PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: AB3342

Operation Name	Fourth Development Policy Loan (DPL 4)
Region	EAST ASIA AND PACIFIC
Sector	General finance sector (50%); General public administration sector (50%)
Project ID	P105637
Borrower(s)	MINISTRY OF FINANCE
Implementing Agency	COORDINATING MINISTRY FOR THE ECONOMY
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1. Country and Sector Background

Ten years after the East Asian financial crisis, Indonesia has emerged as a very different country. It has embraced political pluralism and participation, and is in a strong position to resume high growth and accelerate poverty reduction. Prudent fiscal and macroeconomic policies, particularly low budget deficits, have been instrumental in Indonesia's recovery, with the most dramatic improvement in the form of reduced debt levels — from 80 percent of GDP in 2000 to some 37 percent of GDP by mid-2007.[1] Despite several shocks during the past three years (e.g., natural disasters, terrorist strikes in Jakarta and Bali, and global fuel price increases), the economy has performed well and has now overcome the impact of the slowdown experienced towards the end of 2005 that resulted in dramatic fuel price increases (and consequently higher inflation and interest rates). The World Bank projects growth to surpass 6 percent in 2007, adding a boost to the Government's poverty reduction efforts.

Indonesia's current challenge is no longer fiscal consolidation but instead how to spend the available resources most effectively. As a result of the sharp reduction in fuel subsidies in 2005, as well as declining debt service payments and increasing revenues, Indonesia has created additional "fiscal space" of US$15 billion annually (out of a total national budget of some US$80 billion in 2007). Equivalent to around 4 percent of GDP, this is the largest increase in additional fiscal resources since the oil revenue windfall in the 1970s.

However, Indonesia still faces many challenges and is performing below its potential, particularly with respect to the investment climate, public financial management and public service delivery. The government is committed to tackling these difficult microeconomic and institutional reforms, which are at the core of the DPL program.

[1] Given debt-to-GDP figures are based on a year 2000 GDP base. Previous estimates based on a 1993 GDP base were substantially higher, at close to 100 percent of GDP.

2. Operation Objectives

The overall goal of the DPL program is to help the Government achieve its medium-term growth and poverty reduction objectives. The proposed DPL 4 is the fourth in a programmatic series of single-tranche operations. The program has evolved in step with the Government reform agenda, shifting from an initial focus on macro-reforms to institutional reforms designed to create the regulatory frameworks and policies required to sustain medium-term growth and social development. Specifically, it supports a core set of policy actions in the Government's medium-term strategy (RPJM) and annual work plans (RKP), and builds on Government-issued policy packages, to achieve three critical and mutually reinforcing objectives: (i) an improved investment climate; (ii) enhanced public financial management, governance, and anti-corruption; and (iii) improved public service delivery.

The policy dialogue was anchored by a core set of specific policy actions. Among others, policy actions proposed under DPL 4 are designed to continue to strengthen measures to enhance institutional reforms aimed at improving small and medium enterprises (SME) access to finance and increasing the investment-to-GDP ratio. Other policy actions aim to reduce the burden on the business community, making it easier and less costly to register and license new businesses. On governance, the DPL program is expected to accelerate reform measures that improve budget management and render financial systems more transparent and effective. New areas include civil service reform and public service delivery, including enhanced quality of education services through improved teacher qualification.

3. Rationale for Bank Involvement

The Bank continues to play a key role in supporting Indonesia's reform process through the DPL program. The DPL operation provides the Government with a reliable source of financing to meet its gross financing needs and reduces the average cost of borrowing while also extending the Government's debt maturity. Simultaneously, the DPL has created a platform for an effective policy dialogue and engagement between the government and development partners, namely, the World Bank, the Asian Development Bank (ADB), and the Government of Japan. This engagement provides an impetus for decision-makers to debate, coordinate, and prioritize policy and institutional reforms reinforcing the Government's reform agenda. More broadly speaking, the DPL has helped the Government to implement key elements of its 2004-09 RPJM, or medium-term strategy, by translating broad objectives into a set of high-priority policy actions. Overall progress has been made commensurate with expectations, both in terms of achieving the DPL program's original outcomes and fulfillment of critical reform measures that underpin each operation.

4. Financing

The DPL 4 is a single-tranche IBRD loan of US$600 million that will be made available upon loan effectiveness, as policy actions supported by the loan/credit will have been completed prior to Board presentation. For the IBRD loan, the Government has confirmed that Indonesia will borrow this amount as a Fixed Spread Loan (FSL) in US Dollar currency.

The operation has benefited from a harmonized policy dialogue and parallel financing by two of Indonesia's largest development partners. The Government of Japan was closely involved in the policy dialogue and preparation of DPL 1-3 and provided parallel financing for US$100 million for each operation. For DPL 4, it has expressed an interest in parallel financing (the amount is yet to be determined). At the request of the Government of Indonesia, the Asian Development Bank (ADB) also extended parallel financing for DPL 2-3 for US$200 million and a similar amount of parallel financing is expected for DPL 4.

5. Institutional and Implementation Arrangements

The loan disbursement will follow the standard Bank procedures for Development Policy Lending. The loan amount will be disbursed into a foreign currency account of the Borrower at Bank Indonesia that forms part of Indonesia's official foreign exchange reserves. The equivalent Rupiah amount will immediately be transferred to the General Operational Treasury (SBUN) account of the Borrower that is used to finance budget expenditures, as the loan is intended to be used to support the general Government budget. The Borrower will provide to the Bank a written confirmation that this transfer has been completed, and provide to the Bank any other relevant information relating to these matters that the Bank may reasonably request. Disbursements of the loan will not be linked to any specific purchases and no procurement requirements have to be satisfied, except that the Borrower is required to comply with the standard negative list of excluded items that may not be financed with Bank loan proceeds. Ongoing discussions with the Government on the overall reform program being supported by the series of DPLs will form the basis for reporting on substantive policy issues.

6. Benefits and Risks

The key benefits expected from the program are:

- Progress towards the Government's medium-term objectives through improved (i) investment climate; (ii) public financial management/governance; and (iii) service delivery to the poor.
- Sustained Bank engagement in policy dialogue with the Government on the direction and content of, and strategies for, its economic, structural, and institutional reform agenda.
- Coordination of development partners and parallel financing by key development partners (World Bank, Asian Development Bank, Government of Japan) around a common policy framework and dialogue.

The operation and the Government's reform program are subject to several risks:

- The Government has continuing problems in implementing its budget effectively. Delays in procurement are particularly problematic and affect the Government's ability to deliver on its investment program. More broadly, there remain problems in the pace of Government spending with more than half of the Government's capital and operational budget still spent in the last quarter of each fiscal year.
- Corruption remains a widely recognized problem in Indonesia and concerns remain over the use of foreign loan funds to support the Government budget. This has generated opposition to foreign loans, in particular from, but not limited to, civil society groups. Anti-debt sentiment is also found in the legislature, where several key political parties

have placed pressure on the Government to limit foreign debt exposure. Such sentiment raises potential risks for budget support operations such as the DPL, as the legislature seeks to play a stronger role in overseeing foreign borrowing.

③ Although the DPL has supported significant progress in strengthening the fiduciary framework, there remains a substantial unfinished agenda that will continue to need to be addressed in DPL operations. Problem areas include budget execution, off-budget accounts, procurement and auditing, all of which have the potential to adversely impact the DPL program.

7. Poverty, Social Impacts and Environment Aspects

A social impact and poverty assessment found that the proposed DPL 4 triggers are unlikely to harm the poor, while several triggers have the potential to reduce poverty in the medium to long term. The links between poverty reduction and areas such as tax and customs administration, investment procedures, financial sector improvements, and increased transparency are indirect, through increased economic growth. Bureaucratic barriers to establishing new businesses, increasing access to finance, and strengthening transparency are all areas that are constraints on growth in the medium term. An environment impact review of the DPL 4 Policy Matrix concluded that of the 18 triggers most have negligible or unlikely environmental impacts.

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