International Monetary Fund

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Jakarta, Indonesia
October 31, 1997

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. The attached Memorandum on Economic and Financial Policies outlines the program that Indonesia intends to implement over the next three years to address the fundamental causes of its current financial difficulties, thereby ensuring that the economy is placed on a path of strong and sustainable growth. In support of this program, Indonesia hereby requests a three-year stand-by arrangement from the International Monetary Fund in an amount equivalent to SDR 7.3 billion or 490 percent of quota.

2. The program provides for an early review, within 1–2 months of Board approval as specified by emergency procedures, and four quarterly reviews to be completed during the first year of the program. The first review, which is expected to be completed by March 15, 1998, will be tied to the program targets for December 1997 specified in Annexes A-E, and will focus in particular on progress in implementing the financial restructuring measures and exchange market policies. This review will also finalize understandings, inter alia, on the program for fiscal year 1998/99 (April-March) and will establish the performance criteria for June and September 1998. The second review, expected to be completed by June 15, 1998, will be tied to the program targets for March/April 1998, specified in Annexes A–E, and will cover implementation of structural reforms, including energy price increases.

3. We believe that the policies outlined in the attached Memorandum of Economic and Financial Policies (MEFP) will serve to quickly restore market confidence, which has declined, partly reflecting the contagion effect of the regional currency crisis. We have put in place a comprehensive policy package to deal with insolvent and weakened banks, and to

overcome structural rigidities in the economy. These reforms are supported by prudent fiscal and monetary policy. We recognize that the provision of substantial financing from the Fund and the front-loading of such financing requires an appeal to exceptional circumstances. Accordingly, as the situation stabilizes, which is the early aim of the government's program, Indonesia would forego some of the subsequent purchases and make advance repurchases to the Fund as soon as conditions permit.

4. While we firmly believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, we remain committed to taking any additional measures that may be necessary for this purpose. During the period of the proposed stand-by arrangement, Indonesia will consult with the Managing Director of the Fund on the adoption of any measures that may be appropriate, at the initiative of either the Indonesian authorities or the Managing Director, in accordance with the Fund's policies on such consultations. We will also provide the Fund with such information that it requests on the progress made in policy implementation and achievement of program objectives.

Sincerely yours,

/s/	/s/
Mar'ie Muhammad Minister of Finance	J. Soedradjad Djiwandono Governor, Bank Indonesia

I. Indonesia—Memorandum Of Economic And Financial Policies

II. Background

1. For the past several decades, prudent macroeconomic policies and continuing deregulation have kept Indonesia on a path of rapid economic development. Since the 1970s, economic growth has averaged 7 percent per annum, raising GDP per capita toward the level of middle-income countries, while dramatically lowering the incidence of poverty. The economic structure has become diversified, as dependency on the oil sector has declined and an export-oriented manufacturing base has emerged, led by a dynamic private sector and fueled by high domestic savings and large inflows of foreign direct investment. Meanwhile, macroeconomic balance has been maintained: the budget has been balanced; inflation has been contained, most recently at single digit levels; current account deficits have been relatively low; and international reserves have been built up to a comfortable level.

2. At the same time, a number of underlying weaknesses have emerged, which have made the country vulnerable to adverse external shocks. Structural rigidities arising from regulations in domestic trade and import monopolies have impeded economic efficiency and competitiveness. At the same time, the rapid expansion of the financial system since the late 1980s has left a number of banks with significant amounts of nonperforming loans, straining their liquidity and, in some cases, undermining their financial viability. Also, the relative stability of the rupiah during most of the 1990s, together with the high rates of

return on domestic investment, has both encouraged and facilitated high levels of overseas borrowing, a significant portion of which has been private short-term debt that has been unhedged. Consequently, by end-June 1997, Indonesia's external debt had increased to $140 billion (about 60 percent of GDP), of which $33 billion was short term, while its debt service has remained close to one-third of exports of goods and services.

3. In the wake of the recent currency crisis in the region, the exchange rate has depreciated sharply, to levels that are difficult to justify by macroeconomic fundamentals. From mid-July to mid-October, the cumulative depreciation of the rupiah exceeded 30 percent, while the fall in the Jakarta stock exchange index reached 35 percent, both the largest declines in the region, notwithstanding Indonesia's sound macroeconomic position. The sharp depreciation of the rupiah, beyond levels implied by changes in exchange rates in the region, did not seem to reflect a competitiveness problem, as the export slowdown in 1996 was much less pronounced than in other ASEAN countries, and export growth in the first half of 1997 picked up to 9 percent. Nor did it reflect an unusually large current account imbalance, as the deficit has remained well below that in neighboring countries and has been financed mainly by foreign direct investment.

4. With the fall of the rupiah, banks and corporations that had borrowed from abroad without hedging have faced large increases in their rupiah debt service costs. Moreover, since the currency depreciation has engendered a rise in domestic interest rates, the burden of paying for, and collecting, domestic currency loans has also increased, further straining the position of all corporations and financial institutions, in particular those that were already weak. As this has occurred, the process has become self-reinforcing: growing strains on firms have amplified investor uncertainty and encouraged even healthy companies to rush to hedge their external liabilities in the forward market, thereby intensifying pressures on the exchange rate and domestic interest rates.

5. From the outset of this process, the government has taken vigorous corrective action. To discourage speculative attacks, the exchange rate band was widened in July to 12 percent and, in August, the rupiah was allowed to float, with minimal intervention. This policy was backed by a significant tightening of liquidity conditions, with one-month interest rates on central bank certificates being raised from 11½ percent to above 20 percent. It was also backed by an announcement that the budget surplus would be preserved by postponing major infrastructure projects, cutting development programs, and extending the coverage of the luxury sales tax. Meanwhile, to buoy the real economy, import tariffs on over 150 items (mainly raw materials and other intermediate goods) were reduced effective mid-September, while the 49 percent limit on foreign holdings of listed shares was abolished. These actions, however, were not sufficient to restore confidence in the rupiah and the economy.

III. The Policy Framework

6. The government has put in place a comprehensive policy package to restore confidence and arrest the decline of the rupiah. Strengthened fiscal and monetary policies will provide the supportive macroeconomic framework for restructuring the financial sector and putting in place wide-ranging structural reforms. Monetary policy will be kept tight in the initial period of the program, and combined, if necessary, with closely monitored intervention in

the foreign exchange market to support the exchange rate. These macroeconomic policies will provide the supportive framework for restructuring the financial sector and putting in place wide-ranging structural reforms.

7. The government's policy program is built around three main pillars: first, a strong macroeconomic framework designed to achieve an orderly adjustment in the external current account, and incorporating substantial fiscal adjustment as well as a tight monetary stance; second, a comprehensive strategy to restructure the financial sector, including early closing of insolvent institutions; and third, a broad range of structural measures which also improve governance.

8. The principal macroeconomic objectives of the three-year program include: stabilizing the rupiah while maintaining gross foreign exchange reserves at a comfortable level; limiting the economic downturn during the remainder of this year and next year, before restoring economic growth to its potential rate before the end of the program; containing the initial surge of inflation emanating from the depreciation and other one-time factors to no more than 10 percent through 1998/99 and bringing it gradually back to 5 percent subsequently; and reducing the external current account deficit to below 3 percent of GDP, a level that should ensure a steady decline in the external debt and debt service ratios.

1. Macroeconomic Policies

(a) Fiscal Policy

9. During the past decade, the government has pursued a sound fiscal policy, based on the principle of a balanced budget, which has translated into a sizeable surplus of 1 percent of GDP in the previous two fiscal years. With the anticipated downturn in the economy, the fiscal position is expected to come under substantial pressure. A slowdown in revenues during the remainder of the fiscal year, together with the impact of the drought and the depreciation of the rupiah, are projected to result in a deterioration in the overall fiscal position of about 1 percent of GDP. The government has therefore moved decisively to avoid a deterioration of the fiscal position by cutting spending and introducing revenue measures, which together amount to budgetary savings of about 1 percent of GDP in 1997/98. This strengthening of the fiscal effort is necessary to support the required external adjustment, finance the costs associated with financial sector restructuring, and ensure that the government debt/GDP ratio returns gradually to its pre-restructuring levels.

10. On the expenditure side, following the government's announcement in September of its intentions to cut spending, specific plans have been formulated to postpone or reschedule major state enterprise infrastructure projects and development expenditures. These expenditure measures, which are concentrated in roads, transmigration, irrigation, and energy projects, will improve the central government budget by around ½ percent of GDP. In addition, savings in materials and other routine expenditures will amount to about ¼ percent of GDP.

11. On the revenue side, the base "retail" (or excise) price for tobacco will be increased sufficiently to raise revenue by 10 percent, and for alcohol by 80 percent, effective December 1, 1997. In addition, the government will announce that it will remove all VAT

exemptions where feasible and unless stated in law (including those on imports of sugar and personal goods), with effect from April 1, 1998. These exemption arrangements will be reviewed regularly. Nontax revenues from the Investment Fund will also increase. The government will reduce the expenditure through the fund by Rp500 billion and instead require profitable public enterprises to rely on market financing. These revenue measures, together with the spending cuts, should amount to 1 percent of GDP. As a result, notwithstanding the cyclical factors, there should be only a slight decline in the budgetary surplus. Taking into account the carrying costs of financial sector restructuring, which are roughly estimated at 0.5 percent of GDP, the budget should remain in small surplus.

12. The strong fiscal position will be sustained in 1998/99. The government will maintain a surplus of 1 percent of GDP for the coming fiscal year. The program includes performance criteria consistent with these objectives (Annex B). Budgetary projections are on the conservative side and should allow adequate room for the costs of financial sector restructuring. To achieve this objective, the government intends to adjust administered prices of petroleum products and electricity before the next fiscal year, with a view to eliminating subsidies for these products. The 5 percent local sales tax on gasoline will be introduced by April 1, 1998, and the number of goods subject to the luxury sales tax will be increased. The government will also shortly increase the proportion of the market value of land and buildings assessable for tax to 40 percent for plantations and forestry property. In addition to these adjustments, the budget position will benefit from the full-year impact of the October measures and further strict prioritization of development expenditure. To assist in the prioritization of expenditure, a comprehensive assessment of public expenditure, including that of strategic industries, will be undertaken by the time of the first review.

13. The government also plans to improve tax administration and the structure of the tax system in line with recommendations of the Fiscal Affairs Department of the IMF to improve the buoyancy of non-oil tax revenues. Specific measures will include: (i) raising the annual audit coverage; (ii) developing an improved VAT audit program to focus more on large potential taxpayers; (iii) developing a program to implement a unique, single taxpayer registration number for all tax types; and (iv) improving the recovery of tax arrears.

14. To ensure the quality and durability of the fiscal reform, the government intends to move to a comprehensive and transparent system to report on the public sector fiscal position, including quasi-fiscal operations. The Nontax Revenue Law of May 1997 requires all off-budget funds to be incorporated in the budget within five years. The government has decided, however, to accelerate this process and consolidate into the budget all remaining off-budget funds within the next three years. Line ministries are already required to report their revenues in FY1997/98. Consolidated accounts will be prepared for revenues, expenditures, the overall balance, and financing for the public sector, including central government and financial and nonfinancial enterprises. In the specific case of the Reforestation Fund, the government is committed to ensuring that the funds are used exclusively for their intended purposes of financing reforestation programs, which include those outside the concessional forest areas, development of industrial forestry areas, reforestation of unproductive land, and other reforestation programs.

(b) Monetary and Exchange Rate Policy

15. Bank Indonesia has been prudent in its conduct of monetary policy and, as demonstrated in recent months, is prepared to tighten monetary policy, if required, to maintain stability in financial markets. In the short run, a tight monetary stance will be sustained, as necessary, to support the exchange rate. As the program takes hold and pressures on the exchange rate subside, it should be possible to gradually lower interest rates from their current high level to a more sustainable level, but, given the key importance of maintaining confidence in the rupiah, Bank Indonesia will be mindful of not lowering interest rates prematurely.

16. This strategy will be reinforced, if necessary, by foreign exchange intervention to bolster confidence and provide a clear direction to the market. Such intervention would be supported by a restrictive monetary stance so as to maximize the impact on the exchange rate, while avoiding excessive depletion of international reserves. Consistent with this approach, intervention would be only partially sterilized so as to ensure that monetary conditions tighten as the scale of intervention increases. Accordingly, the ceiling on base money (a performance criterion, specified in Annex A) will be adjusted downward automatically in line with the actual decline in net international reserves. The monthly and quarterly floors on net international reserves are provided in Annex C. We will also collaborate closely with IMF staff on the intervention strategy, including by providing data on daily intervention in the spot and forward market.

17. Beyond the immediate term, monetary policy will focus on limiting the impact of the exchange rate depreciation on prices to less than a full pass-through so that inflation can be kept below 10 percent. To achieve this objective at a time when the economy is slowing and the financial restructuring is likely to slow the demand for money, Bank Indonesia will aim to reduce broad money growth from 27 percent last year to 18 percent in 1997/98 and to 11 percent in 1998/99. This deceleration will be attained by controlling base money, rather than relying on bank-by-bank quantitative lending targets and moral suasion. Bank Indonesia will also engage in open market operations, especially through central bank certificates. In addition, other improvements to indirect monetary management will be made. Consistent with the monetary targets, base money growth will be limited to 18 percent in 1997/98 (6 percent in the period September 1997 to March 1998) and 13½ percent in 1998/99. Within the base money ceilings, limits will be established for Bank Indonesia credits to public agencies and public sector enterprises, as a prelude to phasing them out by the end of the program period.

18. The base money targets will need to be kept under careful review in the context of the financial sector restructuring and will be re-examined at the time of each program review. Over a longer time horizon, the floating of the rupiah will allow monetary policy to be based more exclusively on the objective of domestic price stability. Gradually, as the current situation stabilizes, a set of leading indicators will be developed, and used to gauge inflationary pressures. These indicators will provide a basis for policy formulation.

(c) External Position and Financing

19. With the slowdown in domestic demand, the external current account deficit is expected to decline to less than 3 percent of GDP in 1997/98 and to around 2 percent of GDP in 1998/99. The bulk of these deficits would be financed by continuing inflows of

long-term capital, primarily foreign direct investment and project financing from the World Bank and the Asian Development Bank. The overall payments position, however, is expected to record a substantial deficit, reflecting, inter alia, short-term capital outflows in the first year of the program; the situation remains uncertain for the second year.

20. Available data indicate that the stock of short-term debt stood at $33 billion at end-June 1997. An estimated $11 billion of short-term debt will fall due during the remainder of this fiscal year and around $22 billion during 1998/99. In view of the current turbulence in the regional capital markets, it is extremely difficult to forecast the extent to which short-term debts will be rolled over during the coming year or the magnitude of other pressures on the balance of payments. The extent of outflows of capital, particularly short-term, will be a function of the degree of confidence in the program, based on the strength of our policies and on market assurance that the program is adequately financed. The best way to provide such assurance is to provide sufficient foreign exchange financing to ensure that markets are confident that-even in a pessimistic scenario involving the nonrollover of a substantial proportion of short-term debt-adequate foreign exchange will be available and, by doing so, to prevent the nonrollover in practice.

21. Accordingly, we have requested access to Fund resources of SDR 7.3 billion, equivalent to about $10 billion under a three-year stand-by arrangement. This financing, together with quick-disbursing additional financing expected from the World Bank, the Asian Development Bank and from bilateral donors, will provide sufficient financing over the next three years. The bulk of the financing will be made available in the first year of the program. In addition, we have received assurances of additional substantial financial support, to be made available on a precautionary basis, from other regional and international partners. We are confident that this magnitude of support will ensure that capital outflows are kept to a minimum, allowing the official international reserves to remain above four months of imports. Strict limits will be placed on nonconcessional external borrowing contracted or guaranteed by the public sector, as specified in Annex C.

22. Limits of $5 million per customer on forward foreign currency trading between banks and nonresidents, and on each bank's outstanding position in the forward market, were imposed in early September, as part of our effort to restore order in the foreign exchange market. While these controls do not apply to trade and investment transactions, they will be phased out as soon as possible to encourage reflows of foreign capital and remove distortions caused by this restriction.

2. Financial Sector Restructuring

23. omprehensive restructuring of troubled financial institutions will be key to the success of the program. The share of nonperforming loans of the banking system is high at over 8 percent of total loans, the ratio being much higher for state-owned banks; furthermore, as experience in other countries has shown, measurement problems are likely to result in an underestimation of nonperforming loans. The accumulation of bad loans reflects, to a significant degree, risks associated with rapid credit growth, foreign exchange borrowing, related-party lending, and property sector exposure that have been inadequately managed. The health of the banking system has deteriorated further with the exchange rate depreciation, the hike in interest rates, and the slowdown in economic growth.

24. Already, decisive action has been taken to deal with this problem. Insolvent banks have been closed and weak, but viable, institutions have been required to formulate and implement rehabilitation plans. At the same time, steps are being taken to minimize future systemic risks. In particular, the legal and regulatory environment will be strengthened by establishing strong enforcement mechanisms and introducing a stringent exit policy.

25. These actions are part of a four-part restructuring program which has been put together with technical assistance from IMF, the World Bank, and the ADB to restore public confidence in the financial system. The first part, to isolate clearly unviable institutions from the rest of the financial system, has already been completed as noted above. On November 1, 1997, 16 banks were closed. These banks have already ceased all operations, and their licenses will have been revoked. Consistent with the law, shareholders' losses will not be compensated. Caretaker teams, to be replaced by liquidation teams within 3–4 weeks after closure—both supported by personnel with commercial banking experience—will immediately replace the management of the institutions. Bank Indonesia is preparing plans for effective asset recovery.

26. The government will not guarantee repayment of the liabilities of these banks except for small depositors who will be compensated promptly (within two weeks after bank closure) for up to Rp20 million per depositor per bank. Payments to depositors will be administered by Bank Indonesia and funded by the government. At a later date, once the soundness of the banking system has been established, the government intends to introduce an explicit deposit insurance scheme. The scheme will be designed to minimize moral hazard and to protect deposits up to a specified amount. It will be funded by banks and will cover state-owned as well as private banks. With regard to the liabilities of private nonfinancial corporations, the government will not guarantee any of their liabilities, foreign or domestic.

27. The second part of the strategy is to establish proper procedures and policies to deal promptly with weak but viable financial institutions, so that they can be placed quickly on the road to recovery. Some institutions will be placed under conservatorship or intensified supervision of Bank Indonesia and will be given 60 days to submit to Bank Indonesia, for its approval, a rehabilitation plan to address the banks' weaknesses. Each plan will clearly specify: (i) the sources of any new funds to be injected into the institution; (ii) the proposed changes in ownership structure, management, board of directors, and future focus of activities and procedures; and (iii) the implementation timetable. The specific plans will then be evaluated by Bank Indonesia, with assistance from the ADB and World Bank; these agencies will also assist with the subsequent implementation and monitoring. Any violations of the agreed plan will trigger immediate supervisory action. If Bank Indonesia determines that a rehabilitation plan is insufficient to reestablish financial viability, the bank will be closed. Banks under conservatorship or intensified supervision will be prohibited from distributing dividends. In addition, Bank Indonesia will closely monitor the operations of the 10 banks which have contractual agreements with Bank Indonesia to implement rehabilitation programs that involve new investors and a previously agreed amount of subordinated loans from Bank Indonesia. The financial position of these banks will be reviewed at the end of April 1998. Any of these banks which has not returned to solvency and a rehabilitation plan developed, if necessary, will be closed by the end of 1998. The assessment will be made in consultation with IMF staff. These banks will not be extended

any credit facility by Bank Indonesia until their solvency has been restored. The only exception would be credit provided through the discount window at market rates and in emergency circumstances when the bank is facing a serious run on its deposits.

28. The third element of the strategy is to resolve specific problems of the state and regional development banks. The government's goal is to ensure that these banks are safe and sound while at the same time reducing the risk of incurring fiscal costs to maintain their capital adequacy. On November 1, 1997, the government announced that state bank mergers and other strategic tools will be used to maximize debt recovery, to improve corporate governance and to assure that the banks benefit from increased private ownership and increased participation of private owners in the governance of the banks. A plan for accelerated privatization of the state banks will be drawn up during the first year of the program. Legislation toward that end will be drafted within six months.

29. The government will introduce private sector ownership of at least 20 percent in at least one state bank within one year and will reduce its ownership of at least one state bank to less than 50 percent as soon as legislation for this purpose is enacted. In line with this objective, emphasis will be placed on downsizing, improving efficiency and ensuring that these banks operate according to commercial banking practices. Recapitalization will be used only in conjunction with concurrent privatization. In addition, the state banks will be required to focus on debt recovery, using all legal tools available, including bankruptcy and liquidation procedures. Regulations that require state-owned banks to transfer their nonperforming assets to the State Auction Agency (BUPLN) for collection, will be reviewed with the objective of improving debt recovery of the state banks. The Ministry of Finance, Bank Indonesia and the individual banks will agree on a regulatory contract or a performance contract with clearly established quantitative targets and monitoring mechanisms. To assure full transparency and good governance, the government will immediately engage internationally-recognized firms to conduct portfolio reviews and to audit the banks annually, with the first audit to be conducted as of December 31, 1997. The terms of reference for the portfolio reviews and audits will be drawn up in cooperation with the World Bank.

30. In the case of regional development banks, those with major potential losses will be placed under conservatorship, and the foreign exchange license of one of these banks will be suspended, pending full compliance with Bank Indonesia regulations. These and other weak regional development banks will be rehabilitated according to an action plan prepared in connection with a loan agreement with the ADB. In particular, the banks' shareholders (regional governments) will be required to provide cash injections to recapitalize these institutions. Failure to do so within 1 year by any of these shareholders will result in the banks' closure. The action plan will emphasize a move towards commercial banking principles. Capital adequacy and provisioning standards will gradually be raised to those applicable to commercial banks.

31. Capital markets play an increasing role in intermediation and allocation of savings. However, the domestic bond market is small and needs to be expanded to provide an alternative to funding long-term debt requirements in foreign currencies. To strengthen the domestic bond market, the government will strengthen the regulatory framework with assistance from the ADB to meet international standards.

32. For transparency purposes and to avoid jeopardizing the financial position of Bank Indonesia, costs associated with bank closure and state bank rehabilitation will be financed by the budget or by the issuance of government-guaranteed bonds, the carrying costs of which will be fully covered by the budget.

33. The fourth part of the strategy is to improve the institutional, legal, and regulatory framework for banking operations to ensure the emergence of a sound and efficient financial system. To this end, the laws and decrees governing central bank and banking operations, bank liquidation, as well as legislation, judicial and administrative agencies for title registration, collateral perfection, foreclosure and bankruptcy will be revised to incorporate international best practices. The government regulation will be modified to introduce proper bank liquidation procedures. Regulations concerning foreign ownership of financial institutions will be modified to facilitate entry of international banks and investors into the Indonesian banking system.

34. Prudential regulations and enforcement procedures will be strengthened in line with the Basle Committee's Core Principles of banking supervision. With the assistance of the IMF, reporting requirements for foreign exchange exposure will be modified by end-December 1997 to capture the true risk inherent in foreign exchange positions. These reports will be closely monitored by Bank Indonesia's Supervision Department. High priority will be given to ensuring that loans are classified according to borrower's future capacity to repay, rather than on the basis of repayment history alone, and that provisioning rules are tightened by end-March 1998. In addition, loan loss provisions required by regulations of Bank Indonesia will be fully tax deductible as of the current fiscal year, after verification by tax authorities. The instruction issued by the central bank to raise capital adequacy to 9 percent by end-1997, and 12 percent by end-2001, will be strictly enforced. The Bank Supervision Department of Bank Indonesia will be strengthened to effectively implement risk-based oversight of the banking system, with due regard for the need to strengthen the banks' capacity to provide credit only to solvent borrowers. To preclude conflicts of interest and preferential treatment, Bank Indonesia will continue to divest its holdings in commercial banks and will complete this by mid-1998. An action plan detailing the necessary measures in all of these areas will be prepared in consultation with the IMF.

35. Restrictions on bank lending, other than those required for prudential reasons, will be eliminated with few exceptions. In addition, the government intends to phase out quasi-fiscal operations of Bank Indonesia, and to show all subsidies transparently in the budget. The quantitative limit on lending for land acquisition and development, as well as housing, imposed in July 1997, will be removed. Banks heavily exposed to the property sector will be subject to special on- and off-site supervision. Requirements that direct banks to lend to specific sectors will be eliminated, except for lending to small scale enterprises which is provided at market interest rates. Bank Indonesia liquidity credit extended through banks for specific purposes, or at subsidized interest rates (except for liquidity credit funded by external sources) will be phased out gradually. Progress in this area will be an element to be assessed at the time of the first review.

36. Bank Indonesia will streamline its lender of last resort function. Loans to illiquid but solvent banks will be provided in accordance with stringent access conditions. These loans will be collateralized and extended to individual institutions at increasingly punitive interest

rates. Any emergency assistance to banks to prevent systemic risks will be explicitly guaranteed by the government. Bank Indonesia will develop rules for the Jakarta Clearing House that will transfer settlement risk from Bank Indonesia to participants within six months.

37. The government is convinced that this program, which will be supported by intensive technical assistance by the IMF as well as the ADB and the World Bank, in the context of their structural loans, will restore soundness of the financial system and its ability to intermediate funds efficiently.

3. Structural Reforms

38. The government aims to promote greater transparency in policy making and competition to support an ongoing restructuring of the economy that is necessary to promote growth. To this end, the government intends to speed up its structural reform program through further trade and investment reform, and deregulation and privatization. At the same time, the government will continue to implement measures to alleviate poverty.

(a) Foreign Trade and Investment

39. The government has a comprehensive program, which it introduced in 1995, to reduce most tariffs from 0–40 percent to 0–10 percent by 2003. Items currently subject to tariffs of 15–25 percent will have their rates reduced by 5 percentage points by end-March 1998. On November 3, 1997, the government announced that chemical, steel/metal and fishery products will be brought within the overall plan and tariffs thereon gradually reduced to 5–10 percent by 2003. On January 1, 1998, most tariffs on chemical products will be reduced by 5 percentage points, while tariffs on fishery products will be reduced from 10–20 percent to 5 percent. Most tariffs for steel/metals will be reduced beginning January 1, 1999. Export taxes and restrictions will also gradually be reduced over the next three years. Initially, taxes on rattan, leather, cork, ores and waste aluminum products will be cut. Over the program period, any remaining quantitative import restrictions, other than those which may be justified for health, safety, environment and security reasons, and other nontariff barriers that protect domestic production, will be phased out. Consistent with Indonesia's commitment to the WTO, the local content program for motor vehicles, which gives preferential tariff rates to vehicle manufacturers using a high percentage of local parts, will be phased out by 2000. With respect to the National Car project, the Government of Indonesia will implement ahead of schedule the ruling of the WTO dispute panel.

40. The list of activities open to foreign investors will be simplified and further expanded. The government will study the retail sector with a view to partially opening this sector up to foreign investors and the policy on palm oil which is now open to foreign investment will be applied evenly. The list will be further expanded over the next three years. Progress in this area will be reviewed at the time of the second review.

(b) Deregulation and Privatization

41. Steps will also be taken to promote domestic competition. These measures will aim to increase efficiency, thereby improving the supply of products to consumers. In parallel,

with its efforts to increase private sector efficiency and competitiveness, the government will undertake a public sector expenditure and investment review in order to promote more efficient use of government resources. This review, to be carried out in collaboration with the World Bank, will include expenditures by the central government, state-owned enterprises and strategic industries. The review will be completed in six months and will result in a comprehensive program to improve fiscal efficiency and restructure state-owned enterprises and strategic industries. It will be the basis for an accelerated program of privatization. The government intends to phase out import and marketing monopolies and price controls on agricultural commodities except for rice, sugar, and cloves over the next three years. As a first step, on November 3, 1997, wheat and wheat flour, soybeans and garlic were made freely importable. In order to alleviate the burden of adjustment on the part of the affected parties, import tariffs will be applied to soybeans and dried garlic (20 percent) and wheat flour (10 percent) and will be reduced to 5 percent by 2003. Price controls on cement will be eliminated effective November 3, 1997.

42. Steps will also be taken to promote competition by accelerating privatization and expanding the role of the private sector in the provision of infrastructure. To ensure a level playing field among companies bidding for government projects, the government has already established guidelines for procurement and contracting procedures. The implementation regulations will be issued by end-December 1997.

43. Oversight of public enterprises has been moved to the Ministry of Finance from line ministries and a Privatization Board has been established. In September, the 49 percent limit on foreign investment in companies listed on the stock exchange was removed. A clear framework will be established for the management and privatization (either through share flotation or negotiated enterprise sale) of government assets by the time of the first review,including: (i) criteria for determining whether enterprises should be closed, restructured or fully privatized; and (ii) a transparent sales process that maximizes the return to government from sales and treats all bidders equally. Within this framework, the government aims to accelerate privatization and to take decisive action to restructure or close poorly performing enterprises. Two enterprises will be prepared for listing during the first year of the program and additional tranches of government-controlled shares of listed public enterprises will be offered for sale. Nonviable enterprises will be closed. Clear profit and performance targets will be established for public enterprises remaining in the public sector, which will be made public and reported upon annually. Progress in this area will be reviewed at the time of the second review.

(c) The Environment

44. Realignment of key resource prices and usage charges, especially for forestry and water use, would yield substantial revenue and at the same time promote important environmental objectives. The government has undertaken to review the administration and allocation of forestry concessions, with a view to significantly raising stumpage fees in 1998/99, and has committed to use the proceeds of the Reforestation Fund solely for sustainable management of forestry resources.

(d) Social Safety Net

45. Indonesia has made significant progress in alleviating poverty over the past 30 years. Yet, large numbers of poor still remain, and it is imperative that the adjustment program does not result in a worsening of their economic and social conditions. The depreciation should benefit the rural poor by raising output prices in the export-oriented agricultural sector. Measures necessary to achieve fiscal targets will protect expenditures on health and education. In addition, efforts to target assistance to the poor will be intensified, including by expanding the program for the least developed villages, initiated in 1994, which has proved cost effective in creating rural infrastructure and expanding employment opportunities for the poor. Moreover, poverty eradication and more equal income distribution are to be major themes of the next five-year development plan, which begins in 1999. In particular, budgetary allocations for social spending will be increased, so as to ensure that all Indonesians receive at least nine years of education and better basic medical services.

Program Monitoring and Data Issues

46. The following quarterly quantitative performance criteria have been set to monitor progress under the program: (i) a ceiling on base money; (ii) a floor on the net international reserves of Bank Indonesia; (iii) a floor on the overall government surplus; (iv) a ceiling on the contracting of external public and publicly-guaranteed loans with maturity of more than one year; and (v) a ceiling on the stock of public and publicly-guaranteed short-term external debt. These quantitative performance criteria, indicative targets, and precise definitions of quantitative variables monitored under the program are set out in Annexes A–D. Structural performance criteria and benchmarks on financial restructuring, and other policy measures, are laid out in Annex E.

47. During the period of the arrangement, the government will not accumulate any new external payments arrears, and will not impose new or intensify existing restrictions on payments and transfers for current international transactions, or introduce or modify multiple currency practices, or conclude bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles of Agreement, or impose new or intensify existing import restrictions for balance of payments reasons.

48. To improve transparency, and allow market participants to make more informed assessments of economic developments, the publication and dissemination of key economic data will be improved substantially. From December 1, 1997, the authorities will publish biweekly data on key elements of Bank Indonesia's foreign exchange position, including gross international reserves and external liabilities. This step will be examined during the first review. The authorities are also working closely with other regulatory agencies and with financial institutions to ensure they publish regular and comprehensive data on the financial condition of the latter, including on nonperforming loans, capital adequacy, as well as ownership structures and affiliations. Monthly data on all central government activity (including domestic revenues and expenditures) will be collected and released within two months of the end of each reporting period. To improve further the provision of high-quality data to the public, additional technical assistance from the Fund has been requested, so that Indonesia's data can be brought into compliance with the Special Data Dissemination Standard, by December 1998.

ATTACHMENTS
ANNEX A

Monetary Targets
1. Performance Criteria on Base Money

Outstanding stock as of:[1]	Limit (In billions of rupiah)
End-September 1997 (actual)	41,062
End-December 1997 (performance criterion)	42,723
End-March 1998 (performance criterion)	42,744
End-June 1998 (indicative)[2]	44,240
End-September 1998 (indicative)[2]	45,789

[1]Calculated as the average of the closing positions on the last five working days of the month and the first five working days of the following month.

[2]Performance criterion will be set at the time of the first review of the arrangement.

Base money is defined as currency in circulation (with banks and with the rest of the public), bank deposits at Bank Indonesia (BI) in rupiah, private sector demand deposits at BI, aggregate debit balances at BI and the aggregate reserve deficiency. Aggregate debit balances refers to the sum of all negative bank balances at BI. The aggregate reserve deficiency is defined as the amount by which aggregate statutory reserves against rupiah deposits and rupiah deposit substitutes exceed the sum of banks' positive reserve balances at BI.

The following adjustments will apply:

• The base money limits will be reduced (increased) by one-fifth of the shortfall (excess) in net international reserves of BI (NIR) below (above) the baseline path set out in Annex D, translated into rupiah at the average exchange rate prevailing in the month concerned.

• Changes in reserve requirements will modify the base money ceiling according to the formula:

$$\Delta M = \Delta r\ B_0 + r_0\ \Delta B + \Delta r\ \Delta B$$

where M denotes base money; r_0 denotes the reserve requirement prior to any change; B_0 denotes the rupiah reservable base in the period prior to any change; Δr is the change in the reserve requirement ratio; and ΔB denotes the immediate change in the rupiah reservable base as a result of changes in its definition.

ANNEX B

Fiscal Targets
1. Performance Criteria on the Overall Central Government Balance

	Floor (In trillions of rupiah)
Cumulative balance from End-March 1997 to:	
End-September 1997 (actual)	7,605
End-December 1997 (performance criterion)	7,600
End-March 1998 (performance criterion)	3,500
Cumulative balance from End-March 1998 to:	
End-June 1998 (indicative)[1]	2,100
End-September 1998 (indicative)[1]	3,000

[1]Performance criterion will be set at the time of the first review of the arrangement.

The balance is defined as the negative of the sum of (i) net foreign borrowing; (ii) change in net credit from the banking system (excluding the amount of bonds and other government obligations, if any, incurred for the purpose of recapitalizing banks); and (iii) net financing from all other sources to the government.

Net foreign financing is defined as government foreign borrowing less amortization (including debt prepayments) of foreign debt, with transactions translated into rupiah each month at the average exchange rates for that month. Net credit from the banking system is defined as the change in net credit to government (including SBI holdings and commercial loans and the extrabudgetary funds), as reported in the consolidated government accounts in the monetary survey. Net financing from all other sources includes receipts from the sale of government assets.

Government deposits in foreign exchange as of September 30, 1997 will be evaluated at constant exchange rates (Annex D). Monthly changes in government foreign currency balances will be converted into rupiah at the average exchange prevailing for that month.

ANNEX C

External Sector Targets
1. Performance Criteria on Net International Reserves of BI

	Floor (In billions of U.S. dollars)
End-September 1997 (actual)	24.5
End-December 1997 (performance criterion)	17.4
End-March 1998 (performance criterion)	16.0

End-June 1998 (indicative)[1]	14.0
End-September 1998 (indicative)[1]	12.5

[1]Performance criterion to be set at the time of the first review of the arrangement.

For monitoring purposes, net international reserves of BI (NIR) is defined as the sum of (i) the U.S. dollar value of gross foreign assets in foreign currencies minus gross liabilities in foreign currencies; (ii) the net forward position of BI; and (iii) reserves against foreign currency deposits.

Gross foreign assets will include all foreign currency-denominated claims of BI, including monetary gold, holdings of SDRs, and the reserve position in the IMF. Excluded from gross foreign assets will be participation in international financial institutions, as well as holdings of nonconvertible currencies, and claims on residents. Gross foreign liabilities are all foreign currency denominated liabilities of contracted maturity up to and including one year plus the use of Fund credit. All assets and liabilities will be valued using the exchange rates and gold price shown in Annex D.

The net forward position is defined as the difference between the face value of foreign currency-denominated BI off-balance sheet (forwards, swaps, options, and any futures market contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents.

The floor on NIR will be adjusted upwards by any excess in balance of payments support loans over the program baseline in Annex D.

2. Performance Criteria on Contracting or Guaranteeing of New External Debt

	Limit (In billions of U.S. dollars)
Cumulative change in stock from end-September 1997	
End-December 1997 (performance criterion)	750
End-March 1998 (performance criterion)	3,000
Cumulative change in stock from end-March 1998	
End-June 1998 (indicative)[1]	1,050
End-September 1998 (indicative)[1]	1,900

[1]Indicative target to be revised and set at the time of the first review of the arrangement.

The limit applies to the contracting or guaranteeing by the public sector of new nonconcessional external debt with an original maturity of more than one year, which is defined as loans containing a grant element of less than 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates. Excluded from the limits are credits extended by the IMF and balance of payments support loans.

Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee is issued.

These limits exclude a possible $1.4 billion in borrowing by BI, mainly to roll over maturing stand-by loans (credit lines).

3. Performance Criteria on the Stock of Short-term Debt Outstanding

	Limit (In billions of U.S. dollars)
End-September 1997 (actual)	598
End-December 1997 (performance criterion)	800
End-March 1998 (performance criterion)	800
End-June 1998 (indicative)[1]	800
End-September 1998 (indicative)[1]	800

[1]Indicative target to be revised and set at the time of the first review of the arrangement.

The limits apply to the stock of debt of maturity of one year or less, contracted or guaranteed by the public sector. Excluded are balance of payments support loans, normal import-related credits, reserve liabilities of Bank Indonesia, and forward contracts, swaps, and other futures market contracts.

ANNEX D

Program Assumptions and Reporting
1. Program Baselines for Balance of Payments Financing Package

	1997		1998		
	Sept.	Dec.	Mar.	Jun.	Sep.
	(In billions of U.S. dollars)				
Baseline NIR	24.5	19.9	19.0	17.0	15.5
Minimum floor on NIR	24.5	17.4	16.0	14.0	12.5
Balance of payments support (cumulative)[1]	0	0	0	0	0
Balance of payments support (cumulative)[1]	0	0	0	0	0

[1]Includes all quick-disbursing balance of payments support loans from multilateral and bilateral sources, including similar loans channeled to the government budget, but excluding short-term loans that are reserve liabilities of BI.

2. Exchange Rates and Gold Price to be Used Under the Program[1]

	Rupiah per Unit of Foreign Currency
U.S. dollar	3,275
Japanese yen (100 yen)	2,716
Deutsche mark	1,853
Pound sterling	5,284
French franc	552
Swiss franc	2,255
SDR	4,475
ECU	3,642
Gold price (U.S. dollars per ounce)	294

[1]Currencies not shown here will be converted using the official rate for September 30, 1997 used by the IMF's Treasurer's Department.

3. Reporting

Monitoring the program will require accurate and timely data. All information on performance criteria, indicative targets, and balance of payments support loans will be reported to Fund staff within eight weeks of the reference date. In addition, detailed data on government revenues and expenditures, costs of financial sector restructuring (including liquidity support from Bank Indonesia), and the monetary survey will be provided monthly. Data on base money (showing all the factors affecting reserve money), foreign exchange intervention (in both the spot and forward markets), the net forward position, net foreign assets, and open market operations (including the stocks of SBIs and SBPUs) will be provided daily.

ANNEX E

Structural Measures

Performance Criteria/Benchmarks for End-December 1997

• Closure of banks placed under intensified supervision or conservatorship that do not submit rehabilitation plans or whose plans are not approved by Bank Indonesia.[1]

• Establishment of quantitative performance targets for state-owned banks together with monitoring mechanisms. These are to be agreed by Ministry of Finance, Bank Indonesia and state-owned banks.[1]

• Issuance of implementation regulations on procurement and contracting procedures.[1]

Performance Criteria/Benchmarks for end-March/April 1998

• Introduction of full tax deductibility of loan loss provisions (by end-March 1998).

• Audits of state-owned banks by internationally recognized accounting firms (by end-March 1998).

• Reduction of tariffs in line with commitments specified in paragraph 39 (by end-April 1998).

• Completion of public expenditure review (by end-March 1998).

• Increase in prices of petroleum products to eliminate subsidies (by end-March 1998).[2]

• Increase in electricity prices by 30 percent (by end-March 1998).[2]

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[1]These measures are structural performance criteria.
[2] These measures are structural performance criteria.