Indonesia's Medium-term Development Plan and Public Debt Sustainability

Sumio Ishikawa*

Abstract

Indonesia has passed through the stage overcoming the difficulties that resulted from the financial and currency crisis of 1997 and is now in the process of the transition toward a new stage looking for further prosperity. In politics, a general election was held in 2004, bringing major changes in the power balance among the political parties in Indonesia. Furthermore, for the first time in Indonesian history, a direct presidential election was carried out in the same year, whereupon Mr. Yudhoyono, who was considered likely to eradicate corruption, was elected president. In economics, growth surged to more than 5% in 2004, and investment also showed the highest increase in recent years, which had until then been stagnant. Banks' lending, which had decreased in the aftermath of the financial and currency crisis, expanded in 2004, especially in the consumer lending. In fiscal policy, the primary surplus has been maintained, and outstanding public debt has been declining.

The new administration announced a Medium-term Development Plan (2004-2009). Under this plan, the government will aim at building an economically and socially prosperous nation and changing the high-cost economic structure by improving the investment climate. Since export growth remains sluggish, it is necessary to enhance industrial competitiveness; therefore, the government's plan would appear to be appropriate. In order to implement the plan steadily, it is essential to secure public support and fiscal resources. In order to obtain public support, the government must demonstrate achievements in a visible way and should institute specific and practical policies in each annual plan. To secure fiscal resources for the plan, while fiscal discipline is still needed, the government can flexibly approach the objective of achieving a balanced budget in 2009 to accomplish the goals set in the plan.

This paper examines the recent macroeconomic development in Indonesia, which is under the process of transition toward a new stage, and reviews Indonesia's Medium-term Development Plan (2004-2009) with its impact on the public debt sustainability. According to the estimates given in this paper, even if the fiscal deficit continues at just under 1% of GDP each year and a balanced budget will not be achieved by 2009, public debt will fall by about 20 percentage points of GDP by 2009. While fiscal financing will depend more on government securities than it did, government securities holders have been diversified to a certain degree. It is important to continue fostering the secondary market for government securities, and the government is expected to make further efforts to that end.

Introduction

Indonesia has passed through the stage overcoming the difficulties that resulted from the financial and currency crisis of 1997 and is now in the process of the transition toward a new stage looking for further prosperity. In politics, a general election was held in April 2004, the Indonesian Democratic Party-Struggle, the ruling party before the election, lost a tremendous number of seats, while the Democratic Party, a newly founded party led by Yudhoyono, a former coordinating minister for political and security affairs, made gains. As a result, there were major changes in the power balance among the

* Director, Division 1, Country Economic Analysis Department, JBIC. This paper does not represent any official position of the Country Economic Analysis Department or the Japan Bank for International Cooperation, but contains the author's personal opinions.

1 The number of seats gained by each party is the Indonesian Democratic Party-Struggle (from 153 to 109), the Golkar Party (from 120 to 128), Democratic Party (new party, 57), and the Welfare Party (from 7 to 45).

political parties in Indonesia.[1] Furthermore, for the first time in Indonesian history, a direct presidential election was carried out in July the same year, and Mr. Yudhoyono, with political support from the population desiring the eradication of corruption, defeated Megawati (the incumbent president) in the runoff election implemented in September. Mr. Yudhoyono assumed the presidency in October.

In economics, the real GDP growth rate increased to more than 5% in 2004 and investment, which had until then been stagnant, showed the highest increase in recent years. Bank lending, which had decreased in the aftermath of the financial and currency crisis, expanded in 2004, especially in consumer lending, and the stock market began to grow at a healthy pace. Though the outstanding public debt exceeded GDP immediately after the financial and currency crisis, it has declined in recent years thanks to Indonesia's improved fiscal balance, and thus public debt sustainability has improved.

The Yudhoyono administration announced the Medium-term Development Plan (2004-2009) (MTDP) in January 2005. According to the MTDP, the government set the creation of a prosperous Indonesia through economic and social sector development as one of its three agendas, and it lays out policy directions for changing the high-cost economic structure by improving the investment climate and enhancing industrial competitiveness. Although, as described above, Indonesia has recovered economic stability and has shown some signs of growth, further investment expansion is an urgent issue since the investment/GDP ratio has not yet recovered to the 1997 level, and export growth has remained sluggish.

This paper discusses the recent macroeconomic development in Indonesia, which, as mentioned above, is under the process of transition to a new stage, and reviews the country's MTDP with its impact on public debt sustainability. The Indonesian government requested the rescheduling of its debt from its Paris Club creditors after the financial and currency crisis, and while the consolidation period of the rescheduling was terminated at the end of 2003, there have basically been no subsequent problems servicing its external debt.[2] Meanwhile, according to the MTDP, the government aims to decrease the public debt outstanding by further reduction of the fiscal deficit that will allow the country to weather any future external shocks. However, government expenditures may increase over the medium term since the government needs to secure financial resources to actively carry out the MTDP. The administration is recommended to pursue a balanced fiscal polic, aiming at effective implementation of the MTDP while maintaining public debt sustainability.

Chapter 1 overviews the recent macroeconomic development in Indonesia, Chapter 2 describes the outlines of the MTDP, Chapter 3 discusses public debt sustainability, and finally Chapter 4 concludes the paper.

Chapter 1: Recent Macroeconomic Development

1. Growth

Real GDP growth rate was 5.1% in 2004, which was the highest since the 1997 financial and currency

Table 1. Gross Domestic Products

	2001	2002	2003	2004
		(%)		
Real GDP growth rate	3.8	4.4	4.9	5.1
Demand [1/]				
Consumption	2.6	3.2	3.1	3.1
Private	2.2	2.4	2.4	3.0
Public	0.5	0.9	0.7	0.1
Gross fixed capital formation	1.3	1.0	0.2	3.1
Inventory increase/decrease	0.5	-2.0	-1.2	2.8
Net exports	-1.0	0.8	2.3	-3.6
Export	0.3	-0.5	3.1	3.3
Import	-1.3	1.3	-0.8	-6.9
Statistical discrepancy	0.4	1.4	0.4	-0.4
Production [1/]				
Agriculture	0.6	0.5	0.7	0.6
Mining	0.0	0.1	-0.1	-0.5
Manufacturing	0.9	1.5	1.5	1.7
Electricity/gas/water	0.0	0.1	0.0	0.0
Construction	0.3	0.3	0.4	0.5
Trade/hotels/restaurants	0.7	0.6	0.9	0.9
Transportation/communications	0.4	0.4	0.6	0.7
Financing	0.5	0.5	0.6	0.7
Services	0.3	0.3	0.4	0.4

1/ Rates of contribution of each item to the real GDP growth rate.
Source: BPS

2 In 2005, Indonesia decided to accept the moratorium that the Paris Club creditors offered relating to the 2004 Indian Ocean earthquake and tsunami, but this was granted on an exceptional basis as humanitarian and reconstruction assistance.

crisis (see Table 1). Consumption continued to play a leading role in economic growth with a contribution rate of 3.1%, and the contribution rate for fixed capital formation (investment) was also 3.1%, the highest in recent years. However, the methodology of reporting foreign trade data was changed in 2004, which resulted in overestimation of the growth rate of exports and imports in 2004.[3] Since investment is estimated partially by using the data on the import of capital goods, its change may also be overestimated. It is quite difficult to identify the extent to which such overestimations are made. However, as described later, it appears that, after such overestimations are corrected, investment has grown, while exports (especially non-oil/gas export) have not grown in 2004. With regard to industrial production, the contribution of the manufacturing industries (especially the transportation equipment and chemical product industries) to economic growth was high, and that of trade, hotels, restaurants, transportation, communications, and finance, follow them.

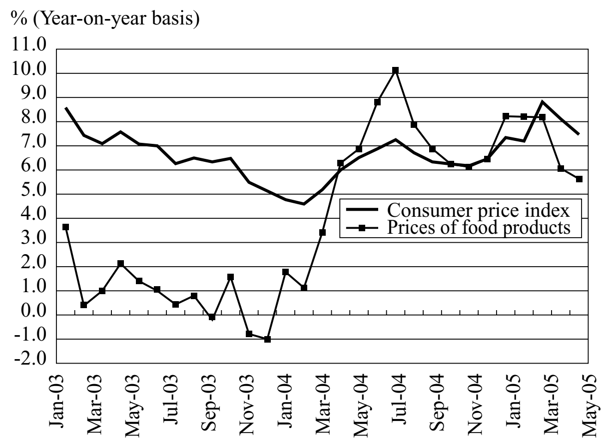
2. Inflation and monetary policy

The change in the consumer price index (CPI) increased from a little less than 5% in February 2004 compared to the same month in the previous year to a little more than 7% in July 2004 (see Figure 1). Although it decreased slightly after that, it once again increased to a little more than 7% in January 2005. Especially food products such as cereals, meat, spices, etc., contributed to these price increases. The prices of fuel products were raised by an average of 29% on March 1, 2005,[4] which helped to lift the change in the CPI in March to 8.8%. However, "second-round effects," such as wage increases resulting from price increases, have not been observed so far, and the change in the CPI for April was 8.1% and went down to 7.4% in both May and June.

The government's monetary policy was somewhat eased between the end of 2003 and early 2004, but it was slightly tightened again in June 2004 by raising the reserve requirement from 5% to 8%. The interest rate of one-month SBIs (Sertificat Bank Indonesia, or central bank bills) fell to 7.34% in April 2004, but after that it bottomed out. Deposit interest rates also showed a downward trend until March 2004, but after that they rose slightly[5] (see Figure 2). Lending interest rates continued to fall through late 2004. It is pointed out that this happened because bank lending expanded in late 2004, and competition among banks was intensified.

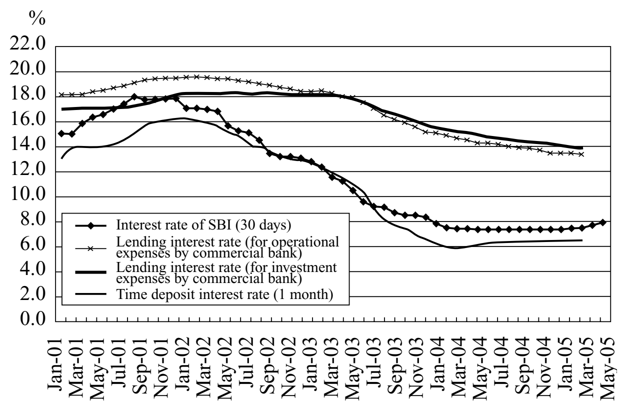
In May 2004, the rupiah rapidly declined against

Figure 1. Inflation Rate



Source: CEIC

Figure 2. Interest Rate



Source: CEIC

3 More precisely, the export and import data used to be reported with hard copy, but data have been reported with electronic files since January 2004 as for import, and since May 2004 as for export. This has resulted in the expansion of the coverage of export and import data.

4 The administration raised the prices of fuel products (marine fuel oil, industrial fuel oil, gasoline, etc.), excluding kerosene for home use, in order to reduce the fuel subsidy.

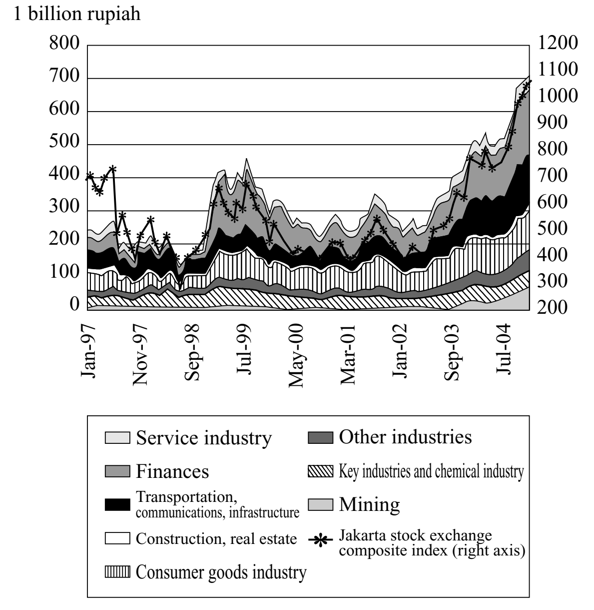
the US dollar along with other Asian currencies. However, it began to appreciate in early July as the outcome of the first presidential election became clear, afterward hovering between 9,000 and 9,400 to the dollar (see Figure 3). Since the volume of transactions in the Indonesian foreign exchange market is not large, the rupiah fluctuates more widely than the currencies of its neighboring countries. The rupiah has weakened since March 2005, reaching 9,700 to the dollar at the end of April. The weakening of the rupiah was pointed out to be triggered by the worsening of inflation and increased oil imports by Pertamina, Indonesia's state oil firm, in March. With the currency weakening and the rising of interest rates in the United States, Bank Indonesia increased the number of auctions for SBI (bills) from twice a month to once a week to absorb liquidity in the market and raised the interest rate of one-month SBIs to 8.44% in early July. The rupiah, after slightly strengthened, depreciated to around 9,800 to the dollar in early July.

Stock prices steadily rose in 2003 and also saw a similar trend in 2004. Even after the Indian Ocean earthquake, they have continued rising (see Figure 4). Stocks actively traded are those of financial institutions (especially banks), companies related to infrastructure (especially communications companies), etc., and the total market capitalization of all listed stocks almost tripled from 231 trillion rupiahs in January 2003 (a little more than 10% of GDP) to 730 trillion rupiahs at the end of 2004 (about 30% of GDP).

Figure 3 Nominal Exchange Rate

Source: Bloomberg

Figure 4. Total Market Value of Listed Stocks and Stock Exchange index



Source: Bloomberg

3. Fiscal Policy

In 2004, government revenue increased more than government expenditures, the budget deficit declined from 1.8% of GDP in 2003 to 1.2% of GDP in 2004 (see Table 2). Total revenue increased from 16.7% of GDP in 2003 to 17.7% of GDP in 2004, thanks to an increase in oil and gas related revenues resulting from the upsurge in oil prices in 2004. Current expenditures increased from 9.3% of GDP in 2003 to 10.3% of GDP in 2004 due to the increase in the fuel subsidy resulting from the oil price surge, which offset the reduction of interest payments entailed by the decline of interest rates. Even so, overall expenditures grew to 18.9% of GDP, up only by 0.4%

35 The decline in the lending interest rates was slower than that in the deposit interest rates in 2003, which may be reflected by the following factors. At that time, there was a strong incentive for banks to maintain high interest spreads as it would allow them to improve their financial positions such as increase their capital. Also there was less competition among banks to cut lending interest rates since banks did nothing, but kept a large volume of government securities on their own, which means there were not many opportunities to expand new credits.

Table 2. Government Operations

	2001	2002	2003	2004 Amended budget
	(in percent of GDP)			
Total revenues	16.1	16.7	17.9	18.7
Oil/gas revenue	4.1	3.9	4.7	5.6
Non-oil/gas revenue	11.9	12.7	13.0	12.9
Tax revenue	10.4	10.9	11.2	11.5
Nontax revenue	1.6	1.8	1.8	1.4
Grant	0.0	0.0	0.0	0.3
Total expenditures	17.6	18.5	18.9	19.5
Central government expenditures	12.3	12.6	13.3	13.9
Current expenditures	10.2	9.3	10.3	12.0
Personnel/material expenses	2.8	3.1	3.1	3.7
Subsidies	2.1	2.1	3.7	3.7
Interest payment	4.8	3.4	2.7	2.2
Others	0.4	0.7	0.9	2.4
Expenditures related to Aceh	—	—	—	0.5
Capital expenditure	2.2	3.3	3.0	1.9
Transfer to local governments	5.3	5.9	5.6	5.6
Primary balance	3.3	1.5	1.5	1.5
Fiscal balance	-1.5	-1.8	-1.2	-0.8
Finances	1.5	1.8	1.2	0.8
Domestic finances	1.1	1.7	1.9	1.1
External finances	0.4	0.2	-0.6	-0.3

Source: Indonesian Government, the author estimates

from the previous year because the capital expenditures and the transfer to local governments were reduced.

The amendments to the budget for 2005, which were approved by the parliament in June 2005, aimed to curtail the budget deficit to 0.8% of GDP as the original budget did.[6] The amended budget has incorporated the reduction of the fuel subsidy resulting from the increase in fuel prices. However, the assumption of the oil price was raised from 24 dollars per barrel indicated in the original budget to 45 dollars per barrel, thus the subsidy in the amended budget has been 3.6% of GDP, which is slightly less than the subsidy in the original budget. Moreover, the amended budget allocated 0.5% of GDP for the reconstruction from the earthquake and tsunami disaster and incorporated the assistance from the donor community pledged in January 2005, as well as the moratorium that the Paris Club creditors offered with respect to the tsunami damage. With those amendments, government revenues and expenditures are expected to be 18.6% and 19.3% of GDP, respectively.

4. External Sector

The trade surplus recorded 21.2 billion (8.2% of GDP) in 2004. The trade surplus was smaller in 2004 than in 2003, while it may be difficult to accurately compare 2004 with the previous year as the data reporting methodology for export and import data has been changed as mentioned above (see Table 3). The trade surplus was underestimated as the data reporting methodology was changed for exports and subsequently changed for imports. Though, statistically, exports were larger than that in 2003 by 12% (oil/gas export and non-oil/gas export increases over the previous year of 15.9% and 10.7%, respectively), and imports in 2004 were larger than that in 2003 by 27.8% (oil/gas import and non-oil/gas import increases of over the previous year of 24.2% and 42.7%, respectively), exports may have shown no actual growth from the previous year considering the

Table 3. Balance of Payments

	2003	2004	2005 Forecast
	(US $ billion)		
Current account	8.11	2.88	2.97
Trade balance	24.56	21.23	21.93
Export	64.11	71.78	80.65
Oil/gas	15.23	17.66	22.69
Non-oil/gas	48.88	54.13	57.96
Import	39.55	50.55	58.72
Oil/gas	7.82	11.17	14.98
Non-oil/gas	31.72	39.39	43.75
Services balance	-11.73	-11.20	-11.97
Income balance	-6.22	-8.33	-8.64
Current transfers	1.49	1.18	1.66
Capital balance	-3.18	2.24	2.75
Direct investment	-0.60	1.04	1.27
Portfolio investment	2.25	2.79	2.74
Others	-4.83	-1.60	-1.26
Government borrowing	1.84	2.38	2.90
Government repayment	-5.27	-5.19	-4.57
Others	-1.40	1.21	0.40
Errors and omissions	-4.33	-3.90	-2.75
Overall balance	0.60	1.21	2.97
Financing	-0.60	-1.21	-2.97
Change in gross foreign reserves (-:increase)	-4.26	-0.02	0.21
Reference:			
Gross foreign reserves (US $ billion)	36.3	36.3	36.1
(in months of import)	7.7	5.6	5.0
Current account/GDP	3.4	1.1	1.1
Trade balance/GDP	10.3	8.2	8.0
Capital balance/GDP	-3.1	-0.6	0.0
Debt services ratio(cash basis)	32.0	30.0	20.5

Source: Indonesian Government, the author estimates.

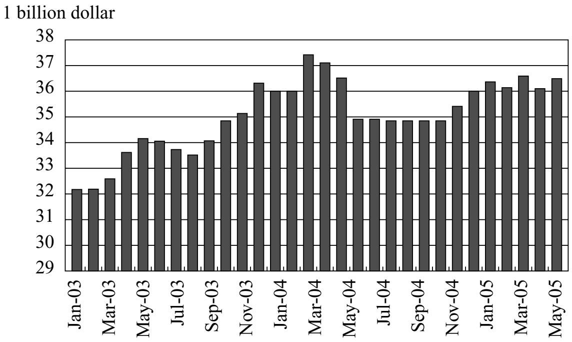
6 Under the former administration, the original budget for 2005 was approved by the parliament in September 2004.

10%-20% expansion of data coverage resulting from the change in the data reporting methodology.

The current account surplus shrank from 8.1 billion dollars in 2003 (3.4% of the GDP) to 2.9 billion dollars (1.1% of the GDP) in 2004 as a result of the smaller trade surplus mentioned above and the deteriorating income balance. The income balance was deteriorated because, as a result of the upsurge of oil prices, profit remittance relating to the development of oil sites by foreign capital increased. However, the trade surplus was underestimated due to the changes in the data reporting methodology mentioned above, and the current account surplus also seems to have been underestimated.

The capital account improved from a deficit of 3.2 billion dollars in 2003 to a surplus of 2.2 billion dollars in 2004 because of the increase in the government borrowing, and an inflow of portfolio investment, even though public debt repayment began as a consequence of the ending of the Paris Club rescheduling at the end of 2003. The foreign reserves declined slightly due to an intervention in the exchange market when the exchange rate depreciated in May 2004, but since then they have showed a gradual recovery and reached 36.4 billion dollars (equivalent to imports for 5.6 months) in May 2005 (see Figure 5).

Figure 5. Grass Foreign Reserves



Source: CEIC

Chapter 2: Medium-term Development Plan

1. Outline of the Medium-term Development Plan

The Yudhoyono administration announced the MTDP (2004-2009) in January 2005. While the MTDP appreciated what the previous five-year plan (PROPENAS 1999-2004) had achieved, it spells out that further reform would be needed for (i) "establishing democracy and justice for all," (ii) "creating an Indonesia that is safe and peaceful," and (iii) "improving prosperity" economically and socially, and thus it set those three goals as main agendas for the MTDP. More specifically, first of all, to establish democracy and justice in Indonesia, the MTDP aims at intensifying efforts to improve the judicial systems, establish the rule of law, and eliminate corruption, and thus to establish government trusted by the people. Secondly, to create a safe and peaceful society, the administration aims at eradicating regional conflicts, conventional crimes, smuggling, and terrorism; fostering public awareness to protect the safety and peace of civil society; and strengthening state institutions maintaining law and order such as the police and military forces. Finally, to build an economically and socially prosperous country, the MTDP aims at further expansion of investment and exports, which have been sluggish so far, and of economic growth together with job creation and poverty reduction. As an issue commonly associated with these three agendas in the MTDP, the administration intends to strengthen the role of civil society (the private sector) in politics, the policy-making processes, and economic activities.

Particularly in the third agenda, that of building an economically and socially prosperous country, the government will decisively implement policies for macroeconomic stability, including the reduction of the fiscal deficit, while it will also strengthen industrial competitiveness and promote investment and exports, in order to achieve economic growth with enough job creation. The government, considering that economic growth must be accompanied by poverty reduction, will also implement measures to reduce poverty over the medium and long term. The MTDP, with these policy targets, aims at achieving an annual economic growth rate of 6% to 7% and reducing the unemployment rate and poverty rate from their respective current 10% and 16% to 5% and 8% in 2009. To achieve these goals, the economic policies in the MTDP focus on (i) macro-economic stability, (ii) the improvement of the business climate, and (iii) the revitalization of the agriculture, forestry, and fisheries industry, while enhancing social policies in the area of education and health.

More specific goals for the economic policies, especially for macro-economic stability and the improvement of the business climate, are as follows:

(1) Macro-economic Stability

(i) Inflation: to stay at around 5%

(ii) Fiscal policy: to achieve a balanced budget by 2009 and reduce the public debt to 32% of GDP by 2009

(iii) Reform of the financial sector: to establish a prudential supervisory agency (OJK) and a deposit insurance scheme and to foster non-bank financial institutions (e.g., mutual funds, pensions, and insurance companies)

(2) Improvement of business climate

(i) The reduction in the transaction costs for doing business and barriers to entry (including a reduction in the number of business permits/licenses, simplification and transparency of procedures related to the tax administration, and early enactment of a new investment law)

(ii) To reduce the time period for duty and VAT rebates with a view to promoting exports

(iii) To foster small/medium-sized enterprises (e.g., improve access of small/medium-sized enterprises to credit and technical assistance)

(iv) Labor market reform (e.g., the improvement of costly labor regulations and the improvement of regulations related to labor disputes)

(v) The development of infrastructure (e.g., water supplies, transportation (roads, railroads, ports, and airports), and energy supplies)

(3) Revitalization of the agriculture, forestry, and fisheries industry

(i) Support for farmers: to facilitate access to financial resources

(ii) Development of rural infrastructure: roads, irrigation, etc.

(iii) Development of agro-business: removal of entry barriers

2. Effectiveness and Feasibility of the Medium-term Development Plan

(1) Effectiveness of the Agendas in the MTDP

For Indonesia's economy to grow further, government policy should focus on (i) strengthening industrial competitiveness and expanding exports (especially non-oil/gas exports) over the medium and long-term future; (ii) creating job opportunities and reducing poverty by achieving a high level of economic growth; and (iii) easing the debt service burden by reducing the public debt and shifting the government's spending toward poverty reduction measures, etc. To strengthen industrial competitiveness, investment expansion is essential, and improving the investment climate, as well as the effectiveness of governance, is needed. The budget deficit needs to be reduced further by boosting tax revenues, and the expenditure policy needs to be reviewed, such as cutting down the fuel subsidy, etc. The MTDP adequately points out the critical economic challenge that Indonesia faces, thus the agendas set in the MTDP are appropriate. Nevertheless, some criticize that there is nothing new in the MTDP as many of the policy directions in the MTDP were also addressed in the previous five-year plans.

In terms of the business climate, as indicated in the World Bank's "Doing Business in 2004," Indonesia is ranked lower than other countries in the region with regard to the number of procedures, the time and the cost of investment applications, as well as the employment climate index, etc. As the donor community and investors have often underscored the importance of the agendas and specific objectives mentioned above, these agendas and objectives seem proper. As for labor market reform, the labor cost has been increasing along with an increase in wages in recent years, and thus the competitiveness of various industries, especially that of labor-intensive industries, has been weakened. After the fall of the Suharto administration, Indonesia shifted policies toward worker protection: enacting a new trade unions law in 2000, promoting the independence of trade unions; and enacting a new labor law in 2003, focusing on the protection of workers. However, the labor market is now rigid due to the strengthening of workers' rights, and thus labor market reform, shown in the MTDP, is critical especially through deregulation.

(2) The Macroeconomic Framework

The MTDP aims at raising the real GDP growth rate to 7.6% by 2009. To achieve this target, investment is expected to increase from 19% of GDP in 2004 to 29% of GDP in 2009, and exports are expected to increase by 6% to 10% each year (see Table 4). However, because it is anticipated that the exchange rate will rise to 8,700 rupiahs to the dollar on a nominal basis by 2009, and that, even on a real basis, it will appreciate about 15% in those five years, competitiveness needs to be strengthened to a considerable extent by reducing production costs, etc., so that the export growth mentioned above can be achieved. Though the government assumes the increase of non-traditional exports, such as machinery and chemical products, as well as the increase of traditional labor-intensive exports, such as textiles and footwear, further direct investment needs to be attracted from abroad by improving the business climate to a considerable extent so that new industries can be more competitive. Since improving the business climate requires judicial reform, elimination of corruption, etc., which will take time to be accomplished, considerable effort will be needed to realize the macro framework mentioned above.

The government aims to improve the fiscal balance, from a deficit of 0.7% of GDP in 2005 to a surplus of 0.3% in 2009, by increasing revenue by 1.6 percentage points from 2005 to 2009 mainly through improvement of the tax administration and by containing expenditure expansion up to 0.6 percentage points on a net basis through cutting

Table 4. Macroeconomic Framework in the Medium-term Development Plan

	2005	2006	2007	2008	2009
	(annual percentage change, unless otherwise indicated)				
Real GDP growth rate	5.5	6.1	6.7	7.2	7.6
Consumption	4.1	5.2	5	5.8	6.3
Investment	14.6	17.8	16.3	14.3	12.8
Export	5.7	6	6.4	7.4	10.1
Import	10.3	8.6	10.2	10.8	11
Inflation rate	7	5.5	5	4	3
Nominal exchange rate (rupiah/U.S.dollar)	8900	8800	8800	8700	8700
Change in real exchange rate (-: appreciation)	-4.5	-4.3	-2.8	-2.9	-0.9
	(in percent of GDP)				
Investment	21	23.1	25.3	27.1	28.5
Public	3.4	3.6	3.6	3.8	4.1
Private	17.6	19.5	21.7	23.3	24.4
Savings	22.7	23.6	25.5	27	28
Savings-investment gap	1.6	0.6	0.1	-0.2	-0.5
Revenue	14.5	14.9	14.9	15.3	16.1
Tax revenue	11.4	11.6	11.9	12.6	13.6
Others	3.1	3.3	2.9	2.6	2.4
Expenditures	15.2	15.5	15.2	15.3	15.8
Central government	10.2	10.1	9.8	9.6	9.6
Transfer to local governments	5	5.4	5.4	5.7	6.2
Fiscal balance	-0.7	-0.6	-0.3	0	0.3
Finance	0.7	0.6	0.3	0	-0.3
Domestic	1.4	1.1	0.8	0.4	0.1
Foreign	-0.8	-0.5	-0.5	-0.4	-0.4
Public debt	48	43.9	39.5	35.4	31.8
Foreign	21.6	19.3	16.7	14.4	12.6
Domestic	26.3	24.6	22.8	21	19.2

Source: Inclonesin's government

central government expenditures (0.6% of GDP) and the expanding transfer to local governments (1.2% of GDP). However, this revenue and expenditure outlook, which is based on the assumed oil price of 28 dollars per barrel, will vary in accordance with actual oil price developments. Moreover, the challenge is to achieve such a level of revenue expansion (2.2% of GDP with regard to tax revenues) only by improving the tax administration. Since the tax reform laws drafted under the former government, which the present government is reviewing, focuses on raising the personal taxable income threshold, introduction of a tax amnesty, gradual reduction of customs duties, etc., tax revenues can decline at least in the short term. The government intends to make tax collection more effective by simplifying the corporate income tax, improving the VAT refund procedure, etc. However, these measures alone may not likely generate the increase in tax revenues as mentioned above. Expenditures may be cut to a certain degree through the reduction of the fuel subsidy if oil prices go down as assumed in the MTDP, but implementation of the MTDP will require fiscal costs, such as security and military expenses, judicial system-related expenses, poverty reduction-related expenses, etc.

(3) Challenges for the Future

As mentioned above, in order to achieve these three agendas of the MTDP, the government intends to strengthen the role of civil society, and it needs to convince the people of the MTDP's progress in order to retain their support for it. While the MTDP covers five years, BAPPENAS is now making annual plans with a policy matrix that shows specific measures to be taken and the timing for their implementation. The point is how well BAPPENAS can present effective and practical measures. For the 2005 annual plan, only minor modifications are added to the plan made by the former government, while the 2006 annual plan was finalized in June after conducting public hearings.

Another important point is that the government must secure the financial resources necessary to implement the MTDP. The government apparently has not calculated in detail the fiscal costs necessary for the implementation of the MTDP, thus the fiscal outlook mentioned above may change depending on those costs. It is important to calculate the fiscal costs (e.g., security/military expenses, judicial system-related expenses, poverty reduction-related expenses, infrastructure improvement expenses) necessary to implement the MTDP precisely and to create a realistic financing plan. If a realistic financing plan is not developed, the implementation of the 5-year plan may be delayed.

Chapter 3: Public Debt Sustainability

1. Public Debt after the Asian Financial and Currency Crisis

The outstanding public debt rose to a little more than 90% of GDP in 1999. A large amount of government securities was issued to recapitalize banks affected by the Asian financial and currency crisis, while the foreign debt swelled compared to GDP due to the rapid depreciation of the exchange rate (see Table 5). The domestic debt expanded rapidly from 11% of GDP in 1998 to 47% of GDP in 1999, while foreign debt expanded from 23% of GDP in 1997 to 47% of GDP in 1999. Meanwhile, the face value of foreign debt increased only from 50.9 billion dollars in 1997 to 65.6 billion dollars in 1999, while the exchange rate depreciated sharply from 2,890 rupiahs to the dollar in 1997 to 7,848 rupiahs to the dollar in 1999.

The outstanding public debt has gradually decreased since 1999 to 57% of GDP in 2004. New issuance of government securities has been withheld since 2001, and the nominal GDP expanded more rapidly, thus domestic debt declined in relation to GDP. Foreign debt has continued declining since 1999 because, while an increase of nominal foreign debt stayed low, the nominal GDP expanded.

This public debt decline was made possible by the continued primary surplus of Indonesia's fiscal position. The stability of the public debt in relation to GDP depends on the primary fiscal balance, as well as nominal interest rate, nominal GDP growth rate, etc. If the primary fiscal balance deteriorates, or the nominal interest rate greatly exceeds the nominal GDP growth rate, the outstanding public debt will expand in relation to GDP. In the case of Indonesia, the primary fiscal balance has been surplus even after the Asian financial and currency crisis. On the other

Table 5. Public Debt Development

	1997	1998	1999	2000	2001	2002	2003	2004	2005
	(in percent of GDP, unless otherwise indicated)								
Public Debt	…	72.8	93.3	87.8	80.4	71.9	63.2	56.9	51.2
Domestic debt	…	10.6	46.5	49.1	42.5	39.0	32.9	29.0	25.8
Percentage point of change [1/]	…	…	35.9	2.6	-6.7	-3.5	-6.1	-3.8	-3.2
(factors)									
Public domestic debt[2/]			37.3	12.3	1.9	0.6	-2.7	-0.2	0.1
Nominal GDP[2/]			-1.4	-9.7	-8.6	-4.1	-3.5	-3.7	-3.3
Foreign debt[3/]	23.4	62.2	46.8	38.7	37.9	32.9	30.3	27.9	25.3
Percentage point of change [1/]	-0.7	38.8	-15.4	-8.1	-0.7	-5.0	-2.6	-2.4	-2.6
(factors)									
Public foreign debt [4/]	-2.0	7.9	5.2	-1.0	-1.0	1.8	2.7	-0.2	-0.8
Nominal exchange rate [4/]	5.0	39.0	-12.5	2.6	7.0	-3.1	-2.4	1.1	1.4
Nominal GDP [4/]	-3.7	-8.0	-8.1	-9.8	-6.8	-3.6	-2.9	-3.4	-3.2
(Reference)									
Public domestic debt (in trillion rupiah)	…	101.2	511.2	682.7	715.2	726.5	672.1	668.6	672.0
Public foreign debt (US$ billion)	50.9	58.2	65.6	63.9	62.3	65.8	72.3	71.9	69.7
Nominal exchange rate (rupiah/US$: period average)	2,890	10,210	7,848	8,405	10,256	9,316	8,577	8,939	9,450
Nominal GDP (in trillion rupiah)	628	956	1,100	1,390	1,684	1,863	2,046	2,303	2,600
Nominal GDP growth rate (y)	17.9	52.3	15.1	26.4	21.2	10.6	9.8	12.6	12.9
Nominal interest rate (r)[5/]	…	…	6.1	4.9	7.1	6.6	5.1	4.8	5.0
Primary fiscal deficit (d) (-: surplus)	-2.8	-1.3	-1.4	-2.7	-2.8	-3.3	-1.5	-1.5	-1.3

1/ The percentage point of change is a result of calculating the increase/decrease of domestic and foreign debts in relation to GDP.
2/ If DDt is the domestic debt outstanding and Yt is the nominal GDP, then the following expression holds:

$$\Delta\frac{DD_t}{Y_t}=\frac{1}{Y_t}\Delta DD_t+DD_{t-1}\Delta\left(\frac{1}{Y_t}\right)$$

In this equation, the first term is a factor arising from the change in public domestic debt, the second term a factor arising from the change in the nominal GDP. The magnitude of each factor is calculated in this table.
3/ Foreign debt includes foreign bonds.
4/ If EDt is the foreign debt outstanding and et is the nominal exchange rate, then the following expression holds:

$$\Delta\frac{ED_t e_t}{Y_t}=\frac{e_t}{Y_t}\Delta ED_t+\frac{ED_{t-1}}{Y_t}\Delta e_t+ED_{t-1}e_{t-1}\Delta\left(\frac{1}{Y_t}\right)$$

In this equation, the first term is a factor arising from the change in public foreign debt, the second term a factor arising from the change in the nominal exchange rate, and the third term a factor arising from the change in the nominal GDP. The magnitude of each factor is calculated in this table.
5/ The nominal interest rate was calculated from the interest payments in the government expenditures and the outstanding public debt in the previous years.
Source: the Indonesian government, IMF, and the author estimates

hand, the nominal GDP growth rate has been high due to inflation, while relatively low interest has been imposed on the public debt. Therefore, public debt in relation to GDP has continued to decline.

2. Sustainability of the Medium-term Development Plan, Fiscal Policy, and Public Debt

Though public debt in relation to GDP is on a downward trend, the public debt sustainability may be affected by the MTDP. As mentioned above, the government aims to achieve a balanced budget by 2009 within the macroeconomic framework indicated in the MTDP. However, if it requires fiscal costs to implement the MTDP, whether or not a balanced budget can be achieved in 2009 depends on the extent to which the MTDP can be implemented.[7] It is quite difficult to precisely predict to what extent the current Yudhoyono administration will implement the MTDP, but the fact that the government has correctly handled various tasks after the Indian Ocean earthquake, when the government raised the fuel price in March 2005 without significant disorder, and that it is boldly tackling the corruption issue involving the governor of Aceh Province, may provide some promise that some success with the MTDP can be achieved.

To examine future public debt sustainability, a macroeconomic scenario will be presented with the assumption that the Yudhoyono administration will achieve some success with the MTDP. Given the assumed success, the investment climate will see

7 Some of the goals set by the Medium-term Development Plan can be accomplished by improvement of the efficiency of government business. However, in general, there is a high possibility that security/military expenses, judicial system-related expenses, expenses for poverty counter-measures, and expenses for infrastructure improvement, will increase.

Table 6. Medium-term Macroeconomic Outlook (2001 - 2009)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
				Prelim.			Projection		
Growth, Price, Savings, Investment				(y/y, %, unless otherwise indicated)					
Real GDP growth rate	3.8	4.4	4.9	5.1	5.5	5.6	5.7	5.8	5.9
Inflation rate (average)	11.5	11.9	6.6	6.1	7.0	6.0	5.5	4.5	3.5
Exchange rate (average, rupiah/dollar)	10,256	9,316	8,577	8,939	9,450	9,746	10,120	10,408	10,574
					(in percent of GDP)				
National savings	23.4	22.9	22.3	22.1	23.3	23.0	22.8	23.0	23.3
Investment	19.2	19.0	18.9	21.0	22.2	22.3	22.6	23.0	23.5
Fiscal					(in percent of GDP)				
Revenue and grant	17.9	16.1	16.7	17.7	18.3	17.6	17.1	16.7	16.7
Tax revenue	11.0	11.3	11.8	12.2	12.6	12.4	12.4	12.5	12.5
Others	6.9	4.8	4.9	5.5	5.7	5.2	4.7	4.3	4.1
Expenditures	20.3	17.6	18.5	18.9	19.2	18.6	18.1	17.7	17.6
Central government	15.5	12.3	12.6	13.3	13.2	12.8	12.5	11.9	11.7
Transfer to local government	4.8	5.3	5.9	5.6	5.9	5.8	5.6	5.7	5.9
Primary balance	2.8	3.3	1.5	1.5	1.3	1.3	1.0	0.8	0.6
Fiscal balance	-2.4	-1.5	-1.8	-1.2	-0.9	-1.0	-1.0	-0.9	-0.9
Financing	2.4	1.5	1.8	1.2	0.9	1.0	1.0	0.9	0.9
Foreign (net)	0.6	0.4	0.2	-1.0	-0.4	-1.2	-0.8	-0.5	-0.3
Domestic (net) 1/	1.8	1.1	1.7	2.2	1.3	2.2	1.8	1.4	1.2
Public debt	80.4	71.9	63.2	56.9	51.2	46.7	42.8	39.4	36.4
Domestic debt	42.5	39.0	32.9	29.0	25.8	24.1	22.2	20.2	18.6
Foreign debt 2/	37.9	32.9	30.3	27.9	25.3	22.5	20.7	19.2	17.8
Monetary					(an average in the period, %)				
Interest rate of SBI (1 month)	16.6	14.9	9.9	7.4	8.5	8.0	7.3	6.5	5.5
External					(y/y, %)				
Exports	-12.3	3.1	8.4	12.0	12.3	2.4	3.7	4.4	6.3
Imports	-14.1	2.8	10.9	27.8	16.2	2.9	6.5	6.6	8.4
					(in percent of GDP; unless otherwise indicated)				
Trade balance	13.8	11.8	10.3	8.2	8.0	7.4	6.7	6.0	5.6
Current account	4.2	3.9	3.4	1.1	1.1	0.7	0.2	0.0	-0.2
Gross foreign reserves (US$ billion)	28.0	32.0	36.3	36.3	36.1	35.5	36.4	38.1	40.9
Gross foreign reserves (in months of import)	6.7	7.4	7.7	5.6	5.0	4.8	4.7	4.7	4.7
Foreign Public debt (US$ billion)	71.4	74.7	81.7	80.3	77.3	74.0	72.0	70.6	70.1
Foreign public debt 3/	43.5	37.3	34.2	31.2	28.1	24.8	22.5	20.5	18.8
Debt service ratio	36.0	31.2	32.0	30.0	20.5	23.4	21.7	21.1	19.7

1/ This includes foreign bonds in accordance with the government classification.
2/ This excludes the obligation to IMF, but includes foreign bonds.
3/ This includes the obligation to IMF.
Source: the Indonesian government, and the author estimates

some improvement, investment will expand at 6%-8% per annum, and real GDP growth will reach nearly 6% in 2009 (see Table 6). Exports, primarily non-oil/gas exports, will also rise at 3%-5% per annum by volume, and imports will rise at 5%-6% per annum by volume as a result of the investment expansion. The current account will register a surplus of 1.1% of GDP in 2005, but then the surplus will gradually decline, and from 2008, the current account will run into deficit.

In terms of fiscal policy, personnel/material expenditures, capital expenditures, etc., will slightly rise in relation to GDP with a successful implementation of the MTDP. The oil price will rise to 43 dollars per barrel in 2006, but then it will decline to 38 dollars per barrel in 2009.[8] Revenue as a whole will decline from 18% of GDP in 2005 to 17% of GDP in 2009 on the assumption that tax revenues from non-oil/gas products will slightly expand by strengthening the tax administration. Assuming no major changes in the fuel subsidy policy, the expenditure will decline to 17%-18% of GDP in 2009 as the fuel subsidy decreases in line with the reduction of oil prices, and interest payment will

8 The oil price forecast mentioned above is in line with the IMF's "World Economic Outlook, April 2005."

diminish, reflecting the reduction of the public debt. As a result, the fiscal deficit will expand to 1.0% of GDP in 2006, and after that will level off at 0.9%. Therefore, the budget, contrary to the government's forecast, will not be balanced in 2009.

With this macroeconomic outlook, the public debt will decline from 51% of GDP in 2005 to 36% of GDP in 2009. This decline reflects the assumptions that the primary fiscal balance will be a surplus and that the nominal GDP growth rate remains at a higher level than the nominal interest rate. The real GDP growth rate rises to about 6% with successful implementation of the MTDP. The reduction of the public debt drops the ratio of interest payments to revenue from 13% in 2005 to 8% in 2009 and the revenue for debt servicing to revenue from 20% in 2005 to 18% in 2009.

3. Financing Needs and Strategies

Financing of the deficit should be analyzed in order to address public debt sustainability. The financing needs, defined as the sum of fiscal deficit and debt amortization, were 4.4% of GDP in 2003 and 4.5% of GDP in 2004. (Table 7) These needs were financed in 2003 by the Paris Club rescheduling (1.2% of GDP), recovery of bank assets (1% of GDP), etc., but increased the dependence on government securities (1.4% of GDP) and domestic bank finances[9] (1.1% of GDP). While the financing needs will be reduced in 2005, it is estimated that finance through government securities will increase to 1.7% of GDP, while financing through recovery of bank assets will decline to 0.1%-0.2% of GDP. Meanwhile, a tsunami-related moratorium (principal only, 0.6% of GDP) will be granted by the Paris Club creditors.

After 2006, the moratorium by the Paris Club will not be granted, and the recovery of bank assets will decline. Therefore, dependence on government securities will further increase. The financing needs will slightly decrease from 3.4% of GDP in 2005 to 3.2% of GDP in 2009, and the issuance of government securities will remain at more than 2% of GDP until 2009. The government intends to reduce the fiscal deficit, squeeze the financing needs, and issue government securities while fostering their secondary markets. As budgeted, foreign bonds worth 1 billion US dollars were issued in April 2005, and also domestic bonds worth 13 trillion rupiahs were issued between January and April 2005.[10] Since interest rates are on an upward trend, it is somewhat difficult to decide when domestic bonds should be issued, and thus an issuance of domestic bonds in March was postponed. However, since the volume of domestic bonds bid exceeded the volume targeted at

Table 7. Financing Needs for Fiscal Policy and Trend of Finance Strategy

	2001	2002	2003	2004	2005	2006	2007	2008	2009
				Prelim.	Amended budget	Projection			
									(in percent of GDP,%)
Financing needs	4.9	3.8	4.5	4.4	3.6	3.5	3.4	3.3	3.2
Fiscal deficit	2.4	1.5	1.8	1.2	0.8	1.0	1.0	0.9	0.9
Amortization	2.5	2.3	2.7	3.1	2.8	2.7	2.5	2.5	2.4
Foreign	2.5	2.1	2.0	2.0	2.0	1.9	1.6	1.5	1.4
Domestic	0.0	0.2	0.7	1.1	0.8	0.8	1.0	1.0	1.0
Finance	4.9	3.8	4.5	4.4	3.6	3.5	3.4	3.3	3.2
Foreign finance	3.1	2.5	2.1	1.0	1.7	0.7	0.8	1.0	1.1
Reschedule/moratorium	1.6	1.4	1.2	0.0	0.6	0.0	0.0	0.0	0.0
Borrowing	1.6	1.0	0.9	1.0	1.1	0.7	0.8	1.0	1.1
Domestic finance	1.8	1.3	2.4	3.3	1.9	2.8	2.6	2.3	2.2
Domestic banks	-0.1	-0.2	0.5	1.1	0.0	0.0	0.0	0.0	0.0
Privatization rerenue	0.2	0.4	0.4	0.2	0.1	0.1	0.1	0.0	0.0
Recovery of bank assets	1.7	1.0	1.0	0.7	0.2	0.1	0.0	0.0	0.0
Government securities[1/]	0.0	0.1	0.6	1.4	1.7	2.6	2.5	2.3	2.1

1/ This includes foreign bonds in accordance with the government classification.
Souce: the Indonesian government, and the author estimates

9 In this context, domestic bank finances mean withdrawals from the government deposit account (investment funds accounts, etc.).

10 The government issues domestic bonds once a month, and according to the amendments to the 2005 budget, 33 trillion rupiahs worth of domestic bonds (1.5% of GDP) are expected to be issued.

the time of each issuance,[11] there is little concern over the demand for government securities.

The fostering of the secondary market for domestic bonds is still a challenge as banks hold about 70% of the total. Holders of domestic bonds have been diversified to a certain extent: mutual funds, growing rapidly these days, hold 14% of total domestic bonds outstanding; insurance companies hold 7%; pension funds 4%; foreign investors 4%, etc. To further develop the secondary market in the future, it is necessary to improve the information system as well as the infrastructure for trading, and the capital market supervisory agency (BAPEPAM) is now reviewing the regulations and systems for market improvement.

Conclusion

As mentioned at the beginning of this paper, Indonesia has been changing, both politically and economically. To maintain the momentum of these changes in order to achieve further economic growth in the medium term, the government must steadily implement the agendas specified in the MTDP. To this end, the government needs to secure the financial resources necessary to implement the MTDP, thus government expenditures may expand if the fiscal cost for the MTDP turns out to be larger than the expectation, or the achievement of the MTDP exceeds the assumed level. On the other hand, less implementation of the MTDP will reduce the pressure on government expenditures, but will delay the investment climate improvement and make the real GDP growth rate and export growth rate less than the assumption. The scenario exercise presented in this paper shows that the public debt will be reduced by 20 percentage points over the medium term. Although the government intends to balance the budget by 2009, it also needs to secure the financial resources for successful implementation of the MTDP.

However, there exist several risks associated with this scenario. First, the oil price may be different from what the government has projected. Not only does the oil price have an effect on revenues related to oil and gas, but it also has an effect on expenditures, specifically the fuel subsidy and the transfer to local governments. The net impact of an oil price increase on the budget was said to be neutral or somewhat negative but may be different as the prices of fuel product were raised in March 2005. Future impact is contingent on the future policy on fuel product prices. Second, the rupiah fluctuates more widely than the currencies of its neighboring countries, thus the economy may experience temporary instability caused by the exchange rate fluctuation. The government should implement careful fiscal management so that it can balance the targets of maintaining public debt sustainability and the sound implementation of the MTDP.

11 The volumes of bids for the January and February issuances were respectively 6 and 3 times as large as the initially targeted volumes, and the volume of bids for the April issuance again exceeded 1.6 times the volume initially targeted.

Reference

BAPPENAS (2005), Executive Summary of Indonesia's Medium Term Development Strategy 2004-2009.

International Monetary Fund (2005), "Indonesia: Report of the Post-Program Monitoring Discussions."

International Monetary Fund (2004), "Indonesia: Selected Issues."

International Monetary Fund (2005), "World Economic Outlook, April 2005"

Sri Mulyani Indrawati, Overview of Indonesia's Medium-term Development Plan 2004-2009, speech presented on January 19, 2005. http://www. bappenas.go.id/pnData/news/200501/01 Overview of RPJMN 2004-2009-CGI 2005-final.pdf

The Ministry of Finance of the Republic of Indonesia (2005), http://www.djapk.depkeu.go.id/

World Bank (2004), Doing Business, http://rru.worldbank.org/DoingBusiness/