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

Letter of Development Policy

Dear Mr. Kim,

On behalf of the Government of Indonesia, we would like to provide an update on recent economic, political and policy developments, and to request the World Bank’s support for a policy-based lending operation through Second Connectivity Development Policy Loan (Connectivity DPL-2) for USD 300 million.

The current Government is now approaching the last year of its second and final term in office. We remain focused on our core reform agenda to improve economic growth, generate better employment, and reduce poverty and regional disparities while enhancing governance. Despite the current financial market turbulence, we expect the country's economic growth will remain resilient in the future as we have strived to put in place a strong macroeconomic foundation for our economy to grow further. With a diversified economic base and a growing middle class, consumer spending and investments have good medium- to long-term prospects. While we expect a lower economic growth in 2013, we have continued to adjust our fiscal and environment. We recently introduced a policy package to help stabilize the economy and put a more solid foundation for growth in the coming years.

To reach the country’s full potential economic growth, we will need to embark upon more progressive reforms to accelerate infrastructure development including improved connectivity along with investments in human capital. The Government has more than doubled its budget allocation to support infrastructure development and connectivity investments since 2010. In 2013, Rp 205.8 trillion is allocated by the central government
for capital/infrastructure spending including supporting connectivity-related projects in eastern Indonesia. While significant challenges remain, a large increase in the infrastructure spending in the past few years together with reforms implemented to support infrastructure development have started to bear fruit. Indonesia’s global competitiveness index ranking rose by twelve places to 38th in the 2013 based on the Global Competitiveness Index 2013 – 2014 by the World Economic Forum. According to the report, the most improvement for Indonesia’s competitiveness was in the infrastructure pillar where it moved up by 17 places to 61st.

To expedite the process of sustainable economic growth in Indonesia, the Indonesian Government developed and implemented the Master Plan for Acceleration and Expansion of Indonesia Economic Development (MP3EI) in 2011. The MP3EI targets to accelerate our economic growth by structurally transforming the economy through investments in priority sectors and changing ‘business as usual’ practices. The MP3EI focuses on three strategic pillars: (i) development of six economic corridors to foster centers of growth in each major island; (ii) strengthening of national connectivity to build synergies and linkages between the centers of growth, including international connectivity for trade and tourism; and (iii) acceleration of technological and research and development capacity.

The Government connectivity reform program is anchored in the second pillar of the MP3EI. The joint support of the Asian Development Bank, the World Bank and the Government of Japan for our national connectivity reform program would produce high dividends over the medium-term. It reinforces the Government’s reform progress and generates productive synergies with our development partners while providing Indonesia with a reliable source of development financing. For 2013, we are requesting that the Asian Development Bank, the World Bank, and the Government of Japan to provide US$ 400 million, US$ 300 million and US$ 200 million respectively for this Second Connectivity Development Policy Loan.

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 pendulum of capital flow has swung back somewhat to advanced economies. 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 280 bps, and the rupiah has depreciated by close to 18 percent against the US dollar year to date. The Credit Default Swap 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 macroeconomic side, Bank Indonesia has increased its policy rate 150 bps 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 US$ 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 US$ 5 billion contingent financing facility with the support from the Asian Development Bank, the World Bank, the Government of Australia and the Government of Japan.

Thanks to the extensive structural reforms implemented over the last few years, many of which have been supported by the development partners, Indonesia would 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 which is 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 that 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, connectivity and 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, and a proposal to adjust electricity tariffs for selected customers to further improve the quality of spending. As in the 2012 and 2013 Budgets, and reflecting the potential the uncertainties over the outlook, the proposed 2014 Budget includes provisions relating to crisis preparedness to allow the Government the flexibility to respond to potentially rapidly changing macroeconomic developments.

**Strengthening Coordination and Regulatory Frameworks for Connectivity**

The MP3EI provides a strategic guidance on policies to improve national connectivity. Recognizing the fact that nearly every aspect of connectivity falls under the jurisdiction of multiple government bodies, we are thus strengthening coordination across
institutions and are examining ways to harmonize key regulations related to connectivity. We have identified the lack of coordination and capacity in preparing bankable projects to meet international standard and unclear budget mechanisms for financing project pre-feasibility studies as key constraints to accelerating infrastructure development. We have completed a draft regulation aimed at revitalizing the Policy Committee for the Acceleration of Infrastructure Provision (KKPPI) by streamlining its structure and strengthening its functions, including developing infrastructure policy and priority projects, coordinating implementation of project pre-feasibility studies, determining the source of financing for each priority project, and facilitating in streamlining of infrastructure development.

We recognize that the public resources available for financing large infrastructure projects are limited and because of that we will have to also rely on private sector financing. One avenue for attracting private investment is through public-private partnerships (PPPs) for infrastructure. We have established supportive legal, regulatory and institutional frameworks, along with the Indonesia Infrastructure Guarantee Fund and the Indonesia Infrastructure Financing Facility. We are also taking steps to strengthen and revitalize the capacity to prepare and successfully transact bankable PPP projects, although challenges remain in this area. To provide further incentives for PPPs and to more transparently allocate public sector support, we have set up a viability gap fund (VGF) mechanism to enhance financial viability of projects that are socially and economically desirable but may have inadequate financial returns. We are also in the process of establishing a PPP Unit within the Ministry of Finance to strengthen internal coordination in the preparation of PPP projects on a revolving fund basis.

Strengthening Intra-island Connectivity

Rural development in much of Indonesia's vast archipelago is constrained by inadequate roads, rail infrastructure, and intermodal transport links. In order to spread the benefits of economic development and reduce rural poverty, we aim to improve access of rural areas to the nearest growth centers, industrial zones and ports. Many of our provincial and district roads are in poor condition. To address this problem, we have rolled out performance-based contracts while piloting a more efficient grant allocation mechanism for road maintenance with sub-national governments.

Uncertainties surrounding land acquisition have been a major deterrent to investment by causing delays in infrastructure development by the government and the private sector, particularly for toll roads. To address this issue, the Government has now completed the regulatory framework by the issuance of three regulations from the National Land Agency, the Ministry of Finance, and the Ministry of Home Affairs. Capacity building and socialization of the new regulation to all relevant government agencies is now ongoing to help effective application of the new regulation framework on land acquisition for development for public interest.
We also continue to restructure the railway sector to become more competitive and responsive to public needs. With the enactment of Law No. 23/2007 on Railway, Presidential Regulation No. 53/2012, which sets the institutional arrangements and general rules for provisions of subsidized passenger services under public service obligations (PSO), maintenance operations, and track access charges (TAC) in the railway sector, along with the ministerial guidelines, to improve certainty in provisions of PSO services in railway while encouraging growth in commercial railway services. Further, we have rolled out performance-based contracts, while putting in place a medium term plan for the national road network in order to improve the planning and implementation of public road investments.

**Improving Inter-Island Connectivity**

We have also embarked on reforms aimed at reducing the cost of inter-island shipping while improving transport and information technology (ICT) access in the eastern part of Indonesia. As a large archipelagic country, our producers suffer from high costs due to poor logistics and inadequate market and transport information.

Developing regular container services along major ports across Indonesia’s economic corridors is an important step for developing an efficient and reliable sea freight network. These new routes will also help reduce freight loads on the country’s overloaded road network. The government has issued a port master plan to provide clear long-term direction on port development across the archipelago.

In order to improve connectivity with eastern Indonesia, we have increased the frequency of pioneer shipping services for more remote island ports while reviewing the current institutional arrangement. Connectivity also involves improved access to ICT services so we are implementing an ICT Fund to incentivize and accelerate the development of backbone communications infrastructure in the currently underserved areas of Indonesia. Further, we have prepared a National Port Master Plan that establishes the classification and traffic projection for all Indonesian sea ports, which will help establish priority and development plans for each individual sea port for the next 20 years.

**Improving International Connectivity**

We have made progress on trade facilitation. We recognize that improving transparency in trade regulations is a key to facilitate international trade. The Indonesian National Single Window (INSW) plays an important role in reducing the time and costs of importing and exporting by facilitating single submission, single processing, and single approval of import/export documents. While the development of the INSW was conducted in stages, now 18 agencies and 6 major ports, which together represent about 80 percent of Indonesia’s total international trade volume, have been part of the INSW system. Most recently, the Ministry of Trade and the
Ministry of Agriculture were incorporated into the INSW. The function of the INSW agency is currently being performed by DG Customs. We expect to finalize a clear organizational set-up of the INSW to play increasingly significant role in facilitating trade in the coming years. The government will issue a presidential decree to set the organizational setup of the INSW.

Recognizing that improved connectivity requires integrated end-to-end supply chains, the President issued a National Logistics Blueprint (NLB) in 2012 in order to reduce logistics costs and prepare for ASEAN integration. To effectively implement the NLB, we have developed an integrated monitoring mechanism to assess progress in the implementation and improvement of the national logistics system.

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 potential financial market turbulence. At the same time, we are pushing ahead with our medium- and long-term economic reforms to meet our development priorities. The Government values the support provided by development partners in helping to address Indonesia’s critical constraints related to connectivity and inclusive growth. In closing, let me reiterate the Government’s strong ownership of and commitment to the connectivity reform program where we are soliciting the support of the Asian Development Bank, the World Bank and the Government of Japan. We look forward to continue engagement and support of the development partners for Indonesia’s economic development agenda in the coming years.

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