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INDONESIA

WORLD BANK GROUP

PRIVATE SECTOR DEVELOPMENT STRATEGY

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Private Sector Development Unit
East Asia and Pacific Region

CURRENCY EQUIVALENTS

Currency unit: Rupiah (Rp) as of December 20, 2000
US$1 = Rp 9,225

FISCAL YEAR

Until March 31, 2000: April 1 to March 31
Until December 31, 2000: April 1 to December 31
From January 1, 2001: January 1 to December 31

ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities
ADB	Asian Development Bank
AMC	Asset Management Unit Credit
AMI	Asset Management Unit Investment
BAPEPAM	Capital Markets Authority
BOT	Build Operate Transfer
BRAP	Bank Restructuring Assistance Project
CAR	Capital Adequacy Ratio
CAS	Country Assistance Strategy
CBS	Committee for Business Supervision
CGI	Consultative Group for Indonesia
CIDA	Canadian International Development Agency
CRTAP	Corporate Restructuring Technical Assistance Project
FCGI	Forum for Corporate Governance in Indonesia
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FSPC	Financial Sector Policy Committee
FY	Financial Year
GDP	Gross Domestic Product
GNP	Gross National Product
HTI	Industrial Timber Plantation
IBRA	Indonesian Bank Restructuring Agency
ICSE	Indonesian Commodity Stock Exchange
ICT	Information and Communications Technology
IFC	International Finance Corporation
IFI	International Financial Institution
IIDP	Information Infrastructure Development Project
IMF	International Monetary Fund
IPP	Independent Power Producer
IPTEKNET	Government Internet Service Provider
JITF	Jakarta Initiative Task Force
KADIN	Indonesian Chamber of Commerce
KKN	Corruption Collusion and Nepotism
KSO	Telecoms Cooperation Agreement
KUD	State Sanctioned Rural Cooperatives
LEI	Indonesian Eco-Labelling Institute
LOI	Letter of Intent
MIGA	Multilateral Investment Guarantee Agency
MISE	Ministry of Investment and State Enterprises
MoAF	Ministry of Agriculture and Forestry
MoF	Ministry of Finance
NBFI	Non-banking Financial Institution
NCCG	National Committee on Corporate Governance
NGO	Non-government Organization
NSA	New Spending Authority
PDAM	Public Water Supplier
PHRD	Policy and Human Resources Development Grant
PLN	State Power Utility
PRSL	Policy Reform Support Loan
PSD	Private Sector Development
PSP	Private Sector Provision

PSS	Private Sector Strategy	USAID	United States Agency for International Development
SBI	Bank Indonesia Certificates		
SME	Small and Medium Enterprise	VAT	Value Added Tax
SOE	State Owned Enterprise	WB	World Bank
TA	Technical Assistance	WBG	World Bank Group
TELEMATIKA	Committee for Telematics	WWF	World Wildlife Fund

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INDONESIA: WORLD BANK GROUP PRIVATE SECTOR DEVELOPMENT STRATEGY

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INDONESIA

WORLD BANK GROUP PRIVATE SECTOR DEVELOPMENT STRATEGY

EXECUTIVE SUMMARY

Overview

The level of poverty in Indonesia and the vulnerability of the poor will not be permanently reduced without sustained, broad based economic recovery and growth. This growth can only be generated and sustained by private activity. But past patterns of development contributed to the onset, the severity and the length of the financial and economic crisis. Indonesia's potential will not be realized without a pattern of private sector activity that is very different from the past. Indonesia cannot afford to miss the opportunity offered by the crisis to make fundamental changes in the business environment and in the way business is done.

Indonesia's large corporations account for 60 percent of GDP. But 99.5 percent of employment is in enterprises with less than 100 employees. The small and medium enterprise sector is highly underdeveloped. The result of this is a lost productive potential from a "missing middle" group of enterprises that in more economically developed countries is the driving force for development. With the top ten families owning more than 60 percent of the corporate assets, ownership concentration in Indonesia is higher than in other countries in the region. Close relationships between corporations, banks and government, poor oversight by the regulators, insider control and pervasive state ownership of economic assets have all acted against the openness to competition and transparency that are necessary for sustainable growth and resilience to shock.

The first priority should be for the banking and corporate sectors to speed up the resolution of the corporate debt overhang so that financial flows for investment and working capital can resume. Secondly, the many structural inefficiencies that led to the crisis and made it deeper and longer lasting in Indonesia than elsewhere in Asia need to be overcome. Reforms are needed to enable Indonesia to become a modern market economy and avoid future crises. This means fighting corruption in the public administration and ensuring the rule of law through the court system, reinforcing property rights and dispute resolution mechanisms, ensuring open and transparent transactions through more competition and better corporate governance, and creating a business environment where following the rules rather than crony capitalism is the norm. The state needs to withdraw transparently from its over-extended ownership of productive assets and allow the private sector to realize its potential as the driving force for growth. But at the same time the state has to step up and take on its legitimate oversight role by strengthening the rules, and the institutions that enforce them. This means improving supervision of the banks and financial markets, creating independent regulators for public monopolies, developing and enforcing competition law, and enforcing financial disclosure and audit of financial institutions and public corporations. Thirdly, measures to ensure that the necessary growth is broad based and sustainable will be necessary. This means firstly removing the current obstacles to small and medium enterprise activity and promoting SME development. It also means building the necessary physical and social infrastructure and ensuring that growth is environmentally sustainable, particularly for Indonesia's forests, mineral and marine resources. Finally, Indonesia will need to create the infrastructure and regulatory environment necessary to take full advantage of the new information and communications technologies.

The private sector was hit hard by the crisis

The crisis had a devastating impact on the corporate sector, particularly in construction, financial services and manufacturing. The corporates had depended excessively on foreign borrowing and very little on equity finance. In late 1997 a large part of the corporate and banking sector became insolvent. Small enterprises, the majority of which are in agriculture, suffered less than the corporate sector as they were not as exposed to the devaluation of the rupiah. They did, however suffer from the decline in aggregate demand resulting from the crisis.

GDP recovered and grew by 4-5 percent over the year to the third quarter of 2000. The incipient recovery was relatively well spread across the sectors, with investment gaining importance over consumption, and non-oil exports contributing substantially. But the financial markets have not yet recovered, due mainly to continued concerns about political instability and regional violence and delays in corporate restructuring. The stock market in December 2000 had lost one third of its value since December 1999. Since the start of the crisis 68 out of 237 banks have been closed, and another 12 banks nationalized in an effort to stabilize the banking system. As the banking sector begins to emerge, the Government is directly in control of 70 percent of the deposits in the banking system, compared to 40 percent in Korea, and 23 percent in Thailand. The bank recapitalization program has been extremely costly. A total of about Rp 650 trillion of sovereign bonds have been issued and this to recapitalize the banks only to a capital adequacy ratio (CAR) of 4 percent. Bank lending is resuming, up just under 6 percent in the first half of 2000 compared with the previous year, but lending is mostly for short term working capital rather than for investment. Large non-performing loan portfolios are still holding back bank profitability.

Indonesian corporate debt in late 2000 is around $117 billion - 70 percent of this is for large private corporations and 30 percent for state-owned enterprises and SMEs. Of the total, 48 percent is owed to foreign creditors and more than 70 percent is denominated in foreign currencies. Around 49 percent of corporate debt is distressed. Of the large corporate debt, three-quarters is distressed and in need of restructuring. After a very late start, corporate debt restructuring began to pick up towards the end of 1999. Around $15 billion in distressed corporate debt has been restructured since the crisis began, and most of that during the year 2000. A number of large debt restructuring deals are imminent and both creditors and debtors are cautiously optimistic that, barring unforeseen problems, the momentum will continue.

There are many impediments to robust recovery and sustainable growth

Banking and corporate restructuring. Sustainable economic growth cannot begin until banking and corporate debt restructuring have made substantial progress, and there is a long way to go. The Indonesian Bank Restructuring Agency's (IBRA) internal governance needs improvement and IBRA's last two annual audits included disclaimers of opinion. Following some recent high profile transactions involving well connected conglomerates, the quality of IBRA's restructuring deals is currently being questioned and there is an urgent need for IBRA to adopt transparent debt restructuring principles, especially for its largest obligors. The slow speed of divestiture of IBRA's assets is also causing concern not only because of the consequent delay to the restructuring of the economy and but also because of the acute need for revenues from asset sales to cover the cost of bank recapitalization. There are doubts about IBRA's and Government's willingness to accept that realization from the assets to be sold will likely be much less than their book value. The restructuring and privatization of Indonesia's state banks is an urgent priority for the creation of a healthy banking system, but progress to date has been very slow.

In addition to the high profile cases, there are also concerns about the quality of many of the other corporate restructuring deals concluded to date. They have relied excessively on term extensions and debt equity conversions. Little real operational restructuring has taken place and the risk is that many corporates could remain vulnerable to future crisis even after restructuring. The bankruptcy process in Indonesia does not pose a credible threat to recalcitrant debtors and much effort has gone into devising ways of getting around this, including granting IBRA extraordinary powers to seize assets and giving the voluntary debt restructuring agency, JITF, additional leverage to refer non-cooperative debtors to the Ministerial Committee, FSPC, for referral on to the Attorney General. These measures have yet to be seriously tested, however and it remains to be seen whether they will be effective. Meanwhile some progress has been made in offering tax and regulatory incentives to parties concluding debt restructuring deals. Further implementing rules are needed to make these measures fully effective.

Structural weaknesses. Restructuring the banks and resolving the debt overhang are only the first steps. Action needs to be taken to remove a formidable range of structural impediments and constraints to sustainable and equitable economic growth. These cannot be resolved overnight but action to deal with them needs to begin and be sustained over time. These impediments fall into several broad categories:

- Poor governance and corruption in the public sector;
- The uncertainties surrounding the forthcoming decentralization process;
- The absence of an effective court system and the longstanding need for legal and judicial reform;
- Poor corporate governance, particularly lack of information disclosure or enforcement against offenders;
- The need for effective rules and institutions to implement competition policy;
- A less than welcoming climate for foreign direct investment; and
- The extended role of the state and its crowding out of private sector activity.

Impediments to long term sustainable development. Broad based growth cannot happen without development of the SME sector. At present SMEs face a number of impediments including market distortions acting against them, excessive regulation, corruption and red tape, ineffective support systems, low skills development and a banking system that lacks the capacity or skills to lend to SMEs. Rural areas in particular remain underdeveloped as public sector delivery systems have not provided farmers with effective services or access to micro-finance.

The effectiveness of attempts to privatize physical infrastructure in the 1990s were limited by lack of independent regulation, by lack of competitive market structures and by lack of transparency in many of the deals that were concluded. One consequence is the frequency of high profile contractual disputes between the public utilities and their private partners. Government policies do not yet favor transparent privatization of infrastructure and frequently act to crowd out new private investors. Similar considerations apply in the health and education sectors where private providers frequently are able to reach poorer sections of the population that the public providers do not reach, and in other cases are able to provide better quality services at lower cost. But government policies have discriminated against private providers.

In forestry, the distorted incentive framework, irresponsible behavior by timber companies and lack of enforcement of regulations against offenders has led to a crisis of illegal logging which is threatening the very existence of Indonesia's forests.

Finally, Indonesia is lagging behind neighboring countries in embracing the new information and communications technologies. The legal and regulatory framework for e-commerce does not yet exist. Government itself has not used the new technologies to advantage. Important opportunities are being missed, in terms of the possibilities of making existing business more effective, of opportunities for creating completely new businesses, and of the benefits from increased transparency that would accrue to the population from putting government on line and using new electronic and communications applications in education and other public services.

World Bank Group Private Sector Development Strategy

The World Bank Group's (WBG's) vision and strategy for development of the private sector responds closely to that recently elaborated in Government's ten point economic recovery program. It is based on solid analysis of the conditions on the ground in Indonesia and continuous dialogue with and feedback from beneficiaries, our partners in the private sector, in government, and among the donors. To sharpen up the relevance and focus of this private sector development strategy, the WBG held discussions during its preparation with focus groups of private entrepreneurs, and also commissioned a business environment survey of private businesses in Indonesia.

The medium term vision is one in which, firstly, the immediate aftermath of the crisis will have been resolved, with a healthy restructured banking sector lending again for corporate investment and working capital. Secondly, progress will have been made in resolving the structural impediments to private sector led growth mentioned above. Private activity would be based mainly on competition and effectiveness rather than on protective relationships between government, the banks and the corporate sector. Thirdly, the private sector will be playing the leading role in generating growth and fiscal resources and providing the public infrastructure and services needed for sustained poverty reduction. The ownership pattern would be less concentrated than in the past, but more broadly based on accelerated development of SMEs and broader share ownership in the large corporations.

The role of the WBG. The WBG is taking advantage of the synergies resulting from the recently implemented co-management of Bank PSD and IFC activities in the East Asia Region and the joint WB/IFC Global Product Groups. We are being selective in our interventions, operating in catalytic mode, supporting activities for which there is a strong government or partner commitment, a demonstrated country need and where we have a comparative advantage. The WBG is maximizing opportunities to leverage its scarce resources with those of other donors and investors and taking care to avoid duplication of activities. Private sector development is a cross-sectoral objective and, where possible, PSD activities are being mainstreamed through the Bank's sector projects and other interventions. In a few cases, such as banking and corporate restructuring, corporate governance, competition policy, SME development and information and communications technology , the WBG is implementing free standing projects, trust fund grants or advisory activities.

Crisis response activities. The Bank has worked closely with the IMF and the ADB since the onset of the crisis, in supporting government's banking and corporate restructuring program and will continue to do so until the crisis is over, with technical assistance, lending, trust funds and analytical and advisory activities (AAA). IFC is supporting corporate restructuring by actively restructuring problem projects in its own portfolio and seeking out candidates for demonstration restructuring transactions.

Addressing structural weaknesses. In the areas of public sector governance and decentralization, the Bank is leveraging donor resources through the multi-donor Governance Partnership and through trust funds to provide advice to government and we propose to continue this assistance as a priority. In legal and judicial reform the Bank is playing the role of coordinator of donor activities in response to a request from the Government. Trust funds and a component of a Bank project will also support training activities for Commercial Court personnel. In corporate governance, the Bank through its AAA is sponsoring seminars and other best practice dissemination events. The Bank also proposes to complete a benchmarking exercise of Indonesian corporate governance practices during the coming year. IFC is applying corporate governance best practices through its role as a shareholder in a number of Indonesian corporations. The Bank is taking the lead and coordinating among the donors in providing help to the new competition agency. In promotion of foreign direct investment, FIAS has provided a number of missions and is ready to respond to further requests. MIGA's operations in Indonesia were affected by a claim from one of its projects. As a result, it has suspended its guarantee activity in Indonesia, but it is accepting applications of interest and is keen to support the resumption of FDI in Indonesia. In privatization, the Bank has played a key advisory role in the past but there is little receptiveness from Government at present. The ADB now has the lead in this area.

Promoting long term sustainable development. SME development in Indonesia is a priority area of assistance for the new Joint Bank/IFC SME Unit. The WBG has supported a variety of SME programs and projects over the years in Indonesia. The focus at present is on policy advice, improved delivery of business development services through a decentralized SME facility, and the building of capacity within banks to lend to SMEs. In rural and urban development, the Bank will continue to promote private sector development through its sector projects and IFC will work through investments in agribusiness. In infrastructure, the Bank will continue to promote privatization and private participation through its ongoing sector projects in telecommunications, power and transport. IFC is looking for opportunities to invest in the transport and water sectors. The Bank will seek means of promoting the private provision of social services in health and education through its sector projects and AAA advisory activities. In forestry, the Bank has supported reforms through its policy based lending and is leading the forest policy dialogue with government and other partners. The WBG is ready to invest in the oil, gas and mining sectors, based on sound policy and regulatory frameworks. In mining, the emphasis will be on small scale mining activities in a decentralized environment. In information and communications technology, the Bank is supporting preparation of a national networking strategy including upgrading of the regulatory framework for e-commerce and supporting government on line initiatives.

INDONESIA

WORLD BANK GROUP PRIVATE SECTOR DEVELOPMENT STRATEGY

I. INTRODUCTION

Economic recovery and renewed sustained growth are essential for poverty alleviation and are therefore top priorities in the World Bank Group's Country Assistance Strategy (CAS) for Indonesia. The necessary recovery and growth will not be achieved without restoring private sector confidence and investment, both of which have suffered badly during the crisis. This in turn will depend on addressing critical weaknesses, many of which are long standing and more severe in Indonesia than in other East Asian countries. In addition to the political turmoil over the last two and a half years and uncertainties over Government's future decentralization plans, these weaknesses include:

- Slow progress in bank and corporate debt restructuring
- Structural market inefficiencies resulting from poor law enforcement, poor governance, poor implementation of competition policy and continued dominance of the state in key sectors
- An underdeveloped base for private sector activity, especially SMEs and rural employment opportunities
- Underdevelopment of physical and social infrastructure, and of capacity to compete in the knowledge economy.

The WBG's strategy to help Indonesia deal with these weaknesses will have the following guiding principles:

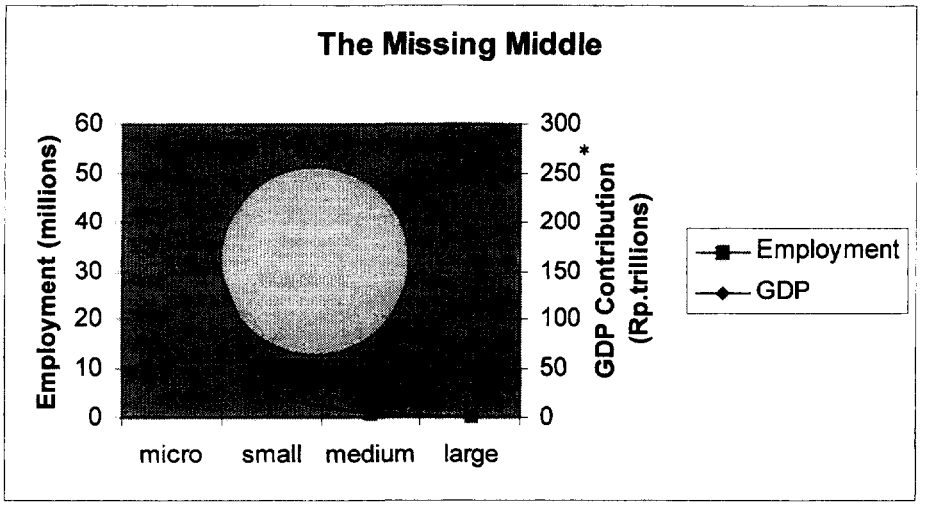
- Help resolve the financial crisis, deal with the corporate debt overhang and restore financial flows for investment
- Develop efficient, competitive, transparent and open transactions with well-defined property rights, effective and clear enforcement of contractual obligations, and an efficient system for the resolution of disputes. Establish effective public administration ensuring reduced corruption, good public and corporate governance, efficient institutions and processes for customs and taxation, and transparent and effective privatization
- Promote long term sustainable broad based development. Build the necessary efficient and sustainable infrastructure in terms of the social sectors (health, education, pensions, etc.), physical infrastructure (transport, energy, telecommunications, etc.) and the critical technological and informational base which Indonesia will need to keep up and compete in the global economy.

In this Private Sector Strategy (PSS) we first present information on recent developments in the private sector and on progress in resolving the banking and corporate debt crises. We then examine the major policy issues and impediments to private sector led recovery and sustainable growth before outlining the WBG's private sector assistance strategy for the next three years. The issues affecting private sector recovery and sustainable growth are complex and interlocking and will change in relative importance over time. For ease of presentation we have linked the issues and proposed actions under three groupings – responding to the crisis, addressing structural weaknesses, and promoting the long term role of the private sector. However many of the issues and strategy proposals could appropriately be placed in more than one of these groups or under completely separate independent headings.

II. PRIVATE SECTOR LED RECOVERY HAS BEGUN

A. The Indonesian Private Sector

The industrial structure in Indonesia is heavily dependent on large corporations for its output, and on micro-enterprises for employment. Before the crisis, firms with fewer than 100 employees accounted for 39 percent of Indonesia's GDP, but 99.5 percent of its workforce. This structure is the result of an enabling environment that favors larger firms and discriminates against smaller ones. The concentration of economic power in a few large firms constrains access to markets and resources for the vast majority of firms. It also exposes smaller businesses to higher levels of corruption, and results in millions of enterprises remaining in the informal sector. Because of this the vast majority of Indonesians are employed in firms with low margins and low



*GDP statistics reflect that micro, small and medium enterprises together generate Rp177 trillion of GDP – breakout is not yet available.

growth prospects. The result is low salaries and benefits, and high vulnerability to poverty.

As with many developing countries, the lopsided economic structure results in a "missing middle" of small and medium sized firms (SMEs), which can be the engine for growth and dynamism in a country. An effective private sector development strategy should focus on building an enabling environment, infrastructure, a financial system, and a regulatory system which allows firms of all sizes to compete on an even playing field.

The dominance of SMEs is especially pronounced in agriculture and services such as transportation and catering. Their role in manufacturing is relatively small—small enterprises and households account for about 8 percent of value added in manufacturing. Small enterprises account for 19% of total commercial bank lending despite contributing 42% of GDP. The chief sources of SME financing are the state banks and the government's Liquidity Credit Scheme. Around 10% of all SMEs borrow from banks. Private sector financial institutions are not actively involved in the SME sector. There is only limited venture capital available to SMEs. Indonesia has 69 venture capital companies with a total of Rp 1.7 trillion in funds. Indonesia ranks eleventh in Asia for the size of the funds. Also the amount invested per company in Indonesia is small (about Rp 123 million per investment).

There were around 1,800 large enterprises in Indonesia in 1998, accounting for most of manufacturing, finance and foreign trade. Among these, 288 companies were listed on the Jakarta Stock Exchange. Corporations in Indonesia are mainly family-controlled. A recent study found that 71.5% of Indonesia's publicly traded corporations are family-controlled. Only 5.1% of Indonesia's corporations are widely held. Indonesia has the highest share of family controlled corporations in the East Asia region. In most companies, ultimate control is through a pyramid structure and is the most concentrated in the Region. Cross-ownership is relatively insignificant. Almost 17% of total market capitalization is under the ultimate control of a single family. The top ten families control close to 60 percent of total market capitalization.

Separation of management from ownership is rare in the Indonesian corporate sector. Management of more than four-fifths of firms which are not widely-held is related to the family of the controlling shareholder. There have been extensive and non-transparent links between government and business. Many members or business partners of the controlling families have also served in government in some capacity. These families, therefore, have had a strong effect on the economic policy of the government. In addition, the share of state ownership of Indonesian corporations is one of the highest in the region.

The financial sector has shared many of the same characteristics as the corporate sector. It is dominated by banks. The commercial banking sector itself has been dominated by a few large domestic commercial banks with extensive branch networks. The commercial banks have been dominated by handful of families with powerful connections to the local and international business community and to the government. Before the crisis, Indonesia's financial sector had undergone extensive liberalization, had a weak regulatory and supervisory framework, poor risk management and excessive lending with large exposures to the real estate sector. Financial liberalization had led to an explosive growth of new banks from 124 in 1988 to 244 in 1994. Most of Indonesia's large conglomerates had set up or acquired at least one bank.

The result of the above was high vulnerability. The concentration of wealth, and the important direct and indirect channels through which the government has played an active role in business activity and through which businessmen may have influenced politicians, suggests that the ineffectiveness of the legal and regulatory systems in Indonesia may be largely due to the forms and concentration of control over the corporate sector and the strong links between business and politics. If the role of a limited number of families in the corporate sector is large and the government is heavily involved and influenced by business, the legal and regulatory system (e.g. antimonopoly) is less likely to have evolved in a manner to protect minority shareholders, or to promote transparent and market-based activities.

On the corporate side, this has resulted in poor corporate governance and too much insider control, which have contributed to the weak performance and risky investment of many Indonesian corporations prior to the financial crisis. Meanwhile, liberalization of domestic banking combined with weak supervision and cozy relationships between banks and corporates, has boosted the quantity but undermined the quality of bank lending to the corporate sector. Studies on the East Asian crisis have found that "connections"- with industrial groups or influential families—have increased the probability of distress in Indonesian financial institutions, suggesting that supervisors had granted selective prior forbearance from prudential regulations.

The underdevelopment of domestic non-bank capital markets has contributed to the concentration of risk by limiting the number of options for corporate financing. The Indonesian experience, supported by data on corporate financial structure of emerging market countries, suggests a correspondence between vulnerability to crisis and bank dominance of the financial

system. Volatile capital inflows, generally short-term and flowing directly to corporations, have also increased the vulnerability to crisis.

Private Sector Consultations

During the preparation of this PSS the IFC and the Bank met with a broad cross-section of private sector interests in Indonesia. The aim was to extend the process of consultation, used in the preparation of the CAS, to the private sector. Meetings were held with groups of bankers, private firms, consultants, business and SME associations. The views expressed during these meetings played a key role in determining the emphasis and priorities of the PSS and CAS. See the box on page 26 for the results of these discussions.

The Impact of the Crisis on the Private Sector

Before the crisis, private capacity had been created to take advantage of continued rapid growth, and, more than any other country in the region, was financed by massive foreign borrowing. However, in 1997 the collapse in aggregate demand resulted in tremendous excess productive capacity in the system. The burden of repaying foreign currency loans multiplied as a result of the currency depreciation. Liquidity disappeared as foreign financiers withdrew and local financial institutions were incapacitated. Consequently, companies could not meet operating requirements. Even exporters were suffering from increased costs of, and lack of finance for imported inputs and were affected by declines in regional demand.

The collapse was particularly pronounced in construction, financial services and manufacturing. Large exporters were later able to take advantage of the depreciation of the rupiah and better access to trade financing to counteract the collapse in domestic demand. To the extent to which the majority of SMEs are in agriculture, are little dependent on foreign trade and did not have significant borrowings, they were less affected by the depreciation of the Rupiah and the increase in interest rates. They were, however, severely affected by the collapse in domestic demand and the deterioration in the overall business environment.

Private creditors reduced their exposure wherever possible, while the late start in restructuring of many distressed corporations increased interest arrears. Trade and working capital financing have resumed slowly this year. Medium and long-term loans from foreign banks totaled around $0.5 billion between January and September 2000. In August the central bank agreed again to guarantee short-term trade credits extended by foreign banks to domestic banks up to $1.6bn, backed by a counter-guarantee from the government. But retrenchment by foreign and joint-venture companies led to about $3.5 billion in net outflows in the first half of 2000, following $4 billion for last year as a whole. There has been only one international bond issue this year - by Asia Pulp and Paper. Although the external debt of foreign-controlled companies and joint-ventures is largely being serviced, the independent power producers have had servicing problems because of the precarious financial situation of the state-owned power utility, PLN.

Rising concerns about political instability and renewed regional violence have soured the investment climate. Foreign purchases of domestic stocks plunged from $1.2 billion for 1999 as a whole to only $0.1 billion in the first eight months of 2000. Stock market capitalization, which reached $60 billion at the end of December 1999, fell to around $40 billion in early September, 30 percent of GDP. New funds raised have been limited. As a result of large losses, however, half of

the 285 listed companies were moved from the main board in early July to a new development board set up for companies undergoing financial restructuring. 7 companies were de-listed between January and early September following 20 companies in 1999. Poor credit quality and liquidity constraints for some state banks, despite recapitalization, are still holding back the resumption of bank lending to the private sector. In addition to dealing with numerous operational problems, banks prefer to hold central bank certificates (SBI), and interest-bearing recapitalization bonds, which carry a zero risk weighting. A weak legal system also means that banks are reluctant to extend credit to the private sector unless they know their clients have a good record of genuinely trying to make payments under adverse conditions.

B. Banks are Slowly Recovering from the Crisis

Table 1: Indonesia's Banks Before and after the Crisis

	Number of Banks		Share of Deposits (percent)	
	June 1997	June 2000	June 1997	June 2000
State Owned *	34	43	37	70
Private	160	79	57	18
Foreign and Joint Venture	43	39	6	12
Total	237	161	100	100

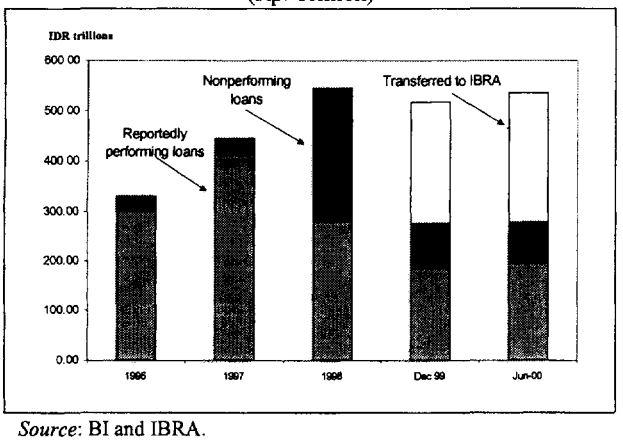
*Include nationalized banks, regional development banks, and the export-import bank
Source: BI and World Bank staff estimates.

The crisis has had a profound impact on the banking system and has resulted in a large increase in state ownership of banks. Since the start of the crisis 68 out of 237 banks have been closed, and another 12 banks nationalized in an effort to stabilize the banking system. Now, Indonesia has 161 domestic banks after some mergers and creation of a new export-import bank (Table 1) During the crisis, deposits migrated from private banks to the state banking sector in a flight to perceived safety. As the sector begins to emerge, the Government finds itself directly in control of 70 percent of the deposits in the banking system, compared to 40 percent in Korea, and 23 percent in Thailand. These deposits are held in 42 Government-owned banks, four of which were state-owned pre-crisis, 12 are newly nationalized, and 26 are regional development banks. The Government also holds significant stakes in the private recapitalized banks as a result of the recapitalization program.

The bank recapitalization program has been extremely costly. A total of about Rp 650 trillion of sovereign bonds have been issued. Of this amount, approximately Rp 268 trillion has been used for the State Banks and an additional Rp 18 trillion will be needed to complete the program. Despite the costs, the resulting recapitalization was to only four percent of risk-weighted assets, half the international standard of eight percent.

Banks are beginning hesitantly to lend again. Bank Indonesia's June 2000 lending survey of fifteen banks representing 75 percent of total bank deposits found that Rp 15.8 trillion of new loans have been extended since the beginning of 2000 - a modest increase of 5.7 percent. However, as this figure includes both renewed and restructured loans, genuinely new lending is probably less than reported.

Figure 1: Indonesia: banking system loan assets
(Rp. Trillion)



Source: BI and IBRA.

On aggregate, the banking system still recorded a loss in the first half of 2000. Performance is unlikely to improve any time soon, as rising market interest rates caused a deterioration in interest margins in the third quarter. Most deposits are in rate-sensitive 30 day time deposits which react faster than lending rates to changes in market conditions. Moreover, the still substantial non-performing loan portfolio contributes nothing to interest margins. But the biggest drain on profitability remain high operating costs due to the lack of meaningful operational restructuring.

C. Corporate Debt Restructuring has Begun

Corporate Indonesia is still deeply in debt although restructuring has started. The quality of restructuring has fallen short of expectations, and tax and legal impediments continue to hinder restructuring. Deeper restructuring will require massive efforts from both debtors and creditors, but this is a price worth paying for a healthy corporate Indonesia. Indonesian business debt at the end of September 2000 was around US$117 billion - US$82 billion for large private corporations and US$35 billion for state-owned enterprises and SMEs (Table 2). Of this total, 48 percent was owed to foreign creditors and more than 70 percent was denominated in foreign currencies. Of the large corporate debt, three-quarters is distressed and in need of restructuring.

Increased restructuring volume. Some debtors and creditors have started to reach agreements on corporate debt restructuring. IBRA has resolved tentatively 73 percent of its credits to its Top 21 obligors. Corporate foreign debt also shows encouraging signs — The Coordinating Minister recently noted that some US$10 billion was resolved. Foreign banks indicate that agreements with several large debtors have either been reached or are imminent. Creditors will end up with 20-40 percent shareholdings in a number of well-known companies as a result of debt/equity conversions. New procedures have given an impetus to the Jakarta Initiative Task Force (JITF). As of mid December, 64 companies with aggregate debt of US$11.9 billion were actively involved in JITF mediation. To date, 28 cases, with a total debt of US$5.31 billion, have concluded binding restructuring agreements between creditors and debtors with JITF's assistance. The new structured mediation procedures and referral of cases by FSPC have allowed JITF to settle more cases. The new procedures, which have been in place since April 2000, permit the FSPC to impose sanctions on uncooperative debtors, including referral to the Attorney General Office for initiation of bankruptcy proceedings. JITF's regulatory facilitation role has also been strengthened through better coordination with BAPEPAM, Bank Indonesia, the MoF, and the stock exchanges.

But there are doubts about the quality of restructuring. Analysis of a sample of 34 IBRA and JITF cases which included the restructuring of US$8 billion in debt raises questions about the adequacy of operational restructuring and reduction of debt to sustainable levels. 59 percent of the debt was restructured through rate reductions, term extensions, and/or grace periods on repayment; 38 percent through conversions of debt into equity; and only three percent through debt write-offs. Exclusion of one transaction involving a US$1.1 billion debt/equity conversion would increase the

use of debt rescheduling technique to 68 percent. There was heavy reliance on debt rescheduling, especially grace periods, on interest payments on US$1.3 billion in debt. The concern is whether corporate debt has been reduced enough through debt/equity conversions and write-offs and whether operating cash flows will suffice to service remaining debt at market rates and terms when grace periods and other concessions expire. If not, Indonesian corporations could fall back into distress. Most Indonesian corporations could emerge from the crisis fairly intact. But without major operational restructuring efforts these companies will remain in a weakened and vulnerable condition, and corporate Indonesia is unlikely to sustain, let alone accelerate a recovery.

Table 2: Debtors and creditors
(US$ billion)

	State banks	**IBRA AMC**	**other local inc. BTO**	**Foreign banks**	**Securities holders**	*Total*
State enterprises	3.4	1.6	0.5	6.0	0.2	*11.71*
Large private corporations	3.8	21.4	3.0	51.8	2.2	*82.2*
SMEs	7.3	3.9	8.6	2.3	0.5	*22.6*
Total	*14.5*	*26.9*	*12.1*	*60.1*	*2.9*	***116.5***

Source: JITF, staff estimates.

III. MAIN CONSTRAINTS TO PRIVATE SECTOR RECOVERY AND GROWTH

The crisis brought into sharp relief a number of serious structural problems and impediments to sustainable private sector activity in Indonesia. Many of these problems had previously been acknowledged but had not been addressed during the period when a comfortable and apparently steady level of growth, combined with extensive links between the corporate sector and the apparently permanent regime, had instilled a sense of security. Following the crisis the newly elected Government has recognized and begun to deal with these issues, with the initial focus necessarily on banking and corporate debt restructuring. However the size of the political and economic reform agenda is daunting and Government is constrained in its ability to act by its lack of resources and its fragile power base.

In particular the crisis has revealed the extent of the weaknesses in Indonesia's business environment, and what needs to be done if the recovery is to be sustainable. Although entrepreneurs have found ways of adapting to the poor environment the following are some improvements that will be necessary if markets in Indonesia are to work efficiently, or in some cases, at all:

- a commitment of the government to encouraging the private sector – reflected partly in the extent to which it is willing to privatize SOEs but also in its assurance of a framework of clear property rights;
- the openness of markets to domestic and foreign investment – evidenced by the absence of entry barriers, or price or currency controls;
- adequacy of a legal framework and oversight institutions – reflected in a good company law, protection for shareholders, and adequate judicial systems to enforce contracts and resolve disputes;
- soundness of the financial infrastructure – reflected in sound accounting practices, existence of banking and securities laws, and functioning regulatory bodies;
- a non-distortionary tax system; and
- socio-economic and political stability – reflected in the rule of law, absence of social tensions and sound management of the economy.

Results of the World Business Environment Survey in Indonesia

A survey of a diverse group of 100 small, medium and large firms in Indonesia was carried out by the Gallup Organization for the World Bank in June and July, 2000. It revealed that macroeconomic and policy instability and uncertainty are the leading concerns of Indonesian firms. At the same time, there is a fundamental concern that markets are somehow unfair, although the exact source of this unfairness requires further analysis. Financing, although the fifth leading constraint in terms of relative score, was chosen by the largest number of firms as their single leading problem. Interest rates are a leading source of concern. Crime, theft and disorder are also important concerns. Corruption appears to be substantial, and in terms of frequency Indonesia is among the leading countries in the world for petty bribery. It is also clear that corruption is a significant constraint for firms doing business with government and that the overall out-of-pocket expenses involved in bribery are substantial. But perhaps because of the mutual benefits of corruption to payer and payee, the "tax" firms would pay to get rid of corruption is substantially less than what they reportedly paid in bribes. Taxes and regulations rank surprisingly low in overall constraints, although if "high taxes" had been rated by themselves, they would have placed fourth among general constraints. Finally, although infrastructure does not appear to be a leading impediment, public service in the area of roads is held in lower esteem than other types of infrastructure service.

A. Further Measures Needed to Resolve the Debt Crisis

Financial Sector Restructuring

The Need to improve IBRA's corporate governance and internal controls. The Minister of Finance signed a Decree in July 2000 appointing two ex-officio and seven independent members to IBRA's oversight committee. However, political uncertainties threaten to cause further confusion in IBRA's governance and, hence, delays in the implementation of the structural reform program. There is concern over IBRA's ability to properly mitigate its transactional and treasury related risks. An audit of IBRA's 1998 and 1999 financial statements included a disclaimer of opinion, owing to the scope of audit exceptions found. IBRA has, however begun adopting measures to shore up its financial reporting and record keeping.

Need for IBRA to implement a transparent resolution and disposition process. With the takeover of more than half of Indonesia's banking sector IBRA has become the largest domestic financial institution and is by far the largest domestic creditor. Through its Asset Management Unit Investment (AMI) which holds the corporate shares pledged as collateral to banks subsequently taken over by IBRA, it is also a major shareholder in the Indonesian corporate sector. Transferring these assets back to private ownership is one of IBRA's most urgent challenges. During 2000 IBRA, through its Asset Management Unit Credit (AMC), has begun more systematically to dispose of its holdings. Initially its SME loans were outsourced to local financial institutions Since June, IBRA has successfully sold two groups of non-performing residential mortgage loans and a third group of larger restructured commercial loans. IBRA's upcoming focus will need to be on selling its mid-tier corporate loans. This category of approximately 1,500 debtors with a combined nominal value of about Rp 140 trillion have been subject to the least attention to date. In the sale of this medium and larger sized corporate loan book, government policy-makers and IBRA alike will have to acknowledge the losses inherent in such non-performing loans. Substantial discounts from nominal value can be expected.

Recapitalization, restructuring and privatization of state banks. There remain deep structural weaknesses within the banking system. The Government directly controls one-half of the banking system's liabilities through four state-owned banks. As the banks begin restructuring, the Government will need to prevent and refrain from political interference. The mandate of the newly established oversight unit in the Ministry of Finance is narrow and unclear. The recent cabinet reshuffle moving the responsibility of all SOEs to MoF adds to the uncertainty. Interim performance contracts have proven insufficient to bring about substantive restructuring of the state banks and much remains to be done. Problems of the state banks include:

- the need for more far reaching management changes
- the need for better risk management systems
- the need to reduce staffing as technology improvements are implemented. Strategic planning, organization structure and internal audit are all areas in need of strengthening.
- The need for operational restructuring before they would appeal to potential private investors.

Corporate Debt Restructuring

Quality of Restructuring. Concerns about the quality of IBRA's restructuring agreements were raised at the October 2000 meeting in Tokyo of the Consultative Group for. Indonesia's donors stressed the importance of adhering to a clear set of principles aimed at maximizing

revenue recovery for the state and ensuring transparency and consistent application of the process to all large debtors. Discussions focused on the need for the foundation of any restructuring plan to be an independent professional assessment of the future viability of the enterprise. This assessment would explore all options for recovery, including the closure or sale of loss-making and non-core units. It would also include an estimated level of sustainable debt, based on independent due diligence. Following approval by the FSPC, there would be full disclosure of the broad terms and underlying rationale for the proposed restructuring – so that parliament and the public can assess whether in practice the principles have been followed. In late December 2000 these issues remain unresolved. The principles are still under discussion and need to be finalized and applied as soon as possible.

Lack of "sticks." The lack of reliable means to impose losses on debtors or force their cooperation still slows down corporate restructuring. Bankruptcy petitions by IBRA were until recently rejected consistently by the courts. Some recent decisions and the appointment of ad hoc judges in bankruptcy cases give some hope. However, even straightforward measures to protect creditor rights have not been effective, and taking control over collateral remains fraught with difficulties. Creditors that hold shares as collateral have found it difficult to sell these shares without the approval of existing shareholders.

Additional "stick-strengthening" measures should include the appointment of more ad hoc judges to insolvency cases; more technical assistance for judges, an Attorney General's Office/Joint Investigative Team presence at insolvency hearings and prompt investigation of judges who make dubious rulings, greater use by IBRA of its extraordinary PP-17 powers, and withdrawal of permits – e.g., to do business with the Government, access to Government credits, listing on the Jakarta Stock Exchange – for recalcitrant debtors. History suggests, however, that reform of Indonesia's legal system will take time and efforts at corporate restructuring cannot assume the availability of a robust bankruptcy/foreclosure option.

Tax and regulatory impediments. Numerous tax and regulatory impediments to corporate restructuring still prevail. The most important tax impediments are: (i) requirement for tax withholding on accrued but unpaid interest; (ii) creation of a VAT liability in the case of debt/asset swaps; (iii) transfer duties on debt/asset swaps involving real estates; (iv) recognition of income to the debtor upon cancellation of indebtedness in the course of a cash settlement, debt/asset swap, or debt/equity conversion; and (v) limits on the carry-forward of net operating losses. Regulatory impediments include: (i) a securities regulator (BAPEPAM) requirement for a tender offer to all existing shareholders if a proposed debt/equity conversion involves more than 20 percent of a company's equity; (ii) par value restrictions on the issuance of new equity; (iii) a BI requirement for banks to sell converted equity within 5 years, or within 2 years if the company is profitable; (iv) concerns about "intentional" Legal Lending Limit violations if a bank with diminished capital enters into a restructuring agreement; (v) possible de-listing from the Jakarta Stock Exchange, making it more difficult to sell converted equity; (vi) limits on the ability of IBRA to take losses on debt restructuring; and (vii) restrictions on foreign financial institutions in obtaining good title to collateral.

Availability of loans. Reduced access to financing is a problem facing Indonesian companies. Trade finance is now available, and some companies have overseas funds for working capital. But several factors still limit access to financing; e.g., the weak capital positions of local banks, reluctance by foreign banks to increase their Indonesia exposure, and mistrust in existing corporate management and the legal system and opaque capital structures. Access to new loans is likely to be the strongest catalyst for restructuring, and the Government, private investors, and the IFIs should work together to maximize this possibility.

B. Structural Weaknesses

Public Sector Governance and Decentralization

Public Sector Governance

Poor governance in the public sector has had serious consequences for Indonesia's private sector. Extensive corruption has raised the costs of doing business: from approvals and investment clearances to customs, taxation and purchase of public services. Influence peddling has subverted fair competition and created monopolies and oligopolies. 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. Moreover, a predatory state sector has subverted a level playing field in many sectors and inefficient state enterprises and government departments have provided poor quality and high cost services. Corruption and lack of capacity in government make for a poor regulatory environment. In the pre-crisis years of high growth, some parts of Indonesia's private sector, particularly the large family owned conglomerates, thrived despite these weaknesses. Bribery and collusion rather than fair competition were commonplace although exposure to international competition through a liberal import regime placed limits on such behavior. Anti-competitive behavior has therefore tended to concentrate on the non-tradables, particularly in civil works and other construction activities, consultancies, etc. and this has been further encouraged by restrictions on competition in domestic procurement through preferences for local suppliers. In the Suharto era, personal connections also bought monopolies or reduced competition. These distortions have affected the nature of some Indonesian private businesses which were protected from international competition because of regulations that required foreign investors to seek domestic partners. However the new more open political environment in Indonesia has led to widespread calls for improved accountability in Government and an end to the previously cosy relationship between the corporate and the public sectors.

Decentralization

Indonesia is on the verge of a major rapid decentralization. The new legal framework will more than double the subnational share of general government spending to well over 40 percent, making Indonesia one of the most decentralized countries in the world. The districts/cities will manage most Government services, including health, education, and local infrastructure. They will have a major role in the implementation of the Government's regulatory functions in business licensing, land and zoning, environmental management and natural resource management. In addition to opportunities, decentralization poses risks to the private sector including:

- the current limited local tax base could induce local governments to seek more informal ways of raising revenues thus adding to the cost of doing business. This has already happened to one mining company, which agreed to finance a trust fund for supporting social welfare in the region of operation.
- the free flow of goods, services, and capital might be negatively affected by decentralization. Some regions' actions have already been contrary to regulatory safeguards in the Law. The protection of individuals or enterprises against Government is weak and depends on an ill-functioning court system.
- risks of a fragmented, uncertain business environment as districts set their own norms and standards.

Legal and Judicial Reform and Corporate Governance

Legal and Judicial Reform

The court system in Indonesia has been viewed for several decades by the business community as an unreliable vehicle for the resolution of disputes or the enforcement of rights and obligations. Despite this, Indonesia was, until the onset of the crisis in 1997, the recipient of very large capital inflows, showing that the unreliability of the courts in acting efficiently, competently and judiciously was not perceived as a significant problem for the growth of the private sector. This may be attributed to two factors. First, for nearly twenty the economy was so robust that commercial failures were few and far between. And, when they occurred, there were so many other opportunities for profit that investors simply moved on. Secondly, where problems arose, relationships to well connected persons and government officials were the preferred mechanism for addressing them. It was this pattern of behavior that in significant part gave rise to the "KKN", or "corruption, collusion and nepotism" rallying cry of the anti-Suharto regime forces that led to Suharto's fall in May 1998.

Following the crisis, many business people and policy makers inside and outside Indonesia focussed for the first time on the capacity of the law and the courts to address the effect of a massive pulling out of funds and termination of credit facilities. The bankruptcy law at the time was a product of the early twentieth century, it had almost never been used in the life-time of most sitting judges; and their probity and competence were in any event viewed with extreme skepticism. The result was rapid action on the part of both the Indonesian authorities and the international financial institutions to attempt to have a credible insolvency law put into place and a credible court established to apply such law. In August 1998, therefore, a revised bankruptcy law was introduced and a new commercial court was brought into being.

The new court got off to a poor beginning. Its early decisions were widely criticized, despite a concerted effort to select competent judges and the carrying out of intensive training courses. 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 enterprise and to fight commercial fraud.

Nevertheless, the effort needs to be made, for a failure to do so will have one or both of two consequences, both undesirable for Indonesia. One will be that investment will simply not flow to Indonesia in the magnitude that an economy with the resources and of the size that Indonesia warrants, for investors will continue to place a large risk premium on doing business in or with the country. The other could be a reversion to the cronyistic and collusive practices of the Suharto years, which will contribute powerfully to continued fragility of the political and economic scene.

Corporate Governance

A recent investor survey by McKinsey of six Asian countries (Indonesia, Japan, Korea, Malaysia, Taiwan, and Thailand) tried to put a "value" on good corporate governance by asking investors in Asia, Europe and the U.S. whether they were willing to pay a premium for well

McKinsey Investor Opinion Survey

Country	Perceived Quality of Corporate Governance	
	Asian Investors	US Investors
Japan	2.9	2.2
Taiwan	2.6	2.3
Korea	2.2	1.8
Thailand	1.8	1.3
Indonesia	1.1	1.1

Country	Premium for Good Corporate Governance (%)
US	18
Japan	20
Taiwan	20
Korea	24
Malaysia	25
Thailand	26
Indonesia	27

Note: Respondents rated the quality of corporate governance on a scale of 1 (very poor) - 5 (very
Source: McKinsey Investor Opinion survey, undertaken in September/October 1999 McKinsey and Company, in cooperation with the International Investor's Asia Pacific Institute.

governed companies. The results of this survey were telling: Indonesia fared the worst in terms of corporate governance ("very poor") and in Indonesia investors were willing to pay the greatest premium for well governed companies (27%).

Among East Asian countries Indonesia ranks the lowest on measures of judicial efficacy and corruption and exhibits the highest concentration of ownership control among crisis-affected economies (see table below) The predominant Indonesian conglomerate structure is one in which a large number of firms, typically including at least one bank and nonbank financial institution,are controlled by a single family, often through pyramid structures, interlocking ownership, and deviations from one-share one vote rules. Company boards tend to be composed of individuals with allegiance to the controlling family.

Corporate Sector Ownership Concentration and Legal Framework in Asia

Economy	Concentration of ownership control among top 15 families (%)	Efficiency of judicial system index	Rule of law index	Corruption index
Japan	2.8	10.00	8.98	8.52
Taiwan, China	20.1	6.75	8.52	6.85
Malaysia	28.3	9.00	6.78	7.38
Singapore	29.9	10.00	8.57	8.22
Hong Kong, China	34.4	10.00	8.22	8.52
Korea, Rep. of	38.4	6.00	5.35	5.30
Thailand	53.5	3.25	6.25	5.18
Philippines	55.1	4.75	2.73	2.92
Indonesia	61.7	2.5	3.98	2.15

Source: East Asia: Recovery and Beyond, The World Bank, 2000.
Note: Economies are ranked by degree of ownership concentration. The three indices rank from 1 (worst) to 10 (best).

Corporate governance reform in Indonesia will depend on a combination of strategies, short and longer term. Improving financial disclosure is an immediate and obtainable goal but requires determined action on the part of the regulators (BAPEPAM and the Exchanges), the professions (accounting primarily but the legal and other financial professionals as well), and the business community. A longer term objective would be improving the legal and regulatory framework; this would include good legal rules that can be enforced. While a respected and well functioning judiciary is an ultimate and desirable goal (and one which would permit a high degree of "self-regulation" of commercial activity), in the interim, measures must be found to compensate for its current inadequacies. This shifts the burden to the regulators. In the short term the ownership of large sections of the banking and corporate sectors by IBRA provides an opportunity for IBRA to improve transparency by getting information on these banks and corporates into the public domain.

Closely related to the process of corporate governance reforms, banking law reform must address the incestuous relationships between banks and their owners which are rife with opportunities for self-dealing and conflict of interest, both of which are the scourge of corporate governance in many Asian countries.

Although the above problems will take many years to resolve there have been positive recent developments on the corporate governance front in Indonesia. The National Committee for Corporate Governance (NCCG) has produced the first draft of a Code on Good Corporate Governance; it is not perfect but it is a starting point. The Dutch government is providing technical assistance on corporate governance and the Asian Development Bank too is preparing technical assistance to support the NCCG. Private sector groups such as the newly created Forum on Corporate Governance in Indonesia (FCGI), KADIN and the Indonesian Netherlands Association, also have corporate governance on their agendas. As well, in part with the assistance of USAID, corporate governance has become a focal point of academic investigation and dialogue. In addition, although at a very preliminary stage, there are several institutes in the process of formation with a focus on corporate governance.

Competition Policy and Foreign Direct Investment

Competition Policy

One of the outcomes of the crisis in Indonesia is a strong domestic consensus in favor of change in the way business is done, by the government and by the private sector. Lack of competition in the domestic markets has imposed enormous costs on the economy. Concentration has increased in product and service markets, and this has given rise to market power, resulting in inferior products and fewer choices, to the detriment of Indonesian consumers, especially the poorest who can least afford to buy expensive alternatives. Ownership is concentrated, thereby enabling a few large firms or family groups to engage in rent-seeking behavior and wield political influence to shape public policy in their favor. Under the right conditions conglomerates can be supportive of rapid, equitable growth. But in the case of Indonesia, their dominance has been strengthened by policies and regulations according them market power and protecting them from competition. With fewer options to invest, capital markets remain stunted for a country the size of Indonesia. Finally opportunities for broad participation in the economy are limited due to various barriers to entry, and preferential treatment. The consequent growth pattern has left Indonesia vulnerable to crisis and popular resentment.

In March 1999, Indonesia enacted the Law regarding Prohibition of Monopoly Practices and Unhealthy Competition ("Competition Law"). The goal of this law is to provide a regulatory framework to protect market competition, especially against a wide range of anti-competitive business practices prevailing in the country; namely: horizontal and vertical restraints (i.e., collusive price-fixing, input/output allocation, market division, and other restrictions to market access); abuse of dominant position (i.e., exclusionary practices, tying arrangements, refusal to deal, resale price maintenance, predatory practices, price discrimination, exclusive dealings), and mergers and acquisitions. The new law also provides an institutional framework for policy and law enforcement through the Commission for Business Supervision ("CBS"), an independent government authority charged with exclusive enforcement powers.

After a late start, the implementation of new competition law is at the initial stages. The CBS has been established. Now its effectiveness will depend on its capacity, an adequate understanding of the forces that affect competition in markets, and the use of legal and policy instruments. The CBS will need to set priorities and develop instruments that ensure market transparency and fairness. Finally, the CBS will need to enforce compliance programs; and implement an effective advocacy strategies for competition policy.

Foreign Direct Investment Policy

The attitude towards foreign direct investment (FDI) in Indonesia, expressed in the law, appears welcoming and encouraging, for there are few officially stated restrictions on size, sector or level of foreign shareholding for most FDI investments. But this is negated at the level of implementing regulations, which restrict the entry of foreign investments and skilled workers, allow unpredictable and discretionary Government treatment of applications for foreign investments. Complex and cumbersome systems of company registration and licensing, land access, and customs privileges contribute to investor uncertainty.

A major deficiency is that the implementation of national investment policy, through regulations governing registrations, licenses and approvals etc., lacks the transparency, consistency, predictability and accountability necessary to be truly attractive to foreign investors. The current environment imposes transaction costs that may render potential investments

uneconomic. To regain investor confidence Government needs to take a "whole of government" approach with a supportive and credible strategy that would make the procedure for foreign investment as fair, user-friendly and encouraging as possible.

There is an overriding problem with most business issues, including land ownership, under the law as it stands in Indonesia. Based on Roman-Dutch law and a codification of Common Law, those parliamentary laws that exist are largely out-of-date. Such laws are multi-layered, requiring implementing decrees at both the Presidential and Ministerial levels for their operation. Conflicts between the basic laws and the implementing Presidential and Ministerial decrees lead to great confusion. These conflicts and confusions when coupled with a judiciary, which representatives of the local legal profession report is corrupt, make for very unpredictable outcomes.

The environment cannot improve significantly until the Government addresses both the restrictive nature of the 1967 investment laws and the general conflicts and confusions found in the basic commercial laws and implementing decrees. Under the current law, FDI and most domestic investments are subject to a long, costly and uncertain process of obtaining establishment, operational and location licenses. The licensing system requires a sequential process that is both time consuming and expensive and subject to informal regulations or "red tape". At the implementation stage other licenses are required including approval for changes in production capacity or production of additional/different products, since the original approval is both industry, product and capacity specific. Changes in ownership in a foreign investment or the acquisition by a foreign investor of an existing domestic company also require approvals.

Under such a system, delegation of investment approvals from the Head of Government to more appropriate levels alone will not accomplish deregulation of the investment system, since the criteria used to approve the license must still comply with provisions of capacity limitations carried over from the import substituting period and other operating restrictions. In addition, numerous licenses are required from other agencies of government. The screening and approval system, introduced in the 1960s, are the residue of an inward-looking import substitution policy and the desire to limit the role and influence of foreign capital. The costs and risks imposed by this approach to investment attraction makes Indonesia's investment process less competitive than its neighbors and limits the type of investment that can be attracted.

The primary issue is whether there is any merit in trying to reorient the current system or would it be better served by completely reengineering the whole approach. Whilst there are good reasons to maintain the status quo - the existing investment in current procedures, practices, staff skills, training and experience; and political, bureaucratic, and investor comfort with what they know and understand – it is clear that without a complete reengineering little will really change.

The Extended Ownership Role of the State

State-owned enterprises have long played a central role in Indonesia's economy, accounting for 70+% of GNP by the early 1980s and still for around 40% today. Many foreign-owned enterprises were nationalized in the years following Independence, while many new SOEs were established to promote development of key sectors that were beyond the capacity of the country's nascent private sector. As well as dominating the "commanding heights" of the economy--including power, oil and gas, transport infrastructure, shipping and civil aviation, telecommunications, cement, fertilizer, steel, plantations and banking--the state extended its ownership role into other sectors - consulting, contracting, retailing, trading, small scale manufacturing, and property development. Consumers and taxpayers have had to bear the costs of

poor quality, coverage, and efficiency of public services--and of poor corporate governance--while private sector competitors have often found themselves playing uphill on sloping pitches.

During the mid/late 1980s, the Government initiated SOE reforms, but in the absence of a strong political champion, progress with privatization has been slow. In the period to mid-1997, minority stakes in six companies (Telkom, Indosat, Tambang Timah, Aneka Tambang, Semen Gresik, and BNI) were floated on domestic and--in some instances--overseas stock exchanges, while stakes in two smaller companies (Intirub, Aneka Gas Industri) were divested through trade sales.

The onset of the crisis resulted initially in a strengthened commitment to SOE reform and privatization, with the Habibie Government establishing a new State Ministry for the Empowerment of State Enterprises. A Masterplan for SOE Reform and Privatization was published in December 1998, and during 1998-1999 further shares were sold in two already listed SOEs (Semen Gresik and Telkom). In addition, strategic partners were successfully sought for two newly created container terminal concession companies operating at the ports of Jakarta and Surabaya. However, these transactions prompted significant public opposition and allegations of corrupt practices. The Gus Dur Government also quickly reaffirmed support for SOE reform and privatization, established a restructured State Ministry of Investment and State Enterprises (MISE), and committed to specific privatization targets in its January 2000 LOI to IMF. However, while an updated Masterplan was published in May 2000, political backing for privatization has been weak and no further transactions had been completed as of December 2000. There is no longer a separate Ministry for State Enterprises in the Cabinet. Since August 2000, shareholder responsibility has reverted to MoF.

While the crisis has served to expose the weaknesses and poor performance of SOEs--particularly those, such as Pertamina, that were subjected to performance audits and others, such as Garuda, that are in serious financial difficulty--it has also turned public sentiment against privatization. On the one hand, the image of the private sector has been seriously damaged by successive revelations concerning the malpractices of Indonesia's once powerful conglomerates. On the other, there is in many quarters strong antipathy to the prospect of selling stakes in key SOEs to foreigners coupled with continuing concern about the transparency of past privatization transactions. In the absence of a strong "privatization champion", these concerns are amenable to exploitation by those with vested interests in maintaining the status quo.

The achievements on SOE reform have also been limited. There has been little significant SOE debt restructuring, except where this has been driven by lenders or by Government commitments to IFIs. And even here progress has been slow. In many key infrastructure sectors--such as telecommunications--the Government has been hesitant in moving ahead with much needed sector restructuring, in part because of weak coordination among the Ministries responsible for sector policy, sector regulation, and SOE ownership. While considerable attention is now being given to improving SOE corporate governance, which is generally recognized to be very poor, there are reasons for concern that initiatives in this area could be used to defer actions on SOE debt restructuring and privatization. Finally with the takeover of formerly private assets by IBRA, the role of the state as a corporate owner has been extended even further and the need to develop and implement a coherent privatization strategy has become more urgent than ever.

C. Impediments to Long Term Sustainable Development

Constraints to SME Development

Boosting growth with social justice are key objectives in Indonesia. Small and medium enterprise development contributes to both. Before the crisis, firms with fewer than 100 employees accounted for 39 percent of Indonesia's GDP, but 99.5 percent of its workforce. The value added per worker in large enterprises was 10 times those in small enterprises and 300 times those in micro enterprises, illustrating the labor intensity of SMEs as well as the probability of significant inefficiencies. Moreover, studies have shown that this gap is widening. Aside from the income and equity implications, this means that Indonesia has been unable to benefit from the innovation, flexibility, and dynamism of SMEs.

These weaknesses were exacerbated by the economic crisis, which has hit SMEs hard. A survey done at the end of 1998 found that since the onset of the crisis 24 percent of SMEs had halted operations, 37 percent had seen production drop by more than half, 25 percent had seen production drop by less than half, and only 13 percent had been able to maintain production at previous levels. From January 1997 to May 1998, there was a 75 percent reduction in monthly SME lending, a result of higher interest rates, declining working capital needs, the insolvency of the banking system and increased riskiness of lending.

Since then, SMEs have rebounded more rapidly than the corporate sector. This is partially due to their lower level of indebtedness prior to the crisis and to their much lower foreign debt exposure, but also due to their ability to rapidly adapt to the changing environment. Now, SMEs are seen as a major engine for economic recovery. If this is to occur, however, there need to be serious efforts made to improve the enabling environment for the small enterprise sector.

Market distortions. Government-licensed monopolies, corporate tax breaks, restrictions on market entry and investments, and price controls are generally disadvantageous to smaller enterprises which have neither the resources nor the political clout to benefit from most of these policies. Even policies nominally created to help SMEs -- such as mandatory partnership or lending programs -- lead to inefficient allocations of resources without promoting sustained benefits.

Corruption and red tape. Corruption and red-tape account for an estimated 30 percent of SME business costs in Indonesia. One study found that 46 licenses were required to operate a simple trade business. Moreover, recent surveys have shown that in spite of the Government's elimination of 73 licenses, levies have actually increased during the crisis.

SME support system. Indonesia already has dozens of programs run by a variety of ministries aimed at supporting smaller enterprises. Little public data exists on the impact these programs have on client productivity and their costs. Moreover, many programs overlap or duplicate each other, indicating a lack of strategic planning and coordination between different parts of the government. In particular, there seems to have been no government-wide strategy to determine which projects should be implemented, and how performance should be measured. The result is a surfeit of ineffective programs contributing little to the ultimate productivity of SMEs yet demanding resources that could be used elsewhere. As these activities are decentralized, there is a risk that poor program design and inefficiencies will proliferate.

Low skills development. In a recent study, 58 percent of SMEs cited human resource development as a major obstacle to growth. Enterprise surveys consistently show that most SMEs

don't know about government assistance programs they may be eligible to use, or they hold these programs in low esteem. Reasons for this include: inappropriate and inflexible program design; low skill levels of service providers; focus on quantity over quality; improper targeting of programs; and administrative waste.

Bank credit. Indonesian banks are required to lend at least 20 percent of their loans to small borrowers. This leads to inefficient lending practices by banks with no strategic interest in SMEs. It also diminishes the attractiveness of SME lending as a niche market for specialized commercial banks. The result is under-investment in the lending technologies which could make this business segment more profitable. Compounding this is a general lack of credible guarantee programs and credit information systems (i.e., credit scoring systems, credit bureaus and registries) which could help make SME lending less risky.

Constraints to Private Initiative in Rural Areas

Agribusiness remains central to the Indonesian private sector, accounting for more than 20 percent of GDP, 43 percent of the employed labor force and 12 percent of exports. It is also a key sector to promote economic development with widespread benefits and with a capacity to directly address poverty concerns. More than 65 percent of the population and 74 percent of the poor live in rural areas. It is also estimated that 60 percent of the poor are in households where the agriculture sector is the main source of income, whether from labor or land. The sector, however, continues to go through an adjustment period as the crisis has left many companies greatly indebted and unable to source end financing to complete their investment programs. This has been compounded by the State's incapacity to fulfill its obligations. The Nucleus Estate and Smallholder program was designed to increase rural incomes and resettle landless families on unused land. The Government was to provide financing for the smallholders' participation but has been unable to fulfill its commitments, leaving nucleus companies with a significant shortfall in their financing plans, and rising social tensions. However, at the same time, entire subsectors of agribusiness are also being de-monopolized and liberalized, creating real opportunities for private entrepreneurs.

Farmer Organizations. With the removal in 1998 of the monopoly of state-sanctioned rural cooperatives – KUD – there are a range of alternative private business structures emerging that better meet farmers needs and provide services to them as entrepreneurs. This deepening of the organizational fabric of rural areas, based on membership control of management and focused on providing services to this membership, will be a critical part of improving the rural environment for farming as a private business.

Marketing arrangements for export commodities have traditionally been dominated by traders, with farmers not well organized enough to influence the existing national commodity organizations. As a consequence, price signals that would normally give good indications to farmers regarding produce quality premiums, varietal demand in consumer markets, and the like, have often been distorted at the farm gate level. Some of these marketing arrangements are beginning to change, and the start-up of trading by the Indonesian Commodity Stock Exchange will bring both new discipline to, as well as open p new channels for, domestic marketing arrangements for the commodities that will trade on the ICSE.

The performance of Government and state-owned enterprises in supplying physical input markets important in the farming sector not been responsive to the demands by farmers for more choice of variety, more timely availability, and more associated services. There are opportunities for farmers to take direct control of input procurement rather than have government agencies

control it. For the fertilizer sector, there is scope for phased privatization of the production units that are under the holding company PT Pusri. The agenda also calls for a separation of the marketing capacity of PT Pusri to autonomous management right away. Opening of external and domestic trade to new entrants, recently accomplished, was also part of this agenda. In seed and planting material markets too, the existence of state-owned producers and marketers, and provision of subsidies, has had a dampening effect on private sector development.

There are opportunities for private sector involvement in service delivery. In the case of research, there is already private research capacity, primarily in the plantation crop sector, with plantation commodity investor groups or associations either undertaking research directly, or financing research being done under contract with public research institutions or universities. There is much potential for more private involvement in agricultural and forestry extension planning and provision.

Expansion of access to micro-finance is a crucial ingredient for broad-based benefits to result from a private sector strategy (see previous section on SME development). Current government policy supports a plethora of subsidized micro-credit lines each targeting a limited, usually sectorally-defined, beneficiary group, with little attention being paid to sustainability or institutional foundations of micro-finance delivery. There is a need for an incentive framework that allows for commercial provision of micro-finance by private organizations and minimal government intervention in the individual risk assessments underlying credit provision. If there is need for subsidies to achieve government objectives on breadth of access to micro-finance, then the access itself should be subsidized rather than interest rates.

Constraints to Private Provision of Infrastructure

The Government's efforts to attract private investment in infrastructure focused initially on the power sector, with proposals for Indonesia's first IPP (Paiton I) first being solicited in 1990. By end-1997, "take-or-pay" agreements had been concluded for 27 IPP projects, all but a few of which were unsolicited.

During the mid-1990s, Telkom--the state-owned domestic telecommunications enterprise--entered into agreements with five competitively selected consortia to develop and operate fixed line telephony services in five of its seven regions through cooperation (KSO) agreements. Private firms were also licensed to provide other types of telecommunications services--notably mobile telephony--subject to at least one of the two telecommunications SOEs (Telkom, Indosat) holding an equity stake in them. In the transport sector, efforts to secure private participation initially focused on toll roads, with prospective investors being required to cooperate with the state-owned toll road company Jasa Marga. The initial projects were negotiated directly with politically connected local groups, but during the mid-1990s procedures for competitive selection were implemented. Various schemes involving new private investment in ports, airports, and railways infrastructure were under active discussion during the mid-1990s, but--with the notable exception of a new container terminal at Jakarta's Tanjung Priok port--few significant projects were implemented. In the water sector, the most significant step was the award of concession agreements for water supply in Jakarta to two international consortia.

The strategies adopted by Government were conditioned by legal frameworks that reserved key sectors of the economy for state-owned enterprises, and constrained by the absence of transparent and independent regulatory arrangements and by weaknesses in the domestic banking system and capital markets. Outcomes were also shaped in part by the de facto requirement for prospective investors to have a politically connected local partner, and by institutional weaknesses

in some of the agencies and SOEs charged with negotiating contracts. Well before the crisis, it was evident that private participation in Indonesia's infrastructure sector was being accomplished at a high cost and with substantial risks.

When the crisis struck, many private infrastructure ventures quickly encountered serious problems. Construction of several toll roads and other projects was halted when their financing dried up. Other projects stopped following the issue of a Presidential Decree that classified them as "postponed" or "subject to review" (this Decree triggered a number of claims under political risk insurance). PLN quickly found itself unable to meet its US$-denominated payment obligations under its gas supply and IPP contracts, and is now engaged in renegotiating the latter. Two IPPs have filed for international arbitration, and one has secured awards against both PLN and the Government. More recently, contractual disputes between Telkom and its KSO partners have been exacerbated by the Government's announcement of plans to terminate Telkom's monopoly on fixed line telephony ahead of schedule.

Progress towards resolving problems has been slow, in part because of the depth of the crisis and the number and size of the projects affected, in part because of frequent changes in key Government agencies, and in the part because of widespread allegations that deals were secured through corruption, collusion and nepotism. While the Government's greatly increased debt burden makes it imperative for the private sector to play an expanded role in future infrastructure provision, the prospects for this happening will be bleak until significant progress has been made towards resolving the problems affecting existing agreements.

During the mid-1990s, the Bank proposed the adoption of a cross-sectoral framework for private participation in infrastructure to help reduce risks and costs and continued to highlight the need for wide-ranging legal and regulatory reform. Advice was provided on the drafting of a cross-sectoral framework, but Government commitment was lacking and the envisaged regulation (Presidential Decree 7 of 1998) was only issued after the crisis had struck. Progress on legal and regulatory reform has also been slow. A new Telecommunications Law was passed in 1999, and--while it removed previous constraints on private participation--it failed to make explicit provision for independent regulation. A policy paper issued in 1998 mapped out a comprehensive reform program for the power sector, but progress with its implementation--and especially the passage of a new Electricity Law--has slipped well behind schedule.

Lack of infrastructure is also an issue for rural development. Rural roads, water and sanitation, rural electrification: in all these areas, there is scope for local communities identifying their needs/priorities, then with public funding support (and local cost sharing), along with contracting and technical guidelines, doing their own contracting from private sector construction companies. Indonesia could certainly have a healthier framework for local communities working more directly with private contractors in the investment phase.

The main constraints to private provision of urban water and other services are: (i) the lack of an enabling legal framework; (ii) unclear GOI policy; (iii) objections of most public sector water providers to having their operations privatized; (iv) most of PDAMs are small and weak financially, and therefore not attractive for private operators; and (v) absence of a regulatory body. In 1997, at the request of the Government, the Bank prepared a policy paper on urban water (Urban Water Supply Sector Policy Framework), which addressed these issues. One of its recommendations was to establish a regulatory body for PSP schemes, prior to signing any contract with private operators.

Targeted subsidies at the expense of non- beneficiaries has proven not only inefficient but inequitable. On the other hand there are many precedents for suppliers of water, and other urban and rural services, generating significant cash flows by providing services that users want and are willing to pay for. To supplement weak regulation there is also much scope for a greater role for local government and community and consumer advocacy groups in ensuring adequate delivery and quality of urban and other public services. Experience has shown that there is a need for great care in providing a policy framework to BOT contracts for bulk water supply and other infrastructure services. There is a need, among other things for a policy framework that clearly defines the circumstances and mechanics under which national government and sub-sovereign guarantees can be accessed.

Private provision of social services

Education

Over recent years, the Government has increasingly realized that it is unable to finance publicly or staff directly a complete public education service and has increasingly turned to the private sector to complement public schooling. A large minority of all pre-tertiary education is provided by private service providers (17% of primary enrollment, 40% of junior secondary enrollment and over 50% of senior secondary enrollment. Almost all private providers are subsidized from the public purse to some extent.

Private schools are often a residual supplier, providing education services where public provision is deficient. They do this at a fraction of the cost of public schools. But because of low revenues, many private schools have trouble hiring qualified full-time staff. This leaves private schools with little option other than to rely on part-time Government teachers.

Private schools are often able to rapidly expand into areas where government schools have not been established; they are as common in isolated rural as in central urban areas. They can deliver services at a fraction of the public cost of creating government schools. Government schools, while offering good service, will be difficult to establish at a rate equal to the anticipated growth in post crisis private demand. While Government has pledged to realize universal basic education, its most efficient route would be to set up incentives to encourage the private sector, rather than attempt the effort on its own. There is a need to improve the flow of information regarding regulations and the eligibility of private schools for government assistance. There is also need to empower managers at the province and district levels.

Health

A high proportion of health services is already provided privately. However, much of this is delivered by doctors, dentists, nurses, midwives and other health worker categories who are civil servants. Removing impediments to private sector provision in the health sector is critically important. The central government will not have the funds or mandate to operate the sort of publicly financed and directly staffed service distribution network that it set up in the 1980s.

However, there are impediments to further private sector development in the health sector: Many public facilities are *priced below costs*. Despite being justified on poverty grounds, subsidized services benefit primarily middle class consumers, especially those covered by the insurance scheme for active and retired government employees who clearly could pay more. So private clinics and hospitals must compete with low price public services. Despite this, because of quality concerns much of the population already bypasses the public sector.

Until now, *private service providers have had trouble competing for quality full time staff* since most health workers would prefer to retain their government employment status with its benefits such as income security, health insurance and pension rights. *Private drug producers have had to compete with subsidized publicly owned firms.* The three large drug SOEs have benefited from many advantages. For example, during the crisis the government producers were allowed to purchase dollars at a discounted rupiah rate in order to import raw materials. The drug SOEs have been designated as the exclusive producers of some items and given access to investment funds on a subsidized basis.

Health finance is also poorly regulated. This is largely because the Government has focused far less on creating an enabling environment in which all comers may flourish, than establishing and expanding in direct competition with private insurers, its own comprehensive system of health insurance. In addition, regulation of the two public insurance SOEs with their secure positions in several sub-markets has been weak and ineffective. *Tax codes are not friendly to private health service provision or private insurance.* This is because there are no tax deductions etc. for health expenditures or coverage. Thus, prepaid care must be purchased from income net of taxes.

Forestry

Indonesia's forest resources are being severely depleted by unsustainable exploitation. At full capacity, the plywood industry's demand for logs would have been about 17 million m^3 in 1992. By 1998, the full-capacity potential intake of logs by plymills had risen to at least 23.1 m^3/yr which is, coincidentally, the same as the 22.5 million m^3/yr that used to be accepted as the sustainable yield of Indonesia's production forests. In terms of actual production the industry required a total log input of 19.9 million m^3 in 1998. At the same time, pulp and paper production capacity increased five-fold since 1990 and had capacity to use up to 23.2 million m^3/yr in 1998 (its reported intake was 15.0 million m^3).

New pulp manufacturers are obligated to establish timber plantations so that their dependence on natural forest diminishes over time. However, both companies and regulators have been delinquent to the extent that the aggregate area planted is only 21% of the total required. Only 1.2 million m^3 of pulpwood was supplied from industrial timber plantations (HTI) in 1998, and the HTI harvest has remained flat since 1995. Prior to that year, HTIs produced a negligible amount of timber. With sawmills consuming between 9.4 and 14.9 million m^3/yr (1996 figure), a low-end estimate of log demand from the processing industry in 1998 is 44.3 million m^3/yr. Other estimates range as high as 78.8 million m^3/yr. *In other words, timber from natural forest is being used at from two to nearly four times the sustainable rate and the officially-reported annual cut.* The Ministry of Agriculture and Forestry (MoAF) has estimated the average annual rate of forest cover loss for the last 12 years at 1.8 million hectares. Interim results of an ongoing MoAF assessment of forest quality show that out of 46.8 million ha of production forest examined thus far, almost 30 percent is now "agricultural land, estate crops, degraded areas or areas without tree cover".

Preferential treatment e.g. low-interest loans from the Reforestation Fund, and a history of protective regulations including a log export ban, a prohibitive log export tax and a regulation that required vertical integration, have fueled over-expansion in wood processing. Mismanagement of logging concessions is common, and the regulatory response has been inadequate. Government decisions on the use of forest land have alienated local communities. Illegal activities flourish in the forests, due largely to excess demand for logs by the processors. Two conclusions can be drawn from this. One is that the commercially viable forests are at risk of disappearing as early as

2010, after which there would be a sharp contraction of the wood processing industry. The second is that the industry is heavily engaged in the illegal log business.

Connectivity and the New Economy

Indonesia is lagging behind in the development of information infrastructure and in the provision of the range of information and communications technology (ICT) products and services that are becoming standard in its international competitors. Opportunities are being missed by Indonesia to use the new technologies to enhance efficiency in the way mainstream business is done and also to take advantage of new business opportunities, particularly in the e-commerce area. Government is not taking advantage of the potential improvements in efficiency, service, governance and transparency that would arise from putting Government on line. Indonesia risks becoming a casualty of the international "digital divide", and for a country the size of Indonesia the possibility of an internal divide between the haves and have nots is an added risk. The potential benefits that the new technologies could bring to the Indonesian population in terms of enhanced access to quality education, for example, are enormous. The risks of lost opportunities will become greater for Indonesia as decentralization unfolds.

Factors holding Indonesia back include underdevelopment of the telecommunications infrastructure necessary for enhanced connectivity, and the lack of coordination at the Government level concerning development of ICT for government and the regulatory framework for the private sector. The result is an underdeveloped legal and regulatory framework governing entry and competition in the ICT sector, lack of e-commerce and internet security and standards, a low level of utilization by government of ICT, and a shortage of high quality education to develop the human resource base needed for the industry to expand. Indonesia lacks a strong domestic base for development of the new technologies and there are few partnerships between global ICT companies and indigenous companies.

The Government has recognized in its public statements that information infrastructure is critical for national development, competitiveness and cohesion and has been taking initiatives to catch up. A positive step was the creation of the interministerial committee TELEMATIKA and the creation of the Government internet service provider IPTEKNET. There are also plans to remove constraints to competition, strengthen legal and regulatory frameworks including protection of intellectual property rights and develop a national backbone communication transmission system. Plans to privatize the major fixed line telecoms service providers INDOSAT and TELKOM, if implemented, would also lead the way to providing the necessary physical infrastructure for further development of ICT.

IV. WORLD BANK GROUP PRIVATE SECTOR DEVELOPMENT STRATEGY

A. Medium Term Goals

The preceding diagnosis has outlined the constraints and obstacles to be overcome if Indonesia's private sector is to achieve the broad based growth necessary for sustainable poverty reduction. The crisis, while exposing the Indonesian people to great hardship, has also provided an opportunity and impetus for change, not only politically and socially but also in the pattern of economic development. The crisis has revealed weaknesses in the structure of the economy that were less obvious before. It has brought about changes in public awareness. The new demands for transparency and accountability applied to public governance are also being reflected in the demands for changes in the business environment and in the way business is done. Government's statements reflect an intention to take advantage of this opportunity. The costs of missing the opportunity would be not only slower recovery and more poverty but also increased vulnerability to crises in the future.

The medium term vision is one in which, firstly, the immediate aftermath of the crisis will have been resolved, with a healthy restructured banking sector lending again for corporate investment and working capital. Secondly, progress will have been made in resolving the structural impediments to private sector led growth mentioned above. The market would be based on competition and effectiveness rather than on protective relationships between government and the corporate sector. Thirdly the private sector will be playing the leading role in generating growth and fiscal resources and providing the public infrastructure and social services needed for sustained poverty reduction. The predominant ownership pattern would be less concentrated than in the past, becoming more broadly based through accelerated development of SMEs and broader share ownership in the large corporations.

Government's Ten Point Program for Economic Recovery

- Create stability in the financial sector;
- Increase revenue levels from non-oil exports;
- Increase agricultural productivity and the welfare of farmers;
- Accelerate banking and private sector restructuring;
- Place priority on equity-based rather than loan-based recovery;
- Carryout a value-creation approach to privatization of state-owned assets;
- Optimize utilization of natural resources;
- Expand the development of micro-, small- and medium-scale enterprises;
- Increase employment generation, particularly in the rural areas.

The achievement of these goals will require actions by Government in a number of areas. Firstly the banking and corporate debt crisis needs to be fully resolved, in cost effective manner which equitably balances the responsibilities of corporates, financiers and taxpayers, so that normal economic activity can resume fully. Secondly if Indonesia is to take its place fully in the global market economy the State will have to withdraw from its major and recently increased role in the ownership of productive resources while at the same time strengthening its role in enabling and encouraging private sector activity based on transparent rules.

On the one hand, therefore, the State needs to accelerate the divestiture of state owned assets, not only those of the SOEs but also those recently acquired by IBRA during the crisis, and reduce the crowding out effect that Government activities are having in many economic sectors, not least of which are the public infrastructure and social sectors and rural and urban development. On the other hand, while reducing its activities in some areas the State will need to build adequate

institutional capacity to support and regulate private sector activity. This will require improved public governance and stronger efforts to combat corruption, strengthened banking and non-banking financial sector supervision, enforcement of competition policy, reform and strengthening of the legal and judicial system, creation of independent regulators for public monopolies, strengthening of accounting and audit requirements and capacity, strengthening the enforcement of environmental regulations and creation of a legal and regulatory environment for Indonesia to take maximum advantage of new technologies and the knowledge economy.

B. The Role of the World Bank Group

The WBG's Private Sector Strategy (PSS) for Indonesia is based on the diagnosis and vision outlined above. It is an integral part of the Country Assistance Strategy (CAS). The WBG's role will be catalytic, supporting policies implemented by Government. The WBG has neither the capacity nor the intention of trying to manage the program for Government. Proposed interventions are grouped below into three categories corresponding to those used in the foregoing sections. The first category includes measures to help consolidate Indonesia's immediate recovery from the financial crisis. The second consists of interventions to help address structural weaknesses in the economy. The third consists of measures to support the development of the private sector as the main engine of recovery and sustainable broad based growth and the leading provider of physical economic infrastructure and essential services to the public.

Results of Meetings with the Private Sector

In September, 2000, as part of the preparation of this PSS, the Bank and IFC met with a cross-section of Indonesian entrepreneurs in four focus groups. The purpose was to hear the concerns of private business people on the constraints they are facing and to get their views on the role of the World Bank Group in Indonesia. High on the list of concerns expressed were the need to build a healthy financial sector and to restore financial flows for new investment. Focus group participants emphasized the need for IBRA to divest its assets rapidly to the private sector and for Government to complete rapidly the restructuring and privatization of state banks. Other finance related concerns were the need to broaden and deepen the capital markets and to promote deeper operational restructuring of distressed corporates. The need to maintain macroeconomic stability was regarded as overarching and the need for the WBG to maintain its supporting role in this area was emphasized. The need to speed up privatization of SOEs was also underlined and the telecommunications sector was singled out as a priority for liberalization and privatization. The need for Government to improve the environment for SME development was emphasized, in particular by relaxing the burden of regulation on SMEs and by providing help to banks to improve their SME lending capacity. The absence of transparency, competition and good corporate governance, and the need to strengthen the rule of Law were repeatedly mentioned as constraints to doing business in Indonesia, especially by foreign investors. The World Bank Group was asked to continue playing its convening and mobilizing roles and providing impartial policy advice to Government to help ensure that international best practices were applied in all the above areas of concern. IFC was asked to maintain its catalytic role as an investor in strategic industries. There were several requests that the WBG maintain and strengthen its activities in the dissemination of international best practices by means of seminars, conferences and media presentations. These activities were said to be very useful in broadening public support for reform.

The proposed strategy implies changes in the WBG priorities in the PSD area in Indonesia and in the content of our programs. Some of these changes are already evident in the heavy emphasis on the crisis response elements of our private sector strategy - in banking and corporate restructuring. The WBG's initiatives in promoting openness and transparency through legal and judicial reform, better public and corporate governance and competition policy are also new and reflect the lessons we and others have learned from the crisis. We shall respond to the new

upcoming challenges of decentralization by providing advice to provincial and local levels where appropriate, particularly in the area of foreign direct investment policy. We intend to give renewed emphasis to SME development with the aim of promoting a broader based growth that provides benefits to all. Also within our sector initiatives in health, education, infrastructure, urban and rural development, mining and forestry, we shall encourage government policy that favors, rather than hinders, the contribution of the private sector to broad based sustainable growth and poverty alleviation. A new area of WBG support will be help create a policy and regulatory environment which will help Indonesia take maximum advantages of the new information and communications technologies.

The challenges are many and the WBG cannot do everything. We shall have to be selective. In a constrained resource environment the WBG will focus its attention and resources on those areas where there is a demonstrated country need, a demand from Government and other partners and receptiveness for our help, and where we have a comparative advantage. To the extent possible we shall work with and rely on initiatives financed by our donor and other partners to avoid duplication and to leverage our resources. In each of the following sub-sections which describe proposed interventions, we apply these criteria and give an indication of the proposed priority, level of effort and resources, and leverage to be employed through partner activities.

C. Supporting Financial and Corporate Sector Recovery after the Crisis

Bank Restructuring and Financial Institutions

Successful build-up and strengthening of the private sector as the driver of economic growth in Indonesia will be highly dependent on the success of the ongoing bank and corporate restructuring efforts. The Bank has, since the onset of the crisis, been supporting the immediate crisis response and bank recapitalization efforts and providing technical assistance to the Indonesian Bank Restructuring Agency (IBRA) and the state bank restructuring program. The Bank is also financing the $20 million Banking Reform Assistance Project (BRAP) which provides for a broad range of TA to IBRA and to the banking reform process. Banking sector reforms have also been supported under two Bank adjustment loans, Policy Reform Support Loans I and II.

IBRD and IFC Cooperation in Indonesia

The World Bank Group's East Asia Region is taking a unique approach to private sector development (PSD). In this region, co-management has been introduced to maximize the synergies available from close coordination of Bank/IFC activities. Accordingly, both IFC *and* Bank PSD staff report to a single IFC Director. In addition many of the Bank /IFC PSD interventions in Indonesia, particularly those in oil and gas, mining, information and communication technology advisory services and SME development, are staffed from the new joint IBRD/IFC Global Product Groups. The IBRD supports PSD by working on improvements to the policy, regulatory and institutional environment whereas IFC intervenes mainly by means of direct equity participation or loans to private sector entities.

These loan programs were implemented in coordination with the financial sector conditionality of the IMF agreements. In addition the Bank is implementing financial sector technical assistance through two grants - US$847,920 PHRD and US$690,000 ASEM. The Bank will continue as a top priority, in close collaboration with the IMF and the ADB, to support the Indonesian Government in the restructuring of the financial system and to support the institutional capacity building efforts of IBRA. To this end the Bank will be driving a joint effort

with other IFIs to help the government put together a medium to longer term financial sector strategy to capture fully the opportunities created by the crisis for building a functioning financial system for the future. The strategy will focus on:

- Building a robust banking system complemented by the development of non-bank financial institutions and the financial markets
- Widening access to finance both in rural areas and by micro-borrowers
- Developing sound regulatory underpinnings for the financial sector with a strong supervisory system and deposit insurance system

In the financial sector, a key priority for IFC is to address the imbalance in the economy between demand for liquidity facilities from a corporate sector in urgent need of trade finance and working capital and its supply, from a banking sector facing severe capital adequacy constraints. Towards this end, and as part of its post crisis strategy, IFC will explore opportunities to (a) help provide liquidity facilities, (b) assist in the further recapitalization of banks, increasing CARs from 4% to a target 8%, (c) assist banks in restructuring their asset base - currently dominated by recapitalization bonds - through development of an active secondary bond market, and (d) invest in restructuring funds or other specialized institutions targeting development of an active distressed debt market.

IFC's longer term strategy aims to improve the depth of competition in the financial sector: firstly through a strengthening of institutions and building of new institutions, secondly by improving the robustness of the financial system by addressing the financial strength and management capacity of individual institutions (with special focus on micro finance, NBFIs and life insurance), and thirdly by improving productivity of local banks through usage of new technologies such as e-commerce and e-banking.

A specific aspect of the strategy for the longer term is the promotion of a broader and deeper financial market, which IFC would aim to do through support to such institutions as specialized brokerage firms and pension fund management companies, provision of greater liquidity to bond and swap markets via partial guarantees, and support to housing finance via long-term local currency funding. Also included would be establishment of a credit information bureau. Finally, an important long-term priority is the improvement of corporate governance, which IFC would promote through its role as a shareholder in its investee companies.

Corporate Restructuring

The Bank has taken the lead among the donors in helping Government design its corporate restructuring program. The program is being implemented through IBRA's two asset management units and through the Jakarta Initiative Task Force (JITF), an agency created to facilitate voluntary restructuring agreements between debtors and creditors. The Bank's assistance is financed through the Bank Restructuring Assistance Project (BRAP) and the trust funds mentioned above and through the $30 million Corporate Restructuring Technical Assistance Project (CRTAP). Both IBRA and JITF have also received help from USAID. Recent efforts have focused on speeding up the corporate restructuring process by streamlining IBRA's operating rules, strengthening the mandate, procedures and leverage of the JITF, and streamlining the regulatory framework governing corporate restructuring transactions. Increasingly our advice will be focused on improving the quality, in terms of sustainability and equity, of corporate restructuring transactions. We also plan to support strengthening the Commercial Court and other elements of the bankruptcy process. Bank staff have worked closely and will continue to work on the design and implementation of the corporate restructuring component of the IMF program. The Bank's Policy

Reform Support Loans (PRSLs) I and II contained corporate restructuring conditionality. In addition, the Bank will continue to advise the FSPC Secretariat and the other relevant institutions on policies pertaining to corporate restructuring. The Bank is implementing two PHRD technical assistance grants of $1.3 million and $1.7 million, mainly to help assist corporate restructuring. Since corporate restructuring is a top country priority and the Bank is taking the lead role among the donors we shall continue to make help in corporate restructuring a priority until the corporate debt overhang problem has been resolved.

The IFC portfolio has 14 problem projects, with a total exposure of US$364 million ($138 million A loans, $43 million equity and $183 million B loans, representing about 43.5% of IFC total exposure). IFC has completed 4 restructurings totaling US$ 135.3 million or about 42% of our problem loan portfolio. As in other crisis affected countries, the first requests from Indonesia for IFC's assistance came from its portfolio companies. IFC has done substantial amount of work to protect its portfolio by working on restructuring, and where appropriate, recapitalizing its portfolio companies. Only one portfolio company (Dharmala Agrifood) has been put into liquidation proceedings as a result of other creditors taking legal action.

Simultaneously, IFC has worked on a fast response to the different types of demand for its services: the traditional need for long-term project financing and credit lines to financial institutions, as well as new demand for working capital finance and operational and financial restructuring. Given the enormous size of the problem and IFC's limited resources, the focus is on highly visible interventions with strong demonstration effects and positive impact on market psychology in view of the lack of investors confidence in Indonesia at the moment. IFC's projects in corporate restructuring typically combine financial, operational and managerial (corporate governance) restructuring using a variety of instruments such as loan/equity, quasi-equity and technical assistance. IFC has commissioned a study to identify potential candidates for restructuring and is working with a number of corporates to help in the restructuring process.

In addition to individual transactions. IFC is exploring ways to leverage its resources at wholesale level through specialized investment funds to respond to the urgent needs for equity capital in the Indonesian corporate sector.

D. Helping Overcome Long-Standing Structural Weaknesses

Improving Openness and Transparency

Public Governance

The *Bank's Governance Strategy* is outlined in the main body of the CAS. Of particular relevance for private sector development is the focus on, first, helping Indonesia give its poor a stake in the new democracy and build trust in government, by ensuring efficient delivery of key services in our areas of comparative advantage (health, education, social safety nets, urban municipal services) and working on reducing corruption. And second, on assisting Indonesia's integration to the global economy by moving from an economy governed by informal contacts and networks to one which is transparent, rules-based and subject to the discipline of competitive markets. This implies a government commitment to equitable enforcement of the rule of law to build up investor confidence in a level playing field for economic activity, and measures aimed at ensuring transparency in the allocation and use of public financial resources.

Decentralization

Decentralization will bring a large amount of uncertainty for investors and existing enterprises. Even if all safeguards against local governments' abuse of their decentralized powers work in the end, the transition to a new system will necessarily take time. Though our policy dialogue the Bank will focus on helping Government create the necessary clarity. In working on decentralization the Bank will leverage donor resources though the Governance Partnership. Measures the Bank could support might include:

- Clarify Regulation 25/00, and reassess the role of the center in setting national norms and standards. Improvements of the regulations should be accompanied by an elaborate information campaign that spells out the limits of local government's authority.
- Include civil society and the business community in the dissemination of the decentralization laws.
- Improve the administrative courts by devoting more resources for training and staffing of administrative courts, and building an information system that disseminates court rulings in administrative cases against local governments. This should be accompanied by a public information campaign that spells out citizen's and business rights against abuses of local government.
- Measures to provide a revenue base to local governments and to increase fiscal accountability, thus countering tendencies to raise illegal levies and charges on enterprises operating locally.
- Prioritize the decentralization of land management and zoning in order to allow for clear property rights, and to create a powerful interest group in good governance—namely land owners.
- Require performance reporting from service delivery units and user councils (e.g., parent-teacher associations, health boards, among others).

Legal and Judicial Reform

The Bank has played the role of convenor/coordinator for external assistance on legal and judicial reform. This responds to a statement by Vice President Megawati requesting the Bank to take the lead in this area and to a strong demand among donors.

A major diagnostic assessment conducted by Indonesian experts in 1996 under Bank sponsorship remains largely valid. Two areas were identified in this assessment as critical: the need to promote confidence in the judiciary, and the need to upgrade the professionalism and integrity of the legal system. Four components are necessary for a comprehensive framework of legal and judicial reform:

- legal education, testing and discipline;
- good governance in the legal system and administrative law reform;
- improved administration of justice, and
- improved legislative capabilities.

The Bank's role will be to facilitate and coordinate the work of the various steering committees and working groups as well as the analytical, financial and technical assistance contributions of donors. In addition, the Bank financed Corporate Restructuring TA Project does include a component to support training and development of Commercial Court personnel.

Improving Corporate Governance

Among the donors, the ADB has been given the lead by Government to provide support for corporate governance in Indonesia. The Bank has been providing back up technical assistance, focussing mainly on developing an awareness of the need in Indonesia for better corporate governance. This work contributed to the creation in 1999 of the National Committee on Corporate Governance (NCCG), a public private partnership which brings together representatives of the main groups who are interested in improved corporate governance i.e. regulators, self-regulatory organizations, the accounting and legal professions, the banks, the corporate issuers, their shareholders and managers. The Bank has provided hands on advice on corporate governance principles and rules and has sponsored a number of dissemination and public awareness events on corporate governance bringing international expertise to advise in Indonesia. We plan to continue this work during FY01-03 and to disseminate international best ethical management practices in the corporate sector in cooperation with the ADB, with bilateral donors and with the private sector, using mostly trust funds. In partnership with the big five accounting firms we propose to complete an exercise to benchmark Indonesian corporate governance practices to international standards and assess support for strengthening of corporate governance institutions. We shall also, where appropriate, provide technical assistance to Indonesian initiatives to create institutions such as an Institute of Corporate Directors, focusing on improved corporate governance.

IFC has an important role to play in improving corporate governance at a number of levels. First, various aspects of corporate governance are an integral part of IFC corporate restructuring transactions. These may include restrictions on related party transactions, and technical assistance to improve accounting and management practices. Improved transparency and disclosure are important mechanisms for IFC to protect and monitor its interests as a minority investor. Second, as a shareholder, IFC participates directly in the governance of some of its investee companies. Third, self-standing technical assistance in certain pioneer highly visible interventions to improve managerial and governance practices in individual companies. Fourth, investments in specialized training institutions for corporate directors. Fifth, policy advice on various aspects of the legal and regulatory framework for corporate governance.

(ii) Promoting Competition

Competition Policy

The Bank has played the coordinating role among the donors, including USAID, AUSAID, CIDA, ADB, GTZ and others, in mobilizing support for the creation of the new competition agency, the Committee for Business Supervision. We plan to continue this work as a priority over the next three years, giving priority to establishing the CBS and making it an effective institution. Priority initial actions to support the CBS include:

- Development of an organizational structure and selection and training of management and key staff
- Design of a clear set of regulations, administrative guidelines, and interpretation and policy documents
- Dissemination of information on the goals and scope of the law among public, academic, consumer and business sectors.
- Applying standards for competition policy in a number of leading sectors in the Indonesian economy.
- Developing of an advocacy policy and enforcement agenda for CBS.

- Implementing a corporate compliance program that facilitates firms' understanding of the goals and scope of competition policy/law.

Promoting Foreign Direct Investment

The Bank/IFC's Foreign Investment Advisory Service (FIAS) has carried out a number of missions to advise Government on policies to promote FDI. We propose to continue this assistance if requested by Government. FIAS would focus its attention on modifying the current philosophy which is based on screening and approval of foreign investment applications and moving to a simple licensing system, implemented through simple and transparent Negative, Reserved and Restricted lists. Within this re-engineered system an appropriate agency would act as an investment promoter and facilitation organization rather than a 'one stop shop' and regulator. Further, certain procedures require critical changes in order to meet internationally acceptable practice adopted by competitors for FDI.

MIGA paid its first claim for a project in Indonesia in June 2000 for an amount of $15 million. At present MIGA has suspended its guarantee activities in Indonesia. However, MIGA will resume cover as soon as MIGA and the Government settle on the handling of the claim. MIGA is keen to support the resumption of foreign direct investment flows into the country and will continue to accept applications of interest from investors. As part of its regional technical assistance efforts under the Miyazawa Initiative, MIGA is providing assistance and advice to Indonesia to help increase FDI inflows. Toward this end, an institutional assessment of the Indonesian investment promotion agency, followed by very specific capacity building programs, is slated for FY01.

(iii) Reducing the Ownership Role of the State

The Bank has been providing advice and assistance to Government on matters relating to SOE reform and privatization for many years. During 1997/1998, an IDF grant financed the services of an advisor who was instrumental in preparing the Government's 1998 Masterplan for SOE reform and privatization. Subsequently, technical assistance to MISE on SOE governance and privatization has been financed by ADB under a TA Grant. However, the Bank continues to provide advice through helping shape and monitor implementation of the IMF program. Progress has been slow and the ADB in now playing the leading role in SOE reform; accordingly we have given this activity a low priority over the last year. We are, however, ready to intensify our assistance to the Government if requested, mobilizing our comparative advantage to help Indonesia apply international best practices in SOE privatization.

E. Promoting Long Term Sustainable Private Sector Led Growth

(i) Broadening the Base of Development

Development of Small and Medium Enterprises

The WBG has financed a wide range of projects, programs, policy initiatives, economic sector work, and product development in support of SME development in Indonesia over the past 25 years. As a result, the WBG is in the position to apply a comprehensive approach to addressing constraints to SME development. The recently created global SME department institutionalizes this experience and would lead to faster dissemination of best practices capitalizing on the synergies between the Bank and IFC to deliver assistance to small companies. Although the ADB is at present taking the lead among the donors in SME development and JICA also plans to

provide assistance, SME development is a high priority for Indonesia and for the new Cabinet and we have been requested by the Government to continue our help in this area.

WBG work in the SME sector in Indonesia will focus on (i) working with ADB on the coordination of donor and NGO work in SME development; (ii) policy advice on improving the environment for SME development; (iii) piloting innovative programs and mechanisms for efficient delivery of business services for SMEs; IFC intends to mobilize donor funds to finance (i) a decentralized SME facility to provide a range of services for SMEs; (ii) build financial infrastructure for SMEs such as credit bureaus. IFC is also searching for opportunities for investment and provision of TA to financial intermediaries focusing on SMEs and microenterprises.

Rural and Urban Development

The WBG can play a strong role in the development of agribusiness in Indonesia and contribute to rural development, in the short-term as well as in the long-term. IFC can immediately assist the recovery of selected agribusiness companies through financial restructuring, improvement of corporate governance and the provision of long-term finance. This would include post-privatization investments to rehabilitate under-performing state-owned estates. Emphasis will be on the mobilization of co-financing, currently not available due to country risk. This will contribute to the restoration of economic activity in rural areas, including much needed wage employment and to the appeasement of social tensions. By imposing its rigorous environmental and social guidelines, the WBG will establish corporate best practice and ensure the sustainability of the selected projects.

In the medium term, the WBG has an equally strong role to play in the further liberalization and development of agricultural markets so that international price signals are appropriately transmitted to farmers and the benefits of development are widely shared in the countryside. The Bank will focus on the policy framework and regulatory environment and, in collaboration with IFC, assist the development of market institutions (e.g. commodity exchanges) to increase transparency and specific financial instruments to maximize trading opportunities. IFC will also actively pursue opportunities to develop private infrastructure for the marketing of agricultural and food products. The Bank will continue its project financed initiatives to promote the creation of private farmer organizations and rural water user associations, increasing private participation in the supply of agricultural inputs and in the marketing of agricultural commodities, and promoting the private provision of services such as research and extension. In urban water supply the Bank will, through its projects, continue to focus on improving the regulatory framework for private involvement and promoting investment in water supply by private operators.

(ii) Promoting Sustainable Private Provision of Infrastructure and Social Services

Private Participation in Infrastructure

Through its sector projects in power, telecommunications and transport the Bank has taken the lead in providing a great deal of hands on advice in promoting the role of the private sector in the infrastructure sectors. We shall continue to work through these projects over the next three years to promote the conditions for private participation in infrastructure. The emphasis will be on the creation of competitive market structures and of independent regulatory authorities, and on helping with the privatization of state run infrastructure enterprises. Given the urgency and following a request from the Coordinating Minister, we shall devote particular attention over the

coming year to the reform and privatization of the telecommunications sector, mobilizing resources and trust funds for this purpose in addition to funds available under the ongoing Telecoms projects.

Infrastructure has not accounted for a large share of IFC's activity in Indonesia due mostly to problems in transparency and corruption in awarding concessions and contracts. The crisis and the devaluation of the currency have also affected the economic viability of some infrastructure projects in the context of existing tariff structures. IFC is expected to increase its activities in line with government's progress in privatization. These activities are likely to be concentrated in sectors such as water and transport, where the development needs are particularly acute and where the Bank and others are providing assistance to the government in establishing a regulatory structure.

Private Provision of Social Services

Through its sectoral projects in education and health the Bank will focus on creating an adequate regulatory environment and a level playing field for private provision of education and health services. The aims will be to improve coverage and quality and reduce crowding out of the private sector by often inefficient subsidized state activities. Health and education are relatively new areas for IFC, where the Corporation is learning the best ways to support private sector efforts. IFC's investments in the provision of private health care delivery and private education in Indonesia complement the Bank's strategy directed at improved poverty focusing of public health care and education, and will be fully consistent with the strategy papers presented to the Board of Directors for these two sectors.

(iii) Promoting Environmentally Sustainable Development of Forestry and Natural Resources

Forestry

The Bank has incorporated forest policy reforms in both of its recent Policy Reform Support loans. In recent years, the Bank has placed emphasis on forest policy dialogue with the Government and other stakeholders. We sponsored a one-day "post CGI" seminar to illustrate the problems of the forests in January 2000, and we chair the CGI Donor Forum on Forestry that was established after the February 2000 CGI to assist GOI in dealing with the forestry issues and monitor progress. The Bank through an IDF grant supported the establishment of the Indonesia Eco-labeling Institute (LEI) to introduce market-based measures to promote sustainable timber management. LEI is now fully functional, with 11 timber concessions covering about 1.5 million hectares scheduled for certification during 2000, and 20 more concessions preparing for certification. In 1999, the World Bank - WWF Alliance for Forest Conservation and Sustainable Management supported a LEI program to train local communities and NGOs in forest certification. The Alliance also recently funded an international seminar and national workshop on control of illegal logging. Over the medium term we propose to continue leading the policy dialogue on sustainable forestry development and playing our convening and coordinating role among the donors.

The issues of corporate indebtedness and industrial overcapacity in the forest sector are especially relevant to private sector development strategy. MoAF needs to establish better cooperation with the Ministry of Trade and Industry and the Board of Investment so that issues of wood supply and timber plantations are incorporated into export promotion and investment licensing. A more urgent issue that also requires interagency coordination concerns forest sector

debt and assets held by IBRA (at least US$ 4 billion). The Bank and other donors are encouraging GOI to set up an interagency panel that would review and advise on all proposed wood sector debt restructuring and asset sale proposals in light of the realities of the sector. Some guiding principals for the review are the following:

- Firms with a pattern of illegal activities, such as mismanagement of concessions and failure to comply with timber plantation requirements, should not be rewarded with special financial considerations in debt workouts.
- Companies should not receive financial support or subsidy to continue with illegal practices.
- Due diligence in the case of investment and restructuring proposals should include confirmation of provisions for legal, sustainable wood supply.
- In decisions to sell assets or leave them with present owners, "fit and proper" tests should be applied.
- The tendency to take measures to save a financially troubled wood processing business should be balanced against the imperative of dramatically reducing the imbalance between timber demand and supply in order to save the industry as a whole.
- Promote establishment of timber plantations, but not when it involves converting natural forest.

Other Traditional Productive Sectors where the WBG has Comparative Advantages

Oil and gas. Firstly, as a result of its skills and international experience in the oil and gas sector, the WBG can play a strong role in helping design and implement a program of reform in the sector. This includes the design and the implementation of the legal and regulatory framework, setting up new (regulatory) agencies, price reforms, the restructuring of the industry, and the SOEs, assistance in evaluating the impacts of the energy sector on the environment, designing policies to reduce pollution (e.g. by reducing lead), evaluation of gas utilization and design of strategies to add value to gas resources.

Secondly, the WBG, principally through IFC and MIGA, and, possibly IBRD through guarantee operations, can help finance new private investment in the oil, gas and chemicals sector. While the largest, export oriented projects with the international oil majors are unlikely to need such assistance, many other investors find it difficult to mobilize appropriate long term finance. Particular areas of focus are likely to be small and medium size oil and chemicals exporters; projects, such as gas developments which are focused on meeting local demand, and projects where IFC/MIGA can play a particular role in helping ensure appropriate environmental and social standards. Government has expressed its support for the Bank Group's involvement and our level of effort will depend on continuing commitment from Government.

Mining. The WBG would seek to assist in reviving the development of this crucial industry, currently accounting for some 10% of Indonesia's GDP. Exploration and investment have dwindled drastically in recent times in the context of political insecurities, particularly regarding the contracts of work system. The Bank would focus on the policy framework. The aim would be to help Indonesia create a stable legal, fiscal and institutional environment to allow resumption of growth and sustainable development, accordance with potential. Emphasis would be on promoting a greater sharing of benefits resulting from mining activities at the local and regional levels and the need to provide small scale mining with a legal basis. An important component would be on helping local/regional authorities for the regulation of small scale mining, especially mining rights, protection of property, and environmental safeguards.

At the same time, IFC would support long-term funding of the sector by attracting private investment in the expansion of existing mining operations or in the start-up of new projects. In all of these, IFC's strong environmental and social record can add real value by preventing environmental damage and socio-cultural crises, in particular given the rise of illegal small-scale mining adjunct to larger mining operations. There are opportunities for IFC support in projects in coal (Indonesia is a source of low sulfur high energy coal for Asian and European markets) and on a selected basis in gold and in chemical alumina. The government has expressed an interest in the Bank Group's involvement in mining development and our level of effort will depend on the extent and continuity of this commitment.

(iv) Preparing for Competition in the Knowledge Economy

The Bank is already actively promoting the upgrading of information technology and connectivity in Indonesia through its Information Infrastructure Development Project (IIDP) and through its telecommunications sector investment projects. In response to a request from the Minister of Science and Technology, over the next few months we shall reallocate the resources of the IIDP to respond to rapidly unfolding priorities. We have already started working in partnership with USAID, JICA and will extend this partnership to other donors and the private sector, using grant funded TA and own resources, in a number of knowledge economy based areas including:

- In the short term - a strategic study on opportunities and constraints to developing Indonesia's software, systems integration, and internet sector and helping Government formulate its proposed National Networking Development Plan
- Improving the e-commerce policy and regulatory environment including the removal of barriers to entry, the promotion of competition and strengthening of government's enabling role
- Supporting government online and the interministerial committee TELEMATIKA, support for pilot developments in e-procurement, health service provision, distance learning, and e-governance
- privatization of the public internet service provider IPTEKNET
- creation of an independent regulator for the telecommunications sector and privatization of the fixed line service providers INDOSAT and TELKOM.