



Report and Recommendation of the President to the Board of Directors

Project Number: 43009
April 2009

Proposed Loan
Republic of Indonesia: Public Expenditure Support
Facility Program

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 15 April 2009)

Currency Unit	–	rupiah (Rp)
Rp1.00	=	\$10,900.00
\$1.00	=	Rp0.000092

ABBREVIATIONS

ADB	–	Asian Development Bank
BAPPEDA	–	Badan Perencanaan Pembangunan Daerah (Sub-National Development Planning Agency)
BAPPENAS	–	Badan Perencanaan Pembangunan Nasional (National Development and Planning Agency)
BOS	–	Operational Aid to Schools Program
BPK	–	Supreme Audit Agency
BPKP	–	Badan Pengawasan Keuangan dan Pembangunan (State Development Audit Agency)
BPS	–	Central Bureau of Statistics
CMEA	–	Coordinating Ministry for Economic Affairs
CMSW	–	Coordinating Ministry for Social Welfare
DG	–	Director General
DIPA	–	Budget Activity Lists
DPL	–	Development Policy Loan
DPR	–	House of Representatives
DPSP	–	Development Policy Support Program
EITI	–	Extractive Industries Transparency Initiative
FSAP	–	financial sector assessment program
GDP	–	gross domestic product
GFSM	–	Government Finance Statistics Manual
IMF	–	International Monetary Fund
KPK	–	Corruption Eradication Commission
LIBOR	–	London interbank offered rate
LKPP	–	National Public Procurement Office
LPS	–	Indonesian Deposit Insurance Agency
MDA	–	Ministry, Department, and Agency
MDG	–	Millennium Development Goal
MenPAN	–	Ministry for State Apparatus Reform
MOF	–	Ministry of Finance
MOT	–	Ministry of Trade
NGO	–	nongovernment organization
NPL	–	nonperforming loan
OECD	–	Organisation for Economic Co-operation and Development
OIS	–	overnight index swap
PESF	–	Public Expenditure Support Facility
PFM	–	Public Finance Management
PNPM	–	National Community Empowerment Program
RKP	–	Government's annual work plan
RPJM	–	Rencana Pembangunan Jangka Menengah (Medium-Term National Development Plan)
Satker	–	budget spending units

SOE	–	state-owned enterprise
Susenas	–	Survey Sosial-Ekonomi Nasional (National Socioeconomic Survey)
TSA	–	treasury single account
UCT	–	unconditional cash transfer

NOTES

- (i) The fiscal year (FY) of the Government and its agencies ends on 31 December. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2009 ends on 31 December 2009.
- (ii) In this report, "\$" refers to US dollars.

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LOAN AND PROGRAM SUMMARY

Borrower	Republic of Indonesia
The Proposal	The proposal includes a loan of \$1,000,000,000 under the Public Expenditure Support Facility Program.
Classification	Targeting Classification: General intervention Sector: Public sector management Subsectors: Economic management and management of public affairs; public expenditure and fiscal management Themes: Economic growth; governance; private sector development Subthemes: Promoting macroeconomic stability; public administration (national and decentralized); private sector investment
Environment Assessment	Category C
The Program Rationale	<p>The global turmoil in financial markets since September 2008 has adversely and significantly affected Indonesia's economy since the fourth quarter (Q4) of 2008 in three ways: (i) balance sheet deleveraging in the United States (US) caused investors to unbundle financial portfolios in Indonesia, leading to some capital flight in October 2008; (ii) the global credit crunch and elevated banking sector risk have made it expensive for Indonesia to access international debt markets, both for the public and private sectors, including accessing trade finance; and (iii) the second round effects of the global financial crash on the real sector have resulted in a severe and broad-based economic recession in several of Indonesia's major trading partners, affecting demand for Indonesian exports and investment inflows. These effects are manifested in a number of forms: (i) the Indonesian stock market declined by 31% during October 2008; (ii) yields on medium-term domestic bonds increased by nearly 400 basis points; (iii) Indonesia's international bond spreads surged by about 650 basis points; (iv) the rupiah exchange rate depreciated by 17% against the US dollar; and (v) exports contracted in February by 33%, the first time in several years.</p> <p>While the direct effect of the global crisis on the banking system in Indonesia has been limited because of lack of direct investment in troubled US assets, liquidity in the banking system has been very tight since September 2008. The yields on Indonesian domestic bonds remained elevated and rose more sharply than elsewhere in Southeast Asia since October 2008. Government finances have been especially vulnerable to spikes in global risk aversion and contagion from external markets because of the country's large gross financing needs and the need for a fiscal stimulus. The term structure of Indonesia's bonds led to sharply higher debt issuances in 2007 and 2008, and amortization is projected to remain at high levels through 2011. During normal market conditions, Indonesia was able to raise more than \$12 billion from domestic and international markets in both 2007 and 2008. However,</p>

tighter global liquidity and higher risk premiums combined with high gross financing needs have raised interest rates on Indonesian debt compared with other economies in the region. With prohibitive yields on rupiah and US dollar bonds, the Government could not access funds from the credit markets in Q4 2008—raising concerns about possible budget financing constraints in 2009. Liquidity in the credit markets has eased since January 2009, allowing the Government to access domestic resources although at a higher cost than under normal conditions.

In January 2009, the Government revised its budget to reflect the deteriorating external environment and the need to provide fiscal stimulus. As a result, Indonesia's 2009 budget deficit has been increased from 1.0% of gross domestic product (GDP) to 2.5%, and gross financing needs from Rp171.4 trillion to Rp270.7 trillion.

In this context, the Government requested the World Bank, Asian Development Bank (ADB), and other development partners to provide a Public Expenditure Support Facility (PESF). The Government has stated that it intends to access the facility only under certain circumstances set out in its financing plan, such as in the event of renewed difficulties in accessing credit markets as occurred in Q4 2008 (i.e., a contingent loan).

Under the PESF Program, the Government will implement a series of confidence-boosting policy measures aimed at sending a strong positive signal to the markets, making it more likely that Indonesia will meet its commercial market borrowing targets for 2009. These policy measures address the increased short-term vulnerabilities and risks to the Indonesian economy from the global financial crisis and sharp slowdown in the global economy, and underpin the key priorities of the Government's reform agenda. These measures include actions to (i) reassure financial markets and maintain financial system stability, (ii) sustain critical public expenditures while maintaining budget discipline to mitigate the poverty impacts of the growth slowdown, and (iii) crowd in private investment and support exports.

The PESF is part of a joint effort of the World Bank, ADB, Government of Australia, and Government of Japan to support a common crisis-mitigating action agenda with the Government, and provide contingent budget financing in the event of further instability in credit markets that may result in a shortfall in budget financing needs. The PESF complements the World Bank's Development Policy Loan and ADB's Development Policy Support Program series, which reflect the Government's commitment to reforms over the medium term.

Under the best case scenario where the Government meets all of its financing targets from market sources, in which global financial conditions do not deteriorate substantially and approval of the PESF sends a strong positive market signal, no withdrawal would be expected under the PESF. Under a second scenario, in which market conditions

remain tight and the drawdown triggers set out in the financing plan are met, the Government may exercise its options to access the PESF funds. Under a third scenario, in which there is a sharp deterioration in global financial markets, creating macroeconomic instability and/or a balance-of-payments crisis, the PESF is unlikely to be effective and Indonesia will need crisis mitigation support.

Impact and Outcome

The PESF will (i) support the Government's efforts to mobilize funds from commercial markets by capitalizing on the expected confidence created by the PESF support package, and (ii) serve as a precautionary measure to provide additional financing to the Government for the larger fiscal stimulus now needed. The policy actions are designed to accomplish the following:

- (i) Reassure financial markets and maintain financial system stability by enhancing the financial safety net; maintain stability of the banking system; and ensure predictability in the Government's financing requirements for 2009 and 2010.
- (ii) Sustain critical public expenditures while maintaining budget discipline to mitigate the poverty impacts of the growth slowdown through strengthening coordination of national poverty reduction efforts; establishing a national poverty monitoring and response system; and increasing critical public expenditures in poverty alleviation, social protection, and infrastructure maintenance and development. This will be done by undertaking actions to speed up budget disbursement, by improving efficiency in budget disbursements, promoting advance procurement, and carrying over unspent cash from the 2008 budget.
- (iii) Crowd in private investment and support exports by revising the implementing decree for the new investment law, improving transparency in revenues from extractive industries, and enhancing access to trade finance.

Financing Plan

A loan of \$1,000,000,000 from ADB's ordinary capital resources will be provided under ADB's London interbank offered rate (LIBOR)-based lending facility for the PESF Program. The loan will have a 15-year term including a grace period of 3 years, an interest rate determined in accordance with ADB's LIBOR-based lending facility, and such other terms and conditions set forth in the draft program loan agreement.

Period and Tranching

The PESF program period will be from 1 September 2008, when the global financial crisis erupted, to 31 December 2010, with a single tranche loan of \$1,000,000,000 to be disbursed in phased withdrawals when the Government has met the policy actions set out in the policy matrix and the drawdown triggers set out in its financing plan.

Counterpart Funds

The Government will use the local currency counterpart funds generated by the loan proceeds to meet program expenditures and

associated costs of reforms, and to help maintain current social expenditure and infrastructure spending.

Executing Agency	Coordinating Ministry for Economic Affairs (CMEA)
Implementation Arrangements	The Ministry of Finance (MOF), Ministry of Trade (MOT), Coordinating Ministry for Social Welfare (CMSW), and National Development and Planning Agency (BAPPENAS) are the Implementing Agencies. CMEA, as the Executing Agency, will be responsible for overall program implementation activities and coordination and reporting to ADB; it will be supported by the Implementing Agencies (MOF, MOT, CMSW, and BAPPENAS). The Government has established a program steering committee to implement the Government's financing plan, chaired by the director general of the Debt Management Office (MOF), and comprising representatives from CMEA, MOF, and BAPPENAS, and representatives of each development partner cofinancing the PESF. The program steering committee will meet in the first week of each quarter to review implementation of the financing plan and determine the Government's financing shortfalls. CMEA will be responsible for day-to-day program implementation activities, and will report on implementation progress.
Procurement and Disbursement	The loan proceeds will be used to finance the full foreign exchange costs (excluding local duties and taxes) of items produced and procured in ADB member countries, excluding ineligible items and imports financed by other bilateral and multilateral sources. The loan proceeds will be disbursed to the Borrower in accordance with the provisions of ADB's <i>Simplification of Disbursement Procedures and Related Requirements for Program Loans</i> .
Program Benefits and Beneficiaries	The PESF will provide significant benefits and have a positive impact on the Government's fiscal situation as it will do the following: <ul style="list-style-type: none"> (i) Allow the Government to mobilize resources from commercial markets by capitalizing on the expected confidence created by the PESF support package by reassuring financial markets and maintaining financial system stability, thereby reducing the Government's cost of borrowing from the market. (ii) Ensure that the Government can meet its financing requirements of its fiscal budget and any additional stimulus required if the economic slowdown is sharper than expected. (iii) Ensure that the Government can maintain its momentum toward achieving its medium-term development objectives while managing the negative impacts of the international credit crunch on Indonesia's access to credit markets and the economic slowdown by (a) reassuring financial markets and maintaining financial system stability, (b) mitigating the poverty impacts of the growth slowdown, (c) sustaining critical public

expenditures while maintaining budget discipline, and (d) crowding in private investment and supporting exports.

Risks and Assumptions

The PESF is firmly embedded in the Government's Medium Term Development Plan 2004–2009 and complements ADB's Development Policy Support Program loan series, cofinanced with the World Bank. The assumptions underlying the PESF include the following:

- (i) Continued strong commitment for reforms supported by World Bank and ADB Development Policy Support Program series.
- (ii) The global economy stabilizes from the financial crisis.

However, the PESF has risks:

- (i) **External vulnerabilities.** The external risks remain high, especially during a period of global financial turmoil and uncertainty and the ongoing international credit crunch, as well as the emerging second round effects of a sharp economic slowdown. Indonesia is a financially open economy and there are significant foreign holdings, especially in the stock market and government bonds. Indonesia continues to be vulnerable to shifts in investor liquidity needs, as deleveraging proceeds in North America and Europe. If significant funds are pulled back because of liquidity demands by investors in these areas and/or increased emerging market risk aversion, this could lead to increased pressure on international reserves and/or exchange rates, as well as on the domestic money market. In addition, the Government has large gross financing needs over the next few years, and tighter credit markets and increased risk aversion could severely limit its ability to tap international financial markets. This could force the Government to cut budgetary outlays to maintain fiscal balance even after full access to the PESF, with adverse consequences for infrastructure and social expenditure. Mitigating these risks will require solid cooperation between the central bank and the economic ministries to reassure bondholders that their investments are safe while enhancing efforts to crowd in private investment to the extent possible through the reforms supported by the PESF.
- (ii) **Sharp economic slowdown.** The Government revised its growth projection from 6.0% to 5.0% in January and again to 4.5% in March 2009 as the economy deteriorated. The growth projections are likely to be revised downward as more evidence emerges of the magnitude of the global economic slowdown over the next several weeks. This would affect revenue collections and require further

revisions to the 2009 budget and financing plan. The PESF provides fiscal flexibility by providing for further fiscal expansion as allowed for in the agreed financing plan.

- (iii) **Fiduciary constraints.** Notwithstanding the improvements under way, there are continuing concerns regarding utilization of public resources. The overall fiduciary assessments undertaken since 2001 (with the *Country Financial Accountability Assessment*) have indicated considerable improvements in the fiduciary environment in Indonesia (Appendix 8). Ongoing programs supported by several development partners provide significant technical assistance support to strengthen fiduciary governance. The PESF inclusion of strengthening budgetary procedures and controls, accompanied by increased transparency in financial management, will significantly enhance transparency.
- (iv) **Legislative and presidential elections in 2009.** The Government remains committed to sustaining its economic reform agenda despite the global economic recession, the international credit crunch, and general elections next year. Unfortunately, elections often reduce the time horizons of politicians, leading them to avoid new policy initiatives in the pre-election period and shifting their focus to populist short-term measures. This could undermine the reform agenda supported by the PESF. Conversely, the prospect of elections could spur political action into ensuring that critical government expenditures and accompanying reforms are undertaken to demonstrate a continued and clear record of accomplishments. The Program guards against reversals in the policy actions by linking scheduled withdrawals of the loan amount to maintaining the program measures and broad objectives intact.

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan for \$1,000,000,000 to the Republic of Indonesia under the Public Expenditure Support Facility Program. The program design and monitoring framework is in Appendix 1.

II. THE MACROECONOMIC CONTEXT

A. The Request for a Public Expenditure Support Facility

2. The proposed Public Expenditure Support Facility (PESF) comes at a critical time for Indonesia and is designed to maintain the momentum of Indonesia's key development efforts at a time of global financial market crisis and most likely the sharpest slowdown in the global economy since World War II. Like many other developing economies, Indonesia has had to cope with the first round effects of the turmoil and crisis of confidence that have disrupted the global financial system in the last 7 months and effectively froze Indonesia's access to commercial debt markets at the end of 2008. Coming into the global crisis, Indonesia's macroeconomic performance was impressive. The economy was expanding at about 6% in the first three quarters of 2008, its highest growth rate since the Asian financial crisis of 1997–1998. The primary budget has been in surplus for the last 3 years and its overall deficit for 2008 is estimated at 0.1% of gross domestic product (GDP) on the back of strong revenue growth and a reduction in fuel subsidies. Indonesia's debt–GDP ratio continuously declined from 55% in 2004 to 35% in 2007, and dropped further to 33% by the end of 2008.

3. The global turmoil in financial markets since September 2008 has adversely and significantly affected Indonesia's financial markets from the fourth quarter (Q4) of 2008 until now in two ways: (i) balance sheet deleveraging in the United States (US) caused investors to unbundle financial portfolios in Indonesia, leading to some capital flight; and (ii) the global credit crunch has made it expensive for both Indonesia's public and private sector to access international debt markets. Indonesia is preparing for the second round effects of a sharp slowdown in global economic growth on its economy and potentially continued tight liquidity in 2009. The economies of Indonesia's major trading partners have entered recession. Global trade contracted in Q4 2008, the first time since 1982. Indonesia's export growth is expected to be negative in the first half of 2009 because of the fall in global demand and commodity prices. In addition, the global credit crisis has resulted in US dollar shortages that have affected the cost of trade financing and investment flows. There is now a consensus in the international community that countries should operate counter-cyclical fiscal and monetary policies to mitigate the worst effects of the financial crisis on the real economy. With lessons learned from the 1998 financial crisis, the Government has revised the 2009 budget to include a fiscal stimulus package of Rp73.2 trillion (\$6.8 billion, 1.3% of GDP). As a result of these budget changes, the 2009 budget deficit has been revised from 1.0% of GDP to 2.5%, and its gross financing requirements from Rp170.5 trillion to Rp271.4 trillion. The Government recognizes that additional fiscal stimulus may be necessary if the domestic economy slows further in the coming months.

4. In the context of the first round effects, the Government asked the World Bank in September 2008 to provide a PESF of \$2 billion and to facilitate financing of an additional \$3 billion–\$4 billion from other development partners. The Government has stated it intends to exercise this financing only under certain circumstances set out in its financing plan, such as difficulties in accessing credit markets (para. 8). The World Bank agreed, and shortly after September 2008 the Asian Development Bank (ADB), Government of Australia, and

Government of Japan agreed to join the PESF. The request for financing stemmed from concerns about Indonesia's ability to meet its gross financing needs—which will be high in the next 2 years because of the maturity structure and servicing costs of its existing debt—if the current global liquidity crisis does not ease significantly over the next 6–12 months. The Government is also concerned about ensuring predictability in its budget financing, given the necessity for a fiscal stimulus. Therefore, the PESF serves two purposes: (i) to encourage the Government to first mobilize resources from commercial markets by capitalizing on the expected confidence created by the PESF support; and (ii) to serve as a precautionary measure to provide additional financing to the Government for its larger fiscal stimulus in the event it can not be fully funded from market financing. The Government believes that the announcement of a support package, backed up by a program of confidence-boosting policy measures, would send a strong positive signal to the markets, making it more likely that Indonesia would meet its commercial market borrowing targets for 2009.

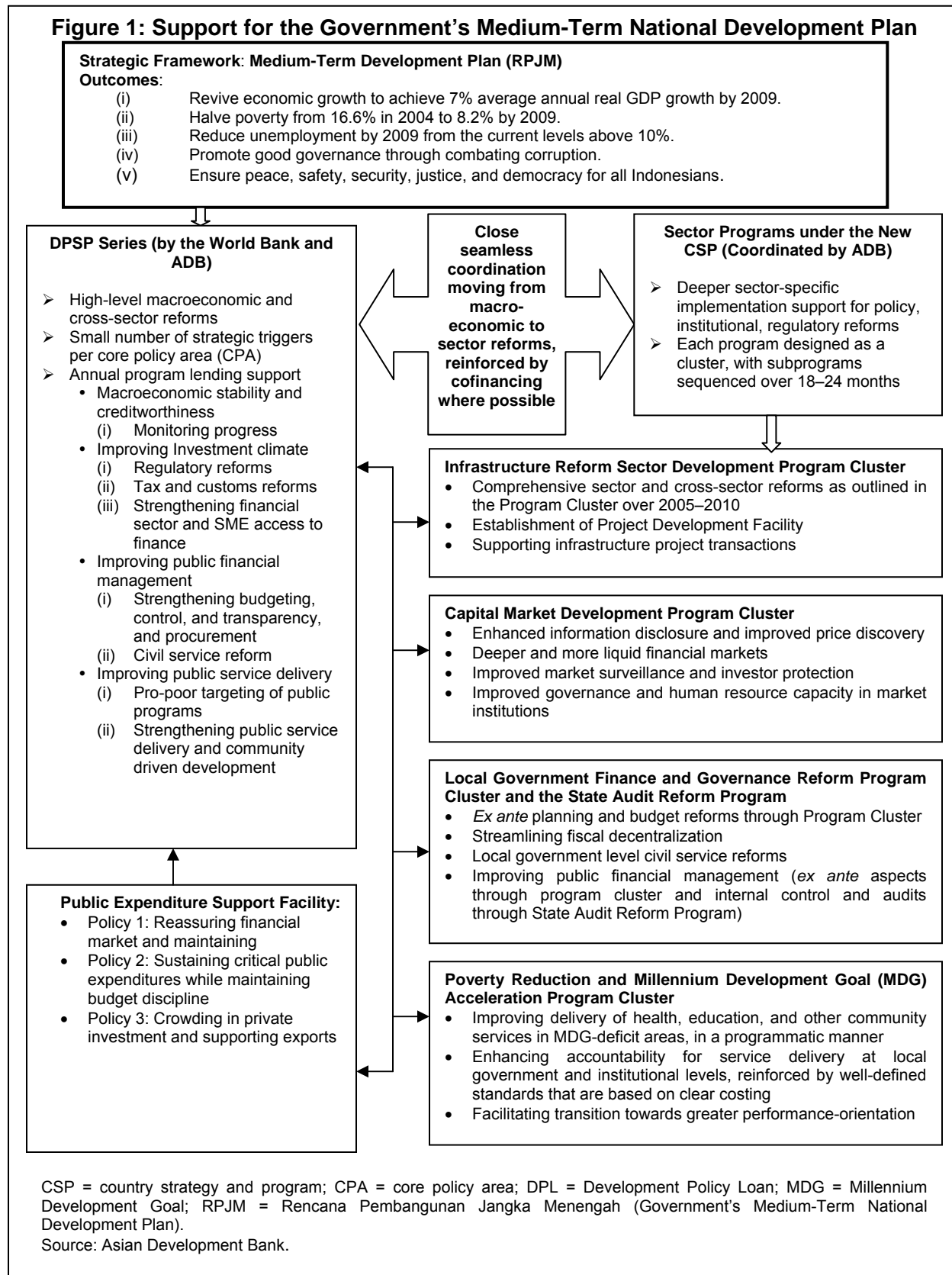
B. The Government and Its Development Strategy

5. The PESF supports the Government's development agenda as articulated in its Medium-Term National Development Plan 2004–2009 (RPJM). The RPJM includes the eight medium-term development goals that provide an overarching framework, placing human development and poverty reduction at the center of the development agenda. The Government's annual work plan (RKP), approved each year by the Cabinet, guides RPJM implementation. The RKP for 2009 importantly revises the poverty target to 12%–14% from 15.4% in March 2008, given the intractable nature of poverty and the slow progress in defeating poverty until more inclusive growth had been developed during the last several years. As a consequence, the RKP for 2009 continues with the following three priority areas: (i) providing basic services and alleviating poverty by developing rural areas, focusing on education services, health and family planning, and rural infrastructure; (ii) accelerating and improving the quality of growth through enhanced economic stability and resilience supported by the development of agriculture, infrastructure, and energy sectors; and (iii) enhancing anticorruption measures, including through bureaucracy reform. Of these, the focus areas on poverty alleviation, education services, economic growth, and economic stability relate to the core policy areas of the Development Policy Support Program¹ (DPSP) series; ADB's Infrastructure Reform Sector Development Program² addresses the focus area on infrastructure development. These interrelated programs in support of the RPJM are shown in Figure 1. The purpose of the proposed PESF is to preserve this development momentum as Indonesia encounters and manages the fiscal externalities of the international credit crunch.

¹ ADB. 2008. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Indonesia for the Fourth Development Policy Support Program*. Manila (Loan 2488).

² ADB. 2008. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Indonesia for the Infrastructure Reform Sector Development Program (Subprogram 2)*. Manila (Loan 2475).

Figure 1: Support for the Government's Medium-Term National Development Plan



6. The PESF complements ADB's existing loan programs to Indonesia, in particular the DPSP-4, which was approved by the ADB Board of Directors on 29 November 2008. The DPSP series aims to advance Indonesia's longer-term institutional reform agenda and focuses on the many important but often incremental steps that need to be taken to realize this long-term agenda (Appendix 8), whereas the PESF Program implements measures that deal with the current situation. The PESF focuses on a subset of the policy areas covered under the DPSP plus some additional ones (financial sector stability, macroeconomic stability, and trade finance). These are areas in which further policy action is important as part of a proactive response to the adverse current situation and likely future stresses, e.g., the need to take proactive steps to maintain critical public expenditures and reassure investors given the current situation and the potential severity of the expected growth slowdown in 2009.

C. The Government and its Development Partners

7. The PESF, structured as a single tranche loan with scheduled and multiple withdrawals contingent on certain conditions set out under the Government's financing plan being met during the program period, aims to help the Government continue to maintain its MDGs of higher economic growth, lower unemployment, and reduction of poverty as articulated in its RKP—at a critical time of global financial market failure and recession, as highlighted in its development policy letter (Appendix 2). To achieve the program goals, the PESF does the following: (i) it implements a series of policy measures designed to boost market confidence in Indonesia's financial sector, improve budget efficiency, and mitigate the increased risks and vulnerabilities to the domestic economy—to allow the Government to mobilize resources from commercial markets by capitalizing on the expected confidence created by the PESF support package; and (ii) with consensus from development partners, the Program supports the Government's larger fiscal stimulus.

8. **Contingent Program Approach.** Key features of the PESF include (i) a single tranche loan with scheduled and multiple withdrawals; (ii) a small number of high-impact policy measures designed to address the adverse impacts of the ongoing financial crisis completed prior to consideration by the Board; (iii) a financing plan for the Government's projected gross financing needs for 2009, including projected commercial borrowings in the domestic and international markets; and (iv) withdrawals of the loan amount to be made when the drawdown triggers set in the Government's financing plan are met (paras. 40–42) and the policy measures introduced under the Program continue to remain in place. In this way, the PESF Program mirrors features of the World Bank's PESF parallel cofinancing loan of a development policy loan with a deferred drawdown option whereby subsequent withdrawals of the single tranche loan are contingent on the drawdown triggers set out in the financing plan being met. Under the best case scenario where the Government meets all of its financing targets from market sources, in which the global financial conditions do not deteriorate substantially and approval of the PESF sends a strong positive market signal, no withdrawal would be expected under the PESF. Under a second scenario, in which the market condition remains tight and the drawdown triggers set out in the financing plan are met, the Government can exercise its options to access the PESF funds. Under a third scenario, in which there is a sharp deterioration in the global financial market creating macroeconomic instability and/or a balance-of-payments crisis, the PESF is unlikely to be effective and Indonesia will need crisis mitigation support.

9. **Government and Development Partner Coordination.** The PESF loan is a joint effort of the Government and development partners to support a common policy agenda and broad financing plan. The PESF reflects a proactive policy response by the Government to mitigate

the increased vulnerabilities and risks to the Indonesian financial sector and domestic economy from the recent global turmoil in financial markets, as well as development partners' commitment to provide Indonesia with fiscal resources to support program implementation including the financing plan. The PESF also reflects the Government's commitment to its longer-term reform agenda, both within and outside the World Bank's DPL series and ADB's cofinanced DPSP series, by helping to accelerate necessary reforms under the DPL/DPSP reform agenda. The Government's financing plan includes three lending modalities to address different dimensions of the financial crisis on the Indonesian economy, while supporting a common set of objectives of the PESF as a contingent program. The modalities include (i) a noncontingent program loan, (ii) a loan facility contingent on shortfalls in budget financing and when the drawdown triggers set in the financing plan are met, and (iii) guarantees of Government of Indonesia sovereign debt. Option (ii) aims to address financing shortfalls arising from difficulties in accessing international and domestic credit markets. Option (iii) is designed to enhance the Government's access to international bond markets, lower its interest costs, and diversify its funding sources. The development partners are providing a mix of options (ii) and (iii). The World Bank approved its contingent loan of \$2.0 billion on 3 March 2009, the Government of Japan has approved \$1.5 billion in a combination of loan guarantees and contingent loans, ADB has proposed to provide a contingent loan of \$1.0 billion, and the Government of Australia has committed to a contingent loan of \$1.0 billion to the PESF (and is currently in the process of completing the legal requirement of its lending modality).

10. The PESF Program has a number of important features. First, it is fully based on the Government's reform agenda and this promotes full ownership. Second, the policy measures specifically address the increased vulnerabilities and risks to the domestic economy emanating from the global financial turmoil based on lessons learned from the 1997–1998 Asian financial crisis. In this way, it is not overloaded with reform measures but rather complements the DPSP/DPL series that focuses on a more comprehensive and longer-term institutional reform agenda. Third, the PESF encourages the Government to first access commercial markets for financing by embedding the Government's financing plan in the PESF Program, including targets for bond issuances. In this way, the PESF would not distort the Government's incentives to source financing from credit markets. At the same time, the PESF recognizes that the Government needs to conduct fiscal stimulus and it may be unrealistic for the Government to finance the entire stimulus through commercial borrowings as this may crowd out Indonesian corporations' commercial borrowings with an adverse impact on investment. Fourth, designed as a single tranche loan with scheduled withdrawals during the program period contingent on meeting the withdrawal triggers set out in the Government's financing plan, it encourages continuous engagement by the development partners during the current adverse economic environment.

III. THE SECTOR

A. Recent Economic Developments and the Impacts of the Global Financial Crisis

11. **Macroeconomic Performance.** Indonesia enjoyed its best macroeconomic performance in 2007 and 2008 (Appendix 4). Up until September 2008, it was able to withstand the negative impacts from the global crisis thanks to prudent macroeconomic policy, a strengthened financial sector, and protective levels of foreign exchange reserves (Table 1). Economic growth accelerated to a 10-year high of 6.3% in 2007. Despite unstable global financial markets and a slowing world economy, Indonesia did not experience a growth slowdown in the first half of 2008 and economic growth remained respectable at 6.1% in Q3 2008. The overall budget deficit was low by international standards at 1.3% of GDP in 2007.

Total tax revenues in the first 10 months of 2008 were about 50% higher than during the equivalent period in 2007 and this increase appears to be broadly based. This, with significant expenditure adjustments to curb subsidies, reduced the budget deficit further to 0.1% of GDP in 2008. With continued fiscal discipline, Indonesia has achieved the most dramatic decline in debt–GDP ratio of any major economy in Southeast Asia. Indonesia's debt–GDP ratio declined significantly from 55% in 2004 to 35% in 2007 and dropped further to 33% by end of 2008. Balance of payments recorded a respectable surplus of 2.4% of GDP in 2007 and remained reasonably robust in the first half of 2008. Indonesia continued to accumulate foreign reserves through the first half of 2008, peaking at \$60 billion in the middle of the year.

Table 1: Key Macroeconomic Indicators for Indonesia, 2003–2008

Item	Fiscal Year					
	2003	2004	2005	2006	2007	2008 ^a
A. Income and Growth						
1. GDP per Capita (\$, current)	1,050	1,188	1,304	1,641	1,925	2,150
2. GDP Growth (% , in constant prices)	4.8	5.0	5.7	5.5	6.3	6.1
a. Agriculture	3.8	2.8	2.7	3.4	3.5	4.8
b. Industry	3.8	3.9	4.7	4.5	4.7	3.7
c. Services	6.4	7.1	7.9	7.4	8.9	8.9
B. Saving and Investment (current and market prices, % of GDP)						
1. Gross Domestic Investment	18.9	21.8	23.6	24.1	24.9	24.8
2. Gross National Saving	22.3	23.0	23.7	26.8	27.4	25.6
C. Money and Inflation (annual % change)						
1. Consumer Price Index (average)	6.8	6.1	10.5	13.1	6.4	10.3
2. Total Liquidity (M2)	8.1	8.1	16.4	14.9	18.9	14.6
D. Government Finance (% of GDP)						
1. Revenue	17.0	17.6	17.9	19.1	17.9	19.8
2. Expenditure and Onlending	18.7	18.6	18.4	20.0	19.2	19.9
3. Overall Fiscal Surplus (Deficit)	(1.7)	(1.0)	(0.5)	(0.9)	(1.3)	(0.1)
E. Balance of Payments						
1. Merchandise Trade Balance (% of GDP)	10.3	7.9	6.1	8.1	7.6	4.5
2. Current Account Balance (% of GDP)	3.5	0.6	0.1	2.9	2.4	0.1
3. Merchandise Export (\$)	8.4	10.4	22.9	19.0	14.0	18.0
(annual % change)						
4. Merchandise Import (\$)	10.9	28.0	37.2	6.3	15.0	36.0
(annual % change)						
F. External Payments Indicators						
1. Gross Official Reserves (in \$ billion)	36.3	36.3	34.7	42.6	56.9	51.6
(in months of imports of goods)	(6.1)	(5.0)	(4.4)	(4.7)	(5.1)	(4.3)
2. External Debt Service (% of exports of goods and services)	32.0	27.1	17.3	24.8	19.4	18.4
3. Total External Debt (% of GDP)	56.9	55.4	46.3	34.8	32.6	32.6
G. Memorandum Items						
1. GDP (current prices, Rp trillion)	2,013.7	2,295.8	2,774.3	3,339.5	3,957.4	4,954.0
2. Exchange Rate (Rp/\$, average)	8,573.4	8,934.6	9,712.0	9,020.0	9,136.2	9,692.0
3. Population (million)	219.9	222.9	226.0	228.9	231.7	238.0

— = not available, () = negative, GDP = gross domestic product.

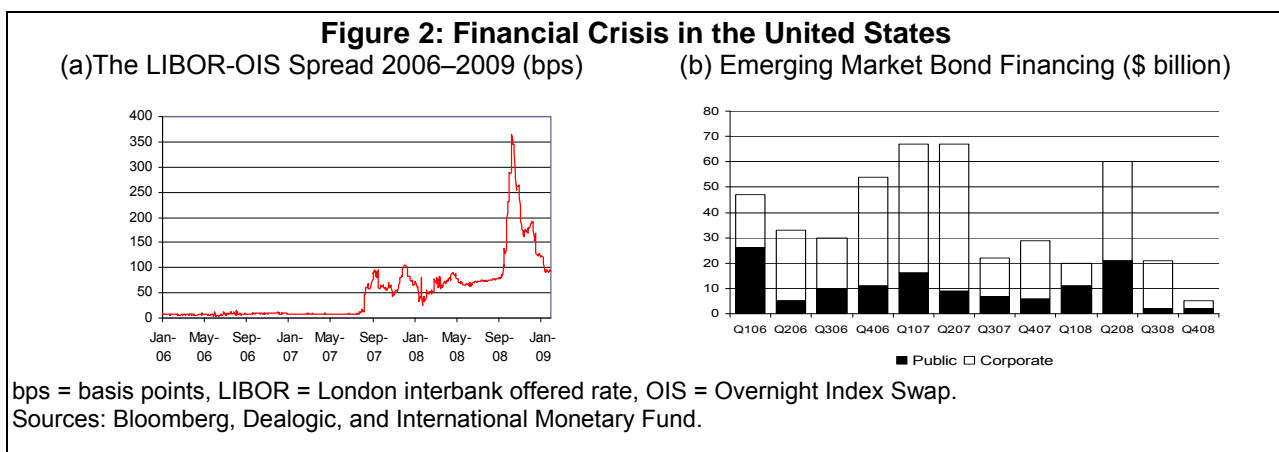
^a Asian Development Bank estimates.

Sources: Bank of Indonesia, Central Bureau of Statistics (CPS), International Monetary Fund, and Asian Development Bank estimates.

12. **Inflation.** After experiencing double-digit inflation in 2005 and 2006, inflation in Indonesia fell to 6.4% in 2007. The unexpected surge in international food and energy prices early in 2008 resulted in higher domestic inflation in 2008. Inflation peaked at 12% in Q3 2008 following the tightening of monetary policy and falling commodity prices as the global economy started to show recessionary conditions. Inflation reached 11% at the end of 2008. ADB staff

forecasts for inflation suggest that it will decelerate in the first semester of 2009 owing to sharply lower commodity prices and falling domestic demand.

13. **Global Financial Crisis.** The turmoil in financial markets intensified in September 2008 following the failure of important financial institutions in the US, which froze interbank and credit markets around the world and pushed the price of risk upward, triggering a global liquidity shortage worldwide. One indicator to illustrate the financial stress is the spread between the 3-month London interbank offered rate (LIBOR) and the 3-month overnight index swap (OIS). While LIBOR measures the market's anticipation of monetary policy, plus a risk premium, the OIS measures what the markets expect the US Federal Reserve funds rate to be over the 3-month period comparable to the 3-month LIBOR. Thus, the spread between LIBOR and the OIS captures risks perceptions in the credit markets and closely tracks the breakdown in key financial markets.³ As shown in Figure 2(a), the LIBOR–OIS spread before July 2007 was stable at around 10 basis points. The start of the subprime mortgage elevated risk perceptions, and the failure of important financial institutions in the US and uncertainty intensified the crisis in September 2008, pushing the spread to over 350 basis points. While the LIBOR–OIS spread has declined significantly, the interbank market remains dysfunctional. Much of the liquidity supplied by the central bank to commercial banks now ends up back in the central banks, reflecting continuing worries about counterparty concerns and uncertainty surrounding the amount needed to fund future assets.⁴



14. The drying up of liquidity, continued deleveraging, and heightened risk aversion have deepened the withdrawal of capital from developing member countries and caused the cost of capital to rise. As shown in Figure 2(b), lending to emerging markets has dropped sharply. Emerging bond markets were virtually shut down for a period in Q4 2008. Corporations are expected to tap banks for shorter-term loans, raising rollover risks further. Capital markets remained reluctant to lend because of potentially large rollover risks and the challenges the corporations face ahead resulting from the economic slowdown. The Institute of International Finance estimated that net private capital flow to emerging economies declined to \$467 billion in 2008—about half of the 2007 level—and forecasts a sharp decline to \$165 billion for 2009.⁵ The

³ The LIBOR-OIS measure is clearly tracked by the other measures of liquidity and credit risk, all of which indicate a similar pattern and timing in the resulting breakdown of financial markets. See International Monetary Fund. 2009. *World Economic Outlook, chapter 4. How Linkages Fuel the Fire: The Transmission of Financial Stress from Advanced to Emerging Economies*. Washington, D.C. (April).

⁴ International Monetary Fund. 2009. *Global Financial Stability Report Market Update*. Washington, D.C. (January). Available: <http://www.imf.org/external/pubs/ft/fmu/eng/2009/01/index.htm>.

⁵ Institute of International Finance. 2009. *Capital Flow to Emerging Market Economies*. Washington, D.C. (January).

breakdown in financial markets has hit investment and production, pushed the world's major economies into recession, and reduced international trade with knock-on effects on developing member countries.

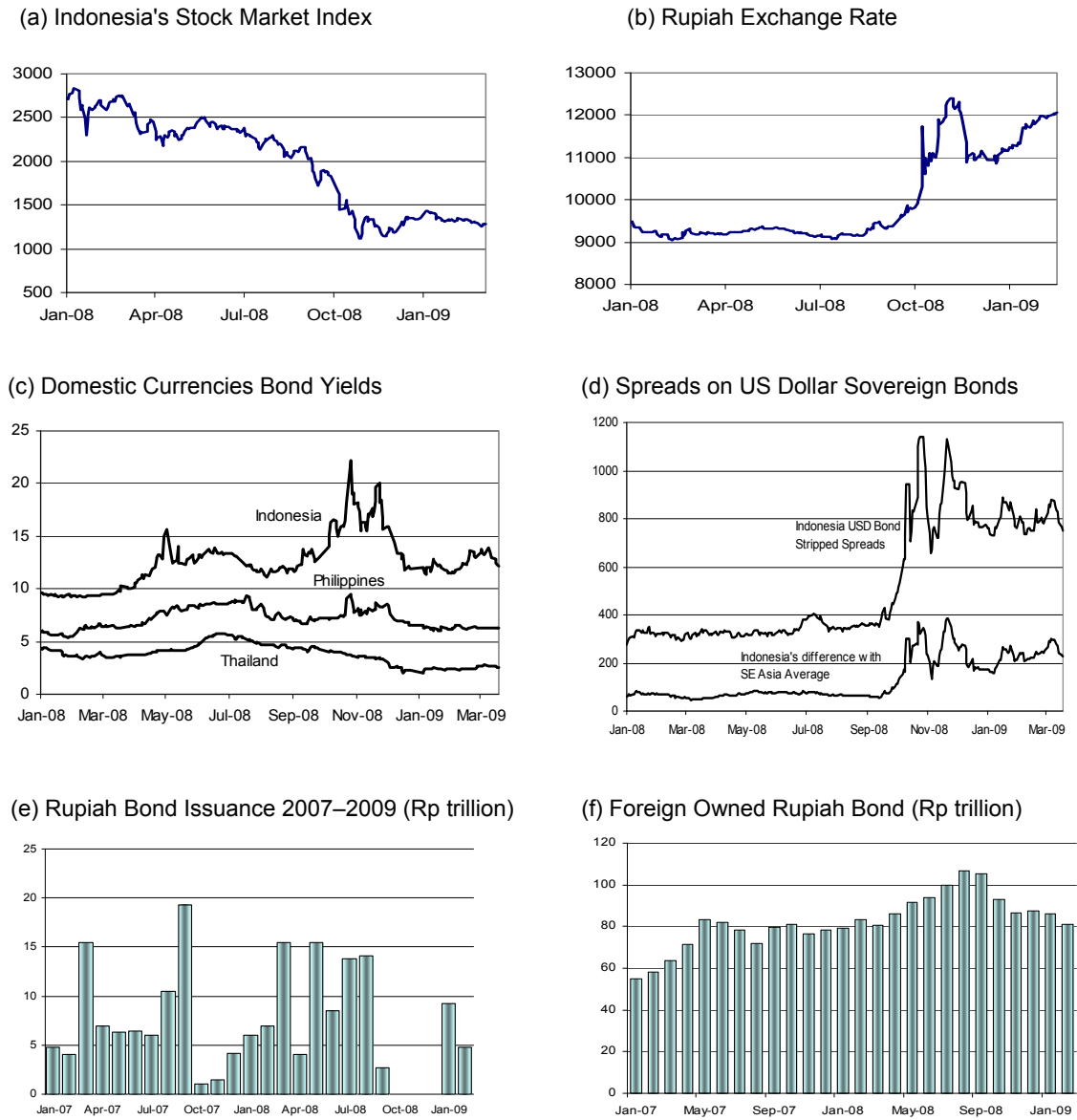
15. **Financial Sector Repercussions.** Large and negative impacts on the Indonesian economy emerged in October 2008 resulting from Indonesia's relatively open capital account and significant foreign ownership of the country's bond and stock markets (Figure 3). These impacts were manifested in a number of forms: (i) the stock market declined by 31% during October 2008, (ii) yields on medium-term domestic bonds increased by nearly 400 basis points, (iii) Indonesia's international bond spreads surged by about 650 basis points, and (iv) the rupiah depreciated by 17% against the US dollar. In addition, the Government lost almost \$7 billion of its international reserves during the same month—falling to \$50.6 billion at end of October. The direct effect of the global crisis on Indonesia's banking system has been minor because of lack of direct investment in the troubled US assets. However, the indirect impacts on the Indonesian financial sector have been significant. Two major impacts are as follows: (i) liquidity in the banking system has been very tight since September because of a rapid increase in domestic lending of about 30%, in part attributable to the squeeze on US dollar lines, and capital outflow; and (ii) elevated risk perceptions about the Indonesian financial sector and economy have limited Indonesia's access to international credit markets and raised the cost of borrowing. Indonesia has experienced portfolio outflows, reflecting the deteriorating financial positions abroad. By the end of December 2008, the Indonesian stock exchange had fallen by over 50% since the start of the year, typical of other markets in the region. Government debt markets have been hit especially hard by the widening global crisis, with yields on both rupiah and US dollar bonds rising sharply (Figure 3). The yields on Indonesian domestic bonds remained elevated and rose more sharply than elsewhere in the region in September and October 2008. The yields recovered somewhat in November as sales by foreign bondholders slowed, but the market remains fragile and bond yields remain more than one-third above their levels in July 2008.

16. **Fiscal Impact.** Government finances have been especially vulnerable to spikes in global risk aversion and contagion from external markets because of the country's large gross financing needs and the need for a fiscal stimulus. The term structure of Indonesia's bonds led to sharply higher debt issuances in 2007 and 2008, and amortization is projected to remain at high levels through 2011. During normal market conditions, Indonesia was able to raise a sufficient amount of more than \$12 billion from domestic and international markets in both 2007 and 2008 (Table 2-page 10). However, tighter global liquidity and higher risk premiums combined with high gross financing needs has raised interest rates on Indonesian debt compared with other economies in the region. With prohibitive yields on domestic and US dollar bonds, the Government could not access funds from the credit markets in Q4 2008, raising concerns about possible budget financing constraints in 2009 (Figure 3 [e]).

17. **Government's Policy Response.** The Government has taken a number of proactive measures aimed at reducing the likelihood of further disruption, and maintaining the confidence and stability of the financial system. Key measures include the following: (i) establishment of a financial safety net regulation that clearly establishes the roles, responsibilities, and procedures that govern the actions and responses of Bank Indonesia, the minister of finance, and the Deposit Insurance Corporation in the event of the failure of a financial institution; (ii) the central bank strengthened its lender of last resort facility; (iii) increased coverage of the deposit insurance scheme; and (iv) the central bank eased liquidity in the banking sector through monetary expansion (paras. 37–38). With these measures in place, some indicators have shown signs of improvement, although it is still too early to be certain that this will be sustained. The stock market and the rupiah have stabilized since November 2008 and the international

reserves position has remained sufficient at around \$55 billion at the end of March 2009. Inflation declined to 7.9% in March 2009 and is expected to decline further in the first half of 2009. While significant amounts of external capital have already been withdrawn from the country's financial markets, Indonesia remains vulnerable to further foreign capital outflows and domestic capital flight.

Figure 3: Impacts of Global Financial Crisis in Indonesia



Sources: Ministry of Finance, World Bank, JP. Morgan, and CEIC Data Company Ltd.

Table 2: Government of Indonesia Financing 2009
(\$ billion)

Item	Year			
	2007	2008	2009	2009
	Audited	Actual	Budget	Rev. Budget
A. Overall budget deficit	5.45	0.34	5.46	12.02
Primary budget deficit	(3.28)	(8.80)	(5.35)	2.63
Interest payments	8.73	9.14	10.81	10.06
Securities	5.92	6.18	7.38	6.37
Foreign loans	2.81	2.96	3.44	3.69
B. Amortization	12.87	10.68	11.33	10.64
Securities	6.53	4.16	4.78	4.08
Foreign loans	6.34	6.52	6.55	6.55
C. Other	0.22	0.26	1.45	1.28
Gross Financing Need (A+B+C)	18.54	11.28	18.24	24.61
D. Domestic and commercial	14.01	12.12	12.70	15.32
Banking and other sources	1.22	(0.91)	2.10	6.26
Securities	12.79	13.03	10.60	9.06
Rupiah bonds	11.30	8.97	8.60	7.06
US dollar bonds	1.49	4.06	2.00	2.00
E. Official foreign financing	3.73	4.59	5.54	5.24
Program loans	2.15	3.05	2.80	2.90
Project loans	1.58	1.53	2.75	2.34
F. Additional Financing	—	—	—	4.05
Gross Financing Plan (D+E+F)	17.74	16.71	18.24	24.61
Surplus/(Deficit) Financing	(0.81)	5.43	0.00	0.00
Memorandum items:				
Exchange rate: rupiah per US dollar	9,140	9,692	9,400	11,000
Nominal GDP (Rp trillion)	3957.40	5049.00	5327.50	5,487.83

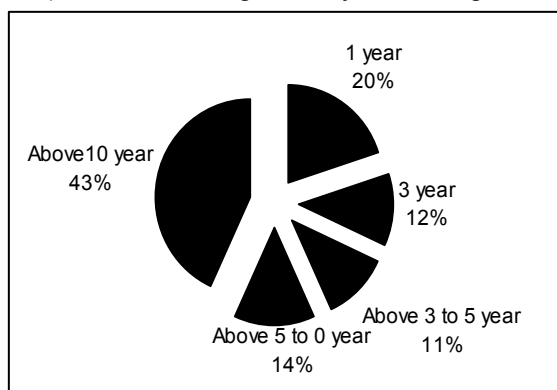
() = negative, — = data not available, GDP = gross domestic product.

Source: Ministry of Finance.

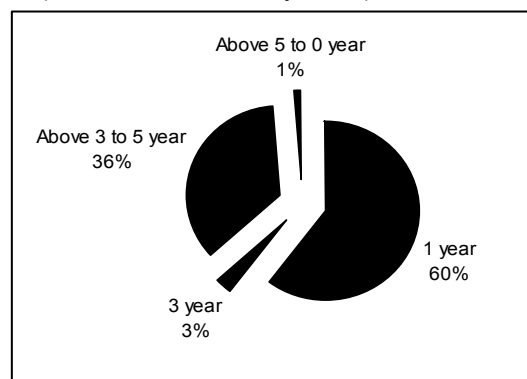
18. **Liquidity.** Domestic market liquidity has started to ease since January 2009. After a lull of 3 months, the Government reentered the domestic market for selling government bonds. It successfully raised about Rp9.2 trillion in bonds in January and again Rp4.8 trillion in February. It also reentered international credit markets and raised \$2 billion in 10-year bonds and \$1 billion in 5-year bonds in February 2009. While recent developments are encouraging, the Government projects that market conditions will be more difficult for the rest of the year. In addition, the maturities structure of the recent domestic issuance was skewed toward 1-year bonds, indicating that elevated risk and tight liquidity in the domestic financial sector remains. As Figure 4 shows, prior to the global crisis bonds with maturity above 3 years accounted for 80% of the total volume of bond issuances. In January 2009, the structure was reversed with 1-year bonds accounting for 60% and maturity above 3 years accounting for 20% of total issuances. This will elevate rollover risk and budget financing pressures over the next 2 years. The issuance of international bonds was also at relatively high cost, with yields more than 800 basis points above comparable US treasury bills.

Figure 4: Government Bond Issuance by Tenor

(a) Pre-Global Crisis
(issuances during January 2007–August 2008)



(b) Global Crisis
(issuances in January 2009)



Note: The Government issues rupiah-denominated bonds with the following maturities: 1 year, 2 years, 3 years, 5 years, 7 years, 10 years, 15 years, and 30 years.

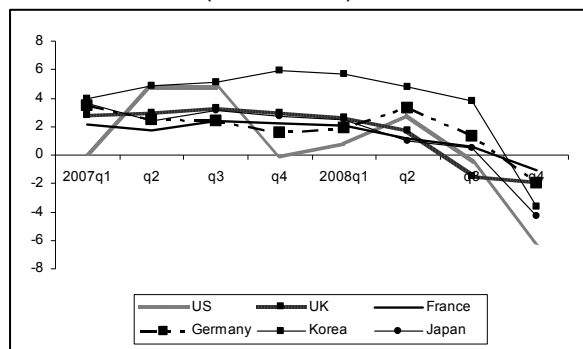
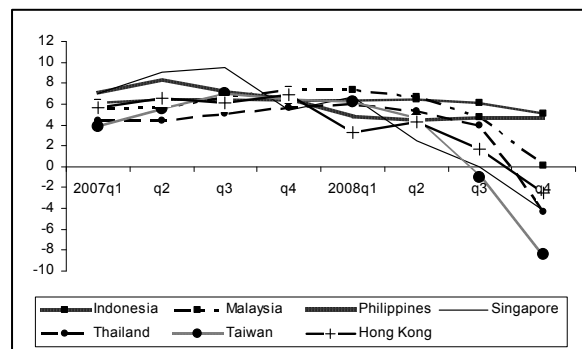
Source: Ministry of Finance.

B. Issues and Opportunities

19. **The Second Round Effects of the Global Crisis.** The condition of the global economy deteriorated markedly in Q4 2008, with economic indicators in all major developed economies pointing toward a severe downward and broad-based real-economy adjustment. New economic data on the global economy released in March 2009 point to a much deeper and most likely protracted recession in several of Indonesia's major trading partners not seen since after World War II. The economies of the US, United Kingdom (UK), and Japan contracted in Q3 and Q4 2008 (Figure 5), with the US economy contracting by 6.3% in Q4 2008 on a year-on-year basis. The Republic of Korea's economy contracted by 3.6% in Q4 2008. Singapore's economy, a bell-weather for the Southeast Asia exports industry, contracted by 4.2% in Q4 2008 on a year-on-year basis; and its government projects that GDP will contract 6%–9% in 2009.⁶ Global trade is projected to contract in 2009 for the first time in 27 years. The International Monetary Fund (IMF)⁷ again revised its forecasts in January 2009 and suggested that global growth would fall to 0.5% in 2009 from 3.8% in 2008. Against uncertainties in the financial markets, activities in the advanced economies are expected to contract by 2%. Economic growth in emerging and developing economies is also expected to slow sharply to 3.2% from 6.2% in 2008 because of falling export demand, lower commodity prices, and much tighter external financing constraints. The lingering after-effects on the global economy of the financial crash of 2007–2008 and the demand destruction of 2008–2009 suggest that the pace of recovery will be slow and the subsequent expansion may not return to the pace that prevailed in 2004–2007 for some years to come.

⁶ Ministry of Trade and Industry. 2009. *MTI Revises Forecast for 2009 GDP Growth*, Press Release, Singapore (April). Available: <http://app.mti.gov.sg>.

⁷ International Monetary Fund. 2009. *World Economic Outlook Update*. Washington, D.C. (January). Available: <http://www.imf.org/external/pubs/ft/weo/2009/update/01/index.htm>.

Figure 5: Economic Growth—International Comparison**(a) Economic Growth in Major OECD Countries (2007–2008)****(b) Economic Growth in Southeast Asia**

OECD = Organisation for Economic Co-operation and Development.
Source: Various national statistics agencies.

20. International action to prevent the crisis from worsening further has been unprecedentedly aggressive. Early October 2008 saw a coordinated interest rate cut by major central banks in advanced economies (with the notable exception of Japan, where rates were already extremely low). Policy rates have continued to fall since then and further reductions are likely in early 2009. Unorthodox measures—such as substantial expansion in the balance sheets of the central banks (quantitative easing), and central bank easing of the criteria governing the quality of securities acceptable as collateral—were undertaken by the US Federal Reserve and other central banks, and these measures are likely to be further expanded in 2009.⁸ On the fiscal side, the US, European Union, Japan, and UK have all announced significant fiscal stimulus packages. Despite these and other massive rescue packages, financial markets remain highly stressed because of elevated risks, linked to lacking confidence in counterparties and their balance sheets.

21. Against this backdrop, economic growth in Indonesia is expected to decelerate in 2009 because of the projected sharp reduction in external demand for exports. Indeed, export value contracted by 33% year-on-year in February 2009. The recent decline in commodity prices will also have a negative impact on Indonesia. Projected decline in capital inflows, particularly foreign direct investment, will constrain investment. The Government has revised its macroeconomic framework and projects growth to decline to 4.5% for 2009, with higher unemployment and increase poverty rate. The Economist Intelligence Unit projects a lower growth rate of about 2% resulting from faltering exports and stalling foreign investments.⁹

22. **Poverty Alleviation and Employment.** Indonesia has made solid progress in poverty reduction since the Asian financial crisis. High and inclusive economic growth over the past 6 years has benefited the poor. The poverty rate has fallen by about one percentage point per year since 2003, reaching 17.8% in 2006, and falling further to 15.4% in 2008. However, poverty remains a serious problem in Indonesia with over 35 million persons below the national poverty

⁸ For example, the US Federal Reserve's balance sheet was expanded from \$800 billion in 2008 to \$2.1 trillion by October 2008.

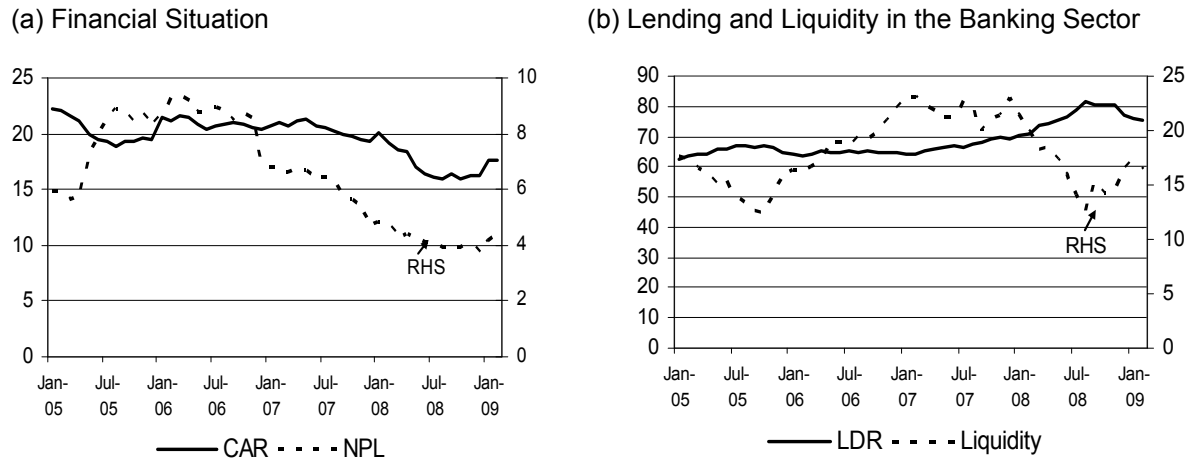
⁹ Economist Intelligence Unit. 2009. *Indonesia*, Country Report. London (February)

line and another 42% vulnerable to falling into poverty if their circumstances suddenly deteriorate (Appendix 5). Public services remain inadequate for a middle-income country, and non-income poverty is also a major problem in terms of high malnutrition and maternal mortality rates, inadequate access to safe water and sanitation, and education outcomes. Furthermore, inequality is increasing and disparities between regions remain high. On the employment front, the results have been mixed. Open unemployment has declined from its peak of 11.2% in 2005 to 8.0% in 2008 because of solid economic growth. However, shares of formal employment in total employment remain relatively stagnant at around 32% of the work force. The Government is concerned that the current global financial crisis will have adverse effects on its efforts to reduce poverty if there is a significant reduction in economic growth, retrenchments, and shrinking employment opportunities. Recent retrenchment data from the Department of Manpower and Transmigration point to increased layoffs, particularly in the export sector. Based on the current low case growth scenario of 4.5% economic growth for 2009, the National Development Planning Agency (BAPPENAS) projects that unemployment could increase by up to 1 million persons or 0.8 percentage points, and poverty could increase by about 3 million–4 million persons or about 1–2 percentage points of the population—reversing recent gains in poverty reduction. In this context of second round effects in a global environment of tight liquidity and elevated banking sector risk, key issues for Indonesia mitigating the global impact of the crisis on its economy include (i) reassuring financial markets and maintaining financial system stability, (ii) sustaining critical public expenditures and the need for a fiscal stimulus, and (iii) sustaining exports and private sector investment. The challenges facing Indonesia as a result of the global financial crisis are summarized in a problem tree presented in Appendix 9.

1. Reassuring Financial Markets and Maintaining Financial System Stability

23. After the 1997–1998 Asian financial crisis, the Government introduced a series of regulatory reforms to its financial sector. The main change has been a focus on risk-based supervision and consolidated supervision of groups rather than traditional monitoring of compliance with regulations by individual banks. This has involved better understanding of banks' risk management and internal control systems, focus on corporate governance and responsibilities of board of directors and management, stress testing of capital adequacy, and improved off-site monitoring systems. Indonesia has made progress in strengthening supervision capacity, off-site monitoring, early warning systems, corporate governance, and responsibilities of board of directors and management.¹⁰ Regulatory reforms and reforms to supervision practices have greatly strengthened the soundness of the Indonesian banking sector to withstand the indirect effects of the global financial crisis. These measures were recently tested in the recent case of a bank failure at the end of 2008, where empowered regulatory authorities were able to take control of the situation quickly with minimum impact on confidence in the banking sector. Bank Indonesia dismissed the bank's management and the Deposit Insurance Agency (LPS) swiftly took over and recapitalized the bank. With limited exposure to troubled US assets, banks' capital adequacy ratios remain sound and NPLs were relatively low in February 2009 (Figure 6). The loan–deposit ratio has dropped gradually to 75.5% after peaking at 81.6% in August 2008. Banking sector liquidity (liquid assets to total assets) also started ease in December 2008 but remained relatively tight in Q1 2009.

¹⁰ Lindgren, Carl-Johan 2006. *Banking Integration in the ASEAN Region: An Overview*. Manila: ADB (May).

Figure 6: Indonesia's Banking Sector Performance Indicators

CAR = capital adequacy ratio, NPL = nonperforming loan ratio, LDR = loan to deposit ratio, and liquidity measured by share of banking sector liquid assets to total assets.

Sources: Various national statistics agencies.

24. Vulnerabilities to Financial Sector. As the second round effects of the global crisis spillover to the real sector, demand for credit is expected to fall, and NPLs are expected to rise in 2009—placing some stress on the domestic banking sector. Moreover, financial sector risks remain elevated because of continued uncertainty about the extent of damage to the global financial system, so Indonesia remains vulnerable to any additional shocks to the global financial sector. Lessons from the 1997–1998 financial crisis demonstrate the importance for the Government to reassure financial markets quickly about the soundness of its banking system and ensure that measures are in place to address increased risks. These include enhanced coordination and clarification of responsibilities between the Ministry of Finance (MOF) and the central bank in the case of both nonsystemic and systemic banking crises, and a credible deposit insurance scheme that retains confidence in the banking system while minimizing moral hazard. Another area for strengthening is the central bank's lender of last resort facility. Under the current Bank Indonesia Law (Law No. 23/1999), Bank Indonesia is the lender of last resort for the banking sector. This means that banks could borrow in the short term from Bank Indonesia, backed up by high quality assets (government bonds and Bank Indonesia Certificate [SBI]). The recent tight liquidity pressure in the interbank market meant that Bank Indonesia would be unable to take prompt action to ease such pressures and prevent liquidity problems from becoming more systemic.

2. Sustaining Critical Public Expenditures While Maintaining Budget Discipline

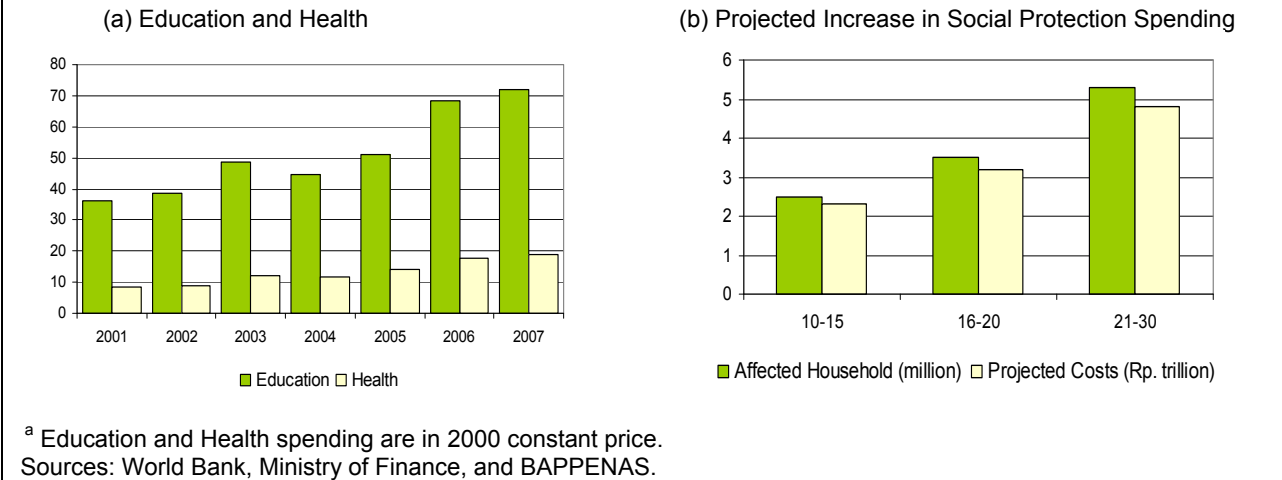
25. Need for Fiscal Stimulus. With the unfolding impacts on growth in regional economies, the Government's economic priorities focused on protecting the real sector and mitigating the effects on poverty, in addition to maintaining confidence and stability in the financial sector. In January 2009, the Government revised its 2009 budget, which was passed by parliament in November 2008. It now assumes a lower economic growth rate of 4.5%, down from 6%, with further downward revisions expected in the coming months, an exchange rate of Rp11,000 (up from Rp9,400), and oil prices around \$45 per barrel (down from \$80 per barrel). These budget revisions lower tax revenue collections by Rp64.1 trillion and nontax revenue collections by Rp73.1 trillion. Savings from fuel and other subsidies from the fall in oil prices add Rp34 trillion.

While spending in some non-priority sectors will be revised down, the revised budget protects spending on public infrastructure, education, and poverty alleviation programs. The budget also provides additional fiscal stimulus measures on the expenditure side (Rp16.9 trillion) and tax relief to stressed sectors on the revenue side (Rp56.3 trillion). The Government has budgeted Rp3.8 trillion (or \$345 million) for its unconditional cash transfer (UCT) program for January and February 2009 to mitigate the poverty impact of the global crisis. As a result, the Government now projects an increase in the budget deficit from 1.0% of GDP to 2.5% of GDP, and increased gross financing needs from \$18.2 billion to \$24.6 billion for 2009 (Table 2). MOF estimates that the fiscal stimulus is equivalent to 1.3% of GDP.

26. Public Expenditure. The effectiveness of the fiscal stimulus will depend on the budget allocation to priority sectors and the speed of disbursements. Under the World Bank's DPL and ADB's DPSP, the Government has made much progress in improving budget credibility, execution, and reporting. However, weaknesses remain in budget execution, especially delays in disbursements and procurement caused by administration weakness. In the current adverse conditions, it will be important for the Government to advance its procurement processing timetable for 2009, shift discretionary spending to priority areas in a timely manner, and roll over unspent 2008 budget for public infrastructure.

27. Poverty Impacts. A core purpose of the fiscal stimulus is to protect jobs and recent gains in poverty reduction. The Government has several poverty alleviation programs that can easily be scaled up. In 2008, the Government reactivated the UCT program to compensate poor families for the fuel and commodity rice increases. The UCT program covered 19 million households based on the database used in the previous UCT in 2005 and 2006. Each household received Rp100,000 per month on a quarterly basis. Available data about the antipoverty effectiveness of the UCT is encouraging. According to data from the 2008 National Socioeconomic Survey (Susenas), the UCT maintained the welfare levels of 60% of recipient households and assisted 30% of recipient households to escape from poverty, while about 10% of households under the scheme fell into poverty because of food price inflation in 2008. The Government has extended the UCT to the first 2 months of 2009 and this could be prolonged if necessary. The Government has allocated Rp7 trillion for the National Empowerment Program (PNPM) for 2009. Under lower growth scenarios for 2009, BAPPENAS projects that poverty-related spending will increase by about Rp9.9 trillion (Rp4.9 trillion for the existing social protection programs (Figure 7[b]) and Rp5 trillion for PNPM). The conditional cash transfer program is still in a pilot stage, covering 1 million households, and is unlikely to be scaled up to mitigate the poverty effects of the economic slowdown. The Government has several other programs related to the social sector, including education and health. Through the national and regional budgets, social expenditure has increased substantially in real terms since 2001 (Figure 7). Government spending on education and health in real terms increased by over 100% from 2001 to 2007. The share of education spending in the Government's 2007 budget was 17% and health spending accounted for 4.5%. It will be important to protect the gains in social spending during the current adverse situation. However, the effectiveness of the fiscal stimulus in mitigating the poverty effects will also depend on how the Government is able to quickly identify families at risk of falling into poverty or more severe poverty, and deterioration in regional incomes from the slowdown in exports. Currently, the Government does not have a poverty monitoring and response mechanism that could provide information about developments in household poverty on a timely basis that would allow the Government to respond promptly with targeted poverty alleviation programs. Thus, to mitigate the effects of the economic slowdown, it will be important for the Government to establish a poverty monitoring unit coordinated across relevant ministries.

Figure 7: Indonesia's Social Spending^a



3. Crowding in Private Investment and Supporting Exports

28. Trade finance to developing countries is highly vulnerable in times of crisis. It collapsed during the 1997–1998 Asian financial crisis, when bank lending declined by 80%. Up until September 2008, Indonesia’s exports were reaching record levels, primarily driven by high commodity prices, with manufacturing exports also performing well. Investment, which slumped during the 1998 crisis and took 5 years before it turned around, was growing in 2006 and 2007 (Figure 8). Foreign direct investment approvals were also robust in 2007. The global financial crisis and recessionary conditions began to affect Indonesia’s exports and investment in several ways: (i) the commodity price bust resulted in contraction in commodity export values by November 2008; (ii) the slowdown in global demand for exports began to hurt manufacturing exports, particularly garments and machinery; and (iii) the global credit crunch increased the cost of trade financing and sharply reduced trade finance as counterpart banks were reluctant to accept letters of credit. While no comprehensive data on the supply of trade finance is readily available, there is anecdotal evidence that trade finance has become tight. Bank customers are now required to put an 80%–100% cash margin to have a letter of credit opened by banks, compared with 20%–30% before the crisis. The global credit crunch and uncertainty about economic growth have caused several foreign and domestic investments to be put on hold. The Indonesian central bank projects private sector lending to decline from 35% in 2008 to about 15%–18% in 2009, although this is seen as optimistic by market commentators.

29. In this context of slowing exports and waning market confidence, it will be important to introduce measures that boost confidence and improve access to trade finance. In particular, the banking sector provides limited trade finance products; about 85% of exports are financed on a cash basis, with the other 15% financed through letters of credit. Indonesia has a specialist export bank (Bank Ekspor) although assessments of its performance indicate mixed results. The Government has drafted a new law converting Bank Ekspor into an export–import agency that would provide different trade finance products, including export credit guarantees, as well as a mandate to support diversification of export markets and small and medium-sized enterprises’ access to trade finance. The global financial crisis and the resulting credit crunch was a catalyst for quick passage of the law in January 2009. It will be important to complete the new regulatory framework for the agency and operationalize it over the next 12 months.



C. Lessons

30. While the sources of the current global financial crisis and associated risks to the Indonesian economy are different from the 1997–1998 Asian economic crisis, and subsequent reforms have made the Indonesian economy much more resilient to external shocks, lessons learned from the 1998 economic crisis are embedded in the PESF Program. Key lessons relevant to the current situation include the following:

- (i) The Government must introduce measures that maintain confidence in the banking sector. The absence of deposit insurance in 1997 exacerbated the fall in confidence in the domestic banking sector after 16 banks were closed in November 1997. The Government introduced a blanket guarantee in January 1998. Later in 2004, the Government introduced legislation to phase out the blanket guarantee with a deposit insurance scheme.
- (ii) A special resolution regime for prompt corrective action to address failing banks is needed to prevent systemic collapse, rapidly restructure failing banks, and ensure that fiscal authorities are ready to support bank resolution through capital injections as necessary. The absence of such frameworks in 1997–1998 Asian crisis required the establishment of a special and temporary resolution agency at great cost and involving mishandling.
- (iii) The central bank should ensure liquidity in domestic credit markets to avoid a credit crunch and ensure that banks maintain adequate capital.
- (iv) The Government should ensure that access to trade finance remains open to exporters and importers.
- (v) The Government should provide an appropriate fiscal stimulus while maintaining fiscal discipline. During 1998, the Government operated budget surpluses as the government administration was unable to disburse because of political crisis. This exacerbated the deep recession and its duration. Thus, it is important to provide for timely spending disbursements to ensure the fiscal stimulus is effective.

- (vi) Effective social assistance programs are necessary to mitigate the worse effects of the economic slowdown on vulnerable families. In this regard, it is important to establish effective poverty monitoring systems to quickly identify and target vulnerable groups and regions for assistance. It is critical to have social assistance programs and mechanisms to ensure timely assistance and minimize leakages to non-target groups. The lack of effective programs in 1998 meant that vulnerable groups quickly fell into poverty, with little assistance from the Government, resulting in increased rates and severity of poverty.

IV. THE PROPOSED PROGRAM

A. Impact and Outcome

31. The impact of the PESF will be to mitigate the adverse economic and social consequences of the global financial crisis on Indonesia. The outcome of the PESF will be to secure adequate access to budget financing for critical expenditures and the required counter-cyclical policy.

32. The PESF includes a series of policy measures that address the increased vulnerabilities and risks to the Indonesian economy from the global financial crisis and sharp slowdown in the global economy, and underpin the key priorities of the Government's reform agenda. These reforms are designed to accomplish the following:

- (i) **Financial system stability.** Reassure financial markets and maintain financial system stability by enhancing the financial safety net, maintaining the stability of the banking system, and ensuring predictability in the Government's financing requirements for 2009 and 2010.
- (ii) **Critical public expenditure.** Sustain critical public expenditures while maintaining budget discipline to mitigate the poverty impacts of the growth slowdown through strengthened coordination of national poverty reduction efforts; establishing a national poverty monitoring and response system; and increasing critical public expenditures in the areas of poverty alleviation, social protection, and infrastructure maintenance and development. This will be done by undertaking actions to speed up budget disbursement through improving efficiency in budget disbursements, promoting advance procurement, and carrying over unspent cash from the 2008 budget.
- (iii) **Private investment and exports.** Crowd in private investment and exports by revising the implementing decree for the Investment Law, improving transparency in revenues from extractive industries, and enhancing access to trade finance.

33. The PESF is designed to be a single-tranche loan with scheduled and multiple withdrawals to be made over the program period on the condition that, prior to each withdrawal, (i) the Government has met the drawdown triggers set out in the financing plan, (ii) the Government has maintained an appropriate macroeconomic framework, and (iii) the Government has not reversed any policy actions under the policy matrix. The design and monitoring framework for the PESF is in Appendix 1, the PESF policy matrix is in Appendix 2, and Appendix 3 contains the donor coordination matrix.

B. Policy Framework and Actions

34. All 12 policy measures required for the PESF were carried out between September 2008 and March 2009.

1. Actions to Reassure Financial Markets and Maintain Financial System Stability

35. The PESF supports the Government's efforts to implement several actions promptly to reassure financial markets about the soundness of the financial sector and the regulatory framework to respond to the global financial crisis. The following measures toward boosting confidence in the financial system were completed before Board consideration of the PESF Program.

36. **Financial Safety Net.** In October 2008, the Government issued Government Regulation in Lieu of Law (Perpu No. 4/2008) on Financial Safety Net. The legislation establishes the roles, responsibilities, and procedures that govern the actions and responses of Bank Indonesia, MOF, and Indonesia Deposit Insurance Corporation in the event of the failure of a financial institution. In December 2008 parliament requested a revised draft to be submitted. The Government has submitted a revised draft to parliament and the bill is being deliberated by a special parliamentary committee.

37. **Deposit Insurance Scheme.** One lesson from the 1998 financial crisis is that the absence of a credible deposit insurance scheme can exacerbate confidence in the banking sector and lead to systemic runs on banks. To arrest the run on banks in January 1998, the Government provided a blanket guarantee on deposits. This was intended as an interim measure until it established a deposit insurance system. In September 2004, the Law on Deposit Insurance Agency was passed; and in October 2005, the Indonesian Deposit Insurance Agency (LPS) was officially established. With the establishment of LPS, the coverage of the deposit guarantee was gradually reduced from the full coverage instituted at the time of the Asian financial crisis to Rp100 million by March 2007. With the onset of the global credit crisis, the Government increased the maximum amount of insured deposits to Rp2 billion from Rp100 million. The Government Regulation in Lieu of Law No. 3/2008 dated 13 October 2008 allows LPS to change the amount of insured deposits in the event that there is a risk that could reduce public confidence and endanger financial system stability. This legislation was followed up immediately with the issuance of Government Regulation No. 66/2008 on the same date, which increased the maximum amount of insured deposits to Rp2 billion from Rp100 million. The regulation also allows the Government to provide a blanket guarantee of deposits, if it deems it necessary. However, this authority does not cover interbank deposits. The regulation was also introduced to align the regulatory framework with neighboring countries (including; Hong Kong, Malaysia, and Singapore) that had introduced a temporary unlimited guarantee on bank deposits in line with similar actions in several Organisation for Economic Co-operation and Development (OECD) countries including Australia, Ireland, and the UK. Perpu No. 3/2008 on the amendment to the Deposit Insurance Corporation Law has been approved by the parliament and is now Law No. 7 Year 2009.

38. **Lender of Last Resort Facility.** Under the current Bank Indonesia Law, Bank Indonesia is the lender of last resort for the banking sector. This means that banks could borrow in the short term from Bank Indonesia, backed up by high quality assets (government bonds and Bank Indonesia Certificate (SBIs). The recent tight liquidity pressure in the interbank market had prompted Bank Indonesia to take action to ease such pressures and to prevent liquidity

problems from becoming more systemic. It has done so by accepting an additional type of assets as collateral for short-term financing to banks. The Government issued a Government Regulation in Lieu of Law No. 2/2008 that amends the Bank Indonesia Law; and Bank Indonesia issued a circular letter (No. 10/29/DPM) which, under certain circumstances, broadens the types of assets that banks can use as collaterals when borrowing from Bank Indonesia. Perpu No. 2/2008 on the amendment of the Bank Indonesia Law has been approved by parliament and is now Law No. 6 Year 2009.

39. **Financial Sector Assessment Program.** Following up from its commitment at the G-20 summit in November 2008, the Government has formally requested the IMF and World Bank to conduct a financial sector assessment program (FSAP) for Indonesia. The FSAP, which will be the first for Indonesia, seeks to identify the strengths and vulnerabilities of a country's financial system, determine how key sources of risk are being managed, ascertain the sector's developmental and technical assistance needs, and help prioritize policy responses. The FSAP, led by the IMF and World Bank, will take about 1 year to complete. The implementation of FSAP recommendations to strengthen the country's financial system will be used as input into the proposed ADB DPSP series and Capital Market Program.

40. **Budget Financing Requirements.** With increased uncertainty about the functioning of global credit markets over the next 12–24 months, and in view of the need for a fiscal stimulus, the Government has issued a contingent financing plan in case there are shortfalls in its budget financing in 2009. The Government has indicated that its first preference is to use its access to domestic and/or international markets to meet its financing targets. The financing plan incorporates quarterly targets for rupiah and US dollar bond issuances. Under the financing plan, the Government has projected financing requirements from the market of \$12.5 billion equivalent for 2009. However, in the event of tight market conditions, the Government and development partners have established broad parameters on the basis of which the Government may withdraw the \$5.5 billion funds available from the PESF to meet its quarterly financing shortfall during the program period. The Government and development partners will assess the Government's financing shortfall every quarter and determine if disbursement from the PESF is required. The Government and development partners view the financing plan as an important fiscal risk management tool during the uncertain and difficult global environment, and will review these parameters on an ongoing basis. If the contingent loan is not fully drawn in 2009, the financing plan includes a mechanism for rolling over available funds to be potentially used within the context of the financing plan for 2010.

41. In line with the financing plan, the Government and development partners have committed to the principles that the loan would be used only where the following circumstances exist:

- (i) **Sound Macroeconomic Framework.** The overall macroeconomic situation continues to be sound and the policy program on track. However, given the global financing crisis and the importance of the Government's financing plan, the development partners and the Government have decided that a review of the Government's macroeconomic policy framework and its progress in carrying out the PESF (including its financing plan) will be undertaken on a quarterly basis in accordance with the jointly agreed governance arrangements.
- (ii) **Limited Market Access.** Indonesia has limited market access because of global and/or domestic liquidity constraints, so it needs access to the facility to maintain public spending and/or requires additional fiscal stimulus. The withdrawals will be linked to Indonesia's access to market finance, where access will be assessed

from a set of objective criteria (such as yields on domestic and foreign debt) guided by best practices in debt management (such as allocation of short versus long-term debt tenure considerations and currency composition of debt), required changes in the fiscal policy stance (such as the need for further fiscal stimulus), and any potential crowding out effects on private sector credit.

- (iii) **Phased Withdrawals.** Withdrawals from the PESF are phased as needed. The full amount of the loan is unlikely to be required at once. Therefore, the Government has articulated a schedule of withdrawals in line with its financing plan. It is expected that the loan will be withdrawn each quarter after the joint government and development partner review meeting, with a cap on the maximum amount that can be drawn down each quarter. In the event that the Government does not utilize the full amount of the loan (either partially or fully) in any one quarter, such unutilized amounts will be rolled over to another quarter until the Program's completion date at the end of 2010. However, if market conditions continue to improve, the Government may not withdraw funds from the PESF. If there are unwithdrawn loan amounts at the end of the Program, the Government and/or ADB can cancel the unwithdrawn amounts.
- (iv) **Proportionate disbursement from development partners.** The financing plan indicates that if the withdrawal is warranted, the Government will draw down support from development partners proportional to their commitment. This way, the support and risk would be spread across all the partners participating in the PESF.

42. The financing plan includes a governance arrangement that allows the Government and its development partners, including ADB, to meet in the quarterly meetings or extraordinary meetings to (i) assess the Government's macroeconomic policy framework, (ii) evaluate progress in implementation of the financing plan, and (iii) determine the amount that the Government will draw on support provided by the ADB and other development partners. The Government and any development partner could also request additional meetings to respond to evolving economic conditions. In the event that the Government proposes changes to the financing plan, but the changes do not involve a change to the objective of the financing plan (such as changes in the Government's financing targets or its market access parameters), these will be done on a consensus basis with the Government and other development partners. The revisions to the parameters will be guided by, but not limited to, the following considerations: (i) inflation rate, (ii) increased cost of bonds with longer maturities, (iii) bond maturities structure and volume consistent with past practice and prudent debt management, and (iv) possible crowding effects on the private sector.

2. **Actions to Sustain Critical Public Expenditures While Maintaining Budget Discipline**

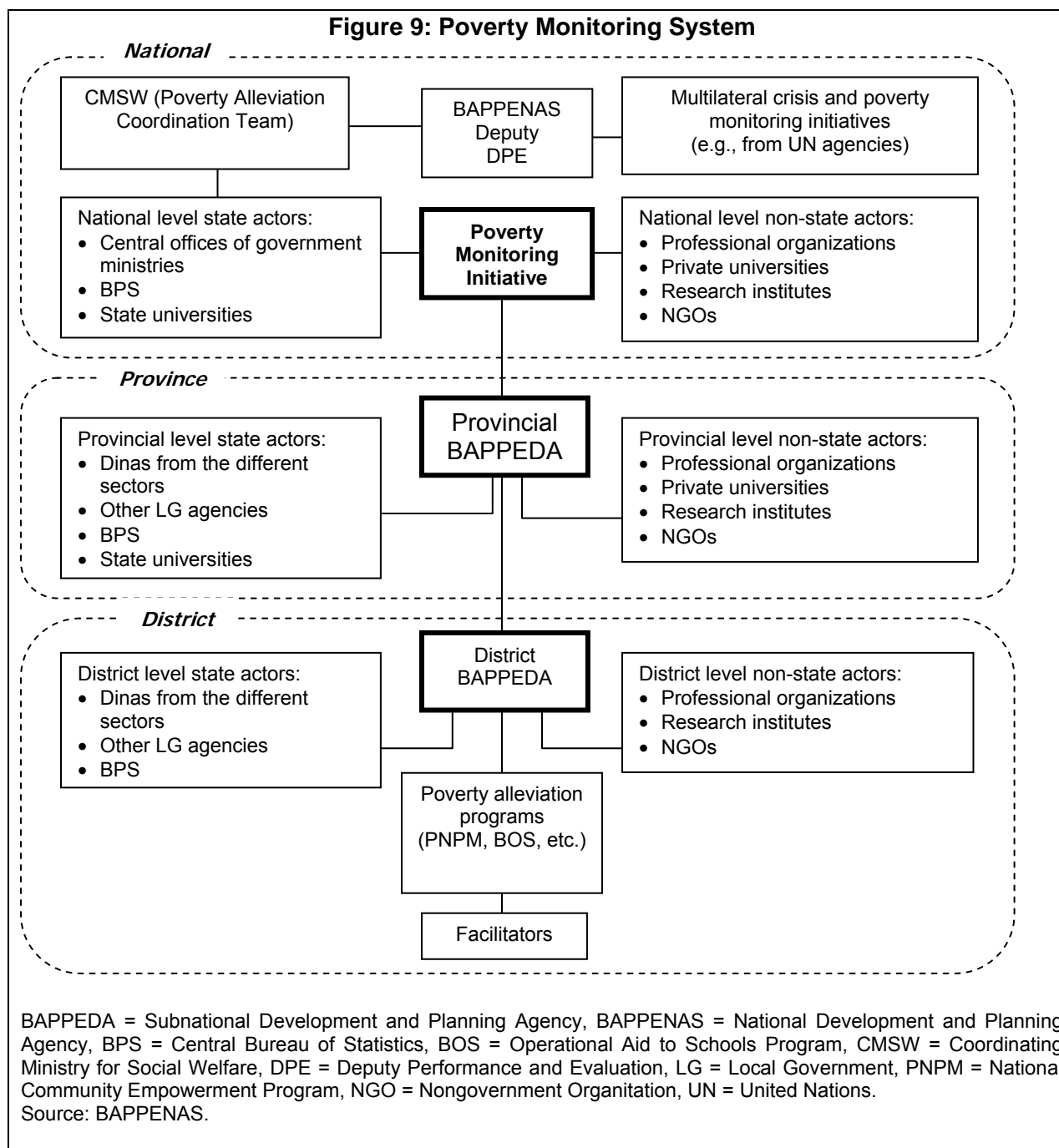
43. The PESF supports the Government's strategy to mitigate the adverse poverty impact from the global financial crisis and destruction in external demand. The following measures toward protecting the poor were completed before Board consideration of the PESF Program.

44. **Poverty Monitoring System.** While the financial crisis will affect many sectors, the focus of this initiative—to measure poverty impacts—will be collecting real-time data on employment and dismissals, wage data, farmers' incomes, prices of basic commodities, health, education, and social welfare. Preliminary data and information about the socioeconomic impacts will be obtained through media tracking, followed by data collection via national and local government apparatus, networks/partners, local nongovernment organizations (NGOs)

and associations, local universities, and poverty program field facilitators. Secondary data analysis will be available from related government agencies such as the Central Bureau of Statistics (BPS), Department of Manpower and Transmigration, and other ministries/government institutions concerned. The emphasis will be on providing an accurate account of the socioeconomic impact of the crisis, especially its implications on the level and extent of poverty. With this information, the poverty monitoring system would be able to (i) provide a timely assessment of the poverty impact of the current global financial crisis to stakeholders concerned, i.e., the Government, international agencies, development partners, NGOs, and civil society; (ii) provide the Government with policy-relevant recommendations; (iii) assist in the formulation of effective policies and programs; and (iv) provide feedback on the effectiveness of the Government's policies and programs put in place to respond to the negative impacts of the financial crisis.

45. Overall responsibility for the poverty monitoring system will rest with the deputy for development performance evaluation in BAPPENAS (Figure 9). At district and provincial levels, the Subnational Development Agencies (BAPPEDAs) will be the contact points for data and information gathering on the impact of the global crisis. Such data may originate from the various sectoral departments, other local government agencies, or BPS. In addition, nonstate actors (such as regional offices of professional organizations and associations, research institutes, and NGOs) may be sources of data on the regional impact of the crisis. Facilitators of the different poverty alleviation programs (such as PNPM, Operational Aid to Schools Program (BOS), Unconditional Cash Transfer (UCT) will also be able to provide reliable data on the impact of the crisis.

46. **National Poverty Reduction Efforts.** After extensive consultations within government, and with development agencies and civil society for the past 6 months, the Government issued a presidential regulation on coordination of national poverty reduction efforts in March 2009. The proposed decree is important at this stage because it will help coordinate and streamline the implementation of poverty reduction efforts at both national and local levels. The decree outlines the functions, responsibilities, and organization of the coordination committees for poverty reduction at national, provincial, and district levels. At the national level, the coordination committee is led by the coordinating minister for social welfare, with membership from all major ministries. At provincial level, the committee is chaired by the provincial governor and at district level by the district governor. The committees will have three working groups focusing on social safety net programs, community empowerment programs, and microcredit and small business development. With the decree, the Government will harmonize and streamline interventions from some 60 community-based projects executed by 22 sectoral ministries as well as activities from NGOs. This will enable the Government to respond more efficiently to poverty impacts from the financial crisis.



47. **Poverty Alleviation Efforts.** To protect critical public expenditures, the Government undertook the following measures to expedite disbursement in 2009:

- (i) Implemented a socialization campaign to promote advance procurement processing, appoint multiyear treasury officers, and speed up disbursements through Director General (DG) Treasury.
- (ii) Established a monitoring committee for the budget activity list (DIPA) 2009 to improve budget disbursements. The committee is established under a Ministry of Finance decree and comprises the DG Treasury (chair), DG Budget, head of

Fiscal Policy Office, and BAPPENAS. It meets monthly to review the progress of funds disbursement and readiness of DIPA releases to ensure that all bottlenecks in the disbursement of budget funds are removed in real time in close consultation with the ministries concerned.

- (iii) Improved the recording and reporting system in the *satkers* (budget spending units). DG Treasury has provided *satkers* with a software application called SAI that is being used to register expenditure transactions and compile financial accounts. An updated version of this software, scheduled for rollout in January 2009, will include recording and reporting features.
- (iv) Issued an MOF regulation with a simplified mechanism and process for carryover of unspent 2008 budget for the PNPM to April 2009, as provided for under Article 7A of Law No. 16/2008 on the revision of FY2008 budget.
- (v) Issued an MOF regulation outlining procedures for simplified amending of 2009 DIPA documents and carryover of unspent 2008 budget for infrastructure. MOF regulation No. 46/2008 on the procedure for amending the 2008 DIPA documents permits line ministries to reallocate across sub-activities under a simpler budget (DIPA) revision mechanism without prior amendment of the budget allotment. This will allow for carryover of last year's infrastructure projects as provided for under Article 12 of the 2009 budget (Law No. 41/2008).

3. Actions to Crowd in Private Investment and Support Exports

48. The PESF supports the Government's efforts to improve access to trade finance and crowd in investment. To mitigate the impact of global turmoil in investment and trade, the Government has developed a set of policy measures, including to (i) boost investor sentiment through revising investment regulations, (ii) improving transparency in extractive industries revenues, and (iii) easing access to trade finance for exporters. The Government undertook the following measures before Board consideration of the PESF Program.

49. **Revisions to Investment Regulation.** In 2007, parliament enacted a new investment law that replaced the separate laws on foreign and domestic investment dating from 1967 and 1968, and provides a single legislative framework for domestic and foreign investment, a long standing objective that has featured in the Government's policy dialogue with ADB since 1998. Article 12 of the new law states that all business activities not explicitly closed or restricted to investment are open, and that restrictions must be listed in a presidential regulation. This is the first time that an Indonesian law has required a single comprehensive investment negative list, issued by the President, and it is the first clear statement in law that activities not included in the list are fully open to investment. However, the subsequent implementing decree (Presidential Regulation No. 77/2007) on the negative list received a mixed reaction from investors. It included a grandfather clause for foreign investors that exceed foreign equity limits, but uncertainties and differing interpretations created new forms of investor uncertainty. Additional uncertainty has also emanated from the Government's failure to follow up on its announcement that it would change a long-standing policy of not applying the investment negative list to publicly listed companies—creating widespread uncertainty among listed companies at a time when the domestic capital market is under severe pressure. Recognizing these regulatory uncertainties and the need to boost investor confidence, the Government has prepared a draft revision to Presidential Regulation No. 77/2007 that clarifies the rules and relaxes restrictions in key sectors

50. **Extractive Industries Transparency Initiative.** The Government recognizes that the steady decline in exploration and investment in the oil sector is partly caused by uncertainty

over rules on tax treatment and production sharing. To address this, the Government has initiated the accession process to sign up to and implement the Extractive Industries Transparency Initiative (EITI). It has sent a formal letter to the EITI secretariat to initiate the process. Three ministries, CMEA, MOF, and Ministry of Energy and Mineral Resources, have issued a memorandum of understanding (MOU) to set up the institution that will drive EITI implementation. The implementation process will take about 2 years. In 2009, efforts will include preliminary meetings of the steering group, establishing its secretariat, developing a work plan and securing resources for implementation, and acceptance of Indonesia as an EITI candidate country. In 2010, an independent reconciler will design reporting templates and build capacity to fill in reporting templates, and the Government and industry will submit the templates to the steering group. The process which will lead to greater clarity in regulations, rules, and revenue reporting will improve transparency and boost investor sentiment in the oil, gas, and mining sectors over the medium term.

51. **Trade Finance.** The Government has taken both short- and longer-term measures to address trade finance issues. In the short term, it has activated its rediscount window for trade receivables. The rediscount window is not envisaged as credit coverage but as a mechanism to increase dollar liquidity. The mechanism works as follows: the exporter sells its accepted letter of credit to Bank Indonesia at a small discount, allowing the exporter receivables in advance. The facility has a minimum letter of credit value of \$10,000 allowing small and medium-sized enterprises to access the rediscount window. The letter of credit must be issued from an overseas bank with a AAA rating from Standard and Poor's credit rating agency.

52. **Export Financing Agency.** The Law No. 2/2009 on the establishment of an export financing agency was promulgated in January 2009 aimed at improving trade finance over the medium term. Under the new law, the current Bank Ekspor Indonesia (a commercial bank) will be converted into an export financing agency within 9 months. The agency will be responsible for developing trade finance products to improve trade, including trade finance guarantees. Its mandate also includes promoting trade to nontraditional markets. This initiative is supported by the proposed Trade Finance Facilitation Program.¹¹ Indonesia is one of the priority countries to be supported under the Program. Discussions on implementation of the Trade Finance Facilitation Program with financial institutions are ongoing, and operations are expected to start in the second half of 2009.

C. Financing Plan

53. The Government has requested a loan of \$1 billion from ADB's ordinary capital resources for the PESF Program. The loan will have a 15-year term, including a grace period of 3 years, with an interest rate to be determined in accordance with ADB's LIBOR-based lending facility and a commitment charge of 0.15% per annum;¹² and such other terms and conditions as are substantially in accordance with those set forth in the draft program loan agreement presented to the Board.

54. Gross financing needs of the Government have increased from \$18.2 billion in 2008 to \$24.6 billion in 2009 based on the revised 2009 budget. These growing financing needs reflect increased levels of domestic and foreign debt principal repayments, and changes to the 2009 budget (Table 2). The revised 2009 budget projects a lower increase in revenues because of

¹¹ ADB. 2009. *Report and Recommendation of the President to the Board of Directors on a Proposed Change in the Project Scope and Increase Exposure Limit REG: Trade Finance*. Manila (Loan 2033-REG).

¹² The Board has reduced the commitment charge to 0.15%, and waived the front-end fee of 1.00% for loans approved from 1 July 2007 up to and including 30 June 2009.

the economic slowdown, and the need for additional spending to stimulate the economy in 2009 and for poverty alleviation programs. The revised budget protects social sector spending, in particular education and funding for the flagship community-based poverty alleviation program, to provide a cushion for adversely affected households. Overall, the Government is budgeting for additional spending and counter-cyclical spending up to Rp73.2 trillion in 2009. According to its financing plan (Table 3), the Government indicated that gross financing of \$24.6 billion will be met from the following sources: (i) \$9.1 billion from issuance of domestic and international bond issuance in the markets, (ii) \$6.3 billion from the banking system and excess financing from 2008, (iii) \$5.2 billion from the Official Development Assistance program and project lending; and (iv) \$4.1 billion additional financing. The Government will draw down the PESF and related support from other development partners when it cannot meet its financing targets from the markets within specified market access conditions specified in the Government's financing plan (paras. 40–42) and other conditions set out in the loan agreement.

Table 3: Projected Financing Requirements of the Government of Indonesia for 2009
(\$ billion)

Financing Mix	Proposed Amount
Gross Financing Requirements	24.61
Less Amortization	10.64
Net Financing Requirement	13.97
Programmed Gross External Borrowings	7.24
of which:	
ADB's Proposed Loan Pipeline	0.75
Development Policy Support Program	0.20
Indonesia Infrastructure Financing Facility	0.10
Capital Market Development (Subprogram 2)	0.30
National Community Empowerment Project	0.07
Metropolitan Sanitation Project	0.05
Java Bali Distribution Performance Improvement	0.04
Other Donors and Commercial Borrowings	6.73

ADB = Asian Development Bank.

Note: Exchange rate: \$1 = Rp11,000.

Sources: Ministry of Finance and ADB estimates.

55. The Government has provided ADB with (i) the reasons for its decision to borrow under ADB's LIBOR-based lending facility on the basis of these terms and conditions, and (ii) an undertaking that these choices were its own independent decision and not made in reliance on any communication or advice from ADB.

D. Implementation Arrangements

1. Program Management

56. The Coordinating Ministry for Economic Affairs (CMEA) will be the Program Executing Agency. MOF, Ministry of Trade (MOT), Coordinating Ministry for Social Welfare (CMSW), and BAPPENAS will be the Implementing Agencies. CMEA, as the Executing Agency, will be responsible for overall Program implementation and coordination; it will be supported by the Implementing Agencies (MOF, MOT, CMSW, and BAPPENAS). The Government has established a program steering committee, chaired by the director general of the Debt Management Office (MOF); and comprising representatives from CMEA, MOF, and BAPPENAS, and each development partner cofinancing the PESF. The committee will meet in the first week

of each quarter to review implementation of the Government's financing plan and assess and determine the Government's financing shortfalls. CMEA will be responsible for day-to-day program implementation activities, and will report on implementation progress to ADB.

2. Implementation Period

57. The program implementation period for the PESF is from 1 September 2008, when the turmoil in global financial markets began, to 31 December 2010. The support package for 2010 is subject to the Government's submission of its 2010 financing plan. All actions included in the policy matrix were implemented from September 2008 to March 2009.

3. Procurement and Disbursement Arrangements

58. The program loan of \$1 billion will be released as a single tranche loan with scheduled and multiple withdrawals to be made over the program period on the condition that, prior to each withdrawal (i) the Government has met the drawdown triggers set out in the financing plan, (ii) the Government has maintained an appropriate macroeconomic framework, and (iii) the Government continues to fulfill the agreed policy actions and has not committed any actions which reversed the objective of the Program. The scheduled withdrawals from the tranche will be made in accordance with the fiscal financing needs of the Government on a quarterly basis over fiscal years 2009 and 2010. Prior to each withdrawal under the tranche, the Government, ADB, and development partners will agree that all of the required drawdown triggers have been met. The loan proceeds will be used to finance the full foreign exchange costs (excluding local duties and taxes) of items produced and procured in ADB member countries, no more than 180 days before the effectiveness date of the loan. Items specified in the list of ineligible items (Appendix 7) and imports financed by other bilateral and multilateral sources are excluded. In accordance with the provisions of ADB's *Simplification of Disbursement Procedures and Related Requirements for Program Loans*,¹³ the loan proceeds will be disbursed to the Government of Indonesia as the Borrower. No supporting import documentation will be required if during each year that loan proceeds are expected to be disbursed, the value of Indonesia's total imports minus imports from nonmember countries, ineligible imports, and imports financed under other official development assistance is equal to or greater than the amount of the loan expected to be disbursed during such year. The Government will certify its compliance with this formula with each withdrawal request. Otherwise, import documentation under existing procedures will be required. Disbursements will be made under the simplified procedures for program loans. In accordance with the simplified disbursement procedures and related requirements for program loans, all goods and services produced and originating in ADB member countries will be procured, with due consideration to economy and efficiency, in accordance with the Government's standard public procedures and normal private sector commercial practices acceptable to ADB. Goods commonly traded on the international commodity market will be procured in accordance with procedures appropriate to the trade and acceptable to ADB. If at the end of the Program there are unwithdrawn loan amounts, the Government and/or ADB can cancel the unwithdrawn amounts.

59. The reform needs supported under the PESF will be financed by local currency counterpart funds generated from the proceeds of the program loan.

¹³ ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila

4. Anticorruption and Fiduciary Issues

60. ADB's *Anticorruption Policy* (1998, as amended to date) was explained to and discussed with the Government. Consistent with its commitment to good governance, accountability, and transparency, ADB reserves the right to investigate, directly or through its agents, any alleged corrupt, fraudulent, collusive, or coercive practices relating to the Program. To support these efforts, relevant provisions of ADB's *Anticorruption Policy* are included in the loan regulations and the bidding documents for the Program. In particular, all contracts financed by ADB in connection with the Program shall include provisions specifying the right of ADB to audit and examine the records and accounts of the Executing Agency and all contractors, suppliers, consultants, and other service providers as they relate to the Program.

61. A core component of the Indonesian DPSP series focuses on strengthening public financial management and improving budget preparation, execution, transparency and accountability. The public financial management systems in Indonesia have strengths and weaknesses. Strengths include a sound regulatory framework across most parts of the budget cycle; an orderly, transparent, and predictable budget formulation process; fund predictability for budget execution; sound budget classification; comprehensive and transparent budget documentation; government accounting standards aligned with comparable international standards; a chart of accounts that is broadly consistent with Government Finance Statistics Manual 2001 (GFSM); and a strengthened external audit institution.

62. The fiduciary assessment for the PESF Program draws on recent economic and sector work undertaken by the World Bank,¹⁴ ADB,¹⁵ and other development partners (Appendix 8). The fiduciary assessments undertaken in 2008 have indicated considerable improvements in the overall fiduciary environment in Indonesia since 2001. Ongoing programs supported by several development partners provide significant technical assistance support to strengthen fiduciary governance. The PESF Program has benefited from these past and ongoing reforms. At the same time, the PESF introduces additional measures to strengthen the public financial management system to ensure timely disbursements necessary to mitigate the adverse situation on growth and poverty.

5. Accounting, Auditing, and Reporting

63. ADB retains the right to audit the use of loan proceeds and to verify the accuracy of the Government's certification for withdrawal applications. Before the first withdrawal, the Government will open a deposit account at the central bank (Bank Indonesia) to receive loan proceeds. The account will be managed, operated, and liquidated in accordance with terms satisfactory to ADB.

6. Performance Monitoring, Evaluation, and Program Review

64. ADB, with the Government and other development partners cofinancing the PESF, will carry out quarterly reviews of program implementation, and assess the shortfall in the Government's financing requirements as set out in the financing plan. The Government will

¹⁴ World Bank. 2008. *Public Expenditure and Financial Assessment*, Report No. 42098 ID, Washington, D.C. (June)

¹⁵ ADB. 2007. *Sector Report on Accountability and Audit in Indonesia*. (Produced under TA-4473 INO: Support for Implementation of Program Loan). Manila

keep ADB informed of the outcome of policy discussions with other multilateral and bilateral agencies that have implications for PESF implementation, and provide ADB with the opportunity to comment on any resulting policy proposals. ADB, in collaboration with the steering committee, will undertake a review of the Program every quarter after loan effectiveness to review the outcome of the PESF.

65. The Government and its development partners have agreed on the updated outcome and output indicators to monitor PESF implementation and evaluate its impact, within the overall PESF framework (Appendix 1).

V. PROGRAM BENEFITS, IMPACTS, ASSUMPTIONS, AND RISKS

A. Expected Impacts

66. The key benefits expected from the PESF are to allow the Government to mobilize resources from commercial markets by

- (i) reassuring financial markets and maintaining financial system stability;
- (ii) ensuring that the Government can meet its financing requirements of its budget and any additional stimulus required if the economic slowdown is sharper than expected;
- (iii) ensuring that the Government can maintain its momentum toward achieving its medium-term development objectives while managing the negative impacts of the international credit crunch on Indonesia's access to credit markets and the economic slowdown by (a) reassuring financial markets and maintaining financial system stability, (b) mitigating the poverty impacts of the growth slowdown, (c) sustaining critical public expenditures while maintaining budget discipline, and (d) crowding in private investment and supporting exports;
- (iv) aiding harmonization and cofinancing by the key development partners (ADB, World Bank, and the governments of Japan and Australia) around a common policy matrix and dialogue, and the resulting endorsement of the Government's macroeconomic management and response to the externalities of the international credit crunch; and
- (v) enabling the Government to attract capital from private sources and lower the Government's cost of funding.

B. Risks and Mitigating Measures

67. The PESF is subject to the following risks:

- (i) **External vulnerabilities.** The risks remain high, especially during a period of global financial turmoil and uncertainty and the ongoing international credit crunch, and now the emerging second round effects of a sharp economic slowdown. Indonesia is a financially open economy and there are significant foreign holdings, especially in the stock market and government bonds which have only been repatriated partially to date. Indonesia continues to be vulnerable to shifts in investor liquidity needs as deleveraging proceeds in North America and Europe. If significant funds are pulled back because of liquidity demands by investors in these areas and/or increased emerging market risk aversion, this could lead to increased pressure on international reserves and/or exchange rates, as well as on the domestic money market. In addition, the Government has large

gross financing needs over the next few years, and tighter credit markets and increased risk aversion could severely limit its ability to tap international financial markets. This could force the Government to cut budgetary outlays to maintain fiscal balance, even after full access to the PESF, with adverse consequences for infrastructure and social expenditure. Mitigating these risks will require solid cooperation between the central bank and the economic ministries to reassure bondholders that their investments are safe (from inflation and exchange rate movements) while crowding in private investment to the extent possible through the kinds of reforms supported by the PESF.

- (ii) **Sharp economic slowdown.** In January 2009, the Government revised its growth projection from 6% to 5% in January and again to 4.5% in March 2009 as the economy was beginning to deteriorate. These growth projections are likely to be revised downward as more evidence emerges of the magnitude of the global economic slowdown over the next several weeks. This will affect revenue collections and require further revisions to the 2009 budget and financing plan. The PESF provides fiscal flexibility by providing for further fiscal expansion as allowed for in the agreed financing plan.
- (iii) **Fiduciary constraints.** Notwithstanding the improvements under way, there are continuing concerns regarding utilization of public resources. The overall fiduciary assessments undertaken since 2001 (with the *Country Financial Accountability Assessment*) have indicated considerable improvements in the fiduciary environment in Indonesia (Appendix 8). Ongoing programs supported by several development partners provide significant technical assistance support to strengthen fiduciary governance. The PESF inclusion of strengthening budgetary procedures and controls will significantly enhance transparency, especially in financial management.
- (iv) **Legislative and presidential elections in 2009.** The Government remains committed to sustaining its economic reform agenda despite the global economic recession, the international credit crunch and general elections next year. Unfortunately, elections often reduce the time horizons of politicians, leading them to avoid new policy initiatives in the pre-election period and shifting their focus to populist short-term measures. This could undermine the reform agenda supported by the PESF. Conversely, the prospect of elections could spur political action into ensuring that critical government expenditures and accompanying reforms are undertaken to demonstrate a continued and clear record of accomplishments. The Program guards against reversals in the policy actions by linking scheduled withdrawals of the loan amount to maintaining intact the program measures and broad objectives.

VI. ASSURANCES

68. In addition to the standard assurances, the Government has given the following assurances, which are incorporated in the legal documents:

- (i) Counterpart funds will be used to finance the local currency costs relating to the implementation of the Program and other activities consistent with the objectives of the Program and will provide the necessary budget appropriations to finance

the structural adjustment costs relating to the implementation of reforms under the Program.

- (ii) The policies and actions taken prior to the PESF loan agreement, as described in the development policy letter (including the policy matrix), will continue to be in effect for the duration of the Program and subsequently.
- (iii) The Government will keep ADB informed of, and the Government and ADB will from time to time exchange views on, sector issues and policy reforms that may be considered necessary or desirable, including the progress made in carrying out policies and actions set out in the policy letter and the policy matrix.
- (iv) The Government will promptly discuss with ADB problems and constraints encountered during implementation of the Program and appropriate measures to overcome or mitigate such problems and constraints.
- (v) The Government will keep ADB informed of policy discussions with other multilateral or bilateral agencies that have implications for implementation of the Program, and will provide ADB with an opportunity to comment on any resulting policy proposals. The Borrower will consider ADB's views before finalizing and implementing any such proposals.

VII. RECOMMENDATION

69. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$1,000,000,000 to the Republic of Indonesia for the Public Expenditure Support Facility Program from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; a term of 15 years, including a grace period of 3 years; such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board; and on such terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Haruhiko Kuroda
President

30 April 2009

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and/or Indicators	Data Sources and/or Reporting Mechanisms	Assumptions and Risks
<p>Impact Adverse economic and social impact of the global financial crisis mitigated</p>	<p>Real GDP growth sustained at an average of more than 5% over 2009–2011</p> <p>Poverty incidence reduced from 15.1% in 2008 to 12.0% in 2011</p>	<p>Central Bureau of Statistics (i) national income accounts</p> <p>(ii) annual National Socioeconomic Survey (Susenas)</p>	<p>Assumptions Continued Government strong commitment for reforms</p> <p>Global economy begins to recover from the financial crisis at the beginning of 2010</p> <p>Risk Weak implementation of reforms</p>
<p>Outcome Adequate access to budget financing for critical expenditure and required counter-cyclical fiscal policy secured</p>	<p>Supplementary budget approved to include fiscal stimulus of at least 1.3% of GDP</p> <p>Government's 2009 budget financing needs from the market of Rp139.5 trillion obtained</p> <p>Yields on Republic of Indonesia sovereign bonds reduced toward pre-September 2008 levels (average yields on 5-year bond in 2008 = 10.24%; yields in January 2009 = 11.85%)</p>	<p>Ministry of Finance budget reports</p> <p>Minutes of the PESF quarterly meeting endorsed by development partners and government</p> <p>Debt management office reports to the PESF committee</p>	<p>Assumption Inflation pressure eases</p> <p>Risks Counter-cyclical fiscal policy insufficient to mitigate growth slowdown</p> <p>Crisis policy responses are not well coordinated and weak administrative capacities hinder acceleration of procurement timetable and timely disbursements</p> <p>Renewed global financial turmoil leads to further global credit crunch</p>
<p>Outputs 1. Financial system stability maintained</p>	<p>Deposits in the banking system increased by 15% in 2009 over 2008 levels (baseline: November 2008 = Rp1,708 trillion)</p> <p>NPLs of the banking system remain reasonably low at</p>	<p>Bank Indonesia published statistics on deposits and NPLs</p> <p>Bank Indonesia published statistics on deposits and NPLs</p>	<p>Assumptions Appropriate monetary policy</p> <p>Improved banking supervision</p> <p>Risk Domestic confidence in the banking system weakened</p>

Design Summary	Performance Targets and/or Indicators	Data Sources and/or Reporting Mechanisms	Assumptions and Risks
<p>2. Critical public spending protected and increased if the economy slows further</p> <p>3. Investment restrictions clarified</p> <p>4. Access to export financing eased</p>	<p>below 6% (baseline: November 2008 = 4.0%)</p> <p>5-year credit default swap returned to pre-crisis level of below 300 basis points</p> <p>Number of affected persons receiving targeted social assistance maintained at 19 million households (end of 2008 level for the unconditional cash transfer program)</p> <p>Share of infrastructure spending in central government budget maintained (11% in 2008)</p> <p>Percentage of capital expenditure disbursed in the first half of 2009 increased (from 21% in 2008)</p> <p>Investor's complaints on the negative list reduced</p> <p>Restrictions on foreign direct investment in key economic sectors clarified and reduced</p> <p>The use of letter of credit for trade finance increased (15% in 2008)</p>	<p>Bloomberg</p> <p>Ministry of Finance, Coordinating Ministry for Social Welfare, and BAPPENAS poverty monitoring and response quarterly report</p> <p>Ministry of Finance Line ministries</p> <p>Ministry of Finance budget report on disbursements</p> <p>Ministry of Public Works</p> <p>Government website Indonesian Chamber of Commerce and Industry (KADIN)</p> <p>Indonesia Investment Coordinating Board (BKPM)</p> <p>Bank Indonesia</p> <p>Government statistics on trade finance</p>	<p>Assumption Pro-poor targeting under social assistance program remains effective</p> <p>Risks Social assistance program overstretched</p> <p>Weak interministerial coordination</p> <p>Assumptions New IT system to process DIPA put in place early</p> <p>Capacity in line ministries improved</p> <p>Risk Weak interministerial coordination</p> <p>Assumption Timely interministerial support for the regulation</p> <p>Risk Weak interministerial coordination</p> <p>Assumptions Commercial Banks are able to participate in re-discount window program quickly</p> <p>More exporters move from cash to letter of credit-based transaction</p>

Activities with Milestones	Inputs
<p>1. Maintaining financial sector stability:</p> <p>1.1 Government submits a draft financial safety net law (January 2009).</p> <p>1.2 Parliament approves supplementary budget for 2009 (February 2009). Government issue financing plan Increase ceiling on deposit insurance</p> <p>1.3. Government issues financing plan for 2009 (last week of January 2009).</p> <p>1.4 PESF committee meets in April, July, October, and December 2009 to verify the macroeconomic situation, the Government's financing needs shortfalls, and any drawdowns from the PESF facility loans.</p> <p>1.5. Government issues Republic of Indonesia sovereign dollar bonds in Q1 and Q2 2009.</p> <p>2. Critical public spending protected and expanded if economy slows further:</p> <p>2.1 Ministry of Finance issues regulations to permit carryover of unspent funds from 2008 (January 2009).</p> <p>2.2 Establish a poverty monitoring system in anticipation of a possible growth slowdown or crisis (January 2009).</p> <p>2.3 Issue regulations that expedite budget disbursements (January 2009).</p> <p>3. Clarify investment restrictions:</p> <p>3.1 Prepare a draft Presidential Regulation to clarify the investment negative list (March 2009).</p> <p>4. Ease access to trade finance:</p> <p>4.1 Bank Indonesia issues regulation on rediscount window for trade finance (December 2008).</p>	<p>ADB's program loan: \$1.0 billion</p> <p>World Bank loan: \$2.0 billion equivalent</p> <p>Government of Japan: \$1.5 billion equivalent</p> <p>Government of Australia: \$1.0 billion equivalent</p>

BAPPENAS = Badan Perencanaan Pembangunan Nasional (National Development and Planning Agency), DIPA = Budget Activity List, GDP = gross domestic product, NPL = nonperforming loan, PESF = Public Expenditure Support Facility, Q = quarter.

DEVELOPMENT POLICY LETTER AND POLICY MATRIX

A. Development Policy Letter



Letter of Development Policy

No. S – 53/MK/2009

Jakarta, 28 January 2009

Mr. Robert Zoellick
President
The World Bank
Washington, DC

Mr. Haruhiko Kuroda
President
Asian Development Bank
Manila

Mr. Shoichi Nakagawa
Minister of Finance
Tokyo
Japan

Mr. Wayne Swan
Treasurer
Canberra
Australia

Dear Mr. Zoellick, Mr. Kuroda, Mr. Nakagawa and Mr. Swan,

On behalf of the Indonesian Government I am writing to request your support for our reform program in the face of the current difficult global economic environment, including through the provision of contingent budget financing.

We very much appreciate the financial support and technical assistance being provided under the various Development Policy Loans, as well bilateral agreements and technical assistance initiatives. In fact, our reforms, including many that you have been supporting, have placed us in a better position to deal with the mounting crisis. That said, the financial crisis that began in the developed world last year has affected Indonesia and we anticipate a difficult period for growth and potentially, in terms of access to the domestic

and international financing we need to deliver on poverty reduction and other development objectives. We will present to Parliament our revised budget projections for the year ahead but it is clear that worsening global developments will significantly reduce growth in Indonesia over the next year or two. The dimensions of the global downturn are becoming clearer and are generally worse than expected while uncertainty continues to remain high. In the meantime our access to international and domestic financial markets has been dramatically affected and we remain very concerned about our ability to obtain sufficient budget finance. We are committed to accessing domestic and international capital markets as our main source of financing and last year we enacted a number of measures designed to reassure financial markets. This month we have begun to reissue debt and it has gone relatively well. However, given the illiquidity we witnessed in October and November 2008 and projection throughout the year 2009, we would be remiss if we did not also ask for your assistance through a contingent facility.

Through most of 2008 the Indonesian economy performed quite well and poverty and jobs outcomes improved despite softening world markets. However, the crisis in global financial markets and dramatic drop in commodity prices that accelerated in October and November hit Indonesian financial markets hard as interest rates spiked, the exchange rate depreciated sharply and stock prices crashed. We are now beginning to see the spillover into the real sector as exports and commodity prices are falling rapidly and liquidity pressures investment and consumer lending. In response, the Government and Bank Indonesia have moved to address the crisis. We have been concentrating in three areas: measures to reassure financial markets; measures to maintain, even accelerate, critical public spending; and measures to sustain exports and attract private investment. We anticipate that the net effect of our efforts will build on existing reforms to address the increasingly difficult and uncertain times ahead.

In our 2009 Budget submission to Parliament we anticipated that there might be financing difficulties and proposed a 2009 deficit of approximately 1 percent of GDP. However we also requested increased discretion, including to reallocate budgetary funds toward social and infrastructure spending and to respond flexibly to the possible need for contingent financing. This authority was granted in the event that the economy was worse than projected or financial markets were inaccessible. In our resubmission to Parliament we have proposed to exercise this provision and to widen the budget deficit to 2.5 percent of GDP. To provide added confidence we are requesting contingent financing of between 5 and 6 billion dollars from all sources over the 2009 and 2010 budget years, although given the uncertainty more would be preferable. Specifically based on our discussions with you we request a package of contingent loans or equivalent support totaling US\$2 billion from the World Bank, US\$1 Billion from the Government of Japan, US\$1 billion from the Government of Australia and US\$1 billion from the Asian Development Bank.

THE ECONOMIC SITUATION AND OUR RESPONSE

The macroeconomic picture in Indonesia is changing rapidly. Economic growth through the first three quarter of 2008 was 6.3 percent with investment especially strong. Before

the recent economic turmoil we had projected that growth in this range would carry us into 2009. Initial results show some slowing in GDP in the fourth quarter last year but momentum remains reasonably strong and we still anticipate growth around 6 percent for the quarter and over 6 percent for 2008 as a whole.

However, since October the situation in our financial markets has been extremely volatile and the impact of the global crisis is spilling over into real economic activity. There have been unusual and threatening spikes in interest and exchange rates which have affected investment and production decisions. One of the main transmission channels from the global growth slowdown is expected to be through our exports. In October and November export values fell by 12 percent and 11 percent respectively from the month earlier and are now below a year earlier. Conversely, inflation which had been one of our greatest concerns earlier in the year has begun to moderate substantially in November and in December we began to see some small deflation. Inflationary expectations have now returned to targeted levels reducing price pressures and allowing us to reverse the tightening cycle on interest rates. Thus Bank Indonesia reduced administered interest rates by 25 basis points in December and another 50 basis points in January, to 8.75 percent currently, and we are now starting to see some decline in bank rates as well. Some of the reduction in domestic prices arises from the decline in commodity prices globally, especially the international oil price. The Government has taken the opportunity of lower international oil prices to reduce administered prices of gasoline and diesel, while agreeing with Parliament that we will move to prices that reflect economic opportunity costs for premium gasoline. In the longer term we remain committed to reducing fuel subsidies and replacing them with a better targeted and administered social protection system.

With the world economy continuing to deteriorate and the results of the 2008 budget available we have taken the opportunity to propose to Parliament a supplementary budget. This budget includes revised macroeconomic assumptions, a higher deficit and some adjustments to spending. It is now clear that growth is slowing and will likely continue to slow. Thus our revised growth outlook is for the economy to come in between 4.5 and 5 percent this year while the exchange rate will be higher and inflation and interest rates lower. We are now looking at international oil prices at 45 dollars a barrel down from 80 dollars a barrel assumed earlier. Last year's outcome was very strong in terms of tax revenues but the economic downturn and the lower commodity prices are expected to reduce tax revenues in 2009 to well below the level targeted in the original 2009 budget approved in November last year while lower oil prices will significantly reduce non-tax revenues thus widening the deficit. We would also like to put in place some additional stimulus to provide for higher growth than would otherwise be possible. The net effect is an increase in the budget deficit from 1 to 2.5 percent of GDP. A substantial part of the financing of this deficit is available from the unspent balances rolling over from last year, of close to 1 percent of GDP, but there is some additional financing need created as well, i.e. close to ½ percent of GDP. We anticipate that the higher deficit, and the fiscal stimulus it enables, will allow growth to come in nearer the

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top of our range, reducing some of the economic and social pressures that would otherwise emerge.

Like the rest of the world the most immediate effects of the global financial crisis have been the impact on liquidity both domestic and foreign currency. Liquidity is especially scarce and correspondingly expensive. This is happening in part because the world financial system is deleveraging and in part because perceptions about counterparty risk have increased. Illiquidity and increased risk perceptions have created a number of problems for us, but two important ones relate to the functioning of the interbank market, especially for smaller banks, and for trade finance more broadly. We anticipate a possibility that smaller banks and non-bank financial institutions might face liquidity and perhaps solvency problems as the slower growth plays out. We have taken a number of steps to address this concern. We have passed regulations that allow the Government and Bank Indonesia increased flexibility for deposit insurance, including the ability to put in place a blanket guarantee as some of our neighbors have done. We do not currently see the need for this measure and have currently limited ourselves to increasing the deposit guarantee from 100 million rupiah to 2 billion rupiah. Another measure frees up needed liquidity in the banking system by allowing banks to use performing loans as collateral against short term borrowings from the Central Bank. Both of these measures were subsequently adopted by Parliament into law. We have also reduced required reserves that Bank's hold (especially foreign currency), providing additional liquidity to the market. In November we had introduced another regulation in lieu of law designed to clarify the roles and strengthen the legal basis for Bank Indonesia and the Ministry of Finance to intervene in troubled banks and non-bank financial institutions that pose systemic risks. This measure has not yet been agreed on with Parliament and turned into law but we have resubmitted a revised bill on how best to deal with these situations, to be deliberated and agreed during the current session of Parliament.

Indonesia as member of the G-20 committed to a transparent assessment of our regulatory and financial system at the G-20 meeting in November in Washington DC. We are confident that our regulations and supervision procedures are good but the economic crisis has revealed faults almost everywhere and we look forward to an in-depth assessment of our financial institutions. Thus we have requested the World Bank and the IMF to carry out a financial sector assessment program for Indonesia. We anticipate that this program will assist us in building a strong foundation for our financial system for the longer term especially as we look to deepen and broaden bank and non-bank financial institutions.

One issue of concern to financial markets has been the amount of gross financing the Government requires in 2009 and 2010. Due to increase on financing needed to accommodate the stimulus combined with high levels of debt coming due, total borrowing needs are already a concern to financial markets, both domestic and international. This, combined with the problems of liquidity and counterparty risk, have acted to raise Government borrowing costs and threaten access to international sources that we have been using for a number of years. It is this concern that motivated our



conversations with our development partners. These conversations led to a plan for contingent financing designed to reinforce the reforms we were undertaking to address the imminent crisis and generate market confidence. As I indicated above, our principle has been to access capital markets with the contingent financing designed to provide a clear back stop in the event that this was not possible or prohibitively expensive and we have developed a financing plan that spells this out.

While the economy continues to slow, and financial markets remain volatile there has been some calming since December. The exchange rate pulled back from its low and reaches a new stable equilibrium, while interest rates, especially domestic ones fell significantly. In part this reflects a broader calming in international capital markets, but in part we believe it represents growing market confidence in Indonesian policy making and the underlying strength of our economic position. However, we also believe that the markets have factored in the positive responses from the development partners for the contingent financing proposed here.

A key concern as we face a difficult year ahead is the need to sustain livelihoods while building for the future. This inevitably involves maintaining or increasing social and infrastructure spending. To do this we increased social spending and maintained spending on infrastructure in the budget passed last year. In the revised budget we are proposing to increase the stimulus provided through 27.5 trillion rupiah in increased spending on social programs, tax incentives and infrastructure. The details will be worked out with Parliament over the next couple of weeks. Another area of concern in recent years has been our ability to deliver on budgeted spending levels and to shift more of our spending to earlier in the year when possible and prudent. To accelerate spending on identified priorities in 2009 we are allowing the carry over of unspent balances on the critical PNPM anti-poverty program and have eased procedures to allow increased funding for existing infrastructure programs. Both of these should provide a needed economic stimulus earlier this year. We have developed policies designed to accelerate spending including through accelerated procurement procedures (preparation and tendering in anticipation of the following years financing), procedures designed to facilitate continuity of project teams in multi-year projects, and through simplified procedures to reallocate across sub-activities. To monitor and suggest further improvements we have established a team responsible for monitoring and improving budget execution. We have made an intense effort to raise the awareness of these measures at all levels of the government and across the country and again anticipate that this should allow more spending earlier in the budget year and as such improve the economic response.

The other key priority in the face of the crisis is to improve social protection. The last few years have seen the development of a social protection system, including a nationwide program of community grants (often for local infrastructure), the piloting of a conditional cash transfer system and a program of unconditional cash transfers designed to assist the poor adjust to fuel and food price shocks. These programs are now in operation but they were designed against the employment, poverty and social situation as they were last year. If and when the economic situation deteriorates in specific areas these programs can

help but only if we are aware of problems and respond effectively. The Planning Ministry is establishing a social and poverty monitoring and response system to anticipate problems as they arise and we are also proposing to Parliament to use the increased budget flexibility to reallocate spending toward social programs to allow us to address specific problems in targeted areas. To coordinate this Poverty effort (in the face of the crisis), but also to address longer term challenges we have submitted to the President a decree that clarifies responsibilities and establishes a central coordinating body for poverty reduction efforts.

The third pillar of our strategy looks to tackle the problems in the private sector as companies attempt to address problems of slackening demand and inaccessible trade finance. The current global conditions make it even more imperative that Indonesia remains competitive for the dwindling investments and that we position ourselves as best possible for the recovery. To do this we are moving ahead on the longer term reform agenda on the investment climate and to broaden the ASEAN single market and promote trade more generally.

As we move into 2009 we are fortunate that recent reforms to the income tax law are coming into effect. These changes reduce corporate and individual taxes and tax rates (with further reductions to come) as well as provide incentives for companies to go public. To these we are adding additional fiscal measures for selected labor intensive sectors. As I noted, while falling considerably we anticipate that Indonesian growth will remain attractive to investment in certain sectors and we want to promote new investments and encourage existing investors to expand. Thus we are pushing ahead with reforms designed to clarify unresolved issues around our investment law and negative list. Specifically, we propose to update sector restrictions on the investment negative list to bring them into line with our commitments under the ASEAN Economic Community Blueprint, to clarify the details of grandfathering and the status of publicly listed companies, and to clarify that line ministries cannot create new restrictions on investment beyond those contained in the presidential regulation on the investment negative list.

While oil and commodity prices have fallen substantially since their peak in 2008 most analysts project that higher and perhaps substantially higher oil prices as world economic growth returns. Indonesia has substantial reserves of oil, gas and minerals and we intend to position ourselves to take advantage of this recovery in demand and prices. The Parliament has just passed a Mining Law that should provide more certainty for mining companies investing in these resources. To further improve certainty we are placing an increased emphasis on transparency in extractive industries. With improved transparency for national and regional governments as well as mining and oil companies we hope to reduce the uncertainty around investments and therefore increase demand. To reinforce the benefits the Government has submitted a request to begin the process of joining the Extractive Industries Transparency Initiative.


Finally, we have been especially concerned with the difficulties exporters are facing with respect to trade finance and we are also moving to address this problem. First, Bank

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Indonesia has opened a rediscount window for trade finance to increase the amount of financing available for these activities and Parliament has just passed a law creating a new export financing agency that should, over the year ahead, assist existing and especially new exporters gain access to critical trade financing. In the slightly longer term we very much believe that Indonesia will continue to grow based on a widening export base and we remain committed to our engagement with the WTO and ASEAN to promote international trade and investment.

Conclusion

The year will likely bring difficulties to all of us. Despite these circumstances the Government of Indonesia remains committed to pushing ahead with our reform agenda while continuing to work to reduce poverty as best we are able. Thus we appreciate your positive expressions of support and look forward to working with you in the context of this contingency operation.

 Minister of Finance
Republic of Indonesia


Sri Mulyani Indrawati

 Coordinating Minister for the Economy
Republic of Indonesia


Sri Mulyani Indrawati

B. Policy Matrix for Public Expenditure Support Facility Program

Table A2.1: Policy Area 1: Reassuring Financial Markets and Maintaining Financial System Stability

No.	Proposed Policy Action	Responsible Agency and Documentation Required	Status
1.	Submit to Parliament a draft law that clarifies the roles, responsibilities, and procedures that govern the actions and responses of Bank Indonesia, the Ministry of Finance, and the Deposit Insurance Corporation in the event of the failure of a financial institution.	Ministry of Finance (Draft Law on Financial Safety Net)	Completed. The Government submitted a draft law on Financial Safety Net to parliament on 14 January 2009 and the draft currently is being deliberated by a Special Parliamentary Committee.
2.	Take steps to maintain the stability of the banking system by:		
	a. Issuing a Government Regulation in Lieu of Law that allows for increasing the ceiling on deposit insurance	Ministry of Finance (amended Deposit Insurance Law)	Completed. Parliament has approved the relevant law 13 January 2009. The ceiling was raised from Rp100 million to Rp2 billion through Government Regulation No. 66/2008.
	b. Issuing a Government Regulation in Lieu of Law that amends the Bank Indonesia Law regarding the types of assets that banks can use as collateral for short-term borrowing from the central bank	Bank Indonesia (amended Bank Indonesia Law)	Completed. Parliament has approved the relevant law on 13 January 2009.
3.	Initiate a financial sector assessment program.	Ministry of Finance and Bank Indonesia (Joint Letter dated 23 December 2008)	Completed. A letter requesting a financial sector assessment program was sent to the International Monetary Fund and the World Bank by the minister of finance and the governor of Bank Indonesia.
4.	Issue and commit to implement a financing program for 2009, which specifies the terms and circumstances under which the Government would draw on the support available from the PESF and from Indonesia's other development partners.	Ministry of Finance (Director General Debt Management Decree No. KEP04/PU/2009)	Completed. The decree was issued on 27 January 2009.

PESF = Public Expenditure Support Facility.

Source: Asian Development Bank.

Table A2.2: Policy Area 2: Sustaining Critical Public Expenditures While Maintaining Budget Discipline

No.	Proposed Policy Action	Agency Responsible and Documentation Required	Status
5.	Issue a Ministerial Directive to establish a poverty monitoring and response system in anticipation of a possible growth slowdown or crisis	BAPPENAS (Ministerial Directive 0014/M.PPN/01/2009)	Completed. The ministerial directive was issued on 27 January 2009.
6.	Issue a presidential regulation on coordination of national poverty reduction efforts	Coordinating Ministry for People's Welfare. (Presidential regulation on coordination of national poverty reduction efforts).	Completed. The presidential regulation was issued on 27 March 2009.
7.	Include specific provisions in the 2009 budget law to sustain, and if necessary, increase critical public expenditures in areas of poverty alleviation, social protection, and infrastructure maintenance and development in the event of a pronounced growth slowdown	Ministry of Finance (Law No. 41/2008)	Completed. This has been articulated in Law No. 41/2008 on 2009 budget.
8.	Implement specific regulatory measures to expedite budget disbursement and enhance the ability of the Government to rapidly direct public expenditures to preempt as well as mitigate any adverse impacts of a growth slowdown	Ministry of Finance (Regulations Nos. 240/PMK.05/2008; 06/PMK.02/2009; and 15/KMK.05/2009)	Completed. The three ministerial regulations were issued to expedite budget disbursement to mitigate the impact of a growth slowdown.

BAPPENAS = Badan Perencanaan Pembangunan Nasional (National Development and Planning Agency).
Source: Asian Development Bank.

Table A2.3: Policy Area 3: Crowding in Private Investment and Supporting Exports

No.	Proposed Policy Action	Agency Responsible and Documentation Required	Status
9.	Prepare a draft of a presidential regulation on the investment negative list that accommodates Indonesia's international commitments on sectoral restrictions; and clarifies the status of publicly listed companies, foreign equity limits for direct investment, grandfathering, and the creation of investment restrictions beyond those stipulated in the investment negative list	Coordinating Ministry for Economic Affairs and Ministry of Trade (draft presidential regulation)	Completed.
10.	Take steps to increase transparency regarding revenues from extractive industries by:		
	a. Issuing an interministerial memorandum of understanding on the preparation for the implementation of transparency on state income from extractive industries	Coordinating Ministry for Economic Affairs, Ministry of Finance, and Ministry of Energy and Mineral Resources (MOU-01/M.EKON/01/2009; MOU-54/MK/01/2009; MOU-0274/MEM/01/2009)	Completed. The three ministries issued the memorandum of understanding to increase transparency regarding revenues from extractive industries on 15 January 2009.
	b. Signing on to the Extractive Industries Transparency Initiative	Coordinating Ministry of Economic Affairs (letter from the minister to EITI secretariat)	Completed. Letter from the coordinating minister of economic affairs to the EITI Secretariat was sent on 31 December 2008.
11.	Open a rediscount window for trade finance	Bank Indonesia (Regulation No.10/34/PBI/2008)	Completed. Bank Indonesia has introduced a special discount window for trade finance as an emergency response measure to assist in trade financing.
12.	Promulgate a law on the establishment of an export financing agency	Coordinating Ministry for Economic Affairs (Law No.2/2009)	Completed. In January 2009, parliament passed a law establishing the Export Financing Agency.

EITI = Extractive Industries Transparency Initiative.

Source: Asian Development Bank.

DEVELOPMENT PARTNERS COORDINATION MATRIX

Core Policy Area in the Development Policy Support Program	Components	ADB Support for Policy Reforms	Support from Other Development Partners
A. Improved Investment Climate	1. Improve tax and customs administration	Local tax reforms (Local Government Finance and Governance Reform Sector Development Program: Loan 2193-INO)	AusAID: improving government tax revenues through activities undertaken at the Large Taxpayers Office under Technical Assistance Management Facility III AusAID/IMF: national level tax reforms World Bank: local government tax reforms ASEAN Secretariat: facilitating trade with a national single windows
	2. Improve trade policy	Enhancing foreign trade tariff competitiveness and improved research capability of trade ministry (Loan 1738-INO)	The European Union: trade-related cooperation JICA: trade-related technical assistance
	3. Improve investment procedures and reduce business start-up time	Enhancing industrial competitiveness; 2002–2004 amendments to the Investment Law (Loan 1738-INO)	World Bank; USAID; Japan IFC: Indonesia SME Assistance
	4. Strengthen small business	Industrial Competitiveness and SME development (Loan 1738-INO) and SME Export Development Project (Loan 1978-INO)	IFC: Indonesia SME Assistance
	5. Strengthen the financial sector	Financial governance reform focused on strengthening supervisory architecture, and market development (Loan 1965-INO) Long-term financing modalities (establishment of Secondary Mortgage Facility) Enhancing financial and corporate governance in state-owned enterprises (Loan 1866-INO) Capital Market Development Program (Loan 2379-INO)	AusAID (financial stability, capital market, and nonbank financial institutions), IMF (restructuring), World Bank (restructuring, product development, mutual funds), USAID (deposit insurance), IMF (mutual funds)
B. Improved Public Financial Management and Anticorruption	6. Strengthen budgeting, controls, transparency in financial management	Support for state-owned enterprises' financial management reforms; audits (Loan 1866-INO)	World Bank (public financial management and revenue administration reforms)

Core Policy Area in the Development Policy Support Program	Components	ADB Support for Policy Reforms	Support from Other Development Partners
		Policy, institutional, legal, and regulatory reforms in audit sector (Loan 2126-INO) Capacity development for State Audit and Inspection Agency (Loans 2127-INO and 1620-INO)	World Bank (support to Supreme Audit Agency; crosscutting work through country financial accountability assessment) CIDA USAID
	7. Improve procurement process and outcomes		World Bank (procurement assessment report)
	8. Initiate civil service reform		UNDP (governance) GTZ (civil service)
C. Improved Delivery of Public Services	9. Institutionalize assessments of service delivery mechanism		World Bank (guidelines for monitoring and evaluation work of a new proposed deputy under BAPPENAS)
	10. Strengthen public service delivery in education, water, local government, and community-based development	Sustainable Capacity Building for Decentralization (Loan 1964-INO)	World Bank (community-driven development programs) AusAID (local government bonds) USAID (Decentralized Basic Education Program)

ASEAN = Association of Southeast Asian Nations, AusAID = Australian Agency for International Development, BAPPENAS = Badan Perencanaan Pembangunan Nasional National Development Planning Agency), CIDA = Canadian International Development Agency, GTZ = Deutsche Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Cooperation), IMF = International Monetary Fund, JICA = Japan International Cooperation Agency, SME = small and medium-sized enterprise, UNDP = United Nations Development Programme, USAID = United States Agency for International Development
Source: Asian Development Bank.

SECTOR ANALYSIS 1: MACROECONOMIC ASSESSMENT AND DEBT SUSTAINABILITY ASSESSMENT

1. The sector analysis assesses the recent macroeconomic developments and provides the background to identification of issues and threats faced by the Government from the ongoing global financial crisis in achieving its development objectives to maintain progress in enhancing macroeconomic stability and reducing poverty.

A. Real Sector and Inflation

2. **Economic Performance.** Indonesia enters the global financial crisis with respectable economic performance. Economic growth accelerated to a 10-year high of 6.3% in 2007. Despite unstable global financial markets and a slowing world economy, Indonesia did not experience a growth slowdown in the first half of 2008 and economic growth remained strong at 6.1% in the third quarter (Q3) (Figure A4.1[a]). Available estimates suggest that growth in Q4 remained relatively robust, bringing economic growth to about 6% in 2008. Economic growth has become broader based, with a strong pickup in investment and stronger export performance attributed to high prices of commodities during the first half of the year (Figure A4.1[b]). Economic growth since 2006 appears to have been more employment friendly since unemployment declined from 10.3% in 2006 to 8.3% in 2008 (Figure A4.1[c]). The poverty rate has also fallen significantly, reaching the pre-crisis level of 16.6% in 2007 and falling further to 15.4% in 2008.

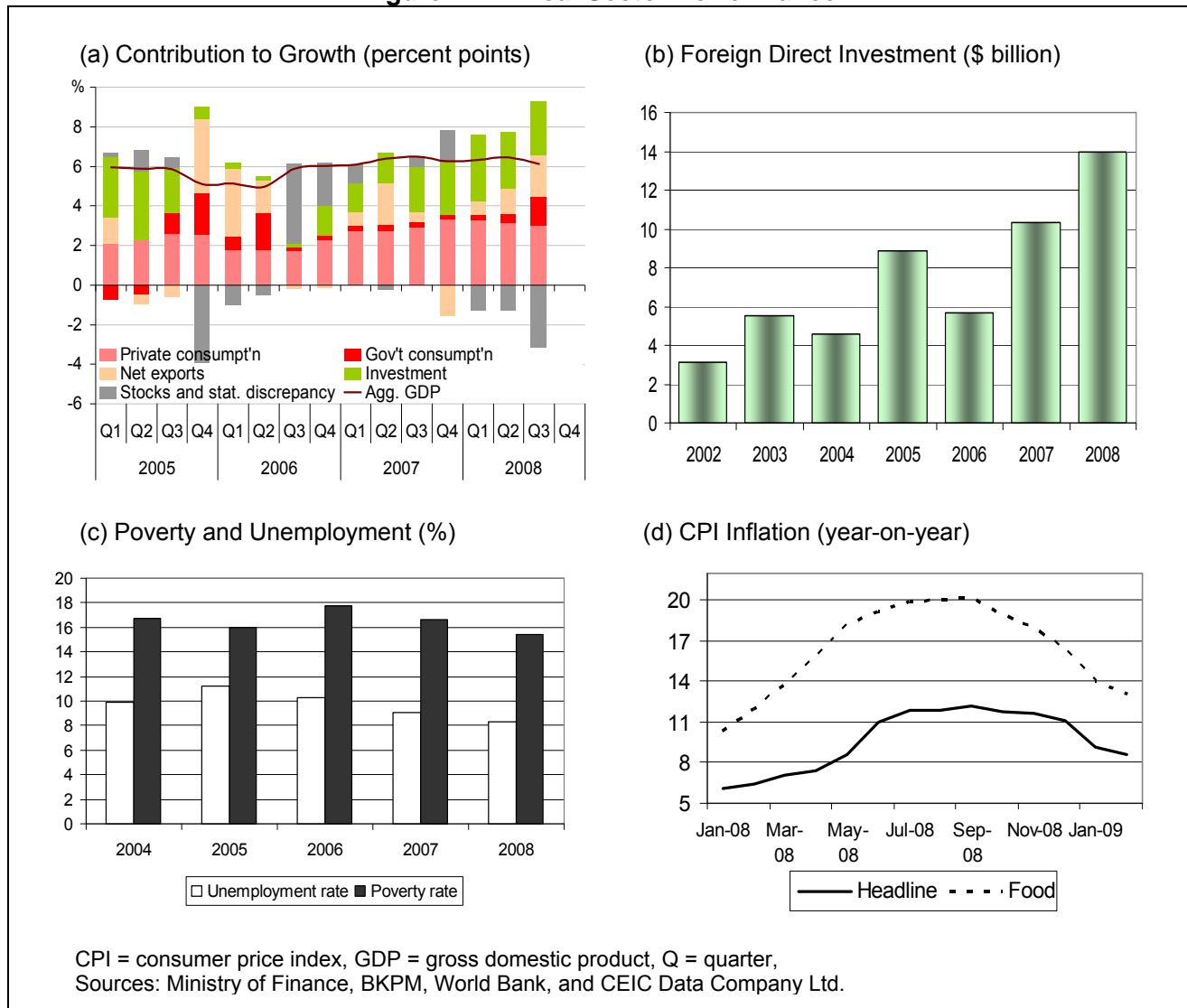
3. Looking ahead, global growth is expected to slow sharply to its lowest pace since the 2001 recession, and global financial conditions are expected to tighten further. The International Monetary Fund (IMF)¹ revised its forecasts in January 2009 and suggested that global growth would fall to 0.5% in 2009 from 3.8% in 2008. Against uncertainties in the financial markets, activities in the advanced economies are expected to contract by 2%. Economic growth in emerging and developing economies is also expected to slow sharply to 3.2% from 6.2% in 2008 because of falling export demand, lower commodity prices, and much tighter external financing constraints. The global economy is projected to experience gradual recovery in 2010, but the outlook is highly uncertain. Against this backdrop, economic growth in Indonesia is expected to decelerate in 2009 because of a projected sharp reduction in external demand for exports. The recent decline in commodity prices will also have a negative impact on Indonesia. Projected decline in capital inflows, particularly foreign direct investment, would constrain investment. Private consumption, the largest source of growth, would be hurt by more sluggish earning, expected higher levels of unemployment and underemployment, and public desire to save during uncertain times. The Government plans to introduce a modest fiscal stimulus to prevent a sharp economic slowdown, which could significantly reverse progress in reducing poverty.

4. **Inflation.** While inflation has been a major concern since the start of 2008, the pressure has eased since Q3 2008. Like in many countries in the region, inflationary pressure was driven by largely external factors related to escalating international prices of food and commodities (Figure A4.1[d]). Domestic factors also contributed as lending to the private sector grew by over 30% in Q3 2008. In response to the rising inflation, Bank Indonesia progressively increased its rate by 150 basis points to 9.50% in October 2008. However, year-on-year Consumer Price Index (CPI) inflation fell from a peak of 12.1% in August to 7.9% by March 2009. Waning

¹ International Monetary Fund. 2009, *World Economic Outlook Update*. Washington, D.C. (January). Available: <http://www.imf.org/external/pubs/ft/weo/2009/update/01/index.htm>

inflationary pressures, reduction in the downward pressures on the rupiah, and the rapidly weakening growth prospects led Bank Indonesia to lower its policy rate to 7.5% in April 2009. Inflation is projected to decline rapidly to 6%–7% in the second half of 2009.

Figure A4.1: Real Sector Performance

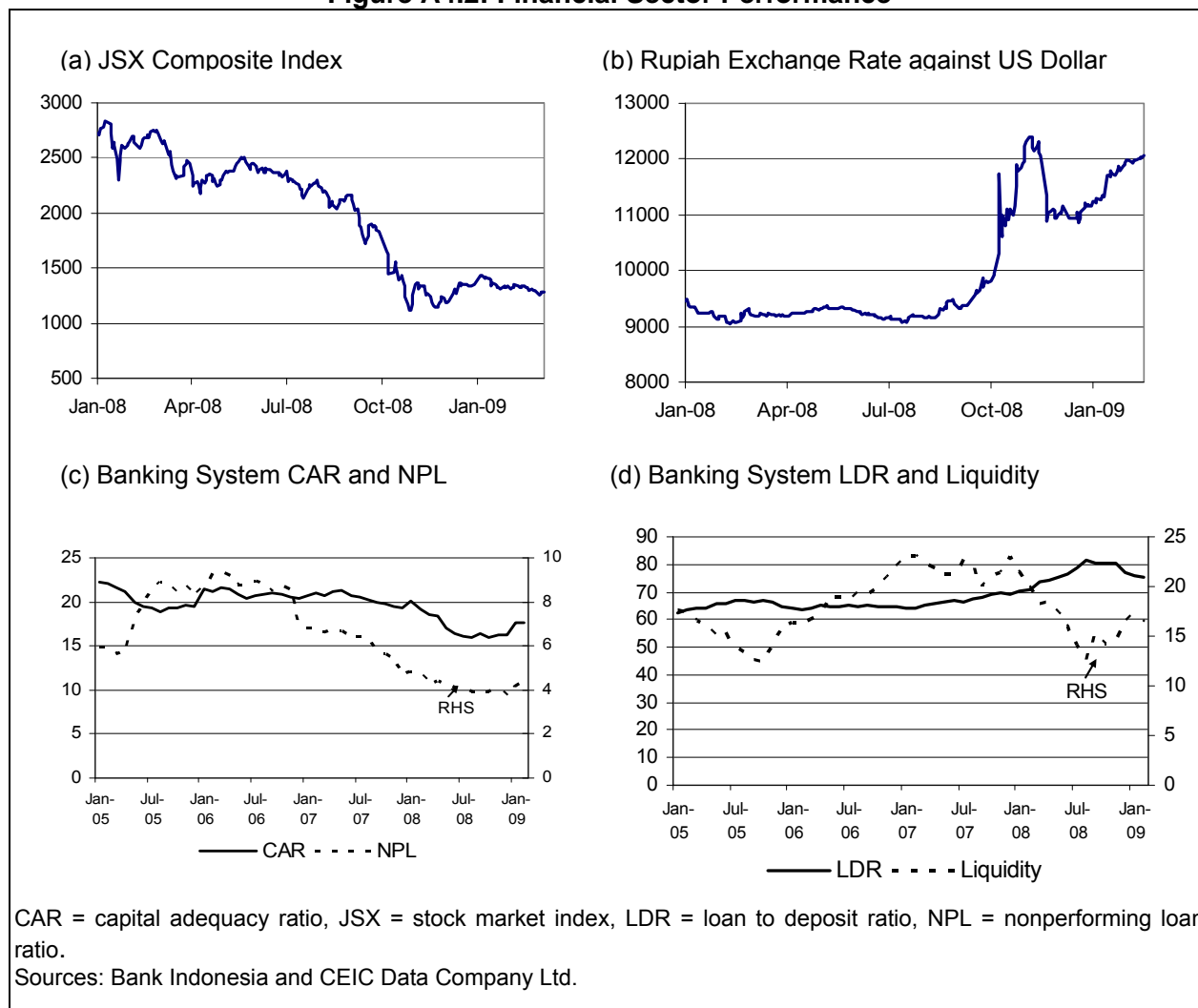


B. Financial Sector

5. **Stock Markets and the Rupiah.** Indonesia's stock markets and the rupiah have been adversely affected by the global financial crisis. After being one of the best performers in Southeast Asia in 2007, the stock market index (JSX) experienced very large correction in 2008. As of 30 December 2008, the stock market index had plummeted more than 50% for the year, with over a quarter of the decline occurring since early October (Figure A4.2[a]). After moving broadly stable against the US dollar since mid-2006, the rupiah came under pressure from early October to late November and depreciated by more than 30%. The rupiah has recovered part of the loss and stabilized around Rp11,000–Rp12,000 per \$1 since December 2008 (Figure A4.2[b]). Initially, Bank Indonesia intervened heavily in the spot market in September and October, driven in part by concerns that a large depreciation of the rupiah would risk

triggering domestic capital flight. Subsequently, Bank Indonesia reduced its net intervention in November and allowed the rupiah to find its new equilibrium. The public adjusted well to a significant depreciation of the rupiah and the feared domestic capital flight did not occur. The foreign reserve position of Bank Indonesia has remained relatively stable since November 2008.

Figure A4.2: Financial Sector Performance



6. Domestic Banking System. The direct impacts of the global financial crisis on the domestic banking system have been limited so far. The banking system has not been significantly affected by direct effects of the global crisis because of limited direct investment in troubled US assets. The banking system, which accounts for nearly 80% of the financial sector's assets, remains relatively strong. As shown in Figure A4.2(c), the average capital adequacy ratio of the banking system has declined slightly since early 2008, but remained relatively high at 18% in February 2009. Nonperforming loans (NPLs) increased slightly relative to end-2008 but remained low at 4.3% in February 2009. After declining to around 14% in October 2008, the liquidity–assets ratio has improved marginally to 16% in February 2009 (Figure A4.2[d]). However, the banking sector is expected to face new challenges going forward. US dollar liquidity in the banking system has remained very tight since September 2008 due to capital outflow. Projected weakening economic growth going forward would affect corporations and

result in rising NPLs and erosion of bank capital. Nonbank financial institutions have also financed a large proportion of their borrowing needs from foreign sources, so they will be affected by the tightening global financial market. These corporations will need to rely more on domestic lending in future, which could tighten liquidity further. Moreover, given Indonesia's exposure to externally mobile capital, continued volatility in international financial markets and spikes in global risk aversion could cause further disruptive capital outflows.

7. **Government Policy Response.** The Government is well aware of the challenges ahead and has taken a number of proactive measures. To reduce the likelihood of further disruption and maintain the stability of the financial system, the President of Indonesia issued the financial safety net regulation to establish clearly the roles, responsibilities, and procedures that govern the actions and responses of Bank Indonesia, Ministry of Finance, and Deposit Insurance Corporation in the event of the failure of a financial institution. The Government also issued Government Regulation No. 66/2008 to increase the ceiling on deposit insurance from Rp100 million to Rp2 billion, while giving the Government the authority to raise the deposit insurance ceiling further or issue a blanket universal guarantee quickly if circumstances demand. These measures have, to date, helped maintain the stability of the Indonesian banking system. In the recent case of a small nonsystemic bank failure, the measures empowered the regulatory authorities to take control of the situation quickly. Monetary policy moved to ease liquidity, including December's cut in interest rates. Bank Indonesia has also introduced a rediscount window for trade finance. This facility would facilitate exporters to repatriate export earnings to help with domestic US dollar liquidity and encourage them to deal with high-rated international financial institutions for safety.

C. External Sector

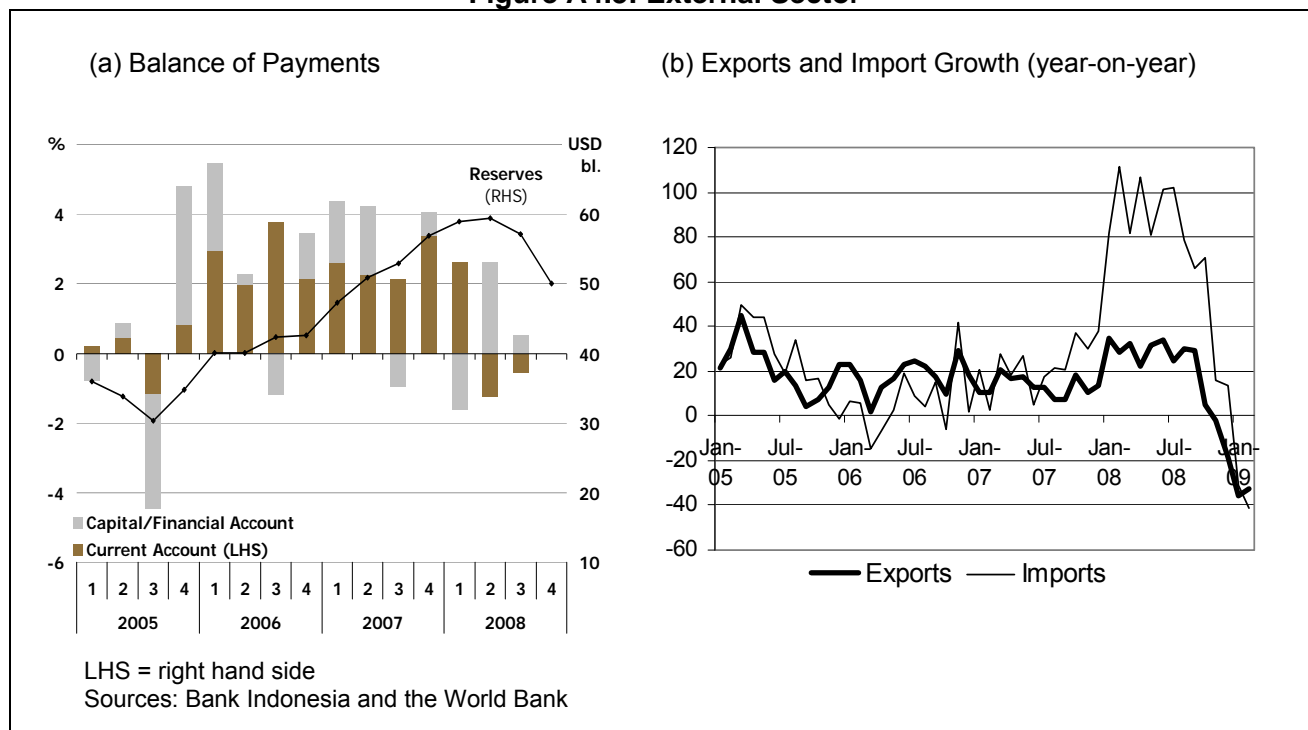
8. **Balance of Payments.** The balance of payments surplus is expected to decline amid the pressure from the global financial crisis. Indonesia recoded a balance of payments surplus of 2.5% of gross domestic product (GDP) in 2007 and remained robust in the first half of 2008 (Figure A4.3[a]). The global financial crisis has put increased pressure on the balance of payments. Exports year-on-year have started to decline sharply since December because of falling commodity prices and a slowdown in demand from developed countries. Although declining, imports remained relatively strong during the same period because of the need for materials and capital goods (Figure A4.3[b]). As a result, the balance of payment surplus receded significantly at the end of 2008. The capital and financial accounts worsened considerably as negative sentiment spurred by the global financial crisis prompted a large capital outflow in October. Part of the outflow, however, was compensated by large official capital inflows in December.

9. **Public and Private Sectors.** Overall, exposure of both the private and public sectors appears manageable. Indonesian firms have increasingly financed their investment through retained earnings, and leverage ratios in the corporate sector have fallen. The IMF estimates that Indonesian firms obtained almost half of their external financing from foreign sources in 2007.² This exposure makes firms vulnerable to rollover risks if the current global financial market conditions continue. Bank Indonesia Bank suggests that about \$22 billion of short-term public and private external debt due in 2009. About 30% corporations owe to their parent companies overseas and some are expected to rollover their debt. With sufficient level of

² International Monetary Fund. 2008. *Indonesia: Selected Issues*; IMF Country Report No. 08/298, Washington, D.C. (September)

International reserves at \$55 billion at the end of March 2009, the short-term debt position would be manageable.

Figure A4.3: External Sector



10. **Capital Flight.** The global financial crisis has heightened the risk of capital flight significantly. Indonesia is more vulnerable to capital flight because of its relatively open capital account and significant foreign presence in its stock and bond markets. While significant amounts of external capital have already been withdrawn from the country's financial markets, Indonesia remains vulnerable to further capital flight. Foreigners still holds around 14%, or Rp9 trillion, of the stock of government bonds. In addition, domestic investors have been sensitive to exchange rate movements, which could be triggered by another cycle of foreign capital repatriation caused by liquidity demands and rising risk. Although experience in January to March 2009 suggests that domestic investors have started to adjust to larger exchange rate movements, it is too early to be certain. While nonbank financial corporations are believed to have reasonably well-diversified sources of finance and not to be significantly leveraged, experience indicates that domestic capital markets are quite volatile and subject to sudden changes in sentiment originating in domestic and international markets. In addition, the size of the Government's gross financing needs could still pose risks despite the country's strong fiscal position. In brief, prolonged instability in international financial markets and protracted recession episodes in developed countries may pose challenges to the country's balance of payments.

D. Fiscal Sector and Debt Sustainability

11. **Budget.** The Government almost achieved a balance budget in 2008. An early estimate of the central government budget outturn for 2008 suggests that the budget deficit is reduced to 0.1% of GDP, compared with 1.3% of GDP in 2007. The improvement in the Government's budgetary position reflects continued fiscal discipline, policy actions to address energy subsidies, and significant progress in improving tax collections. In May 2008, the Government raised subsidized fuel prices by an average of 29%, relieving some of the budgetary burden of soaring

oil prices. Significant growth in government revenue collection since late 2007 has also strengthened Indonesia's fiscal position. Total tax revenues in 2008 were about 34% higher than tax revenues in 2007 levels because (i) the Government's efforts to improve tax administration and tax registration expanded the tax base through the Sunset Policy, (ii) tax office internal personnel management improved, (iii) targeting of special taxpayers was enhanced, and (iv) efforts to resolve a backlog of value-added tax refunds led to artificially low value-added tax revenues in 2007. The Sunset Policy encourages the public to have a tax file number and allows them to pay incorrect tax returns from previous years without penalty. Therefore, part of the increased revenue collection in 2008 is expected to be one-off.

12. **Budget Law.** The 2009 budget law passed in November 2008 continued the spirit of fiscal discipline, while containing a number of positive measures. To reduce its financing needs, the Government initially targeted a budget deficit of 1% of GDP. The budget contains provisions to ensure that priority publicly funded infrastructure projects are financed even if market conditions are unfavorable. The budget also protects social sector spending, in particular funding for the flagship community-based poverty alleviation facility, to provide a cushion for households that are adversely affected by any growth slowdown. Article 23 of the Budget Law provides the Government with flexibility to provide a fiscal stimulus in the face of a likely growth slowdown, while continuing to maintain fiscal discipline.

13. The 2009 budget was based on more optimistic economic growth, higher oil prices, and stronger rupiah. With projected weakening growth in 2009, a depreciated rupiah, and significantly lower oil prices, the Government revised the budget assumptions in January 2009. Although the revision helps the expenditure side, through a reduction in government spending on subsidies and transfers to the subnational governments (Rp60.7 trillion), its impact on the revenue side is much bigger—tax revenue declines by Rp64.1 trillion and nontax revenue declines by Rp73.1 trillion. The net effect of the revision is a higher budget deficit of Rp139.5 trillion (2.5% of GDP). While part of the increased deficit under the revised budget will be financed by the excess financing of 2008 of about Rp51.3 trillion, the revision requires additional budget financing of about Rp36.9 trillion (\$3.4 billion) relative to the budget.

14. **Budgetary Costs of Energy Subsidies.** In the 2009 budget, the Government took a further innovative step to try to contain the budgetary costs of energy subsidies. The Government is using the current low international fuel prices to educate the public about the benefit of linking domestic prices to movements in international prices. The sharp fall in oil prices through November and December 2008 has allowed the Government to reduce domestic gasoline and diesel prices three times. Effective implementation of a well-designed domestic fuel pricing mechanism would contribute to lowering the fiscal risks from the energy policies. In addition, in 2009 the Government will reduce the effective base for regional transfers by the total amount of all subsidies being provided. The measure will effectively reduce the energy subsidy cost by 26% for the central Government, while aligning the incentives of regional governments in supporting the reduction of fuel subsidies.

15. **Public Debt.** The consistent prudent fiscal policy has enabled Indonesia to reduce its public debt burden significantly. In the past 5 years, Indonesia's public debt–GDP ratio has fallen sharply, from over 55% in 2004 to around 32% at the end of 2008. Debt sustainability analysis jointly prepared by the IMF and World Bank staff suggest that, under the baseline scenario of continued historical growth and low budget deficit, the debt–GDP ratio will decline

further in 2012.³ Under most types of extreme shocks, Indonesia's debt levels and servicing obligations would remain within most thresholds for concern (Figure A4.4). For example, with a one-time 30% real depreciation of the rupiah, the debt-GDP ratio would increase debt levels by a little over 10% of GDP. A reduction in future growth by one standard deviation will increase the debt-GDP ratio by around 8%. As noted earlier, despite the country's strong fiscal position, government finances have been especially vulnerable to spikes in global risk aversion and contagion from external markets because of the country's large gross financing needs. The term structure of Indonesia's bonds led to sharply higher turnover in 2007 and 2008, and amortization is projected to remain at high levels through 2011 (Table A4).

Figure A4.4: Government Debt and Its Sustainability

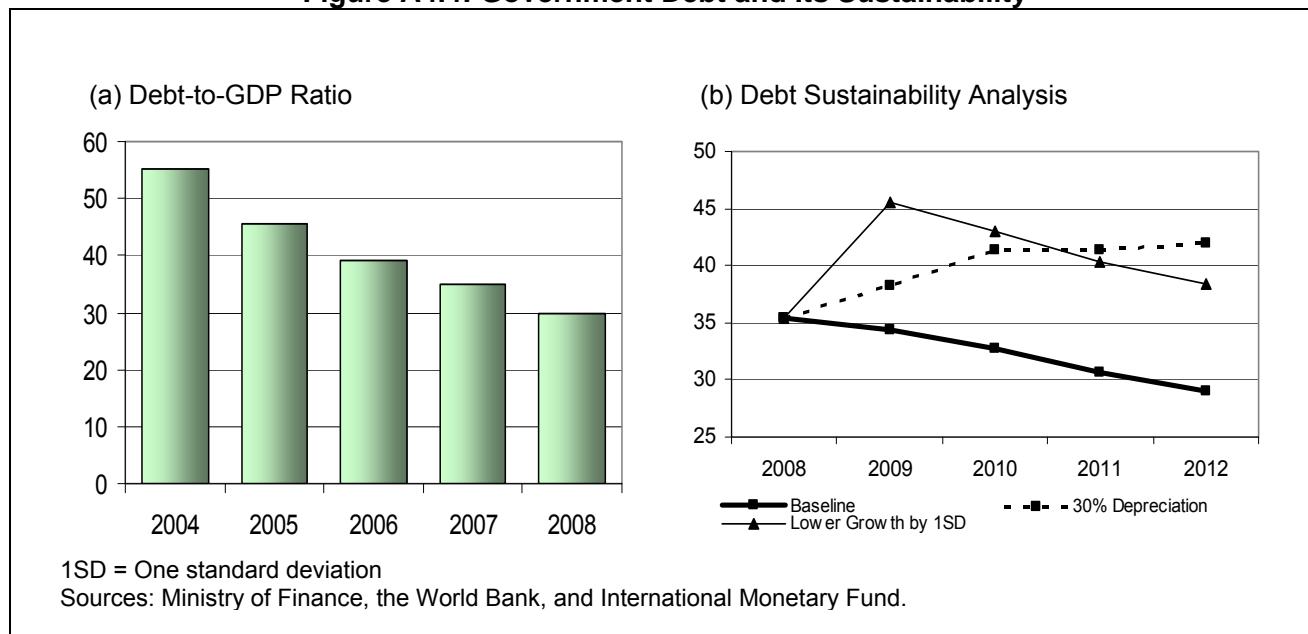


Table A4: Principal Payment
(Rp trillion)

ITEM	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Principal Payment of:																
Foreign Loan	74.4	60.3	53.4	51.8	53.3	52.2	51.8	46.5	39.5	37.7	35.5	33.5	27.4	21.1	15.6	12.3
Foreign Securities	–	–	–	–	–	14.2	10.1	9.8	10.9	20.8	–	–	–	–	–	–
Domestic Securities	42.0	40.6	43.8	46.9	47.5	30.2	38.9	29.9	33.8	37.8	37.5	45.9	26.9	34.8	33.3	19.1
Interest Payment of:																
Foreign Loan	20.5	17.8	15.8	14.0	12.2	10.4	8.8	7.7	6.0	4.9	3.9	3.0	2.2	1.6	1.2	0.9
Foreign Securities	8.9	8.9	8.9	8.9	8.9	8.5	7.6	6.8	6.1	5.0	4.3	4.3	4.3	4.3	4.3	4.3
Domestic Securities	52.7	49.7	46.2	41.4	36.4	32.4	29.0	26.2	24.3	22.0	19.6	16.7	12.8	10.9	8.7	6.4

– = data not available.

Source: Ministry of Finance.

³ World Bank. 2009. *Public Expenditure Support Facility on the Amount of US\$2 Billion to the Republic of Indonesia*, Program Document, Washington, D.C. (March)

SECTOR ANALYSIS 2: EMPLOYMENT AND POVERTY ASSESSMENT

1. The sector analysis assesses recent developments in Indonesia's labor market and poverty reduction efforts, and provides estimates of the potential impact of the current adverse economic situation on these indicators. It also provides the background to identification of issues and policy options. Employment creation and poverty reduction are the Government's two key policy priorities. In its Medium-Term Development Plan 2004–2009, the Government's goal is to reduce unemployment to 5% and poverty to 14% by the end of this year. Improvements in the business climate, infrastructure, and social policy spending are central to its strategy. However, achieving these goals of lower poverty and unemployment in 2009 is now unlikely and the indicators are expected to deteriorate given the current adverse economic conditions.

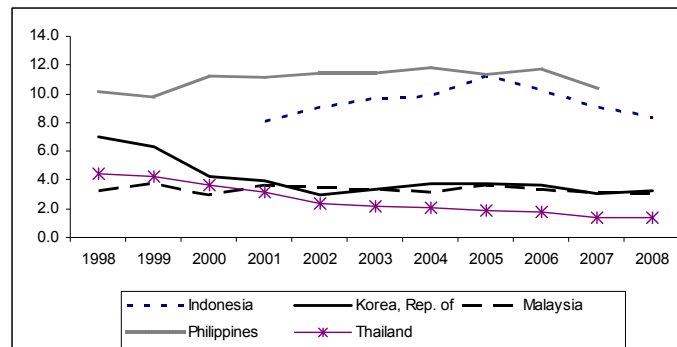
A. Recent Labor Market Performance

2. Sluggish Labor Market.

Indonesia experienced a decade of sluggish labor market performance after the Asian financial crisis of 1997–1998. From 2000 to 2006, aggregate employment rose steadily by an average of 1.0% per annum. However, it was slower than growth in the labor force (about 2.0% per annum), resulting in rising unemployment.

Open unemployment increased from an average of 4.0% in the 1990s to 6.7% in 2006. In 2001, BPS published an expanded definition of unemployment to include an estimate of “discouraged” workers (workers who have given up hope of finding a job). This added an additional 3 million persons to the unemployment figures and produced an unemployment rate of 11.2% in 2005. Figure A5.1 shows that this rate approached levels in the Philippines, and was considerably higher than rates in other Asian economies affected by the crisis (Korea, Rep. of, Malaysia, and Thailand). This was partly because the faster pace of manufacturing growth in the other countries created a large number of jobs and helped to absorb the growing labor force.

Figure A5.1: Regional Unemployment Rates (%)



Notes: For Indonesia, the Philippines, and Thailand, the rates include estimates of discouraged workers. Indonesia revised its unemployment definition in 2001 consistent with neighboring economies, so no prior unemployment figures are available for the revised definition.

Sources: Labor force survey of the five countries.

3. **Other Weaknesses.** Aggregate employment masked further weaknesses in labor market performance. In a dualistic labor surplus economy like Indonesia's, labor market weaknesses show up in diverging trends between the formal and informal sectors and across economic sectors—not in aggregate employment (or unemployment and underemployment) figures. Formal wage employment (defined as regular and casual wage employment) expanded by 0.8% per annum from 2001 to early 2006, with regular wage employment declining by 0.7% per annum despite some recovery since 2004.¹ In contrast, informal employment expanded by

¹ Prior to 2001, BPS defined wage employment as comprising regular wage employees and agriculture casual wage employees. In 2001, it separated the two types of wageworkers.

an average of 1.9% per annum.² Indonesia's performance was disappointing in terms of poor job recovery. It also contrasted with the pre-crisis years when high investment, including foreign direct investment, combined with export-led growth, was a major source of employment creation. During those years, real wages increased as labor moved from low productivity jobs in agriculture and traditional services to higher productivity jobs in modern manufacturing and services. Figure A5.2 shows where new labor force entrants found (or did not find) jobs in pre- and post-crisis periods. From 1991 to 1997, two-thirds of new job seekers found jobs in the formal sector, about 16% entered informal sector activities, and the remainder became unemployed. These trends were reversed after the crisis, with 55% of new job seekers entering the informal sector, 11% becoming unemployed, and only 33% finding jobs in the higher paying formal sector.

4. **Economic Growth.** Growth in 2007 and 2008 was accompanied by a corresponding pickup in wage employment for the first time since 1997. A steady rise in growth since 2006—reaching 6% or more—increased demand for regular wage employment by an average of about 2.5% per annum in 2007 and 2008, the fastest rate in a decade. Unemployment also declined from its peak of 11.2% in 2005 to 8.4% in 2008 (Figure A5.1).

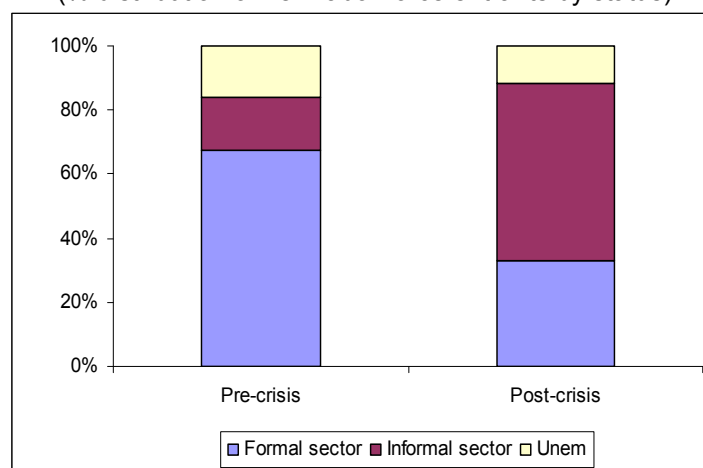
5. However, empirical analysis suggests that more regular wage jobs should have been created in the last 7 years. Empirical analysis of labor demand indicates that a 1% increase in gross domestic product (GDP) results in a 0.43% increase in formal wage employment. Analysis also shows that employment growth tends to lag real GDP growth by about 12 months. With economic growth averaging above 5% since 2000, and reaching 6% in 2007 and 2008, about 4 million regular wage jobs should have been created from 2001 to 2008, assuming all other things unchanged. However, total regular wage employment increased by only 3.2 million, giving a shortfall of up to 800,000 jobs:

$$\log \text{Formal Employment}(t) = -3.6 + 0.11 \log \text{GDP}(t) + 0.43 \log \text{GDP}(t-1)$$

(4.0) (0.5) (1.9)***

*** significant at 10% level. Annual data from 1990 to 2004

Figure A5.2: Fewer Job Seekers Found Employment in the Formal Wage Sector After 2000
(% distribution of new labor force entrants by status)



Notes: Formal employment is defined as comprising of regular wage employees plus agriculture casual wage employees; Pre-crisis refers to 1991–1997; Post-crisis refers to 2000–2008; Unem = unemployment
Source: Indonesia Labor force survey, various years.

² Informal employment includes self-employed workers, casual wagers in the nonagricultural sector, and unpaid family workers.

6. **Rigid Labor Policy.** Increased labor policy rigidities since 2000 have dampened employment recovery. An aggressive minimum wage policy and the doubling of severance pay entitlements in 2000 help explain the slow recovery in wage employment during this period. A National Development and Planning Agency (BAPPENAS) Labor Policy Review in 2003³ argued that substantial increases in minimum wages from 2000 to 2003 dampened employment creation. A United States Agency for International Development-Growth, Investment and Trade Project (USAID-GIAT) survey of 100 firms⁴ observed that substantial increases in severance rates after 2000 had coincided with reduced hiring of permanent workers in the modern economy. Labor market rigidities—most importantly minimum wages and severance costs—were cited in the USAID-GIAT survey as among the key factors inhibiting investment in labor-intensive sectors. Minimum wages have risen substantially in the post-crisis period, increasing by more than 50% in real terms in some major industrial centers from 2000 to 2003, but moderated from 2004 to 2008. Asian Development Bank (ADB) staff estimates suggest that minimum wage increases in Indonesia do not affect employment in the short term (less than 12 months) for most groups of workers, but reduce employment of youths, females, and low educated workers in the longer term.⁵ Severance pay is another major rigidity in the labor market. Rates have more than doubled since 1996 and are now among the highest in the region (Table A5.1). Severance regulation has discouraged employers from engaging workers on a permanent basis.

Table A5.1: Severance rates for an employee by tenure and dismissed for economic reasons: selected countries
(in monthly wages)

Country	4 Years Service	10 Years Service	20 Years Service
Indonesia	13.8	25.5	28.0
Korea, Rep. of	4.0	10.0	20.0
Malaysia ^a	2.0	6.7	13.3
Philippines	4.0	10.0	20.0
Thailand	6.0	12.0	17.0

^a Under Malaysian law mandatory severance pay only covers workers with monthly wage below RM1,500 and laborers and manual workers.

Sources: Labor codes of the five countries.

7. In this context of relatively rigid labor market policies, a sharp slowdown in the economy is likely to lead to job losses in the formal sector and rising youth unemployment. BAPPENAS projects that under different growth scenarios, unemployment could rise between 500,000 and 1,000,000 persons in 2009, mainly youth unemployment. Job losses are likely to first occur in the export sector (especially in labor-intensive sectors such as garments, footwear, and electronics) and later in services, as the economic slowdown becomes more broad-based by mid-2009. Anecdotal evidence suggests that job losses are occurring at a rapid rate in some sectors, such as garments. Data collected from the Department of Manpower and Transmigration show 14,000 job losses in the garment center of Bandung in West Java in January alone, and several thousands of workers have been laid off in Jakarta and East Java in recent weeks, indicating that the worst effects may be based in urban centers.

B. Policies to Boost Employment

8. **Fiscal Expansion.** In the short term, the Government's fiscal expansion will save some jobs. Under its fiscal stimulus package, the Government has temporarily removed income tax on wages of less than Rp5 million per month in the manufacturing and agriculture sectors, and this

³ National Development Planning Agency, 2003. *Labor Policy Review*. Jakarta (March)

⁴ USAID-GIAT. 2003. *Swimming Against the Tide? Indonesia's Employment Protection Legislation*, Jakarta (September).

⁵ ADB. 2006. *Indonesia: Labor Market Policies*. Manila (staff report).

may help lower the cost of retaining lower paid workers. The Government has also allocated funding to some of its poverty reduction programs which have employment components, such as the national community empowerment program (PNPM). This should create some jobs but these will be insufficient to offset expected losses in the export sector over the coming months. The Government's focus will be to provide assistance to families vulnerable to poverty as a result of job losses. The newly established poverty monitoring unit at BAPPENAS will collect timely employment data by region and sector, which will aid policy makers to develop timely mitigating responses. The extension of the unconditional cash transfer (UCT) program, amounting to \$345 million to the first quarter (Q1) of 2009, will also provide some assistance to families that are vulnerable to falling into poverty because of job losses. This program may be extended to several months. However, sustained economic growth above 6% is necessary to generate sufficient jobs in the modern sector to absorb new job entrants in the market over the next decade. Therefore, with the likelihood that the global economy will not begin recovery until later in 2010, jobs losses are expected to continue over the next 18 months.

9. **Policy Reform.** Over the longer term, reforms to labor market policies will be necessary to boost formal employment. In May 2006, the Government proposed a comprehensive labor policy reform program as part of its "white paper" to improve the investment climate. Reforms including reducing severance rates, allowing fixed-term contracts cumulatively up to 5 years before employee conversion to permanent status, permitting outsourcing to core activities, and linking wage adjustments to productivity are critical for employment creation. Major unions rallied against the proposals in May 2006. In response, the Government postponed implementation of reforms. There is less appetite for such reforms under current economic conditions, and in an election year. Nevertheless, over the longer term, reforms to severance pay and fixed-term contract arrangements will be necessary to boost job recovery once the global economic crisis subsides.

C. Recent Developments in Poverty

10. **Poverty Reduction.** Indonesia has made much progress in reducing poverty. Based on data from the National Socioeconomic Survey (Susenas), the official headcount poverty rate based on daily caloric intake has consistently declined over the last 20 years from above 40% in the early 1980s to 17% by 1996; it spiked to 23% in 1999 and then fell back to 16% by 2005. However, the reduction in fuel subsidies and surge in rice prices in 2006 lifted the poverty rate to 17.8%. Price stability, a strong rise in economic growth, and job creation helped bring poverty down to 15.4% by March 2008 (or 35 million persons) as shown in Table A5.2. As in most developing economies, poverty is a rural phenomenon, with rural poverty rates around 18%. Economic growth, with rapid formal employment creation and stable prices, remain the most important antipoverty drivers in Indonesia.

Table A5.2: Poverty Rates

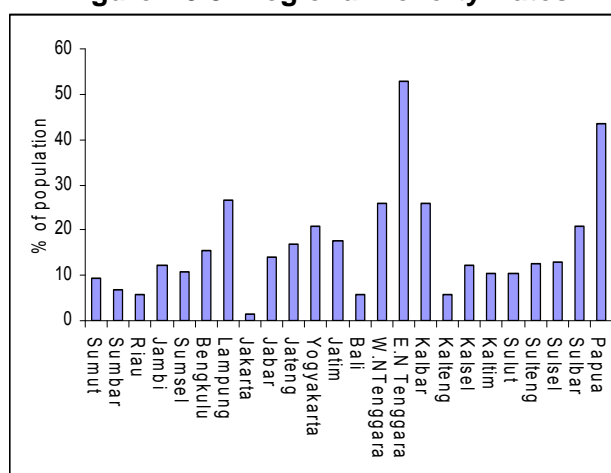
Year	% Poor People (headcount index)		
	Urban	Rural	Total
1990	16.8	14.3	15.1
1993	13.4	13.8	13.7
1996	9.7	12.3	11.3
1996**	13.8	19.8	17.6
1999	19.4	26.0	23.4
2002	14.5	21.1	18.2
2003	13.6	20.2	17.4
2004	12.1	20.0	16.7
2005	11.7	20.0	16.0
2006	15.5	21.8	17.8
2007	12.5	20.4	16.6
2008	11.7	17.7	15.4

* Revised estimates based on new methodology poverty line.
Source: Central Bureau of Statistics, Jakarta.

11. The proportion of the population vulnerable to falling into poverty remains high at around 46% of the population, based on the \$2 a day poverty rate. Modest shocks to family income—such as drought and other natural disasters, and high inflation—can push millions of families into poverty as about 30% of the population resides slightly above the poverty line. Public services remain inadequate for a middle-income country, and the other dimensions of poverty are also major problems in terms of high malnutrition and maternal mortality rates, inadequate access to safe water and sanitation, and insufficient education outcomes. Access to rural infrastructure is limited. Inequality is increasing and disparities between regions remain high, with regional pockets of relatively high and severe poverty in East Indonesia (East and West Nusa Tenggara), Papua, and Lampung (Figure A5.3).

12. **Antipoverty Measures.** The Government has introduced several antipoverty programs and measures to address the different dimensions of poverty in Indonesia. Three key lessons learned from the 1998 financial crisis were: (i) the critical importance of establishing a permanent social assistance or poverty alleviation program that could be quickly activated or scaled up, (ii) the need for a poverty monitoring and coordination mechanism, and (iii) need to reorient some public expenditures toward social policy linked to breaking the cycle of family poverty. The Government introduced the UCT program in 2005 to mitigate the income effects of the fuel price increase. This program was reactivated in 2008 in response to the surge in inflation. About 19 million families were covered by the UCT in 2008. Preliminary data from the 2008 Susenas indicate that the UCT program has been effective in keeping 60% of household recipients from falling into poverty in 2007 and 30% of recipients had actually escaped poverty. The Government is also piloting the conditional cash transfer program, whereby transfers are linked to family progress in child school attendance and child health indicators. Currently, the program covers six provinces and 1 million families although progress toward a national rollout has been slow because of institutional capacity constraints at the subnational level. Since 2004, real spending on education and health in the national and subnational budgets have increased substantially as part of the Government's medium-term objective of universal education and health.

Figure A5.3: Regional Poverty Rates



EN = East Nusa Tenggara, WN = West Nusa Tenggara.
Source: Susenas, National Bureau of Statistics, Jakarta.

13. **Poverty Impact of Financial Crisis.** The current adverse economic situation threatens to reverse recent gains in poverty reduction. The economy is expected to slow down in 2009, with growth projections ranging from 2.0% to 4.5%. Exports in January declined by 36% on a year-on-year basis, suggesting that the lower end of projections is an increasingly likely outcome for 2009. BAPPENAS estimates that, under its low-growth scenario (4%), about 5 million additional persons will need social assistance during the downturn (about 2% of the population) in 2009. If economic growth falls to 2%, these numbers will be much higher. Moreover, a slowing economy reduces government revenues which in turn threaten the Government's efforts to protect the large increases in social spending made in the last 2 years.

D. Policies to Mitigate the Worst Effects of the Global Financial Crisis

14. The Government is acutely aware that the current adverse economic situation threatens substantial gains made in reducing poverty in recent years. In response to these threats, and to protect social spending, it will permit an increase in the budget deficit from an initial 1.0% of GDP to 2.5% of GDP in 2009. This larger deficit allows for a fiscal stimulus through a supplementary budget approved by parliament in February 2009. To this effort, the Government intends to scale up its poverty alleviation programs under the supplementary budget. These include increasing the coverage of the subsidized rice program (Raskins), school scholarship program, extending the UCT into 2009 at a cost of at least \$345 million, and the PNPM. In addition, under the Public Expenditure Support Facility, the Government has established a poverty monitoring unit and a coordination mechanism to be able to assess social economic data quickly and respond with programs to assist vulnerable families.

SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY

Country/Project Title: Indonesia/Public Expenditure Support Facility Program

Lending/Financing
Modality:

Policy-based program loan

Department/
Division:

Southeast Asia Department/
Financial Sector, Public Management and Trade
Division

I. POVERTY ANALYSIS AND STRATEGY

A. Linkages to the National Poverty Reduction Strategy and Country Partnership Strategy

Contribution of the sector or subsector to reduce poverty in Indonesia: The PESF provides support for government measures aimed at mitigating the impact of the global financial crisis and keeping the country on track to meet its MDGs.

B. Poverty Analysis

Targeting Classification: General intervention

1. Key Issues

The current global financial crisis, while different in nature and complexity from the Asian financial crisis in 1997–1998, is expected to have a marked impact on Indonesia—resulting in reduced economic growth, retrenchment, and shrinking employment opportunities; and a general deterioration in living standards for a significant portion of the population (See Appendix 5).

2. Design Features. The PESF provides necessary support for government efforts to mitigate the effects of the crisis, including support for a stimulus package, cash transfer programs for the poor, and maintaining critical spending on social sectors and infrastructure.

C. Poverty Impact Analysis for Policy-Based Lending

The PESF supports the Government's fiscal stimulus package, aimed at mitigating the impact of the crisis—particularly with respect to poor and vulnerable groups—as well as measures aimed at strengthening poverty monitoring, and improving coordination in poverty reduction efforts.

II. SOCIAL ANALYSIS AND STRATEGY

A. Findings of Social Analysis

According to data from the 2008 National Socioeconomic Survey (Susenas), the Government's unconditional cash transfer program (UCT) maintained the welfare levels of 60% of household UCT recipients and assisted 30% of recipient households to escape from poverty, while about 10% of recipient households fell into poverty because of food price inflation in 2008. The policy actions under the PESF support the Government to maintain progress achieved under UCT and other poverty alleviation programs.

B. Consultation and Participation

1. Provide a summary of the consultation and participation process during the project preparation. As part of the PESF process, extensive consultations were held with a wide range of stakeholders, including the private sector, civil society groups, and development partners.

2. What level of consultation and participation (C&P) is envisaged during the project implementation and monitoring?

Information sharing Consultation Collaborative decision making Empowerment

3. Was a C&P plan prepared? Yes No

If a C&P plan was prepared, describe key features and resources provided to implement the plan (including budget, consultant input, etc.). If no, explain why. The PESF process supports the Government's C&P process.

C. Gender and Development

1. Key Issues. The PESF has indirect gender impacts through its emphasis on reducing poverty and unemployment by reorienting public expenditures to social services and productive needs. The improved poverty orientation of public spending increases women's access to essential services needed for achieving MDG targets, including improving child and maternal

health.

2. Key Actions. Measures included in the design to promote gender equality and women’s empowerment—access to and use of relevant services, resources, assets, or opportunities and participation in decision-making processes:

- Gender plan Other actions/measures No action/measure

III. SOCIAL SAFEGUARD ISSUES AND OTHER SOCIAL RISKS

Issue	Significant, Limited, or No Impact	Strategy to Address Issue	Plan or Other Measures Included in Design
Involuntary Resettlement	No impact	Implementation of the PESF will not require involuntary resettlement.	<input type="checkbox"/> Full Plan <input type="checkbox"/> Short Plan <input type="checkbox"/> Resettlement Framework <input checked="" type="checkbox"/> No Action
Indigenous Peoples	No impact	The PESF does not specifically target indigenous people and is not expected to have significant negative effects on indigenous people.	<input type="checkbox"/> Plan <input type="checkbox"/> Other Action <input type="checkbox"/> Indigenous Peoples Framework <input checked="" type="checkbox"/> No Action
Labor <input type="checkbox"/> Employment opportunities <input type="checkbox"/> Labor retrenchment <input type="checkbox"/> Core labor standards	No impact	Sustained economic growth is expected to result in more jobs. The PESF does not envisage any changes to labor market policies.	<input type="checkbox"/> Plan <input type="checkbox"/> Other Action <input checked="" type="checkbox"/> No Action
Affordability	No impact	The poor and vulnerable are expected to benefit disproportionately from reoriented public expenditures to social services and the eventual implementation of the conditional cash transfer program.	<input type="checkbox"/> Action <input checked="" type="checkbox"/> No Action
Other Risks and/or Vulnerabilities <input type="checkbox"/> HIV/AIDS <input type="checkbox"/> Human trafficking <input type="checkbox"/> Others(conflict, political instability, etc), please specify		The livelihood of the poor and vulnerable is expected to be positively affected.	<input type="checkbox"/> Plan <input type="checkbox"/> Other Action <input checked="" type="checkbox"/> No Action

IV. MONITORING AND EVALUATION

Are social indicators included in the design and monitoring framework to facilitate monitoring of social development activities and/or social impacts during project implementation? Yes

MDG = Millennium Development Goal, PESF = Public Expenditure Support Facility.

LIST OF INELIGIBLE ITEMS

1. Loan proceeds will finance the foreign currency expenditures for the reasonable cost of imported goods required during the Public Expenditure Support Facility Program.
2. No withdrawals will be made for the following:
 - (i) expenditures for goods included in the following groups or subgroups of the United Nations Standard International Trade Classification, Revision 3 (SITC, Rev. 3) or any successor groups or subgroups under future revisions to the SITC, as designated by the Asian Development Bank (ADB) by notice to the Borrower:

Table A7 Ineligible Items

Chapter	Heading	Description of Items
112		Alcoholic beverages
121		Tobacco, unmanufactured; tobacco refuse
122		Tobacco, manufactured (whether or not containing tobacco substitute)
525		Radioactive and associated materials
667		Pearls, precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors, and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors
728	728.43	Tobacco processing machinery
897	897.3	Jewelry of gold, silver or platinum-group metals (except watches and watch cases) and goldsmiths' or silversmiths' wares (including set gems)
971		Gold, nonmonetary (excluding gold ore and concentrates)

Source: United Nations.

- (ii) expenditures in the currency of the Borrower or of goods supplied from the territory of the Borrower;
- (iii) expenditures for goods supplied under a contract that any national or international financing institution or agency will have financed or has agreed to finance, including any contract financed under any loan or grant from the ADB;
- (iv) expenditures for goods intended for a military or paramilitary purpose or for luxury consumption;
- (v) expenditures for narcotics;
- (vi) expenditures for environmentally hazardous goods, the manufacture, use or import of which is prohibited under the laws of the Borrower or international agreements to which the Borrower is a party [, and any other goods designated as environmentally hazardous by agreement between the Borrower and ADB];¹ and
- (vii) expenditures on account of any payment prohibited by the Borrower in compliance with a decision of the United Nations Security Council taken under Chapter VII of the Charter of the United Nations.

¹ The bracketed clause is to be included only if agreement between the Borrower and ADB on a list of goods designated as environmentally hazardous for purposes of the loan has been reached and recorded in the agreed minutes of negotiations or a supplemental letter.

FIDUCIARY ASSESSMENT¹

A. Background and Analytical Underpinnings

1. The PESF provides general budget support to the Government and will be executed through the Government's public financial management systems. This assessment summarizes the current state of these systems and ongoing reforms, with a view to assessing the fiduciary risks related to this development policy loan.

2. The public financial management systems in Indonesia have strengths and weaknesses. The strengths include a sound regulatory framework for most parts of the budget cycle; an orderly, transparent, and predictable budget formulation process; fund predictability for budget execution; sound budget classification; comprehensive and transparent budget documentation; government accounting standards that are aligned with comparable international standards; a chart of accounts that is broadly consistent with Government Finance Statistics Manual (GFSM) 2001; and a strengthened external audit institution.

3. These strong points are the result of a concerted reform effort among key stakeholders to the budget process since the political transition in 1998. These efforts were given momentum and direction in the 2001 white paper on public financial management reform. Key stakeholders to the budget process remain committed to further reform through an evolving and pragmatic reform agenda. The focus of government reform is on the implementation of an integrated financial management information system, further unification of the budget, further improvement of the chart of accounts, restructuring of budget programs, the introduction of a medium-term expenditure framework and performance-based budgeting, full rollout of the treasury single account (TSA), improvement of the institutional and regulatory framework for procurement, improvements to cash and asset management, internal controls, and internal and external audit.

4. The DPL/DPSP series has had public financial management as an area of focus and has contributed to significant improvements in the last few years. This assessment draws on recent economic and sector work undertaken by the World Bank, Asian Development Bank (ADB),² and other development partners. This includes a Public Expenditure and Financial Assessment (PEFA) concluded in June 2008,³ a joint World Bank–IMF mission on Strengthening Budget Management undertaken in June 2008, a previous joint Bank–Fund mission on Budget Reform Priorities reported to the Government in June 2007, and the September 2008 update of the Report on the Observance of Standards and Codes on Fiscal Transparency in Indonesia from 2006.⁴ It also draws on the ongoing policy dialogue and advisory services provided through the Government Financial Management and Revenue Administration Project (GFM RAP) and the associated Public Financial Management (PFM) Multi-Donor Trust Fund.

¹ This Appendix has been extracted from ADB. 2008. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Indonesia for the Fourth Development Policy Support Program*. Manila (Loan 2488).

² ADB. 2007. *Sector Report on Accountability and Audit in Indonesia*. (Produced under TA-4473 INO: Support for Implementation of Program Loan). Manila

³ World Bank. 2008. *Public Expenditure and Financial Assessment*, Report No. 42098 ID, Washington, D.C. (June)

⁴ International Monetary Fund. 2006. *Selected Issues*, Country Report No. 08/298, Washington, D.C. (September)

B. Key PFM Issues—Recent Developments and the Way Ahead

5. Significant advances have been made in budget preparation—instituting a state budget, which combines the previous separate recurrent and development budgets, and improvements in budget transparency. However, problems in budget execution persist, with 50% of capital expenditure still being spent in the last quarter. The Director General (DG) Treasury has conducted a survey of the impediments to the disbursement of budgetary funds through questionnaires. The results of the survey are being reviewed and will form the basis of an action plan to smooth out disbursements during the fiscal year.

6. Implementation of a TSA, as foreseen by State Treasury Law No. 1/2004, is ongoing. The Treasury, in cooperation with Bank Indonesia, has tested the daily sweep of government revenue deposits from collecting branches and post offices into the TSA. Depending on the success of the pilot test, the daily sweep will be extended to all commercial bank branches. The public procurement environment has witnessed improvements in the last few years. However, there are still weaknesses in its regulatory and implementation aspects. Presidential Regulation No. 106/2007 was signed in December 2007 establishing an independent agency National Public Procurement Office (LKPP) that is responsible for planning and development of strategies, policies, and regulations associated with procurement using public funds. It is a priority to make the newly established LKPP operational by recruiting staff and allocating budget.

7. The Government Accounting Standards are well aligned with comparable international standards, and the chart of accounts is broadly consistent with GFSM 2001. Aggregate government annual financial statements have been prepared in a timely manner for 4 years but there are questions of reliability. The Supreme Audit Agency (BPK) has for the last 4 years issued a “disclaimer” opinion on these financial statements. Internal control weaknesses in the preparation of the financial statements and instances of noncompliance with applicable regulations were cited among the reasons for the disclaimer.

8. The Government’s internal audit framework is extensive but the institutional structure is complex. Government Regulation No. 60/2008 on the Government’s Internal Controls defines more clearly the roles and responsibilities of the different players in internal audit. The overall internal control framework continues to be weak, with paper-intensive processes and inefficient use of human resources. The Government is preparing for the implementation of an integrated financial management system known as SPAN to replace the multitude of financial data processing applications currently used by government institutions.

9. The external audit institution, BPK, has received a significant increase in its operating budget to fund an increase in the number of auditors as well as regional offices. The audit report on the financial statements is submitted to legislature within 5 months after the end of the year.

10. Powerful independent oversight and prosecutorial institutions such as the Corruption Eradication Commission (KPK) and the Anti-Corruption Court have begun to deliver tangible results. High-profile corruption investigations have been launched, leading to a number of successful prosecutions.

11. Parliamentary oversight of budget processes has been strengthened. Parliamentary commissions have become particularly active in scrutinizing and amending the Government’s draft annual budget. The Government published an IMF fiscal transparency report and disseminated throughout Indonesia. The public availability of fiscal information is already

improving and the Government has published a fiscal risk statement together with the 2008 and 2009 budgets.

12. These reforms directly influence the environment in which public expenditure is planned, budgeted, executed, and accounted for across all levels of government. A more detailed commentary on progress in implementing these reforms is given below to help identify the attendant risks arising from the Borrower's capacity to manage this loan and determine the fiduciary arrangements for this operation.

C. Reforming Budget Formulation

13. Fiscal relationships between the executive and legislature are defined in the State Finance Law No. 17/2003. The House of Representatives (DPR) is the principal legislative body and it plays a significant role in shaping budget and fiscal policy. The budget is passed by agreement between the President and the DPR. The process involves an examination by the DPR of the macroeconomic framework, macro-fiscal policies, and detailed budget allocations. The budget has been the centerpiece of strengthening the legislature vis-à-vis the executive in the political transition following 1998, and the relative roles of the executive and legislative branches in this area are evolving.

14. The budget documentation is comprehensive. The main outstanding area of improvement is explanation of the expenditure implications of new policy initiatives. The laws governing budget management clearly specify the responsibilities of the minister of finance, and comprehensive regulations have been developed. While the President, as head of the Government, has overall authority to exercise national fiscal management, Law No. 17/2003 clearly delegates the responsibility of overall fiscal management of central government finances to the minister of finance as chief financial officer. The law also assigns responsibilities to individual ministers, governors, and other local authorities for financial management and accountability in their jurisdictions.

15. Provisions of the new regulations are being implemented. Budget classification and execution is based on administrative, economic, and functional classification consistent with GFSM 2001. The Ministry of Finance (MOF) is developing plans for a medium-term expenditure framework to guide budget policy. Forward estimates at the aggregate level were introduced with the 2008 and 2009 budgets. Efforts in BAPPENAS and MOF are ongoing to redefine the budget program structure, and develop templates and manuals for a medium-term expenditure framework and performance-based budgeting. The efforts are planned to be pilot tested in the coming years.

16. The level of extra-budgetary expenditures is not known and the issue is not on the reform agenda.

D. Reforming Budget Execution

17. Indonesia still spends 50% of its total capital expenditure in the final quarter of the year.⁵ For the past 6 years, spending has started slowly and then accelerated toward the end of the year. This spending pattern is of concern because project implementation is disrupted by an adverse cycle. Moreover, under-spending on capital expenditure constrains increases in

⁵ World Bank. 2007. *Indonesia Public Expenditure Review 2007: Spending for Development*. Washington, D.C.: World Bank.

infrastructure investments. Slow and back-loaded disbursements are symptoms of more severe challenges that are encountered at each stage of the public expenditure management cycle.

18. The Government maintains a comparatively rigid budget execution process. Detailed input controls aim to ensure that the composition of the budget complies with political priorities and that the budget is not altered during execution. Spending warrants (DIPAs), while now issued at the start of the fiscal year, contain excessive amounts of detail—leaving little flexibility for adjustments in the composition of inputs needed to carry out a given activity. Reallocations across DIPAs from delayed programs to better-performing ones that could enhance satisfactory implementation of the overall expenditure program require lengthy revision, sometimes involving parliament. Such inflexibility creates practical difficulties and inefficiencies.

19. With expanding fiscal space, public investment is increasing, putting additional pressure on PFM systems. Planning and executing public investment is inherently more demanding than current or mandatory expenditure.

E. Reforming Treasury, Cash, and Asset Management

20. Transparency is still weakened by a multitude of bank accounts. The Director General Treasury itself maintains multiple bank accounts, both in rupiah and foreign currency, at Bank Indonesia. External audit reports from 2004 to 2006 noted that around 4,600 bank accounts have not been reported to the DG Treasury. By the end of December 2007, MOF completed a census of all government accounts and identified 32,570 accounts. Some 2,086 accounts were subsequently closed and efforts are ongoing to determine which of the remaining 30,484 accounts can be included in the TSA regime, either directly or through a mechanism of daily sweeps into the TSA.

21. Regulations associated with Law No. 1/2004 will address this weakness and provide for (i) the installation of a TSA at Bank Indonesia; (ii) the conversion of operational bank accounts at commercial banks into zero-balance transit accounts; and (iii) a mandatory review at MOF of bank accounts of all state agencies outside DG Treasury oversight. Pilot runs for testing zero-balance arrangements with commercial banks for the expenditure accounts have been successful. Rollout of the TSA to the revenue accounts, which was initially scheduled for the first quarter (Q1) of 2008, has been postponed. This is due to pending negotiations with Bank Indonesia and commercial banks on interest payments for government balances held at Bank Indonesia, and remuneration of banking services by the Government. The daily sweep will cover deposits made the previous day—not on the same day—since commercial banks have agreed not to charge for this service provided the sweep is done the following day. This would be a significant improvement to the current practice, established in 1989, of sweeping revenue accounts twice a week.

22. The implementing regulation for Law No. 1/2004, Government Regulation No. 36/2007 on Cash Management, was issued in July 2007 detailing the governance and setup of cash management. In addition, a number of MOF regulations (PMK) have been issued to further establishment of the TSA:

- (i) PMK 57 is the generic PMK to regulate opening of bank accounts by the line ministries.
- (ii) PMK 58 mandates a census of the existing line ministry accounts.
- (iii) PMK 59 mandates senior officers (echelon I) of MOF to disclose bank accounts, if any are being operated.

23. The cash-based accounting system generates timely records of revenue and expenditure transactions, but does not track monthly arrears. Transaction records are electronically transmitted to the directorate of accounts at DG Treasury headquarters for consolidation and generation of periodic reports on budget execution. However, DG Treasury plans to move toward an accrual recording system, which would make this possible.

24. MOF is preparing the implementation of an integrated financial management system to replace the multitude of financial data processing applications currently used by government institutions. The system is known as SPAN. It will integrate and replace the multiple software applications within the Treasury as well as those being implemented in the DG Budget to support the budget formulation process. Following some delay, the second stage bidding process for SPAN was initiated in August 2008 and the contract for provision of turnkey services for SPAN is expected to be signed by April 2009. A new management and implementation structure for the project is now being established.

25. Government assets are not comprehensively recorded, properly organized, or fairly valued. An integrated and automated asset management system, which will enable the Government to optimize the use of its assets across ministries and regions, will be established in 2009.

F. Procurement Reforms

26. The past few years have witnessed improvements in the public procurement environment. Presidential Decree No. 80/2003 provided a national public procurement regulation that meets most of what is generally regarded as accepted international practice, including the basic principles of transparency, open and fair competition, economy, and efficiency. This decree also requires the establishment of a national public procurement office as a regulatory body for public procurement. With the introduction of Keppres No. 80/2003, a previous certification (“pre-qualification”) process for suppliers/providers of goods and services was, in most instances, abandoned by the Government. This previously led to segmentation of the market, especially at the provincial level. Keppres No. 80/2003 also established the basis for sanctions, complaint handling, and requirements for certification of users.

27. However, the public procurement system still has significant deficiencies in its regulatory and, more importantly, implementation aspects. There have been delays in establishing a strong regulatory body; slow progress in the development of procurement regulations anchored by a law; slow progress in the development of standard tools in terms of bidding documents and users manuals; weakness in procurement capacity in implementing agencies, especially at provincial and district levels; and collusion and corruption practices in the bidding process as well as concerns over the efficiency of anticorruption and sanction measures.

28. This is supported by the findings of some analytical tools and reports, such as the self-diagnostic assessment conducted by the LKPP in 2007, using the baseline indicators tool developed under the World Bank and Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee Procurement Round Table initiative. The assessment of the baseline indicators presents a snapshot comparison of the actual system against the international standards or the “model system” that the baseline indicators represent. Baseline benchmarking of Indonesia’s procurement system in June 2007 showed it scoring 62.5% for the legislative and regulatory framework (pillar I), 55% for institutional framework and management capacity (pillar II), 59.3% for procurement operations and market practices (pillar III), and 69% for integrity and transparency of the public procurement system

(pillar IV) in comparison with recognized international standards. Other studies indicate that there is significant room for improvement.

29. LKPP will report directly to the President of Indonesia. The organizational structure for the new LKPP is being developed. In addition to the chair, who heads LKPP, and an executive secretary, there will be four departments, each headed by a deputy with responsibilities for (i) strategy and policy development; (ii) monitoring, evaluation, and information systems; (iii) human resources development; and (iv) legal affairs and settlement of objections. LKPP is currently staffing echelon II positions and is expected to fill all the staffing needs by the end of 2009.

30. A number of laws have been enacted since 2000 that affect, or refer to, public procurement. These include civil works, state finance, treasury, audit, and small-scale business. The pace of Indonesia's decentralization reforms has impacted on public sector procurement at all levels of government—ministers, governors, and even mayors are able to issue decrees, regulations, and instructions. The plethora of regulations is often inconsistent and many regulations do not meet accepted international practice. Consequently, national procurement reform and the need for national procurement policies and standards are critical.

31. Indonesia's legal framework for public sector procurement can best be strengthened by anchoring it with an overarching consolidated and comprehensive national public sector procurement law at the highest level that (i) establishes the fundamental principles and procedures applicable to all public sector procurement; (ii) allows for the imposition of sanctions where the principles and procedures, particularly those relating to good governance and ethics, are not met; (iii) amends other laws that refer to public sector procurement; and (iv) ensures that such a law has the necessary authority in a decentralized environment. LKPP is currently drafting a procurement law with a projected time horizon of 2 years its enactment, as it needs to go through a review and consultation process followed by submission to parliament.

32. In the meantime, LKPP has consolidated the different amendments of Keppres No. 80/2003 into one document, which it plans to simplify for users.

33. **Standard Bidding Documents.** No national standard bidding documents are used regularly by all government agencies in Indonesia. Some implementing agencies (such as the Ministry of Public Works) have developed standard bidding documents for their own use. The LKPP, through the support of ADB, has drafted eight national model standard bidding documents. These include (i) an explanatory guide, (ii) goods with prequalification, (iii) goods with post-qualification, (iv) works with prequalification, (v) works with post-qualification, (vi) other services with prequalification, (vii) other services with post-qualification, and (viii) consulting services. These are available in a draft form but their use is not mandatory and they are being used on a pilot basis. It is important for LKPP to collect users' comments on these documents, improve them, and mandate their use on a national basis. One of the improvements would be to harmonize such documents with those of international development partners such as the World Bank, ADB, Japan Bank for International Cooperation, and Australian Agency for International Development.

34. **Public Procurement Function.** There has been growing concern, from both the Government and ADB, over the pace of project implementation. Significant delays and slow disbursement seem to occur across the entire PFM cycle. Government agencies reported delays and difficulties in budget preparation and approval, budget execution, and implementation/ procurement. Specifically, there are concerns with the

implementation/procurement capacity of government staff and the absence of incentives for project managers/procurement committees. In addition, fear of prosecution by auditors and anticorruption agencies has affected projects because of the reluctance of officials to take action amid growing worries of being prosecuted under anticorruption legislation, even over minor mistakes. LKPP is considering assessing the introduction of central procurement units in ministries and at local government level.

35. **Capacity Building.** Keppres No. 80/2003 required the Government to adopt an examination system and certification for procurement practitioners within government contracting entities to ensure that their level of competence is consistent with their level of responsibilities. So far, the rate of staff passing the basic procurement certification is very low (less than 20%), which increases the need for a strategic approach to capacity building. LKPP is developing a strategy for human resources, training, and certification on public procurement. This will entail development of training courses and criteria for tertiary institutions.

36. **Corruption, Sanctions, and Independent Appeals Mechanism.** Despite improvements in the public procurement system, concerns remain over corrupt and collusive practices. While addressing this requires an overall governance strategy, several important elements in the procurement system can support such a strategy, e.g., an independent complaints mechanism, an effective sanctions mechanism, and improving transparency in the procurement process through the use of e-procurement.

37. Keppres No. 80/2003 requires the establishment of a complaints handling mechanism. However, this is not set up independently but within each implementing agency. LKPP is developing a strategy to approach complaints handling. While it is imperative to develop procedures for an independent complaints handling mechanism, LKPP should avoid becoming the agency to which these complaints are addressed but rather develop a system and monitor its efficiency and reliability.

38. **e-Procurement.** The Ministry of Public Works, Ministry of Communications and Information, and City of Surabaya have been at the forefront in the development of e-government procurement technology. The LKPP was also taking the lead on behalf of the Government for implementation of e-government procurement in Indonesia at a national and subnational level. It is now critical to develop a road map for implementation of e-government procurement in Indonesia, setting the roles of different stakeholders, and the responsibility for ensuring minimum interoperability and core data standards for the various e-government procurement providers to comply with.

G. Accounting and Reporting on Budget Execution

39. The Government's aggregate annual financial statements have been prepared in a timely manner for 4 years (2004, 2005, 2006, and 2007). They present revenues, expenditures and transfers, surpluses/deficits, and financing aggregates compared with budget provisions. A balance sheet and a cash flow statement are also presented, along with a full statement of government accounting policy. Although the timeliness is a significant achievement, concerns remain over their reliability. BPK has for the last 4 years issued a "disclaimer" opinion on these financial statements. Among the reasons cited for this were internal control weaknesses in the preparation of the financial statements and instances of noncompliance with applicable regulations.

40. The government accounting standards are well aligned with comparable international standards. However, technical capacity constraints limit the pace at which these standards can be implemented at all levels of government, including line ministries and subnational governments. Capacity constraints in the line ministries are being addressed through staff training via an ambitious training program that aims to train over 7,000 accounting staff—at least one staff member per budget spending units (*satker*) by the end of FY2009.

41. Monthly and quarterly reports on budget realization are produced by each ministry and sent to MOF for consolidation. A midyear unaudited report on budget realization is presented to the DPR in July and is available to civil society. However, there are reconciliation issues between the budget realization reports of the Treasury and those of the ministries, departments, and agencies (MDAs). These differences are reported as a suspense item in the budget realization reports, which have been disclosed in the annual financial statements since 2004.

42. The Government issued Finance Minister Regulation No. 171/PMK.05/2007 on Accounting System for Line Ministries. The changes brought about by the new regulation include an emphasis on

- (i) line ministries being responsible for recording the budget allotment for their ministries; and
- (ii) receivables, payables, and investment recording by the line ministries which should be recorded and reported in the line ministries' financial statements.

43. Based on the new regulations, line ministries will assume responsibility for their budget monitoring—they do not have to depend on MOF controls only—and the financial statements of line ministries will present a more accurate picture of their financial position.

44. Although commendable action has been taken to improve government financial reporting, there continue to be serious challenges in making government financial statements reliable, as reported by BPK in its annual audit report for 2006. This reflects the immense challenges that lie ahead in an environment where accounting capacity at the grassroots level is weak and accounting processes are not yet integrated or fully automated.

H. External Audit

45. BPK was established under the constitution and its roles and responsibilities are set out in Law No.15/2004. The organizational structure of BPK is outlined in the Decree of Secretary General No. 34/2007 and No. 39/2007 and its governance arrangements were set out in Law No. 15/2006. BPK has a mandate to audit all government entities including MDAs and state-owned enterprises (SOEs). Its independence from the executive branch is reflected in its board members being appointed by parliament. BPK has recently received a significant increase in its operating budget to fund an increase in the number of auditors and administrative staff as well as the number of regional offices.⁶

46. All expenditures, revenues, assets, and liabilities of the Government are subject to audit by BPK. This situation has arisen from the requirements enacted in taxation laws (No. 6/1983 and No. 16/2000) under which only the minister of finance can authorize access to individual

⁶ The total annual budget for BPK increased from Rp234 billion in 2004 to Rp1.5 trillion in 2008 while the number of regional offices increased from 7 (2004) to 29 (2008).

taxpayer records, on a case-by-case basis. As a result, BPK has been unable to audit taxation revenues, which represent about 70% of central government revenues.

47. BPK performs financial, performance, and special purpose audits. The audits are undertaken in accordance with the BPK Auditing Standards, which are stipulated in BPK Regulation No. 1/2007 on State Finance Auditing Standards. These standards are generally in line with international standards and have been applied since FY2006. The audit report on the financial statements is submitted to the legislature within 5 months after the end of the fiscal year. In the past 4 years, the submission of the audited financial reports to parliament has been timely. BPK also submits interim audit reports to parliament every 6 months on irregularities and inefficiencies it has identified at MDAs.

48. Auditees generally submit formal responses on audit recommendations and their implementation to BPK. The extent of follow-up is regularly monitored by BPK and reported in its interim audit reports. Records maintained at BPK indicate that, on average, 80% of audited entities submit formal responses on audit findings although this may not reflect the relative importance of recommendations.

49. A peer review of BPK was completed in 2004 and this revealed serious weaknesses in capacity. Since then, improvements have been made gradually, with new hiring and training. BPK has a follow-up peer review planned for FY2009.

I. Internal Controls and Internal Audit

50. The internal audit framework of the Government is extensive but the institutional structure is complex and the mandates and division of labor between the various internal audit institutions have not been clear. Presidential Regulation No. 60/2008 on government internal controls issued in August 2008 defines more clearly the roles and responsibilities of the different players.

51. The State Development Audit Agency (BPKP) is now entrusted with the task of designing the guidelines on internal control implementation, providing training and improving the competence of the Government's internal auditors on the Government's internal controls—essentially an advisory role. BPKP is also mandated to audit cross-sectoral activities, respond to audit requests by the President, and audit the Government's treasury activities if assigned by MOF.

52. Inspectors general are still the main internal audit apparatus of the line ministries. In principle, inspectors general have a mandate to audit all MDAs activities and determine their annual audit plan independently and all units within an MDA are required to provide data needed by inspectors general. In practice, most audits by inspectors general check compliance with technical and operational aspects of activities, including compliance with internal control procedures. Evaluations to determine the adequacy of internal control systems are rarely carried out. A systematic risk-based approach to internal audits is still in its infancy. Since 2006, inspectors general also have reviewed their MDA's annual financial statements to ensure their accuracy, reliability, and integrity prior to their submission to DG Treasury in MOF.

53. There was no formal commitment control system at *satker* and MDA level that records, reports, monitors, or controls spending commitments during the year against approved budgets and cash availability. However, Finance Minister Regulation No 171/PMK.05/2007 on

Accounting System for Line Ministries passes on the responsibility for commitment control to line ministries. The DIPA documents prepared by MOF, which are detailed down to the spending unit or *satker* level, establish annual budget ceilings on expenditure commitments. These DIPAs generally prevent MDAs from placing orders above the approved budgets (DIPA limits) for particular spending items.

54. MOF Regulation No. 134/PMK.06/2005 and DG Treasury Regulation No. PER-66/PB/2005 prescribe detailed procedures for payment of salary and non-salary expenditures, which supplement other written procedures on accounting and recording transactions. However, the processes are paper-intensive and involve inefficient use of staff resources. For example, the supporting documentation required for payment of goods and services covers multiple documents that duplicate information, with weak audit trails and accounting evidence.⁷

55. BPK's audit report for 2006 records numerous instances of noncompliance with rules for processing and recording transactions such as noncompliance with procurement procedures, payments not supported by adequate documentation, and overpayments.

56. In relation to subnational accounts, the auditing responsibility of is assigned to the internal auditor of local governments (Bawasda). Lack of trained and skilled auditors and methodology results in Bawasda being the weakest component of the Government's internal control framework.

57. The overall internal control environment continues to be weak. However, recent regulations on the accountability of line ministries and internal control are positive developments.

J. Reforming Regional Public Financial Management

58. Decentralization has provided local governments with significant resources and authority. More than one-third of general government expenditures are now executed by subnational governments. This requires an adequate regulatory framework and PFM capacity at the local level. After decentralization, the central Government passed comprehensive legislation for PFM reforms at the regional level to mirror the changes being made at the center. The regulatory framework for regional PFM reforms is now largely in place, including mechanisms for fiscal transfers to local governments. However, most regions lack adequate technical and human resources to implement the reforms. Subnational governments are obliged by law to report certain fiscal and financial information to the central Government. Most local governments now report the information required, although with some delay. Accordingly, it is possible to produce consolidated (though delayed) general government reports.

59. Allocations to individual subnational government units are formally issued with the passing of the national budget in October before the financial year commences, but notional allocations are included in the budget presented to the DPR in August. In practice, this leaves sufficient time for subnational government units to finalize their budgets but submissions are often late because of local government constraints. However, budget allocations of shared revenues (nontax revenue) are not issued before March or April in the fiscal year. The central Government significantly underestimates the notional allocations, and disbursements from the center to the regions are back-loaded toward the end of the fiscal year. Both practices are

⁷ In the Government's view, the procedures may create some duplication of work. However, this approach is taken to maintain a check and balance mechanism and clarify roles, as mandated by Law No. 1/2004 on State Treasury.

deliberately chosen by the central Government to ensure fiscal discipline, but they constrain successful financial management at local level.

60. Because of over-budgeting of expenditure by subnational governments and under-budgeting of transfers by the central Government, many subnational governments have built up reserves in recent years.

K. State-Owned Enterprises

61. Indonesia has a sound legal framework for corporate governance and monitoring SOE operations. Firstly, the SOE Law No. 19/2003 sets a clear ownership policy as the state is not allowed to be involved in the day-to-day management of SOEs and must allow them full operational autonomy. Secondly, a 2002 ministerial decree clearly details corporate governance responsibilities, including the need to (i) submit each SOE's financial statements to the State Ministry for State-Owned Enterprises and to the appropriate line ministry each quarter, (ii) prepare annual financial statements that must be audited internally and by an independent auditor, and (iii) publish SOE annual reports in a timely manner.

62. Existing laws and regulations governing SOEs are not implemented effectively. Long delays still occur in auditing and publishing SOE financial statements. SOE annual reports are usually only regularly and systematically made public in cases where companies have accessed the local capital markets with listed instruments. The Government has included fiscal risk statements in the budgets for FY2008 and FY2009 and is working on improving the quality of the budget process.

63. The planned use of public-private partnerships to accelerate investment will create fiscal risks that merit disclosure and the Government has taken steps to mitigate those risks. Presidential Regulation No. 67/2005 emphasizes careful project preparation and the selection of bidders in an open, competitive tender; and gives the minister of finance the right to approve or reject requests for government support.

L. Debt Management

64. During the previous DPL/DPSP series, two major initiatives in debt management were implemented: a clear debt management strategy that was publicly announced, and a newly created DG for Public Debt Management that has risk management oversight for both domestic and external debts.

65. By 2007, the Government had also successfully reduced its debt-GDP ratio to about 35% from the peak of over 90% in 1999. Despite the positive development in terms of debt sustainability and institutional reforms, the Government's institutional capacity to manage public debt remains weak. Audit reports confirm that data and reports on domestic debt are reliable but indicate that data and reports on foreign debt differ from development partners records and may not be accurate.

M. Governance and Anticorruption

66. Indicators of corruption in Indonesia are improving, albeit slowly. Sufficient and dedicated resources have been made available to most of the agencies critical to anticorruption efforts. Powerful independent oversight and prosecutorial institutions such as KPK and the Anti-Corruption Court have begun to deliver tangible results. In addition, institutions like BPK,

Financial Transaction and Analysis Centre, and Attorney General's Office have all critically improved their anticorruption track record.

67. High profile corruption investigations have been launched, leading to a number of successful prosecutions. For example, as of September 2008, seven parliamentary members were under investigation or prosecution as suspects in several corruption cases, most of them involving bribery. Some of the parliamentary members were arrested when caught receiving bribes. A senior prosecutor has been sentenced to 20 years in prison for receiving bribes. This case led to the removal of three very senior prosecutors, including two deputies of the attorney general.

68. While there have clearly been successes and there is strong momentum in investigating and prosecuting individual corruption cases, there has been less progress in developing and implementing a coherent, well-focused strategy for corruption prevention within the state administration. Ministry for State Apparatus Reform (MenPAN) the ministry tasked with coordinating, monitoring, and evaluating implementation of such a strategy, has limited capability in this regard. As a result, implementation of the existing anticorruption strategy for the state administration has been weak.

69. While progress in developing and implementing a coherent, well-focused strategy for corruption prevention in the state administration is limited, recent developments have been promising. Previously, KPK was in charge of pushing and monitoring bureaucratic reform as a corruption prevention measure within several institutions such as MOF, Supreme Court, and BPK. When this task was handed over to MenPAN in 2007, progress became very slow. Despite the limited progress by MenPAN, important internal bureaucratic reforms are well under way in individual government agencies including the Ministry of Foreign Affairs, Ministry of Trade, and most recently the Attorney General's Office.

N. Key Areas for Future Attention

70. Going forward, progress on the following key ongoing PFM reforms will need to be closely monitored:

- (i) ensuring coherence and momentum in PFM reform;
- (ii) deepening the reforms of the central government budgetary sector, along the lines discussed in paras. 66–69;
- (iii) ensuring greater integrity and more effective management of public funds through continued implementation of a TSA, automating the treasury payments system, and the institution of measures to prevent the proliferation of off-budget bank accounts;
- (iv) strengthening internal audit institutions by establishing synergistic relationships between them, and removing overlaps;
- (v) implementation of a new treasury system, extending implementation of Government Accounting Standards, and reengineering of underlying business processes at spending agencies to ensure reliable financial reporting; and
- (vi) widening the reforms throughout government. This means extending modern financial accountability and management processes to subnational governments in a coordinated manner and bringing these fully in line with emerging national standards.

71. Many of these reforms are being actively considered and prioritized, and the Government is developing implementation plans. Implementation is well under way concerning the TSA and the institutional framework for procurement.

72. The capacity to monitor these and other reforms centrally has recently been established at the secretary general's office of MOF. Indonesia would benefit from a coherent reform plan or strategy to ensure proper phasing and coordination of PFM reforms. This would also allow for enhanced monitoring and accountability within the Government, and thus provide additional momentum and direction to reform efforts.

O. Management of Foreign Exchange

73. The foreign exchange control environment is assessed to be generally satisfactory. The country is no longer subject to the extended arrangement from the IMF. Bank Indonesia was last subject to the transitional procedures under the Fund's safeguards assessment policy in 2002. That assessment recommended remedial action to address a number of vulnerabilities in the audit arrangements of Bank Indonesia. The main recommendations have been implemented, including the establishment of an independent audit committee at Bank Indonesia and the publication of Bank Indonesia's audited financial statements. Audited financial statements of Bank Indonesia for 2007 have been reviewed and the audit report issued by BPK contained an unqualified audit opinion.

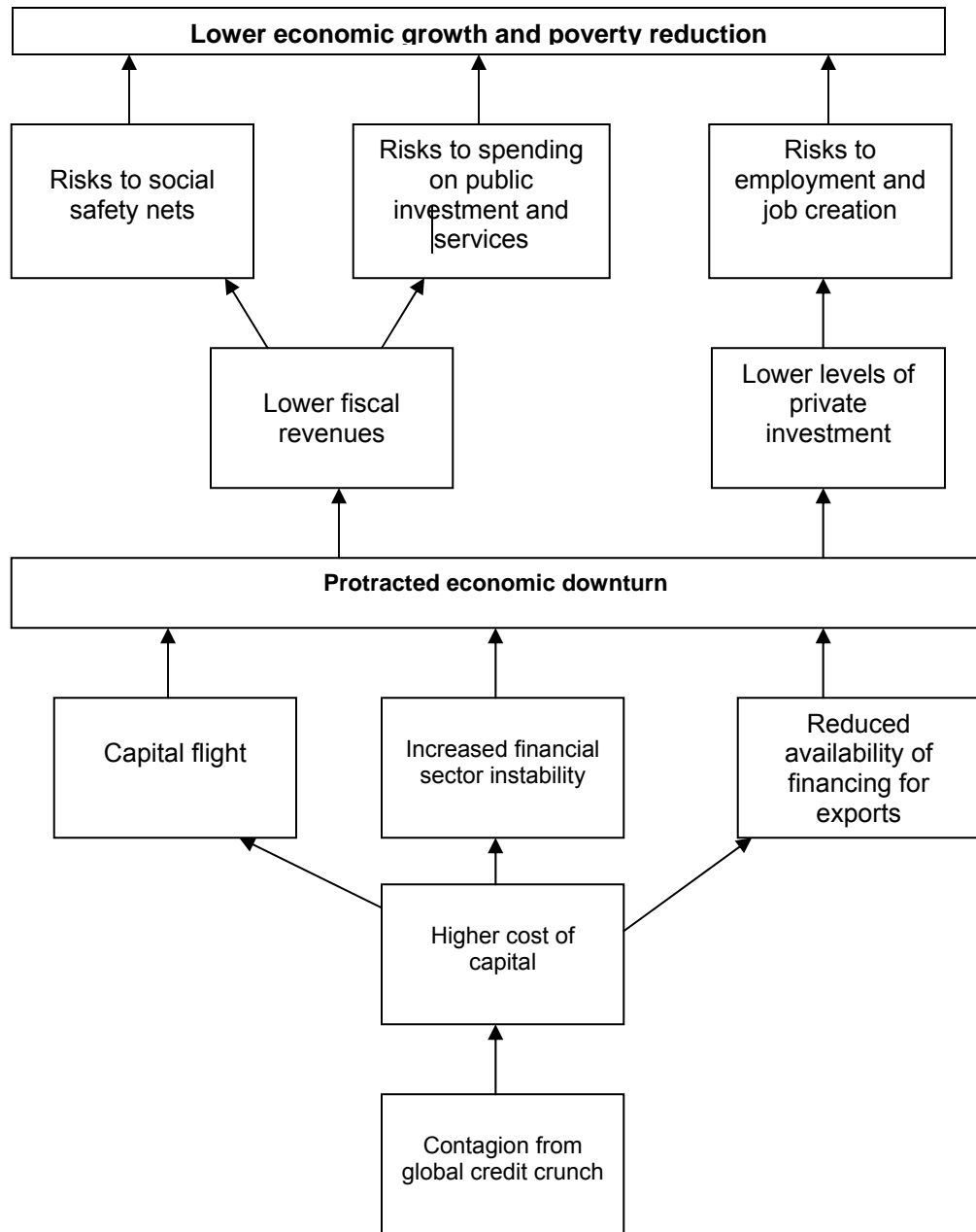
P. Conclusion

74. Indonesia has established a sound legal and administrative framework for modern PFM. Changes in the legal and regulatory architecture are now largely complete and the momentum has shifted toward implementation of new PFM practices.

75. Known weaknesses in financial management and accountability continue to be addressed gradually through the PFM reform program. The development partners are actively engaged in this process. Key elements of the reforms are supported by the DPL/DPSP triggers, as well as the GFMRAP project and initiatives supported by development partners. However, much remains to be done, and it will take time to realize the full impact of these reforms.

76. In the meantime, some fiduciary risks will arise for this operation. Although the pace of implementing the planned reforms has been somewhat slow over the past year, the trajectory of reform is in the right direction and the current government continues to demonstrate a commitment to continue the task of completing the planned reforms in PFM. Taking these into consideration, ADB assessment team does not propose putting in place any additional fiduciary arrangements for this operation.

PUBLIC EXPENDITURE SUPPORT FACILITY PROBLEM TREE



Source: Asian Development Bank.