depreciation in 2003						75.8	90.7	79.4	72.6	66.7	61.0
Historical Statistics for Key Variables (past 10 years)											
						<u>Historical Average</u>	<u>Standard Deviation</u>		<u>Average</u>		
						excl. 98 and 99	excl. 98 and 99		2002–07		
Current account deficit, excluding interest payments						-2.9	4.3		-3.8		
Net nondebt creating capital inflows						-2.2	...		1.8		
Nominal external interest rate (in percent)						5.3	0.6		3.5		
Real GDP growth (in percent)						6.4	1.8		4.4		
GDP deflator in U.S. dollars (change in percent)						0.7	6.2		7.4		

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

NOTE: Sensitivity tests are based on historical averages excluding 1998 and 1999, as these years represent extreme outliers.

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

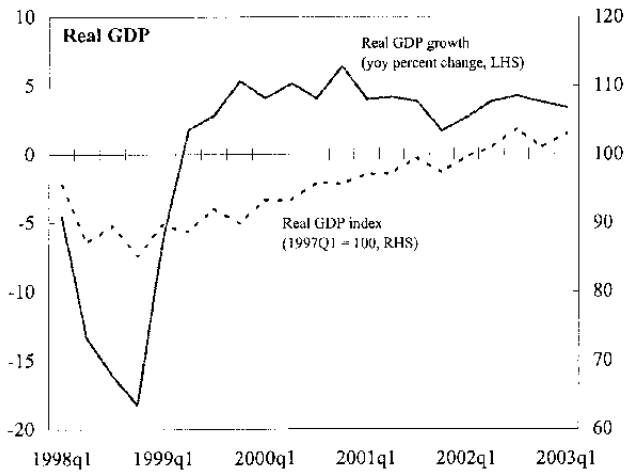
Table 11. Indonesia: Indicators of Debt Service to the Fund, 2001–10
(In billions of U.S. dollars)

	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	4.1	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	14.7	12.1	12.1	13.4	16.2	17.6	10.8	8.8
In percent of reserves of Bank Indonesia 1/	8.0	8.1	4.6	3.5	4.0	4.5	5.0	5.3	2.9	2.1
Outstanding Fund credit	9.21	8.41	9.21	8.33	7.31	6.11	4.68	3.03	2.06	1.31
In percent of GDP	6.5	4.9	4.5	3.7	3.0	2.4	1.7	1.0	0.6	0.4
In percent of nonfinancial public debt	12.4	10.7	11.8	11.0	10.2	8.9	7.1	4.8	3.4	2.2
In percent of reserves of Bank Indonesia 1/	32.9	26.2	26.8	25.1	23.0	19.6	14.7	9.1	5.8	3.4
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	18.2	16.3	14.1	14.6	13.9	12.4	12.1	11.0	9.9
In percent of GDP	7.8	6.7	5.3	4.2	4.3	4.0	3.5	3.4	3.0	2.7

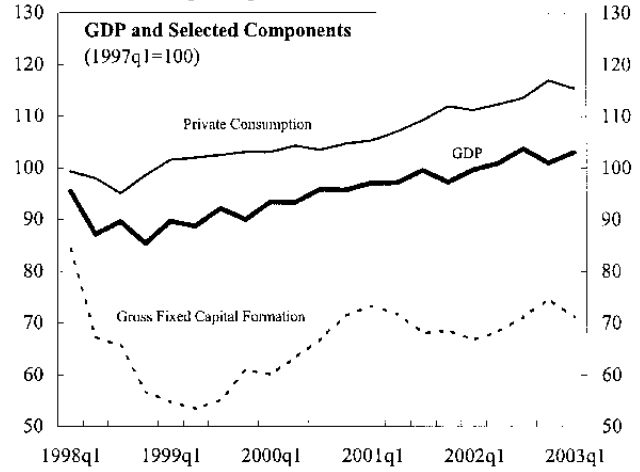
1/ End of period reserves.

Figure 1. Recent Macroeconomic Developments

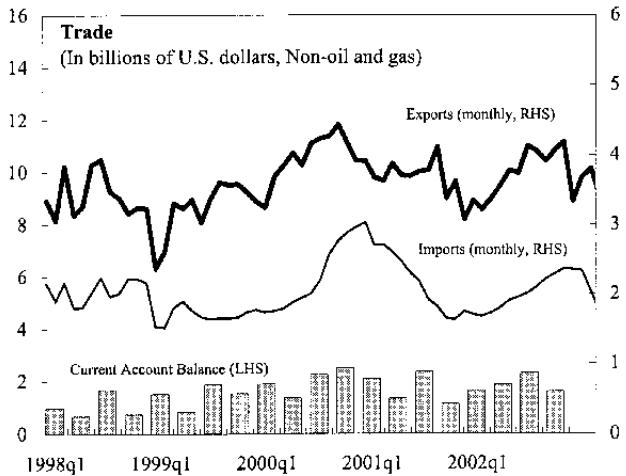
GDP growth has remained steady...



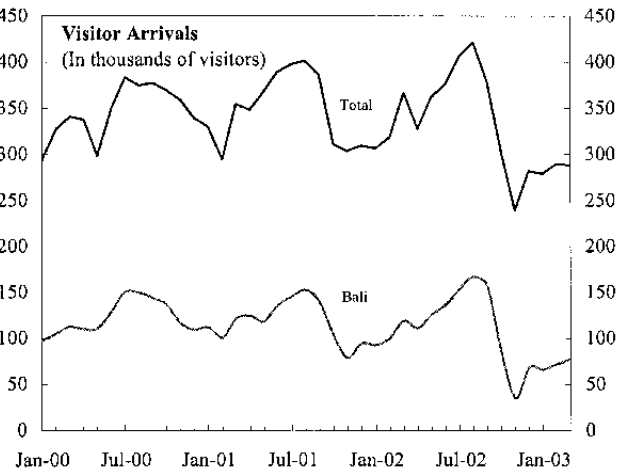
...as private consumption has generally held up, even in the face of adverse shocks.



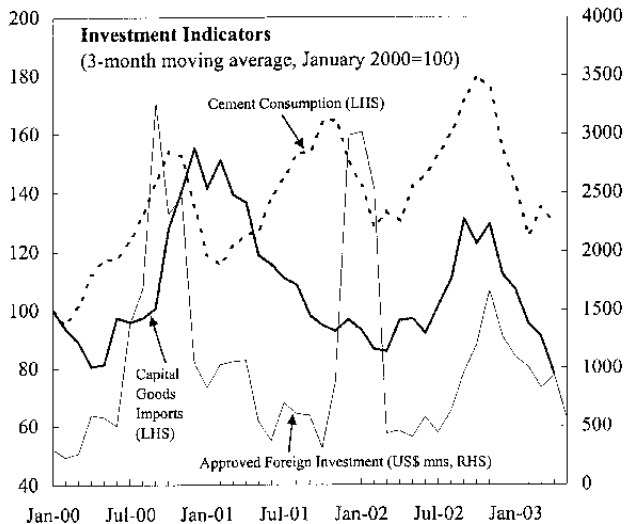
Merchandise exports have remained strong...



...although tourist arrivals have declined.



Investment indicators are showing tentative signs of improvement...



...and the outlook for growth remains generally stable.

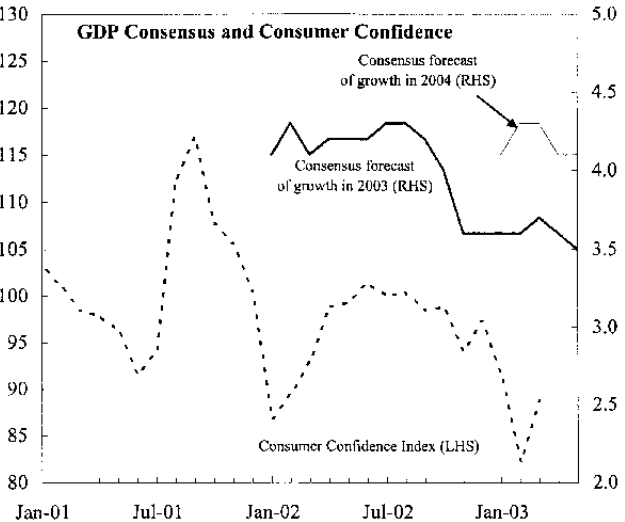
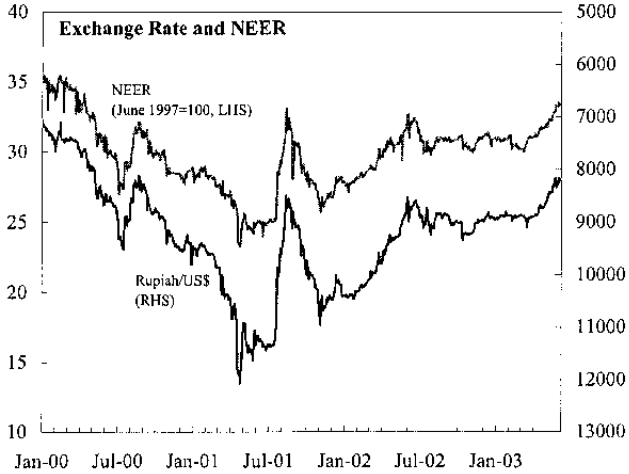
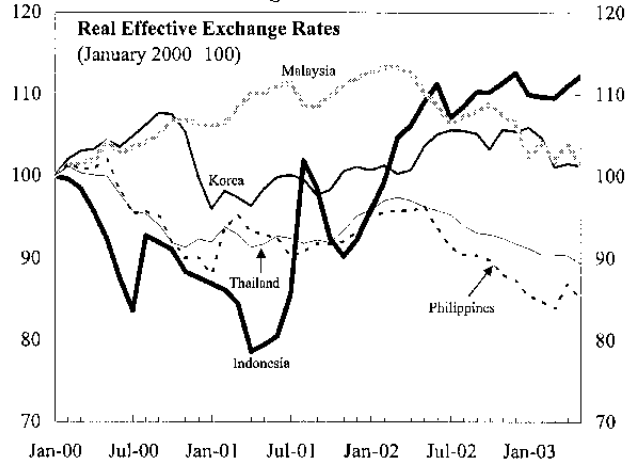


Figure 2. Market Sentiment and Financial Indicators

The ongoing strengthening of the exchange rate has accelerated in recent months...



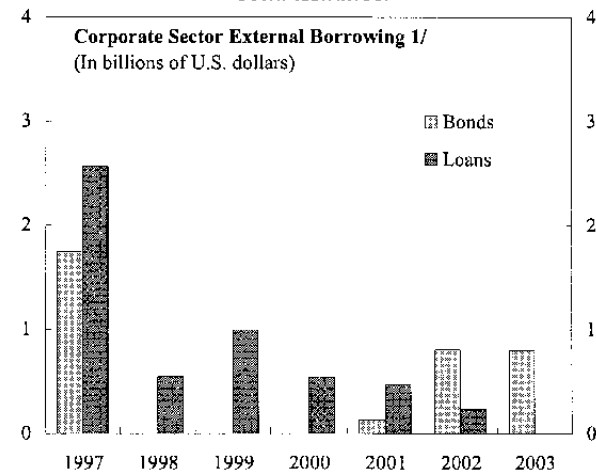
...and the rupiah has now appreciated significantly relative to other regional currencies.



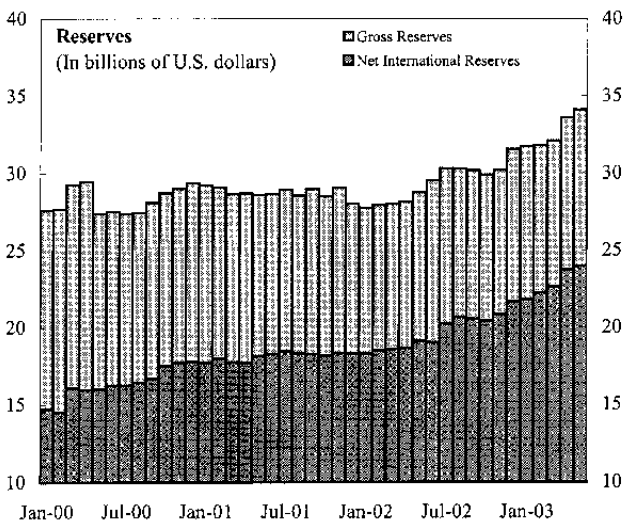
Improved market sentiment has contributed to a stock market rally...



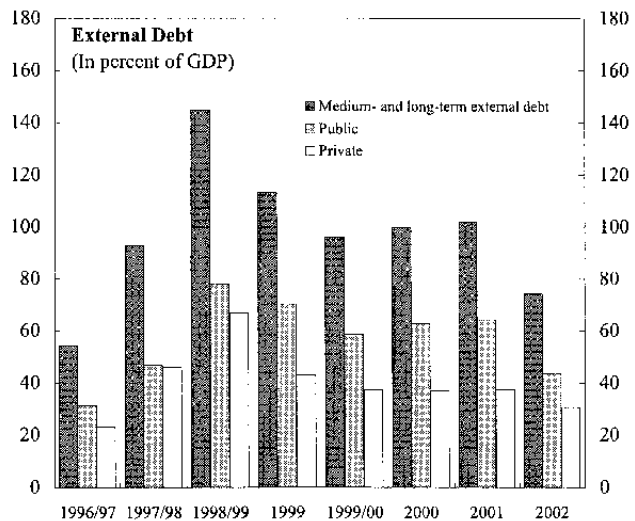
...and has facilitated an increase in external corporate bond issuance.



External vulnerability continues to be reduced as reserves rise...



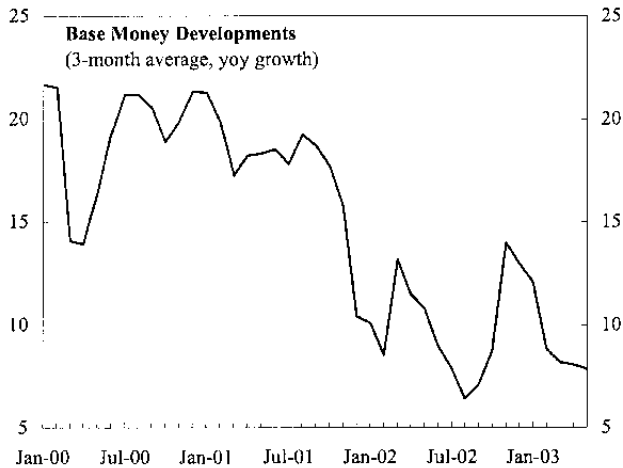
...and external debt continues to decline.



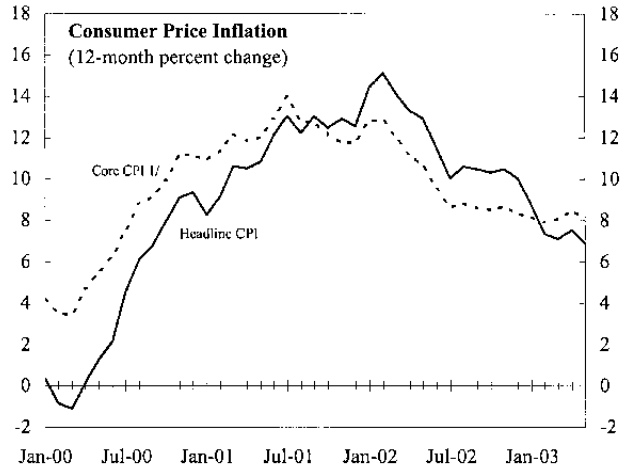
1/ Includes financial sector.

Figure 3. Monetary and Banking Developments

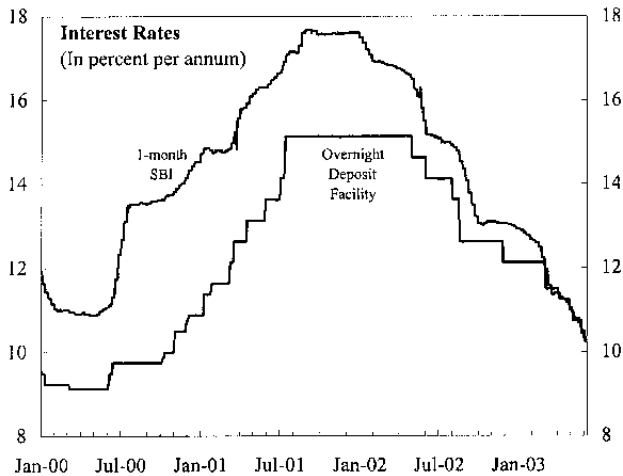
Base money growth remains subdued.



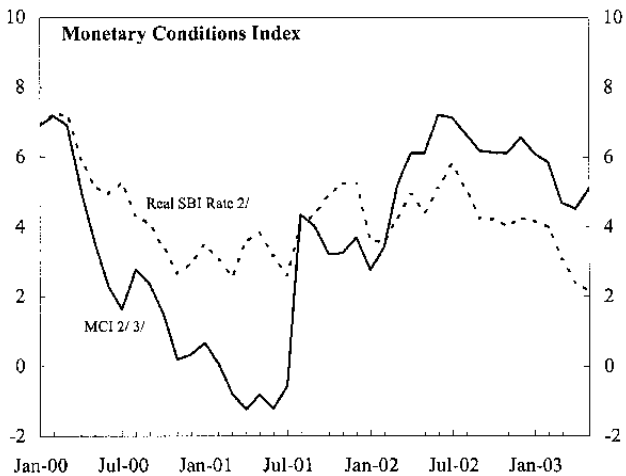
Inflation has moderated significantly...



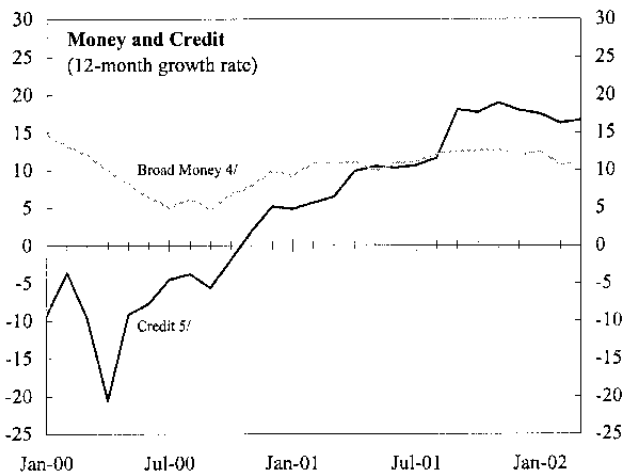
...enabling policy rates to be lowered.



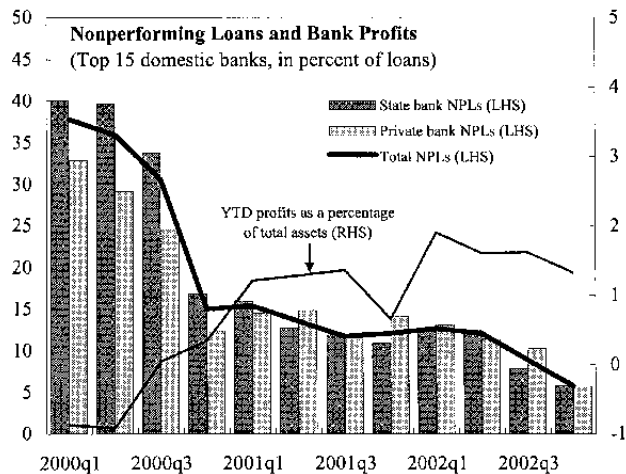
However, monetary conditions remain relatively tight.



Credit growth has outpaced broad money growth...



...with increased intermediation supported by an improvement in bank financial indicators.



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 May 31, 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	8,253.86	396.95
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	3.03	1.27

IV. Outstanding Purchases and Loans	<u>SDR Millions</u>	<u>Percent of Quota</u>
Stand-by arrangements	91.73	4.41
Extended arrangements	6,228.32	299.54

V. Financial Arrangements	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved</u>	<u>Amount Drawn</u>
<u>Type</u>			<u>(SDR Millions)</u>	<u>(SDR Millions)</u>
EFF	Feb. 04, 2000	Dec. 31, 2003	3,638.00	2,605.82
EFF	Aug. 25, 1998	Feb. 04, 2000	5,383.10	3,740.68
Stand-by	Nov. 05, 1997	Aug. 25, 1998	8,338.24	3,577.40

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	437.2	678.1	774.8	1,015.6	1,302.4
Charges/Interest	<u>72.8</u>	<u>136.2</u>	<u>119.3</u>	<u>100.1</u>	<u>74.3</u>
Total	509.9	814.3	894.1	1,115.7	1,376.6

VII. Exchange Arrangements

The rupiah has floated since August 14, 1997. The market exchange rate was Rp 8,338 per U.S. dollar on May 29, 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

While the extended arrangement is effective, Indonesia is on a 24-month consultation cycle, subject to the terms of Decision 12794-(02/79), adopted July 15, 2002, as amended. 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 recommendations concerning the establishment of an independent audit committee at BI and the publication of BI's audited financial statements have been implemented. A mid-year audit of BI's foreign exchange reserves (conducted by the independent accounting firm of PricewaterhouseCoopers) was completed in October 2002. 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, which have since been mostly addressed. The staff has recommended the continued involvement of an independent firm in BI's external audit mechanism and is following this up with the authorities.

COORDINATING MINISTER OF ECONOMIC AFFAIRS
REPUBLIC OF INDONESIA

Jakarta, Indonesia
June 11, 2003

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

Dear Mr. Köhler:

1. This letter updates progress in meeting the policy objectives under our economic program for 2003 described in the Memorandum of Economic Policies (MEFP) of March 18, 2003. The program is continuing to restore market confidence and enhance growth prospects. In recent months, the rupiah has appreciated further, inflation has remained on a downward trend, there has been an additional build-up in international reserves, and economic growth has been sustained. These developments have occurred against the backdrop of turbulent international economic and political events, revealing the Indonesian economy's growing resilience to adverse shocks.

2. All end-March quantitative performance criteria and indicative targets were met (Table 1). IBRA's cash recoveries for the first quarter fell short of the target, but with promising results from the ongoing asset sales program, the program is back on track and the cumulative Rp 7 trillion cash target for June is expected to be met. With regard to the other policy actions covered by the structural benchmarks through April, all have now been implemented except for finalization of the blueprint for strengthening the treasury budget functions of the Ministry of Finance, which has been delayed. Additional time was needed to finalize the blueprint pending an independent review by an external consulting firm; we now expect the blueprint to be finalized by mid-year.

3. Fiscal policy is on track to achieve the 2003 deficit target of 1.8 percent of GDP. In the first quarter, the budget unexpectedly recorded a surplus, in part reflecting temporary expenditure shortfalls. Revenue performance was largely on target, and we are continuing to make steady progress in improving tax and customs administration. Given the recent fall in world oil prices, fuel subsidies are now declining. In the area of provincial and local budget reporting, we are strengthening efforts to minimize reporting delays, including through the imposition of sanctions on regions that fail to submit their end-2002 reports by the middle of the year.

4. Monetary policy remains firmly geared toward supporting the downward trend in inflation and maintaining exchange rate stability. While reducing interest rates further, Bank Indonesia has achieved its monetary and reserves targets with sizeable margins, which we expect to maintain in the period ahead.

5. A comprehensive plan for a sound financial safety net has been developed by the Ministry of Finance and Bank Indonesia. As expected, the plan provides for the creation of a deposit insurance scheme, lender of last resort capability for BI, and a supervisory and regulatory agency for the financial sector. It defines the primary roles of the various authorities in the safety net, and specifies the sequencing of reforms for an orderly phase-out of the blanket guarantee in due course. We now intend to prepare legislation in line with this plan for submission to Parliament during the second half of this year; we have also established a joint working group to develop operational modalities.

6. IBRA continues to make good progress toward achieving its annual asset recoveries target. Results from the recently completed loan sale program were encouraging, and IBRA has recently launched the sale of virtually all of its remaining asset holdings. The bank divestment program is also advancing; we have completed the sale of Bank Danamon, have announced our plan to launch the majority sale of Bank Lippo this month, and have advanced preparations for the divestment of BII. With regard to the shareholder settlement agreements with former bank owners, we remain committed to full settlement of the commercial terms under the agreements by end-June. To this end, while we continue to work with cooperative debtors to receive cash and other assets against their obligations, we are taking steps to strengthen the legal basis to enable the use of nonjudicial means to pursue recalcitrant debtors.

7. Improving the governance of state banks remains a priority of the government. The Ministry of State-Owned Enterprises has begun strengthening its staff resources to monitor state bank performance, additional commissioners are being appointed at BRI and BTN, and new annual performance contracts for bank managers have been prepared as needed. We are also requesting each of the state-owned banks to submit corrective action plans, based on their recently completed annual audits, by July. With respect to Bank Mandiri, we have strengthened the Bank's management through the appointment of five new Directors, and are proceeding with plans for the launching of the IPO during the second quarter. A comprehensive, time-bound restructuring plan for BTN has been approved, and implementation initiated by the bank's Directors. Having reduced its nonperforming loans, BNI has prepared a detailed plan to eliminate its remaining impaired assets during 2004.

8. We have also made progress in other elements of the structural reform agenda. In the legal area, we continue to work toward establishing the Anti-Corruption Commission (ACC) by end-year. The amendments to the Foundations Law were recently submitted to Parliament. During the debate of the amendments, the legal basis for the Supreme Audit Agency (BPK) to undertake audits of military and other foundations receiving state funds or financing of state activities will be clarified. In the area of public sector governance, we are making progress in implementing our program of state enterprise audits.

9. In view of the progress made under the program, we request completion of the ninth review under the Extended Arrangement. It is proposed to leave our targets for the remainder of the year unchanged, while converting the indicative nature of the relevant quantitative targets for September established at the time of the eighth review into performance criteria. We will continue to consult with the Fund in the period ahead on economic policies, and we expect to have the remaining two reviews completed by September and December 2003.

Sincerely yours,

/sd/

Dorodjatun Kuntjoro-Jakti
Coordinating Minister for
Economic Affairs

/sd/

Boediono
Minister of Finance

/sd/

Burhanuddin Abdullah
Governor
Bank Indonesia

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

	2002		2003			
	Dec.	Mar.		Jun.	Sep.	Dec.
	Actual	PC	Actual	PC	PC	IT
Monetary and fiscal targets						
Net domestic assets (NDA) of Bank Indonesia	-16.8	-24.5	-36.9	-19.4	-15.6	0.6
Base money (indicative target) 2/	132.2	129.3	123.0	134.5	138.1	150.4
Overall central government balance 3/	-28.3	-7.6	10.1	-15.6	-25.6	-34.4
External targets (in billions of U.S. dollars)						
Net international reserves (NIR) of Bank Indonesia 4/	22.2	22.2	23.2	22.2	22.2	22.2
Contracting or guaranteeing of new noncessional external debt 5/	0.8	0.3	0.0	0.6	1.0	1.5
<i>Of which:</i> Government debt to commercial creditors	0.1	0.2	0.0	0.2	0.2	0.2
Stock of short-term external debt outstanding	0.5	2.5	0.1	2.5	2.5	2.5

1/ Definitions are contained in the Technical Memorandum of Understanding (EBS/03/35, Supplement 1). Continuous performance criteria are: the nonaccumulation of public external arrears and no securitization or forward sale of receipts from natural resources.

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

3/ 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.

4/ Outstanding stocks (floor).

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

Table 2. 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.
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Press Release No. 03/95
FOR IMMEDIATE RELEASE
June 25, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Ninth Review of Indonesia Program, Approves US\$486 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) completed today its ninth 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\$486 million), bringing the total amount drawn under the arrangement to SDR 2.9 billion (about US\$4 billion).

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

“The Indonesian authorities are to be commended for their continued strong policy performance under their arrangement with the Fund. The economy is sustaining steady growth despite a number of external and domestic shocks; inflation has continued to decline; and there has been an additional buildup of international reserves. These developments have contributed to a further improvement in financial market sentiment, manifested in a strengthening of the rupiah, and a sharp rise in the stock market.

“Indonesia’s fiscal policy remains geared toward achieving a significant fiscal consolidation and reduction in public debt. Budget performance through the first quarter was well within the program’s target and is on track to achieve the full-year target of 1.8 percent of GDP. Other priorities in the fiscal area are being met through a strengthening of the decentralization framework and efforts to enhance the public expenditure management system.

“Bank Indonesia’s prudent conduct of monetary policy has contributed to a sustained decline in inflation and appreciation of the rupiah. These developments have allowed interest rates to decline in support of economic recovery, and a continued cautious monetary stance will help achieve a further and lasting decline in inflation.

“Progress has also been made in structural areas, including on IBRA recoveries, which are on track to meet the annual target. Going forward, the priority is to ensure a transparent disposition of the assets of IBRA’s largest debtors, and enhance recoveries from the bank shareholder settlement agreements through intensified efforts to ensure compliance. The authorities are also encouraged to keep up the momentum of the privatization program.

“Financial sector reforms continue to advance on schedule. The divestment of Bank Danamon was recently concluded, the timetable for the divestment of Bank Lippo has been announced, and the initial public offering (IPO) of the country’s largest bank, Bank Mandiri, is expected to be concluded shortly. A comprehensive plan to strengthen the financial sector safety net has been completed, representing an important milestone in the reform of the financial system.

“Sustained strong progress on the government’s comprehensive reform agenda will be key to improving Indonesia’s investment climate and maintaining market confidence. Priorities are legal and judicial reforms, including the establishment of the Anti-Corruption Commission, the adoption of amendments to the bankruptcy law, and the reform of the Commercial Court.

“The Fund looks forward to a continued close cooperation and policy dialogue with the authorities in the period ahead,” Mr. Sugisaki stated.