

**REPORT AND RECOMMENDATION
OF THE
PRESIDENT
TO THE
BOARD OF DIRECTORS
ON A
PROPOSED LOAN
AND TECHNICAL ASSISTANCE GRANT
TO THE
REPUBLIC OF INDONESIA
FOR THE
SMALL AND MEDIUM ENTERPRISE EXPORT DEVELOPMENT PROJECT**

November 2002

CURRENCY EQUIVALENTS

(as of 25 November 2002)

Currency Unit	–	rupiah (Rp)
Rp1.00	=	\$0.000111
\$1.00	=	Rp9,009

ABBREVIATIONS

ADB	–	Asian Development Bank
BDS	–	business development services
BEI	–	PT Bank Ekspor Indonesia (Persero)
BI	–	Bank Indonesia
BNI	–	Bank Negara Indonesia
BRI	–	Bank Rakyat Indonesia
CAR	–	capital adequacy ratio
CP	–	cleaner production
DFL	–	development finance loan
FIRR	–	financial internal rate of return
I/O	–	input-output
ICSMED	–	Industrial Competitiveness and Small and Medium Enterprise Development
IEPC	–	Industrial Efficiency and Pollution Control Project
IETC	–	Indonesia Export Training Center
IFC	–	International Finance Corporation
ISO	–	International Organization for Standardization
JBIC	–	Japan Bank for International Cooperation
JICA	–	Japan International Cooperation Agency
KfW	–	Kreditanstalt für Wiederaufbau (German Development Corporation)
LC	–	letter of credit
LDR	–	loan-to-deposit ratio
LLL	–	legal lending limit
MTAP	–	Mid-Term Action Plan
MOF	–	Ministry of Finance
MOIT	–	Ministry of Industry and Trade
NOP	–	net open position
NPL	–	nonperforming loan
PB	–	participating bank
PROPENAS	–	Medium-Term Development Strategy
ROA	–	return on assets
SEIF	–	Small and Medium Exporters' Investment Facility
SMEs	–	small and medium enterprises
SMEEDP	–	Small and Medium Enterprise Export Development Project
TA	–	technical assistance

NOTES

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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LOAN AND PROJECT SUMMARY

Borrower	Republic of Indonesia
Classification	Economic Growth
Environmental Assessment	Category B. Environmental implications of the proposed Project were reviewed at appraisal. The subprojects to be financed by the Asian Development Bank (ADB) will be required to satisfy ADB's environmental guidelines.
Project Description	<p>The Small and Medium Enterprise Export Development Project (SMEEDP) comprises a part of the Government and ADB efforts to promote development of small and medium enterprises (SMEs) in Indonesia and is a follow up to the earlier approved Industrial Competitiveness and SME Development Program (Loan 1738-INO, approved in March 2000), which focuses on regulatory framework and policies, and technical assistance (TA) for the development of business development services (TA 3829-INO, approved in January 2002). The SMEEDP focuses on the issue of SME financing, specifically that for small and medium exporters and their network of suppliers, and will consist of (i) a loan of \$85 million to provide investment credit, and (ii) TA of \$500,000. To complement the proposed TA, the Government of Japan, through the Japan International Cooperation Agency (JICA), will finance, on a grant and parallel basis, technical assistance to support development of SMEs. The proposed TA and the Japan's SME promotion program will be implemented in close coordination with technical assistance to the SME sector being provided by other development partners.</p>
Rationale	<p>The 1997-1998 crisis pushed a large number of people below the poverty line. During the process of economic recovery, SMEs, especially export-oriented firms, offered particular resilience; benefited from the depreciation of the rupiah; and provided substantial job opportunities, contributing to poverty reduction. Yet it was clearly recognized that Indonesia had failed to fully take advantage of the SME sector because of a number of impediments. Recognizing the importance of SMEs for Indonesia's economic recovery and future growth, and for poverty reduction through employment creation, the Government considered development of SMEs among the country's most important economic initiatives, especially in its strategy for poverty reduction. Accordingly, the Poverty Partnership Agreement between the Government and ADB also noted SME development as a key area for ADB's future assistance in Indonesia.</p> <p>Key impediments to the development of SMEs include (i) regulatory framework biased against SMEs; (ii) the lack of sustainable business development services for SMEs; and (iii) difficulty of SMEs to obtain financing, particularly for meeting investment requirements. Through</p>

ADB's earlier assistance, the issues of regulatory framework and business development services are being addressed; however, there have been no effective initiatives to address the issue of SME financing.

One of the major lessons from the crisis is that firms should secure funds to meet their investment needs in the same currency as their revenue stream. Export-oriented SMEs would be naturally hedged against foreign exchange risks. At the same time, given the current market conditions, SMEs are having difficulty in obtaining financing. Indonesian banks often look only at collateral and offer only short-term funds. The introduction of foreign exchange term financing for investment purposes with TA for improving the communication between banks and SMEs will help to channel needed funds to SMEs for high quality projects.

Objectives

The SMEEDP will support economic growth and assist in reducing poverty through job creation and promotion of labor-intensive exports. As part of a larger assistance strategy, the Project aims at supporting the SME export sector directly via investment capital, a niche market within the entire SME sector lending. Indirectly, the Project will improve the appraisal capacity of banks to undertake investment lending as well as the exporters' capacity to apply for bank credit with sound financial advisory services. The Project presents integrated support to export-oriented SMEs nationwide, with priority to be given to subprojects from selected provinces with export potential such as East and Central Java (part of ADB's geographical focus), Sulawesi (part of the East ASEAN Growth Area), and Bali. Components are as follows:

- (i) Small and Medium Exporters' Investment Facility (SEIF) for small exporters to meet investment requirements for capacity expansion and modernization; these investment funds will be channeled to public and private banks through Bank Ekspor Indonesia (BEI), which will manage the banks' risks, while the participating banks (PBs) will manage the exporters' risk (exporters will assume the foreign exchange risk of the subloans); and
- (ii) TA grant of \$500,000 to strengthen credit and project appraisal capacity for all PBs through technical administration unit, including training for bankers on SME credit scoring, basic trade finance instruments, as well as financial advisory services for SME exporters to have access to the SEIF.

Cost Estimates

The total cost of the Project is estimated at \$113 million equivalent. Of the total cost, \$85 million or 75% is the foreign exchange cost and \$28 million or 25% is the local currency cost. The former will involve funding for \$85 million to finance the SEIF.

Financing Plan**(1) SEIF**

Source	Foreign Exchange	Local Currency	Total Cost
ADB	85.0	0.0	85.0
Sub-borrowers' Equity ^a	0.0	14.0	14.0
Participating Banks ^b	0.0	14.0	14.0
Local Currency Financing	0.0	0.0	0.0
Total	85.0	28.0	113.0

^a Includes equity by SMEs.

^b Includes working capital or short-term lending to SMEs by participating banks.

(2) \$500,000 TA grant for support of a Technical Assistance and Monitoring Unit (TAMU) at BEI. In parallel to this TA, the Government of Japan will finance an SME promotion program to complement the proposed TA, totaling \$5 million.

Loan Amount and Terms

The loan amount will be \$85 million from ADB's ordinary capital resources. The Borrower will be the Republic of Indonesia. The loan currency, interest modality, and repayment schedule are stated in the loan agreement and in accordance with ADB's Policy on its London interbank offered rate (LIBOR) based loan product. The standard commitment charge of 0.75% per annum applies on undisbursed amounts according to the following estimated disbursement schedule: \$15 million, first year; \$30 million, second year; and \$40 million, third year. A front-end fee will be payable in an amount equivalent to 1% of the amount of the loan, and will be capitalized in the loan.

Relending Terms

The Borrower will relend the loan proceeds of \$85 million to BEI, the sole implementing bank. The relending terms and conditions will be identical to those of the ADB loan to the Borrower except that the Borrower will charge banks 50 basis points. BEI will manage the participating banks' (PBs) risk and charge an administration fee to all PBs. The PBs will manage the commercial risk of exporters and charge onlending interest rates to the final sub-borrowers (the SMEs) at market rates. TAMU will support the bank's credit assessment of SME subloans if necessary. For individual small and medium exporters, the maximum subloan size financed by ADB will be \$600,000 with a free limit of \$450,000. For exporters with demonstrated business networks of more than 20 SMEs, the maximum subloan size financed by ADB will be \$1 million with a free limit of \$750,000. Under either type of free limit, the first three subloans made by each PB will be subject to the approval of ADB. Subloans exceeding the free limit will continue requiring prior ADB approval. The tenor of subloans will be for a maximum of 8 years, including a maximum of 3 years of grace period.

Period of Utilization	The closing date for submission of subloan applications for approval and authorization for withdrawals will be 3 years after the date of ADB's loan effectiveness. The closing date for disbursements will be 5 years after the same date.
Estimated Completion Date	31 December 2007
Executing Agency	The Directorate General of Financial Institutions of the Ministry of Finance
Implementing Bank	Bank Ekspor Indonesia
Participating Banks	Bank Negara Indonesia, Bank Rakyat Indonesia, Bank Mandiri, Bank Danamon, Bank Niaga, and Bank Bukopin
Procurement	The provisions of ADB's <i>Guidelines for Procurement</i> applicable to development finance institutions will be followed. All procurement will be from ADB member countries. Sub-borrowers will be encouraged to procure goods through international competitive bidding and/or international shopping. Procurement will be conducted transparently and in conformity with ADB's anticorruption policy.
Project Benefits and Beneficiaries	The main benefits for the Government and SME exporters will include (i) investments in new technologies for export growth during economic recovery, (ii) sustainable direct and indirect employment generation through labor-intensive exports, (iii) increased direct exports from SMEs, (iv) enhanced market-oriented business advisory services to SMEs through existing business networks to complement investments and increased labor productivity, and (v) improved mechanism for delivery of credit to SMEs through adequate and transparent financial intermediation and project management.
Risks and Assumptions	The Government's overall commitment to SME development through comprehensive economic and regulatory reforms is likely to continue. Under the expectations of economic recovery, it is highly likely to have financially viable subprojects to meet the Project's goals, given the current pipeline, SME lending potential of banks, and the prospects of Indonesia's non-oil and gas exports.
Advisory Technical Assistance	The TA will help strengthen the SME lending operations of the PBs selected and will coordinate among SME exporters, PBs, technical and business advisory services, and relevant external aid activities for SME exporters and government entities to facilitate successful utilization of the credit line. About 18 person-months of international and 22 person-months of domestic consulting services will be required. Consultants will be recruited in accordance with ADB's <i>Guidelines on the Use of Consultants</i> and arrangements satisfactory to ADB for the engagement of domestic consultants.

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to the Republic of Indonesia for the Small and Medium Enterprise Export Development Project (SMEEDP) (Appendix 1 for project framework). The report also describes proposed technical assistance (TA) for Small and Medium Enterprise Export Development, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, will approve the TA.

II. RATIONALE: SECTOR PERFORMANCE, PROBLEMS, AND OPPORTUNITIES

A. Performance Indicators and Analysis: SME Exports

2. In the recovery of the Indonesian economy after the Asian economic crisis in 1997-1998, small and medium enterprises (SMEs) displayed particular resilience. Because of SMEs' employment-generating capacity, the Government and ADB have recognized the importance of supporting their development as an effective poverty reduction strategy. This is reflected in the Poverty Reduction Partnership Agreement signed in 2001. Also, the Government has prepared a Mid-Term Action Plan (MTAP) for SMEs¹ announced by President Megawati in April 2002. The plan highlights the role of SMEs to broaden the economic base and to accelerate much-needed structural reforms.

3. In Indonesia, SMEs weathered the crisis well and grew at a faster pace than the rest of the economy, as a number of them turned to exports due to the favorable exchange rate (Appendix 2). SME exports grew by 3.6% in 1998 and 5.8% in 1999. In contrast, exports by large exporters declined by 0.8% in 1998 and by 7.5% in 1999.² While the recovery has been faster among SMEs, it could have been higher if the constraints inhibiting their development had been addressed. Small firms (those with fewer than 100 workers) had higher export growth than larger firms between 1996 and 2000, and their share of total exports doubled. However, their contribution to exports continues to be modest (2.8% in 1996 and up to 4.1% in 2000). For countries in need of higher economic growth, focus on SME exports could provide the highest returns in terms of growth given the low, but rapidly expanding, market shares of these firms.³

4. While direct SME export growth has been achieved substantially by finding niche markets and adapting costs and quality to market demand, a significant part of SME exports simply go unrecorded because they occur indirectly through subcontracting arrangements with larger firms or traders. In the case of food exports, for instance, smallholders and fishermen who grow food crops or collect seafood and fish depend on the processing and exporting capacity of larger firms. This explains in part why the Indonesian data indicate that SMEs export about less than 10% of all non-oil and gas exports, a percentage below the estimates for Singapore, Japan, and Philippines, its

¹ *Mid-Term Action Plan – Small and Medium Enterprise, 2002-2004*. Jakarta: State Ministry of Cooperatives and Small and Medium Enterprises, p. 35.

² *Indonesia's Trade Performance during the Economic Crisis*, mimeo, USAID-Partnership for Economic Growth Project. 2000. Jakarta: Ministry of Industry and Trade.

³ The export share of microenterprises is negligible (less than 1%), and hence may be unsuitable for short-term high growth strategies.

closest ASEAN counterpart, and substantially lower than those for People's Republic of China and Taipei, China.⁴

B. Analysis of Key Constraints and Opportunities

1. Constraint Analysis

5. The large potential of SMEs to generate employment and value added is a highly desirable development goal in a populous and capital-short country such as Indonesia, but presents many constraints. The industrial structure in Indonesia has been dominated by large enterprises in terms of value added, while small firms play a key role as the locus of most employment. In manufacturing alone, of 10.2 million people employed, nearly 60% are employed in microenterprises and SMEs.

6. Growth potential depends on enterprise size and the constraints faced. Small firms tend not to grow into productive medium firms (what is also known as “the missing middle”). The phenomenon illustrates the structural constraints that have characterized Indonesian economy for decades (Appendix 2).

7. These constraints include (i) a poor policy environment to conduct private business, which disproportionately penalizes SMEs because it is relatively more expensive for SMEs to deal with a myriad of overlapping and sometimes contradicting regulations; (ii) the lack of adequate business development services (BDS) for SMEs in an environment where the Government—and external aid agencies—have provided services at low cost without substantial outreach or sustainability; and (iii) the lack of financial and physical infrastructure to support SMEs with access to markets with reliable production, and even exports. Assistance has aimed at reducing and eliminating these constraints through a series of step-by-step, well-integrated interventions by ADB and other agencies, such as ADB's Industrial Competitiveness and SME Development (ICSMED) Program and the associated technical assistance (TA),⁵ which supported the Government to prepare the comprehensive MTAP for SMEs.

a. Constraints in Policy and Regulatory Frameworks

8. Reducing or eliminating the regulatory burden on SMEs is one of the greatest spurs to entrepreneurship. Problems stem from regulatory systems developed in the image of large firms, rewarding economies of scale and stability rather than flexibility, and the cumulative pressure of regulatory requirements for SMEs. Small firms have reduced capacity to absorb unproductive expenditures because they have less capital as well as fewer managerial resources. SMEs identify high compliance costs, extensive and complicated paperwork, and economic regulations that prohibit certain activities as the most onerous constraints they face.

9. Under the ICSMED Program, the Government has created better conditions for entrepreneurs, especially small entrepreneurs. In particular, ADB TA supported the Government's review and revision of several business-related regulations, the set-up of the competition bureau

⁴ Harvie, C. and B. Lee. 2002. *The Role of SMEs in National Economies of East Asia*. Tables 2.7 and 2.8. UK: Elgar Publishing. For Indonesia, estimates range from 5 to 10% of exports; for Singapore and Japan, 15 to 16%; for People's Republic of China, Republic of Korea, and Taipei, China the estimates are above 40%.

⁵ ADB. 2000. *Technical Assistance to the Republic of Indonesia for Small and Medium Enterprise Development and Technical Assistance to the Republic of Indonesia for Promoting Deregulation and Competition*. Manila. Both TAs accompanied Loan 1738-INO, *Industrial Competitiveness and SME Development Program*. For other economic and sector work, see Appendix 2.

(the first one of its kind in Indonesia), a less regulatory role for the Board of Investments, and a comprehensive SME policy under the MTAP. Under a new and ongoing TA,⁶ ADB has continued to support this policy reform by moving its focus from policy planning at the center to implementation of specific pilot projects at the local level. For instance, local one-stop shops in Central Java and South Sulawesi will allow SMEs to acquire information about regulations and carry out administrative formalities in one office only. Also, local and national regulations that discourage the creation and expansion of smaller enterprises will continue to be reviewed and discussed. The existing requirements to start or expand an enterprise—the time, cost, complexity, and registration requirements—are especially burdensome for SMEs and need to be minimized or eliminated completely. These developments are part of the ICSMED Program's spirit of reducing bureaucracy, minimizing administrative burdens, streamlining procedures, and reducing compliance costs for all enterprises.

b. Constraints in Managerial Capacity

10. Schemes to support managerial capacity of SMEs will be unsuccessful in the absence of a vibrant entrepreneurial sector, consisting of those who sense opportunities and take risks in the face of uncertainty and develop new goods and services using available resources. The entrepreneurial process remains complex and influenced by social, cultural, and political factors.

11. Lack of markets for BDS—defined broadly as short-term services to improve business management—constrains SME performance in developing countries. In some cases, government (and external) intervention has prevented the development of sustainable markets for these services through the traditional approach of heavy and direct intervention to subsidize and provide a direct supply of services to SMEs. The result of the traditional approach was poor quality services, irrelevant to SMEs and with very limited outreach. The market for BDS providers is growing as the supply of professionals rises and as SMEs acknowledge the usefulness of external and timely advice in a number of areas related to their business growth.

12. BDS comprise a number of short-term services that help small entrepreneurs upgrade their productivity by improving workplace organization, handling inventories, improving product design, using bank credit, etc. Similar to the case of high regulatory costs, it is onerous for SMEs to assume the costs of all these productivity-enhancing processes by themselves, because each of them involves some high first-time, entry, or learning cost. For financial management techniques, some SMEs do not even apply for credit, because they know they cannot fulfill the entry requirements into a banking relationship. Proper use of BDS could help SMEs initiate or upgrade their financial inputs from banks whether through general financial advice on using simple bank accounts to high-quality business plans for long-term loans. For advanced production techniques, the cost of learning or transfer of these processes may be lessened through the use of BDS or through subcontracting for larger firms (vertical learning) or through clustering among other SMEs (horizontal learning or learning from peers). In fact, subcontracting⁷ appears to have made learning more accessible for SMEs in Japan and Republic of Korea, where SMEs have been successfully integrated into their export-oriented manufacturing sectors.

⁶ ADB. 2002. *Technical Assistance to the Republic of Indonesia for Strengthening Business Development Services for Small and Medium Enterprises*. Manila.

⁷ Subcontracting is common among medium-sized exporters in rattan, furniture, and garments. See Levy, B., Berry, A., and Nugent, J. 1999. *Fulfilling the Export Potential of Small and Medium Firms*. Boston: Kluwer Academic Publishers. Also, see Brahmantyo and Mustika. 2002. Benefits of the Existence of Trading Houses to Export-oriented SMEs. In *Small Business through the Economic Crisis*. The Asia Foundation.

c. Constraints in Access to Financial Markets

13. Most SMEs lack access to formal financial markets, mainly standard bank lending. High collateral requirements, complex and time-consuming credit application procedures, small size of credit, and general distrust towards outsiders are some of the factors that explain why SMEs do not tend to use bank loans and prefer other—sometimes even more expensive—sources of financing. The Asia Foundation and ADB found that only about one fifth of all Indonesian SMEs tend to have loans from banks.⁸ If the crisis affected some SMEs through increased interest rates and reduced profits, they tended to be a minority, according to a recent World Bank report.⁹ In fact, the low reliance on bank loans by the majority of Indonesian SMEs gave them an additional advantage. However, chronic low exposure to credit constrains the long-run growth potential of SMEs, which would have grown faster in an unconstrained credit environment.

14. The same World Bank report estimates that the prospects of SME lending by Indonesian banks appear to be good, with growth rates of 25% for 2002-2003. However, these growth prospects may pose challenges to banks that look to implement such aggressive growth strategies. Indonesian state-owned and private banks have to face the challenge of increasing their lending by looking for new smaller clients (and loans), a departure from the precrisis days of cozy corporate relationships. Today Indonesian banks need to reconsider their product mix, credit and pricing policies, marketing, human resource mix, branch networks, and management information systems to reach out to SME clients. Despite the initial signs of recovery in the banking system, a new equilibrium in the market of credit suppliers and credit users has yet to be reached, despite the apparent liquidity from banks and increased credit needs of SMEs. Greater and easier access to finance is vital to the prospects for any export-led economic recovery, but banks may not be able to support recovery, given their own set of binding constraints. Many banks are still suffering from nonperforming loans (NPLs), and restructuring has reduced their capacity to bear the credit risks of new lending, especially SME lending, given the need to maintain prudential norms.

15. One of the reasons why growth prospects appear so high is that Indonesian commercial banks had only a small portion of their portfolio in SME lending (Appendix 3, Table 2). Although Bank Indonesia (BI) estimates by loan size show that almost one quarter of all bank loans are “SME” loans, banking analysts estimate that the proportion of actual lending to SMEs must be much lower (perhaps 10-15%) because of multiple small loans by corporate borrowers or a multitude of small consumer loans. After the crisis, a more balance clientele is emerging, and restructured banks are determined to adopt new business plans to attract SME clients. For instance, the large state-owned banks such as Bank Negara Indonesia (BNI), Mandiri, and Bank Rakyat Indonesia (BRI) can reach SMEs across Indonesia through their extensive branch networks (almost 2,000 branches among these four banks). Their business strategies note the need to shift from their traditional customer base to SMEs, whether by scaling up or down their target clientele. So, for instance, on the one hand, BRI has traditionally lent to a large number of microenterprises in rural areas, and is currently boosting its retail banking to attract larger SME clients (it has opened nine SME centers). On the other hand, BNI and Mandiri, which have traditionally lent to more corporate clients, now have plans to focus on smaller accounts through better cost-effective operational techniques such as credit scoring. Other smaller banks such as Bank Danamon, Bank

⁸ GFA-Swisscontact. 2001. *Best Practice in Promoting Market-based Lending*. Policy Paper No. 3. *Technical Assistance to the Republic of Indonesia for Small and Medium Enterprise Development*. Available: <http://www.adbtasme.or.id>

⁹ The report shows that only less than 9% of SME debt at banks can be classified as category 5 risk. Based on surveys on the use of bank loans, the report concludes less than 2% of all SMEs may be benefited by the decree on SME debt restructuring approved in July 2002. See van Gelder, F. and Broadfoot. 2002. *Small and Medium Enterprise Debt Restructuring*. Jakarta. World Bank.

Niaga, and Bank Bukopin (a private bank) have better established SME clienteles than the large state-owned banks. With almost 85% of banks' assets still in the hands of the Government, privatization (or reprivatization) of banks in the next few years is expected to improve their efficiency and commercial orientation, and, hence their ability and incentives for SME lending. In the meantime, all major banks are making or expected to adopt soon changes in their operations by opening more business centers to cater SME clients, streamlining their procedures further to reduce the costs of assessing small loans, and adopting risk management guidelines to improve portfolio quality, among other operational changes (Appendix 3, Tables 3 and 4). These changes in the banking sector are aimed at meeting the needs of a more sophisticated clientele of SME credit users as they improve their own financial management capacity (paras. 10-12).

2. Rationale for the Project

16. The SME sector in Indonesia is probably one of the most heterogeneous in Asia. No comprehensive approach could deal with the constraints faced by all SMEs. A multifaceted and gradual approach to Indonesian SMEs will be most effective in a rapidly changing environment. The Project has to be placed in the context of the Government's efforts to revive and develop the SME sector since the crisis, and within ADB support in the area.

17. The MTAP has identified the key impediments to the development of SMEs: (i) inappropriate regulatory framework under which equal conditions did not exist for SMEs vis-à-vis larger companies, (ii) unavailability of private sector-led and sustainable BDS for SMEs, and (iii) difficulty for SMEs to obtain financing. Through ADB's and other agencies' earlier assistance, the issues of regulatory framework and BDS are being addressed; however, there have been no effective initiatives to address the issue of SME commercial financing, one of the key actions proposed in the MTAP.

18. Access to finance for private enterprises (and SMEs) was drastically reduced during the crisis, and the mobilization of financial funds continues to be challenging until today. In particular, long-term funds in foreign exchange available for investment have decreased within the banking system after the crisis and have not yet recovered (Appendix 3, Figure 1). Available funds are priced at comparatively high rates due to country risk perceptions. The proposed project will complement temporarily a banking system that, currently, cannot provide sufficient long-term funding for SME exporters who have expressed strong demand for the credit. Bank Ekspor Indonesia's (BEI), an apex institution with a clean commercial record, provides an administrative and TA focal point for banks' lending to SMEs, and for SME exporters in the process of improving their access to formal bank financing (Appendix 3, Table 5).

19. While a well-defined credit line will improve the supply of funds in the system, it cannot be expected on its own to solve the sluggish intermediation of financial funds in Indonesia. Other complementary improvements in the financial sector are needed at various levels. First, further deepening in financial sector reforms by the Government will strengthen the banking sector,¹⁰ while aid agencies have continued to provide selective financial policy advice to the Government (Ministry of Finance [MOF] and BI) and state-owned banks through targeted advisors. Also, specific policy actions are required to improve intermediation of funds to SMEs. Some of them are found under the assurances of the proposed project such as an adequate implementation of the SME debt restructuring decree; further progress in MTAP implementation; and further discussion

¹⁰ ADB. 1998. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Indonesia for Financial Governance Reform: Sector Development*. Manila. Loan 1618 disbursed its last tranche of \$350 million in July 2002.

about nonphysical collateral among the central bank, banks, and stakeholders. A specific policy initiative towards the use of credit information, contemplated as part of the ongoing TA and MTAP, will produce the first blueprint of a credit information bureau¹¹ in Indonesia, which will help improve long-term access to all types of credit, especially for SMEs, as it facilitates borrower assessments by banks. Finally, commercial banks themselves need to improve their own financial intermediation roles. A change in the strategic goal of further SME lending needs to be matched by a change in operational strategies and banking culture. Also, the credit line needs to be complemented with the extensive number of externally-funded projects on BDS to be coordinated under this Project, not only to ensure utilization of the credit line for sound SME investments, but to support the need for better mobilization of investment financing from banks to businesses. In the near future, other types of SME financing will also be necessary. Access to domestic and international capital markets, nonexistent or underutilized by SMEs today, will need to be supported as alternatives to bank funding, and as part of a financial graduation policy.

a. Government's Strategy

20. The Medium-Term Development Strategy (PROPENAS) for 2001-2005¹² aims at strengthening the foundations of the economy for sustained economic growth, national cohesion, and social stability; achieving good governance and the rule of law; strengthening regional autonomy; and developing social programs. These goals represent a change in paradigm from a centralized power under the New Order regime to "the empowerment of people's economy." To advance this change, a recovery program stated that the "government intervention is to be minimized to give wider opportunity and freedom to the cooperative movement and SMEs to develop autonomous business activities."¹³

21. The Government has embarked on the reform of its industrial policy to accelerate SME development and increase the competitiveness of Indonesian industry supported by the ICSMED. Among other ongoing economic reforms, the Government has streamlined existing subsidized lines of credit for SMEs and announced a competitive investment policy to be reflected in a new investment law. To develop further industrial and SME reforms, the Government created two interministerial task forces during the Program (the SME Task Force and the Deregulation and Competition Task Force). First, the SME Task Force (soon to be institutionalized) helped in accelerating SME policy reform. It assessed (i) the institutional framework needed for SME promotion; (ii) the provision of commercially based credit to SMEs; and (iii) the provision of sustainable supporting business services for SME trading, marketing, and exports. The assessment provided the Government with recommendations for improvements in SME policy, which were also reflected in the finalization of the MTAP, announced in April 2002. Also, the Deregulation and Competition Task Force reviewed and suggested the modification of policies that affect industrial development and investment negatively in the country. The Task Force, with support from ADB, prepared an Indonesia Regulatory Review Manual for training of officials within the Central Government in identifying, reviewing, and revising business regulations. Under the new TA, the practice will soon be extended to local government officials in 2003 and 2004 in several districts.

¹¹ The blueprint is part of the ADB. 2002. *Technical Assistance to Indonesia for Strengthening Business Development Services for Small and Medium Enterprises*. Manila. A preliminary report was prepared under the former ADB. 2000. *Technical Assistance to Indonesia for Small and Medium Enterprise Development*. Manila.

¹² At the end of the national plan, REPELITA VI (1994-1998), the preparation of REPELITA VII was postponed with the economic crisis in 1997 and the nearly concurrent political transition. In 1999, the new Government presented PROPENAS, which defined its development strategy.

¹³ Coordinating Ministry of Economic Affairs. 2000. *Indonesia Rebuilds: A Ten-Point Program for Economic Recovery and Sustainable Development in the World's Fourth Most Populous Country*. Jakarta.

b. Lessons Learned

22. Many external agencies have supported credit lines for SMEs to encourage employment and to diversify the economy. The strategy for SMEs has generally been to ease the scarcity of term finance by providing funds and improving the banking system's ability to lend to them. In 1996, the World Bank undertook for the first time a detailed empirical analysis of its SME support in three countries over a period of more than 20 years.¹⁴ The study concludes that the expected outcomes of credit lines for term financing were not always achieved, and provides three key lessons for future operations: First, support for SMEs can create more jobs, but it could fall below expectations. In the Philippines, support for SMEs was considered to be effective in creating jobs, and less so in reducing poverty, boosting Philippine exports, or shifting the location of industries—the originally stated objectives. In Sri Lanka, too, SMEs were a good vehicle for creating jobs, especially important in an economy undergoing restructuring. The results were less impressive for Ecuador. Second, banks needed to learn more about SMEs. Starting with more flexible financial products, such as basic short-term credit, one way to start to reduce the risk perception of SME clients is by using building blocks toward a more complex banking relationship before using long-term loans. Direct support to SMEs in Sri Lanka did go a long way toward improving the prudential soundness of the banking system, and NPLs among SMEs were below the market average. Finally, the report concludes that good institutions cannot overcome a weak policy environment. By providing deeply subsidized credit to borrowers (such as in Ecuador), rather than access to credit, the credit lines merely substituted government transfers for borrower finance. Reforming the financial sector or relying on a sustainable microfinance institution would have been a better way to provide support for small entrepreneurs unable to get credit.

23. ADB's direct involvement in financial intermediation with similar credit lines to enterprises has been through the two development finance loans (DFLs). Between 1989 and 1993, the first development finance loan (DFL) (Loan 0981-INO) in an amount of \$200 million was almost fully utilized (\$194 million); it was followed by a second DFL (Loan 1223-INO) for \$200 million in 1993. Under DFL II, the Government re-lent the ADB loan in dollars to nine banks: directly to two state-owned banks and through the central bank to several private banks. Subloans were onlent in dollars to eligible subprojects for financing the foreign exchange content of their capital expenditure, but the project faced low utilization, primarily because of high subloan interest rates under the prevalent market conditions. Interest rates on the dollar-denominated subloans were not competitive with dollar loans available from multiple sources of credit before the crisis. More importantly, the extensive due diligence, documentation, and reporting requirements without any monitoring support made subloans even less attractive compared with cheaper and simpler requirements under conventional commercial bank loans. ADB's interest rate under its dollar facility was generally higher than alternative London interbank offered rate (LIBOR)-based funding available to banks, and the two state-owned banks (Bank EXIM¹⁵ and BNI) decided to cancel their allocation shortly after loan effectiveness. With only private intermediaries, the loan agreement was amended further. It reduced the cost of subloan processing by increasing the free limit amount for each subloan to \$3 million from the original \$1 million, giving banks more room to select, approve, and monitor subloans. But it was insufficient to stimulate utilization. Once the 1997 financial crisis broke out, there was a further cancellation of funds of DFL II because the remaining private banks were unable to find eligible sub-borrowers. The loan was closed in March 1999 with final utilization

¹⁴ A summary of the findings was published under World Bank (WB). 1998. *Support for Smaller Enterprises*. Precis No. 173. Washington, DC: WB.

¹⁵ Bank EXIM has since been merged with Bank Mandiri. The former Bank EXIM was unrelated to BEI.

of \$76 million of the original \$200 million. Most of the 52 subprojects were in garments and shrimp production on the island of Java, with no substantive evidence of employment or export creation.¹⁶

24. The SMEEDP takes into consideration lessons from international experience (para. 22) and specific lessons from ADB's Indonesia operations (para. 23). Compared with international experience, the SMEEDP can be expected to generate jobs and exports in a period of recovery in the economic cycle. The SMEEDP will also support banks' current efforts to get into bankable operations with creditworthy SMEs, as most exporting clients already have access to short-term bank credit. At the same time, the SMEEDP takes a radical departure from past subsidized pricing of credit, so no price distortions are found such as those faced by SMEs in Latin America. Compared with previous operations in Indonesia, a key lesson for the SMEEDP has been to ensure that the interest cost to the participating bank and the subblending interest rate are competitive with alternative funding sources. In this respect, the expected availability of ADB's LIBOR-based lending facility for investment by small exporters will be a major advantage compared with DFL II, since long-term funds in foreign exchange are not readily available to banks at competitive cost due to the lingering effects of the crisis and recent bank restructuring. Given present economic and country risk conditions, there is now much reduced availability of credit lines to Indonesian banks (Appendix 3, Figure 1). This reduces the likely source of competition from alternative funding sources, and underlines the need for a credit facility to address an important temporary constraint to ongoing SME export growth in need of foreign exchange for investment in the upgrading of plants and equipment during the recovery. Finally, administration requirements have also been simplified from the start and centralized under one administrator (BEI) with TA to reduce the costs of a transparent and targeted intervention with emphasis on SME exporters, and with a simplified disbursement procedure not available before.

c. ADB's Strategy and Policy Dialogue

25. Since 1998, ADB has played a lead role in SME policy development. In the formulation of the ICSMED policy framework, ADB launched substantial economic and sector work (Appendix 4) and promoted aid coordination meetings to reach agreement on the SME policy agenda. In line with the ADB strategy, substantial work was undertaken in 1998-2002 to develop understanding of the issues and constraints facing the SME sector and to identify requirements for this sector. ADB strategy recognizes that support for SME development is crucial to ensure pro-poor, pro-jobs, sustainable recovery and that assistance is needed in access to exports and domestic markets, increased access to financial services, strengthening linkages to the large-scale manufacturing sector, and improvement of investment and market advisory services. Active project assistance and appropriate development policies are required to encourage growth of the SME sector, especially in the regions.

26. ADB's support for SME development is substantive and has evolved systematically. In the first phase, ADB's SME development strategy for Indonesia through policy dialogue conducted under ICSMED advocated rationalization and streamlining of the industrial policy, regulation, and institutional framework to improve incentives for trade and industry. Concurrently, ADB's support for strengthening the financial system and its governance will provide a range of instruments and volume of financing required for sustained industrial and SME development. As a follow-up to this intensive policy dialogue and the progress attained in certain segments of the finance and industry sector, ADB's SME development strategy is to focus, in a second phase, on a comprehensive assistance package to SMEs. The proposed project focuses on export-oriented SMEs to provide

¹⁶ ADB. 2002. *Project Completion Report on the Second Development Finance Project in Indonesia*. Manila.

direct financial assistance to augment access to investment financing, and to complement financial and export business advisory services.

27. ADB has played a key role since 1997 in coordinating SME policy dialogue with the support of the aid community and various Government agencies. This culminated in ADB's approval of the ICSMED program. The ongoing ICSMED program aims at changes in regulations to improve the private business environment in Indonesia. It also aims at rationalizing assistance to SMEs by (i) improving policy coordination and implementation, (ii) improving financial intermediation, and (iii) developing proposals for BDS support. The program loan includes, for instance, an investment policy geared towards issues of industrial competitiveness rather than introducing additional incentives for SMEs. The more liberal industrial framework will further SME development by reducing the excessive costs of operating in a monopolistic environment. The investment policy statement has already been prepared and was announced by the Government in 2001 as one of the core conditions for the disbursement of the incentive tranche of the Program Loan in February 2002. A key release condition for the final tranche is the actual enactment of the investment law, and the Government has requested an extension on the Program Loan until 2003.

28. Rationalization of SME credit schemes has been another core condition of the ICSMED program. The condition has been fully complied with by issuing a decree on SME credit schemes with a gradual phase-out of subsidized credit (June 2001). Throughout the years, many credit programs for small (and large) firms were heavily subsidized, which contributed to credit rationing, that is, subsidized credit created such a large demand for low-priced credit that it had to be rationed, excluding viable SMEs. In this respect, subsidization of credit for small firms has become unsustainable, and the Government has moved towards dismantling the complex subsidized programs of the past. Since 1999, BI has not been allowed to provide liquidity credit for subsidized credit schemes. However, as a transitional measure, BI Law 23 requires that the credit schemes already committed prior to the Law should continue, and that the Government should pay the interest subsidy of these outstanding credit schemes until they expired. That is, the credit schemes financed by BI will eventually be automatically abolished. Today, besides the interest subsidy for the outstanding credit programs under BI liquidity credit, the Government supports interest subsidies for two credit programs (consumer and housing credit), as well as Kredit Ketahanan Program (KKP), a consolidated credit line from five previous credit schemes for agriculture and cooperatives.

d. Relevant External Assistance to the SME Sector

29. As Indonesia recovers from the crisis, bilateral and multilateral agencies have adjusted their operations from the short-term response to the crisis to that of medium-term development (Appendix 5).

30. Japan, the largest bilateral source of development assistance to Indonesia, has provided significant financial and technical support to the SME sector in the country. In 1998, for instance, the Japan Bank for International Cooperation (JBIC) provided a \$1 billion facility to Indonesia to help support the country's export-led economic recovery. Specifically, the facility was provided for the settlement of transactions based on the letters of credit (LCs) issued by Indonesian local banks to finance necessary imports for the Indonesian export sector. In December 2000, the facility was revised to provide working capital financing (\$300 million) in addition to LC confirmation services (\$700 million). The facility is fully utilized and is to be fully repaid by BEI in June 2003. On the technical support for SMEs, the Government of Japan, through JICA, financed a detailed assessment of the SME sector in response to a November 1999 request from the Government of Indonesia. The assessment was completed in July 2000 and was used for the formulation of an SME promotion program in Indonesia to be funded by the Government of Japan over the period of

2002-2006, which will be implemented in parallel to the proposed TA. Japan is the leader of the SME Donor Committee for the Consultative Group of Indonesia (CGI), in active coordination with ADB, the World Bank and other bilateral agencies.

31. The joint SME unit of the World Bank and the International Finance Corporation (IFC) plans to become involved in SME policy advice (currently the World Bank provides advice on SME debt restructuring as part of its financial policy advisory role), improved delivery of BDS, and capacity building within provincial banks that lend to SMEs. In 2001, IFC activities (including its SME support) were put on hold but were reactivated in 2002 after Indonesian courts resolved satisfactorily cases involving IFC-funded investments. The IFC Private Sector Strategy for Indonesia plans to support development of a healthy restructured banking sector and lending for the development of a competitive private sector and for corporate investment. In 2001, IFC invested \$5 million in equity in Bank NISP, a private small bank with SME clientele. In 2003, IFC plans to establish a private sector BDS facility headquartered in Bali.

32. After the crisis, bilateral agencies expanded their assistance programs for SMEs in a number of specific areas, mainly policy advice. The United States Agency for International Development focused on supporting corporate and financial reforms including banking regulations meant to improve SME lending. Australian assistance has been directed to Eastern Indonesia and advisory support for strengthening of government audit, monitoring of state-owned banks, bankruptcy and commercial law, foreign investment, and trade policies, including support for capacity building for government officials in preparation of compliance with World Trade Organization (WTO) procedures. The Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) has focused on SME promotion and vocational training, while the Kreditanstalt für Wiederaufbau (KfW) successfully supported two investment credit lines in local currency for SMEs until 2001 and plans to continue a second phase of its credit line for investments in cleaner production in 2003. Finally, a number of other international and bilateral agencies work in Indonesia on SME policy reform and nonfinancial services for SMEs in different geographical areas, such as the Canadian Development Agency (especially in North and South Sulawesi), SwissContact (East Java), and the Asia Foundation (Bali and West Java). They work in close cooperation and coordination with the SME Donor Committee, led by Japan.

III. THE PROPOSED PROJECT

A. Objectives

33. The Project will aim at promoting economic growth and sustainable employment generation through the strengthening of the SME export sector, which will directly contribute to reduce poverty. In pursuit of this goal, the SMEEDP will facilitate the development and promotion of SME exports by helping to increase value added, diversifying SME businesses, and fostering backward and forward linkages nationwide through term loans to SME exporters.

B. Components and Outputs

34. The Project will provide comprehensive support for SME export development through term credit for expansion supported by business services to access credit and export markets. The SMEEDP will provide the Small and Medium Exporters' Investment Facility (SEIF). This will comprise a credit line, through public and private banks, that will on lend proceeds to directly finance the foreign exchange components of capital expenditures for SME exporters, and to

indirectly finance their supporting industries.¹⁷ This will alleviate constraints in the postcrisis period, where economic activity has gained momentum but banks, despite their restructuring, have not been able to mobilize long-term foreign exchange funds for financing SME capital expenditures.

C. Special Features of the SMEEDP

35. The Project links policy work to project financing. The assurances under the Project aim at reinforcing the progress achieved under recent policy dialogue and TA. First, the letter of intent issued under review of the Extended Financing Facility of the IMF states that the SME debt restructuring decree write-offs or restructuring measures will be left as commercial decisions rather than provide for mandated haircuts. Second, progress under the recently announced MTAP for SMEs will improve SME policy coordination within the Government, improve local government capacity to review and revise regulations, propose discussion of BI regulations affecting SME lending such as moveable collateral registries, announce the steering committee for a credit bureau, and develop a forum of BDS providers to discuss the new government orientation on business services provision. All these policy actions will contribute to support a long-term strategy of increasing access of SMEs to financial markets.

36. The proposed Project acknowledges business networks and clusters, common forms of production and trading in Indonesia. First, it incorporates an incentive to banks to allocate subloans to exporters such as trading houses that may constitute a network of SMEs. This form of lending bridges the difficulties of lending to individual and noncreditworthy SMEs with the ability to borrow by larger firms, which usually take only short-term loans. The subloan supports the efforts of some trading houses to enter into manufacturing to improve the quality of goods to be exported while indirectly supporting their own suppliers or subcontractors.

D. Cost Estimates

37. The total cost of the Project is estimated at \$113 million equivalent. This comprises a foreign exchange cost of \$85 million and a local currency cost of \$28 million equivalent, financed by sub-borrowers' equity and/or participating banks. The former will involve funding for \$85 million to finance the SEIF.

E. Financing Plan

38. It is proposed that ADB provide a loan of \$85 million to the Republic of Indonesia from its ordinary capital resources. The loan's foreign currency (dollars), interest modality and repayment are stated in the Loan Agreement in accordance with ADB's LIBOR-based Loan Product. A commitment charge of 0.75% per annum applies. The commitment charge will commence 60 days after signing the loan agreement and will be paid semiannually by the Government against the undisbursed portion of standard staggered amounts of the loan (15% for the first year, 45% for the second year, 85% for the third year, and 100% thereafter). In addition, a front-end fee will be payable in an amount equivalent to 1% of the amount of the loan and will be capitalized in the loan.¹⁸

39. For the SEIF, the Government will make proceeds of the loan available to BEI, BNI, and BRI through three subsidiary loans of \$50 million, \$20 million, and \$15 million, respectively, that

¹⁷ SME exporters include direct and indirect exporters and their supporting industries that have sufficient revenues in foreign exchange to repay subloans.

¹⁸ ADB will have the right to withdraw such amount from the proceeds of the loan and pay itself such amounts as front-end fee at loan effectiveness.

will have the same terms and conditions as the loan from ADB to the Government, in relation to interest, front-end fee, and commitment charges, in addition to a fee of 50 basis points, according to government regulations. BEI will relend the proceeds of its subsidiary loan to eligible PBs based on onlending agreements between BEI and each of its PBs. BRI and BNI will also act as PBs. The PBs will onlend the SEIF funds to eligible sub-borrowers as subloans. The subloans will finance up to 100% of the entire direct and indirect foreign exchange cost of a qualified subproject, but in no case more than 75% of the total cost of such project. The subloans will not finance the cost of acquisition of land use rights, taxes, duties, and wages. Each sub-borrower will provide equity financing of not less than 25% of the total cost of its subproject, and PBs may provide counterpart funds to finance the local currency cost requirements. PBs will be encouraged to give priority to subprojects outside Jakarta (provinces in the East ASEAN Growth Area and in ADB's geographical focus areas, such as Central and East Java), but not excluding sub-borrowers with headquarters in Jakarta.

40. BEI will relend these funds in foreign exchange to PBs, and these PBs will onlend the funds to sub-borrowers in foreign currency. The foreign exchange risks will be borne by the sub-borrowers who are naturally hedged against these risks because their export revenues are denominated in foreign currency. The relending interest rates to be charged by BEI to its PBs will be LIBOR plus 125 basis points, which includes a loan administration fee. Under a loan administration agreement, BEI will also be charging a loan administration fee of 15 basis points to BRI and BNI for the Technical Assistance Monitoring Unit (TAMU) services BEI will be providing so that the total cost of funds to BRI and BNI will be LIBOR plus 125 basis points. BEI may further charge an additional risk premium based on negotiations with PBs, other than BNI and BRI. Since BEI will not be undertaking channeling of loan proceeds from and repayment obligations to the Government on behalf of BNI and BRI, BNI and BRI will not be charged a similar additional risk premium. Other than the BEI risk premium charged on Danamon, Bukopin, Niaga, Mandiri, and other PBs, the cost of borrowing to sub-borrowers out of loan proceeds as between BRI and BNI on the one hand and Danamon, Bukopin, Niaga, and Mandiri will be governed by risk perception of the sub-borrower only. Subloan repayment schedules will be based on the cash-flow forecasts for the subprojects. PBs will revolve the repaid subloans to make further advances to SMEs within the overall time frame of the Project. The last date for submission of subloan applications to ADB will be 3 years after the date of loan effectiveness. The last date for disbursement under any subloan will be 5 years from the date of effectiveness of the ADB loan to the Republic of Indonesia. Only expenditures incurred for a subproject not earlier than 180 days prior to receipt by ADB of withdrawal applications will be eligible for financing under the loan after the loan effectiveness date.

F. Implementation Arrangements

41. The Directorate General of Financial Institutions MOF will be the Executing Agency. BEI will be the implementing and loan administration agency for the SEIF to be available through Indonesian state-owned and private banks to SME exporters.

42. The SEIF will provide long-term foreign currency debt funding to SME exporters, and indirectly to their supporting industries, to finance capital investment loans, excluding land purchasing; and preinvestment/permanent working capital, including financing for essential imported inputs. The proposed loan will make available long-term funds across Indonesia to SME exporters who can prudently manage the foreign exchange risk.

43. The selection of participating banks for the SEIF is based on the following criteria: (i) past and projected financial condition in terms of solvency, liquidity, profitability, portfolio quality, and efficiency in financial intermediation; (ii) past and projected track record on lending to SMEs; (iii)

credit appraisal capabilities, particularly for project finance to SMEs; (iv) past experience in servicing credit lines of other aid agencies; and (v) corporate governance practices. During the disbursement period of the proposed Project, to qualify for disbursement under the loan, a PB must demonstrate compliance with the following applicable prudential regulations and guidelines of BI, as amended from time to time, and any other requirements of ADB through quarterly financial indicators to be monitored by TAMU:

- (i) capital adequacy ratio not lower than 8%;
- (ii) net open position of a maximum 20%;
- (iii) a loan to deposit ratio not higher than 100%;
- (iv) positive return on assets;
- (v) NPLs should not exceed 5%;
- (vi) loan loss provisions; and
- (vii) legal lending limit, reflecting the maximum exposure to a single borrower or group of borrowers not exceeding 20% of capital resources.

44. According to these criteria, BNI, BRI, Bank Mandiri, Bank Niaga, Bank Danamon, and Bank Bukopin were pre-selected for this Project as of September 2002 and the continued compliance with these criteria will be monitored through annual audited reports. Based on a thorough market assessment, the PBs have proposed a first-year credit line allocation of \$13 million as follows: BNI will have a first-year allocation of \$3 million; BRI, \$2.5 million; Bank Mandiri, \$2 million; Bank Niaga, \$2 million, Bank Danamon, \$2 million; and Bank Bukopin, \$1.5 million. Allocations for the subsequent years of the Project will be based on first-come-first-served basis according to disbursement records.

1. Project Organization and Management

45. In addition to a competent credit department, the Executing Agency, in consultation with BEI, will establish TAMU as a support unit. TAMU will be staffed with competent personnel, headed by a senior BEI official, and consultants. TAMU will oversee the preparation, appraisal, and implementation of all subprojects to be financed under the Project nationwide through the PBs.

2. Selection, Appraisal, and Approval of Subprojects

46. ADB will finance the direct and indirect foreign exchange costs of subprojects with a maximum ADB-funded subloan size of \$600,000 for individual small and medium exporters (subloan debtor); and/or subprojects with a maximum ADB-funded subloan size of \$1,000,000 for exporters with a demonstrated business network, defined as follows: (i) a trader/manufacturer (the subloan debtor) and a group of a minimum of 20 micro/SMEs (suppliers and/or subcontractors); (ii) both parties (debtor and micro/SMEs) should have a letter of agreement that will state the benefits to micro/SMEs from the ADB subloan and will be reviewed by TAMU. Subloans for business networks are expected to benefit SME production performance with increased access to the use of more modern machinery; access to closer marketing and/or production services from traders/manufacturers; and, hence, increased production capacity or revenues from sales. All other conditions for the SEIF under \$600,000 will apply to subloans for business networks. Subloans under the SEIF will finance fixed investments including capital goods, and technology for new investment projects or for modernization of existing enterprises. Initial incremental foreign exchange working capital necessary for the operationalization of fixed investments may also be financed from the ADB loan without exceeding 35% of the total subloan.

47. All PBs will follow the subloan approval form and appraisal reports for potential subloans provided by TAMU and approved by ADB. Following internal approval by the PB, a subloan

application including the subloan approval form and appraisal report will be submitted to TAMU, which will forward them to ADB. ADB will approve the first three subloans granted by each PB before establishing (i) a free limit of \$450,000 per subloan for single exporters, and (ii) a free limit of \$750,000 per subloan for exporters with demonstrated business networks. Thereafter, for subloans above the free limits, ADB will provide approval or requested revisions based on timely prior receipt of adequate and complete documentation processed by TAMU. For eligible subloans below the free limit, PBs will provide direct approval and report to TAMU. For loans below the free limit, TAMU will notify ADB.

48. The selection of subprojects will be based on sound banking, commercial, and financial criteria reflecting economic and financial viability. In particular, the following criteria for subproject selection will be applied: (i) all sub-borrowers are required to be exporters and, hence, to earn adequate revenues in foreign exchange to repay their loans on schedule; (ii) at least 25% of the subproject cost should be financed by the sub-borrower as equity; (iii) the subproject should have a financial internal rate of return not less than 12%; (iv) the sub-borrower should maintain a debt service coverage ratio of no less than 1.2 times within 3 years from the date of disbursement of the subloan or when the subproject's production reaches full capacity, whichever is earlier; (v) the sub-borrower should maintain a positive cash flow after repayments of SEIF loan interest and principal during the full subloan repayment period; and (vi) sub-borrowers should have adequate collateral in accordance with each PB internal credit assessment process and BI regulations. Also, subprojects will have to meet prevailing labor and social standards and regulations in Indonesia. Further, eligible subprojects will have to comply with ADB's and the Government's procurement, environment, safety, and other social safeguard requirements, according to TAMU.

49. The sub-borrowers will manage the foreign currency risks of a subloan, while the PBs will manage the credit risks of the sub-borrowers. BEI will manage bank risks. It is expected that, on average, 150 subloans will result in additional investment and employment in 150 direct individual exporters over the life of the Project and indirectly in up to 3,000 SMEs via subcontracting arrangements. The PBs have already submitted a potential pipeline that will translate into an actual pipeline worth \$13 million for the first year, while the balance of \$72 million will be allocated on a first-come-first-served-basis in the following 2 years.

3. Procurement

50. ADB's *Guidelines for Procurement* applicable to subloans to PBs will be followed with the assistance of BEI and the TAMU. These guidelines may require sub-borrowers to (i) demonstrate that the procurement procedures adopted are appropriate in the circumstances; (ii) ensure that the goods and services to be financed by subloans are purchased at a reasonable price, account also being taken of other relevant factors such as time of delivery; efficiency and reliability of the goods; their suitability for the subproject; availability of maintenance facilities and spare parts; and, in the case of services, the quality and the competence of the parties rendering them; and (iii) ensure that all goods and services financed under the subloans are procured from ADB member countries. Sub-borrowers will be encouraged to adopt international competitive bidding procedures where the amount is unusually large, and it will be in the interest of economy and efficiency to follow such procedures or international shopping ones.

4. Disbursement Arrangements

51. MOF and BEI will jointly request establishment of an imprest account (special account). The ceiling of the special account will be set at \$7.5 million. The initial advance and subsequent replenishments to the special account will be based on planned disbursements for the six

successive months of the Project. The loan proceeds will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (Appendix 6).

5. Accounting, Auditing, and Reporting

52. BEI and the PBs will have their accounts and financial statements (balance sheets, income statements, and statements of sources and application of funds) audited annually in accordance with sound and standard auditing standards by independent external auditors acceptable to BI and ADB. BEI and the PBs will submit to ADB not later than 6 months after the close of each financial year their audited financial statements and annual reports.¹⁹ BEI, through TAMU, will submit to ADB all reports that ADB may reasonably request concerning the loan and its utilization; the subloans; other matters relating to the purposes of the Project; and the quarterly progress reports, in a format to be agreed upon with ADB, within 60 days after the end of the relevant quarter with assistance of TAMU; and a project completion report within 3 months of the project closing date.

53. BEI and the PBs will inform and give ADB an opportunity to comment on any substantial amendments to the banks' management, ownership, or legal constitution. If the amendments affect implementation of the proposed Project, BEI and the PBs will conduct consultations with ADB prior to making any final changes in their operational policies.

6. Monitoring of Subprojects

54. TAMU at BEI will monitor the financial and economic performance of subprojects, as well as evaluate their socioeconomic and environmental benefits. In addition, a random sample of subprojects could be selected for ongoing, long-term benefit monitoring and evaluation by TAMU in coordination with ADB staff. Specific data collection and reporting formats will be developed and implemented in a computerized database. Specific areas to be covered include (i) financial and operational performance of the subprojects; (ii) direct and indirect employment creation attributable to the subprojects (e.g., through supply of inputs); and (iii) business linkages with micro and SMEs, if applicable.

IV. THE TECHNICAL ASSISTANCE

55. The proposed TA for this project is based on the findings and recommendations of TA 3416 (Promoting Deregulation and Competition) and TA 3417 (SME Development)²⁰ and aims to complement the implementation of the proposed loan to Indonesia.

56. The scope of the TA (Appendix 7) will focus on

- (i) strengthening of SME exporters' capacity to meet eligibility criteria and submit bankable proposals;
- (ii) strengthening of project and credit appraisal and monitoring capacity for PBs; and
- (iii) coordinating external assistance to SME exporters.

57. The TA is estimated to require \$620,000 equivalent, consisting of \$300,000 in foreign exchange cost and \$320,000 equivalent in local currency cost. ADB will cover \$300,000

¹⁹ In accordance with ADB's new policy, if there is a delay in submission of annual audited accounts beyond 6 months, a formal warning will be issued, and if there is a delay beyond 12 months, disbursements will be suspended.

²⁰ See footnote 5. Both TAs accompanied the ongoing Loan 1738-INO: *Industrial Competitiveness and SME Development Loan*, for \$200 million approved in March 2000 and extended until December 2002.

equivalent, including all of the foreign exchange cost and \$200,000 equivalent of the local currency cost, to be financed by ADB's TA funding program on or about approval of the loan until about December 2004. The Government will finance the balance of the local currency cost in counterpart funds. The TA will support TAMU at BEI in Jakarta, and promote SEIF through BDS outside Jakarta, with emphasis on Bali. The TA will also be complemented by ADB's ongoing TA 3829-INO in supporting BDS in four local governments in Central Java and South Sulawesi and ongoing TA 3837-INO in improving environmental performance of SMEs.²¹ In parallel, the Government of Japan, through JICA, will finance on a grant basis a SME promotion program between 2002-2006 for a total of \$5 million equivalent. JICA's SME program includes institutional support to BEI, support to provincial export training and promotion centers in East Java, North Sumatra, South Sulawesi and South Kalimantan, and a study on SME clusters. The TA and JICA's SME promotion program will be implemented in close coordination with ongoing TA from other sources such as the World Bank and IFC (see Appendix 5).

V. PROJECT BENEFITS, IMPACTS, AND RISKS

A. Impact of Export-Oriented SME Development on Poverty

58. An ADB Poverty Assessment for Indonesia has identified SME growth as one of the main engines for pro-poor growth when supported by well-functioning competitive markets.²² In 2001, ADB also signed a Poverty Partnership Agreement with the Government to reduce the level of absolute poverty by half by 2015, putting poverty reduction at the center of its development strategy in Indonesia. While the largest number of absolute poor live on Java, the percentage of the population below the poverty line is greater in the outer islands. Policy and project lending will have a positive impact on poverty to the extent that it increases the incomes of workers and their families. These increases in incomes from paid labor—the main asset of the poor—will help raise them over the poverty line, and, hence, reduce their absolute number, as well as the percentage of people under the poverty line.

59. The employment impact of the loan is expected to be large (Appendix 8). SMEEDP-funded expansion will necessitate increased labor inputs both in the form of direct employment and through increased demand for raw materials or intermediate inputs provided by individuals or microenterprises. For example, where the availability of kiln-dried wood is a limitation, investment in a wood kiln dryer, will allow a furniture manufacturer to accept more orders and create an enlarged market for the supply of components and raw materials. While there are also some employment impacts related to the physical implementation of the expansion such as in construction, the employment impacts referred to here are sustainable for the life of the investment. Moreover additional employment is generated as SMEEDP funds are repaid and re-lent.

60. The first round impact of the investment is estimated to be between 1 million and 2 million job-years with relatively low capital-labor ratios and high labor productivity compared with large enterprises. Increases in capital expenditures (hence, in exports) will translate into higher gains in employment among SMEs than in larger firms. The initial pipeline of investments proposed for the SMEEDP suggests an employment impact of 1.5 million job-years for a total project investment of

²¹ ADB. 2002. *Technical Assistance to the Republic of Indonesia for Improving the Environmental Performance of Small and Medium Enterprises by Promoting Cleaner Production*. Manila.

²² ADB. 2002. *Assessment of Poverty in Indonesia*. Vol. 1 and 2.

about \$110 million.²³ One case study of the fish processing with cold storage equipment in South Sulawesi indicated substantial demand for SMEEDP loan products for upgrading and expansion, suggesting that for each \$500,000 invested, 500 new full time jobs-years are created, requiring the inputs from 10,000 fisherfolk-years. A separate review of a KfW credit line for clean technologies in SMEs shows that a \$50,000 investment in a plastics chipping factory generated 100 additional jobs years and required 800 person-years to provide sufficient recyclable waste material to meet the needs of the new investment.

61. Finally, there is a significant potential impact on poverty by subprojects in furniture-exporting clusters in Jepara-Semarang (Central Java). Most exporters interviewed indicated that they would invest to double their exports. For example, between 1996 and 1999, average exports from Jepara increased by almost \$50 million and generated 7,518 additional jobs. Extrapolating from this experience, a doubling of exports in Jepara with support of the SEIF could generate around 7,500 additional direct jobs, and more than 75,000 supporting jobs. All these are indicative of the high and low case scenarios for employment impact.

B. Financial Analysis of Indicative Pipeline

62. The analysis, based on about 60 potential specific SME subprojects identified by the PBs during June-September 2002, demonstrates the strong demand for the SEIF (Appendix 9). As of 30 September 2002, the PBs had provided basic information on 62 SME exporters, who are potential SEIF borrowers. The subprojects have a range of financial internal rates of return from 15% to 100%, and adequate average debt service ratios of 1.9. Sixty percent of the subprojects are in regions outside Java such as the islands of Sulawesi, Kalimantan, Sumatra, and Bali. Most industries involve wood, fish, or handicraft products, which are consistent with the high presence of micro and SMEs in these industries. The indicative pipeline of \$28 million supports the amounts pre-allocated to the PBs during the first year and the overall loan utilization.

C. Environment

63. The Project will have a beneficial environmental impact through the replacement of obsolete technology by new, cleaner, and more environment-friendly technology as supported by an ongoing TA 3837-INO (Appendix 10). Not only will cleaner production practices reduce environmental problems and conserve natural resources but they can help boost access to international markets by small Indonesian exporters who do not always meet international quality standards. Under the proposed project, the Government and BEI will ensure that all subprojects comply with the applicable government environmental standards and requirements and with ADB's policies, and that appropriate safeguards and mechanisms for compliance are built into each subproject, as necessary. While environmental screening of all proposed investments is necessary, the initial environmental examination or environmental impact assessment will be carried out when warranted. Every subproject will conform to the Environmental Assessment Procedures and Requirements of the Government and ADB.

D. Exchange and Commercial Risks

64. There are no foreign exchange risks in transactions for BEI or the PBs. In subloans under the SEIF, exporters with the SEIF loans will be naturally protected against foreign exchange risks because of their foreign exchange earnings.

²³ Estimates are based on a \$35 million investment with an additional 47,000 job-years in SME sub-borrowers, plus 15 subcontractor job-years for each of these jobs (i.e., 705,000 job-years).

65. Under the SEIF, the financial risk of NPLs (due to bad credit decisions) will be mitigated by strict application of the requirements for financial soundness of the sub-borrower and viability of their investments through business advisory services. TAMU, and associated TA from external sources, will support the ability of the PBs to enhance their credit appraisal capacities and apply their own (and ADB's) criteria for subloan processing in accordance with ADB's standards. The PBs' branch networks should give them access to local knowledge with respect to the performance and character of the applicants reducing default risks.

66. Under the SEIF, borrowing SMEs will be sensitive to marketing risks, particularly in export markets. Any failure in marketing would reduce their financial viability and ability to service debt. This risk is mitigated by the project design, which focuses on products in which Indonesia has a clear comparative advantage such as labor-intensive products like furniture and agroprocessing. Sub-borrowers will be required to demonstrate their marketing strategies.

VI. ASSURANCES

67. In addition to the standard assurances, the Government, BEI and the PBs have given the following assurances, which are incorporated in the legal documents.

(i) *Medium Term Action Plan*

- (1) Commencing one year after loan effectiveness, the Government will report annually in writing to ADB progress on the implementation of the April 2002 Medium Term Action Plan for SMEs through a reporting system developed under ADB technical assistance.

(ii) *Eligibility of BEI and PBs*

- (2) Except as ADB may otherwise agree in order to ensure that BEI and the PB concerned will remain eligible for access to loan proceeds, under its respective Relending Agreement or Subsidiary Loan Agreement, the Government will cause BEI and each such PB to submit to ADB an opinion through their annual audited reports in form and substance satisfactory to ADB, from an independent external auditor whose qualifications, experience and terms of reference are acceptable to ADB to certify that:
 - a) the PB concerned meets, exceeds or is otherwise in compliance with all applicable prudential regulations and guidelines of Bank Indonesia, as amended from time to time, including but not limited to (i) a net open position (NOP) not in excess of 20 percent; (ii) a loan-to-deposit ratio (LDR) not in excess of 100 percent; (iii) loan loss provisions sufficient to cover non-performing assets; and (iv) a legal lending limit (LLL) in compliance with BI's regulations; (v) a capital adequacy ratio (CAR) of not less than 8 percent.
 - b) BEI meets, exceeds or is otherwise in compliance with all applicable prudential regulations and guidelines of Bank Indonesia, as amended from time to time, including but not limited to (i) a NOP not in excess of 20 percent; (ii) loan loss provisions sufficient to cover nonperforming assets; and (iii) a LLL not in excess of 20 percent of BEI's capital resources.

- c) BEI and the PB concerned meets, exceeds or is otherwise in compliance with (i) a ratio on net nonperforming loans (NPLs) to total loan portfolio not in excess of 5 percent for loans; and (ii) a positive Return to Assets ratio.
- (3) Except as ADB may otherwise agree in order to ensure that the PB concerned will remain eligible for access to loan proceeds, under its respective Relending Agreement or Subsidiary Loan Agreement, the Government will also cause each such PB to submit through the TAMU an annual Letter of Representation to ADB providing ongoing representations and warranties from the PB satisfactory to ADB that the PB concerned will have, inter alia, certified to (i) past and projected financial conditions in terms of solvency, liquidity, profitability, portfolio quality and efficiency in financial intermediation; (ii) past and projected lending to SMEs; (iii) credit appraisal capabilities for lending to SMEs; and (iv) application of corporate governance standards and practices acceptable to Bank Indonesia.

(iii) Criteria for Subprojects

- (4) The Government and BEI will cause the PBs to ensure that (i) subloans do not exceed 75% of the total subproject cost; (ii) subloans do not finance cost of acquisition of land use rights, taxes, duties and wages; (iii) the subloan size from the concerned PB to a SME will not exceed \$600,000 for individual exporters or \$1,000,000 for exporters with demonstrated business linkages with SMEs as defined in the Loan Agreement; (iv) foreign exchange for initial and incremental working capital for operationalization of fixed investment will be subject to a maximum of 35% of the entire subloan; and (v) subloans do not finance subprojects involving firearms, narcotics, tobacco or spirits.
- (5) ADB's prior approval will be required the first three subloans of any PB irrespective of subloan size, and above the free limits of \$450,000 for subloans for individual SME exporters and of \$750,000 for exporters with demonstrated business linkages with SMEs.
- (6) The Government will ensure, or will cause BEI to ensure, that PBs finance subprojects through subloans under the Project that will meet the following selection criteria:
- a) The qualified sub-borrower will be an exporter who will earn sufficient foreign exchange revenues to meet sub-loan repayment schedules;
 - b) the contribution to the qualified subproject, including its working capital, provided by the qualified sub-borrower, will be at least 25 percent of the total cost of the qualified subproject, provided in the form of equity;
 - c) the financial internal rate of return (FIRR) for each qualified subproject will be not less than 12 percent;
 - d) no later than three years after the disbursement of a subloan or at the subproject's attainment of full production capacity, whichever is earlier, the qualified sub-borrower will not incur any debt, unless the net revenues of the qualified sub-borrower for the 12 months prior to the date of such incurrence will be at least 1.2 times the estimated maximum debt service requirements of the qualified sub-borrower for any succeeding financial year on all the debt of the qualified sub-borrower, including the debt to be incurred.

- e) the qualified sub-borrower will achieve and maintain throughout the subloan repayment period, a positive cash flow after repayments of the subloan's principal and interest;
- f) the qualified sub-borrower will have and maintain adequate collateral in accordance with the concerned PB's internal credit assessment and Bank Indonesia's regulations; and
- g) Preference will be given to qualified sub-borrowers located outside Jakarta, but such selection may include qualified sub-borrowers with headquarters in Jakarta.

(iv) Social and Environmental Assurances

- (7) The Government will ensure or cause BEI to ensure that the PBs finance qualified subprojects under the Project where each qualified sub-borrower will be in compliance with the Government's environmental, safety, social safeguard, procurement, labor and social protection laws, standards, regulations and requirements and ADB's environmental guidelines and requirements, and social safeguard policies, including ADB's Policy on Involuntary Resettlement, Indigenous Peoples' Policy and Social Protection Strategy.
- (8) The Government will cause BEI and the PBs to ensure, that the qualified subprojects shall be carried out in accordance with the environmental laws, regulations and standards of the Government and ADB's environmental procedures, requirements and guidelines, as amended from time to time. The Government will also ensure that all monitoring and mitigation measures are undertaken for environmental impact assessments or initial environmental examinations in accordance with ADB's environmental guidelines.

VII. RECOMMENDATION

68. I am satisfied that the proposed loan would comply with the Articles of Agreement of ADB and recommend that the Board approve the loan of \$85,000,000 to the Republic of Indonesia for the Small and Medium Enterprise Export Development Project, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's LIBOR-based loan facility; an amortization period of 15 years, including a grace period of 3 years; and such as other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Implementation Agreements presented to the Board.

TADAO CHINO
President

26 November 2002

PROJECT FRAMEWORK

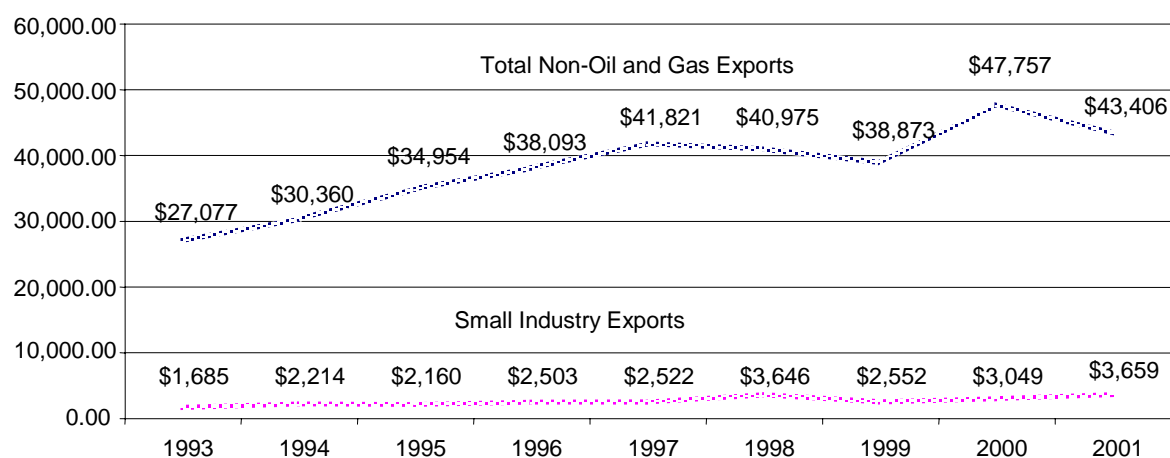
Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>1. Goals</p> <ul style="list-style-type: none"> • Poverty reduction in Indonesia • Balanced and sustainable economic growth • Commercially, financially viable, and sustainable private sector small and medium enterprises (SMEs) 	<ul style="list-style-type: none"> • Absolute poverty reduced by 50% from 20% in 2002 to 10% in 2015 • Total non-oil and gas exports increased from \$50 billion (2002 baseline) to at least \$75 billion by 2015 • Share of SME exports increased from 10% (2002 baseline) to at least 15% by 2015 	<ul style="list-style-type: none"> • Government macroeconomic and social statistics • Asian Development Bank (ADB) project performance audit report 	
<p>2. Purposes</p> <p>(i) Increased exports by SMEs</p> <p>(ii) Increased SME employment opportunities</p>	<ul style="list-style-type: none"> • Value of direct exports by SMEs increases from \$4 billion (2002 baseline) to at least \$6 billion by 2005 • Employment increases attributable to SMEs of 1.5 million job years by 2005 	<ul style="list-style-type: none"> • Government macroeconomic labor, trade, and social statistics regarding SME performance • ADB project completion report 	<ul style="list-style-type: none"> • Macroeconomic and political stability • Overall government comprehensive economic and regulatory reforms will continue. • SME's will improve product designs/quality to capture export markets.
<p>3. Outputs</p> <ul style="list-style-type: none"> • Institutional capacity building of participating banks (PBs) in credit appraisal of SME projects under market conditions 	<p>By the end of the Project:</p> <ul style="list-style-type: none"> • SME Exporters' Investment Facility providing business advisory services • Financing of 100-150 sub-borrowers via PBs by 2005, consistent with objectives and regional priorities of the Project 	<ul style="list-style-type: none"> • Project progress reports by TA Monitoring Unit (TAMU) at BEI • Quarterly reports by TAMU at Bank Ekspor Indonesia (BEI) showing PBs' financial indicators for continuing participation • ADB loan review missions 	<ul style="list-style-type: none"> • Continued improvements in corporate governance by PBs
<ul style="list-style-type: none"> • PBs enhanced capacity to undertake sound credit approval and risk analysis of subprojects and to provide financial advisory services for SMEs 	<ul style="list-style-type: none"> • Enhanced credit appraisal and risk analysis systems operational in at least 3 of the 6 PBs by 2005 	<ul style="list-style-type: none"> • Visits to PBs by TAMU • Visits to TAMU by ADB missions 	<ul style="list-style-type: none"> • Ability of sub-borrowers to meet lending criteria • Effective aid coordination on SME matters will continue.
<p>4. Activities/Inputs</p> <p>Competent TAMU established at BEI by 2002</p> <p>a) Development of SEIF</p>	<p>SME exporters with access to business development services through business centers in selected cities across Indonesia</p>	<ul style="list-style-type: none"> • Review and monitoring by ADB missions 	<ul style="list-style-type: none"> • Adequate absorptive capacity of PBs for the input of the technical assistance (TA)

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
b) Capacity building/training/presentations for PB counterpart staff on project financing, (together with other aid agencies) c) On a need basis, provision of financial advisory services for SME sub-borrowers d) Provision of long-term foreign currency debt funding for SME exporters	Start: 2003 Complete: 2005 Responsible: TA consultants Start: 2003 Complete: 2005 Responsible: PBs Start: 2003 and continuing Responsible: PBs		<ul style="list-style-type: none"> • Existence of financially and commercially viable subprojects that meet the Project's development goals
5. Inputs <ul style="list-style-type: none"> • Loan • TA consultants 	<ul style="list-style-type: none"> • \$85 million • \$0.5 million • International, 18 person-months • Domestic, 22 person-months 	<ul style="list-style-type: none"> • ADB disbursement records • ADB project records 	

SECTOR AND SUBSECTOR ANALYSIS: SME EXPORT PERFORMANCE¹

1. Indonesian exports have been slow to recover from the crisis. Companies manufacturing for export, especially small and medium enterprises (SMEs), have substantial growth potential.² SME exports have grown over time but still represent a small fraction of the total (Figure A2.1). On the supply side, the recent drop or stagnation of Indonesian exports was caused mostly by “traditional” factors, such as (i) strengthening of the rupiah exchange rate, (ii) instability of security and law enforcement, (iii) high transaction costs due to corruption, and (iv) frequent labor activities demanding wage increases. On the demand side, the drop of the manufacturing sector occurred, among others in footwear, fish and shrimp, chemical products, spices, coffee, tea, and jewelry, which involve mostly SME suppliers. These Indonesian products are losing against similar competitive products from emerging economies such as People’s Republic of China, India, Thailand, and Viet Nam.

Figure A2.1: Total and SME Non-oil and Gas Exports
1993-2001 (\$ million)



Source: Ministry of Industry and Trade (Small Industry Exports) as cited by Urata, Shujiro (2000, Table I-7). "Policy Recommendation for SME Promotion in the Republic of Indonesia," July, JICA, 1999-2001 are estimates from same source. SMEs are defined as those with assets below Rp5 billion. Non-oil and gas total exports from Central Bureau of Statistics.

2. Most of Indonesia’s non-oil and gas exports are products with some degree of processing or manufacturing (almost 88%, see Table A2.1). For those produced on a contract basis for internationally known brand names, such as electronics and footwear, trade promotion may be limited, because these products already have international marketing managed from outside Indonesia. Products with a niche market could offer more results for trade promotion. Many of these exports are undertaken in sectors that have (or are expected to have) a large number of SMEs, and even microenterprises.

¹ Prepared by Jan ter Wengel, Department of Economics, Free University of Amsterdam.

² Most Indonesian exports have some degree of processing or manufacturing. In 2000, total exports reached \$65 billion: one fifth were oil and gas exports (\$15 billion) and one tenth (\$6 billion) were raw materials such as ores and metals (tin and nickel), nonferrous metals, rubber, logs, pulp, and unprocessed agricultural and fish products.

Table A2.1: Composition of Non-Oil and Gas Exports, 2000

Item	Exports (\$ million)	Share of Total Exports	Potential Presence of SMEs
Total Non-Oil and Gas Exports	47,757.30	100%	
Agriculture Sector ³	2,728.60	5.71%	High
Mining Sector ⁴	3,040.80	6.37%	Low
Industry Sector	41,983.40	100%	87.91%
Fiber, Yarn, Textiles, and Textile Products	8,182.40	19.5%	Low
Electronics	7,899.10	18.8%	Low
Wood Products	4,729.50	11.3%	High
Steel, Machinery, and Automotive parts	3,249.20	7.7%	Low
Pulp and Paper Products	3,001.90	7.2%	Low
Leather, Leather Products, and Footwear	2,075.40	4.9%	High
Basic Chemicals	1,957.90	4.7%	Low
Palm Oil and Products	2,044.80	4.9%	High
Rubber and Rubber Products	1,320.00	3.1%	Low
Foods and Beverages	851.7	2.0%	High
Electrical Equipment	931.6	2.2%	Low
Copper and Tin Products	936.2	2.2%	High
Ceramic, Marble, and Glass Products	596	1.4%	High
Plastic Products	570.9	1.4%	Low
Silver, Gold, Precious Metals, and Jewelry	500.6	1.2%	High
Sporting Goods and Musical Instruments	482.2	1.1%	High
Aluminum Products	455.6	1.1%	Low
Rattan Products	352.9	0.8%	High
Fertilizer	347.4	0.8%	Low
Cameras and Optical Products	246.9	0.6%	Low
Cement and Products	189.8	0.5%	Low
Cigarettes	157.4	0.4%	Low
Other Chemical Products	184.6	0.4%	Low
Handicraft	142.6	0.3%	High
Molasses and Products	128.7	0.3%	High
Other Products	126.9	0.3%	High
Medicaments	87.1	0.2%	Low
Animal Feeds	95.4	0.2%	High
Essential Oils	56	0.1%	High
Cosmetics	64.5	0.2%	Low
Wood Tar, Gum, and Gambier Products	18.2	0.0%	High

Source: Biro Pusat Statistik (Central Bureau of Statistics), processed by Ministry of Industry and Trade, <http://www.dprin.go.id>

3. There is a large body of literature describing SME presence in export markets. However, differences in the size classification prevent a clear distinction of sectors where SMEs are well established within a specific subsector or commodity. Table A2.1 summarizes SME presence in some major industrial or manufactured products by indicating whether there is a “low” or “high” potential presence of SMEs, according to many sources. For example, SME exports are

³ Sixty percent of the sector exports was shrimp (37%), cocoa (9%), coffee (11%), and tuna (5%).

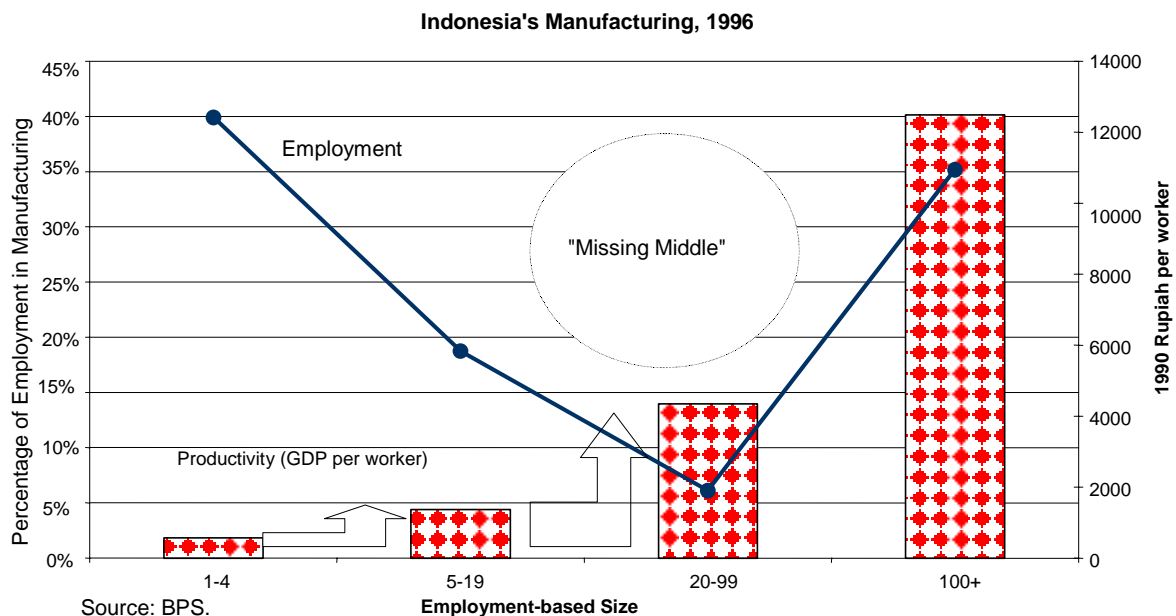
⁴ Ninety five percent of the sector exports was cooper ore (53%) and coal (42%).

expected to be concentrated in the wood products and textile, garments, and footwear subsectors. Together, some authors estimate that these subsectors are responsible for some 50% of SME exports from Indonesia. In addition, basic machinery contributes another 16% to SME exports. Smallholders are important in growing food and cash crops, and there is potential for further SME involvement, however, much of the processing and exporting takes place through larger firms. Overall, a closer look at Indonesian SME exports reveals the following main characteristics:

- (i) SME exports are concentrated in labor-intensive subsectors where low wages are important to enhance the comparative and competitive position of foreign markets.
- (ii) Indonesian SME exports are concentrated in clusters. It is well known that SME furniture, garments, and basic machinery production is located primarily in agglomerations of small firms. These clusters participate in international trade networks to bring down the transaction costs of international trade.
- (iii) SME exports have increased throughout the crisis years due to their relatively limited reliance on imported components compared with those of larger companies.

4. Presently, only the Central Bureau of Statistics (Biro Pusat Statistik [BPS]) makes a systematic distinction among household (cottage), small, medium, and large-scale enterprises on the basis of the number of workers. Our focus will be on SMEs and large enterprises, not microenterprises. According to the 1996 CBS census, the microenterprise sector employs nearly two thirds of the manufacturing workforce. Despite their large contribution to employment, data on microenterprises tend to be unavailable in a comparable format to those of more structured businesses. More importantly, promotion of microenterprises may not necessarily be a high- return activity, such as export activity, for countries in need of an acceleration in growth. Larger increases in productivity occur as firms grow into the small and/or medium categories. See Figure A2.2.

Figure A2.2: Missing a "Productive Middle"



5. The crisis occurred towards the end of 1997 and peaked in 1998. If one takes the 5-year span between 1996 and 2000 to examine the impact of the crisis, one allows for some time to adjust after the unprecedented contraction of 1998. The Asian Crisis caused a large turmoil in Indonesia's industrial structure, even though in the aggregate the number of firms appeared to be almost unaffected. This appendix uses the latest available data for more than 20,000 industrial enterprises from the *Annual Manufacturing Survey of 1996 and 2000* produced by the Central Bureau of Statistics. Surveys recorded 22,997 firms in operation in 1996 and 22,174 in 2000, i.e., a modest decline of 3.5% in the number of firms. However, the first impression when one compares these two snapshots hides the fact that 6,100 firms (26.5% of all firms in 1996) closed down between 1996 and 2000, and 5,277 new firms started operations during the same period.

6. Despite of the great upheaval in firm numbers among the smallest firms, the number of jobs in the very small-scale sector (small enterprises employing 20-49 workers) remained about the same. Due to firm closures, 121 thousand jobs were lost; the expansion of the remaining smallest firms led to 28,000 more jobs; and, the new smallest firms created 91,000 jobs. The net result was an employment loss of less than 1%. In all other size categories (except the largest firms), firms showed increments in total employment. The largest firms lost nearly 50,000 jobs primarily as a result of employment reduction in the surviving very large industries, which showed a contraction rather than an expansion. The resulting jobs became more productive. Increases in value added with a constant labor force would point to an increase in productivity that might lead to increased exports. The gains in value added proved to be highest for the smallest firms and lower for the remaining sectors. In fact, the increase in productivity registered by small firms probably accounts for the lion's share of the impressive increase in exports by these firms. When one compares the 2000 figures with the 1996 figures, small firms increased their exports by 83% while exports of the largest enterprises decreased by 10% (Table A2.2).

Table A2.2: Exports by Firm Dynamics, Indonesia, 1996-2000
(billion constant 2000 rupiah)

Worker-based Size ¹	Change in Exports because of Firm Exits	Changes in Exports because of Expansions	Changes in Exports because of New Entries	Total Change in Exports in 2000	Total Exports in 1996	% Export Growth	Percentage of Total Exports in 2000
	(1)	(2)	(3)	(4)=(1)+(2)+(3)	(5)	(4)/(5)	(6)=(4)+(5)/
Small 1	-354	608	579	833	1001	83.2	1.3%
Small 2	-448	571	1287	1409	2531	55.7	2.8%
Medium 1	-830	2866	3311	5347	7346	72.8	9.1%
Medium 2	-1832	3204	4279	5652	23958	23.6	21.2%
Large 1	-2793	7170	5608	9985	23440	42.6	23.9%
Large 2	-5288	-5486	4540	-6233	64336	-9.7	41.6%
TOTAL	-11546	8934	19604	16992	122613	13.9	100.0%

¹ Small 1 (20-49 workers); Small 2 (50-99 workers); Medium 1 (100-100 workers); Medium 2 (200-499 workers); Large 1 (500-999 workers); and Large 2 (1,000 workers or more).
Source: 1996 and 2000 Industrial Surveys. BPS.

7. Financing, equipment, and materials are just some of the key inputs for producing exports. First, lack of credit has often been identified as one of the major obstacles to the growth

of SMEs. Therefore, we introduce the availability of finance, as proxied by the interest paid by firms on loans, to examine the impact of finance on exports. Also, the relative use of machinery could also be considered an explanatory variable for SME exports. Thus the use of machinery would indicate specialization and the capacity to produce according to narrowly defined technical specifications. These characteristics should be conducive to export. Finally, the value of imported inputs is important in the explanation of exports when specific imports are essential to the production of exports, and the exporting activity is related to assembly rather than production.

8. Access to credit proved a significant variable in the explanation of exports in both the SME and large sectors. While some of the success by SMEs in overcoming the crisis years has been related to their lack of bank loans (the Asia Foundation and other surveys indicate that less than one fifth of SMEs had access to bank loans), the negative effect of bank loans on enterprises tended to be stronger for non-exporting enterprises that took loans in foreign currency and that were affected by the subsequent devaluation after the crisis. Bank loans or “financial inputs” are still important determinants to sustain export activity.

9. The relative use of machinery also proved to be a significant export determinant in both the SME and large sectors. The significance of the positive coefficient for the SME sector is, however, much greater than that for the large sector. Thus, the great importance of labor productivity in the explanation of SME exports may be related to the use of machinery. This fact only reinforces the view that SME sector exports are to a large extent driven by specialization and productivity. This view may be further supported by the fact that large sector exports appear to be much more dependent on imported inputs. The coefficient for imported inputs is highly significant for the large sector, while it has no statistical significance in the SME regression. The high reliance on imported inputs among large conglomerates in Indonesia also affected their capacity to recover from the crisis. Many large sector enterprises may be engaged in assembly of imported parts rather than direct production operations.

10. SMEs rely more on specialization, productivity, and external industrial services to accomplish export competitiveness than their large-scale counterparts. Based on recent industrial statistics and comparing them with those of the precrisis period, Indonesian SMEs show higher growth in productivity and exports than their larger counterparts. Case studies have indicated that various mechanisms were already at work in Indonesian manufacturing SMEs such as technology diffusion through foreign buyers, active subcontracting, and clustering. Other factors have also contributed to export growth such as the ability to secure access to credit. The crisis itself appears to have shed unproductive enterprises, improved labor productivity and increased exports, especially among the smallest enterprises. Policies that focus on SME-specific success factors or strengths such as specialization may prove to be more effective to overcome the hefty disparity between SMEs and large corporations, and boost SME export potential.

OVERALL PERFORMANCE OF BANKING SECTOR AND INTERMEDIARY BANKS¹

A. Overview of the Banking System

1. After the crisis, the Government of Indonesia embarked on a liquidation and stabilization program to restore public confidence in the banking sector, which has proven costly but effective. Despite the fact that government bonds for recapitalization of banks amounted to Rp645 trillion or \$76 billion, the comprehensive bank restructuring has helped remarkably to improve banking sector indicators (Table A3.1). Banks' capital and profits improved, and nonperforming loans (NPLs) in the system declined. Total banking sector capital, which had dropped sharply to negative Rp129.8 trillion after the crisis in 1998, recovered to Rp62.3 trillion in 2001. Total profit before tax recovered from negative Rp178.6 trillion to Rp131 trillion, and NPLs from 48.6% to 12.1% during the same period. Despite the improved performance of the banking sector in 2001 and 2002, several factors still hinder their intermediation function. Loans (in both local currency and foreign exchange) dropped dramatically after the crisis and have yet to recover precrisis levels, and so has the use of deposits for loans. Banks prefer high interest payments from recapitalization bonds to the risk of lending. Loan-to-deposit ratios (LDRs) are much higher for foreign exchange than for local currency. In 2001, the banks' LDR for foreign currency stood at 63.8%, more than double the LDR for local currency.

Table A3.1: Banking Indicators, Indonesia, 1998-2001

Indicator	1998	1999	2000	2001
Deposits (Rp trillion)	625.4	617.6	699.1	797.4
Capital (Rp trillion)	(129.8)	(41.2)	52.3	62.3
Total Assets (Rp trillion)	895.5	1,006.7	1,030.5	1,099.7
LDR in Local Currency	72.8%	28.5%	27.4%	31.4%
LDR in Foreign Exchange	121.8%	63.7%	70.8%	63.8%
Loans in Local Currency (Rp trillion)	313.1	140.5	152.5	202.6
Loans in Foreign Exchange (Rp trillion)	174.3	84.6	116.5	105.0
NPL – gross (%)	48.6	32.8	18.8	12.1
NPL – net (%)	34.7	7.3	5.8	3.6
Profit (Loss) before Tax (Rp trillion)	(178.6)	(91.7)	10.5	13.1
ROA (%)	0.38	(9.11)	1.02	1.19

LDR = loan-to-deposit ratio, NPL = nonperforming loan, ROA = return on assets
Source: Bank Indonesia.

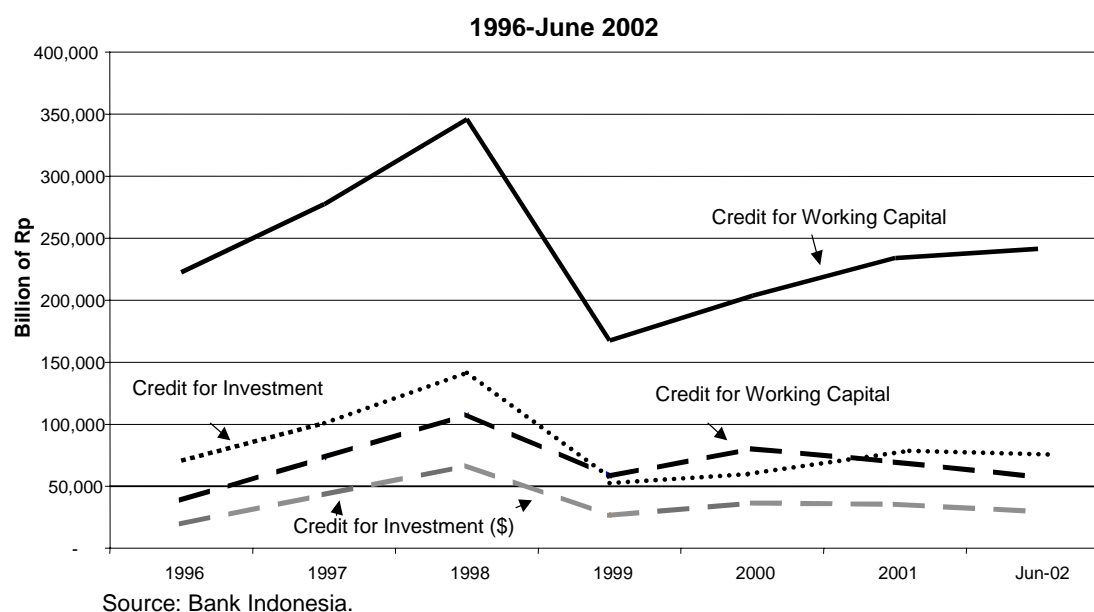
2. Credit from banks requires better intermediation. Credit for investment (long-term) loans has been slower in recovering, even more so in the case of investment credit in foreign exchange (Figure A3.1). Progress in credit and corporate restructuring has been slow because of (i) prolonged disagreement on terms and conditions of debt restructuring between debtors and creditors; (ii) decline in collateral value under the current economic conditions; (iii) increased country risk,² which has resulted in higher interest costs for financing abroad for exporters and for domestic banks borrowing from overseas, and has made foreign investors risk averse concerning the investment in Indonesia; (iv) volatility at the exchange rate; and (v) the uncertainty and complexity of legal matters. Banks generally prefer holding government bonds for stable interest income to disposing of them in order to provide new credit, given the limited

¹ Prepared by Eiichi Sasaki, Investment Officer, SEGF, in collaboration with Edgard Rodriguez, Michael Ryan, and Hari Purnomo.

² In September 2002, Standard & Poor's upgraded the sovereign rating for Indonesia from selective default to CCC+ (foreign currency) and C (local currency).

alternatives available for low-risk lending under the current less conducive macroeconomic conditions.

Figure A3.1. Credit for Working Capital and Investment in Local Currency and Foreign Exchange



3. Banks are urged to increase credit to all economic sectors, in particular small and medium enterprises (SMEs). However, there is no unique definition of an SME, let alone a common definition of an SME loan. Lack of data about the ultimate beneficiaries of small loans explains why the working hypothesis has been to use “small loans” as a synonym for “SME loans.” In fact, the trend has been for banks to move to smaller loans as part of their shift away from large corporations. Banks have slowly started to regard loans to SMEs as profitable because of (i) the relatively low portion of NPLs in this segment, (ii) their need for risk diversification, (iii) the higher profit margin in SME lending, (iv) low sensitivity to changes in interest rates, and (v) SMEs’ compliance with their loan repayment obligations. Table A3.2 shows the breakdown of loans by size and by type of bank. As of 2001, “micro and small” loans (below Rp1 billion) were equivalent to 18.7% of the total credit, while “micro, small, and medium” loans (below Rp5 billion), corresponded to 27.4%. Of all loans below Rp5 billion, state and private banks (the latter have various degrees of state ownership after their restructuring) provided most (82.7%) vis-à-vis the share of 11.2% for foreign banks. Large increases in SME lending by Indonesian banks in 2002 and 2003 are expected in these size categories, which banks refer as retail (micro and small) and mid market (small and medium) loans.

Table A3.2. Credit by Loan Size and Type of Bank, December 2001
(Rp billion)

Type of Bank	All Sizes	< Rp1 bn	Rp1-5 bn	Rp5-25 bn	Rp25-50 bn	>Rp50 bn
		Micro	Small	Medium	Corporate	Corporat
State	98,951	21,870	6,672	14,258	10,879	45,271
Regional	4,755	3,777	481	429	68	-
Private	84,283	17,953	11,673	15,698	10,336	28,624
Foreign	68,994	4,525	3,337	18,459	13,251	29,422
Total Credit	256,983	48,125	22,163	48,844	34,534	103,317

Source: Special tabulations. Bank Indonesia.

4. While the growth trends are welcome, for many banks there are serious risks to implementing such aggressive growth strategies. On the one hand, banks need to consider the quality of their portfolios. The overall trend for NPLs has been to decline consistently with the success of the restructuring of the banking sector. NPLs for SME loans show that the quality of this portfolio has been high throughout and they pose no immediate risk for banks (Table A3.3). On the other hand, banks still need to implement better systems that will allow them to successfully enlarge their SME business, let alone SME investment credit. Most of the banks under consideration are in the midst of launching corporate strategies that will help them to improve their product mix, credit and pricing policies, human resource mix, branch network configuration, and management information systems (Table A3.3). Most importantly, a change in mindset may be needed not just at the head office, but at each and every branch. Without such fundamental changes, larger SME portfolios could lead to greater losses in the future.

5. Part of the change in strategy for lending to SMEs includes an increased portion of lending for SMEs (Table A3.4). The proposed project aims at increasing the availability of long-term funds in foreign exchange for investment lending among SME exporters. The participating banks (PBs) under the project have (i) good prospects for privatization in the near future; (ii) good developments in terms of SME focus in their operations (as reflected in their annual reports and interviews); (iii) very good quality of SME lending, with average NPLs significantly below 5%; (iv) reasonably high use of foreign exchange in terms of LDRs in foreign exchange; and (v) absorptive capacity for the Project's funds that reflects their current absorption of loans in foreign exchange and their clientele of exporters. An overview of the six PFIs is given as supplementary appendices.

Table A3.3: An Overview of Participating Banks, 2002

Indicators	Bank Negara Indonesia	Bank Rakyat Indonesia	Bank Mandiri	Bank Danamon	Bank Niaga	Bank Bukopin
Privatization status in 2002	State-owned bank; divesture plans to be announced	State-owned bank; divesture plans to be announced	In mid-2002, 30% was to be sold, but initial public offering was delayed until late 2002.	Strategic sale of 51% and an offering expected by year's end	Sale of 51% stake was delayed because of low bids.	Private bank
Recent developments in small and medium enterprise (SME) focus for lending operations	Focus on increased SME lending; has opened 4 small business centers (SBCs) for servicing retail customers; one new micro-lending department	Continued commitment to micro and SMEs; products include consumer loans, program-based credit, and loans to SMEs	Focus on increased SME lending: an increase of 36% in 2001; set up 3 new business centers in Jakarta for SMEs	Focus of growth strategy: 68% increase from SME loans in 2000; has opened SME centers in Padang, Makassar, Denpasar, and Jakarta	Focus on providing an array of retail banking products and services; to open branches in some key commercial centers across Indonesia	Focus on rural economy by providing financing support to cooperatives, small-scale and micro businesses
SME lending procedure	Prior to approval, BNI has a tiered monitoring system: the risk control unit, the compliance office, and internal supervision unit; loans above Rp350 million (approx. \$40,000) are to be approved by regional offices; collateral requirement 140% of loan amount	Loans above Rp1 billion (approx \$110,000) get approval from credit committee in regional offices; time to approval is 1-2 months; require collateral asset with value at least 120% of loan	Branch offices have authority to approve loan up to Rp1 billion; above that should get approval from credit committee in regional office; time to loan approval 1-2 months; require collateral asset with value at least 120% of loan	Branch offices have authority to approve loan up to Rp1 billion; above that should get approval from credit committee in regional office; require collateral asset with value at least 120% of loan; time to approval 1-2 months	Branch offices have authority to approve loan up to Rp500 million; above that should get approval from credit committee in regional office; require collateral asset with value at least 120-140% of loan; time to approval 1-2 months	Branch offices have authority to approve loan up to Rp200 million; above that should get approval from credit committee in regional office; time to approval 1-2 months; require collateral asset with value at least 120% of loan
Credit scoring systems in place	Implements customer risk rating (CRR) and customer credit rating (CCR); CRR based on 4 main ratings: industry rating, business condition,	Has set policies regarding CRR; rating is useful to determine probability of borrowers default in each rating category and calculates	In collaboration with Boston Consulting Group, set up a credit policy and analysis department to develop and maintain scoreboard for	Management of credit risk and scoring system lies in the measurement of the portfolio credit risk; credit committees established in head office and at	Known for its consistent approach as well as strong adherence to prudential banking in its lending policies; in every credit process, checks	Has implemented a CRR system in evaluating loan feasibility, based on modern information and technology system as well as highly qualified staff

Indicators	Bank Negara Indonesia	Bank Rakyat Indonesia	Bank Mandiri	Bank Danamon	Bank Niaga	Bank Bukopin
	evaluation of financial performance and management performance; CCR calculates probability of loss for the bank in the event of borrower default	probability of loss to estimate its exposure to credit risk; established a collateral assurance team to appraise independently collateral for loans above a preset amount	consumer/ SME loans	regional and branch levels; head of credit committee sets policies and strategies for credit management, risk rating, and scoring system related to risk exposure by a borrower	and balances carried out by an independent credit committee that includes an independent credit reviewer	
Risk management in place	Established its Risk Control Division, which acts as an independent committee for risk management policies covering market risk, credit risk, and operational risk	Set up a Risk Management Committee (RMC) as the highest authority for risk management system; RMC responsible for formulating policies in implementing risk management; preparing a manual; giving approval for risk management strategies (such as setting the limit for every unit and preparing contingency plans); evaluating risk components in portfolio	Implemented enhanced risk management procedures to meet international best practice standards; setting up an independent risk and capital committee; applied the "four eye" principle to new loans, whereby every credit decision is made by two persons, one from business unit and one from risk management unit	Formed separate independent unit called Risk Management and Compliance Division (RMD); RMD performs daily monitoring of market risk exposure and has developed various models based on guidelines by Bank Indonesia and the Basel Capital Accord; methodology includes simulation analysis	Maintains several executive committees such as Risk Management Committee; Credit Policy Committee; Asset Liability Committee; and Market Risk Committee; the committees are supported by an operating system and standard operating procedures as well as highly qualified personnel with the expertise to manage risks in their respective areas	Started formulating a comprehensive risk management guiding policy based on the bank's own vision and mission statement, and in line with international best practice principles as well as current developments in the national banking sector

Source: Banks' reports and interviews.

Table A3.4: Performance Indicators of Participating Banks, 2001

Indicators	Bank BNI	Bank BRI	Bank Mandiri	Bank Danamon	Bank Niaga	Bank Bukopin
No. of accounts (\$ million)	7.5 million	28.2 million	6 million	1.6 million	1 million	0.2 million
Network of branches						
Branches	685	324	478	464	133	194
Rural village units	0	3,823	0	0	0	0
Overseas branches	6	2	4	0	0	0
Total staff	13,483	37,500	17,204	12,838	3,430	2,712
Total lending 2001 (\$ Trillion)	35.2	33.5	47.2	10.5	7.8	5.1
Government bonds (% of assets, 2001)	47.0%	37.3%	58.5%	52.7%	36.3%	0.0%
Lending in foreign exchange (% of total loans)	45%	17.1%	43.4%	14.8%	51.8%	14.2%
LDR in foreign exchange (2001)	93.0%	192.3%	68.5%	34.3%	83.6%	91.7%
Estimated SME portfolio (2002)	25%	85%	25%	30%	45%	75%
NPL of no more than 5% for SME portfolio	< 3%	< 1%	< 5%	< 1%	< 1%	< 1%
Monitorable indicators						
a. CAR minimum 8%	14.2%	13.3%	26.4%	35.5%	16.6%	16.8%
b. NOP < 20%	14.5%	11.4%	19.4%	2.4%	2.3%	12.1%
c. LDR<100%	35.2%	56.1%	24.7%	26.3%	45.0%	6.7%
d. ROA>0%	1.4%	1.6%	1.6%	1.4%	0.4%	2.1%
e. Net ^a NPL <5%	5.1%	-4.9%	-2.9%	-1.8%	2.5%	0.4%

LDR = loan-to-deposit ratio, NPL = nonperforming loan, SME = small and medium enterprise, CAR = capital adequacy ratio, NOP = net open position, ROA = return on assets

^a NPLs minus loss provisions over total loan portfolio.

Source: Banks' Annual reports and estimates.

B. Bank Ekspor Indonesia

1. Ownership, Management, and Organization

6. Bank Ekspor Indonesia (BEI), wholly owned by the Indonesian Government, was established in July 1999 and was granted a business license in August 1999 under Indonesia's banking act. Subscribed and paid-up capital is Rp3 trillion (approximate \$312 million). BEI operates through a board consisting of three commissioners appointed by the Government, a board of directors consisting of a president director and two managing directors, nine divisional heads, and two regional marketing office heads. All board members (commissioner and directors) have passed the fit and proper test of Bank Indonesia (BI).

2. Policies, Scope of Operations, and Lending Policies and Procedures

7. The board focuses on maintaining BEI operations in line with Government Decree no.37/1999, which states that the objective of BEI is to support the development of Indonesian exporters' competitiveness. BEI is a special bank that does not provide the usual commercial banking services such as deposit facilities. It focuses specifically on every aspect of export financing. Almost every business cycle in export-import financing activities can be supported by BEI, from import LC guarantee up to export bill receivable discounting. Other financing and services provided by BEI are import LC financing, pre-shipment export financing guarantee, export working capital loan financing, and investment financing (under the proposed Small and Medium Enterprise Export Development Project).

3. Operational Performance

8. A summary of BEI's operational performance (actual income for 1999 to 2001 and projected income for 2002) is given below. Compared with 2000, total assets of 2001 decreased by 12.79%, due to the repayment of the bank's borrowing to the Japan Bank for International Cooperation (JBIC) two-step loan scheme. Although in 2001, BEI started to pay back its funding from JBIC, the bank's financing facilities grew significantly from only Rp157 million in 1999 to Rp5.8 trillion in 2001. Therefore to maintain financing activities, BEI should establish its credibility in order to find other funding sources. BEI's overall operating performance for 2001, based on BI-CAMEL criteria for soundness of a bank, was a "sound/healthy" rating of 97.13%.

4. Financial Performance and Portfolio Quality

9. In its first year of operation in 1999, BEI made a small profit, and its capital base remained intact. Moreover, in 2000 and 2001, BEI generated a large amount of profit before tax—Rp248 billion in 2000 and Rp438 billion in 2001 (Table A3.5). It is thus considered one of the most profitable banks in Indonesia in terms of return on assets (ROA) and return on equity (ROE) ratios. In 2001, BEI had an ROA of 3.30% and a ROE of 8.44%, much higher than the average 1.2% ROA of the banking industry in Indonesia as a whole. Its ratio of possible loss-incurring assets to total earning assets in 2001 was zero, whereas the ratio of allowance for possible losses to total earning assets was 1.4%. It has no nonperforming loan portfolio.

5. Future Performance and Conclusion

10. As a bank with a focus on export activities and exporters, BEI should have a strong funding in foreign exchange to cover the demand of exporters. A major challenge ahead is to

find other funding sources if the JBIC foreign currency loan cannot be extended. BEI should be able to find other funding sources with interest rates lower than commercial market (JBIC's rate was remarkably lower than the commercial rate), so that BEI can relend or refinance other banks at competitive rates. By having reasonably priced wholesale funding, BEI could generate an adequate profit margin to cover its costs and to provide low interest rates to support exporters.

11. The management of BEI has composed a blueprint of the BEI Corporate Plan for 2000-2004 that is to be implemented for the next five years. The Corporate Plan is essential for BEI as a long-term business and growth strategy to fulfill its vision of becoming a world class export credit agency with implementation of good corporate governance and internationally accepted operational procedures. With the strong performance BEI has achieved during the past 3 years, BEI's day-to-day operations in 2002 anticipate such future role.

12. BEI had also achieved a significant improvement in serving SMEs. According to its annual report, operations involving SMEs grew by 153.11% in 2001, representing a share of more than half of all loan disbursements (Rp7.33 trillion).

Table A3.5
Bank Ekspor Indonesia Summary Balance Sheet
(as of 31 December 2001)

Item	(Rp million)			
	1999	2000	2001	Projected 2002
Assets				
Cash on Hand	1	22	99	100
Due from Bank Indonesia	1,365	290,577	810	972
Due from Other Banks	870,076	9,802,881	5,365,579	765,579
Loans Receivable - net	157,196	2,718,357	5,844,027	6,428,430
Other Assets	1,998,860	69,463	22,849	2,690,280
TOTAL ASSETS	3,027,498	12,881,300	11,233,364	9,885,360
Liabilities				
Due to Other Banks	0	77,009	16,455	21,392
Other Liabilities	8,388	27,669	53,208	3,118,417
Fund Borrowing	0	9,595,000	7,800,000	3,200,000
Total Liabilities	8,388	9,699,678	7,869,663	6,339,809
Shareholders' Funds				
Equity	3,000,000	3,000,000	3,000,000	3,000,000
Reserves	19,110	181,622	363,701	545,552
Total Stockholders' Funds	3,019,110	3,181,622	3,363,701	3,545,552
Total Liabilities and Shareholders' Funds	3,027,498	12,881,300	11,233,364	9,885,360
Capital-Adequacy Ratio (%)	8,053.18	132.40	135.52	155%
Loan-Deposits Ratio (BI Regulation) (%)	0.00	0.00	0.00	0.00

BI = Bank Indonesia

Source: Bank Ekspor Indonesia (BEI).

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Bilateral and Multilateral Assistance to SMEs by MTAP Main Heading

Broad Objective under MTAP (2002-2004)	Recently Completed, Ongoing, and Planned Bilateral activities	Recently Completed, Ongoing, and Planned Multilateral activities
a. Policy Environment for SMEs: "Create a Conducive Business Environment"	<p>JICA – Japan SME development recommendations – The "Urata" Report, EA: MOIT (C)</p> <p>USAID – US</p> <ul style="list-style-type: none"> • SME Policy Advisors, EA: BI, MOIT, US\$0.6 million (INP) • Policy Reform for Increased SME Growth (US\$0.75 million –INP) • Partnership for Enterprise Policy Reform (US\$2.1 million - INP) • The Asia Foundation – Business Climate <p>GTZ – Germany</p> <ul style="list-style-type: none"> • Integrated Decentralization Strategies for Regional EHRD (DM6 million – INP) 	<p>ADB</p> <ul style="list-style-type: none"> • Industrial Competitiveness and SME Development Program Loan (ICSMED), EA: MOF (US\$200 million – INP); with supporting TAs • TA for Promoting Deregulation and Competition at MOIT (US\$1.5 million – C); • TA for SME Development at SMOCSME (US\$2 million – C) • Regional TA on SME development in BIMP-EAGA (C), US\$2 million • TA for BDS for SMEs (TA 3829)– Component on Credit Information Bureau (EA: BAPPENAS, MOIT, SMOCSME and Bank Indonesia, INP)
b. "Development of Entrepreneurship and Competitive SME"	<p>GTZ - Germany</p> <ul style="list-style-type: none"> • SME Promotion (Central Java, several districts, DM2 million, INP) <p>Swisscontact (Switzerland)</p> <ul style="list-style-type: none"> • Voucher Program - Business Development Centers (East and Central Java, Jabotabek, and Sulawesi, SFR1 million a year, INP) <p>USAID – US</p> <ul style="list-style-type: none"> • Global Technology Network (\$0.1 million, INP); Vertical Intervention Program – Asemhaki (US\$0.5 million, INP) <p>CIDA -- Canada</p> <ul style="list-style-type: none"> • Private Sector Program (PEP), EA: SMOCSME and Chambers of Commerce, C\$4.9 million (INP) <p>JICA – Japan</p> <ul style="list-style-type: none"> • SME Clusters in Indonesia (MOIT, US\$2.5 million, INP) • Regional Export Training Centers (NAFED) 	<p>World Bank/IFC</p> <ul style="list-style-type: none"> • Private Sector-led Business Development Service Center in Bali for Eastern Indonesia (US\$20 million, P) <p>ADB</p> <ul style="list-style-type: none"> • BDS for SMEs – Component: Facilitating BDS for local governments in Central Java and South Sulawesi (EA: MOIT, US\$1.5 million, INP) • Improving SME Performance with Cleaner Production (EA: MOIT, US\$0.5 million, INP) <p>UNDP</p> <ul style="list-style-type: none"> • Poverty Alleviation through Rural-Urban Linkages • Partnership for Local Economic Development (Sulawesi, Irian Jaya, Sumatra, and Bali, INP) <p>UNIDO</p> <ul style="list-style-type: none"> • SME Cluster Program in 24 Provinces (INP)
c. "Improving Access to Productive Resources" (Financial Advice and Resources)	<p>FINANCIAL POLICY ADVICE</p> <p>AusAid – Australia TAMF – Financial Monitoring Advisors for State-Owned Banks (INP)</p> <p>USAID -- US</p> <ul style="list-style-type: none"> • BRI's training and MIS (US\$0.5 million, INP) • Islamic Banking Study (US\$0.05 million, C) • Institutional Transformation for skills and Self-Sufficiency for Profit Poverty Lending (BPRs) (US\$2 million, C) 	<p>FINANCIAL POLICY ADVICE</p> <p>World Bank</p> <ul style="list-style-type: none"> • SME Debt Restructuring, Advisor (INP) <p>World Bank/IFC</p> <ul style="list-style-type: none"> • Training of Banks' Staff – Pre- and Post-Financing Assistance to Financial Institutions for SMEs (P) <p>ADB</p>

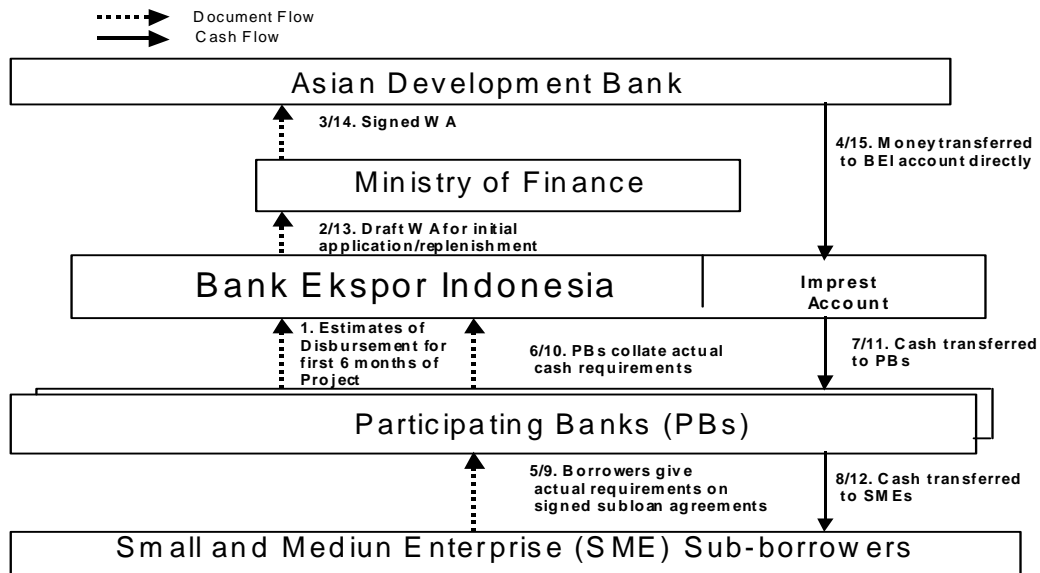
Broad Objective under MTAP (2002-2004)	Recently Completed, Ongoing, and Planned Bilateral activities	Recently Completed, Ongoing, and Planned Multilateral activities
	(BPRs) (US\$2 million, C) <ul style="list-style-type: none"> • Self-employed Microentrepreneur (SEMBADA, US\$3million, P) • Micro and SME Credit Advisors, Bank Indonesia (INP) • SME Debt Restructuring (US\$0.1 million, INP) • Japan Overseas Development Corporation developing a new financing scheme for SMEs for BRI: a study (C) 	<ul style="list-style-type: none"> • Financial Governance Reform Development Program Loan, US\$1.4 billion, (C) • Industrial Competitiveness and SME Development, US\$200 million (INP)
	<p>FINANCIAL RESOURCES</p> <p>KfW (Germany) Industrial Efficiency and Pollution Control – Credit line for SME Investments in Cleaner Production – (€12 million, C)</p> <p>CIDA (Canada) DPA Project (Trade Finance for SMEs using trade credit insurance, C)</p> <p>USAID (US) Loan Portfolio Guarantee (LPG, US\$4.5 million, INP)</p>	<p>FINANCIAL RESOURCES</p> <p>WB/IFC Equity Investment in Bank NISP, US\$5 million (C)</p> <p>ADB SME Export Development Project – Credit Line for Investments by SME Exporters, EA: MOF and BEI through banks, US\$85 million (P)</p>

ADB= Asian Development Bank, AusAID = Australian Agency for International Development, BDS = business development services, BEI = Bank Ekspor Indonesia, BPR = microfinance institutions, BRI = Bank Rakyat Indonesia, C = completed, EA = Executing Agency, IFC = International Finance Corporation, INP = in progress, JICA = Japan International Cooperation Agency, KfW = Kreditanstalt für Wiederaufbau, LPG = loan portfolio guarantee, MIS = management information system, MOF = Ministry of Finance, MOIT = Ministry of Industry and Trade, MTAP = Mid-Term Action Plan, NAFED = National Agency for Export Development, P = planned, SEMBADA = self-employed microentrepreneur, SME = small and medium enterprise, TA = technical assistance, UNDP = United Nations Development Programme, UNIDO = United Nations Industrial Development Organization
N.A.- not available

LOAN IMPLEMENTATION

A. Flow of Funds¹

Figure A6.1: Flow of Documents and Funds



1. The project will have only one imprest account. The funds will “pass through” from Bank Ekspor Indonesia (BEI) to participating banks to small and medium enterprises (SMEs), once the SMEs have submitted their actual requirements.

1. Participating banks (PBs) provide BEI estimates of subloan disbursements for the first 6 months of the Project. The total amount (\$7.5 million as of August 2002) will represent the initial advance. Note that the initial advance may be less than the imprest account ceiling at the initial stages of the Project.
2. BEI prepares a draft withdrawal application (WA) for initial advance for submission to Ministry of Finance (MOF). Attached (as per the Asian Development Bank’s [ADB] regulations) will be the expected disbursements on approved subloans as provided in step 1.
3. MOF submits signed WA together with estimate as provided in step 2, and reconciliation statement of the imprest account.
4. ADB disburses the initial advance to the BEI imprest account. This initial advance will act as the imprest ceiling.
5. SMEs provide firm cash requirements to PBs on a regular basis.
6. PBs submit requirements to BEI.
7. BEI transfers cash requirements to each PB.
8. PBs transfer funds to SMEs.
- 9-12. Repeat of steps 5-8.

¹ Prepared by Farzana Ahmed, Financial Management Specialist, IRM.

13. When the imprest balance is approximately 50% of initial advance amount, BEI will submit a draft WA to MOF for replenishment. Supporting documentation will be the bank statement and a list of the SME subloans against which a disbursement has been made. The assumption is that the replenishment will be based on the actual expenses incurred. If the estimated requirements for the following 6 months is more than the initial advance amount then an additional amount will be requested, supported by a justification. The maximum balance at any time in the imprest account cannot exceed the imprest account ceiling established in step 1 unless a special request is made to ADB.
14. MOF submits signed WA to ADB.
15. ADB replenishes the imprest account.

B. Estimated Schedule

2. The envisaged schedule is as follows:

Loan Effectiveness	—	March 2003
1 st Year Commitments and Disbursement	—	May-November 2003
2 st Year Commitments and Disbursement	—	May-November 2004
3 rd Year Commitments and Disbursement	—	May-November 2005
4 th & 5 th Year Disbursements	—	May-November 2006-2007
Project Closing Date	—	June 2007
Project Completion Date	—	December 2007
Project Completion Report	—	June-December 2008

TECHNICAL ASSISTANCE

1. The proposed Technical Assistance for SEIF shall be part of a Technical Assistance and Monitoring Unit (TAMU) that will support Bank Ekspor Indonesia (BEI) and the Executing Agency in the implementation of SEIF in liaison with other donor-sponsored assistance for SME exporters supported by ADB and other donors. TAMU will be located at BEI during the course of the Project. The consultants are expected to be either international or domestic individual consultants.
2. TAMU will focus on:
 - (i) coordinating sub-loan processing administration and monitoring procedures between PBs, MOF and ADB according to the agreed implementation arrangements;
 - (ii) supporting MOF and BEI to prepare reports or provide documentation in relation to loan administration;
 - (iii) providing lessons learned on the on-going administration of the new apex modality to improve financial intermediation and on the intermediation experiences of other regional export agencies;
 - (iv) improving skills of credit officers from the PBs related to project identification and appraisal of small investment projects;
 - (v) supporting eligible SME exporters to apply for SEIF through the eligible PBs, especially in locations outside Jakarta with export potential;
 - (vi) reviewing letters of agreement for the economic impact on micro and SMEs of eligible sub-projects, including the nature of the business network;
 - (vii) promoting SEIF in coordination with other donor activities in support of SME exporters; and
 - (viii) reviewing the initial environment examination of sub-projects by PBs to identify environmentally sensitive subprojects.
3. TAMU will only have an advisory and monitoring role. The approval of subloans takes place at the selected PBs, which will assess the credit risk of SME exporters. BEI and ADB (Indonesia Resident Mission or IRM) will process subloan applications in accordance with the implementation arrangements.
4. Throughout the project's implementation, ADB will maintain in parallel close coordination with the expert from the Japan International Cooperation Agency (JICA) at BEI. JICA is the administrator of Japan's SME promotion program in Indonesia, which includes activities such as the export training centers. In 1988, the Government of Japan provided a grant of about \$16 million equivalent to finance the establishment of the Indonesia Export Training Center (IETC). In conjunction with the proposed TA, Japan's SME promotion program aims at setting up four regional export training and promotion centers to provide training for export, trade information and promotion services for SMEs in East Java (starting in 2002), North Sumatra and South Sulawesi (2003) and Kalimantan (2004).
5. In parallel, other donors will also support TAMU through their actual or planned activities between 2002 and 2005. These include: IFC's Facility for business development services to be headquartered in Denpasar, Bali (to start on 2003); the World Bank with expert on SME financial regulations in Jakarta (on-going); AusAid with experts on BEI's risk management (planned) and on NAFED's training for exporters (early 2003); and CIDA with experts on private

sector development and trade promotion (on-going until 2007). See Appendix 5 on Bilateral and Multilateral Assistance for SMEs.

6. Terms of reference for the consultants follow.

A. Financial Specialist/Team Leader at TAMU (international, 18 months)

7. The consultant should be experienced financial specialist with extensive working experience in Indonesia related to implementation of SME credit programs funded by international agencies. Other qualifications include:

- (i) graduate in business administration, economics or banking;
- (ii) minimum 10 years experience as international adviser/ team leader of SME loan projects financed by international donors and GOI;
- (iii) familiar with the Indonesian banking environment and Government institutions;
- (iv) experience from commercial banks; and
- (v) fluent in English and Bahasa Indonesia.

8. The full-time or part-time specific tasks for team leader will include:

- (i) before the start of SEIF
 - a) review and recommend organizational apex arrangements for BEI and MOF;
 - b) design project identification and appraisal procedures for efficient and transparent project management of SEIF;
 - c) assess adequacy of risk management, internal control, project monitoring and loan administration of SEIF funds and sub-loans in the individual PBs;
 - d) coordinate SEIF "socialization" to PBs and SME exporters through direct activities and/or other donor assistance projects.
- (ii) during the life of the Project
 - a) support PBs in identifying and developing subloan proposals according to SEIF procedures;
 - b) coordinate and supervise project implementation of the SEIF by PBs, TAMU staff and donor sponsored technical assistance;
 - c) prepare quarterly progress reports for BEI, MOF and ADB; the reports will contain feedback on the apex arrangements and recommendations for improvement; and
 - d) streamline analysis of small investment subprojects that will support the branches of PBs make their own approval decisions, and hence submit proposals to ADB for subloan approval/authorization, according to SEIF procedures, contained in the loan agreement.

B. BDS Specialist with focus on access to finance (domestic, 18 months)

9. The financial BDS specialist should be experienced in providing financial BDS to SMEs with extensive working experience in provincial cities of Indonesia. The financial specialist will be part of TAMU and will be located in Denpasar and able to travel to the other nearby provincial cities with significant export volume, depending on the needs of the TA for BDS (3829-INO) operating in Java and Sulawesi. The financial BDS specialist has the crucial role to

activate potential demand for investment funds among SME exporters. The main function of the specialist is improve the supply of investment-related non-financial services, by identifying sustainable export-oriented investment sub-projects outside Jakarta, that meet the eligibility criteria under SEIF in provinces where opportunities for export exist such as Bali (Denpasar), Central Java (Semarang), East Java (Surabaya) and South Sulawesi (Makassar). While the specialist will focus on Bali, he/she will provide support to nearby areas as needed by TAMU.

10. Examples of financial “pre-investment” BDS to be provided will include:

- (i) initial flash diagnostics to verify and clarify perceived investment needs;
- (ii) technical and commercial information to find appropriate financial solutions;
- (iii) more in-depth diagnostics to elaborate the sub-projects; and
- (iv) preparing business plans with SEIF financing.

11. Qualifications for the financial BDS specialist include:

- (i) graduate in business administration;
- (ii) minimum 5-8 years experience in financial management for SMEs;
- (iii) familiar with the Indonesian commercial banking; and
- (iv) fluent in Bahasa Indonesia and English.

12. The specific tasks will include:

- (i) before the start of SEIF
 - a) familiarize with the Team Leader’s design project identification and appraisal procedures for efficient and transparent project management of SEIF;
 - b) support the Team Leader to coordinate SEIF “socialization” to selected PB branches and SME exporters;
 - c) identify potential BDS providers, offering services for investment- and business planning; and
 - d) provide specific training to BDS providers in the field of business planning according to the requirements for loan applications under SEIF.
- (ii) during the life of the Project
 - a) support PBs in identifying and developing a minimum of 30 eligible subloan proposals under SEIF in the selected locations outside Jakarta;
 - b) coordinate and supervise project implementation of SEIF by PBs, TAMU staff and donor sponsored technical assistance;
 - c) support BDS providers in establishing investment and business plans for potential loan proposals;
 - d) provide feedback to streamline analysis of small investment sub-projects that will support the branches of PBs make their own approval decisions, and hence submit proposals to ADB for subloan approval/authorization, according to SEIF procedures, contained in the loan agreement; and
 - e) interact with IFC, JICA and other donors’ facilities.

C. SME Credit Specialists for TAMU (domestic, 4 months)

13. The specialists will work on a part-time basis under the supervision of the team leader as required. They shall have extensive experience in implementing of credit programs for small and medium enterprises in Indonesia, including provision of consulting services to PBs and their credit officers as well as to SMEs.

14. The specialists will have the following qualifications:

- (i) graduate in business administration, agriculture or industrial engineering;
- (ii) minimum 5 years experience from financial institutions or private consultant firms related to implementation of credit programs for SMEs;
- (iii) familiar with the Indonesian banking environment and institutions;
- (iv) broad-based working experience as SME consultant; and
- (v) good working knowledge of English.

15. Their specific tasks could include to:

- (i) identify in cooperation with local PB staff and business service providers project proposals from potential SME exporters that could be financed under SEIF;
- (ii) assist credit officers of branches of PBs in conducting project identification and credit appraisal of project proposals to be financed under SEIF;
- (iii) promote SEIF to groups of SMEs, business associations and BDS providers and provide liaison among them and the PBs and BEI; and
- (iv) assist TAMU compile information, and provide support for special studies/reports/surveys as required.

COST ESTIMATES AND FINANCING PLAN
(US\$)

	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing			
1. Consultants			
a. Remuneration			
i. International Consultants	300,000	0	300,000
ii. Domestic Consultants	0	90,000	90,000
b. Travel	0	40,000	40,000
c. Reports, Promotion Materials, and Communications	0	10,000	10,000
2. Equipment	0	0	0
3. Training for local bank officers and promotion of SEIF and training activities in association with other donors	0	50,000	50,000
4. Contingencies	0	10,000	10,000
Subtotal (A)	300,000	200,000	500,000
B. Government Financing			
1. Domestic professional staff in TAMU	0	60,000	60,000
2. TAMU Office Space	0	28,000	28,000
3. Accommodation and air/land transport	0	12,000	12,000
4. Training in- and out-the country	0	12,000	12,000
5. Contingencies	0	8,000	8,000
Subtotal (B)	0	120,000	120,000
TOTAL (A) + (B)	300,000	320,000	620,000

SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY¹

A. Background

1. The poverty reduction potential of small and medium enterprises (SMEs) in Indonesia has been well demonstrated. The Poverty Assessment (PA) for Indonesia² notes that policies fostering SMEs are key to reducing poverty, as the number of SMEs is large, they are distributed all over the country, they use labor-intensive technology, and they can absorb lower-skill labor. The last point is particularly important, as 60% of the prime age labor force³ has had only 6 years of education or less.

2. SMEs are a major stepping-stone out of poverty and an engine of growth. Unskilled or semiskilled workers are coupled with technology, thereby increasing their productivity more than could otherwise be done through the application of their labor alone. The Economic Census⁴ shows that the productivity of workers triples as they move from micro to small enterprises and triples again from small to medium enterprises. The 1995 national input-output (I/O) matrix⁵ also indicates a relatively high value-added multiplier in the sectors where SMEs are concentrated. These sectors include agricultural product processing, basic iron and steel industries, textiles and clothing, and wood products. The I/O tables also show high labor productivity in these same sectors. The trade sector, another important area of SME concentration, reports high value added, but not necessarily high labor productivity.

3. By contrast the agriculture sector, where the poor are concentrated, shows much lower value added and labor productivity. Higher value added and labor productivity are reflected in worker wages. Therefore one would expect SME workers to fare better than informal sector workers. Monitoring changes in welfare through real wages⁶ indicates that workers in the manufacturing sector have fared much better than agricultural laborers and urban informal sector workers⁷ since mid-1999, when the impact of the crisis began to recede.

4. SMEs provide employment opportunities for both men and women. Some industries are very male dominated such as the basic metal industries and furniture. Other industries such as food processing and garments are very female-oriented. Overall, the trade and manufacturing sectors provide employment for a larger proportion of the female workforce, nearly double the rate of males for the lower two income quintiles, representing the poor and near poor. SMEs provide the main alternative to agriculture in rural areas where many are located to take advantage of the availability of land and water, or the proximity of raw materials.

5. In addition to providing necessary quality work opportunities for Indonesia's burgeoning labor force, SMEs promote more employment creation by drawing on goods and services from the sectors where the poor are concentrated. As with value added and labor productivity, the I/O tables show deep backward linkages in the sectors populated by SMEs.

¹ Prepared by Lisa Kulp, Social Sector Development Specialist, SERD.

² ADB. 2000. *Assessment of Poverty in Indonesia: Main Report*. Manila.

³ ADB. 2000. *Assessment of Poverty in Indonesia: Statistical Appendices*. Manila. This figure includes individuals ranging in age from 20 to 54.

⁴ Research is carried out every 10 years. The most recent was the 1996 census.

⁵ Latest information available. The 2000 I/O matrix is still under processing.

⁶ ADB. 2001. *Technical Assistance to the Republic of Indonesia for Developing Leading Indicators for Poverty Monitoring*. Manila.

⁷ ADB. 2002. *Poverty Monitoring Report*. Vol. 7. Manila.

6. The relative resilience of SMEs through the crisis, their close ties to sectors where the poor provide goods and services, and especially their labor absorption capacity have highlighted their potential for poverty reduction. The Indonesian labor force must absorb about 2.5 million new entrants each year. As the Indonesian labor market is relatively mobile, the immediate result of the 1997 economic crisis was a shifting of workers across sectors, with agriculture, the safety net of last resort, registering the largest increase. But after nearly 5 years of moribund growth, unemployment is rising, particularly among the young, fueling existing trends toward increased social tension and instability.

7. While the 2001 Poverty Reduction Partnership Agreement (PRPA) notes the importance of pro-poor growth and employment promotion, the First Annual Poverty Reduction Partnership Review, which was signed in April 2002, further notes that “given the sustained high levels of poverty and unemployment and low level of growth, greater emphasis must be placed on a short-term growth program to accelerate pro-poor growth for employment creation without compromising macroeconomic stability.” Although the PRPA review did not prescribe the means to accelerate pro-poor growth for employment creation, support for SME development, particularly SMEs in trade and manufacturing, is clearly one such avenue.

8. The decline in poverty from the mid-1980s into the 1990s was largely due to a rise in trade and exports. The PA notes that this rise was due to policies stimulating labor-intensive exports, which enabled the shift of workers from agriculture into higher productivity jobs in the sectors where the export-based SMEs are clustered. By the mid-1990s, however, Indonesia’s competitive advantage was weakening. While the first phase of export-oriented industrialization, based on simple technologies and cheap labor, remains important, it can no longer be relied upon exclusively as the prime mover of growth and poverty reduction. To this end, the Poverty Partnership Agreement notes that Indonesia will have to make the transition to the next phase of industrial development based on technology- and skill-intensive industries.

9. How well Indonesia makes this transition will depend on its ability to access knowledge and funding for the necessary retooling. While the government has attempted to provide these services directly, these attempts have not always proved successful. The PA notes the need to provide access for SMEs to technical and managerial skills through private sector providers such as training institutions and business consultants. It further notes the need to strengthen SME access to the financial sector.

B. The Project

10. The Small and Medium Enterprise Export Development Project (SMEEDP) will serve the needs of a subgroup of SMEs—the export SMEs. It will do so through two channels. First, it will provide sustainable long-term financing for upgrading, expansion, and permanent working capital and by promoting access to financial and business services. Subloans may be made to SMEs as well as to trading houses with close ties to SMEs. Lending to SMEs through trading houses will enable access to SMEs with the potential for growth but which have not yet achieved the design and quality required by the international market, the ability to deal with export procedures, or the ability to communicate with foreign buyers; still require liquidity support; and may not be able to fully assume the risk associated with expansion. As trading houses are clustered in sectors with the greatest linkages to the poor such as garments and handicrafts, this further extends the scope of the loan to SMEs with the greatest labor absorbing potential.

11. The employment impact of the loan is expected to be large. SMEEDP-funded expansion will necessitate increased labor inputs in the form of direct employment and through increased demand for raw or intermediate inputs provided by individuals or microenterprises. For example, where the availability of kiln-dried wood is a limitation, investment in a kiln dryer will allow a furniture manufacturer to accept more orders. The manufacturer would hire additional permanent workers for finishing, while production of parts, such as chair and table legs, would be done by smaller suppliers using the manufacturer-provided kiln-dried wood. While there are also some employment impacts related to the physical implementation of the expansion such as in construction, the employment impacts referred to here are sustainable for the life of the investment. Moreover additional employment will be generated as SMEEDP funds are repaid and re-lent (second-round effects).

12. The first round impact of investment is estimated to be between 1 million and 2 million job years. One case study of cold storage in the fish processing industry in South Sulawesi indicated substantial demand for SMEEDP loan products for upgrading and expansion suggesting that for each \$500,000 invested, 500 new full-time jobs years are created requiring the inputs from 10,000 fisherfolk-years. A separate review of a Kreditanstalt für Wiederaufbau (KfW) credit line for clean technologies in SMEs shows that a \$50,000 investment in a plastics chipping factory generated 100 additional jobs-years and required 800 scavengers-years to provide sufficient recyclable waste material to meet the needs of the new investment. These are the high-and low-case scenarios for employment impact. The initial pipeline of investments proposed for the SMEEDP suggests an employment impact of 1.5 million job-years.⁸

13. The SMEEDP provides long-term employment prospects for unskilled and semiskilled workers vital to absorb the 2.5 million entrants to the labor market each year and provides prospects for more productive work for a large segment of the labor force including the 10% seeking work and better opportunities and the 60% of the workers currently engaged in the informal sector. It is not possible to calculate the percentage of poor that would benefit from the additional employment or the percentage by which the incidence of poverty would be reduced because of the SMEEDP. With respect to the former, a worker is poor if he or she is a member of a poor household. The SMEEDP will not require a household income and expenditure survey for new employees at entry. It is likely that the majority of the new jobs and new opportunities will accrue to individuals who would otherwise be vulnerable to poverty by virtue of their low level of education. The incidence of poverty is affected by many factors beyond the scope of the SMEEDP, including changes in the price of major staple foods. Nonetheless, the majority of these workers expecting to find productive work in the SME sector under the program will be drawn from among the poor or near poor and would otherwise continue to compete in the already overcrowded and less well remunerated informal sector.

⁸ Based on \$35 million of total project investment creating additional 47,000 job-years at the borrowing SMEs plus 705,000 job-years in subcontractors and supplies (i.e., additional job-years for each SME job-year created).

14. The summary poverty reduction and social strategy follows.

SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY

A. Linkages to the Country Poverty Analysis

Sector identified as a national priority in country poverty analysis?	Yes	Sector identified as a national priority in country poverty partnership agreement?	Yes
Contribution of the sector/subsector to reduce poverty in Indonesia: The Poverty Assessment for Indonesia (footnote 2) notes that policies fostering small and medium enterprises (SMEs) are key to reducing poverty, as the number of SMEs is large, they are distributed all over the country, they use labor-intensive technology, and they can absorb lower-skill labor. This is particularly important, as 60% of the prime age labor force (footnote 3) have had only 6 years of education or less. In addition to providing necessary quality work opportunities for Indonesia's burgeoning labor force, SMEs promote employment creation by drawing on goods and services from the sectors where the poor are concentrated.			

B. Poverty Analysis

Proposed Classification:

Growth

The SMEEDP provides long-term employment prospects for unskilled and semiskilled workers vital to absorb the 2.5 million entrants to the labor market each year and provides prospects for more productive work for a large segment of the labor force including the 10% seeking work and better opportunities and the 60% currently engaged in the informal sector. The first round impact of the loan is expected to be about 1.5 million job-years. The majority of these workers expecting to find productive work in the SME sector under the program will be drawn from among the poor or near poor and would otherwise continue to compete in the already overcrowded and less well remunerated informal sector.

C. Participation Process

Stakeholder analysis prepared	Yes
Participation strategy	No

D. Social Issues

Subject	Significant, Not Significant, None	Strategy to Address Issues	Output Prepared ^a
Resettlement ^b	None	No negative impacts to be mitigated	None
Gender	None	No negative impacts to be mitigated	No
Affordability	None	No negative impacts to be mitigated	No
Labor	None	No negative impacts to be mitigated	No
Indigenous People	None	No negative impacts to be mitigated	No
Other Risks/Vulnerabilities	None	No negative impacts to be mitigated	No

^a A plan will be required if any of the potential issues are found to be significant.

^b Significant involuntary resettlement requires a full settlement plan; nonsignificant resettlement requires a short resettlement plan.

Economic and Financial Analysis: Indicative Pipeline and Selected Reviews of Prospective Sub-loans

A. Overview

1. The first-round economic benefits of an \$85-million investment in new machinery and equipment by exporters could be classified as those generating additional employment, exports (sales in foreign currency). Assumptions include:
 - (i) Total project cost to be entirely financed by subloans and sub-borrowers contributions (minimum 25% of subloan).
 - (ii) A 10-year life of capital investment.
 - (iii) Second and third generation subloans through repayments and re-lending (tranching disbursements over the first 3 years of the Project; while second- and even third-generation disbursements will occur depending on repayments and maturity profile).
 - (iv) \$1 of annual additional exports for every 20-25 cents increase in capital investment (based on pipeline submitted and interviews with exporters).
 - (v) One direct job-year for every \$1,000-1,500 of additional investment expenditures per year (based on pipeline submitted and interviews with exporters).
 - (vi) Fifteen new supporting jobs-year for each direct job created in SME (based on case studies from social analysis).
 - (vii) Other benefits do not factor in improvements in better quality of products to be produced and exported, improvements in workers' skills to operate cleaner and better machinery, and/or improvements in overall management of enterprises.

Table A9.1: Overview of Additional Jobs and Exports of SMEEDP

Time Frame	Estimated Average Investment (total project cost)	Additional Direct jobs-year	Additional Subcontractor/Supplier Jobs-year	Additional Exports (millions in US\$)
Assumptions	(1)	(2)/\$1,500 capital expenditure a year	15 related jobs*(2)	(1)/\$0.20
Total from 1 st to 3 rd Year	\$110 million	47000	705000	\$550 million a year
Total from 4 th to 7 th Year	\$60 million	80571	1208571	\$300 million a year
Total from 8 th to 15 th Year	\$120 million	161143	2417143	\$600 million a year
Cumulative TOTAL	\$290 million	288714	4330714	\$1.45 billion a year

2. Access to credit has proven to have a significant variable in the explanation of exports (Appendix 2 – Subsector Analysis). Bank credit is one important source of financing investment expenditures in SME (another would be direct equity investments from overseas or domestic investors). Within Indonesia, the commercial bank system has outstanding investment credit in US\$ of \$8 billion as of June 2002. If 25% of this credit goes to investment in SMEs, ADB assistance through SMEEDP would account for about 6-14% of investment credit. Higher capital investment has proven to be a significant export determinant in exports. Moreover, its impact is much greater for SMEs than for the corporate sector, because of the SME low initial productivity of their labor force. With proper complementary machinery, greater labor productivity gains (and wages) explain in part the recent success of SMEs in exports. More productive employment stands to be more than 1 million jobs-year, which would absorb part of the new job seekers entering the manufacturing labor market each year in Indonesia (about 250,000 a year). Finally, in terms of exports, SMEEDP is expected to generate about \$1.5 billion over the different stages of the project. The benefit of such an increase is significant compared to the estimated total exports in the subsector (\$3.6 billion in 2001).

**Table A9.2: Indicative Pipeline of Subprojects
(as of 30 September 2002)**

Industry	Province	Estimated	Estimated Loan	Annual Sales	Annual Export	Additional	Additional	Networks with	Debt Equity	Debt Service	Financial	Overall
		Project Cost \$	Size \$	Revenues \$	Revenues \$	Exports \$	Employment					
Wood processing industry	South Kalimantan	2,368,000	600,000	3,022,000	2,414,000	800,000	29	Subcontractors	0.22	2.33	100.0%	High
Plastic industry	Jakarta	383,000	268,000	1,289,000	644,000	100,000	47	n/a	0.51	1.68	27.4%	High
Handicraft producer	Bali	16,700	11,000	50,000	16,700	6,000	9	Subcontractors	2.87	1.98	100.0%	Medium
Wood processing industry	North Sumatra	222,000	189,000	234,500	234,500	60,000	32	Subcontractors	1.60	1.44	72.4%	High
Furniture factory	Central Java	1,283,000	600,000	5,000,000	4,995,000	2,400,000	173	Subcontractors	1.62	1.44	16.3%	Medium
Fish processing industry	North Sumatra	222,222	188,000	1,023,000	324,000	150,000	21	Fishermen	0.21	2.28	56.7%	High
Textile industry	West Java	560,000	445,000	605,000	200,000	50,000	34	n/a	0.66	0.17	58.2%	Medium
Furniture producer	West Java	275,000	220,000	510,000	25,000	100,000	10	Subcontractors	0.10	1.67	81.1%	High
Garment industry	West Java	550,000	440,000	780,000	400,000	80,000	43	n/a	0.08	1.92	46.6%	Medium
Fish processing	North Sulawesi	296,000	240,000	533,000	110,000	30,000	108	n/a	0.13	2.47	39.2%	High
Sub-total Bank Rakyat Indonesia		6,175,922	3,201,000	13,046,500	9,363,200	3,776,000	506					
Wood process./furniture ind.	West Java	1,000,000	600,000	2,800,000	2,800,000	2,100,000	200	n/a	1.77	1.25	50.9%	High
Furniture factory	Jakarta	1,225,000	900,000	2,923,000	1,694,900	424,000	100	Subcontractors	0.80	1.64	100.0%	High
Garment industry	West Java	1,192,806	600,000	13,895,600	13,895,600	6,950,000	300	n/a	4.40	1.32	15.2%	Low
Footwear industry	Jakarta	400,000	316,100	790,000	475,000	200,000	250	Subcontractors	3.19	1.41	54.8%	High
Wood processing industry	Central Java	2,210,000	1,000,000	8,157,000	8,157,000	1,630,000	25	Subcontractors	n.a	1.92	80.6%	High
Wood processing industry	Central Java	948,000	578,000	2,168,000	2,168,000	540,000	70	Subcontractors	1.21	2.67	82.3%	High
Wood processing industry	Central Java	85,000	56,000	692,400	277,800	75,000	14	Subcontractors	n.a	1.27	100.0%	High
Textile industry	Jakarta	2,000,000	600,000	11,246,800	9,841,000	2,950,000	25	n/a	2.67	1.31	100.0%	Medium
Furniture factory	Central Java	411,900	166,700	873,000	873,000	220,000	120	Subcontractors	0.18	2.35	68.3%	High
Wood processing industry	North Sumatra	666,000	666,000	3,981,000	3,981,000	1,000,000	461	Subcontractors	0.65	1.34	100.0%	High
Fish processing industry	North Sumatra	1,100,000	900,000	18,000,000	18,000,000		75	Fishermen	n.a	n.a.	n.a.	High
Areca-nut & Gambir exporter	West Sumatra	650,000	360,000	575,000	575,000	115,000	34	Gambir and nut collector	0.56	1.35	72.3%	High
Cassia vera exporter	West Sumatra	500,000	390,000	1,575,000	1,420,000	350,000	22	Cassia vera farmers	0.81	2.08	100.0%	High
Fish processing industry	Central Java	1,842,500	1,000,000	3,795,578	3,050,000	1,800,000	120	Local Fishermen	0.46	1.41	34.0%	High
Garment exporter	Bali	195,000	145,000	1,385,000	280,000	150,000	70	Subcontractors	0.48	1.92	86.5%	High
Tea factory	East Java	1,185,000	600,000	725,000	650,000	400,000	35	Tea farmers	0.41	1.84	40.5%	Medium
Palm-oil industry	West Sumatra	3,439,000	1,000,000	6,480,000	6,480,000	1,250,000	51	Oil-palm farmers	0.33	3.55	74.3%	High
Wood processing industry	West Sumatra	843,000	600,000	2,897,000	2,897,000	300,000	60	n/a	0.26	3.21	100.0%	High
Wood processing industry	West Sumatra	895,000	600,000	2,792,000	2,792,000	450,000	62	n/a	0.10	1.80	93.0%	High
Fish processing industry	Central Java	225,000	156,000	1,289,000	730,000	250,000	120	n/a	0.11	3.78	100.0%	High
Wood processing industry	Central Java	450,000	367,000	1,320,000	675,000	300,000	90	n/a	0.32	1.28	26.4%	Medium
Wood processing industry	Central Java	300,000	240,000	765,000	765,000	230,000	122	n/a	0.58	1.29	22.6%	Medium
Wood furniture industry	Central Java	890,000	280,000	725,000	435,000	175,000	122	n/a	0.55	1.83	18.4%	Medium
Wood furniture industry	Central Java	550,000	450,000	1,601,000	1,601,000	320,000	250	Subcontractors	0.44	1.32	75.7%	High
Garment industry	Central Java	550,000	450,000	280,000	280,000	170,000	373	Subcontractors	0.17	1.38	35.8%	High
Sub-total Bank BNI		23,753,206	13,020,800	91,731,378	84,793,300	22,349,000	3,171					
Crump rubber industry	South Kalimantan	4,880,000	1,000,000	4,780,000	4,780,000	1,200,000	104	Rubber plantations	2.42	1.40	41.2%	Medium
Wood processing industry	East Kalimantan	556,000	389,000	2,206,000	2,206,000	661,000	80	Subcontractors	0.03	1.95	32.9%	High
Wood processing industry	West Java	570,000	445,000	1,077,000	1,077,000	270,000	45	Subcontractors	0.59	2.32	100.0%	High
Wood working and furniture	Central Java	666,667	222,222	2,000,000	1,800,000		n.a.	Subcontractors	n.a	n.a	n.a	n.a
Fibre glass and pipe industry	Central Java	632,222	350,000	3,666,666	2,566,666		0	Subcontractors	n.a	n.a	n.a	n.a
Tissue paper industry	West Java	600,000	420,000	2,000,000	1,000,000	300,000	100	n/a	0.16	3.88	100.0%	High
Textile industry	West Java	600,000	339,500	733,333	586,666		n.a.	n/a	0.21			
Aromatic oil industry	West Sumatra	75,000	60,000	167,000	167,000	45,000	8	Subcontractors	No debt	3.08	66.9%	High
Sub-total Bank Danamon		8,504,889	3,165,722	16,629,999	14,183,332	2,431,000	337					
Fish processing/canning ind.	North Sumatra	1,220,000	900,000	4,230,000	2,538,000	635,000	100	Fishermen	1.31	3.60	27.58 %	High
Coffee exporter	East Java	445,000	270,000	1,025,067	923,100	230,000	24	Coffee growers	10.00	1.32	19.6%	Low
Fish processing industry	East Java	283,000	216,500	320,400	320,400	160,200	66	Fishermen	0.87	1.28	22.3%	High
Fish processing industry	South Kalimantan	303,000	258,550	266,000	266,000	140,000	66	Fishermen	2.61	1.46	41.9%	Medium
Furniture factory	East Java	307,500	300,000	232,460	232,460	58,000	70	Subcontractors	2.07	2.69	40.5%	High
Wood processing industry	North Sumatra	280,000	222,000	2,500,000	2,500,000	500,000	n.a.	n/a	1.03	1.39	100.0%	High
Textile industry	West Java	492,000	400,000	8,550,000	8,550,000	8,550,000	n.a.	n/a	0.61	4.43	100.0%	High
Carbob active industry	Jakarta	1,939,570	422,000	1,585,000	1,426,000	560,000	n.a.	n/a	0.75	2.60	33.7%	Medium
Sub-total Bank Niaga		5,270,070	2,989,050	18,708,927	16,755,960	10,833,200	326					
Agribusiness trading	South Sulawesi	2,200,000	600,000	345,861	86,465	21,650	62	n/a	1.10	1.31	100.0%	Medium
Cocoa and Clove Traders	South Sulawesi	556,000	444,800	7,000,000	2,800,000	700,000	5	Smallscale farmers	0.65	1.81	100.0%	High
Furniture producer	Central Java	135,000	112,000	249,000	219,000	100,000	85	Subcontractors	0.70	1.92	60.3%	High
Cocoa and Clove Traders	South Sulawesi	2,272,393	1,000,000	2,560,000	1,400,000	400,000	300	Smallscale farmers	0.14	2.40	62.2%	High
Sub-total Bank Bukopin		5,163,393	2,156,800	10,154,861	4,505,465	1,221,650	452					
Garment industry	West Java	1,000,000	600,000	8,790,000	8,790,000	90,000	200	n/a	2.06	1.59	43.5%	Medium
Wood flooring & ratan furnit.	South Sulawesi	950,000	600,000	5,200,000	5,200,000	1,500,000	650	Rattan collectors	4.80	1.26	69.2%	Medium
Cold Storage for Shrimp	South Sulawesi	3,650,000	1,000,000	9,300,000	9,300,000	1,900,000	800	Fishermen	3.60	1.24	58.3%	High
Leather Shoe Manufacturer	East Java	1,800,000	600,000	10,000,000	5,000,000	1,500,000	250	n/a	0.85	1.32	98.8%	High
Plastic industry	Jakarta	1,644,000	600,000	2,500,000	2,125,000	1,000,000	200	n/a	2.99	1.31	27.5%	Medium
Agribusiness trading	West Sumatra	450,000	295,000	525,000	472,000	356,000	140	Farmers	0.52	1.29	14.6%	Medium
Wood furniture industry	Central Java	105,000	56,000	306,000	306,000	122,000	15	Subcontractors	0.09	4.14	78.8%	High
Sub-total Bank Mandiri		9,599,000	3,751,000	36,621,000	31,193,000	6,468,000	2,255					
TOTAL		58,466,480	28,284,372	186,892,665	160,794,257	47,078,850	7,047		1.23	1.94	63.9%	

B. Financial Analysis of Subprojects

1. The following is a summary of information on selected small and medium enterprise (SME) exporters taken from the questionnaires submitted by the participating banks to the Small and Medium Enterprise Export Development Project (SMEEDP) Reformulation Mission team. The exporters are all interested to become small and medium exporters' investment facility (SEIF) sub-borrowers in their respective banks. Complete project proposals for SEIF subloans from these and other SME exporters will be appraised in accordance with agreed upon subloan regulations for the SEIF by the participating banks and the technical assistance monitoring unit (TAMU), when the Government and the Asian Development Bank (ADB) have signed a loan agreement for the SEIF.

2. Assumptions in calculating the financial internal rate of return (FIRR) are based on the following assumptions:

- (i). The economic life of each subproject is 6 years due to the fact that most capital investments are for machinery, equipment, and vehicles,
- (ii). Investments will be completed during the first year; i.e., construction works and installation of machinery and equipment including trial runs,
- (iii). Several SME investments are small compared with the earning capacity of the SMEs that submitted the project proposals. This has led to high FIRR for these project proposals. FIRRs above 100% are given without specifying the actual FIRR figure.
- (iv). The average company tax rate is 30%.

Table A9.3: Selected Subproject Summaries Based on Indicative Pipeline

No	Subproject Location	Main Products for Export	DER and FIRR	Subproject Summary and Business Prospects
1	Medan, North Sumatra	Fish processing (canned crab meat and fishmeal) \$3.8 million (2001) mainly to USA	1.31 27.58 %	Packing equipment. The company is not exposed to competition from similar firms in North Sumatra. The demand for its products exceeds its present production capacity. Export prices are stable and increasing. The company does not experience special problems related to procurement of raw materials from local fishermen and wholesale traders. Profit margin before tax is around 15%.
2	Sidoarjo, East Java	Fish processing (dry fry or <i>teri nasi</i>) \$290,000 (2001), mainly to Japan	0.87 22.25 %	General machinery for cooling and transportation. Production of <i>teri nasi</i> in Japan is declining. The main production centers for <i>teri nasi</i> are Indonesian coastal towns. The company has developed special products for the Japanese market, together with business relations in Japan. The firm also has long-term supplying arrangements with local fishermen whose families participate in the <i>teri nasi</i> processing. The new investments include an extension of the main production plant in Tuban; and procurement of trucks, production equipment, and machinery. The company's monthly export is eight containers of processed <i>teri nasi</i> to Japanese buyers. Each container of processed fish products requires 40 tons of fresh <i>teri-fish</i> ; i.e., the average monthly production is 320 tons. The

No	Subproject Location	Main Products for Export	DER and FIRR	Subproject Summary and Business Prospects
3	Banjarmasin, South Kalimantan	Fish processing industry (frozen sea shrimps) \$240,000 (2002), mainly Europe and Taipei, China	2.61 41.92 %	firm's pretax profit margin is in the range 3-4%. Packing and cooling equipment. The subproject will increase production capacity to cope with increased demand for its products in Japan. It will start to export to Japan, when the investments are completed. There are for the time being no other similar enterprises in South Kalimantan. Sea shrimps used to be shipped to Surabaya, East Java for processing and export before the company started its operations. The firm's profit margin before tax is around 3%.
4	Tangerang, Banten	Garment Industry (brassieres and lingerie) \$12.5 million (2001) to USA and Europe	4.4 15.20 %	General machinery. There is considerable competition in the garment industry. The firm competes with similar firms from People's Republic of China; Hong Kong, China; Republic of Korea; and Mexico. The firm's strategy is to maintain and develop good business relations with its customers, maintain high product quality through intensive quality control measures, and deliver customer orders on time. The company's pretax profit is less than 1%.
5	Banjarmasin, South Kalimantan	Rubber industry Rubber (crump rubber) \$4.3 million (2001), mainly USA and Asia	2.42 41.18 %	Boiler. The owners of this company are affiliated with a similar bigger enterprise in Kalimantan. They have more than 30 years of experience as producers of crump rubber. The demand for crump rubber is stable and slowly increasing, while the export price is fluctuating in line with the world market price. Crump rubber factories in Indonesia are able to adjust their procurement cost of raw materials in line with export price fluctuation. The company's profit margin before tax is in the range 4-5%.
6	Tarakan, East Kalimantan	Wood processing (wood chips and raw material for paper factories) \$1.9 million (2001), mainly to Japan, Republic of Korea, and Philippines	0.025 32.89%	Wood cutters. This is the only producer of wood chips for export in East Kalimantan. The production process is simple and environmentally friendly. The company procures raw materials, i.e., waste wood and acacia trees, from wood processing enterprises and industrial forests firms. The company is not facing special problems related to raw material supply and export. It has established good business relations with its main customers in Japan. Profit margin before tax is 4%.
7	Barito Kuala, South Kalimantan	Wood processing industry (office tables, wood block profiles, wood parquet or floor tiles) and building components \$2.7 million (2001), mainly to USA	0.22 Above 100 %	Precision wood cutters. Logs are supplied by forest concession holders. So far there have been no major problems related to raw material supply. Marketing and sales of products in the local market and in the export markets are stable and steadily increasing. The company has developed good business relations with its main customers. It is very profitable with a gross profit margin before tax of 14%.
8	South Jakarta, DKI	Plastic industry (packaging material, and flexible container bags)	0.51 27.38 %	Mixers and blowers. The company plans to increase its production capacity by 25% with the planned investment in machinery so that monthly production will increase from 60,000 meters to 75,000 meters of plastic sheets. The main product, flexible container bags, is used to cover various types of products such as purified thalic acid, soda ash, and other chemical materials. The company

No	Subproject Location	Main Products for Export	DER and FIRR	Subproject Summary and Business Prospects
		\$580,000 (2001), mainly to USA		sells of its production to foreign customers. The demand for container bags is increasing, and the company needs to increase its production capacity to meet orders. The company's profit margin before tax is in the range 4-5%.
9	Karangasan, Bali	Handicraft industry (utensils made of coconut shell, and furniture with mosaic design) \$15,000 (2001) to Japan and Republic of Korea	2.87 Above 100 %	Polishers and wood cutters. There are many of these small-scale handicraft producers on Bali. The company manages to compete and grow due to innovative product design and high product quality. Profit margin before tax is in the range 8-10%.
10	Deli Serdang, North Sumatra	Wood processing (wood flooring, wood profiles, building materials, and parquet tiles) \$211,136 (2001), mainly to Europe and People's Republic of China	1.62 16.29 %	General machinery. There are many similar wood-processing firms on Sumatra. The company is already producing at full capacity, and needs to expand its production capacity to meet customer demand. The firm follows international export standards for its products. It has established strict quality control and product inspection procedures in the factory. It has developed firm and good business relations with its main foreign customers. The firm's pretax profit is around 4%.
11	Semarang, Central Java	Furniture industry (dinner tables and chairs, cupboards, cabinets, and bedroom furniture sets) \$6 million (2001), mainly to USA (53%), Europe (20%), and Asia and the Pacific (the rest)	1.62 16.29%	General machinery. The owner has developed the company into medium-sized modern wood furniture industry since 1978. He has established business linkages with around 200 smaller companies, which are subcontracted to supply semi-finished and finished furniture to the company. The demand for its products has been stable and increasing during the last 3 years. The company procures 30% of its total sales volume from subcontractors. It is facing competition from similar firms in Indonesia, Viet Nam and People's Republic of China. The owner is able to compete by focusing on attractive design combined with artwork carvings. The new investment cost will cover the cost of a combined factory and storage building equipped with new production machinery and equipment imported from Italy; Taipei,China; and Germany.

SUMMARY INITIAL ENVIRONMENT EXAMINATION

A. Introduction

1. The Government of Indonesia, through its Ministry of Environment (MOE), is unable to monitor and control pollution and waste caused by the large number of small and medium enterprises (SMEs) in Indonesia. MOE issues environmental regulations and determines the environmental parameter values for various types of pollutants and industrial waste. Government employees assigned to MOE and the district administration units (Bapedalda) are charged with monitoring all types of business enterprises, including SMEs to see that they comply with the environmental regulations. Government control of pollution caused by small enterprises is very weak. Medium-sized enterprises are more frequently controlled, but there is little real pressure from the Government staff to force SMEs to comply with the environmental regulations and parameters (chemical oxygen demand and biochemical oxygen demand limits). The main pressure forcing SMEs to reduce pollution and waste comes from neighbors and customers of the SMEs. Many SME exporters have undertaken environmentally friendly investments based on demand and recommendations from their foreign customers.

2. The development challenge for Indonesia is to help SMEs improve their environmental performance by reducing pollution, conserving resources, and providing a healthy working environment to enable SMEs to meet environmental management standards for maintaining and/or promoting their exports. Overall, the Project will have a beneficial environmental impact through the replacement of obsolete technology by new, cleaner, and more environment-friendly technology. Not only will cleaner production practices reduce environmental problems but they can help boost access to international markets by small Indonesian exporters who do not always meet international quality standards.

3. Under the proposed Project, the Government and BEI will ensure that all subprojects comply with the applicable government environmental standards, requirements, and ADB's policies, and that appropriate safeguards and mechanisms for compliance are built into each subproject, as necessary. While environmental screening of all proposed investments is necessary, the initial environmental examination or environmental impact assessment will be carried out when warranted.

B. Description of Project and Environment

4. Three main types of environmental investments can be undertaken by SMEs under the small and medium exporters' investment facility (SEIF):

- (i) investments in production facilities aiming at substantial pollution reduction and/or natural resource savings by financing of more efficient and cleaner production equipment/process technologies;
- (ii) investments in machinery and equipment to be used by the SME to recycle, reuse, and recover (3 R) waste materials and waste products; and
- (iii) investment in waste treatment plants and equipment to reduce and neutralize industrial waste and pollution after the production process (end-of-pipe solutions).

5. Bank Ekspor Indonesia (BEI) and the other commercial banks that participate in the SEIF will make use of available technical assistance (TA) from the Asian Development Bank (ADB), Kreditanstalt für Wiederaufbau (KfW), and other agencies during the subproject implementation period to pay attention to the following development issues (paras. 6-9), and potential impacts and mitigation strategies (paras. 10-11).

1. Environmental Standards: A Long-Term Need of SME Exporters

6. Export restrictions for environmental protection are not included under the trade provision in international trading. However, requiring imports to meet the national environment and health safety is clearly permitted under the current multilateral trade rules. Therefore, under these circumstances, it is very likely that emerging environmental labeling programs will affect Indonesia's exports to the countries where the public environmental awareness has reflected on the consumer environmental preference. The adoption of International Organization for Standardization (ISO) 14001 on Environmental Management System in 1996 can facilitate parity and mutual recognition among ISO members including Indonesia. The certification procedure for either ISO 14001 or another ecolabeling scheme requires the assessment of the whole life cycle of products. For example, in wood products (e.g., pulp and paper, furniture), sound management of the sources of the wood has become an important factor for certification. Similarly, for other products such as garments, sound production processes of raw materials have also turned out to be one of the important factors for granting an ecolabel. Therefore, without improving SMEs' production processes, SME exporters will have difficulties in expanding or maintaining their markets. At present, only 35 of 600 furniture exporters that belong to the Association of Furniture and Handicraft Producers have received the chain of custody certificate required by buyers of furniture and wood products from European countries and the United States.

2. Adoption of Cleaner Production by SMEs: Need for Government Action

7. As large industries struggle to survive the economic crisis, SMEs continue to play an important role in the country's economy. Increasing production of SMEs in manufacturing may result in significant environmental costs. Although the problems have been regularly reported in local newspapers, there is no systematic monitoring of environmental problems, and of the health and safety of SME activities. The Ministry of Industry and Trade (MOIT) reports that pollution associated with SME activities, particularly in the manufacturing sector, has created serious environmental problems. In Klaten, Central Java, where SME activities involving electroplating are concentrated, groundwater is no longer fit for domestic consumption due to its high level of chemical contamination. In Sidoarjo, East Java, MOIT reports that workers in SMEs and the population near the SMEs' areas of activities are beginning to suffer from serious skin and respiratory problems caused by industrial pollution.

8. The Government's current policies to address environmental management concerns associated with industrial activity have not been designed in favor of SMEs' activities. For example, in dealing with pollution, the current policy focuses on end-of-pipe treatment based on a set of effluent standards. The industries are required to treat their wastes before discharging them into the environment. However, waste treatment should not be the end, but only the beginning of another process outside production. For instance, wastewater treatment to meet effluent standards may generate harmful sludge that needs to be burned or buried and that as a result causes soil contamination or air pollution. In addition, waste treatment through individual or common treatment facilities requires significant financial resources. Therefore, the current end-of-pipe treatment policy is not practical for SMEs in reducing pollution.

9. In finding a win-win solution to deal with environmental problems, including pollution from SMEs' activities, cleaner production (CP) is a more promising approach, supported by the investment facility under the Small and Medium Enterprise Export Development Project (SMEEDP). In general, the adoption of CP involves improving housekeeping, substituting harmful chemicals used in the process with less harmful or biodegradable substances, and modifying the process for effective use of raw materials and reducing byproducts including waste. Therefore, the

adoption of CP in SMEs' activities will help them to increase their productivity, at the same time reducing environmental problems associated with their activities and providing a hygienic working environment. The adoption of CP practices is not new in Indonesia; however, only few SMEs have adopted CP practices that have proven compatible with their needs. It can directly identify where intervention is necessary to improve SMEs' productivity and avoid environmental problems.

C. Potential Environment Impacts and Mitigation

1. Additional External Assistance for SMEs and Environment: CP Financing

10. The SEIF could cooperate with additional external financing for cleaner production technologies. The German Government, through KfW, is considering a second environmental credit program (IEPC) for Indonesian SMEs. KfW may provide a grant to finance a TA unit for this credit program to work closely with the proposed Technical Assistance Monitoring Unit (TAMU). The soft loan will be channeled as rupiah-denominated subloans to SMEs by selected participating banks. It is proposed to KfW that BEI and the Ministry of Finance (MOF) implement this credit program in line with tasks and responsibilities of each party similar to what is envisaged under the proposed SMEEDP. An eligible SME could apply for subloans from both the SEIF under the SMEEDP and KfW's IEPC.

2. Institutional Monitoring: TAMU and Other External Assistance

11. ADB has TAs focused on improving SME productivity, such as the ongoing TA for Business Development Services (TA-3829), and which will coordinate with TAMU under the proposed SMEEDP (see terms of reference for TAMU in Appendix 4). It is expected that the implementation of the TA on CP by ADB will also assist the Government in addressing environmental problems associated with SME development through CP strategy and practices.¹ The latter TA will develop models on the adoption of CP practices for selected types of SMEs products; disseminate the tested models among relevant SME associations, and develop links with other information and training centers; and improve SMEs' access to environmental certification agencies. Also, it is expected that the environmental TA by ADB will support efforts by other international agencies, working to improve standards of SME production. These include (i) Swisscontact for improving electroplating techniques in SMEs; (ii) Japan International Cooperation Agency, for improving the design and quality of SME products, particularly wood, rattan, brick, tofu, and fermented soybean; (iii) Government of Italy, for improving quality and design of leather, rubber, and plastic products; (iv) Government of Norway, for handling wastewater from leather production; and (v) World Bank through its Western Java and Jakarta Environmental Management Program, for handling wastes from textile and batik productions, and training to introduce CP.

D. Findings and Recommendations

12. Part of the negative impact comes from the activity of SMEs in the electroplating and casting industries, which are highly polluting, as their wastes are categorized as hazardous and toxic. The implementation of CP techniques (e.g., improving housekeeping, and recycling and reusing chemicals) in electroplating and casting will help to demonstrate waste reduction, and benefits to other SMEs in adopting CP. However, based on the analysis of the sector (Appendix 8), exports from industries with extensive use of electroplating and with many SMEs are not the norm. Metal exports with high SME presence are copper and tin products, and silver, gold and jewelry. In

¹ ADB. 2002. *Technical Assistance to Indonesia for Improving the Environmental Performance of Small and Medium Enterprises by Promoting Cleaner Production*. Manila.

2000, both activities represented 3.4% of all Indonesian exports, but only a fraction of them came from SMEs (Table 1, Appendix 8). Therefore, few of these are SME exporters that may be prospective applicants to the SEIF under the proposed SMEEDP. Prospective SEIF subprojects need to pay attention to their potential environmental impact and concerns.

1. Potential Environmental Impact of Subprojects

13. A closer examination of the potential investments in subprojects in Appendix 7 (Indicative Pipeline) shows that there are no SMEs exporting metal products (or products with substantial electroplating content). Most subprojects involve investments in newer and cleaner technologies available for fish processing (such as cold storage units) and furniture making (such as wood driers). For example, one SME in the crispy fish chip industry produces about 6 TM/month and employs four workers, the adoption of CP, together with new equipment, as proposed under the credit, would increase a total saving of about \$1500 with an additional investment in CP techniques of about \$1000. This saving would result from improving the cutting and steaming process as well as reducing wasted raw materials. The benefits of using a newer cutter and steamer would be much larger. Another example comes from export-oriented batik garments. One SME produces 130,000 pieces per year and employs 30 daily workers; the adoption of CP techniques through improving of its housekeeping, particularly in washing and dyeing processes, would result in savings of about \$8,000 per year due to reduced water and chemical consumption as well as fewer rejected products. Investment in new washers and driers will reinforce these benefits.

14. Despite these good examples, there is a whole range of environmental issues that need to be observed and addressed during the operational period after the investments are completed. Some of the issues are linked to cleaner production, i.e. water and energy savings, better housekeeping, effective use of raw materials with less waste, substitution of harmful chemicals with less harmful or biodegradable substances, etc. Other issues are related to reuse, recycling, and recovery of waste products and chemicals used in the production process and finally waste treatment in waste treatment plants, incinerators and dumpsites. SME owners need to be trained and informed on environmental management and production. TAMU will cooperate with environmental experts and environmental agencies to promote environmentally friendly production processes and compliance by the SME sub-borrowers with environmental regulations and production standards.

2. Potential Environmental Concerns of Construction and Location

15. Construction work tend to disturb the environment when the SME sites are in the middle of other types of buildings and human activities. as is often the case in Indonesia. Planned construction work is relatively "light" for most of the SMEs that were contacted during the survey. There is very little if no need to use explosives or other dangerous work procedures during site preparation and construction work for the planned buildings and infrastructure facilities. Use of heavy construction equipment is also very limited for most of the planned investments.

16. Most SEIF subloans will be granted to existing SMEs, which plan to expand their production capacity. Such SMEs are located on suitable or less suitable sites, and the enterprises are not planning to relocate their production and business operations. Poor or insufficient infrastructure (road conditions, water and electricity supply) is a common problem faced by SMEs in Indonesia. Rapid urban development combined with poor town planning has caused big problems for many SMEs, which started their operations several years ago on sites "far" from other buildings in open land. During relative short periods their locations have changed and they become "middle of the town locations" close to housing estates, schools, and marketplaces. Banks and SME owners are aware of the poor infrastructure and urban development problems, but they can do very little on

their own to solve these problems. The SMEs will gradually be forced to undertake environmental investments forced upon them by the environment with municipal authorities as their partners. Several of the SMEs surveyed are located in industrial estates equipped with wastewater treatment plants. The estate operator has contracted firms that collect the solid waste from each of the tenants regularly.

E. Conclusions

17. Negative pollution impact of subprojects under the SMEEDP is unlikely, given the size of subprojects and the type of industrial activities. A positive impact of the subprojects should be emphasized, since the SMEEDP encourages the adoption of CP technologies. The Project will also benefit from external assistance to foster the use of CP. The proposed SMEEDP would have, at worst, a neutral net impact upon the environment. Based on this initial examination, it is recommended to adopt Category B for the above project.

18. Under the SMEEDP, TAMU will ensure that all subprojects observe ADB's and the Government's necessary environmental safeguards. It will also require close monitoring of subprojects in high-risk industries (electroplating and tanneries) or areas. The monitoring will be done on a case-by-case basis. TAMU will discuss the environmental issues with management staff of BEI and the participating banks (PBs) and issue recommendations regarding environmental matters that need to be observed by the lenders and the sub-borrowers in cooperation with environmental experts and MoE staff. TAMU, in coordination with other external assistance, will promote CP.