Indonesia—Assessment Letter for the Asian Development Bank
October 10, 2013

Recent Developments, Outlook, and Risks

Over the past few years, Indonesia has faced a shift in the global economic environment, stemming initially from slowing growth in major emerging market economies (EMEs) and falling commodity prices, and more recently from tighter funding conditions tied to a prospective exit from extraordinary global monetary accommodation. Since pressures intensified in May 2013, external portfolio inflows have reversed, the rupiah has depreciated significantly, and government borrowing costs have risen to multi-year highs.

Developments and outlook: The reversal of earlier tailwinds from high EME growth, buoyant commodity prices, and plentiful global liquidity, along with accommodative domestic policies, has put pressure on Indonesia's balance of payments Growth in Indonesia is projected to slow to 5–5½ percent in 2013 and 2014 from 6¼ percent in 2012 due to sluggish investment, weakening external demand, and tighter funding conditions. Inflation is expected to reach 9½ percent at end 2013 before moderating, with necessary adjustments in administered fuel prices, their second-round effects, and exchange rate pass-through the driving forces. Despite weak nonoil import growth, the current account deficit is expected to widen to more than 3 percent of GDP in 2013 and 2014 given external conditions, projected declines in commodity prices, and sizable net oil and gas imports. It is being financed by FDI, official, and portfolio inflows, but has also seen a reserves drawdown, with gross reserves declining to US$96 billion (5.3 months of imports) at end-September 2013 from US$113 billion (6.4 months of imports) at end 2012.

Monetary and exchange rate developments: Since June 2013, Bank Indonesia (BI) has raised its policy rate by 150 bps to 7.25 percent to address external and inflation pressures. It has also increased deposit and lending facility rates and the instruments available to banks to manage liquidity. Credit growth, which was 20 percent (y/y) in July, is expected to slow in the near term. BI has also eased up on foreign exchange market intervention, taken steps to improve market liquidity, and allowed the rupiah to depreciate to reduce external pressures.

Fiscal policy and debt management: To contain external and fiscal imbalances, the government raised subsidized fuel prices in June 2013 by an average of 33 percent and provided temporary support to the most vulnerable households to mitigate the impact. However, owing to underperformance in revenues and high energy subsidy costs in the first half of 2013, the overall fiscal deficit is expected to be around 2.5 percent of GDP in 2013 compared to 1.9 percent of GDP in 2012. Public debt and external debt (public and private) which were at 25 and 29 percent of GDP, respectively, at end 2012, remain sustainable.

Risks: Key risks are protracted volatility in EMEs, exacerbated by a disorderly unwinding of unconventional monetary policies in advanced economies and/or a more pronounced growth slowdown among major trade partners, including China and India, in combination with a further softening in commodity prices. A deterioration in investor sentiment, prompted by external conditions and policy uncertainty, could intensify macroeconomic pressures and feed back into confidence.

Policy Framework

The current policy stance is broadly appropriate. Recent measures aim to restore stability and reduce vulnerabilities. Clear communication and coordination will help their effectiveness.

Monetary policy should continue to aim at containing balance of payments and inflation pressures. Bank Indonesia will need to maintain a coherent monetary policy framework with a clear anchor. Further policy rate hikes by BI may be necessary if pressures do not subside. The exchange rate and bond yields should be allowed to move flexibly to reflect market conditions and facilitate adjustment.

Fiscal policy should support monetary policy in this effort, upfront by limiting the overall deficit to 2 percent of GDP in 2013 to avoid funding pressures. The initial draft 2014 budget appropriately targeted a deficit of 1½ percent of GDP, but achieving this will require firm policy measures focused on tax and subsidy reforms. Maintaining space for development spending and new social protections in 2014 is also a priority. In addition, the government should take adequate measures ensure access contingent financing lines, if necessary.

Financial sector policies should be geared toward ensuring a smooth transition in 2014 of bank supervision from BI to OJK—the financial services authority. Responsibilities for macro- and micro-prudential surveillance need to be clearly delineated, supported by actions to strengthen the financial stability architecture. Banks' asset quality and capital positions are generally sound, but financial indicators bear close watch given rapid credit expansion in recent years, the rise in loan-to-deposit ratios, and slowdown in economic activity.

Structural reforms should focus on accelerating infrastructure investment, easing labor market rigidities, deepening financial markets, and creating a more open trade and investment regime to reduce long-standing supply bottlenecks and broaden the export base. The government announced several measures in August 2013 aimed at addressing some of these shortcomings, but more comprehensive and cohesiveness actions are needed.

IMF Relations

The 2012 IMF Article IV consultation was concluded by the IMF's Executive Board in September 2012. An Executive Board meeting for the 2013 Article IV Consultation is tentatively scheduled in November 2013. A joint IMF-World Bank FSAP was completed in 2010. In recent years, the IMF has provided technical assistance in tax administration, treasury reform, and asset and liability management; banking supervision, financial safety nets, and financial deepening; and statistical development.