

ASIAN DEVELOPMENT BANK

**COUNTRY ASSISTANCE PLAN UPDATE
(2001-2003)**

INDONESIA

MAY 2001

INDONESIA: CAP (2001-2003) UPDATE

A. Country Developments

Domestic Developments

1. In some areas social tensions and outbreaks of sectarian or political violence continue. Published reports estimate that in 2000 the number of internal refugees surpassed 1 million people. The security situation in Aceh, in particular, is said to be deteriorating in early 2001 despite public efforts by President Wahid to reach a political settlement. This emphasizes the need to approach development efforts with a regional or localized context.
2. The Government faces major political difficulties in meeting the problems of the country as enunciated at the Consultative Group meeting in Tokyo in October 2000. Monetary policy is hobbled by the political infighting over statutory and de facto independence of the Bank of Indonesia. The President, himself, acts from a minority position in Parliament. Increasingly vocal civil society organizations call for review of past and present government decisions. Local governments are moving to assert a new independence in decision-making. These developments complicate the formidable challenges of encouraging long-term reform, especially those addressing poor governance in the face of entrenched interests.

Economic Performance

3. *Economic Growth:* Modest growth was experienced in Indonesia in 2000 with GDP rising 4.8 percent. This signals the end of the sharp recession in 1998 in which GDP contracted by 13.2 percent and there was no growth in 1999. The major area of strength is exports, which have risen in response to the depreciation of the rupiah and the resolution of crisis difficulties such as the lack of export credits and general banking services. In contrast to surging exports, domestic spending by businesses, households, and the public sector rose only moderately. Investment spending, in particular, has yet to respond to the end of the crisis. Household income has recovered from the recent recession, but weak demand for labor restrains spending.
4. *Fiscal balances:* Public sector spending is constrained by crisis-swollen public sector debt, although high world oil prices provide some room for spending. Budgeted spending (including transfers to local governments) in FY 2000¹ increased from the previous fiscal year by slightly more than one percentage point to 21.6 percent of GDP. Against this revenues were projected to increase only approximately one-half percentage point. The overall budget deficit was projected to slide to 4.8 percent of GDP in FY 2000 from 4 percent in the preceding fiscal year. Very preliminary figures in early 2001 show stronger than anticipated revenues and a lower fiscal deficit.
5. The largest single element in the expenditure budget is domestic interest payments, at 4.2 percent of GDP in FY 2000. Interest payments on external debts are less than one-half the domestic debt burden. The emergence of a serious public debt burden reflects the costs of recent financial crisis, especially the use of public funds to recapitalize the banking sector.

¹ FY 2000 was April 1-December 31, 2000. The nine-month "year" being a transition between 12-month fiscal years that ended on March 31 and FY 2001 which corresponds to the calendar year. Comparisons between FY are thus complicated by different monthly patterns in addition to structural changes in budget procedures.

6. *Inflation:* Over the year, inflation increased. The 9.4 percent increase in the consumer price index (CPI) over the twelve months of 2000 was considerably more than the 1.9 percent rise in 1999 but below the price surges during the financial crisis. Price increases were larger than targeted especially in the second half of 2000. At that time, renewed weakness in the rupiah resulted in some upward inflationary pressure. In addition, higher fuel costs, resulting from the Government's program to reduce subsidies were also a factor in the growing price increases in the second half of the year.

7. *External Sector:* As noted, exports in 2000 were a significant factor in restoring economic growth. Most of the increase in exports was in non-oil and gas products: in electrical equipment and textiles and some natural resource products, particularly aluminum and nickel. Raw materials and capital goods purchases paced imports. Overall the current account showed a surplus of \$11.3 billion or 6.6 percent of GDP. The inflow of funds from strong export sales was partially offset by continued capital flight reflecting both net negative foreign direct investment as well as outflows of portfolio capital. Reserves have increased to over \$29 billion, in excess of 6 months of imports and government external debt service payments.

8. *Employment:* Indonesia has a relatively flexible labor market and even during the crisis, on an annual basis, the number of people reported working increased. Changes in aggregate economic activity, even severe changes, such as during the crisis tend to be reflected in real wage rates rather than in aggregate employment. Consistent with this, preliminary estimates for 2000 suggest that the modest GDP growth has encouraged a small increase in aggregate employment—up roughly 1 percent from 1999 to 90 million—and a small decline in the unemployment rate—from 6.4 percent in 1999 to 6.1 percent.

The Government's Reform Program

9. The Government of Indonesia has committed itself to a far-reaching program of reforms. A number of these stem from the lessons of the East Asian financial crisis—the need to strengthen banking and corporate governance, for example. Here the experience of Indonesia is similar to that of other crisis-affected countries. Formal reforms such as the establishment of bankruptcy courts were not matched by changes in behavior. In other areas the reform program stems clearly from Indonesia's historical background—decades of centralized authoritarian rule are being replaced by an extremely ambitious program of decentralization, transferring power and administrative responsibility to district level governments.

10. The Consultative Group for Indonesia, meeting in Tokyo in October 2000 found general support for the Government's reform efforts. Since then there has been growing concern on the pace of the reforms, particularly by the IMF.² The IMF's concerns include issues relating to the proposals to amend the Central Bank law which could affect its independence; lack of sufficient progress on particular privatization commitments by the Government agency tasked with managing assets acquired during bank recapitalization exercises; and the fiscal implications of the decentralization program.

11. The World Bank released in January 2001 its new Country Assistance Strategy (CAS) which focuses on three broad areas to achieve its overarching goal of reducing poverty and vulnerability: (i) sustaining economic recovery and promoting broad based growth; (ii) building national institutions for accountable government; and (iii) delivering better public services to the

² In February 2000, Indonesia entered into its third arrangement with International Monetary Fund (IMF) since the economic crisis began—an extended fund facility (EFF) for \$5 billion over 2000-2002.

poor. World Bank envisages three possible scenarios for annual lending levels based on progress in policy reforms: *base case scenario* where annual lending would amount to \$400 million presumes continuance of the current situation with some slippages in structural reforms but continued macroeconomic stability that would help sustain poverty reduction; *high case* where annual lending could rise to \$1 billion including adjustment lending if policy performance improves; and *crisis scenario* where new lending could cease altogether if there is major policy slippage, political instability or widespread breakdown of law and order.

B. Poverty

12. A Poverty Assessment for Indonesia was completed by ADB in September 2000. According to this Assessment, the incidence of poverty increased sharply from 17.6 percent in 1996 to 24.2 percent in December 1998 before falling to 18.2 percent by August 1999. Amongst other observations, the Assessment recommends that in planning investments that reduce poverty, both the incidence of poverty in a region as well as numbers of poor have to be considered. There needs to be more regular support for monitoring of poverty. While the recent move towards decentralization has considerable potential to reduce poverty, regional capacity can act as a constraint.

13. Following up on the Poverty Assessment, ADB began work on the Poverty Partnership Agreement which was signed between the Government and ADB on 5 April 2001.

C. Governance

14. Since the decentralization of operations to IRM, the ADB has played a very active part in the Partnership for Governance Reform in Indonesia: the Director, IRM is represented at and the Policy Committee of the Partnership. The Partnership has taken an active lead in assessing governance needs, coordinating international assistance, and spotlighting model efforts at reform. The ADB has taken the lead in corporate governance and actively participates in other areas, especially anti-corruption, public procurement and financial management, and decentralization activities.

D. Decentralization

15. The Government has officially introduced a decentralized administrative structure with effect from 1 January 2001. The steps taken include finalization of implementing regulations under Laws 22 and 25 of 1999 on decentralization; reassignment of relevant central staff to local governments; and finalization of shares of local governments under the General Allocation Fund for the 2001 budgets. Substantial work has been involved in these processes, including the difficult task of fine-tuning revenue allocations against competing claims from local governments.

16. However, concerns have been raised from several quarters, including ADB, about the decentralization process. These include (a) the possibility that unregulated borrowings by local governments that is permitted under the current laws could undermine public fiscal stability; (b) concerns about the fiduciary standards with respect to local government functioning; (c) concerns that local governments may not be willing or able to allocate sufficient resources to development activities out of devolved revenues, which could limit long term development,

provision of basic services and poverty reduction; and (d) the lack of definition of the role of the central government in promoting equitable development in local areas including its role in channeling resources from external sources. The Government is aware that considerable further work, including through amendments to existing laws and regulations, would be required and is working in consultation with the donor community to undertake further measures to complete the decentralization process. ADB will accordingly keep providing essential support for the implementation of decentralization reforms, both under its loan and TA program, building on its previous assistance.

E. Portfolio Performance

17. Although disbursements in 2000 from project loans totaled \$478 million exceeding the projection of \$387 million for the year, disbursement levels have continued at much below pre-crisis levels. This was the result of slower implementation during the crisis, during which period implementation problems such as availability of counterpart budgets were aggravated. Program loan disbursements were in general well behind schedule with only \$270 million disbursed in 2000 from program loan tranches against projections of \$800 million. This reflects the general delay in compliance with tranche release conditionalities. Efforts to improve portfolio performance have continued and are expected to be strengthened with the decentralization of portfolio management supervision to ADB's Indonesia Resident Mission.

F. Private Sector Operations

18. Although in general private investors still retain a cautious stance with respect to investments in Indonesia, PSG is beginning to build its pipeline of prospective projects in the country. Most of these projects involve privatization of infrastructure facilities and services. The first likely candidate is the ADB-assisted privatization of the Pekanbaru municipal water supply services, where the competitive bidding exercise has just been completed with the award of concession and the signing of concession agreement. The winning bidder has commenced serious discussions with PSG for possible ADB financial assistance. The risk-mitigating participation of ADB in this project is considered crucial to achieving financial closure. Another project where ADB support is expected to be sought is for the Jakarta water supply concessions which have just been renegotiated and which would now need long-term finance for further improvement of services. This would be a good example of public-private partnership in the provision of basic urban services. The Jakarta international airport is another possibility. It is being prepared for privatization and the Government is finalizing the bidding procedures. PSG has been approached by one of the prospective bidders for possible ADB assistance.

G. The Program for 2001

19. The original program in the CAP comprised of 6 loans for a total lending level of \$800 million and 23 technical assistance projects (6 PPTAs and 17 AOTAs) for \$20.2 million. In early February 2001, ADB held discussions with the Government to confirm the 2001 loan and TA program. This, along with a number of other factors enumerated in para. 20 below, resulted in some changes in the loan and technical assistance program and in the lending level. The amended list of loans and TAs for 2001 is attached.

The Loan Program

20. Several factors have influenced the structure of the loan program and will have a bearing on the actual lending level for 2001. These include ADB's pledge of delivering a loan program of \$800-\$1200 million including ADF availability at the Consultative Group Meeting in Tokyo in October 2000; the need to maintain a net positive transfer of resources during a period of fiscal difficulties faced by the Government; progress made by the Government in the pace of reforms; the country's absorptive capacity particularly in the context of decentralization; and the speed of processing of a number of loans with tight processing schedules.

21. The program contains 7 loans totaling \$1000 million consistent with the CGI pledge, including two program loans. The inclusion of program loans reflects the continued need for fast disbursing assistance to provide vitally needed budgetary support as well as carry out crucial policy reforms in the areas of financial and corporate governance which figure as areas of high emphasis in the COS. The actual lending level in 2001 is, however, contingent upon Government's ability to achieve satisfactory progress in reforms and on timely processing. The program anticipates continued availability of ADF, which is justified in view of insufficient recovery of per-capita incomes following the crisis. The ADF will be allocated for projects targeting poverty reduction in the decentralized context and will greatly assist in maintenance of vitally needed social services at the local government level. A total ADF allocation of \$150 million is being considered for 2001.

22. Current expectations, are that at least 4 loans totaling \$550 million are likely to be approved in the year. The remaining 3 loans totaling \$450 million are contingent on progress in sector reforms and timely processing. The lending level, therefore, is projected within the range \$550-1000 million.

23. The loan program was developed as part of the interim country strategy in response to the crisis; it reflects fully, however, the priorities under the new COS as well. The areas emphasized in the 2001 loan program are poverty reduction, human and social development, corporate and financial governance, and focused infrastructure investment (for electrification) for balanced regional development. The high emphasis on financial and corporate governance in the 2001 program reflects the importance attached to good governance as the main anchor for attaining the central objective of poverty reduction in Indonesia.

The Technical Assistance Program

24. The 2001 TA program now comprises a total of 25 projects (8 PPTAs and 17 AOTAs) for a total of \$20.6 million. The larger number of TA projects responds specifically to the special current requirements of Indonesia by providing assistance for needed policy advice and capacity building inputs in critical areas, as well as helping to develop a healthy pipeline of projects through the larger number of PPTAs. All TAs reflect the priorities outlined in the new COS for Indonesia, as may be seen in the column indicating this in the TA table. There has been particular emphasis on poverty, good governance and decentralization.

25. Improved monitoring of poverty is now an important need for policy planners. This has been emphasized in the Poverty Assessment. Advisory TA for establishing a system for obtaining more frequently available and reliable indicators has now been programmed for 2001. Apart from this, the TA program will help develop projects for poverty reduction such as through

the PPTAs for urban poverty reduction, rural development and microfinance; and also provide critical advisory assistance such as in SME development.

26. A detailed strategy for good governance including an anti-corruption action plan is currently being finalized in close coordination with the World Bank and other concerned donors, and taking into account the Governance Partnership framework. This will lead shortly to identification of required TA projects either in support of earlier ADB work such capacity building of the Anti-Corruption Commission or new initiatives such as establishing an inspection agency for public works. In support of this an advisory TA for implementation in 2001 has been programmed. Another AOTA on procurement has been included at Government's request to address major concerns in this area. The Governance Partnership of which ADB is a founding member along with other donors and Indonesian partners, has developed a coordinated program of action which anticipates support from ADB. Accordingly, another AOTA has been included to support this activity.

27. Smooth implementation of decentralization is one of the Government's most pressing preoccupations at present. The Government has requested ADB for assistance in this area and new TA initiatives have been included in the 2001 program as a consequence. These include assistance in the area of policies for management of economic and social disparities amongst regions; assistance to the Government for monitoring and evaluating the decentralization process and providing policy advice to local governments; and supporting private sector participation for infrastructure development in local communities. These are in addition to existing sectoral advisory TAs that focus exclusively on decentralization or have important components relating to capacity building for decentralization, such as in education, water supply, health and energy.

2001 LOAN PROGRAM								
Sector/Project Name	Poverty Classification ^a	Crosscutting Operational Priority ^b	Responsible Division	Year of PPTA	TOTAL	PROJECT COST (\$ MILLION)		
						Bank		
						OCR	ADF	Total
Agriculture and Natural Resources								
1 Poor Farmer Income Improvement	CPI	HD	AEAR	1999/2000		100	50	150
Industry and Finance								
1 Non-Bank Financial Governance Program	ODI	PSD	IEFI	1999		200	-	200
2 SME Development	ODI	PSD	IEFI	2000		100	-	100
3 SOE Governance and Privatization Program	ODI	PSD	IEFI	1999		200	-	200
Energy								
1 Outer Island Electrification I	ODI	PSD	IEEN	2000		150	-	150
Social Infrastructure								
1 Decentralized Basic Education I	PI	HD	AEEH	1998/2000			100	100
2 Water Supply and Sanitation	CPI	HD	AEWU	1999/2000		100		100
Total						850	150	1,000

^a CPI = Core Poverty Intervention; PI = Poverty Intervention; ODI = Other Development Interventions

^b ENV = Environmental Protection; GAD = Gender and Development; GG = Good Governance; HD = Human Development; PSD = Private Sector Development; and RC = Regional Cooperation.

2001 TECHNICAL ASSISTANCE PROGRAM								
Sector/Project Name	Responsible Division	Type of TA	COS Focus	AMOUNT (\$'000)			Total	
				BANK		Others		
				ACCSF	JSF/TASF			
Agriculture and Natural Resources								
1 Agriculture and Rural Development Strategy	AEAR/IRM	AO	RD		1,000	-	1,000	
2 Rural Micro Finance	AEAR	PP	RD			1,000	1,000	
3 Community Empowerment for Rural development Project II	AEAR	PP	RD		600		600	
4 Water Resource Management	AEFN	PP	NRM		500		500	
	Subtotal				-	2,100	1,000	3,100
Industry and Finance								
1 Development of Financial Services Supervisory Institutions	IEFI	AO	FS		1,700		1,700	
2 Commercialization of Public Service Obligations	IEFI	AO	GG		1,000		1,000	
3 SOE Privatization and Restructuring II	IEFI	AO	CG		2,600		2,600	
4 Strengthening SME Services	IEFI	AO	SME			800	800	
	Subtotal				5,300	800	-	6,100
Energy								
1 Power Sector SDP II	IEEN	PP	GG,CG,CE		800	-	800	
2 Energy Policy	IEEN	AO	DEC		500		500	
3 Gas Sector Development Plan	IEEN	AO	NRM, CE		490		490	
	Subtotal				-	1,790	-	1,790
Transport and Communications								
1 Road Rehabilitation II	IETC	PP	TS,RD,DEC		800	-	800	
	Subtotal				-	800	-	800
Social Infrastructure								
1 Decentralized Health Service II	AEEH	PP	DEC		-	1,000	-	1,000
2 Support for Decentralized Basic Education Management	AEEH	AO	HSD		-	1,000	-	1,000
3 Community based Water Supply and Sanitation	AEWU	PP	HSD		-	800	-	800
4 PDAM Restructuring and Rehabilitation	AEWU	AO	HSD,CG				600	600
5 Urban Poverty Reduction	AEEH	PP	HSD		640	-	640	
	Subtotal				640	2,800	600	4,040
Cross Cutting Issues								
<i>Governance</i>								
1 Anti Corruption /Governance	PE1	AO	GG		-	750	-	750
2 Support for Governance Partnership	IRM	AO	GG			800		800
3 Procurement Policies, Legal Framework, and Institutions	COPP / IRM	AO	GG		-	500	-	500
<i>Decentralization</i>								
1 Fiscal Decentralization	PE1	AO	DEC		-	500	-	500
2 Capacity Building for Decentralization (Monitoring and Evaluation, Guidelines on Local Economic Regulations)	AEWU / IRM	AO	DEC		-	1,200	-	1,200
3 Managing Regional Disparity on Economic and Poverty Program Under Decentralization	IRM/PE1	AO	DEC			600		600
4 Private Sector Participation Infrastructure under Decentralization	IRM	AO	II/CE/DEC		-	150	-	150
<i>Poverty</i>								
1 Poverty Monitoring	PE1/IRM	AO	POV		-	300	-	300
	Subtotal				-	4,800	-	4,800
	Total				5,940	13,090	1,600	20,630

COS Focus Abbreviations	
CE	Competitive Economy
CG	Corporate Governance
DEC	Decentralization
FS	Financial Sector
GG	Good Governance
HSD	Human and Social Development
II	Infrastructure Investment
NRM	Natural Resource Management
POV	Poverty
RD	Rural Development
SME	Small & Medium Enterprises
TS	Transport System