Letter of Development Policy

Jakarta, October 5 2012

Mr. James Yong Kim
President
The World Bank
1818 H Street, NW
Washington, DC 20433

Dear Mr. Kim,

On behalf of the Government of Indonesia, we would like to express our gratitude for the long term support that the World Bank has provided as a development partner within the multilateral economic and financial framework. We are hereby writing, on behalf of the Government of Indonesia to request the World Bank support through three lending operations:

- The Institutional, Tax Administration, Social and Investment Development Policy Loan (INSTANSI DPL) for USD 300 million.
- The Financial Sector and Investment Climate Reform and Modernization Development Policy Loan (FIRM DPL) for USD 100 million.
- The Connectivity Development Policy Loan for USD 100 million.

These three operations together form an important package of support to the Government that will help it achieve its medium term economic development and poverty reduction goals for Indonesia. Each of the development policy loans addresses strategic areas of reform including public financial management, poverty alleviation, financial sector development, investment climate, and connectivity. The three operations are fully aligned with the priority elements of our development agenda, as we have outlined in Indonesia’s National Medium-Term Development Plan (RPJMN) 2010-2014, the Master Plan for Acceleration and Expansion of Indonesia’s Economic Development 2011-2025 (MP3EI), as well as the Annual Government Action Plans (RKP), ministry/agency work programs, and reform packages. As you are aware, Indonesia has made important progress over the past decade in many areas of social and economic development and poverty reduction. However, continued implementation of its earnest reform agenda is essential if it is to meet the goals in terms of sustainable and inclusive growth. This Letter of Development Policy outlines the Government’s recent progress implementing its reform program and its medium term agenda in the areas supported by the loans.
Indonesia has established a good track record in advancing key policy and institutional reforms. The Government intends to continue the reforms, and anticipates that the proposed program lending overall will continue to support these efforts. The financial support provided for these three DPLs will complement and build upon the DPLs 1-8 supported from 2003-2011 and the USD 2.0 billion in financing provided by the World Bank through the Program for Economic Resilience, Investment and Social Assistance (PERISAI) Development Policy Loan with Deferred Drawdown Option in May 2012. Since May, other development partners including the Government of Japan, Australia, and the Asian Development Bank have also committed additional financing to PERISAI, which aims to enhance the Government's preparedness to address the potential adverse impact of ongoing volatility in financial markets on Government's ability to meet its gross fiscal financing needs from markets. This facility is expected to help ensure that Indonesia can continue with its earnest development and reform agenda even in the event of a crisis.

Output growth in Indonesia has been consistent throughout the last decade, broad based and strong, as well as relatively crisis resistant, bouncing back to pre-crisis levels since 2008-9. This mainly reflects increasing private sector investment and strong domestic consumption. Through its fiscal policy stance and policy reform agenda, the Government also made efforts to support growth in the face of a weaker, and uncertain, international environment, in conjunction with Bank Indonesia's supportive monetary policy.

Indonesia also enjoys low fiscal deficits, supported by the Government efforts to increase revenue and contain our expenditures, and we have concurrently been able to reduce our external imbalances and improve investor sentiment. In the future, we are committed to furthering our efforts to enhance our crisis preparedness and reduce any potential financial market volatility in the face of ongoing global economic turmoil, and in parallel, boost medium term growth.

**Enhancing the quality of public spending for poverty reduction and service delivery**

The Government remains committed to accelerating the pace of poverty reduction. Since the 2009 elections, there has been renewed commitment by the Government to intensify policy reforms that support poverty reduction and improve the effectiveness of national poverty reduction programs. The RPJMN 2010-2014 highlights the Government's aim to lower the poverty rate to 8-10 percent by 2014 under the President's triple-track development strategy (pro-growth, pro-jobs and pro-poor) that will reduce poverty by strengthening economic growth, stimulating job creation, and deepening investments in our poverty reduction strategy. The latter include further improvements in the targeting and monitoring of poverty alleviation programs and measurement of poverty, to ensure that these programs reach the intended beneficiaries and to better inform policy choices going forward.

We also recognize that better targeted allocations of public funds toward development priorities and more efficient, transparent and accountable spending are essential to further improving public service delivery and the overall quality of spending. Over the past decade, we have made significant progress in the way public finances are managed and in increasing transparency and independent oversight. Changes in the legal and regulatory framework are now largely complete, expenditure controls have been strengthened within a unified budget, government accounting
standards have been formally established and are largely being adhered to in the production of comprehensive annual financial statements, while the capacity of the internal and external audit functions continues to grow. A new public Financial Management Information System (SPAN), which should streamline budget execution and provide more timely and robust information for budget management at all levels of government, is expected to be rolled out in 2013. The reform momentum has also gradually shifted toward the implementation of more performance orientated practices with the introduction of the Medium-Term Expenditure framework (MTEF), Performance-Based Budgeting (PBB), and results-based monitoring.

Developing a sound, efficient and inclusive financial sector

In recent years, the Government has made important progress in terms of achieving stability in the financial sector. This has been demonstrated by improved soundness indicators of the banking sector in particular, and the relatively modest impact to date of both the global financial market instability since 2008 and ongoing crisis in the Eurozone. The Government has responded proactively to such global developments, identifying and implementing key measures to maintain the stability of the financial sector and to reduce volatility in our financial markets. For instance, the Government has established a bond stabilization framework that aims to stabilize the government bond market in the case of a sudden reversal in capital flows or shock. This mechanism includes a number of potential actions to stabilize government bond market in the case of crisis.

In addition to our efforts noted above, we plan to continue our longer term reforms to promote financial sector stability, by pursuing reform of the underlying legal and regulatory framework. Reinforcing the Government’s commitment to promote the financial stability, in October 2011, the Indonesian Parliament passed the new Financial Services Authority Law (the “OJK Law”), which provides the legal basis for the establishment of a new consolidated financial sector supervisory authority. Importantly, in the medium and longer term this law provides us with an opportunity to further strengthen the quality of financial sector supervision in Indonesia. In this way, the new law establishes a legal basis for improved coordination in monitoring financial sector stability through the Financial Sector Stability Coordination Forum. To this end, we are supporting efforts to improve crisis prevention and management arrangements. This has included development of the National Crisis Management Protocol, and agreement on information sharing and coordination arrangements between the Ministry of Finance, Bank Indonesia, and Indonesia Deposit Insurance Corporation (LPS).

The current global economic environment reinforces the importance for Indonesia financial sector authorities to continue to implement its reform agenda related to financial sector diversification and inclusion. This includes the pursuit of deeper reforms of the financial sector to enhance efficiency and expand access to services for the poor and underserved. In the medium term, this will imply measures to promote the development of non-bank financial institutions, including capital markets and insurance sector. Specific reform challenges and priority measures are outlined in the Bapepam-LK Capital Market and NBFI Master Plan 2010-2014, which is currently under implementation. The Government’s reform program will also include taking important steps to implement the National Strategy for Financial Inclusion in order to enhance the prospects of the poor engaging in Indonesia’s financial system and accessing a wide range of
saving, credit, and insurance products. The development of a sound, deep, and efficient financial sector in Indonesia is required to promote medium term job creation, enterprise development, and poverty reduction.

**Supporting improvements in the investment climate**

The Government has recently embarked on a wide range of prudent regulatory reforms in order to improve competitiveness and encourage investment in Indonesia. As a result of these measures, a number of perception-based and objective indicators of the investment climate improved, and this has been reflected in increasing investment flows. In 2010, Indonesia emerged from the recent financial crisis of 2008-2009 with FDI inflows at over USD 13 billion, and further enjoyed substantially increased FDI levels of 19.2 billion in 2011.

Building on these efforts, we plan to deepen our focus on providing a positive investment climate that enables business to grow and will work with us towards achieving our goal to boost Indonesia’s economic growth to 7-9 percent during the coming decades, as outlined in our Master Plan for the Acceleration and Expansion of Indonesia’s Economic Development 2011-2025. Under this framework, we recognize that a healthy business climate increases investment and leads to stronger job-generating growth. Therefore we plan to continue reform in areas such as business licensing and regulatory reform, for example by establishing a regulatory review committee specifically supporting MP3EI. As part of the efforts to improve the business environment, we are also focusing on commercial dispute resolution, and developing the legal framework to streamline current procedures and decrease delays in small claims resolution. Looking forward, we plan to work together with all parties, including both central and local government, on debottlenecking, regulations, incentives and the acceleration of infrastructure development needed by all stakeholders in Indonesia’s growth.

**Improving national connectivity**

The government realizes that addressing challenges in connectivity is an important for Indonesia to optimize its growth potentials and strengthen inclusive growth. Bottlenecks in connectivity have been identified as a major development constraint that Indonesia needs to address, if it wishes to see rapid economic transformation. Poor domestic connectivity has increased domestic logistics cost, hinder integration in domestic economy, undermine manufacturing competitiveness and impose barriers for inclusive growth in lagging regions in Indonesia. Problems in international connectivity also impede Indonesia’s potential to benefit fully from integration with the global market.

Addressing connectivity challenges is a cross-cutting issue and integral part in Indonesia’s Five-Year National Strategic Plan RPJMN 2010-2014 and the Master Plan for Acceleration and Expansion of Indonesia’s Economic Development 2011-2025 (MP3EI) that the Government is committed to implement. MP3EI outlines the importance the Government places on strengthening national connectivity, with the Master Plan calling for efforts to reinforce, connect and complement the six regional corridors of growth in particular.
In recent years, the Government has also made significant policy and institutional reform efforts to address connectivity challenges. The Government introduced reforms aimed at improving policy coordination surrounding connectivity, improving domestic logistics efficiency, facilitating investment in public infrastructure projects, improving trade facilitation and strengthening inclusive development. We introduced a National Logistics Blueprint that will guide reforms in logistics and established the mechanism for linking these reforms with implementation of the MP3EI. Recently, we issued an implementing regulation for the new Land Acquisition Law that would help facilitate investment projects that enhance national connectivity. The Government has also introduced reforms to strengthen Information and Communications Technology (ICT) connection, particularly for Eastern Indonesia. On international connectivity, we continue to undertake reforms surrounding the Indonesian National Single Window (INSW) as a mechanism to better facilitate international trade.

We therefore plan to focus our efforts going forward on a reform program that is aimed at reducing domestic logistics costs and strengthen inclusive development, including efforts to strengthen national coordination and regulation, and connectivity on an intra-island, inter-island and international level.

Conclusion

In conclusion, Indonesia continues to make solid progress in the areas to be supported by the DPL program lending, specifically towards enhancing the quality of public spending for poverty reduction and service delivery, developing a sound, efficient and inclusive financial sector, supporting improvements in the investment climate, and improving national connectivity. We therefore appreciate your positive response to our request for support and look forward to working with you in the context of the INSTANSI, FIRM, and Connectivity DPLs.

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