

CONSULTATIVE GROUP MEETING FOR INDONESIA

JAKARTA, NOVEMBER 7–8, 2001

STATEMENT BY THE IMF REPRESENTATIVE

1. Ladies and Gentlemen, thank you very much for the opportunity to be here today and to report to you on the status of the Government of Indonesia's economic program, supported by the IMF's extended arrangement. As all of you are aware, in September, the IMF's Executive Board approved the third review of the extended arrangement with Indonesia. The review was based on the government's adoption of early confidence-building measures, as well as its resolve to maintain macroeconomic stability and reinvigorate reforms. An IMF team is beginning discussions this week with Coordinating Minister Dorodjatun and the government's economic team on the fourth review under the IMF program.

2. The economic context for the implementation of the program is perhaps uniquely challenging at this juncture. The new government inherited a fragile economic situation that called for greater progress in critically needed structural reforms that lagged significantly behind schedule. The need to accelerate these reforms, and provide a firm basis for future growth, job creation, and poverty reduction, has been made ever more urgent by the aftermath of the events of September 11 and the evident global slowdown. I would like to note three aspects of the current economic context that warrant particular attention in that regard:

- Market sentiment has weakened significantly since September 11. Although conditions improved substantially in August on hopes of a return to political stability and early initiatives on economic policy, this optimism has been eroded by concerns related to events following the U.S. military action abroad as well as the effects of the global slowdown. The market has also taken note of delays in certain key reforms. The rupiah has weakened significantly more than other regional currencies, to once again breach the Rp 10,000 per dollar level, and the stock market also has been under downward pressure.
- The depreciation of the rupiah comes at a time when the risk of inflation has re-emerged, with the rate of price increase now in the 12–13 percent range. As a result, it has become more difficult to make the macroeconomic policy mix more supportive of growth. With a weak rupiah putting direct upward pressure on prices, and risk premia high, there has been no scope so far for reducing interest rates. Weakness in the rupiah also adds to pressures on the budget and creates a less conducive environment for progress in corporate restructuring.
- All this occurs at a time when Indonesia's economic recovery is slowing. With weakening domestic and external conditions, real GDP growth for 2001 is now

expected to slow to 3 percent, well below the 5 percent assumed in the original 2001 budget.

3. The latest developments highlight the vulnerability of the Indonesian economy and expose the distance that Indonesia still needs to travel to return to a path of sustained growth. The full impact of the global downturn on Indonesia's economic recovery is still uncertain. However, it is clear that the government must press ahead with its macroeconomic and structural reform program. Particularly in a world where markets are increasingly differentiating among emerging market borrowers, the priority must be to reassure domestic and international investors that the strategy for economic recovery remains intact. Any other approach will risk a prolonged and even further weakening in the investment climate, and added delays to Indonesia's recovery from the 1997-98 crisis.

4. The main policy requirements in such an approach lie in the following key areas, which are by now familiar to all of you:

- Making decisive progress towards fiscal sustainability and a reduction of Indonesia's large public debt burden;
- Making headway in restructuring and privatizing assets held by the public sector;
- Implementing a monetary policy aimed at bringing inflation back to single digits over the course of next year;
- Strengthening efforts to reduce vulnerabilities in the banking system and restore a functioning credit mechanism; and
- Accelerating efforts to improve the investment climate through governance and legal reforms.

Let me now turn to discussing each of these important areas in some further detail.

Fiscal Sustainability and the Macroeconomic Framework

5. The government is making a strong effort to re-establish a sustainable fiscal position. Through adherence to a conservative medium-term budget consolidation path, the government plans to reduce its debt to a manageable level.

6. In 2001, Indonesia's fiscal outlook was significantly affected by the costs of decentralization and servicing the domestic debt that stemmed from the recapitalization of the banking system, as well as a weakening in the macroeconomic environment early in the year. The government and Parliament moved together in June to pass a revised budget aimed at containing the deficit in 2001 to 3.7 percent of GDP, the original budget target. We recently had the opportunity to review with the government the 2001 budget situation. The review indicated that revenues and expenditures appear to be evolving in line with the budget targets. There was a concern, however, that financing could fall short of the levels assumed

in the budget. In order to avoid undue spending compression, the government is putting into place a comprehensive plan to address the financing problem, including steps related to asset sales, privatization, and reforms linked to external donor support.

7. Turning now to fiscal policy in the period ahead, let me start with the macroeconomic framework that underpins the 2002 budget. The budget is based on economic growth of 4 percent next year, and inflation of 9 percent. Despite the difficult external environment confronting Indonesia, we believe that these targets, while ambitious, are still achievable, provided policies are both strengthened and implemented consistently.

8. The current account surplus is projected to narrow in 2002, possibly sharply. Given the weak outlook for oil prices, the trade surplus is likely to narrow. Also, the prospects for income from tourism have clearly weakened. To maintain an adequate level of reserves amid this outlook, the persistent deficit on capital flows will have to be reduced. Clearly the priority must be on reducing private capital outflows, which will require strengthened policy implementation to boost investor confidence. However, continued inflows of official capital will also be needed.

9. This macroeconomic framework is clearly subject to significant downside risks and an immediate priority of our joint work with the authorities is to identify measures to mitigate these risks. Early measures in the key structural reform areas to improve market confidence in the program and ensure access to official financing will be critical in this regard.

10. With that as background, we welcome the passage by Parliament of the budget for 2002. The budget clearly signals the government's commitment to restoring fiscal sustainability under difficult economic conditions. It targets a substantially lower deficit of 2.5 percent of GDP, based on conservative assumptions for key economic variables such as the exchange rate and interest rates.

11. To achieve the deficit target, Parliament has approved a package of measures—equivalent to about 2 percent of GDP—to increase non-oil revenues and reduce untargeted subsidies. The budget thus includes new tax policy initiatives to strengthen the income tax and broaden the base of the VAT, as well as measures to improve tax administration, particularly for large taxpayers. A technical assistance team from the IMF's Fiscal Affairs Department is currently in Jakarta to assist with the detailed design of the proposed programs to strengthen large taxpayer compliance and arrears collection.

12. The budget also includes further increases in fuel and electricity prices to reduce energy subsidies. Before these price increases are effected, it is critical that adequate compensation mechanisms are in place to protect the poor. Efforts are also being made to secure savings in the wage bill. Such improvements in the structure of the budget provide scope for an overdue increase in outlays on programs to improve the delivery of basic social services such as education, health and social welfare.

13. The government has set ambitious targets for receipts from IBRA asset recoveries and the privatization of state-owned enterprises. Of these receipts, those assumed to finance the budget deficit have been set conservatively, at around 1½ percent of GDP, with any additional receipts earmarked for domestic debt reduction. We support this approach, which is fiscally prudent and hopefully will help create the necessary political consensus for moving ahead more forcefully with asset sales and privatization. The budget therefore assumes net external financing of about 1 percent of GDP, or about \$2 billion, significantly lower than in 2001. With scheduled amortization payments of around \$5 billion estimated to fall due in 2002 (after taking into account the Paris Club rescheduling through March 2002), this implies a residual gross financing need of \$7 billion.

14. We believe this is an appropriately ambitious budget, which is worthy of the continued support from the international community. While a large portion of the external financing need can be filled through disbursements of project financing, there is likely to remain a significant additional external financing need. This will require new exceptional financing either in the form of new program aid commitments or from a possible successor Paris Club rescheduling.

15. Another aspect of fiscal policy I should mention here is the process of fiscal decentralization. In consultation with Parliament, the government is reviewing the decentralization framework to improve its implementation in 2002. General areas where work is ongoing include possible refinements to the formula for allocating the general allocation grant across regions, regional taxation, and expenditure assignments between the center and the regions. Meanwhile, a key priority is to ensure that the immediate risks to macroeconomic stability from the decentralization process are well contained. In that regard, efforts need to be intensified to establish an effective financial reporting system at the regional level. Also, adequate safeguards need to be in place to control local government borrowing. All in all, our view is that the implementation of the 2002 budgetary framework will make an important contribution toward setting the stage for a sustained recovery over the medium term.

Other Key Policies

16. Let me now review what we regard as the other main policy priorities over the coming 12 months.

Monetary Policy

17. One of the key tasks will be for Bank Indonesia to arrest the upward trend in inflation, with the aim of bringing inflation back to single digits in the course of 2002. In the period since July as a whole, monetary conditions have tightened, with a rise in interest rates and a partial recovery of the rupiah. However, this tightening will only have an impact on base money growth and inflation with a lag, and the recent weakness in the rupiah risks putting renewed upward pressure on prices. It will be crucial for Bank Indonesia to maintain a firm monetary stance until inflation risks have been firmly contained.

Asset Recovery and Privatization

18. Indonesia must accelerate the restructuring and privatization of assets held by the public sector. This is an imperative for two reasons. First, to raise resources for the budget and help the government reduce its debt burden. Second, and perhaps more fundamentally, to put the assets back to work in the private sector in order to strengthen the investment environment and boost growth. We therefore support the ambitious targets that the government has set for 2002. But they clearly pose a considerable challenge, and the government will need to take measures on a wide front to achieve the planned acceleration in recoveries. For IBRA, key steps that need to be taken include: reaching legal closure on loan restructurings related to IBRA's largest obligors that are in line with the government's restructuring principles, accelerating already planned initiatives to sell off IBRA's stock of both unstructured and restructured loans, setting concrete deadlines for the resolution of problems of non-cooperative bank owners, and selling IBRA's banks.

19. Progress to date with the privatization of state-owned enterprises has been disappointing. To restore business confidence and sustain the economic recovery, it is vital that the government overcome obstacles in this area. The extent of government involvement in the productive sectors of the economy not only hinders efficiency, but is also difficult to justify given the large public debt burden. The government should make every effort to succeed in its approach of focusing on a few key sales to launch the process and demonstrate a clear break from the disappointing track record of the past.

Banking System

20. Reducing remaining vulnerabilities in the banking system and bringing it back to profitability remains a major challenge. Following the initial phases of stabilization and recapitalization the focus has turned increasingly to the process of consolidation and restructuring, with a view to revitalizing the credit process, entrenching sound governance, and returning banks to private ownership. The IMF—along with the World Bank, AsDB and others—is assisting in efforts to improve bank supervision and strengthen governance in the state banks. While some progress has been made in these areas, considerable challenges remain and further impetus needs to be given to such reforms to place the banking system on a sounder footing.

21. The government has, until recently, been unable to make a concrete start on returning the recapitalized banks to the private sector, a long-standing priority under the program. We therefore attach considerable importance to the successful majority sale of Bank BCA, as this would send a strong signal that Indonesia is firmly committed to return banking assets to the private sector. We therefore welcome the government's plan to conclude this sale by the end of the year.

Institution Building and Governance

22. The economic program must continue to accord high priority to institution-building and improved governance, especially in the key economic institutions, without which a stable environment for investment cannot be established.

- As you know, agreement on the principles governing IBRA's largest debt restructurings was an important initiative of the third review. Much now depends on the quality of the reviews conducted by IBRA's oversight committee and the responses of the FSPC.
- Equally important for confidence in the reform process are legal and judicial reforms. Immediate priorities in that regard are reform of the insolvency system, a strengthening in court system governance and anti-corruption efforts more generally, and improvements in the functioning of the commercial court.
- Improved fiscal transparency, through the audit of off-budget funds and public enterprises and agencies remains an important objective of the program.

Progress is under way in all these areas, but it will require continued support, to enable these historic institutional changes to take root.

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23. I have outlined what we believe constitute the critical elements of Indonesia's reform agenda at this juncture. Adhering to it will require a determined commitment by the government and by Parliament to the economic reform process. Notwithstanding the current difficult environment, we are encouraged that all parties agree on the imperatives of preserving economic stability, as evidenced by the agreement on a prudent budget supported by bold measures for 2002. Early confidence building steps are needed to solidify the process of structural reform. With strong implementation in these areas, we believe the Indonesian program deserves the continued support of the international community.