Submission No 118

Inquiry into Australia's Relations with Indonesia

Organisation: Treasury

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Australian Government
The Treasury

23 January, 2003

Ms Janet Holmes
Secretary to the Committee
Joint Standing Committee on Foreign Affairs, Defence and Trade
Parliament House
Canberra ACT 2600

Dear Ms Holmes

INQUIRY INTO AUSTRALIA'S RELATIONSHIP WITH INDONESIA

Please find attached Treasury's submission to the inquiry of the Joint Standing Committee on Foreign Affairs, Defence and Trade into *Australia's relationship with Indonesia*, as requested in your letter of 17 November 2003.

Yours sincerely

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FOREIGN AFFAIRS SUB-COMMITTEE OF THE JOINT STANDING COMMITTEE ON FOREIGN AFFAIRS, DEFENCE AND TRADE

TREASURY SUBMISSION

TO THE INQUIRY INTO AUSTRALIA'S RELATIONSHIP WITH INDONESIA

JANUARY 2004

Introduction

This submission is prepared in response to questions of the committee received by the Treasury on 17 November 2003.

Indonesia's IMF program

The 1997-98 Asian financial crisis impacted upon Indonesia more severely than any other regional economy. In response to the crisis, Indonesia entered into a three-year Stand-By Arrangement (SBA)[1] with the IMF on 5 November 1997. This was replaced by an Extended Fund Facility (EFF) from 25 August 1998. After the expiry of this program, a new EFF was approved on 4 February 2000. This current EFF was originally a three-year program, but on 28 January 2002 it was extended by one year, to conclude at the end of 2003. Further details on Indonesia's IMF relations are provided in Attachment 1.

On 28 July 2003 the Government of Indonesia (GoI) announced that it would not seek to extend the current IMF program, but would retain a policy dialogue with the IMF from 2004 through Post-Program Monitoring (PPM)[2]. The GoI followed this announcement with the release on 15 September 2003 of an economic White Paper outlining its program of economic reforms to be implemented leading up to and after its exit from the EFF.

The Australian Government supports Indonesia's intention to graduate from its IMF program, while recognising Indonesia will continue to face significant economic challenges going forward. Maintaining sound policy discipline and a commitment to economic reform will be the key to addressing these challenges and in that regard the White Paper program is a positive development.

Indonesia's economic agenda

Indonesia has made good progress towards macroeconomic stabilisation, especially over the past two to three years. The budget deficit has been reduced from 3.7 per cent of GDP in 2001 to an estimated 1.9 per cent of GDP in 2003. The official 2004 budget deficit target is 1.3 per cent of GDP, and Indonesia aims to achieve a balanced budget by 2005-06. The central government debt to GDP ratio has been reduced from 100.3 per cent in 2000 to 66.9 per cent at the end of 2003 (IMF projection). This has been achieved through steady (albeit modest) GDP growth, fiscal consolidation, and a strengthening currency (which reduces the domestic value of foreign currency denominated debts). CPI inflation has fallen from 10 per cent at the beginning of 2003, to 5.1 per cent in the twelve months to December 2003. International credit rating agencies have recognised Indonesia's improved fundamentals with ratings upgrades during 2003. Data on key macroeconomic indicators is provided in Attachment 2.

Notwithstanding its progress in these areas, Indonesia still faces significant economic challenges. For the past four years, GDP growth has mostly been generated by the consumer sector and has been in the range of 3 to 4 per cent, but it would require growth rates of around 6 per cent to make significant inroads into unemployment and poverty. A return to such pre-crisis rates of growth would require a significant improvement in the environment for investment, which in turn will require on-going progress to address governance and corruption issues, the financial system, and the security situation. These problems are also affecting the performance of the export sector. For the time being, Indonesia does not realistically have the option of stimulating growth through fiscal expansion as the size of its ongoing debt burden makes continued progress on fiscal consolidation essential.

The commitment of the GoI to continued reform in a number of areas will be critical to the restoration of investor confidence and growth. The requirement of having to meet periodic reviews under the IMF program, including a series of policy targets to be met by specified dates, has provided impetus to the reform process. From 2004 the GoI itself will need to generate such impetus. Moreover, against the background of the significant economic challenges that it faces, Indonesia has been and continues to deal with profound processes of political and social change. These processes will remain dynamic in 2004, when both Parliamentary and Presidential elections are due.

The expiry of Indonesia's IMF program should not be construed as signalling disengagement by the international community from Indonesia and its economic reform process. The IMF will continue to review the progress of Indonesia's policies on a twice-yearly basis as part of the PPM mechanism. It will also continue to provide technical assistance and maintain close policy dialogue, including regular staff visits. The World Bank also remains engaged, having recently approved a new three-year Country Assistance Strategy (CAS) which makes available significant funding increases pending progress in reform. The Asian Development Bank and various donor countries, including Japan, Australia and the US, continue to provide funds and technical assistance and to engage in policy dialogue. In that regard, Treasury is an active participant in Australia's technical assistance program to Indonesia.

Since Indonesia's announcement of its intention to graduate from its IMF program, signs regarding the prospects for continued reform and eventual recovery have generally been positive. The White Paper was well received by the financial markets and the IMF, and its implementation, at this early stage, appears to be progressing reasonably well. In recent months the GoI has dealt quite successfully with a number of troublesome policy issues, including amendments to its Anti-Money Laundering Law and tighter supervision of bank-sponsored mutual funds, and progress has been made towards the establishment of the Anti-Corruption Commission (ACC). Bank sector restructuring and asset recoveries through the Indonesian Bank Restructuring Agency (IBRA) are on track and the 2003 target for privatisation proceeds is likely to be achieved or nearly so. All of these developments are pleasing considering that, during the term of the EFF, progress on the structural reform agenda was generally found to be more problematic than macroeconomic stabilisation.[3]

Indonesia's debt challenge and post-2003 financing requirements

Prior to the Asian financial crisis, Indonesia's public debt position was sound. The country had almost no domestic public debt, and its external debt was owed predominantly to international institutions on concessional terms. During the crisis, public debt expanded rapidly due to the large volume of recapitalisation bonds issued to support the banking system after its near-collapse. In addition, the severe decline in the value of the domestic currency, the rupiah, raised the domestic-currency value of public debts denominated in foreign currencies. Central government debt rose from 22.9 per cent of GDP in FY1996-97 to 61.5 per cent of GDP in FY1997-98, peaking at 100.3 per cent of GDP in FY2000.[4]

In recent years Indonesia has made steady progress in reducing its debt ratios, through a combination of fiscal consolidation, modest GDP growth, and the recovery of the rupiah as confidence gradually returned. Central government debt had declined to 66.9 per cent of GDP by the end of 2003 (IMF projection).[5] The central government's debt interest payments as a percentage of GDP have declined from 6.6 per cent in 2001 to a projected 4.1 per cent in 2003, which is still substantial considering that total central government revenue in 2003 was only 18.7 per cent of GDP.

From 1998, as a result of the Asian crisis and the expansion in its public debt, Indonesia experienced significant problems in financing its budget deficits and meeting debt repayments. To address this problem, in 1998, 2000 and 2002 it approached the Paris Club of international creditors and negotiated a series of two-year debt rescheduling agreements. Over this six-year period, Paris Club debt rescheduling contributed US$15 billion to Indonesia's financing task, including around US$3 billion in 2003. However, the Paris Club usually requires an active IMF program as a condition of access to its debt rescheduling mechanism, which is a practice that Australia supports.[6] Therefore, as a consequence of its graduation from the IMF program, from 2004 Indonesia is unlikely to have further access to the Paris Club, and therefore will need to meet its financing requirements through other means. Indonesia's decision to not extend its IMF program, and thereby not access Paris Club rescheduling, comes at a time when Indonesia already faces significant financing challenges given its budget deficit position, substantial debt repayment obligations and lack of a track record in international bond markets.

Nevertheless, Indonesia should be able to meet its post-2003 financing requirements, provided that it maintains market confidence and remains committed to its reform agenda. It could achieve this through a combination of continued fiscal consolidation, privatisation receipts, issuance of domestic and international bonds, the drawdown of certain foreign currency deposits held by the central Government, and other measures. Attachment 3 outlines the budget financing plan for 2004. Because Indonesia has historically not been active in international bond markets, its capacity to raise funds through bond issuances is untested. However, the progress that Indonesia has made in areas such as fiscal and debt consolidation have been well recognised by financial markets, making substantial new bond issuances a feasible option provided that financial market confidence is maintained.

During 2003, Indonesia approached a number of creditor governments including Australia seeking debt relief, principally in the form of debt swaps. Our understanding is that only Germany and France have agreed to debt swaps with Indonesia. Since the announcement of its decision to graduate from its IMF program, Indonesia has not approached the Australian Government seeking debt relief.

As a member of the Paris Club and as one of Indonesia's sovereign creditors, Australia has participated in the 1998, 2000 and 2002 rescheduling rounds, rescheduling a total of US$390 million in bilateral debts. This has been the sole vehicle by which Australia has provided debt relief to Indonesia to date. In accordance with Indonesia's assessed needs, this debt relief has been in the form of debt rescheduling as opposed to outright debt forgiveness.

Australia's policy on debt relief is clear; we will not consider any form of debt relief or debt rescheduling for any country outside the auspices of the Paris Club or the Highly Indebted Poor Countries (HIPC) initiative. Paris Club debt rescheduling usually requires an active IMF program, whereas the HIPC initiative requires an active IMF program as a condition for debt forgiveness. (HIPC has additional eligibility criteria designed to restrict it to very low-income countries, which exclude Indonesia.) Moreover, under the *International Monetary Agreements Act 1947* the Australian Government is only authorised to provide financial assistance, such as debt relief, to another country where that country has an active IMF program.

It is worth noting that the annual value of Australia's Official Development Assistance to Indonesia (A$151.7 million in 2003-04) exceeds the amount of annual Indonesian debt repayments to Australia (between A$75 million and A$85 million annually over the next several years, at current exchange rates). Moreover, this form of assistance provides Indonesia not only with funding but also technical expertise.

As part of its commitment to economic engagement in the region, Treasury is an active participant in Australia's technical assistance effort to Indonesia, providing advice in such areas as fiscal strategy and financial sector supervision.

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[1] A central role of the IMF is to provide loans to member countries experiencing balance of payments difficulties. This lending is financed from the membership quotas subscribed by all member countries. Financing occurs by allowing the borrowing country to use its own currency to purchase Special Drawing Rights (SDRs), which are a notional currency equivalent to a basket of US dollars, euros, yen and pounds sterling. Member countries may borrow up to the value of their reserve tranche (one-quarter of quota in the case of Indonesia) at any time without condition. When seeking to borrow IMF resources in excess of their reserve tranche, a country is obliged to undertake an IMF-monitored program of economic reforms. This is to ensure that the country will be able to remedy its original balance of payments problem and to repay the borrowed IMF resources. Access to each tranche of SDRs is conditional upon adherence to this program. The two most common types of IMF program are the Stand-By Arrangement (SBA) and the Extended Funds Facility (EFF).

The SBA is designed to address short-term balance-of-payments problems and is the most widely used facility of the IMF. The length of an SBA is typically 12-18 months. Repayment is expected within 2¼-4 years unless an extension is approved. The borrowing country need not necessarily draw down the funds available under an SBA.

The EFF was established in 1974 to help countries address more protracted balance-of-payments problems with roots in the structure of their economies. Arrangements under the EFF are thus longer (3 years). Repayment is expected within 4½-7 years unless an extension is approved.

Under an SBA or EFF, prior to each purchase of SDRs, the member undergoes periodic reviews (typically semi-annually or quarterly) in which a series of criteria must be met by specific dates. Members formally request an arrangement with the IMF through a Letter of Intent (LoI). The LoI describes the economic program to be supported by IMF resources and may be accompanied by a more detailed Memorandum of Economic and Financial Policies.

[2] Post-Program Monitoring (PPM) is a standard process for countries that have finished their IMF programs but still have debts outstanding to the IMF in excess of quota. It is designed to provide ongoing monitoring and involves semi-annual reviews. Prior to the recent 11th Review of its EFF, Indonesia's debts outstanding to the IMF were SDR6,713 million, or 322.86 per cent of quota.

[3] Indonesia recently decided to make publicly available the documentation relating to its IMF program reviews. The Staff Reports for the three most recent reviews are now available on the IMF website; the Eleventh and final Review was considered by the IMF Board on Friday 19 December 2003. These documents are useful sources of further information on Indonesia's IMF relations and economic reforms.

[4] Until FY1999/00, the Indonesian fiscal year ran from April to March. FY2000 ran from April to December. Since 2001, the Indonesian fiscal year has been aligned with the calendar year.

[5] The central government accounts for almost all of Indonesia's gross public sector debt. During the Soeharto era, provincial and local governments had almost no authority to issue their own debt, and although they have now acquired this authority in principle through Indonesia's post-Soeharto decentralisation process, this authority is not yet being exercised on a significant scale. For comparison, the gross public sector debt to GDP ratio was 24.5 per cent in 1996/97, 104.1 per cent in 2000 and is projected at 68.2 per cent for 2003 (IMF data).

[6] The Paris Club's usual requirement of an active IMF program also enables the IMF to play an important role in actual Paris Club deliberations, whereby it reports on the economic conditions and financing needs of each applicant country.

ATTACHMENT 1: INDONESIA - IMF RELATIONS
(As of 31 December 2003)

Membership Status: Joined 21 February 1967; Article VIII

General Resources Account	SDR Millions	Percent of Quota
Quota	2,079.30	100.00
Reserve position in Fund	145.50	7.00

Outstanding Purchases and Loans	SDR Millions	Percent of Quota
Extended arrangements	6,915.08	332.57

Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Millions)	Amount Drawn (SDR Millions)
EFF	4 Feb 2000	31 Dec 2003	3,638.00	3,638.00
EFF	25 Aug 1998	4 Feb 2000	5,383.10	3,797.70
Stand-By	5 Nov 1997	25 Aug 1998	8,338.24	3,669.12

Source: IMF.

Note: The SDR exchange rate on 7 January 2004 was SDR1 = US$1.49272.

ATTACHMENT 2: INDONESIA - MAJOR ECONOMIC INDICATORS (PER CENT)

	2000	2001	2002	2003	2004
GDP growth	4.9	3.3	3.7	3.9	4.5
CPI inflation (Dec to Dec)	9.3	12.5	10.0	5.1	6.5
Current account balance (%GDP)	5.3	4.9	4.5	3.5	..
Budget deficit (%GDP)	1.1	3.7	1.8	1.9	1.3
Central government debt (%GDP)	100	91	80	67	62
External debt (med-long term; %GDP)	94	93	75	62	54
Exchange rate (Rp/US$; year end)	9,595	10,400	8,950	8453	..

Sources: 2003 CPI from Statistics Indonesia; other GDP and CPI actuals from CEIC database; GDP and CPI forecasts are December 2003 Consensus. 2003 exchange rate, from the Jakarta Post, is the closing rate on 2 January 2004. All other data from IMF 11th Review Staff Report. Forecasts/ estimates/ targets are shaded.

ATTACHMENT 3: INDONESIA'S FINANCING NEEDS AND SOURCES
US$ billion [a]

	2003 [b]	2004
1. Gross financing needs (2+3)	8.7	10.5
2. Budget deficit	3.8	2.9
3. Debt amortisation [c]	4.9	7.6
a. Domestic		2.4
b. Foreign		5.2
4. Sources of financing (5+6+7)	8.7	10.5
5. Domestic financing (excluding bonds)	2.5	3.4
a. Privatisation and asset sales	2.9	1.2
b. Deposit draw downs	0	2.2
c. Other	-0.4	--
6. Foreign financing (excluding bonds)	6.3	3.3
a. Paris Club debt rescheduling	3.0	0
b. CGI financing	2.7	2.8 [d]
c. Non-CGI foreign financing	0.6	0.5
7. Planned bond issuance	--	3.8 [e]

Sources: 2003 figures from World Bank brief for Consultative Group on Indonesia (CGI) meeting of 21-22 January 2003, *Indonesia: Maintaining Stability, Deepening Reforms*. 2004 figures from World Bank brief for CGI meeting of 11 December 2003, *Indonesia: Beyond Macroeconomic Stability*.

a. Indonesian nominal GDP in 2003 was approximately Rp1,780 trillion (IMF projection), or US$207.6 billion when converted at the period average exchange rate of Rp8,575/US$.

b. The 2003 figures, having been published at the beginning of that year, are projections formed at that time, and will differ somewhat from the actual outturns. They are used here for ease of comparison with the 2004 figures, which are based on the 2004 budget.

c. Debt principle repayments due. Debt interest payments are incorporated in the figures for the budget deficit (item 2). 2004 domestic debt amortisation includes some debt buybacks. In the 2003 figures, debt buybacks are incorporated in other domestic financing (item 5c).

d. A total of US$2.8 billion in loans and grants through the central budget was pledged by creditors at the CGI meeting on 11 December 2003.

e. The majority of the 2004 issuances will comprise domestic currency bonds.