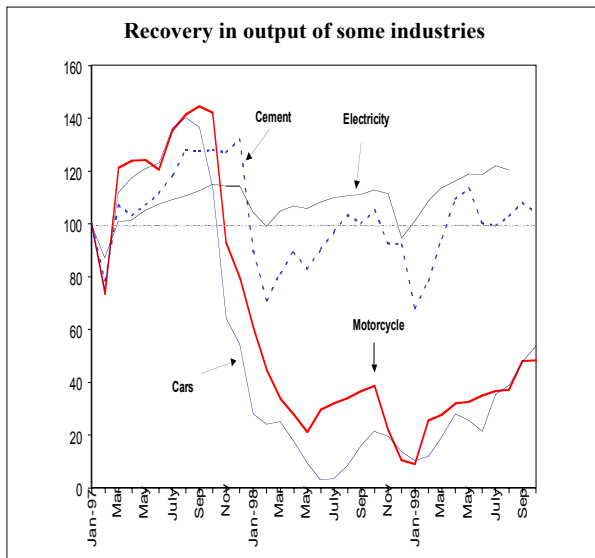


# INDONESIA

## MACROECONOMIC UPDATE

### Current Development

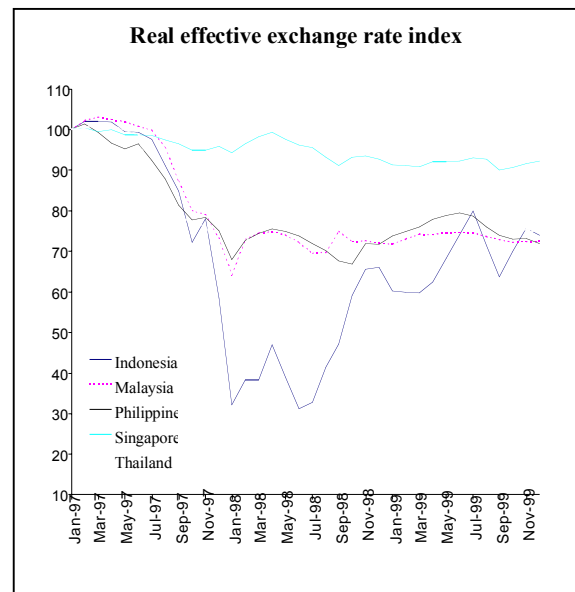
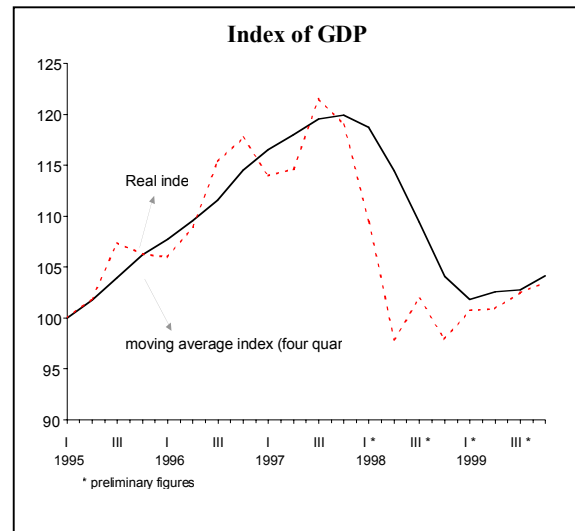
Indonesia's macroeconomic performance in recent months shows continued gradual recovery despite continued social unrest on outer islands and slow progress with corporate and bank restructuring. Production continues its gradual recovery. Manufacturing and services are inching their way up; agriculture's performance, however, has been below expectations. GDP rose again in the third quarter of 1999 (1 percent compared to the previous quarter) and the Government forecasts GDP growth for the FY1999/00 fiscal year to be about 2 percent. External demand appears to be helping (in part due to higher oil prices). Exports have climbed for four months now, contributing to a steadily growing trade surplus.



This tentative recovery continues to be accompanied by very low inflation. The annual rate is less than 2 percent (November 1999 CPI vs. November 1998). Interest rates (as indicated by the SBI rate) continue to decline, albeit very slowly now. The differential between domestic and international interest rates (represented by SIBOR) and the forex swap premium are now at pre-crisis levels (6-7 percentage points). Interest rates (30 day SBI) fell from 18 percent in early July to 13-14 percent in late July and has remained relatively stable at that level since then. It was at 11.1% on January 10, 2000.

The exchange rate has remained steady at Rp. 7000-7500 per US dollar, despite occasional political and economic shocks. The rupiah had depreciated from 6,775 per US

dollar on July 1 to 8,260 on September 10 (a fall of 18 percent). Following the Presidential election and the selection of the Cabinet, it appreciated again to below 7000 per US\$ in November, 1999, before easing back to Rp 7,250/US\$ by January 18, 2000. The stock exchange also fell in September (from 673 at the start of July 1999 to 563 in September (a fall of 16 percent)) but then clawed its way back to 686 by January 18, 2000.



Public finance. On the fiscal side, revenues have been higher than expected, largely due to higher oil prices and unexpectedly high tax receipts for interest income. The FY99/00 fiscal deficit is now expected to be only 3.8% of GDP, compared with an initial budget plan of 6.8% of

GDP. The FY2000 budget (i.e. for the 9 months April to December) has been prepared in consultation with the IMF and the World Bank and was presented to parliament on January 20, 2000. It has an overall deficit of 5% of GDP and includes interest payments of 6.5% of GDP.

*The need for effective public debt management has become urgent.* The economic crisis has left Indonesia's Government deeply in debt. The total debt of the central government has risen in the past two years from about US\$51 billion (23 percent of GDP) to an estimated US\$147 billion (91 percent of GDP) in end-March-2000. This sharp increase in government debt is primarily due to the issuance of bank restructuring bonds (US\$85 billion, equivalent to about 52% of GDP). This debt burden is high by international standards and will severely constrain fiscal flexibility throughout the term of the current government. Debt service obligations will be over 50 percent of government revenue for at least the next two years. Domestic debt service payments are rising rapidly, with interest payments over \$6 billion per annum and projected bond maturities peaking at nearly \$6 billion equivalent in 2004 and over \$9 billion equivalent in 2008. Hence, sources of future financing (external and domestic) are very important to ensure that net financing flows remain manageable. This makes the development of a domestic capital market urgent. Though very large, Indonesia's Government debt is manageable, given a combination of sustained domestic actions and external support. But the debt burden is so large that the actions needed to reduce it will severely strain policy making and Indonesia's institutional capacity for implementation.

### **Issues and Areas to Watch**

*Parliamentary discussion of the FY2000 budget.* The increased role of parliament associated with the political transition makes parliamentary review more important than in recent years. Fuel price increases, bank restructuring costs and civil service salaries are likely to feature in this discussion.

*IMF Board review of the revised program in February.*

*The Paris Club response* to Indonesia's request to reschedule amortization payments for a further two years, beginning in April, 2000.

The next *Consultative Group meeting (CGI)* is scheduled for February 1-2, 2000. This is being held for the first time in Jakarta. It will be preceded by a high-level forestry meeting on January 26 and 27 (responding to the commitment made at the last CGI) and a consultation with civil society. In another first, private investors will be briefed immediately after the CGI meeting.

### **Program Implementation and Assessment**

Indonesia's progress toward macroeconomic recovery has

been increasingly encouraging, although serious problems remain and clouds on the political landscape portend continuing risks. A new Government under President Abdurrahman Wahid (Gus Dur) was elected in October, with Megawati Sukarnoputri (PDI-P) as Vice President. Earlier, Amien Rais (PAN) had been elected chairman of the MPR and Akbar Tanjung (Golkar) chairman of the DPR. The new "Cabinet of National Unity" was named on October 26, 1999. An informal donors' meeting was held at the World Bank Office in Jakarta on December 15, at which Minister Kwik outlined the new Government's economic program, stating that "governance issues lie at the heart of the reform effort." Although, efforts by the new administration to address issues of corruption and governance as well as regional tensions are underway, investor confidence is yet to be restored. The secessionist movement in Aceh appears to have gathered some momentum, while regional violence, especially in Ambon, appears to have escalated to alarming levels. Favorable developments including a rupiah exchange rate which is fluctuating in a narrow band and falling interest rates, have only partially alleviated market concerns and perceptions of continued vulnerabilities.

### **Bank Instruments**

With the completion of the political transition, and early signs that the economy has turned the corner, the World Bank is working with its partners in Indonesia to prepare a new *Country Assistance Strategy*. The last Progress Report, reviewed by the Board in March 1999, focused on the short-term crisis response agenda. The lead-up to the February 2000 CGI will provide a good opportunity to discuss the longer-term development goals and priorities of the new Government. The new CAS is scheduled to be completed for Board discussion in early FY01.

The Bank's *policy-based lending* to Indonesia is closely coordinated with the overall reform agenda that is underway with support from the IMF, ADB, Japan and our other development partners. There have been four adjustment loans to date: (a) The first *Policy Reform Support Loan (PRSL)* - \$1 billion (approved and declared effective on July 2, 1998); (b) *Policy Reform Support Loan II (PRSL II)* - \$500 million (approved May 27, 1999 and made effective on June 17, 1999); (c) *Social Safety Net Adjustment Loan* - \$600 million in two tranches ( approved May 27, 1999 and to become effective in the last week of January, 2000); and (d) the *Water Sector Adjustment Loan* - \$300 million in three tranches ( approved May 27, 1999, effective and first tranche released in June 1999).

The form and focus of further adjustment support is currently being discussed. The new Letter of Intent to the IMF was signed on January 20, 2000.

*Grant Funds.* The Bank-administered ASEM Trust Fund is supporting a program of Financial Sector Advisory

Services (\$385,000 and \$305,000), primarily to help establish an Independent Review Committee of international and Indonesian experts for IBRA, and to enhance TA coordination for IBRA and Bank Indonesia. ASEM support has also concentrated on improving institutional performance at the local level. ASEM is also playing a key role in helping Indonesia's decentralization efforts with programs to improve local government public expenditure and financial management systems - Improving Local Government Public Expenditure Systems, Reporting and Transparency (\$298,500); and a Water Utility Rescue Program (\$396,000). ASEM also finances a program to Improving Fiscal Policy Analysis by the Ministry of Finance (\$440,000).

*Analytical and Advisory Services* are being provided in the areas of good governance, fiscal and administrative decentralization, poverty assessments, fiscal transparency and budgetary processes, SME development and trade financing.

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## FINANCIAL SECTOR UPDATE

### CURRENT DEVELOPMENTS

The election of a new government in October 1999 provides the potential for a dramatic turnaround in Indonesia's efforts to resolve its economic crisis. For more than two years, Indonesia has struggled to create a functioning financial system able to restructure massively insolvent banks and to create bankable borrowers by restructuring unviable corporations. By mid-1998, a sound strategy for financial sector recovery had been articulated. Unfortunately, political uncertainties, a search for painless solutions and attempts to accommodate well-placed vested interests precluded effective implementation of the agreed upon strategy.

Initial announcements by the new government raise hopes that the focus will finally be on resolving the crisis. The new government's statements suggest a sincere commitment (a) to stamp out the long-tolerated culture of KKN; (b) to make decisions in a transparent manner; and (c) to base government decisions on a desire to maximize the pace of recovery and to minimize ultimate fiscal costs.

The last *Quarterly Update* (9/22/99) identified an inter-bank claims settlement scandal that had been uncovered at Bank Bali. As a result of the inability of the former government to address that scandal in a transparent manner, IFI budget support was suspended and morale at IBRA, BI, and MISOE deteriorated seriously. Moreover, little progress was made in restructuring private and state-owned banks, creating a capacity for bank supervision and enforcement, or in corporate restructuring and debt recovery. On November 2, the new government disclosed a report on the scandal and cleared the way for the resumption of talks with the IFIs on future budgetary support. Discussions with the IFI's are proceeding and the IMF anticipates resuming budgetary support by mid-January.

### *Issues and Areas to Watch*

Although early signals are encouraging, the government faces daunting challenges. The fragile coalition is led by a number of ministers with little previous experience. Senior officials are un-tainted by previous scandals, but they need time to understand the complexity of the country's political, economic and social problems. Moreover, they need to build an internal consensus and to assure that there is political will to support the agencies tasked with resolving the crisis. In the coming months, the commitment to transparency and reform is likely to be challenged in a number of key areas, including:

- Buffering IBRA from external pressures and strengthening the agency's external governance, internal controls and transparency.
- Completing the Attorney General's investigation into the corruption aspects of the Bank Bali matter and resolving inter-bank claims.
- Demonstrating the GOI's commitment to a transparent asset disposition process as well as foreign ownership of banks, by conducting Bank Bali's public rights offering now scheduled for January and launching BCA's IPO in February.
- Accelerating debt recovery and corporate restructuring (through greater co-ordination between IBRA and the Jakarta Initiative Task Force, "JITF") and the referral of recalcitrant debtors for appropriate legal action.
- Signaling that continued abuses in the state banking sector will no longer be tolerated, by changing management of state-owned banks.
- Implementing BI's master plan to strengthen supervision and demonstrating its capacity and willingness to supervise both private and state-owned banks and to enforce prudential regulations that have long been ignored.

## **Program Implementation and Assessment**

### ***Corporate Governance and Transparency***

With assistance from the Bank, IBRA has conducted a tender and is currently negotiating a consulting contract for a comprehensive governance and operational review and reform program. The goals of this engagement will be to strengthen IBRA's governance and management structures and thereby buffer it from political pressures. Consultant recommendations are to be issued by end-March. In addition, the international community will continue to watch for evidence that personnel changes are consistent with providing IBRA with technical excellence and with autonomy from politically vested interests.

To avoid the recurrence of other inter-bank claims settlement scandals, IBRA engaged an international accounting firm to complete an inventory of all pending inter-bank claims. The government's resolve will be tested in (a) assuring appropriate judicial proceedings against individuals and entities involved in the Bank Bali affair, (b) identifying and dealing with similar improprieties in other institutions, (c) completing the audit of all inter-bank claims, (d) publishing a transparent process for honoring the government's guarantee and (e) actually processing claims by making a very small number payments by year-end, and then in the new year resolving the far larger number of claims which the authorities have not yet been able to reconcile with bank records.

IBRA has engaged an international accounting firm to finalize its accounting policies and procedures and anticipates issuing its September 1999 audited statements during the first quarter of 2000. Periodic statements will be issued on a regular basis thereafter.

### ***Bank Restructuring***

IBRA is now responsible for the restructuring of 12 BTO banks. A number of key actions have been announced for the coming weeks and months which include: holding Bank Bali's public rights offering in January; launching the IPO for BCA in February, and selling both Bank Niaga and Bank Bali by open tender during the first quarter of 2000; and finalizing and implementing integration of the eight remaining BTO banks into Danamon and BCA by May.

Attention is also being focussed on the recapitalization of the four remaining state banks. Specifically, the recapitalization of Bank Mandiri is nearing completion. The bank received its first recapitalization bonds tranche of IDR 103 trillion in October 1999. An independent due diligence study is currently underway to determine as of end-December, the amount needed to top-up the bank's capital and the DPR (Indonesian Parliament) has approved the issuance of total bonds of IDR 178 trillion. An independent adviser has reviewed the viability of Mandiri's business plan and presented its findings to the recapitalization committee, who is authorized to endorse recapitalization for state banks. Drafting of a performance contract has been initiated, to be signed between management and the government by year-end 1999.

Recapitalization of the other three state banks (BNI, BRI and BTN) is to be initiated only after new management teams have been appointed and their business plans reviewed and approved. Continued losses and the recent Texmaco scandal dramatize the need to replace management teams, to initiate operational restructuring, and to sign performance contracts with the new management. In the case of at least one bank (BNI), it is anticipated that the authorities will engage a third party firm to assist in the implementation of the restructuring.

Beyond attracting new management teams and agreeing on operational objectives to reduce the need for yet further capital injections, the MISOE will need to establish a monitoring unit to track whether the state-banks are improving their profitability and efficiency and are reducing their risk profile. Although much responsibility for monitoring of prudential requirements should fall on BI, the MISOE will also need to address its responsibilities as the owner of these banks by monitoring performance and planning for privatization.

### ***Debt Recovery and Corporate Restructuring***

Markets are watching to see if IBRA is able both to meet its well-publicized asset collection target of IDR 17 trillion

for fiscal 2000 and to initiate legal actions against a number of its most recalcitrant corporate borrowers. As of November 1999, IBRA reported cash collections of IDR 8.3 trillion, of which IDR 3.5 trillion was from AMC (manages loan collections) and IDR 4.8 trillion from AMI (manages equity holdings). IDR 4 trillion of the AMI amount represents excess proceeds received from private shareholders in the rights offerings to recapitalize private banks. It is not clear if these proceeds will be available to offset interest expenses or will need to be retained in the banks in order to maintain adequate capital. AMI may have difficulty meeting its IDR 12.8 target for FY 1999/2000, as a number of company sales, which are dependent upon strong market conditions, have been rescheduled to year 2000.

Meanwhile, IBRA's AMI has reached agreement with eight former bank owners for settlement of violations on affiliated lending. In the case of banks that were closed or taken over in 1998, holding companies have been established for management and eventual sale of enterprises. Asset transfers have been now completed for five of the eight cases, representing about IDR 96 trillion or 88 percent of the settlement amount. As for the banks that were intervened in March 1999, legal and accounting due diligence, to support negotiations between IBRA and former bank owners, are well under way. The estimated settlement value is IDR 25 trillion.

Presently, the AMI controls more than two hundred ongoing enterprise assets, involved in a wide variety of business sectors. The agriculture business represents 35% of total asset value, with real estate ranking second at 24%. To maximize the value of these assets, IBRA must exercise adequate over-sight of the holding companies and their respective enterprises. This requires that IBRA establish full time management within each of the holding companies as well as effective reporting systems to monitor the performance of the underlying enterprise.

AMC's disposition strategy anticipates the resolution of retail and SME loans through blanket 'crash programs' offering discounts on accrued interest and penalties to debtors willing to prepay their accounts. (Preliminary results on the 'crash programs' are encouraging, with many smaller debtors pre-paying their loans.) Commercial loans are to be outsourced for management beginning in the first quarter of 2000 to a third party using transparent procedures, while corporate loans are to remain under IBRA's direct management.

*While the implementation of these programs is encouraging, the key to IBRA's success lies in restructuring the large corporate loans.* This will require both a functioning resolution system (bankruptcy) and the ability to recognize the losses inherent in the portfolio. Given problems in the judicial system, IBRA has been equipped with special powers (PP17) to drive debt recovery without judicial rulings. External pressures,

however, have mounted since the issuance of the regulation and the Supreme Court is now reviewing the regulation. If overturned, all of IBRA's actions to date could be called in question. In addition, the GOI has taken recent steps to strengthen the judiciary and the resolution process. In this connection, IBRA has committed to filing legal actions (bankruptcy or asset seizures using PP 17 powers) by the end of December. The Jakarta Initiative Task Force (JITF) is also being given the ability to recommend the referral of cases of non-cooperating debtors to the attorney general for the initiation of bankruptcy proceedings. IBRA has agreed to refer five cases to the JITF to test its new role. IBRA is in the process of developing policies and procedures which will allow it to recognize the losses in its non-performing loans through the use of appropriate restructuring techniques, including partial debt-forgiveness in commercially reasonable circumstances.

### ***Strengthening Financial Regulation and Supervision***

In November, BI adopted a plan to overhaul its bank supervision and examination functions. The Senior Deputy Governor has been appointed to oversee and coordinate bank supervision and examination functions. Bank and IMF staff will continue discussions with BI to ensure that the framework is sound and that appropriate technical assistance needs are identified and coordinated.

The new central bank law stipulates that bank supervision is to be transferred to a new independent institution by end year 2002. While no decisions regarding the establishment of this new institution have been taken to date, Bank Indonesia needs to ensure that the supervisory transfer can be expedited with minimum disruptions.

### **Instruments for the Financial Sector**

*Banking Reform Assistance Project.* \$20 million. Provides TA for implementation of banking reforms (approved 12/4/1997 and made effective on 4/8/1998).

*Policy Reform Support Loan (PRSL).* \$1 billion. Documents the reform program on a broad range of issues and mirrors elements of financial sector conditionality of the IMF agreements (approved 7/2/1998).

*Grant funding.* \$847,920 PHRD approved and \$690,000 ASEM approved.

*PRSL II.* \$500 million. Documents the continuation of the reform program begun under PRSL (approved 5/27/1999 and made effective on 6/17/1999).

*Banking Reform Assistance Project II (possible).* \$30 million. To provide additional technical assistance for implementation of banking reforms, with particular

emphasis debt-recovery, bank supervision, and monetary performance of re-capitalized banks. Agreements with the authorities on the need for or uses of this loan have not been reached and a firm Board date has not been established.

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## CORPORATE SECTOR UPDATE

### Current Developments

Progress in corporate debt restructuring in Indonesia remains very slow. Major impediments have included: (i) the political uncertainty, lack of resolve, and political interference that have prevailed during most of the period since the onset of the crisis; (ii) an inadequate bankruptcy mechanism which still provides no credible threat or incentives for debtors to enter voluntary workout agreements; (iii) the sheer magnitude and complexity of the corporate debt burden in Indonesia, compared with other East Asian countries—60 percent of Indonesian corporates' creditors are foreign banks; (iv) fragmentation among the institutions charged with the task of encouraging corporate restructuring and continued lack of political and logistical support for their operations; (v) pervasively poor corporate governance, especially with respect to disclosure of financial information and enforcement against offenders; (vi) the late start in restructuring the banking system; (vii) the complex tax, legal and regulatory framework impacting on the corporate restructuring process; and finally (viii) continued lack of investor confidence due to all of the above and other factors.

The August 1998 Frankfurt Agreements led to the creation of an institutional framework for corporate debt restructuring which depended firstly on the government sponsored Jakarta Initiative Task Force (JITF). The JITF was launched in November 1998 with help from the Bank and other donors. It has provided a framework for voluntary out of court debt negotiations following guidelines known as the Jakarta Principles which are based on the so called "London Rules" developed by the Bank of England. The JITF was also intended to operate a regulatory facilitation group or "One Stop Shop" to help fast track the process of obtaining regulatory approvals for restructuring deals. The Indonesian Debt Restructuring Agency (INDRA) was also created in late 1998 and offers a facility for hedging against devaluation of the rupiah for restructuring agreements which are under implementation. At about the same time Parliament approved a new bankruptcy law and the Commercial Court was created.

In late 1998 corporate indebtedness was estimated at \$118 billion. Since then a total of more than 320 corporates, representing more than \$23 billion in debts, have registered with the JITF. JITF's results have been very disappointing, however. The process has resulted in restructuring the debts of only 6 companies with the resolution of a total indebtedness of less than \$ 1 billion. Meanwhile a slow but steady trickle of debt restructuring agreements has been concluded outside the JITF

framework, the most notable of which has been PT Astra which restructured debts of \$1.1 billion. Only one entity, PT Danareksa has used the INDRA facility since it was created and the INDRA scheme has been criticized as too complicated. JITF's "One Stop Shop" has had little work to do. Bankruptcy rulings from the Commercial Court continue to be unpredictable. Judges and other actors in the bankruptcy system are widely regarded as incompetent and/or corrupt. Despite support from the IFIs and the donors, JITF has never had the political support and resources it needed from above. It is staffed at the senior level almost entirely by expatriates and has not had enough of the senior Indonesians needed to establish its credibility within Indonesia. In the absence of an effective bankruptcy process or other effective incentives or mechanisms to bring them to the negotiating table, most debtors have de facto declared an unofficial moratorium on debt repayments.

Table 1

Jakarta Initiative Task Force  
Registered Restructuring Cases (December 1999)

Industry Sector	Number of Cases (of which standstill or agreement in principle)	Debt Estimate (US\$ billion)	Rupiah billion
Agribusiness	5 (1)	0.4	6.9
Basic Industry	34 (6)	6.8	3,980.8
Chemicals	10 (2)	3.5	604.1
Consumer Goods	6 (3)	0.4	5.9
Textile and Garment	22 (2)	3.0	2,683.1
Finance	16 (2)	1.3	1,290.1
Infrastructure and Utilities	10 (3)	1.0	386.3
Mining	5	0.5	0.5
Real Estate	76(7)	1.3	3,797.7
Trading, Services and Investment	63 (13)	3.7	763.7
Transportation	4	0.8	613.8
Various	72 (19)	0.7	533.7
Total	323 (58)	23.4	14,666.7

Source: JITF

Since its operating rules were approved in October, 1999, the Asset Management Unit of the Indonesian Bank Restructuring Agency (IBRA) has been playing a growing role in restructuring, foreclosing and disposing of the loan portfolio it has acquired. After taking over the portfolios of the failed banks IBRA is now the largest domestic creditor in Indonesia. It has extraordinary powers (so called PP17 powers) to seize assets of non-cooperative debtors and, like any other creditor, is also able to use the normal bankruptcy process. IBRA's role in corporate debt restructuring is growing rapidly. IBRA has not suffered

from the lack of resources, or to the same extent from the lack of political backing, that have hobbled the JITF. IBRA is staffed at the senior level by a group of well qualified and competent Indonesians, backed as appropriate with expatriate advisors.

IBRA's loan portfolio totals Rp 230 trillion of which 96 percent in value is corporate and commercial. The largest 10 obligors account for 24.8 percent of the portfolio value and the largest 50 for 54.5 percent. The emphasis in loan management and disposal has been on starting small to get early successes. Important features of the IBRA program include an emphasis on collections, restructuring of viable loans, use of outsourcing to maximize transparency and industry expertise, and the use of JITF to facilitate negotiations where appropriate. The objectives are to maximize recovery and to minimize social costs. Debtors are classified according to their prospects and intentions and a range of restructuring alternatives are being used. They include payment and tenor rescheduling, waivers of penalties or past due interest, new capital injections, repayment of part of the principle, asset sales by debtors, debt equity conversions and issuance of convertible bonds. Since mid-1999 IBRA has been requiring its largest obligors to sign letters of commitment and, in an unprecedented display of transparency and in the face of much opposition from debtors, has been publishing in the press on a regular basis details of the arrears owed by major debtors. This has created the perception that IBRA is an organization with teeth that it is able to use.

But IBRA too has had its problems. IBRA's PP17 powers were not made fully effective until October, 1999. It had difficulties initially in enforcing these powers against politically well connected debtors. In implementing these powers and in going through the bankruptcy court, IBRA is still subject to the same enforcement difficulties as other creditors. IBRA's ability to act decisively suffered a setback during the Bank Bali scandal in summer of 1999. So, although IBRA has had teeth, it is only now beginning to use them effectively. IBRA, although well staffed and resourced, has an extremely high work load and some other creditors have complained that IBRA is unable to give adequate attention to all of the many debt negotiations that it is involved in and that this has resulted in delays in restructuring. To date IBRA has not been allowed to give "haircuts" on loan principle as part of its debt workout procedures and this has also put the agency at odds with other creditors in trying to reach restructuring proposals. At present, with help from the Bank, IBRA is undergoing an internal management review.

In an attempt to send a strong message to debtors, IBRA in mid-December used its PP17 powers for the first time by seizing 14 hectares of property from PT Sinar Slipi Sejahtera, a debtor firm owned by ex-President Suharto's daughter. IBRA had earlier announced that it would file legal suits against a number of other non-cooperative debtors including the PT Surya Perkasa Inti Utama (PSP)

Group and two companies in the Tirtamas Group among others. IBRA is fighting several lower court decisions that have impeded its attempts to collect debts. At the same time however, IBRA lost its appeal to the Supreme Court to overturn a lower court ruling against its attempt to recover debts from Sempati Air. More recently IBRA has been actively seeking investors to buy its 40 percent stake in PT Astra and announced an agreement in principle to sell its stake in the Bakrie Nirvana resort in Bali.

**Table 2**

**Indonesian Bank Restructuring Agency  
Active Debt Restructuring Cases (December 1999)**

<i>Restructuring Stage</i>	<i>Number of Cases</i>	<i>Debt Estimate US \$ billion</i>	<i>Rupiah (billion)</i>
Initial Negotiation	515	1.85	19,553.8
Standstill Agreement	16	0.0	1,239.0
Advisory Assignment	199	1.82	17,071.3
Due Diligence Underway	141	1.5	13,196.0
Start Restructuring Negotiations	46	0.4	6,777.5
Finalize Restructuring Proposal	35	1.2	2,445.7
Implement Restructuring Proposal	7	0.1	65.0
<b>Total</b>	<b>959</b>	<b>6.9</b>	<b>60,348.3</b>

Source: IBRA

***Issues and Areas to Watch***

This is a critical time and a crossroads for corporate restructuring in Indonesia. There is a new Government with a window of opportunity for decisive action. Encouragingly the new IMF agreement includes some elements critically needed to strengthen the corporate restructuring process and observers will now be watching to see whether or not Government will have the resolve to implement these measures fully. Will the Government allow IBRA to pursue some high profile cases of delinquent debtors through the enhanced corporate restructuring framework? Will Government stand behind IBRA's use of its PP17 powers and its ability to refer cases for bankruptcy? Will IBRA successfully conclude the cases it is currently pursuing and will it raise its sights and go after even larger cases?

Following the recent resignations of JITF's Chairman and Chief Operating Officer will Government replace them with champions committed to the difficult task of speeding up corporate restructuring? Will JITF be given the political

backing and resources that it has not received to date and without which it will continue to suffer from poor credibility and will be unable to play a useful role? Will Government give JITF's enhanced mediation process a chance to work by referring some high profile non-IBRA or minority IBRA cases to JITF for action? In case of non-cooperation by the debtors, will Government, on JITF's recommendation, refer these cases to the Attorney General for bankruptcy? In summary will JITF be allowed and equipped to make a useful contribution to corporate restructuring alongside IBRA, or will JITF fade into obscurity as IBRA consolidates its position as the Government's main corporate restructuring agency?

Will the Attorney General aggressively pursue cases of corruption in the Commercial Court? Will the Commercial Court begin to hand down bankruptcy rulings with competence and predictability? Will these rulings be enforced? To what extent will the major non-cooperative debtors lobby and gain political support and will the Government be able to withstand this pressure and stay the course?

Finally if Government action through IBRA, JITF and the Attorney General's office is successful, will debtors and creditors follow the lead and start to conclude their own voluntary restructuring agreements without being compelled to do so by Government? The future direction, credibility and outcome of the Government's new corporate restructuring strategy will depend to a large extent on the answers to these questions.

**Policy Implementation and Assessment**

Since mid-1999, the lack of progress in Indonesian corporate restructuring has led the Bank to consult intensively with a broad cross-section of stakeholders inside and outside Indonesia on options for strengthening the strategy. In October 1999 the Bank held a corporate restructuring strategy review in Washington, inviting managers from IBRA and JITF to make presentations. The attendees included practitioners from inside and outside the Bank working on corporate restructuring throughout East Asia. This review produced a set of recommendations which have been the basis for further discussions in Indonesia. In summary they included: (i) compensate for the lack of a credible bankruptcy threat with extraordinary temporary measures—both sticks and carrots; (ii) rationalize and strengthen the institutional framework for the workout processes; (iii) ensure adequate logistical support, which has not been present to date, for implementation; (iv) allow IBRA to give "haircuts" and follow other international best practices in negotiating debt restructuring deals; (v) put more emphasis on operational restructuring, not just debt restructuring; (vi) strengthen the commercial court and the bankruptcy process; (vii) strengthen corporate governance, both disclosure and enforcement; and (viii) simplify the tax and regulatory



environment as it affects the corporate restructuring process.

The conclusions that emerged from this review process were factored into recent discussions between the Government, the private sector, the Bank and the IMF and a strengthened corporate restructuring framework has been adopted by Government as a result. The key features of this new strategy are as follows:

- Modification of IBRA's rules to allow IBRA to use greater flexibility, including offering haircuts, in debt restructuring negotiations
- Legal protection for IBRA staff who apply these rules
- Greater use of the bankruptcy system by IBRA
- Closer cooperation between IBRA and the JITF
- Enhancement of the Jakarta Principles applied by JITF by adding time-bound mediation procedures
- Increasing the leverage of the JITF by granting referral authority from JITF to the Government to the Attorney General for bankruptcy proceedings
- Provision of adequate resources for JITF
- Strengthening of the bankruptcy process
- Improvements to the corporate governance framework

The success of this strengthened framework will depend on the resolve of the new Government to take tough action on a number of fronts, notably in pursuing high profile cases against bad debtors and in rooting out cases of corruption, including within the court system. Also, if JITF is to begin playing a meaningful role alongside IBRA it will need to receive political support, a mandate, and resources that it has been denied to date.

## **Bank Instruments**

The Bank has supported IBRA and JITF with two projects - the Bank Restructuring Assistance Project (BRAP) and the Corporate Restructuring Technical Assistance Project (CRTAP). The CRTAP also includes a component for strengthening the Commercial Court. In addition the Bank continues to use its own administrative budget to provide ongoing advice on corporate restructuring to the Government. The Bank is implementing two PHRD technical assistance grants of \$1.3 million and \$1.7 million to help mainly with assistance for corporate restructuring.

IFC has been working on individual corporate restructuring transactions in which it is an investor and is also

implementing a \$1.7 million PHRD Grant to identify good potential corporate restructuring candidates and begin their restructuring on a pilot basis. In addition the Bank is providing advisory services from its own budget and with Trust Fund Grants to help in developing and implementing a corporate legal reform and corporate governance strategy, a strategy for developing small and medium enterprises and direct advice for reform and privatization of the state owned enterprise sector.

## SOCIAL UPDATE

### Key Social Indicators

	Latest data (date)	Previous Period (date)
<b>Human Development</b>	<b>1998/99</b>	<b>1997/98</b>
Primary enrollment rate (net)	95.0	94.1
Female		
Male		
Secondary enrollment (net)	53.2	54.4
Female		
Male		
Tertiary enrollment	2,499,000	2,451,000
Female (% total enrollment)	N/A	41.3
Male (% total enrollment)	N/A	58.7
Infant mortality rate		
From DHS	45.7(92-97)	58.9(87-92)
From SUPAS	51.4 (1991)	71 (1986)
<b>Poverty &amp; Income Distribution.</b>	<b>1998</b>	<b>1996</b>
National Headcount Index 1/	20.3 (Dec)	11.34 (Feb)
Urban Headcount Index 1/		9.71 (Feb)
Rural Headcount Index 1/		12.3 (Feb)
Gini Index	0.37 (Jan)	0.38 (Jan)
<b>Government Expenditures</b>	<b>98/99</b>	<b>96/97</b>
Health budget ('93 rp billion)	2,105	2,592
As % of total	2.6	2.7
Education budget ('93 rp billion)	4,229	5,846
As % of total	5.2	3.9
<b>Labor Market</b>	<b>1998</b>	<b>1997</b>
Unemployment rate (%)	5.5 (Aug)	4.7 (Aug)
Female	6.1 (Aug)	5.6 (Aug)
Male	5.0 (Aug)	4.1 (Aug)
Participation rate (%)	66.9 (Aug)	66.3 (Aug)
Female	51.1 (Aug)	49.9 (Aug)
Male	83.2 (Aug)	83.4 (Aug)
# of strikes/# of workers/ days lost	278/152,000 /1.55 m	350/221,537/ 2.5 m (1996)
Real wages (%change)		
Formal sector	(-34)	
Agriculture sector	(-40)	
Formal as % of total employment	34.6	37.2
Female/male wage ratio	0.80 (Aug)	0.81 (Aug)

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

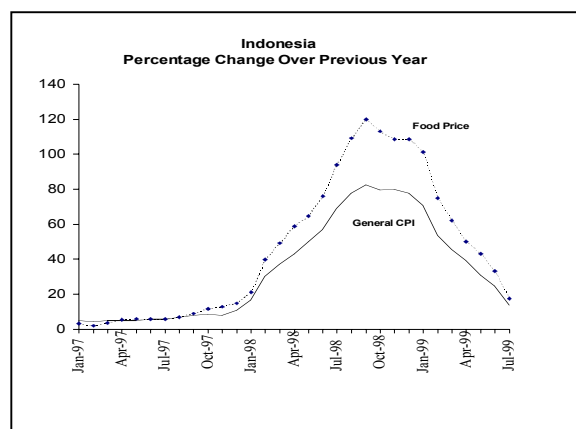
### Current Developments

*Social/Political highlights.* There have been further outbreaks of local conflict in Ambon and in the Maluku Islands. Vice President Megawati has recently traveled to those regions to try and achieve some solution to the crisis. The sectarian violence spread to the island of

Lombok, with Muslim-Christian clashes in Mataram. Aceh, at the western tip of Sumatra, has also experienced ongoing conflict. The President traveled to Aceh and promised a "quick" resolution to the crisis but did not provide details. The Indonesian military estimates that 450 people have been killed in the last year, and many press reports put the figure much higher. The conflict has apparently resulted in the displacement of 300,000 – 400,000 people.

*Social impact of the crisis.* The most recent data on household consumption comes from the accelerated sub-sample of the 1999 SUSENAS (this is 10,000 of the 65,000 households in the sample). Using the same methodology as the 1996 official poverty analysis, this shows a rise in the percentage of households falling below the poverty line from 11.3 to 20.31 percent. These estimates are consistent with earlier reports from the IFLS2+ survey and the UNICEF 100 villages survey. The 100 villages survey, when adjusted for relative price changes faced by the poor and to a level consistent with the BPS estimates, shows the poverty headcount rising from 11 percent in May 1997 to 20.7 percent in August 1998. The IFLS, when similarly adjusted to be comparable in level and changes with BPS produces a poverty rate for August/September 1998 of 20.1 percent.

There is some suggestion that poverty has fallen since Feb 1999 as real consumption expenditures in the national accounts have risen and the relative (and nominal) price of rice has fallen. Preliminary indications from an August 1999 household survey suggests that poverty rates may have fallen by as much as 2-3 percentage points from their February levels.



While the aggregate impact of the contraction on poverty is not as high as originally estimated, this does not mean that all sections of society are coping equally well. All survey sources show a very heterogeneous geographical impact, with urban areas and Java hit harder than other parts of the country.

A major issue for the increase in the poverty rate was the huge increase in the relative price of rice. Between the two SUSENAS of February 1996 and February 1999 the price of rice rose 180 percent while the price of non-food items rose by only 80 percent. This contributed to the rise in the poverty rate over and above what would have been expected due to the fall in output.

In this regard, the government's decision to impose a tariff on the price of rice (430 rp/kg) and hence maintain the high price dictated by the floor procurement price set by BULOG (the national logistics agency) is particularly unfortunate.

Recent inequality analysis also gives cause for concern over the fate of the poorest and most vulnerable households. Overall, the nominal Gini coefficient (which measures inequality) has changed very little over the crisis period. However, this masks important differences in urban and rural areas, and does not take account of the effect of relative price changes on inequality. The latter is important because the poor have faced higher inflation than the rich (due to the importance of food in their consumption basket), and net producers have faced more favorable relative price changes than net consumers (due to the rising price of tradables).

Applying the Gini coefficient to household incomes deflated to reflect actual consumption patterns, urban inequality has decreased from 0.299 to 0.289 (principally due to a fall among richer urban households) while rural inequality has increased from 0.265 to 0.289 (apparently due to worsening conditions for rural laborers).

Inequality indices sensitive to developments at the top and bottom of the income distribution provide some further insights. The rise in rural inequality is found to be due to increasing inequality in the bottom tail of the distribution (the poorest), while lower urban inequality is primarily driven by a collapse in incomes of the top half of the income distribution. This is consistent with trends in the severity of poverty, which increased substantially for rural households between 1997 and 1998.

These results can be interpreted as an increase in vulnerability for rural households, with some sections (likely to be agricultural laborers, who are net consumers) suffering a very strong drop in incomes. This interpretation of the inequality data is supported by available data on real wages. Agricultural wages are reported to have fallen by approximately 40 percent in real terms between 1997 and 1998 (a shock for the poorest in rural areas), and formal sector wages to have

fallen by 34 percent (a shock for the upper and middle sections of the income distribution in urban areas). The data on formal sector wages is more reliable than that on agricultural wages, and the latter should be interpreted with caution.

The decline in real wages has been far more important than unemployment in channeling the impact of the contraction in the labor market. Open unemployment rose slightly, from 4.7 percent in August 1997 to 5.5 percent in August 1998. The main impact on family welfare, however, is through the decline in real wages. There has also been a major shift in employment from the formal to the informal sector (percentage of workers employed in the latter rose from 62.8 percent to 65.4 percent between 1997 and 1998); and from the modern to the agricultural sectors (workers employed in agriculture rose from 40.8 percent in 1997 to 45 percent of the labor force in August 1998).

Educational indicators have stayed fairly stable since the beginning of the crisis, with net primary enrollment up slightly in 1998/99, at 95 percent compared to 94 percent in 1997/98. Secondary enrollment has dropped slightly, from 54.4 percent to 53.2 percent. The latest official figures on enrollments for 1999/2000 indicate that primary enrollments rates are at pre-crisis levels while lower secondary enrollment has dropped by around 2 percentage points.

However, whereas in 1997 there was no correlation between per capita expenditure and enrollment rates, by 1998 lower per capita expenditure is associated with a lower probability of enrollment (IFLS2+). This indicates that, while overall enrollment levels have not dropped, poorer families have had more difficulty in keeping their children in school.

There are also indications, at the tertiary level, that students are choosing to prolong studies until labor market opportunities improve. Preliminary data for the current school year indicate no further fall in enrollments and perhaps a modest rise.

Health outcomes are more difficult to measure: there are no estimates of infant mortality since the crisis, and nutritional data (available until August 1998 only) does not show a rise in wasting and stunting among children. This does not preclude, however, a worsening of nutritional indicators among the poorest: more data is required.

Analysis from the 1995, 1997 and 1998 SUSENAS surveys shows that self-reported morbidity over the 1995-1998 period has changed little - the percentage of the population reporting an illness during a one month period was the same in 1998 as in 1995 (25.5%), and

slightly higher than in 1997 (24.4%). But, health care utilization rates declined quite dramatically - while 53% of those reporting an illness sought modern medical care in 1997, only 41% did so in 1998. Among those who sought health care, fewer people went to public health facilities. In 1997, 27 percent of those who were ill went to public facilities and 28 percent to private facilities whereas in 1998, only 20 percent went to public facilities, and 24% to private facilities.

## Program Implementation

*Background.* The 1997/98 economic contraction resulted in rapid increases in poverty in Indonesia, in particular in urban areas and on Java. In response to the 97/98 economic contraction, the Government of Indonesia (GOI), supported by the Bank and other donors, developed a three-pronged response to the social impacts of the crisis: (i) maintaining food security; (ii) expanding employment and income generation opportunities; and (iii) preserving access to critical social services. This was accompanied by a public commitment by the government to address governance issues, in particular efforts to minimize corruption in safety net programs.

*Recent developments in the social sectors.* The Government's operational guidelines for the "key" safety net programs include five-point monitoring plans to strengthen transparency and financial controls in the programs. Information folders on key safety net programs have been compiled and made available to the public in 100 districts in Indonesia. As of the date of this report, however, training has been carried out in these "safeguarding" activities and many are underway, but spending authority had not been released to start implementation in all of the programs, pending Bank's release of the SSNAL.

*Implementation of the SSN programs is mixed.* While OPK (the targeted subsidized rice) and education and health programs have been implemented, the PDM-DKE and the labor creation programs have been delayed in implementation (which the government attributes to the delay in the Bank's disbursement of the SSNAL). As these were the programs which created the most difficulties in the previous year this is not entirely a negative.

Efforts to maintain government spending on health and education at constant real levels have not been successful. Total public sector health spending fell by 8 percent in 1997/98 and a further 12 percent in 1998/99. This represents a 9 percent and 13 percent decrease respectively in real per capita terms. The gap between the budgetary allocation and actual expenditure has also increased since the crisis, from 10 percent in 1994-97 to

32 percent in 1998/99 (for the 73 percent of the health sector budget for which data are available).

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

Late in June 1999 a Government Regulation was signed by then President Habibie which opens the opportunity for a revision of the legal status of selected state universities to be recognized under commercial law as financially independent entities. This move will address in part a long standing concern about poor quality teaching in universities resulting from low salaries and a lack of incentives.

While the nature of these new financial entities will be non-profit making it is expected that there will be significant increases in tuition fees and some student unrest can be expected. To balance this a condition for the granting of greater autonomy will be that the university operates an expanded scholarship program to ensure equity of access.

## Bank Instruments

*Budgetary support.* The first tranche of the Social Safety Net Adjustment Loan was disbursed on January 31st, 2000. Supervision is planned for February. The second tranche will not be disbursed in this government fiscal year ending March 31st.

*Project portfolio.* The Bank, in coordination with other donors, has continued to provide direct support to the social safety net and key social services through its investment project portfolio. A new project to support employment and income-generating activities in urban areas - the Urban Poverty Project - has recently been declared effective, the program has been launched by the government, and facilitators are beginning work in the field to prepare for activities.

The portfolio also includes the "stay at school" project for scholarships and block grants for primary schools, in coordination with ADB, and several projects in the health sector. In partnership with AusAid and GOI, we are conducting sector work on Education Strategy Development. While the scholarships program has been a successful response to the crisis, the Bank and GOI are discussing an "exit strategy" so that attention can return to the overall sectoral reform agenda.

In addition, the Bank continues to support structural poverty reduction through the Kecamatan Development Project and the Village Infrastructure Program.

*Analytical Work.* A Poverty Assessment is planned and preliminary results will be available by the end of the Bank fiscal year. A series of working papers on the social impact of the economic crisis from both

quantitative and qualitative research have been produced by the Social Monitoring and Early Response Unit (SMERU), a unit set up with support from the World Bank, AusAid, USAID, and ASEM trust funds. These are available on SMERU's web page: [www.smeru.or.id](http://www.smeru.or.id).

- Macroeconomic Update was prepared by Sudarshan Gooptu (EASPR)
- Financial Sector Update was prepared by Ruth Neyens (FPO)
- Corporate Sector Update was prepared by Bernard Drum (EACIF)
- Social Update was prepared by Sarah Cliffe (EASPR); updated by Lant Pritchett in January 2000.

## Indonesia Economic Indicators

Indonesia	1997	1998	1999							
	Year	Year	Q1	Q2	Q3	Q4	Sep	Oct	Nov	Dec
<b>Output, Employment and Prices</b>										
GDP ( % change previous year)	4.7	-13.2	-8.0	3.1	0.5	..	..	..	..	..
Industrial production index (1993=100)	157.4	136.4	146.4	150.2	151.0	..	..	..	..	..
(% change, previous year)	13.1	-13.3	4.9	20.2	9.9	..	..	..	..	..
Unemployment Rate (%)	4.7	7.0								
Real Wage Growth (%)	4.1	-29.9								
Consumer price index (% change, previous yr.)	6.1	58.5	55.8	31.2	6.6	1.7	1.2	1.6	1.6	1.9
<b>Public Sector</b>										
Government balance (% GDP) /1	-0.6	-2.7	..	..	..	..	..	..	..	..
Domestic public sector debt (% GDP)	..	..	..	..	..	..	..	..	..	..
<b>Foreign Trade, BOP and External Debt</b>										
Trade balance (\$US billions)	10.1	18.4	4.0	4.5	5.3	5.5	..	..	..	..
Exports of goods, (\$US billions)	56.3	50.4	10.8	12.4	13.4	14.1	..	..	..	..
(% change, previous year)	12.2	-10.5	-15.7	-6.0	-0.7	29.6	..	..	..	..
Key export: , (% change, previous year)										
Imports of goods, (\$US billions)	46.2	31.9	6.8	7.9	8.0	8.6	..	..	..	..
(% change, previous year)	4.5	-30.9	-15.4	-3.4	-3.9	16.7	..	..	..	..
Current account balance (\$US billions)	-0.6	4.1	1.5	0.8	1.6	1.2	..	..	..	..
(percent GDP)	-0.3									
Foreign Direct Investment (US\$ millions)	4677.0	-356.0	-144.0	-77.0	-32.0	-144.0				
Total external debt (\$US billions)	136.2	150.9	149.9	144.9	..	..	..	..	..	..
(% GDP)	64.0	158.0								
Short-term debt (\$US billions)	18.8	13.1	12.5	11.0	..	..	..	..	..	..
Debt service ratio (% exports of g&s)	48.0	57.6	..	..	..	..	..	..	..	..
Reserves, excluding gold (\$US billions)	16.6	22.7	25.2	26.3	..	..	..	..	..	..
(months of imports of goods only)	3.0	5.9	7.2	6.2	..	..	..	..	..	..
<b>Financial Markets</b>										
Domestic credit (% change, previous year)	42.0	36.0	-10.2	-4.0	34.4	..	0.9	-2.7	0.1	..
Short-term interest rate /2	21.4	48.6	37.7	29.4	14.4	..	12.5	11.4	11.2	..
Exchange rate (end-period)	4,950	8,067	8,862	6,724	8,368	7,059	8,368	6,905	7,400	7,059
Real effective exchange rate (1990=100, + = appn)	96.6	47.3	61.4	68.6	..	..	..	..	..	..
(% change, previous year)	-5.5	-51.0	60.8	59.6	..	..	..	..	..	..
Stock market index (Aug 1998=100), eop	401.7	398.0	393.6	662.0	547.9	676.9	547.9	593.9	583.8	676.9
Memo: GDP (US\$ millions)	212,634	95,478	31,083	36,884	36,809	38,847	..	..	..	..
<i>GDP (Rupiah billions)</i>	627,695	942,844	273,171	283,899	280,068	279,261				
<i>Average US\$/Rupiah</i>	2,952	9,875	8,788	7,697	7,609	7,189				

/1 Central government budget, Indonesia FY (April-March), where 1997 is April 1997-March 1998.

/2 One month deposit interest rate in commercial bank.