

# INDONESIA

Amid slowing world trade and regional growth, the Megawati administration has inherited a fragile economy. Financial markets gave the new team a strong vote of confidence but the honeymoon will be short. The Government faces a daunting agenda, including: maintaining macroeconomic stability, accelerating bank and corporate restructuring, regaining fiscal sustainability, and ensuring continued service delivery to the poor while rapidly decentralizing government.

## MACROECONOMIC ROUNDUP

**Political developments.** The last two months have generated some cautious optimism in Indonesia. Following a special session of the Peoples' Consultative Assembly, there was a smooth and peaceful transfer of presidential power from Abdurrahman Wahid to Megawati Soekarnoputri, ending months of heightened social tensions and political uncertainty. The new President earned general acclaim in the press for her new cabinet appointments – especially her choice of professionals to hold key economic portfolios. The new administration's economic team promptly initiated negotiations with the IMF and signed a letter of intent on August 27, 2001 (Box 1). The new letter of intent emphasizes measures to restore macroeconomic stability and re-start the stalled structural reform program in the bank and corporate sectors.

**The exchange rate.** The markets responded favorably to these developments. After depreciating virtually continuously throughout 2000 and the first half of 2001, the Rupiah had reached Rp. 11,600 per US dollar by May 28, 2001, its lowest value since 1998. But the resolution of the political crisis sparked a rally that carried the Rupiah to Rp. 8,500 per US dollar, representing a 25 percent appreciation in less than three months. Despite these gains, however, the Rupiah remains weaker than other regional currencies in real terms. Moreover, in recent days, the Rupiah has once again started to decline, reflecting a deteriorating external payments position.

**Inflation and interest rates.** The weakness in the Rupiah combined with administrative price increases (for fuel), government wage hikes, and accelerated monetary growth, to push inflation from virtually zero in April 2000 to a two-year high of over 13 percent in July 2001 (although it subsided marginally to 12.2 percent in August). Monetary policy was slow to respond as Bank Indonesia – concerned with the impact of higher interest rates on the budget as well

as the intermediation margins of banks – allowed base money to grow faster than warranted. In addition, during this period, a range of uncertainties impeded the management of Bank Indonesia, including controversy over possible amendments to the central bank law.

**The real economy.** Recovery in the real economy also remains fragile. Despite the fact that the second quarter GDP results were better than expected, the first half results reveal a marked slowdown in growth—3.4 percent over the same period the previous year (compared to 4.7 percent in the first semester of 2000). Growth in government consumption eased because of fiscal strains, but consumption growth held up well, despite a sharp decrease in consumer confidence amid political turmoil, and net exports declined substantially in the wake of the global slowdown (see below). But the big surprise was fixed capital formation which, defying pervasive evidence of investor pessimism, climbed significantly in the first half of 2001, maintaining a trend that began in early 2000. Part of this could be statistical artifact, owing to the choice of investment deflator. But it could also indicate increased maintenance and rehabilitation of capital stock as growing manufacturing and rising capacity utilization have exacted a toll on existing plant and machinery. In export industries, it may reflect genuine investment in new capacity as firms responded to high profitability in the wake depreciation in the currency. Despite this, however, investment continues to be below pre-crisis levels.

Slower GDP growth in 2001 has been the result of a slowdown in virtually all sectors of the economy – but this was particularly pronounced in some of the non-tradable subsectors, including construction, transport, and finance. Puzzlingly, other non-tradable subsectors, such as utilities and retail and wholesale trade, continued to perform relatively well, showing few signs of being affected by the rest of the economy.

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**Box 1: Selected Government Commitments in the Letter of Intent of August 27, 2001**Macroeconomic framework and Policies

- Maintain a growth target in 2001 of 3-3.5 percent, inflation 9-11 percent.
- Reduce base money growth to 12 percent by March 2002.
- Review implementation of 2001 budget and framework for 2002 budget in mid-October.
- Draft 2002 budget to include a deficit of 2-3 percent of GDP.
- Submit to Parliament the draft Sovereign Debt Securities Law.

Fiscal Decentralization

- Transfer to the regions a total of 2.1 million civil servants by end-2002.
- Calculate revenue sharing and General Allocation Fund transfers based on original budget estimate.
- Use contingency funds only up to the Rp. 3 trillion allocated in the revised budget.
- Finalize modalities to issue bonds in last quarter 2001 to resource surplus regions.
- Complete audits of the allocation of the contingency funds by end 2001.
- Refine the formula for the General Allocation Fund for use in 2002.

Banking System Reforms

- Launch Bank Mandiri IPO (up to 30 percent of shares) by end-2001.
- Publish key financial data for individual banks by end-2001.
- Adopt action plan to improve supervision, regulations, and governance of NBFIs.
- Complete by end-2001 all outstanding issues from BI's 1999-2000 audit.
- Resolve BLBI credits issue between BI, GOI, and Parliament by end-2001.
- Finalize replenishment of Government Guarantee Scheme by first week of September.
- Remove BII's impaired assets and replace with government bonds by mid-September.

IBRA Asset Recovery and Restructuring

- Respond to the OC review of first four large restructurings by mid-September.
- Publish next round of ten OC reviews by mid-October.
- Launch sale of unstructured loans by end-2001 using competitive bidding mechanisms.
- Discuss with Parliament sale of 51 percent of BCA to a strategic partner.
- Sell majority stake in Bank Niaga by end-2001.

Corporate Restructuring and Legal Reforms

- Restructure a cumulative total of \$14-15 billion by end-2001.
- Refer from FSPC by end-December 2001 cases with a total debt of \$10-11 billion.
- Submit an amended version of the Bankruptcy Law to Parliament by end-2001.
- The Anti-Corruption Commission to become fully effective in coming months.

Public Sector and Other Structural Reforms

- BPKP audit of the Reforestation Fund will be completed by end-2001.
- Publish audits and announce corrective actions of key SOEs by end-September.
- Publish audit of the tax office by end-September and announce corrective actions by mid-October.

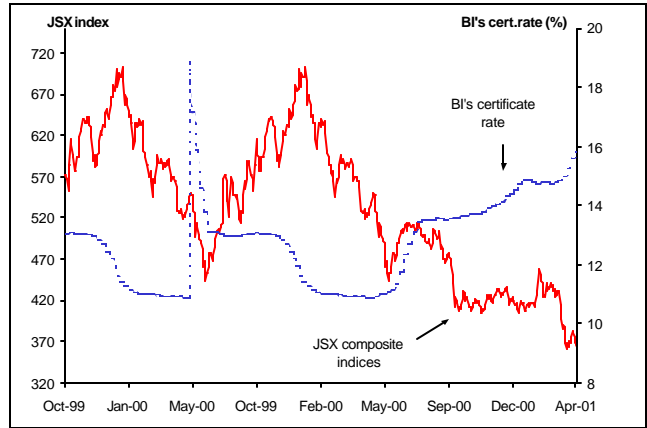
**Figure 1: A macroeconomic snapshot, January 2000 – August 2001**

**The Rupiah depreciated from January 2000 to May 2001 before climbing sharply.**  
(Rupiah per US\$, spot rate daily)



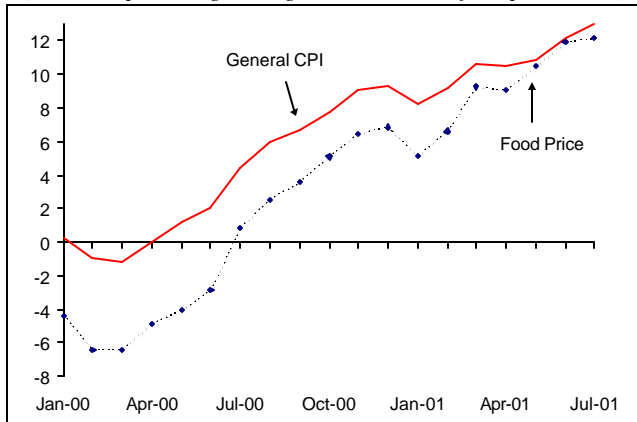
Source: Bloomberg

**The stock exchange declined**  
(Jakarta stock exchange composite index and one month Bank Indonesia certificate rate)



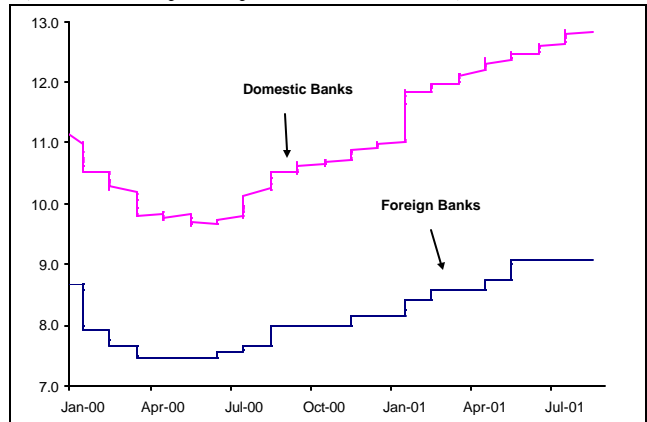
Source: CBS

**Inflation climbed.**  
(12 month percentage change in consumer & food price index)



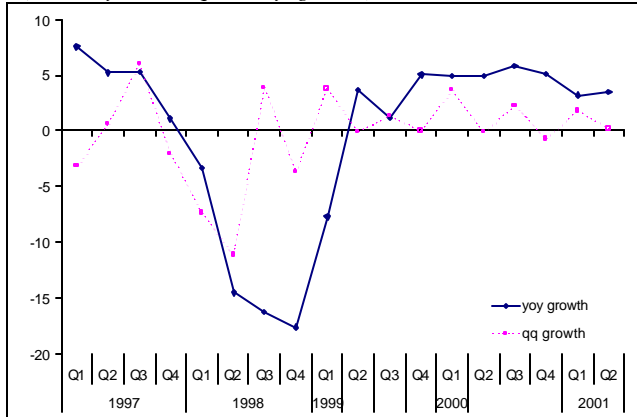
Source: CBS

**After initially falling, interest rates climbed too.**  
(One month Rupiah deposit rate in Indonesia)



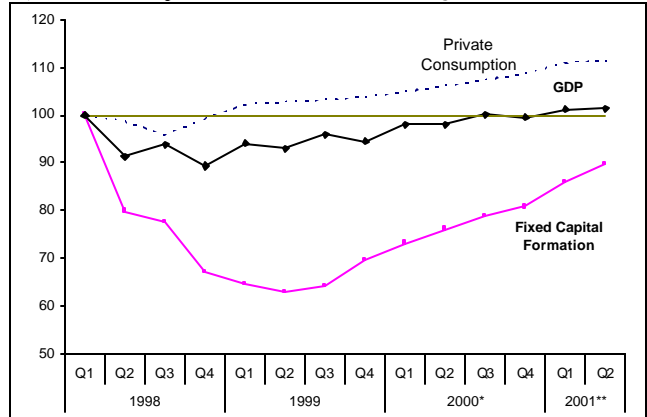
Source: Bank Indonesia

**GDP growth remained positive.**  
(% Y on year and quarterly growth)



Source: CBS

**Fixed capital formation climbed steadily**  
(GDP, consumption and investment index, Q1 1998=100)



Source: CBS

**Table 1: GDP growth slowed in 2001**

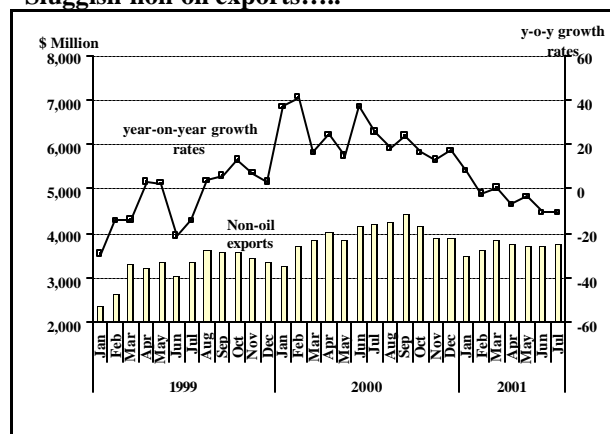
(Growth in percent compared to same semester the previous year)

	2000		2001
	Sem. 1	Sem. 2	Sem.1
<b>GDP growth</b>	4.7	4.8	3.4
<b>Non-oil GDP</b>	5.1	5.4	3.9
<b>By expenditure category</b>			
Consumption	2.8	5.0	5.4
Household	2.9	4.3	5.3
Government	1.6	11.9	5.8
Investment	16.8	18.9	17.7
Exports	18.1	14.1	14.4
Imports	4.4	32.0	34.4
<b>By sector</b>			
<i>Tradables</i>			
Agriculture	-2.5	6.3	1.5
Mining & quarrying	1.8	2.8	1.7
Manufacturing	7.7	4.8	4.2
<i>Non-tradables</i>			
Construction	10.6	3.1	0.5
Finance	5.5	3.9	2.7
Transport	10.6	8.3	6.7
Utilities	9.8	7.8	8.6
Retail trade etc.	6.0	5.4	5.5
Other	2.3	2.2	1.8

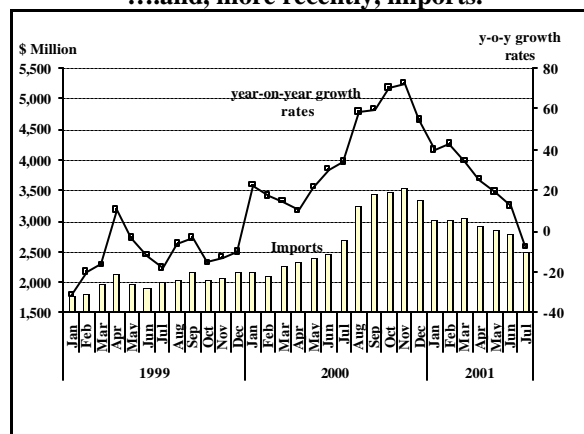
**International trade.** The combination of a global slowdown and resilient domestic demand has shrunk the monthly trade surplus moderately – even though the downward pressure on the Rupiah throughout 2000 and the first half of 2001 has given Indonesian products a strong price advantage in domestic and international markets.

Year-on-year export growth has been negative now for four months in a row, mirroring the performance of other countries in the region. Non-oil exports for July 2001 was 10.9 percentage points below July 2000, the second straight month for which there was a double digit decline -- the first time this has happened since June and July 1999. Electrical products destined for the United States and Japan have been hardest hit. In addition, a shutdown in Acehnese gas production triggered by regional unrest affected gas exports, and declining world oil prices dampened oil export revenues. The deceleration in domestic demand and weaker exports meant that imports also declined for the first time in July 2001. The slowdown has been marked, as one would expect, in imports of intermediate goods (notably in chemical products), while consumer goods have remained reasonably steady.

**External payments and international reserves.** Official foreign exchange reserves drifted down from \$29.4 billion in end-2000 to \$28.6 billion in end-August, 2001. But this relatively stable reserve position belies the large imbalances between the official and private capital accounts. The official capital account continues to be in significant surplus, thanks in large part to the Paris Club arrangement. But the private capital account is in large deficit owing to continued capital outflows and despite large amounts of exceptional financing (arrears and rescheduling of overdue private corporate debt). Arrears accumulation appears to be declining gradually, however, as an increasing number of indebted banks and corporates reach rescheduling agreements with their creditors. Finally, net FDI continues to be significantly negative – partly because inflows have slowed to a trickle but also because FDI corporates are paying off their debt.<sup>1</sup>

**Figure 2: A Slowdown in International Trade****Sluggish non-oil exports.....**

Source: BPS

**.....and, more recently, imports.**

Source: BPS

<sup>1</sup> Indonesia's FDI outflow estimates are overestimated because they include repayments by FDI companies to commercial creditors, including banks and NBFIs – which should strictly be included under "Other investment according to the IMF's *Balance of Payments Manual*

## Slow progress in bank restructuring and reform

**Bank financial performance.** Bank restructuring and reform slowed in the first half of 2001 on account of a difficult political and policy environment and deteriorating economic conditions. To make matters worse, the financial performance of the banking system continued to cause concern, largely because the banking system as a whole remains under-capitalized – despite a large injection of government bonds. Although some banks have capital well in excess of 8 percent of risk weighted assets, a few are struggling to meet this prudential requirement by the cut-off date of end-2001. Furthermore, some banks were re-capitalized with bonds bearing below-market, fixed interest rates and the steady climb in market interest rates has lowered their (mark-to-market) asset value. Higher interest rates narrowed intermediation margins, especially for those banks holding large amounts of fixed interest rate bonds. This further eroded the equity base of these banks and will likely remain a recurring problem unless the Government swaps fixed rate bonds for variable rate bonds or allows banks to mark their assets to market, and absorbs the fiscal costs of higher interest payments or additional recapitalization. On the bright side, NPLs in banks declined by Rp. 28 trillion in 2000 as troubled loans got restructured. But little is known about the underlying quality of the restructured loans and whether they could become non-performing in the future, especially if macroeconomic conditions deteriorate further.

**State and nationalized banks.** State bank recapitalization was completed in late 2000 but little progress has been made since then on operational restructuring or governance reforms. This should begin in BNI and BRI, for which performance contracts and business plans have now been finalized. Bank Mandiri has progressed with some operational restructuring in advance of an IPO planned to be completed by end-2001. Nevertheless, the manner in which it has addressed its liquidity problem (by transferring in government deposits) is not sustainable, and efforts will need to be made to broaden its deposit base. Moreover, Bank Mandiri is also planning to acquire BII (a troubled bank taken over recently by IBRA) to strengthen its own branch network. Care will need to be taken that this acquisition does not jeopardize Mandiri's own liquidity, profitability, asset quality, and efficiency.

The privatization of BCA and Bank Niaga have faced continued delays, reflecting fundamental concerns within the government and parliament. Ten percent of BCA's stock was sold in a public offering, but bids from two strategic investors for a further 30 percent were considered unsatisfactory. The new government is now discussing with parliament the option of selling a 51 percent stake in the bank in the expectation that this will attract better offers. Other banks under IBRA will also need to be privatized (Bank Niaga, for example, is slated for privatization by end-2001), but in most cases there will need to be some further

financial restructuring, including a swap of variable rate for fixed rate bonds.

**Bank Indonesia.** Progress, albeit slow, continues to be made in strengthening Bank Indonesia's supervisory capacity, even as it plans the establishment of an independent Financial Sector Supervisory Institution (FSSI). Work is ongoing to develop onsite supervision capability in all large banks, implement risk-based supervision, address the deficiencies related to the Basle Core Principles for Effective Supervision, and publish individual bank data monthly. As important, after discussion with parliament, the Government is expected to replenish the Government Deposit Guarantee Fund in Bank Indonesia, in an amount of Rp. 40 trillion, to enable IBRA to continue uninterrupted with its bank restructuring program.

**IBRA Asset recoveries.** This is another area where progress continues to be difficult in the absence of adequate political consensus and support. By end-July 2001, IBRA was able to recover Rp. 13.3 trillion, about 34 percent of its total 2001 recovery target of Rp. 39.5 trillion.<sup>2</sup>

Some 60 percent, or Rp. 7.8 trillion, was achieved through the settlement, auction, or refinancing of the corporate loans that IBRA holds. An additional Rp. 5 trillion in sales are in the pipeline following special incentives for cash settlement, and procedures are being finalized to swap restructured loans with recapitalization bonds and to dispose of unrestructured loans using competitive bidding mechanisms.

The remaining 40 percent of IBRA's 2001 recovery performance has been achieved through the sale of industrial and other assets that were pledged by banks owners. This effort is being thwarted by lack of cooperation by some bank owners, and IBRA is pursuing legal action in eight such cases. Making things worse, many of the pledged assets are subject to legal encumbrances and, in some cases, sales of assets are complicated by the legal troubles of the owners themselves.

To improve the governance framework for IBRA, large restructuring cases involving more than Rp. 1 trillion in restructured loans are subject to review by the Financial Sector Policy Committee (FSPC). The final decision of the FSPC in such cases is subject to further review by an independent Oversight Committee to ensure that these large restructurings are consistent with a published set of corporate restructuring principles that had been developed with the assistance of the World Bank and the IMF. Reviews for the first four restructurings have now been made publicly available and show that none accorded with the agreed principles. The Government must now prepare a public response either agreeing to re-negotiate or stating the

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<sup>2</sup> The bulk of the Rp. 39.5 trillion recovery is to be in the form of cash. Some Rp. 10 trillion can be achieved by swapping restructured loans for recapitalization bonds.

reasons why such a deviation from the principles would still be justified.

Finally, IBRA has now been brought under the purview of the Minister of State Owned Enterprises who, among his other duties, is also responsible for the state enterprise privatization program.

### Fiscal Sustainability

Fiscal sustainability has become a crucial medium-term challenge for Indonesia. In this context, the outcome of the 2001 budget and the preparation of the 2002 budget should become important first steps in consolidating the government's fiscal position, and providing a firm basis for further measures in succeeding years.

**Table 2: IBRA gross asset recoveries, Jan-July 2001**

	Target for 2001	Jan-July recoveries	Share of target (%)
Loan sales	14.7	7.9	54
Enterprise equity sales	10.7	3.5	33
Other asset sales	4.1	1.9	46
Redeemed bonds	10.0	0.0	0
Total recoveries	39.5	13.3	34

Source: IBRA.

**The 2001 budget.** The fiscal outlook for 2001 continues to be difficult. The combination of higher interest rates and a weaker exchange rate had raised the projected deficit from 3.7 percent of GP to 6.0 percent (Box 2). Parliament approved a package of measures in mid-June 2001 to restore the projected deficit to 3.7 percent of GDP to be consistent with projected financing from domestic nonbank sources (IBRA cash recoveries and privatization receipts) and external financing. The revision to the budget contained several bold measures with an estimated total impact equivalent to about 2.3 percent of GDP. The approved package included:

- increasing fuel prices for non-industrial users by just over 30 percent;<sup>3</sup>
- raising electricity prices for large consumers in two phases by an average of 17½ percent (with the second increase to be completed in October);
- reduce the non-neutrality of fiscal decentralization on the central government budget;

<sup>3</sup> This comes on top of an increase in fuel prices on April 1, 2001 in which the government raised prices for industrial users by 108 percent and will reset them monthly to equal 50 percent of the international market price. Furthermore, foreign ships, vessels with international destinations, foreign mining and oil and gas companies will be required to pay for fuel at the international rate.

- selected cuts in lesser priority development spending; and
- a range of administrative revenue measures.

The budget revisions also included some Rp. 2.2 trillion in schemes to offset the impact of the fuel and electricity price increases on the poor. In all, seven schemes were designed. These were: the expansion of the OPK subsidized rice scheme by 1.215 million households; bus subsidy schemes to avoid increases in bus fares; various health initiatives; various education programs for the poor; a clean water scheme in 314 locations; a micro-capital scheme through 1,000 institutions; and a coastal community empowerment scheme. Despite the urgent need for some of these measures, several of them have been delayed. The most important of these schemes, however – the expansion of the OPK subsidized rice scheme – has been started by BULOG, but in the absence of any progress reports, no assessment of its effectiveness can be made. The next most important scheme – to subsidize bus operators and avoid an increase in bus fares – has been dropped because bus operators in most urban areas increased their fares following the fuel price hike and were no longer in need of a government subsidy.

The budget revisions notwithstanding, the fiscal outlook continues to be difficult. On the revenue side, oil revenues are likely to suffer a shortfall because of lower-than-expected production. On the expenditure side, oil subsidies are likely to come in higher than expected, as domestic consumption is expected to exceed projections.

And there is likely to be a shortfall in available domestic and external financing as well – for three reasons. First, we have already noted that IBRA sales are lagging. Second, meeting the privatization target in the few months remaining this fiscal year will prove to be challenging. No state enterprises were privatized in 2000, even though the 2000 budget included a privatization revenue target of Rp. 6.5 trillion. In the priority enterprises targeted for privatization, many issues still need resolution – including appropriate regulatory structures – before sale can commence. Finally, program financing is expected to fall short of expectations. The second tranche of the World Bank's Social Safety Net Adjustment Loan (SSNAL) was cancelled because the conditions of tranche release were not fulfilled. Similarly, in the remaining program loans, most of which are being offered by the ADB (with some co-financing from Japan), there continue to be several conditions that are still to be met. Unless there is a concerted effort by all branches of government to meet these policy conditions, there is a strong likelihood the disbursement of these loans will slip into the next fiscal year. Ironically, because the budget deficit is measured on a cash basis, this will cause the deficit to be *lower* rather than higher, but the flip side of this would be domestic arrears.

### Box 2: New structural underpinnings budget dynamics

In earlier years, a depreciating currency and higher oil prices would have a positive effect of the budget – and higher domestic interest rates would have no effect. Not any more. Fiscal decentralization and the newly acquired burden of variable interest rate domestic debt have changed the structural underpinnings of the budget. A depreciation in the currency of Rp. 1000 per dollar enlarges the deficit by 0.6 percentage points of GDP. Similarly, a 10 percent increase in the oil price now *increases* the central government deficit by 0.2 percent of GDP. The key reason is that increased revenues from depreciation and higher oil prices is shared with the regions, while higher spending on interest and fuel subsidies is not. In addition, a 100 basis points rise in interest rates swells the deficit by 0.15 percent of GDP, not to mention adding contingent liabilities to the government's balance sheet if it also contributes to higher recapitalization needs in banks. Unfortunately for Indonesia, recent movement in all three variables has been in the direction of worsening the budget. The budget no longer possesses automatic stabilizers; the only stabilizer now is conscious corrective action by government. This year, the government restricted the damage of depreciation and oil price increase by maintaining the transfers to the regions at the amounts in the original budget. Next year, the Government plans to further reduce fuel subsidies, thereby regaining the hedge in the budget against exchange rate movements.

**The draft 2002 budget.** The Government has submitted a draft 2002 budget to parliament on September 7, 2001. The draft budget incorporates an overall deficit of 2.5 percent of GDP, consistent with the overarching policy of balancing the continued need for maintaining a central development budget while consolidating the government's debt position. The draft budget assumes for 2002 a GDP growth rate of 5 percent—which is somewhat on the high side, but largely inconsequential—an annual inflation rate of 8 percent, and an exchange rate of Rp. 8500 per dollar. Key features of the draft budget include: a deficit of 2.5 percent of GDP; some increases in tax revenues based on improved tax administration and some changes in excise taxes; a very modest rise in civil service salaries; a further increase in fuel prices and consequential reduction in fuel subsidies; changes to the formula for allocating central grants to districts (making the allocation more equalizing); a central government development budget of 2.8 percent of GDP; a challenging target for IBRA and privatization sales; and an external financing strategy that maximizes the use of concessional finance. Planned new donor financing is lower than this year's, and Government is preparing for another round of Paris Club rescheduling should the need arise.

The draft budget represents a considered approach to gradually bringing the deficit down while keeping the government's debt service burden to a minimum (under the

circumstances). This comes, however, at some cost: the central government's development budget, for example, is expected to be cut to 2.8 percent of GDP (down from 3.1 percent in this year's budget). This decline is significant, if only because the development budget has already been cut three years in a row, and this is reflected in the state of Indonesia's infrastructure and declining quality in social services. Of course, local governments could compensate by increasing the size of their development budgets (now estimated to be about 2.0 percent of GDP), but there is no certainty this will actually happen, as the regions are free to spend their general grant as they see fit.

Maintaining the deficit at 2.5 percent of GDP requires a significant improvement in tax effort. Oil revenues—which are expected to amount to 6.9 percent of GDP, will drop to only 3.9 percent of GDP next year because of lower oil prices and a stronger Rupiah. To counter this, the Government plans to increase tax revenues with 1.3 percentage point of GDP to 12.8 percent—a plan that will require significant administrative reforms.

### Service delivery to the poor in a decentralized environment

The ongoing transition to a decentralized system of government, while creating uncertainties in the short term, also provides Indonesia greater hope for sustainable progress on poverty reduction in the long term. There is now much more open debate in Indonesia over key development issues such as debt, corruption, and the participation of civil society in public policy formulation. Greater transparency in politics and government is building pressure for reform.

A free press keeps a watchful eye on the political process and the courts. If properly managed, decentralization can help build local democratic institutions and give people greater control over their lives. But, if managed badly, the transition to a decentralized Indonesia could not only derail macroeconomic stability, but also seriously affect the delivery of government services. Special attention must be paid to the way in which it is carried out or the poor could well be left behind.

On the basis of Indonesia's national poverty line, more than 30 million Indonesians live in poverty today. But once the multidimensional breadth and dynamics of poverty are acknowledged, *poverty is a reality that, in one form or another, confronts more than half of all Indonesians*. The 1997/98 economic contraction resulted in rapid increases in poverty in Indonesia, in particular in urban areas and on Java. In response, the Government developed a three-pronged response to the social impacts of the crisis: (i) maintaining food security; (ii) expanding employment and income generation opportunities; and (iii) preserving access to critical social services.

This crisis strategy was accompanied by a public commitment by the government to address governance issues, in particular efforts to minimize corruption in safety

net programs, although they were unable to fulfill the second tranche disbursement criteria of the Social Safety Net Adjustment Loan (SSNAL) linked to these commitments, and the loan closed in December, 2000 without disbursing the final \$300 million.

**Table 3: Key Social Indicators**

	Latest Data (date)	Previous Period (date)
<b>Human Development</b>	<b>2000</b>	<b>1999</b>
Primary enrollment rate (net)	92.3	94.3
Female	92.6	94.5
Male	92	94.2
Secondary enrollment (net)	59.6	65.4
Female	60.7	66.2
Male	58.6	64.7
Tertiary enrollment	37.9	45.7
Female (% total enrollment)	38.9	48.5
Male (% total enrollment)	36.9	43.1
Infant mortality rate		
From DHS	45.7	58.9
From SUPAS	(92-97)	(87-92)
	51.4	71 (1986)
	(1991)	
<b>Poverty &amp; Income Distribution.</b>	<b>2000*</b>	<b>1999</b>
National Headcount Index 1/		
Urban Headcount Index 1/	22 (Feb)	23.5(Feb)
Rural Headcount Index 1/	16.6	20
Gini Index 2/	26.2	26
	0.30	0.30
<b>Government Expenditures</b>	<b>FY2000</b>	<b>FY99/00</b>
Health budget	1,473	2,054
As % of total	2.3	2.9
Education budget	6,128	8,539
As % of total	9.8	12.1
<b>Labor Market</b>	<b>2000</b>	<b>1999</b>
Unemployment rate (%)	6.1	6.4
Female	6.7	6.9
Male	5.7	6.0
Participation rate (%)	67.3	66.9
Female	51.7	51.2
Male	84.2	83.6
Real wages ( %change)	13.6	1.95
Manufacturing sector	21.5	-0.7
Agriculture sector	10.75	1.78
Female/male wage ratio	70.19	67.7

\* Very Preliminary results

1/ Using BPS Poverty Line

2/ Based on Core Susenas Expenditure

*Efforts to maintain government spending on health and education at constant real levels have not been successful.* Total public sector health spending fell by 8 percent in 1997/98 and a further 12 percent in 1998/99. As far as 2000 is concerned, government health expenditures per capita were not sustained at the peak pre-crisis figure, but were protected at or above the mid 1990s level. Nevertheless, average per capita outlays remained very low overall and were especially low in provinces such as West Java. During the economic downturn, much greater use was made of donor assistance, but such support did not, it appears, contribute to the sustainability of health financing and spending. There also were shifts in the composition of expenditures, including reduced per capita public spending on primary health care and a rise in per capita hospital outlays. These trends in outlays ran counter to policy intentions and actual needs. In short, spending patterns exhibited significant weaknesses even as the country was shifting to new funding and allocation arrangements in 2001.

In the education sector, too, total public expenditure fell by 41 percent between 1996/97 and 1997/98, but rebounded somewhat in 1998/99 to 72 percent of pre-crisis levels. Total realized public spending on education has declined both as a share of total government expenditures (7.7 percent in 1996/97 to 3.9 percent in 1997/98) and as a share of GDP (1.4 percent in 1996/97 to 0.7 percent in 1997/98). Despite shortfalls in financing, several studies have indicated that the social cost in terms of dropouts from primary and secondary schools has been small – partly because of targeted school scholarship schemes that were successfully implemented using innovative means for transferring the resources to needy students. These schemes are being continued, but there remains a dire need for improving the quality of basic education in Indonesia and for rehabilitating functioning schools in the poorest parts of the country.

*Real wages in agriculture and industry* are one of the few indicators available for evaluating the impact of these programs on poverty alleviation and service delivery to the poor. With little data that allows the tracking of poverty on a periodic basis, the purchasing power of the daily or weekly wage is a reasonable proxy for the incomes of the poor. In the year ending March 2001 real wages of agricultural workers declined marginally. Industrial workers' real wages stagnated in the last three quarters of 2000. And construction workers' wages rose over the year ending in May 2001. This would seem to suggest that in 2000, the poverty headcount index would be unlikely to have changed substantially. This would also be consistent with the observation that in 2000, the exchange rate depreciated substantially and inflation climbed, both forces acting to compress real wages and counteracting the beneficial effects of real economic growth on the demand for labor.

The Susenas 2000 also contained a component on *self-perceived changes in family welfare* over the period 1997-2000, and although these types of questions are difficult to answer and interpret meaningfully, they yielded interesting results. Highest improvements were noted for availability of staple foods at markets, access to health services, participation in religious activities and feeling of security. Households felt they were worse off when it came to their ability to obtain formal-sector jobs, and opportunities for recreational activities. Overall, most Indonesian households consider themselves slightly better off than three years ago, although this varies by location: slightly higher improvements are reported for Java compared to off-Java, and substantially higher improvements are reported in rural areas compared to urban areas.

*The impact of the decentralization process on the poor* is difficult to determine at this early stage, although a number of problems are emerging. One critical problem is a lack of minimum service standards which would maintain a basic level of services to the poor. Moreover, simply the added difficulty of monitoring expenditures on key services when a large part of government spending is decentralized to provinces or districts is proving a serious challenge.

The transition itself presents some important hurdles, as illustrated by current experience with basic immunization. Responsibility for what had been one of the most centralized health programs was largely shifted to provinces and districts. They are expected to finance most of the operational costs, with sharply decreased resources now available for immunization from the center. While complete data are not available, a recent Bank supervision mission to two provinces revealed that *none* of the districts visited by the mission had allocated *any* resources for immunization in their annual budget plans. This reflects either weak advocacy by the central government, a serious lack of district capacity in priority setting, or the districts' collective belief that the central government might be forced to resume funding for this basic public health service.

Education is a further example of transitional difficulties: thousands of teachers went on strike because back pay due to a salary increase was not paid out. The reason for this was that the central government—which determines wages—announced the salary increase largely after local budgets had been passed. Thus, even though the central government increased the grants to the regions to cover the increase, this could not be disbursed because there was no authorized budget.

**Table 4: Broad Indicators of Poverty**

Dimension of Poverty Empirical Measure (%)	2000	1999	2004 Goal
Material Standard of Living Headcount Expenditure Poverty/a	25.79	27.13	Half '99*
Human Investment Completion of basic ed for bottom quintile	57	52	67*
Infant mortality bottom quintile	n.a.	109	77*
Children in bottom quintile with acute respiratory infection treated medically	39.1	39	45*
Infrastructure Access Access of bottom quintile to "improved" water sources	23.3	22	62*
Access of bottom quintile to "adequate" sanitation	13.6	13	31*
Social Poverty Percent of bottom quintile who participate in local political decisions that affect their lives	(LLI data) 13		16*
Vulnerability to material poverty Vulnerability to expenditure poverty	n.a.	50	Half '99*

\*Proposed goals

/a very preliminary result from Susenas 2000 core module

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