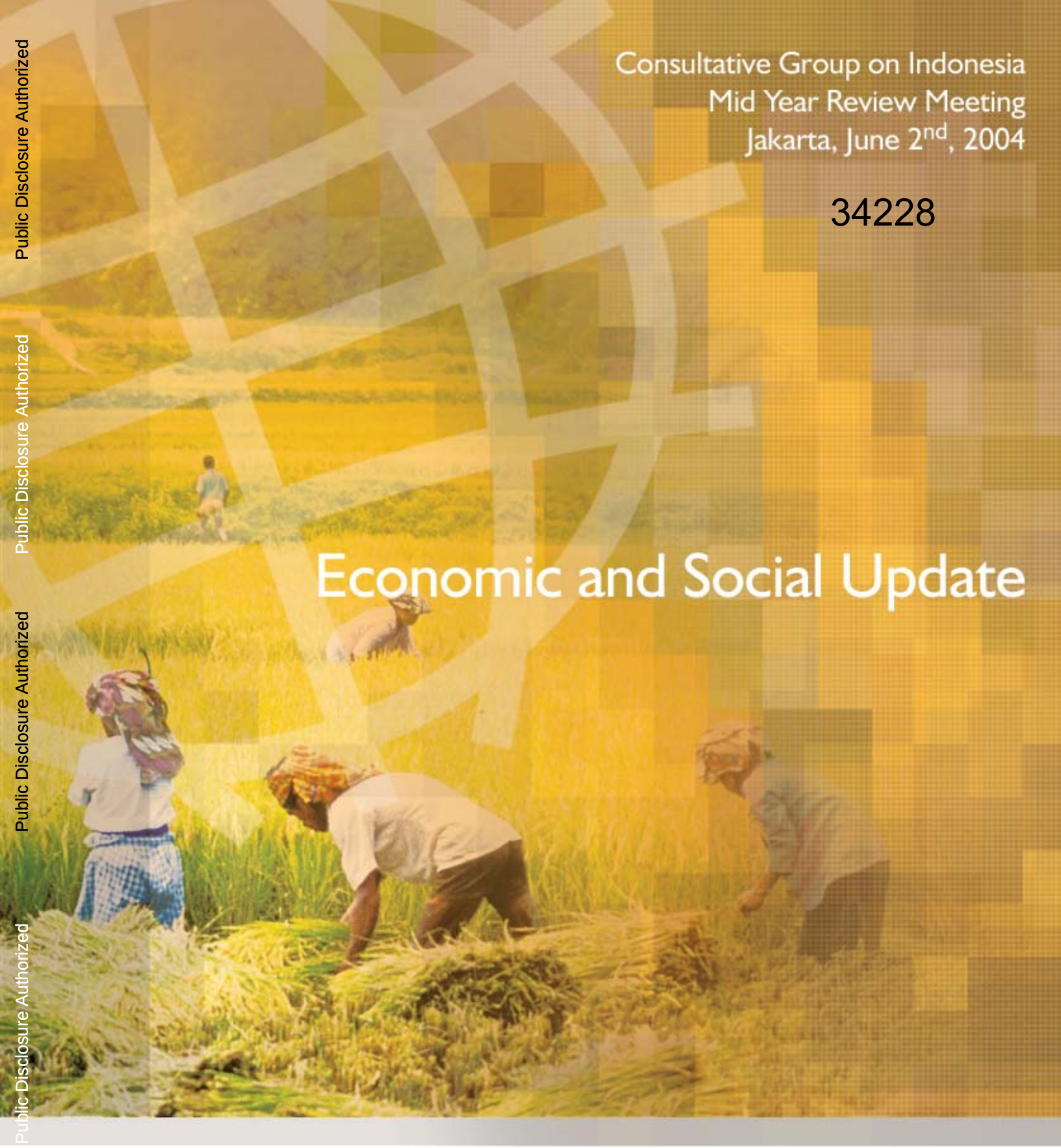
Consultative Group on Indonesia
Mid Year Review Meeting
Jakarta, June 2nd, 2004

Economic and Social Update



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Economic and Social Update

Acknowledgements

This brief for the interim CGI of June 2, 2004 takes stock of recent economic and social developments and evaluates the first ten months of implementation of the White Paper, the Government's plan of policy actions issued in September 2003. The report draws on the Government's own White Paper implementation report which is published on a regular basis and was submitted to the CGI for discussion.

This report was written by a team comprising Yoichiro Ishihara (TTL), Magda Adriani, Vivi Alatas, Jehan Arulpragasam, Agnes Cusack, Wolfgang Fengler, Joel Hellman, Bert Hofman, Kurnya Roesad and P.S Srinivas. Indra Irnawan formatted the document for printing.

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Interim Consultative Group on Indonesia
Economic and Social Update

Continued macroeconomic stability and a stronger international economy are supporting renewed growth in Indonesia, and are contributing to a reduction in poverty. The Government's Economic Policy Package, known as the White Paper, has played an important part in this, as it clearly laid out the Government's own commitment to reforms in the aftermath of the IMF supported program and helped to maintain the momentum of those reforms. But despite the progress made in meeting most of the White Paper targets, Indonesia has yet to see a demonstrable positive impact on levels of investment, exports, employment or service delivery to the poor. In part, this is because many of the White Paper measures are in the form of the passage of laws and decrees or the establishment of new institutions, whose effective implementation and performance will need to be proven over time. In addition, specific policy actions outside the context of the White Paper and controversial court decisions continue to damage perceptions of Indonesia's investment climate. The challenge for Government is to maintain the momentum on the White Paper to ensure effective implementation of the measures adopted towards improving the investment climate and competitiveness in the medium run. This is needed for broad-based growth, which coupled with actions to improve service delivery will be key to substantial poverty reduction and meeting the MDG targets on which Indonesia is lagging. This will require better policy coordination and management – in particular in the critical area of justice sector reform and anti-corruption to ensure that all policy actions work to support the White Paper goals.

I. Recent Economic and Social Developments

Achievements…

Continued growth. In 2003 growth remained steady at 4.5 percent based on revised GDP numbers,[1] the same as in 2002, but considerably higher than expected in the wake of the negative impact of the Iraq War and SARS. The revised numbers also show a significantly higher level of GDP, as more goods and services are included in the new numbers. Growth is mainly driven by private consumption that continues to benefit from lower interest rates and lower inflationary expectations. In addition, local government spending, fed by shares from oil and gas revenues, also fuelled growth. For the first quarter of 2004 growth was at 4.5 percent (yoy) confirming the positive trend continued during the period, private consumption remained the main driver of growth. Continued improvements in the international outlook and high commodity prices are likely to further support growth (see Economic Outlook, p.7).

Declining fiscal and external risks. Indonesia's government and external debt position has improved markedly. On the basis of higher GDP and lower deficits, government debt to GDP declined to 59 percent by the end of 2003, 38 percentage points below its peak level of 1999, and 9 percentage points lower than end-2002. The end-2003 ratio is below the 60 percent target stipulated in the State Finance Law No.17/2003.[2] The preliminary 2003 state budget outturn shows that the budget deficit to GDP ratio was 2 percent, close to the revised budget of 1.9 percent. The 2003 budget benefited from favorable macroeconomic conditions such as high oil and gas prices and low domestic and international interest rates, although non-oil and gas tax collection fell below target levels. Preliminary numbers for the first quarter of 2004 suggest that the government's 1.2 percent deficit target remains within reach. Indonesia's external debt to GDP also declined. The ratio hit 55 percent in 2003, well under its peak of 158 percent of GDP at end-1998, and 9 percentage points lower than at end 2002. Short-term debt over reserves, an indicator of liquidity risks, improved as well to 41 percent by end-September 2003, the latest available numbers.

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[1] The base year for the National Account was changed from 1993 to 2000 in May 2004. As a result, 2003 growth rate was revised from 4.1 percent (1993 base) to 4.5 percent (2000 base).
[2] The ratio was 69 percent based on the 1993 base GDP, but it is 59 percent due to larger GDP on the 2000 base year.

Continued fiscal consolidation and reduced vulnerability have paid off. The Government was able to float an international bond issue in early March at yields that were well below other countries with better credit ratings. The Government issued US$1 billion in bonds, more than twice the amount originally planned. Despite this, the issue was more than four times oversubscribed. Standard and Poor's, an international rating agency, has upgraded its rating outlook for Indonesia from 'stable' to 'positive,' indicating that it is considering an upgrade in the near future.

Poverty declines. Preliminary results from the 2003 SUSENAS household survey suggest that poverty levels have continued to decline. The survey shows that the poverty headcount ratio dropped from 16.0 percent in 2002 to 15.1 percent in 2003, lower than the pre-crisis level of 15.7 percent in 1996 (Table 1). Steady growth and lower inflation since the survey in February last year are likely to have reduced poverty. Inflation fell below 5 percent earlier this year, and the rise in food prices has been modest. This is good news for the poor, who spend more than half their budget on food. However, while poverty is declining, more than half the population of Indonesians still live on less than US$2 per day.

Table 1: Change in poverty headcount index from 1996 to 2003

	96	99	02	03
National poverty line	15.7	27.1	16.0	15.1
International poverty line				
1 dollar a day	7.8	12.0	7.2	7.2
2 dollar a day	50.5	65.1	53.5	52.9

Source: World Bank staff estimates

…And the Challenges

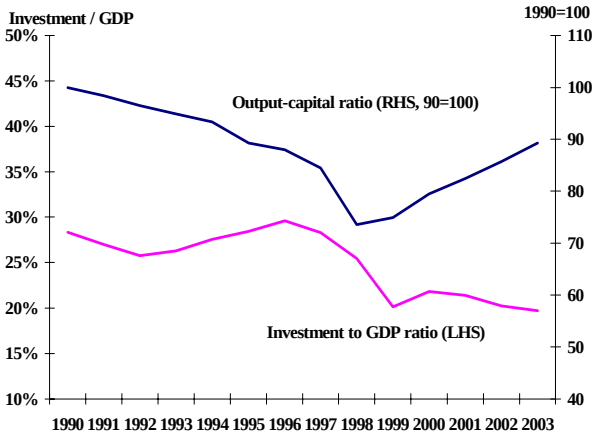
Financial markets have come off their high. While the markets reacted positively to the peaceful parliamentary elections in early April, concerns on rising global interest rates and a slowdown of China's economy sent markets off their peaks achieved earlier in the year. The Rupiah depreciated to above Rp.9,000 against the US dollar in May to a levels not seen since November 2002. And the Jakarta Stock Exchange index fell below 700 in mid-May, about 20 percent below its all-time high recorded at the end of April. Foreign investors, who had boosted the stock market and the Rupiah earlier in the year, have been selling off their stocks in recent weeks, whereas foreign banks have reduced their net exposure to the overnight interbank market, a proxy for demands on the rupiah assets. The direct impact of these financial market movements is unlikely to be substantial, as shareholding by individuals is still limited, and the effects on private consumption, the main driver of growth, are likely to be small. Better prospects for the US economy, the reason for higher interest rates, are likely to have a positive impact on the economy through exports.

Investment activity remains weak. Weak investment growth is one of the main factors holding back Indonesia's growth. Investment grew by only 2.2 percent in 2003, and the investment to GDP ratio declined to 17.8 percent in 2003, the lowest level since the early 1970s.[3] The quality of investment is also of concern. In recent years, investment has shifted to property investment such as construction of shopping malls and apartments. In contrast, non-property investment declined in 2003. Investment approval numbers suggest that this trend is not likely to turn around soon: data[4] until April this year show that domestic investment approvals are 28 percent below that of 2003, foreign investment is down by 49 percent. On a positive note, 15 new oil and gas contracts were signed in 2003, compared with just one in 2002.[5]

[3] The ratio before 1983 is derived from constant data due to data availability.
[4] Oil and gas sector, and financial sector are not included.
[5] In 1997, Indonesia signed 29 oil and gas contracts.

Investment remains low despite the steady rise in capacity utilization since the crisis. The combination of low investment and steady economic growth suggests that installed productive capital is increasingly utilized,[6] and that capital utilization is now at levels comparable to the early 1990s (Figure 1). If the past is any guide, current levels of capacity utilization should trigger higher investment levels. However, the lack of it suggests that investors still consider Indonesia's investment climate as unattractive. For policy makers, this suggets that the improvement climate would have a direct impact on additional investment. In contrast, higher demand is increasingly likely to run into supply bottlenecks for growth acceleration if investment does not pick up.

Figure 1: Investment to GDP ratio and capacity utilization in 1990-2003



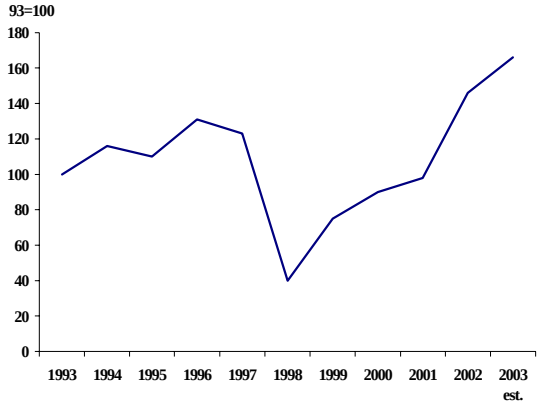
Note: Output-capital ratio is used for as a proxy for the capacity utilization
Source: BPS, World Bank staff estimates

Export competitiveness under pressure. Indonesia need to strengthen its international competitivenenss to take advantages should work on its international competitiveness to take advantage of the improving international environment. Export growth is lagging behind that of regional competitors: Indonesia's exports increased by only 10 percent in 1996-2003. During the same period, Korea's exports grew by 114 percent followed by Thailand (70 percent) and Malaysia (43 percent). Even in the rapidly growing exports to China, Indonesia is falling behind as well. While Indonesia's exports to China grew by 30 percent in 2003, they are not growing as rapidly as those of regional competitors, so Indonesia is losing market share. In 2000, Indonesia's share in China among 5 East Asian economies (Indonesia, Korea, Malaysia, the Philippines and Thailand) was still 11.2 percent, but it fell to 7.4 percent in 2003.

Disappointing export growth is partly due to rising unit labor costs. Whereas the depreciation of the Rupiah sharply cut labor costs during and right after the crisis, the rebounding Rupiah combined with rapidly recovering wages has pushed up unit labor costs, which now 35 percent above 1996 levels (Figure 2). Another indicator of competitiveness, the competitor weighted real exchange rate has also risen sharply in recent years as well (Figure 3). While some of the cost increases captured by these competitiveness measures, such as more market-based pricing for energy, reflect desirable reforms, other developments are less encouraging. High wage increases are outpacing productivity increases in the aftermath of the crisis, and rising costs related to corruption and failing infrastructure are reducing competitiveness. Lower investment, especially FDI, may also feed into disappointing export performance, as in the past, foreign companies were a key driver of export growth.[7] The recent weakening of the Rupiah, while of some concern for the inflation outlook, could help in restoring some of this lost ground. But the Government should rethink its trade and competitiveness policy in the medium run to remain competitive in an increasingly globalizing world. Recent moves towards more protectionist trade policy do not support this objective.

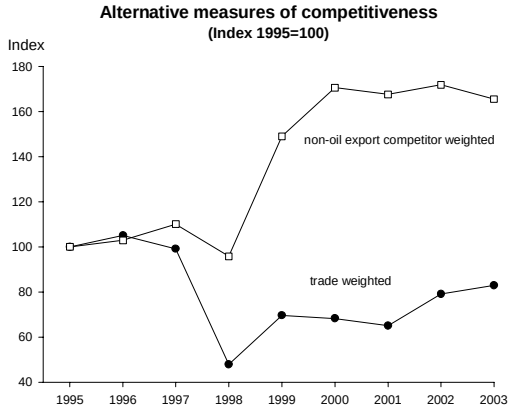
[6] Existing survey data on capital utilization from BPS and MOIT are not very strong, and have little predictive power for investment behavior. The estimates referred to in the text use the output-capital ratio as an indicator for capacity utilization. Taking account of a trend decrease in this ratio, an increase points towards an increase in capital utilization.
[7] FDI companies accounted for 30 percent of manufacturing exports in 2001 (CGI Brief 2003, p.3).

Figure 2: Rising Indonesia's labor costs
(Unit labor costs in manufacturing in US$, 93=100)



Source: IMF

Figure 3: Loss in competitiveness
(trade weighted and competitor weighted real exchange rates)



Source: World Bank staff estimates

Unemployment still rising. Despite macroeconomic stability and steady growth, labor market conditions continue to decline. The unemployment rate increased from 9.1 percent in 2002 to 9.5 percent in 2003.[8] Among the unemployed, young people account for an increasing share: almost 2/3 of the unemployed are between 15 and 24. The youth unemployment rate stood at 27.9 percent in 2003, three times the overall unemployment rate. Another worrying trend is the decline in employment in the formal sector—new jobs are only created in the informal sector, and these jobs are generally low skilled and low paid. It is in particular the low-skilled laborers that are losing their job in the formal sector.

High formal sector wage increases in the aftermath of the crisis, in part driven by a rapid rise in the minimum wage, share some of the blame along with uncertainty about future labor costs due to the pending labor market and social security regulations. Fortunately, recent wage settlements and minimum wage decisions have been moderate, allowing labor productivity to catch up with past wage increases. However, to turn around the trend in unemployment, higher growth is needed. If history is any guide, growth should be in the order of 4.5-5.5 percent just to absorb new entrants to the labor markets (2-2.5 million a year) at prevailing wage levels.[9] As consumption growth is already substantial, and fiscal constraints are likely to curtail growth of government spending, such growth should come from higher investment and exports.

Weak service delivery leading to poor social development outcomes. Despite the reduction in income poverty, the non-income aspects of poverty persist as serious problems in Indonesia, compounded by the weak delivery of services to the poor. The Government recently issued its *Progress Report on the Millennium Development Goals*. This report highlights some of the continued challenges to improving social welfare in Indonesia, particularly with regard to health and education outcomes. For example, Indonesia's maternal mortality rate is two times greater than the Philippines and five times greater than Vietnam. The risk of a mother dying in childbirth in Indonesia is around 1 in 65, compared with 1 in 1,100 in Thailand. Severe malnutrition among infants has increased from 6.3 percent in 1989 to 8.0 percent in 2002. Moreover, although Indonesia made progress in reducing infant mortality, inequality between

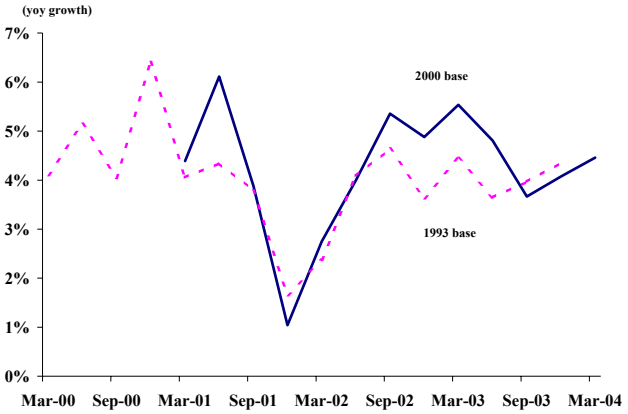
[8] Since 2001, the BPS adopted a wider definition of open unemployment, which includes discouraged workers. As a result, unemployment rates jumped significantly. BPS data are based on the annual labor force survey (Sakernas) and quarterly surveys (Indikator Ketenegakerjaan). Annual data from the Sakernas are not fully comparable to the quarterly data, as the latter focuses only on selected indicators, using smaller sample sizes and varying coverage of provinces.

[9] Of course, for creating low value added/low wage jobs in the informal sector, less growth is needed.

regions is significant. For example the infant mortality rate of West Nusa Tenggara (103 per 1,000 births) is nearly five times higher than that of Jogjakarta (23 per 1,000 births). Indonesia ranks third in the world in terms of contributing to the global TB burden, with the number of new tuberculosis cases at an estimated 582,000 each year. Enrollment in junior secondary education shows significant disparities between rural and urban areas, and between poverty quintiles. Improving service delivery to turn around these poor outcomes remains an integral part of the poverty reduction agenda.

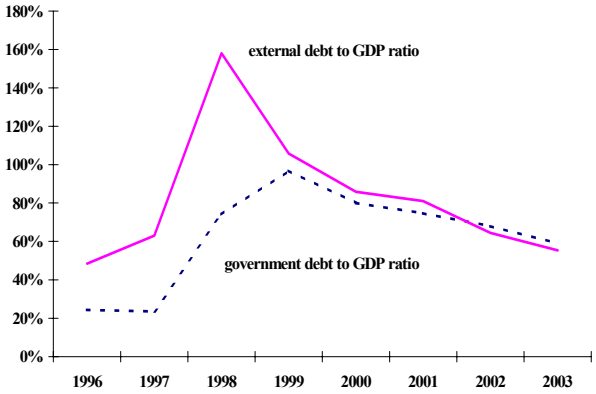
A Snapshot of Indonesia's Economic and Social Developments

Figure 4: Steady Growth Continues
(constant GDP growth rate, percent)



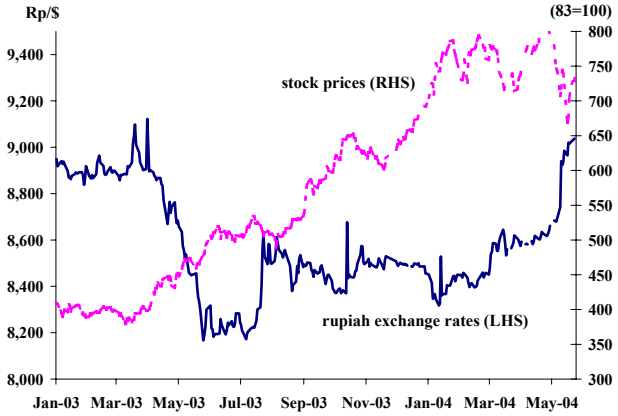
Source; BPS

Figure 5. Fiscal and External Risks are Abating
(government and external debt as a share of GDP)



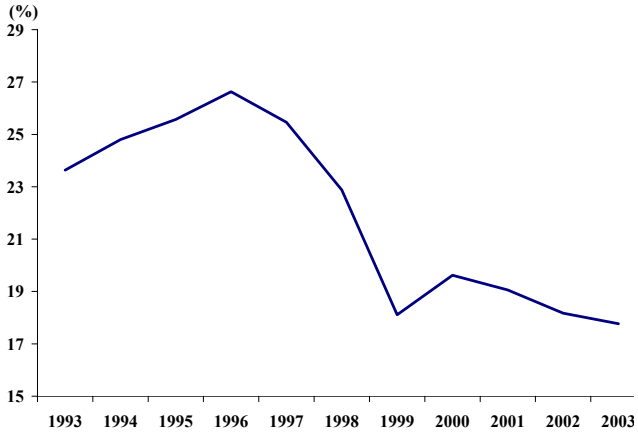
Source: BPS, Bank Indonesia, MOF, staff calculation

Figure 6: Financial Market Jittery
(Rupiah exchange rate and JSX stock index (83=100)



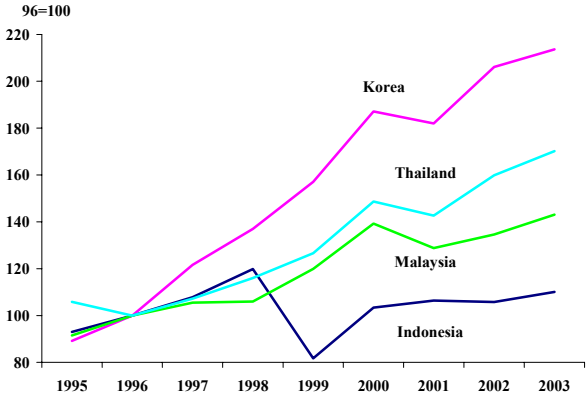
Source: CEIC

Figure 7. Investment still declining
(investment to GDP ratio, nominal)



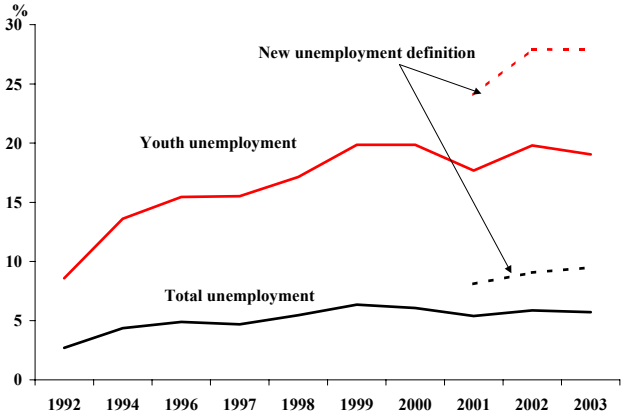
Source: BPS, staff calculation

Figure 8. Lagging export performance
(constant exports in the national account, 96=100)



Note: Indonesia number is based on the 1993 base national account
Source: CEIC, staff calculation

Figure 9. Youth unemployment on the rise
(overall and youth unemployment rates)



Source: BPS, staff calculation

II. Economic Outlook[10]

Indonesia's growth stands to benefit in the short term from the ongoing strong upswing in international economic activity and continued macroeconomic stability. In the medium term, growth prospects depend on the pace at which reforms improve the investment climate and increase productivity of the economy. Key risks to this outlook are a "hard landing" of China's economy, and financial market turbulence. However, the possible negative impact of the risks to growth is likely to be limited.

Better short term growth prospects. In the short term, on the back of an improving international environment, the World Bank expects the growth rate now to be 4.5 percent in 2004, close to the Government's expectation of 4.8 percent, and 0.5 percent higher than at the time of the CGI in December 2003 (Table 2). Consumption is likely to remain the key driver of growth: private consumption continues to benefit from the drop in interest rates over the past year, whereas government as a whole stands to benefit form higher oil and gas prices. Although consumption jumped in the quarter after the 1999 elections, this is unlikely to be repeated this year. In 1999 there was significant uncertainty about the elections, and when they went by peacefully, the reduction in uncertainty translated into lower real interest rates and boosted growth. This time, the general expectation is that the elections will be smooth, and consequently, no boost to consumption on the account of the elections is to be expected.

Table 2: 2004 Growth Projection

	Old	New	Impact on growth
World Trade volume (%)	7.9	8.2	+0.1
Oil prices ($/bbl)	22	25	+0.2
Inflation rate (%)	5.5	5.0	+0.2

Source: World Bank staff estimates

Medium term growth will depend on progress in reforms, and improvements in the investment climate. Indonesia's growth in the past was achieved by high investments that rapidly built up the capital stock, an increase in labor market participation and labor quality, relatively high increases in productivity caused by structural change in the economy, and reforms that made Indonesia an increasingly open economy (Table 3). Assuming an investment growth rate at 4 percent, even the high productivity growth rates of the past will only be enough to achieve some 4 percent growth in the medium term, not enough to absorb the new entrants in the labor force.[11] Higher growth requires higher investment growth, and increased productivity, and both can be triggered by reforms that improve the investment climate. Assuming that reforms such as those in the White Paper continue to be implemented over the medium term, the World Bank expects that Indonesia's growth could gradually increase to 6 percent.

Table 3: Growth Accounting in Indonesia

	1961-2000
GDP growth	5.5
Capital stock	1.2
Labor force	1.8
Labor quality	0.6
TFP	1.9

Note: labor quality is based on years of schooling;
Source: World Bank staff estimates

[10] Simulation is based on the Ministry of Finance model (MODFI version 17).
[11] Labor force and labor quality growth rates are exogenous variables;

Two short-term risks could affect this outlook: (i) a sharp slowdown in the Chinese economy, and (ii) increased financial market volatility. The simulation below suggests the impact on growth would be limited (Table 4).

Table 4: Shocks and Impact on 2004 Growth

Item	Change	Impact on Growth				
1. Market Pressure						
Rupiah exchange rate	+Rp.300	*				
Real interest rate 1/	+1%		*			
2. China slow down						
Non-oil and gas exports	-0.75%			*		
Oil prices	-$5/bbl				*	
3. Quicker US recovery						
Non-oil and gas exports	+0.5%					*
Impacts on 2004 Growth		+0.2	-0.9	-0.3	0.0	0.2

1/ Increase in time deposit rate by 2 percent and that in CPI by 1 percent;
Source: World Bank staff calculation using MODFI

A sharp slowdown in the Chinese economy would have a limited direct impact on Indonesia's growth. If the Chinese economy is in for an unexpected "hard landing" as a result of the authorities' attempt to slow the economy down, exports to China would be affected, while exports to other economies in the region are likely to slow as well, because they would be affected by China's slowdown. In 2003 non-oil and gas exports, China accounted for 6 percent of Indonesia's exports, while other economies in the region (Korea, Malaysia, the Philippines, Singapore and Thailand) made up 24 percent. However, the effects of even a major slowdown are likely to remain limited: a 5 percent decline in exports to China combined with a 2.5 percent export decline to other economies in the region, would lower Indonesia's non-oil and gas exports by 0.75 percent. In turn, this would result in the reduction of growth rate by 0.3 percentage points. If growth rate is reduced by 0.3 percentage points, the state budget would be negatively affected by Rp.0.5 trillion, 0.03 percent of GDP. A possible decline in oil and gas prices in the wake of a China slowdown could add to these effects, but barring major knock-on effects in capital flows, the impact is likely to remain limited.

The impact of the financial market volatility depends on how it affects inflation and interest rate. A real interest rate rise of 1 percentage point (2 percent increase in policy interest rates and 1 percent increase in the inflation rate) would lower the growth rate by 0.9 percentage points, mainly through a slowdown in consumption. If such an increase in interest rates is caused by an unexpected acceleration in the US economy, the impact of higher rates is likely to be offset by better export prospects. If, however, the rise in real interest rates is homegrown, say by a volatile election than expected at present, the impact could be significant. A minor depreciation of the Rupiah exchanger rate, around Rp.300, would positively affect the growth rate by 0.2 percentage points through exports. A minor depreciation of the Rupiah would increase revenues, notably higher oil and gas revenues, but it would also increase foreign debt repayments. On balance, the impact would be almost neutral.

III. The White Paper after 10 Months

1. Introduction

Ten months into the program, the *Economic Policy Package Pre- and Post IMF* as the *White Paper* is officially known, has played an important role in the transition after the IMF-supported program came to an end in December 2003. Bank Indonesia issued a separate plan to complement the White Paper, and aimed at continued prudent monetary policies. The White Paper has been effective in bridging the so-called "credibility gap" the absence of a regular IMF's letter of intent. As such the program has been instrumental in maintaining macroeconomic stability.

The White Paper has also played an important role in maintaining the momentum of the reform process. The implementation, closely monitored by a team led by the Coordinating Minister for the Economy, has been impressive with over three-quarters of the measures committed to implemented on time, or with minor delays. At the same time, some of the priority actions of the White Paper are still outstanding, and some of the actions taken within the context of the White Paper may have been less effective in contributing to the government's objectives. And some of the policies introduced outside the purview of the White Paper may have distracted from the goals of the White Paper altogether. Indeed, the White Paper has yet to become the main instrument for policy coordination as initially intended.

As the implementation horizon for the current White Paper is rapidly approaching, the Government needs to maintain momentum on priority actions, ensure that all policy actions and announcements serve the goals of the White Paper, reinvigorate support for reforms key to the investment climate such as justice sector reforms, and develop plans for continued improvements of the investment climate and competitiveness in the medium-run. Major achievements and outstanding issues are summarized in Table 5.

Table 5: The White Paper- Major Achievements and Outstanding Issues

	Achievements	Outstanding Issues
Macroeconomic Stability	• Treasury Law (No.1/1994) • Revised rules on public procurement (Keppres 80/2003) • MOF reorganization; • Divestment of Bank BNI and PGN • Submission of amendments of Law 22/99 and Law 25/99	• Revision of tax and tax administration law • Amendment of Law 22/99 and Law 25/99
Financial Sector Restructuring	• Draft LPS Law (Deposit Insurance) • Draft OJK Law (financial authority service) • Divestment of Bank Lippo and BII • Amendment of Bank Indonesia Law	• Privatization of Bank Permata • Strengthening of the governance of state banks
Investment, Exports and Employment	• Law on Judiciary Commission • Blueprint for the Supreme Court • Anti-corruption commission members appointed • National investment and export team One-roof licensing system for investment approval • Electricity market supervisory agency	• Amendments to the Bankruptcy Law; • Outstanding regulations on Labor Law and Industrial Dispute Law

Source: Coordinating Ministry for Economic Affairs, World Bank Staff

2. Major Achievements

The government issued the White Paper on September 15, 2003, as an instruction of the President (INPRES No.5/2003). The document was unique for Indonesia: while the country has a long tradition of planning, for the first time concrete, time bound policy actions were announced and committed to the Indonesian people. Also, in assembling the Paper, the Government consulted widely among stakeholders including the private sector, civil society and the international community. In all, some 200 concrete measures with specific time frame were announced, in pursuit of three objectives: (i) maintaining macroeconomic stability, (ii) restructuring and reforming the financial sector and (iii) increasing investment, exports and employment.

By April 2004, the government had successfully completed 99 policy actions out of 133 actions declared. Many of those actions were minor ones, but the Government can also look back on some major achievements, primarily in the areas of *maintaining macroeconomic stability* and *restructuring of the financial sector*. Some of the key achievements are listed below.

Maintaining Macroeconomic Stability

Important progress has been made to improve fiduciary management in government. Divestment of several assets has contributed to financing the deficit for the 2004 budget. Key measures taken include:

(i) **The Treasury Law (No.1/2004)** was passed by Parliament. Together with the state finance law (No.17/2003), and the forthcoming State Audit Law currently in Parliament, these laws promise a major improvement in accountability and transparency in Government Finances.

(ii) **The revised presidential decree on public procurement.** The revised rules on public procurement (Keppres 80/2003) are likely to increase competition in state purchases, reduce the scope for collusion among bidders, and as a result give more value for the taxpayers' money.

(iii) **The reorganization of the Ministry of Finance** was decided by Presidential Decree. Following the State Finances and Treasury Law, the Ministry of Finance is undergoing a major reform. Its main goal is the establishment of a modern treasury.

(iv) **Divestment of Bank BRI, PGN.** The Government kept its divestment plans to assure sufficient domestic financing for the 2004 budget.

(v) **Submission to Parliament of amendments of Law 22/1999 on decentralization and Law 25/1999 on fiscal balances.** The proposed direct elections of the heads of regions would improve accountability at the local level. The proposed ex-ante review of local tax PERDA's would curb the proliferation of nuisance taxes and, therefore, improve the investment climate. The plethora of local taxes issued since decentralization has become a deterrent for investors.

Restructuring and Reforming the Financial Sector

In term of restructuring and reforming the financial sector is concerned, the Government continues to complete building the financial safety net that would allow a phasing out of the blanket guarantee.

(i) **Draft LPS (deposit insurance) Law.** This important building block of a financial safety net was sent to Parliament. With the closure of IBRA, a special unit under the Ministry of Finance has taken over the task of administrating the deposit insurance until the LPS is fully functional.

(ii) **Draft OJK (financial service authority) Law.** After agreement on a solid transition plan, this draft law to regulate financial supervision in the financial sector, was sent to Parliament. Temporarily, Bank Indonesia and MOF signed a MoU on resolution and provision of liquidity supports to troubled banks.

(iii) **Divestment of Bank Lippo and BII.** The Government's shares in these two banks that encountered problems following the crisis were sold.

(iv) **Amendment of Bank Indonesia Law.** This puts the lender of last resort function back in the system.

Increasing Investment, Exports and Employment

The majority of policy commitments have been made in the area of increasing investment, exports, and employment. These commitments, however, varied from major policy moves to little more than a statement of various ministries' investments plans. There was considerable progress in setting out new plans for justice sector reform and establishing a new institutional infrastructure to combat corruption, but these developments are still at a very early stage with no demonstrable impact on the problem as yet. Moreover, this progress was compromised by a series of high-profile rulings from the court system that continued to raise concerns about the fairness and impartiality of the courts. Little progress has been achieved in the clarification of licensing authority and in making the investment and export team operationally effective.[12] Major steps include:

(i) **The Law on the Judicial Commission** has been passed by Parliament. In future, this independent Commission is to provide an oversight role to ensure the honor, dignity and behavior of judges as well as proposing candidates for the Supreme Court.

(ii) **The Supreme Court launched a series of Blueprints** to guide reform of various aspects of the court system, the commercial court and the newly established anti-corruption court. These Blueprints provide a comprehensive approach to reforming the courts system.

(iii) **The Anti-Corruption Commission** has been established with the appointment of five commissioners and the provision of an appropriate budget allocation. The Commission has wide-ranging powers to investigate and prosecute corruption cases, undertake corruption prevention measures, monitor corruption, and promote education and outreach efforts. The Commission is currently recruiting a staff and establishing its internal procedures and structures, while reviewing and investigating corruption cases.

(iv) **The national investment and export improvement team** has been set up. The team is led by the President herself, with daily coordinator is Minister Dorodjatun. Sub-teams are led by Theo Toemion, a chairman of the Investment Coordinating Borad (investment) and Minister of Trade and Industry Rini Soewandi (exports).

(v) **A one-roof licensing system** for investment approvals (Presidential decree No.28/2004) has been re-established.

(vi) **An Electricity Market Supervisory Agency** has been set up. However, implementing regulations for the electricity law are still lacking, and therefore the powers and effectiveness of the committee remain unclear.

3. Outstanding Issues

Much of the progress noted above has been limited to passing laws, launching plans, and establishing new structures, but there remain a number of issues regarding the substance of the measures taken, their impact on outcomes and the supporting measures needed to be taken in order to make them effective. Some of these issues are described below:

Macroeconomic Stability

Tax policy and administration, key for the investment climate. In the area of macroeconomic stability, a key outstanding issue is the submission of revisions to the tax and tax administration laws. The Government has maintained a commendable dialogue on these important laws. In general, investors are looking for concrete steps that balance the powers of tax enforcement of the tax administration with accountability and transparency. Simplified refund procedures, more efficient audits, improved access to appeals to the tax court, a larger role of the inspectorate general to investigate abuse by tax administrators, and strict limitations (if not abolishment) of debtors' prison during tax investigations would all provide such balance. Including provisions to this extent in the draft laws to be sent to Parliament and in follow-up regulations would therefore be welcomed.

Some concerns also remain on the tax policy revisions proposed by MOF. These revisions go a long way in meeting the

[12] Export sub-working group have identified problems and made proposals in taxation, custom and ports.

Government's objective of a simpler and more efficient tax system, but at the same time some further options to achieve that remain unexplored. And finally, there is some concern over a shortfall in revenues that would occur with the proposed changes. The Government therefore needs to put inplace compensating measures of any possible revenue shortfall before the revisions are implemented.

Decentralization laws raise concerns. The amendments to law 22 and law 25 submitted to Parliament raise some concerns. The proposed revisions for Law 22 do not settle the difficult issue of roles and responsibilities of different levels of government. This is not only of concern to investors, who need to know clearly how approvals for the various aspects of investment are arranged, but also for those who care abut public services, as unclear assignments of functions are affecting services such as education and health care. On the fiscal side, the Government proposal to recentralize the salary bill by formalizing the civil servant wage allocation in DAU (General Allocation Fund), could undermine fiscal discipline in the regions and local service reform initiatives. Finally, the borrowing framework for local governments has undergone some improvements, but it remains unclear what happens in case a local government default to parties other than the center.

Restructuring and Reforming the Financial Sector

In the area of restructuring and reforming the financial sector, the privatization of Bank Permata is still outstanding, and better governance of state banks remains an issue of concern. More broadly, the plans of state-owned banks to acquire Bank Permata or to merge with other state-owned banks could threaten the Government's achievements in this area. Some state-owned banks are already large enough to pose systemic risks to the banking system and operational weakness continues, as highlighted by recent scandals and frauds. Increasing their size at this point is be counter to the Government's efforts to reduce systemic risk. In addition, it is not clear that there are significant benefits of such mergers. As the owner of these banks, the government should carefully consider the adverse consequences of such mergers. Viewed from several perspectives, avoiding such mergers would best meet the Government's and Bank Indonesia's own objectives of creating a stronger and more competitive banking sector; they would also convey a strong positive message to the markets. A clear statement from the Government regarding its stand on the issue would help considerably in clarifying the situation.

Increasing Investment, Exports and Employment

In the wide-ranging area of increasing investment, exports and employment numerous issues are still outstanding.

Legal Issues and Bankruptcy Law. Perhaps the most pressing legal issue is the outstanding amendments to the Bankruptcy Law. These amendments are meant to prevent frivolous bankruptcy claims such as the previous high-profile decision against Manulife. Unfortunately, these types of cases continue to appear, as recently shown in the case against Prudential Insurance. The impact of these high-profile cases on perceptions of Indonesia's investment climate cannot be underestimated, for they undermine the recent progress made in announcing the blueprints for court reform. Ending the stalemate on the amendments and getting them passed by Parliament would send a strong signal to the investor community that the Government is serious in addressing its concerns.

Legal uncertainty remain a key concern for investors. Indonesia's courts continue to make decisions that are widely seen among investors as biased or otherwise compromised. In two cases, the courts decided in favor of plaintiffs that filed suit to nullify syndicated loan agreements with international bank consortia on the grounds that syndicated loans are against Indonesian law. In one case, the court even awarded punitive damages to the plaintiff for business losses suffered. Court reforms as outlined for in the Blueprints remain critical to improving legal certainty in Indonesia.

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[13] Regarding the regulations on the Labor Law, 18 ministerial decrees, 1 presidential decree, and 1 government regulation were made, while 7 ministerial decrees, 2 presidential decrees and 3 government regulations are outstanding.

Regulations on Labor Law and Industrial Dispute Law. A further pressing issue is that of the outstanding regulations on the labor law[13] and the industrial dispute law. These laws were heavily debated before and during the Parliamentary discussions on the laws, and several contentious issues remain.[14] However, now that the law is passed, getting the implementing regulations in place is becoming urgent. The reason is that the law lacks specifics, so as long as the regulations are outstanding a potential employer cannot determine what the costs of hiring labor will be. As a result, hiring decisions are likely to be postponed. In a similar vein, the social security bill put to parliament earlier this year, is also adding to the uncertainty of labor costs, and could therefore contribute to the lack of employment growth. Resolving these uncertainties by issuing regulations on the laws, and clarifying the intention of the social security bill are therefore important to raising employment.

PRSP. With regards to developing a Poverty Reduction Strategy (PRSP), the Core Team had completed a draft of the PRSP by the end of May 2004. The draft establishes a set of broad principles and guidelines for pro-poor policy making by the Government. The vision and principles laid out would represent important commitments by Government toward reducing poverty. However, the PRSP draft does not represent a full strategy per se, in that it does not lay out *how* the Government would implement the broad principles and vision. To make for an operational strategy there would be a further need for clear priorities and specific, time-bound actions, including the fiscal choices and financing plan that this would entail, as well as targets and indicators of success related to solid poverty diagnostics. One option for moving forward would be to use the principles outlined in the draft PRSP to drive the preparation of the new medium-term plan so that the plan would then become Indonesia's Poverty Reduction Strategy, to be approved by the incoming Government. By doing so, the strategy for poverty reduction would be embedded in the planning document and more closely linked to actual budgetary and financing choices. Such an approach is likely enhance more directly the poverty focus of the Government's program.

Other Issues. Some of the delays on the milestones of the White Paper are unlikely to affect the investment climate. The revision of the draft investment law seems not to be a priority of investors, as most can live with the current one, especially now that the negative list of sectors in which foreigners are not allowed to invest has been further reduced. The absence of a trade law, as called for in the White Paper, can be seen as an unexpected benefit to the investment climate, as such a law could easily be used to introduce measures that could weather the competitiveness of the Indonesian economy. Recent trade measures, including a temporary ban on rice, import licensing of certain imports, and plans to re-introduce export bans of certain goods undermine the Government's long-standing commitment to Indonesia's traditionally open economy.

4. Beyond the White Paper

The White Paper is intended to be a bridging policy package whose lifespan of 18 months will expire by the end of 2004. With seven months to go until then, the Government needs to:

(i) **Press ahead with the outstanding measures**. Important policy actions such as the implementing regulations on the State Finance Law, Treasury Law, and Labor Law need to be introduced.

(ii) **Ensure that the policy actions taken under the banner of the White Paper indeed meet the stated goals of the policy package.** This would require active involvement of senior policy makers in the quality control of the policy actions proposed by the line ministries.

(iii) **Ensure that policies outside the purview of the White Paper are consistent with its goals.** The Government could take a more active interest in events affecting Indonesia's image in the investor community, including court decisions potentially affecting the investment climate. While the courts are now independent, Government remains key in expressing demand for reforms of the system as well as in providing resources to make these reforms happen. In a similar vein, the Government should continue to take an active interest in a well-functioning anti-corruption commission.

[14] These include the limitations on outsourcing work and the obligation to give severance pay to employees that leave a company, irrespective of the circumstances under which that employee left.

(iv) **Commit now to continue reforms beyond the lifespan of the White Paper.** While not without flaws, the White Paper has provided the Government with a vehicle to present concrete policy actions and benchmarks for reforms, a feature that the traditional planning documents lacked. Going forward, the Government needs to consider what policy actions in the medium term are needed to shore up investment, exports, and employment. A list of actions the Government wants to commit to in its regular planning documents may well be worth considering The draft PJM 2005-2009 (medium-term plan), the draft Transitional National Development Plan 2005-2006, or the draft Government Working Plan (RKP) 2005 that the current Government is preparing for consideration by the incoming government, could all serve as vehicle to present such a medium-term plan.

(END)