



Consultative Group Meeting for Indonesia

January 19–20, 2005

Statement of IMF Representative

Introduction

1. **Let me begin by expressing our deep sympathy for the human losses and devastation that Indonesia has suffered in the wake of the tsunami.** The disaster in South Asia has deeply touched all of us in the international community. The government and people of Indonesia have responded in unison to work day and night to respond to the calamity. We at the IMF are ready to assist in any way that we can.
2. **While, clearly, the most immediate concern is to provide relief and minimize human suffering, President Yudhoyono's continued commitment to sound economic policies is welcome.** Bappenas, supported by multilateral agencies, has completed an initial assessment of the reconstruction needs and the economic and social impacts arising from the tragedy. While the impact on economic growth is likely to be limited at the national level, the financing needs for rehabilitation and reconstruction of Aceh will be substantial. Although the temporary moratorium on debt service offered by the Paris Club last week could relieve some of the short-term financing needs, it is important that, given the scale of the devastation, grants provide the primary form of help in the rebuilding. At the same time, the President's continued commitment to press ahead with broader economic reforms is very important. Ultimately, it will be the longer-term reform efforts that will help Indonesia address its unemployment and poverty problems.
3. **With this in mind, I will present a brief overview of how we see the economic policy priorities and outlook, as well as the role of the IMF.** A Fund mission visited Indonesia in early December, prior to the tsunami, to discuss economic policies with the new government. The mission was the second formal set of discussions conducted in the post-program context (the staff's report will be discussed by the IMF's Executive Board in early February). It provided a timely opportunity to take stock of the great strides, both on the macroeconomic and structural fronts, that Indonesia has made since the 1997-98 economic crisis, and to discuss the road ahead. With regard to the latter, we agreed with the government's focus on the maintenance of macroeconomic stability combined with a broadening of structural reforms as the way to increase private investment and generate high-quality growth.

Policy priorities

4. **Looking beyond the vital short-term efforts to help those affected by the natural disaster as well as the longer term reconstruction process, the main challenge for the government remains the realization of Indonesia's growth potential.** Although macroeconomic developments were favorable in 2004, a strengthened policy effort is needed to deal with unemployment and poverty. Provided that such efforts are realized, the IMF agrees with the government that annual growth rates could rise to the 6–7 percent range over the medium term.

5. **While the human cost of the tsunami is beyond measure, and the cost of rebuilding lost wealth and productive capital in the region is large, the overall economic impact on output and activity is expected to be limited.** In part this is because of Aceh's small share in overall economic activity and in part because of the progress in improving the functioning of the economy over the last several years. Our preliminary assessment is that the disaster will have only a minimal impact on Indonesia's overall growth rate this year, if any, leaving projected growth at close to 5½ percent. Indeed, in recognition of the limited overall macro effect, financial markets have been resilient.

6. **Looking beyond the tragedy, the overall economic policy priorities are well known.** The new government has a considerable political mandate to address long-standing problems holding back investment and growth. In November, the President announced his government's 100-day plan, and at the same time, the government is completing its medium-term economic strategy. As regards economic policies in specific areas, we agree with the government's focus on:

- **Continued fiscal consolidation.** The government is aiming at a budget deficit in the order of 1 percent of GDP in 2005, by strengthening tax administration and reorienting spending toward high priority areas, including a phasing-out of the poorly targeted fuel subsidies. This deficit target may have to be adjusted slightly if donor flows for reconstruction in Aceh were disbursed through the budget and partly financed by new loans. However, as already noted we agree that it is important to cover the cost of disaster management and reconstruction as much as possible through grants, which would keep a lid on the deficit and ensure that the debt-to-GDP ratio remains on a steady downward path.
- **Strengthening tax administration and ensuring that tax policy changes are revenue neutral.** Significant progress has been made in strengthening tax administration and it will be important to further consolidate these improvements to safeguard tax revenues and medium-term fiscal consolidation. At the same time, tax policy changes, some of which have been recently announced, should be designed so as to be revenue neutral. In this context, one risk that we do see to the budget situation is the possibility of revenue losses over the medium term arising from the tax amnesty under consideration. Amnesties discourage tax compliance and should be

avoided. Should the government wish to proceed, it would be critical to first strengthen tax administration to minimize undesired effects on compliance.

- **Monetary policy geared toward low inflation.** Bank Indonesia appropriately plans to continue to orient monetary policy toward low and stable inflation. At the same time, BI will maintain a flexible exchange rate system, which is consistent with the objective of eventually adopting formal inflation targeting, and also helping make the economy robust to shocks.
- **Continued financial sector reforms.** The authorities have indicated that they are committed to a sound banking system, building on the progress made in the last few years. A strengthening of asset quality and governance at state banks, and complete the establishment of the financial sector safety net are the top priorities here.
- **Improvements in the investment climate.** The government is rightly focused on good governance, legal and judicial reforms, and competitiveness of the labor market—issues that are critical to improving the investment climate. It has already taken actions towards resolving disputes with foreign investors and attack corruption. Speedy implementation of the existing blueprints to improve the functioning of the Commercial Court, the Anti-Corruption Court, and the Supreme Court, and the appointment of the Judicial Commission will all be important in establishing the credibility of the legal system, which has been one of the concerns of potential investors. Making changes in the labor environment to bring minimum wages, severance payments and outsourcing regulations in line with competitors, while safeguarding the rights of labor, would help to boost investment flows and absorb the unemployed.
- **Infrastructure development and the role of the private sector.** Finally, let me note the Infrastructure Summit that preceded this donor meeting. The strong participation in the summit is testimony to the amount of interest that it has generated and an indication of the potential for involving the private sector participation in infrastructure. It will now be important for the government to establish an institutional framework for such investments. As regards PPP ventures the government will need to ensure that projects with the highest social rates of return are chosen, and avoid the creation of unfunded liabilities for the budget. At the same time, the regulatory environment should be such that the banking sector can support the process but without compromising the continued recovery in its financial viability.

7. **After Indonesia's successful graduation from the IMF-supported financing program at the end of 2003, our work has focused on policy advice and technical assistance.** We have maintained a close policy dialogue and exchanged ideas on key economic issues with the government. We are also continuing to provide technical assistance in fiscal reforms, monetary policy, banking reforms, and economic statistics. In all of these efforts, we are working closely with our partners in the international community.

8. **Looking ahead, we stand ready to continue such support.** As the IMF's Managing Director stressed during his visit to Indonesia less than two weeks ago, we are also available to provide help in certain ways in our areas of expertise in the wake of the tsunami disaster. The IMF is able to quickly provide financial emergency assistance to affected countries in the wake of such natural disasters. We can assist in the assessment of the macroeconomic and associated impacts of the disaster (here, we are already working closely with Bappenas and the World Bank). We can provide technical assistance to help track donor inflows and ensure that they are used for the intended purpose. And finally we can help design measures towards the effective functioning of the banking and payments systems in the affected region in the aftermath of the destruction.

Concluding remarks

9. **While this meeting was planned before the tsunami disaster hit Indonesia, the urgency of mobilizing international support is even more pressing now.** The international community has responded expeditiously and generously to the disaster. Let me again reiterate that our Managing Director has said that, on our side, the IMF is committed "to help as much as possible in the international assistance effort."

10. **We join all of you present today in the hope that Indonesia will stay on the path towards higher growth.** The government's priorities are the right ones and successful implementation of its planned economic agenda will help achieve the higher growth rates and reduction in unemployment and poverty levels that Indonesia aspires to. We do not expect that the disaster and the resulting suffering, albeit immense in human terms, will lead Indonesia off the path to higher growth and welfare for its citizens, and we have been very encouraged by the government's approach in this regard in the wake of the disaster.

Thank you.

Table 1. Indonesia: Medium-Term Framework, 2003–09

	2003	2004	2005	2006	2007	2008	2009
	Act.	Est.	Projected				
Output and prices (percent change)							
GDP	4.5	5.0	5.5	6.0	6.0	6.2	6.5
Consumer prices (end period)	5.1	6.4	6.0	6.0	5.5	4.0	3.0
Consumer prices (period average)	6.6	6.1	6.0	6.0	5.5	4.5	3.5
Savings and investment (percent of GDP)							
Gross fixed capital investment	19.7	19.9	20.2	20.5	20.7	20.9	21.4
Gross national savings	22.7	22.7	22.1	21.9	21.5	21.1	21.2
Foreign savings	-3.0	-2.8	-1.9	-1.4	-0.8	-0.2	0.2
Public finances (central government, in percent of GDP)							
Revenue	16.1	17.3	16.1	15.7	15.3	15.1	14.9
Expenditure	18.0	18.8	17.1	16.0	15.3	14.8	14.4
Primary balance	1.4	1.5	1.6	2.2	2.2	2.2	2.2
Development expenditure 1/	2.8	2.7	2.8	2.6	2.7	3.1	3.0
Overall balance	-1.9	-1.5	-1.0	-0.3	-0.1	0.2	0.5
Debt	59.2	55.0	49.8	44.8	40.2	35.8	31.7
Balance of payments (billions of U.S. dollars)							
Current account balance	7.3	7.3	5.5	4.4	2.8	0.9	-0.8
Oil and gas (net)	6.7	6.6	6.2	5.5	4.7	4.0	3.2
Non-oil exports (f.o.b)	48.0	53.7	56.4	59.3	62.9	67.1	72.0
Non-oil imports (c.i.f)	-33.7	-39.9	-42.7	-46.2	-49.9	-54.3	-59.2
Capital account balance	-6.7	-6.2	-4.9	-2.7	1.0	3.7	5.3
Overall balance	0.6	1.1	0.6	1.7	3.8	4.6	4.5
Gross reserves							
In billions of U.S. dollars (end period)	36.2	36.3	35.8	36.0	37.8	39.9	43.0
As a share of short-term debt	146.0	159.0	165.0	186.0	205.0	243.0	279.0
External debt							
In billions of U.S. dollars	134.9	129.9	124.9	120.5	117.8	115.5	114.8
In percent of GDP	55.4	49.6	43.3	37.8	34.2	30.9	28.1
External debt service (in billions of US dollars)	6.8	9.5	10.0	10.4	9.7	10.0	9.1
Of which : Paris Club	1.7	4.6	4.5	4.3	4.0	4.0	4.0
Memorandum items:							
Indonesia oil production (000bcpd)	1,200	1,070	1,070	1,070	1,070	1,070	1,070
Indonesian oil price (US\$/bbl)	28.8	36.2	35.5	34.5	32.3	32.3	32.3
Nominal GDP in trillions of rupiah	2,087	2,329	2,610	2,938	3,285	3,646	4,019
Nominal GDP in billions of U.S. dollars	243	262	288	318	344	374	408

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

1/ From 2005, comprises capital spending and social outlays.