MACROECONOMIC UPDATE

Current Developments

Despite the recent political uncertainties and episodes of sporadic violence, Indonesia's macroeconomic indicators remain stable.

On August 23, 2000, the President issued a decree that delegates key functions of the Office of the President to the Vice President, Megawati Sukarnoputri. This decree will be effective until the end of President Wahid's five-year term in 2004. The Vice President will now:

- Chair cabinet meetings and explain of the results of the meetings to the public, as well as monitor and evaluate the performance of cabinet ministers in implementing government programs.
- Coordinate with other state institutions regarding the implementation of government programs.
- Sign decrees on government policies--"but only after they have already been approved by the President"--including decisions on the structure of department-level or non-department level government institutions, including the appointment of "echelon one" officials in those agencies; promotion, removal, or retirement of civil servants and military and police personnel.

On the preceding day, The President dissolved his two advisory councils--the National Economy Council (DEN) and the National Business Development Council (DPUN).

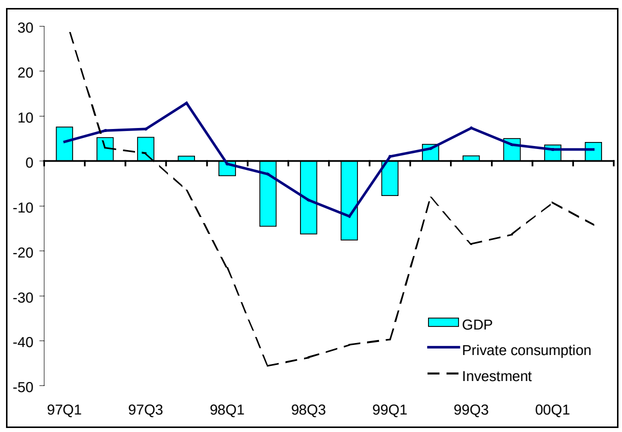
The newly appointed Coordinating Minister for Economy—Dr. Rizal Ramli—launched a 10-point "Economic Recovery Acceleration Plan" on September 4, 2000. This plan will endeavor to implement measures to: achieve stability in the financial sector; boost exports; increase the productivity and welfare of farmers; promote "Equity-based Recovery instead of Loan-based Recovery"; privatization that is "value-creating"; implement decentralization; better utilize Indonesia's natural resource endowment; promote the micro, small and medium scale enterprise sector (SMEs); promote rural development and accelerate banking and private sector restructuring.

Gross Domestic Product (GDP) rose by 4.13 percent in the second quarter of 2000 compared to 3.7 percent the same quarter a year ago (up by 0.53 percent over the previous quarter). Although this increase continues to be driven by increased household consumption (which rose by 0.4 percent), this quarter's GDP growth was influenced by increases in fixed capital formation. Inventories continue to be drawn down sharply so that total investment posted a decline this quarter (Figure 1). However, as discussed later in the Corporate Sector Update, most firms (especially those that have not yet completed restructuring their outstanding debts) continue to find it difficult to obtain new financing from the banks. In addition, the unwillingness of banks to lend can also be attributed to the prevailing uncertainties in Indonesia. Firms are meeting their working capital needs largely through internal cash generation, including through non-payment of scheduled debt service. With a view to boost exports from Indonesia's Small and Medium scale Enterprise (SME) sector, the Government (Department of Industry and Trade) has teamed up with the Indonesian private bank Danamon to provide loans to SMEs through a new small enterprise and trade institution (LPT Indak).

The manufacturing and services sectors are beginning to show some increased activity, but it is too early to arrive at any conclusions about attaining an upward trend. In the second quarter of 2000, all sectors other than agriculture contributed to the GDP increase. The current calendar year's real GDP growth is expected to be at about 4% in line with consensus forecasts from market participants.

Figure 1. Domestic demand shows an upturn

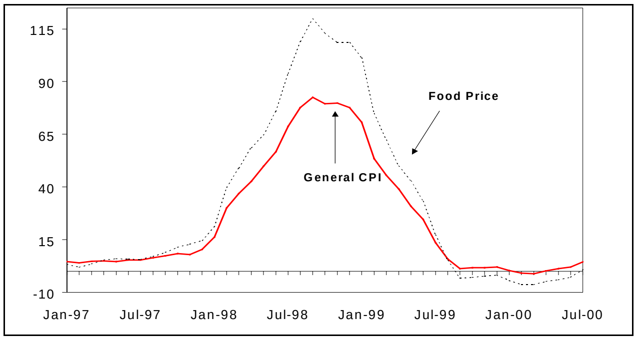
(year on year, percent growth by quarter)



The fragility of the macroeconomic stability is being demonstrated by the recent increase in domestic interest rates (with the 30-day SBI rate inching up to the 13-14% range in July, 2000, up from 12.33% the preceding month) and an inflation estimate for July 2000 of 1.3 percent (up from 0.5% in June 2000) which is somewhat higher than anticipated (Figure 2). The annual inflation rate estimate at end-2Q 2000 is 4.6 percent. The stock market also remains susceptible to political events.

The period of political uncertainty leading to the President's accountability speech slowed the pace of both the state-bank restructuring and the asset disposition programs The cabinet reshuffle and particularly the recent changes in the roles and responsibilities of various bodies on the economic arena threaten to cause further delays in the implementation of the structural reform program, at least in the short run.

Figure 2. Recent inflationary pressure but since the crisis a sharp decline

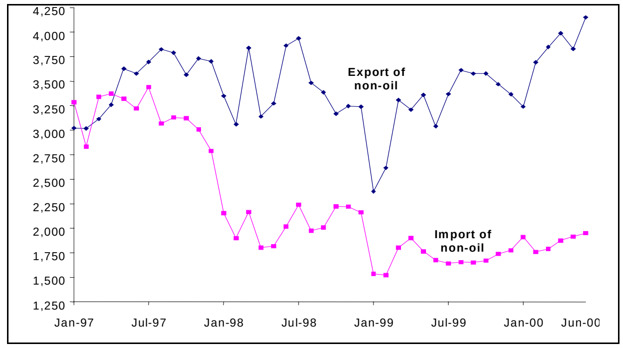


The second quarter of 2000 saw the rupiah weaken beyond the Rp9,500/USD mark and subsequently strengthen to a two-month high of Rp8,045 to the US dollar (on August 21, 2000) as decisions on the new Cabinet and economic team came to closure. The depreciating rupiah and weak domestic demand have improved the trade account significantly. (Figure 3) Total exports are sharply higher than last year and higher than any pre crisis year -- $2.9 billion in the first half of the year 2000, 34.7 percent higher than the same period 1999, and 14 percent higher than 1997. Though this increase has been helped by high oil prices, non-oil exports are also sharply higher -- up 27 percent in the first half year, and 16 percent higher than in the first four months of 1997. Non-oil exports reached US$ 22.7 billion for the first half year 2000, while oil-gas export reached US$ 6.5 billion. Manufacturing exports rose rapidly to the level 32.5 percent higher in the first five months of 2000 than in the same period in 1999. Textiles, furniture and electrical equipment did particularly well. Agricultural and non-oil mineral exports actually fell by 21.8 and 9.0 percent respectively. The US and Japan remain the dominant export destinations for Indonesian goods, with each accounting for more than 24 percent of exports in January-June 2000.

Total imports are recovering from their 1999 lows, to the level 18.4 percent higher in the first semester of 2000, but they are still 36 percent below pre-crisis levels. Capital good imports increased by 16.5 percent in the first five months of 2000. The net effect has been an increase in the current account balance and comfortable reserve levels.

On the fiscal side, actual spending is more on track than last year. Nevertheless, the projected FY2000 fiscal deficit is, like last year, unlikely to meet its targeted 4.8 percent of GDP. Higher than expected revenues due to increased oil prices more than offset the increased expenditures due to the depreciated Rupiah, the additional spending on fuel subsidies due to the postponement of fuel price increases, and the postponed revenue measures. But because of the likely shortfall in asset recovery and privatization, the need for foreign budget financing remains.

Figure 3. Non-oil exports and imports on the rise
(US$ million)



Issues and Areas to Watch

The effectiveness of the recent delegation of responsibilities from the President to Vice President Megawati Sukarnoputri and the cohesiveness of the new Cabinet (and Economic Team). This will have key implications in demonstrating the Government's resolve towards pushing ahead with the ongoing economic reform agenda.

Fiscal situation will continue to be monitored, especially the extent of revenue generation through asset sales under the ongoing financial sector restructuring program—a key aspect of the most recent Letter of Intent (LOI)—and expenditure implications from the implementation of the fiscal decentralization laws.

The budget preparation process for the coming fiscal year will be greatly influenced by the quality of the relationship between the Parliament and the new Economic Team of the Government.

Program Implementation and Assessment

The next meeting of the Consultative Group on Indonesia will be held in October 2000, in Tokyo. Follow-up meetings on specific issues and consultations with civil society will continue to be held in advance in Jakarta.

This quarter also witnessed the completion of the second review under the Extended Fund Facility (EFF) agreement between the International Monetary Fund (IMF) and the Government (a three-year SDR 3.638 billion program) and the signing of a Letter of Intent on September 6, 2000. This LOI was a slightly amended version of the earlier one that Minister Kwik Kian Gie had signed on July 31, 2000. The current LOI, that has been endorsed by the new economic team, was approved by the Fund's Board on September 15. This would trigger the release of about a US$400 million second tranche of the EFF to Indonesia.

Bank Instruments

The World Bank is preparing a new Country Assistance Strategy and is currently holding civil society stakeholder consultations in Indonesia. The new CAS is scheduled to be completed for a World Bank Board discussion in early FY00/01.

The Bank's *policy-based lending* with Indonesia is closely coordinated with the overall reform agenda that is underway with support from the IMF, ADB, Japan and our other development partners. The form and focus of further adjustment support is currently being discussed. In addition, there are two adjustment loans that are currently being disbursed: (a) Social Safety Net Adjustment Loan - US$600 million in two tranches (approved May 27, 1999 and became effective in February 2000). Second tranche yet to be disbursed; and (b) the Water Sector Adjustment Loan - US$300 million in three tranches (approved May 27, 1999, effective and first tranche released in June 1999). Second tranche not yet disbursed. In addition, the World Bank has supported IBRA and JITF and is providing TA for implementation of banking reforms through the Bank Restructuring Assistance Project (BRAP) - US$20 million. (approved 12/4/1997 and made effective on 4/8/1998) and the Corporate Restructuring Technical Assistance Project (CRTAP). One CRTAP component provides for assistance for strengthening the Commercial Court. The Bank, in coordination with other donors, has continued to provide direct support to the social safety net and key social services through its investment project portfolio. In the social sectors, a new project to support employment and income-generating activities in urban areas – the Urban Poverty Project – became effective in late 1999. The corner stone of the project is facilitating the formation of legitimate and democratic kelurahan-level institutions through the support of local facilitators and a team of technical experts. These institutions, called the BKM, receive a grant that is used as a revolving fund for micro-credits to community groups. The project includes 1300 kelurahan in the first stage and another 1800 in the second stage. In the first six months of operation, approximately 1300 BKM have formed. They have lent to 28,000 community groups with roughly 200,000 individual recipients. In addition, the Bank continues to support structural poverty reduction and governance reform through the Kecamatan Development Project and the Village Infrastructure Program. 727 kecamatans in 19 provinces are included in this second year of activities under KDP, and 750 kecamatans are targeted for the third year. The portfolio also includes the "stay in school" project for scholarships and block grants for primary schools, in coordination with ADB, and several projects in the health sector.

Grant Funds. The Bank-administered ASEM Trust Fund is supporting a program of Financial Sector Advisory Services (US$385,000 and US$305,000), primarily to help establish an Independent Review Committee of international and Indonesian experts for IBRA, and to enhance TA coordination for IBRA and Bank Indonesia. ASEM support has also concentrated on improving institutional performance at the local level. ASEM is also playing a key role in helping Indonesia's decentralization efforts with programs to improve local government public expenditure and financial management systems - Improving Local Government Public Expenditure Systems, Reporting and Transparency (US$298,500); and a Water Utility Rescue Program (US$396,000). ASEM also finances a program to Improving Fiscal Policy Analysis by the Ministry of Finance (US$440,000). In the social sectors, an ASEM grant is being used towards SMERU (US$790,000), which funds social impact monitoring activities and social data analysis; and another (US$693,000) to support (a) Community Based Monitoring (US$200,000) (SSN programs and other community development activities), (b) the TKPP ($241,000) (innovative social safety net performance targeting and safeguarding activities), and (c) Tim Pengendali (principally LD) ($252,000) (for independent verification of SSN program performance). Also, an ASEM grant of US$171,000 supported data analyses for the recent poverty assessment. The Bank is implementing two PHRD technical assistance grants of $1.3 million and $1.7 million, mainly to help assist corporate restructuring. PHRD TA Grants (US$847,920) are being used to support the ongoing financial sector reform effort. IFC has been working on individual corporate restructuring transactions in which it is an investor and drawing legal, regulatory, tax, and procedural issues to the attention of Bank staff. IFC is also implementing a $1.7 million PHRD grant to identify good potential corporate restructuring candidates and begin their restructuring on a pilot basis.

Analytical and Advisory Services are being provided in the areas of good governance, civil service reform, fiscal and administrative decentralization, debt management, poverty assessments, fiscal transparency and budgetary processes, SME development and trade financing. To facilitate corporate restructuring, the Bank is providing advisory services to help in developing and implementing a corporate legal reform and corporate governance strategy; a strategy for developing small and medium enterprises; and direct advice for reform and privatization of state-owned enterprises. The Bank is also advising the Financial Sector Policy Committee (FSPC) Secretariat and the other relevant institutions on policies pertaining to corporate restructuring. A series of working papers on the social impact of the economic crisis from both quantitative and qualitative research have been produced by the Social Monitoring and Early Response Unit (SMERU), a unit set up with support from the World Bank, AusAid, USAID, and ASEM trust funds. These are available on SMERU's web page: www.smeru.or.id. Much of this work has been incorporated in the World Bank's Poverty Assessment that is underway. A draft of this report will be presented to civil society and donors prior to the CGI scheduled for October.

FINANCIAL SECTOR UPDATE

Current Developments

Despite the continued uncertainty in the political arena and the persistent difficulties in enforcing contracts through the judicial system, IBRA maintains slow but steady progress in asset disposal and outsourcing activities and in meeting various institutional objectives set forth in the structural reform program.

In the cabinet reshuffle IBRA's Chairman Cacuk Sudarijanto was named to the post of Junior Minister in charge of Restructuring and the National Economy. It is still unclear what this appointment will mean to IBRA as Cacuk will continue to serve as the Chairman with no changes having been indicated in IBRA's management.

- *Oversight Committee (OSC) established to improve IBRA's corporate governance*. Minister of Finance signed the Decree on IBRA's oversight committee on July 17 appointing two ex-officio and seven independent members to the committee with the IRC Chairman Mar'ie Muhammad receiving the post as the Chairman of the OSC. The members are decreed to be "independent professionals with a high level of integrity and commitment in carrying out the tasks entrusted to them." The IBRA Chairman and the Secretary of the Financial Sector Policy Committee (FSPC) will concurrently be members of the Committee ex-officio. The OSC will serve as the Executive and Monitoring Committee of the Implementation of the Tasks of IBRA to strengthen IBRA's operational transparency, to monitor IBRA performance and to provide guidance to IBRA's management on strategic issues. Its tasks specifically include:

  upholding corporate governance and transparency at IBRA, including monitoring policy compliance;
  monitoring the performance of IBRA, especially regarding strategic issues; and
  offering recommendations, solicited or otherwise, to IBRA and the FSPC to further the success of IBRA.

- IBRA's governance structure has further been enhanced through the establishment of an independent Audit Committee.
- *IBRA grossed IDR 4.66 trillion in revenues during the first quarter of FY 2000.* IBRA is making some progress in its efforts to deliver the IDR 18.9 trillion collection target set for FY2000. By end of first quarter 2000 the Asset Management Credit (AMC) unit collected IDR 3.44 trillion, Bank Restructuring Unit (BRU) generated IDR 0.987 trillion with and the rest of the proceeds coming from IBRA's treasury activities. However, with the negative market reaction to the new economic team and the continued uncertainty over the respective roles of FSPC, MoF and the OSC in steering IBRA going forward, IBRA will have a difficult time meeting the highly ambitious disposition targets set forth in the Fund LOI for both end of September and for FY2000.

- *IBRA raised IDR 420 billion from the sale of 6.1% stake in First Pacific,* a regional conglomerate listed on the Hong Kong Stock Exchange. The stake originated from the Salim Group, and was sold through a private placement to a Hong Kong based investment company, Capital International. Meanwhile, IBRA is proceeding with preparations for the sale of also other Holdiko Perkasa assets, namely Wisma BCA (with an international sale tender already launched), Karimun Granite, Mosquito Coil and the Palm Plantations.
- *IBRA concluded successfully the first corporate loans sale.* Salomon Smith Barney-Citigroup, BCA and Hammers Rui were declared as winning bidders in IBRA's first corporate loans sale. The offered corporate loans included loans originating from five debtors, PT Astra Graphia with debt amounting to US$10.6 million, PT Federal International Finance (US$1.1 million and IDR 45 billion), PT Karang Mas Sejahtera (US$23.9 million), PT Satelindo (US$62.4 million) and PT Tiger Mandiri Pratama (US$0.7 million). The loans recovery rate is expected to reach 71% (restructured) of their total book value of USD 98.7 million.
- *IBRA completed the outsourcing of its commercial loans.* Bank Bukopin and Bank Artha Graha-Grant Thornton consortium won IBRA's auction to service the last portion (tranches III and IV) of its commercial loans portfolio. These tranches are valued at IDR 6.8 trillion and include 600 commercial debtors.
- *IBRA completed the sale of the second tranche of mortgage loans.* Bank Artha Graha won this auction with bid price of IDR 389.1 billion. In this deal IBRA achieved 50% recovery rate, exceeding the return of 41% attained in the Tranche I sale.
- *IBRA offered a 100% interest discount to retail and SME debtors participating in the Special Crash Program (SCP).* The SCP program provides a 100 percent discount on interest payments and fines to those retail and SME debtors who are willing to repay fully their loans. The SCP excludes housing, car and credit card loans. To date, IBRA's retail and SME portfolio includes 75,000 debtors with an outstanding IDR 6.4 trillion.
- *Divestment plans of BCA and Bank Niaga to be presented to Parliament by end August.* The government has been preparing the divestment plans for both BCA and Bank Niaga for review before Parliament by end this August. Market sources have questioned the viability of the government's plan to

divest both banks according to the schedule presented. Hence, due to weak investor confidence the sale of these two banks may fall short the targeted revenue of IDR 3.2 trillion.

- *IBRA, Bank Indonesia and Rudy Ramli reached the agreement to end all litigation related with the transfer of Bank Bali to IBRA.* Following the agreement, the Parliament approved the Bank Bali recapitalization plan for IDR 5.356 trillion. In preparation for Bank Bali's recapitalization, the EGM has approved the bank's plan to go forward with its rights issue. IBRA will underwrite any unsubscribed shares. As further legal procedures will have to be undertaken prior to recapitalization, it is currently expected that the bank will be fully recapitalized by October 2000.
- *IBRA won its first bankruptcy case in the Commercial Court.* IBRA has won a bankruptcy petition against one of its non-cooperative debtors, PT Mahadjaja Gemilang, with total debt outstanding of IDR 19.3 billion. The court decision, involving use of ad-hoc judges, was the first one with favorable outcome to IBRA. The company has been declared bankrupt, and placed in receivership.

Table 1. State-owned banks Financial highlights

(in IDR trillion)

	Loans/dep. (%)	*Recap bonds* (issued)	*Net Income*
Bank Mandiri	34	175.0 (100%)	6.6
BNI	43	62.0 (100%)	(2.4)
BRI	69	20.4 (70%)*	1.2
BTN	45	9.8 (70%)*	(1.0)

* as of 25 July 00 – remaining 30% expected end-October

The Government has been taking steps to introduce more active governance in the state-owned banks, the mandate of the newly established over-sight unit in the Ministry of Finance remains narrow and somewhat unclear. Along with the implementation of recapitalization (see Table 1 for status of state bank recap), the Indonesian banking sector is beginning to show signs of stabilization. Positive trends are emerging such as, inter alia, the rise in interest margin and capital, as well as the decline in non-performing loans, and new lending to real sector gradually resuming both in the state banks and the IBRA controlled banks. Nevertheless, the banking sector has not yet fully recovered and much remains to be done in implementing an in-depth restructuring program that addresses the deep structural weaknesses within the banking system.

- *The Ministry of Finance took steps to make its Monitoring Unit operational to monitor the performance of the state banks and their compliance with the interim performance contracts, signed by their new management.* By decree, the Monitoring Unit's mandate was set in a very narrow scope, and it remains unclear what its role will be with regard to governance, audits, and preparation for privatization -- all crucial elements for the recovery of the state banking sector and thus for the economy. The cabinet reshuffle moving the responsibility of all SOE's to MOF adds to the uncertainty. In spite of management changes and the on-going recapitalization to be completed in October, interim performance contracts have thus far proven insufficient to bring about substantive improvement in the restructuring of the state banks. There remains the need to strengthen their governance and management as well.

- *Banks gradually resuming their lending to the real sector.* Albeit limited, banks are starting to extend new loans. BI's survey on fifteen banks that represent 75 percent of total banks' deposits found that a total of IDR 15.8 trillion new loans have been extended since the beginning of year 2000, which represent a 5.7 percent year to date growth. It must be noted, however, that this figure includes both renewed and restructured loans, which means that truly new lending is significantly lower. Privately recapitalized banks and nationalized banks under IBRA's control report that a majority of these new loans are being directed to corporates and SMEs.
  Despite these positive signs, with the slow pace of new lending, banks will be unlikely meet their financial targets. Banks' lending activities are restrained by the limited room in their capital levels, which barely meet BI's 4 percent limit due to the dominance of zero risk government bonds in banks' portfolio. Hence, banks will need to intensify their operational restructuring, particularly in the area of asset rehabilitation.
- *Management changes in state banks completed.* This year the management of all the state-owned banks have been changed, with BRI (in July) and BTN (in May) being the most recent. This preceded the approval of the banks' business plan by MOF and infusions of recapitalization bonds covering 70% of their recapitalization needs. The new management teams signed an interim performance contract with MOF, defining performance targets and milestones for the second recapitalization tranche expected in October 2000.

In general, the new directors and commissioners selected by the government had their career in the state banking sector (particularly with banks merged into Mandiri), thus raising concern among market participants over their ability to follow through on the much needed changes in the state banking sector. In order to quell such worries, the banks have either engaged consultants (BNI, BTN) or international staff just below board level (BRI - for IT and MIS) with appropriate private banking sector experience.

- *The implementation of the restructuring of BNI continues with the help of Credit Lyonnais Securities Asia (CLSA) and the Boston Consulting Group.* While BNI will benefit from the consultants help, particularly in the debt restructuring. The consultants are currently reviewing the business plan to be annexed to the final performance plan and a contract is expected to be signed in the last quarter of this year.

- *Irregularities detected in the property transfers to Bank Mandiri.* The State Audit Agency (BPK) found irregularities in the sale of property of banks that were merged into Bank Mandiri altogether amounting to IDR 674 billion. During the merger, directors of Bank Exim, BBD, BDN and Bapindo transferred part of the property to PT Pengelola Harta Tetap Mandiri (PHTM). Thereafter, the property appears to have been sold without appropriate approval by the regulatory authorities.
- *Housing finance strategy in the works.* The Ministry of Housing, in coordination with MOF, has started implementing a new strategy for the housing and housing finance sector. The World Bank held a workshop in July this year with the participants from several ministries to discuss the new strategy that is, among other things, expected to modify the subsidy system for low income mortgage loans.
- *Twenty-four foreign banks participate in the Trade Maintenance Facility program.* The foreign banks have committed to lend a total of US$ 1.6 billion to 38 Indonesian banks for international trade transactions, of which US$ 86 million have already been realized. The program requires government guarantees for the transactions.
- *The Commonwealth Bank of Australia plans to invest Aus$ 13 million in a joint venture bank.* The Commonwealth Bank of Australia is planning to increase its stake in BII-Commonwealth to 99 percent.
- *The Attorney General's Office (AGO) filing litigation against 10 banks that received BLBI.* Following the submission of BPK audit on BLBI, the AGO is to start litigation against 10 closed banks (BDNI, BUN, Pelita, Modern, Istismarat, Servitia, Utama, Centris, Deka and Aspac) for misuse of IDR 34.7 trillion of BLBI funds. Meanwhile, BI officials involved in the extension of BLBI are facing further questioning by the AGO.
- *The AGO for the second time extended detention of Syahril Sabirin, Central Bank Governor.* The AGO prolonged the detention of the suspended central bank governor for another 20 days. According to the AGO, the central bank governor could be sentenced to five years in prison if the court found him guilty for corruption in the Bank Bali case.

Issues and Areas to Watch

- The concrete steps the new economic team takes to reassure the markets of the Government's commitment to the state bank and corporate restructuring programs. A key issue being is how, and how quickly, the relative roles and responsibilities of the FSPC, the economic ministers, IBRA's Oversight Committee, and the various economic advisory committees will be determined.
- MOF's ability to create sufficient and credible momentum to the reform program of the state bank sector will be closely watch by the market, as will be continued impetus in IBRA's asset disposition program.

CORPORATE SECTOR UPDATE

Current Developments

The enhanced corporate restructuring framework that was adopted in early 2000, and agreed as part of the new IMF program has begun to achieve results. Earlier delays had contributed to delays in the disbursement of funds to Indonesia from the IMF. During the first three months of 2000 the Jakarta Initiative Task Force (JITF) had experienced discontinuities in its management following the resignation of the Chairman and the Chief Operating Officer. There were delays in appointing their successors and immediately thereafter, the newly appointed Chairman resigned. Another new JITF Chairman was put in place in March. Government decided in June this year to close INDRA. Only one corporate restructuring deal had taken advantage of the facility since it was created.

More recently, the newly appointed Coordinating Minister of Economic, Finance and Industry—Dr. Rizal Ramli—has stated that Mr. Cacuk Sudarijanto (the IBRA Chairman) will also assume responsibility over the JITF. Meanwhile, the Financial Sector Policy Committee (FSPC) has proven to be an effective coordinating mechanism, IBRA and JITF are cooperating better than before and Indonesia has met the corporate restructuring targets agreed with the IMF in the current Letter of Intent (LOI).

The Jakarta Initiative Task Force (JITF) has just completed it's first quarterly survey of corporate indebtedness. According to the preliminary results of this survey, total corporate debt in Indonesia amounted to $117 billion as of June 2000. Of this around 50 percent ($58.6 billion) is owed to offshore creditors and the other 50 percent ($58.4 billion) to onshore creditors. Of the total onshore debt around 45 percent ($ 26 billion) is denominated in foreign exchange. This heavy exposure to foreign exchange denominated loans leaves Indonesian corporates still extraordinarily vulnerable to further devaluations of the rupiah.

Of the onshore portion of the corporate debt, around 64 percent ($37.4 billion) is classified as non-performing. The percentage of offshore loans that are non-performing is not known yet but if the same ratio is applied to that of the onshore loans then around $37.5 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 indicating little improvement in the domestic banks' portfolios during the first half of this year. Among the offshore creditors, Japanese banks are the largest group, accounting for 29.3 percent of offshore loans. The second largest group is the US banks (14.4 percent) followed by the Netherlands (10.56 percent and Germany (6.28 percent). The three largest creditor countries therefore account for more than 50 percent of Indonesia's offshore corporate loans.

The Indonesian Bank Restructuring Agency (IBRA) holds 77 percent (28.9 billion) of the onshore distressed loans. Of this amount, large private corporates (debts of more than IDR 50 billion) account for 87 percent. On the $21 billion onshore performing loans SME's (loans of less than IDR 50 billion) account for 60 percent, state owned enterprises (SOEs) for 22 percent and the remaining 18 percent is owed by large private corporates.

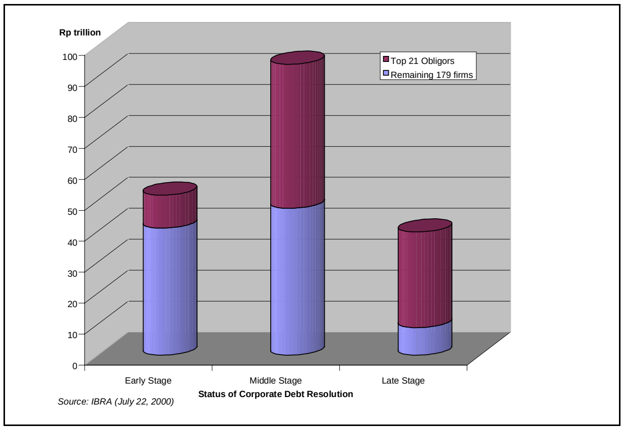
The published figures and anecdotal evidence suggest that over recent months the pace at which IBRA and private creditors have been finalizing restructuring deals with corporate debtors has been gaining momentum. As of July 22, IBRA’s AMC had provisionally resolved 35 percent of Rp 88 trillion in credits to its Top 21 obligors—Rp 25 trillion through restructuring agreements and Rp 6 trillion through commencement of litigation. Groups that have agreed on restructuring 50 percent or more of their IBRA AMC credits without extensive litigation include Bakrie, Napan, Raja Garuda Mas, Rajawali, and Argo Pantes. Groups that have reached little or no agreement with IBRA AMC and/or are heavily involved in litigation, however, include Texmaco, Hasan, PSP, Tirtobumi, Bahana, Dharmala, and Kodel. While quantitative estimates are not yet available, foreign creditors are also indicating that a number of large debt restructuring agreements have been concluded or are imminent.

Both IBRA AMC and private creditor restructuring deals have relied mainly on term extensions, debt/asset swaps, and debt/equity conversions. Sales of non-core businesses or assets to foreign or domestic investors, mergers or spinoffs, additional equity financing, management changes, or court-supervised reorganizations or liquidations have so far not played as great a role in Indonesia as in other East Asian countries. If this continues then Indonesian corporations could emerge from the crisis mostly intact.

IBRA’s AMC recently announced the sale of $103 million (book value) in restructured corporate debt to a consortium including Salomon Smith Barney-Citibank and Bank Central Asia for $72.3 million—a 71 percent realization. Included were the debts of five companies—PT Astra Graphia (electronics), PT Federal International Finance, PT Karangmas Sejahtera (hotel), PT Satelindo, and PT Tigermandiri Pratama (plastic ware).

As indicated in Figure 4, the IBRA AMC portfolio includes Rp 41 trillion in corporate credits below the Top 21-level on which little or no progress has been made. A number of foreign and domestic financial institutions have expressed an interest in bidding for these unrestructured loans and a willingness to share any upside recoveries with IBRA. Foreign financial institutions, however, typically feel that loan pools for auction must be large enough (e.g., Rp 10 trillion) to make it worth their while to bid and set up a local operation to restructure/administer purchased loans.

Figure 4. Status of IBRA AMC's efforts to resolve credits to top 200 obligors



Source: IBRA (July 22, 2000)

On July 25, Minister Kwik announced that the Government may scrap agreements entered into by IBRA with such groups as Salim and Gajah Tunggal in settlement of violations of limits on lending by their banks to related parties. Separately, it has been reported that the Government is exploring a "package" sale of Salim Group assets to several potential investors—including to companies linked to the Malaysian Government or to an investor group linked to the Salim family.

Table 2 shows that as of August 25, JITF had 67 active corporate cases involving $13.3 billion in debts. (Previously registered but inactive cases have been removed from JITF's reported figures) These active cases have included six referrals from the Financial Sector Policy Committee (FSPC). 24 JITF cases have been completed, involving $5.2 billion in debt. This represents important progress when compared with the less than $1 billion in debt restructured through JITF up to February of this year. JITF has so far been meeting its targets as spelled out in the LOI to the IMF. Particularly useful have been the new time bound mediation procedures and the improvements regulatory incentives for corporate restructuring.

Issues and Areas to Watch

Progress in corporate restructuring is still slow and it remains to be seen whether major non-cooperative debtors can be successfully pressured into reaching agreements. A key issue is whether the new Cabinet will continue support for the enhanced corporate restructuring framework that is at last beginning to produce concrete results and will push for more rapid corporate restructuring

Table 2. JITF is currently facilitating the restructuring of US$13.3 billion in corporate debt

(67 active corporate cases).

INDUSTRY SECTOR	*NO. OF CASES (of which completed)*	*EST. US$ DEBT (US$ Mn.)*	*EST. RUPIAH DEBT (Rp. Bn)*	*EST. TOTAL DEBT (US$ Mn equiv.)*
Agri-Business	4 (1)	677	4,665	1,260
Basic Industry And Chemicals	15 (5)	4,064	1,576	4,261
Consumer Goods	3 (2)	423	76	432
Finance	8 (3)	1,224	1,382	1,397
Infrastructure, Utilities and Transportation	3 (2)	313	281	349
Mining	2(1)	71	130	88
Property And Real Estate	10 (2)	548	1,838	778
Trading, Services And Investment	10 (7)	2,125	130	2,142
Other	12 (1)	2,165	3,859	2,648
TOTAL	67 (24)	11,612	13,939	13,355

Source: Jakarta Initiative Task Force (JITF).

The lack of reliable means to impose losses on debtors or force their cooperation has continued to bedevil corporate restructuring in Indonesia. Over the last two months IBRA has won two small bankruptcy cases in the Commercial Court, one against PT Landasan Terus Sentosa, and more recently a second against Mahadjaja Gemilang, and further referrals by IBRA are planned. Other creditors in recent months have successfully brought bankruptcy cases against debtors in the Commercial Court. Another encouraging development over the last few days is the announcement that three judges will be prosecuted for corruption. But all the recent bankruptcy cases that IBRA has won are still subject to possible reversal by the Supreme Court. Until there is an assurance of more reliable court decisions, referrals may serve only to re-emphasize the relative weakness of creditors.

While recent progress by IBRA's AMC in reaching debt restructuring agreements with its Top 21 obligors is encouraging, some bankers have questioned 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.

There remain a number of tax, legal, and regulatory impediments to corporate restructuring. In the most recent LOI, the Government has committed to addressing many of these impediments. JITF has been taking the lead, with some success, to provide regulatory relief in cooperation with the various agencies concerned, in particular Bank Indonesia, BAPEPAM, Jakarta Stock Exchange, and the Ministry of Finance.

Progress by IBRA AMC in resolving the corporate debts of its top 22-200 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 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.

Companies need to obtain sufficient financing. While trade finance is available and some groups have access to overseas sources of funds, several factors may limit the access of many corporations to financing for working capital or capital investment – e.g., the weak capital position of local banks, country-exposure limits for foreign banks, mistrust, and non-transparent corporate structures. Corporations may need to demonstrate a credible commitment to deeper corporate restructuring in return for access to additional financing.

Policy Implementation and Assessment

Initial results from the enhanced corporate restructuring framework are encouraging. There is, however, 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. Recent 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 managements 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. Both the Government and international financial institutions (IFIs) should work with private investors to encourage greater linkage between access to financing and additional necessary restructuring.

SOCIAL SECTOR UPDATE

Key Social Indicators

	Latest data (date)	Previous Period (date)
Human Development	**1999/2000**	**1997/98**
Primary enrollment rate (net)	95.1	94.1
Female		
Male		
Secondary enrollment (net)	55.2	54.4
Female		
Male		
Tertiary enrollment	2,285,170	2,451,000
Female (% total enrollment)	46.3	41.3
Male (% total enrollment)	53.7	58.7
Infant mortality rate		
From DHS	45.7(92-97)	58.9(87-92)
From SUPAS	51.4 (1991)	71 (1986)
Poverty & Income Distribution.	**1999 (Feb.)**	**1996 (Feb.)**
National Headcount Index 1/	27.1	15.7
Urban Headcount Index 1/	16.3	7.2
Rural Headcount Index 1/	34.1	20.5
Gini Index	0.32	0.36
Government Expenditures	**98/99**	**96/97**
Health budget ('93 rp billion)	2,105	2,592
As % of total	2.6	2.7
Education budget ('93 rp billion)	4,229	5,846
As % of total	5.2	3.9
Labor Market	**1999 (Aug.)**	**1998 (Aug.)**
Unemployment rate (%)	6.4	5.5
Female	6.9	6.1
Male	6.0	5.0
Participation rate (%)	67.2	66.9
Female	51.2	51.1
Male	83.6	83.2
# of strikes/# of workers/ days lost	NA	350/221,537/ 2.5 m (1996)
Real wages (%change)	+12.0 (98-99)	
Formal as % of total employment	35.6	34.2
Female/male wage ratio	0.79	0.82

1/ Using a poverty threshold of $1.30 at 1993 PPP dollars

Current Developments

Social/Political highlights. A state of civil emergency was declared in Central Maluku as the sectarian violence worsened over the past few months with the arrival of *jihad* forces. Pattimura University in Ambon was destroyed in a July arson attack, with resulting losses surmounting Rp 1 trillion. About 300,000 residents are currently living in temporary shelters in and around Ambon. 15,000 Ambon IDPs have now arrived in Kupang, West Timor, and significant new waves of refugees headed to North Sulawesi and Irian Jaya are being accepted with increasing reluctance by local governments and residents. Man-made disaster was capped on August 29th by an earthquake registering 6.4 on the Richter scale. Intensive violence also spread to North Maluku during the past few months, resulting in large movements of IDPs to North Sulawesi and other areas. A 3-month "humanitarian pause" took effect in Aceh on June 2nd, during which 63 people have been killed in the province. Parties are now considering an extension of the "pause."

The MPR concluded its annual session in mid-August. In addition to the cabinet re-shuffle noted earlier, the Parliament unanimously passed a controversial TNI-sponsored Constitutional amendment prohibiting retroactive prosecution for crimes committed when no laws against such acts existed. This has put into question the ability of the Attorney General to effectively prosecute the cases of human rights abuses in East Timor. Suspects in the cases are/were expected to be announced shortly.

Social impact of the crisis. Substantial work has recently been completed on the impact of the crisis using various data sources. This section discusses very briefly each of six topics: (a) the change in measured poverty rates over the course of the crisis; (b) who the poor are; (c) where the poor are; (d) impact on education, health and nutrition; (e) the impact on employment; (f) how households cope with the crisis. The crisis impacts and coping strategies reveal information about the Indonesian economy, society and government that are critical elements in building a poverty reduction strategy. The major points that emerge are:

- That the shock and the rise in poverty was far from uniform, and there is large fluidity in who, at any point in time, is "poor."
- That individuals and communities are not passive, but actively respond to changed circumstances with strategies to cope as families and communities.
- That the crisis did not cause, but has laid bare and worsened, long-standing weaknesses in the education and health sectors.

The change in measured poverty rates over the course of the crisis. The National Socioeconomic Survey (SUSENAS) is the main data source of information on poverty in Indonesia. Measures gathered from SUSENAS 1996 and 1999 indicated that the crisis has resulted in a substantial increase in poverty. Our estimates indicated that national level poverty increased from 15.7 % to 27.1 %. The number of urban poor has doubled, while we have seen a 75 % increase in the number of rural poor1. Recent

[1] These estimates were computed using iterative methods. In order to produce a methodologically superior estimate we had to

estimates of gini coefficients show that inequality has decreased slightly over the three-year period.

Who are the poor? They tend to have low education, work in agriculture and live in rural areas. Eighty seven percent of the poor live in households in which the head of household has a primary school education or less—only 5 percent of the poor have a secondary school education or better. Almost 60 percent of the poor are in households where the agriculture sector is the main source of income (whether from labor or land) -- even though the "modern" sector has a quarter of all workers, they only have 15 percent of the poor. In keeping with that, fully three quarters of the poor live in rural areas.

Where are the poor? The poorest regions—all with poverty rates 10 percent or more above the national average—are scattered rural areas: the Eastern Islands (Papua, NTT, Maluku, NTB) but also others (SE Sulawesi, E. Java, Lampung, W. Kalimantan, C.Java). However the bulk of the poor are in Java—where 61 percent of the poor live, mainly because Java was slightly poorer than average (as measured in 1999) and 54 percent of Indonesians live on Java.

Vulnerable to poverty. Who is poor at any point in time is very fluid, and people and households enter and exit periods of poverty frequently. This means that a large swath of the Indonesian population that is today "not poor" is nevertheless at risk of becoming poor. Any adverse shock to their incomes (or necessary expenditures) could easily force them over the (arbitrary) line into poverty. Even if only 27 percent are poor now, between 30 and 60 percent of households are vulnerable to poverty over a three year horizon2.

Impact on education, health, and nutrition. Whether in response to government scholarships and block grants to school programs or otherwise, school enrolments have not declined markedly, although there have been higher drop out rates amongst poorer families. Primary school enrolment rates continued to increase during the crisis and junior secondary school enrolments decreased very slightly in 1998 but increased to beyond their pre-crisis level in 1999.

Studies revealed very little crisis impact on health. For instance, the number of malnourished children has slightly increased and the infant mortality rate has continued its steady decline through the crisis.3 There have been slight increases in the number of people reporting health problems. There is some evidence that women's health has suffered more than men's and children's. Women report a larger increase in health problems and women's body mass indexes have declined.4

This lack of a large crisis impact is cause for relief, but not cause for complacency, as even before the crisis Indonesia had quite poor indicators of nutritional status. Some of the apparent "increase" in malnutrition is simply a greater openness and willingness to admit and confront the issue. The situation in health is similar to that in education: the problem is not so much the new impact of the crisis as the continuing, and chronic, problems that have developed in the basic health care and education delivery systems in Indonesia.

The impact on employment. The main direct labor market impact was a large reduction in the industrial and construction sectors in the urban areas, most of whom found employment in the informal sector at much lower incomes. At the same time, the total labor force continued to grow, with an additional 2.1 million workers entering the labor force in 1999. Open unemployment continued to rise slightly, from 4.7 percent in 1997, 5.5 percent in 1998, to 6.4% in 1999. However, the decline in real wages has had a larger impact than the contraction in the labor market, although recent estimates of real wages by sector provides some hope. For most sectors we observe substantial, i.e. more than 10 %, increase in real wages between 1998 and 1999, except for agriculture and mining sectors where real wages have dropped by 4 % and 16 %.

The labor market has also seen a shift in women's employment patters. First, many of the modern sector factories employed young, mostly unmarried, women, and these sectors were hit particularly hard. Second, in many households with children, women had to take on additional work for pay so that the fraction of women in the labor force in certain areas actually went up as women took on additional earning activities. Third, there are reports of difficult changes in the rural areas as migration patterns changed the labor market in some agricultural tasks which had become predominantly female. We find no substantial changes in the sectoral shares of employment between 1998 and 1999.

Coping Strategies. People are not merely passive victims of the crisis, but have coped with the crisis relying on themselves and their families, friends and communities, (and to varying degrees) government programs. A survey in December 1998 asked people what means they had used to cope with the crisis, which were three-fold: reducing expenditures, borrowing, and attempting to raise incomes, the results are presented. In reducing expenditures non-necessities were cut most frequently: clothing (68%) and recreation (53%) were most frequently cut. Then followed necessary expenses, but which could be reduced, such as

sacrifice comparability with the BPS estimates (11.3 percent in February 1996)

[2] Pritchett, Lant, Asep Suryahadi and Sudarno Sumarto (2000), *Quantifying Vulnerability to Poverty: A Proposed Measure, with Application to Indonesia*, SMERU Working Paper, May, Social Monitoring and Early Response Unit, Jakarta.

[3] World bank Annual Development Report 1979-1999, as cited in Atmarita et al. (1999).

[4] As shown in the Susenas and IFLS data.

reducing the quality of foods (52%) and reducing transportation expenses (48%). Another 38% of the poor (but only 22 percent of non-poor) were even forced to reduce the quantity of food consumed. A second option of the poor was to maintain necessary expenditures by borrowing or selling assets. By far and away the most frequent means was to borrow from others, which almost a third of the poor (and a quarter of the non-poor) did during the crisis. The third option was trying to raise incomes. In a flexible labor market this comes from doing additional jobs, working more hours and expanding the number of members in the family who work.

PROGRAM IMPLEMENTATION

Background. 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.

Recent developments in the social sectors. The Government's operational guidelines for the "key" safety net programs include five-point monitoring plans to strengthen transparency and financial controls in the programs. Information folders on key safety net programs have been compiled and made available to the public in 230 districts in Indonesia. Complaint resolutions units have also been established, and 222 districts have initiated public consultation forums with civil society representatives on social safety net activities.

Implementation of the SSN programs is mixed. Implementation of the he 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 these programs are not expected to be fully operational until November at the earliest.

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 currently being updated and are expected to be available in October.

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).

- Macroeconomic Update was prepared by Sudarshan Gooptu (EASPR)
- Financial Sector Update was prepared by Paula Perttunen and Ruth Neyens (FRO)
- Corporate Sector Update was prepared by Bernard Drum and Bill Mako (EACIF)
Social Update was prepared by Jacqueline Pomeroy with inputs from Ani Dasgupta, Sandy Lieberman, Scott, Vivi Alatas and the SMERU (EACIF).

INDONESIA ECONOMIC INDICATORS

	1997	1998	1999	1999		2000				
	Year	**Year**	**Year**	**Q3**	**Q4**	**Q1**	**Q2**	**May**	**Jun**	**Jul**
Output, Employment and Prices										
GDP (% change previous year)	4.7	-13.0	0.3	1.2	5.0	3.6	4.1			
Industrial production index (1993=100)	157.4	136.4	169.8	185.1	190.6					
(% change, previous year)	13.2	-13.3	24.5	34.7	32.6					
Unemployment Rate (%)	4.8	18.4	19.1							
Real Wage Growth (%)	4.1	-29.9	2.0							
Consumer price index (% change, previous year)	6.1	58.5	20.5	1.2	1.9	-1.2	2.0	1.2	2.0	4.4
Public Sector										
Government balance (% GDP)	-0.6	-2.1	-1.5							
Domestic public sector debt (% GDP)										
Foreign Trade, BOP and External Debt										
Trade balance (million$US) 4/	10,067	18,429	20,643	6,344	5,804	6,264	6,353			
Exports of goods, ($millionUS)	56,297	50,371	51,242	14,270	13,760	15,113	15,212			
(% change, previous year)	12.2	-10.5	1.7	6.0	26.4	39.8	22.7			
Imports of goods, ($millionUS)	-46,230	-31,942	-30,599	-7,946	-7,926	-7,956	-8,849			
(% change, previous year)	4.5	-30.9	-4.2	-5.2	8.3	30.7	-211.5			
Current account balance ($millionUS)	-604	4,097	5,781	1,885	1,536	1,898	2,095			
(percent GDP)	-0.3	4.1	4.0	5.7	3.9	4.8				
Foreign Direct Investment (million US$)	4,677	-356	-3,270	-698	-1,450	-1,232	-942			
Total external debt (million $US)	136,088	150,886	148,097	145,942	148,097	144,282				
(% GDP)	64.0	150.6	103.3	110.0	93.0	92.2				
Short-term debt (million $US)	35,104	23,702	19,035		19,035					
Reserves, including gold ($US billion)	16,587	22,713	26,445	26,032	26,445	28,461				
(months of imports of goods and services)	-3.0	-5.3	-6.4	-7.7	-8.0	-8.0				
Financial Markets										
Domestic credit (% change, previous year)	42.0	36.0	17.3	9.7	17.3	43.4	60.6	46.0	60.6	
Short-term interest rate /5	25.4	41.4	12.2	12.5	12.2	10.8	10.37	10.43	10.37	
Exchange rate (end-period)	2,953	9,875	7,809	8,368	7,059	7,608	8,741	8,460	8,741	
Real effective exchange rate (1990=100 and + = appn)	96.6	47.3	68.1	61.8	74.5		73.1	74.5		
(% change, previous year)	-5.5	-51.0	43.9	61.4	12.0					
Stock market index (end-period, Aug 88=100)	402	398	677	548	677	583	515	454	515	
Memo: GDP in US$ million	212,562	100,218	143,353	33,173	39,821	39,133	35,407		35,407	