Letter of Development Policy

Jakarta, September 30, 2013

No. S-208/M.EKON/09/2013
No. S-699/MK.08/2013

Mr. Jim Yong Kim
President
The World Bank
Washington D.C., USA

Dear Mr. Kim,

On behalf of the Government of Indonesia, we would like to provide an update on our recent economic reform developments, and to request the World Bank's support through policy-based lending operation of the Second Institutional, Tax, Administration, Social and Investment Development Policy Loan (INSTANSI DPL-2) for USD 400 million.

This operation provides an important package of support that would contribute to Indonesia's medium-term economic development, poverty alleviation and shared prosperity objectives. As the current Government is nearly ended its second and final term in office, we remain focused on the core reform agenda to improve economic growth, generate better employment, reduce poverty and regional disparities, while enhancing governance. Sustained solid economic growth in the past few years has generated more employment and reduced poverty. We have strived to put in place a strong macroeconomic foundation for economy to grow further. Despite the current financial markets turbulence, we expect that our economic growth will remain resilient in the future. With a diversified economic base and a growing middle class, consumer spending and investments have good medium- and long-term prospects. While we expect a slower economic growth in 2013, we have continued to adjust our fiscal and monetary policy settings to the recent changes in the external and domestic environment. We have also introduced a policy package to help stabilize the economy and put a more solid foundation for growth in the coming years.

Our key objective is to achieve growth above 5 percent range in the next couple of years, as a more sustainable global economic recovery takes root. In order to reach the country's full potential, we will need to embark upon more progressive reforms to lead the improvements in public institutions and capacities, particularly those aimed towards poverty alleviation, shared prosperity, and developed public financial management. The proposed development policy lending operation is fully aligned with our medium and long-term agenda, as detailed in the National Medium-Term Development Plan (RPJMN) 2010-2014. During the last decade, Indonesia has made significant progress toward its economic development and poverty alleviation objectives. We recognize that reform efforts to improve the quality of public spending will need to progress further and we will continue the productive collaboration with our
development partners in this key priority beyond 2013. Therefore, although we had previously envisioned proposed operation to be the last of a two-year, programmatic DPL series, it appears likely at the moment, that the operation would need to be extended from two to three years ahead.

The purpose of this Letter of Development Policy is to provide an update on the Indonesia’s recent progress towards implementing its reform program and medium-term agenda in the policy areas supported by the proposed lending operation.

The Economic Situation

Like many other countries in the region, Indonesia has faced a number of external challenges. Since the announcement of the potential quantitative easing (QE) tapering by the US Federal Reserve Bank, the capital flow has swung back somewhat to advanced economies, particularly the US and Japan. It has created a ripple effect across emerging economies that had earlier experienced large capital inflows, including Indonesia. From end-May to late August, the Jakarta Stock Exchange Index fell by close to 25 percent prior to rebounding by 10 percent and the 5-year Indonesia Rupiah (IDR) bond yield rose by 280bps; the rupiah has depreciated by close to 18 percent against the US dollar year to date. The Credit Default Swap (CDS) rate for Indonesia has increased more sharply than other countries in the region. While the primary trigger was external and related to the potential QE tapering, Indonesia has been more severely affected mainly because of its relatively open capital account and the significant foreign presence in its stock and bond markets. At the same time, the domestic bond market is still very shallow compared to other countries in the region.

To cope with the heightened financial market turbulence, the Government has implemented comprehensive measures. On the macro front, Bank Indonesia has increased its policy rate by 150bps from June to September, to reach 7 percent, and allowed more room for the rupiah to depreciate. The Government has also issued structural policy measures targeted to reduce the current account deficit, support investment and exports, and ease inflationary pressure from key commodities. To add a buffer to the country’s large reserves, the swap line between Bank Indonesia and Bank of Japan worth USD 12 billion has been extended for another 2 years. In addition, to ensure that Indonesia could continue with its development and reform agenda, even in the event of larger financial market turbulence, the Government had already put together a USD 5 billion contingent financing facility with the support from the Asian Development Bank, Government of Australia, Government of Japan and the World Bank.

Thanks to the extensive structural reforms implemented over the last few years, many of which have been supported by the development partners, Indonesia should continue to be relatively well-positioned to weather the increasing global economic and financial headwinds for emerging markets. The revised 2013 Budget approved in June 2013 also includes measures to increase fuel prices and compensation for the poor, while providing the Government with significant flexibility to respond to evolving global economic conditions. Despite a projected increased budget deficit to 2.4 percent of GDP, needed to support increased infrastructure spending, the downward trajectory of government debt-to-GDP ratio is projected to continue in 2013. With its strong capital base, the financial sector should remain resilient to the financial market turbulence. We believe all these factors, together with continued structural reforms, would support continued solid investment and economic growth in the country over the medium-term.

The Government is committed to continuously improving Indonesia’s economic resilience such as improving poverty reduction, strengthening bureaucracy reforms, and programs as outlined
in the proposed 2014 Budget that is currently under discussion with Parliament and is expected to be approved by end October. The proposed Budget also foresees the implementation of new policies such as the health dimension of the new National Social Security Law, as discussed below, and a proposal to adjust electricity tariffs for selected customers to further improve the quality of spending. As in the 2012 and 2013 Budgets, the proposed 2014 Budget includes provisions relating to crisis preparedness to allow the Government the flexibility to respond to potentially rapidly changing macroeconomic developments.

Enhancing the quality of public spending for poverty alleviation and shared prosperity

The Government remains committed to enhance poverty alleviation and shared prosperity efforts. Since taking up office in 2009, the Government continues to intensify policy reforms that support poverty reduction, by adopting a pro-poor approach towards economic development. The RPJMN 2010-2014 emphasized poverty reduction as its highest development priority by maintaining strong growth and job creation, and continuing implementation of the national poverty reduction framework; and the revised 2014 budget maintains this thrust, with a targeted poverty rate of 9 to 10 percent. We recognize the need to boost social assistance programs, in order for them to reach their full potential in contributing to efforts to accelerate poverty reduction. The oversight of national poverty reduction programs was therefore elevated to a cabinet-level national team led by the Vice-President, which continues to play a key role in preparing reform policies and monitoring their implementation. At the same time, in order to move towards a more effective and integrated system of poverty reduction programs, a national registry of poor and vulnerable households was developed to improve program targeting.

Social spending has increased significantly under the revised 2013 Budget, with the introduction of the compensation package for the subsidized fuel price increase in June 2013, which aims to partly help shield poor households from the impact of higher fuel prices. The package demonstrates the important steps that had been taken towards developing a more comprehensive, integrated and well-targeted social support system. These include the policy measures aimed towards improving poverty measurements and targeting of the poor, such as the development of the national registry of poor and vulnerable households. The approved package of compensation measures totals IDR 29 trillion (USD 2.7 billion), or about three-quarters of the estimated total fuel subsidy savings in 2013. The compensation package comprises two main components: (i) an unconditional cash transfer (BLSM) for 15.5 million of Indonesia’s poorest households (around 90 million people) for a period of four months, the provision of additional rice to beneficiaries of the Rice for the Poor (Raskin) program, and additional spending on infrastructure programs; and (ii) expansion of the financial assistance for poor students and conditional cash transfers for health (PKH).

Indonesia is also moving ahead towards strengthening social protection, through the establishment of a new national social security system. The 2004 landmark legislation on the National Social Security Law (SJSN Law) provides the principles and goals of the national social security system, and establishes a series of social insurance funds financed by employer, worker and government contributions that cover all Indonesian workers in both the formal and informal sectors. More recently, the 2011 Social Security Administrator Law (BPJS Law) establishes two nationwide social insurance administrators: the BPJS Health and the BPJS Employment. In accordance with the BPJS Law, the Government is to merge by January 2014 all existing social health insurance mechanisms into a single-payer system. Improving the performance of National Health Insurance for the Poor and Near Poor (Jamkesmas) will also be
key to attaining universal health coverage in Indonesia by the stated goal of 2019, which necessitates the readiness of the supply-side and the financial sustainability of the program.

Conclusion

Despite the global economic challenges, the Government of Indonesia has continued to implement proactive measures to ensure that the country sustains its solid economic growth and poverty reduction. We are committed to maintaining macroeconomic stability while enhancing our preparedness for meeting any global economic shocks or financial market turbulence. At the same time, we are pushing ahead with our medium- and long-term economic reforms to meet our development priorities. In closing, let us reiterate the Government's strong ownership and commitment to improve the quality of public spending and strengthen social protection program where we are soliciting the support of the World Bank. We look forward to continued engagement and support for Indonesia's economic development agenda in the coming years.

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