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INDONESIA: Country Assistance Strategy and the World Bank Group's Private Sector Development Strategy

We consider a discussion of the Bank's assistance strategy and the Bank Group's Private Sector Development Strategy in Indonesia, at this time to be particularly opportune. We recognize that Indonesia finds itself in the midst of a major political transition toward a democratic society, and that it has met many challenges over the past year. Also, some progress has taken place in the aftermath of the worst economic crisis in Southeast Asia. Nonetheless, we are very concerned about the lack of momentum in economic and judicial reforms. Corruption remains a significant challenge for Indonesia and is severely tarnishing Indonesia's reputation as an attractive venue for investments. We broadly support the Bank's proposed assistance strategy as it addresses the tough economic and structural challenges facing Indonesia. At the same time, we seriously question the appropriateness of ongoing IFC activity in Indonesia given fundamental structural weaknesses in the legal and judicial system, weaknesses which the government has yet to address in a meaningful manner. In this context, we would highlight the importance of two major cross-cutting and inter-related priorities that must continue to receive priority attention by the government of Indonesia as well as the Bank and the international development community; namely **governance** and **decentralization.**

General Economic Environment

It is noteworthy that Indonesia should face one of the least dramatic growth slowdowns in East Asia in 2001. While we share the Bank's view that Indonesia will likely "muddle through" in 2001 as the slowdown in foreign markets coupled with the commodity heavy export basket will temper growth, we believe that there are more downside risks than upside risks and see the Bank's "performance" scenario of political stability and aggressive implementation of structural reforms as highly unlikely. Generally speaking, we are pleased with the economic progress Indonesia has shown since the financial crisis. Economic growth was healthy and exports recovered well in 2000. But, in spite of these notable achievements, we have deep concerns about the pace of structural reform and remaining financial sector frailties and we share the Bank's view that many risks remain in Indonesia's recovery. We would highlight the following points on the economic situation in Indonesia:

- Although declines in the stock market have leveled off in recent months, we are still

concerned about the current financial market fragility. Short-term interest rates have continued their upward trend, reflecting efforts by the central bank to support the falling *rupiah*. And many are skeptical that recent restrictions imposed on overseas dollar purchases will lend support to the currency.

- The process of asset disposal under the Indonesian Bank Restructuring Agency (IBRA) in the latter part 2000 was not as smooth as it could have been. Although IBRA met and even exceeded asset disposal targets set by the IMF, this came primarily from a windfall asset sale in November. IBRA's overall performance in 2000 was plagued by a general lack of transparency and an associated concern that some decisions were taken without true arm's length relationships. We believe transparent asset sales and improved corporate governance are essential in restoring confidence in the financial system.

- Indonesia's fiscal outlook remains highly uncertain. We believe the authorities were overly optimistic in their exchange rate forecasts for 2001. Moreover, the uncertain start to the fiscal decentralization process raises questions about the likelihood of Indonesia achieving the fiscal targets. Given the country's debt overhang we urge the authorities:
  1. To demonstrate fiscal restraint and minimize financing pressures on the already fragile financial sector.
  2. Not to monetize the debt through bond issues to the central bank.

- We urge the authorities to resolve the difficulties involving Bank Indonesia as expeditiously as possible, as the continuing uncertainty is eroding investor confidence. Finally, we encourage Indonesia to get its IMF program back on solid ground.

Bank's Assistance Strategy

The Country Assistance Strategy, which focuses on institution building and strengthening human capital, is appropriate given the risks of an economic reversal in the country and the need to strengthen governance and decentralisation. We agree especially with staff's analysis of the need for a strong focus on governance, especially since governance is seen as the "weak link" in the country's development strategy. Investor surveys show Indonesia to have among the worst corporate governance in East Asia. To date, Indonesia's commitment to judicial, civil service and corporate governance reforms has been at best uneven and at worst weak and the reform process suffers from a lack of coherent coordination and leadership (para 18). Anti-corruption measures have largely been ad hoc and some have been undermined by lack of budgetary support, mistrust and lack of capacity. **Clearly it is important that the Bank and other development partners send a strong message to the Indonesian authorities on the need to improve governance.** Stronger governance is critical to longer term development and poverty reduction in order to attract the private investors that will contribute to the country's economic recovery. The country's risk profile with international investors, reflected by the 700 basis point spread on Indonesian bonds over US Treasury bills, remains high.

Private Sector Development: Foreign Capital Mobilization for Investment

We concur with staff that without new credit or investment, the economy will "run out of steam" (para 6). Private sector growth is the engine of development. However, the Private Sector Development Strategy paints a very dismal picture as to the current environment for private investment in Indonesia, both domestic and foreign. We were particularly struck by the fundamental weaknesses in the legal and judicial systems described in the document:

"A weak and corrupt legal system has made it impossible to enforce contracts and absence of the rule of law have made honest enterprises vulnerable to abuse of power by the state and by unruly elements. ... The reputation of the court has not recovered and is unlikely to do so until a pattern emerges of decisions that the investor and creditor community have confidence in. The prognosis is not good. While the Government of Adurrahman Wahid has declared itself committed to combating corruption, it has taken little meaningful action to deter corruption in the courts. Furthermore, it has shown almost no recognition of the need to pursue any sort of comprehensive strategy for broader reform of the legal and judicial system in order to upgrade its ability to contribute to the stable functioning of commercial enterprises and to fight commercial fraud." (Page 11 - 12.)

The current situation of a Canadian company offers a very telling illustration of these weaknesses. Manulife Financial is a respected Canadian corporation with over one hundred years of experience in Asia. It has been operating successfully in Indonesia for the past fifteen years. It was the first foreign financial services company to invest in Indonesia's recapitalization of bonds. Manulife Financial is committed to continuing to contribute to economic growth and development in Indonesia.

Since 1988, Manulife Indonesia has operated as a joint venture by three shareholders: Manulife Financial of Canada (51%), PT Dharmala Sekti Sejahtera (40%) and IFC (9%). Unfortunately, in mid-1997 PT Dharmala Sekti Sejahtera began experiencing serious financial distress that culminated with the creditors of the company petitioning for the bankruptcy of Dharmala Sekti Sejahtera in March, 2000. In fact, the PT Dharmala Sekti Sejahtera bankruptcy represented the first major bankruptcy under Indonesia's reformed bankruptcy laws. On October 26, 2000 Manulife Financial announced a substantial new investment of approximately US$20 million to acquire PT Dharmala Sekti Sejahtera's forty percent interest in Manulife Indonesia. This acquisition occurred through a court supervised, Ministry of Finance approved public auction. The Indonesia Bank Restructuring Agency (IBRA) was the major creditor of the PT Dharmala Sekti Sejahtera and the major recipient of the proceeds of the sale. This transaction has yet to be completed and Manulife Indonesia is under investigation for potential fraud and corruption. We have reason to believe that this investigation and associated legal action has not been conducted in a manner consistent with due process. We also understand that other international financial institutions such as Standard Chartered Bank, Amex Bank, Deutschebank and more recently the IFC have filed civil and/or criminal complaints related to the Dharmala Sekti Sejahtera bankruptcy.

Manulife Financial investment is a significant contribution to Indonesia's financial restructuring program. Its collapse would have unfortunate consequences all round. Another failed asset restructuring involving a foreign financial institution would negatively affect the international

financial community's confidence in Indonesia to carry out financial reform and would reflect very badly on the operation of the country's new bankruptcy laws.

It is worth remembering that financial reform itself, plus investor confidence built on a sound environment for private sector engagement are cornerstones of the development plan for Indonesia. If the Indonesian institutions are to leverage private sector investment, arbitrary and discriminatory actions must cease and, even more importantly, investors must be able to have confidence in the legal and judicial systems and be assured that they can have proper and fair means for addressing legitimate disputes. We agree with the comments in paragraph 6 of the Country Assistance Strategy that the government needs to remove the legal, regulatory and tax impediments against financial sector restructuring (para 6). Furthermore, its must develop and implement a strategy to strengthen the entire financial sector. We are concerned, however, that the government is proceeding too slowly with financial sector reform and that this discourages potential investor support for the restructuring process

The challenges ahead are immense. We fully agree with the four priorities articulated in the Private Sector Development Strategy, namely:

1. speed up the resolution of the corporate debt overhang;
2. addressing the many structural inefficiencies which will enable Indonesia to become a modern market economy and avoid future crises;
3. supporting measures to ensure that the growth is broad-based and sustainable; and
4. creating the infrastructure and regulatory environment necessary to take full advantage of the new information and communications technology.

We welcome the proposed medium-term goals in the Bank Group's strategy, particularly measures to support the development of the private sector as the main engine of recovery and sustainable broad based growth. However, we strongly believe that the Bank Group's priorities in the short term should also be to help remove impediments to the well-functioning of its existing operations, including impediments which prevent legitimate asset restructuring in Indonesia. Therefore, there should be more focus in the strategy on ongoing Bank Group's operations, which continue to be affected by the lack of openness to competition and transparency. The specific Canadian experience described above, coupled with the broader assessment laid out in the Private Sector Development Strategy and MIGA's decision to suspend operations in Indonesia, leads us to ask the question: Is a "business-as-usual" approach appropriate for IFC investments at this time given the clear and fundamental structural weaknesses articulated in the Bank's Private Sector Development Strategy? We ask this question based on the real concerns we have that the basic legal and judicial systems are not in place to ensure the protection of legitimate private sector investments. Following up on this concern we would also like to discuss the following issues:

- What response has IFC received from the Indonesian authorities with respect to the Manulife Indonesia transaction and others (e.g., PT Panca Overseas Finance)?
- Could staff update the Board on problems the IFC is facing in its operations in Indonesia?

While we do indeed have real concerns as to the current environment for private sector investment in Indonesia and the government's real commitment to address these concerns, we

welcome staff's Private Sector Development Strategy Paper. It is very useful to have the benefit of this document when discussing the Country Assistance Strategy, particularly since the Bank Group's private sector development strategy is integrated across the Group's activities. (page. 22, para 43, Country Assistance Strategy). Given this fact, we also welcome the appointment of a joint Director for Bank and IFC activities in the country.

Decentralization

We agree with and fully support the Bank's analysis of the far-reaching implications of the decentralization process underway in Indonesia. We note, with some concern, that there remains a lack of consensus within the Government over the scope and method of implementation of this important component of democratization. In other fora, we have urged the government of Indonesia to continue its work to further define the process, develop a measured and phased plan for implementation and coordinate actions amongst a variety of critical ministries (notably, those related to natural resource management and social development) such that a coherent plan for decentralization could be implemented. The Bank's role in a number of areas, such as the planned Analytical and Advisory Activities and Economic and Sector work contributing to the delivery of public goods and services at the sub-national level, the development of decentralized environmental management, and provincial public expenditure reviews are clearly valuable activities. In addition, the Bank's proposed efforts to utilize lessons learned regarding demand driven service delivery and bottom-up planning in future social sector and basic infrastructure lending are to be commended. We would welcome elaboration by Bank staff on how exactly communities will be involved in these planning processes and how the Bank foresees that the needs of the beneficiaries (i.e., the poor in local communities) will be taken into account.

In the same vein, the intention to support pro-poor and reform minded sub-national entities is innovative and appropriate. We would also like to ensure that, as the Country Assistance Strategy itself notes, targeted support to communities with weaker governments is provided so that they are not left behind and that substantial gaps do not develop between "winners" and "losers" at the community level. It is equally important that local governments are sensitive to the need to and possess the capacity to create the appropriate policy and institutional environment, supported by sound governance practices, that are essential for both domestic and foreign investors. Could staff comment on the prospects for an improvement in governance practices under decentralization?

Aid Coordination and Consultations

The Country Assistance Strategy notes that the Bank is cooperating with the Asian Development Bank in supporting governance, financial sector and corporate sector restructuring. How is this work to be divided between the Bank and Asian Development Bank? What specific consultations were undertaken with the Asian Development Bank in developing the Private Sector Development Strategy? The Bank is also working with the IMF and Asian Development Bank in helping the government contain the risks of fiscal decentralization. How are the respective roles of the three institutions being defined? How close is coordination at the working level? How will statistics in the Asian Development Bank's Poverty Assessment for Indonesia be

integrated and utilized during the preparation of Indonesia's Poverty Reduction Strategy Paper and the World Bank's Country Assistance Strategy?

The development of the Country Assistance Strategy and the Private Sector Development strategies have benefited from broad consultations with civil society and the private sector. While we recognize that these consultations have been more open than in the past, we would be interested in staff's view of just how open these consultations were and on how representative the civil society organizations were of the poor, minorities and women. What impact did these consultations have on drafting? To what extent have representatives of emerging decentralized authorities been engaged in the consultative process and to what extent do these authorities buy in to the CAS objectives?

Lending Case Scenarios

While we strongly believe that the base case scenario will prevail in Indonesia, we share staff's concern about the potential for downside risks. **We can then generally support the base lending program under the current IDA 12 arrangements.** We fully agree that World Bank support should hinge on the government's progress in implementing fiscal, financial and judicial reform.

In closing, we would like to take the opportunity to express our sincere thanks and gratitude to staff and management of the IFC and the Bank for all of their efforts in Indonesia. We fully agree with Country Director Mark Baird's analysis: attracting offshore private investment is essential for Indonesia and its fight against poverty. Private sector investment is crucial to boosting the growth rate and sustaining it. However, the attractiveness of Indonesia as a location for new private sector investment will be determined in part by the experiences of companies currently active in Indonesia: their experiences will convey a clear message as to the rights of foreign companies. Our ability to come together to highlight governance issues in a country like Indonesia is indispensable to all of our efforts to sustain private sector investments in Indonesia.