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The World Bank

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Report No. 7)47

PROGRAM PERFORMANCE AUDIT REPORT

INDONESIA

FIRST AND SECOND TRADE POLICY ADJUSTMENT LOANS
(LOANS 2780-IND AND 2937-IND)

JUNE 30, 1989

Operations Evaluation Department

CURRENCY EQUIVALENTS

Currency Unit	=	Rupiah (Rp)
US$1.00	=	Rp 1,670
Rp 1 million	=	US$599

FISCAL YEAR OF BORROWER

April 1 - March 31

ABBREVIATIONS AND ACRONYMS

BAPPENAS	-	National Development Planning Agency
BKPM	-	Investment Coordinating Board
BULOG	-	Badan Urusan Logistik (The National Logistics Agency)
CCCN	-	Customs Coordination Council Nomenclature
CBU	-	Completely Built Up
CKD	-	Completely Knocked Down
EKUIN	-	Coordinating Ministry for Economic Matters
GOI	-	Government of Indonesia
IGGI	-	Inter-Governmental Group on Indonesia
IPEDA	-	Iuran Pembangunan Daerah (the old land tax)
NTB	-	Non-Tariff Barrier
O&M	-	Operations and Maintenance
P4BM	-	Implementing Agency for May 6 Scheme
REPELITA	-	National Five-Year Development Plan
SBI	-	Central Bank Certificates
SBPU	-	Private Sector Promissory Notes
SGS	-	Societe Generale de Surveillance S.A.
SOE	-	Statement of Expenditure
TIPSC	-	Trade and Industrial Policy Steering Committee
TPAL I	-	First Trade Policy Adjustment Loan
TPAL II	-	Second Trade Policy Adjustment Loan
VAT	-	Value-Added Tax

Import License Categories:

AT	-	Agen Tunggal (Licensed Agent)
IP	-	Importir Produser (Actual User)
IT	-	Importir Tardaftar (Approved Trader)
IU	-	Importir Umum (General Importer)
KS	-	PT Krakatau Steel
PI	-	Produsen Importir (Producer Importer)
TT	-	PT Tambang Timah

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

Office of Director-General
Operations Evaluation

August 25, 1989

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Program Performance Audit Report on Indonesia First and Second Trade Policy Adjustment Loans (Loans 2780-IND and 2937-IND)

Attached, for information, is a copy of a report entitled "Program Performance Audit Report on Indonesia First and Second Trade Policy Adjustment Loans (Loans 2780-IND and 2937-IND)" prepared by the Operations Evaluation Department.

Attachment

PROGRAM PERFORMANCE AUDIT MEMORANDUM

INDONESIA

FIRST AND SECOND TRADE POLICY ADJUSTMENT LOANS (LOANS 2780-IND AND 2937-IND

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INDONESIA

FIRST AND SECOND TRADE POLICY ADJUSTMENT LOANS (LOANS 2780-IND AND 2937-IND)

PREFACE

This is a performance audit of the Bank's First and Second Trade Policy Adjustment Loans (TPALs) to Indonesia. TPAL I (Loan 2780-IND, US$300 million) was signed on February 6, 1987, and fully disbursed by June 30, 1987. TPAL II (Loan 2937-IND, US$300 million) was signed on June 10, 1988, and was fully disbursed by November 17, 1988.

The audit consists of a Program Performance Audit Memorandum (PPAM), prepared by the Operations Evaluation Department (OED), and Program Completion Reports (PCRs), prepared by the Asia Regional Office. The PPAM is based on a review of the President's Reports (No. P-4429-IND, dated June 30, 1986, and No. P-4794-IND, dated April 19, 1988), the loan agreements, the Summaries of Board Discussions, and the PCRs and related documents in the Bank's files. Bank staff associated with the loans have been interviewed and discussions have been held with IMF staff. An OED mission visited Indonesia in January 1989 to review the trade policy adjustment operations with Government officials and private sector representatives. The valuable assistance provided by the Borrower, the Bank's Resident Mission in Jakarta, and the staff at headquarters, is gratefully acknowledged.

The PCR provides a good account and assessment of the project experience, and discusses the performance of the Bank and the project executing agencies. The PPAR elaborates on particular aspects, such as the appropriate mix and coordination of macroeconomic policy instruments, the sequencing of the reforms, and the effectiveness of the overall program.

Following standard OED procedures, copies of the draft PPAR were sent to the Government and the Borrower. The Borrower's comments have been taken into account in finalizing the report and have been reproduced as an attachment to the PPAR.

PROGRAM PERFORMANCE AUDIT REPORT

INDONESIA

TRADE POLICY ADJUSTMENT LOAN
(LOAN 2780-IND)

BASIC DATA SHEET
(US$ Million)

LOAN STATUS

Original	Disbursed	Cancelled	As of 05/31/89 Repaid	As of 05/31/89 Outstanding
300.00	300.00	0.00	0.00	300.00

CUMULATIVE DISBURSEMENTS

	FY87
(i) Estimated	300.0
(ii) Actual	300.0
(iii) (ii) and % of (i)	100.0

OTHER LOAN DATA

	Original Date	Actual or Reestimated
First Mention in Files	-	11/10/86
Appraisal Mission	-	11-12/86
Negotiations	-	12/19/86
Board Approval	-	02/03/87
Loan Agreement	-	02/06/87
Effectiveness	04/07/87	03/18/87
Closing	-	06/30/87
Actual Completion	-	06/30/87

STAFF INPUT

	FY87	FY88	Total
Preappraisal	15.9	-	15.9
Appraisal	4.8	-	4.8
Negotiation	1.8	-	1.8
Supervision	3.8	13.4	17.2
Total	26.3	13.4	39.7

MISSION DATA

Item	Month/ Year	No. of Weeks	No. of Persons	Staff Weeks /a	Date of Report
Preparation/ Preappraisal	09-10/86	8.0	3	10.0	
Appraisal	11-12/86	9.0	3	12.5	12/30/86
Supervision	03-06/87	-	2	4.0	
Completion	06/00/88	-	2	2.0	06/30/88

/a Includes total staff weeks devoted to TPAL based on the Time Recording System.

FOLLOW-ON LOAN

Second Trade Policy Adjustment Loan
(Loan 2937-IND)
Signed June 10, 1988

PROGRAM PERFORMANCE AUDIT REPORT

INDONESIA

SECOND TRADE POLICY ADJUSTMENT LOAN (LOAN 2337-IND)

BASIC DATA SHEET
(US$ Million)

LOAN STATUS

Original	Disbursed	Cancelled	As of 05/31/89 Repaid	As of 05/31/89 Outstanding
300.00	300.00	0.00	0.00	300.00

CUMULATIVE DISBURSEMENTS

	FY89
(i) Estimated	300.0
(ii) Actual	300.0
(iii) (ii) and % of (i)	100.0

OTHER LOAN DATA

	Original Date	Actual or Reestimated
First Mention in Files	-	02/17/88
Appraisal Mission	-	01-02/88
Negotiations	-	04/01/88
Board Approval	-	05/10/88
Loan Agreement	-	06/10/88
Effectiveness	06/88	08/01/88
Closing	-	03/31/89
Actual Completion	-	03/31/89

STAFF INPUT

	FY87	FY88	Total
Negotiation	-	16.0	16.0
Total	-	16.0	16.0

MISSION DATA

Item	Month/ Year	No. of Weeks	No. of Persons	Staff Weeks /a	Date of Report
Preparation	12/87-01/88	6	3	8.0	
Appraisal	01-02/88	4	3	8.0	04/19/88
Supervision	08-11/88	-	2	2.7	
Completion	03/00/89	2	2	2.0	03/10/89

/a Total inputs based on Time Recording System.

FOLLOW-ON LOAN

Private Sector Development Loan
(Loan 3080-IND)
Signed July 21, 1989

PROGRAM PERFORMANCE AUDIT REPORT

INDONESIA

FIRST AND SECOND TRADE POLICY ADJUSTMENT LOANS (LOANS 2780-IND AND 2937-IND)

EVALUATION SUMMARY

Background

1. The rapid growth of income, consumption, and investment that characterized the 1970s in Indonesia corresponded with an escalation in oil prices. Indonesia used its oil income to develop its industrial and agricultural base and to contribute to social development. Its fortunes were, however, reversed in the early 1980s with the collapse of oil prices. Underlying structural problems surfaced and contributed to emerging economic difficulties. Indonesia responded by undertaking reforms designed to restore internal and external balance and the potential for long-term growth with financial stability.

2. Beginning with a major devaluation of its currency in 1983, Indonesia adjusted to the diminished export income in two ways: (a) reducing expenditure by appropriate monetary and fiscal strategies; and (b) liberalizing the complex trade and regulatory environment. Both measures were designed to improve resource allocation and promote private sector development. These actions were supported by two Trade Policy Adjustment Loans. These loans were ex post in the sense that they were granted in response to actions that were already taken by the Government, but on the tacit understanding that the reform program was anchored within a medium-term framework of adjustment and growth. The first loan (TPAL I) became effective on March 18, 1987, and the second loan (TPAL II) on August 8, 1988. Each loan was for a sum of US$300 million. The loans have been fully disbursed.

The Adjustment Program

3. TPAL I supported the first phase of adjustment. A central element in GOI's adjustment program was the restraint of expenditure to counter rising inflation and restore internal balance. The brunt of the cuts occurred in government investment expenditures where priorities focussed on the completion of on-going projects, foreign aided projects, projects with a focus on employment and equity and operation and maintenance operations. Improved external balance was promoted by a further exchange rate devaluation in September 1986 and the exchange rate was subsequently allowed to depreciate against a falling US dollar. These measures were reinforced by improvements in the trade regime to increase the competitiveness of exports and efficiency of imports, as well as to inject greater competitiveness into the industrial sector. Recognizing a role for

foreign private investment in a strategy for economic diversification, many of the restrictions on foreign participation in local business enterprises were relaxed.

4. TPAL II supported the second stage of the Government's reform program. GOI reinforced and consolidated the policies and measures it had undertaken in earlier years and built on the progress achieved in 1986. In 1987 and 1988, the shift from import restrictions to a tariff-based trade regime was continued and measures were taken to lower tariff ceilings as well as tariff dispersion. The regulatory environment for certain categories of exports was further eased. Additional fields of investment were opened to foreign and domestic investors. Restrictions prohibiting foreign-owned companies from marketing Indonesian export goods were abolished. Foreign companies were allowed to purchase domestic inputs without limitation and rules regarding the hiring of expatriates were relaxed.

5. Reforms at the level of the production sector were complemented by changes in the financial sector. These included liberalization of most interest rate controls on State Bank deposits, establishment of rural banks, elimination of credit ceilings for all banks, and a reduction in the number of programs qualifying for new Bank Indonesia liquidity credits. Measures were instituted to improve the functioning of the Jakarta Stock Exchange and to improve access for smaller, less well established companies seeking to mobilize resources through the capital market.

6. The policy reforms implemented in conjunction with TPAL I and II must be seen as a continuation of a process which commenced soon after the decline in oil prices in 1981. They gathered momentum with a major devaluation of the rupiah in 1983. Box 1 summarizes the key adjustments.

Impact of Adjustment Policies

Internal Balance

7. The macroeconomic policy package that was associated with TPAL I and II consisted of a major fiscal effort, a conservative monetary strategy and an exchange rate policy directed towards restoring internal and external balance. It has yielded positive results (see Box 2). Inflation slowed down to 8.7% in 1988. An important reason for the fall in inflation is the reduction in the central government's budget deficit, which resulted from a major improvement in tax effort as well as a reduction in expenditures. Non-oil taxes rose from 5.9% of GDP in 1982/83 to an estimated 8.5% in 1988/89, while government expenditure over the same period declined from 22.2% of GDP to about 19.3%.

Structural Shifts

8. Economic growth also picked up as a result of improved performance of the non-oil sector, which grew faster than overall GDP. The improved performance of the non-oil sector was reflected in its share of total exports, which rose very rapidly. Non-oil exports financed 28% of non-oil imports in 1981, but this share had increased to almost 85% by 1988.

Box 1: ADJUSTMENT POLICIES, 1983/84-1988/89	
Instruments	**Policy Description**
Exchange Rate	(i) **Rupiah devalued by 28% (IMF method) in March 1983.** (ii) **Exchange rate made more flexible since March 1983.** (iii) **Rupiah devalued by 31% (IMF method) in September 1986.** (iv) **Exchange rate allowed to depreciate against a falling US dollar since September 1986.**
Fiscal Policy	(i) **A major tax reform initiated, starting in January 1984.** (ii) **Follow-up steps taken to strengthen tax administration.** (iii) **Large capital and import-intensive projects rephased.** (iv) **Major cutbacks in government real capital spending.** (v) **Tight control maintained since 1983 on the use of non-concessional import-related credits.** (vi) **Restraints on civil service employment and salaries.**
Monetary and Financial Policies	(i) A major financial reform initiated in June 1983, involving removal of interest rate and credit ceilings for state bank operations and introduction of new instruments of monetary control. (ii) A new set of financial measures introduced in October and December 1988, aimed at enhancing financial sector efficiency and boosting capital markets. (iii) Improved monetary management to control inflation. (iv) Improved short-term monetary management to curb exchange rate speculation.
Trade Policy	(i) An across-the-board reduction in nominal tariffs, implemented in March 1985. (ii) Measures to provide internationally priced inputs to exporters announced on May 6, 1986. (iii) Significant reduction in import-licensing restrictions, initiated through a series of measures, in October 1986, January and December 1987, and November 1988. (iv) Steps taken in December 1987 to reduce the anti-export bias of trade policy by reducing regulatory restrictions for exporters.
Regulatory Reforms	(i) Steps taken through the May and October 1986, and January and December 1987 packages to reduce the investment and capacity licensing requirements, relax foreign investment regulations, and reduce the role of the local content program. (ii) Reorganization of customs, ports, and shipping operations in April 1985 to reduce freight costs and cut procedural time. (iii) Substantial deregulation of maritime activities announced in November 1988 to reduce cost and encourage private sector participation.

Source: World Bank, Country Economic Report, May 1989.

Box 2: INDONESIA--KEY ECONOMIC INDICATORS, 1981-88

Key Parameters	1981	1982	1983	1984	1985	1986	1987	1988
	Annual Average Growth (Percent)							
GDP	6.6	-0.3	3.3	6.4	1.7	3.7	3.9	4.7
GDP p.c.	4.4	-2.4	1.1	4.2	-1.6	1.7	1.9	2.6
Non-Oil GDP	8.6	4.2	3.8	4.5	3.8	3.9	4.6	5.6
Agriculture	4.8	1.1	1.9	4.2	4.2	2.6	1.8	3.8
Manufacturing	9.5	0.9	2.7	6.2	6.2	4.9	7.1	9.0
Consumption	10.1	6.6	1.8	3.3	2.7	2.3	2.2	4.0
Public	9.8	9.6	-2.6	3.4	7.4	0.1	-3.7	1.5
Private	10.2	6.0	2.7	3.3	1.8	2.7	3.3	4.4
Investment	12.9	8.7	-1.1	-5.9	-6.0	-7.0	1.9	7.0
Public	n.a.	20.2	-3.7	-12.9	2.4	-19.6	-1.7	6.3
Private	n.a.	-1.9	1.8	1.5	-13.8	6.8	4.9	7.6
Inflation	8.6	9.0	10.7	11.7	4.9	5.5	9.6	8.7
	In Percent of GDP							
Exports	26.7	20.4	26.8	25.6	23.4	21.0	27.3	27.0
Non-Oil Exports	4.5	4.0	6.8	7.0	7.3	9.3	13.2	15.2
Imports	29.7	28.1	32.4	28.5	25.9	26.9	29.9	29.8
Trade	56.4	48.5	59.2	54.1	49.3	48.0	57.2	56.8
Current Account	-2.9	-7.6	-5.5	-2.7	-2.3	-5.6	-2.2	-2.3
Budget Balance	-1.3	-4.4	-2.2	0.8	-2.8	-3.9	-2.4	-2.8
National Savings	27.8	22.6	21.4	22.0	22.0	17.9	20.0	19.8
Public	9.2	8.2	9.4	10.2	8.3	4.9	5.7	6.0
Private	18.6	14.4	12.0	11.8	13.7	13.0	14.3	13.8
Debt/GDP /a	17.6	20.9	28.9	28.2	33.4	45.1	61.8	55.9
Debt Service Ratio /a	8.2	11.4	12.1	16.5	19.6	30.9	29.2	31.5
Gross External Debt ($ bln)	16.3	19.8	23.4	24.0	28.3	34.3	43.2	43.5
Net Foreign Assets ($ bln)	10.8	7.5	10.0	11.7	12.6	9.6	10.8	10.0

/a Debt service excludes prepayments. All debt figures refer to public and publicly guaranteed debt.

Source: World Bank.

Growth was spearheaded by the manufacturing sector, which showed an annual increase of about 34% per year between 1982-87, picking up to 38% in 1986-88. As a result of favorable overall export growth, the current account deficit of the balance of payments has been reduced from 7.6% of GDP in 1982 to about 2.3% in 1988. Net foreign assets, at approximately $10 billion in 1988, were equivalent to 4.2 months of imports, compared to a ratio of 2.0 months of imports in 1982/83.

Debt Issues

9. The debt service ratio amounted to 31.5% in 1988 (Box 2). The reasons for the growth in debt have been identified as the depreciation of the US dollar in relation to the currencies in which Indonesia is indebted, rising international interest rates, and the continuing current account deficit in the balance of payments.1/ There are indications, however, that the debt situation is improving. The debt/GDP ratio declined from about 62% in 1987 to about 56% in 1988, and the ratio of debt to exports also fell, partly as a result of good export performance.

Social Impact

10. The pace and pattern of real growth is a critical determinant of employment and earnings. In the urban formal sector, economic growth is a determinant also of the level of employment. There is evidence of an increase in open unemployment in urban areas, but it is not clear as to how much of this is directly related to budgetary resource constraints which reduced the rate of labor absorption. Labor earnings are estimated to have declined in trade, and real wages of construction workers and civil servants have also been stagnant. The available evidence suggests a stagnation or even a decline in real labor earnings during the adjustment.

11. Apart from economic growth, specific government expenditure programs, such as those with respect to education, health, family planning, water supply, and housing, can have an impact on living standards, especially on the poorer segments of the population. The resource crunch has limited the growth of these expenditures. The Government has, therefore, redefined its priorities, protecting the most vital social programs and improving the delivery system. The Bank's sector work shows that despite these attempts there is some evidence that the availability and quality of some essential services may have suffered. While public sector investment expenditure declined by an annual average of 2.0% between 1981-88 (Table 4.3), private investment remained positive by slightly under 1%, and picked up strongly in 1987 and 1988 to an annual average of 6.25%. The non-oil sector, which is relatively labor intensive, grew faster than overall GDP (Table 4.2). Non-oil exports, especially a wide range of labor-intensive manufactures, also showed phenomenal growth, rising from an annual average of 33.8% in 1982/83-1986/87, to 42.6% in 1986/87-1987/88 (Table 3.9). This robust non-oil export performance moderated adverse effects resulting from lower rates of growth of public expenditures and investment.

1/ Indonesia: Strategy for Growth and Structural Change, World Bank Report No. 7758-IND, May 3, 1989.

Major Issues of Adjustment and Growth

Expenditure Reduction Policy

12. A conservative fiscal strategy has been at the core of Indonesia's adjustment program. This has meant an increase in the tax ratio and a reduction in expenditures, principally, public sector capital expenditure. The policies and measures have, in conjunction with monetary and exchange rate policies, restored better internal and external balance. Nevertheless, the current inflation rate of 8%-9% is still regarded as high. Any measures to reduce this would necessitate an intensification of current fiscal/monetary stringency. It must be recognized, however, that in the long term, public sector investment deficits may adversely affect the creation of infrastructure needed to promote private sector development. Public investment also contributes to employment expansion. While there is an obvious case for a revival of investment, it has to be accompanied by policies and measures to raise levels of domestic savings. Additional savings may be generated through improved financial performance of state economic enterprises, greater efficiency in government expenditures (lower ICORs), and an increase in the tax ratio, which is estimated to be low by standards or comparators in the Asian region.

Interest Rate Strategy

13. The second issue concerns the dualistic impact of interest rate policy. In the Indonesian system, the government is constitutionally prohibited from borrowing in domestic markets or from the Central Bank. Hence, its fiscal deficit is financed from foreign sources. Indonesia also has a system of open capital markets. Hence, Indonesia has to keep its domestic interest rate at a level that assures it of an inflow of foreign capital sufficient in amount to finance its non-aid current account deficit.

14. The interest rate differential, which meets this test, is based on the difference between domestic inflation and inflation in the principal overseas financial markets plus the expected depreciation of the Indonesian currency and the risk premium demanded by foreign savers for holding deposits in rupiah. Technically, therefore, the higher the level of inflation in Indonesia, and the greater the expected exchange depreciation (the current assumption is for an annual 5% depreciation of the real effective exchange rate), and the greater the risk premium (dictated by the Debt/GDP ratio), the higher the required domestic-international interest rate differential. A policy dilemma occurs when high interest rates increase debt service and deter private investment. This calls for a much stronger fiscal effort and improved incentives for promoting domestic savings. Given Indonesia's open capital market, exchange rate strategy becomes subject to interest rate concerns; continued depreciation of the exchange rate drives the interest rate higher because foreign savers need to be covered against future exchange depreciation. Thus, policies to promote external balance through continued exchange rate depreciation could indirectly act as a disincentive to domestic investment and add to debt service if interest rates are driven higher.

15. Interest rates can be kept down by reducing the non-aid current account deficit and improving access to concessionary capital transfers. This could be supplemented by foreign private investment, which, in turn, would require improvements in the regulatory framework. Major efforts are also needed to increase national savings, which have declined as a share of GDP (see Box 2). One of the ways in which this may be achieved is by slowing the rate of growth of consumption and targetting it appropriately. The policy issue, therefore, is the extent to which consumption growth should be restrained in order to promote higher levels of investment, without increasing the non-aid current account deficit, or inducing a rise in interest rates. The main instrument to achieve this is an improved fiscal strategy. The budget for 1989/90 demonstrates that the government has made a start in this direction.

Exchange Rate Variations

16. The real effective rate depreciated at an annual rate of 13% between 1981-88. The Five Year Plan 1989-94 (Repelita V) assumes an annual 5% depreciation of the real effective exchange rate. The question is whether an annual depreciation of 5% would be adequate for maintaining the export advantage that has been gained over the last few years and for improving the current account deficit, currently running at approximately 2.3% of GDP. Indonesia's export competitiveness has benefited in recent years from the appreciation of the Taiwanese currency and the overheating in Thailand's economy. These features have provided added "protection" to the real effective exchange rate. Any lessening of the constraints hampering exports of Indonesia's competitors could exercise greater pressure on its exchange rate, in the absence of countervailing policies. The policy issue is whether intensified monetary restraint is desirable as a means of protecting the foreign exchange reserve or whether greater robustness in the management of the real effective exchange rate is justified as a means to safeguard Indonesia's export competitiveness. The prevailing inflation rate of approximately 9% would seem to suggest a slightly more cautious monetary policy than now exists. GOI should, at the same time, be prepared to respond to any change in its international trading competitiveness by an appropriate change in its real effective exchange rate.

Trade Regime

17. Important steps have been taken, since March 1985, to free the trade regime from a complex licensing system and regulatory environment. The first round of reforms centered on a shift from licensing to tariffs. While this process has been almost completed with respect to manufactures, it has only just begun in agriculture. The next steps are to complete this transition. As licensing restrictions have been reduced, there has been a widespread use of temporary import surcharges imposed on an ad hoc basis to maintain the protective equivalence of the licenses. The next step would be to rationalize these; they should be removed or converted into tariffs where this is justified.

18. The deregulation of past controls that hindered trade has been a step in the right direction. However, the reforms to date have been determined by an ad hoc committee with shifting membership and power distribution. The changes, announced by decree and with specific content and timing, are difficult to forecast. There is a need to formalize the decision-making process in this regard through the establishment of appropriate institutions at a sufficiently high level in the administration with a properly staffed secretariat, which would be as free as possible from political interests. The objective should be to make the decision-making processes on both trade policy and administration as transparent and predictable as possible.

Export Restrictions

19. Export restrictions consist of bans, quotas, the designation of approved exporters, and quality controls. Bans are aimed at increasing value-added before the export stage. Quotas have the same objective. as well as securing domestic supplies. Approved exporters, or marketing organizations, restrict access to export trade to a few rent-seeking individuals. While quality control is desirable for maintaining export markets, it could also act as a channel for conferring rents. In view of their distortive effects, it is desirable that the entire system of export restrictions be reviewed. There may be an argument for bans, but their effect on value-added needs to be documented. Similarly, the justification for quotas and the distribution of resulting rents should be examined. There is also a strong case for granting approved exporter status freely to applicants meeting clearly stated requirements. Considerable scope exists for making the quality control administration more transparent.

Sustaining Program Benefits

20. Indonesia's effort at economic stabilization and structural adjustment, which began in 1983 and gained momentum over the last three years, is on a sound path. It has necessitated courageous policies and measures and imposed hardship on some sections of the community through reduced expenditure, which exacerbated underlying unemployment problems. However, the basis is being laid for future growth with stability. To consolidate the progress that has been achieved so far, Indonesia will need to focus on continued improvement in investment promotion, savings mobilization and private sector development. Further steps are needed to implement the program of tariff rationalization, liberalization of the regulatory environment for production and trade, and to strengthen GOI's in-house policy analysis and implementation capability.

21. There is a case for increasing the national investment rate from its present level of 20% of GDP, to promote a higher rate of economic growth and to generate increased employment. During the adjustment period, Indonesia permitted the growth of consumption to exceed the growth of GDP. But given the rising debt service and limited domestic savings, any acceleration of investment will require some curtailment of consumption or a commensurate growth in export income. Export growth has been very good but further acceleration may be limited. Therefore, an expanded savings effort must be the key to future economic progress.

22. The liberalization of the trade regime, combined with an improved environment for private investment, has led to a rapid growth of production in the non-oil sector and exports. Given the complexity of the regulatory system, the response to the changes has been exceptional. The incentives created by a realistic exchange rate strategy have complemented the movement on trade liberalization. But further action is necessary. The movement from the licensing system to tariffs in the manufacturing sector is nearly complete, while it has just begun in agriculture. The next steps are to complete this transition and to move to unify and rationalize the tariff system. These actions must be complemented by measures to improve the transparency of the regulatory system and simplify and codify laws and regulations relating to corporate and commercial activity. Given the limited savings available and the need to absorb the latest in management practice and skills, further liberalization of the laws relating to foreign private investment may be appropriate.

23. Parallel action is also required to further improve the regulatory system governing investment. In this context, an important step would be the abolition of the investment licensing system for industry, in favor of a free system with a short negative list of controlled sectors. This would provide a greater measure of transparency and help toward attracting foreign private investment. This should be matched by a credible legal structure for business, which should, as a minimum, include specific and enforceable bankruptcy provisions.

24. Sustainability of the benefits reaped so far would also depend on the formalization of the process of adjustment and structural change through the creation of an appropriate administrative framework. It would necessitate the establishment of a Tariff Commission which would be relatively free of political interest and would have the resources to undertake policy analysis and make appropriate recommendations for implementing the program of trade liberalization. It will also have the task of monitoring progress and conducting surveys to assess impact. These would be valuable feedback into the policy-making process.

Role of the Bank

Conditionalities

25. The Bank's strategy for promoting Indonesia's trade policy reforms departed from the conventional pattern. In this case, the loans were a response to actions that were taken within the framework of a medium-term adjustment program that had been clearly spelled out by the Government and supported by the Bank.2/ Hence, no *ex ante* conditionality was attached to

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2/ These were articulated in two Statements on Economic and Trade Policy, dated December 19, 1986, and February 29, 1988, respectively, addressed to the President of the World Bank by the Hon. Ali Wardhana, Indonesia's Ministry Coordinator for the Economy, Finance, and Industry. President's Report No. P-4429-INS, dated December 30, 1986, and President's Report No. P-4794-INS, dated April 19, 1988.

either TPAL I or TPAL II. The strategy succeeded for two reasons. First, the Indonesian government had been exposed to a range of in-depth and high quality economic and sector work, conducted by the Bank for almost a decade. This provided the analytical basis for the deregulation actions taken by the Government in 1985. The assistance provided by a well staffed Resident Mission, complemented by economists from headquarters, facilitated an active policy dialogue. Second, the economic crisis that was precipitated by the fall in the price of oil, beginning in 1981 and accentuated in 1986, gave the Government a unique opportunity to implement adjustment measures that the Bank had proposed but the Government had postponed. The Bank supported this action effectively. It complemented its studies on trade policy with technical assistance to facilitate implementation of reforms and focussed its dialogue on the priority areas germane to a successful adjustment effort.

Economic and Sector Work

26. The Bank's analytical support and policy dialogue contributed to the articulation of appropriate policy responses to problems of macroeconomic management. In the aftermath of the collapse of oil prices in 1986, the Bank's macroeconomic orientations focussed on five critical adjustment areas: (i) exchange rate management, to respond to external shocks and maintain the competitiveness of non-oil exports; (ii) appropriate fiscal and monetary strategies, to control expenditure and reduce inflationary pressure; (iii) public resource mobilization, through effective tax administration and improved cost recovery policies; (iv) focussed expenditure priorities, especially for O&M and poverty-related programs; and (v) external debt management and debt service.

27. In the early 1980s, the Bank was in the vanguard of advocates for greater deregulation of the economy and liberalization of the trade regime. Major studies on trade and industrial policy issues were completed in 1981 and 1985.3/ They identified the costs of the complex regulatory environment for business and charted the broad policy directions for the future. Concurrent with the devaluation of the rupiah in 1986, GOI needed a strategy for implementing reforms with respect to the trade regime and the regulatory system. The Bank responded with two studies: (i) enterprise regulation and (ii) trade policy reform and implementation. Both studies will be completed in 1989. At the request of GOI, the Bank has also initiated a major study of the financial sector. This report will be the basis for a continuing dialogue on financial sector policies. Technical assistance on maritime sector reforms has been provided under the National Ports Development Project (FY85) and continued by a Bank-financed consultant within the Ministry of Communications.

3/ Selected Issues in Industrial Development Strategy, World Bank, [illegible] and Selected Issues of Industrial Development, World Bank, 1985.

Coordinating the Assistance Strategy

28. The technical advice provided by the Bank with respect to the implementation of trade policy reforms was important to Indonesia. This was reinforced by two trade policy loans, totalling US$300 million. It provided valuable balance-of-payments support during a period when this was under pressure due to liberalization. Equally important was the catalytic role the Bank played vis-a-vis the Intergovernmental Group for Indonesia (IGGI) in mobilizing substantial financial support for Indonesia (Box 3). As a result, Indonesia was able to capture significant resource transfers on concessionary terms. Without such assistance, the process of adjustment could have been more painful and necessitated greater hardship for the poorer segments of the population. The concessionary assistance from IGGI inter alia enabled GOI to restructure its external debt obligations by paying off its commercial liabilities. Consequently, the debt profile in the next decade is projected to remain within manageable dimensions.

Box 3: INDONESIA: WORLD BANK ASSISTANCE, 1981-88 /a
(US$ millions)

	1981	1982	1983	1984	1985	1986	1987	1988
Commitments	837	977	1,210	987	1,068	982	1,418	1,067
- Project loans	837	977	1,210	987	1,068	707	614	767
- Sector loans						275	504	
- Special assistance							300	300
Disbursements	451	661	608	881	815	846	1,389	1,650
Repayments	161	223	273	325	407	660	899	1,088
Net transfers	290	438	335	556	408	186	490	562
Memo Item								
Total IGGI net transfers /b	682	688	495	666	477	173	960	1,414

/a Includes IDA.
/b Includes IBRD and IDA.

Source: Debt Recording System, IEC, World Bank.

Project Support

29. A cluster of projects supportive of the objectives of the trade policy adjustment program complemented the Bank's assistance strategy for growth and export diversification. A manpower development and training project, which was approved in May 1986, has as its core objectives the establishment of a national vocational training system to train

approximately 20,000 pupils each year in key skills and occupations. Two export development loans, the first of which was approved in May 1986, were designed to strengthen Indonesia's efforts at export diversification through the provision of technical assistance and training facilities and the availability of long-term credit for export-oriented investments. This has been followed by an industrial restructuring project, which provides direct financial and technical assistance to selected individual enterprises that have difficulty in adjusting to the increasingly competitive environment consequent on investment deregulation and trade liberalization. The three subsectors initially selected for this purpose are engineering, textiles, and pulp and paper. A loan for private sector development will reinforce the objectives of the trade policy adjustment loans and provide for close monitoring of the progress of the macroeconomic and trade policy reforms.

Collaboration with IMF

30. There has been close coordination with the IMF with respect to TPAL I and II. It took the form of informal exchanges and consultations during loan preparation. IMF staff reviewed reports pertaining to the loans and fully supported them. The latest IMF Consultation Report was issued on April 15, 1988. Indonesia has had no stand-by or extended arrangements with the Fund since 1973. Its last purchase from the IMF was for SDR463 million in May 1987, under the Compensatory Financing Facility. This purchase increased Indonesia's total outstanding IMF obligations to SDR505 million at the end of 1987. After the last Consultation Report, the IMF Executive Board expressed its satisfaction that Indonesia's exchange system remained free of restrictions on payments and transfers for current international transactions. Effective May 7, 1988, Indonesia accepted Article VIII status in the IMF.

Loan Administration and Coordination

31. Procurement and disbursement procedures for TPAL I and II were designed to ensure a quick resource transfer. The loans reimbursed 100% of foreign expenditures for eligible imports by the public or private sector, for which payments were made after the date of loan signing. There was no retroactive financing under the loans. The loans specified a standard list of ineligible imports, i. e. goods intended for military and paramilitary purposes or for luxury consumption; goods financed from other official multilateral or bilateral sources; uranium; and goods procured under contracts of less than US$100,000. All purchases in the amount of US$5 million equivalent or more were to be procured through International Competitive Bidding (ICB) in accordance with Bank guidelines. Both loans were largely used to finance private sector imports of industrial raw materials. The counterpart funds generated by imports financed under the loans were credited to a special account in Bank Indonesia and were used to finance priority public expenditure programs included in the Government's budget. Table 6.1 in the PPAM provides a description of the product groups financed under TPALs I and II, together with the sources from which they were purchased.

Conclusions and Recommendations

32. The Indonesian experience in economic stabilization and trade policy adjustment raises a number of interesting strategic and technical issues, which are discussed in more detail in Chapter VII.

(a) Strategy Issues

First, the Bank was correct in consistently adhering to a policy and issue-oriented schedule of economic and sector work over time, despite variations in the quality of the country policy dialogue. Consequently, the Bank was able to capture an opportunity when it was presented.

Second, structural adjustment seems to work better in a stable financial environment. Indonesia's sequencing of economic stabilization prior to formal structural adjustment was appropriate.

Third, adjustment is easier to accomplish and works more smoothly when the international environment for trade is favorable. Indonesia benefitted from export constraints in Taiwan and Thailand.

Fourth, concessionary resource transfers remove the sting from the hardships resulting from adjustment. In Indonesia's case, it inter alia helped in changing the composition of external debt and alleviated the debt servicing burden.

Fifth, the short-run focus of expenditure adjustment on investment may be a good policy choice on economic and political grounds. While growth in investment after the initial phase of the program is necessary for its ultimate success, an initial pause may assist investors in making right decisions, while support of consumption during the program enhances its political acceptability.

(b) Macroeconomic Issues

First, interest rates have a central role to play, given Indonesia's open capital market and flexible exchange rate policies. In this case, the non-aid current account deficit is financed by capital movements responding to interest rate differentials which are sensitive to the level of domestic inflation.

Second, periods of financial repression associated with an economic stabilization/adjustment program should not be protracted, because of the adverse effects on regeneration of economic and social infrastructure. The Indonesian adjustment program, which commenced in 1983, has come to a point where the postponement of many worthwhile infrastructure projects may have begun to act as a binding constraint on private investment and economic growth. Deficits, which have emerged in the social sectors, also need to be redressed.

Third, adjustment programs must be cognizant of the employment effects of reduced expenditure policies. A reversal of these trends requires much higher levels of investment. Careful choice of projects, supported by appropriate technology, technical training, and revitalization of domestic financial markets is necessary.

(c) Trade Policy Issues

First, it is appropriate to sequence the process of trade liberalization by reducing Non-Tariff Barriers (NTBs) prior to movement on tariffs. This approach helps to moderate the shocks from an across-the-board reduction of trade protection, while providing industrialists with time to make necessary adjustments. It also furnishes the Government with revenue which could be used to promote industrial restructuring.

Second, tariffs and import surcharges serve as substitutes for NTBs. Hence, they must be seen as a transition to a stage in which levels of import protection will be determined on optimal criteria. The proposed study of the Country Department on Trade Policy Reform is to be welcomed.

Third, the desirability of a system of export controls, especially export bans, needs to be examined. Export bans and other forms of restraint on exports confer rents on those who obtain licenses, or those who can circumvent them. They, therefore, create vested interests which may be difficult to dislodge.

Fourth, investment licensing arrangements constitute another form of protective device. Their dismantlement would represent a major step forward in promoting neutrality in the trade regime.

Fifth, the policy-making apparatus for trade protection should be formalized and backstopped by a working Secretariat that is properly equipped and insulated from political interests. The objective should be to make the decision-making process on policy and administration as simple as possible.

Sixth, the legal framework for commerce and banking, as it now exists, acts as a constraint on modernization of the economy. It needs to be made transparent and simplified.

(d) Sustainability and Implementation

33. Sustainability of the progress achieved so far in the field of trade and investment will depend on attention to four major areas:

First, there is a need to increase opportunities for gainful employment. This can only occur in an environment that is relatively free of regimentation and one that promotes investment.

While concessionary capital flows have partially compensated for the decline in oil revenues, they cannot be a permanent device to sustain consumption and investment. Greater efforts are needed to expand domestic savings. This may require changes in fiscal strategies, interest rate policies, and financial intermediation processes.

Second, further steps are needed to rationalize the tariff system. Such a process would sensitize domestic producers to efficiency criteria. These actions need to be complemented by measures that strengthen the transparency of the trade regime.

Third, the regulatory system governing investment has to be further simplified by the introduction of a short negative list.

Fourth, a formal administrative framework needs to be established for the evaluation of the tariff system and for monitoring impact and providing appropriate feedback to the decision-making agencies.

Overall Assessment

34. Indonesia's economic adjustment program, which began in the mid-1980s, was a response to the economic crisis, which had its genesis in a sharp decline in oil prices and an adverse movement in its terms of trade. Its twin objectives were (a) macroeconomic stabilization and (b) improvements in resource allocative efficiency. The policies and measures for attaining economic stability necessitated reductions in government expenditure, monetary restraint, high interest rates, improved fiscal effort, removal of pricing policy distortions, and exchange rate competitiveness. The economy's structural disequilibria were addressed by policies to liberalize foreign trade and dismantle the complex regulatory environment.

35. This shift in economic strategy yielded considerable dividends. The growth of inflation slowed down, budgetary and external current account deficits were reduced, and foreign exchange reserves strengthened. The debt service ratio, however, still remains at a high level, but prudent external debt management has led to improvements in the ratio of outstanding debt to GDP.

36. Important structural changes have occurred. A striking feature is the rapid increase in the growth of the non-oil economy and an outstanding non-oil export performance. The manufacturing sector has been the fastest growing sector, in terms of it contribution to GDP as well as to exports. This increase stemmed from important trade liberalization measures, which reduced the anti-export bias in the system, and depreciation of the real effective exchange rate. The export base has been diversified in ways that could not have been contemplated a few years back.

37. While these measures deserve to be commended, problems still remain. The deregulation process, which has begun to get under way, requires rationalization of the tariff structure. The investment licensing system needs to be further simplified and put on the basis of a short negative list. While the first steps in trade and investment liberalization have been relatively easy to undertake, the second stage of this process may be more difficult to undertake. This stage also has to be underpinned by appropriate macroeconomic policies which promote financial stability and allocative efficiency. Policies toward this end would give high priority to an improvement in the operating efficiency of Indonesia's State Economic Enterprises (SEEs).

38. Deficits in areas essential to the quality of life may have to be addressed. Bottlenecks in economic infrastructure are assuming proportions which may act as a major constraint on future growth. Action on all these fronts will require careful preparation, regular monitoring, and further Bank support.

39. To sum up: the program of adjustment that was initiated by the Indonesian Government in 1983 and intensified in conjunction with TPALs I and II yielded good initial results. The Bank's program of economic and sector work and complementary project support have been major components in this process. Bank support during the adjustment process has been appropriate, timely, and well sequenced. Its policy dialogue has been close and meaningful. The well staffed Resident Mission has, over a period of two decades, made a major contribution toward forging a spirit of mutual respect and trust in the relationship, which warrants further financial support with ex post conditionality.

PROGRAM PERFORMANCE AUDIT MEMORANDUM

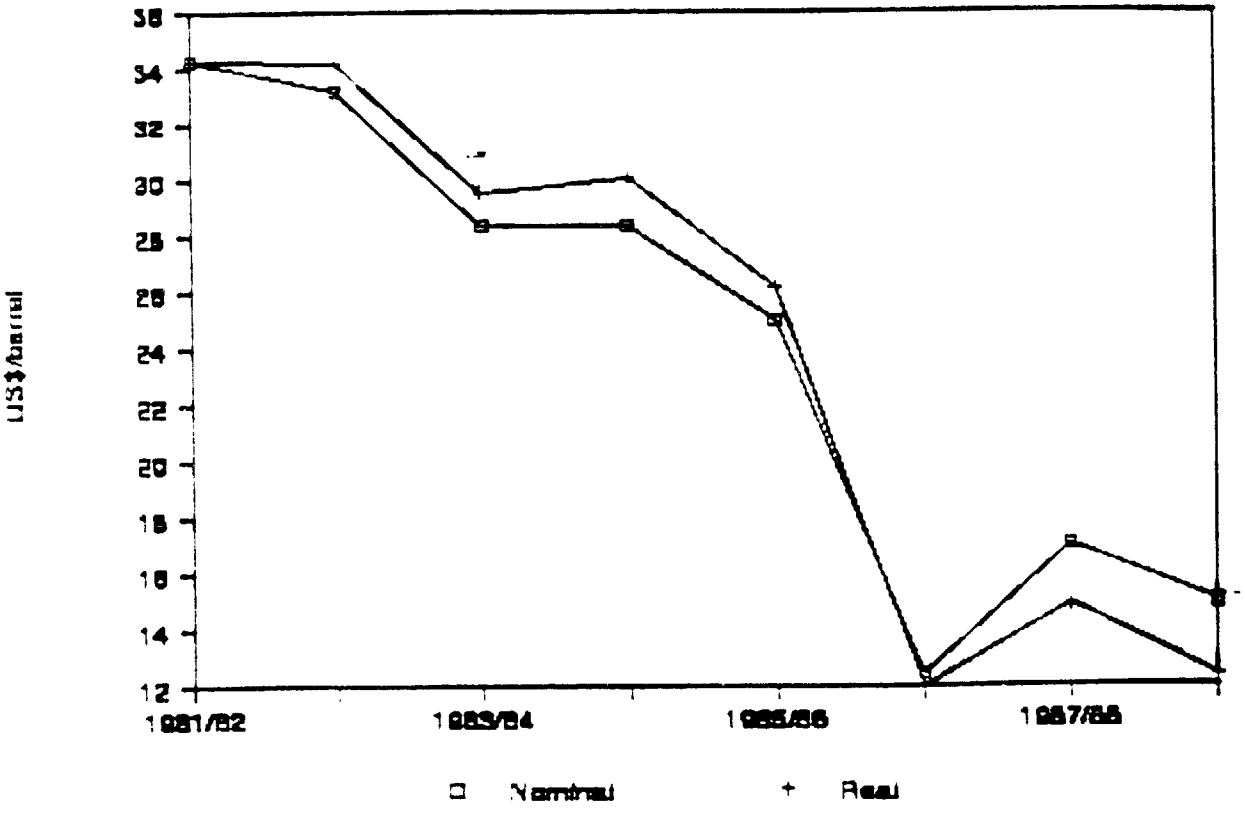
INDONESIA

FIRST AND SECOND TRADE POLICY ADJUSTMENT LOANS (LOANS 2780-IND AND 2937-IND)

I. BACKGROUND

1.01 Indonesia's rapid economic growth in the 1970s was associated with the upsurge in oil prices. Indonesia succeeded in mobilizing these resources to promote important gains in infrastructure development and to improve the quality of life of its citizens. However, resource allocative efficiency was sub-optimal because of a highly protective trade regime and a complex network of regulatory systems that constrained investment and trade. Indonesia's fortunes suffered a setback beginning in 1981 and subsequently in 1986 as a result of a precipitous decline in the world price of oil. The crude export price, which had risen to US$34.3/barrel in 1981/82, commenced a slide which led to a price of US$25.0/barrel in 1985/86 and US$15.0/barrel in 1988/89. The decline **(see Graph 1.1)** in world commodity prices, combined with the world recession in the early 1980s, aggravated the pressures on the economy.

GRAPH 1.1: OIL PRICE TREND



Note: Real price is in 1981 US$ deflated by Manufacturers Unit Value index.

1.02 Since mid-1985, the depreciation of the US dollar has been another source of external shock. As a large proportion of Indonesia's foreign debt is denominated in currencies that have appreciated vis-a-vis the dollar, Indonesia's total debt in dollar terms has surged, causing a significant increase in debt service payments (interest and amortization). The combination of lower oil prices and adverse affects of international currency fluctuations has caused a rapid increase in Indonesia's debt service burden.

1.03 The magnitude of the adverse effect of external shocks is illustrated in Table 1.1. On average, Indonesia lost some 9%-10% of its GNP per annum due to external disturbances over the 1983-1988 period. The loss of income was especially large during the 1981-88 period. As expected, the terms of trade effect was dominant. The interest rate effect was minimal, but the exchange rate effect significantly worsened in 1988. Clearly, the burden of the external shocks has been substantial and has presented a major challenge to policymakers. Indeed, without a forceful policy response, this large loss of income could have easily destabilized the economy.

Table 1.1: IMPACT OF EXTERNAL SHOCKS 1983/84-1988/89 /a
(Percent of GNP)

	Actual					Estimated	Average
	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1983-88
Loss of Income							
Terms of Trade Effect (1981 Prices)	2.5	2.0	5.7	15.6	13.3	14.1	8.9
Exchange Rate Effect (1981 Exchange Rate)	-0.2	-0.3	-0.4	0.3	0.9	1.5	0.3
Interest Rate Effect (1981 Interest Rate)	0.6	0.4	0.1	0.0	-0.5	0.0	0.1
Total Effect	2.9	2.1	5.4	15.9	13.7	15.6	9.3

/a The effect of a shock in any year is measured as the difference between 1981 price and current price values, and expressed as percentage of GNP.

Source: World Bank staff estimates.

II. ADJUSTMENT: OBJECTIVES AND POLICIES

A. Background to Trade Policy Adjustment Loans (TPAL) I and II

2.01 Indonesia's adjustment program was initiated in 1983 and has been intensified since the collapse of oil prices in 1986. In broad terms, two types of policy adjustments have been made. First, the Government has adopted more austere macroeconomic policies to restore financial stability. Second, to sustain the development momentum over the medium to longer term, it has embarked on a major program to restructure the economy, aimed at reducing Indonesia's heavy dependence on oil as a source of foreign exchange and budgetary revenues and improving economic efficiency. The key elements of this structural adjustment program include a range of measures to strengthen domestic resource mobilization, expand non-oil exports, and promote a more competitive and dynamic non-oil economy.

B. Trade Policy Adjustment Loan I

2.02 The Government's adjustment program was intensified following the external shocks of 1986, and the Bank supported the Government's recent reform efforts, particularly as it has related to trade and industrial policy, with the first Trade Policy Adjustment Loan (TPAL I). An important distinguishing feature of this loan was that the policy measures it supported were announced prior to loan appraisal. This approach was considered appropriate because: (a) the Bank's prior discussions with the Government had resulted in a common understanding of the measures that needed to be taken; (b) analysis of the measures to be supported by TPAL I showed them to be substantive and deserving of support; (c) it was recognized from the outset that the measures taken were part of a medium-term adjustment program to which the Government was strongly committed, and that subsequent reforms could provide the basis for a series of policy-based loans; and (d) the Government's strong track record on economic management provided the basis for expecting that further policy measures would be taken.

2.03 The objectives of the loan were to: (a) support the substantial reforms, especially in the area of trade policy, undertaken by the Government during 1986 and to monitor their implementation; (b) assist the Government of Indonesia (GOI) to bring about an early recovery in economic activity consistent with external and domestic financial stability; and (c) maintain the policy dialogue on further reforms for promoting the efficiency and longer term viability of the economy. These objectives were to be achieved partly through balance of payments support and partly through on-going consultation on policy issues and improved institutional arrangements for administration of the trade regime. A related technical assistance loan was to be processed to finance a number of macroeconomic and trade related studies. In particular, an up-to-date effective rate of protection study was identified as a priority in order to gain a clearer picture of the economy-wide distortions created by the existing trade regime. It was also suggested that the reform process could be assisted if the Government established a permanent body to coordinate future Government effort on deregulation.

2.04 GOI policies can be grouped under five categories:

(a) Macroeconomic Adjustment

2.05 In January 1986, an austere budget was announced for 1986/87. Current expenditures, other than interest on external debt, were budgeted to remain basically flat in nominal terms. Capital expenditures (including transfers to public enterprises) were reduced by almost 25%, with the rupiah development budgets of government departments cut by 40%-55%. In making these cuts, GOI also focussed the composition of the public investment program, giving priority to: (a) the completion of on-going projects; (b) the provision of counterpart funds for foreign-aided projects; (c) projects with a particular focus on equity and employment; and (d) the funding of operations and maintenance (O&M) expenditures.

(b) Export Promotion

2.06 Faced with the prospect of lower oil prices over the medium term, the rupiah was devalued by 31% (from Rp 1,134 to Rp 1,644 per US dollar) on September 12, 1986.

(c) Financial Policies

2.07 Throughout 1986/87, GOI maintained a conservative monetary stance. During the first 6 months of 1986/87, total rupiah liquidity grew at an annual rate of 14% and domestic credit at 28%. This marked a considerable slowdown from the previous year (1985/86), when rupiah liquidity rose by 27% and domestic credit by 42%.

(d) Trade Policy

2.08 In May 1986, the Government announced a package of measures designed to provide internationally priced inputs to exporters. Under the scheme, "producer-exporters" were given the option of importing their inputs free from licensing restrictions and exempt from import duties. On October 25, 1986, GOI announced a package of trade reforms to reduce import restrictions, improve industrial efficiency and promote non-oil exports: (a) all restrictive import licensing arrangements were removed for 165 items (e.g. tires, glass, paper, dyes, synthetic fibers, some electrical appliances and vehicle parts); (b) import licensing restrictions were relaxed on 110 items (e.g. chemicals and machinery) for actual users and licensed agents; (c) tariff rates were increased for 154 items, to compensate for the removal of NTBs; and (d) tariff rates for another 152 items not produced domestically (e.g. certain chemicals, steel products, and electrical components) were lowered, mostly to the range of 0%-5%.

(e) Foreign Investment

2.09 As part of the May 6, 1986 package, the Government took a number of steps to promote foreign investments: (a) the requirements for local participation in joint ventures were relaxed for investment in certain priority subsectors which are important for exporters and employment generation; (b) the validity of investment licenses was extended to 30

years; and (c) the operational limitations on joint ventures with majority local participation were eased. Further changes were introduced in October 1986, to treat foreign investors more like domestic investors. In particular: (i) foreign investment was allowed in existing firms in priority sectors, especially for exports (whereas previously foreign investors had to set up new joint-venture companies); (ii) investment by multilateral financial institutions (IFC, ADB, IDB) was to be treated as national participation; (iii) foreign investment companies were given access to export credit from state banks on the same terms as domestic firms; (iv) foreign investment companies were allowed to act as marketing channels for export products of other companies; and (v) ceilings on the swap facility for foreign exchange coverage were removed, thereby providing joint ventures access to investment credits from state banks on roughly the same terms as for domestic companies.

C. Trade Policy Adjustment Loan II

2.10 In the first period of adjustment (1982-85), the Government implemented policies to mobilize domestic resources (the financial and fiscal reforms of 1983) and launched a program of trade reforms (the maritime and tariff reforms of 1985). The latter program was reinforced by the second round of trade policy reforms in 1986, which were supported by the first Trade Policy Adjustment Loan. Since 1986, the Government has intensified its program of adjustment by: (a) extending the program of trade policy reform; (b) beginning to deregulate industry; (c) relaxing policies governing foreign investment; and (d) extending its 1983 financial sector reforms. The primary objective of these reforms, in conjunction with the macroeconomic adjustment measures, was to raise economic efficiency and to increase earnings from non-oil exports. This new set of measures was supported by a second Trade Policy Adjustment Loan which focussed on (i) trade policy, (ii) industrial deregulation and foreign investment and (iii) financial sector reform.

(a) Trade Policy Reform

2.11 GOI maintained the momentum on trade policy reform in 1987 through two major packages announced on January 15, 1987 and December 24, 1987, and a series of smaller policy actions. These measures: (i) continued the shift from import restrictions to tariff-based protection; (ii) adhered strictly to the lower tariff ceiling in setting tariff rates on the products removed from NTB protection; (iii) continued steps toward tariff rationalization; (iv) broadened the scope of the system giving exporters access to inputs at internationally competitive prices; and (v) reduced remaining export restrictions.

2.12 The January and December packages of 1987 marked substantial progress in GOI's primary objective of moving away from a trade regime dependent on NTBs leading to the removal of an additional 342 items from license control, accounting for 20% of all items and 23% of total import value previously restricted. The share of manufacturing production protected by import licensing declined from 42% at the end of 1986 to 35% at the end of 1987. The reduction in NTBs was concentrated in activities with the highest effective rates of protection. In addition to the removal

of import licensing restrictions, the January and December packages relaxed some of the remaining restrictions, particularly in the textile and engineering goods sectors, by placing them under the IP (actual user) license category. This is the least restrictive license, and allows all producers who require these items as inputs to import them freely. As a result of the measures taken during 1987, virtually all production in textiles falls under the unrestricted or IP license category. Similar progress was made in many branches of the engineering goods sector, although several final goods remained under restrictive license or import bans.

2.13 The second main element of the 1987 trade reforms related to tariff policy. Tariff adjustments aimed at conforming to the reduced level and dispersion of the new tariff structure were introduced in 1985. Under the two trade reform packages of 1987, tariffs for 121 items were adjusted upwards and tariffs for 178 items lowered. Temporary surcharges were also imposed on 51 import items. The increases in tariffs compensated for the effects of the removal of import licensing restrictions, but remained within the lower tariff ceilings set in 1985. The reductions in tariffs in the January 1987 package (as in the earlier October 1986 package) concentrated on products not locally produced, and were intended to offset the cost-raising effects of the September 1986 devaluation. The December reductions went beyond this limited objective by reducing tariffs on some domestically produced items that were removed from import license restriction in earlier decrees, thereby marking an important beginning toward the next trade reform objective of further tariff rationalization. The need to obtain a special export license was abolished; several export bans and quotas were removed; and access by exporters to the May 6 scheme broadened.

(b) Industrial Deregulation and Foreign Investment Policies

2.14 A start was made in 1985 when the investment process was streamlined. In 1986, fields of investment open to both foreign and domestic companies were specified more clearly and the number of areas open to private foreign and domestic investment was expanded substantially. Moreover, foreign investment companies were given greater access to domestic capital and financial institutions, and domestic ownership requirements were eased.

2.15 Firms were allowed to increase production by up to 30% of their licensed capacity without requiring new investment approval and diversify production within much broader product categories, thereby improving operational flexibility and promoting greater competition. Requirements for investment licenses were streamlined and additional fields of investment opened to private domestic and foreign investors. A series of measures relaxed foreign investment regulations: domestic ownership requirements were eased significantly; restrictions prohibiting foreign-owned companies from marketing Indonesian export goods were removed; foreign firms were allowed to purchase domestic inputs without restriction; and rules regarding the hiring of expatriate personnel were relaxed.

(c) Financial Sector Reform

2.16 In June 1983, GOI launched a comprehensive reform of the financial sector, which included a liberalization of most interest rate controls on state bank deposits, the elimination of credit ceilings for all banks, and a reduction in the number of programs qualifying for new Bank Indonesia liquidity credits. These reforms had a far-reaching impact on the financial system, successfully increasing domestic resource mobilization, promoting greater competition and market orientation, and improving the allocation of credit. Bank Indonesia also introduced a range of new monetary instruments (e.g. SBIs and SBPUs)1/ to improve monetary management and encourage development of an active interbank money market. In July 1987, an auction system was introduced to determine SBI and SBPU volumes and discount rates, which, in combination with other monetary measures, helped ease the speculative pressure against the rupiah.

2.17 Concerns about the longer term effect of high interest rates on investment and the financial viability of enterprises, and the relative lack of term transformation in the banking system, led GOI to undertake specific measures in December 1987 to strengthen the role of equity markets. First, to increase the supply of securities, listing requirements on the Jakarta Stock Exchange, which now lists only 24 companies with a market capitalization of about US$60 million, were simplified through the elimination of all but three pieces of essential documentation. Second, supportive measures were introduced to improve the institutional framework (e.g. pricing mechanisms) and the operation of capital market institutions (e.g. underwriters, guarantors, stock traders). Third, GOI created an over-the-counter (OTC) market to enable smaller, less well-established companies to mobilize investment requirements through the capital market. Finally, in an attempt to strengthen the demand for securities, GOI planned to encourage the issue of bearer shares and also allow foreign investors to purchase shares in the OTC market.

III. MAJOR ISSUES IN TRADE POLICY ADJUSTMENT

A. Macroeconomic Policy

3.01 Indonesia is an example of a country adopting a policy of structural reform and deregulation after a successful stabilization effort. The average rate of inflation on the CPI has been 7.9% since 1982; in 1988, it was 8.5%. The macroeconomic policy package of the period of TPALs I and II, 1987-88, has included a fiscal effort that has raised non-oil tax

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1/ SBIs are Central Bank certificates and SBPUs are private sector promissory notes held by banks, and rediscounted by the Central Bank.

revenue significantly and produced a primary budget surplus. Monetary policy has been tight enough to keep real interest rates sufficiently above world rates to maintain international reserves at a satisfactory level, while at the same time stimulating growth in private investment. After two successful discrete real devaluations, the exchange rate now is gradually depreciating in real terms against a currency basket.

3.02 The results of this policy package have been impressive. Inflation has been contained below 10% in 1987 and 1988, despite a 31% devaluation in September 1986. The real growth rate of national income was 4%-5% in 1987 and 1988 in the face of terms of trade shocks of about 13%-15% each year. Non-oil exports doubled from 1985/86 to 1988/89, and the non-interest current account shows an estimated surplus of 2.1% of GNP in 1988/89. The debt service and debt to GNP ratios increased sharply as oil revenues fell, but these have been stable in 1987-88, as the GOI has amortized high-interest commercial debt using concessional loans, partly leveraged on the $600 million provided by the TPALs.

3.03 Indonesia is a good example for the application of the classic Salter-Swan analysis of policy for internal and external balance in a "small" open economy with a pegged exchange rate.2/ Indonesia has internationally open capital markets and an exchange rate that is pegged at any point in time to a currency basket. If we take low inflation as the sign of internal balance and stable foreign exchange reserves as the sign of external balance, we can apply the Salter-Swan analysis, with fiscal policy aimed at internal balance and monetary policy aimed at external balance. With a mild increase in inflation following the 1986 devaluation, and some apparent loss in reserves in 1988, the analysis would call for a tightening of both fiscal and monetary policy. This has been the direction of policy since 1987.

Fiscal Policy and Internal Balance

3.04 The overall stance of fiscal policy tightened from the early 1980s to the beginning of the TPAL period, and tightened again during that period. The evolution of the central government budget since the early 1980s is summarized in Table 3.1. The overall deficit was 4.4% of GDP in 1982/83, and external interest payments were 1.1% of GDP. Thus, the primary, non-interest deficit was 3.3%. By 1985/86, the overall deficit was down to 2.8%, and the primary deficit was down to 0.9%.

2/ See W. Salter, "Internal and External Balance: The Role of Price and Expenditure Effects," Economic Record, August 1959, 226-38, and T. Swan, "Longer Run Problems of the Balance of Payments," in R. E. Caves and H. G. Johnson, eds., Readings in International Economics (Irwin, 1968).

Table 3.1: CENTRAL GOVERNMENT BUDGET, 1982/83-89/90
(Rp. Trillion at Current Prices)

	Actuals				Estimated	
	1982/83	1985/86	1986/87	1987/88	1988/89	1989/90
Revenues and Grants	11.9	18.8	16.7	21.8	23.5	24.9
Oil and LNG Taxes	7.6	10.7	6.3	10.4	9.5	8.0
Non-Oil Taxes	3.8	6.4	7.9	9.0	11.9	14.3
Non-Tax Revenues /a	0.4	1.5	2.2	2.0	1.6	2.0
Grants	0.1	0.2	0.3	0.4	0.5	0.6
Current Expenditures	8.2	12.7	13.4	15.5	16.8	19.2
External Interest	0.7	1.8	2.8	3.8	4.3	5.0
Subsidies	1.4	1.4	0.9	1.4	1.0	0.7
Other	6.1	9.5	9.7	10.3	11.5	13.5
Government Savings	3.7	6.1	3.3	6.3	6.7	5.7
Capital Expenditure	6.6	8.7	7.3	9.2	10.5	10.0
Overall Balance	-2.9	-2.7	-4.0	-2.9	-3.8	-4.0
Financed by:						
External Loans (Net)	2.0	1.8	3.7	2.8	4.2	4.3
Disbursements	2.7	4.3	6.8	8.8	11.2	12.1
Principal Repayments	0.7	2.5	3.1	6.0	7.0	7.8
Asset Drawdown /b	0.9	0.9	0.3	0.1	-0.4	0.0
Memo Items (% of GDP):						
Non-Oil Taxes	5.9	6.7	7.8	7.6	8.9	9.6
Government Savings	5.7	6.4	3.3	5.3	4.9	3.9
Overall Balance	-4.4	-2.8	-3.9	-2.4	-2.8	-2.9
Total Expenditure	22.7	22.6	20.3	20.7	20.1	19.7
Net Domestic Expenditure /c	11.4	8.5	3.8	4.1	2.2	0.8
Primary Balance /d	-3.3	-0.9	-1.2	0.7	0.4	0.6

/a Includes domestic oil surplus in 1986/87.
/b Excludes gain from valuation adjustment in 1986/87, estimated at Rp. 1.8 trillion.
/c Defined as the domestic content of expenditure less non-oil revenues.
/d Defined as overall balances less interest payments.

Source: Ministry of Finance and World Bank staff estimates.

3.05 From 1985/86 to 1986/87, the first year of the TPAL, oil and LNG tax revenue fell from Rp 10.7 to Rp 6.3 trillion, or from 11.2% to 6.2% of GDP as the oil price fell. This revenue shortfall increased the primary deficit by just 0.3% of GDP, as non-oil tax effort was raised and capital expenditures were reduced. Thus, while the overall deficit increased to 3.9% of GDP in 1986/87, the increase was far less than the shortfall in oil and LNG revenues, reflecting a substantial fiscal effort.

3.06 During the TPAL period of 1987/88 and 1988/89, oil and non-oil tax revenues were increased. Total expenditure as a percent of GDP has been flat since 1986/87. As a result, the overall deficit was reduced to about 2.5% of GDP in both years. The primary balance moved into surplus in 1987/88; in 1988/89 the surplus is estimated at 0.4% of GDP.

3.07 The World Bank staff projections for the 1989/90 budget show a roughly constant, but still tight, budget stance. Total expenditure falls slightly, from 20.1% to 19.7% of GDP. Oil and LNG tax revenues are projected to fall, based on the assumption that the average price of oil for the year will be $14 per barrel. Non-oil taxes continue to rise to 9.6% of GDP. The net result is a roughly constant overall deficit and primary surplus, as fractions of GDP.

3.08 An important aspect of the fiscal picture is the increase in non-oil tax effort since the tax reform of 1984. Table 3.1 shows non-oil taxes rising from 5.9% of GDP in 1982/83, before the reform, to 8.9% in 1988/89, and a projected 9.6% in 1989/90. This is below the level of other ASEAN resource-rich countries, 12.1% for the Philippines and 14.9% for Thailand in 1987 (see Indonesia: Strategy for Growth and Structural Change, Report No. 7758-IND, May 3, 1989, hereafter Report, Table 2.8). But it does show substantial progress, and in 1988/89 Indonesia still had oil and LNG revenues of 6.6% of GDP. The main sources of the increase in non-oil tax effort have been the income and value-added taxes, as is shown in Table 3.2. The 1984 tax reform began the substitution of the VAT for the sales tax, and the efficiency of collection of the income tax has been increased. The result was a jump in the sales/VAT percent of GDP in 1985/86, and in the income tax percent in 1986/87. The two ratios to GDP have continued to increase, to a combined total of 7.2% projected in 1989/90. This increase since 1984 represents an increase in tax efficiency because it has shifted the tax base from production toward income and expenditure. Thus, the non-oil tax effort shows substantial improvement and a continuation of the trend during should be expected and encouraged.

3.09 At the macroeconomic level, the fiscal situation in Indonesia seems stable and improving. The public debt ratios increased substantially from 1984 to 1986/87. The ratio of debt to GDP reached 65.7% in 1987, and fell slightly in 1988. [Report, Graph 1.3] Virtually all of the Government's debt is held abroad, since the constitution prohibits domestic borrowing. So a comparison at this point of debt to exports is also relevant. The debt indicators are summarized, in comparison to other countries, in Table 3.3. The debt-export ratio peaked in 1986, and has decreased since. Public debt was 2.2 times exports in 1987 in Table 3.3. The DOD/GNP ratio of 65.7% is higher than the average of 48.1% for the "highly indebted countries", but the ratio of 2.2 times exports is below their average of 2.7.

Table 3.2: INCOME AND SALES/VALUE ADDED TAX RECEIPTS AS PERCENT OF GDP

Year	Income	Sales/VAT	Total
1984/85	0.5	0.7	1.2
85/86	0.7	2.4	3.1
86/87	2.2	2.9	5.1
87/88	2.2	2.9	5.1
88/89 /a	2.8	3.6	6.4
89/90 /a	3.3	3.9	7.2

/a Estimated.

Source: World Bank Country Economic Report, May 1989, Statistical Annex.

Table 3.3: DEBT INDICATORS FOR SELECTED COUNTRIES (Percent)

	Indonesia	Highly Indebted Countries /a	All Developing Countries
Total External Debt /b			
DOD/GNP	82.5	63.1	49.7
DOD/Exports	275.8	356.9	212.1
Public MLT Debt			
DOD/GNP	65.7	48.1	38.5
DOD/Exports	219.6	272.2	164.3
Concessional/DOD	33.2	6.0	21.6
Variable Rate/DOD	25.1	66.0	43.6
Debt Service/Exports	29.3	24.5	19.1
Interest/Exports	21.6	15.6	8.4
Net Transfers/Imports	1.0	-9.6	-4.8

/a Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

/b Includes public and private MLT debt, use of IMF credit and short-term debt.

Source: World, World Debt Tables (1988-89 Edition), and staff estimates.

3.10 The falling debt/GDP ratio reflects the high growth rate relative to real borrowing rate, and the shift of the primary budget to surplus. The standard formula for the growth of the debt/GDP ratio is:

$$(1) \quad db = (r - n)b + p,$$

where b is the ratio of debt to GDP, db is its rate of growth, r is the real interest rate, n is the growth rate of the tax base, and p is the primary deficit. Both r greater than n and a primary deficit contribute to a growing debt/GDP ratio (db>0). As shown in Table 3.1, the budget has shown a primary surplus since 1987/88, so p in the formula is negative. The real growth rate of GDP was 4.7% in 1988, and Tables 3.1 and 3.2 show tax effort rising. So the growth rate of the tax base n is greater than the growth rate of GDP.

3.11 The average real borrowing rate r on Indonesia's debt is well below the growth rate n in the formula. In 1987, 33.2% of Indonesia's public debt was at concessional rates, compared to 6% for the highly indebted countries. Table 3.1 shows large amounts of both disbursements and amortization payments on external public debt since 1985/86. In 1989/90, disbursements are estimated at 8.2% of GDP, and amortization at 5.3%. These gross flows represent Indonesia's borrowing at concessional rates, partially by levering the TPALs, and simultaneously retiring commercial debt. This continuing twist of the debt structure toward concessional debt brings down the average borrowing rate r in the formula. So the rising tax effort and the debt strategy make the borrowing rate r less than the growth rate n, so the first term in the formula is also negative.

3.12 Thus, after the terms-of-trade shocks of 1986-1988, Indonesia's debt, which is at the same time public and foreign, grew quickly relative to GDP. But the fiscal program has provided a primary surplus and growth of the non-oil tax base, and the debt strategy the reduction in the borrowing rate. These together have stabilized the debt ratios and turned their paths downward. These trends should be applauded and expected to continue.

3.13 In the Salter-Swan analysis, fiscal policy is aimed primarily at internal balance, represented here by a low rate of inflation. Indicators of domestic inflation are shown in Table 3.4. The relatively high inflation rates of the early 1980s were reduced to 5%-7% on the general indicators in 1985 and 1986, as the primary budget deficit was reduced (see Table 3.1). The 31% nominal devaluation in September 1986 raised traded goods prices in late 1986 and 1987, as shown by the "proximate indicators" in Table 3.4. These show increases of 22% and 16% for import and export goods, respectively, and 13% for rice, in 1987.

3.14 The inflation rate on the export and import goods price indexes slowed in 1988 o about 12%. The inflation rate of the rice price, however, continued to increase, to 31% in 1988. This reflected an increase of the same amount in the world price (US dollar price in Bangkok, International Financial Statistics 4/89) in 1988. The rising rice price is likely to produce upward pressure on non-traded goods prices through wages.

Table 3.4: DOMESTIC INFLATION INDICATORS, 1980-88
(Percent Change: Period Average) /a

	1980	1981	1982	1983	1984	1985	1986	1987	1988
General Indicators									
CPI-17 cities	18.1	16.9	9.5	11.8	10.5	4.7	5.8	9.5 /b	8.5 /b
WPI /c	19.4	9.8	8.2	20.9	11.4	5.2	6.9	20.7	10.0 /d
Non-oil GDP deflator	23.0	10.2	8.6	14.3	12.0	6.6	7.1	9.8	9.5
Specific Indicators									
CPI-Jakarta	17.9	8.6	9.0	10.7	11.7	4.9	5.5	9.6 /b	8.7 /b
CPI-22 cities /e	36.7	13.6	10.9	14.9	7.3	7.9	6.2	14.1	8.9
KFM-K3 /f	19.8	12.0	7.3	10.0	12.2	12.7	13.5	21.9	9.7
Nine essential commodities									
- Urban	17.8	6.6	9.7	14.8	11.3	2.4	5.4	6.7	13.4
- Rural	18.5	16.5	12.7	19.9	12.5	-1.1	11.8	12.9	17.1
Farmers' household consumption /i	20.5	15.8	12.1	23.7	18.6	11.6	12.2	16.7	5.3
Proximate Indicators									
Import goods prices	15.6	9.8	5.2	20.9	13.0	5.3	8.4	22.5	11.5 /d
Export goods prices /c	17.4	-1.4	3.1	33.8	14.0	0.9	13.0	30.8	7.7
Urban rice prices /j	12.9	9.4	12.9	19.8	5.8	-2.6	-10.6	11.6	24.8
Non-traded goods prices	17.6	7.6	14.1	16.3	13.5	6.9	3.7	8.2	4.7

/a Previous economic reports used a year-end basis.
/b Revised estimates reflecting adjusted rice prices for Jakarta.
/c Excluding exports of oil and gas.
/d Revised estimates reflecting adjusted import prices.
/e Weighted average of individual city indexes.
/f Physical Minimum Requirements index for 3-child family; weighted average for 26 provinces (excluding East Timor).
/g Component of CPI-17 cities index.
/h Unweighted average of Java and Madura and Outer Islands.
/i Component of Farmers' Terms and Trade index; weighted average for Yogyakarta and West, Central, and East Java.
/j For 1980-1984, wholesale price in Jakarta. For 1984-1988, weighted average of urban medium-quality retail rice prices in 26 provinces (excluding East Timor).

Source: Central Bureau of Statistics and World Bank staff estimates.

3.15 The single best indicator for internal balance is probably the inflation rate for non-traded goods. This is the last row in Table 3.4. With the price of imported inputs and rice rising, and some shift of demand toward non-traded goods with the devaluation, non-traded goods prices rose by 8.2% in 1987. But even with some pressure from the rice price, inflation for non-traded goods was down to 4.7% in 1988. This shows that the devaluation of 1986 did change the ratio of traded to non-traded goods, and was not passed through to a general increase in prices.

3.16 In terms of maintenance of internal balance, the tightening of fiscal policy from a primary deficit of 1.2% of GDP in 1986/87 to a surplus of 0.7% in 1987/88 and 0.4% in 1988/89 was the complement to the devaluation that prevented its spread to the general price level. With non-traded goods inflation still at 4.7% in 1988, continuation of this tight fiscal position with a 1% primary surplus, rather than the projected slight easing to 0.4% might be in order.

Monetary Policy and External Balance

3.17 The proximate target for monetary policy in the Salter-Swan analysis for Indonesia is external balance, represented by the maintenance of the desired foreign exchange reserve position. This assignment of policy is required by the combination of open capital markets and a pegged exchange rate. While the exchange rate is adjusted against a currency basket daily, it is not floating. At any point in time, the authorities are committed to the existing nominal rate against the dollar. In this situation, monetary policy must be tight enough to keep interest rates high enough that the private capital inflow finances the current account deficit less official net borrowing. This is the degree of tightness that will maintain the level of reserves. With a stable demand for money as a function of real income, the price level, expected inflation, and the interest rate, given values for the first three variables and a proximate target for the interest rate sets the demand for money. This, in turn, sets the growth in the domestic component of the monetary base that is consistent with stable foreign exchange reserves. Indonesian monetary policy is a good example of the monetary component of the classic analysis.

3.18 This mode of operation of monetary policy is set out in Tables 3.5-3.7. Table 3.5 shows net foreign assets (NFA) of the monetary system and the Central Bank and imports since 1984, omitting 1986 when the data would have to be adjusted for the September maxi-devaluation. The dollar values of NFA in the monetary system and the Central Bank were about the same in 1984 and 1987. Then in 1988, NFA of the Central Bank fell by $1.7 billion, and NFA of the system fell by $1.2 billion, implying an increase of $0.5 billion in the banking system. Imports in dollars fell in the slowdown in 1985, and then recovered to $16.3 billion in 1988.

Table 3.5: NET FOREIGN ASSETS AND IMPORTS
(US$ billions)

Period	1984	1985	1987	1988
Net Foreign Assets (NFA)(end of period)				
Monetary System	11.50	12.60	11.20	10.00 /a
Central Bank	7.50	8.20	7.50	5.80 /a
Imports of Goods and Services /b	15.70	14.10	15.00	16.30
System NFA/Imports	0.73	0.89	0.75	0.61
Central Bank; NFA/Imports	0.48	0.58	0.50	0.36

/a End of October 1988.
/b Imports for fiscal years containing year-end NFA observation.

Source: Country Economic Report Statistical Annex, IFS for exchange rates.

3.19 The ratios at the bottom of the table show the movements in import coverage of NFA. Coverage rose, in 1985, as NFA increased and imports fell, and then returned to the 1984 level, for both the system and the Central Bank, in 1987. In 1988, both coverage ratios fell substantially. In October 1988, NFA in the monetary system covered 7.3 months' imports, and Central Bank NFA about 4.3 months. These are still reasonable levels of coverage. But unless a conscious decision was taken by the monetary authorities to reduce the coverage ratios of NFA in 1988, the movement would indicate that a tightening of monetary policy was in order.

3.20 The levels of domestic interest rates and international interest rate differentials are shown in Table 3.6. Here we compare deposit rates; later, in the section on financial structure, we discuss the spread between borrowing and lending rates. With open capital markets, to prevent capital net outflow, the domestic deposit rate must be kept above the world rate plus the inflation differential by an amount that at least allows for the expected rate of real depreciation plus any risk premium for holding deposits in rupiah. This "real interest differential" is shown since 1981 in the last row of the table. Until 1983, with regulated interest rates and capital controls, the differential was negative; the controls were preventing an outflow. After the financial reform of 1984, the differential became positive, as required with open capital markets and an expectation of real depreciation.

Table 3.6: DOMESTIC INTEREST RATES, 1981-1988
(Annual Averages: Percent p.a.)

	1981	1983	1984	1985	1986	1987	1988
Deposit Rates /a	6.0	14.6	18.0	14.5	14.6	17.0	17.6
Real Deposit Rates /b	-10.7	2.8	7.5	9.8	8.8	7.5	9.1
Average Lending Rates (all banks) /c	15.0	18.7	23.0	20.5	20.2	21.2	21.5
Real Lending Rates /d	4.8	4.4	11.0	13.9	13.1	11.4	12.0
Memo Items							
International Interest Rates /e	16.7	9.9	11.2	8.6	6.9	7.3	8.0
Inflation Differential between Indonesia and USA /f	6.5	7.5	6.2	1.0	3.8	6.2	5.3
Swap Premium /g	5.1	5.1	5.1	5.1	5.1 /g	9.1	9.1 /h
Differential between Lending and Borrowing Rates		4.1	5.0	6.0	5.6	4.2	3.9
Real Interest Differential /c	-17.2	-2.8	0.6	4.9	3.9	3.5	4.3

/a Six-month deposit rate of state banks.
/b Using CPI-17 cities as deflator.
/c Weighted average interest rate for non-priority credits.
/d Using non-oil GDP deflator.
/e Six-month LIBOR for US$ deposits.
/f Using CPI.
/g A new premium of 8.1 was set in September 1986.
/h Since October 27, 1988, the swap premium is determined on the basis of the differential between LIBOR and the average domestic deposit.
/i Deposit rate less international rate less inflation differential.

Source: Bank Indonesia, International Financial Statistics (IMF), and World Bank staff estimates.

3.21 In 1985, the real interest differential was increased to 4.9 percentage points. Then, in 1986, it was reduced to 3.9 points, and further to 3.5 points in 1987. It may be that this differential was too small, and accounts for the drop in the reserve/import coverage ratios in 1988 that are shown in Table 3.5. The reaction to the fall in coverage can be seen in the increase in the differential in 1988.

3.22 The maxi-devaluation in 1986 may have sensitized the markets to the possibility of further action. In addition, the audit team was told during the mission that the new plan, REPELITA V, incorporates an assumption of a real depreciation of about 5% per year. Some further real depreciation may be needed to stimulate manufacturing exports, but its expectation requires that the real interest differential be increased to continue to stabilize reserves and finance the current account deficit. The adjustment of monetary policy to restore the real interest differential of about 4.5% seems to have come in 1988.

3.23 The data on monetary aggregates in Table 3.7 confirm this tightening. The growth rate of reserve money was reduced from around 20% in 1985-86 to 10.7% in 1987 and 9.6% in 1988. Growth in M1 slowed accordingly, to 8.6% in 1987 and 8.0% in 1988. Since these growth rates are lower than that of nominal GDP, the ratios of reserve money and M1 to GDP fell in 1987 and 1988, after rising the previous two years. This shows a substantial tightening of monetary policy. The combination of low RM/GDP ratio and a 9% rate of inflation makes the inflation tax trivial in Indonesia. The tax revenue is about 0.54 (= .09 x .06) percent of GDP.

Table 3.7: MONETARY AGGREGATES, 1984-88
(Rp. billions)

End of Period	1984	1985	1986	1987	1988 /a
Reserve Money (RM)	5,473	6,435	7,808	8,646	7,966
Percent Change	12.0	19.4	21.3	10.7	9.6 /b
M1	8,541	10,104	11,677	12,685	13,165
Percent Change	12.8	18.3	15.6	8.6	8.0 /b
Quasi Money (QM)	9,356	13,049	15,984	21,200	27,977
Percent Change	31.9	39.5	22.5	32.6	33.6 /b
RM/GDP (%)	6.3	6.8	8.1	7.5	6.1 /c
M1/GDP (%)	9.8	10.7	12.2	11.1	10.0 /c
QM/GDP (%)	10.7	13.8	16.7	18.5	21.3 /c

/a Stock figures for end of November.
/b November 1988 over November 1987.
/c Assumes estimated GDP of Rp. 131,146 billion.

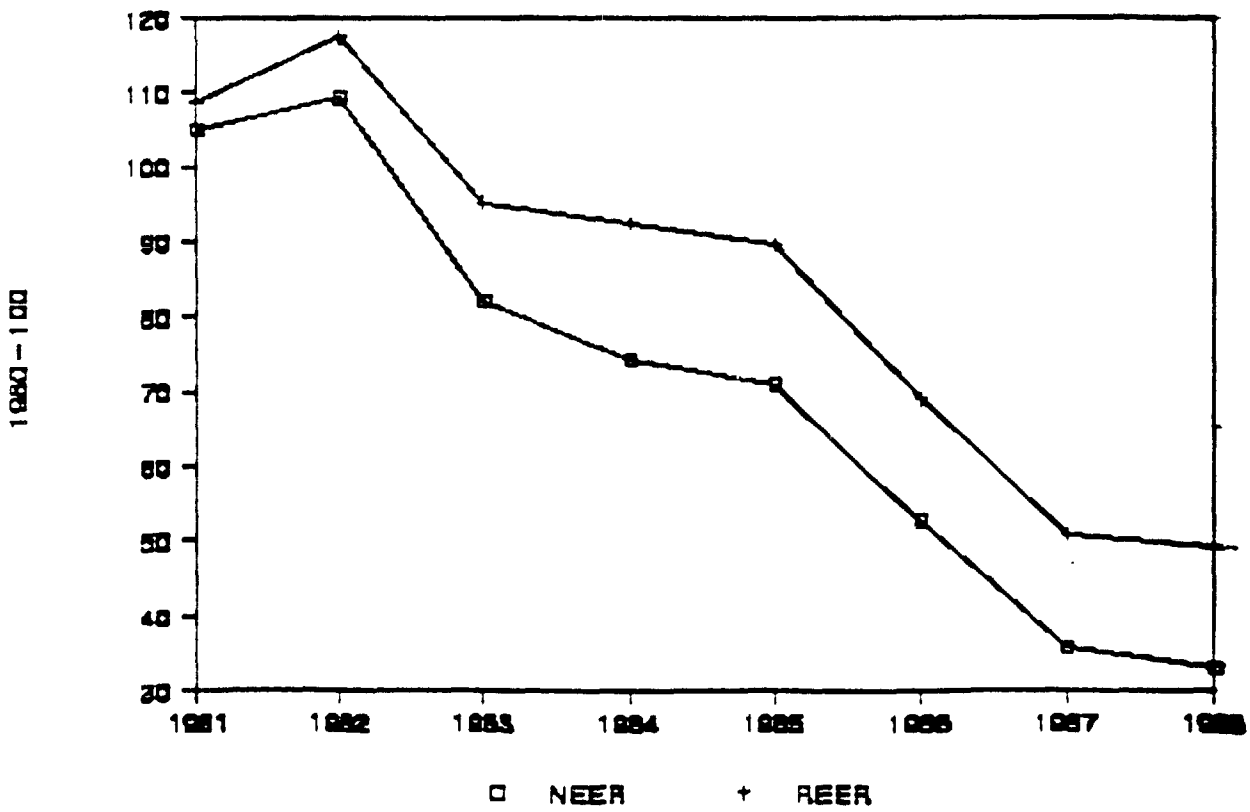
Source: Country Economic Report, May 1989, Statistical Appendix.

3.24 The rise in the ratio of quasi money (QM) to GDP since 1984 presumably reflects the financial reform that began then and has continued under the TPALs, and the reduction of inflation shown in Table 3.4. The continued growth in the QM/GDP ratio since 1986 is also consistent with the public's expectation of continued low inflation despite the devaluation. Thus, the movement of the monetary aggregates is consistent with a gradual tightening of policy, combined with a growing public demand for deposits in the banking system. The only modification of this policy stance that might be recommended is that it be tightened slightly to raise the international interest differential if the Central Bank's net foreign asset position is to be strengthened.

Exchange Rate Policy and the Trade Balance

3.25 The paths of the nominal and real effective exchange rates of Indonesia since 1981 are shown in Graph 3.1. The trend real depreciation from 1981 to 1988 is 13% per year. The upward drift in 1982 and the slow downward movement in 1983-85 were the result essentially of pegging to the U.S. dollar. The real appreciation of 1982 was followed by a jump devaluation of 28% in March 1983. The drift of 1983-85 was ended with another jump devaluation of 31% in September 1986. This accounts for the steep movement from 1985 to 1987 in the graph. From September 1986 to the end of 1988 the real effective rate has shown a real depreciation of about 5% at an annual rate.

GRAPH 3.1: EXCHANGE RATE MOVEMENT



NEER = Nominal Effective Exchange Rate.
REER = Real Effective Exchange Rate.

3.26 Before the jump devaluation of 1986, exchange rate policy was analyzed and conducted in terms of the dollar. Since September 1986, it has been conducted in terms of the effective rate, computed using trade weights. The Central Bank computes the real effective rate as up to date as possible. Then on the basis of short-term projections, it can compute the movement of the nominal rate against the dollar that will keep the real effective rate moving along the desired path.3/ This is approximately the rate set daily by the Bank. Since September 1986, the real effective rate has depreciated at an annual rate of about 5%. The next five-year (REPELITA V) plan assumes an annual depreciation of 5% in real effective terms.

3.27 Given that the real effective rate depreciated at an annual rate of 13% on average from 1981 to 1988, one might ask whether a 5% annual rate of depreciation will succeed in maintaining the improvement in the trade balance that has been achieved since 1986. A potential answer would be that the tightening of monetary and fiscal policy since 1986 has raised the equilibrium real exchange rate, so that a slower rate of depreciation is in order. The jump devaluation of September 1986 adjusted for the expansionary policies that had been pursued until then; a slower rate of depreciation is justified by the new tighter policies.

3.28 This is a plausible scenario, but the consistency of exchange rate policy and monetary and fiscal policy should be carefully monitored in the macroeconomic framework discussed in Chapter 2 of the Report. The 3.5%-4.0% domestic-international rate interest differentials of 1986 and 1987 shown in the bottom line of Table 3.6 may not be consistent with a 5% expected real depreciation, once the persistence of this movement comes to be perceived by the markets. A monetary policy aimed at maintaining an equilibrium level of reserves may ultimately have to aim at a higher interest rate differential, as shown in the 1988 correction.

3.29 The balance of payments since 1981/82 is summarized in Table 3.8. Here we focus on the trade and current account developments, and relate them to the path of the real exchange rate. Earlier we discussed the overall balance, that is, movements in official net foreign assets. Later, capital movements will be discussed under the heading of the debt strategy. The trade balance shows an improvement from the early 1980s to 1985/86, a drop in 1986/87, as the price of oil fell, and then a sharp recovery beginning 1987/88. The important underlying movement, however, is in the non-oil trade position.

3/ The methodology for the computation of the movement of the nominal rate against the numeraire that gives the desired movement of the real effective rate is developed in W. H. Branson and L. T. Katseli, "Currency Baskets and Real Effective Exchange Rates," in M. Gersovitz, et al, eds., The Theory and Experience of Economic Development, London, George Allen and Unwin, 1982.

Table 3.8: BALANCE OF PAYMENTS, 1981/82-1988/89
(US$ billion at current prices)

	Actuals					Estimated
	1981/82	1982/83	1985/86	1986/87	1987/88	1988/89
Merchandise Exports (FOB)	23.0	18.6	18.5	13.7	18.1	19.8
- Oil and LNG	18.8	14.7	12.3	7.0	8.6	7.7
- Non-oil	4.2	3.9	6.2	6.7	9.5	12.1
Merchandise Imports (CIF)	-20.0	-20.6	-14.4	-12.7	-14.2	-15.5
- Oil and LNG	-5.4	-4.8	-3.2	-2.3	-2.4	-2.1
- Non-oil	-14.6	-15.8	-11.2	-10.4	-11.8	-13.4
Trade Balance	3.0	-2.0	4.1	1.0	3.9	4.3
Non-factor services (net)	-2.6	-1.7	-1.9	-1.6	-1.5	-1.8
Interest payments (MLT)	-1.3	-1.5	-2.1	-2.4	-2.8	-3.0
Other factor services (net)	-1.9	-2.2	-2.3	-1.2	-1.5	-1.7
Official transfers	0.1	0.1	0.2	0.2	0.3	0.3
Current Account Balance	-2.7	-7.3	-2.0	-4.0	-1.6	-1.9
- Oil and LNG	9.8	7.2	5.9	2.4	3.8	3.0
- Non-oil	-12.5	-14.5	-7.9	-6.4	-5.4	-4.9
Public MLT loans (net)	2.2	4.0	1.4	2.7	2.1	2.7
- Disbursements	(3.3)	(5.1)	(3.9)	(5.2)	(6.0)	7.1
- Principal Repayments /a	(-1.1)	(-1.1)	(-2.5)	(-2.5)	(-3.9)	(4.4)
Other capital (net)	0.6	0.0	1.5	-1.7	0.7	-1.6
Use of net foreign assets	-0.1	3.3	-0.9	3.0	-1.2	0.8
Memo Items:						
Net official reserves	6.4	3.0	5.8	5.0	6.0	5.4
- Months of imports	(3.7)	(2.0)	(5.5)	(4.3)	(4.6)	(3.7)
Total net foreign assets	10.8	7.5	12.6	9.6	10.8 /b	10.0
Current account/GNP (%)	-3.0	-7.9	-2.4	-5.9	-2.3	-2.5
Non-interest current account balance	-1.2	-5.6	0.5	-1.3	1.5	1.6
- % of GNP	-1.3	-6.0	0.7	-1.9	2.3	2.1
MLT debt service/ exports (%) /c	10.4	16.8	24.4	37.3	33.9	36.3

/a Includes prepayments of US$420 million in 1985/86, US$626 million in 1987/88 and US$341 million in 1988/89.

/b Excludes US$326 million of prepayments, committed during the year but not completed until June 1988.

/c Debt service excluded prepayments; denominator is gross exports of goods and services.

Source: Bank Indonesia and World Bank staff estimates.

3.30 In the early 1980s, non-oil trade showed a deficit of $10-11 billion. By 1985/86, before the fall in the oil price and the trade policy reform, this deficit was down to $5.0 billion. In 1986/87, as the net oil and LNG surplus fell by $4.4 billion, the non-oil trade deficit was reduced to $3.7 billion. Adjustment in non-oil trade began as the oil price fell! By 1988/89, under the policies supported by the TPALs, the non-oil deficit is estimated to be down to $1.3 billion.

3.31 Within non-oil trade, imports fell from the level of $14-16 billion in the early 1980s to $11 billion in 1985/86. They remained around that level during the adjustment years of 1986-1988, and are estimated to rise to $13 billion in 1988/89, as the import regime is deregulated. Non-oil exports increased from the $4 billion level in the early 1980s to $6-7 billion in 1985-87, and are estimated at $12.1 billion in 1988/89. It is difficult to separate the effects on non-oil exports of the real devaluation in 1986 from the trade policy reform, but the jump in non-oil exports by nearly $3 billion in 1987/88 must be partially attributable to exchange rate policy.

3.32 Non-oil merchandise exports are disaggregated in Table 3.9. In the table, it is clear that manufactures have led non-oil export growth throughout the period since the early 1980s, with textiles and plywood products leading until 1986/87. But growth since 1986/87, during the period of the TPALs, has been strongest in the diverse group of "others" among manufactured goods. This group was 30% of manufactures exports in 1986/87; by 1988/89 it rose to 38%. This is a product group that has been greatly energized by the combination of exchange rate policy and trade policy reform.

3.33 A further disaggregation of the other manufactures group is shown in Table 3.10. There, three groups of especially fast growth can be seen. The first is plastics and ceramics, with over 200% growth per year since 1985. The second is a diverse group of glass and metal products, furniture, shoes, and iron and steel, with growth rates of 100%-125%. The third is a more traditional group of paper and rubber products, and matting, with 80%-90% growth. The audit mission visited eight exporters in the manufacturing sector. All reported positive effects from the exchange rate and trade regimes. One manufacturer of metal and plastic products reported exports growing from $1.0 million per month in 1987 to $1.5 million in 1988 and an anticipated $3.0 million per month in 1989. This exporter, and the others in the "other" manufacturing, viewed the change in the trade regime as permanent and pervasive. They are proceeding with an expansion of capacity to continue export growth.

Table 3.9: NON-OIL MERCHANDISE EXPORTS, 1982/83-1988/89

	Value at Current Prices (US$ Million)				Real Growth Rates (% p.a.)		
	Actual			Estimate	1982/83-	1986/87-	1987/88
	1982/83	1986/87	1987/88	1988/89	1986/87	1987/88	1988/89
Agricultural Commodities	2,398	3,262	3,885	4,592	7.3	15.0	3.7
Timber Products	575	436	627	760	-4.2	13.8	9.7
Rubber	615	752	1,055	1,278	4.9	12.6	0.6
Coffee	363	752	497	555	6.7	-11.4	12.0
Palm Oil	103	114	214	328	15.9	23.7	12.4
Tea	116	106	119	138	8.2	-5.3	9.2
Shrimp	204	317	368	580	7.2	56.9	20.0
Rattan	82	99	162	56	6.8	16.5	-67.4
Others	340	687	844	898	9.9	23.8	3.0
Minerals & Metals	676	725	1,080	1,381	9.9	15.0	-3.5
Tin	349	156	143	172	-3.0	-8.4	12.8
Gold	0	61	308	260	-	347.8	-11.7
Aluminum	48	201	245	313	53.4	-14.1	-27.0
Copper	115	144	186	227	5.7	7.0	7.9
Nickel (Total)	139	112	146	350	-1.6	-20.4	20.8
Others	25	52	51	59	27.0	-26.3	-21.3
Manufactured Goods	854	2,744	4,537	6,128	33.8	42.6	27.1
Textiles	180	744	1,283	1,757	42.0	50.9	26.5
Plywood/Panel Products	324	1,156	1,834	2,034	35.5	29.5	10.4
Others	350	814	1,420	2,338	27.1	51.9	45.2
Total Non-Oil Exports	3,928	6,731	9,502	12,100	13.6	25.8	13.6

Source: Central Bureau of Statistics and World Bank staff estimates.

Table 3.10: MAJOR ITEMS WITHIN "OTHER" MANUFACTURED EXPORTS (US$ million at current prices)

	Actual			Estimate	Nominal Growth Rate
	1985	1986	1987	1988	1985-88 (% p.a.)
Plastics	1.5	12.5	24.7	56.1	232.7
Ceramics	0.5	1.2	4.5	14.1	212.8
Glass and Glass Products	8.3	12.7	30.7	93.7	124.1
Other Articles of Basic Metal	5.4	7.6	17.4	56.9	119.6
Sandal, Shoes	8.2	8.8	23.5	82.6	116.1
Furniture	7.1	9.2	27.2	69.7	113.9
Iron and Steel	34.2	69.5	196.0	296.2	105.2
Paper and Paper Products	20.9	31.8	95.8	138.2	87.5
Rubber Products	7.5	11.3	24.2	48.8	86.5
Matting	13.3	19.4	47.2	76.4	79.2
Cement	21.5	39.8	56.1	75.6	52.1
Other	93.8	122.7	91.9	240.7	36.9
Processed Food	56.7	81.5	105.9	139.2	34.9
Pharmaceutical Products	6.5	7.0	9.4	15.4	33.3
Leather and Leather Products	37.5	43.9	53.8	77.6	27.4
Fertilizer	80.0	127.3	86.0	134.1	18.8
Animal Feed	90.8	97.8	113.2	147.5	17.5
Total	493.5	703.9	1,007.6	1,762.6	52.8

Source: Central Bureau of Statistics and World Bank staff estimates.

3.34 In summary, the exchange rate policy put in place after the devaluation of 1986 is supporting growth in non-traditional manufactures exports, as well as exports in the agriculture, mineral, and traditional manufactures sectors. The anticipation of a continued real depreciation with an open capital market places a constraint on monetary policy to hold real interest rates by a prescribed margin well above world rates. If this begins to depress domestic investment, the policy of gradual real depreciation may have to be reconsidered. But during the TPAL period, exchange rate policy succeeded in supporting an extremely rapid adjustment of the non-oil trade balance.

Macroeconomic Policy Issues

3.35 The two important issues for macroeconomic policy that emerge from the above analysis are a possible need to tighten further, or not to ease, on both monetary and fiscal policy, and the maintenance of consistency of these policy settings with exchange rate policy. The reduction of the real interest rate differential against LIBOR in 1986 and 1987 may not have been

consistent with continued financing of the current account deficit. This required some tightening on monetary policy, which happened in 1988. The slight easing on the fiscal side from a primary surplus of 0.7% of GDP in 1987/88 to 0.4% in 1988/89 may need to be reversed. Both of these minor corrections would contribute to a further reduction in inflation.

3.36 The policy of gradual real depreciation is recognized by the authorities and the Bank staff to place a constraint on monetary policy to hold real interest rates above world rates. This has not yet had a perceptible depressive effect on investment in the tradeable goods sectors or in construction. But the connection of interest rates to exchange rate policy, and the potential effect of interest rates on investment, make consistency of monetary and fiscal policy, exchange rate policy, and investment a high priority for the medium-term macroeconomic framework. This priority is recognized in the Report.

3.37 The decline in public capital expenditure has been felt in areas critical to the promotion of economic growth (e.g. power, transportation and telecommunications). However, any rise in public fixed investment will inevitably increase pressures on the non-aid current account deficit as well as interest rates. This could deter private investment. GOI has three alternatives: it could lower its level of net foreign assets, increase borrowings of concessionary foreign assistance, or raise the levels of domestic savings. While the first two alternatives must be seen as essentially temporary palliatives, the longer-term solution has to revolve around an increase in domestic savings. The opportunities for improving savings are discussed in Chapter VI.

B. Trade Policy Reform

3.38 Before the deregulation and reform that began in 1986, Indonesian trade was highly regulated, mainly through a system of import licensing and export restrictions in some areas and other direct interventions in others. Data are available that indicate the degree of restriction on the import side. The evidence on the export side is more impressionistic. Table 3.11 shows that in mid-1986, 42.9% of import value was under license, protecting 41.4% of total domestic production and 52% of manufacturing.

3.39 The policy direction on exports since 1986 has been to reduce restrictions and permit inputs into export production to enter free of duty and VAT. Some export restrictions remain, such as bans on export of raw rattan, logs, and low-grade rubber, quotas on several agricultural exports, and administratively-controlled, approved exporter regulations and export quality control. But under the successful implementation of the "May 6" program that was begun on May 6, 1986, producers who export 65% of their output can import inputs free of duty and VAT. Taxes are paid ex-post on inputs used for domestic production.

Table 3.11: IMPACT OF REFORM PACKAGES ON IMPORT LICENSING COVERAGE SINCE 1986

Coverage	Mid-1986	End-1987	End-1988
% of CCCN items	31.5	21.7	16.3
% of import value	42.9	25.2	20.8
% of total domestic production	41.4	37.6	28.9
Memo item:			
% of domestic production in:			
manufacturing	52.0	35.3	26.0
agriculture	65.5	64.6	50.2
mining and minerals	0.2	0.2	0.2

Source: World Bank staff estimates.

Import Regime

3.40 The import regime has moved away from restrictive licensing toward a tariff-based regime. Goods have been moved from more restrictive to less restrictive lists, or de-listed altogether. By the end of 1988, 20.8% of total import value was under license, half the percentage in 1986, as shown in Table 3.11. The fraction of total production protected by license was 28.9%, and that of manufacturing production was 26%, again half the percentage in 1986. These data overstate the degree of remaining protection, however, since the remaining license for export producers is freely available. Tariffs have been raised to provide approximately the degree of protection of the previous licensing, while tariff dispersion seems to have been reduced. Thus, under the TPALs, the first stage of the reform, moving from a license-based to a tariff system, is nearly complete in manufacturing, but just beginning in agriculture.

3.41 In 1989, there are four license categories for imports. The IU license is generally available for any importer of unlisted goods. The IP license is available for any export producer that imports listed inputs. The IT license permits trading companies to import listed final goods. Finally, the AT license permits imports by the designated agent of a large foreign producer, e.g., SONY Corporation. The reforms have reduced the import value under the IP, IT, and AT licenses to 20.8% of total import value by the end of 1988, as shown in Table 3.11. Furthermore, the IP license does not appear to be restrictive, as it is generally available to export producers. So the end-1988 data in the table reflect much less restriction on goods remaining under license than the mid-1986 data.

3.42 The changes in the tariff schedule for the entire economy are summarized in Table 3.12, and changes across broad sectors are shown in Table 3.13. Table 3.12 shows the tariff cut that took place in 1985, and the fairly constant average level since then. This average has been maintained as imports have been moved from more restrictive to less restrictive license categories. The 1985 cut increased the index of tariff dispersion from 61.5 to 107.8. The index has been subsequently reduced by the reforms since 1985.

Table 3.12: CHANGES IN THE TARIFF SCHEDULE FOR THE WHOLE ECONOMY SINCE 1985 /a

	Pre-1985	1985	1988	1989
Average Tariff Rates (%)				
Unweighted	37.3	27.0	24.0	24.4
Weighted				
- by import value	22.0	13.0	14.5	14.5
- by domestic production /b		17.1	16.6	17.0
Index of Dispersion /c	61.5	107.8	90.0	84.4

/a "Pre-1985" refers to the 1983 Tariff Law in effect from 1983 to 1985; 1985 reflects rates in effect after the 1985 reform; 1988 refers to rates in effect after the November 1988 package; and 1989 refers to the Harmonized System as provided by the Department of Finance in February 1989. Tariffs are inclusive of surcharges and specific duties have been converted to ad valorem equivalents.

/b Based on a sample of 1,200 tariff positions.

/c Measured by the coefficient of variation.

Source: Ministry of Finance, Central Bureau of Statistics and World Bank staff estimates.

3.43 The weighted (wgt) average tariffs in Table 3.13 show small increases from the post-cut levels in 1985 to 1989 in agriculture and manufacturing, and a large drop in dispersion in manufacturing. The dispersion index generally fell in the disaggregated manufacturing sectors. Combining the information in Tables 3.11 and 3.13, we see that protection of the manufacturing sector by import licensing has been reduced by more than half since 1986, tariff dispersion has been reduced, and the average tariff level has been maintained. The tariff schedule remains escalated, with effective protection highest for consumer goods and perhaps negative for intermediate goods. This is the basis for the judgment that the first stage of reform is nearly complete in the manufacturing sector.

Table 3.13: LEVEL AND DISPERSION OF TARIFFS IN BROAD SECTORS, 1985 AND 1989

	1985 CCCN Schedule			1989 HS Schedule		
	Average Tariff		Index of	Average Tariff		Index of
	UNW (%)	WGT (%)	Dispersion	UNW (%)	WGT (%)	Dispersion
Agriculture	17.4	2.9	69.1	16.9	4.2	69.3
Mining	4.6	1.0	87.6	4.5	1.0	89.7
Manufacturing	28.4	23.8	106.6	25.5	15.4	82.9
A. Manufacturing sectors:						
- Food, beer, tobacco	36.6	15.6	86.4	28.4	15.0	61.3
- Textile and leather	56.0	30.7	74.0	44.0	31.9	43.9
- Wood and products	29.6	40.1	46.6	30.8	40.0	41.6
- Paper and printing	21.6	17.3	62.9	20.3	10.4	65.9
- Chems, petrol., coal	17.0	6.8	137.7	16.7	7.3	113.5
- Non-metal minerals	35.5	15.8	86.9	34.1	16.8	63.4
- Basic metals	10.4	8.4	71.8	11.7	9.4	112.5
- Metal prod., machin.	19.6	16.9	93.6	20.3	19.7	99.4
- Other manufacturing	32.0	26.1	54.9	34.1	29.7	49.0
B. Manufactured products:						
- Consumer goods	46.3	31.9	77.1	39.1	31.3	53.6
- Intermediate goods	14.7	9.4	85.9	15.4	9.9	91.7
- Capital goods	17.2	13.1	130.4	16.4	16.3	103.7

Key to Table:
UNW = unweighted average tariff
WGT = weighted average, using import weights

Source: Ministry of Finance and Central Bureau of Statistics.

3.44 In the agricultural sector, the extent of protection by licensing was the same at the end of 1987 as in the middle of 1986. The first steps in removing license protection came in November 1988, reducing coverage from 64.6% to 50.2% in Table 3.10. The average tariff in agriculture in 1989 is much lower than in manufacturing, as is shown in Table 3.13, but has a high degree of dispersion. This pattern of broad license coverage and low average but highly dispersed tariffs in agriculture reflects a selective use of protection. This presumably leads to over-investment in some low-return agricultural sectors.

3.45 The structure of effective protection in Indonesia as of early 1989 is summarized at the one-digit aggregate level in Table 3.14. The estimates are from a model that is on line at the resident mission. They are based on a 1987 study that used the 1981 input-output structure, and the tariff changes prior to the November 1988 decrees. The study is currently being updated.

Table 3.14: EFFECTIVE RATES OF PROTECTION

Industry Sector	Output Rps. bill.	VA(O) %	VA(U) %	NRP %	ERP %	RERP %
1 Food crops	16,450.8	83.6	66.8	15	25.2	10.1
2 Estate and other crops	5,829.6	74.6	65.6	7	13.6	-0.1
3 Livestock	4,873.6	49.9	37.7	23	32.3	16.3
4 Forestry	1,598.2	86.1	107.7	-17	-20.1	-29.8
5 Fishing	2,132.9	76.8	59.1	25	30.0	14.2
6 Mining and quarrying	14,785.4	86.4	86.8	0	-0.4	-12.5
7 Food, beverages and tobacco	17,976.4	18.1	9.0	23	101.1	76.8
8 Textiles/clothes/footwear	3,808.2	30.9	14.6	35	111.8	86.2
9 Wood products	3,888.8	36.9	30.8	3	19.9	5.4
10 Paper products	1,123.4	34.2	29.4	22	16.3	2.2
11 Chemicals	2,856.8	42.2	25.7	21	64.5	44.6
12 Oil and gas	10,702.4	37.8	38.3	0	-1.2	-13.2
13 Non-metallic products	5,396.0	33.8	20.9	23	62.0	42.4
14 Basic metals	1,871.8	39.9	34.7	8	15.0	1.1
15 Engineering	6,585.8	29.9	13.5	38	121.6	94.8
16 Other manufacturing	486.9	36.0	17.1	38	111.1	85.6

(O) = Effects of existing policies
(U) = Relative to free trade

Source: World Bank Staff Estimates (John Wilton Program, January 1989).

3.46 The last column in the table gives the real effective rate of protection (RERP) for the 16 aggregate sectors. The high protection sectors are foods (7), textiles/clothes/footwear (8), and engineering (15), and other manufacturing (16). The latter is the sector with fastest export growth, as was shown in Table 3.9 earlier. Medium protection in the 40%-45% range is afforded the chemicals (11) and non-metallic manufactures (13). Negative protection goes to forestry (4), mining and quarrying (6), and oil and gas (12). This ranking of sectors by effective protection rates may be sensible for Indonesia. Tariff rationalization may involve mainly reducing the range of RERPs, rather than reordering them in a major way.

3.47 The dispersion of the RERPs across the 138 underlying disaggregated sectors is summarized in Table 3.15. The dispersion has a mode between 0% and -10%, and a spike above 110%. Thus, the dispersion in 1989 shows a distribution that rises quickly below -10% and tails off sharply above a RERP of 30%, except for 14.1% of the sectors that have rates above 110%. These latter include 12 sectors with the maximum protection level of 600%. These most highly protected sectors are a group of consumer foods, such as milk products, sugar, and wheat flour, tires, motorcycles, household electricals, batteries, and ceramics and earthenware.

Table 3.15: DISPERSION OF REAL ERP'S
(Percent)

		RERP (0)	<	-30	:	3.8
-30	<=	RERP (0)	<	-20	:	4.3
-20	<=	RERP (0)	<	-10	:	10.3
-10	<=	RERP (0)	<	0	:	20.4
0	<=	RERP (0)	<	10	:	16.6
10	<=	RERP (0)	<	20	:	11.4
20	<=	RERP (0)	<	30	:	3.0
30	<=	RERP (0)	<	40	:	2.2
40	<=	RERP (0)	<	50	:	5.1
50	<=	RERP (0)	<	60	:	1.7
60	<=	RERP (0)	<	70	:	2.6
70	<=	RERP (0)	<	80	:	1.4
80	<=	RERP (0)	<	90	:	1.2
90	<=	RERP (0)	<	100	:	1.9
100	<=	RERP (0)	<	110	:	0.0
110	<=	RERP (0)	<		:	14.1

MEAN = 61.2 SD = 151.6

(0) = Under existing policies

Source: World Bank Staff Estimates (John Wilton Program, January 1989).

3.48 The movement from the licensing system to tariffs in the manufacturing sector is nearly complete, while it has just begun in agriculture. The next steps are to complete this transition, and to move to unify and rationalize the tariff system. As licensing restrictions have been reduced tariff protection in the form of temporary surcharges has been widely imposed on an ad hoc basis. These should be removed or converted into tariffs where this is justified (Box 4). The reform in Indonesia is well underway, but only underway.

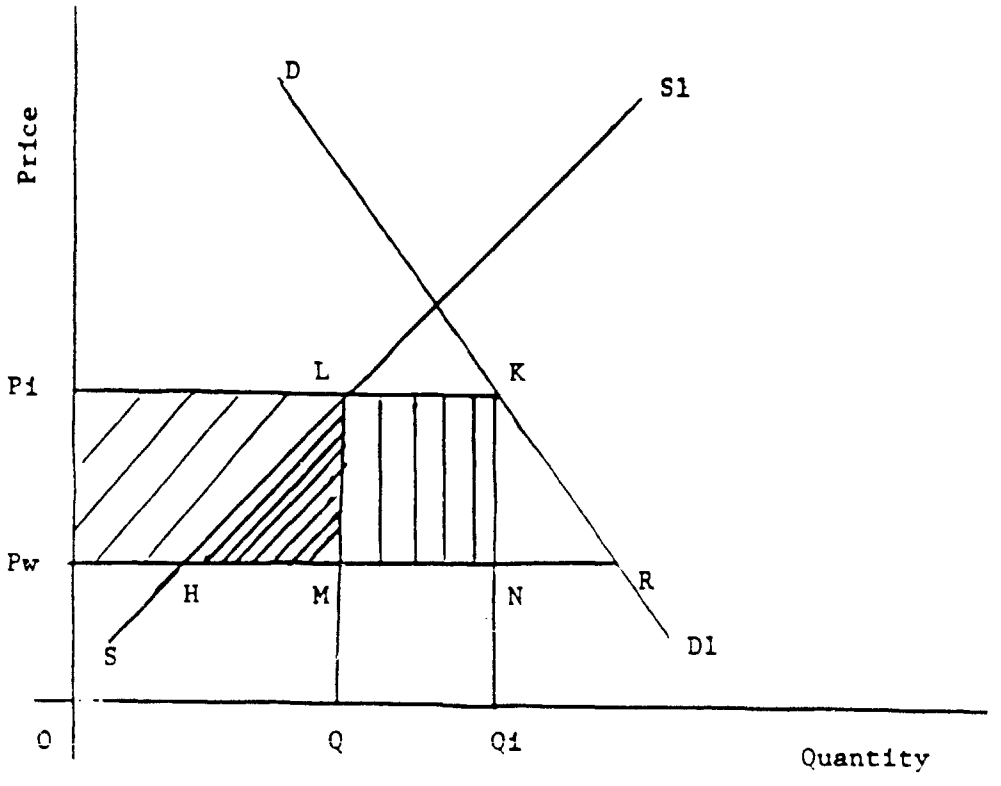
3.49 The second aspect of the import regime that requires attention is its administration. The reforms to date have been determined by an ad hoc committee run from the Finance Ministry, with a shifting membership and power distribution. The changes are announced by decrees whose specific content and timing cannot be forecast. This may be necessary during the first stages of the reform, to circumvent the formation of opposing coalitions against specific reforms. But while the general direction of the policy reforms is known to the interested parties, their erratic progress makes investment decision-making difficult. Thus, gradually the policy-making body should be institutionalized, perhaps as an evolving tariff commission. Any new decrees should be accompanied with clear directions for their implementation (forms for license applications, etc.) and a clear statement on which previous regulation they supersede. The objective should be to make the decision-making processes on both trade policy and administration as transparent and predictable as possible.

Export Policy

3.50 Export policy currently, and during the TPAL period, works through two distinct channels. The first is a range of export restrictions, which are intended to guide the private sector either away from some export activities or into particular forms of export activity. The second is the "May 6," or P4BM (for its administration) program, which allows export producers to import inputs free of duty and VAT. Progress on removing or rationalizing export restrictions has been mixed since 1986, while the P4BM program has been quite successful.

3.51 The export restrictions are bans, quotas, designation of an approved exporter, and quality controls. The sectors to which they apply are shown in Table 3.16. The bans are aimed at increasing value-added before the export stage. The quotas seem to either have that objective or to secure domestic supply. The approved exporters, or marketing organizations limit access to exporting, and create rents for those approved. There is an obvious argument for quality control to insure access to the international market, but its administration also can provide rents. There may be an argument for some of the bans, but their effect on value-added should be documented. Similarly, the justification for the quotas and the distribution of the resulting rents should be examined. The approved exporter status should be freely granted to applicants meeting clearly stated requirements, and the quality control administration should be transparent. The desirability of the entire system of export restrictions should be reviewed.

Box 4: EFFECT OF A SHIFT FROM QUOTAS TO TARIFFS



The effect of the switch from quota licensing to tariffs is illustrated here. Domestic supply and demand are SS1 and DD1, respectively. The world price is Pw, and the free trade, domestic output would be at point H on the supply curve, consumption at point R on the demand curve, and imports would be HR. If a quota is imposed at Qi, the price rises to Pi, and imports fall to LK. The area LMNK is rent to the licensed import agent. The switch to a tariff can hold imports to LK, if the tariff rate is (Pi-Pw)/Pw. In this case, the rent LMNK becomes tariff revenue to the government. In fact, tariff revenues have increased by 50% in Indonesia from 1986/87 to projected 1989/90.

Table 3.16: SECTORS WITH EXPORT RESTRICTIONS, 1989

Restriction	Sectors
Export ban	Some coffee and rubber, raw and semi-process rattan, hide, logs, scrap and steel
Export quota	Fertilizer, salt, flour, rice, paper, soybeans, crude palm oil
Approved exporter	Pepper, cassia vera, nutmeg, sawnwood, plywood
Quality control	Fish, manioc, shrimp, coffee, tea, pepper, spices, vegetable oil, cocoa beans, rubber, wood products

Source: Report, May 1989, fn 12, p. 61.

3.52 The P4BM program allows export producers to import inputs free of duty and VAT. A producer who exports 65% of output can obtain an IP license which provides exemption from duty on inputs, with ex-post payment on the percent used for domestic production. A producer with a smaller export proportion can obtain a duty drawback ex-post. Data on implementation of the program are shown in Table 3.17. By the end of 1988, 1,098 firms were using the program, with $626 million imports actually covered, almost all through exemption. Two aspects of the program deserve some scrutiny. First, approvals are running four times realized imports. Presumably, this is because producers obtain approval for the maximum expected imports, but the size of the difference remains to be explained. Second, the preponderance of exemptions could mean that the administration of drawbacks is costly. On the other side, it may be that the 65% provision is not binding.

Table 3.17: IMPLEMENTATION OF MAY 6 SCHEME

	No. of Firms	Value of Imports (US$ million)		Value of Taxes /a (US$ million)		Processing Time (No. of days)	
		Approved	Realized	Duty Exempt	Duty Drawback	For Exempt	For Drawback
1986 (July-Dec)	242	236	65	76	0	12	24
1987 (Jan-Dec)	482	902	297	230	6	7	17
1988 (Jan-Dec)	1,098	2,447	626	855	20	6	13

/a On approval basis.

Source: Agency for Export Facilities and Financial Data Processing (P4BM).

3.53 The administration of the P4BM program seems quite efficient. Table 3.17 shows a short and falling processing time for approval. The administration has a program for training exporters to make their applications directly using a personal computer, so that approval is immediate. As of 1989, an export producer can obtain a permanent IP license and bring in all imports duty-free through P4BM. The audit mission interviewed several export firms that were fully satisfied with the operation of the program.

Trade Policy Issues

3.54 The main issues for trade policy are clear. Deregulation on imports and exports should proceed, and the administration of trade policy should be rationalized and institutionalized. The first stage of shifting from a licensing system to a tariff-based system that is approximately equally protective on average has been nearly completed for manufactures, and barely begun for agriculture. The second stage of unifying and rationalizing the tariff structure comes next for manufactures. The shift to a tariff-based system must be completed for agriculture.

3.55 The analysis of effective protection above suggests that the rationalization of the tariff structure can concentrate on the sectors with extremely high tariffs, mostly at the consumer end of the agricultural sector, and also at the consumer end of manufactures. These tariffs presumably reflect concern about food security and past attempts at import substitution in the area of consumer manufacturing. The rationalization process might focus on these two areas.

3.56 On the export side, the priority might be to re-examine the role of export restrictions. Some of them in the agricultural sector, again, may reflect food security concerns. And some of the quality controls, especially in the agricultural sector, might legitimately reflect concern for reputation on international markets. But these should be administered with clear criteria for entry. The bans that are meant to generate upstream value-added should be evaluated along with local-content requirements for foreign direct investment. These policies should be aimed at the same target, and their application, where appropriate, integrated.

3.57 Improvement of the administration of trade policy includes both the institutional mechanism for making policy, and the mechanism for implementing and evaluating it. The first stage of deregulation, shifting from licenses to tariffs, may have required that the policy decisions be made quickly and by an ad hoc, high-level committee, in order to prevent or forestall the formation of effective opposing coalitions. In a sense, policy may have had to be made by a politically moving target in order to succeed. However, once the import regime is converted to a tariff base, and the export restrictions have been rationalized, trade policy should be set in as transparent and stable a fashion as possible. This will minimize uncertainty in the private sector and provide a stable environment for investment.

3.58 These considerations argue for the establishment of a stable, high-level committee chaired by a minister responsible for trade policy. This group would be responsible for major decisions in rationalizing the tariff structure, removing export restrictions, and regulating inward foreign investment and trade generally. The trade minister will need a bureaucracy that can effectively analyze trade and tariff issues and deal with GATT questions. The bureaucracy will also need an arm that deals with appeals for protection within the GATT codes, and under the trade legislation set by the policy committee. The bureaucracy might include a tariff commission that is somewhat independent of the political process, which would be responsible for the economic analysis of the tariff and trade regimes.

C. Industrial Policy Reform

3.59 Before the beginning of industrial deregulation in 1986, industry in Indonesia was highly regulated. The jurisdictions and mandates of the regulators at several levels of government was uncoordinated, giving rise to "excessive and sometimes contradictory regulations", to use the words of the Report (p. 6). The system was highly controlled but unplanned. The combination of domestic investment and capacity licensing and restriction on foreign investment made Indonesia a country with rigid internal capital controls.

3.60 Provincial and local regulations on investment and land use and labor regulations further hampered both the level and allocation of investment and economic activity in general. In addition the legal framework for business is outmoded; court decisions are not recorded, for example. These institutional rigidities are increasingly costly in an economy that is modernizing and diversifying, and becoming increasingly open.

3.61 In 1986 the government began to ease and rationalize industrial regulation in investment, both domestic and foreign. Continued progress in these areas is high on the current agenda. At the end of 1988, regulations governing the internal shipping industry were rewritten. Also in 1988, reform measures were taken in the financial sector. These actions show the government's intent to streamline and rationalize the system of industrial regulation, but in this area the action is just beginning.

Investment and Capacity Licensing

3.62 Until 1986, Indonesia had an extremely rigid investment licensing system, in which existing firms in a sector essentially had veto authority over new entrants. The principle guiding licensing of new investments or capacity expansion was that no new capacity was needed if existing firms were successfully supplying the market. Since there is always some price at which supply equals demand, it was rarely difficult for existing firms to show that they could meet the demand. In this system, the rents did not have to be sought!

3.63 In 1987, the licensing system was relaxed somewhat. Firms are now allowed to expand capacity by 30% with ex post notification rather than permission. The categories of products for which investment is licensed have been broadened so that producers can be more flexible in their choice of product mix. The number of separate licenses that are needed has been reduced, and the Investment Authority (BKPM) has instituted a "one-stop" system for obtaining licenses. Operating licenses are now good for the life of the firm rather than requiring periodic renewal. Beginning in 1986, restrictions on inward foreign direct investments have also been eased.

3.64 The results of this partial easing of the licensing regime and requirements on foreign investment are shown in Table 3.18. Domestic investment approvals in real terms tripled from 1985 to 1988, and approved foreign investments more than quadrupled. Since the officials in BKPM get administrative credit points for the amount of investment they approve, it would be interesting to obtain comparable data on actual investment. These data are not available, apparently. Nevertheless, real progress is being made on licensing and foreign investment.

Table 3.18: INVESTMENT APPROVALS BY BKPM

Period	1985	1986	1987	1988
Domestic (Rp trillion)	3.7	4.4	10.3	14.9
% change		19	134	45
Domestic (1985 prices) /a	3.7	4.1	8.2	10.7
% change		11	100	30
Foreign (US$ billion)	0.9	0.8	1.5	4.4
% change		-11	88	193

/a Using WPI general index excluding petroleum exports.

Source: Project Completion Report, Indonesia Trade Policy Adjustment Loan (Loan), Table 1.

3.65 Much, however, remains to be done. The existing investment restrictions are summarized in Table 3.19. The four categories of investment licenses are described in the note. In categories I-III, the higher category includes the lower ones. Thus, if a sector is open for foreign investment, category I, then it is also open for domestic investment, category II, and small-scale investment, category III. The licensing system is positive, so the uncovered items, 26% percent of the total, can be invested in only at the discretion of the relevant ministry. The restriction "existing firms only" is particularly important in the metal products sector, where the effective protection rates are 85%-95% (see Table 3.14).

Table 3.19: INDONESIA: SUMMARY OF INVESTMENT RESTRICTIONS

		No. of	Categories					Restrictions					
		KKI Comm.	I	II	III	IV	Not Covered in DSP	Existing Firms Only	Manu. Required	Location	Small Scale Enterprise	Other	Total
31	Food, beverages, tobacco	1,147	370	467	829	51	258	29	0	53	465	60	539
31	Textiles	668	364	419	570	0	118	9	0	110	295	242	454
33	Wood	301	55	111	209	0	92	1	0	21	86	48	122
34	Paper	205	84	187	198	1	6	58	0	0	0	35	93
35	Chemicals	1,581	484	665	727	8	797	30	0	29	78	73	182
36	Non-metallic minerals	291	67	164	183	3	105	2	0	9	7	12	22
37	Basic metals	353	329	329	329	9	15	0	0	53	25	5	73
38	Metal products	1,625	1,236	1,521	1,547	38	240	190	499	33	160	245	869
39	Other	381	183	199	271	0	110	0	10	0	125	1	136
	TOTAL	6,722	3,172	4,062	4,863	110	1,751	319	509	308	1,241	721	2,490

Note: Categories I through IV indicate the number of sectors at the 7-digit Indonesian Industrial classification that are:

(I) open to foreign investors (PMA);

(II) open to domestic investors seeking incentives (PMDN);

(III) open to small scale investors and non-PMA/PMDN firms; and

(IV) closed to further investment.

The next column indicates the number of sectors that are not covered in the DSP list. The remaining columns indicate various restrictions that are specified in the DSP list. These are in order of sequence:

(i) expansion can be undertaken by existing firms only;

(ii) domestic manufacturing required;

(iii) a location specific restriction;

(iv) restricted to small scale enterprises only;

(v) other restrictions; and

(vi) the total number of restrictions.

Source: Investment Priority List (DSP), 1987, Klasifikasi Komoditi Indonesia, BPS 1985, and CAFI Economic Bulletin, June 1987.

3.66 The pervasiveness of the investment licensing system is evident from Table 3.19. The manufacturers and exporters that the audit mission interviewed included manufacturers in textiles, wood products, and metal products. None of these reported any problems with the licensing system, and most were expanding their capacity. These satisfied producers, however, already have their licenses and are operating in a protected environment. So investment seems to be growing under the somewhat relaxed licensing system, but the basic reform of moving to a negative list remains.

Financial Reform

3.67 The financial industry in Indonesia is highly concentrated, with the largest five institutions controlling 65%-75% of total assets among banks, insurance companies, pension funds, and non-bank financial institutions (NBFIs). Government involvement is pervasive; the government owns the five largest banks. Bank Indonesia (BI) subsidizes lending for investment via a system of liquidity credits, in which commercial banks can refinance loans at BI at rates well below market. These credits are around 40% of total private credit, and over 80% of them flow through state banks.

3.68 In October and December of 1988, the government announced major reforms for the financial industry. The main objectives are to improve its efficiency and to increase the availability of long-term financing. Several measures were aimed at increasing the ease of entry into the banking sector, notably for foreign and rural banks. State enterprises can now place up to 50% of their deposits with non-state banks. Limits on interbank borrowing were eliminated, and the maturity of SBIs (the note issued by BI in lieu of government debt, used as the counterpart in open-market operations) was increased from 7 days to 6 months. Maximum loan concentration ratios and minimum capital requirements were specified for banks and NBFIs. An OTC market has been established, and private stock exchanges are now allowed to be established. Reserve requirements were unified, and set at 2%.

3.69 These measures are a substantial departure from past practice, and their implementation will strengthen the industry. Freer entry and the provision for capital requirements and maximum loan concentration should reduce the spread of lending rates over deposit rates. Allowing deposits from state enterprises to non-state banks will strengthen their position. Whether the reserve requirement should be set so low is an issue we take up below. One might also question the emphasis on long-term finance. It may be better to concentrate on improving BI regulation of the banking system, recognizing that investors can roll over short-term debt with confidence, as long as the banking system is stable.

Industrial and Financial Policy Issues

3.70 The most important next step in industrial policy is elimination of the investment licensing system in favor of a free system with a short negative list of controlled sectors. This should be followed by rationalization of the provincial and local regulations governing investment. These steps would allow Indonesia to make a substantial move toward its efficiency frontier. A second major priority is to revamp, or rather to create, a credible legal structure for business. This should include specific and enforceable bankruptcy provisions.

3.71 In the financial sector, formulation of prudential regulations and strengthening BI's supervisory capacity and performance are the highest priority. The reforms of 1988 are a major step in the right direction; the BI staff and procedures should be strengthened in order to implement them. The one potentially troublesome step in the 1988 reforms is the low setting

of the reserve ratio. This may appear desirable for reducing the spread. But with SBIs available at 15%, one can expect the banking system to stay loaned up. As long as there is a substantial spread between the rate on a safe asset and zero-return reserves, there is no reason to expect banks to hold excess reserves. This means that the money multiplier will become very large, reaching 50 at the limit. This will make the monetary system extremely sensitive to open-market operations. Either paying interest on reserves or an increase in the reserve ratio would reduce this sensitivity.

3.72 Overall, the progress made in industrial policy reform beginning in 1986 is quite substantial. A good beginning has been made, and the objective of policy now should be to keep up the momentum.

IV. IMPACT OF THE ADJUSTMENT PROGRAM

4.01 The impact of the adjustment program at the macroeconomic level has been discussed in detail under the heading of "macroeconomic policy" in Chapter 3. The growth rate of real national income was maintained at 4%-5% in 1987 and 1988, despite terms of trade shocks of 13%-15% each year. Inflation was held below 10% as measured by the CPI or non-oil GDP deflator despite a 31% devaluation in 1986. The rate of inflation in non-traded goods prices was 4.7% in 1988. Non-oil exports doubled from 1985/86 to 1988/89, and the non-interest current account shows a surplus of about 2.6% in 1988/89. The debt service and debt to GNP ratios increased as oil revenues fell, but these stabilized in 1987-88, and are projected to fall beginning in 1989. Thus, the combination of tight monetary and fiscal policy, and devaluation that did not get passed through into wages and non-traded prices, and therefore moved the real exchange rate, resulted in an exemplary adjustment effort at the macro level.

4.02 The impact has also been striking at the sectoral and micro levels. The growth of non-oil manufacturing has been especially strong; it is now the fastest growing sector in the economy. Non-oil exports now finance nearly 85% of non-oil imports. On the expenditure side, however, the impact has fallen mainly on investment. The ratio of consumption to GDP was about the same in 1988 as in 1981. So the burden of adjustment has been largely shifted to the future, in the form of reduced investment during the adjustment period.

4.03 This pattern of adjustment may be good policy in the Indonesian case. During a period of major transition in the economic regime an investment pause might be expected, as private and public investors wait to see the shape of the new economy. In addition, it may be essential politically to maintain consumption during the transition, in order not to discredit immediately the change in policy. And the efficiency gains from the reforms could easily raise the growth path relative to the one that existed after the shocks but before the reforms. Thus, the point here is not to criticize the choice of the composition of expenditure adjustment, but to caution that investment should increase as a share of GDP in the near future, as the economy is re-shaped along more outward- and market-oriented lines.

4.04 In this chapter we discuss the sectoral and micro impacts of adjustment summarized above. First we look at the sectoral adjustment on the production side. Next we look at the expenditure side. Then we turn to impacts on income, employment, and social indicators.

A. Structure of Production

4.05 Some important aspects of the changes in the structure of production are summarized in Table 4.1. Indonesia's dependence on oil income has been substantially reduced and the role of more promising and sustainable sources of growth such as manufacturing has increased. The strong positive response of non-oil exports, manufacturing production, and private investment to the adjustment program has been especially encouraging. The process of structural transformation is not complete, but with sustained progress in implementing on-going reforms and initiating new policy changes in required areas, Indonesia can be expected to reach a higher real growth path on a self-sustained basis.

Table 4.1: INDONESIA'S ECONOMIC STRUCTURE, 1981/82-1988/89
(Percent)

	1981/82	1985/86	1988/89
Oil/LNG to Total Exports /a	80.8	66.6	35.8
Non-Oil Exports to Non-Oil Imports /a	28.8	55.4	90.3
Oil/LNG Revenues to Total Revenues	70.7	57.5	41.3
Government Expenditure to GDP	22.1	22.6	20.1
Private Fixed Investment to Total Fixed Investment /b	52.1	47.9	56.9
Manufacturing to Non-Oil GDP /b	8.4	8.8	9.5

/a Goods only; in current dollars.
/b Calendar year basis; in 1983 prices.

Source: World Bank staff estimates.

4.06 The adjustment program also helped to sustain a better than expected rate of economic growth, despite the loss of oil income and tax revenues. As shown in Table 4.2, economic growth was reduced significantly over the adjustment period, but remained positive, even in per capita terms. The contribution of factors underlying rapid growth during the 1970s--rice, import-substituting manufacturing and large public investment --weakened in the adjustment phase. Nevertheless, given the severity of the external shocks, the ability to sustain a 3% per year growth rate of

the overall economy and a 4% growth of the non-oil economy while stabilizing the budget, the current account, and inflation is a notable performance. Furthermore, there are encouraging signs of economic recovery as indicated by the upward trend in the rate of growth of the non-oil economy since 1987, reaching 5.1% in 1988.

4.07 The recovery in the growth of non-oil manufacturing in 1987 and 1988 is an important aspect of the data in Table 4.2. During the 1970s, import-substituting manufacturing grew rapidly. Table 4.2 shows a growth rate of 14.1% per year for non-oil manufacturing in 1974-81. The slump during the adjustment period reduced the average growth for 1982-86 to 4%. But by 1988 the yearly growth rate in non-oil manufacturing was up to 9%, the fastest-growing sector once more. The encouraging aspect of this resurgence of growth in non-oil manufacturing is that now it is export-oriented. This is now the leading growth sector of the economy.

Table 4.2: OVERALL AND SECTORAL GDP PERFORMANCE, 1973-1988 /a
(Real Growth, Percent Per Annum)

	1973-81	1981-86	1987	1988
GDP	7.5	3.0	3.9	4.7
Non-Oil GDP	8.0	3.9	4.6	5.6
Agriculture	3.4	2.7	1.8	3.8
Manufacturing /b	14.1	4.0	7.1	9.0
Services, etc.	10.0	4.5	5.6	5.6
Memo Item:				
Per Capita GDP	5.2	0.8	1.9	2.7

/a CBS is currently reviewing its data and methodology for estimating GDP. This is expected to result in higher estimates of real growth rates for some sectors, especially in 1988.
/b Excludes LNG and oil refineries.

Source: Central Bureau of Statistics.

B. Impact on Expenditure

4.08 The lower growth of GDP in conjunction with the deterioration in the terms of trade had an adverse effect on national incomes during 1982-86, as is shown in Table 4.3. The reduction in revenues brought about substantial cutback in public investment. Private investment fell noticeably up to 1985 but has been recovering since then. The growth rate of

private consumption also declined significantly, although consumption grew faster than national income. Overall, the main adjustment came in the public sector, especially in public investment. As a result of expenditure restraints, especially the large reduction in budget-financed capital spending, the share of public expenditure (consumption and investment) fell from 22.4% of GDP in 1981 to 18.0% in 1988. In the private sector, the decline in investment growth in the first few years of the adjustment period was caused by higher real interest rates and lower aggregate demand. Since 1986, private investment has been recovering, responding to improved incentives resulting from regulatory reforms and a more buoyant level of economic activity.

Table 4.3: IMPACT OF ADJUSTMENT POLICIES ON NATIONAL EXPENDITURE (1973-1988)

	Real Growth Rate (% p.a.)				Composition of Expenditures (% of GDP) /a	
	1973-81	1981-88	1987	1988	1981	1988
National Income /b	11.4	1.8	4.7	4.8	97.9	88.6
Consumption	8.2	3.3	2.2	4.0	69.5	69.3
Public	10.1	2.2	-3.7	1.5	10.6	9.8
Private	7.8	3.4	3.3	4.4	58.9	59.5
Fixed Investment	11.7	-0.5	1.9	7.0	24.7	18.9
Public	11.0	-2.0	-1.7	6.3	11.8	8.2
Private	12.3	0.7	4.9	7.6	12.9	10.7
Memo Item:						
Per Capita National Income	9.1	-0.2	2.7	2.8		
Per Capita Private Consumption	5.5	1.4	1.3	2.4		

/a In 1983 prices.
/b Gross National Income corrected for terms-of-trade changes.

Source: Central Bureau of Statistics and World Bank staff estimates.

4.09 The sharp decline in the growth rate of investment over the 1981-88 period as a whole has reduced the pace of capital formation, thereby lowering the expansion of the economy's productive capacity. The adverse effect on output growth, however, has been partially offset by improvements in the efficiency of use of capital, brought about by improved allocation of resources resulting from interest rate deregulation, real exchange rate depreciation, regulatory reforms and reordering of public

expenditure priorities. Although there is still substantial scope for further efficiency gains, it will be difficult to sustain economic recovery over the medium term without a sustained expansion of private investment. Similarly, continued cutbacks in public infrastructure investment can have serious adverse effects on the profitability of private investment over the medium term by creating bottlenecks resulting from inadequate availability of essential services.

C. The Social Impact of Adjustment

4.10 The pace and pattern of real growth is a critical determinant of employment and earnings. Given the structure of Indonesia's labor markets, a slowdown in economic activity is largely manifested in a reduction in labor earnings rather than in employment levels.4/ However, in the urban formal sector, economic growth is a determinant also of the level of employment. Indeed, available evidence suggests that there has been an increase in the rate of open unemployment in the urban areas. Much of this unemployment is concentrated among upper-secondary school leavers. Because flexibility of urban educated job seekers is rather limited, a slowdown in demand, brought about by lower economic growth and budgetary resource constraints, has reduced the rate of their absorption in employment.

4.11 For the bulk of the work force (outside urban formal employment), the main adjustment burden has fallen on earnings. Thus, labor earnings have fallen in trade, and real wages of construction workers and civil servants have stagnated. In manufacturing, real wages have continued to grow, but at a slower pace than before the external shocks. Real wage rates in agriculture have also stagnated. On the whole, available evidence suggests a stagnation or even a decline in real labor earnings during the adjustment period.

4.12 As noted, the average inflation rate came down in the adjustment period, especially for non-traded goods. However, specific price indexes for low-income rural groups show higher inflation rates than the general indicators and the surge in rice prices during 1987-88 appears to have significantly hurt the poor. Thus, reflecting the higher rice prices, the cost of nine essential commodities [index] in 1988 grew by 13% for urban areas and by 17% for rural areas. These price increases were higher than the economy-wide indicators of inflation (9%-10% for the CPI and non-oil GDP deflator).

4/ Recent data show that more than half of all employment is in agriculture and over 70% in rural areas. Employment outside agriculture is concentrated on services, with manufacturing accounting for only 20% of non-agricultural employment. Outside government services, low and unstable earnings in informal sector activities predominate in urban areas. The considerable flexibility of rural and urban informal labor markets allows a rapid expansion of employment during periods of low economic growth, but at reduced real earnings.

4.13 Apart from economic growth, specific government expenditure programs can have a significant impact on the living standards of the population, especially of the poor. Important in this respect are expenditures on education, health, family planning, water supply and housing. Buoyed by growing oil revenues during the 1970s, the Government financed large expansion programs in many of these areas, especially in health, family planning, and education. The resource crunch that occurred in the wake of the external disturbances has severely limited the growth of these expenditures. The Government has responded by redefining priorities, aimed at protecting important social programs (INPRES) and improving the quality of services (emphasis on O&M). Nevertheless, there is some evidence that the availability and quality of many essential services may have weakened.5/

V. SUSTAINING PROGRAM BENEFITS

5.01 Responding to the sharp decline in its income, resulting from the fall in international oil prices in the early 1980s, Indonesia initiated a two-pronged effort to stabilize its economy and establish the conditions for longer term economic growth through structural adjustment. These efforts have resulted in considerable dividends for the economy. An unfinished agenda, however, still remains. The success with which Indonesia addresses this agenda will determine the degree to which the benefits of the adjustment can be sustained. The principal issues are: (a) investment promotion; (b) savings mobilization; (c) private sector development; and (d) export performance and debt management.

(a) Investment

5.02 The retrenchment in national expenditure that accompanied the economic stabilization program inevitably left its stamp on public expenditure, whose share fell from 22% of GDP in 1981 to 17% in 1988. Private investment also declined in the early years of the adjustment period, but has recovered somewhat since 1986. There is a need to increase the national investment rate from the present 18% of GDP, in order to promote higher levels of growth and provide much needed infrastructure in the areas of power, transportation, and telecommunications; these investments should facilitate private investment in the non-oil sector, which will constitute the mainstream of growth in the future. The adjustment process also affected investments in social development, e.g. health and education. Efforts to redress this, and especially to increase the absorption of additions to the work force, will necessitate an increase in investment.

5/ Some partial indicators reported in the Bank's sector work include: the relative neglect of the KIP programs; the inability to achieve the piped water supply targets; the reduced quality of health services; low quality of schooling; and resource cutbacks in family planning and nutrition programs.

(b) Savings Mobilization

5.03 The promotion of an enhanced volume of investment in a non-inflationary environment and avoidance of an increase in external debt, would require a corresponding increase in savings effort. Table 5.1 reveals that there has been a steady decline in national savings and the resulting savings investment gap has been consistently financed by foreign savings. A low savings/investment ratio could exercise a binding constraint on future economic growth. The current burden of debt service also suggests that the growth in savings will need to exceed the growth in GDP for several years. Fortunately for Indonesia, there are several avenues for improving its savings effort.

5.04 Despite improvements in the efficiency of tax administration and the introduction of the VAT, there is considerable scope for improving Indonesia's tax effort, which lags considerably behind that of its comparators in the ASEAN region. Private savings have responded to the improvement in real interest rates recently, but further efforts may be needed to improve the efficiency of the financial intermediation process. Further improvements in the process of savings mobilization are also possible through an improvement in the financial performance of public enterprises.

(c) Incentives for Private Sector Development

5.05 The reforms associated with the structural adjustment process have led to a sharp improvement in the growth of non-oil GDP, resulting in a rapid increase in its share of exports. The core policy instrument in this strategy has been the maintenance of a competitive real effective exchange rate combined with reforms in the trade regime, which removed the anti-export bias. These measures were reinforced by considerable progress in liberalizing the regulatory framework governing foreign and domestic private investment, production capacity, and exports. While much has been done to improve the environment for facilitating production, further deregulation measures, supported by policies to simplify and codify the laws relating to corporate and commercial activities, need to be addressed.

5.06 The interest rate strategy pursued by GOI also has an important role to play in a strategy for promoting private sector investment. The economic stabilization measures that were implemented led to high real interest rates. While this has led to an incentive for savers, it has acted as a disincentive for investors. One aspect of this problem derives from the large differential between deposit and lending rates in the banking system. While the spread has fallen from the very high levels of earlier years, continued attention to this facet is necessary if private investment is to be promoted. The high domestic interest rates are also a reciprocal of the external current account deficit. Given Indonesia's open capital markets, the financing of this deficit necessitates an interest rate that is high enough to compensate for expected exchange depreciation and inflation.

Table 5.1: SAVING-INVESTMENT BALANCES, 1981-1988 /a
(Percent of GDP at Current Prices)

	1981	1982	1983	1984	1985	1986	1987	1988
Total Domestic Investment	29.7	29.1	27.7	25.5	24.3	23.4	23.2	22.2
Fixed Investment	24.2	25.9	25.7	22.5	20.8	20.5	19.9	20.3
Change in Stocks	5.5	3.3	1.9	3.0	3.5	2.9	3.3	1.9
National Savings	27.8	22.6	21.4	22.0	22.0	17.6	20.0	19.8
Saving-Investment Gap	- 1.9	- 6.5	- 6.3	- 3.5	- 2.3	- 5.5	- 3.2	- 2.4
Foreign Savings /b	1.9	6.5	6.3	3.5	2.3	5.5	3.2	2.4
Public Sector								
Gross Domestic Investment /c	10.7	12.7	12.6	10.3	10.9	9.7	9.3	9.1
Savings	9.2	8.2	9.4	10.2	8.3	4.9	5.7	6.0
Saving-Investment Gap	- 1.5	- 4.5	- 3.2	- 0.1	- 2.6	- 4.8	- 3.6	- 3.1
Private Sector								
Gross Domestic Investment	19.0	16.4	15.1	15.2	13.4	13.7	13.9	13.1
Fixed Investment	13.5	13.2	13.2	12.2	9.9	10.8	10.6	11.2
Change in Stocks	5.5	3.3	1.9	3.0	3.5	2.9	3.3	1.9
Savings	18.6	14.4	12.0	11.8	13.7	13.0	14.3	13.8
Saving-Investment Gap	- 0.4	- 2.0	- 3.1	- 3.4	0.3	- 0.7	0.4	0.7

/a All data converted to calendar year basis.
/b Current account deficit.
/c Fixed investment only. Investment in stock changes is assumed to be financed by the private sector.

Source: Central Bureau of Statistics and World Bank staff estimates.

(d) External Trade and Debt

5.07 There are several elements in the international economic environment that have a bearing on Indonesia's efforts to promote growth with financial stability (see Table 5.2). Foremost is the growth in the world economy, because the transmission effects via Indonesia's terms of trade can make a significant difference. OECD growth prospects are crucial to the success of this effort but equally, concerted efforts are needed to reduce or eliminate trade barriers on Indonesian exports of manufactures. In the absence of such liberalization, the growth in Indonesia's non-oil exports could well slow down over the next decade.

5.08 A large portion of Indonesia's foreign debt is denominated in currencies that have appreciated in terms of the United States dollar. Dollar depreciation has exacerbated Indonesia's debt service payments in

recent years. Unless there is a significant rise in export earnings, this too could exercise a binding constraint on future growth, unless compensated for by a rise in net resource transfers to Indonesia on concessionary terms. Indonesia's strategy of prepaying some of its external debt is one way of offsetting the adverse consequences of dollar depreciation on its external debt service. In the past, it seems that Indonesia has lost when the U.S. dollar depreciated, because the denomination of the debt was skewed away from the U.S. dollar relative to the denomination of export receipts. If this has been the case, Bank Indonesia should avail itself of IMF facilities for diversifying its debt denomination to optimal portfolio proportions.

Table 5.2: SELECTED INDICATORS OF INTERNATIONAL ECONOMIC ACTIVITY, 1988-2000

	Estimated	Projected				Growth Rate(% p.a.)		
	1988	1989	1990	1995	2000	1988-1990	1990-1995	1995 2000
Economic Activity								
OECD Growth (% p.a.)	4.0	2.0	2.3	3.0	3.0	2.2	3.0	3.0
Price Indices (1985=100)								
Commodity Prices in Constant Dollars /b	84.0	78.7	77.1	81.8	81.2	-4.6	1.2	-0.1
Manufacturing Unit Values in Current Dollars	140.7	149.5	151.7	183.0	226.6	3.8	3.8	4.4
Oil Prices (US$/barrel)								
In 1985 Dollars /c	10.7	10.4	10.9	12.0	13.4	1.0	1.9	2.2
In Current Dollars	15.0	15.5	16.6	22.0	30.4	7.0	5.8	6.7
Interest Rates (%)								
LIBOR /d	8.0	8.5	8.4	6.9	6.7			
Real Interest Rate /c	4.2	3.1	2.8	2.4	1.7			

/a End of period.
/b Nominal price index for 33 commodities (excluding energy), deflated by the World Bank's manufacturing unit value (MUV) index.
/c Deflated by MUV index.
/d Six-month London Interbank Offered Rate.
/e LIBOR deflated by the change in the US GNP deflator.

Source: World Bank staff estimated.

VI. ROLE OF THE BANK

6.01 The Bank's strategy for promoting the trade adjustment policy reforms departed from its conventional pattern in that rather than making the loan conditional on the implementation of agreed policy reforms and tranching disbursements to accord with performance, it designed the loans as a supporting mechanism for actions that were taken within an agreed framework of a medium-term adjustment program. This strategy has apparently succeeded very well. There were two reasons for this. First, the Indonesian authorities had been exposed to a range of in-depth and high quality economic and sector work conducted by the Bank for almost a decade. The assistance of the Resident Mission, which was well staffed and complemented by economists from headquarters, enabled the Bank to participate in an active policy dialogue and to render whatever help was needed in addressing day-to-day problems in economic management. Second, the onset of the economic crisis precipitated by the fall in the price of oil in the early eighties, and subsequently in 1986, offered the administration an opportunity to implement adjustment measures which were long overdue. The Bank was positioned to capture this very effectively.

(a) Economic and Sector Work

6.02 Beginning in early 1980 and subsequently in 1985, the Bank completed studies of Trade and Industrial policy issues. They set the tone for key reforms relating to deregulation and trade. These were followed up by technical assistance to the Government's Trade and Industrial Policy Steering Committee and the mounting of a study of the Financial Sector. In conducting its policy dialogue on macroeconomic issues, the Bank focussed intensively on five areas:

(i) exchange rate management
(ii) fiscal and monetary policy
(iii) resource mobilization and tax administration
(iv) public expenditure priorities, and
(v) external debt management.

These were highly pertinent to the adjustment effort. The appraisal and supervision of the two Trade Policy Adjustment loans facilitated this dialogue.

(b) Coordinating the Assistance Strategy

6.03 The two Trade Policy Adjustment Loans played a catalytic role in mobilizing donor support within the umbrella of the IGGI, for Indonesia's adjustment effort. A significant part of the loans were on concessional terms and this enabled GOI to address the twin problems of debt management resulting from the depreciation of the U.S. dollar, and rising international interest rates. The combined effect of early prepayment of commercial debt facilitated by concessional loans--and the improved fiscal effort put Indonesia into a position where it could cope with the servicing of its external debt over the coming years, without seriously jeopardizing its development effort.

(c) Cooperation with the IMF

6.04 A close and continuous dialogue evolved with the IMF throughout the adjustment program. IMF staff reviewed reports associated with TPAL I and TPAL II and supported the loans. IMF representatives were also invited to Board presentations of the loans. The most recent IMF Consultation Report was released on April 15, 1988. Indonesia has no standby arrangement or extended arrangement with the IMF. Indonesia's last purchase from the IMF amounted to SDR 463 million in May 1987 under the Compensatory Financing Facility. This purchase increased Indonesia's total outstanding IMF obligations to SDR 505 million at the end of 1987. After the last Consultation Report, the IMF Executive Board expressed its satisfaction that Indonesia's exchange system remained free of restrictions on payments and transfers for current international transactions. Indonesia accepted Article VIII status in the Fund, with effect from May 7, 1988.

(d) Conditionality

6.05 No ex ante conditionality was attached to TPAL I and TPAL II. When the Bank and the country are in an on-going cooperative relationship, there appears to be little need for specific conditionality. The country knows that if it deviates from the policy course that it and the Bank have agreed on, even implicitly, it may have to forego Bank assistance in the future. So the Bank can rely on the country's interest in maintaining "good standing" with the Bank. In this situation, the Bank can lend, conditional on past events, as predictors of the future course of policy.

(e) Loan Administration and Coordination

6.06 Procurement and disbursement procedures of TPAl I and II were designed to ensure rapid drawdown of loan proceeds. The loans were used to reimburse 100% of foreign expenditures for eligible imports by the public or private sector for which payments were made after the date of loan signing. There was no retroactive financing under the loans. The loans specified a standard list of ineligible imports, i.e., goods intended for military and paramilitary purposes, or for luxury consumption; goods financed from other official multilateral or bilateral sources; uranium; and goods procured under contracts of less than US$100,000. Bank Indonesia was responsible for maintaining and administering the loan account.

6.07 All purchases in the amount of US$5 million equivalent or more were to be procured through International Competitive Bidding (ICB) in accordance with Bank guidelines. Procurement by the private or public sector of goods contracted at a price less than US$5 million equivalent were handled on the basis of normal commercial practice or following normal Government procurement procedures acceptable to the Bank. Disbursements of eligible import expenditures were based on Statements of Expenditures (SOEs) for imports valued at less that US$5 million; for imports above this amount full documentation was required. Since all contracts submitted to the Bank by the Borrower were below US$5 million, no ICB was involved in procurement, and the loans' were disbursed on the basis of SOE procedures.

6.08 Disbursements under TPAL I were made in April (US$140 million equivalent) and June 1987 (US$160 equivalent). Disbursements under TPAL II were completed by November 1988. As shown in Table 6.1, TPAL II has been largely used to finance private sector imports of industrial raw materials. The counterpart funds generated by imports financed under the loans were credited to a special account in Bank Indonesia and were used to finance priority public expenditure programs associated with GOI's budgets.

Table 6.1: IMPORTS FINANCED BY TPALS I AND II
(US$ millions)

Product Groups	Source					
	USA	Europe	Japan	Asia /a	Other Countries	Total
Industrial raw materials	52.2	28.9	91.3	95.8	51.0	391.1
Agricultural inputs and equipment	1.5	0.6	0.2	1.7	0.4	4.5
Construction materials and equipment	3.8	0.1	26.6	9.6	1.5	41.6
Mechanical machinery and equipment	4.2	9.6	18.6	9.1	0.2	41.8
Electrical machinery and equipment	1.1	1.4	9.4	1.4	2.1	15.4
Transport machinery and equipment	0.5	1.0	97.0	0.9	9.0	108.3
Miscellaneous	7.4	9.3	11.1	14.7	16.8	69.3
Total	70.7	50.9	254.2	143.2	81.0	600.0

/a Includes goods transshipped through Singapore.

Source: World Bank.

VII. PRINCIPAL CONCLUSIONS AND RECOMMENDATIONS

(a) Strategy Issues

7.01 The merit in devising and consistently adhering to a policy and issue oriented framework of economic and sector work over time, irrespective of the state of the country policy dialogue, emerged as a major conclusion from the evaluation. In the case of Indonesia, this work was carried out over a decade or more, despite past unwillingness on the part of the administration to participate in a meaningful dialogue to liberalize the trade regime and the regulatory system. The collapse of oil prices prompted the government to reappraise its development strategy. The exposure of the administration to previous economic and sector work conducted by the Bank, contributed significantly towards facilitating GOI's design of the adjustment strategy. Once the decision to adjust was made voluntarily, it was comprehensive and the Bank was able to complement it with its technical and financial resources.

7.02 The second conclusion which emerges from the evaluation is that structural adjustment works better in a stable financial environment. This means that economic stabilization precedes structural adjustment. In Indonesia's case, the process of economic stabilization commenced two to three years prior to the initiation of the trade policy adjustment program. The rupiah was devalued in March 1983 and the exchange rate made more flexible. This was followed by a major financial reform starting in June 1983 involving removal of interest rate and credit ceilings for state bank operations, followed by a tax reform in early 1984. Consequently, steady improvements occurred with respect to reduction of inflation, the central government budget deficit and the current account of the balance of payments. Indonesia was, therefore, well positioned to commence its structural adjustment when it was formally initiated in 1986.

7.03 The third conclusion is that structural reform is easier to implement and works smoothly when the international economic environment is favorable to the country that is adjusting. In Indonesia's case, OECD growth rates were high in 1987 and 1988 and this facilitated exports. Indonesia competes with Thailand and Taiwan (China) in international markets. The overheating of the Thai economy and the currency appreciation in Taiwan benefitted Indonesian exports. In the absence of these factors, Indonesia would have had to take even more stringent expenditure reducing and exchange rate policies to achieve the same level of export performance that it did.

7.04 The fourth conclusion is that the short-run focus of expenditure adjustment on investment may be a good policy choice, for several reasons.

(1) It spreads the cost of the program into future generations, who will benefit from it.

(2) In a period of rapid and uncertain policy change, an investment pause is natural, or investors wait until the new policy direction is clear. It also provides an opportunity to weed out unprofitable investment programs.

(3) The point of the program is to make the economy more efficient, or to lift it to a higher growth path. So a pause in investment can be afforded.

(4) Finally, support of consumption during the program may increase its political acceptability.

Thus, while growth in investment after the initial phase of the program is necessary for its ultimate success, an initial pause, to support consumption, may be optimal.

7.05 Finally, the adjustment process needs to be accompanied by positive net international resource transfers (Box 3), because they help to ease the shocks imposed by adjustment in the period of high debt service. Indonesia is saddled with a high debt/GDP ratio as well as debt service.

The depreciation of the U.S. dollar compounded Indonesia's debt service burden, since a significant portion of its external debt is denominated in non-dollar currencies. Depreciation of the U.S. dollar after 1985 added US$7.4 billion (23%) to Indonesia's public debt at end-1988 and US$1.2 billion (20%) to its debt servicing during 1988. High international interest rates worsened the transfer problem for Indonesia. This adverse development was, however, more than compensated by timely and substantial concessionary resource transfers. Indonesia was able to use this assistance to prepay much of its commercial debt. Consequently the debt profile in the next decade is projected to be within manageable dimensions, since the ratios of DOD to GNP and exports have been steadily falling since 1987; these trends are expected to continue throughout the 1990s.

(b) Macroeconomic Issues

7.06 First, interest rates have a central role to play given Indonesia's open capital market. In this case, the non-aid current account deficit is equilibrated by capital movements responding to interest rate differentials. The domestic interest rate is, therefore, determined to some extent by the prevailing international interest rate, the domestic and international inflationary differential and the risk premium associated with deposits held in rupiah. Hence the only way to lower the domestic interest rate is to reduce the external current account deficit. One way to achieve this is to increase domestic savings; ideally domestic savings would need to grow faster than GDP if the external current account deficit is to be removed.

7.07 Second, periods of financial austerity associated with an economic stabilization/adjustment program should not be protracted. The Indonesian program commenced in 1983 and intensified in 1986. Many worthwhile capital investments have been postponed or curtailed. Deficits in power, transportation, and telecommunications could become a binding constraint on public and private sector development and export growth. Sizeable deficits have also emerged in the social sectors, with a need to increase expenditure in health and education. While it is right to expect the export sector to generate the required savings for investment in the future capital stock, there is scope for increasing savings through an improvement in tax effort, better financial performance of state economic enterprises, and enhanced private savings.

7.08 Third, adjustment programs need to be cognizant of the income effects of reduced expenditure policies. Indonesia's adjustment program has necessitated a curtailment in capital expenditure (principally in the public sector) and this may have reduced labor absorption. The evidence is that the adjustment was facilitated by declining real wages in the formal sector and reduced earnings in the informal sector. A reversal of these trends can occur if improvements in the policy environment are matched by an increase in national investment beyond the 20% of GDP now recorded. This would require careful choice of projects, appropriate technology, technical training, and revitalization of domestic financial markets. Improvements in the regulatory system and the financial sector will continue to require priority attention.

(c) Trade Policy Issues

First, it is appropriate to sequence the process of trade liberalization by replacing Non-Tariff Barriers (NTBs) with tariffs prior to reducing protection. This approach helps to moderate the shocks from a sudden reduction of trade protection, while providing industrialists with time to make necessary adjustments. It also furnishes the Government with revenue which could be used to promote industrial restructuring.

Second, tariffs and import surcharges serve as substitutes for NTBs. Hence, they must be seen as a transition to a stage in which levels of import protection will be determined on optimal criteria. The proposed study of the Country Department on Trade Policy Reform is to be welcomed.

Third, the desirability of a system of export controls, especially export bans, needs to be examined. Export bans and other forms of restraint on exports confer rents on those who obtain licenses, or those who can circumvent them. They, therefore, create vested interests which may be difficult to dislodge.

Fourth, investment licensing arrangements constitute another form of protective device. Their dismantlement would represent a major step forward in promoting neutrality in the trade regime.

Fifth, the policy-making apparatus for trade protection should be formalized and backstopped by a working Secretariat that is properly equipped and insulated from political interests. The objective should be to make the decision-making process on policy and administration as simple and transparent as possible.

Sixth, the legal framework for commerce and banking, as it now exists, acts as a constraint on modernization of the economy. It needs to be made transparent and simplified.

(d) Sustainability and Implementation

7.09 Sustainability of the progress achieved so far in the field of trade and investment will depend on attention to four major areas:

First, there is a need to increase opportunities for gainful employment. This can only occur in an environment that is relatively free of regimentation and one that promotes investment. While concessionary capital flows have partially compensated for the decline in oil revenues, they cannot be a permanent device to sustain consumption and investment. Greater efforts are needed to expand domestic savings. This may require changes in fiscal strategies, interest rate policies, and financial intermediation processes.

Second, further steps are needed to rationalize the tariff system and reduce tariff variance. Such a process would sensitize domestic producers to efficiency criteria. These actions need to be complemented by measures that strengthen the transparency of the trade regime.

Third, the regulatory system governing investment has to be further simplified by the introduction of a short negative list.

Fourth, a formal administrative framework needs to be established for the evaluation of the tariff system and for monitoring impact and providing appropriate feedback to the decision-making agencies.

Overall Assessment

7.10 Indonesia's economic adjustment program, which began in the mid-1980s, was a response to the economic crisis, which had its genesis in a sharp decline in oil prices and an adverse movement in its terms of trade. Its twin objectives were (a) macroeconomic stabilization and (b) improvements in resource allocative efficiency. The policies and measures for attaining economic stability necessitated reductions in government expenditure, monetary restraint, high interest rates, improved fiscal effort, removal of pricing policy distortions, and exchange rate competitiveness. The economy's structural disequilibria were addressed by policies to liberalize foreign trade and dismantle the complex regulatory environment.

7.11 This shift in economic strategy yielded considerable dividends. Inflation slowed down, budgetary and external current account deficits were reduced, and foreign exchange reserves strengthened. The debt service ratio, however, still remains at a high level, but prudent external debt management has led to improvements in the ratio of outstanding debt to GDP.

7.12 Important structural changes have occurred. A striking feature is the rapid increase in the growth of the non-oil economy and an outstanding non-oil export performance. The manufacturing sector has been the fastest growing sector, in terms of it contribution to GDP as well as to exports. This increase stemmed from important trade liberalization measures, which reduced the anti-export bias in the system, and depreciation of the real effective exchange rate. The export base has been diversified in ways that could not have been contemplated a few years back.

7.13 While these measures deserve to be commended, problems still remain. The deregulation process, which has begun to get under way, requires rationalization of the tariff structure. The investment licensing system needs to be further simplified and put on the basis of a short negative list. While the first steps in trade and investment liberalization have been relatively easy to undertake, the second stage of this process may be more difficult to undertake. This stage also has to be underpinned by appropriate macroeconomic policies which promote financial stability and allocative efficiency. Policies toward this end would give high priority to an improvement in the operating efficiency of Indonesia's State Economic Enterprises (SEEs).

7.14 Deficits in areas essential to the quality of life may have to be addressed. Bottlenecks in economic infrastructure are assuming proportions which may act as a major constraint on future growth. Action on all these fronts will require careful preparation, regular monitoring, and further Bank support.

7.15 To sum up: the program of adjustment that was initiated by the Indonesian Government in 1983 and intensified in conjunction with TPALs I and II yielded good initial results. The Bank's program of economic and sector work and complementary project support have been major components in this process. Bank support during the adjustment process has been appropriate, timely, and well sequenced. Its policy dialogue has been close and meaningful. The well staffed Resident Mission has, over a period of two decades, made a major contribution toward forging a spirit of mutual respect and trust in the relationship, which warrants further financial support with ex post conditionality.

MINISTER COORDINATOR FOR THE ECONOMY, FINANCE,
INDUSTRY AND DEVELOPMENT SUPERVISION
REPUBLIC OF INDONESIA

Jakarta, December 19, 1986

No : SR-42/M.EKUIN/1986

Mr. Barber Conable
President
The World Bank
1818 H St., N.W.
Washington, D.C. 20433
U. S. A.

Dear Mr. President:

Government's Statement on Economic and Trade Policy

The Government of Indonesia wishes to request a loan from the World Bank in support of a program of economic adjustment, especially in the area of trade policy. This letter provides a description of the current situation, the actions which the Government has taken and the direction of future actions.

Macro-Economic Background

1. Indonesia has faced many challenges in the economic sector mainly caused by the start of a considerable oil price decline and the world economic recession. In order to cope with the tough situation, the Government in 1983 started to take various actions that were of a short-term nature as well as those that had a long-term scope, beginning with the rephasing of large projects, devaluation, overall and fundamental revision of the taxation system, reductions in subsidies and deregulation of the banking sector. For the purpose of increasing non-oil export, INPRES (Presidential Instruction) No. 4 of 1985 was issued with the objective of overcoming the "high cost economy" problem, particularly in the customs, port operation and sea transportation sectors.

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2. In 1986, the sharp drop in the international price of oil caused severe deterioration in Indonesia's balance of payments and the Government's budget. The Government has taken a series of measures to deal with the situation as it unfolded. Anticipating weakness in the oil market, the Government introduced an austere budget, incorporating sharp cutbacks (24%) in development expenditures. With the exception of some foreign aided projects, there were no new investments started with government funding in this fiscal year. Monetary policy was also tightened, leading to a considerable slowing down of credit expansion. As oil prices continued to slip in mid-year and as it became clear that even in the medium term the oil price would remain far below the levels prevailing in 1985, the Government decided to devalue the Indonesian Rupiah by 31 percent. This substantial devaluation prevented the loss of foreign exchange reserves through speculation and should be a powerful means of stabilizing the balance of payments and improving the conditions for an early recovery in economic activity and incomes.

3. With continued prudence in fiscal and monetary policies, the Government expects to halt the deterioration in the balance of payments. Rapid adjustment of the balance of payments is essential because the burden of external debt, despite recent constraints on public borrowing, is high in relation to the now reduced levels of export earnings. While the total debt service ratio was 26% in 1985/86, it is now estimated at about 37% in 1986/87. While the current account deficit will unavoidably widen to about $ 4.1 billion in 1986/87, an important objective of macro-economic management would be to reduce the annual current account deficit to a level below $ 2 billion within the next two years.

4. The key to improvement in the balance of payments is accelerated growth of non-oil exports. The Government is heartened by their growth

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in recent years, from $ 3.9 billion in 1982/83 to $ 6.2 billion last year. No doubt, the recent devaluation will give an added boost to non-oil exports, encouraging the utilization of available excess capacity in the short run and enhancing opportunities for profitable export-oriented investments in the medium term. Recognizing the vital importance of encouraging non-oil exports, the Government introduced in May 1986 a special package of measures designed to ensure that exporters are able to buy their inputs at internationally competitive prices. One element of this scheme is the import duty exemption/drawback available to exporters. Another important facility provided by this scheme is that major exporters can import their inputs directly as needed, completely bypassing the prevailing non-tariff restraints to imports. Our experience in the last several months indicates that the May 6 scheme is being implemented smoothly and efficiently, providing tangible support to exporters.

5. The Government is fully aware that providing special exemptions to exporters is only an interim stage in completing the necessary reforms in the underlying trade regulation themselves. Sustained growth in non-oil exports in a highly competitive international market, with the ever-present threat of protectionism in the industrial countries, requires that Indonesian manufacturing enterprises operate at much higher levels of efficiency. Achieving this goal will require changes in the structure of incentives to redress their current bias against exports. The present system of protection is contributing to the high costs in the Indonesian economy and it is the intention of the Government to rationalize this system as speedily as possible.

Principles of Trade Policy

6. The policy of rationalization of protection is aimed at the following objectives :

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- establishing a protection structure based mainly on tariffs rather than import licenses and thus permitting more precise measurement of the actual degree of protection granted to Indonesian producers;
- reducing the current bias in incentives against export activities and in favour of import substitution; and
- limiting the level of protection, with special provision for infant industries which would enjoy higher levels of protection for specified time periods.

7. The decision to move away from non-tariff barriers and rely on tariffs is based on several considerations. First, tariffs provide a more transparent form of protection, which automatically prevents domestic suppliers from increasing prices above world prices by more than the tariff rate. Second, tariffs are simpler to administer; non-tariff barriers create the potential for abuse and can lead to protracted negotiations amongst the parties concerned. Third, tariffs are easier to adjust so as to rationalize the structure of protection. Finally, tariffs will contribute to the Government's budgetary revenues and help support priority development programs.

Recent Trade Measures and Future Directions

8. During the early 1980s, restrictive importer arrangements were imposed on a range of products. By 1985, about one quarter of imports were subject to licensing restrictions. Of these, very few were actually subject to formal quotas. There have been no new import restrictions introduced since March 1986 and the measures of October 25 signify the beginning of the trend in the opposite direction.

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9. Under the October 25 measures, the Government revoked 6 decrees restricting import licensing for 317 items. Most importantly, approved importer restrictions were abolished for 165 items, including tires, glass, paper and some engineering goods. Another 55 items, including chemicals and knocked-down equipment, can now be imported without restraint by any producer in the amounts required as inputs in his production process. For 50 items, primarily transport machinery, selected overseas suppliers will be allowed to appoint licensed agents approved by the Ministry of Industry, for the purpose of standardizing the product types and ensuring satisfactory after sales services. There will be no other restriction placed on these agents by the Government. The remaining 47 items will continue to be imported by approved traders and producers of the items only.

10. For 154 of the items where import licensing restrictions were removed or relaxed, tariffs were increased to protect the balance of payments and provide transitional protection to domestic producers. However, with only 3 exceptions, the new tariffs are within the tariff ceiling of 60%. Tariffs on another 152 items not produced domestically were reduced, mostly to 0-5%. To protect domestic producers against predatory dumping, import surcharges may be introduced on specified items. However, the Government will only do this on a highly selective and temporary basis, and only after balancing producer and consumer interests.

11. The recent package of measures has still left import restrictions in place on some important product groups such as agricultural output, steel, plastics, etc. These areas are currently being scrutinized with a view to achieving further progress in rationalising the system of protection as rapidly as possible. It is the Government's objective to

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eliminate gradually all non-tariff restrictions on imports except on a small group of products that are harmful to health, strategic to national defense or involve special economic and social considerations. We expect to make further tangible progress in this direction within the next year.

12. The process of moving from non-tariff barriers to a tariff based system of protection has involved some increases in tariff levels. The Government has accepted this as an interim measure in order to gain wider acceptance of the removal of import restrictions. In the medium term, however, it will be necessary to rationalize the structure of tariffs in order to make the industrial sector more efficient, rationalize the excessive level of protection and increase export capacity

13. The process of rationalizing tariffs will start with an early review of imports that currently attract tariffs above the national maximum rate of 60% establised in the 1985 tariff reform, followed by a phased reduction in the maximum nominal tariff rate over the next couple of years. The Government intends to prepare a systematic medium term plan for tariff reform. For this purpose, it will establish appropriate organization and processes to monitor regularly the levels and dispersion of tariff rates, both nominal and effective, with a view to reducing the differential between maximum and minimum rates.

Investment Licensing and Public Enterprises

14. The purpose of the progressive r tionalization the level and system of protection is to expose Indones..'s industry to increased competition from abroad. This will induce it to make the structural adjustments necessary to improve the efficient utilization of existing resources and foster the creation of a productive system capable of competing with foreign goods on a firm footing. The Government

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recognizes that realizing the full potential impact of these improvements would also require relaxation of restrictive licensing arrangements on private investment and domestic trade. Important steps in this direction for foreign investors have already been taken in the May 6 and October 25 packages. Restrictions on domestic investment and trade will be thoroughly studied during the next year. The objective would be to initiate extensive deregulation in this area based on the findings of the study. Greater freedom from licensing procedures would unleash entrepreneurial talent and mobilize more financial resources for investment.

15. The unsatisfactory financial and operating performance of public enterprises has imposed additional strain on the Government budget and, even more importantly, has inhibited progress towards enhancing the efficiency of economic activity in Indonesia. The Government has initiated a program to review the performance of selected public enterprises and to identify appropriate areas for reform, including changes in the system of government supervision and control, as well as in the management and financial structure of individual public enterprises. During the next year Government expects to complete the consolidation of public enterprise accounts, develop an appropriate classification for public enterprises, and prepare a plan for sector restructuring through rehabilitation, merger or divestiture.

Macro Policy Framework.

16. A stable macro-economic environment is important in promoting an outward oriented industrial structure and enhancing productive efficiency. As noted earlier, regaining stability in the balance of payments in the face of lower oil prices is an important objective of the Government.

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Ever since the first signs of weakening in the oil markets, the Government has imposed strict limits on external borrowing and austerity in its own budget operations. These policies have helped to restrain inflation to low levels, but have also led to a dramatic slowdown in economic growth. It is hoped that the ongoing reform of industrial and trade policies will provide the incentives to tap new sources of growth and lead gradually to a recovery in economic activity and incomes. At the same time, continued budgetary and monetary restraint is vital in maintaining macro economic stability and achieving the required adjustment to lower levels of oil revenues.

17. In view of the continued uncertainty regarding the price of oil, it is necessary to continue an austere budget for 1987/88. The Government is taking steps to mobilize greater domestic revenues and intends to restrain budgetted expenditures to the same level in real terms as in the current year. In allocating development expenditures, the highest priority will be given to providing satisfactorily expenditures for operation and maintenance so that greater output can be obtained from available capital stock, especially in infrastructure facilities. Ongoing projects will be reviewed and only those projects that promise satisfactory economic returns will be funded. This will imply that several projects, including some with foreign aid, may have to be cut back. New projects will be undertaken provided they have very high economic benefits and only where foreign assistance is available on suitable terms. An important consideration will be the capacity of the project implementing units to execute the project at the required pace.

18. The Government maintains its strong commitment to the present foreign exchange system. Exchange rate policy will continue to emphasize the objective

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of maintaining international competitiveness of the Indonesian economy, taking account of price and exchange rate movements in trading partners and competitor countries. An austere budget will assist in restraining the growth of money and credit to levels consistent with the growth of real incomes. While some price increases are inevitable in the aftermath of the last devaluation, the Government aims to reduce the inflation rate to below 7 percent per annum by 1988.

19. As in the past, the Government will act promptly to make the requisite policy adjustments if a fundamental macro-economic disequilibrium emerges.

Yours sincerely,

Ali Wardhana
Minister Coordinator for the
Economy, Finance and Industry

MINISTER COORDINATOR FOR THE ECONOMY, FINANCE,
INDUSTRY AND DEVELOPMENT SUPERVISION
REPUBLIC OF INDONESIA

Jakarta, February 29, 1988

No. : SR-14/M.EKUIN/1988

Mr. Barber Conable
President
The World Bank
1818 H St., N.W.
Washington, D.C. 20433
U. S. A.

Dear Mr. President:

Government's Statement on Economic and Trade Policy

1. The Government of Indonesia wishes to request a second loan from the World Bank in support of a program of economic adjustment, especially in the area of trade policy. This letter provides a description of the current situation, the measures which the Government has taken and the direction of future policy actions.

Progress on Economic Adjustment

2. In my last letter to you, dated December 19, 1986, I described the impact of the sharp drop in oil prices on Indonesia's balance of payments and the Government's Budget during 1986, and the actions that the Government had taken in response. Of particular importance were the austere Budget implemented during 1986/87, the 31% devaluation of the Rupiah in September 1986 and the package of trade reforms initiated in October 1986. The Government has continued and extended its economic adjustment program during 1987. Another austere Budget has been implemented during 1987/88, with no increase in civil service salaries and further reductions in real development spending. With the exception of some foreign-aided projects, there were no major new investments started with government funding in this fiscal year. Monetary policy was also tightened, leading to a slowdown of liquidity expansion and reversing speculative pressures against the Rupiah in mid-1987.

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The Government's prudent fiscal and monetary policies have helped to contain domestic inflation below 9% and preserve the competitive advantage provided by the 1986 devaluation.

3. The Government has also maintained the momentum of deregulation in trade policy and industrial licensing during the past year. These measures, together with the competitive exchange rate, have supported a very encouraging expansion of non-oil exports. Non-oil export earnings are now projected to exceed US$ 9 billion in 1987/88, one third higher than last year. Because of this strong performance, we expect to achieve our target of reducing the current account deficit from over US$ 4 billion in 1986/87 to less than US$ 2 billion in 1988/89. During the transition period, Indonesia has been greatly assisted in financing its balance of payments by concessional program aid and local-cost financing from the IGGI. Because of the Government's prudent debt management strategy, and the improved export performance, the debt service ratio is expected to stabilize around 37% this year. The deregulation drive has also provided a needed boost to economic activity: GDP growth has been sustained at around 3% p.a. and private investment (domestic and foreign) has recovered strongly from the low 1986 levels.

4. With the restoration of external and domestic balance, it is essential to revive growth of the non-oil economy to about 5% p.a., in order to absorb the growing labor force at adequate levels of productivity and incomes. The adjustment measures taken by the Government, including the ongoing program of trade and industrial policy reforms, are considered to be an important prerequisite for economic recovery. The adjustment process must, therefore, continue. The continued expansion of non-oil exports is a key element of this strategy, for their direct contribution to production and employment, as well as their role in reducing the burden of external debt and improving Indonesia's creditworthiness in world financial markets. In the

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meantime, continued support from the international community will be required to finance the import requirements related to the export drive and restructuring of the industrial sector. The proposed loan from the World Bank would provide such financing during the coming year, while also showing support for the Government's growth-oriented adjustment program. As such, it can give an important signal to other donors to extend appropriate assistance in continued support of the adjustment process.

5. The Government's strategy of growth with adjustment will require further structural reforms in three key areas: trade policy, industrial regulation and the financial sector. The broad directions of the Government's policies in these areas, as well as supporting policies to maintain a stable macroeconomic environment, are set out below.

Trade Policy Reforms

6. The Government remains strongly committed to the objectives of trade policy as set out in my December 1986 letter, namely:

- establishing a protection structure based on tariffs rather than import licenses, thereby providing a more uniform and transparent level of protection to Indonesian producers;
- reducing the past bias in incentives against export activities and in favour of import substitution; and
- limiting the level of protection, with special provision for infant industries which would enjoy higher levels of protection for specified time periods.

To achieve these objectives, the Government has put into place a well functioning mechanism that allows exporters to have easy access to inputs at internationally competitive prices, while simultaneously phasing out export

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subsidies. The Government has also focussed on eliminating remaining export restrictions and strengthening support for export infrastructure and services. Recognizing the sustained growth of non-oil exports will require a broad based improvement in the structure of incentives, the Government has initiated a major program to reduce and rationalize import protection. Steps to reduce the role of import licensing restrictions and move toward tariff-only based protection are now well underway.

7. The trade reform measures announced in October 1986 and supported under the first Trade Policy Adjustment Loan represented the first step in a process of moving away from restrictive importer arrangements. This trend has been reinforced by two subsequent reform packages announced in January and December 1987. These two packages removed import licensing restrictions on 313 items in the textiles, steel, and machinery sectors. Much of the improvement in the machinery sector was gained by reducing the number of goods rectricted to sole agents (AT), with some 111 of these being removed from license control. This involved removing most of the AT license restrictions that have been added since the original Presidential Decree of 1972. The December package also made a start on removing licenses in the previously untouched area of food and beverages. Overall, about 23% of the import value previously restricted has been removed from licensing control during 1987, bringing the total to 42% since October 1986. We expect to make further tangible progress in this direction within the next year, especially in those areas where import licensing restrictions still provide high protection to domestic production. Preparatory work is currently underway in a number of subsectors. The Government's end objective is to eliminate all non-tariff restrictions on imports except on a small group of products that are harmful to health, strategic to national defense or involve special economic and social considerations.

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8. The Government has also continued to review and revise import tariff rates. In December 1987, tariffs were increased on 121 items and temporary surcharges were imposed on 50 items, most of which were removed from restrictive import licensing. This shift toward tariff-only protection is in line with the objectives set out above. At the same time, tariffs on 179 items were lowered during 1987. These reductions were initially focussed on imported inputs not produced locally, so as to offset the cost-raising effects of the 1986 devaluation. However, in December 1987, the Government also lowered the tariffs on some items removed from license restrictions under an earlier decree (e.g., paper products). Over the medium term, it will also be necessary to rationalize the structure of tariffs in order to reduce excessive and disparate levels of protection. For this purpose, the Government is preparing a revised tariff schedule based on the harmonized system, as part of a medium-term plan for tariff reform. Substantial progress in this area is expected during the coming year. Already, a start has been made on reviewing and reducing some tariffs raised in earlier reform packages. The Government has also clarified that import surcharges will be imposed on a temporary basis only, and their justification will be regularly reviewed.

9. The December package also addresses export restrictions and simplifies exporter procedures. The APE (Exporter Identification Number), APES (Provisional Export Identification Number) and the APET (Limited Exporter Identification Number) have now been abolished. Under the new regulations, both domestic and joint ventures will only have to present their Business Permit to prove their exporter identity. The only exceptions are for products subject to international trading arrangements or where Indonesia is a major supplier to world markets. Export bans on 10 items (primarily processed wood products) and export quotas on 24 items (e.g., refined coconut and palm oil, tires, jewellery) have also been abolished.

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10. To help prepare proposals for further reform, the Government has recently set up the Trade and Industrial Policy Steering Committee (TIPSC). The World Bank is providing assistance to develop the technical capability of TIPSC and undertake studies of trade and industrial policy issues. A study on effective protection rates has already been completed.

Domestic Licensing Reforms

11. The Government recognizes that trade policy reforms need to be complemented by measures to simplify and relax other aspects of the regulatory framework. Considerable progress in this area has been made during 1987. Early in the year, several new sectors were opened to foreign and domestic private investors, the number of licenses required to establish and operate firms were significantly reduced, and greater flexibility was introduced into production decisions through the "broad-banding" of product categories. Further steps were taken in the December package to support the export drive. Joint venture trading companies may now be established to export industrial products and joint venture production companies may market both their own and others' industrial products. Complementary regulations have been promulgated to lower the local participation requirements for joint ventures and relax rules for the employment of expatriate personnel. To promote tourism development, the number of licenses required to construct hotels and other tourist facilities has been drastically reduced and the sector has been fully opened to foreign investment.

12. Despite these improvements, the regulatory environment in Indonesia remains complex and often daunting to potential new investors. To better understand the critical bottlenecks, TIPSC with World Bank assistance will complete a study on industrial regulation issues during 1988. This study will be used to formulate and implement a phased program of deregulation over the

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medium term. During the coming year, the Government expects to make further progress on simplifying and relaxing domestic licensing restrictions. Priority will be given to opening additional sectors to domestic and foreign private investment, and streamlining license application procedures. For the electronics subsector, a new policy is being formulated to complement the recent trade reforms in this area. The Government will also review the system of capacity licensing to ensure that firms can benefit fully from the "broad-banding" measures adopted in 1987.

Financial Sector Reforms

13. The Indonesian financial system has undergone considerable changes since the 1983 reforms, which eliminated most interest rate controls and credit ceilings. These reforms have had a very positive impact on resource mobilization, with time and savings deposits rising by more than 170% over the past four years. In order to diversify the range of financial instruments, the Government announced further measures to strengthen the role of equity markets in December 1987. Listing requirements on the Jakarta stock Exchange have been simplified and actions taken to improve the operations of capital market institutions. The Government has also announced the creation of an over-the-counter (OTC) market to enable smaller, less well-established companies to mobilize investment requirements through the capital market. In order to strengthen the demand for securities, the Government will encourage the issue of bearer shares and allow foreign investors to purchase shares in the OTC market.

14. Despite these improvements, the Government is still concerned about the capacity of the financial system to support the process of economic restructuring and recovery. The cost and availability of credit, especially for long-term investment funds, will critically determine the ability of

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business enterprises to take advantage of the deregulation process currently underway. Related issues of financial sector efficiency and development will be addressed in a joint World Bank-Government study to be completed during 1988/89. The Government intends to use the findings of this study in the design of future financial sector reforms.

Macroeconomic Management

15. A stable macroeconomic environment is important in promoting an outward-oriented industrial structure and enhancing productive efficiency. As noted earlier, regaining stability in the balance of payments in the face of lower oil prices is a primary objective of the Government and considerable progress in this direction has already been made. To sustain the process of adjustment, another austere Budget has been announced for 1988/89. The Budget is based on a prudent oil price assumption of US$ 16/barrel and emphasizes the importance of continued improvements in non-oil tax administration. For the third year in a row, no provision has been made for an increase in civil service salaries (this will only be considered if the resource position is better than expected) and development spending is budgeted to fall in real terms. In allocating expenditures, the highest priority will be given to operations and maintenance, to improve the productivity of existing infrastructure. New projects will be undertaken only when they are shown to have very high economic returns and where foreign assistance is available on suitable terms.

16. The Government has also taken steps to contain investment by public enterprises. Tight control has been kept on utilization of non-concessional import-related credits and equity participation in public enterprises funded through the Budget has been reduced to minimal levels. These policies are to be maintained during 1988/89. With IMF assistance, a preliminary

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consolidation of the financial accounts of public enterprises was completed in January 1988. The President of Indonesia has also requested a review of the financial performance of all public enterprises, to identify potential candidates for rehabilitation, merger or divestiture. The data for this review have now been collected and the Government intends to take appropriate action in the near future. The Government also intends to continue its review of the regulatory framework, with the objective of improving the efficiency and operating performance of public enterprises over the medium term.

17. The Government maintains its strong commitment to the present foreign exchange system. Exchange rate policy will continue to emphasize the objective of maintaining international competitiveness of the Indonesian economy, taking account of price and exchange rate movements in trading partners and competitive countries. The austere Budget announced for 1988/89 will help restrain domestic demand and monetary expansion. With these policies, the Government aims to reduce the inflation rate to below 7% p.a. during 1988 and thereby maintain a competitive exchange rate.

18. As in this past, the Government will act promptly to make the requisite policy adjustments if an unexpected macroeconomic disequilibrium emerges.

Sincerely yours,

Ali Wardhana
Minister Coordinator for the
Economy, Finance and Industry

PROJECT COMPLETION REPORT

TRADE POLICY ADJUSTMENT LOAN
(LOAN 2780-IND)

I. Introduction

1.1 During the 1970s, the Indonesian economy grew at 8% per annum. This growth was supported by a rapid expansion of net oil/LNG export earnings, which rose from US$0.6 billion in 1973/74 to a peak of US$10.6 billion in 1980/81. In that year, oil/LNG accounted for 75% of export earnings and 70% of budget revenues. However, since the early 1980s, the external environment faced by Indonesia has worsened considerably. Over the past five years, real oil prices (adjusted for rising import costs) have fallen by more than 50%, with most of the decline occurring since 1986. At the same time, the burden of Indonesia's external debt increased sharply due to the depreciation of the US Dollar since mid 1985.

1.2 In the absence of a firm policy response these external developments threatened to undermine Indonesia's balance of payments position and cause serious dislocation in the domestic economy. Fortunately the Government met the challenge by adopting a series of measures which stabilized the economy and created the conditions for adjustment and growth over the medium term. The key elements of this program included prudent fiscal and monetary policies, appropriate exchange rate management, increased domestic mobilization, and improvements in the trade and industrial policy regime. The Bank's Trade Policy Adjustment Loan (TPAL I), for US$300 million equivalent (Loan No. P-4429-IND), provided both financial and technical support for this program of reform.

The Emergence of Structural Problems

1.3 During the 1982-85 period, Indonesia had to adjust to the steady weakening of the oil market, the onset of a worldwide recession, and the decline in the prices of several important primary exports (e.g., rubber, palm oil and tin). By 1982/83, Indonesia's current account deficit had widened to US$7.2 billion (7.7% of GNP). In response, the Government initiated an adjustment program designed to maintain balance of payments and fiscal stability, while reducing the economy's dependence on oil revenues. The competitiveness of Indonesia's non-oil exports was enhanced by a 28% devaluation of the Rupiah in March 1983 followed by more flexible exchange rate management; and public expenditure was sharply reduced through the rephasing of many large projects and cutbacks in budgetary subsidies. In addition, resource mobilization was strengthened following comprehensive financial and tax reforms; and major efficiency improvements were made in customs, ports and shipping.

1.4 By 1985/86, these measures had succeeded in restoring macroeconomic stability (see Table 1). The current account deficit declined to US$1.9 billion (2.4% of GNP) in 1985/86; and significant progress was made in controlling inflation, which was brought below 5%. These adjustments led to short-term costs in the form of slower growth of

output and incomes, reduced private and public investment, low rates of capacity utilization, and the emergence of financial problems among industrial enterprises. Problems in the industrial sector were compounded by high and variable levels of protection provided by a proliferation of import licensing restrictions. Nevertheless, prior to the unexpected collapse of oil prices in 1986, Indonesia seemed to have largely overcome its balance of payments difficulties and restored macroeconomic stability.

Table 1: RECENT ECONOMIC DEVELOPMENTS /a

	Actuals		Estimate	
	1978-82	1982-85	1986	1987
Real growth rates (% p.a.)				
GDP	5.3	3.8	3.6	3.7
Non-oil GDP	6.9	4.0	3.8	4.3
- Agriculture	5.0	3.7	2.5	2.3
- Mining	9.2	6.5	4.0	3.1
- Manufacturing	9.3	4.4	6.3	6.9
- Construction	11.0	0.7	2.2	5.6
- Other services	9.3	4.6	4.3	4.9
National income	..	2.2	-2.5	4.2
Private consumption	..	2.8	3.1	3.6
Fixed investment	13.5	-4.4	-7.0	0.6
- Public	..	-3.2	-15.6	-3.9
- Private	..	-5.8	3.1	5.0
Non-oil exports	10.5	17.1	2.8	24.2
Non-oil imports	13.8	-10.7	-12.4	0.8
Ratios (%) /b				
Budget balance/GDP	-4.1	-2.9	-4.6	-2.7
Current account/GNP	-7.7	-2.4	-6.2	-3.1
Debt service/exports	16.4	25.4	36.8	34.7
Fixed investment/GDP	25.9	20.8	20.5	19.7
Prices				
Oil price (US$/bbl) /b	32.9	25.0	12.5	17.0
Terms of trade (1983/84=100) /b	109.3	93.3	62.6	69.2
Domestic inflation (% p.a.)	13.9	8.4	9.1	9.3

/a Balance of payments data are for fiscal years (starting April 1). Other indicators are for calendar years.
/b last year of multi-year periods.

Source: Central Bureau of Statistics and World Bank staff estimates.

1.5 In 1986, the economy again suffered a series of setbacks. Average crude oil prices fell by almost one-half from US$25/barrel in 1985/86 to below US$13/barrel in 1986/87. The loss of oil revenues was equivalent to one-third of both domestic budget revenues and merchandise exports. Indonesia suffered further external shocks from the weakening of non-oil commodity prices and the sharp depreciation of the US dollar. Indonesia was vulnerable to the decline of the US dollar because its exports were mostly dollar dominated whereas about 60% of its external debt was in appreciating currencies. These trends led to a 34% deterioration in the terms of trade and a jump in the debt-service ratio from 26% in 1985 to 37% in 1986. It is estimated that all of the increase in the public debt service ratio since 1985 is due to the combined impact of lower oil prices and exchange rate changes. Although the Government had been adjusting appropriately since the first signs of a deteriorating external environment, nothing could have prepared the economy for the magnitude of the new external shocks. Nor could the Government afford to make up this loss through additional commercial borrowing, as the decline in oil revenues was unlikely to be transitory and Indonesia already had a large overhang of external debt.

The Government's Response

1.6 The Government responded to this second deterioration in the external environment by announcing a series of adjustment measures intended to contain the balance of payments deficit by bringing national spending in line with the reduced level of national income. The Government also intensified its efforts to promote a more competitive and dynamic non-oil economy. There were four key elements to the Government's strategy:

(a) First, the Government adopted more austere fiscal and monetary policies. Current expenditures, excluding debt repayments, were to be held flat in nominal terms, and substantial cuts were made in capital expenditures. Monetary expansion was also controlled to reduce the pressure on domestic prices and the demand for imports.

(b) To further restrain aggregate demand and to encourage the process of structural change, the Government announced a 31% devaluation of the currency on September 12, 1986. This adjustment was considered appropriate in light of the projected loss in oil earnings and the need to preempt disruptive capital outflows. In order to alter the market psychology, which focused exclusively on rupiah/US dollar movements, Bank Indonesia also began to quote rates against five currencies and the SDR.

(c) To achieve the Government's budgetary target and to restore domestic balance, the Government continued its efforts to strengthen domestic resource mobilization. Accordingly, the Government pursued a more flexible interest rate policy to stabilize and attract domestic deposits and took steps to increase non-oil tax revenues.

(d) Lastly, the Government embarked on a series of deregulation measures intended to improve the trade and industrial policy regime. GOI's objectives were to develop a more efficient manufacturing sector, stimulate non-oil exports and thereby encourage the restructuring of the economy over the medium term.

Trade Policy Adjustment Loan

1.7 The Bank's first Trade Policy Adjustment Loan (TPAL I) supported this adjustment program, particularly as it related to trade and industry policy. An important distinguishing feature of this loan was that the policy measures it supported were announced prior to loan appraisal. The approach was considered appropriate because: (a) the Bank's prior discussions with the Government had resulted in a common understanding of the measures that needed to be taken; (b) analysis of the measures to be supported by TPAL I showed them to be substantive and deserving of support; (c) it was recognized from the outset that the measures taken were part of a medium-term adjustment program to which the Government was strongly committed, and that subsequent reforms could provide the basis for a series of policy-based loans; and (d) the Government's strong record on economic management provided the basis for expecting that further policy measures would be taken. The loan was prepared following the September devaluation and GOI's announcement of the October 25 trade reform measures. The loan reflected the close dialogue between the Bank and GOI on macro-management and trade issues, both of which were highlighted in the preceding economic report "Indonesia: Adjusting to Lower Oil Revenues" (Report No. 6201-IND, dated May 20, 1986).

1.8 Throughout the 1970's and early 1980's, Indonesia's trade and industrial policies were inward-looking, promoting investment in highly protected activities geared to supply the domestic market. At the start of the decade the primary instrument of protection was a high and disparate import tariff structure. As pressures from the slowdown in the domestic economy in the early 1980s began to build, tariff protection was supplemented by a proliferation of non-tariff barriers, in the form of import licenses. However, as the costs of the protective regime became apparent and the need to encourage non-oil exports became more pressing, GOI began to reverse its policy stance, announcing two significant reforms during 1985: first, an across-the-board reduction in tariffs which reduced the level and dispersion of tariffs and lowered the ceiling from 225% to 60%; and, second, a complete overhaul of customs, ports and shipping operations. Reductions in these distortions increased the relative importance of non-tariff barriers (NTBs). By the end of 1985, more than 1,700 items (CCCN categories) were subject to import licensing.1/ These items accounted for over 40% of both total import value and traded domestic production. Although import licenses varied considerably in their degree of restrictiveness, by 1986, the import licensing system was the most important distortionary influence in the trade regime, contributing not only to the high level and variability of protection but also fostering unproductive "rent-seeking" behavior.

1/ Of the 1700 items, only 296 had a formal quota imposed. In addition, there were 24 products under import ban (including automobiles, motorcycles, televisions and radios as completely built-up units).

1.9 Responding to this situation, GOI embarked upon a major program of trade and industrial policy reforms in 1986. The first step was taken on May 6, 1986, when GOI announced a package of measures designed to provide internationally-priced inputs to exporters. Indonesia's accession to the GATT Code on Subsidies and Countervailing Duties in 1985 required withdrawal of the Export Certificate Scheme. As a result, it became necessary to find an alternative method to protect the competitiveness of Indonesian exporters from the "high-cost" local economy and import license restrictions. The May 6 program was designed to do this by allowing "producer-exporters" the option of importing their inputs free of restrictions and exempt from import duties. The significance of the program goes beyond allowing imports to be brought in duty free as it also allows exporters to bypass import license restrictions. In addition, a duty drawback facility was created to enable indirect exporters to reclaim import duties.

1.10 In October 1986, following the 31% devaluation of the previous month, GOI embarked upon a more fundamental program of reform. The intention was to initiate a phased program to reduce import licenses and move towards an import regime based solely on tariffs. Under the October package, import restrictions were removed on 197 items, accounting for 11% of all items and 19% of total import value previously restricted. As a result, the share of manufacturing production protected by restrictive import licensing declined by about 14%. The October package focussed on a number of highly protected activities such as chemicals, paints and dyes, tires and tubes, hides and leather, and glass. A start was also made in relaxing import licensing restrictions in the mechanical and electrical equipment subsectors.

1.11 The Bank's analysis of of these reforms, coupled with the Government's strong record of macroeconomic management, provided the basis for TPAL I. The objectives of the Loan were to: (a) support the substantial reforms, especially in the area of trade policy, undertaken by the Government during 1986 and to monitor their implementation; (b) assist GOI to bring about an early recovery in economic activity consistent with external and domestic financial stability; and (c) maintain the policy dialogue on further reforms for promoting the efficiency and longer-term viability of the economy. These objectives were to be achieved partly through balance of payments support and partly through ongoing consultation on policy issues and improved institutional arrangements for administration of the trade regime. A related technical assistance loan was to be processed in the near future, to finance a number of macroeconomic and trade related studies. In particular, an up-to-date effective rate of protection study was identified as a priority, to gain a clearer picture of economywide distortions created by the existing trade regime. The Bank also proposed that Government establish a Trade and Industry Policy Steering Committee to coordinate future Government effort on deregulation.

1.12 In addition to the steps already taken, GOI's "Statement on Economic and Trade Policy" provided a clear indication that the Government would continue to maintain macroeconomic stability and that further progress in implementing structural reforms would be forthcoming. In terms of follow-up steps, the Bank explained that it would monitor closely, through frequent consultation with GOI, the progress on

implementation of GOI's package of measures on trade reform and macroeconomic management. In particular, the Bank would pay attention to: (a) continued prudence on fiscal and monetary policies, including scrutiny of the public investment program; (b) continued appropriate exchange rate management; (c) further measures to reduce non-tariff barriers (NTBs) and rationalize the tariff structure; and (d) progress on studies of industrial regulations and public enterprises. The Bank also explained that if satisfactory progress in these areas were made, a follow-up loan could be considered in about a year.

II. Implementation of the Reform Program

Macro-economic Management

2.1 GOI managed to contain the overall budget deficit for 1986/87 to 4.6% of GDP, below the Government's target of 5% (see Table 2). This was achieved by an appropriate combination of revenue raising and expenditure reducing policies. An increased effort to implement the series of tax reforms introduced in 1984-86 -- designed to simplify the tax code and broaden the revenue base -- resulted in a 25% increase in non-oil taxes.2/ Non-tax revenues also increased as a result of the Government decision to maintain domestic fuel prices at the pre-1986 level despite the fall in world prices. On the expenditure side, the Government kept current expenditures close to budgeted levels. Civil servants salaries were frozen, and a reduction in subsidies partly offset the increase in interest payments on external debt resulting from the September devaluation. Capital expenditures were also tightly controlled. Development expenditures were reduced by about 25% in real terms in 1986/87. This decline occurred despite significant improvements in the implementation of foreign aided projects, and reflected the very cautious attitude adopted by Government towards rupiah spending. As a result, the rupiah development spending by Departments (excluding Defense) is estimated to have been cut by almost 60%. Reduced rupiah development expenditure is the major reason for the sharp decline in net domestic expenditure (i.e., the domestic content of government spending less non-oil revenues), which fell from 8.3% of GDP in 1985/86 to 4.1% in 1986/87, indicating the severe economic restraint imposed by the budget.

2.2 GOI's austere budgetary stance was supported by appropriate monetary policy. Despite two episodes of capital flight and the inevitable monetary problems associated with the September devaluation, the monetary authorities maintained stability in the financial markets. Adjusting for valuation changes resulting from the September devaluation, total domestic credit rose by 21.8% in 1986, significantly below the rate of expansion in 1985.

2.3 GOI's cautious approach to fiscal and monetary policy was maintained in 1987/88. Although the Government's resource position in 1987/88 turned out to be better than budgeted, due to higher oil prices and a further increase in non-oil taxes, expenditures remained tightly restrained. Civil service salaries were frozen for a second year, but overall current expenditures increased because of the continued rise in

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2/ For more details see Chapter 3, "Indonesia: Strategy for Economic Recovery", Report No. 6694-IND, May 5, 1987.

Table 2: CENTRAL GOVERNMENT BUDGET, 1982/83-1987/88
(Rp. trillion at current prices)

	Actuals			Budget	Estimate
	1982/83	1985/86	1986/87	1987/88	1987/88
Revenues and grants	12.0	18.6	16.5	17.3	21.7
Oil and LNG taxes	7.6	10.7	6.3	6.9	10.1
Non-oil taxes	3.8	6.3	7.9	9.1	9.5
Non-tax revenues /a	0.4	1.5	2.2	1.2	1.8
Grants	0.1	0.1	0.1	0.1	0.3
Current expenditures /b	8.2	12.4	13.2	13.0	15.2
External interest	0.7	1.8	2.8	3.4	3.8
Subsidies	1.4	1.1	0.5	0.2	1.2
Other	6.1	9.5	9.9	9.4	10.2
Government savings	3.7	6.3	3.3	4.3	6.5
Capital expenditure	6.4	9.0	8.0	6.4	9.7
Overall balance	-2.7	-2.8	-4.7	-2.0	-3.2
Financed by:					
External loans (net)	2.1	1.8	3.8	2.0	3.1
Disbursements	2.8	4.4	7.1	5.4	8.0
- Project aid	(2.0)	(3.5)	(4.1)	(4.4)	(5.3)
- Other /c	(0.8)	(0.9)	(3.0)	(1.0)	(2.7)
Amortization	0.7	2.6	3.3	3.4	4.9
Asset drawdown /d	0.6	0.9	0.9	0.0	0.1
Memo items (% of GDP):					
Revenue and grants	18.3	19.6	16.2	14.7	18.5
Non-oil taxes	5.9	6.6	7.8	7.8	8.1
Government savings	5.7	6.6	3.2	3.7	5.6
Overall balance	-4.1	-2.9	-4.6	-1.7	-2.7
Total expenditure	22.4	22.5	20.8	16.5	21.2
Net domestic expenditure /e	11.0	8.3	4.1	1.0	4.0

/a Includes domestic oil surplus in 1986/87.

/b Derived from routine expenditure by deducting amortization and adding the fertilizer subsidy, export certificates, defense spending and the recurrent component of development expenditure.

/c Refers to program loans, special local-cost financing and commercial borrowing.

/d Excludes gain from valuation adjustment in 1986/87, estimated at Rp. 1.8 trillion.

/e Defined as the domestic content of expenditure less non-oil revenues.

Source: Ministry of Finance and World Bank staff estimates.

external interest payments and the consolidation of banking arrears related to the fertilizer subsidy. The very large additional reduction that was planned in rupiah development expenditure was partly avoided by using special external assistance to finance the local cost of foreign aided projects. Nevertheless, the overall budget deficit was reduced to 2.7% of GDP in 1987/88 and net domestic expenditure was held at 4.0%. As regards monetary policy, the growth of rupiah liquidity was maintained at the slower rate of the previous year, resulting in an average expansion in rupiah liquidity of 22% p.a. over the past two years compared to 33% in 1985. The authorities continued to pursue a flexible interest rate policy so as to maintain stability in domestic financial markets and prevent capital flight.

Structural Reforms

2.4 Trade Policy. The implementation of the two trade reform measures supported under TPAL I (May 6 and October 25, 1986) has been generally satisfactory. The May 6 scheme has worked smoothly, with "arms-length" administration and minimal delays in processing applications. As shown in Table 3, the scheme has provided exporters with almost US$1 billion of imports during the 18 months through December 1987, accounting for about 6% of total non-oil imports over this period. These imports were allowed to bypass the approved-trader restrictions and were exempted from US$430 million in taxes. Encouragingly, access to the May 6 scheme has broadened from the initial focus on textile exports to include significant numbers of exporters in the processed food, chemical and wood product sectors. The October reforms became effective immediately through two decrees issued by the Departments of Trade and Finance. Imports have

Table 3: IMPLEMENTATION OF MAY 6 SCHEME /a
(US$ million)

Activity	Value of Imports Approved	Value of Exemptions Import Duty	Value of Exemptions VAT
Exports	989.4	310.0	122.5
Textiles and garments	315.5	148.5	46.3
Processed foods	329.3	104.9	37.0
Chemicals	73.6	17.3	8.3
Wood products	105.5	13.5	11.8
Other	165.5	25.8	19.1
GOI projects /b	168.6	31.8	-
Total	1,158.0	341.8	122.5

/a From July 1, 1986 to December 31, 1987.
/b The May 6 scheme also applies to contractors for foreign-assisted GOI projects. However, the text discussion focuses on exporters only.

Source: Ministry of Finance.

subsequently increased sharply for items removed from licensing restrictions or where tariffs were reduced. For example, third quarter comparisons from 1986 to 1987 show import value increases of 35% for basic chemicals, 26% for dyes and tanning materials, 61% for textiles and fibers, and 35% for motor vehicle components. However there have been some bureaucratic delays in clarifying license application requirements and procedures (e.g., for sole agencies), while high tariffs have constrained the import of some items removed from licensing restrictions (e.g., paper products). As noted below, a start has been made in tackling these problems under the 1987 reform packages. Finally, the Government also established, in July 1987, a Trade and Industry Policy Steering Committee (TIPSC) to coordinate future deregulation measures.

2.5 GOI has maintained the momentum of trade policy reform, along the lines laid out in the Government's "Statement on Economic and Trade Policy". Two major trade reform packages were announced on January 15, 1987 and December 24, 1987, supported by a series of smaller policy actions. These measures, have: (i) continued the shift from import restrictions to tariff-based protection; (ii) adhered strictly to the lower tariff ceiling in setting tariff rates on the products removed from NTB protection; (iii) taken initial steps toward tariff rationalization; (iv) broadened the scope of the May 6 scheme giving exporters access to inputs at internationally competitive prices; and (v) reduced remaining export restrictions.

2.6 The measures taken in 1987 provided the basis for the Bank's Second Trade Policy Adjustment Loan, which is currently being disbursed.3/ In brief, the January and December packages have together resulted in the removal of an additional 342 items from license control, accounting for 20% of all items and 23% of total import value previously restricted. More importantly, the share of manufacturing production protected by import licensing has declined further from 42% at the end of 1986 to 35% at the end of 1987 (see Table 4). And, as the effective rate of protection study which was undertaken as a result of TPAL I shows, the reduction in NTBs has been concentrated in those activities with the highest effective rates of protection.4/ The January and December packages have also relaxed some of the remaining restrictions, particularly in the textile and engineering goods sectors, by placing them under the IP (actual user) license category. This is the least restrictive license, and allows all producers who require these items as inputs to import them freely. As a result of the measures taken during 1987, virtually all production in textiles falls under the unrestricted or IP license category. Given, in addition, the relatively easy access of exporters to the May 6 scheme, the textile sector is now largely free of import licensing restrictions. Similar progress has been made in many branches of the engineering goods sector, although several final goods remain under restrictive license or import bans.

3/ Approved by the Executive Directors on May 10, 1988, (Report No. P-4794-IND). For detailed assessment of January and December reforms see Annex VI.

4/ The results of the Effective Protection Study are summarized in the President's Report for TPAL II (Report No. P-4794-IND).

Table 4: EFFECT OF REFORM PACKAGES ON IMPORT LICENSING COVERAGE SINCE 1986

Share covered under Import Licensing (%)	Before Reforms (mid-1986)	After Oct. 1986 Reforms /a	After Jan. 1987 Reforms /b	After Dec. 1987 Reforms /b
Import items	31.4	27.9	25.7	21.7
Value of imports	42.9	34.9	31.5	25.2
Manufacturing productions	49.1	42.4	38.8	34.8

/a Measures supported under TPAL I.
/b Measures supported under TPAL II.

Source: President's Report for TPAL II, Annex VI, Table VI.1

2.7 The trade reform measures in both 1986 and 1987 also involved changes in import tariff rates. The major corrective tariff reform occurred in 1985, and the net impact of the subsequent trade reform packages has been small (see Table 5). In total 275 tariffs were adjusted upwards and 331 tariffs were lowered.5/ The increased tariffs compensated for the effects of the removal of import licensing restructions, but remained within the tariff ceiling set in 1985. The reductions in tariffs focussed on those products not produced locally, and were intended to offset the cost raising effects of the September 1986 devaluation. However, it should be noted that the December reductions went beyond this limited objective by reducing tariffs on some domestically produced items that were removed from import license restriction in earlier decrees, but afforded a higher tariff. This is the first step towards the next phase of trade reform, i.e., rationalizing the general tariff structure.

2.8 Lastly, the December package has made more substantial progress than the previous two packages in eliminating some of the direct impediments to exports. The need to obtain a special export license was abolished; several export bans and quotas have been removed; and access by exporters to the May 6 scheme has been broadened. These reforms will reduce the impediments to exporters by eliminating redundant regulations. Furthermore, they will reduce substantially the anti-export bias of the trade regime for existing exporters, thereby increasing the relative profitability of exports and bolstering the export drive.

2.9 Industrial Deregulation and Foreign Investment Policies. Progress in trade policy reform has highlighted the need for complementary measures on industrial deregulation. The performance of the industrial

5/ For detailed examination of these changes see President's Report for TPAL I (Report No. P-4429 IND) and TPAL II (Report No. P-4794 IND).

Table 5: RECENT CHANGES IN THE TARIFF SCHEDULE /a

No. of Tariff Rates /b	1980 Schedule		1985 Schedule		End-1987 Schedule	
	% of CCCN tariff categories	No. of items covered	% of CCCN tariff categories	No. of items covered	% of CCCN tariff categories	No. of items covered
0%	1	6.5	1	16.3	1	9.1
Up to 5%	4	29.2	2	32.0	2	35.4
Up to 10%	6	39.5	3	44.9	3	47.8
Up to 15%	7	41.9	4	50.3	4	52.5
Up to 20%	8	47.8	5	64.0	5	62.5
Up to 30%	10	58.7	6	81.8	6	80.5
Up to 40%	12	70.6	7	91.5	7	90.2
Up to 50%	14	77.9	8	96.2	8	95.4
Up to 60%	15	90.1	9	99.6	9	99.5
Up to 80%	17	95.1	9	99.6	9	99.5
Up to 100%	19	99.6	10	99.9	10	99.9
Up to 200%	24	99.9	11	100.0	11	100.0
Up to 225%	25	100.0				

/a Table shows cumulative number of tariff categories and percent of CCCN items covered at various tariff rates. Specific tariffs are excluded.
/b As of December 24, 1987.

Source: Ministry of Finance and World Bank staff estimates.

sector has been hindered by a multitude of domestic regulations and licensing procedures, particularly investment and capacity licensing. Moreover, additional regulations controlling the activities of foreign investment companies have restricted the flexibility of these firms and reduced the attractiveness of Indonesia to foreign investors. Recognizing these impediments to private sector growth and investment, the Government has taken a series of steps to simplify and relax the regulatory framework.6/

2.10 A start was made in 1985 when the investment process was streamlined. In 1986, fields of investment open to both foreign and domestic companies were specified more clearly and the number of areas open to private foreign and domestic investment was expanded substantially. Moreover, foreign investment companies were given greater access to domestic capital and financial institutions, and domestic ownership requirements were eased.

2.11 The Government's drive to revitalize the private sector and encourage foreign investment gained momentum during 1987. A number of

6/ For detailed assessment see Annex VI Section B of President's Report for TPAL II.

major steps were taken to relax the investment and capacity licensing system and ease foreign investment regulations. As a result of measures taken in June, firms are now allowed to increase production by up to 30% of their licensed capacity without requiring new investment approval. More significantly, firms have been permitted to diversify production within much broader product categories, thereby improving the operational flexibility of firms and promoting greater competition. Furthermore, the requirements for investment licenses were streamlined and additional fields of investment opened to private domestic and foreign investors. The December package included a series of measures to relax foreign investment regulations: domestic ownership requirements were eased significantly; restrictions prohibiting foreign-owned companies from marketing Indonesian export goods were removed; foreign firms are now allowed to purchase domestic input without restriction; and rules regarding the hiring of expatriate personnel were relaxed. These steps have addressed key concerns expressed by foreign investors in Indonesia and will reduce differences in treatment between foreign and domestic firms. Together with the broader regulatory measures, they have removed many of the disincentives to foreign investors and have improved substantially the climate for foreign investment in Indonesia.

2.12 Financial Sector Reform. In June 1983, GOI launched a comprehensive reform of the financial sector, which included a liberalization of most interest rate controls on state bank deposits, the elimination of credit ceilings for all banks, and a reduction in the number of programs qualifying for new Bank Indonesia liquidity credits. These reforms have had a far-reaching impact on the financial system, successfully increasing domestic resource mobilization, promoting greater competition and market orientation, and improving the allocation of credit. Over the past three years, Bank Indonesia has also introduced a range of new monetary instruments (e.g., SBIs, SBPUs)7/ to improve monetary management and encourage development of an active interbank money market. In July 1987, an auction system was introduced to determine SBI and SBPU volumes and discount rates, which, in combination with other monetary measures, helped ease the speculative pressure against the Rupiah.

2.13 Concerns about the longer-term effect of high interest rates on investment and the financial viability of enterprises, and the relative lack of term transformation in the banking system, led GOI to undertake specific measures in December 1987 to strengthen the role of equity markets. First, to increase the supply of securities, listing requirements on the Jakarta Stock Exchange, which now lists only 24 companies with a market capitalization of about US$60 million, were simplified through the elimination of all but three pieces of essential documentation. Second, supportive measures were introduced to improve the institutional framework (e.g., pricing mechanisms) and the operation of capital market institutions (e.g., underwriters, guarantors, stock traders). Third, GOI created an over-the-counter (OTC) market to enable smaller, less well-established companies to mobilize investment requirements through the capital market. Finally, in an attempt to strengthen the demand for securities, GOI will encourage the issue of bearer shares and will allow foreign investors to purchase shares in the OTC market.

7/ SBIs are Central Bank certificates and SBPUs are private sector promissory notes held by banks, and rediscounted by the Central Bank.

Technical Assistance

2.14 The planned technical assistance loan to TPAL I did not materialize. In developing the follow-up technical assistance project four separate separate components had been identified: trade policy and industrial regulations support, public enterprise review, macroeconomic flow of funds analysis, and review of the investment planning and budgeting system. Unfortunately, it proved too difficult to process such a wide range of technical assistance at the same pace. The proposed public enterprise review posed particular problems as the Government felt that a strong Bank presence would hinder rather than further public enterprise reform at this stage. As a result, alternative funding for the three other components was found under ongoing Bank projects and from the IMF.

2.15 In anticipation of these problems, the first phase of the trade policy and industrial regulation work -- an effective rate of protection study -- was financed under the Bank's Fifth BAPINDO Project (Loan No. 2277-IND). GOI gave its full support to this effort, and the consultants were able to finish the study as scheduled by December 1987. Also, in appraising TPAL I and II the Bank has produced datasets and analytical tools relevant to analyzing the significance of the reform effort. Follow-up technical seminars have been organized and the Government is now using the output from both these exercises in its own analytical work. The second phase of the trade and industry work -- which focuses on documenting and assessing the domestic industrial regulatory framework -- was started and is being undertaken by Bank staff. This will be incorporated with the work done in the first phase under a longer term technical assistance effort designed to support the newly formed Trade and Industry Policy Steering Committee.

2.16 With respect to public enterprises, although the planned review has been deferred, some progress has been made. With IMF assistance, a preliminary consolidation of the financial accounts of public enterprises was completed in January 1988. The President of Indonesia has also asked for a review of the financial performance of all public enterprises, to identify potential candidates for rehabilitation, merger or divestiture. The data for this review have now been collected, and the Government has indicated that it intends to initiate a program of reform. In addition, the Government has also taken steps to contain investment by public enterprises. Since 1986 tight control has been kept on utilization of non-concessional import-related credits and equity participation in public enterprises funded through the Budget has been reduced to minimal levels.

III. Impact of the Reform Program and Costs of Adjustment

Impact of Reform Program

3.1 As a result of the Government's fiscal and monetary policies, inflation was held to about 9% p.a. since 1986 -- a remarkable achievement given the magnitude of the September 1986 devaluation. This preserved the competitive advantage provided by the devaluation and greatly improved the

profitability of non-oil exports. In response to this real exchange rate adjustment, as well as the recent deregulation measures, exports have increased substantially. Non-oil exports are estimated to have risen to US$9.4 billion in 1987/1988, an increase of 40% in nominal terms and 24% in real terms over 1986/87. About two thirds of this increment was contributed by manufactured goods, despite the slower growth of textiles (which accounted for a third of manufactured exports in 1986/87). Volume growth of manufactured goods is estimated at 40% in 1987/88. Furthermore, this growth has been achieved across a wide range of products (e.g., paper products, furniture, shoes, batteries), some of which were exported for the first time. Import demand has been restrained due to the Government's prudent fiscal and monetary policy and the September 1986 devaluation. Although there has been a recovery over the past year, the real level of non-oil imports is still 12% lower than in 1985/86.

3.2 Because of the strong non-oil export performance and demand restraint on imports, the current account deficit was contained at US$4.2 billion (6.2% of GNP) in 1986/87 and reduced to an estimated US$2.0 billion (3.1% of GNP) in 1987/88 (see Table 6). The financing of these deficits and higher amortization payments has been eased considerably by the provision of special external assistance, in the form of fast-disbursing program aid and local-cost financing. Disbursements of special assistance totalled about US$0.5 billion in 1986/87 and US$1.4 billion in 1987/88, 8/ or 12% of total non-oil imports over the past year. As such, special assistance has played a very valuable role in helping the Government push ahead with its trade deregulation measures, and by cushioning the economy against the deflationary impact of the drop in oil prices, has facilitated the recovery of private investment and growth. In April 1987, Indonesia also obtained US$606 million from the IMF's Compensatory Finance Facility (CFF). By the end of 1987/88, Bank Indonesia was able to rebuild its net official reserves to US$5.6 billion, equivalent to 4.4 months of imports. This relatively high level of reserves is considered appropriate, given Indonesia's open capital account and the need to ride out occasional episodes of speculation.

3.3 The Government's balanced adjustment program has also helped to sustain a better-than-expected rate of economic growth, despite the loss of oil revenues. Total GDP grew on average by 3.7% p.a. in 1986 and 1987. Most of this growth came from the non-oil economy. Within the non-oil economy, a decline in the growth rates of the agriculture and mining sectors was more than offset by improvements in the performance of the manufacturing, construction and service sectors. Overall performance was buoyed by the strong growth of non-oil exports, while restraining factors were the drought in 1987 and cuts in government spending. There were also encouraging signs of a recovery in private investment, by both domestic and foreign joint-venture investors, in response to better market conditions and improvements in the regulatory environment.9/ In the

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8/ This included disbursements from TPAL I, the local cost financing of World Bank projects by Japan EXIM Bank, and extra program aid and local-cost financing from IGGI members.

9/ Approvals of domestic investment by the Investment Coordinating Board (BKPM) jumped more than 130% in rupiah terms in 1987, whereas foreign investment approvals rose by 76% in dollar terms, in both cases directed primarily towards export activities.

Table 6: BALANCE OF PAYMENTS, 1982/83-1987/88
(US$ billion at current prices)

	Actuals			Estimate
	1982/83	1985/86	1986/87	1987/88
Merchandise exports (fob)	18.6	18.5	13.7	17.9
- Oil & LNG	(14.7)	(12.3)	(7.0)	(8.5)
- Non-oil	(3.9)	(6.2)	(6.7)	(9.4)
Merchandise imports (cif)	-20.6	-14.2	-12.7	-14.1
- Oil & LNG	(-4.8)	(-3.2)	(-2.3)	(-2.5)
- Non-oil	(-15.8)	(11.0)	(-10.4)	(-11.6)
Trade balance	-2.0	4.3	1.0	3.8
Net non-factor services	-1.7	-1.7	-1.5	-1.5
Resource balance	-3.7	2.6	-0.5	2.3
Net factor services & transfers	-3.5	-4.5	-3.7	-4.3
Current account balance	-7.2	-1.9	-4.2	-2.0
of which:				
- Oil & LNG /a	7.2	5.9	2.4	3.7
- Non-oil	-14.4	-7.8	-6.6	-5.7
Net public MLT loans /b	4.0	1.4	2.8	2.4
- Disbursements	(5.1)	(3.9)	(5.4)	(6.3)
- Amortization /c	(-1.1)	(-2.5)	(-2.6)	(-3.9)
Net other capital /d	-0.1	1.4	-1.6	0.8
Use of net foreign assets	3.3	-0.9	3.0	-1.2
Memo items:				
Net official reserves /e	3.0	5.8	5.0	5.6
- Months of imports	(1.7)	(5.5)	(4.3)	(4.4)
Total net foreign assets /f	7.5	12.6	9.6	10.8 /g
Current account/GNP (%)	-7.8	-2.4	-6.2	-3.1

/a Gross earnings from oil/LNG exports less payments for imports and services related to the sector.
/b Includes credits for LNG expansion, LPG and paraxylene projects.
/c Includes prepayments of US$420 million in 1985/86 and US$626 million in 1987/88 (to be completed by June 1988).
/d Includes direct foreign investment, oil/LNG exports credits, a.[1] private capital flows, valuation adjustments, and errors and omissions.
/e Net of outstanding drawings from IMF's Buffer Stock and Compensatory Financing Facilities.
/f Of the banking system (Bank Indonesia and commercial banks).
/g Includes US$326 million of prepayments to be completed by June 1988.

Source: Bank Indonesia and World Bank staff estimates.

manufacturing sector, this revival in investment seems to be broad-based, cutting across all industries and firm-size classes. A noteworthy element is that much of the increase in manufacturing investment was for export activities.

Costs of Adjustment

3.4 The combination of GDP growth and an improvement in Indonesia's terms of trade helped support a real increase in national income of 4.2% in 1987, as compared to a decline of 2.5% in 1986. Even so, in per capita terms, national income at the end of 1987 will still be lower than in 1981. GOI has acted to contain the social costs of this income loss by: (a) giving priority to public spending on agriculture and local infrastructure; (b) promoting non-oil exports, which are generally more labor-intensive; and (c) adopting a more supportive attitude toward activities in the informal sector, particularly in urban areas. For example, the share of agriculture and regional development programs in development expenditure was increased from 18.3% in 1985/86 to 26.2% in the 1988/89 budget. Social programs were also protected, with the share of education, health and urban services remaining flat at about 20%, although the level of absolute cuts has been substantial.

3.5 While slower growth in domestic demand and greater import competition have affected some activities, broad-based export growth and the recovery of private investment have had a salutary effect on employment growth. Many of the fastest-growing export items -- including agricultural products, textiles and garments -- are labor-intensive and important employment-generating activities. Nevertheless, despite these positive actions which have moderated the social costs of adjustment, the Government remains concerned about employment and income growth as Indonesia's labor force is expected to expand by about eight million over the next five years.

3.6 An additional area of concern in this adjustment period is the effects of devaluation and high real interest rates on the financial position of firms. Although there is little overt evidence of a rise in bankruptcies or widespread financial stress, the portfolios of some financial institutions remain weak, and will require careful monitoring to ensure that the financial system can adequately support the adjustment process.

IV. Loan Administration, Use and Coordination

Procurement and Disbursement

4.1 Procurement and disbursement procedures for TPAL I were designed to ensure rapid drawdown of loan proceeds. The loan was used to reimburse 100% of foreign expenditures for eligible imports by the public or private sector for which payments were made after the date of loan signing. There was no retroactive financing under the loan. The loan specified a standard list of ineligible imports, i.e., goods intended for military or paramilitary purposes, or for luxury consumption; goods financed from other official multilateral or bilateral sources; uranium; and goods procured under contracts of less than US$100,000. Bank Indonesia was responsible for maintaining and administering the loan

account. All purchases in the amount of US$5 million equivalent or more were to be procured through International Competitive Bidding (ICB)in accordance with Bank guidelines. Procurement by the private or public sector of goods contracted at a price less than US$5 million equivalent were handled on the basis of normal commercial practice or following normal Government procurement procedures acceptable to the Bank. Disbursements of eligible import expenditures would be based on Statements of Expenditures (SOEs) for imports valued at less than US$5 million; for imports above this amount full documentation would be required. Since all contracts submitted to the Bank by the Borrower were below US$5.0 million, no ICB was involved in procurement, and the loan was disbursed on the basis of SOE procedures. Disbursements under TPAL I were concentrated in April (US$140 million equivalent) and June 1987 (US$160 million equivalent), and proceeded smoothly. The loan has been largely used to finance private sector imports of raw materials and intermediate goods. The counterpart funds generated by imports financed under TPAL I were credited to a special account in Bank Indonesia and were used to finance priority public expenditure programs associated with the Government's 1987-88 Budget.

Use of Counterpart Funds

4.2 The counterpart funds generated by imports financed under the TPAL I were credited to a special account in the Bank Indonesia and were used to finance priority public expenditure programs associated with the Government's Budget.

Coordination with the IMF

4.3 There was good interaction between the Bank and the IMF on the TPAL I program. This took the form of informal exchanges and consultations during loan preparation. The IMF staff participated in reviewing the reports associated with TPAL I, and fully supported the loan.

4.4 The latest IMF Consultation Report was issued on April 15, 1988. GOI has not had any standby or extended arrangements with the IMF since 1973. GOI's last purchase from the IMF was for SDR 463 million in May 1987 under the Compensatory Financing Facility (CFF). This purchase increased Indonesia's total outstanding IMF obligations to SDR 505 million at the end of 1987. After the last Consultation Report, the IMF Executive Board expressed its satisfaction that "Indonesia maintains an exchange system which is free of restrictions on payments and transfers for current international transactions." Effective May 7, 1988, the Government of Indonesia has accepted Article VIII status.

V. Evaluation and Remaining Agenda

Evaluation

5.1 In evaluating an adjustment operation, three benchmarks are relevant. First, were the policy measures supported by the loan fully implemented? Second, did the economic performance resulting from the policy actions match the expectations at loan appraisal? Third, how effective was the loan in supporting a sustainable medium-term adjustment process?

5.2 On the first, the outcome was unequivocal, since the loan was based on policy actions already taken. Moreover, the policy measures have been implemented well and without undue administrative delays. On the second benchmark, the results to date have exceeded expectations at loan appraisal. As noted, the fiscal deficit for 1986/87 was below the Government target and a further large reduction was achieved in 1987/88. This, together with tight monetary management, helped curb inflation and maintain the large gains in competitiveness. Most impressively, non-oil exports reached $9.4 billion in 1987/88 compared with $7.5 billion projected at loan appraisal. This surge in non-oil exports, and somewhat higher oil prices, permitted higher import levels and supported more robust growth than projected (4.3% actual non-oil GDP growth in 1987 compared with 0.9% projected), while also reducing the current account deficit more substantially than anticipated ($2.0 billion deficit compared with a projected deficit of $2.7 billion). Overall, therefore, the economic outcomes and reduction in macroeconomic imbalances have been impressive and exceeded expectations at loan appraisal.

5.3 Finally, the loan has contributed to sustaining the medium-term adjustment process in a number of ways. It has helped mobilize flexible external finance for budgetary and balance of payments support. This special assistance, and the early and strong supply response resulting from the measures supported by the loan, have in turn created a better climate for further deregulation. The technical assistance provided by the Bank subsequent to the loan and the Bank's policy discussions with the Government have assisted in delineating these further steps. As noted, a series of further policy measures were taken following the approval of TPAL I. A comparison of the actual steps taken since the loan was approved with the "areas for follow-up" identified in the Policy Framework clearly indicates the Government's commitment to the adjustment program. Significant steps have been taken to improve the trade regime further through the reduction of import licensing and reform of export policies. In the area of industrial deregulation, the Government's efforts went beyond what was expected by actually initiating steps to relax investment licensing and taking steps to simplify and ease foreign investment regulations. Regarding public enterprises, the Government (with IMF assistance) completed a preliminary consolidation of the financial accounts of public enterprises, but an actual program of reform has yet to be announced. Finally, GOI has pursued, as suggested in the Policy Framework, appropriate macroeconomic policies through a prudent fiscal and monetary stance and sound exchange rate management.

5.4 One of the clearest lessons from the Indonesian experience is that understanding the Government's own agenda is a prerequisite for this type of policy based lending. This enables the Bank to identify areas where the Government is considering reform early on in the decision-making process. As a result, the Bank has focussed on those issues where openness to policy advice, and hence the potential impact of Bank involvement, is greatest. The maintenance of a well staffed Resident Mission has facilitated this process and provided the capacity to respond to Government's initiatives in a timely and substantive manner.

5.5 One constraint to the pace and direction of reform that has been identified during the TPAL I process is the shortage of skilled and policy-oriented staff within GOI. Although there has been significant

progress in the process of policy formulation during the 1980s, much depends on a few over-stretched individuals at the higher echelons of Government. Greater emphasis needs to be placed in building up the institutional capacity within Government to undertake analysis and formulate policy reforms.

5.6 In conclusion, it appears that the Bank's approach of proceeding with a series of untranched loans linked to actions already taken has been appropriate. This has permitted the Bank to provide clear support to the ongoing adjustment effort, while allowing the Government to pursue vigorously future reforms without explicit ties to a Bank loan. On the other hand, the appraisal and supervision of TPAL I (and subsequently TPAL II) provided an important framework for furthering the policy dialogue. While TPAL I will have to be evaluated eventually as part of the continuing adjustment program, the results to date are encouraging. The early and substantive follow-up measures that provided the basis for TPAL II suggest that TPAL I has provided a useful first step in what appears to be a successful adjustment process.

The Remaining Agenda

5.7 Adjustment in Indonesia is proceeding well. Substantial progress has been made in reducing external and internal imbalances. Moreover, exchange rate depreciation, trade reforms and industrial deregulation have strengthened competitiveness, reduced production costs and improved allocative efficiency in the economy leading to a sharp increase in exports and a strong revival of private investment. Nonetheless, the lower price of oil and the steep increase in debt service suggest that stabilization efforts must continue to reduce fiscal and external deficits to sustainable levels during the next two years.

5.8 At the same time, investment must be maintained at its current rate and eventually increased to support the export drive and to provide the basis for economic recovery. Over the medium term, the non-oil economy must grow at least 5% per annum to absorb the growing labor force and permit a meaningful reduction in the level of poverty. This ill require policies that continue to restructure the economy while stimulating investment. Since much of the momentum for growth will come from export expansion and improvements in economywide efficiency, a strat.gy of growth with adjustment also will provide the best means to protect and improve the creditworthiness of the economy. Improved domestic resource mobilization and non-oil export growth will steadily close internal and external resource gaps, providing the basis for growth without recourse to special external support.

5.9 The Government remains committed to maintaining appropriate macroeconomic policies supported by the necessary structural adjustment reform. This has been demonstrated in the recently announced Budget for 1988/89 which anticipates further restraint in both current and capital expenditures. For the third year in a row, the Government has decided to freeze civil service salaries, and real capital spending is projected to fall. The Government is also actively considering further reforms in the trade, industry and financial sectors. To support the Government in this effort, the Bank has provided technical assistance to the Trade and Industrial Policy Steering Committee (TIPSC), which was formed as a result of TPAL I. A proposal for longer term technical assistance has

been drawn up that will consolidate and improve upon the data base and analysis undertaken under the effective rate of protection study and the ongoing industrial regulation study. It is hoped that this will make a useful contribution towards building up the institutional capacity within Government to address trade and industry related issues.

5.10 The Bank is continuing to support GOI's reform program, via the ongoing Second Trade Policy Adjustment Loan.10/ This Loan provides the necessary vehicle through which to continue work started under TPAL I, as well as providing financial support during the adjustment period. Under TPAL II, the Bank has emphasized that particular attention will continue to be paid to (a) further measures to reduce NTBs and rationalize the tariff structure; (b) continued progress on simplifying the regulatory framework and reducing the scope of industrial licensing; (c) the study of complementary reforms in the financial sector, to support industrial restructuring and recovery; (d) appropriate fiscal and monetary policies, to reduce the current account deficit, control inflation and preserve a competitive exchange rate; and (e) prudent external debt management; including limits on import-related credits and careful scrutiny of proposals for large capital-intensive projects. It is hoped that satisfactory progress in these areas could be the basis for a third adjustment loan from the Bank in about a year.

10/ Approved by Executive Directors on April 19, 1988, Report No. P-4794-IND.

PROJECT COMPLETION REPORT

INDONESIA

TRADE POLICY ADJUSTMENT LOAN II (LOAN 2937-IND)

Introduction

1. The external environment faced by Indonesia has worsened considerably since the early 1980s, with sharply lower oil prices, and more recently, the depreciation of the US Dollar. The Government of Indonesia (GOI) has responded effectively to this challenge, taking decisive actions to restrain domestic demand, mobilize additional resources and set in train the structural changes needed to develop the non-oil economy. The World Bank has supported GOI's recent reform efforts through two adjustment loans: Trade Policy Adjustment Loan I (TPAL I) approved on February 3, 1987 1/ and Trade Policy Adjustment Loan II (TPAL II) approved on May 10, 1988. Both loans were for US$300 million.

2. The objectives of TPAL II were to: (a) support the substantial reforms, especially in the area of trade policy, undertaken by GOI during 1987, and ensure that they are implemented well; (b) assist GOI to bring about an early recovery in economic activity consistent with external and domestic financial stability; and (c) maintain the policy dialogue on further reform, including the preparation of a medium-term plan for tariff rationalization. These objectives were to be achieved partly through our ongoing dialogue on policy issues and partly through balance of payments support. In addition to providing direct financing for general imports, the loan played a catalytic role in mobilizing US$2 billion of fast-disbursing special assistance during 1988/89. These additional resources have enabled GOI to push ahead with its deregulation measures, and by cushioning the economy against the deflationary impact of the drop in oil prices, have facilitated the recovery in private investment and growth.

3. As with TPAL I, the loan supported policy measures announced prior to Board presentation. This approach was considered appropriate because: (a) the Bank's prior discussions with GOI had resulted in a common understanding of the measures that needed to be taken; (b) analysis of the measures to be supported by TPAL II showed them to be substantive and deserving of support; (c) the measures taken were part of a medium-term adjustment program to which GOI is strongly committed, and subsequent reforms could provide the basis for a follow-up adjustment loan; and (d) GOI's strong track record on economic management provided the basis for expecting that further policy measures would be taken. The record of the past year indicates that our confidence in GOI's commitment to the adjustment effort was not misplaced.

4. As reviewed below, implementation of the reform program has proceeded well and the results--in terms of stabilizing the economy and promoting structural change--have been very encouraging. Over the past year, GOI has maintained its sound macroeconomic policies and extended the reform process in

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1/ The Project Completion Report for TPAL I was submitted OED on June 30, 1988.

three key areas: trade policy, maritime transport and the financial sector. Additional measures are expected soon in the areas of investment licensing and public enterprise reform. Progress in some areas has exceeded expectations (e.g., financial sector reform) while in others it has lagged behind (e.g., tariff rationalization). However, overall, progress in the key areas identified under TPAL II for monitoring and follow-up has been satisfactory. Accordingly, a third adjustment loan for private sector development is now under preparation and is expected to be presented to the Bank's Board in June 1989. The proposed amount is US$350 million.

Implementation of the Reform Program

5. A key prerequisite for the success of GOI's reform program has been sound macroeconomic policies. Over the past three years, civil service salaries have been frozen and real capital spending by the Central Government has been cut by more than 20%. At the same time, a strong effort has been made to increase budget revenues, primarily through improvements in tax administration. As a result, the ratio of non-oil taxes to GDP has risen from 8.4% in 1985/86 to 10.8% in 1988/89 (see Table 1). The combination of

Table 1: IMPLEMENTATION OF POLICY REFORMS

	1985	1986	1987	1988
1. Fiscal policy /a				
Non-oil taxes (% of non-oil GDP)	8.4	9.8	9.4	10.8
Net domestic expenditure (% of GDP)/b	8.5	3.8	4.1	2.2
Primary balance (% of GDP)	-0.9	-1.1	0.8	0.4
2. Monetary policy				
Reserve money growth (% p.a.)	17.6	21.3	11.0	-5.7
3. Real effective exchange rate (% change) /c	-2.9	-23.0	-26.6	-2.9
4. Coverage of NTBs (%)				
CCCN items	31.5	27.9	21.7	16.3
Import value	42.9	34.9	25.5	20.8
Domestic production	41.4	39.5	37.6	28.9
Manufacturing production	52.0	43.8	35.3	26.0
5. Investment approvals /d				
Domestic (Rp. trillion)	3.7	4.4	10.3	14.9
Foreign (US$ billion)	0.9	0.8	1.5	4.4

/a All data relate to the Central Government only.
/b The domestic content of expenditure less non-oil revenues.
/c Based on annual average data.
/d By BKPM.

expenditure restraint and tax effort has helped to improve the fiscal position of the Central Government, with a decline in net domestic expenditure as a ratio to GDP and generation of a primary surplus. Monetary policy was also tightened, as reflected in the declining growth rate of reserve money. The prudent fiscal and monetary stance has helped to contain domestic inflation to about 9% per annum over the past two years. At the same time, the nominal value of the Rupiah has been gradually depreciated against a basket of currencies. As a result, the real effective exchange has continued to decline, preserving the competitive advantage provided by the devaluation in September 1986.

6. In the area of trade policy reform, the loan was based on measures taken during 1987 to reduce the coverage of non-tariff barriers (NTBs). Through two packages, in January and December 1987, GOI removed 342 items from import licensing restrictions. As shown in Table 1, these reforms accounted for 20% of all items and 22% of import value previously restricted. More importantly, they reduced the coverage of NTBs from 44% to 35% of manufacturing production. Most of the reforms were in highly-protected manufacturing subsectors--such as textiles, garments and footwear, basic metals and engineering goods--where import licensing restrictions had the most deleterious effect on international competitiveness and allocative efficiency.2/ Follow-up discussions with GOI and interviews with firms suggest that these measures have been implemented smoothly. The issuance of import licenses is fairly quick and non-discriminatory, and information regarding the reforms is being disseminated to the firm level.3/

7. Additional measures were taken during 1987 to eliminate some of the direct impediments to exports: (a) the need to obtain a special export license was abolished; (b) several export bans and quotas were removed;4/ and (c) access by exporters to internationally-priced inputs (through the May 6 scheme) was broadened. As shown in Table 2, utilization of the May 6 scheme has continued to expand rapidly, in terms of number of firms and import value covered, while average processing times have been reduced.

2/ Because of the dominant role of agriculture, and the limited reforms in this sector, the coverage of NTBs for the economy as a whole fell only slightly, from 40% to 38% during 1987. Follow-up measures to extend the reforms into the agriculture sector were taken in 1988 (see para. 14). These have significantly reduced the share of domestic production under NTBs.

3/ More recently, in November 1988, all existing import license holders (some 4,880) were required to reregister. By February 1, 3,667 had reapplied and 3,645 (99%) had been approved. Some 42 new importers were also registered during January and February 1989. Import licenses are now valid for as long as the importer remains in business, whereas previously licenses had to be renewed every 3 to 5 years.

4/ During 1988, some new export bans (e.g., semi-processed rattan, lowest-grade rubber) were imposed to increase domestic value added and/or protect the environment. The justification for these bans needs to be reviewed, taking into account market conditions for these products and the impact of the bans on domestic employment and income distribution.

Table 2: IMPLEMENTATION OF MAY 6 SCHEME

	No. of Firms	Value of imports (US$ million)		Processing time (no. of days)	
		Approved	Realized	Exemptions	Drawbacks
1986 /a	242	236	65	12	24
1987	482	902	297	7	17
1988	1,098	2,447	626	6	13

/a From July.

Source: BPKE/PDK.

8. Under the two trade reform packages of 1987, tariffs for 121 items were raised and tariffs for 178 items were lowered. Temporary surcharges were also imposed on 51 import items. The tariff increases compensated for the effects of the removal of import licensing restrictions, but remained within the lower tariff ceiling set in 1985. The tariff reductions in the January 1987 package were concentrated on products not produced domestically, and were intended to offset the cost-raising effects of the September 1986 devaluation. The reductions in December 1987 went beyond this limited objective by reducing some tariffs on domestically-produced goods that were removed from license restrictions under earlier decrees. As shown in Table 3, the cumulative effect of tariff changes since 1985 has been to reduce the range of dispersion, with little effect on the average tariff rate. However, in moving off NTBs, split tariffs and surcharges were used to protect some domestic producers.5/ As a result, there are still marked differences between and within sectors in the level and dispersion of tariffs. This reinforces the importance of broadening the trade reform effort to include a comprehensive rationalization of the tariff schedule.

9. Progress on tariff reform has been slower than expected, due to delays in strengthening GOI's institutional capacity to undertake trade and industrial policy analysis. Despite strenuous efforts by Bank staff, proposals for technical assistance did not materialize. One of the constraints has been the absence of a clear focal point within GOI for trade and industrial policy work. In response to this situation, GOI has recently reconstituted the high-level team on tariffs, under the chairmanship of the Junior Minister of Finance. In addition to tariffs and surcharges, this team also has responsibility for related issues of trade and industrial policy. To be effective, this team will require technical assistance to build up its analytical capacity.

5/ "Split tariff" positions are used to subdivide a standard seven or nine digit CCCN/HS product description into finer product groups with differential tariffs or NTBs applied. Surcharges are also used as a de facto anti-dumping device.

Table 3: CHANGES IN THE TARIFF SCHEDULE /a

	Pre-1985	1985	1988	1989
Average tariff rates (%)				
Unweighted	37.3	27.0	24.0	24.4
Weighted by:				
- Import value	22.0	13.0	14.5	14.5
- Domestic production	26.0	17.1	16.6	17.0
Index of dispersion /b	61.5	107.8	90.0	84.4

/a Tariffs are inclusive of surcharges and specific duties have been converted to ad valorem equivalents.
/b Measured by the coefficient of dispersion.

Source: Ministry of Finance and World Bank staff estimates.

10. A number of major steps were taken during 1987 to relax and simplify the investment and capacity licensing system. Firms are now allowed to increase production by up to 30% of their licensed capacity without requiring new investment approval and to diversify production within much broader product categories, thereby improving the operational flexibility of firms and promoting greater competition. Furthermore, the requirements for investment licenses were streamlined and additional fields of investment opened to private domestic and foreign investors. The December package included a series of measures to relax foreign investment regulations: domestic ownership requirements were eased significantly; restrictions prohibiting foreign-owned companies from marketing Indonesian export goods were removed; foreign firms are now allowed to purchase domestic inputs without restriction; and rules regarding the hiring of expatriate personnel were relaxed. These steps have addressed key concerns expressed by foreign investors in Indonesia and reduce differences in treatment between foreign and domestic firms. Together with the broader regulatory measures, these changes in the investment and capacity licensing system have significantly improved the environment for private investment. This is reflected in Table 1, which shows that investment approvals by BKPM have risen by 230% for domestic investors and 430% for foreign investors over the past two years.

Impact of the Reform Program

11. The two core objectives of GOI's adjustment program are: (a) restoration of financial stability; and (b) sustained recovery of growth. Progress has been good on both fronts. As regards financial stability, the prompt stabilization measures taken in response to the external shocks of 1986 contained the current account deficit to around 6% of GNP in 1986/87 and reduced it to below 3% of GNP over the past two years (see Table 4).

Inflation has also been held to about 9% per annum over the past two years, preserving the competitive advantage provided by the 1986 devaluation. Indonesia's debt burden remained high in 1988, with the debt service ratio over 36%. However, a number of debt indicators (e.g., debt exports, debt/GNP) have already started to decline and all debt indicators are projected to improve steadily over the next few years. This trend reflects the favorable debt structure (reinforced by the availability of special assistance) and the strong economic recovery (especially for non-oil exports). GOI remains committed to servicing its debts on schedule.

Table 4: IMPACT OF POLICY REFORMS
(growth rates, % p.a.)

	1985	1986	1987	1988
Economic activity				
GDP	1.7	3.7	3.9	4.7
Non-oil GDP	3.8	3.9	4.6	5.6
Fixed investment	-6.0	-7.0	1.9	7.0
Public	2.4	-19.6	-1.7	6.3
Private	-13.8	6.8	4.9	7.6
External trade				
Non-oil exports	10.1	3.2	25.8	13.6
Non-oil imports	-13.3	-13.6	5.0	6.6
Other indicators				
Domestic inflation /a	4.7	5.8	9.5	8.5
Current account/GNP (%)	-2.4	-5.9	-2.3	-2.5
Debt service ratio (%) /b	24.4	37.3	33.9	36.3

/a As measured by the urban consumer price index (adjusted).
/b Debt service excludes prepayments.

Source: World Bank staff estimates.

12. The measures taken have helped to provide the basis for a sustained recovery of growth in three ways:

(a) In response to the real exchange rate adjustment, and accompanying deregulation measures, non-oil exports have increased substantially from US$6.7 billion in 1986/87 to an estimated US$12.1 billion in 1988/89, a real increase of 20% per annum. Much of this growth has come from a diversifying base of manufactured goods, with many small and medium-sized private firms contributing substantially.

(b) There is also evidence of resurgence in private investment, especially in export-oriented activities. The sharp increase in investment approvals by BKPM is noted above. Implementation of these approvals is reflected in Table 4, where the growth of private investment is estimated to have accelerated to 8% in 1988. Together with the severe constraint on public investment, this has led to a change in the structure of investment, with the private sector now accounting for about 54% (up from 49% in 1985).

(c) The recent reform measures have also had a positive effect on economic efficiency. As shown in Table 5, the return per unit of investment had declined sharply in 1982-85, as the pace of economic growth began to slow and NTBs were imposed to protect inefficient domestic industries. This trend is also reflected in the high ICOR and fall in total factor productivity (TFP). However, after 1985, there has been a noticeable improvement in all three of these efficiency indicators.

These positive developments have supported a steady increase in the growth rate of non-oil GDP from 3.8% in 1985 to an estimated 5.6% in 1988. With the resurgence of private investment and momentum of the export drive, there is every expectation that this recovery will be sustained.

Table 5: MACROECONOMIC EFFICIENCY INDICATORS

	1974-81	1981-85	1986-88
Rate of return on investment (% p.a.)	31.4	13.1	21.8
ICOR	2.8	7.8	5.2
Total factor productivity change (% p.a.)	0.9	-2.5	1.0

Source: World Bank staff estimates.

13. The recovery in economic growth has helped to contain the social costs of adjustment. GOI has also acted directly to reallocate public spending to poverty-related programs. For example, the shares of development expenditure allocated for social services and agriculture have been significantly increased over the past five years. An effort has also been made to protect regional transfers, which normally finance small-scale and labor-intensive infrastructure projects at the local level. Even so, because of the overall budget constraint, the availability and quality of many basic services has weakened. More fundamentally, because of the severe terms of trade loss, per capita incomes are still lower than in 1981. The main burden of adjustment has fallen on earnings, with real labor earnings in agriculture and services probably stagnating or declining during the recent adjustment period. However, part of the adjustment in the labor market has occurred as

an increase in the rate of open unemployment in urban areas, especially among young school leavers. These trends reinforce the importance of sustaining a higher growth path over the medium term, to absorb the rapidly expanding labor force at higher levels of productivity and income. By restoring stability and promoting restructuring in the economy, GOI's reform program is laying a solid foundation for achievement of this objective.

Progress on the Remaining Agenda

14. Over the past year, GOI has pushed ahead aggressively with its program of adjustment. A central element continues to be maintenance of prudent and stable macroeconomic policies. In the new budget for 1989/90, announced in January, provision is made for an increase in civil service salaries (by 15%). This is appropriate under current circumstances. However, the overall fiscal stance remains cautious, with a primary surplus and declining net domestic expenditure. These trends reflect the strong emphasis placed on public resource mobilization. Several important measures in this area have already been announced: (a) power tariffs were raised an average by 25% on April 1, 1989; (b) VAT has been extended to the wholesale level and most services; (c) the rates and number of items subject to luxury taxes have been increased; and (d) the Government intends to eliminate pesticide subsidies during the coming year.

15. A major package of new trade policy measures was announced in November 1988. A further 295 items have been removed from restrictive import licenses, accounting for an additional 17% of all items and 10% of import value previously restricted. The impact on the share of total domestic production protected by import licensing is much larger than previous packages, declining from 38% at end-1987 to 29% by end-1988.6/ This reflects an effort to push the reform effort into the agriculture, food and beverages sectors (e.g., tobacco, rubber, fruits, palm/coconut oil, processed meat, cigarettes), which constitute a substantial share of domestic value added. With respect to manufacturing, the November package is significant in that it removed all license restrictions on fertilizers as well as plastics, a hitherto difficult area of reform, and made further in-roads into the steel and textile subsectors. The November package also adjusted tariffs and/or surcharges on 191 items, including 25 items for which specific duties have been replaced by ad valorem duties. In addition, Indonesia moved to the new Harmonized System of coding and classifying items on January 1, 1989.

16. GOI also introduced a sweeping reform of maritime transport regulations in 1988. First, the compulsory scrapping policy for ships was suspended in February. This was followed in November by a major deregulation of the shipping industry which: (a) reduced and simplified business license procedures; (b) allowed shipping lines to determine their own route structure and schedules; and (c) allowed national lines to charter foreign flag vessels and form new joint venture companies with foreign lines. This comprehensive set of reforms has removed virtually all regulatory impediments to development

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6/ Of the 29% of domestic production remaining under NTBs, 16 percentage points relate to rice, where the Government maintains import restrictions for food security objectives. Indonesia is an efficient producer of rice for the domestic market.

of an efficient and responsive maritime transport industry. Our preliminary judgement is that as a result Indonesia now has a more open and unregulated shipping industry than most other maritime nations. In response to this major shift in the policy environment, over 40 new shipping companies have already been licensed. This resurgence of competition will have a strong positive effect on the quality of shipping services and transport costs.

17. Finally, GOI has moved ahead with a basic reform of the financial sector. Competition in the banking system is to be stimulated by: (a) facilitating entry of new banks; (b) easing restrictions on establishing new branches; (c) permitting public enterprises to place up to 50% of their deposits with private banks; (d) allowing banks and non-bank financial institutions (NBFIs) to issue shares on the capital market, and NBFIs to issue certificates of deposits (previously limited to banks); and (e) easing the requirements to become a foreign exchange bank. Measures to develop the capital markets include: (a) a withholding tax on time deposits to redress the discrimination against other financial assets; (b) allowing the private sector to operate stock exchanges; (c) the establishment of an over-the-counter (OTC) market (announced in late 1987); and (d) simplified entry into insurance, leasing, factoring, venture capital, consumer finance and securities activities. Finally, steps have been taken to improve the stability of the financial system, by strengthening prudential regulations and the instruments for monetary control.

18. These measures represent a dramatic departure from the past when regulations facilitated the domination of state banks and prevented the development of other segments of the financial market. Implementation of these changes will obviously take time, but there are already signs that the structure of the financial sector will be significantly altered. In the banking sector, for example, two smaller banks have had access to Bank Indonesia clearing facilities suspended--an action that usually leads to closure.7/ Other banks are reported to be merging. By the end of February 1989, new licenses had been issued for 7 new national commercial banks, 3 joint ventures with foreign banks and 47 secondary banks. Several foreign banks are actively considering opening branches. In addition, activity on the Jakarta stock exchange has picked up sharply since October 1988, and the first issue on the new OTC market was successfully completed in early 1989. Not surprisingly, monetary conditions were initially unsettled after the deregulation measures were announced. However, the situation has now returned to normal, with inter-bank rates around 12-15%, and no flight of private capital overseas.

19. In two other areas, new reforms are expected to be announced in the near future. First, further changes are planned in the investment licensing system. In order to make the system more transparent, and to relax licensing restrictions, GOI intends to transform the Investment Priority (DSP) list from a long and incomplete positive list to a short negative list. Second, GOI has recently completed a review of the financial performance of most public enterprises, to identify potential candidates for divestment or reorganization. It is expected that a number of public enterprises will enter

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7/ Bank Indonesia has reaffirmed that it will not provide funds to banks that are facing structural problems and weak management.

into joint ventures with the private sector or issue shares to the public. This latter option was dependent upon recent measures to develop the capital markets.

The Role of the World Bank

20. By any standard, GOI's efforts to restore macroeconomic stability and to accelerate the pace of structural change have been remarkably successful. The agenda for policy reform has been well developed and the Government's credibility for making difficult but correct decisions has been clearly established in the period since 1983. The World Bank has played an important role in these accomplishments. In particular, the Bank has maintained a very close policy dialogue with GOI based on the ESW program and technical assistance from the Resident Mission. This dialogue has been coordinated with IMF and IFC initiatives. At the same time, our annual economic reports, combined with the two adjustment loans (TPAL I and II), have enabled the Bank to play a catalytic role in mobilizing substantial additional external assistance from the Inter-Governmental Group on Indonesia (IGGI) to support the adjustment effort. Disbursements of special assistance totalled US$2 billion in 1988/89, including US$300 million from TPAL II and US$350 million of cofinancing from OECF.

21. The Bank's analytical support and policy dialogue has contributed to defining appropriate policy responses to emerging issues of macroeconomic management. Since the collapse of oil prices in 1986, our macroeconomic work has focussed on five major policy areas: (a) exchange rate management, to respond to external shocks and maintain the competitiveness of non-oil exports; (b) prudent fiscal and monetary policies, to reduce aggregate demand and control inflationary pressures; (c) public resource mobilization, through more effective tax administration and improved cost recovery; (d) more focussed expenditure priorities, especially for O&M and poverty-related programs; and (e) external debt management and borrowing strategy.

22. The World Bank prepared major studies on trade and industrial policy issues in 1981 and 1985. These studies helped to identify the costs of the increasingly cumbersome regulatory environment in Indonesia, and to show the broad directions for future policy change. With the subsequent decline in oil prices, the push for reforms within Indonesia gathered momentum. At the time of the devaluation in 1986, the Government asked for analytical support and advice from the Bank on how to proceed with reforms in the trade regime and regulatory environment. The related analysis provided by Bank staff will be formally presented in two studies--on enterprise regulations and on trade policy reform and implementation--to be completed later in 1989. At the request of GOI, the Bank also initiated a major study of the financial sector in 1988. The main mission visited Indonesia in July 1988 and its preliminary findings fed into the reforms announced later in the year. The completed report will be the basis for a continuing dialogue on financial sector policies. Technical assistance on maritime sector reforms was provided under the National Ports Development Project (FY85) and continued by a Bank-financed consultant within the Ministry of Communications.

Loan Administration and Coordination

23. Procurement and disbursement procedures for TPAL II were designed to ensure rapid drawdown of loan proceeds. The loan was used to reimburse 100% of foreign expenditures for eligible imports by the public or private sector for which payments were made after the date of loan signing. There was no retroactive financing under the loan. The loan specified a standard list of ineligible imports, i.e., goods intended for military and paramilitary purposes, or for luxury consumption; goods financed from other official multilateral or bilateral sources; uranium; and goods procured under contracts of less than US$100,000. Bank Indonesia was responsible for maintaining and administering the loan account. All purchases in the amount of US$5 million equivalent or more were to be procured through International Competitive Bidding (ICB) in accordance with Bank guidelines. Procurement by the private or public sector of goods contracted at a price less than US$5 million equivalent were handled on the basis of normal commercial practice or following normal Government procurement procedures acceptable to the Bank. Disbursements of eligible import expenditures would be based on Statements of Expenditures (SOEs) for imports valued at less than US$5 million; for imports above this amount full documentation would be required. Since all contracts submitted to the Bank by the Borrower were below US$5.0 million, no ICB was involved in procurement, and the loan was disbursed on the basis of SOE procedures.

24. Disbursement for reimbursement of eligible import expenditures was based on documentation prepared by Societe Generale de Surveillance S.A. (SGS) in the course of their customs inspection services. SGS is one of the firms qualified by the Bank to provide trade verification services in Bank operations. In the case of Indonesia, SGS certification provides particularly strong assurance under the system established by INPRES 4/1985. The SGS certificate provides verification of the goods being imported including the quality and quantity of imports and the applicable prevailing C&F export market price in the country of supply. The SGS certificate is also required for the release of the goods at the port of entry. The SGS certificate, therefore, provides all the information needed to ensure compliance with eligibility requirements for purposes of the Bank loan.

25. Disbursements under TPAL II were completed by November 1988. The bulk of disbursements occurred in August (40%) and October (48%). As shown in Table 6, the loan has been largely used to finance private sector imports of industrial raw materials. The counterpart funds generated by imports financed under TPAL II were credited to a special account in Bank Indonesia and were used to finance priority public expenditure programs associated with GOI's 1988/89 budget.

26. There was good coordination with the IMF on the TPAL II program. This took the form of informal exchanges and consultations during loan preparation. IMF staff reviewed the reports associated with TPAL II and fully supported the loan. The latest IMF Consultation Report was issued on April 6, 1989. GOI has not had any standby or extended arrangements with the IMF since 1973. GOI's last purchase from the IMF was for SDR 463 million in May 1987

under the Compensatory Financing Facility (CFF). This purchase represented Indonesia's total outstanding IMF obligations at the end of 1988. After the last Consultation Report (in 1988), the IMF Executive Board expressed its satisfaction that "Indonesia maintains an exchange system which is free of restrictions on payments and transfers for current international transactions." Effective May 7, 1988, the Government of Indonesia has accepted Article VIII status.

Table 6: IMPORTS FINANCED BY TPAL II
(US$ million)

Product groups	Source					
	USA	Europe	Japan	Other Asia/a	Other countries	Total
Industrial raw materials	22.9	17.6	37.0	60.7	42.1	180.3
Agricultural inputs & equipment	1.4	0.6	0.2	1.5	0.1	3.8
Construction materials & equipment	3.3	0.1	5.5	0.5	0.7	10.1
Mechanical machinery & equipment	0.6	2.1	3.3	7.0	0.2	13.2
Electrical machinery & equipment	0.8	1.0	1.4	1.0	0.8	5.0
Transport machinery & equipment	0.5	0.4	32.7	0.6	8.2	42.4
Miscellaneous	4.1	7.3	8.0	17.1	8.7	45.2
Total	33.6	29.1	88.1	88.4	60.8	300.0

/a Includes goods transhipped through Hong Kong and Singapore.

Source: Bank Indonesia.

BORROWER COMMENTS

ATTACHMENT

FE 1371

[illegible]
[illegible]
JAKARTA, INDONESIA

[illegible]

[illegible]
Dear [illegible]
The World Bank
Jakarta

Mr Baird

[illegible]

Dear [illegible]

We have received the Project Performance Audit Report (dated June 19, 1989) prepared by the Operations Evaluation Department on the TPAL I and TPAL II. In general we think the analysis of our economy is sound and we welcome the general conclusion that our performance [illegible] further financial [illegible] with [illegible] [illegible].

However, [illegible] a public document, we would like to [illegible] your attention to some of the statements in it which perhaps need more emphasis. These are :

Page xxiii para 2[illegible] :
"Concurrent with the devaluation of the rupiah in 1986, GOI [illegible] analytical support and Bank advice on ways to [illegible] with reforms"

Page xxxi para 33 :
"Third the [illegible] story system [illegible]"

Page 79 para 6.05 :
"The country knows that if it deviates from the policy course that it and the Bank have agreed on, even implicitly, the Bank could react by reducing or ending support in the [illegible]"

We thank you for your attention

Sincerely yours

[illegible]