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**MEMORANDUM OF THE PRESIDENT
OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
THE INTERNATIONAL DEVELOPMENT ASSOCIATION
AND THE
INTERNATIONAL FINANCE CORPORATION
TO THE
EXECUTIVE DIRECTORS
ON A
COUNTRY ASSISTANCE STRATEGY
OF THE WORLD BANK GROUP
FOR
INDONESIA**

February 8, 2001

Indonesia Country Management Unit
East Asia and Pacific Region

The International Finance Corporation
East Asia and Pacific Department

The FY01-03 Country Assistance Strategy (CAS) for Indonesia, Report No. 21580-IND, dated January 4, 2001, was discussed by the Executive Directors on January 30, 2001. Based on this discussion, and in agreement with the Government of the Republic of Indonesia, the CAS document has been revised and made available to the public.

CURRENCY EQUIVALENTS

Currency unit: Rupiah (Rp) as of December 1, 2000
\$1 = Rp 9,420

FISCAL YEAR

Until March 31, 2000: April 1 to March 31
Until December 31, 2000: April 1 to December 31
From January 1, 2001: January 1 to December 31

ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities	IDA	International Development Association
ADB	Asian Development Bank	IFC	International Finance Corporation
APL	Adaptable Program Loan	IMF	International Monetary Fund
BPS	Central Bureau of Statistics	JBIC	Japan Bank for International Cooperation
CAS	Country Assistance Strategy	JITF	Jakarta Initiative Task Force
CGI	Consultative Group for Indonesia	LOI	Letter of Intent
CFAA	Country Financial Accountability Assessment	MIGA	Multilateral Investment Guarantee Agency
CPAR	Country Procurement Assessment Report	MPR	People's Consultative Assembly
CPPR	Country Portfolio Performance Review	NGO	Non-governmental Organization
CSO	Civil Society Organization	OCS	Operational Core Services
DFID	Department for International Development (United Kingdom)	OED	Operations Evaluation Department
EU	European Union	PROPENAS	GOI five-year plan—FY2001-05
FDI	Foreign Direct Investment	PRSP	Poverty Reduction Strategy Paper
FY	Fiscal Year	SME	Small- and Medium-size Enterprise
GDP	Gross Domestic Product	SOE	State-Owned Enterprise
GEF	Global Environment Facility	SSNAL	Social Safety Net Adjustment Loan
GOI	Government of Indonesia	UNHCR	United Nations High Commission for Refugees
GTZ	Gesellschaft Für Technische Zusammenarbeit (Germany)	USAID	United States Agency for International Development
IBRA	Indonesian Bank Restructuring Agency	WBG	World Bank Group
IBRD	International Bank for Reconstruction And Development	WHO	World Health Organization

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MAP (IBRD No. 30904R1)

EXECUTIVE SUMMARY

i. *Indonesia is striving to emerge from a severe economic crisis, complete its transition to a democratic society, and embark on an ambitious program of decentralization.* Each one of these challenges would test any country. Together, they constitute a highly complex agenda for Indonesia. Yet, Indonesia's move to democracy and decentralization also holds its only promise of building the institutions necessary for sustainable growth and development. The future for Indonesia, therefore, holds enormous opportunities, but also immense risk. The stakes are high—not just for Indonesia but also for the international community. This mix of opportunity and risk forms the recurrent background theme to this Country Assistance Strategy for the World Bank Group.

ii. *The new Government of President Wahid inherited an economy with deep structural flaws, weak institutions, and an entrenched bureaucracy.* Corruption is still rampant and infects the very institutions (the police and judiciary) that are supposed to tackle it. Regional unrest, and political and ethnic tensions threaten national unity and continue to preoccupy the Government. Poor implementation of the far-reaching decentralization program may threaten fiscal stability and disrupt the delivery of public services. Investors remain wary of political uncertainty, the weak legal and judicial system, and uneven policy implementation.

iii. *Yet the very process of political transition and decentralization, while creating acute 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 on the courts. If properly managed, decentralization can help build local democratic institutions and give people greater control over their lives.

iv. *The Bank Group sees Indonesia's future with excitement—and concern.* In a democratizing and decentralizing political and economic system, the opportunities for sustainable development are immense, but so are the risks and constraints. Despite the Bank's association with the past, the new Government still sees the Bank Group as an important development partner going forward—and has asked for an expanded International Development Association (IDA) program. And despite reduced lending levels, the Bank plays an influential role in key policy areas of the economic recovery program—in close association with the International Monetary Fund (IMF) and the Asian Development Bank (ADB). Many other donor agencies are committed to supporting Indonesia, and the Bank has developed close partnerships with them across a broad spectrum of development priorities.

v. This CAS has also been informed by *public consultations* with civil society organizations. They expressed serious concern with high levels of debt and corruption. They recommended the Bank to focus on poverty reduction through “bottom-up” community development, and to involve civil society more actively in future programs. The *private sector strategy* (distributed along with the CAS) also benefited from consultations with private sector representatives. They pointed out the main weaknesses in the current investment climate in Indonesia, which are holding back recovery and job creation for the poor.

vi. *The overarching goal of the World Bank Group in Indonesia will be to support efforts to reduce poverty and vulnerability in a more democratic and decentralized environment.* The number of poor has fallen from crisis levels, but half of all Indonesians remain vulnerable to poverty. Accordingly, the Bank Group's strategy will focus on the following three broad priority areas:

- *Sustaining economic recovery and promoting broad-based growth.* In the short run, this requires macroeconomic stability and accelerated bank and corporate restructuring. In the medium term, it will involve policies and public expenditures aimed at poverty reduction, efficient private sector growth, and human capital and infrastructure development to improve competitiveness;
- *Building national institutions for accountable government,* which includes legal and judicial reforms, civil service reforms, better public financial management and procurement, effective decentralization, and close attention to sustainable management of the rapidly depleting natural resource base of the country; and
- *Delivering better public services to the poor,* which involves assistance to help define government roles and responsibilities as functions are decentralized, support for improved public service delivery by sub-national governments which have demonstrated pro-poor, pro-growth reform, as well as promoting community development and selective assistance to post-conflict areas.

vii. The “*base case*”—considered to be the most likely scenario—presumes the current “muddle-through” situation will continue, with some slippage in structural reforms, but with continued macroeconomic stability that would help sustain poverty reduction. This is not a desirable scenario, providing a fragile foundation for external support to Indonesia, and even harbors risks to the Bank's portfolio as fiduciary standards may slip in a decentralized system. At the same time, the Bank is one of Indonesia's long-term development partners and cannot disassociate itself from this fledgling democracy. The CAS base case program is expected to be robust to most downside risks, while at the same time positioning the Bank for possible upside opportunities. Minimum conditions for the base case would be maintenance of macroeconomic stability, including prudent debt management and progress on asset sales and privatization, minimum fiduciary safeguards for delivery of public services with decentralization, and establishment of organizational arrangements, scope, process, and schedule for developing a broad-based poverty reduction strategy. The key elements for fiscal years (FY) 01-03 are as follows:

- The Bank's portfolio will continue to shrink and stabilize around 50 to 55 projects by FY03. Portfolio management will focus on continued quality improvement and further strengthening of fiduciary controls. The Bank will also step up its support of government efforts to strengthen procurement and financial management, which is at risk of deterioration as public service delivery is decentralized.
- The Bank's Analytical and Advisory Activities (AAA) program will continue to emphasize advisory services, supported by a small but growing body of analytical work, and increased attention to regional issues. This will include its leading role in bank and corporate

restructuring and sectoral reforms. The balance of AAA work will shift from crisis response to longer-term development concerns over the CAS period. The Bank will continue assistance in development and implementation of Government's broad-based poverty strategy.

- A core Bank lending program of up to \$400 million a year—less than one third of pre-crisis levels (around \$1.3 billion a year during FY90-97). The average IBRD/IDA blend would be 65:35 over the CAS period. This is consistent with Indonesia's current IDA-12 allocation. IBRD exposure would be reduced from \$11.8 billion at the end of FY00 to \$10.7 billion by the end of FY03.
- The lending program will focus on projects supporting social services and basic infrastructure for the poor, working increasingly with local governments and communities in regions where the leadership supports open and accountable government, promotes growth, and adopts pro-poor policies. No adjustment lending is foreseen in the base case.

viii. The “*high case*” signals the Bank's willingness to provide more support if policy performance improves. If reforms accelerate, and in line with the Government's request, the CAS foresees raising lending to about \$1 billion a year from FY02. This would include a temporary increase in access to IDA resources, as discussed with the IDA Deputies in Lisbon. There could also be a small amount of adjustment lending, if needed. The program anticipates a move toward programmatic lending in support of governance and sectoral programs as capacity and fiduciary controls improve at the sub-national level. Key up-front actions include: prudent monetary, fiscal and debt management; accelerated bank and corporate restructuring and privatization; agreement on a policy framework for rice; progress on agreed actions to reform procurement and financial management systems; and initial steps on preparation of a broad-based poverty reduction strategy. Regular semiannual policy assessments will be made to determine continued eligibility for the high case and to set performance targets for the next six months.

ix. Unfortunately, there is also a significant *possibility of a crisis scenario*. A breakdown in the Government's Extended Arrangement with the IMF as a result of major policy slippage, including inadequate progress on bank and corporate restructuring, could lead to a rapid erosion of market confidence and deterioration in economic conditions. A similar outcome could result from political instability or a widespread deterioration in law and order. In such adverse situations, the Bank would cease all new lending until base case conditions have been restored, but undertake more crisis-related AAA work. The Bank would continue all ongoing projects, unless they were directly affected by the country situation, and project preparation, so that it could respond quickly once the situation improves. In the event of another macroeconomic shock, the Bank may be asked to contribute to an international rescue effort. The Bank's response this time around will depend on the circumstances, but will need to take account of the Government's high debt burden and risks associated with IBRD's high exposure to Indonesia.

x. The CAS also outlines the current plans of *IFC and MIGA* in Indonesia, and how they fit into the overall Bank Group strategy. The recently prepared private sector strategy, together with joint management of Bank and IFC private sector activities, allow for considerable synergies between the Bank Group's policy and transactions work (e.g., on SMEs), while carefully

managing potential conflicts of interest. Beyond the restructuring of its existing clients, IFC will focus on interventions with strong demonstration effects and positive impact on market perceptions. It will also support SME development, resource-based industries and private participation in infrastructure. MIGA has recently reopened its guarantee operations in Indonesia after the conclusion of an agreement to settle a claim. MIGA will aim to support the flow of foreign direct investment into Indonesia, by supporting economically and developmentally strong projects in Indonesia on a case-by-case basis.

RINGKASAN EKSEKUTIF

- i. *Indonesia sedang berupaya untuk keluar dari krisis ekonomi yang berat, menyelesaikan masa transisinya menuju masyarakat demokratis, dan memulai program desentralisasi yang luas.* Setiap tantangan ini merupakan ujian bagi negara manapun. Secara serempak, tantangan-tantangan tersebut merupakan agenda yang sangat kompleks bagi Indonesia. Namun, langkah Indonesia menuju demokrasi dan desentralisasi juga merupakan harapan satu-satunya untuk membangun lembaga-lembaga yang perlu bagi pertumbuhan dan pembangunan yang berkelanjutan. Karena itu masa depan bagi Indonesia berisi berbagai kesempatan yang hebat, tetapi juga berisiko sangat besar. Taruhannya tinggi—bukan hanya bagi Indonesia tetapi juga bagi masyarakat internasional. Gabungan antara kesempatan dan risiko ini merupakan tema latar yang muncul berulang kali dalam *Country Assistance Strategy* (CAS) Grup Bank Dunia ini.
- ii. *Pemerintah baru di bawah Presiden Wahid mewarisi perekonomian dengan kecacatan struktural yang mendalam, kelembagaan yang lemah, dan sebuah birokrasi yang terlalu mengakar.* Korupsi masih merajalela dan menulari lembaga-lembaga yang justru seharusnya menanganinya (kepolisian dan pengadilan). Keresahan di daerah, serta ketegangan politik dan antar etnik mengancam persatuan nasional dan terus menyita perhatian Pemerintah. Pelaksanaan yang buruk pada program desentralisasi yang meluas dapat mengancam kestabilan fiskal dan mengacaukan penyampaian pelayanan-pelayanan umum. Para investor tetap berhati-hati terhadap ketidakpastian politik, sistem hukum dan pengadilan yang lemah, serta pelaksanaan kebijakan yang tidak merata.
- iii. *Namun justru proses transisi politik maupun desentralisasi tersebut, walaupun menciptakan berbagai ketidakpastian yang genting untuk jangka pendek, juga menyediakan harapan yang lebih besar bagi Indonesia untuk kemajuan yang berkelanjutan dalam pengurangan kemiskinan secara jangka panjang.* Kini terdapat banyak perdebatan tentang masalah-masalah pembangunan di Indonesia, seperti hutang, korupsi dan partisipasi masyarakat sipil dalam perumusan kebijakan publik. Transparansi yang lebih besar dalam bidang politik dan pemerintahan kini terus meningkatkan tekanan untuk pembaharuan. Pers yang bebas dengan waspada mengamati proses politik maupun peradilan. Bila dikelola dengan baik, desentralisasi dapat turut membangun lembaga-lembaga demokratis setempat dan memberikan warga masyarakat kendali yang lebih besar atas kehidupan mereka.
- iv. *Grup Bank Dunia melihat masa depan Indonesia dengan penuh kegembiraan—serta keprihatinan.* Dalam suatu sistem politik dan ekonomi yang semakin demokratis dan terdesentralisasi, besar sekali kesempatan bagi terlaksananya pembangunan yang berkelanjutan, seiring dengan berbagai risiko dan kendalanya. Kendati Bank Dunia sering dikaitkan dengan masa lalu, Pemerintah yang baru masih memandang Grup Bank Dunia sebagai mitra pembangunan yang penting untuk melangkah ke depan—dan telah meminta program Asosiasi Pembangunan Internasional (IDA) yang diperluas. Dan kendatipun tingkat pinjaman telah berkurang, Bank Dunia memainkan peranan penting dalam bidang-bidang kebijakan yang utama pada program pemulihan ekonomi—dalam hubungan yang erat dengan Dana Moneter Internasional (IMF) maupun Bank Pembangunan Asia (ADB). Banyak lembaga donor lainnya berjanji untuk mendukung Indonesia, dan Bank Dunia telah membangun kemitraan yang erat dengan mereka yang melintasi suatu spektrum prioritas pembangunan yang luas.

v. CAS ini juga telah diinformasikan melalui berbagai *konsultasi publik* dengan organisasi-organisasi masyarakat sipil. Telah diungkapkan keprihatinan yang serius terhadap tingginya tingkat hutang dan korupsi. Direkomendasikan agar Bank Dunia mengarahkan fokusnya pada pengurangan kemiskinan melalui pembangunan masyarakat “dari-atas-ke-bawah”, dan dengan lebih aktif melibatkan masyarakat sipil dalam berbagai program di masa depan. *Strategi sektor swasta* (yang didistribusikan bersama dengan CAS) juga memperoleh manfaat dari konsultasi-konsultasi dengan para wakil sektor swasta. Konsultasi-konsultasi tersebut menunjukkan kelemahan-kelemahan utama dalam iklim investasi saat ini di Indonesia, yang menghambat pemulihan dan penciptaan lapangan kerja bagi kaum miskin.

vi. *Tujuan Grup Bank Dunia yang paling penting di Indonesia nantinya adalah mendukung upaya-upaya untuk mengurangi kemiskinan dan keadaan kurang menguntungkan dalam suatu lingkungan yang lebih demokratis dan terdesentralisasi.* Jumlah orang miskin telah berkurang dibanding dengan angka pada tingkat krisis, tetapi separuh dari seluruh penduduk Indonesia tetap rentan terhadap kemiskinan. Sesuai dengan itu, strategi Grup Bank Dunia akan memfokuskan perhatian pada tiga bidang prioritas yang luas berikut ini:

- *Melanjutkan pemulihan ekonomi dan membina pertumbuhan berbasis-luas.* Untuk jangka pendek, ini membutuhkan kestabilan makro-ekonomi serta restrukturisasi bank dan perusahaan yang dipercepat. Untuk jangka menengah, ini akan melibatkan kebijakan-kebijakan dan pengeluaran publik yang ditujukan pada pengurangan kemiskinan, pertumbuhan sektor swasta yang efisien, serta pengembangan sumber daya manusia dan infrastruktur untuk meningkatkan daya saing;
- *Membangun lembaga-lembaga negara demi mewujudkan pemerintah yang bertanggung jawab,* yang mencakup reformasi hukum dan peradilan, reformasi dinas sipil, manajemen keuangan dan pengadaan pelayanan publik yang lebih baik, desentralisasi yang efektif, serta perhatian yang cermat terhadap upaya berkelanjutan untuk mengelola basis sumber daya alam negeri ini yang dengan cepat semakin menipis; serta
- *Penyampaian pelayanan publik yang lebih baik kepada kaum miskin,* yang melibatkan bantuan untuk mendefinisikan peran dan tanggung jawab pemerintah seiring dengan terdesentralisasinya fungsi-fungsi pemerintahan, mendukung peningkatan mutu penyampaian pelayanan publik oleh pemerintah-pemerintah daerah yang terbukti telah melaksanakan pembaharuan yang berpihak pada kaum miskin dan pertumbuhan, serta membina pembangunan masyarakat dan bantuan selektif terhadap kawasan-kawasan paska-konflik.

vii. “*Skenario dasar*”—yang dianggap sebagai skenario yang paling mungkin—memperkirakan bahwa situasi “serba tidak jelas” saat ini akan terus berlangsung, dengan sedikit kemelesetan dalam reformasi struktural, tetapi kestabilan makro-ekonomi akan membantu melanjutkan upaya pengurangan kemiskinan. Ini bukan skenario yang diinginkan karena menciptakan fondasi yang rapuh untuk dukungan eksternal bagi Indonesia, dan bahkan mengandung risiko terhadap portofolio Bank Dunia karena standar-standar fidusier dapat menurun dalam suatu sistem yang terdesentralisasi. Namun Bank Dunia merupakan salah satu mitra pembangunan jangka-panjang bagi Indonesia dan tidak dapat memisahkan diri dari demokrasi yang masih muda ini. Program skenario dasar CAS ini diharapkan kokoh terhadap kebanyakan risiko-risiko negatif, seraya pada waktu yang sama menempatkan Bank Dunia di

hadapan kesempatan-kesempatan positif yang bisa muncul. Syarat-syarat minimum bagi skenario dasar tentunya adalah terpeliharanya kestabilan makro-ekonomi, termasuk pengelolaan hutang secara hati-hati serta kemajuan pada penjualan aset dan privatisasi, perlindungan fidusier minimum untuk penyampaian pelayanan publik yang terdesentralisasi, serta pengadaan pengaturan-pengaturan organisasi, lingkup, proses, dan jadwal untuk mengembangkan suatu strategi pengurangan kemiskinan berbasis luas. Unsur-unsur utama untuk tahun fiskal (TF) 01-03 adalah sebagai berikut:

- Portofolio Bank Dunia akan terus menyusut dan berkisar antara 50 sampai 55 proyek pada TF03. Manajemen portofolio akan berfokus pada peningkatan mutu yang berkesinambungan serta pemantapan pengendalian fidusier lebih lanjut. Bank Dunia juga akan meningkatkan dukungannya terhadap upaya-upaya pemerintah untuk memantapkan pengadaan serta manajemen keuangan, yang berisiko mengalami kemunduran seiring dengan terdesentralisasinya penyampaian pelayanan publik.
- Program Kegiatan Analisa dan Advis (AAA / Analytical and Advisory Activities) oleh Bank Dunia akan terus menekankan pada pelayanan penyediaan advis, didukung oleh sejumlah pekerjaan analisa yang kecil tetapi terus berkembang, dan perhatian yang meningkat terhadap masalah-masalah daerah. Ini akan mencakup peran utamanya dalam restrukturisasi bank dan perusahaan serta reformasi sektoral. Kegiatan AAA selebihnya akan bergeser dari upaya menjawab tantangan krisis kepada masalah pembangunan jangka-panjang selama periode CAS ini. Bank Dunia akan terus membantu dalam pengembangan serta pelaksanaan strategi pengurangan kemiskinan berbasis luas oleh Pemerintah.
- Suatu program peminjaman inti oleh Bank Dunia dapat mencapai \$400 juta setahun—di bawah sepertiga dari tingkat pra-krisis (sekitar \$1.3 milyar setahun selama TF90-97). Perbandingan rata-rata komposisi IBRD/IDA adalah 65:35 selama periode CAS. Hal ini konsisten dengan alokasi IDA-12 untuk Indonesia saat ini. Hutang pinjaman IBRD akan berkurang dari \$11,8 milyar pada akhir TF00 menjadi \$10,7 milyar menjelang akhir TF03.
- Program pinjaman akan berfokus pada proyek-proyek yang mendukung pelayanan sosial serta infrastruktur dasar bagi kaum miskin, dengan semakin banyak bekerjasama dengan pemerintah daerah dan kelompok masyarakat di berbagai daerah dimana para pemimpinnya mendukung pemerintah yang terbuka dan bertanggung jawab, membina pertumbuhan, dan menerima serta menggunakan kebijakan yang berpihak pada kaum miskin. Dalam skenario dasar ini tidak direncanakan adanya *adjustment lending*.

viii. *Skenario-skenario atas* mengisyaratkan kesediaan Bank Dunia untuk meningkatkan dukungannya bila pelaksanaan kebijakan membaik. Bila reformasi semakin cepat, dan sesuai dengan permintaan Pemerintah, CAS meramalkan meningkatnya pinjaman menjadi sekitar \$1 milyar setahun sejak TF02. Ini akan mencakup pertambahan sementara dalam akses ke dana IDA, sebagaimana dibahas bersama para Wakil IDA di Lisbon. Mungkin juga akan ada *adjustment lending* dalam jumlah kecil, jika dibutuhkan. Program tersebut mengantisipasi pemberian pinjaman guna mendukung program pemerintah dan sektoral seiring dengan perlunya peningkatan kapasitas dan pengendalian fidusier pada tingkat pemerintahan daerah. Tindakan-tindakan pertama yang penting mencakup: tindakan moneter, fiskal dan manajemen hutang yang berhati-hati; restrukturisasi bank dan perusahaan serta privatisasi yang dipercepat; kesepakatan mengenai suatu kerangka kebijakan untuk beras; kemajuan pada upaya untuk memperbaiki sistem pengadaan dan manajemen keuangan; serta langkah-langkah awal dalam menyiapkan

suatu strategi pengurangan kemiskinan yang berbasis luas. Penilaian enam bulanan terhadap kebijakan akan diadakan secara teratur untuk menentukan kelayakan selanjutnya terhadap skenario atas ini dan menetapkan sasaran untuk enam bulan berikutnya.

ix. Sayang sekali, ada juga *kemungkinan skenario krisis* yang signifikan. Suatu kemacetan dalam pelaksanaan kesepakatan antara Pemerintah dengan IMF karena melesetnya pelaksanaan kebijakan, termasuk kemajuan yang tidak memadai pada restrukturisasi bank dan perusahaan, dapat mengakibatkan terkikisnya kepercayaan pasar dan merosotnya keadaan ekonomi. Hasil serupa juga bisa terjadi akibat ketidakstabilan politik atau memburuknya penegakan hukum dan ketertiban. Dalam situasi sulit seperti ini, Bank Dunia akan menghentikan semua pinjaman baru sampai kondisi skenario dasar telah dikembalikan, serta akan lebih banyak melakukan kegiatan AAA untuk menanggapi krisis. Bank Dunia akan meneruskan seluruh proyek yang sedang berjalan, kecuali jika proyek tersebut terpengaruh oleh keadaan negara saat itu, dan juga akan meneruskan persiapan proyek agar dapat bergerak secara cepat saat situasi membaik. Jika terjadi krisis makro-ekonomi lagi, Bank Dunia dapat diminta untuk mendukung upaya penyelamatan internasional. Tetapi tanggapan Bank Dunia kali ini akan dibatasi oleh tingginya beban hutang Pemerintah dan kemungkinan kerugian yang berkaitan dengan tingginya risiko yang dipikul IBRD untuk Indonesia.

x. CAS ini juga menggariskan rencana-rencana *IFC dan MIGA* di Indonesia, serta penyesuaiannya dengan strategi Grup Bank Dunia secara keseluruhan. Strategi sektor swasta yang dipersiapkan baru-baru ini, didukung dengan pengelolaan bersama atas kegiatan-kegiatan sektor swasta Bank Dunia dan IFC, akan menciptakan sinergi yang cukup penting antara kebijakan Grup Bank Dunia dan kegiatan transaksi (misalnya, mengenai UKM), seraya menangani potensi kemungkinan konflik kepentingan yang bisa terjadi. Setelah merestrukturisasi para kliennya, IFC akan memfokuskan pada intervensi yang dapat menjadi contoh baik dan berdampak positif atas persepsi pasar. Ia juga akan mendukung pengembangan UKM, industri berbasis sumber daya dan partisipasi swasta dalam pengembangan infrastruktur. MIGA belum lama ini kembali memulai kegiatan penjaminan di Indonesia setelah tercapai suatu penyelesaian atas satu klaim. MIGA akan berupaya untuk mendorong arus investasi asing ke Indonesia, dengan mendukung proyek-proyek di Indonesia yang kuat dari segi ekonomi dan pembangunan, dilihat secara skenario per skenario.

*Jika terjadi distorsi dalam terjemahan ini, mohon mengacu pada naskah asli dalam Bahasa Inggris.

**MEMORANDUM OF THE PRESIDENT OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT,
THE INTERNATIONAL DEVELOPMENT ASSOCIATION
AND THE INTERNATIONAL FINANCE CORPORATION
TO THE EXECUTIVE DIRECTORS ON A
COUNTRY ASSISTANCE STRATEGY OF THE WORLD BANK GROUP
FOR INDONESIA**

1. COUNTRY CONTEXT

POLITICAL TRANSITION

1. **Indonesia is in the midst of a major political transition toward a democratic society.** The country held its first free and open elections since the 1950s in June 1999. Moderate religious leader Abdurrahman Wahid emerged as the new President from a multiparty post-election negotiation process—overtaking Megawati Sukarnoputri who became Vice-President after her party had won a plurality of seats in the legislature. Much has been achieved in the first year of the Wahid government. It has begun to restore democratic freedoms and civil rights and tackle the tough issue of the role of the military in politics. The new parliament ceded independence to East Timor in November 1999. The Government has started a dialogue with a number of regions pressing for greater autonomy. Preparations are under way for a major program of decentralization—to go into effect in January 2001, designed to reverse the extreme centralization of government in Jakarta. Parliament is no longer a rubber stamp, there is a lively and free press, an increasingly vocal and active civil society, and a growing free trade union movement. The forthcoming regional autonomy makes local governments increasingly active, and local legislatures are starting to become more active in overseeing their executive branches.

2. **But the transition is beset with tensions and uncertainty.** The initial governing coalition did not hold and a new more unified cabinet was announced following the annual August session of the People's Consultative Assembly (MPR). But the President has a tenuous relationship with Parliament—as reflected by recent attempts at his impeachment—which affects Government's ability to maintain the momentum of reform. The military retains a political role, albeit a limited one, and a constitutional amendment has reduced chances of them being prosecuted for past wrongdoings. Public impatience and cynicism are being fed by inefficient law enforcement and the slow prosecution of corruption cases, stymied by an entrenched bureaucracy, police and judiciary. The new freedoms have brought to the surface long suppressed ethnic divisions, a deterioration in law and order, and communal violence, particularly in Maluku. Secessionist movements have become increasingly active in Aceh and Irian Jaya. While greater autonomy is contemplated for these regions, tensions have mounted as local aspirations for self-rule are met by determination of the central government and military to maintain Indonesia's territorial integrity. These issues have absorbed most of the Government's energy, leaving policymakers little time for developing policy and strategy.

3. **And the far-reaching decentralization program will have major implications.** Decentralization is a strong political imperative to counter the centrifugal forces within the country. It also makes good economic sense, as Indonesia is unusually centralized for a country

of its size and diversity. 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. And with implementation scheduled to start in January 2001, much needs to be worked out (see Box 1.1 for main features of the decentralization program).

Box 1.1: Main Features of the Decentralization Program

Administrative aspects: Law 22 of 1999 devolves most functions of government to Indonesia's regions—28 provinces and over 350 districts and cities. The key exceptions are national defense, international relations, justice, police, monetary, development planning, religion, and finance. The districts must perform important functions, including health, education, environmental and infrastructure services. The province has only a minor role, mainly in coordination, and backstopping districts and cities that cannot yet perform their functions—which may be an opening for an expanded provincial role. The province will also continue to perform deconcentrated central tasks. Implementing regulations further specify the remaining roles of the central and provincial governments, including setting standards for service delivery. The central government can annul regional bylaws and regulations that conflict with national laws and regulations, but the regions can appeal to the supreme court against the center's decision. The intergovernmental regional autonomy advisory board with representatives from the center and the regions is to advise the President on issues concerning decentralization.

Fiscal aspects: The legal framework (Laws 22 and 25 of 1999) will drastically increase the regional share of general government spending. Preliminary estimates suggest that when decentralization is fully implemented, the regions will spend some 8 to 9 percent of gross domestic product (GDP), or well over 40 percent of general government spending, and over double what they spend now. The bulk of this will be controlled by the districts and cities. The center will share some of the resource revenues with the regions—for 2001 amounting to some 1.3 percent of GDP—but this will only benefit a few regions with natural resources.

For most regions, the general grant will be the main source of revenues. This grant will be a minimum of 25 percent of central government revenues—some 4 percent of GDP for 2001. The general grant will be distributed by a formula that has some equalizing elements, but guarantees a grant at least equal to the recurrent and development grants received in the past—irrespective of other income. The equalization formula does not adequately consider expenditure needs for minimal service provision and thus, poorer regions could be shortchanged. Furthermore, the center can grant special grants but the amounts are small given the current budget environment and their allocation has been given little attention so far.

Regional governments will also be allowed to borrow, but borrowing will be limited by a formula for total debt, by individual Ministry of Finance (MOF) approval for foreign loans, but without the guarantee of central government. The Government can put further limits on regional borrowing, and plans to prohibit regional borrowing for FY2001, except from the central government. Bank and other donor lending to the regions will for now be able to make use of an existing onlending mechanism.

Government has issued regulations on financial management and procurement of the regions. These regulations would allow the regions to largely determine their own financial management, accounting, and procurement system within (broad) guidelines from the central government. This arrangement risks a weakening of the country's fiduciary environment, and a fragmentation of the market for government procurement, as local procurement regulations could favor local suppliers.

To strengthen local own revenue sources the Government has revised the Law 18 of 1997 on regional taxes and levies. The revised law allows regions to establish taxes as long as they obey certain principles. While these principles are sound, the weak monitoring and enforcement capacity of the center risks a return to the pre-1997 days in which local taxes became a serious barrier for internal trade.

FRAGILE ECONOMIC RECOVERY

4. **The nascent recovery from the crisis gained strength during the past year.** Indonesia's economy fared better than expected at the time of the CAS Progress Report. Growth

rebounded earlier than expected, and inflation came down more rapidly, and the country generated a higher than expected current account surplus (see Table 1.1). GDP growth in 2000 is estimated to be in the 4-5 percent range. The recovery is becoming broader based, with investment growth overtaking consumption as a leading contributor. Exports are still growing rapidly, benefiting from the strong depreciation of the Rupiah and buoyant world trade. Encouragingly, non-oil exports did particularly well. Inflation, although accelerating somewhat, remains under control (see Figure 1.1).

Table 1.1: Indonesia Key Economic Indicators: Projections and Actual, FY98/99-FY2000

		FY98/99	FY99/00	FY00/01 ^a
GDP growth (%)	Projection ^b	-13	-1	3
	<i>Actual</i>	<i>-14.1</i>	<i>3.5</i>	<i>4.0</i>
Inflation (% increase in GDP deflator)	Projection	80	20	10
	<i>Actual</i>	<i>75.3</i>	<i>3.1</i>	<i>6.8</i>
Current Account (US\$ billion)	Projection	4.7	5.5	4.4
	<i>Actual</i>	<i>4.6</i>	<i>6.6</i>	<i>5.3</i>

^a Actual 00/01 is preliminary actual for FY00, because of a change in Indonesia's fiscal year.

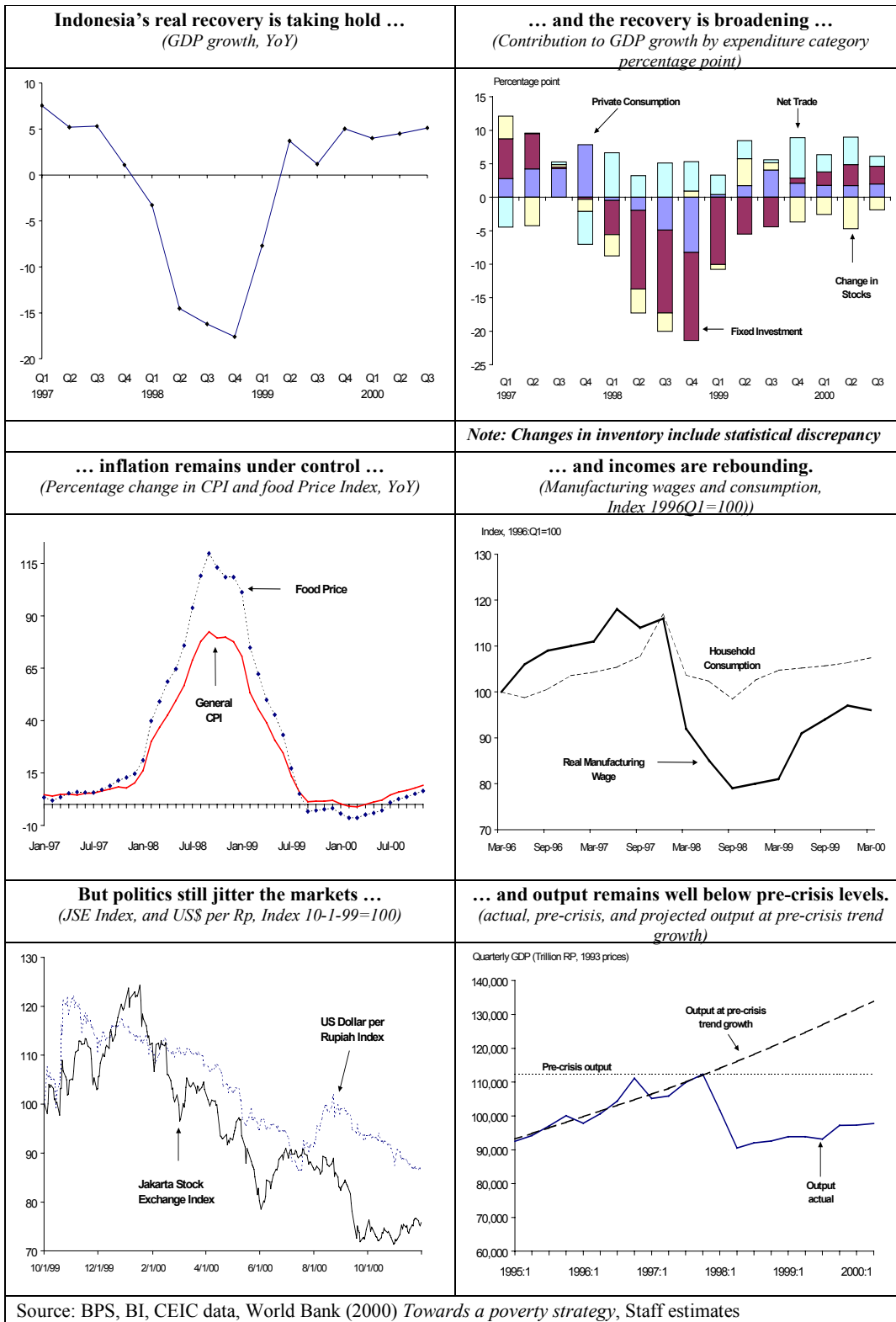
^b Projections from the CAS Progress Report, February 1999.

Source: BPS, Bank Indonesia and Staff Estimates.

5. **But Indonesia's recovering economy was not reflected in improved financial markets.** The Rupiah exchange rate has continued to see wild gyrations over the last year. The capital markets fared little better. The Jakarta stock exchange drifted off its post-crisis peaks in October 1999, and one year later had dropped by 30 percent. Similarly, Indonesia's risk premium in international markets reversed its decline, and spreads on Indonesian US dollar denominated bonds are now more than 700 basis points over US treasury bonds. In contrast with other recovering Asian countries, private capital outflow continues. FY99/00 saw a \$9 billion net private capital outflow from Indonesia, of which \$4 billion was foreign direct investment (FDI) outflow.

6. **Bank and corporate restructuring needs to be accelerated,** because without new credit or investment the recovery will run out of steam. There is some promising progress: the first stage of bank recapitalization has been completed, non-performing loans are falling, new lending has resumed, albeit hesitantly, and a return to bank profitability is near. The Indonesian Bank Restructuring Agency's (IBRA's) governance has improved, and its recovery operations have started in earnest. Voluntary settlements on debt through the Jakarta Initiative Task Force (JITF) and between debtors and creditors have started to pick up. To nurture these tenuous beginnings, Government must complete bank recapitalization while continuing to restructure state banks, strengthen the banks' governance, develop a credit culture, and upgrade risk controls and systems. IBRA asset disposition should be accelerated within a transparent and competitive process to maximize returns, and minimize opportunities for corruption. And legal, regulatory and tax impediments against restructuring should be removed. Over time, Government needs to develop and implement a medium-term strategy to strengthen the entire financial sector. High on this agenda is the privatization of state banks.

Figure 1.1: Indonesia's Fragile Recovery



7. **And Government faces a major challenge in maintaining fiscal sustainability.** The crisis left the Government deeply in debt. After completing bank recapitalization, government debt will add up to a towering 100 percent of GDP, up from 23 percent of GDP before the crisis. And debt service, together with politically sensitive fuel subsidies and the wage bill take up more than four-fifths of government revenues. This puts severe pressure on the budget, and threatens to crowd out development spending. This pressure could well increase with the onset of decentralization next year. Reducing it will involve tough policy choices to raise revenues through better tax administration, phase out inefficient subsidies while protecting the poorest, improve fiscal management, and accelerate privatization and asset recovery.

POVERTY CONTINUES TO BE A CENTRAL ISSUE

8. **While poverty rose sharply in the crisis, the recovery has been decidedly pro-poor.** The crisis dramatically illustrated how much economic growth and stability matter to Indonesia's poor. In the two decades leading up to 1996 poverty levels fell from over 60 percent to less than 12 percent of the population,¹ though many hovered just above the poverty line and remained vulnerable to shocks. So when the economic crisis hit in 1997 following two drought years, and per capita GNP was halved to US\$580,² the expenditure poverty rate shot up—at least doubling from its pre-crisis low (in August 1997) to the peak 27 percent³ in late 1998/early 1999. Indications are that poverty has since fallen substantially from the crisis peak, helped by increasing real wages and improving employment, and the sharp decline in food prices—especially rice. Box 1.2 provides a profile of the poor and vulnerable in 1999.

9. **But despite crisis recovery, various dimensions of poverty still affect half of all Indonesians.** Despite the good news on reductions in expenditure poverty from its crisis peak, Indonesians face startlingly high vulnerability to poverty. The Bank's recent poverty report⁴ shows that over a three-year period between 30 to 60 percent of all Indonesians face a greater than 50-50 chance of periodically experiencing extreme poverty. And poverty takes many forms in addition to material poverty (those living in households with expenditures below the poverty line). Lack of access to basic education and adequate nutrition or of recourse to medical services makes people poor, as do inadequate or nonexistent basic infrastructure (safe water, adequate sanitation, transport and roads, electricity). People who are excluded from social community life or discriminated against experience yet another form of poverty. Important gender differences persist (see Box 1.3). When poverty is expanded to include all these dimensions of vulnerability and human well-being, then poverty in Indonesia is still an issue that concerns about half the population. Tackling poverty therefore will require that all policies, expenditures and programs are evaluated for their impact on the livelihoods of those struggling to escape poverty or who risk

¹ Using head count index and national poverty line from *East Asia: Road to Recovery*, World Bank, 1998.

² In 1999, using the Atlas method, compared to US\$1,097 in 1997.

³ The calculation method used by BPS, which also adopts a *new* poverty line to better match current consumption patterns (i.e., different from the national poverty line used in 1995), results in a lower estimate for the portion of the population living in poverty in February 1999 (23.5 percent).

⁴ *Poverty Reduction in Indonesia: Constructing a New Strategy*, October 2000 (Draft).

Box 1.2: Profile of Indonesia's Poor and Vulnerable in 1999

Characteristics of those in expenditure poverty and where they live...

- 87 percent of the poor live in households in which the head of household has only a primary education or less—only five percent of the poor have a secondary education or better.
- For almost 60 percent of the poor, agriculture provides the main source of income (whether from labor or land).
- More than 75 percent of the poor live in rural areas.
- Most of the poor (61 percent) live on Java.
- The poorest regions, all rural, are scattered and include parts of the eastern islands (Irian Jaya, East Nusa Tenggara, Maluku and West Nusa Tenggara), but also other areas (Southeast Sulawesi, East Java, Lampung, West Kalimantan, and Central Java).

Other ways in which poverty is experienced...

- Expenditure poor households are also much more likely to be “human investment” poor, but a significant share of the non-expenditure poor households also lag in human investment: 22 percent of poor children between 6 and 18 years who have yet to complete basic education are not enrolled in school, while for non-poor households the share is 9 percent.
- 78 percent of the poor, and 51 percent of non-poor, lack access to “improved” water sources. Access to sanitation is even more limited.
- When people are asked to define who are “the poor” in open-ended terms, the breadth and variety of responses is striking; from the common idea of not having enough to eat, to not having enough participation in community life, to being despondent or “having lost faith in God” (from *Consultations with the Poor in Indonesia*, 1999).

falling into it. And during the transition to decentralization special attention must be paid to the way it is carried out or the poor could well be left behind.

GOVERNANCE IS THE WEAK LINK

10. **Governance is Indonesia's key medium-term development challenge.** Weak governance has, if not caused, at least aggravated the economic crisis out of which Indonesia is just emerging. The crisis brought to the surface the lack of accountability, transparency and rule of law in Indonesia, compounded by weak institutions unresponsive to the population at large, and the poor in particular. Indonesia scores consistently low in surveys on rule of law, corruption, and business environment. Illegal gains from corruption have mainly benefited the rich, and were a major factor in the downfall of the Suharto regime. Bad governance has affected the poor across the board, from lack of basic law and order, lack of mechanisms to influence budgetary choices, poor quality of services, and lack of transparency and accountability in the use of funds.

11. **The task of governance reform is huge.** The judiciary, civil service, government financial management, and the role of the state all affect governance. Under the New Order, the *judiciary* functioned largely as an instrument of the executive. The court system, from the judges down, was fundamentally corrupt, while prosecutors were considered facilitators of extortion and bribery. The lack of performance monitoring and sanctions on non-performing judges, lack of transparency of judgments, and absence of systemic jurisprudence all contribute to the perceived absence of rule of law. The slow process in corporate restructuring can at least partly be attributed to the questionable judicial process. The *civil service* suffers from the same lack of transparency, accountability and performance. Corruption has been widespread. It delivered top-

Box 1.3: Gender Inequalities Persist in Indonesian Society...

- Female illiteracy is still considerably higher than male (20 percent and 9 percent) although the gap has narrowed considerably and primary and junior secondary enrollments are nearly gender balanced. Still, stereotypical gender roles are reinforced through school books and the curriculum.
- As for jobs, women are concentrated in low-skill, low-paid employment—71 percent of workers officially recorded as “unpaid family workers” are women, and only 7 percent of the senior administrators and managers are women. Home based workers and those working overseas, both predominantly women, are deprived of basic rights, benefits, or job security, and wages are usually extremely low.
- Women are heavily underrepresented in public life—Parliament has only 10 percent women; women make up 35 percent of civil servants, but only 4 percent are in the highest two echelons; and just 2 percent of village heads are women.
- Women are often victims of violent crime (including State violence)—rape, harassment, or domestic violence, although the real incidence of these crimes is still unknown.

But these statistics do not give the full story. The inequalities are more deeply embedded and have been institutionalized. The main issue facing women in Indonesia is one of visibility and voice. Although the Constitution gives equal rights to women, successive state policy documents have defined separate roles for men and women: men as the heads of households and women as mothers and caretakers. And there is a concern that decentralization may reverse Government’s attention to gender issues.

down services to the public, which are now out of step with the new democratic realities. And *decentralization* will create a further challenge as up to 2.7 million civil servants will have to be reassigned, with major risks of disruptions in service delivery. The lack of sound *financial management and procurement systems* have contributed to the weak traditions of accountability in the public sector. There is no properly functioning system of checks and balances, and lack of transparency makes external performance monitoring virtually impossible. The forthcoming decentralization is likely to make things worse rather than better in the short run as there is little evidence that regional governments will have in place adequate fiduciary controls on local spending.

12. **Weak corporate governance affects the private sector.** Investor surveys show that Indonesia has among the worst corporate governance in East Asian countries. There is a lack of transparency and financial disclosure, accounting and auditing systems are weak, rights of minority investors are insufficient, and interlocking ownership between banks and corporates have contributed to the collapse of the bank and corporate sector during the crisis. Lack of transparency and weak regulatory frameworks also continue to impede private investment in infrastructure and other public services.

POLICY RESPONSE HAS BEEN UNEVEN

13. **Market confidence is affected by weak policy performance.** President Wahid’s first administration was quick to commit to reforms in January 2000 as part of its new three-year

SDR 3.6 billion Extended Arrangement with the IMF, supported by the World Bank and ADB.⁵ But implementation of agreed reforms has been slow. Among others, the Government hesitated on actions to accelerate bank and corporate restructuring, postponed the fuel price increases and phase-out of tax exemptions, and reversed its stance on rice and import tariffs. Foreign investors were further taken aback by policy decisions to restrict foreign investment in a number of sectors. These decisions have since been reversed but at the expense of investor confidence.

14. Government's medium-term policy directions emphasize the importance of improved governance and addressing social inequity and poverty as part of a sustainable and just economic recovery. The State Policy Guidelines, adopted by the MPR after the June 1999 general elections, underline the supremacy of law and the protection of fundamental human rights. It promotes the development of a "people's economy" relying on fair market mechanisms and "empowering" small- and medium-size entrepreneurs and cooperatives linked to improved people's welfare through access to basic needs, thus moving away from the strong central authority and monopolistic business practices enjoyed by a privileged set of cronies in the Suharto era. Rather than the earlier top-down approaches, the intent is to empower communities as main agents of development. The Government's *Propenas* five-year plan (GOI FY2001-05) builds on these guidelines and is organized around five major priority areas: (1) building a democratic political system while maintaining national unity; (2) realizing the supremacy of law and clean governance; (3) accelerating economic recovery and building a sustainable and just development platform; (4) improving the development of people's welfare and cultural resilience, and (5) improving regional development. President Wahid underlined these principles in his MPR accountability speech in August 2000.

15. Building on these principles, the new Cabinet has started to put in place its economic recovery program. The economic team of President Wahid's second Cabinet appointed in August 2000 began strongly, developing a Ten-Point Economic Recovery Program that is the first statement of comprehensive economic policy in the new Indonesia (see Box 1.4). In September, the program was smoothly integrated in Government's Letter of Intent (LOI) related to its Extended Arrangement with the IMF (para. 13). But for now the program is more a statement of objectives rather

Box 1.4: Ten-Point Economic Recovery Program

- Create stability in the financial sector;
- Increase revenue levels from non-oil exports;
- Increase agricultural productivity and the welfare of farmers;
- Accelerate banking and private sector restructuring;
- Place priority on equity-based rather than loan-based recovery;
- Carry out a value-creation approach to privatization of state-owned assets;
- Meet economic decentralization target through an orderly and phased transition;
- Optimize utilization of natural resources;
- Expand the development of micro-, small- and medium-scale enterprises;
- Increase employment generation, particularly in the rural areas.

⁵ The Bank currently works very closely with the IMF and the ADB in preparing the Letter of Intent (LOI) for the Government's Extended Arrangement with the IMF. Consistent with the respective institutional mandates, the IMF takes the lead on macroeconomic policy, the ADB on privatization and SMEs, and the World Bank on most other institutional, structural and social dimensions of development. The IMF, World Bank and ADB share joint responsibilities for financial sector issues.

than a plan, and much effort is required to underpin the objectives with a strategy and—more importantly—to take those actions that lend credibility to the program. In the short run, two issues are crucial to accelerating the recovery: intensifying bank and corporate restructuring, and maintaining fiscal sustainability. In the medium term, Government faces two critical issues. First, it must shift the focus of poverty reduction efforts from crisis response social safety nets to a broad-based strategy for attacking poverty and vulnerability in Indonesia. Second, to consolidate democracy, and to set the conditions for sustainable growth, it must change the way Indonesia is governed.

16. The Government has also initiated steps to develop a comprehensive poverty reduction strategy.

Based on the *Propenas* plan, the Government tabled a national statement on poverty reduction at the Consultative Group for Indonesia (CGI) meeting held in Tokyo in October 2000.⁶ The statement's poverty reduction strategy is based on three pillars: promoting economic opportunities, empowering the poor, and enhancing the effectiveness of the social safety net (see Box 1.5). The statement also lays out the approach for high-level coordination of the poverty strategy: the Vice-President will have responsibility, supported by a task force headed by one or both

Box 1.5: Main Elements of Indonesia's National Statement on Poverty Reduction Strategy for the CGI

- (1) Promoting opportunities for the poor:
- Achieving rapid, sustainable growth
 - Strengthening local governance
 - Providing effective core public services (health, education)
 - Building community infrastructure
- (2) Empowering the poor:
- Strengthening community organization
 - Promoting sustainable rural development
 - Revitalizing small- and medium-size enterprises (SMEs)
- (3) Enhancing social security for the poorest:
- Improving core social safety nets
 - Accelerating development in remote areas

Coordinating Ministers comprising members from Government, Parliament, civil society and donors. A separate stakeholder forum will be set up to monitor poverty reduction efforts.

17. But it needs to follow-up with implementation suited to local government control of service delivery. The Government will need to follow-through quickly on its ambitious plans to coordinate poverty programs and monitoring, and expand its CGI statement into a poverty strategy with broad-based buy-in from regional governments and civil society. Social sector spending shortfalls were pronounced during the crisis, while inefficient fuel subsidies increased their share dramatically and remain greater than the entire development budget in the draft 2001 budget. To make matters worse, recent funding for basic infrastructure and maintenance has been woefully inadequate—undermining Government's poverty efforts. Going forward toward decentralized public service delivery—when over 350 local governments will take charge of planning, budgeting and implementation—the central government will need to redefine its role to keep a national focus on poverty reduction, including a fiscal transfer framework that allows for rewards to sub-national reformers—those that are actively accountable and pro-poor—and targeted support to communities so that those with weaker governments are not left behind. The

⁶ *Poverty Reduction Strategy In Indonesia*, prepared by the Government of Indonesia for the Consultative Group for Indonesia, Tokyo, October 2000.

central government will also need to revitalize monitoring, agree with regions on minimum service standards and poverty reduction goals, and support ways for local governments to learn from each other so that growth and development are broad-based. Once Government organizational arrangements for developing a broad-based poverty strategy (para. 16) are in place, the Bank will review with Government the preparation of a poverty reduction strategy paper (PRSP) to be completed in FY02.

18. **Similarly on governance and anticorruption, the initial steps have been tentative and insufficient.** While the State Policy Guidelines call for a comprehensive reform program embracing the judiciary, civil service, corporate governance and reform at all levels of government, commitment to reform is at best uneven, and at worst weak, and hence the reform process in this area suffers from lack of coherent management, coordination and leadership. Yet public demands for reform are strong and its impatience is growing. The Government's credibility is increasingly at risk as the number of initiatives announced in response to such pressures outpaces its capacity to deliver. Government has, for instance, moved on a wide front of anticorruption measures, many of which were initiated under President Habibie, including an anticorruption law, establishment of a joint investigation team focusing initially on corruption in the judiciary, a national ombudsman commission, as well as preparations for an independent anticorruption agency. But these initiatives have been largely *ad hoc* and often overlap, some have faltered for lack of budget, and for most others the progress is slow. On the legal reform side, the initial efforts by the Law Reform Commission has found little resonance in Government. Considerable mistrust persists due to the failure to indict—until recently—any judge suspected of bribe-taking. Corruption in the Attorney General's office and the police is compounded by lack of capacity to carry out successful prosecution. On the civil service side, there is as yet little effort to address the longer-term issue of civil service reforms.

ECONOMIC OUTLOOK AND RISKS

19. **Indonesia's external environment is likely to become less favorable over the CAS period than it was in the year 2000.** World GDP growth is expected to gradually slow down from over 4 percent in 2000 to somewhat above 3 percent in 2003. Growth in the USA, Indonesia's largest trading partner, is to slow down more rapidly, but that of Japan—the second largest trading partner—will retain a modest 2 percent pace. Growth in world trade is likely to come down as well—from over 11 percent in 2000 to some 8 percent for the rest of the CAS period. This will put pressure on Indonesia's export-led recovery, and on the current account. The expected decline in oil prices—from \$28/barrel (bbl) in 2000 to under \$20/bbl in 2003—will further reduce Indonesia's current account surplus over time. While international interest rates are not expected to rise, Indonesia's risks premium—at present more than 700 basis points over US Treasuries—reflects continued negative sentiments of international investors towards the country.

20. **Several macroeconomic risks could affect Indonesia's prospects.** The high domestic and foreign debt, a weak banking and corporate sector, and a growth rate that is much lower than before the crisis make Indonesia particularly vulnerable to such risks. The key risks are a more rapid decline in oil prices, a further depreciation of the currency, and an increase in domestic interest rates. The Government's ambitious decentralization plan will exert fiscal risks as well.

- A more rapid decline in oil prices than that assumed in the economic base-case scenario (see below) would put pressure on the current account of the balance of payments. But because oil revenues will in future be shared with the regions and oil subsidies are still paid by the central government, the initial impact on the budget is fairly modest. For every dollar decline in oil price, the central budget deficit increases by about \$50 million, or less than 0.05 percent of GDP.
- A further depreciation of the Rupiah would hurt the budget more: although oil revenues will rise in Rupiah terms, the increase is shared with the regions, and the central government would face higher spending on foreign interest payments and imported goods. On a net basis, an exchange rate depreciation of 1,000 Rupiah/US dollar would add some 0.15-0.2 percent of GDP to the budget deficit. Equally, banks and corporations will both remain vulnerable to external shocks in exchange rates and interest rates, in view of the slow progress in financial and corporate restructuring. A weakening of their position may add to the bank recapitalization costs, and reduce revenues from IBRA recoveries.
- But the largest macroeconomic risk stems from the Government's high domestic debt, which is largely in the form of floating rate bonds. Higher domestic real interest rates—triggered by, for instance, political turmoil could cause fiscal havoc: a one percentage point increase in *real* interest rates would cost the Government some 0.3 percent of GDP, or \$500 million equivalent.
- And, despite safeguards, there are considerable risks to fiscal discipline associated with the decentralization program. For next year, the Government has included a contingency reserve of some 0.6 percent of GDP in the budget, and it aims to disallow regional borrowing for now (except from the central government). However, failure to decentralize the civil service, strong regional demands for extra resources, and a weakening of the no-borrowing rule could trigger fiscal pressures and macro-instability.

21. **The fragile political environment and its associated risks to the ongoing reform effort are reflected in the current economic outlook for the “muddle-through” base-case scenario.** Prospects for a sustainable recovery in Indonesia critically depend on progress in bank and corporate restructuring, smooth fiscal decentralization within a framework of overall fiscal consolidation, continued monetary stability and improved governance. But these are complex and far-reaching reforms which require effective government implementation and a sound legal environment—and so expectations of progress must be modest. The “muddle-through” base-case scenario—which represents our assessment of the most likely outcome—assumes that macroeconomic stability is maintained, but that structural reforms are implemented slowly, with frequent slippages and some policy reversals. Investor confidence and private investment (domestic and foreign) revive barely enough to keep GDP growth at about 4 percent a year during the period of the country assistance strategy (CAS, FY01-03). In the absence of decisive policy action, the fiscal position remains marginally sustainable, and the government debt to GDP ratio is expected to decline only modestly to about 88 percent by 2003.⁷ External debt to

⁷ Further debt restructuring is not assumed beyond what has already been obtained recently from the Paris Club and London Club.

GDP will also marginally decline, because lackluster investment activity would limit pressure on the current account of the balance of payments. Table 1.2 shows key economic indicators for the base case and high case scenarios.

Table 1.2: Indonesia: Key Economic Indicators—Base and High Case Projections

	FY00 ^a	<i>Base case projections</i>			<i>High case projections</i>		
		2001	2002	2003	2001	2002	2003
GDP Growth (%)	4	4	4	4	4	5	6
Inflation (% change in GDP deflator)	6.8	8	8	8	5	5	5
Current Account Balance (\$ billion)	5.3	4.4	3.4	2.7	3.0	2.8	-0.2
Government debt (% of GDP)	100	99	94	88	95	86	76
Total External Debt (% of GDP)	102	99	94	89	92	82	73

^a Preliminary (see Table 1.1).

Source: Staff estimates.

22. **A high-case (“performance”) scenario would result from greater political stability, and more aggressive implementation of structural reforms.** This involves an acceleration of bank and corporate restructuring, careful management of the ongoing fiscal decentralization program, and appropriate monetary and exchange rate policies (as agreed in Government’s Extended Arrangement); as well as key actions on legal and judicial reforms, civil service reforms and toward improving financial management and procurement practices. These reforms will help improve investor confidence and raise investment to pre-crisis levels which, in turn, could drive higher GDP growth from 2002 onward. Higher investment demand would reduce the surplus on the current account more rapidly than in the base case. Higher growth, lower interest rates in light of better inflation performance, more asset recovery, and an appreciating exchange rate will accelerate the decline of Government debt to GDP to some 76 percent of GDP by 2003, while external debt to GDP also declines more rapidly to 73 percent of GDP by the same year.

23. **Unfortunately, there is also a not insignificant possibility of a “crisis” scenario.** A key risk is a breakdown of the Government’s Extended Arrangement with the IMF as a result of major policy slippage, including inadequate progress on bank and corporate restructuring. This could lead to a further erosion of market confidence and deterioration in economic conditions. A similar outcome could result from political instability or a widespread deterioration in law and order. In both cases, the turmoil would be reflected in a further worsening in financial markets—especially interest rates and the exchange rate—which would cause a deterioration in the fiscal and balance of payment position. Yet another crisis scenario could result from external shocks such as a more rapid decline in oil prices, a more rapid slow-down of the global economy and global trade growth, or a rise in world interest rates, which could trigger renewed macroeconomic imbalances. Although the consequences are likely to be a far cry from the 1997-99 crisis, the impact of a macroeconomic shock could severely hit a more vulnerable Indonesia, facing a much higher debt burden.

24. **The external financing position is likely to remain fragile in any scenario.** The current account surplus is likely to decline as demand recovers and imports grow while oil prices decline and non-oil export growth slows. New private equity inflows through direct or portfolio investment are likely to remain modest as long as governance reforms, corporate restructuring and privatization remain hesitant. Indonesian companies’ access to new external private

borrowing is likewise expected to be limited as long as their debts are not resolved and their balance sheets remain weak. Despite debt rescheduling by the Paris Club, debt-service on the Government's liabilities will continue to impose a heavy burden on government revenues—and more so after March 2002 when the current Paris Club agreement ends. Further debt rescheduling by official bilateral and private creditors is unlikely, and the Government is correctly reluctant to incur new debt from commercial sources. The Government's debt burden places a premium on concessional sources of external finance. It has, therefore, requested the Bank to blend its International Bank for Reconstruction and Development (IBRD) lending with additional International Development Association (IDA) resources. In the high case, disbursements from the additional IDA commitments, as proposed in the CAS (see para. 78), would begin to benefit the budget mainly in the year 2002 and beyond. This higher external financing would also support the emerging current account deficit caused by the higher investment level in the performance scenario. Additional IDA funds would be contingent on Government's strong performance on governance and poverty, which in turn will help boost investor confidence and prospects for an early recovery and enable Indonesia's rapid return to the international capital markets.

25. **Moving forward, the challenges are enormous.** In any future scenario for the short to medium term, there is likely to be considerable political uncertainty, stop-go policies on reforms, and capacity constraints impeding the Government's ability to carry through on its commitments. The probability is high that Indonesia will "muddle through". The challenge for the Government, and for Indonesia's development partners, will be managing this uncertainty and helping reduce the associated risks. But there is also a real possibility—given Indonesia's past impressive development record—that from this process of muddling through will emerge enough momentum around a subset of reforms that it will be possible to lay the foundations for a more sustained development effort. Indeed the challenge for Indonesia's development partners will be to encourage and to help bring about this latter outcome.

2. BANK GROUP RESPONSE AND PRIORITIES

PROGRESS SINCE LAST CAS

26. **In accordance with the CAS Progress Report the Bank focused on social safety nets, economic recovery, and governance reform.** The Bank continued its strong *social impact* monitoring, and prepared a comprehensive poverty report which now forms the basis for the poverty focus of the CAS. The Social Safety Net Adjustment Loan (SSNAL) helped protect and rationalize budgets for critical crisis response programs, improved designs and targeting, and helped open the way for civil society involvement in program monitoring. Investment lending focused on projects in health and education. In support of *economic stabilization and recovery*, the Bank continued its intensive participation in the Government's Extended Arrangement with the IMF (para. 13), with responsibility for the major structural and social reform components—besides social safety nets, the Bank focused on bank and corporate restructuring, along with sectoral reforms in agriculture and energy. A second policy reform support loan was approved in May 1999. The Bank stepped up its work on *governance and anti-corruption* in close collaboration with partners. It helped establish the Partnership for Governance Reform in Indonesia, which brings together Government, civil society, private sector, and donors to facilitate a national dialogue on governance. The Bank is leading similar donor groups in other areas (para. 62). It chaired three CGI meetings since the last Progress Report in which Government and donors discussed progress on the economic program and governance agenda. Representatives of civil society now attend as observers.

27. **Lending fell short of the CAS Progress Report base case scenario.** During FY98-00, the Bank committed a total of \$3.6 billion, or \$1.3 billion below the base case scenario in the Progress Report (see Table 2.1). The shortfall in adjustment lending was caused by delays in key policy reforms, as well as the Government's reduced borrowing needs for budget support. Lower investment lending reflected both new government priorities (leading to reformulation of the lending program) and reluctance of the new Government to borrow, particularly on IBRD terms, in view of the increase in public debt and Parliament's direction to reduce dependence on foreign borrowing. As a result of these trends, IBRD debt outstanding has been held to about \$11.8 billion (end-FY00).

Table 2.1: Bank Lending: Changes since CAS Progress Report, FY98-00 (\$ million)

	CAS Progress Report	Actual
Adjustment	3,200	2,400
Investment	1,695	1,177
<i>o/w IDA</i>	<i>(310)</i>	<i>(255)</i>
Total	4,895	3,577

28. **The Bank's project portfolio has started to recover from the crisis impact, and fiduciary controls have been strengthened although risks of "leakage" remain high.** Economic recovery and the Bank's portfolio restructuring efforts have substantially reduced portfolio risk and improved performance in line with our earlier plans (see Table 2.2). As part of restructuring, the Bank canceled over \$1.6 billion of undisbursed funds. Indonesia was removed from the Bank's "priority country list" for portfolio improvement plans. The Bank has begun to

**Table 2.2: Bank Portfolio:
Changes since CAS Progress Report, FY98-00**

Indicators	FY98	FY99	FY00	
			CAS Plan	Actual*
% Projects at risk (no.)	54%	28%	20%	21%
% Actual problem projects (no.)	25%	26%	15%	18%
Realism index	47%	95%	75%	83%
Proactivity index	71%	78%	85%	83%
Disbursement ratio	14%	13%	20%	21%

* includes Global Environment Facility (GEF) operations.

strengthen fiduciary controls and staffing to address allegations of misuse of project funds, through tightening of procurement reviews, follow-up on allegations of irregularities, enhanced monitoring of accounting and auditing compliance, additional procurement and financial management staff in the Bank's

Jakarta office, protection of supervision budgets, and beneficiary involvement in monitoring of implementation and use of funds in a number of new projects (see Box 2.1 on recent anti-corruption efforts in Bank-financed projects). The Bank's portfolio was subjected to a number of audits, which acknowledged the stronger management controls while recognizing the challenge of addressing corrupt practices in projects in Indonesia. This challenge is expected to grow as the Bank's portfolio shifts increasingly to "soft" sectors involving smaller procurement contracts and implementation takes place in a newly decentralized administrative and political environment.

Box 2.1: Recent Anti-corruption Efforts in Bank-Financed Projects

While it is not possible to insulate Bank-financed projects from the country environment in which they are implemented, a number of steps have been taken to strengthen fiduciary controls including:

- Tightening of reviews of implementing agencies' procurement financed by the Bank and paying more attention to procurement issues at early stages of project preparation.
- Conducting assessments of the capacity of executing agencies to carry out procurement and financial management, and intensifying ex-post reviews of those contracts that are not subject to prior review by Bank staff under the Bank's procurement guidelines. This also led to a declaration of misprocurement totaling \$4.1 million in FY00.
- Maintaining a database of complaints on procurement.
- Enhancing monitoring of compliance with accounting and auditing requirements, and following up on significant audit findings with executing agencies.
- Protecting resources allocated to project supervision despite pressures on the overall administrative budget.
- Promoting beneficiary involvement in the design and implementation of Bank projects, particularly by building relations with civil society and local communities to help prevent misuse of development funds. Additionally, the Bank prepared a portfolio brief (in English and Bahasa Indonesia) to inform civil society about the Bank-financed projects.
- In collaboration with Government and the Asian Development Bank (ADB), the Bank carried out a country procurement assessment (CPAR, completed in FY01) and country financial accountability assessment (CFAA, FY01) which made recommendations for reform. These were followed by a mission of senior Bank staff to review the fiduciary environment, which made recommendations to strengthen the public procurement and financial management systems and to further strengthen the fiduciary oversight of Bank-financed projects (see para. 68).

LESSONS FROM THE CRISIS

29. **The lessons from the Operations Evaluation Department (OED) review of the Bank's role leading up to the crisis were absorbed in the Bank's program.**⁸ The reorientation of the Bank's program toward poverty alleviation and governance reform addresses the major criticism that the Bank paid insufficient attention to these aspects. This includes efforts to absorb the political, institutional and social dimensions more fully in our country assessments and areas for future assistance. The Bank's relationship with Government has become more candid as we speak out publicly on areas of concern. It has opened up vis-à-vis civil society and strives for enhanced disclosure of its activities. The Bank also speaks out more in the media. The recent shift toward a more open and democratic Indonesia provides a more favorable environment for popular participation in government programs, and engagement with civil society. But it does not ensure that past concerns (e.g., on corruption) will be addressed. And the Bank is expected to remain the target of civil society criticism for its association with the past regime (see paras. 31-33 below).

30. **At the program level, the Bank is including important lessons from the crisis as it repositions its future operations.** The Bank's poverty work has generated important findings on the multidimensional nature of poverty in Indonesia, and developed a deeper understanding of the non-material aspects of poverty. It has learned from the work on the effectiveness of local institutions and communities, as well as from input from civil society during consultations. The lessons from the two recent village infrastructure projects and the ongoing Kecamatan Development Project underlined the strengths of local-level institutions and the importance of "bottom up" planning to better match needs and aspirations with resources. These in turn are the basis for our focus in the CAS on demand-responsive approaches in delivery of public services, which will be absorbed in our future lending for social sectors and basic infrastructure. At the same time, the Bank recognizes the limitations of its recent crisis adjustment lending in Indonesia. The SSNAL, while pioneering program safeguards for more transparency and accountability which improved the effectiveness of crisis programs for the poor, also brought out the difficulty of seeking fundamental institutional reforms in the operations of government programs through an adjustment lending instrument. The crisis social safety net programs also revealed the difficulty of reaching the poor with government programs. In fact, the poor mostly coped by relying on their ingenuity, sacrifices and hard work. Success of the Water Sector Adjustment Loan (WATSAL) underlined the importance of "ownership" of reform by the agencies involved. Through the crisis, the International Finance Corporation's (IFC's) portfolio benefited from its policy of not supporting projects promoted by sponsors with close affiliation to political leaders. In IFC's future operations, it will be particularly careful in selecting credible sponsors, who are transparent, professional and capable.

FEEDBACK FROM CONSULTATIONS

31. **The CAS has been informed by a series of public consultations with civil society organizations (CSOs).** A total of about 400 organizations took part, over a three-month period, through interviews, seminars, and focus group discussions held in four different locations in

⁸ OED Country Assistance Note, February 1999.

Indonesia. The recommendations were compiled and discussed at a national roundtable held in Jakarta in August 2000. They focused on the following themes: economic recovery and poverty alleviation, decentralization of development and regional authority, education, labor issues and employment, improving governance and combating corruption, debt, and community and non-governmental organization (NGO) participation in Bank projects. Consultations also took place with a cross-section of private sector interests and the results of these consultations are outlined in the Bank Group Private Sector Strategy for Indonesia, prepared along with the CAS (para. 43). A summary of civil society feedback is shown below (see Box 2.2).

32. **The consultations took place in a very constructive atmosphere, although the Bank was reminded of concerns about its association with the past regime**, particularly where it concerns debt and corruption (see Box 2.2). While it was recognized that a number of recommendations from the consultations were directed more toward Government than the Bank, particularly where these involve changes in policy, many recommendations are reflected in the Bank's strategy. The types of projects in the CAS lending program are much closer to civil society preferences with their decentralized, community-based approaches. The Bank plans to involve civil society representatives more upstream in the design of future projects, and to make optimal use of disclosure to disseminate information on its activities and projects. It also strengthened anti-corruption controls in its projects, and intends to involve beneficiaries and civil society groups more closely in monitoring. As a follow-up to the national consultation meeting, the Bank plans to support joint Bank-CSO working groups on selected topics (e.g., civil society involvement in Bank projects, micro-finance), provided there is enough interest on the part of CSOs. A full list of recommendations from the consultations, together with the Bank's response, is covered in a separate report on the CAS civil society consultations.⁹

Box 2.2: Summary Feedback from Civil Society Consultations

- The recommendations from civil society representatives called for the Bank to focus on its core development mission of poverty alleviation. This would entail support to the productive sectors, assistance to micro and small business, and support for a people-centered approach to development. Projects that promote access by the poor should be promoted. Privatization should be slowed down to ensure fairness and transparency.
- Civil society organizations suggested that the Bank provide assistance in the decentralization process, working with both regional and central governments.
- Participants saw value in the Bank working on curriculum and teacher training improvements in the national education system, and in developing links with labor groups.
- The Bank was asked to emphasize grassroots activities, involving communities in all aspects of the project cycle and to facilitate the active participation of civil society organizations that are better placed to assist in bottom-up planning of community initiatives. Further dissemination of Bank information was called for.
- The debt issue remains controversial with many CSOs calling for debt reduction, a halt to new lending, or lending at highly concessional terms only. They asked that loans for technical assistance should be minimized, and adjustment loans phased out.
- Feedback indicated that the Bank had paid insufficient attention to the use of its funds, and should share responsibility for corruption in Indonesia. The Bank was asked to promote anti-corruption reform, investigate suspected cases of corruption, support establishment of CSO watchdog groups, and intensify attention to environmental and social safeguards.

⁹ The report is made available on the Bank's Indonesia website (www.worldbank.or.id).

33. **There remain areas where the Bank differs from the recommendations of the CSOs.** Debt is probably the most important one. The Bank has explained that Indonesia is not eligible for debt relief under the Heavily Indebted Poor Countries (HIPC) program, and that it cannot accept the arguments put forward that part of Bank debt should be canceled as it would have been subject to corruption and should be considered “criminal” or “odious.” At the same time, the Bank has worked in different ways to address Indonesia’s debt problem. It has (a) provided assistance on Indonesia’s debt management options, (b) responded positively to Government’s requests to cancel undisbursed loan balances (over \$1.6 billion) and reallocate funds to higher-priority activities (about \$1 billion), and (c) sought greater access to highly concessional IDA resources. The Bank has also strengthened its fiduciary controls to address any misuse of funds in Bank-financed projects. There are other areas where the Bank may differ from the civil society feedback. The Bank would be more positive than CSOs on proceeding more rapidly with privatization in the interest of efficiency improvement, although it strongly agrees with the need for transparency and fairness.

BANK GROUP’S COMPARATIVE ADVANTAGE

34. **The Bank Group remains a high profile player in Indonesia.** The Bank Group plays an important coordinating role among donors in its role as chair of the Consultative Group for Indonesia (CGI). And key bilateral donors look to it to take the lead on the development policy agenda. The Bank also co-leads donor efforts in governance reform (with special focus on legal, anti-corruption and civil service reforms), competition policy, water resource management, and forestry. Even where it is not in the lead, Government and donors rely on it for strong analytical and advisory support (decentralization, SMEs, corporate governance, privatization). The Bank plays a key role in Government’s Extended Arrangement with the IMF, working closely with the IMF and ADB. And its relationship with key policymakers continues to be good—although where it differs on policy it tends to do so more openly than in the past. The Bank’s comparative advantage is based on a strong presence in Jakarta which allows a fast response, a good analytical base on the economy, sectors, and key development issues (poverty, governance, public expenditure management), a good understanding of the implementation environment through the Bank’s large and varied project portfolio, a capacity to channel considerable financial resources through lending and trust funds, and its ability to draw on global knowledge through the Bank’s networks.

35. **Indonesia is also supported, with technical expertise and financial resources, by a wide range of development partners.** These include more than 20 bilateral and over 10 multilateral governmental organizations and several UN agencies, with programs of various size and focus. Indonesia also counts many non-governmental organizations, such as the Ford Foundation and World Wildlife Fund, and private-sector partners among its supporters. In the context of the CGI meeting in October 2000, donors pledged up to \$4.8 billion of official aid for 2001—contingent on budget needs—and an additional \$530 million in technical assistance grants and financial support for non-governmental organizations. This level of support is in proportion to Indonesia’s scale, diversity and development challenges. There is room for donors to specialize in their areas of expertise, for example the UN takes the lead on humanitarian relief, while the World Bank Group and the ADB focus on longer-term development policy support and investments. At the same time, there are many common interests and a need for close collaboration as all partners work to best meet Indonesia’s requirements.

36. **This argues for a selective, flexible approach by the World Bank Group, building on past successes, learning from others and collaborating whenever possible.** The Bank will focus on areas where it can have the greatest impact on poverty and where there is strong local ownership and capacity to deliver. Its program will aim for resilience to shifting local conditions. Most of the Bank's new poverty-oriented, community-based programs have these features. Civil society has also asked the Bank to focus on these areas. At the same time, the Bank will need to look opportunistically for areas where breakthroughs in policy are possible and provide the necessary support to facilitate change. These opportunities are likely to shift during the CAS period, underscoring the need for flexibility. This also calls for greater reliance on analytical and advisory services, and for proactive management of the portfolio. Where the Bank is less effective in responding to development challenges, it relies on other donors to take the lead in partnership fashion (see para. 62).

DEVELOPMENT CHALLENGES AND PRIORITIES FOR THE BANK GROUP

37. **Support for Indonesia's political and economic transition in a highly uncertain environment.** The CAS Progress report provided a road map for responding to the crisis. This CAS attempts to spell out a Bank Group strategy during the forthcoming period of political and economic transition, and to help it manage the considerable risks associated with the large uncertainties in Indonesia today. This implies a two-pronged approach for the Bank Group. *First*, the Bank Group will need to provide continued support for efforts to sustain the stabilization and structural reform objectives under the economic recovery program and help the Government manage the considerable risks associated with the impending decentralization program. *Second*, the Bank Group will need to help Indonesia lay the foundations for a sound medium-term development strategy focused on reducing poverty and vulnerability for the bottom half of Indonesia's population.

38. **The overarching goal of the Bank Group's CAS will be to reduce poverty and vulnerability in a more open and decentralized environment.** This will require attention to government policies that promote broad-based economic growth as a key requirement for poverty reduction. At the same time, the quality of growth matters to make it sustainable and genuinely pro-poor. But it is not just *what* government does, not just *how much* the government spends, but *how well* its services are provided. Strong improvements in governance will be critical to winning back confidence from private investors and giving voice to the poor. With the far reaching decentralization of government functions just around the corner, actions will be required to build strong governance both at the national and local levels to ensure effective public service delivery to the poor. Accordingly, the Bank Group's strategy will focus on working closely with its donor partners on the following three broad priority areas which are closely related to Government's priorities in its economic recovery program and its medium-term development plan:

- **Sustaining economic recovery and promoting broad-based growth.** In the short run, this requires macroeconomic stability and accelerated bank and corporate restructuring. In the medium term, it will involve policies and public expenditures aimed at poverty reduction, efficient private sector growth, and human capital and infrastructure development to improve competitiveness;

- **Building national institutions for accountable government**, which includes legal and judicial reforms, civil service reforms, better public financial management and procurement, effective decentralization; and close attention to sustainable management of the rapidly depleting natural resource base of the country; and
- **Delivering better public services for the poor**, which involves assistance to help define government roles and responsibilities as functions are decentralized, support for improved public service delivery by sub-national governments which have demonstrated pro-poor, pro-growth reform, as well as promoting community development and selective assistance to post-conflict areas.

Sustaining Economic Recovery and Promoting Broad-based Growth

39. **Accelerating bank and corporate restructuring.** In the short run, the core agenda in the financial sector focuses on restoring profitability to the banks, improving supervision, and moving firmly forward with the restructuring and divestiture of the state banks. In the medium term, Government must develop a strategy to reduce the state's involvement in the financial sector—and then implement it. Moving ahead on corporate restructuring involves implementation of the enhanced corporate restructuring framework,¹⁰ adopting further means to force cooperation of recalcitrant debtors, remove tax and regulatory impediments to corporate restructuring, and accelerate IBRA's asset disposal.

40. Bank assistance in this area will remain a high priority, and it will continue to work closely with the IMF and ADB as part of Government's Extended Arrangement (para. 13). In bank restructuring, the Bank will retain its leadership role for work on state banks (excluding Bank Mandiri) and IBRA, while the Fund will work with Bank Indonesia (the central bank), Bank Mandiri, and private banks' restructuring. The Bank will lead a joint effort with the other international financial institutions to help Government develop a medium-term financial sector strategy. In corporate restructuring, the Bank's focus will continue to be on creating and supporting the enabling framework for effective resolution including the support for the corporate restructuring activities of IBRA's two asset management units, the Jakarta Initiative Task Force (JITF), and for improving the commercial court and bankruptcy process. The immediate priority is to establish a clear, transparent and consistent set of principles to govern all large debt restructurings by IBRA. IFC's priority is to focus on strengthening existing financial institutions through investments, attracting strategic investors where possible. In addition to individual restructuring transactions with its existing clients, IFC will explore opportunities to leverage its limited resources at wholesale level through specialized investment funds for urgent equity funding needs of corporates.

41. **Maintaining macroeconomic stability and fiscal sustainability.** A key challenge will be to maintain fiscal sustainability as Government manages the high debt burden and complex decentralization program, while at the same time protecting essential development spending.

¹⁰ The enhanced framework involves improved coordination, allowing IBRA to apply discounts, strengthening JITF's leverage for referral of uncooperative debtors to the Attorney General, time-bound mediation procedures, and removal of regulatory impediments.

Important steps involve raising fiscal revenues, phasing out anti-poor fuel subsidies, improving fiscal management, and accelerating privatization and asset recovery. In support of the Government's Extended Arrangement with the IMF, the IMF leads the effort on macroeconomic policies, the Bank focuses on structural and social policies, the ADB leads on privatization and SMEs, while the IMF, the World Bank and ADB have joint responsibility for financial sector issues (para. 13).

42. **Promoting pro-poor policies and public expenditures.** For the most part, families and individuals will escape poverty and reduce their vulnerability through their own efforts. To help foster an environment in which individuals can make progress, the Bank will focus on the following areas:

- **Supporting broad-based poverty reducing economic growth by keeping rice prices affordable and internal trade open, and supporting rural development through provision of basic infrastructure, credit, research and extension services.** Affordable rice prices matter to the poor because they are net rice consumers. Import controls or higher tariffs on rice would hurt the poor by raising rice prices. The Bank will continue to provide policy advice in this critical area. Since over 70 percent of incomes in rice-growing regions is from non-rice sources, the emphasis of the Bank's rural development support—through analytical work and project support—lies in greater attention to the foundations of rural economic activity.
- **Helping to empower the poor through access to secure possession of land and natural resources and increasing the availability of financial services to them.** The Bank is working to encourage stakeholder dialogue on forestry and land policy. It is also undertaking analytical work and supporting preparation of a Second Land Administration Project to help reverse past practices of land allocation and distribution which disadvantaged the poor, including their community held lands. The Bank's support for micro-finance will focus on increasing access by the poor and institutional strengthening, rather than credit subsidies. A micro finance project is foreseen for FY03. Sound labor market policies are equally important for raising the economic prospects of the poor, as they are helped by a development strategy that favors a rapidly expanding demand for labor and fosters equitable and just labor conditions (see Box 2.3). Among donors, the ILO has the lead in this area.

Box 2.3: Labor Policies in Transition

The broader political changes have opened up labor policies. In 1998, the Government ratified the ILO convention on freedom of association and issued a regulation opening up trade union registration. As a result, new labor unions have sprung up, challenging the only union allowed in the Suharto era. But there are questions about the capacity of business and labor to handle the changes and concerns that implicit alliances between Government, employers and even military and police may persist. Moreover, breakdown of law and order in parts of Indonesia have adversely affected labor relations. Law and order and fair economic relations will require cooperation among Government, employers and employees, and reform of the legal and judicial system, the police and the military. Issues for medium-term consideration involve: (i) further development of the labor relations framework covering the formation of trade unions, collective bargaining, and settlement of industrial disputes; and (ii) regulations governing employment standards, covering issues such as working hours, wage determination, and job security. Longer-term reform will also involve a sustainable system of social protection, including reform of the inefficient government-run Jamsostek social insurance scheme.

- **Helping to keep a poverty focus in public expenditures, including looking hard at what subsidies can be eliminated, and supporting poverty reduction by local governments.** The Bank will continue to support the Government's policy of reducing fuel subsidies which at Rp 36 trillion in 2001 cost more than the entire development budget, and redirecting funds to fund pro-poor programs. How best to encourage poverty agendas at the local level—through budget transfer—is a question the Indonesians are debating and its resolution will equally apply to large donors whose funds pass through the central government. This would involve piloting of different approaches to find what works best. It will also involve tracking of social and poverty indicators. The Bank will focus on the fiscal transfer framework, as well as the minimum standards of service delivery. These will be addressed through policy advice and technical assistance, and in the context of proposed projects in health, education and basic infrastructure.

43. **Enabling competitive private sector development.** The Bank Group's private sector development strategy is integrated across the Group's activities. It involves a combination of policy reform and institutional strengthening to address: (a) an inadequate business environment resulting from poor public governance and corruption, a weak legal and judicial system with poor enforcement, inadequate corporate governance, and continued red tape and burdensome regulations, particularly on SME activities; and (b) a concentrated corporate ownership structure and continued dominance of the state in key sectors combined with an underdeveloped SME sector which in other countries has been the driving force for growth and employment generation. The Bank Group's private sector development strategy, including an elaboration of the respective roles of the Bank, IFC and the Multilateral Investment Guarantee Agency (MIGA), is elaborated in a separate report prepared in connection with the CAS,¹¹ of which a summary is shown in Annex 1. The private sector agenda focuses on:

- helping Indonesia accelerate and complete the recovery from the crisis through banking and corporate restructuring (para. 39);
- addressing structural weaknesses in the economy through technical assistance, policy advice and partnerships, as well as ongoing Bank Group projects, to (a) improve public governance and reduce corruption, (b) improve corporate governance; (c) reform legal and judicial systems, (d) develop a modern competition policy framework, (e) promote foreign direct investment; and (f) reduce the role of the state through privatization of state-owned enterprises; and
- promoting long-term sustainable growth through (a) development of the SME sector, including provision of policy advice on the business environment, piloting innovative programs, helping establish SME support services, and building financial intermediaries, through IFC investment and capacity building initiatives; (b) promoting the role of the private sector in rural and urban development, through ongoing investment projects and planned Adaptable Program Loans (APLs) in water and urban sectors; (c) promoting private delivery of infrastructure and services in health and education, initially through analytical work on the potential for private provision of health services; (d) promoting sustainable

¹¹ *Indonesia: World Bank Group Private Sector Development Strategy*, January 2001 (Report No. 21581-IND).

private development of Indonesia's forest and mineral resources, and (e) preparing Indonesia for the knowledge economy by helping create the legal, institutional and regulatory framework for the new information and communications technologies, in part through assistance from an ongoing information technology project.

44. **Human capital development for competitive growth.** Development of human capital at all levels is critical to both the near and medium term efforts to sustain economic recovery and growth in Indonesia. Decentralization of the delivery of most government services makes capacity building at all levels a priority. Training programs, whether for district officials, local health service administrators or SME managers, have been chronically weak, but the needs will be far greater with decentralization. In the *near term*, the challenges of delivering basic education at the province and district levels and increasing access to quality basic education and health for Indonesia's children will take first priority in Bank assistance, and will be supported by ongoing and proposed projects in education and health, and analytical and advisory activities (AAA). In the *medium term*, attention must be given to skills development and modernizing safety nets, so that skill shortages and the continuing vulnerability to risks such as catastrophic income loss or prohibitive curative health costs will not impede Indonesia's competitive growth. The Bank's assistance in these medium-term areas will be directed in part at the restructuring of Indonesia's senior secondary and higher education and training sectors, both public and private—initially with analytical work and policy dialogue and then, if appropriate, with lending support. Support would be focused on sub-national and regional networks of education and training delivery systems, both public and private. In addition, the Bank, in collaboration with the University of Indonesia, is engaged in establishing a Global Development Learning Network (GDLN), which will provide opportunities for decisionmakers and others to access a global network of peers to share ideas and experience in the main development challenges. Furthermore, assistance will focus on assisting in the design and implementation of situation-relevant health insurance approaches, through ongoing AAA and project work.

45. **Addressing infrastructure bottlenecks.** As economic recovery takes hold, more infrastructure bottlenecks are expected to appear and become a drag on economic growth. Particularly as public spending on maintenance and preservation (especially in roads, water supply and sanitation) have declined over the past few years, and the implementation of infrastructure projects requires long lead times. Decentralization is expected to complicate management of infrastructure, as responsibilities need to be clarified, service standards and investments may further deteriorate, and interregional linkages may suffer. The Bank Group strategy is aimed at: (a) providing assistance for essential investments in maintenance and rehabilitation through ongoing projects and proposed investment projects in eastern Indonesia roads and irrigation systems; (b) improving the policy and legal framework of key sectors (e.g., water, energy) to facilitate competitive private sector investment, including better cost recovery, phasing out inefficient subsidies, development of regulatory capacity, and restructuring sector entities (e.g., state electricity company PLN); and (c) facilitating the implementation of agreed government reforms through joint action by the donors and contributing to financing of future infrastructure needs, by mobilizing co-financing from ADB, the Japan Bank for International Cooperation (JBIC) and United States Agency for International Development (USAID) and others, and, where appropriate, using the Bank Group's various instruments—including possible guarantees. Focus will increasingly be at the regional level to work with receptive local governments in improving local capacity and supporting basic investments in preservation and

upgrading of existing facilities and services, and addressing key bottlenecks. IFC will seek opportunities to encourage private investment in infrastructure in sectors where a suitable regulatory framework is emerging, by seeking to engage commercial and technical partners who will transfer international practice to management and operations of utilities and other infrastructure service companies.

Building National Institutions for Accountable Government

46. **Strong improvements in governance will be critical to winning back investor confidence, giving voice to the poor, protecting the environment, and a key requirement for long term stability.** At the *national level*, action is required on legal and judicial reforms, civil service reforms, improving public financial management and public procurement, and helping the central government better manage its planned major decentralization program. Success depends on strong leadership and ownership from Government for a set of key actions which would bear results over the medium to long term, while looking for a few “quick wins” to build political support for the agenda. A key priority is reducing opportunities for corruption, by strengthening accountability and transparency in the public sector through better procurement, financial management, and audit. At the *regional level*, decentralization provides an opportunity for Government to becoming truly accountable to the people. A high priority will be ensuring the emergence of sound public economic and financial management at the local level with a particular focus on fiduciary controls. At both national and regional levels, the Bank will also approach national environmental policies from the prism of good governance, focusing on forestry and water management. The Bank’s involvement in this area is at two levels.

47. **First, through the Partnership for Governance Reforms in Indonesia—an Indonesian-led body that brings together Government, civil society, the private sector and Indonesia’s major development partners—the Bank together with its two co-sponsoring partners (UNDP and ADB) is supporting the promotion of a national policy dialogue on selected areas of governance.** This dialogue would be underpinned by strategic funding of key governance initiatives aimed at pushing important reform efforts and helping strengthen the demand for governance reforms. These initiatives are funded by a Governance Fund financed by donors. An active Indonesian governing board has identified three cross cutting issues as priorities for the Partnership: anti-corruption, decentralization, and an information outreach on good governance. The Bank’s role in the Partnership is to take the lead in coordinating donor support in two areas of governance reform: legal and judicial reforms and civil service reforms. In addition, the Bank is playing a key role in bringing its global knowledge to bear on the work on anti-corruption and decentralization, particularly through active support from the World Bank Institute (WBI) and the Public Sector Board. It helped the Partnership run a successful anti-corruption workshop and is working towards helping develop a national anti-corruption strategy.

48. **Second, the Bank is attempting to advance the agenda for governance reforms** through direct support to Government in the following areas:

- **legal and judicial reforms:** The Bank’s objective in this perhaps most critical area for strengthening the underpinnings for Indonesia’s nascent democracy and helping win back investor confidence, is to assist Government to develop and implement a time-bound program of action drawing on the promising work of the Law Reform Commission. For such

a program to succeed it will need to be reinforced with decisive action to reduce corruption in the judiciary as a signal of the Government's commitment to such reforms. This will be a major focus of the Bank's dialogue with Government in 2001, drawing heavily on the resources of a multi-donor team.

- **civil service reforms:** The Bank has pursued this issue for over a year through analytical and advisory work, with an initial focus on pay and employment policies and the decentralization of civil service functions. A new report on this issue will be shortly discussed with Government to test the waters of reform. Drawing on this report and on further planned work, the Bank will assist the Government in developing and implementing a civil service strategy.
- **decentralization:** The Bank is working with the IMF, the ADB and donors to help Government contain the risks from the impending decentralization focusing on fiscal decentralization, including measures to support poorer areas and encourage poverty reduction efforts by sub-national governments (para. 42), and the implications for the civil service.
- **the Government's fiduciary controls:** The Bank mounted a strong diagnostic effort in this area, including preparation of a Country Procurement Assessment Review (CPAR, completed in FY01) and a Country Financial and Accountability Assessment (CFAA, FY01). A fiduciary mission from the Bank visited Indonesia in October 2000 to help develop an agenda of action. This was discussed at the CGI meeting in Tokyo and Government undertook to pursue this agenda (para. 69). Progress in this area will be critical to a successful transition to a high case in Indonesia.

49. **Sustainable natural resource management and environmental protection.** Indonesia's environment and natural resources are deteriorating at a considerable cost to society. Decentralization will make this worse as inexperienced sub-national agencies are inheriting management responsibilities. Actions are required to reach sustainable management of the most precious resources—forests, farmland, fisheries, marine ecosystems, water and urban air. The Bank's focus will be on the governance dimensions, since the principal constraint to sound policies in this area are weak institutional capacity and pervasive corruption. The Bank will concentrate on forestry and water resource management, where it is leading multi-donor efforts. In forestry, the main issues involve illegal logging, the large imbalance between sustainable log supply and industry requirements, poor management of production and protection areas, and ill-conceived forest conversion. Policy dialogue is in support of Government's formulation of a National Forest Program involving all stakeholders. In water, the Bank aims for more integrated management on river basin scale and for control of domestic waste water. In addition, we support selective environmental management capacity building of local governments, and development of a coral reef policy and strategy.

50. **The Bank's focus in the governance area has relied heavily on analytical and advisory activities, but lending support is being contemplated to help strengthen central government's capacity in the post-decentralization era.** Reforms will only succeed if there is strong government ownership and support. If this materializes, and the Bank's dialogue and involvement in the Governance Partnership are all intended to bring about such an outcome, the Bank would consider the possibility of a public sector reform loan/credit in a high case scenario.

Such an operation would support a program of public sector reforms and the proposed decentralization, over a three to five-year period, covering support for reform in many of the areas outlined above along with improvements in public expenditure management. A key priority will be to strengthen the central government's capacity to deliver on its residual responsibilities in a post-decentralization era, particularly in setting standards, establishing development priorities, monitoring performance and enhancing accountabilities. Thus such an operation would attempt to provide an umbrella for the provincial level reform operations envisaged in the CAS (see below). Such an operation could also provide matching grant support for sub-national governments by establishing criteria that would create incentives for local governments to pursue good governance strategies.

Delivering Better Public Services to the Poor

51. **In the words of the Government, “The overriding objective of decentralization is to bring the government closer to the people. This enhances local government transparency and accountability as well as community participation.”**¹² Indonesia is just beginning to decentralize and de-concentrate public service delivery, and there is still much to get right—from finalizing regulations and achieving broad agreement with the regions on the implementation timing and strategy, to ensuring civil servants get transferred and paid. As local governments take up their new responsibilities, Government and donors can best support poverty reduction by rewarding those that demonstrate pro-poor reform through matching grants or other resource transfer vehicles. The Bank has started to rebuild its lending pipeline to selectively support creation of capable, demand-responsive sub-national government institutions, and to eventually target a limited number of provinces (2-4) and/or districts, including cities, which have demonstrated reform. Support will focus on services from which the poor benefit most, including basic education, health and basic infrastructure in rural and urban areas. Where district/provincial governments are reluctant to undertake reform, central government and donors could directly support community driven development. The Bank will thus continue to foster “bottom-up” reform by building on its extensive experience with community development in Indonesia. As all donors are affected by the newly decentralized environment, the Bank is also reviewing with Government and other donors how best to coordinate the approach to sub-national assistance.

52. **In the short run (at least through 2002), the Bank will support the Government in specific sectors and regions to maintain service delivery through the transition, while at the same time helping to lay the groundwork for the Government and other donors to direct assistance where it can be most effective in reducing poverty.** Because responsibility for decentralization of administrative functions lies with line-ministries and guidelines have been very general or wanting, sectors are at different stages of preparation and taking different approaches. There is a real risk of service disruption, declining governance standards, and local decisions contrary to national interests. Some district governments appear to be taking steps to protect services and are looking for opportunities for administrative and budget efficiencies. To support the transition, the Bank's assistance will target three priority areas: (1) helping to define sectoral roles and responsibilities across levels of government; (2) supporting a selected number of local governments, which have put reform into practice, to improve the design and

¹² *Poverty Reduction Strategy In Indonesia*, prepared for the Consultative Group for Indonesia, October 2000.

implementation of service delivery; and (3) continuing to help directly empower communities in poor regions (rural and urban). In addition, the Bank will provide selective assistance to areas in conflict.

53. **First, the Bank will help Government define roles and responsibilities for each level—center, province, district and below, and for private sector involvement.** Getting these roles and responsibilities right during the transition period and re-orienting the civil service to become responsive to those it is meant to serve will have long-term implications for the quality of service delivery. For each sector, specific technical issues must be taken into account (see Box 2.4 for examples in irrigation, roads and environment). Thus, the Bank will give priority to supporting Government to identify, give authority to, and build capacity at the appropriate administration level, and help create openings for the private sector where appropriate. Primary sectors of focus include: basic education, health, basic infrastructure (roads, irrigation, urban services, and energy), and environmental management. This will be done in connection with supervision of on-going projects, and as a particular focus in the preparation of new ones, including eastern Indonesia roads, second provincial health, strengthening local education capacity (1&2), and improving quality and responsiveness of community-oriented healthcare, as well as sectoral AAA work.

**Box 2.4: Getting The Right Level of Government Is Critical For Effective Service Delivery:
Examples from Irrigation, Roads and Environmental Management**

Irrigation: Part of the sector is best served through “highly” decentralized arrangements (at the district level), such as operations and maintenance (O&M) and water allocation in irrigation systems at the tertiary and secondary canal levels. However, where externalities and economies of scale demand a more aggregated approach, such as in river basin management (pollution control, O&M, erosion abatement, etc.), decision-making at an intermediate level is required with a larger involvement of provinces. Other functions are best performed at the central level, such as development of policy and regulatory systems and standards, databases, and support for large infrastructure such as dams. However, the picture is complicated as institutional arrangements follow *hydrological* and not administrative boundaries. Thus, water user associations and river basin corporations require close cooperation—between local governments and non-governmental entities as well as among provincial and district governments.

Roads: If responsibility for all aspects of national/provincial roads are decentralized to the district level, Indonesia risks degradation of service on its road network. Overall network planning—planning, programming, and budgeting of a program of works (where national/provincial responsibility is needed) should be distinguished from design and implementation of individual packets of works (where local responsibility is appropriate). “Local” interests could put “local” projects before national/provincial ones, and roads in poorer provinces could deteriorate rapidly. Moreover, if design and construction is decentralized before adequate technical staff, competitive procurement (nationwide), and independent quality assurance or oversight are in place, there is a risk of poor quality work, and deterioration of roads and bridges.

Environmental Management: Decentralizing the majority of environmental management authority to the municipal (district) level is not appropriate; it is not a successful model in other countries, and most that have tried it have recentralized partially or completely. As conceived, decentralization will shift resource development decisions (industrial plant siting, major land development, and exploitation of natural resources) to district control. Environmental assessments (EAs) will be reviewed by provincial commissions. But, where provincial capacity is weak, or where there is no EA required, districts will give the approvals, and there are many incentives for the district to exploit their resources in the short run and ignore longer-term consequences.

54. **Second, the Bank will support selected local governments who have put reform into practice with the basics of effective service delivery and work toward identifying promising provinces and districts for future support.** Government commitment is the prerequisite to effective aid. The Bank aims to help a limited set of provinces and districts (including cities) which have demonstrated reform to develop the basics of transparent, accountable, and demand-responsive public service delivery (see Box 2.5), and to position the Bank to increase sub-national programmatic and investment lending—both within and across sectors—once conditions permit. The Bank will seek to support reform-minded, pro-poor leaders and performing governments, through on-going supervision, project preparation, and sub-national dialogue. Selection criteria and a short-list of areas would be reviewed with the central government, to seek agreement on 2-4 provinces in which the Bank could initiate deeper engagement through consultations with local governments and civil society, and through provincial public expenditure reviews. Adjustable Program Loans (APLs) are being prepared for water management—following reforms supported by the Bank-financed Water Sector Adjustment Loan—and for urban services, which will support sub-national governments which have taken concrete reform measures.¹³ The Bank is also assessing the feasibility of establishing 3-4 regional public information centers to expand its sub-national presence.

**Box 2.5: Encouraging “Demand-Responsive” Service Delivery in
Basic Education and Health**

Prior to the crisis, the Government mobilized a sizable corps of public employees to deliver education and health services. These services were expected to reach the poor by virtue of broad coverage. While impressive gains were made, large gaps between the education and health attainments of the rich and poor remained. For example, the poor have much higher incidence of certain diseases, higher infant and child mortality, poor nutrition and their children lag in school. These discrepancies can be traced back to inadequate performance of teachers, doctors, nurses and other health care providers who lack skills, environment and incentives to address the needs of the poor.

During the crisis, emergency programs, including those supported by the SSNAL, helped to prevent sharp reductions in education and health status common to crisis-hit countries and brought important institutional changes which improved transparency and accountability - complaints were independently monitored and communities had more information and involvement. These “demand-responsive” service delivery mechanisms should be retained in future programs. Bank policy dialogue and projects will also work to help:

- Improve capacity—raise the quality of civil servants (teachers and health workers) in terms of training and capabilities;
- Provide workers more flexibility to structure services based on local needs;
- Provide adequate compensation for those that perform (which will almost certainly require substantial reduction in the numbers);
- Promote private provision of education and health services where appropriate;
- Develop feedback mechanisms and accountability for adequate services to the poor; and
- Create a “broker” or “facilitator” function that works to help the poor articulate their voice.

55. **Third, the Bank will continue to help empower communities so that poor everywhere have an opportunity.** Building on the successes of recent community-driven

¹³ The final approach to APLs will depend on the fiscal transfer framework ultimately agreed.

development projects, the Bank will continue to focus on approaches in which project selection and implementation are in the hands of communities, and which support civil society monitoring of project implementation budgets and expenditures.¹⁴ This approach has shown to better match community investments with local needs, increase women's involvement in development, and build local social capital. The Kecamatan Development Project, for example, increases women's participation in proposal preparation and decision making. In future projects, the Bank will support the Government to retain and enhance the direct fund channeling mechanisms and monitoring systems in these projects, which have yielded 20-40 percent savings over standard public sector delivery of basic infrastructure. These projects would target poorer urban and rural areas, on and off-Java, and will seek to further improve fiduciary controls, quality of outputs, and links with district governments. Proposed new projects include Kecamatan Development Project (supplemental), second Kecamatan Development Project, NTB Poverty (pilot), and Community-based Urban Development.

56. **Assistance to areas in conflict.** At least five provinces are involved in serious violent conflict, while others are affected by large numbers of people displaced by violence. About 15 ongoing Bank projects have components in four of these areas (Maluku, Central Sulawesi, Aceh, West Timor). The Bank may have comparative strengths in dealing with post-conflict situations, as it already deals with many of the underlying economic causes (economic disparities, governance issues, weak government and civil society), and has developed innovative approaches to community development and demand-responsive program design. The Bank's Kecamatan Development Project (KDP) approach provides a possible avenue for assistance to post-conflict areas. But the Bank is not well placed to provide emergency assistance. And risks are high as donor involvement may exacerbate divisions while there are possible reputational risks to the Bank. The Bank therefore does not foresee taking a leadership role among donors in this area, but will seek to get better integrated into the United Nations system for monitoring conditions in violence prone areas and sharing Bank experience in successful poverty approaches that may apply to such areas. Besides, the Bank will (a) develop a more systematic response to the impact of conflict on ongoing projects to ensure continued development impact and protection of project resources, and to create flexibility for possible refocusing of assistance on reconstruction and development in post-conflict areas; and (b) selectively pilot innovative approaches in violent prone areas that address critical needs of the poor (e.g., recent support for widows in Aceh) as the basis for learning and possible wider application in other areas.

¹⁴ The community development model of the two completed village infrastructure projects and the Kecamatan Development Project is now also applied in various other new projects—Urban Poverty Project, Water and Sanitation Supply for Low Income Communities II, rural area development projects, and the school building components in basic education projects.

3. IMPLICATIONS FOR THE BANK GROUP PROGRAM

57. **The Bank Group’s assistance program will require flexibility and adjustments as circumstances change.** The base case—considered to be the most likely scenario—presumes that the current “muddle through” situation will continue, with some slippage in structural reforms, but continued macroeconomic stability (para. 21) that would help sustain poverty reduction. On the downside, there is the possibility of increasing political turmoil, further major policy slippage or external shocks that may further delay implementation of the economic program. At the same time, the change in government offers significant opportunities for fundamental reform that have eluded Indonesia in the last three decades. The Bank Group’s program should be ready to respond and move to a high-case scenario in case reforms accelerate.

58. **The Bank Group’s conservative base case program is expected to be reasonably robust in the face of most downside risks, while at the same time positioning the Bank Group for possible upside opportunities.** The “muddle through” base case scenario provides a tenuous base for Bank Group support to Indonesia. This is not a desirable scenario to undertake much new lending and even harbors risks to our portfolio as fiduciary standards may slip in the newly decentralizing environment. At the same time, the Bank is one of Indonesia’s major long-term development partners and cannot disassociate itself as the country moves through its historic democratic transition. The base case program takes account of these factors and provides for a conservative Bank lending program of up to US\$400 million per year with an average 65:35 IBRD/IDA blend over the CAS period. This is less than one third of pre-crisis lending levels, and would result in a gradual reduction of the Bank’s high exposure in Indonesia (para. 89). The focus will be on poverty and community development projects which are expected to be reasonably robust in such an uncertain environment. The minimum conditions for the base case scenario would be the maintenance of macroeconomic stability, minimum fiduciary safeguards for delivery of public services with decentralization, and establishment of organizational arrangements, scope, process, and schedule for developing a broad-based poverty reduction strategy. A continued strong AAA program in the base case would assist Government in enhancing policy performance, which in turn may lead to a possible high case assistance scenario—including enhanced IBRD and IDA lending. On the other hand, a possible deterioration from the “muddle through” base case scenario could lead the Bank to cease all new lending.

59. **The country’s decentralization move will reshape the Bank Group’s operating environment.** The Bank has begun to prepare for working in a decentralized environment. But during the transition to such an environment, the Bank can expect significant difficulties to its program. It has devoted significant resources to advising the Government on how to minimize the associated risks. Decentralization also presents important medium-term opportunities for the Bank. As explained in the previous section, the Bank has started a consultative process to develop new ways of doing business in this new environment. Much of the Bank’s future new lending will be to assist sub-national governments.

60. **Indonesia’s weak fiduciary environment poses continued risks for the Bank’s portfolio and lending activities.** As noted, Indonesia suffers from weak traditions of accountability in the public sector which has led to widespread corruption and misuse of public funds. This affects donor funds in equal measure. The forthcoming decentralization of a large share of public expenditures to regional governments will compound existing weaknesses. While the Bank has made considerable progress in strengthening fiduciary controls (para. 28), the challenge will be to further enhance protection of its portfolio and lending resources in a context of greater risk. Protecting Bank-financed projects in a sustainable manner can be effective only if there are systemic reforms to Indonesia’s accountability, procurement and financial management framework. Government has indicated its commitment to take steps in this area (para. 69). Besides strengthening its own fiduciary controls, the Bank will condition its lending levels and access to additional IDA on progress in strengthening of public procurement and financial management systems.

61. **The Bank Group program involves close cooperation with the Bank’s development partners based on comparative strength, proactive portfolio management with enhanced fiduciary controls, a high-quality program of analytical and advisory activities focused on key areas of reform and risk management, and a flexible lending program with strong poverty focus.** The CAS program, instruments and assistance scenarios are elaborated in the following sections. Table 3.1 provides an overview of the CAS program components and related Bank instruments and lead partners. A CAS program matrix is shown in Annex B9.

Table 3.1: Bank Group Instruments and Major Partners by Bank Group Program Area

Bank Program Area	Bank Instruments		Major Partner(s)
	National level	Sub-national level	
<i>Economic recovery & quality growth:</i>			
• bank & corporate restructuring	AAA, SPN, IFC	-	IMF, ADB
• macroeconomic stability	AAA	AAA	IMF
• pro-poor policies	LEN, AAA	AAA, LEN	DFID
• private sector development	AAA, IFC, MIGA	AAA	ADB
• human capital development	AAA	AAA, LEN	ADB, WHO
• addressing infrastructure bottlenecks	AAA, IFC, MIGA	AAA, LEN	ADB, Japan
<i>Building national institutions:</i>			
• legal & judicial reform	AAA	-	Netherlands, ADB, USAID
• civil service reform	AAA	-	-
• public procurement & financial mgt.	AAA, SPN	AAA, SPN	ADB, Japan
• managing decentralization	LEN, AAA	-	IMF, ADB, GTZ
• natural resource management	AAA	AAA	EU, DFID
<i>Delivering better public services to the poor:</i>			
• defining roles and responsibilities for each government level	AAA	AAA	ADB
• demand responsive service delivery	AAA	LEN, SPN	ADB, Netherlands
• community development	-	LEN, SPN	ADB, Japan
• assistance to (post) conflict areas	-	AAA, SPN	UNDP, UNHCR

Note: AAA = analytical and advisory services (policy advice, economic and sector work—ESW); LEN = lending; SPN = supervision of ongoing projects

PARTNERSHIPS AND SELECTIVITY

62. **The Bank Group is increasingly pursuing partnership arrangements based on strategic fit and comparative advantage.** This allows the Bank Group much greater selectivity in terms of areas of concentration, while drawing on its partners' skills and expertise to provide the broad overview of the development process that is supported by the Bank's central aid coordination function. In Indonesia, as elsewhere, the Bank Group continues to pursue a multi-layered partnership strategy. Managing these partnerships is resource-intensive, but the payoff for the Bank Group is a leveraging of its resources, and the sharing of knowledge and expertise, and access to civil society that the Bank Group on its own would find difficult to achieve.

63. As **chair of the CGI**, the Bank works closely with most of Indonesia's major development partners who rely on the Bank's analytical work and its close relation with Government to provide them the framework for assistance. In the rapidly changing development context of Indonesia, this implies not just the annual CGI meeting but also regular meetings in Jakarta, including a mid-year informal review of progress on CGI commitments. The CGI itself has evolved into a focused discussion on a range of key issues (e.g., structural reform, poverty reduction, governance, decentralization, forestry), typically led by donor partners with the Bank facilitating, but not leading, the process.

64. In support of the **Government's economic recovery program**, the Bank works closely with the IMF and the Asian Development Bank (ADB) in the context of Government's Extended Arrangement with the IMF. The IMF takes the lead on macroeconomic policy, while the Bank takes the lead on structural and social policies (including corporate restructuring and sectoral policy). ADB is the lead agency on privatization and state-owned enterprise (SOE) reform, and SME development. All three institutions share joint responsibility for support of bank restructuring and financial sector reforms. The Bank works closely with the IMF and ADB in preparing the LOI for the Extended Arrangement.

65. In support of the **Government's medium-term development program**, the Bank Group partnerships are again multi-layered:

- **Sectoral partnerships:** A range of partnerships have emerged in a number of areas, such as governance, decentralization, SME development, competition policy, water resource sector reform and forestry. Each has lead donors and a concerted effort to coordinate donor program and policies in support of a common set of objectives agreed with and sometimes led by Indonesian stakeholders. Perhaps the most ambitious and innovative of these is the Indonesian-led Partnership for Governance Reform in Indonesia, an initiative of the UNDP, the World Bank Group and the ADB, which is intended to support Indonesia's transition to a democratic decentralized society by facilitating a national dialogue on governance issues

aimed at bolstering the demands for reform, with funding to support innovative governance reform.¹⁵

- **Major lenders:** Official lending in support of Indonesia's development priorities is dominated by three agencies: Japan's JBIC, ADB and the World Bank Group. These three agencies work closely together to ensure consistency in approach and policy stance. The Bank has pulled back from areas where its strategic program fit is reduced, such as the large parastatal-led infrastructure investment projects in power and telecommunications which were a big part of the Bank's pre-crisis lending. Japan is still a player, while the Bank complements this role through advice to Government on its policy and regulatory framework for infrastructure (para. 45). IFC in turn is interested to promote private participation in infrastructure (para. 85). The Bank and ADB work together on joint sectoral approaches and in some cases joint documentation (e.g., basic education). The Bank, ADB and JBIC work closely on the period Country Portfolio Performance Reviews (CPPRs) with Government, and the three lenders are coordinating closely to manage the fiduciary risk reviews posed by decentralization.
- **Policy dialogue:** The more important, established bilateral donors look to the Bank Group to take the lead on the overall policy dialogue and seek to complement the Bank Group's role through strategically directed technical assistance on grant terms, thus filling a gap in the Bank Group's arsenal. They support the Bank Group's policy work through consultant trust funds and occasional secondment of staff to the Bank Group office in Jakarta.
- **Cofinancing:** Some donors (most notably the United Kingdom and the Netherlands) do not wish to maintain a large aid presence in Jakarta but are conscientiously choosing to cofinance, on grant terms, the Bank Group's operations, thus softening the overall terms the Bank Group offers. These donors work particularly closely with the Bank Group and have been most supportive in stretching the Bank Group's AAA resources.
- **Partnerships with smaller agencies:** The smaller agencies, such as UNICEF, see the Bank Group as a partner who allows them to marry their local knowledge and expertise with an ability to scale up their activity. These agencies and foundations are keen to work with the Bank Group because they see us amplifying their voices on policy issues and providing them a framework within which they are able to operate.

66. **The CAS program will more systematically exploit synergies within the Bank Group, particularly in private sector development.** Bank and IFC activities in Indonesia are now managed by a joint Director who coordinates private sector development activities. This provides for greater scope in exploiting synergies between policy and transactions, such as applying the lessons from IFC's corporate experience in the Bank's work on developing the

¹⁵ Under the partnership, a *Facility* houses a small number of national and international experts who facilitate an Indonesian-led national dialogue on issues of governance that is informed by surveys, strategic thinking and research, and sharing of international best practices; A *Governance Fund*, which has attracted bilateral donor support (\$25 million) for innovative governance reform proposals from civil society and government agencies. These two vehicles function under the direction of an Indonesian-led Board of Governors shared by two prominent advocates of governance reform.

policy and regulatory frameworks across the sectors in which the Bank is active, for example in banking, legal reform, corporate restructuring and governance, infrastructure and the social sectors. While the Bank will focus on policy and institutional reforms, IFC will invest in priority areas—taking steps to avoid any conflict of interest that may arise. Financial sector, SMEs and mining are good examples. IFC may invest in existing and new financial institutions and strengthen management, credit analysis, risk management. In SMEs, IFC is looking for opportunities to help set up a decentralized SME facility for SME services, and to invest in financial intermediaries serving SMEs. In mining, based on its experience with the Business Partnership for Development, the Bank is looking at strengthening capacity at local and regional levels to develop and enforce environmental regulations, and facilitating partnerships and procedures to set up mechanisms for dispute resolution. IFC in turn could invest in environmentally and socially sustainable mining operations. Within the Group, the Foreign Investment Advisory Group (FIAS) and MIGA focus on strengthening foreign investment services at the regional level in the context of decentralization.

PORTFOLIO MANAGEMENT

67. **Portfolio management will focus on continued quality improvement and further strengthening of fiduciary controls.** The Bank's portfolio will continue to decline in size as more projects are closed than are added. By FY03, we expect our portfolio to stabilize at around 50 to 55—down from 66 projects at end-FY00 (including GEF operations). In view of decentralization, the Bank will be adjusting implementation arrangements with related capacity strengthening in ongoing projects that will operate in the newly decentralized government structure (e.g., basic education and health projects). The Bank will continue to seek quality improvements and emphasize fiduciary oversight in its portfolio through: (a) proactive management of problem projects; (b) restructuring of projects to maintain relevance and improve performance; (c) increased thematic supervision to review systemic issues and enhance cost-effectiveness of supervision work across projects in a sector or region; (d) improved readiness for implementation to avoid start-up delays;¹⁶ and (e) attention to fiduciary controls related to procurement and financial management. The Bank will intensify its work with ADB and JBIC on common approaches to portfolio management as an extension of the joint CPPR work started in FY00. Improvements in portfolio performance during the CAS period are expected to be modest because of the fluidity of the overall environment and uncertainty and challenges caused by the forthcoming decentralization. The portfolio quality targets are shown in Table 3.2.

68. **Actions to strengthen fiduciary controls in procurement and financial management include steps at the national level and at the level of the Bank's portfolio.** Portfolio management in Indonesia will remain challenging because of continued downside risks associated with macroeconomic performance, inadequate project management and governance, limited monitoring and evaluation capabilities, ineffective fiduciary functions (procurement, financial management, internal controls and reporting), and the huge decentralization agenda.

¹⁶ Implementation readiness is judged by a combination of factors, including (1) performance indicators being in place; (2) firm arrangements in place for implementation funding; (3) completion of plans and financing arrangements for any land acquisition and resettlement; (4) establishment and staffing of project implementation units; (5) procurement and financial management/audit arrangements in place; (6) completion of procurement documents for first-year implementation.

Table 3.2: Bank Portfolio Quality Targets, FY01-03

Indicators	FY00 (actual)	FY01	FY02	FY03
% Projects at risk (no.)	21%	18%	17%	16%
% Actual problem projects (no.)	18%	16%	15%	14%
Realism index	83%	85%	90%	90%
Pro-activity index	83%	85%	85%	90%
Disbursement ratio	21%	20%	20%	20%

The Bank also realizes that the deep-seated nature of corruption in Indonesia will make strengthening of fiduciary controls a long-term challenge and managing large fiduciary risks to Bank-financed projects will require constant attention. Also, decentralization if not well managed on fiduciary standards at the local level can pose fiduciary fragmentation and divergence, which will pose severe control risks and result in unnecessary costs. Building on the results of the CPAR and CFAA work in FY00-01 and of a recent high-level Bank mission to review Indonesia's fiduciary control environment, the Bank will support Government efforts toward the preparation and implementation of action plans to strengthen the weak financial management and procurement systems.

69. **At the CGI meeting in Tokyo, the Government made specific commitments to reform the public procurement and financial management systems along the lines of the CPAR and CFAA.** These steps are outlined in Box 3.1, along with an overview of the fiduciary environment and the strategy to protect Bank-financed projects. Satisfactory progress in reform of these systems has been built in as triggers for future Bank lending (see para. 80). This includes immediate steps to ensure for the base case lending program that same fiduciary standards for public procurement and financial management are applied at provincial and district levels, as at the national level. Maintaining uniform standards for procurement and financial management will require a revision of current government regulations related to implementation of the decentralization program. In order to develop a sound fiduciary environment, these actions will need to be complemented by reforms in the overall governance system, including reforms in legal and judicial systems, civil service reform and the overall accountability structure. These efforts are supported by the Bank's work on governance reform (para. 46).

70. **IFC has been able to turn around its portfolio hit by the crisis, by way of intensive restructuring and recapitalizing of its existing client companies.** As in other crisis-affected countries, IFC has worked on restructuring of its existing client companies. IFC's portfolio included 14 problem projects with total exposure of \$364 million (\$138 million A loans, \$43 million equity, and \$183 million B loans), representing about 43 percent of IFC's total exposure in Indonesia. IFC completed four major restructuring projects for a total \$135 million, or about 42 percent of the problem loan portfolio. Only one portfolio company has been put into liquidation proceedings as a result of other creditors taking legal action. IFC will continue to follow up on these efforts in protecting its portfolio.

71. **MIGA has recently reopened its guarantee operations in Indonesia after the conclusion of an agreement to settle a claim.** MIGA's portfolio in Indonesia was affected by a

Box 3.1: Fiduciary Environment and Bank-Financed Projects

The overall fiduciary environment in Indonesia is weak. The findings of the recent CPAR and CFAA confirmed that the public procurement system does not function well and the internal control environment remains inadequate. Practices vary widely from the formal rules and procedures, enforcement is weak and sanctions are rare. There are concerns about the value of money and accountability for public funds. The main problems are:

- Weak compliance with existing procurement rules and procedures; lack of internal controls, oversight and enforcement; uneconomic packaging, inadequate advertising; use of restrictive bidding practices; prevalence of collusive practices; and lack of capacity.
- Lack of clarity in important policy and procedural requirements for public procurement, with an effect on the level of transparency and enforcement
- Absence of a single agency with a mandate for formulation of procurement policy, and monitoring compliance, and for ensuring clear and enforceable sanctions and enforcement mechanisms.
- Absence of strong enforcement when procurement irregularities are discovered and mishandling of funds is reported.
- Unclear roles, responsibility, and authority of various external and internal audit functions.
- Inadequate parliamentary oversight and delays in timely public reporting of financial information.

Decentralization and the increasing shift to new lending to social sector projects, which involve thousands of small-value contracts at the sub-national government level that are generally not subject to prior review by Bank staff and where capacity for implementation and monitoring is generally weak and the accountability issues are significant, would increase fiduciary risks in Bank-financed projects.

Despite the Bank's best efforts, it is simply not possible to fully insulate Bank-financed projects from the systemic problems in the country's environment in which they are implemented. A recent mission of senior staff from Operational Core Services (OCS) recommended further strengthening of accountability and fiduciary oversight in the use of public funds, including those under Bank-financed projects. Building on the outcome of the OCS mission and the CPAR and CFAA, the Bank's strategy to help reduce opportunities for corruption and thereby help ensure that proceeds of Bank loans are used for the intended purposes with due attention to economy and efficiency, has the following four components (besides our broader work on governance reform and anti-corruption):

- **Prevention—Reducing opportunities for corruption in new projects through strengthened project design:** the Bank will pay close attention to the fiduciary environment and capacity of the implementing agencies and incorporate adequate safeguards in the design of new projects. It will give priority in new projects to the provinces and districts that demonstrate concerns for economy, efficiency and transparency in the use of public funds. The Bank will insist on the installation of planning, budgeting, and project management reporting systems, and on additional legal provisions to make the national competitive bidding procedures acceptable to the Bank. It will promote greater beneficiary and civil society involvement in the design, implementation and monitoring of projects to enhance transparency and prevent misuse of funds, and third party verification as a feature of new projects.
- **Strengthening existing mechanisms of fiduciary monitoring and supervision of ongoing projects:** the Bank will intensify efforts for requiring updated and satisfactory annual procurement and financial plans and insisting that they are used for guiding implementation and supervision, conducting regular ex-post procurement and SOE reviews, strengthening capacity of the implementing agencies, and ensuring that procurement complaints and audit findings are followed up. Projects with increased fiduciary risks will receive special attention. The Bank will increase the number of selective site visits to review procurement by sub-national governments and physical progress to match with fiduciary risks.
- **Enforcement—Investigating cases of alleged fraud and corruption:** the Bank will rely on its Corruption and Fraud Investigation Unit (CFIU) to investigate cases of alleged fraud and corruption, and apply sanctions where called for. The first visit of CFIU to Indonesia was in November 2000, and a follow-up mission will take place in early 2001.
- **Supporting Government efforts to reform the public procurement and financial management systems:** This support will follow up on the recommendations of the CPAR and CFAA and the recent OCS fiduciary mission. Full implementation of reforms of the overall systems at all levels of government will take time. At the October 2000 CGI meeting in Tokyo, Government made specific commitments along the lines of the CPAR and CFAA. The Bank's immediate priority will be to support Government efforts to (1) ensure that the same fiduciary standards are applied at national, provincial and district levels; (2) establish a National Public Procurement Office (NPPO) to formulate procurement policy, and enhance and monitor compliance; (3) revise draft laws on State Finance, Treasury and Audit, which been submitted to Parliament already; and (4) support NPPO in the formulation of a public procurement law.

guarantee activities in Indonesia for a year. Recently, extensive negotiations between MIGA and the Government of Indonesia resulted in an agreement for the settlement of the claim. As a result, MIGA will resume its underwriting activities in Indonesia upon the entry into force of the settlement agreement. Over the past year, MIGA has seen a significant demand from investors interested in the finance, infrastructure and resource-based sectors and MIGA intends to pursue these investments in a prudent and cautious manner.

ANALYTICAL AND ADVISORY ACTIVITIES

72. **The Bank is rebuilding its AAA program with heavy emphasis on advisory activities, a small but growing body of analytical work, and increased attention to regional issues.** The main components of the program are shown in Annex B4. In the “muddle-through” base-case scenario, the Bank will retain a high level of advisory activities on immediate policy issues in:

- **Bank and corporate restructuring:** The Bank’s intensive involvement in this key area must be maintained (see para. 40 for the Bank’s areas of emphasis). Not to do so would invite a large reputational risk for the Bank Group.
- **Development of a poverty strategy:** The Bank’s draft paper contributing to a Government poverty strategy will feed into the development of a poverty strategy backed by a multi-stakeholder consultation process. This would also involve assistance for Government’s preparation of a PRSP in FY02 (para. 17).
- **High-priority public procurement and financial management reforms:** Based on ongoing work in public procurement and assessment of the government financial system, the Bank will advise on key initial steps in setting up a public procurement agency, on revisions of the draft Laws on State Finance, Treasury and Audit, currently in Parliament, and on safeguarding public finances in a decentralized environment (para. 69).

73. **The Bank’s AAA program will also include components of a medium-term nature,** such as:

- **Governance:** The Bank’s recent work on fiscal decentralization, civil service reform, financial management, and corporate governance should be considered only the first step in a long-term engagement with these issues—involving advisory activities supported by analytical work.
- **Implementation of the poverty strategy:** Preparation of the poverty strategy in the short term will need to be followed up with support for its implementation, especially at the regional level. The Bank will also continue its agricultural policy dialogue, which it considers a key component of a broad-based poverty strategy.
- **Analytical work at the regional level:** Work will be undertaken to develop a better understanding of local institutions, local capacity, public expenditure programs, fiduciary environment and the quality of public service delivery to the poor. This work will be undertaken by cross-sectoral teams that engage with sub-national governments, civil society

groups, the private sector, and local communities. It will be aimed at developing a new generation of lending operations at sub-national level that embody demand-responsive policies and public service delivery as outlined in the previous section (para. 51).

- **Design and implementation of a long-term financial sector strategy:** The current focus on bank restructuring will now need to make way for a broader and more medium-term reform of the entire financial sector, including non-bank financial institutions, the capital market, rural financial intermediation, and micro-finance.
- **Long-term development prospects:** The Bank intends to initiate a joint work program with Indonesian policy and research institutions and its international development partners to help Indonesia prepare a long-term view of its development prospects focusing, among others, on agriculture, environment, health, education, urban and spatial issues. The Bank's role will primarily be one of facilitator and intellectual interlocutor, while the leadership will come from Indonesian institutions supported by trust funds.

74. **The World Bank Institute (WBI) is fully integrated into the AAA program.** WBI will support the AAA agenda in a few key areas (governance/anticorruption, decentralization, forestry reform), help access the new technology-based global learning networks that the Bank and other development partners are establishing, and make available learning programs to a number of diverse audiences (such as parliamentarians, think tanks, civil society).

LENDING PROGRAM, TRIGGERS AND INSTRUMENTS

75. **The base case lending program could return investment lending to less than one third of pre-crisis levels.** In the “muddle-through” base-case scenario, lending would be up to \$400 million a year, as compared with average lending of about \$1.3 billion a year during FY90-97. This would include Indonesia's current IDA-12 allocation of SDR300 million (about \$400 million), and assumes continued IDA access beyond FY02. If Indonesia's IDA allocation were to be maintained at the level of IDA-12, this would result in an average 65:35 IBRD/IDA blend during the CAS period. Any proposals for an IDA allocation beyond the IDA-12 period (FY00-02) would be considered within the context of the IDA-13 replenishment. Minimum conditions for the base case would be maintenance of macroeconomic stability, including prudent debt management and progress on asset sales and privatization, minimum fiduciary safeguards for delivery of public services with decentralization, and establishment of organizational arrangements, scope, process, and schedule for developing a broad-based poverty reduction strategy. Specifics of these minimum conditions are shown in Table 3.4 below. Lending would be for projects in health, education, basic infrastructure, and community development. The types of poverty-oriented projects in the base case are expected to be reasonably resilient as long as macroeconomic conditions remain stable. No adjustment lending is foreseen in the base case.

76. **The CAS also anticipates possible “crisis” scenarios.** As indicated above, the base case scenario is expected to involve considerable volatility in policy and institutional performance. A breakdown in Government's Extended Arrangement with the IMF as a result of major policy slippage, including inadequate progress on bank and corporate restructuring, could lead to a rapid erosion of market confidence and deterioration in economic conditions. A similar outcome could result from political instability or a widespread deterioration in law and order. In these adverse situations, the Bank would cease all new lending until base case conditions have been

restored. The Bank would however continue all ongoing projects, unless they were directly affected by the country situation, and project preparation, so that it could respond quickly once the situation improves. In the event of another macroeconomic shock, e.g., from lower world oil prices, slower global growth, or volatility in international capital markets, the Bank may be asked to contribute to an international rescue effort with additional adjustment lending or support to crisis-response programs. The Bank's response this time around would depend on the circumstances, but will need to take account of Indonesia's high debt burden as well as IBRD's high exposure in Indonesia (para. 89).

77. The Bank is prepared to move to a higher lending case, if policy performance improves ("performance" scenario). The change in government has offered significant opportunities for fundamental reform. The Bank is working with Government in the various areas of structural and governance reform, and in developing a poverty strategy. In case reforms accelerate, and in line with Government's request, the Bank is prepared to raise lending to about \$1 billion per year from FY02. In such a scenario, increased investment financing needs for basic infrastructure services (urban and rural) are envisaged as economic activity accelerates, besides an accelerated expansion of community development and social sector programs given the higher prospects for sustainability with a broad-based poverty strategy. A high performance environment would allow for an earlier move toward programmatic lending—as early as FY02 for sectoral interventions (APLs for water and urban services). Indonesia would be eligible for adjustment lending in the high case, although it is unlikely to be needed given current budget and balance of payments projections. The high-case program includes a small indicative amount of adjustment lending in FY01-02 (about \$200 million a year) before it is phased out in later years.

78. As part of the high case, the Bank would temporarily increase Indonesia's IDA allocation. At the recent IDA Deputies meeting in Lisbon, Deputies broadly agreed that the processes of reform and improving governance in Indonesia should be strongly supported, including through enhanced IDA allocations as elaborated in the background note from staff.¹⁷ In the meantime, Government has taken initial steps in the areas of poverty reduction and governance reform. Based on adoption *and* sustained implementation of coherent action programs in these areas, the Bank would increase Indonesia's current IDA share by about US\$200 million a year over the period FY01-03. In the high case, the average IBRD/IDA blend would be about 60:40 over the CAS period. The lending scenarios in the base case and the high case are shown in Table 3.3.

79. Indonesia's IDA eligibility would be on a temporary basis. The reforms supported by the higher IDA allocation would boost prospects for an accelerated economic recovery and enable Indonesia's return to full market access. Indonesia is expected to phase out from IDA as economic growth gains momentum and its per capita GNP surpasses again the IDA threshold (\$885 for IDA-12). Based on current projections this is not likely to happen for another four to six years. Using current market sentiments as a guide and the increased uncertainties, Indonesia is more likely to surpass the IDA threshold before it regains the status of a high-creditworthy borrower with full market access.

¹⁷ Staff paper entitled "Indonesia—Recent Developments and Issues That Will Underpin the FY01-03 Country Assistance Strategy," circulated to the IDA Deputies on May 24, 2000.

Table 3.3: Lending Scenarios, FY01-03

	FY00 (Actual)	FY01	FY02	FY03	CAS Period (FY01-03)	IDA-12 Period (FY00-02)
<i>Base-Case ("Muddle-Though" Scenario)</i>						
IBRD:						
-- investment	13	238	280	265	783	531
-- adjustment	-	-	-	-	-	-
<i>Subtotal</i>	13	238	280	265	783	531
IDA	120	160	120	135	415	400
<i>Total</i>	133	398	400	400	1,198	931
<i>High-Case ("Performance" Scenario)</i>						
IBRD:						
-- investment	13	158	400	600	1,158	571
-- adjustment	-	200	200	-	400	400
<i>Subtotal</i>	13	358	600	600	1,558	971
IDA	120	240	400	400	1,040	760
<i>Total</i>	133	598	1,000	1,000	2,598	1,731

80. **The high-case lending scenario is conditioned on a set of upfront reform actions plus continued progress in key reform areas monitored by regular policy performance assessments.** For the high case, upfront actions involve a set of key Government actions in two broad areas—macroeconomic stability and structural reforms, and governance and participation. In the first area, Government will need to take actions aimed at improving macroeconomic performance, accelerating bank and corporate restructuring, implementing its privatization plan, and setting a medium-term direction of rice policy. The Bank will continue to use the LOI as the primary instrument to assess progress on macroeconomic stability, bank and corporate restructuring, and privatization (also see para. 81). Upfront actions in these areas will comprise agreement on the appropriate policies and targets in the LOI. In the second area, key conditions for the high case involve Government actions to strengthen public procurement and financial management systems, and to initiate preparation of a broad-based poverty reduction strategy based on multi-stakeholder consultations. These upfront actions for the high-case lending scenario are elaborated in Table 3.4 below.

81. **The Bank will undertake regular semiannual policy assessments with Government to determine continued eligibility for the high case and to set performance targets for the next six months.** Given the difficulty of setting upfront annual lending triggers for the CAS period in Indonesia's uncertain environment, these semiannual policy assessments will provide the basis to judge whether Indonesia qualifies for the high case scenario. The findings of the review would be made available to the semi-annual CGI meetings for review by the Government with the donor community. A satisfactory outcome of the review would mean that Indonesia would be eligible for enhanced financial support from IBRD and IDA. Alternatively, if policy actions fall short of agreed targets, Indonesia's eligibility will be revisited after six months. These semiannual reviews provide the Bank and the Government a benchmark against which to judge progress and a regular vehicle to discuss structural and social reforms. As part of these reviews, the Bank will continue to use the LOI as the primary instrument to assess progress in the areas of macroeconomic performance, bank and corporate restructuring and privatization. Over time, as the scope of the LOI narrows, the Bank will review with Government the feasibility to move toward a letter of development policy which would outline Government's agreed commitments for social and structural reform not covered in the LOI.

Table 3.4: Minimum Conditions and Up-front Actions for Poverty Reduction in a Base Case and High Case Lending Scenario

Base Case (“Muddle-Through” Scenario)	High Case (“Performance” Scenario)
<i>A. Macroeconomic stability & structural reforms</i>	
Maintain macroeconomic stability: 1. Prudent debt management, and progress on asset sales and privatization, to keep government debt below 100% of GDP* 2. Base money program consistent with inflation below 15% 3. Primary (non-interest) budget surplus at least 1% of GDP	Improve macroeconomic stability:** 1. Government debt below 100% of GDP (2001); 90% (2002) and 80% (2003)* 2. Base money growth program consistent with inflation below 10% 3. Primary (non-interest) surplus of at least 1.5% of GDP Accelerate bank- and corporate restructuring:** 1. Agreement on corporate restructuring principles 2. IBRA cash recovery Rp 27 trillion during 2001 3. Complete privatization of BCA, Bank Niaga Implement privatization plan:** 1. Receipts > Rp 6.5 trillion in FY2001 Set medium-term direction of rice policy: 1. Establish and operationalize interdepartmental working group on rice policy 2. Adopt agreed strategy for future rice policy, including price and trade policy, the role of BULOG, and productivity enhancing measures for farmers
<i>B. Governance and participation</i>	
Provide fiduciary safeguards for delivery of public services with decentralization: 1. Restrict local government borrowing in FY01 2. Apply national standards to local government procurement and financial management Establish organizational arrangements, scope, process, and schedule for developing a broad-based poverty reduction strategy based on multi-stakeholder consultation.	Strengthen public procurement and financial management: 1. Establish and operationalize two high-level committees to guide reform of procurement and financial management systems; 2. Adopt and publish satisfactory action plan to reform the organizational structure and legal framework for procurement; 3. Submit acceptable laws on state finance, treasury and audit to Parliament. Prepare broad-based poverty reduction strategy: 1. Draft agenda on poverty reduction strategy to facilitate consultations; 2. Initiate multi-stakeholder consultations.

* At projected prices and average exchange rate; debt includes debt to IMF.

** Upfront actions will comprise agreement on appropriate policies and targets in the LOI.

82. **The Bank lending program foresees a mix of investment projects that respond to its poverty focus and that would provide flexibility to respond to changing circumstances.** The program’s core investment projects would support delivering better public services to the poor through local governments that have demonstrated reform and community empowerment to reach the poor. Project focus would include: (1) community-based development programs (the recent Kecamatan Development and Urban Poverty Projects provide good examples); (2) human development (sub-national programs in health and education); and (3) basic infrastructure (urban and rural). In addition, investment projects would support pro-poor policies for quality growth,

where appropriate (land administration and access to micro-finance). Particularly in a high case scenario, the Bank intends to use Adaptable Program Loans (APLs) increasingly at the sub-national level, rewarding those regions which undertake pro-poor reforms—both sectoral and broad-based public sector reform toward transparent, accountable government. Such programmatic lending is expected to have the largest poverty reduction impact by targeting provinces and districts whose leaders have already taken pro-poor, pro-growth reform measures (para. 54). This would require sub-national administrative institutions to be functioning in a satisfactory manner—including maintenance of minimum fiduciary standards. A possible public sector reform loan/credit is contemplated at the national level to help strengthen central government capacity in a post-decentralization era.

83. As decentralization proceeds, Bank funds will be increasingly onlent to sub-national governments. Although the Bank is still discussing the regulatory framework with Government, it is likely that its lending will continue to be to the central government. Onlending will probably take place on terms that reflect the borrowing costs to the central government as well as the financial capacity of the local government. The average *cost-sharing ratio* in future projects (three-year rolling average) would be kept at the 75/25 ratio for IDA blend countries. The Bank will consider front-loading of disbursement percentages in individual projects if necessary in view of possible counterpart funds constraints at local levels in the early stages of decentralization.

84. Beyond the restructuring of its existing clients, IFC will focus on interventions with strong demonstration effects and positive impact on market perceptions. IFC has commissioned a study to identify candidates for restructuring assistance. These projects typically combine financial, operational and managerial restructuring, using a variety of instruments loan/equity, quasi-equity and technical assistance. In addition to individual transactions, IFC is exploring ways to leverage its limited resources at wholesale level through specialized investment funds to respond to the urgent needs for equity capital in the corporate sector. As part of IFC's crisis response, the Corporation is pursuing opportunities to help the restructuring process with the recapitalization of private banks, establishment of restructuring funds or other specialized institutions, investments in individual financial institutions, attracting strategic partners where possible, and complementing its investments with capacity building through technical assistance and twinning arrangements. A longer-term objective is to assist the deepening of the Indonesian financial sector through institution building in housing finance and mortgage-based securities products, securitization, corporate bond markets, and e-banking. In addition, IFC has prepared a second trade enhancement facility to respond to urgent needs.

85. In support of SME development, IFC intends to mobilize donor funds to finance a decentralized SME facility to provide a range of services, and build financial infrastructure for SMEs such as credit bureaus. It is looking for opportunities to invest in financial intermediaries focusing on SMEs and micro-enterprises. It is also exploring investment opportunities in resource-based industries, particularly oil and gas, and mining. Finally, IFC is interested to promote private participation in infrastructure in areas where regulatory structures are developing and where development needs are acute, such as water and transport. In a base case scenario, IFC's new business in Indonesia is expected to be in the order of \$140 to 180 million a year for IFC's own account. In a high case, the level could be in the order of \$220 million a year for IFC's own account.

86. **IFC’s investment scenarios would be affected by progress in key reform areas.** IFC activity level would depend on: (a) progress on developing the bankruptcy and legal regime for protecting creditor rights; (b) progress on corporate governance (transparency and minority investor rights); (c) further openings in the FDI regime; and (d) the depth of corporate restructurings in terms of meaningful financial and operational restructuring taking place.

CIVIL SOCIETY OUTREACH

87. **The Bank will continue to extend efforts to engage civil society.** Since the crisis, the Bank has engaged a much more active and vocal civil society. It had to answer to persistent questions that its association with the previous regime contributed to high levels of debt and corruption. Considerable time was spent with members of the NGO community to review aspects of the Bank’s program and discuss their concerns. The recent CAS consultations provided a good forum to discuss the Bank’s role in Indonesia and explain its position on these issues (para. 31). Following the Kecamatan Development Project and Social Safety Net Adjustment Loan models, the Bank is also building in civil society monitoring of project implementation. The new generation of demand-responsive projects would create much greater scope for involvement of all stakeholders in project design and implementation. The Bank has invited interested representatives to look at a sample of projects for ways to reduce possible corruption. Following up on the civil society consultations, the Bank is open to an arrangement for a consortium of “anticorruption” NGOs to act as watchdog over the use of funds in Bank projects, and to work with regional councils comprised of civil society and local government and civil society, to monitor projects during both planning and implementation. In view of the diversity of the NGO community in Indonesia, it may take some time for such a consortium to emerge. The Bank has also increased its disclosure of information and has recently launched a new external website. The Jakarta-based Public Information Center is becoming more proactive in dissemination and outreach, and the Bank is considering establishment of small regional information centers in selected provinces. The media are used more actively in explaining the Bank’s position, and the Bank speaks out more openly when it differs from government positions. The Bank has also developed closer ties with an active Parliament and its relevant committees. If anything, these efforts will need to be intensified to maintain the Bank Group’s relevance in the new Indonesia.

PROGRESS MONITORING

88. **The Bank intends to monitor country progress against poverty reduction indicators once they are agreed in the Government’s broad-based poverty reduction strategy.** Indonesia’s historic approach to poverty overemphasized numerical targets, leaving many important dimensions of poverty and well-being unaddressed (para. 9). But giving up on goals would not be appropriate: without goals consensus in measuring progress would not be possible. To help ensure that progress is being made on the broader concept of poverty, the Bank’s draft poverty report suggests a new set of objectives, but emphasizes that goals should be set as part of the process of creating a poverty strategy which should be open to dialogue and debate among the stakeholders. Table 3.5 gives details of these possible poverty reduction goals to be attained by 2004. On the headcount of expenditure poverty, the proposed goal would reduce the headcount to a slightly lower level than that achieved pre-crisis—halving the headcount from the peak reached during the crisis. Based on CAS review feedback, the goals for “human investment” and “infrastructure access” poverty measures have been scaled back somewhat from

the poverty report given likely setbacks in these areas during the transition to decentralization. These possible goals aim to advance by 2004 the bottom fifth of Indonesian's population (below the 20th percentile by wealth or expenditure) to levels of human investment and access to basic infrastructure, which have been achieved by the those in the lower-middle income strata (20th to 40th percentiles). The Bank is also working with the Government to find ways to measure and track "social poverty," including the number of poor and women who participate fully in community life and in local political decisions that affect their lives.

Table 3.5: Possible Poverty Reduction Goals

Dimension of poverty	Empirical Measure	Current/Recent (% of population or quintile)	Possible Goals (2004)
Material standard of living	Headcount of expenditure poverty (1999)	27	Half
Human Investment	Completion of basic education of bottom quintile (1999)	37	45*
	Infant mortality rate of bottom quintile (1997)	109	77*
	Children in the bottom quintile with acute respiratory infection treated medically (1997)	52	68*
Infrastructure Access	Access of bottom quintile to "improved" water sources (1999)	22	33*
	Access of bottom quintile with "adequate" sanitation (1999)	13	23*
Vulnerability to material poverty	Vulnerability to expenditure poverty (1999)	50	Half

Notes: Current Poverty Rate is from Pradhan, et al. (2000), Vulnerability is from Suryahadi et al. (2000), two of the Human Investment measures are from Gwatkin et al. (2000) based on the 1997 DHS. Infrastructure Access and Basic Education Completion are from SUSENAS data.

*Goals are set to the level currently achieved by those in the 20th-40th percentiles by wealth (DHS) or consumption expenditures.

BANK EXPOSURE AND RISK MANAGEMENT

89. **Bank exposure.** By end-FY00, Indonesia's outstanding debt to IBRD was about \$11.8 billion—one of IBRD's three largest. This is lower than had been foreseen in the CAS Progress Report, but remains close to the Bank's concentration limit of \$13.5 billion for single large borrowers. Net IBRD disbursements, which are likely to be positive this year, will turn negative in the years to come, offset at least partly by net IDA flows (see Table 3.6 below). Even in the high case this will be so from FY03. This is appropriate in view of the government's desire to limit Indonesia's indebtedness, the Bank's greater focus on IDA lending and Indonesia's fragile creditworthiness for IBRD borrowing compared to before the 1997/98 crisis. In the base case, IBRD's exposure will fall to around \$10.7 billion by the end of FY03 and in the high case would reduce only marginally to \$11.2 billion.

90. **Financial risks.** The financial risks to IBRD in Indonesia remain substantial during the CAS period. By end-2000, total external debt service was estimated to be 40 percent of exports of goods and services, and is projected to exceed 30 percent throughout the CAS period—even after the reschedulings so far agreed, particularly by the Paris Club. Also at the end of 2000, Indonesia's total external debt to both GDP and exports—at an estimated 102 percent and 278 percent, respectively—leave the country vulnerable to new shocks. Further details of key

Table 3.6: Bank Exposure Indicators
(\$ million)

	FY00 (actual)	FY01	FY02	FY03
<i>Base Case Scenario</i>				
Debt outstanding and disbursed:	12,457	12,589	12,237	11,517
• IBRD	11,755	11,857	11,460	10,673
• IDA	702	732	777	844
Net disbursements:	221	124	(352)	(721)
• IBRD	201	100	(397)	(787)
• IDA	20	24	45	67
IBRD debt service as % of public debt service ^a	15.5	14.0	15.6	21.7
IBRD debt service as % exports ^a	2.2	2.3	2.5	2.6
<i>High Case Scenario</i>				
Debt outstanding and disbursed:	12,457	12,705	12,615	12,155
• IBRD	11,755	11,967	11,794	11,183
• IDA	702	738	821	972
Net disbursements:	221	240	(89)	(460)
• IBRD	201	210	(173)	(611)
• IDA	20	30	83	150
IBRD debt service as % of public debt service ^a	15.5	14.0	15.8	22.0
IBRD debt service as % exports ^a	2.2	2.4	2.5	2.6

^a Based on government fiscal year.

exposure indicators are shown in Annex B7. It should be noted that these ratios in Indonesia's case are sensitive to oil prices. The generally high level of oil prices in the past year will have been helpful, but Indonesia remains vulnerable to any renewed slippage in oil prices, especially if this results from a more general slowdown in world trade growth, which would hurt Indonesia's non-oil exports at the same time and shrink the current surplus more quickly.¹⁸

91. **Country risks.** As elaborated in the CAS, the Bank Group's assistance strategy in Indonesia is subject to high uncertainty and risk. Broadly, these might include (1) further political tensions; (2) lack of confidence in the reform process, particularly in bank restructuring and sale of state assets; (3) delays in the economic program and reform due to administrative and political constraints—reflecting partly the complexity of decentralization—which would adversely affect the implementation environment of Bank Group projects; (4) further regional and social turmoil, which would complicate coherent macroeconomic (especially fiscal) and structural policies; and (5) a less favorable external environment caused by more rapid decline in oil prices, or slowdown in world trade. These risks, individually or in combination, may threaten more broadly the prospects for restoring macroeconomic stability and growth, and hence Indonesia's external financial position and attractiveness to foreign investors.

¹⁸ The CAS economic scenarios assume a reduction in oil prices from \$28/bbl in 2000 to \$20/bbl in 2003 (para. 19).

92. **The CAS takes account of these risks.** The CAS is built around uncertainty and risk. The base case is based on conservative lending levels compared to earlier years, and the Bank would be ready to cease all new lending in case macroeconomic or political stability is threatened or fiduciary standards deteriorate. The Bank would focus lending on poverty-oriented projects, which are expected to be more resilient to changes in macroeconomic and political conditions. Adjustment lending is only foreseen in a high-case scenario and would be phased out by FY02. AAA is focused on areas where risks are the highest and the potential to lower them the greatest—such as fiscal decentralization, civil service reforms, judicial reforms, government debt management, and public expenditure management. The Bank would also strengthen other risk mitigating measures, such as: (a) continued intelligence gathering on social and political risks; (b) more emphasis on regular contingency planning; and (c) improved risk analysis in new loans.

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