INTERNATIONAL MONETARY FUND

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INDONESIA

2012 ARTICLE IV CONSULTATION

September 2012

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Indonesia, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 6, 2012, with the officials of Indonesia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 21, 2012. 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.
- **Informational Annex** prepared by the IMF.
- **Staff Statement** of September 7, 2012
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its September 7, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Indonesia.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

INDONESIA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

August 21, 2012

KEY ISSUES

Context. A fundamental improvement of the policy framework over the past decade has helped Indonesia weather recent crises well. However, there exists room for policy calibration to address near-term challenges and for policy changes to ensure higher, sustained, and equitable growth over the longer term. The political cycle is picking up with presidential and parliamentary elections both expected in early 2014.

Outlook and risks. Growth is projected to ease to 6 percent in 2012 from 6.5 percent in 2011, as weaker external conditions are somewhat offset by a moderate fiscal stimulus. However, strong domestic demand, underpinned by robust credit growth, will likely push inflation to 5 percent by year-end. Risks to the outlook arise from a possible larger-than-envisaged slowdown in external demand as well as global risk aversion spikes, and their impact could be amplified by policy missteps.

Responding to global uncertainty. The moderate fiscal stimulus in the 2012 budget is appropriate, given weaker external demand. Reducing excess liquidity would improve the effectiveness and credibility of monetary policy. Increased flexibility of the exchange rate, combined with judicious use of reserves when warranted, would address market tensions during bouts of heightened risk aversion.

Enhancing the policy framework. Revamping the monetary policy framework would help better guide market expectations, while increasing fiscal flexibility would strengthen economic resiliency. Replacing costly and inefficient energy subsidies with targeted cash transfers would create room for critically needed increased infrastructure and social spending. Further steps to strengthen financial sector oversight and the systemic crisis response framework would help safeguard financial stability.

Improving growth outcomes. A young population and rising inequality call for growth that is both higher and whose fruits are shared more broadly. This requires better investment and improvements to the business environment. Maintaining an open trade and investment regime would ensure that Indonesia remains an attractive destination for foreign investors.

Approved By
Jerald Schiff and Tom Dorsey

Discussions took place in Jakarta during June 25–July 6, 2012. The team comprised Sanjaya Panth (head), Geoffrey Heenan, Yong Sarah Zhou (all APD), Dora Benedek (FAD), Mali Chivakul (SPR), and Nancy Rawlings (MCM). Aida Budiman, Iss Hafid (both OED), and Milan Zavadjil (Senior Resident Representative) also participated in the discussions. The staff of the IMF office in Jakarta provided valuable assistance to the mission. The team met with Minister of Finance Agus Martowardojo, Bank Indonesia Governor Darmin Nasution, Minister of Trade Gita Wirjawan, other senior officials, and private sector representatives.

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BACKGROUND AND CONTEXT

1. **Indonesia's economic performance has been impressive in recent years** (Figure 1). A fundamental reform of the policy framework over the past decade left Indonesia in a strong position when the global economy turned sour after 2007. Major macroeconomic policy initiatives this past decade have included legally enshrining fiscal discipline as well as the adoption of inflation targeting and a more flexible exchange rate policy. As a result, growth has averaged 5.5 percent during 2002−11, inflation has declined sharply over the medium term, and public debt has fallen from around 76 percent of GDP in 2001 to under 25 percent currently. The strong policy framework ensured that Indonesia came out of the 2008 global financial crisis as well as the initial stages of the Euro-area problems, much better than its Asian peers. Indeed, at 6.5 percent, economic growth in 2011 was the highest in 14 years and by mid-2011, international reserves had nearly doubled from post-Lehman lows.

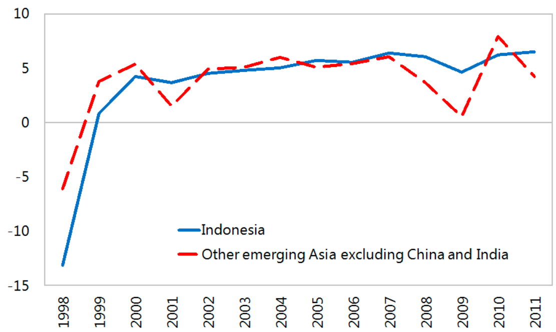
2. **Strong fundamentals notwithstanding, Indonesia is being affected by the weakened global environment.** CDS and EMBI spreads have generally remained more elevated for Indonesia than its peers, suggesting that risk perceptions remain significant despite the strong economic outcomes. Starting in August 2011, Indonesia has also experienced sharp bouts of capital outflows. This occurred against the background of a worsening global environment, but also coincided with some policy developments. Bank Indonesia (BI) significantly lowered its policy rate, allowed market interest rates to fall below the policy rate, and stepped up purchases of government debt, leading to a buildup of liquidity. Similarly, inflation expectations picked up early this year in anticipation of a necessary fuel price hike that, in the event, did not materialize. Some announced changes to the trade and investment regime have also weighed on investor sentiment. So far this year, the rupiah has been among the most depreciated of Asian currencies, and inflation has picked up even as growth has slowed.

3. **The challenge is to build on past policy successes to navigate through near-term global uncertainties and improve growth outcomes further over the longer run.** The first objective warrants some recalibration of monetary policy and contingency planning. As regards the longer term challenges, there is pressing need to increase social spending and infrastructure investment. Steps to improve the business climate, including by maintaining an open trade and investment regime, and further reforms to the macroeconomic policy framework, would also better secure strong and high quality growth.

Figure 1. Indonesia: Context

Strong and resilient growth…

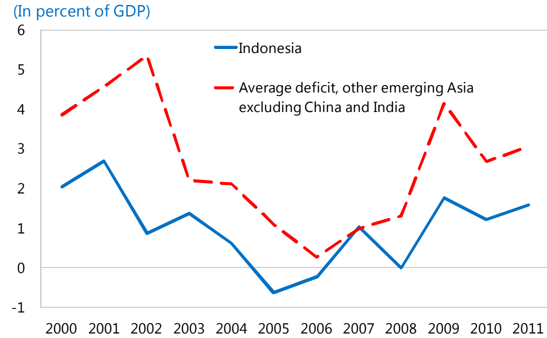
Real GDP Growth
(In percent)



Sources: IMF, *World Economic Outlook*; and IMF staff estimates.

…combined with consistent fiscal discipline…

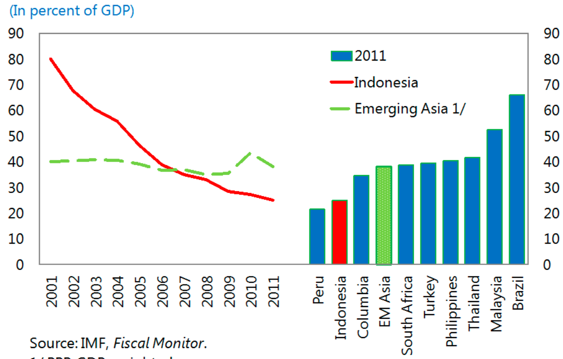
General Government Deficit
(In percent of GDP)



Sources: IMF, *World Economic Outlook*; and IMF staff estimates.

…have led to the creation of enviable fiscal space.

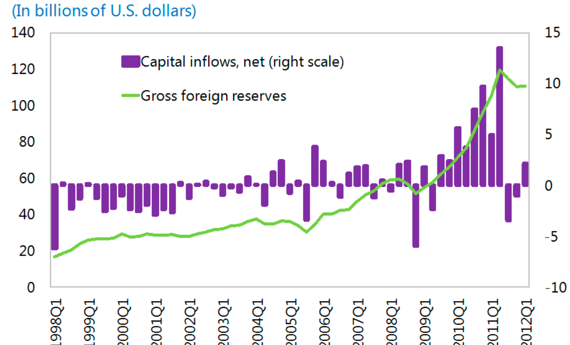
General Government Gross Debt
(In percent of GDP)



Source: IMF, *Fiscal Monitor*.
1/ PPP GDP-weighted average.

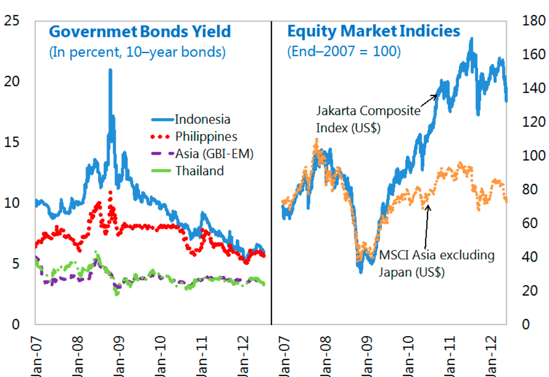
Over the longer term, investors have been bullish on the Indonesia story…

International Reserves and Capital Inflows
(In billions of U.S. dollars)



Sources: CEIC Data Co. Ltd.; and Haver Analytics.

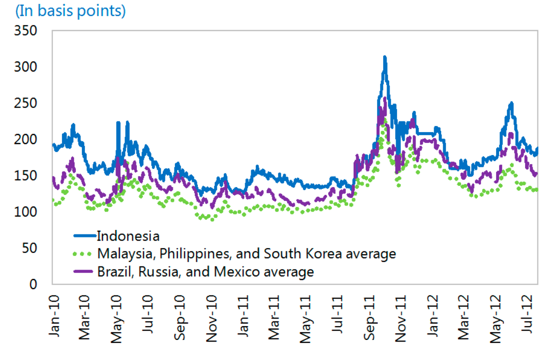
…and inflows have led to declining price premia.



Source: Bloomberg LP.

But risk perceptions remain elevated.

Five-Year Sovereign CDS Spreads
(In basis points)



Source: Bloomberg LP.

NEAR-TERM MACROECONOMIC MANAGEMENT

With growth easing, but inflation expectations persistent, the policy mix for the baseline calls for an accommodative fiscal stance as embodied in the FY2012 budget and tighter monetary policy. Should downside risks materialize, there would be roles for both fiscal and monetary policy, with scope for the latter somewhat limited by the extensive easing that has already occurred.

A. Recent Developments and Near-Term Outlook

4. **Growth is easing on account of the weakened external environment, offset partly by continuing strong domestic demand, while inflation is picking up** (Figure 2). Export volumes declined by 4.7 percent (y/y) during the second quarter of 2012, while import growth accelerated to 25.3 percent (y/y) during the same period. The latter reflects continued strong investment, which grew at 20 percent (Q2 y/y), mostly by the private sector. However, part of this is due to a strong inventory buildup that is unlikely to continue. Robust private consumption and a wider fiscal deficit have also provided some support to growth thus far. Overall, real GDP growth has eased to the 6.3–6.4 percent (y/y) range during the first half of 2012 from 6.5 percent in 2011. With external demand expected to remain weak and inventories to level out, economic growth is projected at 6 percent for 2012 before it picks up again in 2013. Headline CPI inflation bottomed out at 3.7 percent (y/y) in January, but with sequential momentum strong for both core and noncore items, it rose to 4.6 percent in July. With output at or near potential, inflation is expected to end the year at 5 percent, within the authorities' target range of 4.5±1 percent.

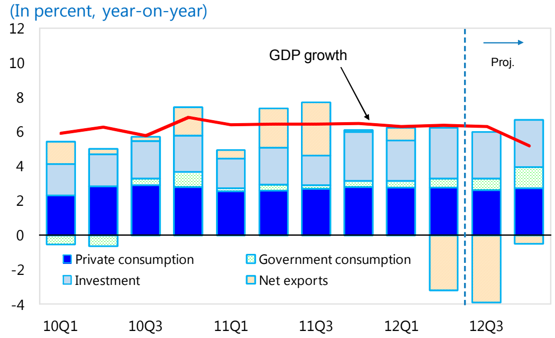
5. **Financial markets have been unsettled in recent months.** Capital outflows prompted some loss of reserves during the second half of 2011. Both the rupiah and equity markets again came under pressure during the spring of 2012 when outflows picked up sharply, compounding pressures on the exchange rate from the weakening current account. Bank Indonesia initially resisted market pressures, which contributed to illiquidity in the foreign exchange market, with onshore/offshore spreads widening sharply in early May. Market conditions improved subsequently after BI increased its sales of foreign exchange, while also allowing the rupiah to depreciate at a faster rate. During May and June, international reserves fell nearly $10 billion to $106.5 billion (compared to a high of $124.6 billion in August 2011), but have since stabilized. Long tenor bond yields increased by 50 bps in May while equities declined by over 13 percent in May–June, though both have since recovered to their April levels.

6. **There are significant external risks to the outlook, accentuated by domestic factors.** Overall, the financial channel appears more important for Indonesia than global growth or

Figure 2. Indonesia: Current Conjuncture

Fiscal support of growth is stepping in….

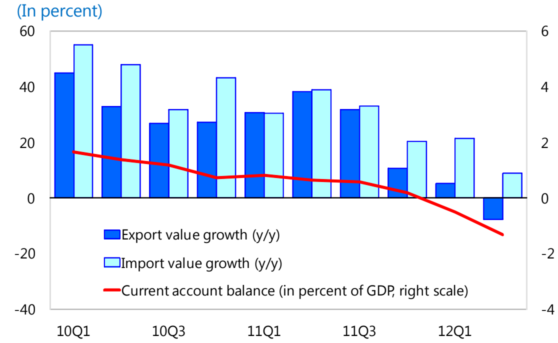
Contribution to GDP Growth
(In percent, year-on-year)



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

…as external demand weakens…

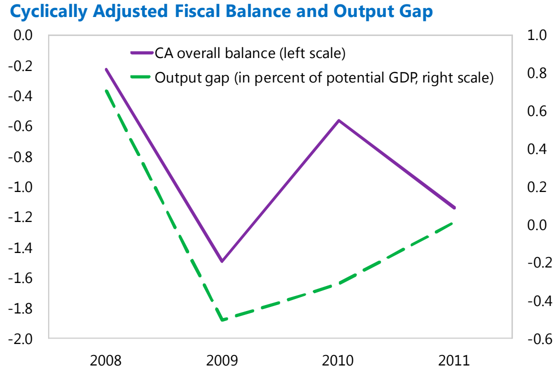
Trade Growth and Current Account
(In percent)



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

…helping maintain output near, potential.

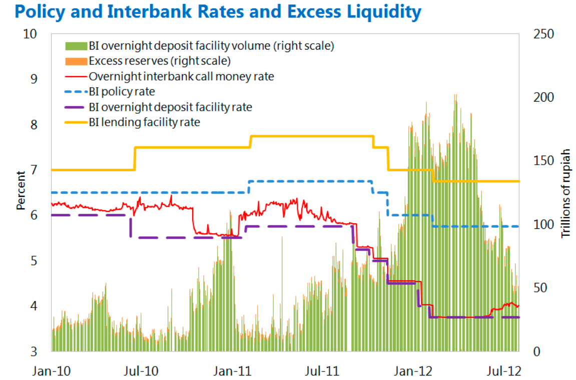
Cyclically Adjusted Fiscal Balance and Output Gap



Sources: CEIC Data Co. Ltd; and IMF staff estimates.

But monetary policy has been loosened aggressively….

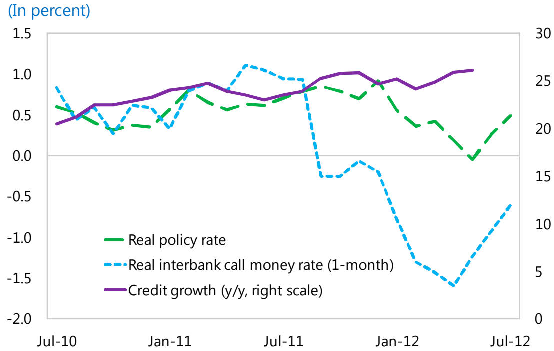
Policy and Interbank Rates and Excess Liquidity



Sources: Bank Indonesia, CEIC Data Co., Bloomberg and IMF Staff calculations.

…real rates have tumbled, credit has picked up…

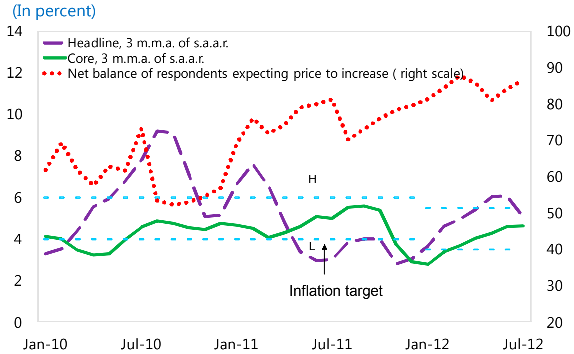
Real Interest Rates and Credit Growth
(In percent)



Sources: CEIC Data Co. Ltd.; Consensus Economics; and IMF staff estimates.

…and incipient inflation pressures have emerged.

CPI Inflation
(In percent)



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

commodity prices (Box 1). Specific sources of risk include a strong intensification of the Euro-area crisis and a hard landing in China. The former would manifest through the capital account, where vulnerability lies in high foreign ownership of local currency debt and low interest rates. Direct trade linkages with Europe are limited, but a hard landing in China could have a significant impact on the current account (Box 2). Other risks include policy coordination problems in the event of distress at a domestic financial institution and an inflation surprise, due to a surge in global food prices.

7. **Authorities' views.** The authorities' outlook was slightly more optimistic, with 2012 growth forecast at 6.3–6.5 percent and BI confident that inflation will remain at around 4.5 percent. They agreed that sizable external risks were posed by both the Euro-area problems and a possible sharp slowdown in China. They emphasized the interconnectedness of the risks, with the Euro-area problems spilling over into slower growth in China, which would then have knock-on effects on Indonesia, not just directly, but also through the impact on other Asian destinations for Indonesia's exports.

B. Monetary and Exchange Rate Policy

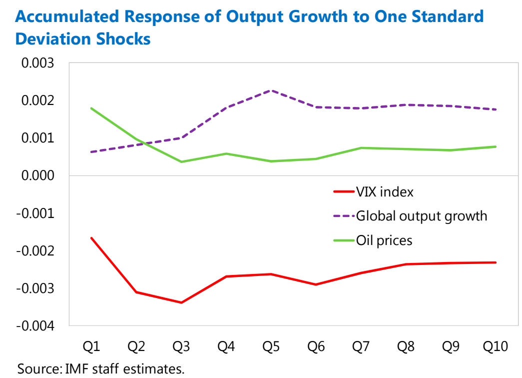
8. **Normalizing liquidity would help safeguard continued economic and financial stability.** Surplus liquidity and strong credit growth (26 percent currently) risk adding to price and exchange market pressures, as well as leading to asset quality deterioration (Figure 3). Increasing the policy rate does not appear necessary at this stage—staff analysis suggests that monetary tightening could be achieved by allowing short-term rates to drift back toward the policy rate, which has been unchanged at 5.75 percent since February (Box 3). In recent months, unsterilized sales of foreign exchange have helped absorb some excess liquidity, money market rates have risen 30–50 bps and in August BI raised the lower bound of its interest rate by 25 bps. However, a further gradual withdrawal of excess liquidity would allow money market rates to drift up further and help: (i) arrest any generalized price pressures; (ii) limit the scope for asset price bubbles to form such as anecdotal evidence suggests may be a risk in some segments of the property market; (iii) ensure that credit growth does not accelerate further and cause NPLs to rise too far from current generally comfortable levels (iv) ameliorate pressures on the rupiah during bouts of global risk aversion by increasing the attractiveness of Indonesian financial assets for foreign portfolio investors.

9. **Risks to the baseline could be addressed through contingency planning.** Bank Indonesia should be prepared to increase the policy rate if inflation accelerates further. As regards external risks, there is only limited scope for monetary policy, given the potential adverse impact on portfolio inflows of lower interest rates, which are already negative in real terms. Nevertheless, if market stress reaches

Box 1. Global Spillovers to Indonesia: Risks and Transmission Channels[1]

There are currently important downside risks for Indonesia arising from abroad. A key question for policymakers is what the impact on domestic growth would be in the event of these risks materializing. A good understanding of the transmission channels is also crucial for determining the appropriate policy response.

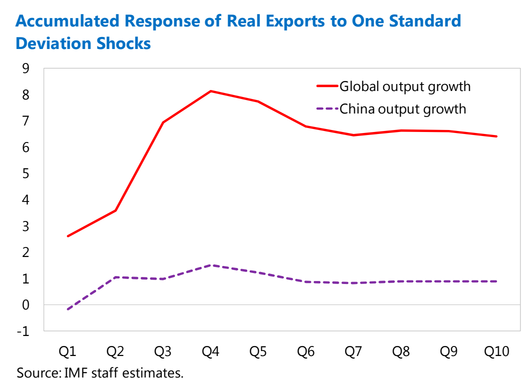
Staff analysis using extrapolations based on historical relationships suggest that financial shocks have a larger impact on Indonesian growth than do shocks to external growth or commodity prices. A one standard deviation decline in global growth (equivalent to 0.6 percentage points) would reduce Indonesian growth by 0.2 percentage points within a year, while an increase in the VIX by one standard deviation (8 points) would result in lower Indonesian growth of about 0.3 percentage points. The impact of global growth on Indonesian growth is somewhat lower than for other Asian economies as expected, given the greater importance of domestic demand in Indonesia. Higher oil prices (used here as a proxy for commodity prices in general) support growth as Indonesia is a commodity exporter.



Source: IMF staff estimates.

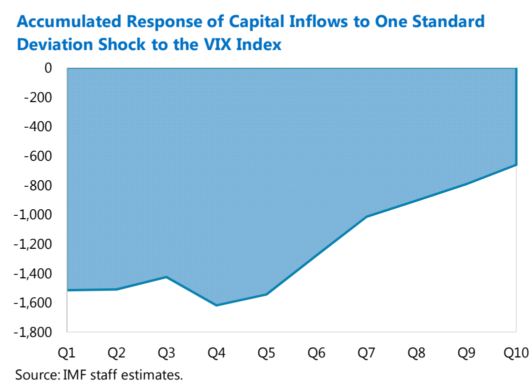
The external shocks are transmitted to Indonesia through the following channels:

- **Trade channel.** A one standard deviation decline in global growth would lower real exports of goods and services by about 8 percent (the relatively low contribution of net exports to Indonesian GDP explains the moderate impact on GDP growth). Chinese GDP growth has about one-fifth the impact of global growth on exports controlling for commodity prices, roughly commensurate with its share of exports.



Source: IMF staff estimates.

- **Financial channel.** The relatively large impact of the VIX on domestic GDP growth appears to work through its impact on net portfolio and other capital flows, which is highly and immediately susceptible to global risk aversion (a one standard deviation or 8 point rise in VIX lowers portfolio and other flows by about $1.5 billion). The financial system has only limited exposure to Europe and little reliance on foreign wholesale funding, but contagion would still occur through a retreat by foreign investors from local capital markets, especially the bond market where their presence is large in Indonesia.

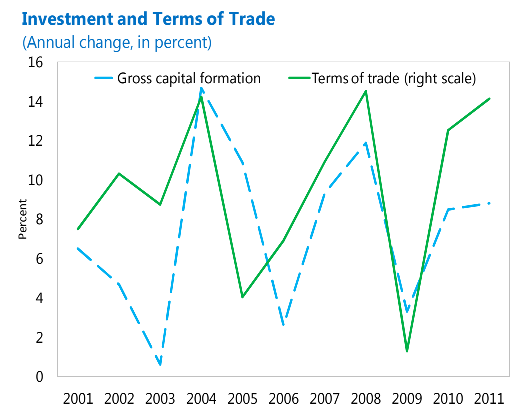


Source: IMF staff estimates.

[1] The analysis uses a Baysian Vector Autoregression ordered as follows: VIX, external GDP growth, global oil price, net portfolio and other capital flows, exports, and domestic GDP growth.

Box 2. China's Growth Pattern: Implications for Indonesia[1]

China's rapid growth in recent years has contributed to robust demand for raw materials. Strong growth, together with the shift in composition toward investment in the 2009 stimulus package, has played an important role in the global commodity boom. Moreover, China has become an important part of the global supply chain in many manufacturing sectors such as electronics.



Indonesia has benefited from China's rise mostly through commodity trade. Indonesia has not become part of the Asian manufacturing supply chains, but has emerged as the top regional resource exporter. The influence from China has been both through commodity prices as well as production and export volumes. The effects have been most pronounced in non-oil and gas commodities, namely coal, palm oil, and rubber. By the 2011 peak, global prices of rubber and palm oil had tripled since 2005, while coal prices had more than doubled. High global prices have spurred investment in these sectors across the Indonesian archipelago.

- China is now a top importer of coal (about 16 percent of global imports), palm oil (25 percent) and rubber (30 percent). Since 2009, China's contribution to global import growth in these commodities has been very high. It is also among the top importers of these commodities from Indonesia.
- For Indonesia, the three commodities together account for about 30 percent of total export value in 2011, ahead of oil and gas (at about 20 percent). The share was only 13 percent in 2005. Investment has increased capacity and led to greater production and export volumes. For example, average coal export volumes increased at about 20 percent per year from 2005 to 2010. As a result, Indonesia has already surpassed Australia as the top global exporter of coal, Thailand as the top exporter of rubber, and Malaysia as the top exporter of palm oil.

Going forward, a change in China's growth rate and pattern could have significant implications for Indonesia. A slowdown in China's growth would impact on Indonesia through both direct trade and commodity price effects. Given the importance of commodity exports to China in recent years, a drop in China's commodity imports could significantly influence domestic investment and consumption in Indonesia. China's slowdown would also have an impact on Indonesia's other major trading partners, adding to the export volume effects. Also, a shift in China away from investment toward consumption would also impact on Indonesia through the commodity channel.

Numerical estimates suggest that the impact on Indonesia's GDP of slower Chinese growth could be significant.

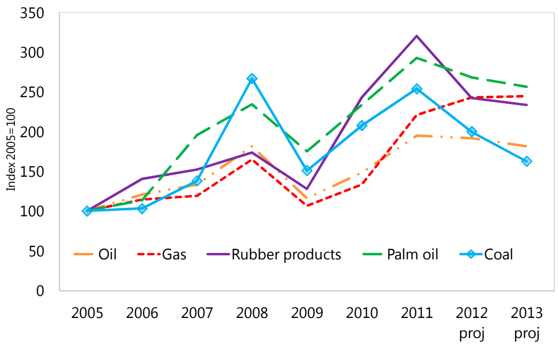
- Using current trade projections and assuming similar global price effects on coal and other commodities, as well as spillovers to other trading partners' demand as in Ahuja and Myrvoda (forthcoming), suggest significant effects on Indonesia's exports. Effects on domestic demand and imports are estimated using empirical relationships for Indonesia between changes in terms of trade and investment, and imports and domestic demand. This approach shows that the impact of a 1 percentage point reduction in China's growth could lower Indonesia's GDP to up to half a percentage point. The magnitude of impact could be lessened if investment remained more resilient than historical relationships imply (e.g., because of increased public investment) or export volume were less affected (e.g., due to Indonesia's cost competitiveness in coal production).
- This result is consistent with some other recent studies, but the exact magnitude remains uncertain. A recent study using a factor augmented VAR (Ahuja and Myrvoda, forthcoming) suggests that a 10 percent decline in China's real estate investment would shave about 1 percent off Chinese growth. Another analysis employing panel data (Nabar and Ahuja, forthcoming) suggests that a 4 percent slow down in China's fixed investment (which would be equivalent to a 10 percent decline in China's real estate investment according to Ahuja and Myrvoda) would lead to a 0.4 percentage point decline in Indonesia's growth. In the VAR study, however, Ahuja and Myrvoda find negligible impact on Indonesia's growth of a slowdown in China's real estate investment. It could be the case that given Indonesia's only very recent rapid rise as a commodity exporter to China, historical patterns are not picking up all the effects on Indonesia in the VAR study.

[1]For detailed discussion, methodology and data sources, see Chapter III of the accompanying selected issues paper.

Box 2. China's Growth Pattern: Implications for Indonesia (concluded)

China's demand has contributed to increases in global commodity prices…

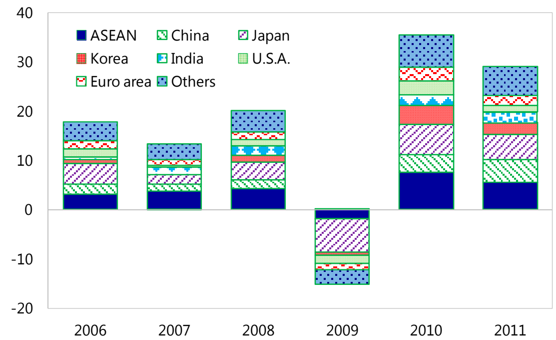
Indonesia: Key Commodity Prices
(Index, 2005=100)



Sources: Commodity Price System database; and IMF staff estimates.

…and Indonesia's export growth.

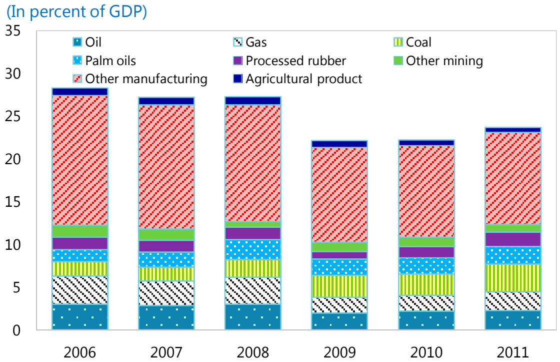
Indonesia: Contribution to Growth in Export of Goods
(In percent, 2006–11)



Sources: IMF staff estimates.

Share of commodity exports, especially coal, palm oils, and rubber has increased…

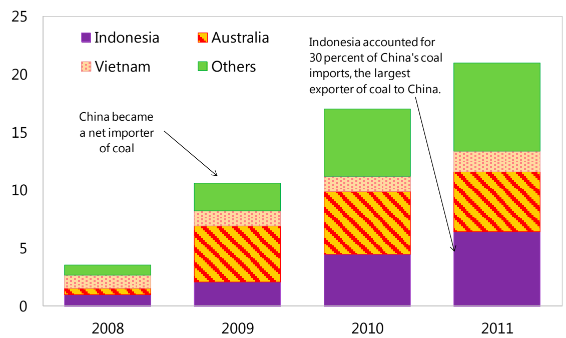
Indonesia: Exports by Sector
(In percent of GDP)



Sources: Indonesian authorities; and IMF staff estimates.

…and Indonesia is now the largest exporter of coal to China and the world.

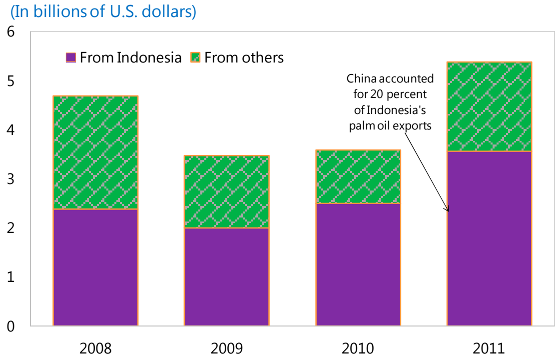
China: Coal Imports
(In billions of U.S. dollars)



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

Palm oil exports to China have also grown…

China: Palm Oil Imports
(In billions of U.S. dollars)



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

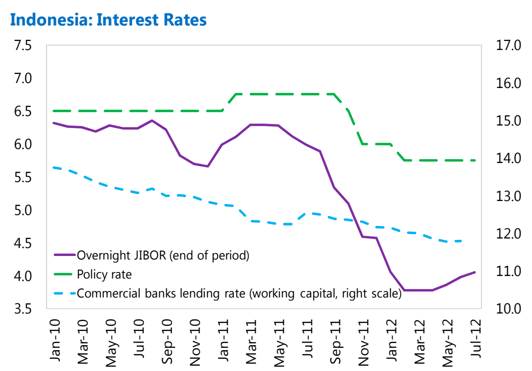
…as well as rubber exports.

China: Rubber Imports Value
(In billions of U.S. dollars)

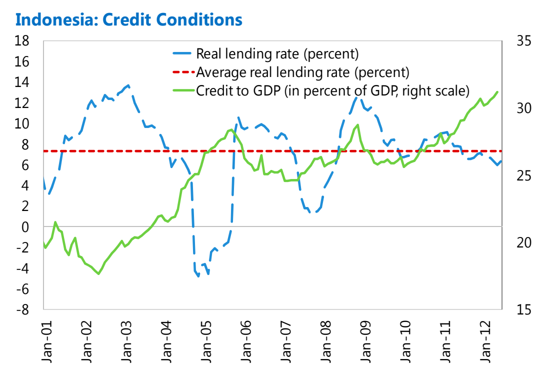
Sources: CEIC Data Company Ltd; and Indonesian authorities.

Box 3. Lending Conditions and Monetary Policy in Indonesia: What Matters?[1]

Policy interest rates are expected to anchor short-term money market rates that act as benchmarks for retail deposit and loan rates, which ultimately affect output and inflation. Historically, retail rates have closely followed the policy rate. Recently, however, money market rates have been allowed to fall well below the policy rate, although BI still considers the latter to be the main signal of its overall stance. This raises the question of what matters more for output and inflation: the BI policy rate or short-term lending conditions more generally, as measured by the spread between the money market and policy rates. This question is of current relevance when real lending rates have fallen below their historical levels and credit growth has risen sharply.



Sources: Bloomberg LP; and CEIC Data Co.



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

To explore this question we estimate an extended Global Projection Model (GPM) for Indonesia using Bayesian techniques. The global financial crisis has highlighted the importance of taking into account both domestic and global shocks (and uncertainty) as well as macrofinancial transmission mechanisms into the design of monetary policy. To that end, our model incorporates such global factors, which then allows us to decompose the importance to monetary policymaking of different types of shocks.

The estimates obtained from the model indicate that the policy rate and its spread with the money market rate are separately important. Specifically, a 1 percentage point increase in the spread leads to a 0.15 percent change in the output gap, compared to 0.13 percent for the policy rate. Inflation dynamics are driven largely by supply side and global price developments, with about 40 percent of the dynamics accounted for by domestic supply and another quarter by global prices. Inflation dynamics are, however, also significantly influenced by the output gap (a 1 percent reduction in the output gap decelerates inflation by 0.26 percent). Taken together with the impact of the spread on the output gap, this suggests scope for currently reducing inflationary pressures by lowering the spread rather than hiking the policy rate itself.

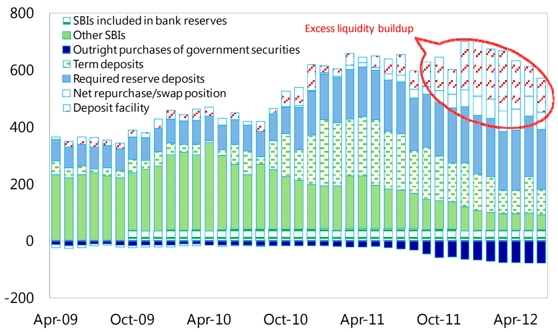
The model estimates and impulse responses shed other important insights for monetary policymaking. First, there are significant second-round effects of headline inflation on core inflation, with a 1 percentage point increase in the difference in headline from core leading to a 0.45 percentage point increase in core inflation. This result is also broadly confirmed by OLS regressions, which shows inflation to be persistent in Indonesia (as does the Bayesian model). We also find that a measure of interest volatility controlling for policy rate changes (a GARCH 1, 1 model of JIBOR volatility conditional on the policy rate and itself) has a negative impact on the output gap. This again highlights the potential benefits of more effectively anchoring short-term market interest rates to the policy rate.

[1] For detailed discussion, methodology and data, sources see Chapter I of the accompanying selected issues paper.

Figure 3. Indonesia: Monetary Operations and Transmission

Liquidity built up despite the use of numerous instruments...

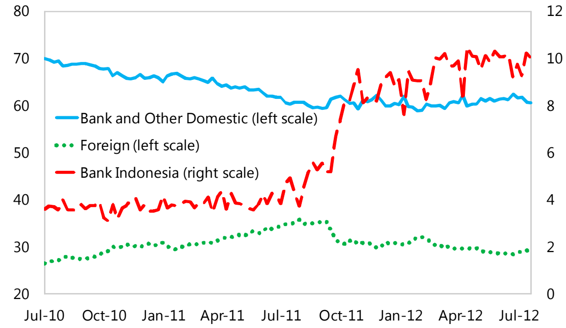
Bank Indonesia's Liquidity Absorption by Instrument
(Negative is liquidity injection, in trillions of rupiah)



Sources: Bank Indonesia; CEIC Data Co. Ltd; Bloomberg LP; and IMF staff calculations.

...in part due to a sharp increase in BI's purchase of government paper...

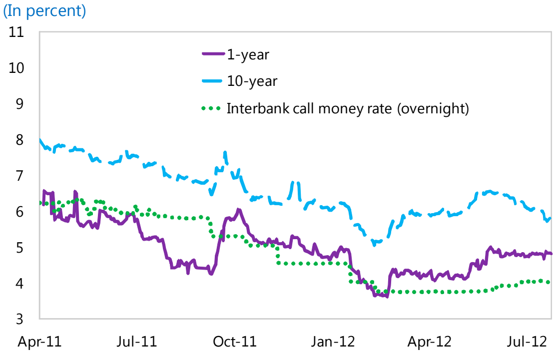
Ownership of Government Securities
(In percent of total outstanding)



Sources: Bank Indonesia, CEIC Data Co. and IMF Staff calculations.

...which led to declining yields.

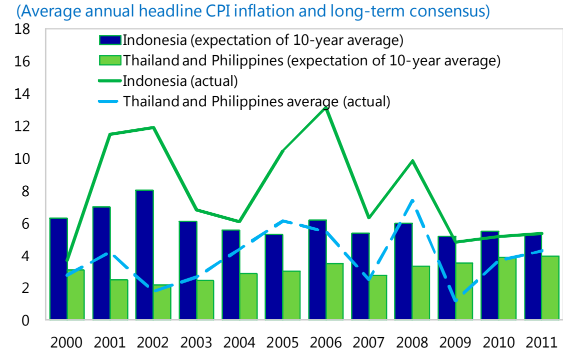
Local Currency Government Bond Yields and Call Money Rates
(In percent)



Source: Bloomberg LP.

Long-term inflation expectations are persistently higher than in other inflation targeting ASEAN countries.

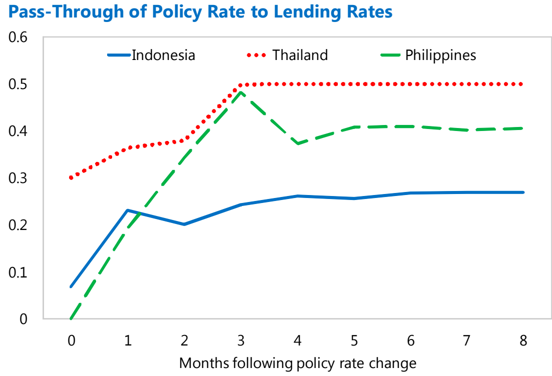
CPI Inflation and Consensus Expectations
(Average annual headline CPI inflation and long-term consensus)



Sources: CEIC Data Co. Ltd; and Consensus Economics.

The policy transmission is weaker...

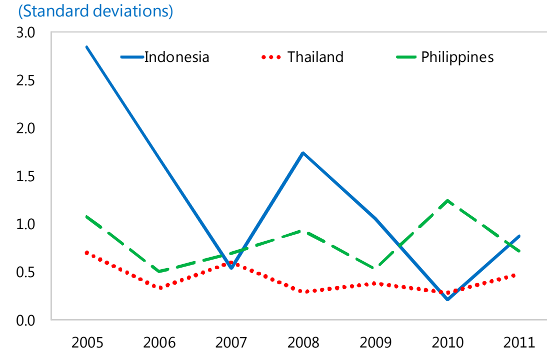
Pass-Through of Policy Rate to Lending Rates



Source: IMF staff estimates.

...and rate volatility is on the rise again.

Volatility of 1-Month Money Market Rates
(Standard deviations)



Sources: CEIC Data Co. Ltd.; and IMF staff estimates.

near-Lehman levels, BI should ensure ample liquidity in both the foreign exchange and rupiah markets.

10. **Increased exchange rate flexibility, combined with judicious use of reserves when warranted, would help address market tensions.** Foreign exchange shortages can lead to a downward spiraling of confidence, leading to further pressures on the exchange rate, thereby creating a vicious circle. The overall external position is strong—reserves are adequate, and preliminary model estimates from the CGER and pilot EBA suggest that from a medium-term perspective the real effective exchange rate is moderately undervalued by 0 − 10 percent relative to fundamentals and desirable policies (Box 4). While allowing the exchange rate to move fully to reflect trends, interventions to smoothen sharp and temporary supply-demand mismatches would help bolster market confidence. A more explicit public statement regarding the primacy of the domestic price stability over the exchange rate consideration would also be helpful.

11. **Strengthening the monetary policy framework would help better guide market expectations.** Bank Indonesia has formally maintained the policy rate as an indicator of its policy stance; but in September 2011, it announced a 50 bps reduction in its deposit facility rate on account of heighted uncertainty in the global financial system and the need to stimulate money market transactions. Bank Indonesia's interventions along the entire yield curve through a variety of instruments have also contributed to uncertainty about the monetary framework. This in turn could weaken BI's ability to guide interest rate expectations. Consistent with its inflation targeting framework, BI could usefully reiterate that its operational target is to keep the overnight money market rate broadly in line with the policy rate. Bank Indonesia could also rationalize its open market instruments and refrain from intervening in the secondary market for government paper, except in cases of extreme market dysfunction.

12. **A more coherent and predictable monetary policy framework, by reducing interest rate volatility, could benefit investment** (Box 5). More effective communication by BI of its policy objectives would better guide market expectations regarding interest rates. Further, market conditions will be more stable if BI's foreign exchange and rupiah operations are both predictable and supportive of market making by participants. For example, BI's introduction of U.S. dollar term deposit facility in response to recent foreign exchange pressures may allow BI to play a larger role in intermediating foreign exchange liquidity among banks, but could also reduce incentives for interbank trading. Similarly, while BI has generally kept system liquidity high to address the segmentation of the rupiah money market, improving the infrastructure and legal basis for the interbank repo market would provide a more lasting solution. Finally, the heavy interventions

Box 4. Indonesia: External Position

Indonesia's external position appears moderately stronger than implied by medium-term fundamentals and desirable policies. Preliminary model estimates from the *Pilot External Sector Report* suggest that Indonesia's medium-term structural current account balance should be a deficit of 2 percent of GDP, compared with the 0.2 percent surplus recorded in 2011. Much of this estimated gap reflects prospective fiscal consolidation in advanced economies, as well as needed larger domestic social safety nets. The current account is expected to turn into a small deficit of around 2 percent in 2012 and in the medium term. This deficit would be consistent with the estimated current account norm as well as with the increase in both public and private investment needed to boost potential output growth.

This current account deficit would likely be funded by trend growth in foreign direct investment. FDI is expected to continue as foreign investors should be attracted by Indonesia's medium-term growth prospects. While external debt as a proportion of GDP is low, portfolio inflows could remain volatile, given the uncertain global environment and the high proportion of government bonds held by offshore investors. Capital flow management measures implemented since mid-2010 were warranted, and should continue to be accompanied by two-sided exchange rate flexibility.

Preliminary model estimates indicate that the real effective exchange rate is currently moderately undervalued by 0–10 percent. However, this undervaluation reflects the nominal depreciation of the rupiah resulting from portfolio outflows over the past 12 months.

- Based on CGER, the REER deviation from estimated equilibrium shows similar results as those suggested by the CGER during the 2011 Article IV consultation, showing an average of 5 percent undervaluation. The deviation ranges from 6 percent overvaluation (macrobalance approach, which computes the REER adjustment needed to close the current account gap), to 10 percent and 11 percent undervaluation (external sustainability approach, which calculates the REER adjustment needed to stabilize the net foreign asset position, and equilibrium real exchange rate approach, which derives the deviation from an equilibrium relationship between REER and a set of fundamentals, respectively).
- Based on the preliminary External Balance Assessment (EBA) model estimates from the *Pilot External Sector Report* , the real exchange rate appears to be at equilibrium according to the real exchange rate method.[1]

Current levels of reserves are well above all standard metrics and the IMF's composite adequacy metric. They remain in the middle of the range among regional peers. Looking ahead, more flexibility of the nominal exchange rate, combined with some intervention to provide adequate market liquidity, would be advisable.

Reserve Adequacy Metrics: Selected Asian Countries 1/

	In percent of GDP	Percent of ST Debt	Percent of ST Debt and CAD 2/	Ratio over 20 percent of M2	Percent of Composite Metric
Indonesia	**12**	**223**	**164**	**166**	**165**
India	17	285	179	98	180
Korea, Republic of	28	171	...	79	132
Malaysia	49	360	...	177	137
Philippines	33	434	...	257	344
Thailand	49	399	...	217	317

1/ Indonesia's reserves are as of July 2012 and other data are 2012 staff projections. Data for other countries are as of end-2011.
2/ Other comparators had current account surpluses in 2011

[1] Estimates of both CGER and EBA methodologies refer to REER values as of March 2012. Until June 2012, the REER has moved by less than 1 percent.

Box 5. Investment: Macroeconomic Volatility and Financial Depth[1]

Rising investment has become a key driver of Indonesia's recent robust growth and its continuation is important to sustain growth going forward. This raises the following question: What macroeconomic policy-related variables are important for determining investment? While attention generally and rightly focuses on the levels of the macroeconomic variables, regression results suggest that reducing the volatility of interest and exchange rates, as well as capital markets deepening, may also be important.

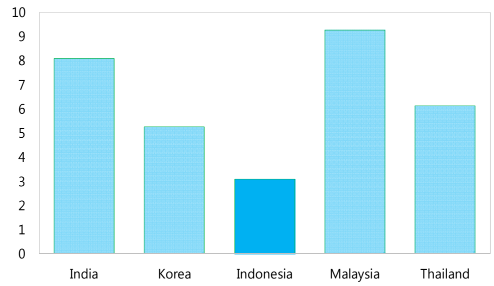
Investment has recently performed strongly but there exists room for improvement. After collapsing in the late 1990s, the investment-to-GDP ratio recovered very sluggishly, and has only recently regained earlier levels. Strong recent investment has focused on the booming mining sector. Infrastructure needs, however, remains pressing, and the public investment ratio is among the lowest in the region. To achieve Indonesia's long-term growth objectives outlined in the economic master plan, high investment needs to be sustained. Putting in place the necessary infrastructure, which is cited as one of the main growth constraints for Indonesia in numerous business surveys, also calls for substantially boosting public investment from the current low levels.

At the aggregate level, investment in Indonesia is negatively correlated with interest rate volatility, exchange rate volatility, and the real lending rate, while it is positively correlated with improvements in the terms of trade. Prudent macroeconomic policies have reduced the cost of capital and the recent high investment growth is being supported by strong regional demand for commodities, which has, in turn, strengthened Indonesia's terms of trade. On the other hand, continued volatility of exchange and interest rates has hurt investment. Notably, interest rate volatility is becoming an increasing factor in affecting investment, as indicated by the nearly doubling of the magnitude of the coefficient in regression estimates for the post-2005 period.

Firm level estimation results confirm the important role interest rate volatility plays in firms' investment decisions. Regression equations with firm-level data show that interest rate volatility negatively affects investment, and confirm that the responsiveness of investment decisions to interest rate volatility has increased significantly in the more recent sample period.

The empirical results also point to the importance of continued financial market deepening and development. Firms' investment decisions are highly affected by their internal cash positions, which suggest that financial markets are not sufficiently developed. Notably, investment decisions by large firms are more responsive to their cash positions than smaller firms. This could be an indication that the current bank-centric financial market in Indonesia is not meeting the needs of large firms who would typically be expected to rely also on other capital markets, such as the bond market to raise resources. However, financial markets in general, and the local currency bond market in particular, are very thin in Indonesia in regional comparison.

Public Investment 1/
(In percent of GDP, current prices)



Source: IMF, *World Economic Outlook* database; and IMF staff calculations.
1/ Average pulic gross fix capital formation over 2008–2011.

Aggregate Investment Growth Determinants 1/

	2001:Q1–2011:Q4	2005:Q1–2011:Q4
Terms of trade growth	0.004 *	0.001
Real lending rate (lag 1)	-0.002 *	0
REER volatility	-0.004 *	-0.001
Interest rate volatility 2/	-0.055 **	-0.096 ***

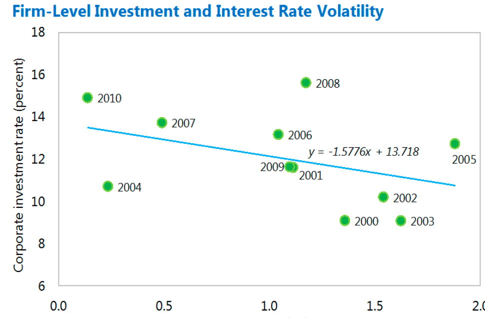
1/ An * indicates significance at 10 percent, ** at 5 percent, and *** at 1 percent.
2/ Calculated by using SBI 1-month and Jibor 1-month interest rates.

Firm-Level Investment Determinants 1/

	1990–2004	2005–2010
Expected profitability	0.881	1.939 ***
Liquidity	0.095 *	0.079 **
Leverage	-0.103 ***	-0.085 ***
Interest rate volatility 2/	-0.002 *	-0.01 **

1/ An * indicates significance at 10 percent, ** at 5 percent, and *** at 1 percent.
2/ Calculated by using SBI 1-month and Jibor 1-month interest rates.

Firm-Level Investment and Interest Rate Volatility



Sources: Bloomberg LP; CEIC Data Company Ltd; and IMF staff calculations.
1/ Calculated by using SBI 1-month and JIBOR 1-month interest rates.

[1] For detailed discussion ,methodology and data sources, see Chapter II of the accompanying selected issues paper.

by BI in the government bond market that have helped to depress yields could deter banks concerned about the large order flows from taking market making positions.

13. A permanent solution to strengthen BI's balance sheet issues would be helpful. The authorities are currently considering swapping a part of BI's holdings of nonmarketable, non-interest-bearing government debt for higher yielding securities. This will help arrest any market perceptions that balance sheet considerations may impinge on BI's monetary policy decisions. However, depending on assumptions about future interest rates, the swap could only postpone the need for a recapitalization for a few years. Replacing the remaining nonmarketable debt should be considered, but a more comprehensive reform of BI's financial relationship with the government, to cover also issues such as cost-sharing of reserve accumulation, taxation, and dividend distribution, could permanently strengthen BI's balance sheet while also limiting scope for political interference in monetary policymaking.

Authorities' Views

14. The authorities are committed to exchange rate flexibility to reflect fundamentals, with interventions limited to smoothing sharp fluctuations. The tensions that had arisen in the foreign exchange market in May were anomalous and when they had become apparent, BI had quickly acted to restore order.

15. Bank Indonesia is confident that a mix of prudential tools, combined with the drawdown of excess liquidity that has already occurred to date, would help achieve its near-term objectives. Such a policy mix would control potential financial risks, ensure sufficient credit to sectors that enhance domestic productive capacity, and help meet the inflation target. The rise in overall credit growth was mostly for investment financing. This would ease any supply-related inflationary pressures and underpin sustained economic growth. Further improvements to the efficiency of the banking system would allow credit growth to continue with little increase in risks, provided prudential tools were employed to curb excessive credit to specific sectors. With this objective in mind, BI had recently placed some prudential limits on consumer lending and on mortgages for high value residential property.

16. The authorities are, nevertheless, aware that addressing all of their objectives required some further development and clarification of their monetary policy framework. They recognize the importance of fleshing out and communicating to the market their evolving policy framework. The framework would minimize market volatility while retaining low inflation by ensuring that supply-side constraints continued to ease and also ensure financial stability. The authorities have initiated a review of the monetary policy framework with the objective of eventually announcing a fully articulated and internally coherent revised framework. A key plank of such a framework would include macroprudential policies, allowing for a greater mix of tools with which to balance multiple objectives. Prudential policies could, for example, help to redirect credit across sectors while interest rates were geared toward ensuring that aggregate credit conditions remained appropriate to maintain growth in productive capacity and toward meeting inflation objectives.

17. The authorities underscored the link between interest and exchange rate volatility and inadequate financial market development. They recognize well the unintended consequences for market development of their interventions and choice of policy instruments. Such tradeoffs had, however, been necessary. For example, large foreign participation in the market for central bank bills had been associated with excessive volatility that had led them to replace the bills with nontradable bank deposit facilities. The authorities ascribe the high volatility to the generally thin financial markets in Indonesia. Money supply and credit were very low in Indonesia in international comparison and other capital markets relatively thinner (Figure 4).

C. Fiscal Policy

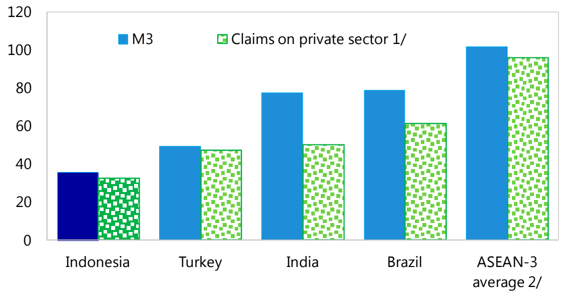
18. The moderate stimulus embodied in the 2012 budget is appropriate, given the downturn in external demand, but expenditure composition is not ideal. The 2012 deficit is expected to rise to 1.8 percent of GDP, up from 1.1 percent in 2011, but still under this year's budget ceiling of 2.2 percent of GDP. An upward adjustment of subsidized energy prices was proposed by the government for this year in April, but put off by parliament unless oil prices exceed a revised higher threshold. Phasing out energy subsidies to provide room for raising public infrastructure and social expenditures, as previously recommended by the Fund, remains a priority in the view of the staff. The postponement of the price adjustment will boost energy subsidies to 3.5 percent of GDP, compared with the 2.6 percent of GDP in total allocated to all of development spending. The impact on overall expenditure growth will likely be limited by the under spending on other items, including public investment. Also, budgeted cash payments to compensate for fuel prices increases will provide some savings if a price adjustment is not implemented.

19. If external risks materialize, any sizable and prolonged economic slowdown should be addressed by the budget, given the limited scope for further monetary easing. Additional discretionary spending would be the best channel, given weak automatic stabilizers and the higher growth impact of expenditures, particularly capital spending. Ideally, a list of infrastructure projects that could be quickly ramped up could be prepared, but given expenditure execution constraints,

Figure 4. Indonesia: Financial Depth

The banking sector is far smaller than in other emerging markets…

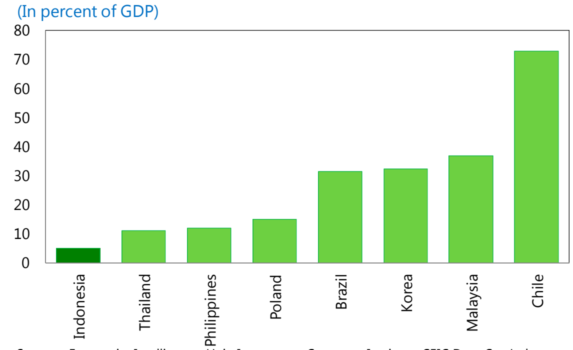
Money Supply and Credit
(In percent of annualized GDP)



Sources: CEIC Data Co. Ltd.; IMF, Integrated Monetary Database; and IMF staff estimates.
1/ Claims on private sector credit at Financial Corporations Survey level.
2/ Includes Malaysia, Thailand, and the Philippines.

…while the contractual saving sector remains undeveloped.

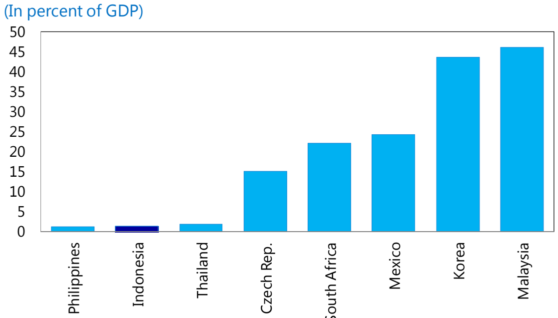
Emerging Market Pension Fund Assets
(In percent of GDP)



Sources: Economist Intelligence Unit; Investment Company Institute; CEIC Data Co., Ltd.; IMF, *World Economic Outlook*; and IMF staff estimates.

Bond issuance is an insignificant source of corporate finance…

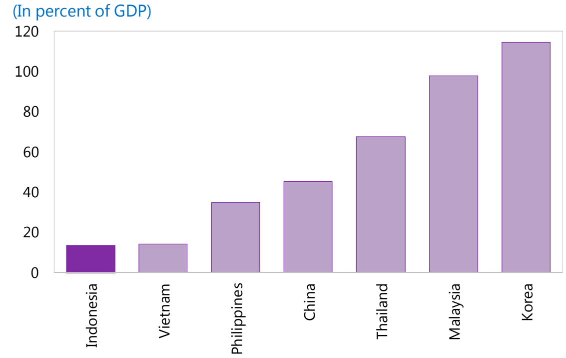
Domestic Debt Securities Outstanding-Corporate Issuers 1/
(In percent of GDP)



Sources: Bank for International Settlements; IMF, *World Economic Outlook*; and IMF staff estimates.
1/ Includes financial institutions and other corporate issuers.

…contributing to the small size of the local currency bond market.

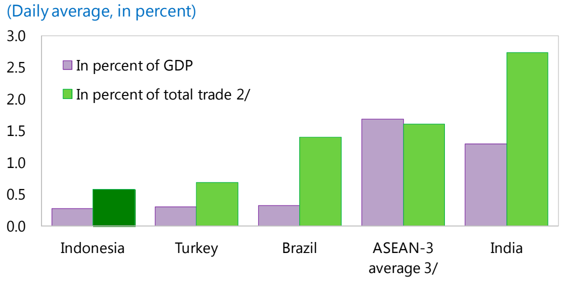
Local Currency Bonds Outstanding
(In percent of GDP)



Source: AsianBondsOnline.

Foreign exchange markets are relatively shallow…

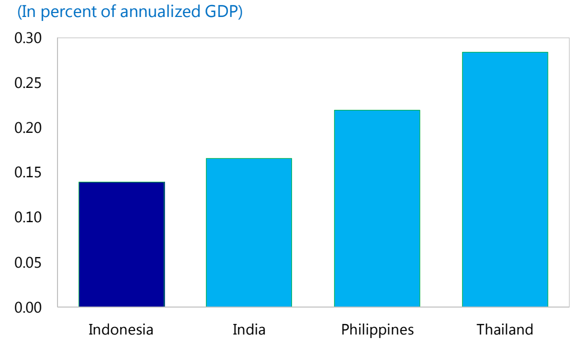
Foreign Exchange Turnover, Onshore 1/
(Daily average, in percent)



Sources: Bank for International Settlements; and IMF, World Economic Outlook.
1/ Includes spot transactions, outright forwards, foreign exchange swaps, currency swaps, options and other products excluding cross-boarder transactions.
2/ In percent of total exports and imports of goods and services.
3/ Includes Malaysia, Thailand, and the Philippines.

…as are interbank money markets.

Overnight Money Market Transactions 1/
(In percent of annualized GDP)

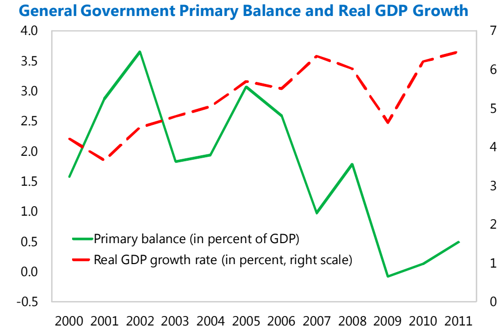


Sources: CEIC Data Co. Ltd; IMF, World Economic Outlook; and IMF staff estimates.
1/ Related to call money turnover where applicable.

other avenues for injecting fiscal stimulus, such as direct cash transfers, may also need to be considered.

20. Sufficient buffers exist to mitigate any short-term disruption to market financing. The government has secured $5 billion contingent financing from the World Bank and bilateral partners. In addition, the government has cash balances of over 2 percent of GDP. By comparison, the government's gross financing requirement for 2012 is around 3 percent of GDP.

21. Increasing fiscal flexibility is a priority. By and large, fiscal policy has not been countercyclical in Indonesia, whereas enhancing fiscal flexibility to maintain growth stability is increasingly important in a volatile global environment. Given that public debt has fallen sharply over the past decade, there is a question as to whether a hard and rigid limit on the deficit that is not sufficiently cognizant of cyclical macroeconomic conditions remains in the best interests of Indonesia. The authorities may want to consider eventually moving from a hard 3 percent deficit ceiling to a rule that requires that the figure not be breached over the cycle while allowing for intracyclical variation.



Sources: CEIC Data Company Ltd; Indonesian authorities; and IMF staff calculations.

22. Authorities' views. The authorities are confident that there exists sufficient scope to use fiscal policy to offset growth risks, should they materialize. The budget for this year includes provisions allowing government to ask parliament for speedy authorization to modify and increase spending if growth and unemployment indicators deteriorate. They also saw scope for expediting some infrastructure investment, in particular in east Indonesia.

23. The authorities emphasized room to increase fiscal flexibility within the existing fiscal framework. While a reassessment of fiscal rules could be considered eventually, there existed significant space under the existing 3 percent of GDP legal limit on annual deficits, to enhance fiscal flexibility by reducing rigidities in the expenditure framework and increasing revenues. In the area of expenditure, the main priority remained to address energy subsidies. There also existed room to raise resources by increasing the tax intake, particularly from the natural resource sector. Overall, both revenue and expenditure reforms, by making the budget more nimble, could strengthen the authorities' abilities to respond to shocks.

D. Financial Sector Stability and Supervision

24. The banking sector is sound, but warrants continued monitoring. Indonesia stands out, regionally and internationally, in strengthening corporate and financial sector balance sheets (Figure 5). Furthermore, banking system asset quality remains satisfactory and banks currently remain profitable and well capitalized, with the capital to risk weighted asset ratio at 16 percent. However, going forward, rapid loan growth could adversely impact both loan quality and capital ratios. Aggressive expansion by banks into lending to small and medium enterprises with limited credit histories and developments in the property market warrant especially continued close monitoring.

25. Bank Indonesia monitors financial stability regularly and good progress is being made to meet Basel III requirements. Recent stress tests have analyzed the spillovers from Europe using various scenarios related to both the trade and funding channels. The results showed that larger banks had sufficient buffers to withstand severe shocks, but several smaller banks could experience declines in capital levels below 8 percent. Banks in Indonesia are expected to meet the capital requirements associated with Basel III, but a number of borderline banks may require special attention. The authorities are also aware of the impact of credit growth on capital and have noted that banks will need to start formulating ways to increase their capital soon.

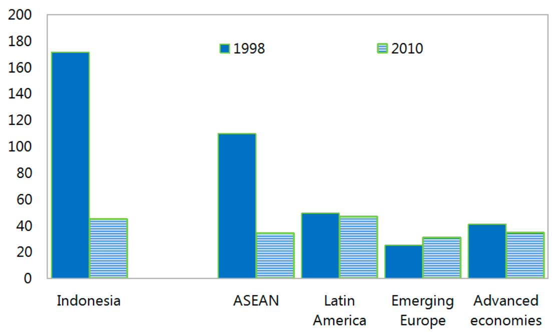
26. The authorities have taken several important steps recently to strengthen financial stability. These include: (i) passage of the Financial Services Authority (OJK) law, with the objective of gradually transferring responsibility for regulation and supervision of the banking, insurance, capital markets, pension funds, and other financial institutions to the new entity, to be completed by end-2013; (ii) establishment of a high level forum for coordinating financial stability; (iii) finalization of a Memorandum of Understanding (MOU) among all entities currently responsible for financial stability; and (iv) the drafting of a revised Financial System Safety Net (FSSN) law.

27. It will be important to address gaps to ensure a smooth transition and finalization of all the above initiatives. Maintaining proper oversight of the supervisory and regulatory functions during the OJK transition is critical. Clarification of certain provisions of, or amendments to, the laws in line with the recommendations of previous Fund technical assistance will also be necessary. For example, the OJK law introduces the concept of a macroprudential policy framework, but does not clearly define the roles or responsibilities for BI or OJK in this area. Similarly, the FSSN draft law provides for differential treatment of solvent and insolvent institutions without defining solvency. More critically, as the legislation is still pending, an operational safety net is not yet in place to support the effective management of a systemic crisis. Also, the MOU does not specify the roles and

Figure 5. Indonesia: Corporate and Financial Sector Soundness and External Liabilities

Corporate balance sheets have strengthened remarkably…

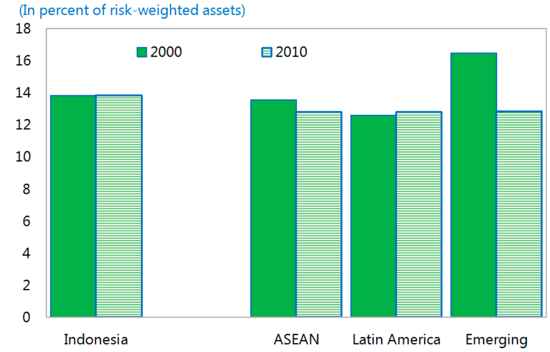
Corporate Debt to Equity
(In percent)



Sources: IMF, Corporate Vulnerability Utility.

…bank capital adequacy remains high.

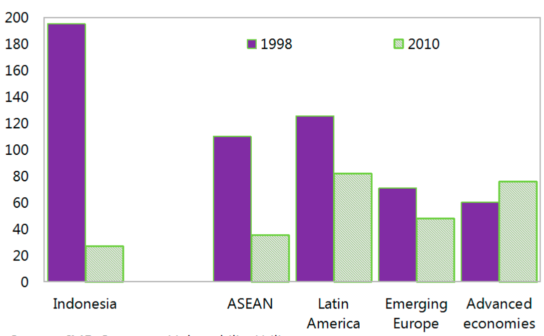
Banks: Tier-1 Capital
(In percent of risk-weighted assets)



Sources: Bankscope; and IMF staff calculations.

While other financial firms have also strengthened the balance sheet.

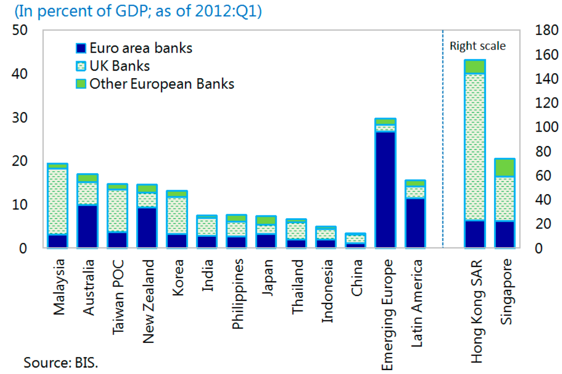
Debt-to-Equity of Financial Firms
(In percent)



Sources: IMF, Corporate Vulnerability Utility.

Risks of European bank deleveraging are low…

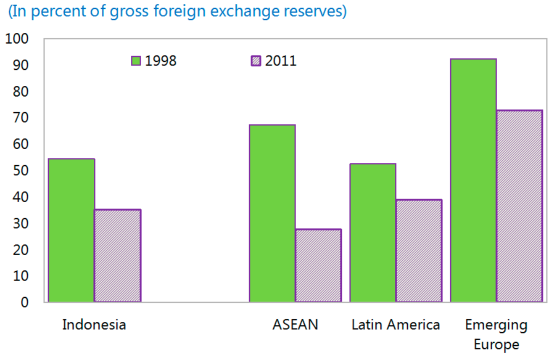
Consolidated Foreign Claims of BIS Reporting Banks on Asia
(In percent of GDP; as of 2012:Q1)



Source: BIS.

…short-term external debt has been declining.

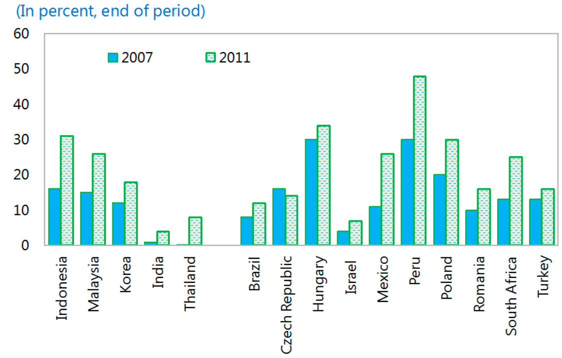
Short-Term External Debt
(In percent of gross foreign exchange reserves)



Sources: IMF, WEO database; CEIC Data Company Ltd.; and IMF staff calculations.

…but foreign holdings of local-currency government debt have increased.

Foreign Holdings of Local Sovereign Bonds
(In percent, end of period)



Sources: Asian Bonds Online; country authorities and IMF staff calculations.

responsibilities of each agency during normal or crisis times, which could lead to decision-making challenges.

28. In June 2012, the Financial Action Task Force (FATF) warned that Indonesia had not made sufficient progress in addressing identified AML/CFT deficiencies. The deficiencies focus on the incomplete CFT legislative framework. A draft CFT law is expected to be discussed by parliament this September, and the prompt passage of this law could prevent potential AML/CFT-related sanctions and blacklisting.

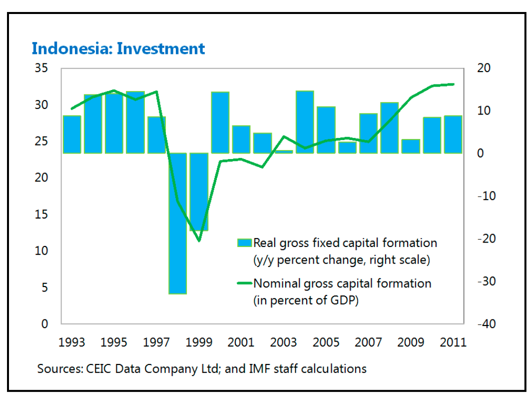
29. Authorities' views. Both the Ministry of Finance and BI recognize the importance of ensuring that gaps do not arise during the transfer of all of their existing supervisory responsibilities to the OJK. They emphasized that they had been careful to select highly qualified and experienced staff for the new agency, which should ensure a smooth transition. As regards the financial sector safety net, a temporary government decree with broadly the same features as the FSSN law could be promulgated in the event of a crisis if the law is not yet in place in time. The authorities were confident that the CFT law would be adopted as scheduled, but meanwhile planned to dispute the FATF conclusions.

SECURING SUSTAINED AND EQUITABLE GROWTH

A young population, relatively high youth unemployment, and rising inequality call for growth that is resilient and whose fruits are shared more broadly. Better investment (physical and human), a strengthening of the macroeconomic policy framework, and improvements to the business environment, can help achieve these objectives.

A. Medium-Term Outlook

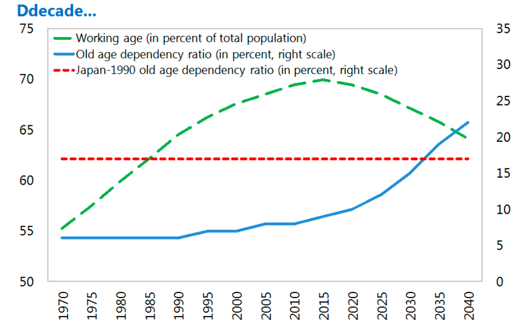
30. Growth could exceed the recent high of 6.5 percent with the right policies and provided global economic conditions remain broadly favorable over the medium term. Indonesia is reaping the benefits of a demographic dividend, investment in relation to GDP has now recovered to the levels seen in the mid-1990s after a long and very sluggish recovery, and low public debt provides ample room, in principle, for increasing social and infrastructure spending. Indonesia's external position is also moving toward its medium-term equilibrium. The emergence of modest current account deficits over the medium term is



consistent with its demographic profile and increase in investment needed to boost potential output growth. Prospects for continued strong foreign direct investment to finance the deficits are enhanced by its strong macroeconomic fundamentals.

31. Achieving improved growth outcomes will, nevertheless, require further initiatives. Despite strong growth, income inequality has been rising (Box 6). Investment in physical capital remains sensitive to financial market volatility and its composition is an issue. In particular, there exists significant room to increase infrastructure investment, which has been identified by numerous business surveys as a major constraint in Indonesia, while staff analysis suggests it can make growth more inclusive. Maximizing the long-term benefits of the current transitionary demographic dividend also requires greater investment in human capital. Indonesia's labor force has been expanding more rapidly than its population. Today, 45 percent of the population is under 25, and the average age of the working population is currently 30–34. However, this demographic dividend will crest in the next decade, as the working population ages, and by 2035, Indonesia will have an aging ratio close to that of Japan in the early 1990s. However, social indicators are currently weak, with infant and maternal mortality among the highest in the region, and public investment in health and education very low in international comparison (Figure 6).

Indonesia's Demographic Dividend will Crest in the Next Ddecade...



Source: United Nations.

32. Authorities' views. The economic Master Plan, unveiled in 2011, recognizes the need to strengthen investment in both infrastructure and human capital formation. The plan aims to transform Indonesia into one of the 10 largest economies in the world by 2025. The hope is that the strategy will raise living standards, lift millions out of poverty, and greatly expand access to education and health care. The plan targets investments of $468 billion over 2011–15, of which nearly half will be in infrastructure.

Box 6. Indonesia: Income Equality, Infrastructure, and Education[1]

Despite robust growth and significant reduction in absolute poverty, Indonesia's income inequality has risen during recent decades. Is there a role for infrastructure and education, both priorities in the authorities' economic Master Plan, in arresting this trend? An empirical cross-country study indicates that the answer is "yes."

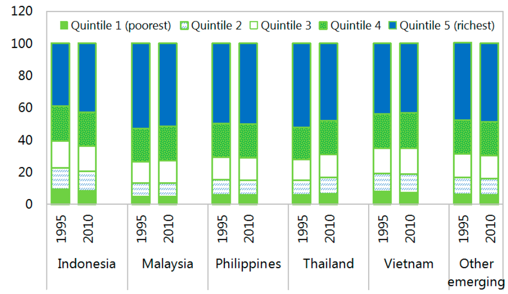
With impressive growth, Indonesia's poverty rate has declined, but like in many other parts of the world, income inequality has been increasing. The percentage of the population living under $1.25 per day has declined from 48 percent to 18 percent during 1999–2010. However, the latest rural and urban Gini indexes are higher than those in 1999. The income share of the richest quintile has also risen while that of the lowest quintile has fallen.

A defining constraint in Indonesia is infrastructure. Basic infrastructure quantity and quality indices capturing information in three key infrastructure sectors—communication, power, and road network for 76 advanced and emerging market economies during 1980–2010, created as part of the study—show that Indonesia continues to lag regionally in both the quantity and quality of its infrastructure.

Regression results confirm the value of infrastructure and education spending in reducing inequality. The regressions, which include a set of standard control variables, indicate that both the quantity and quality of infrastructure have internationally had a significant positive impact on income equality. Infrastructure and income distribution may have two-way causality. Income inequality could prevent the poor from accessing infrastructure services, while at the same time inadequate infrastructure may worsen income inequality. To overcome this endogeneity problem, both infrastructure indexes enter the regressions with one lag.

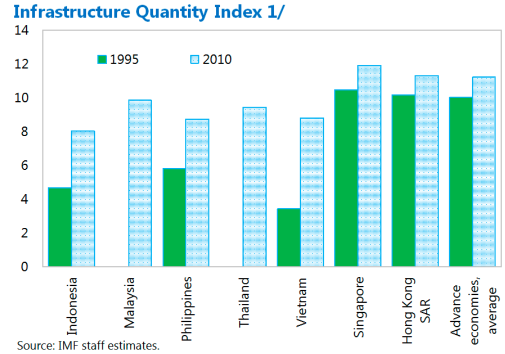
The results also reinforce the importance for income distribution of increasing the share of formal sector employment in Indonesia. Specifically, the higher the share of employment in industry is, the more equal is income distribution.

Income Share by Quintile 1/
(In percent of total)



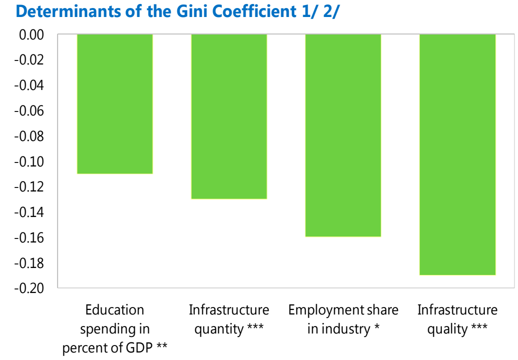
Sources: World Bank, *Povcal database*; and IMF staff estimates.
1/ Calculations are based on 5-year averages.

Infrastructure Quantity Index 1/



Source: IMF staff estimates.
1/ A higher index indicates better infrastructure quantity.

Determinants of the Gini Coefficient 1/ 2/



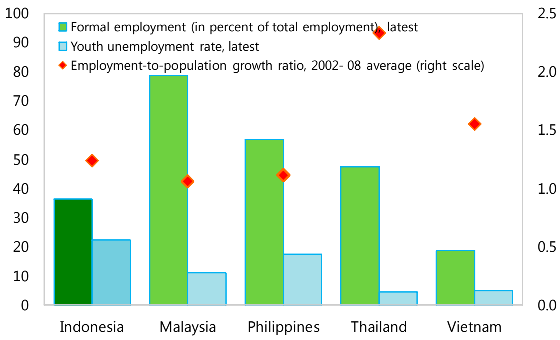
Source: IMF staff estimates.
1/ Measured as the coefficients of the independent variables above.
2/ An * indicates significance at 10 percent, ** at 5 percent, and *** at 1 percent.

[1] Forthcoming working paper by Yan Sun and Dulani Seneviratne (both APD).

Figure 6. Indonesia: Growth Constraints

Employment indicators are not strong...

Employment

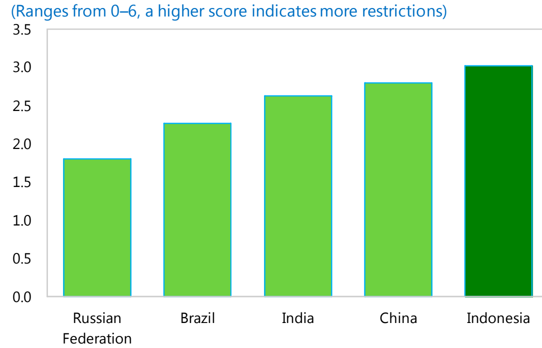


Sources: International Labor Organization; UNESCAP; IMF, *World Economic Outlook*; and IMF staff estimates.

...whereas employment protection is.

OECD Employment Protection Index, 2008

(Ranges from 0–6, a higher score indicates more restrictions)

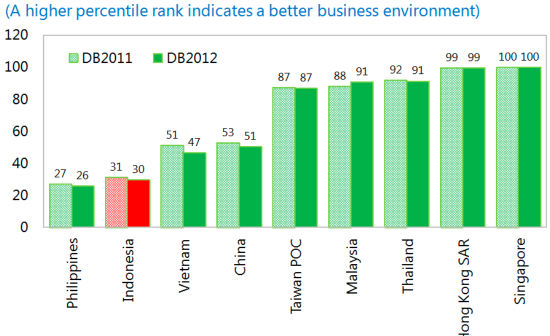


Source: OECD.

Doing business is relatively hard...

Ease of Doing Business 1/

(A higher percentile rank indicates a better business environment)

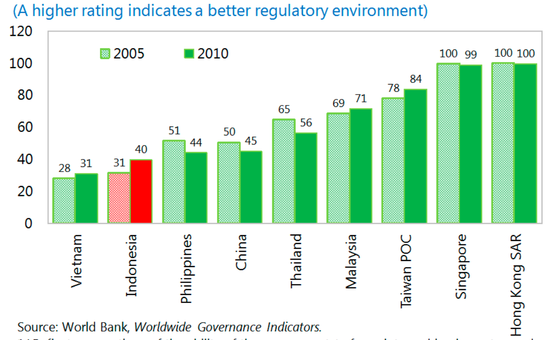


Sources: World Bank, *Doing Business Database* 2012; and IMF staff estimates.
1/ Included as inverse percentile rank of of actual *Ease of Doing Business* rankings.

...in part due to poor quality of regulation.

CPIA Rating: Regulatory Quality

(A higher rating indicates a better regulatory environment)

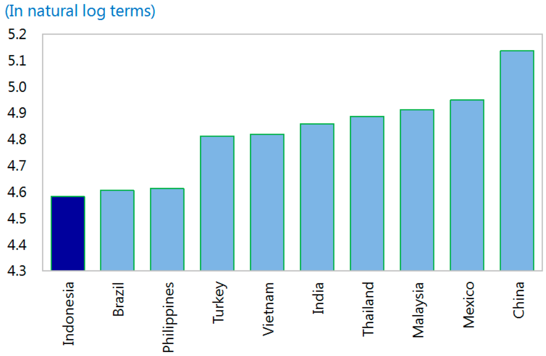


Source: World Bank, *Worldwide Governance Indicators.*
1/ Reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

Education spending...

Real Per Capita Public Education Spending, Average 2000–09

(In natural log terms)

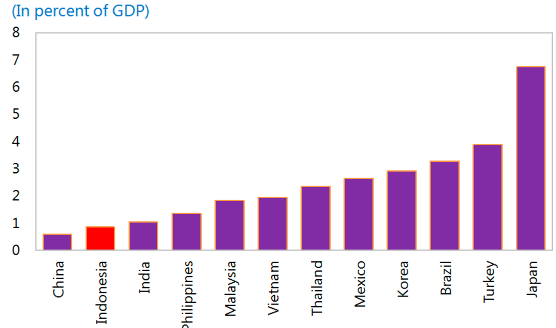


Source: IMF, FAD *health and Education* database.

...and health spending are very low.

Health Spending, Average 2000–2009

(In percent of GDP)



Sources: World Bank, *World Development Indicators;* IMF, *Government Finance Statistics;* Asian Development Bank; UNESCO; World Health Organization; and IMF staff estimates.

B. Macroeconomic Policies to Foster Stable and Inclusive Growth

33. Fiscal reforms to increase capital investment remain a priority. Budget execution still represents a challenge. While capital spending is increasing in absolute terms, only 80 percent of the budgeted amount was executed in 2011, with about half disbursed only in the last two months of the year. Measures taken to improve capital execution have not fully brought about the anticipated results—in the first half of 2012, only 19 percent of budgeted capital spending was disbursed, a pattern broadly similar to previous years. The government has taken several other recent steps to improve the implementation of infrastructure projects. A new procurement regulation has been adopted and budget preparation and payment processes streamlined. However, project development and preparation still remain significant bottlenecks.

34. Government schemes to facilitate infrastructure investment have met with limited success but remain promising, provided fiscal risks are well monitored. The public-private partnership (PPP) program is being held back by weaknesses in project selection and preparation, especially at the local government level. A government guarantee fund for PPPs has been set up with the aim of ring fencing fiscal risks. But its current low capital and the continued potential involvement of the budget to provide guarantees beyond the scope of the fund pose some fiscal risks. The budget would need to provide room for further capital infusions into the fund over the medium term. As regards purely private infrastructure investment, a critical constraint is land. The land acquisition law approved in late-2011 could be an important means for unlocking this bottleneck now that the presidential decree on its implementation has been issued. However, administrative regulations still need to be finalized and further reforms in the area of land will be required to ensure that land titles are clear.

35. As debt continues to decline, there may be scope to increase the deficit to allow for greater social and investment spending. Under the current baseline, public debt is projected to decrease to 17.6 percent of GDP by 2017. However, due to constraints in expenditure execution, the existing deficit ceilings have not become binding yet, suggesting that focus in the near term should remain on improving execution.

Authorities' Views

36. The authorities agree that spending execution, particularly in investment, remains a challenge, but are hopeful about the efficacy of recent initiatives. The decentralized fiscal structure in Indonesia imposed significant coordination challenges. Nevertheless, even if capital execution rates in relation to budgeted amounts had not significantly improved, the absolute volume of investment spending had been increasing significantly due to the reforms undertaken to date. Additional measures about to be adopted to streamline procurement would further ease bottlenecks. As regards the PPP program, the authorities acknowledged that progress had been weak despite seven years of trying, but that with one major successful example in place now to serve as a model for future projects, progress would be accelerated.

37. The authorities were of the view that considerations to increase the deficit ceiling should only be taken up at a later date. The issue would only be relevant once the composition of current spending and the execution of capital spending improved and the deficit ceilings became binding. An important means of increasing social and investment spending in the medium term was to address the issue of energy subsidies, which was recognized in the authorities' roadmap.

C. Deepening Financial Markets

38. Financial deepening will be key to mobilizing domestic savings to fund both private and public investment, as well as providing a greater range of financial products. Low bank credit reflects, in part, the continued aversion to debt since the 1998 financial crisis. In particular, most firms, especially in the dynamic resource extraction sector, choose to finance investment through retained earnings. There is anecdotal evidence that a significant proportion of resident savings are intermediated offshore. The contractual savings sector has yet to take off, due to low levels of formal employment, along with the lack of enforcement of existing pension requirements. Insurance and investment funds have grown from a small base, but do not contribute significantly to the pool of domestic long-term savings.

39. Promoting financial sector development requires a comprehensive strategy based on a well-sequenced set of measures. One of the initial priorities should be to facilitate the development of the money and secondary government bond markets. This could provide better benchmarks for long-term financing, and promote market-making activities. Another key pillar would be expanding the supply of long-term savings through the growth of the pension and mutual funds industry, which would depend a great deal on the design of the expanded social insurance schemes. Demand for credit will benefit from overall improvements in the business climate that would encourage firms outside the resource sector to seek external funding for new investments.

40. Authorities' views. The authorities are extremely keen to develop and deepen financial markets. The key challenge was deciding on the appropriate sequencing of reforms. They welcomed technical assistance from the Fund in this regard.

D. Labor Markets and Social Protection

41. Labor reforms and increased social spending would help unlock more equitable growth. On the surface, Indonesia compares well to its peers in creating employment, at least in relation to population growth. However, youth unemployment rates are among the highest in the region and much of the employment is in the informal sector, which is less efficient and masks some underemployment. Reforming Indonesia's labor laws, which are relatively rigid in international comparison, would help create greater formal and youth employment. Improved public spending on infrastructure, health, and education would also better equip the young for the formal labor market and lead to more equitable growth.

42. Strengthening social protection is very much on the authorities' radar screen. The current social protection system has two elements. The first is a targeted cash transfer program and the second a contributory social insurance program for civil servants and formal sector employees. Although participation is mandatory in the latter, evasion is high and coverage is very low. The National Social Security System (SJSN) Law, when implemented, will provide a comprehensive and radical reform to the system. The law, approved in 2004, creates five social security programs: health insurance, employment injury, pension, old-age savings, and death benefits. Importantly, the new system will cover the entire population, including in the informal sector. The law requires the establishment of administrative bodies for the new programs. Following the passage of the law on the Social Security Administrative Body (BPJS) in 2011, two administrative bodies will be set up: (i) BPJS Health, managing the health fund; and (ii) BPJS Employment, managing the other four funds. Both bodies will be established by transforming current insurance schemes and the transformations are required to take place by 2015.

43. Further steps are, however, required to implement the new social security system. The benefits provided by, and contribution rates to, the system will have to be determined. If they are set inappropriately, the state might incur substantial contingent liability. All formal and informal sector workers will have to be registered and assigned identification numbers. It is, as yet, unclear how collection of contributions will be managed, especially for informal sector workers.

44. Authorities' views. The authorities underscored their continuing commitment to implementing the social security reforms. They agreed that benefits and contribution rates would need to be set in a way that ensured the continued soundness of the fiscal position. They noted that the timetable for the reforms allowed sufficient leeway to gradually roll out the new schemes, with due attention to all the implementation challenges.

E. Business Climate

45. While progress has been made, there exists scope to further improve the business environment. Indonesia has improved its position in the World Economic Forum's Global Competitiveness index (CGI). At 46th, its current rank is supported by its strong macroeconomic environment (23rd, up from 89th in 2007), but infrastructure, institutions, and security remain weak. These weaknesses are also echoed in the World Bank's *Doing Business* survey, where Indonesia's overall ranking was less favorable. Constraints identified there included access to electricity, resolving insolvency, and contract enforcement. Concerns about the business environment are also prominent in the mining community, with mineral extraction companies according Indonesia a relatively weak international ranking (in particular, as regards the stability and predictability of the tax regime) in a recent survey. Finally, the 2010 FSAP noted that weaknesses in the legal and governance framework, including the lack of creditor rights, had undermined investor confidence.

46. A number of trade and investment measures announced in recent months have weighed on investor sentiment. These measures can broadly be divided into five categories: (i) export restrictions and taxes on raw resources; (ii) tighter import licensing requirements, quantitative limitations, and pre-shipment inspections; (iii) requirements for majority stake divestment by foreign mining companies; (iv) point of entry restrictions on some imports; and, (v) single ownership limits on commercial banks. Many of the measures contain exceptions to their applicability, which limits their economic impact. The mining divestment regulation does not apply to existing companies and the single ownership regulation for banks is applicable to existing shareholders only in banks that have weaker financial and corporate governance ratings. Overall, coordination appears lacking as some of the implications of the measures may not have been fully thought through (for example, increasing mineral processing on shore would require a substantial increase in electricity generation) and the unintended consequences of some of the other measures (such as on points of entry) have led them to be subsequently postponed or amended.

47. Authorities' views. The authorities acknowledged that they faced a number of challenges in effectively communicating the motivations behind some of their recent initiatives. There was a need to increase value added in Indonesia as continued reliance on simply exporting raw materials would not create the types of jobs necessary to improve living standards. The banking regulation was aimed at improving corporate governance and did not limit acquisition of domestic banks by strong foreign banks. The authorities were indeed in the process of renegotiating some mining contracts, but only to ensure a more equitable distribution and in a manner that respected the sanctity of contracts. Furthermore, there were domestic policy coordination challenges in a very diverse and vocal democracy that had led to, or necessitated, some of the initiatives. The authorities had introduced the measures in a manner, or were working through them currently, to ensure that Indonesia's external commitments continued to be fully respected.

STAFF APPRAISAL

48. In terms of its fundamentals, Indonesia is in a strong position from which to navigate through current global macroeconomic uncertainties. Its reliance on domestic demand as a driver of growth provides a floor to the risks represented by a possible significant global economic slowdown. Its corporate and financial sector balance sheets are healthy and, following the exemplary reduction in public debt achieved over the past decade, there currently exists enviable fiscal space to support growth, if necessary. The recently weakening external current account is a natural and desirable consequence of its movement toward the long-term equilibrium implied by Indonesia's fundamentals and desirable policies.

49. Risk perceptions, however, remain elevated, underscoring the importance of addressing policy uncertainties going forward. Recent spikes in global risk aversion have impacted on Indonesia, with reserves declining by nearly 15 percent from the August 2011 peak. Inflation expectations have also picked up sharply. To a large extent, global factors lie behind these developments but domestic policies have also played their part. Easy monetary conditions have amplified the impact of capital outflows. Similarly, lack of timely adjustments to subsidized fuel prices have resulted in suppressed inflation when global commodity prices recovered. If not managed carefully, the transition to a unified financial supervisor may raise financial vulnerabilities, especially if the passage of effective FSSN legislation is delayed. The announcement of a number of trade and investment related measures have also led to some questioning of Indonesia's continuing commitment to an open trade and investment regime.

50. Bank Indonesia is encouraged to normalize liquidity. This would help arrest incipient inflation and financial sector risks from building up and will also bolster resiliency to spikes in global risk aversion by ensuring that Indonesian financial assets remain sufficiently attractive to investors. In the staff's view, the current conjuncture calls for reliance on the traditional tools of monetary policy, as prudential measures aimed at specific sectors will not tackle the underlying condition of easy money—limits on any specific sector will only lead to pressures elsewhere in the broader economy.

51. Expeditiously completing the review of the monetary policy framework would be helpful. This would help better guide market expectations and thereby enhance BI's ability to influence financial market conditions indirectly and in a way that better nurtures financial market deepening. Moreover, by reducing volatility stemming from uncertainty regarding BI's policy stance, this could provide more support for private investment than policies to boost lending to specific sectors.

52. It will be critical to address remaining gaps and inconsistencies during the implementation of planned financial sector reforms. Maintaining proper oversight of the supervisory and regulatory functions during the OJK transition will require close coordination by relevant agencies. Most critically, an FSSN law amended to take account of previous Fund recommendations should be adopted as soon as possible to provide a sound legal framework for the effective management of a systemic crisis.

53. The authorities' continuing commitment to exchange rate flexibility is welcome. The exchange rate is moderately undervalued from a medium-term perspective, but continued two-way flexibility of the rate is a critical tool in the authorities' arsenal to address external risks. The authorities are also advised to pay close attention to conditions of foreign exchange market liquidity, as illiquid conditions can significantly damage market confidence and hence give rise to perceptions of risk when fundamentals, such as the level of reserves and the growth outlook, do not warrant them.

54. Continuing with fiscal reforms should remain a priority. There is ample room to improve both the composition of fiscal spending and its execution. As recommended previously, costly and inefficient energy subsidies could be replaced with direct cash transfers to the vulnerable. This would create greater fiscal room to spend on pressing infrastructure, health, and education needs. It would also enhance economic equity. Reforms to streamline and expedite budget execution processes have led to increases in absolute amounts of government capital spending and should continue.

55. An open foreign trade and investment regime remains important. While it is appropriate for Indonesia to seek to move up the value chain, it would also be important to do so in a manner that preserves the attractiveness of Indonesia as a destination for foreign trade and investment. The authorities are encouraged to develop a coordinated framework that balances their industrial policy considerations with economic openness. In this regard, their continuing commitment to Indonesia's external obligations, such as under the WTO process, is welcome. Moving up the value chain should occur naturally as Indonesia builds up its comparative advantages outside the resources sector with greater investment in human capital, reduction in the costs of doing business, and deepening of financial markets.

56. Persevering with structural reforms will yield significant dividends. The authorities have an economic master plan that is well targeted at some of Indonesia's growth constraints. Increasing the rate of growth and making it more equitable will require reforms to the labor market and the business climate. Changes to the social security regime, as planned by the authorities, will better protect the vulnerable.

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

Table 1. Indonesia: Selected Economic Indicators, 2008–13

Nominal GDP (2011): Rp 7,427 trillion or US$846 billion
Main exports (percent of total, 2011): Oil and gas (16.0), coal (13.4), palm oil (9.7), process rubber (7.0), other manufactured goods
GDP per capita (2011): US$3,509
Unemployment rate (Feb. 2012): 6.3 percent
Poverty headcount ratio at national poverty line (2011): 12.5 percent of population

	2008	2009	2010	2011	2012 Proj.	2013 Proj.
Real GDP (percent change)	6.0	4.6	6.2	6.5	6.0	6.3
Domestic demand	7.6	5.2	5.9	6.2	7.7	6.7
Of which:						
Private consumption	5.3	4.9	4.7	4.7	4.9	4.9
Gross fixed investment	11.9	3.3	8.5	8.8	11.0	10.0
Change in stocks 1/	0.1	-0.2	0.6	0.5	0.8	0.1
Net exports 1/	0.7	1.2	0.9	1.5	-1.8	-0.4
Saving and investment (in percent of GDP)						
Gross investment 2/	27.8	31.0	32.6	32.8	34.2	35.2
Gross national saving	27.8	33.0	33.3	33.0	32.3	33.3
Foreign saving (external current account balance)	0.0	-2.0	-0.7	-0.2	1.9	2.0
Prices (12-month percent change)						
Consumer prices (end period)	11.1	2.8	7.0	3.8	5.0	5.1
Consumer prices (period average)	9.8	4.8	5.1	5.4	4.4	5.0
Public finances (in percent of GDP)						
Central government revenue	19.8	15.1	15.8	16.1	16.3	16.0
Central government expenditure	19.9	16.7	16.4	17.3	18.1	17.7
Central government balance	-0.1	-1.6	-0.6	-1.1	-1.8	-1.8
Primary balance	1.7	0.1	0.8	0.1	-0.5	-0.5
Central government debt	33.2	28.6	26.9	24.5	23.5	21.5
Money and credit (12-month percent change; end of period)						
Rupiah M2	12.7	13.8	16.5	17.4	...	...
Base money	-9.2	16.7	28.9	18.3	...	...
Private sector credit	30.7	8.1	22.1	25.8	...	...
One-month interbank rate (period average)	9.1	7.4	6.4	6.2	...	...
Balance of payments (in billions of U.S. dollars)						
Oil and gas (net)	-23.9	-15.2	-25.4	-38.7	-41.2	-40.7
Non-oil exports (f.o.b)	107.9	99.0	129.4	162.7	159.6	167.2
Non-oil imports (f.o.b)	-92.8	-73.5	-102.0	-127.9	-143.5	-154.6
Current account balance	0.1	10.6	5.1	1.7	-17.3	-20.2
Foreign direct investment	9.3	4.9	13.8	18.9	21.4	21.5
Overall balance	-1.9	14.2	30.3	13.8	-2.2	2.5
Gross reserves						
In billions of U.S. dollars (end period)	51.6	66.1	96.2	110.1	107.8	110.3
In months of imports	5.7	5.2	5.9	6.7	5.9	5.7
As a percent of short-term debt 3/	178.5	211.0	226.5	238.4	225.7	217.2
Total external debt						
In billions of U.S. dollars	155.1	172.9	202.4	225.4	233.2	247.9
In percent of GDP	30.4	32.1	28.6	26.6	25.7	23.9
Exchange rate (period average)						
Rupiah per U.S. dollar	9,697	10,406	9,086	8,774	...	...
Nominal effective exchange rate (2005=100)	90.8	86.6	95.2	93.5	...	...
Memorandum items:						
Oil production (thousands of barrels per day)	976	949	945	907	895	890
Indonesian oil price (US$/bbl)	97.0	61.6	79.4	111.5	107.2	101.5
Nominal GDP (in trillions of rupiah)	4,949	5,606	6,436	7,427	8,469	9,745
Nominal GDP (in billions of U.S. dollars)	510	539	708	846	906	1,036

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

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

Table 2. Indonesia: Balance of Payments, 2008–13

(In billions of U.S. dollars, unless otherwise indicated)

	2008 Act.	2009 Act.	2010 Act.	2011 Act.	2012 Proj.	2013 Proj.
Current account	0.1	11.2	5.1	1.7	-17.3	-20.2
Goods, net (trade balance)	22.9	30.9	30.6	33.9	14.7	11.0
Exports, f.o.b.	139.6	119.6	158.1	200.6	199.4	206.3
Of which: Oil and gas	31.7	20.6	28.7	37.9	39.8	39.1
Non-oil and gas	107.9	99.0	129.4	162.7	159.6	167.2
Imports, f.o.b.	-116.7	-88.7	-127.4	-166.6	-184.6	-195.2
Of which: Oil and gas	-23.9	-15.2	-25.4	-38.7	-41.2	-40.7
Non-oil and gas	-92.8	-73.5	-102.0	-127.9	-143.5	-154.6
Services, net	-13.0	-9.7	-9.3	-10.6	-11.7	-13.2
Income, net	-15.1	-14.6	-20.8	-25.8	-24.5	-22.4
Current transfers, net	5.4	4.6	4.6	4.2	4.2	4.3
Capital and financial account	-1.8	4.8	26.7	14.0	15.1	22.7
Capital account	0.3	0.1	0.0	0.0	0.1	0.1
Financial account	-2.1	4.7	26.6	14.0	15.0	22.6
Direct investment, net	3.4	2.6	11.1	11.1	15.4	15.3
Abroad, net	-5.9	-2.2	-2.7	-7.8	-6.0	-6.2
In Indonesia (FDI), net	9.3	4.9	13.8	18.9	21.4	21.5
Portfolio investment, net	1.8	10.3	13.2	4.5	4.2	10.7
Assets, net	-1.3	-0.1	-2.5	-1.0	-1.4	-1.5
Liabilities	3.1	10.5	15.7	5.5	5.6	12.2
Equity securities	0.3	0.8	2.1	-0.3	-0.3	-0.2
Debt securities	2.7	9.7	13.6	5.8	5.9	12.4
Other investment	-7.3	-8.3	2.3	-1.6	-4.7	-3.4
Assets	-10.8	-12.1	-1.7	-6.4	-7.4	-6.5
Trade credit	-5.4	-2.9	-2.6	-5.8	-6.1	-6.5
Loans	-0.3	-0.2	-0.2	-0.5	-0.5	-0.5
Currency and deposits	-5.1	-9.0	1.1	-0.1	-0.8	0.5
Liabilities	3.4	3.8	4.0	4.8	2.6	3.2
Trade credit	0.0	0.0	0.2	1.0	1.0	1.0
Loans	2.8	1.9	0.1	2.8	1.9	1.6
General government	-1.4	-1.2	-0.3	-2.0	0.4	-1.1
Banks	1.4	0.7	-0.6	1.8	0.5	0.9
Other sectors	2.8	2.4	0.9	3.0	0.9	1.8
Currency and deposits	0.6	-0.8	1.6	1.3	0.0	0.5
Other 1/	0.0	2.7	2.0	-0.2	-0.2	0.1
Total	-1.7	16.0	31.8	15.7	-2.2	2.5
Errors and omissions	-0.2	-3.0	-1.5	-1.9	0.0	0.0
Overall balance	-1.9	13.0	30.3	13.8	-2.2	2.5
Reserves and related items	1.9	-14.2	-30.3	-13.8	2.2	-2.5
Memorandum items:						
Reserve assets position (eop)	51.6	66.1	96.2	110.1	107.8	110.3
in months of imports of goods and services	5.7	5.2	5.9	6.7	5.9	5.7
in percent of short-term debt at remaining maturity	178.5	211.0	226.5	238.4	225.7	217.2
in percent of ST debt at RM and foreign holding of IDR debt 2/	129	133	132	149	145	137
Current account (percent of GDP)	0.0	2.0	0.7	0.2	-1.9	-2.0
Non-oil and gas exports, volume growth	0.3	1.0	4.9	9.9	7.8	2.5
Non-oil and gas imports, volume growth	26.3	-17.5	29.2	16.2	16.3	9.2
Terms of trade, percent change (excluding oil)	4.3	-7.1	6.1	2.8	-1.3	-0.2
Terms of trade, percent change (including oil)	5.0	-4.2	3.7	4.8	0.5	0.1
Stock of nonfinancial public sector external debt 3/	89.5	105.5	125.7	136.3	146.4	154.2
in percent of GDP	17.5	19.6	17.8	16.3	15.6	14.9
Nonfinancial public sector debt service (percent of exports)	6.5	8.0	5.5	4.5	4.8	4.5

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

1/ Includes unrecorded capital flows and exceptional financing.
2/ Denominator includes short-term debt at remaining maturity plus foreign holding of long-term government bonds in rupiah.
3/ Includes nonfinancial state-owned enterprises.

Table 3. Indonesia: Monetary Survey, 2008–12

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

	2008	2009	2010	2011	Mar-12	Apr-12	May-12
Bank Indonesia							
Net foreign assets	555.4	606.2	852.0	921.8	940.6	979.5	971.4
Net domestic assets	-210.7	-204.1	-333.6	-308.3	-354.6	-382.9	-366.5
Net claims on central government	176.9	210.0	187.4	240.4	181.2	120.2	112.8
Liquidity operations, net 1/	-155.1	-205.9	-432.6	-475.1	-438.7	-399.9	-372.2
Claims on other sectors 2/	20.2	20.3	18.4	16.5	16.3	16.3	16.3
Other items, net	-252.8	-228.4	-106.8	-90.1	-113.4	-119.5	-123.4
Monetary base	344.7	402.1	518.4	613.5	586.0	596.6	605.0
Monetary survey							
Net foreign assets	590.4	700.4	887.9	868.1	884.9	922.1	926.6
Net domestic assets	1305.5	1441.0	1583.3	2009.2	2,027.0	2,005.2	2,065.5
Net claims on central government	392.1	438.4	374.7	402.5	367.1	313.7	311.2
Claims on other nonfinancial public sector	48.9	67.6	101.0	104.0	109.8	119.5	124.9
Private sector credit	1378.2	1489.4	1818.9	2289.1	2,364.6	2,411.3	2,472.1
Other items, net	-513.8	-554.4	-711.3	-786.5	-814.5	-839.3	-842.6
Broad money 3/	1895.8	2141.4	2471.2	2877.2	2,911.9	2,927.3	2,992.1
Rupiah M2	1613.4	1836.7	2140.2	2513.1	2,530.6	2,549.1	2,592.1
Currency in circulation	209.7	226.0	260.2	307.8	287.0	290.9	294.8
Deposits	1403.7	1610.7	1880.0	2205.3	2,243.6	2,258.2	2,297.4
Foreign currency deposits	279.1	301.1	321.9	349.8	366.5	362.7	384.8
Memorandum items:							
Net international reserves (US$ billions)	49.9	63.8	94.1	101.2	102.1	106.2	101.4
Money multiplier (rupiah M2)	4.7	4.6	4.1	4.1	4.3	4.3	4.3
Base money velocity 4/	14.4	13.9	12.4	12.1	13.5	14.0	13.8
Rupiah M2 velocity 4/	3.1	3.1	3.0	3.0	3.1	3.3	3.2
Annual percentage change:							
Broad money	14.9	13.0	15.4	16.4	18.8	20.2	20.9
Rupiah M2	12.7	13.8	16.5	17.4	20.0	21.1	20.7
Monetary base	-9.2	16.7	28.9	18.3	15.6	14.6	15.0
Private sector credit	30.7	8.1	22.1	25.8	25.7	25.9	25.6

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

1/ Net outstanding monetary instruments,
2/ Includes claims on banks not related to monetary operations.
3/ Includes securities classified as broad money.
4/ Calculated using end-period quarterly GDP, annualized.

Table 4. Indonesia: Summary of Central Government Operations, 2009–13

	2009 Act.	2010 Act.	2011 Act.	2012 Proposed Budget	2012 Revised Budget	2012 Staff proj.	2013 Staff proj.
			(In trillions of rupiah)				
Revenues and grants	848.8	1,016.8	1,197.5	1,292.9	1,344.5	1,381.7	1,555.0
Oil and gas revenues	175.8	211.6	266.5	214.7	254.2	296.7	272.1
Tax revenues	50.0	58.9	73.1	58.7	64.6	75.4	76.8
Nontax revenues	125.8	152.7	193.4	156.0	189.6	221.3	195.3
Non-oil and gas revenues	671.3	802.4	928.4	1,077.4	1,089.4	1,084.2	1,282.1
Tax revenues	569.9	685.8	800.6	960.7	947.1	938.5	1,114.4
Nontax revenues 1/	101.4	116.6	127.8	116.7	142.3	145.7	167.7
Grants	1.7	2.8	2.6	0.8	0.8	0.8	0.9
Expenditure and net lending	937.3	1,056.5	1,281.9	1,418.5	1,534.6	1,534.6	1,727.2
Central government expenditure	628.7	711.7	870.5	954.1	1,058.3	1,050.4	1,186.1
Current expenditure	479.0	566.4	685.9	722.4	834.1	831.5	910.0
Personnel	127.7	147.8	177.5	215.7	212.2	212.2	249.1
Subsidies	138.1	214.1	294.9	208.9	273.2	338.3	329.8
Of which : energy subsidies	94.6	139.9	255.6	168.6	230.4	296.4	285.4
Interest	93.7	88.3	93.3	123.1	117.8	114.3	124.9
Other	119.6	116.2	120.2	174.8	230.9	166.7	206.3
Development expenditure 2/	149.7	145.4	184.6	231.7	224.3	218.9	276.1
Capital Spending	76.0	77.0	113.7	168.1	168.9	146.7	193.2
Social Spending	79.1	68.4	71.0	63.6	55.4	72.2	82.9
Transfers to regions	308.5	344.7	411.3	464.4	476.3	484.2	541.1
			(In percent of GDP)				
Revenues and grants	15.1	15.8	16.1	15.9	15.7	16.3	16.0
Oil and gas revenues	3.1	3.3	3.6	2.6	3.0	3.5	2.8
Non-oil and gas revenues	12.0	12.5	12.5	13.3	12.8	12.8	13.2
Tax revenues	10.2	10.7	10.8	11.8	11.1	11.1	11.4
Nontax revenues 1/	1.8	1.8	1.7	1.4	1.7	1.7	1.7
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	16.7	16.4	17.3	17.5	18.0	18.1	17.7
Current expenditure	8.5	8.8	9.2	8.9	9.8	9.8	9.3
Personnel	2.3	2.3	2.4	2.7	2.5	2.5	2.6
Subsidies	2.5	3.3	4.0	2.6	3.2	4.0	3.4
Of which : energy subsidies	1.7	2.2	3.4	2.1	2.7	3.5	2.9
Interest	1.7	1.4	1.3	1.5	1.4	1.3	1.3
Other	2.1	1.8	1.6	2.2	2.7	2.0	2.1
Development expenditure 2/	2.7	2.3	2.5	2.9	2.6	2.6	2.8
Transfers to regions	5.5	5.4	5.5	5.7	5.6	5.7	5.6
Overall balance	-1.6	-0.6	-1.1	-1.5	-2.2	-1.8	-1.8
Financing	1.6	0.6	1.1	1.0	2.2	1.8	1.8
Domestic	1.2	0.3	1.0	0.9	2.3	1.0	1.3
External	0.3	0.3	0.1	0.1	-0.1	0.8	0.5
Memorandum items:							
Primary balance	0.1	0.8	0.1	0.0	-0.8	-0.5	-0.5
Cyclically adjusted primary balance	0.2	0.8	0.1	...	...	-0.4	-0.5
Non-oil overall balance 3/	-3.2	-1.8	-1.4	...	...	-1.9	-1.7

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

1/ Deposit insurance premia are treated as nontax revenues.

2/ Comprises capital spending and social assistance spending.

3/ Non-oil balance calculated as overall balance excluding oil and gas revenue and expenditure, in percent of non-oil GDP

Table 5. Indonesia: Selected Vulnerability Indicators, 2008–12

	2008	2009	2010	2011	2012 1/	Latest Observation
Key economic and market indicators						
Real GDP growth (in percent)	6.0	4.6	6.2	6.5	6.0	Proj.
CPI inflation (in percent, end of period)	11.1	2.8	7.0	3.8	5.0	Proj.
Short-term (ST) interest rate (in percent) 2/	10.9	6.5	6.3	4.9	4.5	Jul-12
Ten-year government bond yield (in percent)	11.9	10.1	7.6	6.0	5.7	Jul-12
Indonesia EMBI spread (bps, end of period)	762	230	183	274	237	Jul-12
Rupiah/US$ (end of period)	11,120	9,404	8,996	9,069	9,467	Jul-12
External sector						
Current account balance (percent of GDP)	0.0	2.0	0.7	0.2	-1.9	Proj.
Net FDI inflows (percent of GDP)	0.7	0.5	1.6	1.3	1.7	Proj.
Exports (percentage change of US$ value, GNFS)	18.7	-14.2	31.7	26.6	-0.3	Proj.
Real effective exchange rate (end period; 2005=100)	110.1	109.9	124.4	124.7	122.9	Jul-12
Gross international reserves (GIR) in US$ billion	51.6	66.1	96.2	110.1	106.6	Jul-12
GIR in percent of ST debt at remaining maturity (RM)	178.5	211.0	226.5	238.4	225.7	Proj.
Total gross external debt in percent of exports of GNFS	100.1	130.2	115.8	101.9	105.7	Proj.
Gross external financing requirement (US$ billion) 3/	59.1	44.2	54.2	71.0	86.9	Proj.
Public sector (PS) 4/						
Overall balance (percent of GDP)	-0.1	-1.6	-0.6	-1.1	-1.8	Proj.
Primary balance (percent of GDP)	1.7	0.1	0.8	0.1	-0.5	Proj.
Gross PS financing requirement (in percent of GDP) 5/	2.0	3.5	1.7	2.3	3.0	Proj.
Public sector gross debt (PSGD, in percent of GDP)	33.2	28.6	26.9	24.5	23.5	Proj.
Of which : Exposed to rollover risk (in percent of total PSGD) 6/	-1.9	-2.0	-1.1	-1.1	-1.2	Proj.
Exposed to exchange rate risk (in percent of total PSGD) 7/	51.6	46.4	44.3	43.9	45.3	Proj.
Exposed to interest rate risk (in percent of total PSGD) 8/	9.2	9.4	8.7	8.3	7.4	Proj.
Financial sector (FS)						
Capital to risk-weighted assets (in percent) 9/	16.8	17.4	17.2	16.1	17.5	Jun-12
NPLs in percent of total loans	3.2	3.3	2.5	2.2	2.2	Jun-12
FX deposits (in percent of total deposits)	16.6	15.7	14.5	13.6	14.3	May-12
FX loans (in percent of total loans)	18.5	13.9	14.6	15.6	15.8	May-12
Government debt held by FS (percent of total FS assets)	11.4	10.7	8.4	6.4	7.1	May-12
Total credit outstanding (annual percent change)	30.8	10.1	23.3	24.7	26.1	May-12

1/ Staff estimates, projections, or latest available observations as indicated in the last column.
2/ One-month Jakarta Interbank Offered Rate
3/ Current account deficit plus amortization of external debt.
4/ Public sector covers central government only.
5/ Overall balance plus debt amortization.
6/ Short-term debt and maturing medium- and long-term debt, domestic debt only.
7/ Debt in foreign currency or linked to the exchange rate, domestic and external, excluding external debt on concessional terms.
8/ Short-term debt and maturing medium- and long-term debt at variable interest rates for domestic debt. Information on external debt is not available.
9/ From 2010, includes capital charge for operational risk.

Table 6. Indonesia: Medium-Term Macroeconomic Framework, 2010–17

	2010	2011	2012	2013	2014	2015	2016	2017
	Act.		Proj.					
Real GDP (percent change)	6.2	6.5	6.0	6.3	6.5	6.6	6.7	6.8
Domestic demand	5.9	6.2	7.7	6.7	6.6	6.8	6.9	7.0
Of which:								
Private consumption	4.7	4.7	4.9	4.9	5.0	5.0	5.0	5.0
Gross fixed investment	8.5	8.8	11.0	10.0	10.0	10.5	10.7	10.9
Change in stocks 1/	0.6	0.5	0.8	0.1	0.1	0.1	0.1	0.1
Net exports 1/	0.9	1.5	-1.8	-0.4	0.1	-0.3	-0.3	-0.3
Saving and investment (in percent of GDP)								
Gross investment 2/	32.6	32.8	34.2	35.2	36.2	37.4	38.9	40.3
Gross national saving	33.3	33.0	32.3	33.3	34.1	35.2	36.3	37.5
Foreign saving (external current account balance)	-0.7	-0.2	1.9	2.0	2.0	2.3	2.5	2.8
Prices (12-month percent change)								
Consumer prices (end period)	7.0	3.8	5.0	5.1	4.8	4.5	4.2	4.0
Consumer prices (period average)	5.1	5.4	4.4	5.0	4.9	4.7	4.5	4.0
Public finances (in percent of GDP)								
Central government revenue	15.8	16.1	16.3	16.0	15.7	15.5	15.5	15.4
Tax revenues	10.7	10.8	11.1	11.4	11.6	11.8	12.1	12.3
Central government expenditure	16.4	17.3	18.1	17.7	17.6	17.6	17.5	17.5
Central government balance	-0.6	-1.1	-1.8	-1.8	-1.9	-2.0	-2.0	-2.0
Primary balance	0.8	0.1	-0.5	-0.5	-0.6	-0.8	-0.8	-0.8
Central government debt	26.9	24.5	23.5	21.5	20.1	19.1	18.3	17.6
Balance of payments (US$ billions)								
Oil and gas (net)	-25.4	-38.7	-41.2	-40.7	-41.2	-41.9	-42.7	-43.5
Non-oil exports (f.o.b)	129.4	162.7	159.6	167.2	180.3	192.3	206.0	220.9
Non-oil imports (f.o.b)	-102.0	-127.9	-143.5	-154.6	-167.9	-184.0	-202.5	-223.3
Current account balance	5.1	1.7	-17.3	-20.2	-24.8	-31.8	-41.4	-52.7
Foreign direct investment	13.8	18.9	21.4	21.5	23.5	25.9	28.6	31.6
Overall balance	30.3	13.8	-2.2	2.5	3.5	1.0	-1.3	-2.0
Gross reserves								
In billions of U.S. dollars (end period)	96.2	110.1	107.8	110.3	113.8	114.8	113.5	111.5
In months of imports	5.9	6.7	5.9	5.7	5.5	5.2	4.7	4.3
As a percent of short-term debt 3/	226.5	238.4	225.7	217.2	208.5	195.4	177.6	159.0
Total external debt								
In billions of U.S. dollars	202.4	225.4	233.2	247.9	266.4	286.9	311.9	342.4
In percent of GDP	28.6	26.6	25.7	23.9	21.8	20.3	19.1	18.1
Memorandum items:								
Oil production (000bcpd)	945	907	895	890	890	890	890	890
Indonesian oil price (US$/bbl)	79.4	111.5	107.2	101.5	98.7	96.3	94.0	92.0
Nominal GDP (in trillions of Rupiah)	6,436	7,427	8,469	9,745	11,213	12,890	14,804	17,003
Nominal GDP (US$ billions)	708	846	906	1,036	1,222	1,412	1,634	1,896

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

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

APPENDIX I: INDONESIA: RISK ASSESSMENT MATRIX[1]

Nature/Source of Main Threats	Likelihood of Risk[2] (high, medium, or low)	Expected Impact of Risk (high, medium, or low)	Recommended Policy Responses
1. Strong intensification of the Euro-area crisis	**Medium** • Another bout of global risk aversion. This could be triggered by European policy slippages, political uncertainties or a tail risk event of a disorderly exit of a member state • Bank deleveraging and fiscal austerity would depress activity in the Euro-area more than envisaged	**Medium** • Financial channel is expected to dominate through capital outflows as global risk aversion rises. • Weaker global growth would reduce exports and FDIs, lowering Indonesia's growth • With a small export sector, direct trade impact on the economy is not expected to be large • Small direct exposure to EA banks limits damage from bank deleveraging	• Exchange rate should be allowed to move flexibly to absorb shocks, but the authorities should not shy away from foreign exchange intervention in the thin and volatile market • BI to be ready to ensure ample liquidity in both foreign exchange and rupiah markets Emergency liquidity support should be available for viable banks • Fiscal stimulus could be used if downside risk on growth is persistent
2. China's hard landing	**Medium** • Marked slowdown of investment coupled with weak external demand could lead to a hard landing in China • The Chinese authorities will likely try to mitigate the risk through monetary and fiscal stimulus as well as continuous attempt to rebalance the economy toward consumption	**High** • A sharp fall in commodity prices as well as commodity demand from China would affect Indonesia's growth through lower export earnings, investment as well as FDIs in the sector • The demand for Indonesia's main commodities may not be as much affected as those associated only with Chinese investment (i.e., metal)	• Fiscal stimulus is the preferred route given the room • There is less scope to reduce policy rates from the current low levels
3. Inflation surprise	**Low** • Food price spike possibly due to harvest cycle and food import timing	**Medium** • A possible sell-off in the bond market, leading to a yield spike and weaker rupiah • Improved food import policy helps mitigate the impact	• BI should tighten monetary stance • Policies should aim to eliminate supply bottlenecks
4. Small bank failure	**Low** • Failure of a small or medium-sized bank that does not have much liquidity and capital buffer	**Medium** • A bank failure (and a messy resolution) could damage consumer and investor confidence in the capacity of the authorities • The authorities are aware of the resolution implications	• Close coordination by relevant agencies to ensure effective supervision is maintained during OJK transition. A prompt passage of the financial safety net law is needed • Emergency protocols should be developed in the absence of the law • Contingency plans should be formulated for recapitalization or intervention

[1] This IMF reflects staff views on the sources of risks and the overall level of concerns as of the time of discussions with the authorities. The risk assessment matrix shows relatively low probability events that could materially alter the baseline path, which is the scenario most likely to materialize in the view of the staff. Staff's subjective assessment of the relative likelihood among those low probability events is noted in the matrix (ranging from "low" to "high") is consistent across different country reports prepared in a given period.

[2] In case the baseline does not materialize.

APPENDIX II: INDONESIA—PUBLIC AND EXTERNAL DEBT SUSTAINABILITY

A. Public Debt

Public sector debt has been declining as a share of GDP since 2000 despite the global shock in 2009. The ratio fell to a record-low level of 24.5 percent in 2011 (Figure II.1) owing to prudent fiscal management and low fiscal deficits in the last decade. Lower interest rates and high real GDP growth also contributed to debt consolidation. Foreign-currency debt has fallen to less than half of total debt, as the improved fiscal position facilitated government access to the domestic capital market.

The baseline scenario projects a further moderate decline in public sector debt. Despite a larger fiscal deficit, public debt is likely to fall to about 23.5 percent of GDP in 2012, reflecting robust economic growth. In the medium term, continued low levels of fiscal deficit and strong economic growth will support a further decline in public debt to 18 percent of GDP by 2017. Such a strategy will accommodate extra resources for development spending and deliver a small primary deficit around 0.8 percent of GDP.

Public debt is sustainable and robust to macroeconomic and oil price shocks. All the standard stress tests suggest that the debt ratio is likely to remain modest even under shocks from contingent liabilities, sharp exchange rate movements, and higher interest rates (Figure II.1). Fiscal contingent liabilities amounting to 10 percent of GDP could raise the public sector debt to 24.5 percent of GDP by 2017 (at the 2011 level), while currency depreciation of 30 percent would raise the debt ratio to about 21.5 percent of GDP. An increase in real interest rates would have a smaller, but still sizable, effect with the debt ratio reaching 21 percent by 2017. Other macroeconomic shocks have an even more limited impact.

B. External Debt

Indonesia's external debt continues on a steady downward trend, after a temporary increase in 2009. Following a decade of a continuously improving external position, the sharp nominal depreciation of late 2008 and early 2009 temporarily led to an increase in the external debt-to-GDP ratio from 30 percent to 32 percent. However, strong growth and the rapid turnaround in the exchange rate are quickly reversing this increase, with the ratio projected to reach about 26 percent of GDP by 2012 (Figure II.2).

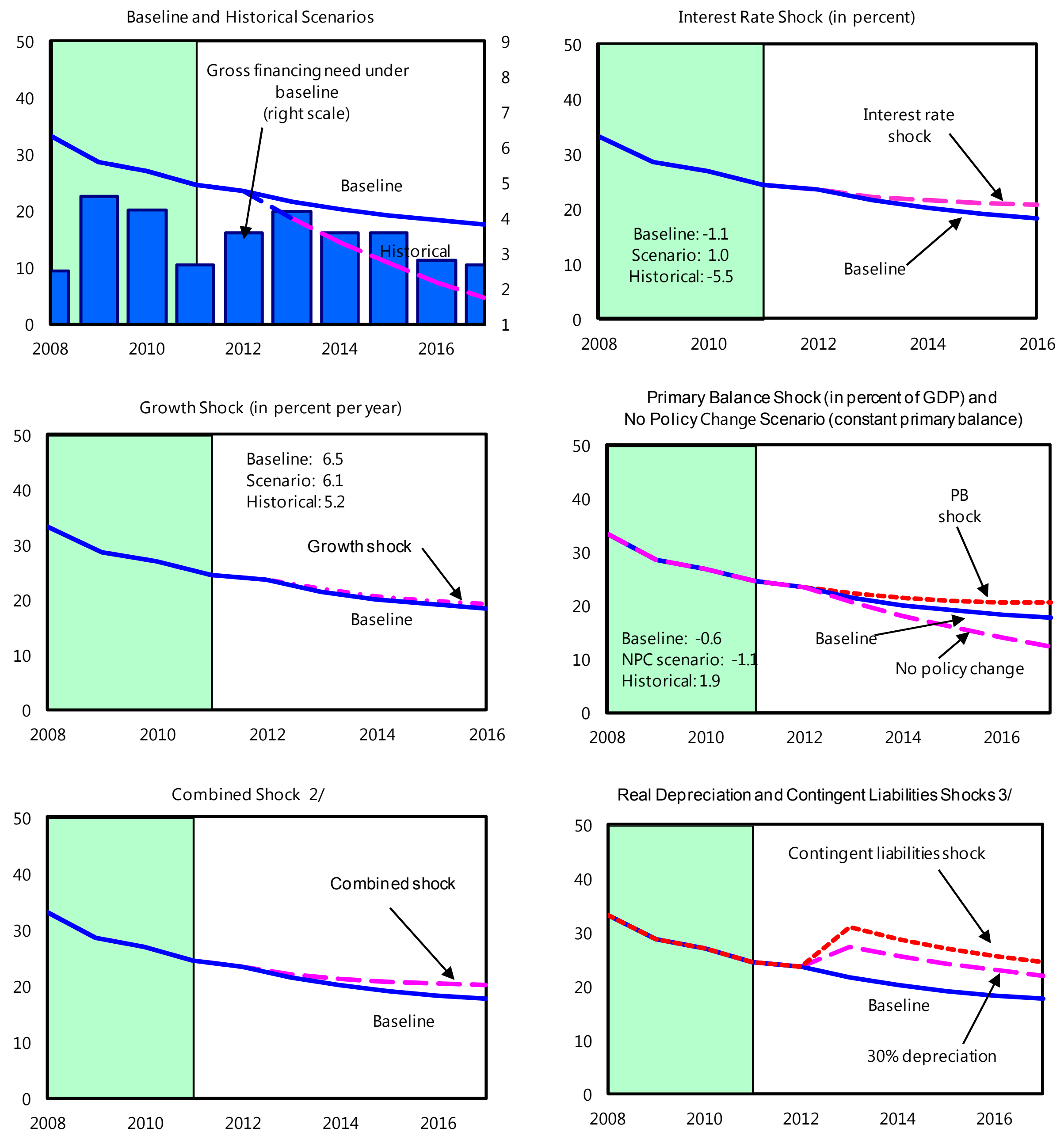
The baseline scenario projects external debt to continue on a declining path over the medium term, reaching 19 percent of GDP by 2017. A weakening current account balance—projected to just under

3 percent of GDP by 2017—is expected to be more than offset by: (i) sustained high real GDP growth in the range of 6−7 percent per year; (ii) increasing non-debt-creating (i.e., FDI) flows; and (iii) some further real appreciation. At -2.5 percent of GDP, the medium-term noninterest current account balance would remain comfortably above the debt-stabilizing level (-3.6 percent of GDP).

External sustainability is robust to most shocks. The external debt ratio is expected to follow a declining path, and remain at manageable levels, under all standardized-shock scenarios. A one-time 30 percent real exchange rate depreciation would have the largest impact, raising the debt ratio by 10 percentage points in 2012, and 4 percentage points over the baseline by 2017.

Figure II.1. Indonesia: Public Debt Sustainability: Bound Tests 1/

(Public debt in percent of GDP)

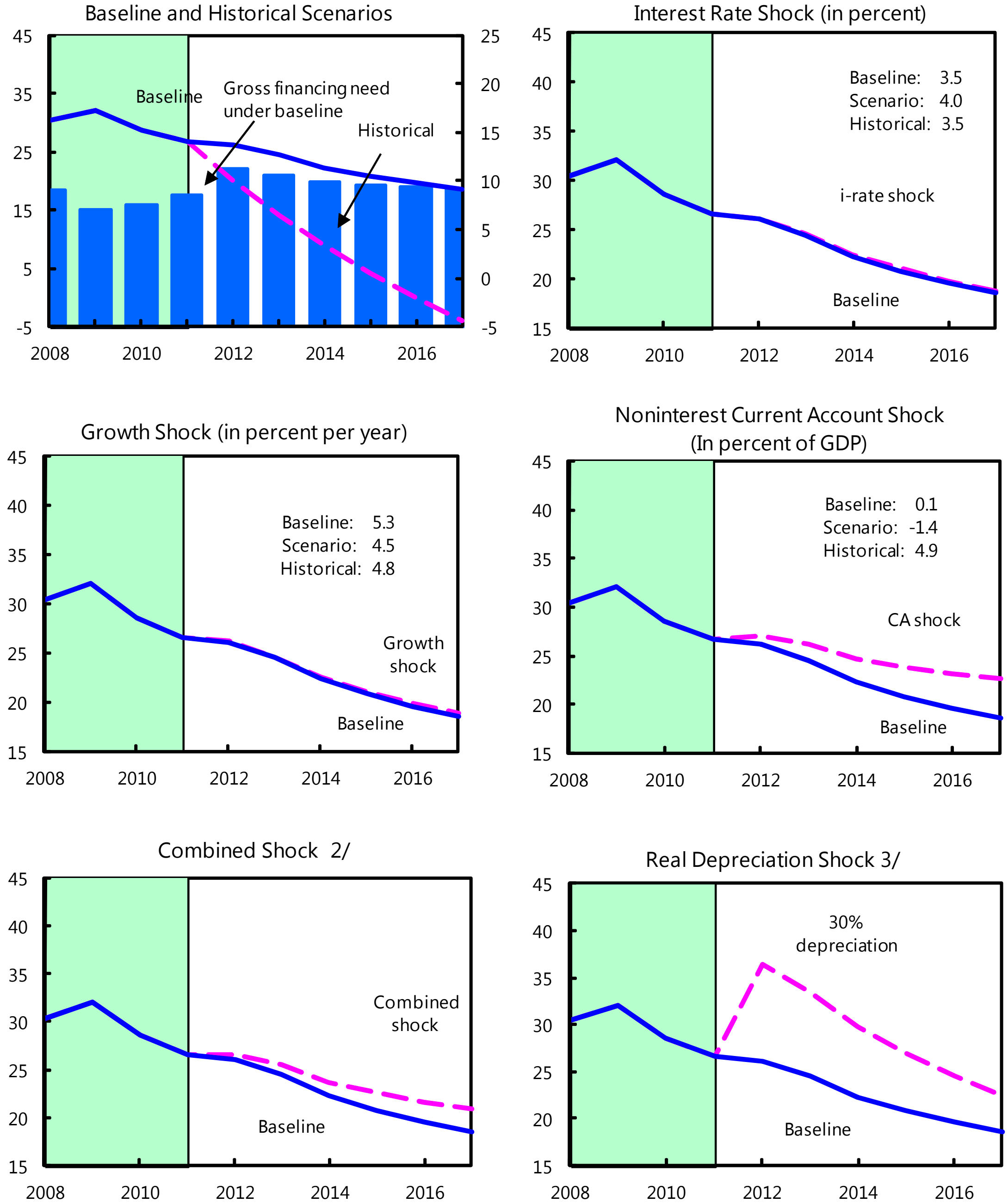


Sources: International Monetary Fund; country desk data; and Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure II.2. Indonesia: External Debt Sustainability: Bound Tests 1/

(External debt, in percent of GDP)



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

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2012.

Table II.1. Indonesia: Public Sector Debt Sustainability Framework, 2005–2017

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
1 Baseline: Public sector debt 1/	46.3	39.0	35.1	33.2	28.6	26.9	24.5	23.5	21.5	20.1	19.1	18.3	17.6	-1.4
Of which: foreign-currency denominated	24.0	18.2	16.5	17.5	13.3	11.9	10.7	10.3	9.3	8.6	7.8	7.1	6.5	
2 Change in public sector debt	-9.5	-7.4	-3.9	-1.8	-4.6	-1.8	-2.4	-0.9	-2.0	-1.4	-1.0	-0.8	-0.7	
3 Identified debt-creating flows (4+7+12)	-8.8	-9.8	-4.3	-4.5	-4.6	-3.0	-2.7	-1.6	-1.3	-1.0	-0.6	-0.5	-0.3	
4 Primary deficit	-3.1	-2.6	-1.0	-1.8	0.1	-0.1	-0.5	0.1	0.5	0.6	0.8	0.8	0.8	
5 Revenue and grants	19.4	20.3	19.3	21.3	16.5	17.0	17.8	18.1	17.8	17.6	17.5	17.5	17.5	
6 Primary (noninterest) expenditure	16.3	17.8	18.3	19.5	16.6	16.9	17.3	18.2	18.3	18.2	18.3	18.2	18.3	
7 Automatic debt dynamics 2/	-5.7	-7.2	-3.3	-2.7	-4.7	-2.8	-2.2	-1.6	-1.8	-1.6	-1.4	-1.3	-1.2	
8 Contribution from interest rate/growth differential 3/	-7.2	-5.5	-4.0	-5.3	-2.2	-2.3	-2.3	-1.6	-1.8	-1.6	-1.4	-1.3	-1.2	
9 *Of which*: contribution from real interest rate	-4.6	-3.4	-1.9	-3.6	-0.9	-0.8	-0.8	-0.3	-0.5	-0.4	-0.2	-0.1	-0.1	
10 *Of which*: contribution from real GDP growth	-2.6	-2.1	-2.1	-1.7	-1.4	-1.5	-1.5	-1.3	-1.3	-1.2	-1.2	-1.1	-1.1	
11 Contribution from exchange rate depreciation 4/	1.5	-1.8	0.7	2.5	-2.5	-0.5	0.1	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2–3) 5/	-0.7	2.5	0.4	2.7	0.0	1.2	0.3	0.6	-0.7	-0.4	-0.4	-0.4	-0.3	
Public sector debt-to-revenue ratio 1/	239.1	191.6	181.7	156.2	173.6	157.9	137.2	129.6	120.6	114.1	109.2	104.7	100.7	
Gross financing need 6/	1.3	2.1	3.5	2.5	4.6	4.2	2.7	3.6	4.2	3.6	3.6	2.8	2.7	
In billions of U.S. dollars	3.8	7.8	15.1	12.8	24.8	29.8	22.7	32.1	42.4	42.6	49.6	44.5	49.4	
Scenario with key variables at their historical averages 7/								23.5	18.6	14.4	10.7	7.4	4.5	-0.8
Scenario with no policy change (constant primary balance) in 2009–2014								23.5	20.5	18.1	16.0	14.1	12.4	-1.0
Key macroeconomic and fiscal assumptions underlying baseline														
Real GDP growth (in percent)	5.7	5.5	6.3	6.0	4.6	6.2	6.5	6.0	6.3	6.5	6.6	6.7	6.8	
Average nominal interest rate on public debt (in percent) 8/	5.3	6.1	6.1	6.4	5.7	5.5	5.4	6.3	6.3	6.6	7.0	7.3	7.5	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-9.0	-8.0	-5.2	-11.7	-2.6	-2.6	-3.0	-1.2	-1.9	-1.4	-0.8	-0.3	0.0	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-5.7	9.3	-4.2	-15.5	18.2	4.5	-0.8	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	14.3	14.1	11.3	18.1	8.3	8.1	8.4	7.5	8.2	8.0	7.8	7.6	7.5	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.2	14.8	9.7	12.9	-11.0	8.2	9.2	11.5	7.0	6.1	6.8	6.5	7.2	
Primary deficit	-3.1	-2.6	-1.0	-1.8	0.1	-0.1	-0.5	0.1	0.5	0.6	0.8	0.8	0.8	

1/ Coverage of public sector debt consists of the gross debt of the central government.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table II.2. Indonesia: External Debt Sustainability Framework, 2005–17

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing noninterest current account 6/
1 Baseline: External debt	47.1	36.4	32.7	30.4	32.1	28.6	26.6	26.1	24.5	22.3	20.8	19.6	18.6	-3.6
2 Change in external debt	-7.3	-10.7	-3.7	-2.3	1.7	-3.5	-2.0	-0.5	-1.6	-2.2	-1.5	-1.2	-1.0	
3 Identified external debt-creating flows (4+8+9)	-7.2	-14.1	-9.5	-5.9	-4.4	-4.1	-3.0	-1.2	-0.9	-0.6	-0.3	0.1	0.4	
4 Current account deficit, excluding interest payments	-1.8	-4.3	-3.5	-0.9	-2.7	-1.3	-0.7	1.5	1.6	1.7	2.0	2.2	2.5	
5 Deficit in balance of goods and services	-2.9	-5.4	-4.8	-1.9	-3.9	-3.0	-2.8	-0.3	0.2	0.4	0.8	1.2	1.5	
6 Exports	35.0	31.6	30.2	30.3	24.6	24.7	26.1	24.4	22.3	20.0	18.3	16.7	15.2	
7 Imports	32.0	26.1	25.4	28.4	20.7	21.7	23.4	24.1	22.5	20.4	19.1	17.9	16.7	
8 Net nondebt creating capital inflows (negative)	-1.6	-1.1	-1.3	-0.7	-0.6	-1.9	-1.3	-1.6	-1.4	-1.3	-1.3	-1.3	-1.3	
9 Automatic debt dynamics 1/	-3.8	-8.7	-4.7	-4.3	-1.0	-1.0	-1.1	-1.1	-1.1	-1.0	-1.0	-0.8	-0.8	
10 Contribution from nominal interest rate	1.7	1.3	1.0	0.9	0.8	0.6	0.5	0.4	0.4	0.4	0.3	0.4	0.3	
11 Contribution from real GDP growth	-2.8	-2.0	-1.9	-1.7	-1.3	-1.5	-1.5	-1.5	-1.5	-1.4	-1.3	-1.2	-1.2	
12 Contribution from price and exchange rate changes 2/	-2.7	-8.0	-3.8	-3.5	-0.4	-5.7	-3.0	-0.2	-1.7	-2.4	-1.7	-1.6	-1.5	
13 Residual, including change in gross foreign assets (2–3) 3/	-0.1	3.5	5.7	3.6	6.1	0.6	1.1	0.7	-0.8	-1.5	-1.2	-1.3	-1.4	
External debt-to-exports ratio (in percent)	134.6	115.3	108.2	100.1	130.2	115.8	101.9	106.8	109.9	111.4	114.0	117.4	121.7	
Gross external financing need (in billions of U.S. dollars) 4/	33.6	19.6	22.8	46.2	38.0	52.8	72.5	101.9	109.0	119.4	133.6	151.2	172.3	
In percent of GDP	11.7	5.4	5.3	9.1	7.0	7.5	8.6	11.3	10.6	9.9	9.6	9.4	9.2	
Scenario with key variables at their historical averages 5/						28.6	26.6	19.9	14.1	9.0	4.3	0.0	-3.9	-0.7
Key macroeconomic assumptions underlying baseline														
Real GDP growth (in percent)	5.7	5.5	6.3	6.0	4.6	6.2	6.5	6.0	6.3	6.5	6.6	6.7	6.8	
GDP deflator in U.S. dollars (change in percent)	5.2	20.9	11.5	11.3	1.0	23.8	12.3	0.6	6.8	10.7	8.3	8.4	8.6	
Nominal external interest rate (in percent)	3.4	3.7	3.4	3.2	2.7	2.3	1.9	1.7	1.7	1.7	1.6	2.3	2.1	
Growth of exports (U.S. dollar terms, in percent)	20.7	15.1	13.4	18.7	-14.2	31.7	26.6	-0.3	3.5	6.1	5.4	5.7	5.9	
Growth of imports (U.S. dollar terms, in percent)	28.0	4.1	15.0	32.3	-23.0	37.6	28.9	10.0	5.9	7.2	8.0	8.3	8.6	
Current account balance, excluding interest payments	1.8	4.3	3.5	0.9	2.7	1.3	0.7	-1.5	-1.6	-1.7	-2.0	-2.2	-2.5	
Net nondebt creating capital inflows	1.6	1.1	1.3	0.7	0.6	1.9	1.3	1.6	1.4	1.3	1.3	1.3	1.3	

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

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

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

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

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

APPENDIX III: INDONESIA—TRANSITION TO GFSM 2001

The presentation of central government operations in the main text of the staff report is currently compatible with the national presentation of the budget. The accounting of government operations in Indonesia is on a cash basis, covers only the central government and is, therefore, not fully compatible with the GFSM 2001 format. To ensure the comparability of IMF staff projections with the authorities' forecast, the staff report table is in the same format as the budget presentation. However, to promote international comparability of government operations, preliminary data consolidated to the general government level in a GFSM 2001 compatible format is also presented in this appendix (see following table).

The Indonesian authorities are in the process of moving to accrual accounting, and they are planning for full implementation by 2015. Although budget reporting by local governments is beginning to improve, it is still subject to long lags, does not follow GFS reporting standards, and does not have a homogenous classification of expenditures. The Ministry of Finance does not obtain comprehensive and timely information on borrowing and debt, making it difficult to monitor general government debt trends.

Table III.1. Indonesia: Summary of General Government Operations, 2005–2011

(In trillions of rupiah)

	2005	2006	2007	2008	2009	2010	2011
Revenue	537.8	679.4	762.2	1,053.1	924.7	1,095.4	1,323.2
Taxes	346.8	409.1	491.4	658.7	619.9	744.7	873.7
Taxes on income, profits, and capital gains	175.3	208.8	238.7	327.5	317.6	356.7	431.1
Taxes on goods and services	134.6	160.8	199.7	260.9	249.8	318.5	354.7
VAT and luxury taxes	101.3	123.0	155.0	209.6	193.1	252.1	277.7
Excise	33.3	37.8	44.7	51.3	56.7	66.4	77.0
Taxes on international trade and transactions	15.2	13.2	20.9	36.3	18.7	28.9	54.1
Taxes not elsewhere classified	21.7	26.2	32.2	34.0	33.9	40.6	33.8
Grants	1.3	1.9	1.7	2.3	1.7	2.8	2.6
Other revenue	189.7	268.5	269.1	392.1	303.1	347.9	446.9
Total expenditure	520.3	671.8	803.0	1,053.2	1,023.4	1,175.6	1,380.2
Expense	388.7	459.4	582.1	800.8	748.7	922.5	1,064.0
Of which :							
Compensation of employees	124.3	158.1	211.3	261.3	295.8	346.4	405.7
Purchases/use of goods and services	33.1	47.1	51.3	56.0	80.7	96.0	113.3
Interest	67.7	79.0	79.5	88.4	93.7	88.3	93.3
Fuel subsidies	95.7	64.2	116.9	223.0	94.6	139.9	255.6
Net acquisition of nonfinancial assets	131.6	212.5	220.9	252.4	274.7	253.1	316.2
Net lending/borrowing	17.5	7.5	-40.9	-0.1	-98.7	-80.2	-57.0
Net acquisition of financial assets	41.2	22.6	-7.9	70.7	-8.6	-16.1	1.7
Of which : policy lending	0.0	0.0	0.0	0.0	6.2	0.0	3.1
Net incurrence of liabilities	23.7	15.1	33.0	70.9	90.1	64.1	58.6

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

INTERNATIONAL MONETARY FUND

INDONESIA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 21, 2012

Prepared By | Asia and Pacific Department

CONTENTS

ANNEX I—FUND RELATIONS

(As of July 31, 2012)

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

II. General Resources Account

	SDR Millions	Percent of Quota
Quota	2,079.30	100.00
Fund holdings of currency	1,933.80	93.00
Reserve position in Fund	145.50	7.00

III. SDR Department

	SDR Millions	Percent of Allocation
Net cumulative allocation	1,980.44	100.00
Holdings	1,761.44	88.94

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Millions)	Amount Drawn (SDR Millions)
EFF	02/04/00	12/31/03	3,638.00	3,638.00
EFF	08/25/98	02/04/00	5,383.10	3,797.70
Stand by	11/05/97	08/25/98	8,338.24	3,669.12

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

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.11	0.22	0.22	0.22	0.22
Total	0.11	0.22	0.22	0.22	0.22

VII. Exchange Arrangements

The rupiah has had a *de jure* free floating exchange arrangement since August 14, 1997, and the current *de facto* arrangement is floating. The market exchange rate was Rp 9,473 per U.S. dollar as of

July 26, 2012. Indonesia has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

VIII. Article IV Consultation

The last Article IV consultation report (IMF Country Report No. 11/309) was discussed by the Executive Board on October 7, 2011.

IX. Resident Representative

Mr. Milan Zavadjil was the Senior Resident Representative from 2008 to July 2012. He will be replaced in September 2012 by Mr. Benedict Bingham.

ANNEX II: WORLD BANK-IMF COLLABORATION

Background

The working relationship between the IMF and the World Bank in Indonesia is acknowledged by both sides to be very strong with joint working programs in many areas and close coordination through frequent meetings between resident offices and with headquarters missions, including the Article IV consultation.

Key Areas with Joint Programs

Budget

- The reform agenda for budget and treasury remains a high priority for both institutions. The strategic framework for joint work is built into joint Bank/Fund budget missions. Currently, the Bank support is being provided through the GFMRAP program, trust funds, and DPLs, with elements in support of (a) efficient treasury operations, including accounting reforms, improved in-year budget disbursement, and regulatory reform; (b) improved linkages between planning and budget preparation through the implementation of a medium-term expenditure framework, performance budgeting, and the enhancement of budget flexibility at the service delivery level; and (c) improved capacity for budget oversight through systems and organizational reform.

Taxation

- Taxation is a priority for the Fund and the Bank with improving tax revenues an important issue for both macroeconomic security and the investment climate. The Fund has a longstanding program of support for the tax department in Indonesia. This program has, in recent years, focused on tax policy and donor coordination, with donor coordination quite important given the size of support for a solid program of tax reform in Indonesia. The Bank support for tax administration reform is largely executed through the comprehensive Program for Indonesian Tax Administration Reform (PINTAR), which was approved in 2009, and trust funds. The participants will check with their respective colleagues, but generally anticipate that the current division of labor will continue.

Asset Liability Management

- The Bank and Fund have been leading an effort to improve asset liability management, including at the Treasury and Debt Management Office of the Ministry of Finance and Bank Indonesia. We envision that the Bank and Fund team will continue to work together as needed.

Financial Sector

- The Bank has focused on broad monitoring of the financial sector with special emphasis on issues that are important for the investment climate (as part of Development Policy Loan programs). Most recently, through its Financial Sector and Investment Climate Reform and Modernization Development Policy Loan, the Bank is supporting the implementation of reforms aimed at maintaining stability, increasing diversification, and enhancing financial sector inclusion in Indonesia. The Fund has concentrated on the banking system per se, with emphasis on bank regulation and supervision. A joint Bank/Fund FSAP was completed in 2010 and some recommendations have been followed through by the authorities. The Bank is to provide technical assistance to implement select FSAP recommendations concerning nonbank financial sector.

Statistics

- The Bank has a major program with the statistics agency that was launched in 2010. The program is being designed to focus on improvements in key statistical series that should improve the ability to understand the Indonesian economy, executed through an institution-wide approach, i.e., including significant IT and personal/institutional reforms. There is a quick-wins program being introduced while the longer-term reforms play out, and the Fund has indicated that it is prepared to continue to assist in the area of government finance statistics.

Macroeconomics

- The Fund continues to take the lead in macroeconomic areas, with the Article IV and other missions, staff reports, and policy notes on arising issues, including the stance of fiscal, monetary, and exchange rate policies, the credibility and effectiveness of monetary policy, macrofinancial linkages, and how events in the global economy are likely to impact Indonesia. The Bank has also taken on a larger role, including on macroeconomic monitoring, public policy dialogue, and capacity building, and there is an ongoing need for close coordination with the Fund. The Bank team has been assisting the Ministry of Finance, Fiscal Policy Office, to improve capacity for macroeconomic monitoring, forecasting, and evidence-based macroeconomic and fiscal policy analysis.

These threads of work are expected to be continued by both parties, and regular meeting(s) will explore other ways to improve existing synergies. These include keeping each other informed about ongoing work, and requests to each other in areas of interest and through periodic meetings. Issues being addressed include, for the Fund, the impact of structurally high inflation rates and associated higher volatility on real interest rates; and for the Bank, the link between macro/fiscal policy and real economic outcomes including growth and poverty, resource-sector fiscal revenues, and longstanding problems in the implementation and effectiveness of government spending.

Indonesia: JMAP Implementation			
Title	**Products**	**Provisional Timing of Missions**	**Expected Delivery Date (Tentative)**
A. Mutual Information on Relevant Work Programs			
Bank work program	Indonesia Economic Quarterly		Launched in April and July 2012; next issues due September and December 2012
	World Bank follow up work related to WB/IMF Financial System Assessment Program missions (October 2009 and February/March 2010)		Ongoing
	Development of the first in a new Development Policy Loan series—Institutional, Tax Administration, Social and Investment (INSTANSI)—plus a Financial Sector and Investment Climate Reform and Modernization (FIRM) Development Policy Loan and a Connectivity Development Policy Loan		November 2012
IMF work program	2011 Article IV mission	July 2011	Board discussion took place in October 2011
	Tax administration technical assistance	July 2011	Ongoing
	2012 staff visit	January 2012	
	2012 Article IV mission	July 2012	Board discussion expected in September 2012
B. Request for Work Program Inputs			
Fund request to Bank	Assessment of economic developments and structural policies		Ongoing
	Information sharing		Ongoing
Bank request to Fund	Assessment of macroeconomic developments and policies		Ongoing
	Information sharing		Ongoing
	Government Financial Statistics training	June 2011	
C. Agreement on Joint Point Products and Missions			
Joint work program	Asset liability management	December 2010	

ANNEX III: RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of December 31, 2011)

Asian Development Bank (ADB) cumulative loans to Indonesia reached $27.17 billion as of end-December 2011. In 2011, the ADB approved a total of $580 million to Indonesia or 3 percent percent of the total loans approved by the institution for the year. The sectors with the largest shares in cumulative lending are public sector management (17.5 percent), agriculture and natural resources (14.9 percent), finance (14.5 percent) and energy (14.1 percent).[1]

Between 1966 and 2011, ADB provided 517 Technical Assistance grants to Indonesia amounting to $359.1 million. The TA grants were financed from ADB's Technical Assistance Special Fund, the Japan Special Fund, and other sources. Measured by cumulative TA approvals, Indonesia is the second largest recipient of TA support from the ADB.

ADB approved a new Country Partnership Strategy 2012−2014 (CPS) with the Government of Indonesia covering the period 2012−2014. The strategy is aligned with the Government's medium-term development plan for 2010−2014 as well as the Masterplan for the Acceleration and Expansion of Indonesia Economic Development 2011−2025. The CPS is closely attuned to the needs of Indonesia as large middle-income country and guided by the government's commitment to "pro-poor, pro-job, pro-growth and pro-environment" development. The two strategic CPS pillars are inclusive growth and environmental sustainability with climate change, mitigation and adaptation. ADB will support government efforts to achieve more inclusive growth by helping to connect poor people and regions to market by upgrading infrastructure improving logistics, and enhancing skills base needed to boost investment, productivity, and employment, and by strengthening local government's capacity for public service delivery.[2]

[1] ADB. 2012. Indonesia Factsheet 2012. Manila.

[2] ADB. 2012. Country Partnership Strategy 2012−2014. Manila.

Table III.1. Sovereign and Nonsovereign Loan Approvals and Disbursements to Indonesia
(In millions of U.S. dollars)

	2004	2005	2006	2007	2008	2009	2010	2011
Loan approvals	225.00	1,145.69	784.80	1,187.10	1,085.00	2,184.20	785.00	580
Loan disbursement	593.50	1,014.99	1,025.88	1,136.30	949.60	739.30	1,079.80	631.9

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

Table III.2. Cumulative Lending to Indonesia
(As of December 31, 2011)

Sector	Loans (No.)	Amount (US$ millions)	Percent 1/
Agriculture and natural resources	99	4,047.00	14.89
Education	32	2,222.35	8.18
Energy	32	3,831.05	14.10
Finance	22	3,926.10	14.45
Health and social protection	13	1,068.30	3.93
Industry and trade	12	645.70	2.38
Public sector management	19	4,767.22	17.54
Transport and ICT	34	2,893.86	10.65
Water supply and other municipal Infrastructure and services	32	1,984.74	7.30
Multisector	18	1,686.22	0.00
Total	313	27,172.54	100.00

Sources: Asian Development Bank, *Indonesia Fact Sheet 2012*.

1/ Total may not add up because of rounding.

ANNEX IV: STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

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

National accounts: Annual and quarterly GDP data are published in a timely manner for both expenditure and production sides with 2000 as the base year. The estimates are based on a limited set of indirect indicators of uncertain quality. Some sectors are influenced strongly by seasonality, and seasonally adjusted data are prepared but not published. In addition, no survey of nonfinancial services is prepared. The Fund has recommended: (i) development of a system to continuously update the census of businesses; (ii) introduction of comprehensive annual establishment surveys for nonfinancial services industries; (iii) publication of annual GDP estimates, including a time series of at least 20 years; (iv) development of a set of annual supply and use tables (SUTS) starting from 2000; and (v) enhancing the convergence exercise on trade data between Bank Indonesia (BI) and Ministry of Finance (MOF). The revision of the base year of national accounts to 2010 is in progress with technical assistance from STA, and GDP estimates based on improved data sources and methodology are expected by 2013.

Price statistics: Price statistics are broadly adequate for surveillance.

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

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

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

Monetary and financial statistics (MFS) and financial soundness indicators (FSIs): Good quality monetary statistics are compiled by BI on a timely basis. With STA assistance, BI has compiled and reported monetary data using the Standardized Report Forms (SRFs), from which an integrated database and alternative presentations of monetary statistics can be drawn to meet the needs of BI and the Fund. Bank Indonesia has also compiled monetary data for Other Financial Corporations (OFCs), comprising only finance companies. To strengthen monetary statistics, STA missions have also recommended the expansion of the coverage of Other Depository Corporations (ODCs) to include mutual funds and the coverage of OFCs to include insurance companies and pension funds. Additional challenges include timely revisions of published banking sector data after supervisory verification.

In addition, with assistance from STA, BI has compiled and reported FSIs to the Fund, which are published on the IMF's FSI website. The FSIs were initially reported on a semi-annual basis. However, starting with the Q4:2011 data, BI has started reporting quarterly FSIs to the Fund. The FSIs for Indonesia comprise of 11 core FSIs, 12 encouraged FSIs for deposit takers, 2 encouraged FSIs for OFCs, and 3 encouraged FSIs for Real Estate Markets. A STA mission in 2011 has recommended BI to coordinate with other relevant institutions to explore the possibility to compile FSIs for Nonfinancial Corporations and Households.

Balance of payments: Trade data have been improved during recent years. Starting in with 2006, the import/export transactions of free trade zones are covered in goods data of balance of payments statistics.

For the capital and financial account, the methodological basis for the compilation of FDI data needs substantial improvement. Inflows are currently calculated based on loan disbursements to companies that have foreign equity using a fixed ratio to estimate equity inflows. Surveys conducted by BI to collect FDI data have a low response rate and the coverage of the directory of enterprises should be improved. Other areas that need improvement include the recording of trade credits and the asset data for portfolio investment and other investment transactions. The magnitude of the errors and omissions item has been significant at times and appears to be related to the under-coverage of assets in the financial account. Financial transactions data are reconciled with changes in the International Investment Position (IIP), except for data on direct investment.

An annual IIP is compiled, but the underlying data are weak in several areas, notably for FDI. External debt statistics have improved considerably with the introduction of an External Debt Information System (EDIS) in 2002 and the recent initiative to publish monthly indicators. Also, as a result of the ongoing reconciliation of data conducted by BI, the IIP and external debt data are fully consistent. However, improvements are still needed with respect to components of private corporate sector data, particularly in distinguishing between scheduled and actual debt service, in estimating the accumulation/reduction of private sector payments arrears, and in estimating rescheduling and debt reductions received by the private sector from external creditors.

II. Data Standards and Quality

Subscriber to the Special Data Dissemination Standard (SDDS) since September 1996, observing most of the SDDS requirements. It uses SDDS flexibility options for the timeliness of the labor market categories (employment, unemployment, and wages/earnings) and general government operations. It is also availing itself of flexibility options for the periodicity of labor market categories (employment and unemployment).	Data ROSC completed in 2005.

Indonesia: Table of Common Indicators Required for Surveillance

(As of August 8, 2012)

	Date of Latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]	Memorandum Items: Data Quality—Methodological soundness[2]	Memorandum Items: Data Quality—Accuracy and Reliability[3]
Exchange rates	8/8/12	8/8/12	D	D	D		
International reserve assets and reserve liabilities of the monetary authorities[4]	7/12	8/12	M	M	M		
Reserve/base money	7/12	8/12	W/M	W/M	W/M	O, LO, O, O	LO, O, O, LO, O
Broad money	6/12	8/12	M	M	M		
Central bank balance sheet	6/12	7/12	M	M	M		
Consolidated balance sheet of the banking system	6/12	8/12	M	M	M		
Interest rates[5]	8/8/12	8/8/12	D	D	D		
Consumer price index	7/12	8/12	M	M	M		
Revenue, expenditure, balance and composition of financing[6]—central government	6/12	7/12	M	M	Mid year	LNO, LNO, LO, LNO	LNO, LO, LO, LO, LNO
Stocks of central government and central government–guaranteed debt	3/12	6/12	Q	Q	Q		
External current account balance	3/12	5/12	Q	Q	Q	LO, LO, LO, LO	LO, O, LO, O, O
Exports and imports of goods and services	6/12	8/12	M	M	M		
GDP/GNP	6/12	8/12	Q	Q	Q	LO, LO, O, LO	LO, LO, LO, LO, LNO
Gross external debt[7]	5/12	7/12	M	M	M		
International investment position[8]	2010	4/12	A	A	A		

[1] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); NA: Not Available.
[2] Reflects the assessment provided in the data ROSC published on July 20, 2005 (based on the findings of the mission that took place during March 28 April 11, 2005), for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[3] Same as footnote 7, except referring to international standards concerning source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.
[4] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[5] Both market based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[6] Foreign, domestic bank, and domestic nonbank financing.
[7] Including currency and maturity composition.
[8] Includes external gross financial assets and liability positions vis à vis nonresidents.

Statement by the IMF Staff Representative on Indonesia
September 7, 2012

This statement provides an update on developments since the staff report was finalized. It does not alter the thrust of the staff appraisal.

1. The latest data are in line with the staff's projections. Domestic demand indicators remain strong, with consumer confidence, cement sales, and motor vehicle sales continuing to hold up, supported by robust credit conditions. Concerns about the widening current account deficit have, however, put some pressure on financial markets in recent weeks. The rupiah weakened by 0.8 percent during August 22−29, and equities and bond prices have drifted down moderately.

2. The government has submitted its initial 2013 budget proposal to parliament. The budget assumes real GDP growth of 6.8 percent and CPI inflation of 4.9 percent (y/y) in 2013. This compares to growth of 6.3 percent and inflation of 5.0 percent projected in the staff report. At 1.6 percent of GDP, the overall deficit target in the draft budget is slightly lower than the staff's projection of 1.8 percent of GDP. The authorities are expecting revenues to grow by 12 percent relative to the 2012 revised budget. The draft budget also proposes to increase capital spending by 15 percent over 2012. While the budget proposal contains provisions for a modest hike in subsidized electricity prices, there are currently no plans to raise subsidized domestic fuel prices. Under current WEO oil price projections and the staff's baseline macroeconomic assumptions, we currently project the energy subsidy bill to reach 3 percent of GDP in 2013, broadly unchanged from the staff report and consistent with the authorities' own estimates.

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

IMF Executive Board Concludes 2012 Article IV Consultation with Indonesia

On September 7, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Indonesia.[1]

Background

Indonesia's economic performance remains strong. At 6.5 percent, growth in 2011 was the highest in over a decade. Growth is now easing modestly on account of the weakened external environment, offset partly by continuing strong domestic demand. Exports have declined in volume terms so far in 2012, while import growth has accelerated sharply on account of strong investment, which grew at 20 percent (Q2, year-on-year). Robust private consumption and a wider fiscal deficit have also provided some support to growth this year. With external demand expected to remain weak and inventories, which have built up significantly in recent months, expected to level out, economic growth is projected at 6 percent for 2012 before it picks up again in 2013.

Headline CPI inflation bottomed out at 3.7 percent (year-on-year) in January, but with sequential momentum strong for both core and noncore items, it rose to 4.6 percent in July. Inflation is expected to end the year at 5 percent, within the authorities' target range of 4.5±1 percent. The fiscal stance is expected to continue to provide a moderate stimulus, with the 2012 deficit projected to rise to 1.8 percent of GDP, up from 1.1 percent in 2011. An increase in subsidized

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

energy prices, proposed by the government for this year in April, was put off by parliament, unless oil prices exceed a revised higher threshold. The postponement of the price adjustment will boost energy subsidies to 3.5 percent of GDP, compared with the 2.6 percent of GDP in total allocated to all of development spending.

Both the rupiah and equity markets came under pressure during the spring of 2012 when outflows picked up sharply, compounding pressures on the exchange rate from the weakening current account. Bank Indonesia (BI) initially resisted market pressures, which contributed to illiquidity in the foreign exchange market, with onshore/offshore spreads widening sharply in early May. Market conditions improved subsequently after BI increased its sales of foreign exchange, while also allowing the rupiah to depreciate at a faster rate. The current account is expected to record a deficit of 1.9 percent of GDP this year, funded mostly by strong foreign direct investment inflows.

Despite some tightening of liquidity conditions and the imposition of prudential limits on consumer and property lending in recent months, financial conditions remain accommodative. As global conditions deteriorated and domestic inflation slowed during August 2011−February 2012, BI eased monetary policy. Since May, unsterilized sales of foreign exchange have helped absorb some excess liquidity, money market rates have risen 30−50 basis points (bps), and BI has increased the lower bound of its interest rate policy corridor by 25 bps. However, liquidity remains high in historical comparison and credit growth (26 percent year-on-year) continues at a robust pace.

Banking system asset quality remains satisfactory and banks are profitable and well capitalized. The authorities have taken several important steps recently to strengthen financial stability. These include: (i) the establishment of a Financial Services Authority that will be fully operational by end-2014; (ii) establishment of a high level forum for coordinating financial stability; and (iii) finalization of a Memorandum of Understanding among all entities currently responsible for financial stability. However, the passage of an effective financial system safety net legislation remains outstanding.

Executive Board Assessment

Executive Directors commended the authorities for their sound economic management, which has helped Indonesia maintain a strong economic performance despite a challenging global environment. Directors noted that, although downside risks remain elevated, the economy's sound fundamentals and ample buffers would allow counter cyclical policy responses, if needed.

Directors noted that, while inflation is within the target band, excess bank liquidity and rapid credit growth warrant continued vigilance and a tightening bias for monetary policy. More broadly, they welcomed the ongoing review of the monetary policy framework, and encouraged the authorities to strengthen their communications strategy to send clearer signals to financial markets and better inform market expectations.

Directors commended the soundness and resilience of the financial system, noting that banks are well capitalized and profitable. They welcomed various initiatives underway to bolster financial regulation and oversight, and recommended careful implementation to minimize transitional risks. They also encouraged the authorities to move quickly to address the remaining gaps in the regime against money laundering and terrorism financing.

Executive Directors welcomed the authorities' commitment to exchange rate flexibility. They underscored that official intervention in the foreign exchange market should take place in the context of a well defined strategy to limit short run volatility. Further development of domestic capital markets would also aid the intermediation of capital flows, reducing volatility. Directors took note of the staff's assessment that the exchange rate is moderately under valued.

Directors commended the authorities' prudent fiscal policies grounded on a strong fiscal framework that has led to a build up of fiscal buffers and a decline in the public debt. They generally considered the modest fiscal stimulus in 2012 to be appropriate in the face of headwinds to growth from the external environment. Directors encouraged the authorities to further advance with fiscal reforms, highlighting the need to improve budget execution, re orient government spending toward the social sectors and infrastructure, replace energy subsidies with targeted cash transfers to the vulnerable, and boost revenue collections.

Directors agreed that deeper structural reforms hold the key to sustained, broad based economic growth. In particular, an open foreign trade and investment regime will be crucial, and should be balanced carefully against domestic industrial policy considerations. In this context, Directors encouraged the authorities to push ahead with reforms to increase Indonesia's productivity and competitiveness. These would include more investment in human capital, a reduction in the cost of doing business, deepening of financial markets, and labor market reforms. Infrastructure and supply bottlenecks also need to be addressed.

Indonesia: Selected Economic Indicators

	2008	2009	2010	2011	2012 Proj.	2013 Proj.
Real GDP (percent change)	6.0	4.6	6.2	6.5	6.0	6.3
Domestic demand	7.6	5.2	5.9	6.2	7.7	6.7
Of which:						
Private consumption	5.3	4.9	4.7	4.7	4.9	4.9
Gross fixed investment	11.9	3.3	8.5	8.8	11.0	10.0
Change in stocks 1/	0.1	-0.2	0.6	0.5	0.8	0.1
Net exports 1/	0.7	1.2	0.9	1.5	-1.8	-0.4
Saving and investment (in percent of GDP)						
Gross investment 2/	27.8	31.0	32.6	32.8	34.2	35.2
Gross national saving	27.8	33.0	33.3	33.0	32.3	33.3
Foreign saving (external current account balance)	0.0	-2.0	-0.7	-0.2	1.9	2.0
Prices (12-month percent change)						
Consumer prices (end period)	11.1	2.8	7.0	3.8	5.0	5.1
Consumer prices (period average)	9.8	4.8	5.1	5.4	4.4	5.0
Public finances (in percent of GDP)						
Central government revenue	19.8	15.1	15.8	16.1	16.3	16.0
Central government expenditure	19.9	16.7	16.4	17.3	18.1	17.7
Central government balance	-0.1	-1.6	-0.6	-1.1	-1.8	-1.8
Primary balance	1.7	0.1	0.8	0.1	-0.5	-0.5
Central government debt	33.2	28.6	26.9	24.5	23.5	21.5
Money and credit (12-month percent change; end of period)						
Rupiah M2	12.7	13.8	16.5	17.4	...	...
Base money	-9.2	16.7	28.9	18.3	...	...
Private sector credit	30.7	8.1	22.1	25.8	...	...
One-month interbank rate (period average)	9.1	7.4	6.4	6.2	…	…
Balance of payments (in billions of U.S. dollars)						
Oil and gas (net)	-23.9	-15.2	-25.4	-38.7	-41.2	-40.7
Non-oil exports (f.o.b)	107.9	99.0	129.4	162.7	159.6	167.2
Non-oil imports (f.o.b)	-92.8	-73.5	-102.0	-127.9	-143.5	-154.6
Current account balance	0.1	10.6	5.1	1.7	-17.3	-20.2
Foreign direct investment	9.3	4.9	13.8	18.9	21.4	21.5
Overall balance	-1.9	14.2	30.3	13.8	-2.2	2.5
Gross reserves						
In billions of U.S. dollars (end period)	51.6	66.1	96.2	110.1	107.8	110.3
In months of imports	5.7	5.2	5.9	6.7	5.9	5.7
As a percent of short-term debt 3/	178.5	211.0	226.5	238.4	225.7	217.2
Total external debt						
In billions of U.S. dollars	155.1	172.9	202.4	225.4	233.2	247.9
In percent of GDP	30.4	32.1	28.6	26.6	25.7	23.9
Exchange rate (period average)						
Rupiah per U.S. dollar	9,697	10,406	9,086	8,774	…	…
Nominal effective exchange rate (2005=100)	90.8	86.6	95.2	93.5	…	…
Memorandum items:						
Oil production (thousands of barrels per day)	976	949	945	907	895	890
Indonesian oil price (US$/bbl)	97.0	61.6	79.4	111.5	107.2	101.5
Nominal GDP (in trillions of rupiah)	4,949	5,606	6,436	7,427	8,469	9,745
Nominal GDP (in billions of U.S. dollars)	510	539	708	846	906	1,036

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

1/ Contribution to GDP growth (percentage points).

2/ Includes changes in stocks.

3/ Short-term debt on a remaining maturity basis.

Statement by Aida Budiman, Alternate Executive Director for Indonesia
and Iss Savitri Hafid, Advisor
September 7, 2012

- The Indonesian authorities would like to thank the IMF team for the fruitful dialogue during the Article IV consultation. The consultation, which focused on policy to address near term challenge and to secure sustainable and equitable growth over the longer term, was constructive and timely. The authorities find the staff report comprehensive and they broadly agree on most of the major policy thrusts. As such, this statement will provide more background of policy making for emphasis and clarification.

Recent Economic Development and Outlook:

- Amid the uncertainty in the global economy, Indonesian economy's resilience was well maintained, charting higher than expected growth of 6.5% in 2011. The economic performance was achieved with better than expected inflation rate –recording 3.8%, lower than the outlook envisaged in last year consultation-, strong external position, prudent fiscal deficit, and sound financial stability.

- Moving forward, the economic growth in 2012 is expected to remain strong at 6.1% – 6.5% although with risk tilted to the downside. Despite weak of global demand and slowdown of regional economy, economic growth will be sustained owing to solid investment and domestic consumption. Meanwhile, fiscal stance will continue to provide stimulus and is set to record deficit by 2.2% of GDP, with emphasis on expanding budget absorption for investment. This will be followed with well maintained public debt and external debt levels. Inflation, despite having strong domestic demand and potential pressure on some components of volatile food, remains benign and is expected to reach the mid-point of the target of 4.5% + 1. In terms of financial stability, various indicators have also continued to show strong resilience of this sector despite the solid credit growth which reached around 26%. Current account remains sound and will be moving along its medium-term norm, predicted to record deficit of some 2% of GDP in 2012, which would be mostly financed by FDI flows. International reserve in July 2012 stood at $106.6 billion and is adequate to cover 5.6 months of imports and government's external debt services payments.

- While the authorities manage to maintain the economic performance, it encounters increasing challenges in their effort to safeguard macro economy and financial stability, as well as to attain sustainable and inclusive economic growth. The challenges emerge from global and domestic economy. From global sphere, with unfolding global economic and financial crisis, Indonesia is facing uncertainty and risks relating to the strength of global economic recovery and its impact to regional economy, the fluctuation of commodity prices, and the volatile capital flows. From domestic side, challenges come from the continuing excess liquidity in the financial sector, the need to improve government spending quality and execution rate, as well as the urgency to expedite the structural reforms remain important policy agenda. Subsequently, the authorities see the focus of the staff report as appropriate.

Monetary Policy

- To achieve and maintain price stability in securing the macroeconomic and financial condition is always the core mandate of monetary policy in Indonesia. Following the adoption of inflation targeting framework in 2005, Bank Indonesia (BI) has continuously made important and bold steps to strengthen the effectiveness of its monetary policy. This is to meet the increasing complex challenges to monetary policy making decision to secure the inflation targets in supporting macroeconomic and financial system stability, arising from both global and domestic conditions. The task is not easy because, as rightly pointed out by Staff, the inflation in Indonesia is also influenced by supply shock. The first Selected Issue Paper (SIP) concluded that 40 percent of inflation dynamic in Indonesia is attributable to domestic supply condition. Naturally this condition is well explained due to the geographical condition of Indonesia –an archipelago country—and other imperfection in market structure, including the supply limitation of goods.

- Notwithstanding the current challenges, BI has initiated a re-evaluation of its monetary policy framework and made some fine tuning for its monetary policy operation. BI strives to optimize all monetary transmission mechanism, and not merely relies on interest rate response. Based on this framework, since mid of 2010 BI has adopted a policy mix of monetary and macroprudential policies, which consist of five areas, namely the interest rate response, the exchange rate policy, the capital flow management, the macroprudential policy, and monetary policy communication and coordination. The timing and magnitude of each policy will be determined on the BI's assessment with regard to the state of economy and macroeconomic outlook within the 2-year framework.

- The exchange rate policy is an important area in managing the stability in Indonesia. The authorities take note and share that the risk perceptions in Indonesia remain high –although decelerating – compared to the strong economic performance and peer group. Nonetheless, they view that this is attributable to the domination of portfolio flows in the economy especially before 2011. Combined with foreign players domination amid the shallow and segmented financial markets, the capital flows vulnerability has caused volatility of rupiah exchange rate which in turns harming the confident level in the financial market, and hence the real sector. To tackle the risks, the exchange rate policy is geared toward maintaining its stability and consistent with overall macroeconomic outlook so as it will complement the interest rate response in achieving the price stability. This has been done through various measures including intervening in foreign exchange market, limiting the speculative pressures, introducing USD term deposit, and improving a longer-term source of foreign exchange supply. The authorities have also consistently conveyed their policy message on the exchange rate namely to smooth-out the excessive fluctuation but not to commit on a pre-determined level.

- Along with intervention strategy in the FX market, BI also purchases the government bonds in the secondary market. Thus far, the dual intervention strategy in the FX and bond markets stabilized both the currency and the government bond price from unnecessary overshooting fluctuation. BI's strategy in the bond market, besides having positive impact in smoothing the government bond market volatility, also buttresses the policy to accumulate stock of government bond to be used as monetary instrument in the open market operations and supports the liquidity management of banking sector. Currently, BI has been quite active in utilizing those bonds as a reverse repo instrument in day-to-day open market operation. The authorities acknowledge the plausibility of market distortion in this strategy and would like to underscore that the implementation has always been conducted with a measured pace both in term of magnitude and timing. BI also continues to strengthen its market surveillance to carefully weigh the impact this dual intervention strategy such that could mitigate the unintended consequences from this operation.

- The continued excess liquidity condition has further weakened the interest rate channel in monetary policy transmission mechanism in Indonesia. To address the excess liquidity phenomenon and to strengthen monetary policy operation associating with the endeavor to stimulate the interbank transactions, BI has widened its operational corridor from 200bps around the policy rate to a non-symmetric corridor (-200bps and +100bps from the policy rate). This policy would address the continuing build-up of excess liquidity condition in the financial sector –due to the securities' issuance—among others through the encouragement to find other asset placements rather than the BI's securities (SBI). The implementation of this strategy would always take into account (i) the need to secure the inflation target as the main objective of macroeconomic policy, and (ii) the need to ensure sufficient yield of rupiah assets' holding. As deemed necessary, the operational corridor can be adjusted accordingly, as witnessed during the recent decision of increasing the lower end by 25bps.

- Thus far, the decision to widen the operational corridor has addressed the liquidity management in money market without triggering unnecessary pressure on inflation and hindering the capital inflows to the economy. The declining trend of money market rate is justifiable due to the excess liquidity condition in banking sector. Meanwhile, contrary to Staff assessment, the inflation dynamic has progressed as expected. Based on July 2012 Consensus Forecast, the inflation expectation for 2012 and 2013 have been revised down from 4.8% and 5.5% in June 2012 to 4.6% and 5.2%, respectively. BI's surveys to consumer and retailer for 3 month and 6 month price expectation have also pointed out to the same direction. The latest estimation of BI models on the inflation forecast for 2012 and 2013 is further confirming that the inflation rate is well within the target. Given the above condition, the authorities have raised inquiry on the conclusion of the first paper of SIP which shows that the lending condition (0.15) is more sensitive compare to the policy rate (0.13). As the numbers are not substantially different, this finding may also be interpreted that the combination of policy rate and widening of operational corridor work as effective as the lending condition to manage the output gap and the inflation target.

- The authorities note the high credit growth could raise concern on the financial stability as well as the inflation management. Nonetheless, the authorities underscore the importance of maintaining a healthy credit growth to support the much needed investment as staff has rightly pointed out in the report. Indeed a decomposition of the strong credit growth shows a comfortable expansion of credit channeling to productive sectors, in which the highest growth by June 2012 goes to investment and working capital credit reaching 29.1% and 28.2% respectively. Meanwhile the consumption credit which grew by 19.6%, contributed only a third of the total credit growth of some 25.6%. Furthermore, the banking intermediation is backed up by the well above 8% of capital adequacy ratio (CAR) and below 5% of gross non-performing loan (NPL). This trend is expected to enhance capability of the supply side responses to demand in the medium to longer run and prevents the economy from overheating; and is within the framework of financial deepening. That said, BI again conveys its firm commitment to safeguard the financial stability. To maintain a healthy credit growth, BI enhances supervision through adoption of risk based supervision, enhancement of early warning function, and adoption of macro prudential measures such as Loan-to-Value (LTV) ratio for automotive and mortgages credit.

- The authorities share the importance of communication for enhancing the effectiveness of monetary policy. BI has strengthened its monetary policy communication through a number of measures, including monthly press release and media communication after the board meeting and monetary policy reports (monthly, quarterly and annually) to provide assessment of the state of economy, economic forecast going forward, and BI monetary policy response and direction. Monthly meeting with market player is also conducted not only to share BI's views on monetary policy but also to gather market inputs. With respect to current policy setting, BI has begun to communicate its ongoing review initiative on monetary policy framework and the intention on its recent refinement of monetary policy operation.

- The authorities acknowledge that there are rooms to improve and strengthen the effectiveness of monetary policy. This has always been the heart of monetary policy framework and will be carried out continuously. In this regard, they re-iterate the request to have a financial deepening TA from the Fund, which is expected to help constructing an integrated guidance encompassing various sectors in the economy, whilst taking into account the impact on macro and financial stability.

Fiscal

- The authorities continue to display its firm commitment to fiscal sustainability and strong public finances. On the revenue side, they strive to increase tax base by holding national tax census, as well as to increase purchasing power of the poor people and SMEs by raising taxable income threshold. In addition, the authorities intensify collection through improving tax payable administration including the effectiveness of auditing and investigation function, enhancing VAT record and reporting, and reviewing submission for obedient taxable person for VAT & taxpayers.

- To accelerate budget absorption spending in 2012 central and regional budget, a team of Evaluation and Monitoring Budget Absorption was established under the auspice of President Work Unit (UKP4). The team monitors and addresses problem that hamper budget execution which mainly lies in the preparation stage. It is expected that the new procurement regulation (adopted end of July 2012) and the streamlined budget preparation and payment process would facilitate better absorption in the future.

- The revised 2012 budget is expected to play effective countercyclical role in anticipating global crisis to maintain the growth momentum. The parliament has approved the new Budget law which allows the government to request additional budget financing with swift parliament approval to secure the implementation of prioritized programs. The authorities share view on the importance to contain energy subsidy and will conduct this through quarterly electricity price adjustment and limitation in fossil fuel subsidy volume. Further, the revised budget law has provided flexibility by allowing the government right to make price adjustment if the average Indonesian Crude Price (ICP) increase more than 15% from the assumption used in budget.

Financial Sector Policy

- The authorities sustain its intensive financial sector reform aiming to optimize the financial sector's contribution to the national economy, in particular by enhancing the intermediation function, bolstering financial sector resilience, strengthening the supervision function, and fostering the financial inclusion. As part of its efforts to enhance bank resilience, BI amended the calculation for risk-weighted assets to increasingly reflect the risks faced by the banks in their CAR and to conform to international standards. In addition, BI sets the loan-to-value level for mortgages and down payments on motor vehicle loans in order to enhance bank prudence when allocating such loans.

- Transition to coordinate the supervisory function under Financial Service Authority (OJK) is well in progress. Coordination between BI and OJK are directed in the Article 7 and its explanation in OJK Act which set the OJK to be in charge of regulation and supervising institutional issues aspect, soundness aspect (among other liquidity, rent ability, solvability asset quality, CAR, Legal Lending Limit, LDR and loan provision) and prudential aspect. These tasks are considered as regulating and supervising micro prudential of financial institution. BI, instead, will be responsible for macro prudential issues that are those not listed in Article 7. To enforce those regulations, OJK will help BI to conduct moral suasion to the banks. To strengthen those duties, BI has submitted draft of BI Act amendments to the Government. The proposed amendments would give mandates to BI to prescribe and implement the macro prudential regulation. Transition toward OJK will be carried out in a cautious and gradual manner. The authorities appreciate support and technical assistance from the Fund in this matter.

- The authorities are aware of the FSSN law importance to support the effective management of a systemic crisis. The FSSN Law has been drafted to align with existing laws which regulate OJK, BI and Indonesia Deposit Insurance Corporation (LPS), and has been submitted to the parliament. Separately, the MOU has been established to facilitate coordination among all entities responsible for financial stability and national crisis management protocol (CMP) while waiting for the parliament process for FSSN law. The responsibility of each institution will depend on the nature of the crisis and will follow the national CMP which also consist CMP under each institution.

- The authorities continue to improve implementation of AML/CFT regime. A number of steps have been taken to prepare a draft bill for legislation by parliament. The bill on Counter Financing Terrorism has been included in the national Legislation Program 2010 – 2014. The draft has been recently updated after engaging with international and bilateral partners and receiving technical assistance to address its main deficiency.

Fostering Stable and Inclusive Growth

- The authorities are fully aware that rising investment is important for stable and inclusive growth. The authorities have recently announced the 2013 budget and work program with main theme on strengthening domestic economy for to increase and expand prosperity. Under this theme, the government with the Parliament agreed to emphasize on several strategic issues, those are (i) enhancing competitiveness through improving investment and business climate and accelerating infrastructure development and employment creation as outlined in the Master Plan for Economic Expansion and Acceleration (MP3EI 2011 – 2025); (ii) increasing economic resilience through strengthening food security, electrification ratio and energy conversion; and (iii) increasing and expanding people's prosperity through human resource development and acceleration of poverty alleviation as outlined in Master Plan for Poverty Alleviation (MP3KI 2012 – 2025). Accordingly, budget allocation for capital spending in 2013 will increase by 14.9% from the 2012 allocation and will focus on energy security, food security and domestic interconnectivity.

- To implement the MP3EI, an-interdepartemental committee has been set up to coordinate the implementation the master plan, monitor and evaluate implementation, and adopt measures to address any obstacle in project implementation. The team has intersectoral unit and cover issue of regulation, connectivity and human resources aspect as well as corridor (development) unit. In addressing issue of connectivity and infrastructure, the authorities continue to promote PPP to mobilize private sector involvement in infrastructure investment. The Indonesia Infrastructure Guarantee Fund which was established to accelerate infrastructure development through PPP, has adopted policies toward better guarantee framework to help encourage pipeline development by making the scheme more acceptable to market. Further, to increase the viability of PPP projects, the authorities are nearing completed of a so-called a Viability Gap Fund that will provide cash to companies to defray the construction costs for PPP projects. The schemes – which will be funded by the remaining over budget (SAL) – aim to make the project with a strong orientation toward public welfare (such as toll roads, village interconnectivity roads and clean-water installations) more commercially viable.

- The authorities are aware that some trade and investment measures recently announced could have weighed on investor sentiment. However, they also wish to highlight their support for down-streaming of the industries to stimulate more new industries. This goal will be conducted in a cautious manner while preserving external commitment in the international trade.

Conclusion

- In summary, Indonesian authorities recognize the challenges they face in their effort to ensure higher, sustained and inclusive growth. They will continue to monitor the economic situation closely and stand ready to ensure that macroeconomic and financial stability are well maintained. In that regard, they acknowledge the staff's advice on such issues, and look forward to a continued fruitful engagement with the Fund.