

## INDONESIA

### “Headline” Developments

- The first quarter of 2001 saw domestic uncertainties increasing as ethnic violence escalated in the province of Central Kalimantan. Fighting also continues in Aceh, Irian Jaya, and Maluku (the Spice Islands).
- The IMF’s review mission, scheduled for late December, 2000, is delayed due to outstanding issues in four areas: the Central Bank Law; fiscal decentralization; the privatization of Bank Niaga and BCA; and corporate restructuring principles. The delay of the mission is contributing to the prevailing negative investor sentiment.
- The macroeconomic news is mixed. Real GDP grew by 4.77 percent in the year 2000 (annual), export revenues climbed sharply, real wages have increased, and the poverty rate has declined. But financial indicators deteriorated: domestic interest rates are on the rise and inflationary pressures have re-emerged. The exchange rate, which remained sluggish at around the Rp. 9,500/US\$ mark in the last two quarters of 2000, slid to over Rp.10,000/US\$ in March 2001.
- On the fiscal front, the fiscal deficit for FY2000 is expected to be less than 2 percent of GDP (compared to the budget target of 4.8 percent)—mainly due to higher oil and gas revenues. In 2001 the fiscal situation is deteriorating. With fiscal decentralization, windfalls in revenues are being shared with the regions while the depreciating rupiah and rising interest rates are putting pressure of central government spending. Access to foreign financing is contingent upon continued progress in the implementation of the ongoing reform program of the Government.
- Political uncertainty, regional and ethnic strife, a deterioration in law and order, and a continued weak judicial system are combining to undermine investor confidence. Critical to restoring investor confidence in the short term will be a resumption of the program with the IMF.
- Rising domestic interest rates are hurting banks, because much of their assets are fixed rate recap bonds, whereas their deposits are short term. The sale of BCA and Bank Niaga has been delayed and corporate restructuring has slowed in 2000. IBRA holds 80 percent of distressed loans of the banking system. IBRA and the FSPC are yet to adopt corporate debt restructuring principles that ensure transparent corporate restructuring.
- The Government’s radical decentralization program is three months underway. There are no reports of major service delivery problems. The general allocation grants have been paid to the regions with few exceptions, but the civil service has not been transferred to regional governments yet. Central government has decided to ban regional borrowing, except through the center. Reports indicate an increase in regional taxes and levies.
- The World Bank’s *Country Assistance Strategy* (CAS) for Indonesia for the period FY01-03 was approved by its Board of Executive Directors in January. This CAS was developed on the basis of extensive discussions with the Government, civil society and other donors. It is currently being disseminated around Indonesia and has been posted on the Bank’s internet web-site.

### MACROECONOMIC SITUATION: Recovery in the face of uncertainties

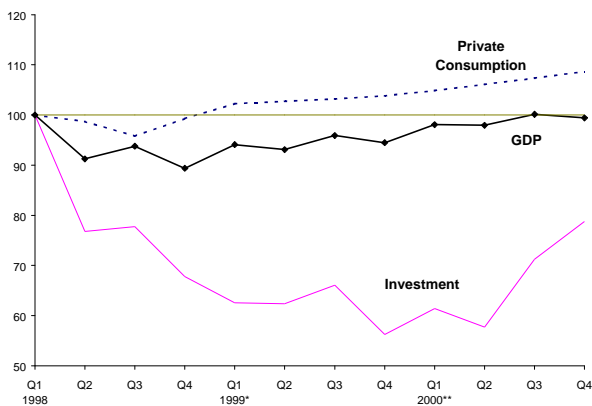
According to Government estimates, gross domestic product (GDP) grew by 4.77 percent in 2000 compared to its level a year ago. This was primarily driven by consumption (accounting for 64 percent of the incremental growth), investment (accounting for 33 percent) and net exports (accounting for 3 percent). Inventories continue to be drawn

down sharply,<sup>1</sup> but contrary to the previous two years, gross fixed capital formation increased as well. In fact, investment growth has overtaken consumption and exports as the leading contributor to GDP growth (Figure 1).<sup>2</sup> On the supply side, transport and communications, manufacturing, utilities and construction accounted for most this GDP growth in 2000 sectors. According to the authorities,

<sup>1</sup> This is a statistical outcome: inventories include statistical discrepancies.

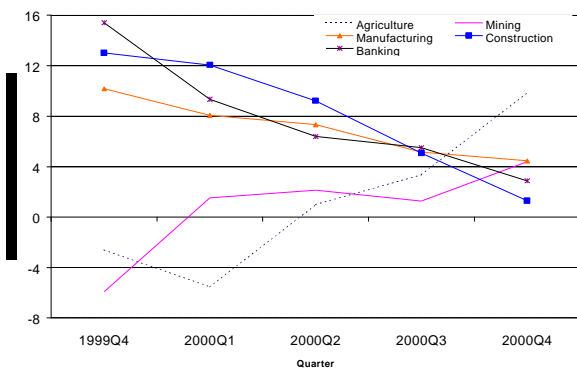
<sup>2</sup> However, the wholesale price index is used to deflate investment. And since most investment goods are imported, the Rupiah depreciation exaggerates real growth in investment.

**Figure 1. Modest GDP growth for 2000.**  
(GDP, consumption, investment indexes, Q1 1998=100)



capacity utilization in the corporate sector has now reached 80 percent and is increasing. However, quarterly data show that growth in most sectors—other than agriculture, mining and quarrying—is slowing down (figure 2). Quarterly GDP growth (y.o.y.) is also slowing in 2000.

**Figure 2. Agriculture, Mining and Quarrying activities increasing while growth in other sectors is slowing.**



The depreciating rupiah has once again improved the trade account this quarter (Figure 3). For the year 2000, total exports were US\$62 billion or 27.4 percent higher than the previous year, and 15.8 percent higher than 1997. Though this increase has been helped by high oil prices, non-oil exports are also higher -- 22.9 percent higher than 1999. Non-oil exports reached US\$47.8 billion for the year 2000, while oil-gas exports reached US\$14.2 billion. There has been some slow down in export growth during the fourth quarter of 2000 and first months of 2001, mainly due to deceleration in world trade, especially to US and Japan.

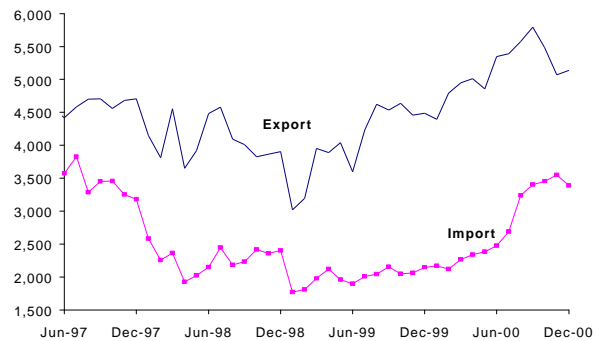
Total imports of goods and services recovered in 2000, growing by 18.2 percent in real terms (1993 prices) but they are still well below pre-crisis levels. The current account balance has remained in surplus, and whereas private capital outflow continued, Indonesia retained comfortable reserve levels—US\$28.75 billion in mid-March 2001.

Growing GDP was reflected in rising real wages and growing employment. This, together with a sharp decline in food prices—especially rice—has resulted in a decline in poverty levels from the crisis peak.

The performance of the real sectors notwithstanding, financial indicators have deteriorated in the last several months. Inflation has been on the rise, with CPI inflation reaching 9.35 percent (y.o.y.) in December 2000, above Bank Indonesia’s target of around 5-7 percent which had been set at the beginning of the year. Inflation for the year 2000, however, only amounted to 3.7 percent, down from over 20 percent in 1999. Increases in administered prices, especially fuel, a rise in civil service wages, and the greater-than-expected depreciation of the rupiah all contributed to inflation.

Last year the average rupiah exchange rate was Rp8,500 per

**Figure 3. The depreciating rupiah and higher oil-prices have helped Indonesian exports (US\$ million)**

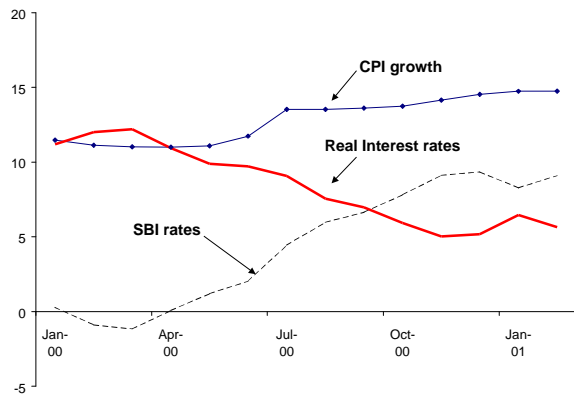


US dollar—more than 20 percent higher than the assumed Rp7,000 per dollar used by the authorities when defining their inflation target. March 2001 saw the rupiah exchange rate plummet below the 10,000 Rp/US\$ mark—mainly fueled by growing regional and ethnic unrest, political uncertainties, and the interruption in the program with the IMF. The weaker rupiah is putting increasing pressure on the fiscal situation of the government, including its ability to make timely debt service payments. Total public debt stood at 86.2 percent of GDP in end-2000 (with just over half of it—US\$68 billion—being owed to external creditors). Government debt service payments accounted for about a third of government revenues in FY2000 and is estimated to be about 40 percent of revenues in FY2001.

With rising inflation, the authorities are caught between pursuing a tight monetary policy, to rein in inflationary pressures, and maintaining low domestic interest rates (to keep banks financially viable and the budget deficit manageable). Domestic interest rates have continued to rise: the 30-day SBI rate hit 14.75 percent in mid-February, 2001, up from 14.5 percent at end-December 2000. But this increase has lagged inflation, and real interest rates have

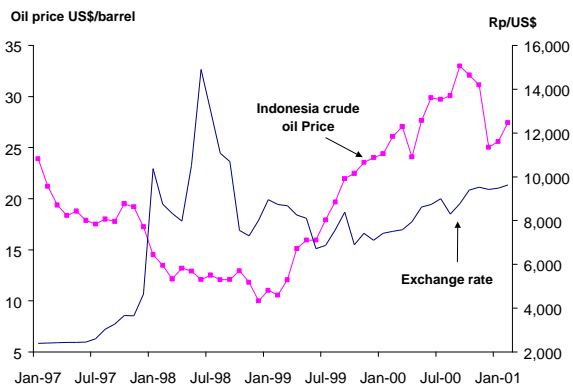
declined significantly over the past three quarters. (Figure 4).

**Figure 4. Keeping domestic interest rates and inflation in check – A policy challenge**



The stock market remains susceptible to political events. At end-February 2001, the Jakarta Stock Market (JSX) composite index was at 432, a 36 percent decline since December 1999.

**Figure 5. Exchange rate (Rp/US\$) and Indonesia oil price (US\$/barrel).**



As in previous years, the fiscal deficit in FY2000 was again smaller than planned. This time around, though, the cause was almost exclusively on the revenue side. Higher oil prices, buoyant imports, and rising wages increased revenues by as much as Rp55 trillion (or some 5 percent of GDP) over what was budgeted. Although there was an offsetting increase in fuel and electricity subsidies, the deficit is likely to remain below 2 percent—less than half the planned 4.8 percent<sup>3</sup>. In 2001, the fiscal situation appears to be worsening.

<sup>3</sup> With IBRA achieving its asset-recovery target, and most donor financing coming through in FY2000, this deficit was over-financed. The Government used this opportunity to build up its deposits in the Central Bank.

Meanwhile, the Government is considering the issuance of sovereign bonds in the international capital markets through the securitization of receivables from the sale of West Natuna natural gas to Singapore. The World Bank, along with the ADB and the IMF, has expressed reservations about the justification for this proposed securitized bond issue at this time. It may also violate the World Bank's negative pledge clause. The World Bank is awaiting further details from the government before commenting further.

Two important policies were issued this quarter. First, in an attempt to reduce the rupiah's volatility in the foreign exchange market, Bank Indonesia issued a new regulation in January 2001 that restricts banks from undertaking foreign currency derivative transactions, and from providing credit to non-residents. It also restricts rupiah transactions with non-residents and off-shore rupiah trading. The markets reacted by starting trading in "Non-deliverable Forwards"(NDFs)—forward contracts in Rupiah's which are settled in a different currency. But the measure increased speculation over imposition of further restrictions on capital mobility. Bank Indonesia (BI) has recently fined a Jakarta-based foreign bank that had transacted in NDFs nine billion rupiah for breaching new foreign exchange trading regulations.

The Government also increased the tax rate on interest income from deposits, savings and SBIs from 15 to 20 percent. Although this tax rate is comparable to that in other countries, it may have an adverse impact on the banks—who need to increase deposit rates, and the marketability of government bonds in the domestic market .

## FINANCIAL SECTOR: Still fragile

Now that the bank recapitalization program has been completed, the focus of financial sector reforms has shifted to asset recovery and the resumption of bank lending to viable corporates. Achievement of IBRA's asset recovery targets for FY01 of Rp27 trillion in cash and Rp10 trillion in bond swaps requires the government accelerate the pace of asset disposal and corporate debt restructuring. In particular, IBRA (in its role as owner of banks it took over during the crisis and that it must privatize) should execute the sale of its two banks, BCA and Niaga; and (as the trustee of assets that they need to dispose of as part of corporate debt restructuring) should resolve the re-negotiation of former bank shareholders' settlement agreements (MSAA); and, ensure that a set of corporate debt restructuring principles be finalized and adopted.

IBRA raised 96 percent of its Rp18.9 trillion recovery target for FY 2000. Parliament agreed to the sale of up to 40 percent of BCA (over and above the 22.5 percent equity that was sold last year) and 51 percent of Bank Niaga.

Meanwhile, the sales of Palm Plantations and the Mosquito Coil Group have been officially launched and winning bidders have been appointed. But neither one of the deals (amounting to IDR 4.2 trillion in total) have been closed pending resolution of outstanding legal issues. Meanwhile, IBRA published a list of holding company assets that are also slated to be sold.

As of mid-February 2001, IBRA reached resolution stage in the restructuring of Rp77 trillion of debt, or 88 percent, of its top 21 obligors loan portfolio. This figure represents the amount of loans for which restructuring MoUs were signed and/or appropriate legal action was initiated against the owners. However, finalized restructuring agreements with the top 21 obligors and/or completed legal actions account for a much lower proportion of loans (29 percent).

**Table 1. IBRA's Recoveries for FY 2000**

(in Rp. trillion)

	<i>Actual</i>	<i>Target</i>	<i>Success Rate</i>
Asset Management Credit (AMC)	14.4	8.8	163 percent
Asset Management Investment (AMI)	2.4	7.2	34 percent
Bank Restructuring Unit (BRU)	1.0	3.0	32 percent
Other Income	1.6	1.8	89 percent
Gross Recoveries	19.4	20.8	93 percent
Net Recoveries	18.1	18.9	96 percent

Source: IBRA

The respective roles of the FSPC and IBRA's Oversight Committee remain under debate. Parliament has raised concerns over the impact of the present organizational structure on IBRA's ability to bring debt restructuring transactions to closure in a timely fashion.

Meanwhile, there continue to be delays in issuing an acceptable set of corporate debt restructuring principles. In the absence of these, individual corporate debt restructuring deals would take considerable time to reach closure and often do not follow international best practice. It is essential that IBRA adopt and apply consistently to all its obligors a set of corporate debt restructuring principles that ensure transparent, real restructuring and equitable sharing of the financial burden between debtors, creditors and taxpayers.

Progress in the restructuring of three state banks, BNI, BRI and BTN, remains slow. The Monitoring and Governance Unit within the Ministry of Finance has been finalizing the business plans and performance contracts with the management of each of the three banks. In addition, the forthcoming Housing Finance Policy of the Government, that will include a new subsidy regulation, will have

significant impact on the future of BTN and the fate of its portfolio.

Issues that remain to be addressed in Indonesia's state banks include:

- Positive net interest spreads in some banks is under threat from the rising interest rates.
- Concerns about the quality of the restructured part of the loan portfolio and that of the remaining NPL portfolio of some banks.
- The pace of operational restructuring (including rationalization of branch networks and staffing levels, improvements in risk management and governance issues) remains slow.
- Business plans and Management Performance contracts are yet to be finalized in some banks. In others, the underlying assumptions behind the finalized business plans may be unduly optimistic (growth, revenues, etc.) thereby having the potential of undermining the realism of the permanent performance contracts in the pipeline.

While IBRA continues to be preoccupied with the management of its asset portfolio, there is growing concern about the financial health of the recapitalized banks. With the Rupiah depreciating and interest rates continuing to rise amidst a deterioration in market confidence, it is only a question of time before banks -- particularly those recapitalized in large measure with fixed-rate bonds -- will once again suffer from negative interest margins. Even if interest rates were to stabilize, many banks will be ill-equipped to achieve the 8 percent capital adequacy ratio requirement by end 2001.

Finally, an amendment to the Central Bank Law is being debated in the Parliament. Some legislators are motivated by a concern for the accountability of management in an independent Central Bank. Others see the proposed amendments as fundamentally altering the central bank's ability to conduct independent and effective monetary policy. The Coordinating Minister recently announced the formation of a panel of eminent foreign and Indonesian central bankers to advise Government and parliament on the suitability of the proposed amendments.

## CORPORATE RESTRUCTURING: Recent Slowdown

The enhanced corporate restructuring framework that was adopted in early 2000 achieved positive results during the year 2000. But restructuring has slowed somewhat in 2001. The published figures and anecdotal evidence suggest that the pace at which IBRA and private creditors were finalizing restructuring deals with corporate debtors continued its momentum throughout 2000. As shown in Table 2, in December, IBRA's AMC had provisionally resolved 88

percent of its Rp 88 trillion in loans to its top 21 obligors. (up from 35 percent in July). For the top 200 obligors the percentage in late stage rose from 9 percent to 57 percent over the same period.

The FSPC proved to be an effective coordinating mechanism, IBRA and JITF cooperated with each other far better than before and JITF exceeded the quantitative corporate restructuring targets agreed with the IMF. The quality of many of the restructuring deals, however, has been questionable and the recent deterioration in the investment environment is likely to slow progress further.

**Table 2. Status of IBRA AMC's Efforts to Resolve Credits**  
(Rupiah trillion)

Group of Obligor	Early Stage	Middle Stage	Late Stage	Total
Top 21	6.1 (7 percent)	4.4 (5 percent)	77.0 (88 percent)	87.5
Top 22-200	21.3 (21 percent)	57.0 (58 percent)	20.9 (21 percent)	99.2
Others	48.6 (63 percent)	22.8 (29 percent)	6.3 (8 percent)	77.7
<b>TOTAL</b>	<b>76.0</b> (29 percent)	<b>84.2</b> (32 percent)	<b>104.2</b> (39 percent)	<b>264.5</b>

Source: IBRA

*Indonesian corporates still remain very vulnerable to further devaluation of the rupiah.* According to the recent quarterly survey of corporate indebtedness conducted by the Jakarta Initiative Task Force (JITF), total corporate debt in Indonesia amounted to \$119 billion as of December 2000. Of this around 48 percent (\$57 billion) is owed to offshore creditors and the other 52 percent (\$62 billion) to onshore creditors. Almost half of the latter (\$29.4 billion) is also denominated in foreign exchange.

*Indonesian corporates continue to accumulate arrears on debt service payments.* Around 62 percent (\$37.3 billion) of the onshore portion of the corporate debt is classified as non-performing. The percentage of offshore loans that are non-performing is not known yet but if the same ratio were applied to that of the onshore loans, after deducting Japanese loans which are largely performing, then around \$22.6 billion of the offshore loans would also be non-performing. At the end of 1997 around 95 percent of total loans in the domestic banking system were categorized as performing. By the end of 1999 this had fallen to around 36 percent and in June 2000 remained at around 36 percent. By December 2000 it had fallen to 30 percent, indicating a deterioration in the domestic banks' portfolios during the second half of the year. Among the offshore creditors, Japanese banks are the largest group, accounting for 31.2 percent of offshore loans. The second largest group is the US banks (13.6 percent) followed by the Netherlands (10.7 percent and Germany (6.4 percent). The three largest creditor countries therefore

account for more than 55.5 percent of Indonesia's offshore corporate loans

The Indonesian Bank Restructuring Agency (IBRA) holds 80 percent (29.9 billion) of the onshore distressed loans. Of this amount, large private corporates (debts of more than Rupiah 50 billion) account for 80 percent. Of the \$24.7 billion onshore performing loans SME's (loans of less than Rupiah 50 billion) account for 60 percent, state owned enterprises (SOEs) for 5 percent and the remaining 36 percent is owed by large private corporates.

**Table 3. JITF Cases under Active Facilitation**

INDUSTRY SECTOR	NO. OF CASES (of which completed)	EST. US\$ DEBT (US\$ billion.)	EST. RUPIAH DEBT (Rp. trillion)	EST. TOTAL DEBT (US\$ billion equiv.)
Agri-Business	9 (1)	2.10	0.41	2.15
Basic Industry And Chemicals	27 (10)	4.62	3.64	5.08
Consumer Goods	4 (2)	0.44	0.09	0.45
Finance	9 (4)	1.24	1.54	1.43
Infrastructure, Utilities and Transportation	2 (2)	0.30	0.27	0.35
Mining	4(1)	0.14	0.18	0.16
Property And Real Estate	16 (6)	1.23	2.33	1.52
Trading, Services And Investment	11 (9)	2.24	0.17	2.26
Other	21 (6)	4.36	3.21	4.77
<b>TOTAL</b>	<b>103 (41)</b>	<b>16.67</b>	<b>11.85</b>	<b>18.15</b>

Source: Jakarta Initiative Task Force (JITF).

*Indonesian corporations are undergoing little fundamental restructuring and could emerge from the crisis largely intact and still very vulnerable.* In the restructuring deals to date, term extensions and grace periods that have been predominant. Sales of non-core businesses or assets to foreign or domestic investors, mergers or spin-offs, additional equity financing, management changes, or court-supervised reorganizations or liquidations have not played as great a role in Indonesia as in other East Asian countries. Corporates and the financial institutions can only regain their health through deeper restructuring through sale of assets, new equity injections and debt equity conversions.

Table 3 shows that as of February 23, 2001, JITF had handled 103 active corporate cases involving \$18.1 billion in debts. These active cases have included 20 referrals from the Financial Sector Policy Committee (FSPC). 41 of the JITF cases have been completed, involving \$10.1 billion in debt. This represents important progress when compared with the less than \$2 billion in debt restructured through JITF up to April 2000 and \$5.2 billion up to August 2000. JITF has so far exceeded its quantitative targets as spelled out in the most recent LOI to the IMF. Particularly useful have been JITF's time bound mediation procedures and the improvements in regulatory incentives, particularly tax breaks, for corporate restructuring. As with IBRA, however, there remain questions about the quality of the restructuring deals concluded.

*Although the quantitative results from the enhanced corporate restructuring framework are encouraging, there is a continuing need for Indonesia's legal system to provide more reliable protections for creditors.* Various proposals to provide stronger "sticks" – e.g., ad hoc judges for insolvency cases, Attorney General/Joint Investigative Team investigations of dubious court rulings, more frequent IBRA use of PP-17 powers, Jakarta Stock Exchange de-listing of recalcitrant debtors, and withdrawal of licenses or privileges extended by the Government – should be pursued. Experience suggests, however, that reform of Indonesia's legal system will take time and that ongoing efforts to promote corporate restructuring cannot assume the availability of a robust bankruptcy option.

The relevant parties—including Bank Indonesia, BAPEPAM, Jakarta Stock Exchange, and the tax authorities—should continue efforts to remove unwarranted impediments to corporate restructuring transactions. The current requirement for financial institutions to sell converted equity within 2-5 years is of particular concern, since debt/equity conversions are likely to feature prominently in Indonesian corporate restructuring transactions. Consideration should be given to allowing financial institutions to hold converted equity indefinitely, but to insist on the most conservative accounting (e.g., 1 Rp per share) for converted equity.

Improved access to financing for working capital and capital investment is likely to be the greatest incentive for corporations to undergo necessary corporate restructuring. Financial institutions will be more willing to provide additional loans or equity investments in companies whose management teams have demonstrated their readiness to focus on core competencies, sell non-core assets, exit from non-competitive businesses, eliminate cross guarantees and otherwise adopt more straightforward capital structures, seek strategic investors, provide or raise additional equity financing, pay down debt, improve financial disclosure, and strengthen corporate governance.

## **DEVELOPMENTS IN SOCIAL SECTORS: Critically dependent on ongoing decentralization process.**

While the numbers in extreme poverty have fallen from the peak levels reached in 1998, nearly half the population, or over 100 million people, are still extremely vulnerable to being pushed into poverty or near poverty during a crisis. The 1997/98 economic contraction resulted in rapid increases in poverty in Indonesia, in particular in urban areas and on Java. In response to the 97/98 economic contraction, the Government of Indonesia (GOI), supported by the Bank and other donors, developed a three-pronged response to the social impacts of the crisis: (i) maintaining food security; (ii) expanding employment and income generation opportunities; and (iii) preserving access to critical social services. This was accompanied by a public commitment by the government to address governance issues, in particular efforts to minimize corruption in safety net programs.

The Government is taking clear steps towards developing a new approach to poverty reduction, beginning with the appointment of a senior advisor to the Coordinating Minister for the Economy. This advisor is tasked with building a core team under the direction of the Vice President that will set priorities and directions for a new poverty reduction strategy. It will work closely with all government ministries to ensure that poverty concerns influence all key government policy and programs decisions. This body is now being legalized and is expected to be operational in April 2001.

*Implementation of the SSN programs is mixed.* Implementation of the OPK (the targeted subsidized rice) and education and health programs are continuing this fiscal year. Budgets for the PDM-DKE and the labor creation programs were only released in August 2000, and were fully operational only during November and December.

Efforts to maintain government spending on health and education at constant real levels have not been successful. Total public sector health spending fell by 8 percent in 1997/98 and a further 12 percent in 1998/99. This represents a 9 percent and 13 percent decrease respectively in real per capita terms. The gap between the budgetary allocation and actual expenditure has also increased since the crisis, from 10 percent in 1994-97 to 32 percent in 1998/99 (for the 73 percent of the health sector budget for which data are available). Expenditure data for 1999/2000 are still being updated.

In the education sector, total public expenditure on education fell by 41 percent between 1996/97 and 1997/98, but rebounded somewhat in 1998/99 to 72 percent of pre-crisis levels. Total realized public spending on education has declined both as a share of total government expenditures (7.7 percent in 1996/97 to 3.9 percent in 1997/98) and as a share of GDP (1.4 percent in 1996/97 to 0.7 percent in 1997/98).

**Table 4. Key Social Indicators**

	<b>Latest Data (date)</b>	<b>Previous Period (date)</b>
<b>Human Development</b>	<b>1998/99</b>	<b>1997/98</b>
Primary enrollment rate (net)	95.3	94.1
Female		
Male		
Secondary enrollment (net)	53.2	54.4
Female		
Male		
Tertiary enrollment	2,499,000	2,451,000
Female ( percent total enrollment)	N/A	41.3
Male ( percent total enrollment)	N/A	58.7
Infant mortality rate		
From DHS	45.7(92-97)	58.9(87-92)
From SUPAS	51.4 (1991)	71 (1986)
<b>Poverty &amp; Income Distribution.</b>	<b>1999</b>	<b>1996</b>
National Headcount Index 1/	20.3 (Dec)	11.34 (Feb)
Urban Headcount Index 1/		9.71 (Feb)
Rural Headcount Index 1/		12.3 (Feb)
Gini Index	0.37 (Jan)	0.38 (Jan)
<b>Government Expenditures</b>	<b>98/99</b>	<b>96/97</b>
Health budget ('93 Rp. billion)	2,105	2,592
As percent of total	2.6	2.7
Education budget ('93 RP. billion)	4,229	5,846
As percent of total	5.2	3.9
<b>Labor Market</b>	<b>2000</b>	<b>1999</b>
Unemployment rate ( percent)	6.1 (Aug)	6.4 (Aug)
Female	6.7 (Aug)	6.9 (Aug)
Male	5.7 (Aug)	6.0 (Aug)
Participation rate ( percent)	67.27	66.9 (Aug)
Female	(Aug)	51.2 (Aug)
Male	51.7 (Aug)	83.6 (Aug)
	84.2 (Aug)	

1/ Using a poverty threshold of about \$1 at 1985 PPP dollars

Social sector spending shortfalls were pronounced during the crisis, while inefficient fuel subsidies increased their share dramatically. These subsidies 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—thereby undermining the Government's poverty efforts.

The ongoing transition to a decentralized system of government, while creating uncertainties in the short term, also provides Indonesia greater hope for sustainable progress on poverty reduction in the long term. If properly managed, decentralization can help build local democratic institutions and give people greater control over their lives. But, if managed badly, the transition to a decentralized Indonesia could not only derail macroeconomic stability, but also seriously affect the delivery of government services.

Three months into the program, no major breakdown in services has been reported. But the program is off to a

slower start than planned, and the civil service is yet to be decentralized. Meanwhile, the distribution of the general grant (DAU) has been announced, and the first two monthly payments have been transferred to the regions. The DAU is hardly equalizing for now—mainly because the Government had to take into account what the regions spent in the past, and what central government spent in a particular region.

Despite the transition arrangements, the regions have been arguing for more funds—the provincial requests for additional funds alone almost exhaust the Rp6 trillion in contingencies included in the budget. A revision of the formula for the DAU is planned for this year. The end-result is likely to determine the distribution of fiscal resources for several years and, in turn, the capacity of the less well-off regions to deliver the public services, especially to the poor. There remains the urgent need to put in place adequate safeguards and reporting arrangements in order to ensure fiscal discipline at the sub-national levels of government.

Government is currently putting in place safeguards to address the considerable risks associated with the ongoing decentralization process and its impact on the poor. These include:

- Restrictions on local borrowing through administrative controls;
- Establishment of a new Directorate General in the Ministry of Finance to monitor local finance, manage contingency funds, provide synergy on project finance; and
- Setting up of a new Regional Autonomy Advisory Board that would help to intermediate any regional disagreements and assist in policy formulation at the sub-national levels.

## OUTSTANDING ISSUES: Toward durable recovery

To maintain macroeconomic stability in uncertain times and cement the durability and sustainability of ongoing corporate/financial sector reforms, much will depend on how expeditiously, yet prudently, the following issues are tackled in the coming months:

**Agreeing on a program with the IMF.** Investor sentiment toward Indonesia continues to be negative – especially when compared to other crisis countries in the region. Critical to boosting investor confidence in the near term will be a resumption in the reform program supported by the IMF. This will also trigger the second consolidation phase of the Paris Club debt rescheduling agreement and will allow it to proceed forward smoothly. And – together with actions on poverty and governance – it will facilitate access to higher levels of lending from the World Bank (under the “High Case” scenario of the CAS—see Box 1). Meanwhile, a high-level advisory group to the President, comprising of Messrs. Ulrich Cartellieri, Lee Kuan Yew, Nobuo Matsunaga and

Paul Volcker, re-emphasized the necessity for the Government to carefully consider the serious risks of further delays in implementing the program agreed with the IMF.

**Maintaining fiscal sustainability.** The fiscal situation for 2001 is worsening with the depreciation of the Rupiah and the rise in domestic interest rates. The currency depreciation is pushing up spending on fuel and electricity subsidies as well.<sup>4</sup> Revenues go up as well as the Rupiah depreciates, but under the new decentralized system of government, these increases are shared with the regions. In addition, the rising domestic interest rates are increasing the burden of servicing the outstanding bank recapitalization bonds, and at the same time are increasing the risk of a deterioration of the banks' balance sheets. However, there are minor offsetting savings (from the wage bill and from interest rate subsidies) but the net result could be a higher than anticipated deficit for FY2001. While it is too early to predict the fiscal outcome for this year, the government would be wise to start preparing for any possible shortfall in meeting its spending needs and begin exploring non-inflationary sources of financing in case it needs it when the time come. Such measures include: shifting more spending items to the regions, saving on some of the unallocated funds, limiting demands on the contingency fund for decentralization, among others.

**Adopting measures to improve investor confidence.** Increased investor confidence in Indonesia will support macroeconomic stability (through a less volatile exchange rate, stronger stock market index, and lower risk premiums), and will attract non-debt private capital flows (including foreign direct investment). With growth in external markets slowing for many export products, continued political uncertainty, and delays in implementing the reform program supported by the IMF, investor confidence in Indonesia is once again waning. The incentives for corporates and banks to reach debt restructuring agreements and get back to normal business are weaker than they were last year. The poor quality of many of the restructuring deals is leaving the Indonesian corporate sector vulnerable to the threat of renewed defaults. There have already been signs that some newly completed restructuring deals are in jeopardy and that some of the large corporates such as Sinar Mas/Asia Pulp and Paper, that weathered the 1997/98 crisis successfully, are now experiencing debt servicing problems.

Generating positive investor sentiments is a multi-faceted endeavor. The government needs to clarify "rules of the game" for investors, increase predictability of government actions and ensure that laws are implemented evenhandedly and credibly. To this end, the following outstanding issues need to be addressed:

- **Modalities of debt restructuring.** IBRA has yet to adopt and apply a set of transparent corporate debt restructuring principles. In the absence of such principles, there are fears that large debtors will be able to strike deals that will not serve the best interests of the State.
- **Whether the Government will take action against non-cooperative debtors referred to the FSPC by JITF and whether IBRA will continue recent successes in its bankruptcy and foreclosure actions.** Progress in corporate restructuring has been largely voluntary and it remains to be seen whether major non-cooperative debtors can be successfully pressured into reaching agreements. Some of the recent bankruptcy cases that IBRA has won are still subject to possible reversal by the Supreme Court. In some others (e.g. in the case of the large trading company Tirtamas Comexindo), the Supreme Court has rejected IBRA's appeals against unsuccessful bankruptcy rulings in the lower court. Until there is an assurance of more reliable court decisions, referrals may serve only to re-emphasize the relative weakness of creditors.
- **Enhancing credibility in the legal system.** There have been recent high profile cases, notably Panca Finance and Davomas, where phantom creditors have emerged to offset bona fide creditor claims, gaining court approval of debtor-friendly composition plans. It remains to be seen whether these court decisions will be successfully appealed or whether more similar cases will emerge and further erode the already very low confidence in the judicial system. Other unscrupulous practices have included non-disclosure and exclusion of debtor assets and asset sale proceeds from debt restructuring negotiations, creation of phantom shareholders to block foreign equity investment, as in the recent *Manulife* case, and use of nominee shell companies by Indonesian conglomerates to buy back assets from creditors at a percentage of the amounts owed creditors.
- **Implementation of agreements between debtors and creditors.** While recent progress by IBRA's AMC in reaching debt restructuring agreements with its Top 200 obligors is encouraging, some bankers continue to question whether debtors have the cash flows and the will to implement these deals. IBRA will need to monitor implementation of these agreements and respond to lags or shortfalls in implementation.
- **Treatment of smaller obligors.** Progress by IBRA AMC in resolving the corporate debts of its smaller obligors bears watching along with the manner in which it disposes off the restructured corporate loans that fall under its purview. In all cases, these credits should be priced through a competitive auction process. Appropriate pricing and provisioning of loans is essential for acquiring banks to push for additional

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<sup>4</sup> The increased spending on the development budget is largely foreign financed, and thus does not significantly impact the fiscal deficit. However, availability of these funds is mostly contingent on continued progress on implementation of ongoing reform program.

corporate restructuring measures – e.g., sales of non-core assets, exits from unprofitable businesses – that may require banks to recognize losses along with their corporate clients.

***Implementing fiscal decentralization with appropriate safeguards and public service delivery standards.*** The Government has issued a decree forbidding local governments from domestic borrowing in 2001, except through the Central Government. For 2002 and beyond, the government will need to rapidly put in place proper principles and safeguards for sub-national borrowing in the implementation of fiscal decentralization. This issue, if left unattended, may put Indonesia's fiscal sustainability at risk. There remains considerable confusion about the division of regulatory powers between center and districts, especially in areas that affect private sector activity. To facilitate private sector activity, the Government needs to clarify responsibilities for tax, investment approval, and private sector regulation; and ensure that administrative courts are better able to enforce the rights of citizens against arbitrary actions by local governments (under Administrative Law 5/1986).

With over 350 local administrations taking on the responsibility for planning, budgeting and implementation, the central government will need to redefine its role to keep a national focus on poverty reduction. This should include a fiscal transfer framework that rewards sub-national reformers and targets support to poor communities so that governments with weaker administrative capacities are not left behind. The central government will also need to establish monitoring systems over local government activity and financial management, and agree with regions on minimum service standards and poverty reduction goals. Promising starts in each of these areas have already been made. The center must also support local governments in increasing capacity for planning and implementation, and for learning from each other, to ensure growth and development in the whole of Indonesia

***Formulating a comprehensive financial sector strategy.*** The Government needs to move forward with articulating a comprehensive financial sector strategy that is accepted by all stakeholders within and outside government. This would serve as a basis for financial sector reforms over the medium term and towards the implementation of an agreed action plan with the necessary “buy-in” among all stakeholders. Further delays in determining the Government's approach to the shape of the future financial landscape may hamper coordination of various financial sector reform efforts at a crucial point in Indonesia's recovery process.

## **BOX 1. WORLD BANK GROUP ACTIVITIES AND INSTRUMENTS IN INDONESIA**

On January 30, 2001, the World Bank's Executive Board approved the new *Country Assistance Strategy* (CAS) for Indonesia for the period FY01-03, expressing strong support for its poverty focus and its attention to sustaining economic recovery and promoting broad-based growth, building national institutions for accountable government, and delivering better public services to the poor. This CAS was developed in close collaboration with the Government of Indonesia and with the assistance of a series of public consultations held with various civil society organizations and networks throughout Indonesia. The process, which involved over 400 civil society organizations, included dialogue with organizations active in socio-economic development, labor movements, social/religious groups, women's movement, democracy and human rights groups, anti-corruption, and anti-debt coalitions. The full CAS document is available on the Bank's website and at its offices in Washington and in Jakarta.

The Bank's proposed programs over the next three-year period will move from crisis relief to more community-based development assistance, with technical assistance and policy advice providing support on the government's reform agenda, and particular emphasis paid to anti-corruption measures within the ongoing Bank portfolio of about 56 projects. The CAS proposes a “base case” lending program of \$400 million per year. This would include highly concessional IDA credits, which account for about one-third of the lending program, to ensure a continuing flow of finance for development and poverty reduction without increasing Indonesia's debt-service demands in the near term. A higher lending program of up to \$1 billion, including a temporary increase in IDA credits, would be triggered from strong implementation performance by the government in several areas—such as macroeconomic management, bank and corporate restructuring, public procurement and financial management, and developing a broad-based poverty strategy. No World Bank adjustment lending is foreseen in the base case lending program. Concurrently, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA) would undertake activities to help improve the poor business environment as well as investor confidence.

The Bank's Analytical and Advisory Services (AAA) program will continue to emphasize advisory services, supported by a small but growing body of analytical work, and increased attention to regional issues. The balance of AAA work will also 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.

The World Bank Group continues to play a key coordinating role among Indonesia's donors as chair of the Consultative Group for Indonesia (CGI). The Bank is also co-leading donor efforts in governance reforms (with special focus on legal, anti-corruption and civil service reforms), competition policy, water resource management, and forestry. It is also providing analytical and advisory services in the areas of decentralization, SMEs, corporate governance, privatization and public debt management). It is also intricately involved in the Government's Extended Arrangement with the IMF, working closely with the IMF and ADB.

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Indonesia Key Indicators	1997	1998	1999	2000/prel.	2000				2001
	Year	Year	Year	Year	Q3	Q4	Nov	Dec	Jan
<b>Output, Employment and Prices</b>									
GDP ( % change previous year)	4.7	-13.1	0.8	4.8	4.4	5.2	..	..	..
Industrial production index (1993=100)	157.4	136.4	169.8	..	..	..	..	..	..
(% change, previous year)	13.2	-13.3	24.5	..	..	..	..	..	..
Unemployment Rate (%)	4.7	5.5	6.4	5.9	..	..	..	..	..
Real Wage Growth (%)	4.1	-29.9	2.0	..	..	..	..	..	..
Consumer price index (% change, previous year)	6.1	58.5	20.5	3.7	6.6	9.3	9.1	9.3	8.3
<b>Public Sector</b>									
Government balance (% GDP)	-0.6	-2.1	-1.5	-3.4	..	..	..	..	..
Domestic public sector debt (% GDP)	0.0	10.5	44.7	50.7	47.6	48.4	..	..	..
<b>Foreign Trade, BOP and External Debt</b>									
Trade balance (million\$US)	10,067	15,682	20,644	25,470	6,343	5,806	..	..	..
Exports of goods, (\$millionUS)	56,297	50,371	51,242	62,511	14,270	13,761	..	..	..
(% change, previous year)	12.2	-10.5	1.7	22.0	13.4	12.5	..	..	..
Key Export, (% change, previous year)	-3.7	-36.7	38.2	50.8	40.4	28.6	..	..	..
Imports of goods, (\$millionUS)	-46,230	-34,689	-30,599	-37,041	-7,927	-7,955	..	..	..
(% change, previous year)	4.5	-25.0	-11.8	21.1	15.9	14.6	..	..	..
Current account balance (\$millionUS )	-5,001	4,097	5,783	3,537	-1,574	1,966	..	..	..
(percent GDP)	-2.3	4.2	4.1	2.3	-4.2	5.5	..	..	..
Foreign Direct Investment (million US\$)	4,677	-356	-2,745	-4,556	-1,084	-1,550	..	..	..
Total external debt (million \$US)	136,088	150,886	148,097	..	..	..	140,623	..	..
(% GDP)	63.1	155.9	104.8	..	93.1	..	..	..	..
Short-term debt (million \$US )	35,104	23,702	19,035	..	..	..	..	..	..
Debt service ratio (% exports of g&s)	..	..	..	..	..	..	..	..	..
Reserves, including gold (\$US billion)	17,396	23,516	27,257	23,314	..	..	28,756	23,314	..
(months of imports of goods and services)	3.3	2.0	1.6	2.1	..	..	..	..	..
<b>Financial Markets</b>									
Domestic credit (% change, previous year)	42.0	36.0	17.3	25.5	23.2	27.0	..	..	..
Short-term interest rate (1 month dep.)	25.4	41.4	12.2	11.5	..	..	11.4	11.5	12.4
Exchange rate (end-period)	2,909	9,875	7,855	8,520	..	..	9,510	9,379	9,446
Real effective exchange rate (1990=100 and + = appn)	96.6	47.3	68.1	..	..	..	63.7	..	..
(% change, previous year)	-5.5	-51.0	43.9	..	..	..	..	..	..
Stock market index (end-period, Aug 88=100)	402	398	677	421	..	..	429	421	426
Memo: GDP in US\$ million (based on Ex.rate eop.)	215,747	96,789	141,309	151,489	37,796	36,032	..	..	..