INDONESIA

The economic recovery that began in 1999 gathered momentum in the first half of 2000. However, further progress in corporate, financial, and administrative reforms is required if the recovery is to be sustained.

Economic Indicator (percent)	1997	1998	1999	2000	2001
GDP growth	4.7	-13.2	0.2	3.5	5.0
Inflation rate	6.2	58.5	20.5	6.0	6.0
Current account/GDP	-2.4	4.1	4.0	3.5	1.0

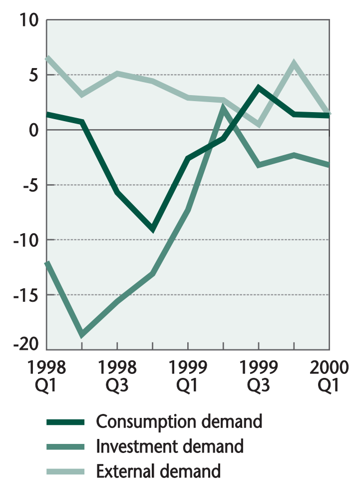
Economic Assessment. Following GDP growth of 0.2 percent in 1999, the economy expanded by 3.2 percent (year-on-year) in the first quarter and 4.1 percent in the second quarter of 2000. The economic recovery is becoming more broad based, with exports and fixed investment now contributing to a turnaround that was initially led by increased private consumption demand. On the aggregate supply side, a strong rebound in export-oriented manufacturing and construction activity has been offset by depressed agriculture sector growth. There are indications that, overall, the recovery has led to a decline in the rate of unemployment.

Year-on-year consumer price inflation for the first seven months of this year was 4.4 percent as against Bank Indonesia's forecast of 5–6 percent. However, a weaker rupiah and higher energy costs led to a sharp increase in inflation in July. Despite sufficient reserves relative to Indonesia's short-term external debt obligations, the rupiah has lost over 20 percent of its value since the beginning of 2000 and has exhibited considerably greater volatility this year than in 1999. This is mainly due to negative market sentiment arising from the country's continuing political uncertainties.

Indonesia's trade account remained in surplus during the first six months of 2000. Although the import contraction of 1999 has given way to import growth due to increased domestic demand for intermediate and capital goods, this has been more than offset by robust export growth led by higher earnings from oil and gas and by a recovery in manufactured exports. The resulting increase in the trade surplus and higher receipts of official flows pushed up gross external reserves to $27.4 billion at the end of June 2000, up from $26.0 billion at the end of 1999.

Fiscal policy will likely remain expansionary over the forecast period. However, fiscal resources are constrained by the massive debt-servicing costs arising from the recapitalization of the banking sector. The net effect of higher oil prices on the Government's fiscal position is unlikely to be substantial as increased government revenues will be partially offset by the higher costs of the government fuel subsidy. As a result, the fiscal deficit for 2000 (which covers the period from April to December to allow for a transition to a calendar-based fiscal year from 2001) is forecast at 4.8 percent of GDP. The Government is currently projecting a reduced budget deficit of 4.0 percent in 2001, on the basis that inflation will remain stable and interest rates will come down further. In the longer term though, fiscal consolidation

Decomposition of GDP Growth by Quarter (percent)



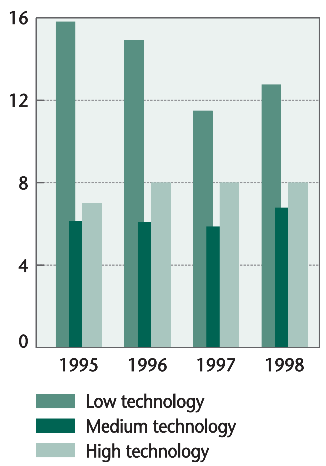
will depend on success in raising sufficient revenues through asset sales of the Indonesian Bank Restructuring Agency (IBRA), improved tax collection, and privatization of state enterprises.

The depreciation of the rupiah has pushed up short-term interest rates, with the key one-month Bank Indonesia Certificates rate rising to 13.4 percent in July from below 11 percent in April 2000. However, the rupiah is likely to strengthen and interest rates to decline if political stability prevails. This will greatly help sustain the still fragile economic recovery.

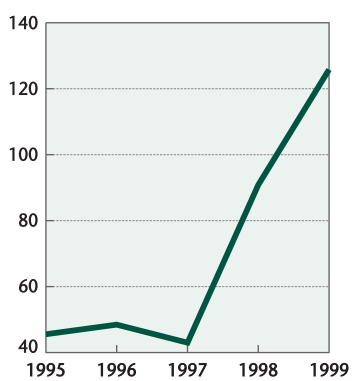
Structural Issues. Substantial progress has been made in restructuring Indonesia's banking system. The task of recapitalizing state banks has now been completed, and only one private bank under the control of the IBRA remains to be recapitalized. Bank consolidation has also progressed, with four state banks having been merged into one and the merger of 10 private banks remaining on track. These developments have led to a cautious increase in bank lending, especially to the export-oriented manufacturing sector. Despite this progress, the unfinished agenda is long and includes the accelerated disposal of IBRA assets. Corporate debt restructuring also lags far behind. The Jakarta Initiative for voluntary debt workouts expects to finalize agreements to restructure the bulk of Indonesia's corporate debt by the end of 2000. A concerted effort by the concerned parties is, however, needed to meet this target. In the meantime, the slow pace of corporate debt restructuring continues to dampen economic recovery.

There has also been progress in implementing the Government's two key decentralization laws, the Law on Regional Autonomy and the Law on Fiscal Balances. In May 2000, the Government approved implementing regulations for the former, and extensive development and administrative functions have already been transferred to local authorities. The Government hopes to finalize the implementing regulations for the latter by the end of 2000. While administrative and fiscal decentralization is intended to improve accountability of the decision-making process, strengthen participation of beneficiaries, and reduce the burden on central government finances, carrying out this ambitious agenda will prove challenging. Among other things, it implies substantial capacity strengthening of public institutions, especially at lower tiers of government.

Technology Exports as Share of Total (percent)



Ratio of Reserves to Short-Term External Debt (percent)



Forecast. The economy is likely to grow by 3–4 percent in 2000 and by 5 percent in 2001. Higher GDP growth will be driven primarily by stronger external demand for manufactured goods and by a higher rate of domestic investment. With Indonesia remaining under a tight IMF monetary program and the likelihood of stable food prices, inflation is unlikely to exceed 5–6 percent in either 2000 or 2001. Indonesia's trade surplus is likely to increase in 2000 as export growth outperforms import growth. However, higher imports of trade-related services and increased outflows of interest, profit, and dividend payments will lead to a narrowing of the current account surplus to 3.5 percent of GDP in 2000. In 2001, the trade surplus will decline as imports start growing faster than exports. This will be accompanied by a higher income and service deficit. As a result, the current account surplus may narrow further to 1 percent of GDP in 2001.