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July 2002
IMF Country Report No. 02/154

Indonesia: Selected Issues

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Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

INDONESIA

Selected Issues

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Approved by Asia and Pacific Department

April 12, 2002

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I. Macroeconomic Performance under the Extended Arrangement[1]

A. Introduction and Summary

1. **With the completion of the fifth review, Indonesia will be approaching the halfway stage under the current extended arrangement**. This chapter takes stock of Indonesia's performance against the original macroeconomic objectives and compares the performance of the Indonesian economy in the postcrisis period against that of the other major "crisis" countries in the region. In this context it also revisits the staff's earlier analysis of the medium-term outlook for Indonesia's debt sustainability.

2. **Performance against the four core macroeconomic objectives of the program—restoring growth, entrenching low inflation, reducing the debt burden and eliminating reliance on exceptional financing—has lagged behind the original expectations of the program**. More generally, Indonesia's recovery from the crisis has been weaker than that of other countries in the region. The principal factor behind the lagging macroeconomic performance has been the failure, over much of the program, to sufficiently accelerate reforms in key areas such as bank and corporate restructuring and judicial reform. The chapter concludes, however, that the core macroeconomic objectives under the program remain attainable, provided that the momentum of reforms is increased.

3. **This chapter is organized as follows**. Section B reviews the background to the current extended arrangement and describes the core macroeconomic objectives of the program. Section C considers the performance against these objectives, focusing in particular on the objectives for growth, inflation, the balance of payments and improving Indonesia's debt sustainability. Section D reviews the medium-term outlook in light of these developments.

B. Background to the Extended Arrangement

4. **The current extended arrangement (EFF) for SDR 3.6 billion was approved in February 2000**. It replaced an extended arrangement approved in August 1998, which in turn had succeeded Indonesia's first stand-by arrangement which was approved in November 1997. The current arrangement was extended to December 2003 at the time of the fourth review to provide more time for the reforms under the program to take root.

5. **The EFF was negotiated against a background of a still fragile economy**. Although macroeconomic stability had been restored and the rupiah had appreciated significantly from its crisis lows, overall progress in restructuring—especially of the bank and corporate sectors—had yet to reach a decisive stage. Government debt had also risen

[1] Prepared by Ben Bingham and Jung Yeon Kim (both APD).

sharply as a result of recapitalizing the banking system and Indonesia's external position remained difficult despite a significant turnaround in the external trade and current accounts.

6. **The new program sought to accelerate reforms**, focusing in particular on the unfinished agenda for bank and corporate restructuring, asset recovery and privatization, and legal and governance reforms. The key objectives were to restore growth, entrench low inflation, reduce the debt burden and eliminate Indonesia's reliance on exceptional external financing. The specific targets under the program included:

- A recovery in economic growth to around 5–6 percent, to bring output back to its precrisis level by 2003;
- Maintaining inflation in the low single digit range;
- Reducing government debt to around 65 percent of GDP by 2004.

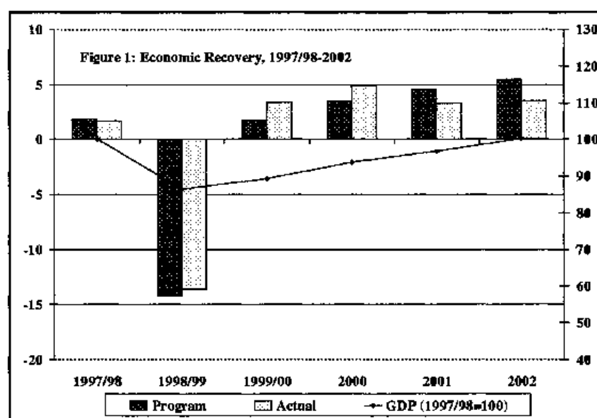
7. **It was recognized that achievement of these objectives was predicated on continued political stability and renewed momentum in restructuring and reforms**, without which the favorable macroeconomic environment assumed under the program—notably further declines in real interest rates and sustaining the appreciation of the rupiah—was unlikely to be realized.

C. Performance Under the Program

8. **This section reviews the performance of the economy since 1999/2000 against the original objectives under the program**. It considers first performance against the growth and inflation objectives, contrasting the experience in Indonesia with other countries in the region. It then reviews progress against the program's balance of payments and public debt objectives and considers the extent to which the key elements of the strategy to reduce Indonesia's debt—fiscal consolidation, asset recovery and favorable macroeconomic environment—have evolved in line with expectations under the original program.

Growth

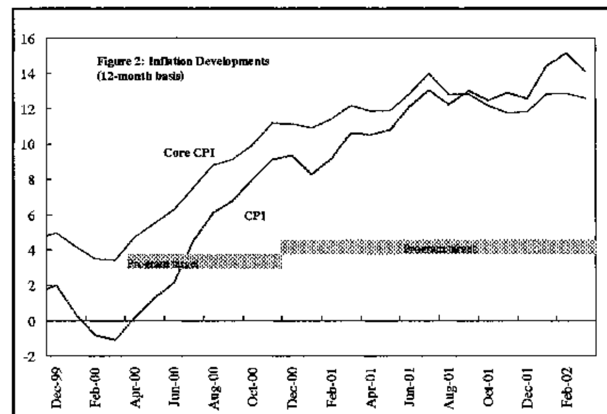
9. **Despite a promising beginning, the economic recovery has yet to fully take hold** (Figure 1). The economy initially rebounded more strongly than anticipated from the crisis. Real GDP grew by 4.8 percent in 2000, above the range of 3–4 percent assumed under the program. The recovery also broadened beyond domestic consumption, with investment making a significant contribution.



10. **The recovery however faltered in 2001**. Growth slowed to 3.3 percent and while private consumption remained buoyant, both investment and exports weakened sharply. The economic slowdown in 2001 reflects in part the impact of the domestic political upheaval in 2000-01 and the weakening global environment, particularly post September 11. Indeed given the difficult environment in 2001, economic activity held up reasonably well. Nevertheless the recent slowdown in investment suggests that the sustainability of the recovery is far from assured and the growth outlook for 2002 is much weaker than envisaged under the original program.

11. **Indonesia's recovery from the crisis has also been significantly weaker than most other crisis countries in the region** (Chart 1). The rapid recovery in output in the region in 1999–2000 was underpinned by strong external demand, particularly for electronics, and a sharp rebound in fixed investment. The recovery was strongest in those countries, such as Malaysia and Korea, where there was substantial early progress on reform that helped boost market confidence. In contrast, in Indonesia, where doubts remained about the authorities' commitment to reform, market sentiment has remained more fragile, real interest rates have been correspondingly higher, and the recovery has been less robust.

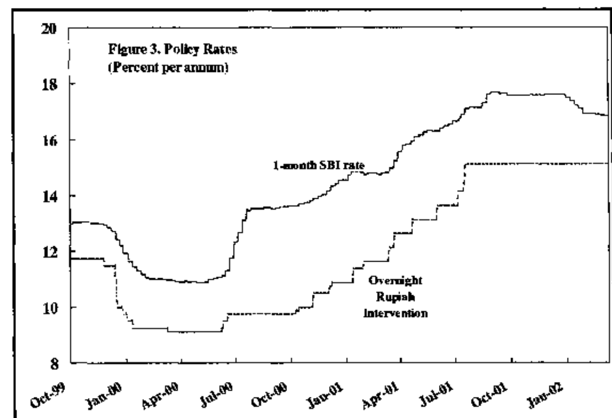
Inflation



12. **Although macroeconomic stability has been maintained, the rate of inflation has been significantly above the range targeted under the program** (Figure 2). Having fallen sharply in 1999/00—to under 5 percent—following the tightening of monetary conditions in the postcrisis stabilization phase, Indonesia's core inflation rate moved steadily upward from mid-2000 onwards, peaking at around 14 percent in mid-2001. The upward trend in inflation abated in the second half of the year and core inflation has eased to 12–13 percent since then. Headline inflation rose sharply in the first two months of 2002, on the effects of large hikes in administered energy prices and supply disruptions associated with the severe floods, but has since fallen back to around 14 percent.

13. **The rise in inflation in Indonesia in 2001 contrasts with that of the other Asian emerging economies**, where inflation remained in the low to mid single digits (Chart 1). One obvious distinguishing factor was the steep depreciation of the rupiah through early 2001. The rupiah depreciated from about Rp 7,000 per dollar in early 2000 to a post crisis low of Rp 12,000 per dollar in April 2001. It has since recovered below Rp 10,000, but remains about 40 percent below its level in early 2000.

14. **Monetary policy, however, was slow to respond to the rise in inflationary pressures in 2000 and early 2001**. As a result, base money growth accelerated sharply, remaining at around 20 percent (12 month basis) throughout 2001.[2] Monetary policy was tightened progressively in the first half of 2001, with the benchmark one-month SBI rate rising by more than 3 percentage points to 17½ percent (Figure 3). Base-money growth has since slowed sharply, falling to around 13–14 percent in early 2002. Since the beginning of the year the SBI rate has fallen by around ¾ of a percentage point.



Balance of payments

15. **The current account surplus has remained significantly higher than projected, reflecting mainly lower imports.** The current account surplus rose to $8 billion (5.2 percent of GDP) in 2000 and remained at $6½ billion (4 percent of GDP) in 2001, compared to an original forecast of near balance (Table 1). Higher oil prices contributed in 2000–01, but the primary reason was weaker imports, linked to the slower recovery in investment.

Table 1. Balance of Payments
Performance against Program Targets

	2000		2001		2002	
	Program	Actual	Program	Actual	Program	Revised
Current account	3.3	8.0	1.0	6.5	-0.2	3.2
Capital Account	-7.5	-6.9	-2.1	-9.4	3.0	-5.6
Of which: private capital	-8.1	-6.0	-0.6	-6.4	-0.5	-3.7
Gross reserves (end period)	26.5	29.4	28.4	28.0	31.7	28.5

16. **The counterpart to the larger current account surplus has been persistent private capital outflows.** The original program had assumed that net private capital flows would be largely in balance by 2001, but the latest staff estimates suggest net outflows remained over $6 billion.[3] Net official inflows have also been weaker than expected,

[2] The linkages between monetary policy and inflation are discussed in Chapter II.

[3] Trends in private capital flows are discussed in Chapter IV.

reflecting primarily the impact of delayed implementation of policy reforms on the disbursement of official program financing.

17. **Progress toward eliminating Indonesia's reliance on exceptional financing has also lagged**. The program had envisaged that international reserves would rise to around $30 billion and that the need for exceptional financing would be eliminated. In the event, reserves accumulation has been slightly weaker than envisaged, and an exceptional financing need is still projected for 2002 and 2003. To close this gap, the authorities have submitted a request to Paris Club creditors for a successor rescheduling covering interest and principal falling due beyond March 2002.

Public Debt

18. **Indonesia's debt burden increased sharply during the crisis**. By the time that the current EFF was negotiated, total government debt had risen from a relatively comfortable precrisis level of around 25 percent of GDP to close to 100 percent of GDP. Most of the increase in debt reflected the issuance of domestic debt to finance the costs of bank restructuring. Thus, by end-1999 domestic debt had risen to over 50 percent of GDP, up from zero before the crisis. External debt had roughly doubled as a percent of GDP, but this reflected largely the impact of the steep depreciation of the rupiah. The increase in external debt in US$ terms was relatively modest.

19. **The program aimed to reduce the government debt-GDP ratio to around 65 percent of GDP by 2004**. The strategy for achieving this objective rested on fiscal consolidation and the mobilization of resources through IBRA asset recovery and privatization. The achievement of sustainable debt dynamics also required a favorable macroeconomic environment, notably a pick-up in GDP growth, a decline in real interest rates to below the growth of real GDP, and a preservation of the appreciation of the rupiah.[4]

20. **Indonesia's debt has yet to be placed on a sustainable footing**, despite the fact that the evolution of the debt-to-GDP ratio has been broadly in line with the path envisaged under the original program. Progress on fiscal consolidation and asset recovery have lagged earlier expectations. More fundamentally, Indonesia has yet to establish the supportive macroeconomic environment of higher growth, declining real interest rates, and a strengthened rupiah upon which the original debt sustainability strategy was predicated.

21. **This section reviews briefly the performance of the individual components of the program strategy in this area,** to obtain a better understanding of the progress made towards the improving Indonesia debt dynamics (Table 1).

---

[4] The rupiah had appreciated from a crisis low of Rp 16,000 per dollar in early 1998 to around Rp 7,100 per dollar by end-1999, just prior to the approval of the current program.

- **Fiscal consolidation**. While the reduction in the primary balance and the overall deficit has outperformed the original program targets, this reflected primarily a windfall from higher-than-expected international oil prices. The underlying non-oil primary deficit was significantly larger than originally programmed in 2000–01. Progress was made in mobilizing non-oil revenues, a key program objective, but this was more than offset by delays in reducing energy subsidies and larger-than-expected costs of fiscal decentralization.[5] The 2002 budget targets, however, will broadly restore the deficit reduction path envisaged under the original program.

- **IBRA Asset Recovery**. The original program strategy was to use IBRA's cash proceeds from asset recoveries to finance the budget, thereby reducing dependence on debt financing, and to use recoveries from sales paid in bonds to directly retire debt. Total cash recoveries over the period 2000–2001 were estimated at 3½ percent of GDP, while total recoveries for direct debt reduction were estimated at just over 3 percent of GDP. Cash recoveries have performed well, exceeding their target in both 2000 and 2001. However, there was a significant shortfall in recoveries for debt reduction. IBRA recoveries from this source totaled less than 1 percent of GDP, and the bulk of these recoveries came from the return of "excess recapitalization bonds" from the banking system, rather than from loan and equity sales. The program for 2002 envisages a significant increase in cash recoveries, although total recoveries are expected to remain below the original program targets.[6]

- **Privatization**. Like IBRA cash recoveries, it was envisaged that privatization proceeds to would help reduce the budget's dependence on debt financing. Progress under the privatization program has, however, been a major area of weakness, with effectively no sales until late 2001. In addition to its negative impact on the public debt dynamics, this performance has also adversely affected investor sentiment more generally. The new government has made the reactivation of the privatization program a priority for 2002.

[5] Subsidies rose to over 6 percent of GDP in FY2000, from 4 percent in FY1999, and remained around 5½ percent in FY2001. Staff estimates suggest that the net cost of fiscal decentralization was about 1½ percent of GDP (Chapter V reviews the experience with fiscal decentralization to date).

[6] Chapter III reviews performance and prospects for IBRA asset recoveries.

Table 2. Fiscal Sustainability, 1999-2004
Performance Compared with Original Program Targets

	Fiscal years					
	1999	2000	2001	2002	2003	2004
a. Government debt			(In percent of GDP)			
Original Program Target	89.3	93.5	87.3	79.5	71.7	66.0
Domestic	50.7	55.0	50.5	45.2	39.7	35.8
External	38.6	38.5	36.8	34.3	32.0	30.2
Actual	88.6	98.9	90.8	74.6	71.6	65.5
Domestic	45.1	52.7	47.3	42.0	37.0	34.4
External	43.5	46.2	43.5	32.6	34.5	31.1
b. Government Budget						
			(In percent of GDP)			
Original program targets						
Central government deficit	-5.0	-5.0	-3.8	-2.7	-1.5	0.7
Primary balance	-0.9	1.5	2.0	2.4	2.8	3.1
Non-oil primary balance	-5.2	-2.6	-1.8	-1.3	…	…
Actual						
Central government deficit	-1.5	-1.1	-3.5	-2.5	-1.7	-1.1
Primary balance	2.4	4.0	2.9	2.8	3.0	3.1
Non-oil primary balance	-2.9	-4.6	-4.1	-1.7	…	…
c. Asset Recovery and Privatization						
			(In percent of GDP)			
Original program targets						
Asset recovery	1.6	2.7	4.0	3.3	2.4	0.5
Cash	1.5	1.8	1.8	1.7	1.2	0.5
Bonds	0.1	0.9	2.2	1.6	1.2	0.0
Privatization	0.8	0.7	0.7	0.8	0.5	0.5
Actual						
Asset recovery	1.6	2.1	2.3	2.6	1.9	0.3
Cash 1/	1.2	2.1	1.9	2.2	…	…
Bonds	0.4	0.0	0.4	0.5	…	…
Privatization	0.3	0.0	0.2	0.2	0.2	0.2
d. Macroeconomic assumptions						
			(In percent, unless indicated otherwise)			
Original program targets						
Growth	2.0	3.0	5.0	5.0	6.0	6.0
Inflation 2/	8.5	3.5	4.5	4.5	4.5	4.5
Interest rate 2/ 3/	16.7	12.2	10.5	9.6	8.5	8.5
Exchange rate (Rupiah per dollar) 2/	7,405	7,000	7,007	7,179	7,382	7,593
Nominal GDP (Rp trillion)	1,135	910	1,299	1,436	1,597	1,775
Actual						
Growth	3.4	4.9	3.3	3.5	4.0	5.5
Inflation 2/	8.5	5.2	11.5	12.4	8.2	7.6
Interest rate 2/ 3/	16.7	12.9	16.5	14.0	12.7	12.1
Exchange rate (Rupiah per dollar) 2/ 4/	7,509	8,765	10,247	9,000	9,125	9,875
Nominal GDP (Rp trillion)	1,120	986	1,491	1,675	1,886	2,140

1/ Transfers to budget.
2/ Period average.
3/ SBI rate.
4/ Projections for 2003 and 2004 onwards assume a constant real exchange rate.

- **Macroeconomic environment**. After a promising start, the macroeconomic environment has turned out very different from that envisaged under the original program. The recovery has been weaker, the nominal exchange rate has been significantly more depreciated, and nominal interest rates have been higher. These factors reflect primarily the failure to reinvigorate the reform agenda sufficiently to achieve a sustained restoration of investor confidence in Indonesia. The prolonged period of domestic political uncertainty was clearly also a significant contributory factor to the weaker economic environment. Higher inflation has temporarily moderated some of the adverse impact on Indonesia's debt dynamics. In particular, the rise in inflation in 2000 and 2001 lowered real interest rates below those envisaged under the original program, easing some of the pressure on Indonesia's debt dynamics.

D. Medium-Term Outlook

22. **The original macroeconomic objectives remain attainable** provided the government is able to establish the mutually reinforcing cycle of economic reforms and rising market confidence envisaged under the original program. Consistent implementation of the economic strategy laid out in the current program provides a basis for achieving this objective. Key aspects of the strategy include continued prudent macroeconomic policies as well as accelerated reforms in the core areas of bank and corporate restructuring, legal and judicial reform and governance. Pursuit of sound policies in other areas, such as labor market reforms,[7] will also be important.

23. **The staff has updated its earlier assessment of the medium-term outlook under such a scenario** (Chart 2). The macroeconomic assumptions are broadly unchanged from that presented under the original program, reflecting an unchanged assessment of Indonesia's economic potential. Growth is projected to accelerate to 5–6 percent over the medium term, inflation is expected to decline gradually to the mid-single digits, the real exchange rate is assumed to appreciate somewhat in 2002 and to broadly maintain its value thereafter, and real interest rates to stabilize at around 4–5 percent over the medium-term. Finally, fiscal policy would be geared to maintaining a primary surplus of about 3– 3½ percent, close to current levels.

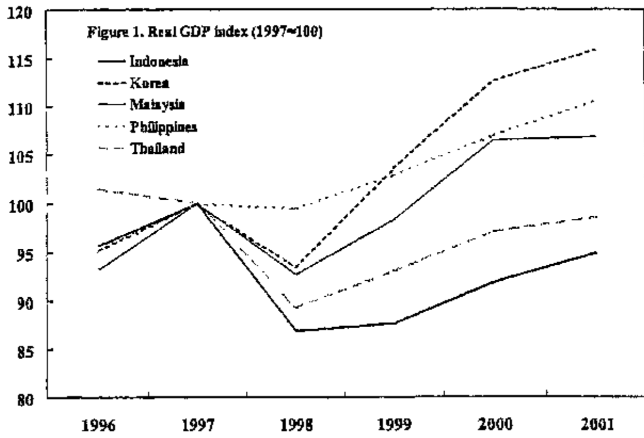
24. **Under the staff's baseline scenario public debt would decline to about two-thirds of GDP by 2004 and to about 50 percent of GDP by 2007**. The budget would move gradually into balance, but with the elimination of untargeted fuel subsidies and continued improvements in the non-oil tax performance, there would be room to boost the priority social and development spending needed to maintain the basic infrastructure, sustain growth, and reduce poverty.

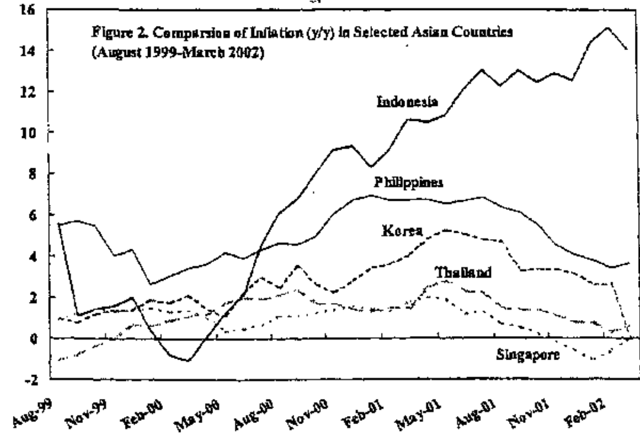
[7] Recent labor market developments and policies are discussed in Chapter VI.

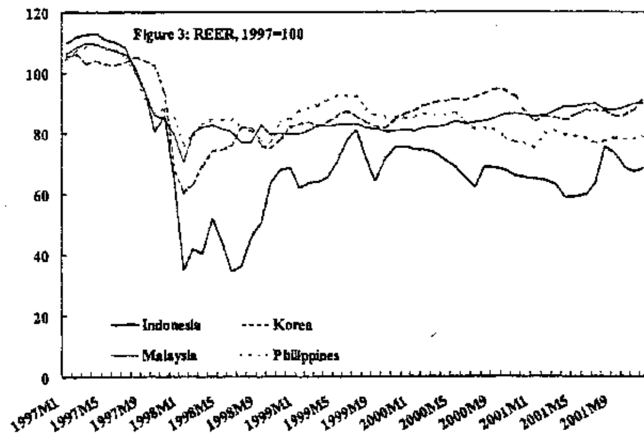
25. **There clearly remain significant downside risks to the achievement of such a scenario**, as progress on reforms has yet to be sufficient to achieve the required turnaround in investor sentiment. Without such a turnaround, investment and growth are unlikely to recover from recent levels on a sustained basis. Risk premia associated with Indonesia would remain high, the exchange rate would remain weak and there would correspondingly be limited scope for monetary policy to be more supportive of an economic recovery, further weakening the economic outlook. Under such an alternative scenario (Chart 2) the decline in the public debt ratio would be significantly more gradual. Progress on asset recovery and privatization would be slower and access to concessional external financing would be reduced. The rise in domestic financing implicit in such a scenario would risk crowding out the private sector recovery.

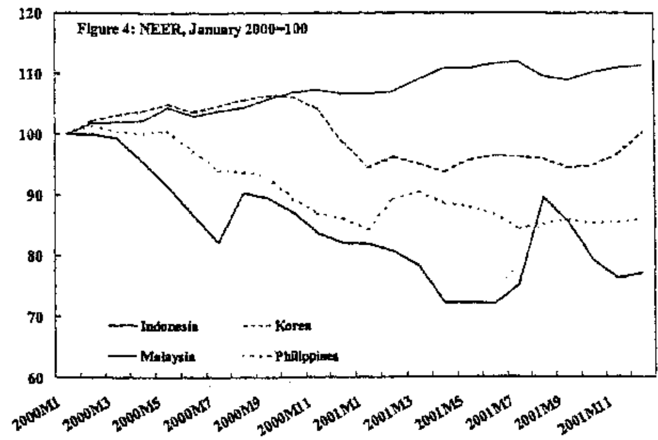
Chart 1:

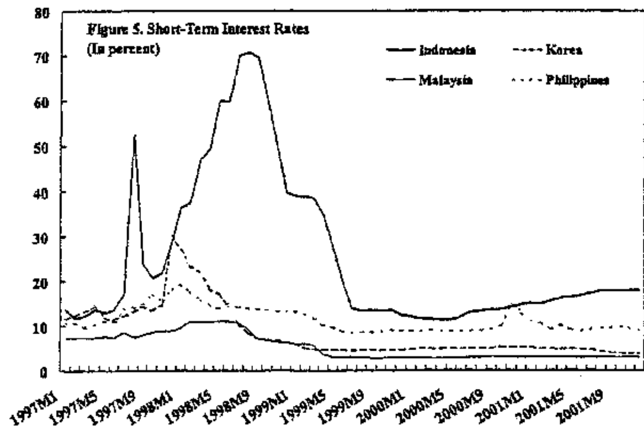
Recovery from Crisis in Comparison to Other Countries in the Region.











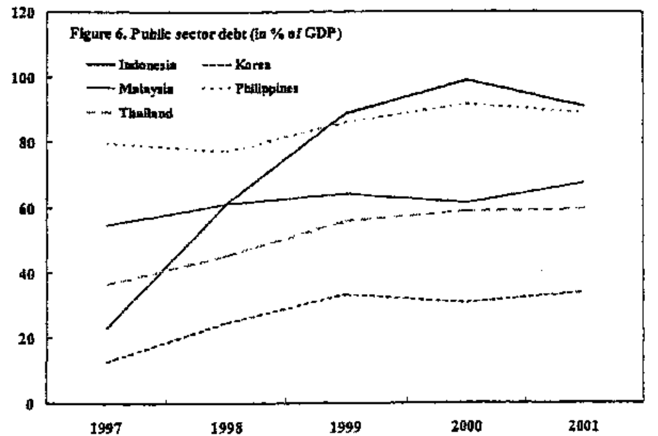
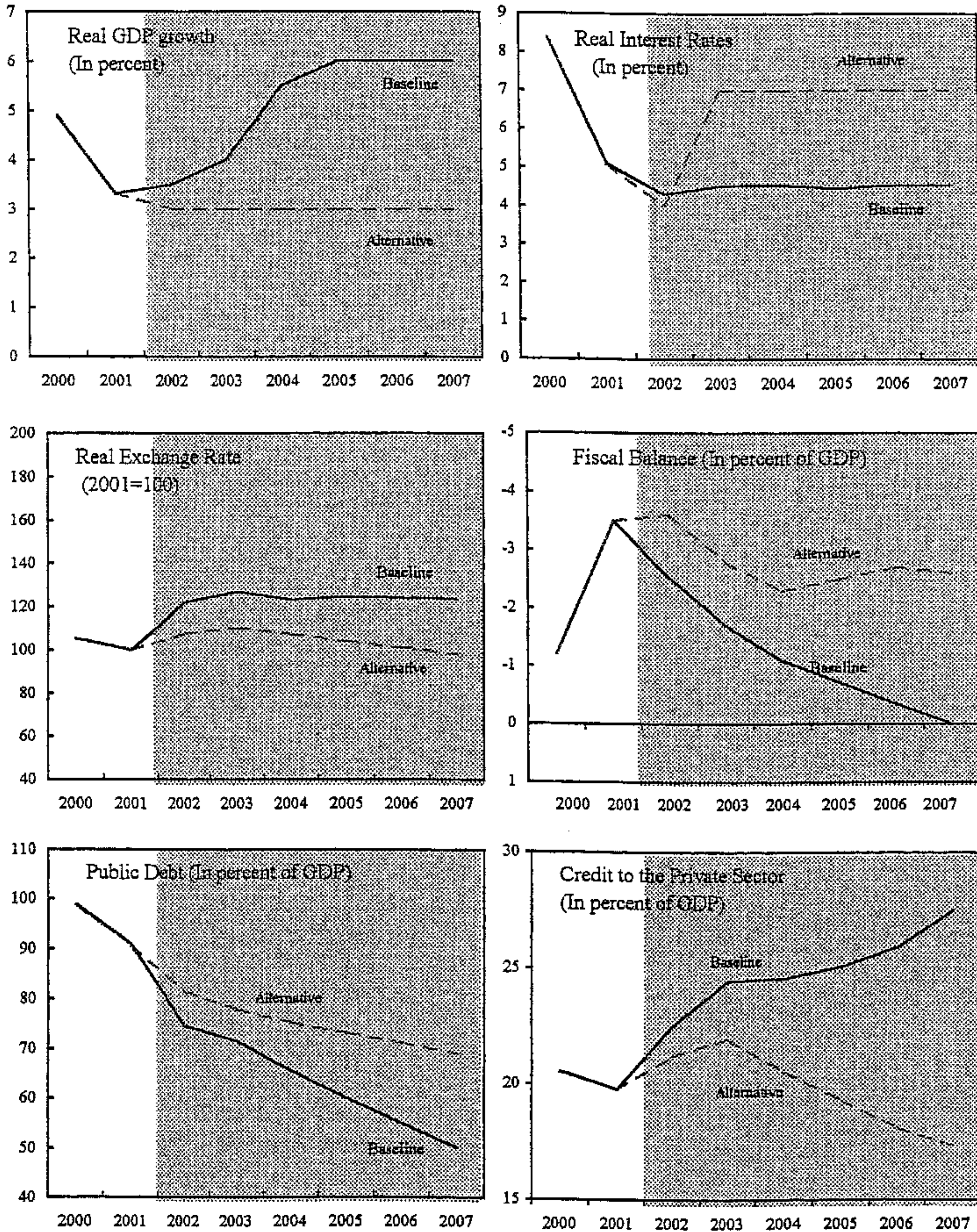


Chart 2:
Medium-Term Framework, 2000–07



Source: Fund staff estimates.

II. Inflation Developments and the Monetary Framework[1]

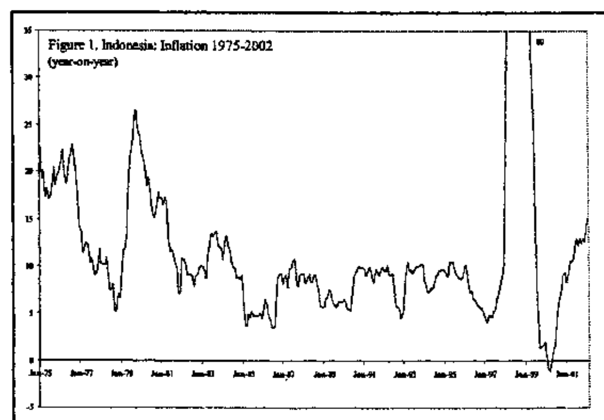
A. Introduction

1. **After falling to a record low in early 2000, inflation in Indonesia has increased significantly to a range of 12–15 percent, exceeding the targets under the government's economic program.** This increase, which has contrasted markedly with the experience elsewhere in the region, has come amid a sustained overshooting of the central bank's targets for base money growth, and persistent weakness in the exchange rate. This has led to questions about the effectiveness of the current monetary framework, which emphasizes operating targets for base money growth as one of the factors used in guiding the stance of monetary policy. In particular, questions have arisen as to whether the demand for base money is sufficiently stable to be used as a guide for monetary policy.

2. **This chapter seeks to address these questions by examining the evidence related to the stability of money demand.** The chapter is organized as follows. Section B briefly reviews past inflation developments, with particular emphasis on the most recent experience. Section C examines trends in monetary aggregates, highlighting developments in the postcrisis period. Section D considers the extent to which a standard money demand framework can account for the actual developments in the monetary aggregates. Section E provides a summary and conclusion.

B. Inflation Developments

3. **From 1985 until 1997, just prior to the economic crisis, Indonesia's headline inflation rate (as measured by the overall CPI) generally fluctuated in the 5–10 percent range.** While this was somewhat higher than in other economies in the region, it was down from an average of 14 percent in the preceding decade, when high inflation was associated with periodic large depreciations of the rupiah (Figure 1).



4. **Inflation increased sharply following the onset of the crisis in 1997–98.** After the abandonment of the exchange rate peg, the rupiah depreciated by nearly 85 percent from June 1997 to June 1998. In addition, monetary control was lost as Bank Indonesia (BI), acting in its role as lender-of-last-resort, channeled massive liquidity support to banks, which was not sterilized. Supply shortages and problems with the distribution system in the

[1] This chapter was prepared by Alexander Wolfson (APD).

aftermath of the crisis, particularly in the agricultural sector, also contributed to the increase in prices. Accordingly, inflation rose from 5 percent in June 1997 to a peak of over 80 percent in September 1998.

5. **BI regained monetary control in mid-1998, adopting a program that was centered on tight control of base money growth.** As a result, the rupiah recovered by about 40 percent in the last quarter of 1998, and monthly inflation slowed sharply, with the annual inflation rate falling back to single digits by the second half of 1999.

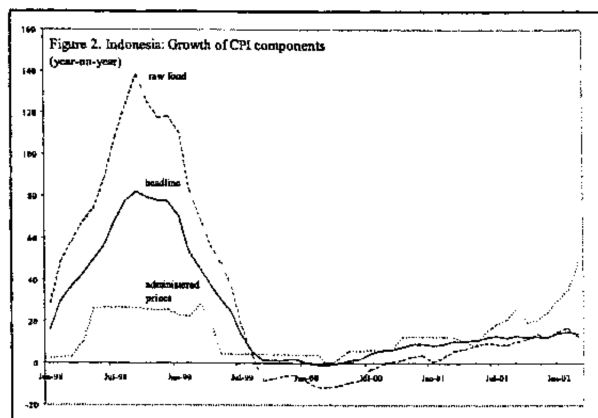


Figure 2. Indonesia: Growth of CPI components (year-on-year)

6. **Headline inflation slowed further in early 2000, with prices actually falling in the first quarter.** From the third quarter of 1999 until mid-2000, headline inflation was below 2 percent. To a large extent, this outcome reflected sharp declines in raw food prices, which comprise over 20 percent of the consumption basket (Figure 2). However, the increase in prices of other goods also slowed, reflecting the large output gap and appreciating currency.

7. **Inflation has since accelerated again, fluctuating in the range of 12–15 percent since mid-2001.** This increase has been broad-based, observed across all categories of goods and services. Large adjustments in the prices of administered goods, including fuel and electricity, have also contributed. Nevertheless, even abstracting from such temporary effects, staff estimates suggest that the core rate of inflation has also risen significantly, to about 12–13 percent. Box 1 discusses alternative measures of underlying inflation.

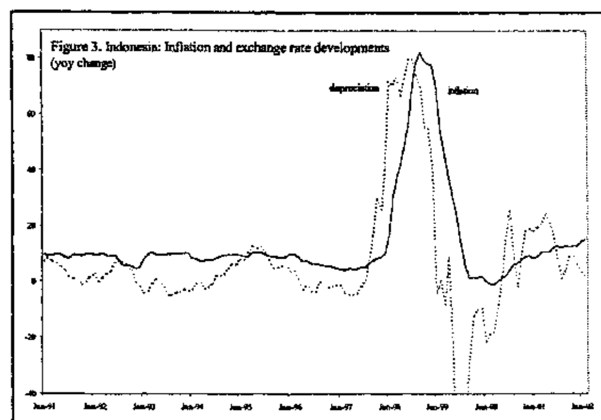


Figure 3. Indonesia: Inflation and exchange rate developments (yoy change)

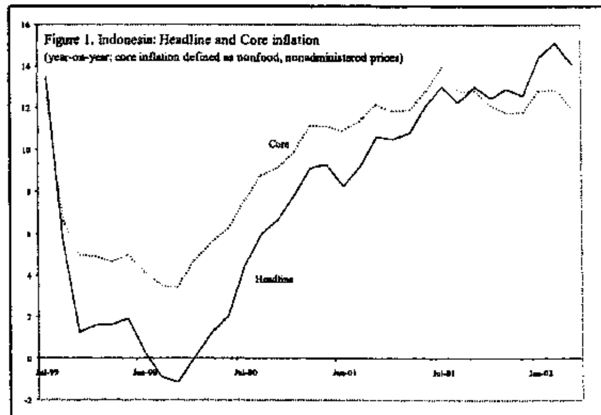
8. **The recent increase in inflation coincides with a period of renewed weakness in the exchange rate** (Figure 3). The rupiah depreciated through most of 2000 and 2001, in response to political upheaval and slow implementation of reforms. A sharp recovery associated with the change of government in mid-2001 proved short-lived, and the rupiah weakened again in the latter part of 2001, before a partial recovery in early 2002. As discussed further below, base money growth accelerated sharply in 2000 and most of 2001.

9. **Previous research finds evidence supporting the link between inflation outcomes, the exchange rate, and money growth in Indonesia.** Ramakrishnan and Vamvakidis (2002) investigate the determinants of inflation for the period 1980 to 2000. They find that movements in the exchange rate, foreign inflation, and base money growth are significant variables in explaining inflation developments in Indonesia. Basri and others (2002) confirm

Box 1. Alternate Measures of Inflation

Overall inflation in Indonesia is measured by the CPI index, based on surveys of consumer prices during the reference period in each month. Some components such as raw food exhibit volatile month-to-month movements, while components with administered prices face large but infrequent adjustments. To disentangle such effects, a number of measures of inflation have been developed. The analysis in the current chapter is based on headline inflation.

Headline inflation This is the increase in prices of the overall CPI index. BI's inflation target for 2002 refers to this definition.



Nonfood inflation Raw food accounts for 22 percent of the CPI basket. Raw food prices move sharply in response to agricultural conditions and shocks, and are not reliable indicators of inflation pressures. In the past, IMF staff have used this as a measure of underlying inflation.

Nonfood, nonadministered prices ("Core") Many components of the CPI basket have prices which are set administratively. For example, about 8 percent of the CPI index consists of petroleum items and utilities (telephone and electricity). In the face of recent large adjustments in the prices of these items, IMF staff have constructed a measure of core inflation excluding this subset of administered prices, as well as raw food prices (Figure 1).

Excluding volatile prices ("Exclusion") The logic for excluding food prices on the basis of volatility can be applied to all components of the CPI. BI constructs a measure of core inflation which excludes excessively volatile components, mostly food items and administered prices. The components of the "exclusion CPI" represent about 60 percent of the full CPI basket.

Excluding volatile prices ("Trim") Instead of permanently dropping items from the measure of underlying inflation, the trim method drops items whose monthly movements exceed some preset level. Thus, the composition of the "trim CPI" changes over time. BI's measure of "trim CPI" drops the 30 items with the highest monthly price change, and the 102 items with the lowest monthly price change. This approach typically excludes 20–30 percent of the CPI basket.

these results, and finds that exchange rate movements are particularly important for explaining short-run inflation outcomes, while money growth helps explain inflation at horizons of a year and longer. McLeod (1997) examines the behavior of prices and monetary aggregates for the precrisis period 1989 to 1995. He finds that the consistent overshooting of the inflation target can be explained by excessive base money growth, resulting from unsterilized capital inflows. He maintains that base money demand is stable, and argues that BI should focus exclusively on base money to achieve its inflation goal.

C. Monetary Developments

10. **In the period leading up to the crisis, monetary policy sought to balance multiple objectives, including high growth, a sustainable balance of payments, and low inflation.** In particular, policy-makers were faced with the competing objectives of seeking to resist a real appreciation in the face of strong capital inflows, while maintaining growth of monetary aggregates consistent with low inflation. Operationally, BI announced an inflation goal, and targeted growth rates for various monetary aggregates—base money, broad money, and bank lending. In practice, the crawling depreciation of the exchange rate served as the nominal anchor. In line with this objective, capital inflows were not sterilized, and the monetary growth targets were generally exceeded.

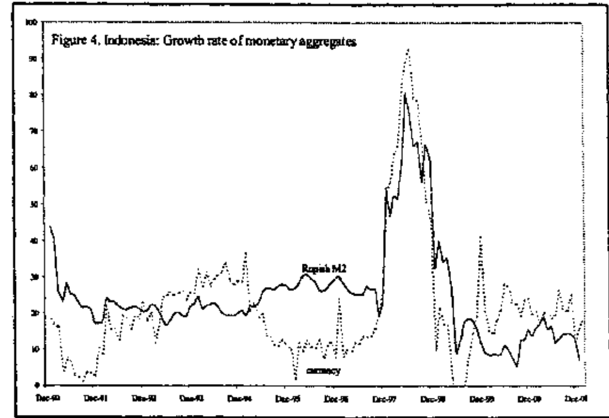


Figure 4. Indonesia: Growth rate of monetary aggregates

11. **There were notable differences in the behavior of the monetary aggregates in the precrisis period** (Figure 4). Rupiah broad money grew at a relatively rapid but stable rate, while currency growth fluctuated sharply. The ratio of broad money (M2) to GDP increased gradually through 1997, in line with the expansion of the banking system (Figure 5). The number of banks more than doubled between 1989 and 1994 as entry rules were relaxed. Currency growth increased to near 30 percent by 1994, during a period of declining interest rates and accelerating real growth. As

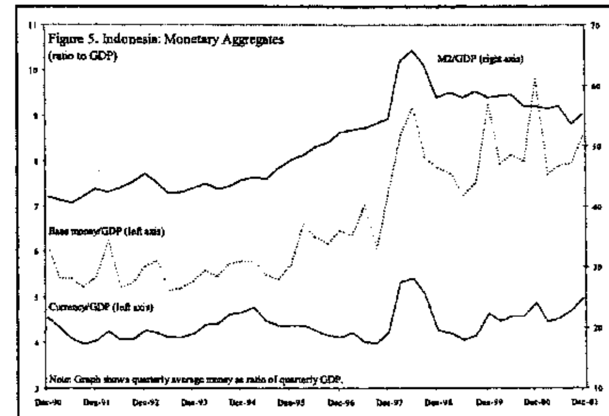


Figure 5. Indonesia: Monetary Aggregates (ratio to GDP)

Note: Graph shows quarterly average money as ratio of quarterly GDP.

interest rates rose before the crisis, currency growth subsided. Reflecting the high share of currency in base money, developments in the ratio of base money to GDP have broadly followed those in currency, although with stronger end-year fluctuations.[2]

12. **All monetary aggregates experienced rapid growth rates during the crisis.** As BI was unable to sterilize the massive liquidity support that was being channeled to banks, base money increased sharply. The growth rate of monetary aggregates peaked in mid-1998, before gradually declining as the government's stabilization program took hold. By end-1998, the ratios of the monetary aggregates to GDP had broadly returned to their precrisis levels.

13. **There have been significant divergences in the behavior of the monetary aggregates in the postcrisis period.** Broad money growth has been subdued, and the ratio of M2-to-GDP has declined gradually. This experience reflects the continued weaknesses in the banking sector, and the slow pace of corporate restructuring and legal reform, which have impeded a recovery in credit creation. In contrast, currency growth has increased sharply to around 20 percent since early 2000, before slowing somewhat in early 2002.

14. **More generally, movements in the currency-to-deposit ratio reflect the impact of secular changes.** The currency-to-deposit ratio experienced a steep decline from a level of around 30 percent in the mid-1980s, to about 12 percent in recent years (Figure 6). The steepest decline occurred in the period through 1990, coinciding with the sharp increase in deposits as a result of liberalization of the financial system, particularly the lifting of some of the controls on deposit rates. After increasing during the crisis, the currency-to-deposit ratio returned to its precrisis level by end-1998. Since then, the ratio has risen steadily to its current level of about 12 percent. These recent trends in the currency-to-deposit ratio reflect the increase in currency growth noted above.

Figure 6. Indonesia: Currency-deposit ratio, 1986-2001

15. **The monetary policy regime has changed dramatically compared with the precrisis period.** Most importantly, the authorities have adopted a floating exchange rate regime. To deal with the crisis and regain control over its balance sheet, BI brought the sources of base money growth under control, discontinuing some liquidity facilities, and increasing penalties for the use of its discount window and bank overdraft facilities. Net

[2] In addition, the ratio of base money-to-GDP experienced permanent increases when BI increased required reserve ratios in February 1996 and April 1997.

domestic assets were targeted to stay broadly unchanged, and a floor was set on net international reserves.

16. **The base money framework was initially successful.** However, in the second half of 2000 and most of 2001, base money and inflation repeatedly exceeded their targets, despite several revisions in these targets (Table 1). The over-run in base money has mainly reflected stronger-than-expected growth in currency in circulation, which comprises almost two-thirds of base money.[3] These deviations in base money from the target path have raised questions about whether this reflects primarily incipient inflationary pressures or instability in the demand for base money. To better understand this experience, it is useful to assess in more depth the factors underlying the demand for money, and the extent to which actual monetary developments can be explained by a standard money demand framework.

Table 1. Indonesia: Inflation Outturn Relative to Targets

	Inflation	Base money	Growth	Residual
Deviation from path expected in November 2000 1/				
Mar-01	2.1	2.2	0.0	-0.2
Jun-01	4.4	7.9	-2.8	-6.3
Sep-01	6.2	10.4	-3.1	-7.3
Dec-01	7.4	-2.0	-3.6	5.8
Deviation from path expected in April 2001 1/				
Jun-01	1.4	5.1	1.6	-2.0
Sep-01	2.0	6.4	-2.0	-6.4
Dec-01	4.7	5.0	-2.0	-2.3
Deviation from path expected in July 2001 1/				
Sep-01	0.8	4.9	-1.3	-5.4
Dec-01	0.0	0.0	-0.7	-0.7

1/ Figures report amount by which the actual outturn at the end of the quarter exceeded the predicted value for that date. The residual column is calculated by imposing the quantity equation (negative residuals imply an underestimate of the change in velocity).

D. Money Demand in Indonesia

Approach

17. **Following a standard framework, real money demand is specified as a function of real output, the opportunity cost of money, and other factors:**

$$m = f(y;r;x),$$

where m is real money, y is real output, r represents opportunity cost variables, and x represents other variables which are believed to affect money demand.

18. **This chapter considers the demand for a variety of monetary aggregates, with particular emphasis on currency demand.** Monthly real broad and narrow money aggregates are calculated by dividing end-month values by the CPI level. Monthly real output is imputed from the official quarterly real output series. All specifications are estimated in logarithmic form.

[3] The other components of base money, namely cash in vaults and commercial banks' deposits at BI are smaller and, except for year-end spikes, exhibit less variation.

19. **The definition of the opportunity cost variable differs depending on the measure of money under consideration.** For the broader aggregates, a real interest rate is constructed based on ex post inflation outcomes (both year-on-year and quarter-on-quarter). Following the standard approach, the nominal deposit rate is used when analyzing the demand for narrower monetary aggregates. This approach presumes that the opportunity cost of holding currency is the foregone interest on deposits. Another alternative to holding rupiah currency is holding foreign currency, which would earn the expected rate of depreciation. The actual ex post rate of depreciation is used to capture this phenomenon.

20. **Money demand was estimated using monthly data from January 1990 through December 2001**. A key consideration is the treatment of the crisis. The postcrisis period differs from the precrisis period in many important ways, including the exchange rate regime, the instruments of monetary policy, and the structure of the financial system. To capture possible changes in the income elasticity of money demand since the crisis, an interaction term is included, defined as a dummy variable times real income, with the dummy variable taking the value of one starting in July 1997 through the end of the sample period. In addition, the specifications are considered separately for the pre- and postcrisis periods. A general shortcoming of such exercises for Indonesia is that only a limited amount of data is available for the postcrisis period.

21. **To account for serial correlation, a lagged-adjustment model is employed, with lagged real money included in the specification.** Elasticities can be calculated from the estimated coefficients.[4] In addition, the specifications include a seasonal dummy variable to control for the temporary increase in currency holdings during the end-year festivities.[5]

22. **Economic theory suggests that the estimated income elasticity of money demand should be near one for currency, and possibly higher for the broader aggregates.** Typically, as income rises and the financial and banking systems become more developed, demand for broad money should increase, while demand for currency would be expected to moderate. As financial intermediation deepens, the need to transact using currency would decline. In the Indonesian case, recent difficulties in the banking system could retard the growth of broad money and lead to a continued reliance on currency. The interest semi-elasticity should be less than zero for currency. Although the interest semi-elasticity for broad money could theoretically be positive, it is generally expected to be less than zero.

23. **Studies for developing countries typically find elasticities consistent with theory.** Sriram (2001) reports on recent studies for a large number of countries, and finds that the income elasticity of broad money demand in developing countries is often above one, while

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[4] For example, the income elasticity is calculated by dividing the coefficient on real income by one minus the coefficient on lagged real money.

[5] Specifications using seasonally adjusted data yield similar results.

the income elasticity of currency demand is close to one in most of these countries. By contrast, Dekle and Pradhan (1997, 1999) find that, for the precrisis period, the income elasticity of broad money demand in Indonesia is near one, and the income elasticity of demand for M1 around 1.5.[6] However, more recent research by BI based on quarterly data from 1984 to 2001 finds that the income elasticity of currency demand is around 1.1, and the income elasticity of broad money demand is near 2 (BI Research Department, 2001). The results in both studies are highly sensitive to the time period considered, and the definition of the opportunity cost variable. Sriram (2001) also reports that the interest semi-elasticity is negative for most countries and monetary aggregates.

Estimation Results

24. **For broad money (M2 and rupiah M2), the results are not fully consistent with theoretical priors or the findings of other studies** (Table 2). Contrary to the findings of other studies, the estimated interest semi-elasticity is positive and statistically significant. In addition, the estimated coefficients vary across specifications and time periods. Alternate

Table 2. Money Demand Specifications for the Period 1990–2001

	M2	Rupiah M2	M1	Base Money	Currency
Constant	-1.94	-0.33	-1.84	-2.55	-2.79
	(0.55)	(0.35)	(0.52)	(0.80)	(0.67)
Interest rate ($x10^3$) 1/	0.68	0.29	-1.54	-1.27	-1.82
	(0.12)	(0.09)	(0.03)	(0.06)	(0.04)
Real income	0.23	0.04	0.25	0.29	0.34
	(0.06)	(0.04)	(0.06)	(0.08)	(0.07)
Lagged money	0.87	0.98	0.78	0.79	0.70
	(0.04)	(0.02)	(0.05)	(0.05)	(0.05)
Crisis*real income ($x10^3$) 1/	2.37	-0.34	2.24	6.33	4.86
	(0.95)	(0.58)	(0.09)	(2.09)	(1.17)
Memo items:					
Income elasticity (precrisis)	1.77	2.25	1.14	1.38	1.13
Income elasticity (postcrisis)	1.79	2.23	1.15	1.41	1.15
Interest semi-elasticity ($x10^3$) 1/	5.25	18.10	-7.00	-6.05	-6.07

Note: Standard errors in parentheses.
1/ For ease of exposition, the table presents actual estimated coefficients multiplied by 1000.

[6] Their specification includes a linear time trend and year-specific dummy variables to account for ongoing liberalization of the financial system.

definitions of the opportunity cost variable and the inclusion of regressors that seek to account for extreme movements in the immediate postcrisis period do not produce robust results. The estimated income elasticities are high (near two), but not inconsistent with results from other developing countries which have undergone significant financial-sector development. The weak results for the broad money specifications could reflect the breakdowns of the monetary transmission mechanism in the postcrisis period.[7]

25. **The specifications for currency and other narrow monetary aggregates yield economically plausible results**. Using data for the full 1990–2001 period, real currency demand increases with real output, as expected, with an income elasticity above one. Increases in deposit rates reduce currency demand, although the estimated semi-elasticities are relatively low.[8] As the coefficient on the crisis variable shows, the income elasticity of currency demand appears to have experienced a small structural increase from the onset of the crisis. The specifications for base money and M1 yield similar results, reflecting the large component of currency in these aggregates. Given these results, the rest of this section focuses on currency demand in greater detail.

26. **For the whole period, the estimated long-run income elasticity of currency demand is greater than one, and broadly stable**. For the period 1990–2001 (including the interaction term to account for the crisis), the estimated long-run income elasticity is slightly above 1.1 (Table 2, last column).[9] The estimated income elasticity is relatively unaffected by the precise time period considered. The coefficient on the interaction term is positive but small. As a result, the estimated long-run income elasticity has barely risen from 1.13 in the precrisis period to 1.15 in the postcrisis period.[10] This result suggests that underlying demand for currency has been remarkably stable, despite the crisis. The estimated long-run income elasticity is consistent with results from other countries and for research covering different time periods in Indonesia.

27. **It is difficult to assess the factors responsible for an income elasticity significantly above one**. The ongoing difficulties of the banking system may reduce the attractiveness of holding deposits and undertaking transactions through the financial system, thereby contributing to the continuing importance of currency. Alternatively, it is possible

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[7] See Bank Indonesia (2001) for an examination of the impact of the banking crisis on the monetary transmission mechanism.

[8] The estimated semi-elasticity of -.0018 in the specification for currency implies that a 100 basis point increase in deposit rates reduces currency demand by 0.18 percent.

[9] For the remainder of this chapter, this specification is considered the preferred model.

[10] Specifications which also include a crisis dummy to account for level changes in currency demand yield similar estimates of the income elasticity.

that as economic development reaches more far-flung and poorer parts of the country which lack banking infrastructure, the demand for currency increases, as a replacement for barter arrangements. Finally, currency demand may have increased in the face of increasing political and economic uncertainty. Such developments are not easily captured in the framework, and specifications including time trends to proxy for these ongoing changes produce inconclusive results.

Alternate Specifications

28. **Splitting the sample into two periods seems to suggest a marked increase in the income elasticity of currency demand in the postcrisis period** (Table 3). Furthermore, a Chow test confirms that the coefficients experience a structural break at the time of the crisis, suggesting that estimates for the whole period which do not account for the crisis may be mis-specified. The behavior of currency in the postcrisis period appears to be highly volatile, however, and the estimated income and interest elasticities vary widely depending on the precise time period considered (last three columns of Table 3). The estimated interest semi-elasticity varies across specifications and time periods. In all cases, higher deposit rates lower currency demand, although the effect is lower for the postcrisis period. The estimated income elasticity in the postcrisis period is above two, which is well above the precrisis value, and inconsistent with findings from other studies. Accordingly, no strong conclusions about the behavior of money demand can be drawn from specifications based only on the short and unstable postcrisis period.

Table 3. Indonesia: Currency Demand Specifications Before and After the Crisis

	Full period 1990–2001	Precrisis 1990–97.6	Postcrisis 1998.1–2001	Postcrisis 1998.7-2001	Postcrisis 1999.7–2001
Constant	-2.06	-2.28	-21.8	-22.3	-28.3
	(0.68)	(0.76)	(3.32)	(3.94)	(3.65)
Interest rate ($x10^3$)	-0.93	-3.52	-3.84	-4.00	-12.6
	(0.41)	(1.38)	(0.56)	(0.5)	(3.21)
Real income	0.22	0.29	2.09	2.11	2.65
	(0.07)	(0.09)	(0.30)	(0.35)	(0.32)
Lagged currency	0.85	0.73	0.10	0.14	-0.04
	(0.04)	(0.07)	(0.11)	(0.11)	(0.10)
Memo items:					
Number of observations	143	89	48	42	30
Income elasticity	1.50	1.08	2.32	2.44	2.56
Interest semi-elasticity ($x10^3$)	-6.22	-12.84	-4.27	-4.57	-12.1
Chow F-test for pre/post crisis	4.25	...	...	...	...

Note: Standard errors in parentheses.

29. **Specifications including exchange rate depreciation as the opportunity cost of currency do not yield robust results.** When exchange rate movements are used instead of the deposit rate, the results suggest that a higher rate of depreciation leads to lower demand for currency,[11] although the coefficient is insignificant (Table 4). If both the deposit rate and the exchange rate depreciation are included, higher depreciation increases the demand for currency. These specifications do not yield robust results, as the estimated income and interest elasticities differ significantly across specifications. Similarly, for the broader monetary aggregates, specifications including exchange rate depreciation yield poor results.

Table 4. Indonesia: Currency Demand Specifications with Exchange Rate Depreciation

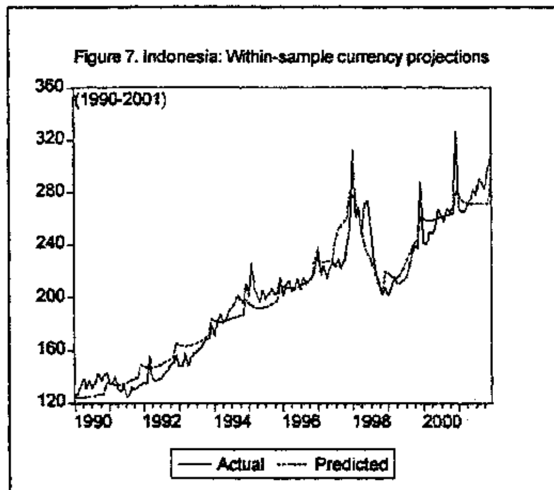
	Full period 1991–2001	Full period 1991–2001	Precrisis 1991–97.6	Postcrisis 1997.7–2001
Constant	-3.15	-4.21	-4.58	0.79
	(0.87)	(0.83)	(1.09)	(2.71)
Interest rate (x10^3)	...	-3.09	-5.79	-4.07
	...	(0.63)	(2.29)	(0.99)
Exchange rate depreciation	-0.02	0.04	1.07	0.09
	(0.01)	(0.02)	(0.79)	(0.03)
Real income	0.35	0.49	0.53	0.15
	(0.09)	(0.09)	(0.12)	(0.21)
Lagged currency	0.75	0.61	0.59	0.52
	(0.06)	(0.06)	(0.08)	(0.10)
Crisis*real income (x10^3)	2.80	5.72	...	...
	(1.11)	(1.18)	...	...
Memo items:				
Number of observations	132	132	78	54
Income elasticity (precrisis)	1.41	1.25	1.29	0.31
Income elasticity (postcrisis)	1.42	1.27	1.29	0.31
Interest semi-elasticity (x10^3)	...	-7.83	-14.03	-8.44

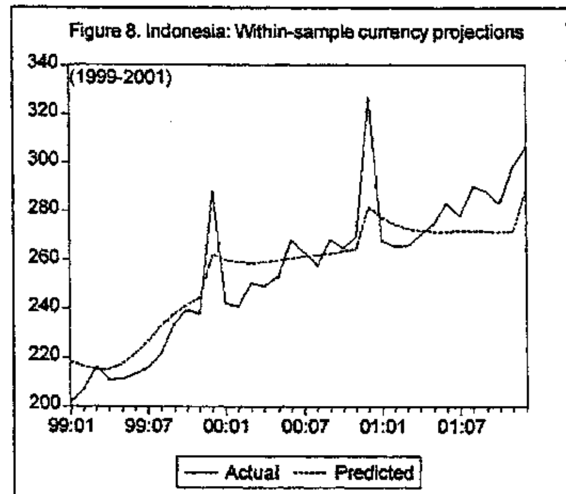
Note: Standard errors in parentheses.

[11] Although somewhat counter-intuitive, this result mirrors the findings of BI's Research Department (mimeo, 2002), and could suggest that depreciation acts as a leading indicator of future inflation, causing individuals to increase their holdings of currency in anticipation of future price rises.

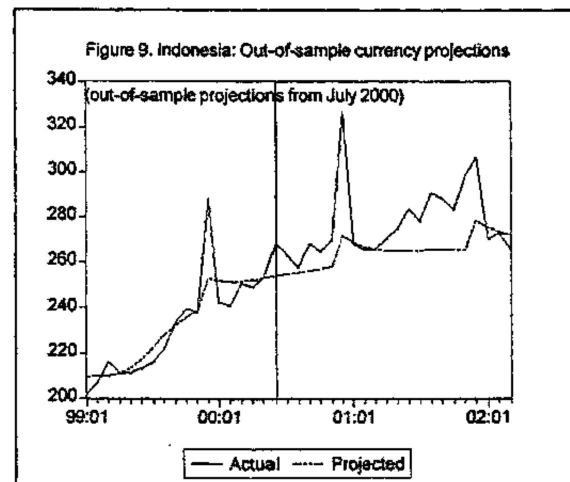
Model Predictions

30. **The preferred model tracks actual currency developments well.** Despite the many shocks over the period, within-sample predicted values fit the actual outcome closely (Figure 7). Although currency is volatile, the simple specification captures the main movements. Historically, deviations of currency from the predicted path tend to be small and corrected relatively quickly. The model does predict a significantly lower level of currency for 2001 than actually occurred (Figure 8). However, since the end of the sample period in 2001, the level of currency has fallen.





31. **The observed decline in currency growth in 2002 is consistent with the predictions from the model.** Out-of-sample projections (based on estimating the preferred model through mid-2000) fit the actual experience through March 2002, except for end-year spikes and a large sustained deviation from March 2001 through the end of that year (Figure 9). It is too early to conclusively assess the reasons for this deviation. However, the fact that recent outcomes can be explained by the model suggest that the over-run in 2001 may have been the result of a temporary shock—possibly related to increased political uncertainty—and not an indication of a permanent increase in currency demand.



E. Conclusions

32. **The Indonesian economy has undergone significant changes in recent years.** Prior to the crisis, the monetary aggregates experienced strong secular movements, partly related to the ongoing development of the financial system. Inflation also fluctuated significantly over this period. As a result of the crisis, the structure of the banking system and the monetary regime changed significantly. In recent years, inflation has risen steadily, while the monetary aggregates have followed divergent paths. Growth in the broad money aggregates has remained subdued, while narrower aggregates, in particular currency, have experienced rapid growth.

33. **Despite the many shocks affecting the economy, the evidence presented in this chapter suggests that monetary developments can be at least partly explained using a standard framework.** Although the results for broad money are weak, a standard framework explains currency demand well. There is evidence that the income elasticity of currency demand is greater than one, and has increased only modestly in the postcrisis period. With the exception of a period in 2001, the model explains actual currency developments well, both within and outside the sample period. The recent decline in currency—in line with the model's predictions—suggests that the 2001 outcome may have reflected largely temporary factors.

34. **These findings suggest that the base money framework remains a useful anchor for monetary policy in Indonesia.** Although currency can experience significant short-term fluctuations, over longer horizons currency demand appears to be relatively stable, with an income elasticity slightly above one. These results appear to imply that part of the reason why inflation has overrun its target is because base money growth has exceeded its programmed path. The findings of this chapter thus highlight the importance of monitoring base money developments, as outturns consistently above the programmed path may provide indications of incipient inflation pressures.

35. **Future work could consider the factors which affect base money outcomes at shorter horizons.** In particular, it would be useful to determine the extent to which base money movements reflect temporary factors. Also, the transmission mechanism between policy interest rates and base money growth could be explored in greater detail.

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III. IBRA: TAKING STOCK AFTER FOUR YEARS OF OPERATION[1]

A. Introduction and Summary

1. **The Indonesian Bank Restructuring Agency (IBRA) was established in January 1998 in response to the banking and economic crisis that hit Indonesia in 1997.** The agency was mandated to administer the government's blanket guarantee programs for all banks' liabilities; manage and restructure banks taken over by IBRA; restructure and dispose of loans in closed IBRA banks; manage shareholder settlement by former bank owners; and recover state funds provided as liquidity support loans to banks.

2. **As part of the bank restructuring program, IBRA has received assets with a face value of roughly Rp 550 trillion (43 percent of 2000 GDP).**[2] Receipts from the management and disposal of these assets sales will help to offset the Rp 703 trillion (55 percent of 2000 GDP) in public sector debt issued towards recapitalizing Indonesia's banks and shoring up the financial sector.[3] However, as the market value of these assets is estimated to be considerably lower than the face value, total recoveries are likely to cover only a fraction of the public cost of the banking crisis.

Table 1. IBRA: Total Transferred Assets (Rp trillions) 1/

Asset type	Face value
AMC	275.2
Loan assets 2/	262.4
Corporate 3/	224.6
Commercial	27.3
SME/retail	10.6
Non-core assets	12.8
AMI (shareholder settlement) 4/	141.4
BRU (govt. bank holdings) 5/	131.7
Total	548.3
As a percent of 2000 GDP	42.8

Source: IBRA.
1/ Represents total assets transferred to IBRA through end-2001.
2/ Principal only.
3/ May include some commercial loans.
4/ Includes Rp 12 trillion settlement of Bank BII.
5/ Represents book value of government investment, after deduction of returned excess recap bonds and exercise of share option rights.

3. **IBRA's performance to date has been mixed.** The annual cash collection targets have been broadly met. However, there has been a significant shortfall in bond recoveries and thus in debt reduction. Between April 1999 and December 2001, cash recoveries amounted to Rp 59 trillion, and recapitalization

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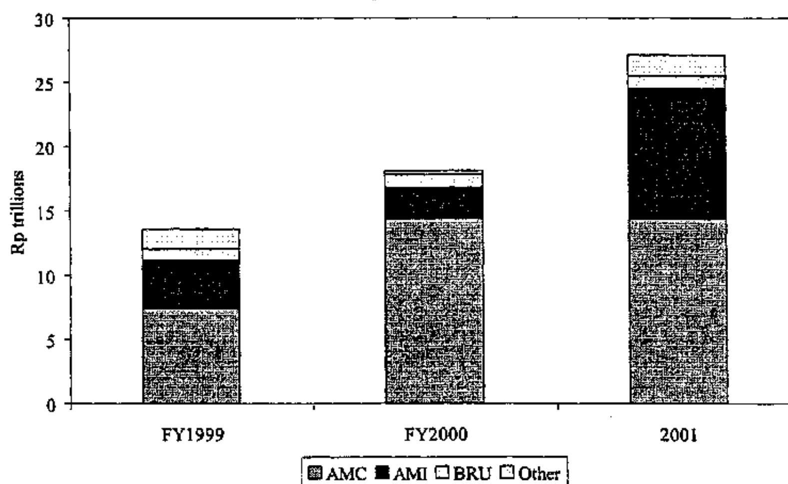
[1] This chapter was prepared by Andrea Richter Hume (APD) in collaboration with World Bank staff.

[2] This estimate includes all assets transferred (loans, noncore assets, and bank equity) or pledged (under the shareholder settlement agreements) to IBRA through end-2001. Government holdings in banks are estimated at book value.

[3] The Rp 703 trillion stock of domestic bonds issued as a result of the financial crisis is composed of Rp 435 trillion in bank recapitalization bonds and Rp 267 trillion in inflation-indexed bonds (indexed principal amount as of January 25, 2002) issued to Bank Indonesia to fund the government guarantee scheme for bank liabilities.

bonds with a nominal value of Rp 11 trillion were returned to IBRA (Figure 1). The bulk of recoveries (60 percent) has come from loan assets, mainly in the form of debt service on loans. Proceeds from shareholder settlement agreements with former bank owners account for roughly one-quarter of total cash recoveries since 1999, while income from bank equity positions managed by IBRA represents less than 5 percent of the total. The remainder was accounted for by income from investments of IBRA funds as well as guarantee premium payments from banks for funding the deposit guarantee scheme.[4]

Figure 1. IBRA Cash Recovery: 1999 - 2001
(Rp trillions)



4. **However, IBRA's asset disposal has lagged.** Loans sales were not launched until May 1999, and have proceeded slowly since then. Due to ongoing disputes, lack of cooperation, and/or outright default of nearly all shareholder settlement agreements with former bank owners, proceeds from the sale of pledged assets have also fallen significantly short of original projections. Finally, bank equity received by the government as part of the recapitalization program remains largely in government hands, due to a lack of political consensus to reprivatize the IBRA banks. As a result of these delays in asset disposal, at end-2001 IBRA still had assets with a face value of roughly Rp 475 trillion (32 percent of 2001 GDP) on its books, nearly four years after establishment of the agency.[5]

5. **Asset recovery rates have been quite low, indicating that total recoveries will fall well short of offsetting the total cost of recapitalizing the banking system.** The low market valuation of IBRA assets has been due to several factors: (i) the high degree of

[4] From 2002 onwards, income from deposit guarantee payments will no longer be counted toward IBRA's cash collection targets.

[5] Transfer of assets to IBRA was still ongoing through end-2001.

impairment of transferred non-performing loan assets; (ii) overvaluation of pledged shareholder assets when originally transferred to IBRA; (iii) weaker conditions in Indonesia's financial and property markets than originally anticipated; and (iv) depreciation of assets since they were transferred to IBRA, in part due to poor management of these assets by IBRA. Thus, after all assets are disposed of, Indonesia will be left with a large public debt stock as a legacy of the 1997–98 crisis.

6. **This chapter reviews the performance of IBRA to date in light of its original strategy, and assesses the challenges that remain for completing its mandate.** Section B presents the main operational units of IBRA, and sets out the original strategy adopted for asset recovery by each of these units. Progress to date is examined in Section C, while Section D considers the challenges that remain for IBRA to complete its goal of returning all assets to the private sector by its sunset date of February 2004. Section E concludes.

B. IBRA Organizational Units and Original Asset Recovery Strategy

Asset Management Credit (AMC)

7. **AMC was set up to restructure and dispose of loans and other (non-core) assets transferred to IBRA from closed (or frozen) and recapitalized banks, including state-owned, joint recap, and taken-over banks.** AMC has been entrusted with managing a Rp 262 trillion portfolio of loans, composed of Rp 225 trillion in corporate loans (principal over Rp 50 billion), Rp 27 trillion in commercial loans (principal of Rp 5–50 billion), and Rp 11 trillion in SME/retail loans (principal under Rp 5 billion).[6] AMC was also tasked with disposing of non-core assets transferred from closed banks, with an estimated face value of Rp 13 trillion.

Corporate loans

8. **The initial strategy for IBRA's corporate debts entailed restructuring the loans before offering them for sale.** The purpose of undertaking restructuring was to aid real sector recovery through improving the financial position of indebted firms, thus allowing them to regain access to credit markets. Also, the aim was for debt restructuring to lead to improve corporate governance and managerial control, as IBRA was usually the primary creditor and could install new management. Another motivation for undertaking debt restructuring before sale, was concern about the risks inherent in returning a large amount of non-performing loans to a still-weak banking system.

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[6] This represents the principal amount of loans transferred to AMC since 1998. In total, loans with a principal of Rp 320 trillion have been transferred to IBRA (including the November 2001 transfer of Sinar Mas Group loans from Bank BII to IBRA); Rp 51 trillion of these have gone to AMI as part of the shareholder settlement program with former bank owners, while the remainder is with BRU or IBRA's Treasury.

9. **The focus of the restructuring effort has been on loans owed by the so-called "Top 21 obligors", given their large share (roughly one-third) in total IBRA loans.** The strategy for managing loan assets was based on an "obligor" concept, under which debtor companies belonging to the same conglomerate ("obligor") would be handled together. Restructuring would entail a careful assessment of the financial condition of the debtor company and its business prospects, which would then allow the determination of a "sustainable" amount of debt. This sustainable portion of debt would be sold and the remaining, "unsustainable" portion of debt converted into equity or quasi-equity, also with a view to its eventual sale.

10. **The disposal of corporate loans was to take place through transparent and market-based auction mechanisms.** There was also a provision for "direct sale" of loans (i.e. without launching a public tender), in cases where a potential buyer offered a minimum of 70 percent of the face value of the loan. In late 2001, IBRA also developed a mechanism to allow for recap bonds to be used as a means of payment for loan purchases (the so-called "Asset-Bond Swap Program"). Strict guidelines were drawn up to govern these sales, which set out a market-based valuation mechanism for calculating the cash equivalent of these bonds, as well as prohibitions on the use of recap bonds to pay for loans of Top 21 obligors (unless the loan's face value was below Rp 250 billion).

Commercial loans

11. **For commercial loans, the asset recovery strategy was based on outsourcing the management of a large share of these loans.** This approach was chosen so as to allow IBRA to concentrate its limited resources on restructuring corporate loans, which represented the bulk of the loan portfolio. Between May and August 2000, IBRA awarded contracts to four banks for the servicing of separate tranches of commercial loans, with a total face value of roughly Rp 13.5 trillion. The servicing agents are paid a management fee for handling the loans and for following up on debt service problems.[7] For the other commercial loans, the strategy envisioned restructuring as well as outright sales.

Retail and SME loans

12. **IBRA's strategy for handling its Rp 10.6 trillion portfolio of SME and retail loans was focused on rapid settlement or disposal.** To encourage debt settlement, incentive programs were offered which granted interest and penalty write-offs ("Crash" program), and in some cases even a 25 percent principal reduction ("Special Crash" program), for settling debt in full within a given time period (usually six months). Loans that did not enter these settlement mechanisms would be offered for sale through loan auctions.

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[7] The fee is based on a monthly payment of roughly Rp 1,000,000 per account plus a success fee of 3.5 to 5 percent of the amount collected.

Asset Management and Investment (AMI)

13. **AMI was given responsibility for managing and disposing of industrial and real estate assets transferred to IBRA from bank shareholders in settlement of outstanding liabilities, and for bank equity holdings acquired by IBRA in the process of bank recapitalization.** Shareholder settlement agreements provided the legal basis under which former owners of closed and taken over banks would settle claims related to their violation of prudential norms, primarily connected party legal lending limits (Box 1). In some cases, shareholders were able to sign agreements under which they pledged sufficient collateral to "settle" their claim in full. These were the so-called Master Shareholder and Settlement Agreements. In cases where shareholders were not able to pledge sufficient collateral, the agreement entailed a "refinancing" of their obligation, and shareholders had to provide a personal guarantee for the entire liability; in other words, would remain personally liable for the entire outstanding amount remaining after recoveries from the sale of pledged collateral. The total due under all settlement agreements amounts to Rp 140 trillion. AMI was also entrusted with the management of other assets originating from taken over banks. These have included collateral pledged by debtor companies, as well as equity positions in debtor companies obtained by the government as a result of the restructuring of loans under AMC.

14. **The strategy for recovery on bank shareholder liabilities was based on selling assets pledged as collateral, as well as receiving regular cash payments as debt service on the settlement agreements.** As described in Box 1, most of the 1998 IBRA banks established holding companies to handle the management and sale of pledged assets.[8] IBRA had representation on these holding companies, and would be closely involved in determining an asset disposal plan. IBRA's ability to enforce the agreements was strengthened by the quasi-judicial power vested in it through government regulation PP17, which gave it the right to sell assets pledged under the holding companies (see below).

Bank Restructuring Unit (BRU)

15. **BRU was entrusted with a variety of responsibilities related to restructuring the Indonesian banking system.** Initially, IBRA oversaw a major consolidation of the banking system through closing unhealthy and non-viable banks. BRU was given responsibility for: (i) administering the government guarantee program for bank liabilities; (ii) managing transactions related to closed or frozen banks; (iii) supervising the financial status and operational performance of banks under IBRA care ("banks-taken-over" (BTO) and "joint-recap" banks); and (iv) the formulation of an annual disposal strategy for bank assets managed by IBRA.

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[8] Originally, the plan had been for the shareholders to transfer the assets directly to IBRA. However, due to concerns related to the notion of government being seen to nationalize assets, holding companies were established instead.

16. **A major responsibility for BRU is managing the equity stakes obtained by the government as a result of its bank recapitalization program.** The government received majority equity stakes in four BTO banks and seven joint-recap banks (Table 2), with a total book value of Rp 132 trillion. The original divestment strategy envisioned the privatization of banks BCA and Niaga by end-2000, and completion of the process of bank divestiture by end-2001.[9]

Table 2. IBRA Equity Stakes in Joint-Recap and Taken Over Banks 1/

	IBRA ownership stake (%)	Book Value of Investment (Rp trillions)
Joint-recap banks		
BII	57	6.6
Lippo	60	6.1
Arta Media	77	0.4
Patriot	81	0.1
Prima Express	89	0.5
Universal	79	4.1
Bukopin	76	0.4
Taken-over banks (BTO)		
Bali	98	5.3
BCA	93	28.5
Danamon	99	70.6
Niaga	97	9.5

1/ Before sales of equity in bank BCA and exercise of share option rights by owners of joint-recap banks.

IBRA Legal Powers

17. **In recognition of the fact that IBRA was mandated with recovering a large amount of government value from bank-related assets, it was vested with quasi-judicial rights to enforce its claims.**[10] Based on Government Regulation 17 ("PP17"), IBRA has public authority to issue a writ (which has legal status and power as a final and binding court decision) to declare a debtor's and its guarantor's debt payable to IBRA within a certain time.[11] Other legal avenues available to IBRA include (i) petitioning the execution of security rights over certain assets (District Court); (ii) submitting a civil lawsuit and petition for debtor imprisonment (District Court); (iii) submitting a bankruptcy petition (Commercial Court); and (iv) submitting a criminal report against the debtor or the company/bank directors to the police (for general crimes, e.g. embezzlement) or to the Attorney General's Office (for special crimes, e.g. corruption). Table 3 below sets out some of these legal remedies and the timeframe each course of action is expected to entail. PP17 legal action is the first priority action for IBRA rather than legal action through a district or commercial court, as actions taken under PP17 can in theory only be postponed or cancelled by a final and binding court decision.

[9] "Memorandum of Economic and Financial Policies" of September 7, 2000.

[10] IBRA's quasi-judicial powers are set out in Article 37A of the Indonesian Banking Law (1999).

[11] PP17 vests IBRA with the authority "to control and/or sell the goods or assets which have been transferred to obtain compensation in respect of the [..] fault, negligence, and/or improper transaction [on the part of bank shareholders, directors, and commissioners]. Such persons [are personally liable and] may be subject to criminal sanctions as stipulated in Article 50 of the Banking Law."

Table 3. Possible Legal Remedies Against Banks and Bank Owners

Party	Instrument	Time frame
	1. Civil Action	
Banks	Default	3-5 years
	Bankruptcy	2 months
	Calling in group debts	IBRA action 1/
Bank shareholders	Enforce personal guarantees / default	3-5 years
	Tort	3-5 years
	Bankruptcy	2 months
	Debtor imprisonment	IBRA action 2/
	2. Criminal Action	
Directors, shareholders	Company law; Attorney General involvement	2-3 years
	Violation of legal lending limits; BI and Attorney General involvement	2-3 years

Source: Netherlands Technical Assistance Project.
1/ As there is a significant degree of intra-group indebtedness amongst IBRA debtor groups, IBRA can force group bankruptcy by calling in group debts.
2/ IBRA has the authority to request summary debtor imprisonment.

C. IBRA's Performance Through 2001

AMC

18. **Although AMC has generally met its annual recovery targets, it has managed to do so primarily thanks to receipts from debt service, as loan disposal has been limited.** By end-2001 only Rp 25 trillion in loans (principal amount) had been either settled by debtors or sold, leaving IBRA with a loan stock of Rp 237 trillion still on its books. From an estimated Rp 13 trillion in non-core assets, roughly Rp 3 trillion has been sold.

Corporate loan restructuring

19. **The loan restructuring effort got off to a slow start.** This was due in part to delays in processing the loans transferred to IBRA from closed or frozen banks, and significant documentation problems encountered in the loan transfer process (known as the "Asset Transfer Kit" or ATK). By June 2000, only 23 percent (in terms of face value) of Top 21 loans that were not in litigation had reached the debt restructuring proposal stage (MOU), while only 2 percent had actually started implementing a restructuring agreement (Table 4). Restructuring accelerated significantly during the following six months, but has stagnated since then; by end-March 2002, the share of loans in the restructuring implementation stages remained below 25 percent. For other corporate loans (i.e. not Top 21), progress in restructuring has been significantly slower, with only 33 percent of non-litigation loans reaching the MOU stage or beyond by end-March 2002. However, a relatively larger share of these (27 percent of total non-litigation loans) had reached the implementation stage of restructuring agreements.

20. **During 2000, concerns emerged that AMC-brokered debt restructurings were providing debtors with excessively favorable restructuring terms.** Key concerns related to the fact that agreements were not based on an adequate assessment of the underlying viability of the enterprise, and thus risked keeping nonviable companies alive (thus exposing the government to further loss of value through asset stripping and the possible incurrence of new liabilities in the future). These agreements also typically were based on below-market interest rates and long maturities, and involved the conversion of a large share of IBRA debt into equity (compared to debt-to-equity conversions proposed for other creditors), thus

Table 4. Progress in Corporate Loan Restructuring, December 1999 - March 2002
(in percent of total loan stock)

		Top 21				*Other corporate*
Restructuring stage		1999 December	2000 June	2001 December	2002 March	2002 March
0	Not initiated	4.8	1.3	0.0	0.0	1.0
1	Initital negotiation	20.0	2.0	0.2	0.2	1.1
2	Creditors' standstill agreement	0.0	0.0	0.0	0.0	0.3
3	Advisory agreement	16.9	1.8	0.0	0.0	1.2
4	Due diligence	18.8	8.6	0.0	0.0	6.4
5	Restructuring negotiation	12.3	52.0	2.5	1.1	18.4
6	Finalize restructuring proposal	13.8	17.6	58.2	58.4	27.4
6.5	of which with signed MoU	0.0	0.0	57.1	52.5	4.5
7	Implementation of restructuring proposal	0.0	1.6	8.8	5.8	9.2
8	Fully paid	0.0	0.1	4.0	4.4	5.0
9	Disposal	0.0	0.0	4.2	7.7	6.1
	Other	0.3	0.0	0.0	0.0	0.0
10 & 11	In litigation (preparation & underway)	13.1	15.1	22.1	22.5	23.9
	Total	100.0	100.1	100.0	100.1	100.0
Memorandum items						
Total stock of loans (Rp trillions)		62.4	87.8	90.8	90.3	128.4
Stock excl. loans in litigation (Rp trillions)		54.2	74.5	70.7	70.0	97.7
Share of ex-litigation loans at MOU stage or beyond (%)		15.9	22.7	95.1	90.8	32.6
Share of ex-litigation loans beyond MOU stage (%)		0.0	2.0	21.8	23.1	26.7

1/ Includes loans handled by other IBRA units, non-resident debtors, retail loans, interbank claims, and derivatives and marketable securities.

significantly eroding IBRA's position as a preferred creditor.[12]

21. **In order to enhance the transparency and quality of debt restructurings, the government publicly adopted a set of Corporate Debt Restructuring Principles in March 2001** (Box 2). The principles set out specific guidelines for debt restructurings, and introduced an independent review process for deals involving large debtors. To ensure transparency, reviews of large debtor restructurings by IBRA's Oversight Committee (OC) have been made public (see Box 3 for a description of the Oversight Committee). Although the OC's suggested revisions are not binding, they have generally been taken into consideration by the Financial Sector Policy Committee (FSPC)[13], which then formally requests IBRA to revise the terms; there have been a number of cases, however, where the final restructuring outcome still featured many of the provisions that were criticized by the OC. By March 20, 2002, the OC had completed reviews of 54 debt restructuring proposals, with another 46 in the pipeline for 2002.

22. **Movement through the restructuring process continues to be slow.** Legal delays have arisen in some cases, which has slowed down implementation considerably. In other cases, agreement with debtors had only been reached provisionally, so that negotiations are in fact still ongoing. There have also been cases where restructuring agreements concluded between IBRA and the debtors were deemed unsatisfactory by the OC, which has resulted in a revision of the original agreements. Finally, disposal of IBRA assets has been slowed somewhat by IBRA capacity constraints on organizing loan sales, and a reluctance to recognize the losses inherent in its loan book.

23. **Despite enhanced oversight, the debt restructuring process has not generally been viewed as a success, with many of the restructured loans effectively in default.** In other cases, loans that have reached the MOU stage have remained stuck there, as the agreements were considered preliminary by the debtors, who appear to have had little intention of completing the process. These difficulties are indicative of the more general weaknesses that still remain in the bankruptcy framework in Indonesia.

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[12] A notable case in which this occurred was for the petrochemical company Chandra Asri, which had total debts of $1.2 billion, of which $460 million was owed to IBRA. The initial proposal entailed IBRA converting 89 percent of its debt into equity, whereas the foreign creditor would convert 14 only percent of its debt into equity, thus significantly weakening IBRA's position as a secured creditor.

[13] The Financial Sector Policy Committee (FSPC) is a cabinet-level committee chaired by the Coordinating Minister for Economic Affairs. In addition to other responsibilities, it is ultimately responsible for IBRA policy.

Corporate loan sales

24. **The first sale of restructured corporate loans was launched in June 2000; loan assets with a face value of Rp 17 trillion had been returned to the private sector by end-February 2002.** So far, no loans from the Top 21 obligors have been sold, although some such loans will be put on the market during 2002. The recovery rate from these sales started out fairly high, equivalent to 70 percent of bids accepted in the June 2000 Corporate Loan Sales I program (Table 5).[14] Subsequent sales saw the recovery rate fall to about 20 percent. Due in part to the decline in the recovery rates offered by bidding investors, IBRA has only managed to sell 57 percent of the corporate loans it has offered for sale through February 2002.

25. **The decline in recovery rates has been due to several factors.** First, assets sold earlier on were generally in better condition (both financially and in terms of documentation) than those sold later. Another reason is that, beginning in May 2001, AMC began selling for sale corporate asset packages, composed of sustainable and non-sustainable debt portions (with the latter having been converted into equity, bonds, and convertible bonds in the debtor companies). This "mixed" portfolio of corporate assets would be expected to fetch a lower rate of return. In addition, the lack of proper restructuring of the loans sold, and purchasers' poor experience in enforcing their creditor rights over the collateral backing purchased loans, may have contributed to the decline in recovery rates.

Table 5. Corporate Loan Sales (Rp trillions)

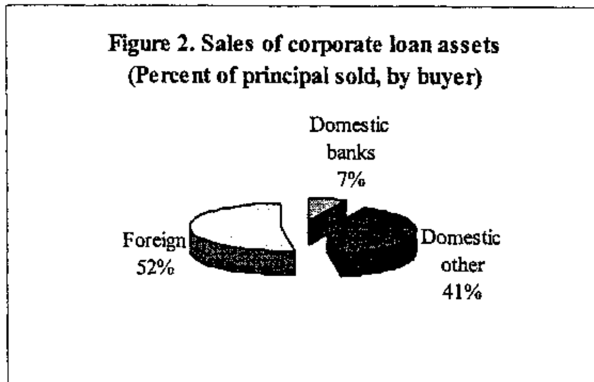
Sales program	Date of sale	Principal offered (1)	Principal receiving bids (2)	Bids made (3)	Recovery rate (%) =(3)/(2)	Principal sold (4)	Bids accepted (5)	Recovery rate (%) =(5)/(4)
CLS I	June 2000	1.6	1.6	0.8	53.2	0.9	0.6	70.1
CLS II	Dec. 2000	7.6	3.0	1.3	41.4	1.8	0.9	50.8
CCAS III	May 2001	7	5.0	1.2	24.9	2.5	1.0	40.7
CCAS IV - 1	Oct. 2001	10.9	9.4	2.1	22.3	9.4	2.1	22.3
CCAS IV - 2	Feb. 2002	2.6	2.5	0.6	22.0	2.5	0.6	22.0
Total		29.7	21.5	6.0	27.8	17.0	5.1	30.2

Note: CLS is "Corporate Loan Sale", while CCAS is "Corporate Core Asset Sale". The former entailed the sale of restructured portions of IBRA corporate loans only, whereas the latter included the sale of equity and quasi-equity positions in the debtor companies that had resulted from the restructuring process.

[14] However, the recovery rate would have been 53 percent if all bids made had been accepted.

26. **So far, Indonesian banks appear to have purchased only a small share of the corporate loans offered for sale by IBRA.** Official estimates indicate that domestic banks purchased less than 10 percent of the total principal value of corporate loans sold through February 2002 (Figure 2). Domestic finance companies and investment funds purchased roughly 40 percent of the total face value sold, while foreign banks and investors accounted for just over half of the total.

Figure 2. Sales of corporate loan assets (Percent of principal sold, by buyer)



27. **IBRA's other disposal mechanisms for corporate loans have not been very successful.** The direct sales program, which requires the purchase price to be at least 70 percent of the face value of the loan, has only resulted in the sale of loans with principal amounting to roughly Rp 130 billion in 2001. With the launch of the asset-bond swap program delayed as technical guidelines were being worked out, bonds have not yet been used as a form of payment in IBRA loan auctions.[15] Moreover, bonds cannot be used as a means of payment in the purchase of large loans.

Commercial loans

28. **Cash recovery from the outsourcing program for the servicing of commercial loans has been poor, and progress in settlement and disposal of non-outsourced commercial loans has been slow.** Through end-February 2002, gross receipts from the program (debt service and debt settlement) were estimated at Rp 2.1 trillion, a rather disappointing result given the size of the loan stock and the management fees paid to the servicing agents. Reports indicate that the program has been less successful than anticipated due to lack of proper incentives in the outsourcing contracts (e.g., compensation for servicing agents was not sufficiently related to performance on the loans they managed). AMC has also been able to settle directly (i.e. not through the outsourcing program) about Rp 3.4 trillion of commercial loans either through full repayment or through sales. A large share of commercial loans has also entered the restructuring process, although most of these remain at a preliminary stage of restructuring.

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[15] Although IBRA recovered a net Rp 6.6 trillion in recap bonds in 2001, none of the transactions behind this result were outright sales. Bank Mandiri remitted Rp 5.2 trillion in recap bonds to IBRA as a repayment for excess recapitalization; Bank Danamon returned Rp 15.1 trillion in bonds in repayment of various outstanding claims; and Bank BII received a net Rp 13.7 trillion from IBRA as part of the SMG loan swap.

SME and retail loans

29. **The program for disposing of SME and retail loans has been a notable area of success.** By end-2001, roughly 70 percent of IBRA's original Rp 10.6 trillion stock of SME and retail loans had been returned to the private sector. Roughly Rp 2.9 trillion in SME/retail debt has been settled through the Crash and Special Crash incentive programs. The other principal mechanism, auctioning SME/retail debt packages, has returned Rp 4.4 trillion in SME/retail debt to the private sector (Table 6).

Table 6. Retail and SME loan sales (Rp billions)

Loan type	Date of sale	Principal offered	Sales proceeds	Recovery rate (%)
Credit card	May 1999	76	39	51.3
Mortgage I	July 2000	328	128	39.0
Mortgage II	August 2000	781	389	49.8
SME, credit card, auto loan	November 2000	3,183	871	27.4
Total		4,368	1,427	32.7

Source: AMC.

AMI

30. **Asset recovery from the shareholder settlement agreements has fallen significantly short of original targets, as only one shareholder settlement agreement has produced significant recoveries.** In addition, the rate of return on assets sold has been lower than originally expected, due in part to the decline in market valuation of assets, but due also to an initial overestimation of the value of many of the pledged assets. Given these facts, total recovery for AMI is likely to be significantly lower than originally envisioned.

Performance of shareholder settlement agreements

31. **Only three of the nine bank owners who signed initial agreements in 1998 have actually finalized them (by completing the transfer of pledged assets).** These bank owners are the Salim Group (which accounts for roughly 90 percent of all proceeds through end-2001), and the two non-holding company shareholder groups (Sudwikatmono and Risjad). All other agreements have some outstanding issues, and four holding companies have not produced any proceeds (Table 1, Box 1). In the case of MRNIAs, where the former shareholders have given a personal guarantee for any liability that may remain after pledged assets have been sold, the considerable decline in the market value of their pledged assets will leave them with a significant debt obligation; it is unclear how these obligations will be met. In the case of Bank Danamon, for example, the remaining assets may only be worth Rp 2 trillion, while the outstanding liability is roughly Rp 11 trillion. Given shareholder's hopes that improving financial and investment conditions may increase the market value of

their pledged assets, and inadequate pressure from IBRA to meet their obligations, there has been little incentive for the shareholders to sell their pledged assets.

32. **Nearly all shareholder settlement agreements are either in dispute or in default.** Those in dispute may feature lack of agreement on the amount of the liability, as well as lack of cooperation from former bank owners in transferring assets to the holding companies. IBRA has had significantly less control over pledged assets than had been envisioned under the original strategy. Under the APUs (debt acknowledgement agreements for the 1999 closed banks), the agreements are simply in default, with bank owners having missed most debt service payments. As a result of these problems, AMI has received considerably less income than originally expected. Only one of the settlement agreements, that for Bank BCA (Salim Group), has actually been performing broadly in accordance with its original terms. Nearly all of AMI's revenue to date (roughly 90 percent) has come from this agreement. Although IBRA has power of attorney (executed and on file) to sell pledged assets in case of default on the agreement, this power has been contested in the courts, and IBRA has been reluctant to use it on a broad scale. Moreover, defaulting and uncooperative shareholders have only in few cases faced significant penalties for their opposition to the use of PP17.

New policy towards shareholder settlement agreements

33. **In light of the poor performance of the settlement agreements, the government introduced a new policy in March 2002 aimed at strengthening enforcement and collections under the agreements.**[16] The stated aim of the policy is to increase the public's sense of economic justice, by ensuring that the former bank owners are made to repay their obligations, while also providing legal certainty for both parties to the agreements. The government has declared its determination to take strict legal actions so as to demonstrate its commitment to (i) "enforcing the law and listening to the voice of the people"; (ii) eradicating "KKN" (corruption, collusion, and nepotism); and (iii) endeavoring to accelerate recoveries for the State which have been pending for four years. The key features of the new policy are as follow:

- Within 30 days, the government shall make a legal determination regarding whether debtors are in compliance with their agreements. A high-level legal team has been appointed to undertake this work, and IBRA's Oversight Committee shall review the determination made by this team before it is communicated to the debtor.

[16] The introduction of this policy represented a significantly enhanced commitment towards enforcing the agreements, compared in particular to an earlier FSPC decision (December 2001), since revoked, under which agreements would have been open to revision (longer maturities and lower interest rates).

- Within 30 days of the original determination, debtors who are in compliance with their agreement shall be provided with a release and discharge from any future criminal charges related to the original violation that gave rise to the liabilities.
- Debtors who are in default will be given three months from receipt of the default determination to come into full compliance with their agreements, before facing strict legal actions to enforce the agreements. These legal actions could include: declaration of bankruptcy, seizure of assets, imprisonment, prosecution on corruption charges, or a travel ban.
- All government agencies involved in enforcing these agreements, namely the Ministry for State-Owned Enterprises, IBRA, Ministry of Justice and Home Affairs, the Attorney General, and the Police, shall step up their cooperation so as to enhance the success of this policy. The Minister of State-Owned Enterprise shall provide monthly progress reports to the President.

BRU[17]

34. **The sale of the government's equity stakes in IBRA's banks has proceeded much slower than envisioned under the original disposal strategy.** The sale of majority stakes in banks BCA and Niaga was expected by end-2000, and the full divestment of all bank equity stakes by end-2001 (Table 7 shows the government's current equity holdings in IBRA banks). However, by end-2001, the only significant sale was a minority share of bank BCA, through a May 2000 IPO (22.5 percent) and a July 2001 public sale (10 percent).[18] These sales raised Rp 1.4 trillion for BRU; the remainder of BRU income for FY1999–2001, Rp 1.3 trillion, came primarily from bank dividends. The lack of progress in this area is due in part to delays in achieving the necessary political consensus for implementing the original divestment strategy. Another delay was caused by the decision in late 2001 to merge four weak IBRA banks with bank Bali. The merger process, which will involve further restructuring, is expected to be completed by end-2002, with divestment of the new bank to follow in 2003.

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[17] This section focuses on BRU's program of bank equity divestment. The staff report provides a discussion of the performance of banks under IBRA control.

[18] In late 2001, the government's holdings in bank Bukopin were fully divested following the exercise of share option rights by the original owners.

Table 7. IBRA Equity Stakes in Joint-Recap and Taken Over Banks, April 2002

	IBRA ownership stake (%)	Share of deposits (%)
Joint recap banks		
Lippo	59	1.4
Arta Media (*)	77	0.2
Patriot (*)	81	0
Prima Express (*)	89	0.2
Universal (*)	79	1.6
Taken-over banks (BTO)		
Bali (*)	98	1.4
BCA 1/	9	11.9
BII 2/	57	3.3
Danamon	99	4.7
Niaga	97	2.1

1/ After the sale of a 51 percent share of Bank BCA to Farallon Capital Management.
2/ BII, previously a joint-recap bank, was taken over by IBRA in July 2001.
(*) Candidate for five-bank merger.

Performance in legal cases and internal financial and control mechanisms

35. **IBRA has had only limited success in enforcing its claims either through the courts or by using its quasi-judicial powers.** Even though actions taken by IBRA under PP17 have the same power as a court order, affected debtors have been successful in challenging this authority and in effect halting the seizure of collateral and other debtor assets. By end-2001, IBRA had processed 2,400 litigation cases, of which 2,125 cases were through the civil courts while 68 cases were brought to the bankruptcy court. Of the total, only 230 were settled, with IBRA mostly on the losing side. For cases brought by IBRA against Top 21 obligors, as of mid-February 2002, IBRA had won 7 out of 25 of the cases in bankruptcy court, and none of the four cases in civil court.

36. **IBRA is seeking to improve its internal financial and control mechanisms.** A longstanding issue is the verification of the nominal value of assets as cited in the original "asset transfer kits" (ATKs) against actual loan documentation.[19] Owing to the poor quality of ATKs received, IBRA has in many cases had to reconstruct the loan payment history and recalculate the amounts due; this effort has represented a significant strain on IBRA's human resources, and explains in part why the restructuring process has taken so long, and loan sales

[19] Outstanding problems in verifying loan documentation have meant that IBRA's audited financial statements contained exceptions in both 1999 and 2000.

have been delayed. In an effort to resolve the matter, IBRA engaged the services of outside consultants to verify the ATK balances for the Top 200 obligors as these represent the bulk of IBRA's loans received by amount. Preliminary results of this analysis indicate that the nominal value of loan assets was significantly overestimated by the originating banks. IBRA is currently assessing options to address this overcapitalization, including the possible return of the excess bonds.

D. Asset Recovery Plan for 2002

37. **At end-2001, IBRA still had assets with an estimated face value of roughly Rp 475 trillion (32 percent of 2001 GDP) on its books** (Table 8). This reflects the slow rate of asset disposal so far. If IBRA is to meet its goal of returning all assets under its management to the private sector by its sunset date of February 2004, asset disposal will have to be stepped up considerably.

Table 8. IBRA: Stock of Assets at end-2001 (Rp trillions)

Asset type	Book value
AMC	246.8
Loan assets 1/	237.4
Corporate 2/	214.1
Commercial	20.3
SME/retail	3.0
Non-core assets	9.4
AMI 3/	106.1
BRU 4/	121.2
Total	474.1
As a percent of 2001 GDP	31.8

Source: IBRA and staff estimates.
1/ Principal only.
2/ May include some loans that are actually commercial loans in size.
3/ Original stock minus the transfer value of sold MSAA assets and cash payments made under MRNIAs. Includes Rp 12 trillion settlement of Bank BII.
4/ Represents book value of government investment, after deduction of returned excess recap bonds and exercise of share option rights.

38. **Recognizing the need to accelerate asset disposal, Parliament has set ambitious IBRA recovery targets for 2002** (Table 9). The target implies an increase of about one third over actual recoveries in 2001. To meet this target, IBRA needs to accelerate efforts in three key areas: (i) sale of its corporate loans, in particular launching the sale of unrestructured corporate loans; (ii) recoveries from its shareholder settlement agreements with former bank owners; and (iii) sale of its banks.

Table 9. IBRA Recovery Targets for 2002 (Rp trillion)

	Jan-Jun	Jul-Sep	Oct-Dec	Total
Gross cash recoveries	14.4	11.0	13.2	38.5
AMC	7.5	9.8	7.2	24.5
AMI	3.9	1.2	4.6	9.7
BRU	3.0	0.0	1.3	4.3
Operational expenses (-)	1.3	0.6	0.5	2.4
Net cash recoveries	13.0	10.4	12.7	36.1
Bond recoveries	0.0	3.0	4.5	7.5

Source: IBRA Finance and Accounting Division.

AMC

39. **The AMC cash target for 2002 (Rp 24.5 trillion) represents two-thirds of total recoveries targeted for IBRA this year.** Another Rp 7.5 trillion in AMC bond recoveries is targeted for 2002. Given that progress in loan restructuring has been slow, most of these recoveries are expected to come from the disposal of unrestructured loans, either through auctions (used for restructured loan sales since December 2000) or new mechanisms, such as joint ventures and securitization. IBRA officials have estimated that achieving the target would require an eight-fold increase in the face value of IBRA loan sales compared with 2001, to nearly Rp 110 trillion. Given this target, AMC will need to move ahead rapidly with the necessary technical preparations. The following loan sales mechanisms are slated for 2002:

- Loan auctions for restructured corporate loan packages, unrestructured corporate loans, and commercial and SME/retail loans.

- Joint venture (JV) sales of unrestructured loans. Although the structure for these joint ventures has yet to be determined, it will likely involve the creation of one or more JV asset management companies (AMCs), to which unrestructured loans will be transferred. Both IBRA and the JV partner would hold equity in the AMCs.

- Securitization of MOU-stage loans into collateralized debt obligations (CDOs). This program would entail the creation of an outside investment structure, to which IBRA loans would be transferred or sold, and which would then sell CDOs to the market.

40. **Meeting the AMC target represents a major challenge.** As noted above, meeting the target will require selling a very large amount of unrestructured loans. It will be important to avoid delays within IBRA and also to ensure that underlying government policies are fully supportive (for example, initiatives such as the recent proposals for large-scale debt write-offs for the SME sector could undermine IBRA's efforts). It will also be important to ensure

that such sales take place through competitive and transparent mechanisms, and that prudential policies are firmly implemented to protect against the risks associated with large sales of unrestructured loans.

41. **IBRA also faces the challenge of managing the significant equity positions that the government has received in debtor companies as a result of the restructuring process.** As of end-2001, these positions had a face value of Rp 83 trillion. Some of these assets will be sold by AMC through future corporate core asset sales (as has already taken place). However, a large share of these assets is likely to be held back from immediate sale, and instead actively managed and possibly repackaged by IBRA for future sales. The potential establishment by IBRA of holding companies to manage any assets that may remain after the end of IBRA's tenure in 2004, as well as those deemed as nationally strategic assets, was approved by the FSPC in March 2002. While repackaging of assets may provide a successful avenue for increasing the recovery value of IBRA assets, care will be needed to ensure that these holding companies do not simply become a warehouse for assets that are deemed either too politically contentious, or otherwise difficult, to sell.

AMI

42. **Asset recovery during 2002 will depend on completing the disposal of assets pledged by the Salim Group, as well as stepping up significantly the enforcement of defaulted shareholder settlement agreements.** As outlined above, AMI is in the first phase of implementing the new policy of enforcing the agreements. Steadfast implementation of the policy should result in a significant increase in returns from these agreements.

BRU

43. **IBRA achieved a major milestone in March 2002 by completing the sale of a 51 percent stake in bank BCA, for an estimated Rp 5.6 trillion.** The bid was won by a consortium led by Farallon Capital, a San Francisco-based investment fund, with capital participation by Djarum, a major Indonesian cigarette manufacturer.

44. **Unlike in previous years, IBRA has already exceeded its target for bank sales receipts in 2002 with the sale of bank BCA.** Over-performance in this area could help offset potential shortfalls elsewhere. Current divestment plans envision the sale of a majority stake in bank Niaga by end-June 2002, with further bank sales slated for the second half. The strategy for the sale of IBRA's remaining banks is expected to be presented to Parliament shortly.

E. Conclusions and Future Challenges

45. **Despite the fact that IBRA is more than two-thirds of the way into its legal tenure, overall progress in asset restructuring and disposal has been relatively slow.** This has partly reflected institutional and political obstacles stemming from a marked lack of political consensus regarding IBRA's mandate, particularly with regards to asset disposal. In addition, there were significant delays in providing IBRA with sufficient legal underpinnings

to implement its asset recovery strategy. Frequent management changes (there have been six IBRA chairmen since its establishment) have also been the cause of further delays in the recovery program.

46. **Looking ahead, IBRA faces major challenges as it seeks to accelerate asset disposal ahead of its February 2004 sunset date.** The 2002 asset recovery targets are appropriately ambitious, but their achievement will require strong commitment on part of IBRA staff, as well as consistent political backing. A key issue in this regard will be the willingness to accept significantly lower returns on many of IBRA's remaining assets, which almost by definition are more difficult to sell. However, it is unlikely that warehousing these assets within IBRA will do much to increase asset value (and more likely will result in a further reduction in value). IBRA therefore must remain committed to rapidly returning these assets to the private sector, using mechanisms that are both market-based and transparent. In this way, IBRA will play its part in fostering a return of investor confidence and laying the basis for a sustained and robust economic recovery.

Box 1. Key Features of Shareholder Settlement Agreements

Shareholder settlement agreements provide the legal basis under which former owners of closed and taken over banks are settling claims related to their violation of prudential norms, primarily connected party legal lending limits and liquidity support provided by BI. These agreements entail bank shareholder obligations amounting to roughly Rp 141 trillion; at end-2001, the remaining obligation was estimated at Rp 106 trillion.

Of the 14 private banks closed or taken over by IBRA in 1998, nine signed settlement agreements entailing claim settlement over four years, for liabilities totaling Rp 112 trillion (Table 1).[1] In seven cases, the shareholders established holding companies to manage and dispose of assets pledged as collateral for shareholder obligations. (For the remaining two, the small amount of collateral did not necessitate the creation of a holding company.) The holding companies are wholly owned by the original shareholders, although in principle IBRA was to participate in managing the company and determine the asset disposal plan. Indebtedness to IBRA was officially transferred from the shareholders to the holding company, which in turn issued promissory notes to IBRA bearing a value equal to the shareholder's obligation minus cash payments initially made as part of the agreement.

Table 1. Shareholder Settlement Agreements for 1998 IBRA Banks

Group	Bank	Holding company	Initial signing date	Due date of promissory notes	Promissory notes issued 1/	Proceeds from asset sales (gross) 2/
MSAAs					(Rp trillions)	
Salim	BCA	Perkasa	9/21/98	11/4/02	52.6	16.3
Nursalim	BDNI	Tunas Sepadam	9/21/98	11/6/02	27.5	0.0
Hasan	BUN	Kiani Wirudha	11/6/98	11/6/02	5.3	0.0
Sudwikatmono	Surya	-	9/29/98	-	1.9	0.6
Risjad	RSI	-	6/4/99	-	0.3	0.2
Total					*87.7*	*17.1*
MRNIAs						
Admadjaja	Danamon	Bentala Kartika	11/6/98	11/6/02	12.5	1.0
Ongko	BUN	Arya Mustika Mulia	12/18/98	12/18/02	8.3	0.0
Hartono	Modern	Cakrawala	12/18/98	12/21/02	2.7	0.1
Hokiarto	Hokindo	Hoswarya Persada	4/23/99	4/23/03	0.3	0.0
Total					*23.8*	*1.1*

Source: IBRA; and staff estimates.
1/ For shareholders without a holding company, represents estimated value of assets pledged by shareholders.
2/ Gross sales receipts through end-2001; excludes dividend payments.

[1] The remaining four (smaller) banks contested their liability and were referred to the Attorney General's office for litigation; these cases have not yet reached legal resolution. There was also a merger of two 1998 IBRA banks.

The 1998 shareholder agreements came in two variants, the Master Shareholder Acquisition Agreement (MSAA) and the Master Refinancing and Note Issuance Agreement (MRNIA), depending on the owners' ability to pledge assets sufficient to cover their liability (Table 2). The most important distinction between the two agreements is that in the case of the MSAA, the agreement was intended to entail a final *settlement* of the bank owners' liability, as the pledged collateral was deemed sufficient in value to cover the entire outstanding liability. In the case of the MRNIA, the agreement entailed a *refinancing* of the liability over four years (although with no set repayment schedule), with bank owners required to provide a personal guarantee through which they remained liable for the entire cash amount set out as the liability.

Table 2. Main Features of MSAAs and MRNIAs

Attribute	MSAA	MRNIA
Estimated value of pledged assets	Covers total obligation	Inadequate coverage
Personal guarantee (to meet shortfall between pledged assets and obligations)	No	Yes
Holdback assets 1/	Yes	No
Holding company establishment	Yes (depends on capability to manage the transferred assets)	Yes
Management of holding company	Appointed by IBRA	Appointed by shareholders
Asset sales	Choice / timing decided by IBRA	Choice / timing decided by shareholder
Market/commercial risk	Borne by IBRA	Borne by shareholders

1/ Under MSAAs, shareholders pledged additional "holdback" assets to cover potential losses stemming from incorrect information provided by shareholders in the settlement process.

Additional settlement agreements in the form of a "deed of (debt) acknowledgement" (APU) were concluded with the owners of 22 banks frozen in 1999, with liabilities of Rp 12.7 trillion.[2] These four-year agreements entailed a regular debt service schedule, with the interest rate set at the SBI rate plus 3 percent. Primary shareholders were required to provide a personal guarantee to back up the agreement. One more settlement agreement was signed in February 2001 with the owners of bank BII on claims amounting to Rp 12 trillion. A personal guarantee and pledge of assets amounting to 145 percent of the liability was obtained from the bank owners.

[2] Of the 44 banks frozen in 1999, eight were found not to have a BLBI liability (hence no settlement agreement was needed), three settled their obligations in cash, six are contesting their liability and were referred to the Attorney General's Office, and two are still in the process of reaching a shareholder settlement agreement.

Box 2. IBRA's Corporate Debt Restructuring Principles

In March 2001, the government adopted Corporate Debt Restructuring Principles, with the aim of fostering a transparent debt restructuring process that will maximize recoveries for the government. The Principles are designed to promote economically viable restructurings, which are critical for allowing indebted companies regain their financial strength, while allowing the government to maximize recoveries. The Principles require that restructuring proposals be based on an assessment of the future viability of the enterprise and estimates of the level of sustainable debt. The assessment is to be based on a full legal and financial due diligence, and include an independent review of the company's business plan. All options for recovery are to be explored, including the sale of loss-making and/or non-core units, or dissolution if the company is found not to be viable.

Sustainable debt is to be rescheduled on market terms, non-productive assets sold and the remaining debt converted into quasi-equity (normally long-term convertible bonds) and equity. IBRA should aim to extract the maximum in cash or other assets as payment and thereafter would maximize the use of convertible bonds or other quasi-equity instruments that require periodic coupon payment. Quasi-equity instruments will retain upside potential by providing IBRA with a right to redeem and/or convert the instruments if there is improvement in the performance or value of the company. With regard to equity, IBRA, together with other similarly situated creditors, will endeavor to assume a majority position (depending on the amount of unsustainable debt converted into equity). This equity position is envisaged to be of a temporary nature and will be used to protect and ensure ultimate recovery of remaining debts to the State.

The Principles entail significantly enhanced oversight of debt workouts proposed by IBRA. The OC is to conduct an independent review of each proposed restructuring transaction above Rp 250 billion that has not been legally closed and that involves single obligors with outstanding debts to IBRA of Rp 750 billion and above. An additional budget is to be provided to allow the OC to hire independent restructuring professionals to carry out the reviews. Reviews have first been carried out for those cases where MOUs had already been considered by the FSPC. For all new cases, reviews are being carried out as soon as IBRA formulates a debt restructuring proposal. The result of the OC's review is submitted together with IBRA's Executive Committee recommendation to the FSPC, which is to publish its final decision on each restructuring case. Although the OC's recommendations are non-binding, the FSPC is required to publish an explanation for any OC recommendation that is not accepted. The OC is also charged with undertaking annual ex-post reviews of those restructuring agreements previously reviewed by the OC to ensure that implementation of the agreements is in line with the original objectives, and will advise IBRA and the FSPC of its findings.

Box 3. IBRA's Oversight Committee

An Oversight Committee (OC) for IBRA was established in July 2000 in order to enhance IBRA's performance, governance, and transparency. The OC has been tasked with three key responsibilities: (i) to uphold and strengthen corporate governance and transparency at IBRA and ensure policy compliance; (ii) to monitor IBRA's performance, especially in strategic areas; and (iii) to make recommendations to IBRA and the FSPC on improvements in these areas. The OC reports to the Minister of Finance and maintains strong links to the FSPC. Its nine members are independent professionals, with strong backgrounds and expertise in law, finance, and economics. To perform its tasks, the OC may appoint independent experts, auditors and consultants.

The OC has played a particularly important role in ensuring that restructurings of IBRA's largest debtors meet the Corporate Debt Rescheduling Principles (Box 2). In the Principles the OC was instructed by the FSPC to conduct an independent review of each restructuring transaction above Rp 250 billion that has not been legally closed and that involves single obligors with outstanding debts to IBRA of Rp 750 billion and above. The result of the OC's review is submitted together with IBRA's Executive Committee recommendation to the FSPC. The OC's recommendations are non-binding.

More recently, the OC has assumed a central role in connection with the government's new policy of enforcing the shareholder settlement agreements. In particular, it will review the determinations made by the legal team tasked with assessing shareholders' compliance with the settlement agreements.

IV. PRIVATE CAPITAL FLOWS TO INDONESIA: 1990–2001[1]

A. Introduction and Summary

1. **During the 1990s, Indonesia's private sector experienced a dramatic reversal of fortune in terms of its access to external financing.** Private capital inflows increased steadily, so that by fiscal year 1996/97,[2] net flows to Indonesia's financial and corporate sectors had reached a surplus of over $16 billion.[3] As the Asian crisis unfolded, new inflows virtually dried up and outflows surged; by fiscal year 1997/98, net flows to the private sector had swung to a deficit of $13 billion.

2. **As a result of the heavy borrowing of the 1990s, by March 1998 Indonesian banks and companies had built up a debt stock of $77 billion (52 percent of GDP), much of which was distressed.** Indonesian banks' external debt was in large part restructured through a government-mediated interbank exchange offer program. Efforts to promote the restructuring of corporate debt were less successful, however, and over half of the estimated $55 billion in corporate external debt may still be distressed.

3. **Tentative signs are emerging that non-sovereign Indonesian borrowers are beginning to regain access to international capital markets.** However, capital flows to Indonesia remain only a fraction of those in the early 1990s, and the recovery has lagged that in other Asian countries.

4. **This chapter reviews the pattern of private capital flows to Indonesia since the early 1990s, focusing in particular on developments since the Asian crisis.** Section B discusses Indonesia's considerable access to market financing in the early to mid-1990s, and Section C describes the impact of the Asian crisis on private flows. The strategies adopted to resolve the considerable stock of distressed external debt owed to private creditors, and the progress made, are examined in Section D. Section E considers the pattern of new private capital flows to Indonesia since the crisis, while Section F presents some concluding remarks.

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[1] Prepared by Andrea Richter Hume (APD) and Sanjaya Panth (PDR).

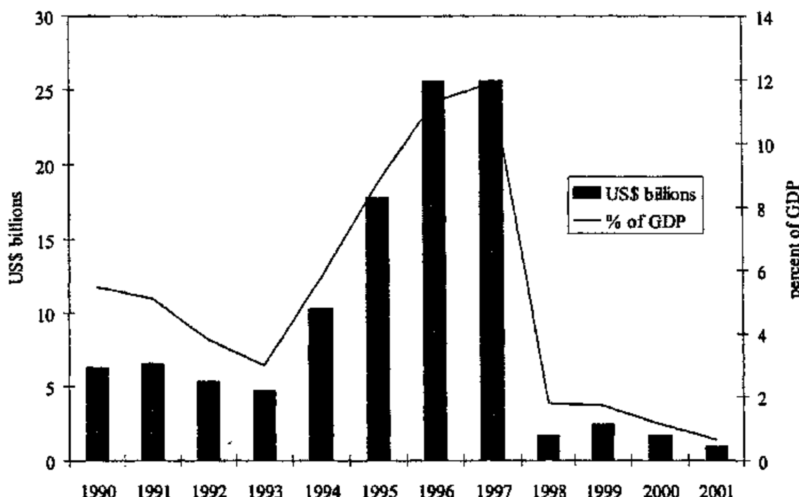
[2] Until 2000, Indonesia's fiscal years ran from April to March.

[3] Balance of payments data (cash basis).

B. Market Access in the Run-up to the Asian Crisis[4]

5. **Indonesia enjoyed considerable access to "spontaneous" global market financing in the 1990s.**[5] Between 1990 and 1993, private inflows of bonds, loans, and portfolio investment averaged $5.7 billion per annum (Figure 1), or roughly 4.3 percent of GDP.[6] These inflows accelerated dramatically starting in 1994, thanks to perceptions of improving economic fundamentals, liberalization of capital market restrictions, and increases in total global flows to emerging markets. Indonesia, along with the rest of Asia, also benefited from a reallocation of global flows away from Latin America in the wake of the Tequila crisis in Mexico. Between 1994 and 1997, annual gross estimated private capital inflows to Indonesia rose from $10.2 billion (5.8 percent of GDP) to $25.6 billion (11.9 percent of GDP), as foreign investors increasingly viewed Indonesia as one of the emerging ASEAN "tigers".

Figure 1. Indonesia: Private Capital Inflows (Bonds, Loans, Portfolio Investment), 1990-2001



6. **During this period, the composition of capital flows remained fairly stable, and reflected the predominance of debt (loans and bonds) over portfolio equity financing.**

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[4] Data sources include Capital Data Bondware, Loanware, the Indonesian authorities and staff calculations. These various sources of data are not entirely comparable, reflecting differences in definitions and coverage.

[5] "Spontaneous" market access is defined here as access to bond, loan, and portfolio investment flows. Although foreign direct investment is clearly an important source of capital, it tends to be a more "restrictive" source of financing, in the sense that it is usually tied to specific investment projects and thus cannot be used freely.

[6] Data for gross portfolio investment flows do not include foreign direct investment.

Debt financing, overwhelmingly in the form of loans, amounted to a cumulative $93 billion during 1990–97, an average of 6 percent of GDP per annum. The large amount of borrowing can be explained in part by the macroeconomic context. The crawling peg exchange rate regime was seen as eliminating most exchange rate risk, thus giving borrowers the confidence to take on FX-denominated debt without necessarily having a natural hedge (i.e. through having significant FX earnings) or taking out a contractual hedge on their borrowings. As Bank Indonesia (BI) raised interested rates in an effort to contain inflationary pressures, the resulting interest rate differential further encouraged foreign borrowing.[7] Also, a significant share of borrowing was accounted for by Indonesian subsidiaries of foreign enterprises, with good access to foreign capital. As a result of the rapid run-up in foreign borrowing, the external debt of banks and the corporate sector (including state-owned enterprises) increased from $28 billion in March 1994 to $77 billion four years later (Table 1). Most of this debt was incurred directly by Indonesian corporates, rather than intermediated through the Indonesian banking system.

Table 1. Indonesia: External Debt, March 1996 - December 2001 (US$ billions) 1/

	Mar. 1996	Mar. 1997	Mar. 1998	Mar. 1999	Mar. 2000	Dec. 2000	Dec. 2001
Public sector	58.6	52.6	54.2	68.4	74.7	74.9	73.8
Central government	58.6	52.6	51.2	59.2	64.2	61.7	62.4
Bank Indonesia	0.0	0.0	3.0	9.2	10.5	13.2	11.4
Banks 2/	8.9	9.6	12.8	11.8	10.5	7.8	7.5
Public	2.9	3.0	5.0	4.9	4.7	4.2	3.8
Private	6.0	6.6	7.8	6.9	5.8	3.6	3.7
Corporates 3/	38.9	50.9	64.6	68.0	57.7	58.5	55.0
Private companies	34.0	47.2	60.8	62.8	51.9	52.8	51.2
State-owned enterprises	4.9	3.7	3.8	5.2	5.8	5.7	3.8
Total 4/	106.4	113.1	131.6	148.2	142.9	141.2	136.3
As a percent of GDP	52.4	48.1	88.6	143.2	95.8	92.8	93.7

Source: Bank Indonesia and JITF.
1/ Debt owed to public and private creditors.
2/ Bank Indonesia data.
3/ JITF data.
4/ Excludes domestic securities held by foreigners.

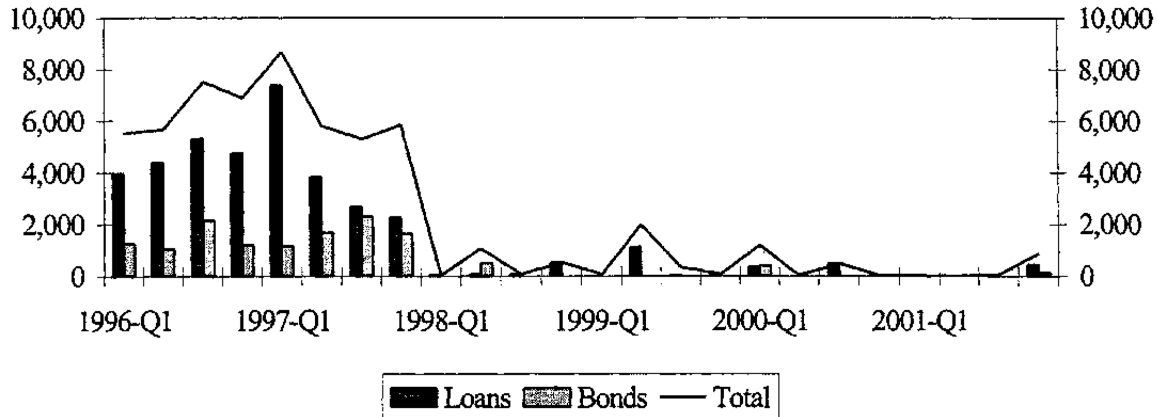
7. **Commercial borrowing by the government remained limited.** With the budget generally in balance or surplus, public sector borrowing requirements were small and official financing sources were readily available for development expenditures. As of mid-1997, total outstanding sovereign debt owed to commercial creditors amounted to less than $1 billion, including the July 1996 10-year, $400 million Yankee bond issue.

[7] The preference for debt financing may also have been due to the reluctance of Indonesian private banks and companies to give up ownership control, which would occur through FDI or portfolio equity financing.

C. The Behavior of Capital Flows During the Asian Crisis

8. **There was a dramatic reversal of private capital flows to Indonesia as the Asian crisis unfolded.** Gross flows had peaked in the first quarter of 1997 at $8.7 billion, equivalent to 16 percent of GDP on an annualized basis (Figure 2). As the rupiah began its rapid depreciation and equity prices start to fall, creditors became increasingly worried about the financial condition of Indonesian borrowers, many of whom had significant unhedged external debt positions. Inflows started declining although bond issuance remained fairly robust through the third quarter of 1997. Significantly, however, unidentified capital outflows began to emerge and the errors and omissions line in the balance of payments swung from a surplus to a large deficit. Net portfolio investment, although not a significant source of inflows in previous years, was particularly affected - net outflows of $5.5 billion were recorded during the last quarter of 1997, compared to net inflows averaging $0.7 billion during the preceding six quarters.[8]

Figure 2. Indonesia: Private Capital Inflows, 1996-2001
(US$ billions)



9. **The depth and duration of the crisis had a profound impact on the corporate sector**. During the 1997/98 fiscal year, capital flows to the corporate sector (including capital flight) as measured in the balance of payments[9] swung by nearly $28 billion. Gross private

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[8] Some of these outflows may simply represent misrecorded capital flight.

[9] Given data limitations, net capital flows to the private corporate sector are measured as a residual between the overall balance of payments and measured flows to the public sector, public enterprises, and banks.

inflows data indicate that only one company, Asia Pulp and Paper (APP), was able to access the offshore bond market in 1998,[10] and that total new loan issuance was minimal, only $0.7 billion, compared to the pre-crisis peak of $18.5 billion in 1996. Lack of access to new inflows in the face of large debt payments falling due led to the emergence of substantial arrears in the corporate sector from the first quarter of 1998 onward.

D. Resolution of Indonesia's Distressed External Debt

10. **The crisis required addressing two problems simultaneously – the hemorrhaging of foreign exchange from Indonesia and the rising stock of distressed external debt.** A joint strategy was devised in an attempt to convince creditors that their existing claims on Indonesian entities would be met, thereby reducing their incentives to diminish their Indonesia exposure even further.

11. **An agreement with commercial creditors on such a multi-pronged strategy was reached in June 1998.** The deal was the culmination of a series of discussions between the Indonesian authorities and the Steering Committees of creditor banks held in New York, Tokyo, and Frankfurt between April and June 1998. The agreement, designed to rein in capital outflows both directly (through the rescheduling of obligations due) and indirectly (by helping normalize relations with creditors), covered three types of debt: (i) interbank debt; (ii) trade financing; and (iii) corporate debt.

Interbank debt restructuring

12. **The initial agreement for restructuring interbank debt entailed an exchange of the original obligations of Indonesian banks for new loans backed by a sovereign guarantee.** These so-called Interbank Exchange Offer (IEO) loans were guaranteed by BI. The agreement addressed the considerable difficulty that banks were facing in rolling over their external lines of credit. Although Indonesian banks continued making considerable net payments on their outstanding obligations – the stock of bank external debt declined by $3.3 billion during the first five months of 1998 – arrears also continued to accumulate. Under such circumstances, creditors were unwilling to roll over maturing debt, thereby exacerbating Indonesia's external financing problems.

13. **The agreement reached in June 1998 on the first IEO loans provided for a rescheduling of obligations falling due before end-March 1999 according to a menu of four options.** The options involved exchanges of eligible debt for new loans with a maturity between one to four years, and interest rates of LIBOR plus an escalating margin depending on the maturity chosen. Under the scheme, the nominal debtor remained the same, but the new loans benefited from a sovereign guarantee. As part of the agreement, foreign creditor banks agreed to roll over maturing lines of credit until the finalization of the exchange offer.

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[10] Although APP retained market access through the Asian crisis, it eventually defaulted on $13 billion in global debts (Box 1).

14. **The definition of debt eligible under the IEO scheme was unduly complex and led to difficulties in arriving at a precise estimate of the eligible amount.**[11] Although the initial estimate was as high as $9 billion, in the event debt amounting to only $2.7 billion was tendered in August 1998. The lower figure reflected the fact that net payments had been made before the exchange took place (total bank debt declined by a further $1.6 billion between end-May and end-August 1998), the roll-over of additional loans maturing after the March 1999 cut-off date, and alternative work-outs arrived at between debtors and creditors.

15. **Agreement on a second interbank debt exchange offer was reached in March 1999, covering debt falling due until end-2001.** The structure of the offer was broadly similar to the first exchange offer with some changes in the definition of eligibility. Overall, the second offer included better terms for Indonesian banks, with a longer consolidation period, longer maturities and grace periods, and lower interest rates. About $3.5 billion of debt was exchanged under the second IEO offer.

16. **The interbank exchange offers substantially increased sovereign commercial liabilities, albeit contingent in nature.** The provision of a government guarantee has not, however, led to substantial costs for the government, as banks (excluding those frozen in connection with bank restructuring) have been able to meet their debt service obligations. The government itself only had a limited amount of commercial debt maturing in the aftermath of the crisis; a total of $0.5 billion in principal payments was restructured under the aegis of the London Club. This was required under the comparable treatment clauses of the 1998 and 2000 Paris Club rescheduling agreements with bilateral official creditors.

Trade financing

17. **The trade-financing element of the agreed strategy required creditor banks to work closely with BI to maintain Indonesian banks' access to trade financing.** The agreement called for participating foreign banks to make their best efforts to maintain, for one year, their aggregate trade credit exposure to Indonesian banks at end-April 1998 levels. Trade credits extended in line with these undertakings would also benefit from a full dollar guarantee from BI. Creditor banks were required to report monthly to BI and their national supervisory authorities on their exposure, with BI using the reports to direct domestic banks with trade credit needs to foreign banks with underutilized commitments. Notwithstanding BI's guarantee, foreign banks remained free to choose their counterparts and to decline any finance transactions proposed by BI.

[11] Eligible debt included short-term debt (excluding trade credits), medium- and long-term debt falling due within the consolidation period, and derivatives other than short-term forward foreign exchange contracts and options used in trade financing.

Corporate debt restructuring

18. **The agreement on corporate external debt reached in 1998 aimed to provide a framework for voluntary restructuring of outstanding obligations consistent with Indonesia's overall payment capacity,** while also providing companies with cash-flow relief and thus, some breathing room from the crisis. The agreement entailed the creation in Auguust 1998 of a new government entity, the Indonesian Debt Restructuring Agency (INDRA), to provide foreign exchange guarantees for domestic corporations that had reached restructuring agreements with creditors (Box 2). This was seen as an important incentive for debtors and creditors to conclude debt workouts, by reducing the uncertainty associated with large swings in the exchange rate. The Jakarta Initiative Task Force (JITF) was subsequently launched in September 1998 to provide technical support for debt restructurings and administer the out-of-court debt workout framework (Box 3).

19. **In contrast to the experience of external interbank and short-term trade debt, much of the external corporate debt remains in distress** (Table 2). Official estimates indicate that as of end-2001, over half (roughly $31 billion) of corporate external debt remained non-current in meeting payments falling due.[12] This estimate of distressed external debt may overstate the true situation to some extent, reflecting the large representation of "foreign direct investment companies" in the corporate external debt statistics. In many cases, loans extended to these firms received the explicit backing of their parent companies, and in some cases even a formal guarantee. As of end-2001, firms that were majority-owned by foreigners accounted for about half of corporate external debt. In addition, while there are no comprehensive data available, some distressed corporate debt assets are being traded at substantial discounts on the secondary market, and part may have been repurchased (see below).

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[12] Data on corporate debt are JITF estimates. Precise figures are unavailable due to weaknesses in the monitoring framework as well as the variety of arrangements reached by Indonesian corporate debtors with their creditors. The estimate reflects some data from the creditor side, the profile of debt between different types of companies, and available domestic data on on-shore distressed debt (close to half of all on-shore loans, which are also significantly distressed, are denominated in foreign currency).

Table 2. Indonesia: Corporate Debt
(In billions of U.S. dollars, as of December 31, 2001) 1/

Status	Onshore	Offshore	Total
Distressed	36.7	30.7	67.4
Non distressed	29.1	24.4	53.5
Total	65.8	55.1	120.9

Source: JITF.
1/ Data do not include trade payables and credit extended by finance and loan companies.

20. **Part of the corporate external debt stock has been restructured**. Although the JITF is itself never a formal party to restructurings, it is charged with administering the out-of-court framework established to facilitate restructuring, and provides support in key areas. Outside of the JITF framework, the Indonesian Bank Restructuring Agency (IBRA) often takes the lead in corporate debt workouts for cases where it is the majority creditor.[13] The total amount of debt (domestic and external) that has been restructured (i.e. with signed legal documentation or some degree of implementation) under the aegis of the JITF or through IBRA stood at about $9.6 billion at end-January 2002, with about half representing external debt. An additional $4.8 billion in debt workout cases under JITF had reached the Memorandum of Understanding (MOU) stage, although in some cases, debtors that had already signed MOUs subsequently defaulted. Outside of the JITF/IBRA framework, an additional 32 companies had reportedly restructured their debt (domestic and external), amounting to $4.2 billion in total, between September 1998 and end-2001.

21. **Completed restructurings have relied heavily on debt rescheduling and debt-to-equity or debt-to-convertible-bond swaps**. The use of absolute write-offs, debt buybacks, and cash payments has been relatively low, particularly for debt restructurings involving the JITF. Companies that have reached restructuring agreements outside of the JITF/IBRA framework report a high percentage of debt rescheduled and a lower percentage of debt-to-equity swaps. This has been attributed to the relatively stronger financial position of these firms in comparison to those whose debt was restructured under IBRA or JITF.

Direct debt workouts

22. **There is also anecdotal evidence that a substantial amount of market-based debt reduction has taken place**. According to market analysts, there appears to be a fairly large secondary market for distressed debt. While estimates of the size of this market are difficult to obtain, market sources suggest that upwards of 30 percent of the distressed debt may have

[13] See Chapter III of this *Selected Issues* paper for a discussion of corporate debt restructuring undertaken by IBRA.

actually been taken out of the market through unreported debt buybacks. These debt buybacks are often undertaken through hidden transactions by nominees of the debtors, who then appear as creditors during restructuring discussions, strengthening the debtor's hand in reaching agreement on resolving the remaining outstanding amounts. Debtors also have financial and regulatory incentives not to report buybacks: tax rules require substantial payments for debt bought back at discounts, and in cases where IBRA is a major creditor, there is a prohibition on buybacks from third parties until IBRA liabilities are settled.

23. **In addition to buybacks, there is also anecdotal evidence of firms having reached informal agreements with creditors for making payments whenever their earnings exceed certain thresholds.** Creditors that have had long established business, familial or personal relationships with debtors may be willing to agree to such understandings and debtors may be willing to abide by them for the same reasons. However, it is difficult to judge how significant these arrangements are, as there are both insufficient incentives and technical difficulties in monitoring understandings reached or payments being made.

E. Private Capital Flows Since the Asian Crisis

24. **New capital flows to Indonesia have barely picked up since the Asian crisis.** For the 1998–2001 period, gross private inflows (bonds, loans, and portfolio investment) have averaged only $1.7 billion per annum, or roughly one-quarter of private inflows in 1990. Moreover, some of these amounts may actually reflect rollovers of maturing debt rather than "new" money. Data from the balance of payments indicate that total net capital flows to the financial and private corporate sectors have remained significantly negative, equivalent to roughly 8.5 percent of GDP in fiscal years 1998 and 1999, and narrowing somewhat to roughly 5 percent of GDP since then.

25. **Although there was some interest in Indonesia in 1999 as a "cheap" investment opportunity, flows have remained extremely limited as deeper structural problems became apparent.** Investor interest has also been constrained by political uncertainty, as well as continued problems in the economy and a perceived lack of serious restructuring in the corporate sector. The March 2001 default of APP on over $13 billion in foreign debt—the largest emerging market debt default in history—further impeded market access for Indonesian firms due to concerns about accounting irregularities (Box 1).

26. **Indonesia's limited access to private capital flows since the Asian crisis contrasts markedly with recent experience in some other Asian crisis economies, most notably Korea.** This reflects a global trend towards greater differentiation between emerging market investment opportunities. According to market analysts, the extent of progress on banking and corporate sector restructuring in the wake of the crisis has been a particularly important factor in this analysis. Also, the legal and judicial frameworks available for handling bankruptcy and other distressed asset situations have come into greater prominence since the crisis. In all these areas, progress in Indonesia is perceived to have lagged.

27. **Despite these concerns, market sentiment towards Indonesia has improved somewhat since mid-2001, as investors have responded favorably to recent signs of greater progress on privatizations and economic reforms more generally.** The resolution of political uncertainty following the election of President Megawati, combined with recent steps to accelerate economic reform and state asset sales, has led to a strengthening of investor sentiment. However, investors remain wary about committing funds to Indonesia, given continued concerns related to weaknesses of the legal and judicial infrastructure, which lessen the ability of investors to enforce their property rights, as well as security issues.[14]

Table 3. Indonesia: 2002 Privatization Program

Company	Industry
Carryover assets from 2001 program	
1. PT Wisma Nusantara International	Hotel & Office Space
2. PT Angkasa Pura II	Airport management
3. PT Indofarma Tbk.	Pharmaceutical
4. PT Kimia Farma Tbk.	Pharmaceutical
5. PT Indosat Tbk.	Telecommunications
6. PT Batubara Bukit Asam	Mining
7. PT Indocement TP,Tbk	Cement
8. PT Semen Gresik Tbk	Cement
9. PT Bank Mandiri	Banking
Assets from 2002 program	
1. PT Intirub	Tire
2. PT Atmindo	Engineering Consultant (Agro)
3. PT Cambrics Primissima	Engineering Consultant
4. PT Iglas	Glass Industry
5. PT Jakarta International Hotel	Hotel, Property
6. PT Kertas Blabak	Paper
7. PT Kertas Padalarang	Paper
8. PT Kertas Basuki Rahmat	Paper
9. PT Indah Karya	Construction Consultant
10. PT Indra Karya	Construction Consultant
11. PT Virama Karya	Construction Consultant
12. PT Yodya Karya	Construction Consultant
13. PT Rukindo	Dredging
14. PT Rekayasa Industri	Engineering Consultant
15. PT Angkasa Pura I	Airport management
16. PT Danareksa	Investment Banking

Source: Ministry of State-Owned Enterprises.

28. **The first major post-Asian crisis Indonesian bond issue took place in December 2001,** when state-owned Bank Mandiri, the largest bank in Indonesia, issued a five-year $125 million floating rate note.[15] The bond's success augurs well for an intended IPO for the bank, which is expected to sell 30 percent of its equity in 2002. The first return of an Indonesian corporate to the global bond market occurred in March 2002, with Medco Energy raising $100 million through a five-year note, issued at a spread of roughly 600 basis points over the 5-year U.S. Treasury note.[16]

29. **With consistent implementation of the 2002 targets for IBRA asset recovery and privatization, equity flows to Indonesia could pick up further**. Recent sales have indicated that interest in Indonesia is

[14] A recent quality-of-life survey conducted by Political and Economic Risk Consultancy of foreign business executives in 12 Asian countries put Indonesia in last place due to heightened concerns about personal security.

[15] The five-year bond, with put and call options after three years, was increased from $100 million to $125 million due to increased demand from offshore investors.

[16] Market reports indicate that a number of other Indonesian banks and companies are planning to access global debt markets this year.

healthy. In December 2001, a 12 percent share issue for Telkom raised $300 million, while the much-anticipated sale of a 51 percent stake in bank BCA in March 2002 has brought in flows of roughly $570 million. The government's privatization program for 2002, which aims to raise Rp 6.5 trillion, includes a number of assets that are likely to draw significant interest from foreign investors (Table 3).

F. Concluding Remarks

30. **In marked contrast to Indonesia's ample access to market financing in the 1990s, new private capital flows have yet to return on any significant scale since the Asian crisis.** Investors have remained wary of providing new financing to the Indonesian corporate sector, which is viewed as having made only limited strides towards restructuring, despite the variety of government efforts in this regard. In addition, problems that have emerged with respect to accounting irregularities in major Indonesian companies (most notably APP), as well as high-profile court cases involving apparent attacks on foreign holdings of Indonesian companies, have added to the perception that investing in Indonesia remains a high-risk proposition. Given the poor state of the corporate sector, capital flows to Indonesian banks have consequently also remained limited, as banks are reluctant to lend to a heavily indebted corporate sector.

31. **Recent indications of a slow return of market confidence are encouraging, but also pose challenges if the mistakes of the past are not to be repeated.** Concerns remain about the extent of real restructuring undertaken by Indonesian companies since the crisis; the banking sector is still in a process of consolidation; and broader structural reforms need to be further accelerated. Given Indonesia's significant need for new private capital inflows over the medium term, progress in these areas is critical, both to attract the necessary financing, as well as to ensure that such financing does not later give rise to new vulnerabilities. In particular, measures to put in place a sound and transparent banking system, improve the legal and judicial framework, and strengthen corporate governance remain key to ensuring that Indonesia can reduce its vulnerability to future vagaries in foreign capital flows.

Box 1. Asia Pulp and Paper

On March 12, 2001, Asia Pulp and Paper (APP), one of the world's leading pulp and paper companies, declared a payments standstill on over $13 billion in global debt. This constituted the largest ever default of an emerging market corporation. The extent of APP's indebtedness caught many of its creditors by surprise, as serious accounting irregularities and APP's network of shell companies had masked the overall financial position of the conglomerate. APP creditors include foreign financial institutions (including Deutsche Bank, ABN Amro and Credit Lyonnais), and large institutional investors. Headquartered in Singapore, APP was once the flagship of the Sinar Mas Group, Indonesia's third-largest conglomerate.[1]

Despite successfully weathering the Asian crisis, APP's heavy borrowing, in part to finance expansion in China, resulted in an unsustainable financial position. APP had enjoyed considerable access to international financing before the crisis, issuing $2.1 billion in debt through mid-1997 and raising equity financing through a listing on the New York Stock Exchange. When Asia's financial crisis hit, investment banks still managed to sell APP's bonds as an Asian recovery play, as pulp and paper prices rebounded in the second half of 1999. Between November 1997 and mid-2000, major APP subsidiaries reportedly issued an additional $4 billion in debt, in part to finance APP's expansion into China. During 2000, however, APP's financial position came under significant pressure due to looming interest payments and a collapse in pulp and paper prices, and investors began demanding increased yields to offset the perception of higher risk. By mid-2000, APP found itself unable to roll over debt falling due, and missed its first interest payment in February 2001. This was followed by a global payments standstill in March 2001.

At the time of default, APP's major creditor groups agreed to a moratorium on legal action against APP, so as to provide the conglomerate with breathing room to work out a restructuring plan. Given this forbearance, APP's creditors, which include bondholders, banks, export credit agencies, and trading companies, reacted negatively when pressure was exerted by the Indonesian government on local APP subsidiaries to continue servicing debt owed to domestic creditors. In early February 2002, APP unveiled a debt-restructuring plan that was broadly dismissed by creditors as unsatisfactory. Creditors reportedly rejected APP's aim to extend the maturity of debts for up to 13 years, and the expectation that the group's founders, Indonesia's Widjaja family, would retain control, with debt-to-equity swaps not discussed. Creditors also complained that APP has continued to pay interest to Indonesian rupiah bondholders, thus violating the terms of the global standstill agreement under which all creditors would be treated the same. Given how much capital is tied up in APP's debt, the slow process in restructuring could dampen prospects for the renewal of private capital flows to Indonesia.

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[1] The Sinar Mas Group includes up to 200 companies in pulp and paper, agriculture, food, property, and finance. APP accounted for roughly 80 percent of the group sales and for almost 6 percent of Indonesia's non-oil exports in 1999.

Box 2. The Indonesian Debt Restructuring Agency (INDRA)

In August 1998, Indonesia launched a framework for the voluntary restructuring of external corporate debt, known as the Indonesian Debt Restructuring Agency (INDRA) program. The key aim of the scheme was to protect debtors from further depreciation of the rupiah while allowing them to benefit from any appreciation of the currency over the following two years. All foreign-currency debt of Indonesian corporations owed to non-resident creditors was eligible for the program (excluding debt with a sovereign guarantee), provided that there was a grace period ending after December 2001 (three years) and a final maturity ending after December 2006 (eight years).

INDRA was intended to operate as a self-financing intermediary between the debtor and creditor, receiving rupiah payments from the debtor and making foreign-exchange payments to the creditor. Debtors would make upfront payments in rupiah in return for the foreign exchange guarantee, with the rupiah funds invested until payments to the creditor fell due. BI was to administer the scheme and be liable for debt repayment. The exchange rate was the best (i.e. most appreciated) 20-day moving average of market rates during the program entry period (August 1998–June 1999), subject to a floor. There was also provision for recalculating the rupiah value of all outstanding loans if the exchange rate appreciated by more than anticipated. The rupiah loans would carry a real interest rate of 5.5 percent, with the principal amount indexed to inflation. Entry into INDRA required creditors and debtors to have already completed a debt workout.

INDRA was allowed to lapse in mid-2000 after only one firm made use of the facility during its two years of operation. The failure of INDRA was attributed to various reasons. Given the significant depreciation of the rupiah, debtors were unwilling to lock themselves into a rate that they considered excessively depreciated, despite the program provision of revaluing the rupiah loan value, should the rupiah appreciate. In addition, many debtors did not qualify, due to their inability to reach debt-workout agreements with creditors. Finally, debtors faced cash flow problems that were likely to have precluded them from making the required rupiah payments, even if they had otherwise qualified for the program.

Box 3. Jakarta Initiative Task Force (JITF)

In an effort to address Indonesia's financial crisis, the government created two institutions to help restructure the banking sector and aid individual companies to restructure their corporate debt. The Indonesian Bank Restructuring Agency (IBRA) was established to oversee the bank restructuring process, while the Jakarta Initiative Task Force (JITF) was established to serve as a mediator and facilitator of specific restructuring cases, particularly those involving foreign lenders. On a case-by-case basis, the JITF applies a set of international "best practice" guidelines for debt restructuring. In applying these guidelines, the JITF is required by FSPC decree to establish and enforce a mediation schedule, specifying the timing and expected results of meetings between the parties. If, during the course of the negotiations, specific issues arise that are appropriate for mediation, JITF personnel intervene and act as mediators.

In the event a company completes a debt restructuring under the JITF and is classified as a "cooperative debtor", it becomes entitled to a series of tax and other regulatory incentives. These include favorable tax treatment with respect to withholding tax and income tax on debt-for-asset and debt-for-equity swaps, regulatory dispensation from BI, and favorable listing treatment from the Jakarta and Surabaya stock exchanges. In the event a company fails to complete a debt restructuring under the JITF *and* is classified as an "uncooperative debtor", the JITF is required to file a report with the FSPC, who may elect to publish the name of the uncooperative debtor or to refer the matter to the Office of the Attorney General with a recommendation for commencement of bankruptcy proceedings.

By providing necessary facilitation and mediation services, as well as a system of "sticks" and "carrots" to encourage productive negotiations, the JITF is intended to accelerate individual debt restructuring negotiations. By end-March 2002, roughly $24 billion in corporate debt had registered with JITF for mediation, with $15 billion having already reached a memorandum of understanding for a restructuring agreement.

V. Fiscal Decentralization: Developments to Date and Key Challenges[1]

A. Introduction and Summary

1. **In 2001, Indonesia initiated a highly ambitious fiscal decentralization process.** The structure of the public sector shifted in short order from being one of the most centralized among large economies to one of the most decentralized. Revenue transfers to regions increased sharply and almost all earmarking was eliminated. The share of public expenditure under the control of sub-national governments doubled overnight, and responsibility for two thirds of the civil service was transferred to the regions.

2. **The first year of decentralization passed without major disruption to public services and many of the risks that had been feared did not materialize**. In this regard, the safeguards put in place by the government at the beginning of the year played a major role. Nonetheless, fully realizing the gains from decentralization will require corrective actions in those areas where weaknesses have emerged, further steps to minimize the risks intrinsic in the new system, and completion of a number of pending issues.

3. **This chapter discusses progress to date and the remaining challenges ahead.** It is organized as follows: section B describes intergovernmental relations before 2001; section C discusses the new regional autonomy model; section D reports on the decentralization experience during 2001, including the role of safeguards put in place to minimize initial risks; section E reviews some of the lessons from international experience; and section F discusses the challenges ahead. Section G concludes.

B. Pre-2001 Intergovernmental Relations[2]

4. **Decentralization initiatives in Indonesia date back to the early days of the republic**. However, throughout this period the center remained reluctant to grant significant autonomy to the regions. In 1957, legislation was passed aimed at revitalizing regional autonomy, but the process was stopped after outbreaks of regional unrest in Sumatra, Sulawesi, and West Java. In 1974, there was another attempt to revitalize regional autonomy with the passage of Law 5/74, but this law was never fully implemented owing in part to concerns about the administrative competence of regional governments. At the same time, regional dissatisfaction with their lack of control over the allocation of public expenditure increased, particularly in natural resource rich regions that saw their resources being absorbed by the center.

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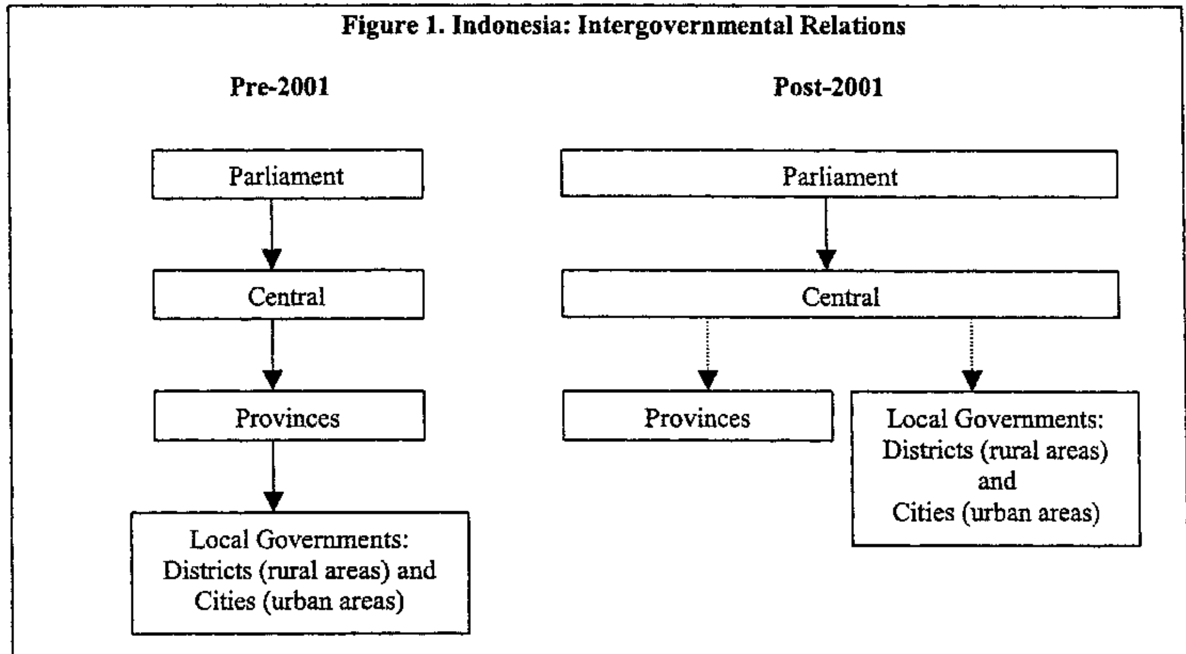
[1] Prepared by Max Alier and Luis Cubeddu (both FAD), in collaboration with World Bank staff.

[2] Shah and Qureshi (1994) present a comprehensive description of pre-2001 fiscal intergovernmental relations in Indonesia.

5. **Despite this dissatisfaction, Indonesia retained a highly centralized system of government until January 2001.** Provinces and local governments were effectively tiers under the central government (Figure 1) in a very hierarchical system.[3] Public services were provided at the local level primarily by the central government, through its deconcentrated ministries or agencies.[4] The governor of a province was appointed by the President, and the head of a district or city was, in turn, appointed by the corresponding provincial governor. Local government heads were in charge of coordinating local agencies in their jurisdictions and carrying out services on behalf of the central government.

Figure 1. Indonesia: Intergovernmental Relations



6. **Revenue responsibility was highly centralized.** The central government was responsible for setting and administering most productive taxes (income tax, VAT, taxes on international trade, excises, and property taxes) and nontax revenue sources. Revenue collection by the central government represented about 95 percent of all revenue, broadly in line with the typical revenue shares in other unitary states, but significantly higher than in

[3] Throughout this chapter, regional governments refer to sub-national levels of government (provincial and local). Local governments refer to districts (in rural areas) and cities (in urban areas).

[4] Deconcentration refers to the delegation of central government functions to its own offices located in provinces, districts, and cities, through which these functions remain the responsibility of the central government. On the other hand, decentralization refers to the transfer of a significant degree of authority and responsibility for public expenditure and revenue from the center to lower levels of government (Alm, and others, 2001).

large federal countries where the central government usually collects only 50–70 percent of total revenue.

7. **Transfers from the central government constituted the main source of revenue for regional governments**. Such transfers, equivalent to about 3 percent of GDP, represented 75 percent of total regional revenues. The bulk of these transfers were in the form of earmarked grants (see below). The transfers also included a small share of the central government's revenue base that was shared with regional governments, including the land and property tax, and some natural resources royalties (Table 1).

Table 1. Indonesia: Pre-2001 Revenue Sharing
(In percent of total collection)

	Central Government	Regional Governments
Land and property tax	19	81
Forestry royalties	55	45
Forestry licenses	30	70
Mining land rents	65	35
Mining royalties	30	70
Clove and copra cesses	0	100

8. **Regional governments had a narrow own revenue base and limited control over tax rates.** Own revenue sources comprised taxes and fees on: (i) motor vehicles (for provinces); (ii) hotel and restaurants, entertainment, advertisement, street lighting, base mineral extraction, and water (for districts); and (iii) property (for cities). Changes to rates were restricted to a prespecified range, and had to be approved by the center.

9. **The allocation of public expenditure was largely controlled, directly or indirectly, by the central government.**[5] The limited capacity of regions to generate own revenue and the high share of specific-purpose grants greatly restricted the ability of regions to independently allocate expenditures. The main grant programs included the Subsidies for Autonomous Regions (SDO), and the Presidential Instructions (Inpres). SDO was a specific-transfer program to finance personnel expenditures (salaries, allowances, and training) of deconcentrated staff. Inpres was a broad grant program that financed the development expenditure needs of the regions. These grants, introduced in the late 1960s, showed large variations from year to year as they responded to changes in national development objectives (Silver, et. al., 2001). Moreover, over time Inpres evolved from a single general-use grant

[5] Regional expenditure, including that determined by earmarked grants, represented about 4 percent of GDP in FY2000.

into a complicated system of general use and earmarked grants. The degree of earmarking increased, covering about two thirds of total Inpres funds by FY1997/98. Regions had some input, subject to central government guidelines, in determining the use of the general-purpose component of Inpres grants.

10. **Regional government borrowing was limited and subject to central government control.** As a result of the tight financing constraint, regional governments did not have much room to run deficits. Borrowing from state and commercial banks was restricted to short-term cash flow purposes while borrowing for long-term projects was done through the center. The most important lending arrangements were: the Subsidiary Loan Arrangement (SLA) and the Regional Development Account (RDA). The SLA was the mechanism to channel external aid funds to regional governments, where the center acted as intermediary and guarantor to the external lender. The RDA funding sources consisted of central budget allocations, and foreign loans and grants. Following the crisis of 1998, measures were introduced to tighten loan approval procedures and to make deductions for loan repayments from the central government transfers for regional governments in the case of default.

11. **Reflecting the above arrangements, regional government operations were a relatively small part of the total public sector prior to decentralization.** A stylized summary is presented in Table 2. Regional revenues and expenditures comprise of only about one-fifth of those of the consolidated public sector, and most of these operations were still effectively controlled by the center.

Table 2. Indonesia: Public Sector Operations, FY 2000
(In percent of GDP)

Consolidated Public Sector		Central Government		Regional Governments 1/	
Revenue	20.9	Revenue	20.0	Revenue	4.0
				Own revenue	0.9
				Transfers from CG	3.1
Expenditure	21.9	Expenditure	21.1	Expenditure	3.9
Current	18.2	Current	15.8	Current	2.4
Development	3.7	Development	2.2	Development	1.5
		Transfers to regions	3.1		
Balance	**-1.0**	**Balance**	**-1.1**	**Balance**	**0.1**

Source: Ministry of Finance and staff estimates.

1/ Estimated on the basis of partial data.

C. The Advent of Fiscal Decentralization

12. **Pressures to increase regional autonomy were already building during the 1990s but rapidly gained momentum following the 1997–98 crisis**. In 1992, the implementing regulations for Law 5/74 were finally issued. Four years later, an experiment with decentralization in 26 districts was undertaken with a view to implementing a broader decentralization reform at a later stage. However, this experiment was overtaken by events with the advent of democracy after the economic crisis. Separatist movements, particularly in regions richly endowed with natural resources such as Aceh and Irian Jaya, started to gain strength. Responding to pressures for more regional autonomy, President Habibie's government moved quickly to draft and enact the basic legal framework governing the design of decentralization.

13. **Two decentralization laws underpinning the new regional autonomy model were approved in May 1999**. The two legal pillars of regional autonomy are: (i) the Regional Autonomy Law (or Law 22/99) governing the distribution of powers (expenditure responsibility) across the different levels of government; and (ii) the Law on Fiscal Balance (or Law 25/99) governing the distribution of resources across the regions. Given the speed with which they were drafted, there are some inconsistencies between these two laws, and relatively little time was allowed for subsequent preparation, including the large quantity of enabling regulations that needed to be passed (some of these are still pending).[6] Law 22/99 drastically rebalanced power in Indonesia by breaking the hierarchical relationship between provincial and local governments (Figure 1). Local governments now have the same direct hierarchical relation with the central government as the provinces. Moreover, this relation is significantly weaker than that between the central government and the provinces before 2001, as heads of provincial and local governments are now appointed by locally elected assemblies. Given that there are roughly 353 districts and 30 provinces, this change has involved a dramatic rebalancing of power.

Expenditure Responsibilities

14. **Under the new model, responsibility for the provision of most public services is decentralized to the local government level**. Law 22/99 defines local government functions as a negative list that excludes functions of national interest, which are delegated to the central government; and functions that span districts, which are reserved for provincial governments. Under this definition, local governments are now in charge of key public services including health, education, and local infrastructure. The central government responsibilities include functions of national interest and setting uniform and minimum guidelines and standards for the provision of services at the regional level. The law defines functions of national interest as: defense, foreign affairs, justice, religious affairs, macroeconomic management (fiscal and monetary policy), and national level strategic and

[6] The initial plan was to implement fiscal decentralization by June 2001. However, its implementation was subsequently advanced to January 1.

policy coordination. Provinces are responsible for the provision of services that span districts and for inter-district coordination. Over a transition period, the provinces may undertake tasks that the districts cannot perform.

Revenue sharing and intergovernmental transfers

15. **The devolution of expenditure responsibility has been accompanied by a large increase in shared revenues and central government transfers, together with the virtual elimination of earmarking.** The revenue sharing base now includes natural resource revenues from oil, gas, forestry, and mining (Table 3), and receipts from land and real estate and personal income taxes. In 2001, Special Autonomy Status was granted to the provinces of Aceh and Papua, significantly increasing their participation coefficients of oil and gas revenue sharing.

Table 3. Indonesia: Natural Resource Revenue Sharing
(In percent of revenue)

	Standard	Special Autonomies	
		Aceh	Papua 1/
Oil revenue	15	55	70
Province	3	22	...
District	6	14	...
Adjacent district	6	19	...
Gas revenue	30	40	70
Province	6	16	...
District	12	10	...
Adjacent district	12	14	...
General mining, forestry, and fishing	80	80	80

1/ The distribution rates have not been determined yet.

16. **Law 25/99 establishes a transfer program that includes the General Allocation Fund (DAU), a general-purpose grant; and the Special Allocation Fund (DAK), for earmarked transfers.** So far the latter is very small and has only been used for reforestation. The DAU, set by law at a minimum of 25 percent of overall revenues net of shared revenue (discussed above), is the most significant component of the transfers (Box 1). The distribution of the DAU is based on the principle of equalizing the "fiscal gap" between expenditure needs and revenue capacity. However, a transitional element—balancing

factor—has also been included in order to avoid abrupt changes in the funding level for individual regions.

Box 1. The General Allocation Grant (DAU)

The grant was introduced in 2001 as part of the decentralization process. Law 25/99 stipulates that the DAU and revenues shared with the regions should account for at least 25 percent of total central government revenues. The DAU replaced the system of transfers to regions composed of the Subsidy for Autonomous Regions (SDO) and Presidential Instructions grants (Inpres) for sectoral expenditure that existed before 2001.

The role of the DAU is to equalize fiscal capacity to carry out expenditure needs. In 2001, a temporary formula, based on fiscal capacity and expenditure needs, was put in place. However, the final amounts distributed were based primarily on historical considerations to ensure that no region received less than in the past (compared with SDO/Inpres grants).

The 2001 formula did not achieve its objective of fiscal equalization, with some regions receiving more revenues than expenditure responsibilities and other regions receiving less revenues than needed. A contingency fund in the 2001 budget allowed the central government to aid the latter. A new formula was put in place in 2002 to correct the deficiencies of the initial formula. However, an additional transitional element was introduced in the form of a "no harm" clause that ensures no regions receive less than in 2001.

Revenue mobilization capacity and borrowing

17. **The capacity of regional governments to increase own revenues has been expanded by the new Law on Regional Taxes (Law 34/2000) but still their revenue base is low.** While the list of permitted regional taxes set out in earlier legislation has been retained, regional governments are now allowed to introduce new taxes without prior central government approval provided they meet certain criteria set out in Law 34. These criteria include that regional tax bases do not conflict with the public interest and are not already subject to tax by the center. The central government has the authority to cancel regional taxes that breach these criteria.

18. **Regional governments' borrowing possibilities have also been increased and direct central government control has been partly replaced by limits on indebtedness.** For long-term debt (domestic and external), the total stock of debt must not exceed 75 percent of a region's revenue and projected debt service must not breach a revenue-debt service ratio of 2.5. At current levels of revenue, these limits imply a maximum stock of sub-national long-term debt of around 5 percent of GDP. The regulations limit short-term debt to one sixth of total expenditure and stipulate that all short-term loans must be settled within the current fiscal year. Only external borrowing is still subject to central government approval. Regions are required to seek central government approval before they enter into negotiations with an external creditor and subsequently before any loan contract is signed.

19. **The central government may also impose additional borrowing controls in the national interest.** National interest is defined to cover circumstances where macroeconomic conditions call for a tightening of the fiscal stance. The regulations also require that regional

borrowing in aggregate must not exceed a level that is "safe for the national economy." Given the current lack of financial information of the regional government accounts and with a view preserving macroeconomic stability, bans on regional borrowing (except through the center) have been in place for 2001 and 2002.

D. The First Year of Decentralization

20. **During 2001, the immediate concerns about disruption to public services and risks to macroeconomic stability were contained.** Over 16,000 public service facilities were transferred to the regions; responsibility for about 2 million civil servants (out of 3.9 million) was transferred;[7] and regional spending is estimated to have increased from 17 percent of total public expenditure in 2000 to over 30 percent (6½ percent of GDP) in 2001. The World Bank estimates that further decentralization of the development budget and the recently adopted special autonomy provisions for two provinces could ultimately raise the sub-national share of expenditure to 45–50 percent in coming years.

21. **The initial success in implementing the decentralization process reflected a number of safeguards put in place by the authorities.** These safeguards included: a ban on regional government borrowing except through the center; inclusion in the budget of a Rp 6 trillion contingency fund to help under-funded regions meet their new expenditure obligations; and transitional arrangements through which the central government continued to pay civil service wages for five months (the payments were deducted from the DAU transfers). Also, during 2001, transfers to regions were based on budgeted rather than actual revenues.

22. **The first year of decentralization did, however, present some problems.** Despite the original intention that decentralization should be fiscally neutral, staff estimates suggest that sub-national governments may have received a net transfer of resources of about 1½ percent of GDP in 2001.[8] Also, there were significant disparities in the distribution of revenue transfers with resource rich regions receiving a large increase in resources as a result of the revenue sharing component of the transfer system. In addition, the initial DAU formula did not achieve the objective of equalizing fiscal capacity across regions, leaving several poor regions in a tight financing situation. The contingency fund included in the 2001 budget allowed the central government to provide aid to these regions. The government also worked during the year on a new more equalizing DAU formula to be implemented in 2002.

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[7] About 1.1 million correspond to deconcentrated staff previously paid via the SDO. Most of the remainder were already physically in the regions but were being paid directly by the central government.

[8] The slow progress in establishing an effective reporting system for regional finances makes it difficult to derive precise estimates. Preliminary data indicates that transfers to regions increased by about 3.8 percent of GDP, whereas the corresponding shift in expenditure responsibilities may have been of the order of 2.3 percent of GDP.

E. Risks of Decentralization[9]

23. **Exploiting the benefits of fiscal decentralization requires careful management of the risks.** Fiscal decentralization can deliver important welfare gains by more closely aligning public expenditure allocation decisions to the population's preferences. These gains can be especially significant in large and diverse countries such as Indonesia. However, international experience shows that there are significant risks to decentralization that can potentially offset any welfare gains. These risks include adverse effects on macroeconomic stability, resource allocation, and the investment climate. The rapid decentralization approach followed in Indonesia may exacerbate such risks.

24. **Decentralization is likely to make it more difficult for the central government to carry out macroeconomic stabilization through budgetary policies.** Mandated transfers to sub-national governments introduce significant inflexibility into central government expenditure. In Indonesia, under current arrangements, about one third of total central government revenues must be shared with regions. Moreover, the expenditure items left with the central government are quite inflexible, for example, interest on the national debt.

25. **Fiscal policy coordination with sub-national governments is difficult to achieve in decentralized countries.** Indeed, the central government may face situations in which it needs to compensate for the procyclicality of budgetary policies by sub-national governments. One example could be oil price windfalls, which under the new arrangements will imply large windfalls for the resource-rich regions. This suggests that safeguards should be developed to ensure that such windfalls are at least partly saved. Irresponsible financial behavior by sub-national governments could create instability concerns, especially when moral hazard problems are not brought under control at an early stage. Indeed, experience in other countries points to the risk that the central government may ultimately face a need to take over debts incurred by the sub-national governments. It is noteworthy that excessive sub-national government indebtedness played an important role in the recent economic crises in Argentina and Brazil.

26. **Macroeconomic stability can also be threatened by a loosening of the fiscal stance in the transition if revenue transfers greatly exceed the transfer of expenditure responsibilities.** Sub-national governments may have incentives to pressure for revenue transfers to precede transferred expenditures and may reject taking over certain expenditure responsibilities, preferring instead to start generate their own expenditure projects. The extent to which this may have occurred in Indonesia in 2001 is difficult to judge, given the paucity of data on local government finances (including whether those regions that received the largest revenue windfall saved or spent it).

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[9] Oates's (1972) seminal paper on fiscal decentralization discusses the main issues in this area. Tanzi (1996) discusses the efficiency gains and macroeconomic aspects of decentralization. Ter-Minassian (ed.) (1997) contains a comprehensive review of international experience in this area.

27. **Moreover, the gains from allocating resources closer to the preferences of the population can be jeopardized by governance problems.** A strong institutional framework, including adequate checks and balances, is needed to prevent these problems. In this regard, mechanisms to increase accountability of regional authorities to their constituencies as well as the central government are essential. Improved budgetary, financial management, and procurement policies are also needed, and present a major challenge for Indonesia given the extent of decentralization to the local government level.

28. **In the short term, the allocation of resources in the economy could be affected by disruption of essential public services.** The disruption of services could result from the lack of clarity in the allocation of expenditure responsibilities, and delays or obstacles to the transfer of personnel, capital, and financial resources to the regions.

29. **The far reaching regulatory powers given to regions, and the possibility of predatory taxation by regional governments, could have a negative effect on the investment climate.** Conflicts between national and regional legislation and regulations are an important source of uncertainty for investors, both local and foreign. Problems have already arisen in these areas in Indonesia, particularly in key resource intensive industries, as well as with regard to the imposition of local fees and taxes.

F. The Challenges Ahead

30. **The challenge now is to capitalize on progress in 2001 by taking corrective actions in those areas where weaknesses have become evident, and completing a number of pending tasks.**

Clarification of Roles and Functions of Different Levels of Government

31. **The rapidity of the decentralization process in Indonesia resulted in a number of inconsistencies and ambiguities legal and regulatory framework with respect to the roles and functions of different levels of government.** As noted, there are also a number of regulations still pending. To avoid generating additional uncertainty, it may be preferable to refrain from radical changes to the regional autonomy model envisaged in Laws 22/99 and 25/99 until enough time has passed to assess the model's performance. Nonetheless, there is considerable work to do in terms of fine tuning the legal and regulatory framework. The central government also needs to set standards for the delivery of services provided by regions, and establish adequate systems to ensure that these standards are being met.

Improve the Distribution of Resources

32. **The new DAU formula approved for 2002 is a step in the right direction in terms of promoting fiscal equalization across regions.** However, Parliament diluted the effectiveness of this revision by imposing the restriction that no region should receive less than in 2001. This both raises the cost for the central government (by 0.1 percent of GDP) and risks setting a bad precedent for the future.

33. **Law 25/00 envisages the provision of sectoral block grants (DAK) in addition to the DAU.** These type of grants have been used only for reforestation so far and in small amounts. In the future, DAK grants could play an important role in the provision of basic health and education services in poorer districts. Moreover, if properly structured, these grants could provide incentives to regional governments to increase development expenditure, for example by including matching funds conditionality. However, the government must be careful not to compromise fiscal discipline and should fit any additional transfers within the overall budget targets.

Provide regions with a proper tax base

34. **The decentralization process as currently designed has not diminished regional dependency on central government transfers, except for regions rich in natural resources that benefit from revenue sharing.** Law 34/00 was an improvement over Law 18/97 in terms of the regions' ability to set new taxes as long as they meet certain criteria and are not in conflict with the national interest. However, the potential tax base was not changed and the taxes that the regions can levy are generally low in yield.

35. **Providing a broader tax base to regions could be achieved by transferring the tax base or by allowing them to impose surcharges (piggy backing) on taxes currently under the central government's control.** The latter option may be preferable in the beginning as nascent regional governments may not have the capacity to administer new tax collections on a major scale. In addition, narrowing the centrally administered tax base could have important negative effects on overall tax administration. Moreover, any additional transfers of the central government's revenue base should be accompanied by further shifts of expenditure responsibilities to ensure fiscal neutrality.

Establish Accountability Mechanisms for Regions

36. **Adequate accountability mechanisms for regions are crucial to maximize welfare gains from decentralization and minimize governance problems.** A system of checks and balances requires establishing proper budgetary practices, including ex-post auditing. This in turn will require development of an adequate financial reporting system. The financial reporting system is also important for the central government to monitor developments in regional finances and take early corrective action, for example if regions' indebtedness breaches the limits set out in the regulations. Also, effective macroeconomic management is only possible when there is reliable information on fiscal developments at a consolidated level. The ban on provincial borrowing has played an important role in keeping the regional finances in check and should be kept in place until such a proper information system has been established.

37. **All these tasks are very demanding for regions with limited administrative capacity.** The central government should provide the necessary training and support for the regions in this areas.

G. Conclusions

38. **Fiscal decentralization in Indonesia was long overdue.** Given Indonesia's diversity and geographical characteristics, decentralization can deliver important welfare gains. However, there are also important risks. The first year passed without major disruption in the provision of public services and the macroeconomic risks were contained, but a fairly daunting agenda remains to be addressed. In particular, the legal and regulatory framework is not yet fully in place, budgetary reporting systems remain inadequate, and the new arrangements have added an important new area of uncertainty to the investment climate that may take time to fully overcome. Adequate budget management, procurement, and accountability practices also still need to be established. Moreover, given the scale of the operation, it is very important that Indonesia learns from the experience of other countries and avoids making similar mistakes. The objective going forward should be to capitalize on the first year's success and ensure that it continues through a coordinated effort by both the central and regional governments to address the remaining agenda.

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VI. Developments in the Labor Market[1]

A. Summary and Introduction

1. **This chapter reviews labor market trends since the onset of the Asian crisis in late 1997**. It examines in particular how the labor market adjusted to the sharp decline in output in 1997–98 and the extent to which the recovery in economic activity in the postcrisis period has supported employment generation and a rebound in wages and labor incomes. The crisis hit Indonesia particularly hard and, although the economy has sustained moderate growth in recent years, the strength of the recovery has been significantly weaker than in the other crisis countries.

2. **The labor market experience in Indonesia during the crisis was in many respects unique**. Despite the fact that it suffered the largest output shock in the region, employment actually *expanded* during the crisis, and despite an increase in the labor force participation rate, open unemployment rose by less than 1 percentage point. Instead, the bulk of the adjustment came through a huge downward adjustment in real wages and a significant shift in employment to the informal sector.[2] While a number of factors—notably the fact that inflation far outpaced wage increases during the crisis—contributed to the unusual composition of the labor market adjustment in Indonesia, a number of commentators have argued that the flexibility of Indonesia's labor market was also a key explanation for why unemployment did not rise more sharply.

3. **In the postcrisis period, growth in formal sector employment has failed to regain the momentum it generated in the decade preceding the crisis**. Such employment growth is critical for a broad-based improvement in living standards. After a brief recovery in 1999, formal sector employment stagnated in 2000 and preliminary indications are that this trend continued in 2001. While the lack of robust economic growth has undoubtedly been a major factor, some observers have argued that the marked reorientation in labor policy since the fall of the Suharto regime in 1998 has also contributed to the slow recovery in formal sector employment. The chapter therefore also reviews the main changes in labor market policies and institutions since the crisis in 1997, focusing in particular on the extent to which key changes, such as recent minimum wage policy, have adversely affected on employment generation in the formal sector.

4. **The chapter concludes that care needs to be taken to ensure that labor reforms are consistent with preserving Indonesia's capacity to attract investment into labor-intensive industries**. While a reorientation of labor policy was clearly overdue, given the repressive policies under the Suharto regime, the chapter cautions that a continuation of the recent upward trend in minimum wages risks undermining Indonesia's competitiveness and

[1] This chapter was prepared by Ben Bingham, Paul Heytens, and Jung Yeon Kim, in collaboration with World Bank staff.

[2] In this paper wage/nonwage employment is used as a proxy for formal/informal employment respectively.

capacity to generate remunerative employment. Early steps to put in place an orderly framework for collective bargaining will also be important to ensure that the long overdue freedoms granted to Indonesia's labor unions can be deployed equitably and effectively with the minimum necessary disruption to industrial relations.

5. **The chapter is organized as follows.** Section B reviews the key factors that contributed to the relative flexibility of the Indonesian labor market prior to the crisis. Section C examines the impact of the crisis on the labor market. Section D reviews key labor market trends in the subsequent period through 2001. Section E considers the major changes in labor policy since the crisis and their impact on employment and wages. Section F concludes.

B. Precrisis Labor Market[3]

6. **Two broad sets of factors contributed to the relative flexibility of the Indonesian labor market on the eve of the Asian crisis.** First, despite the fact that rapid development in the precrisis era had led to significant changes in Indonesia's economic structure—notably a major shift of output from agriculture to industry and services—its labor market had retained many of the features of a classic labor-surplus economy (Table 1).[4]

Table 1. Structure of Employment, 1997
(In percent of total)

	By Sector				By Employment Status		
	Agriculture	Industry	*Of which: Manufacturing*	Services	Wage Employees	Self-Employed	Family-Worker
Indonesia	40.7	19.1	*12.9*	40.2	35.5	44.4	20.1
Korea	11.6	32.5	*21.3*	55.9	63.0	28.2	8.8
Malaysia	19.4	32.2	*23.4*	48.4	75.0	19.0	6.0
Thailand	50.0	20.8	*12.9*	29.1	46.0	33.7	20.3

Sources: CEIC database and Central Bureau of Statistics (BPS, *Sakernas Survey*, 1997).

In particular:

- the share of employment in agriculture remained high, 2–3 times greater than in the more industrialized East Asian economies such as Korea and Malaysia;

[3] The discussion in the subsequent two sections draws on the analysis in Manning (2000).

[4] Most significantly, there continued to be an elastic supply of unskilled labor to support labor-intensive, export-led economic growth.

- the manufacturing sector, which accounted for around one third of output in 1997, still had a relatively small share of total employment (13 percent);

- wage employment accounted for only 35 percent of total employment—50 percent of non-agricultural employment—compared with closer to two-thirds of all employment in more industrialized neighbors.

7. **Second, labor market institutions were not allowed to develop into significant sources of rigidity** (see below). The level of unionization in the economy was low—around 5 percent of the workforce—and, although labor regulation was extended in the 1990s, enforcement was relatively weak and the coverage was largely restricted to the modern corporate sector. Employees in most small and medium-scale enterprises continued to be largely uncovered by labor market regulations and casual employment contracts continued to predominate in the agriculture and construction sectors.

8. **Wages therefore continued to be highly responsive to fluctuations in labor demand**. Piece-rate systems of pay, bonuses linked to firm performance, and flexible employment systems (reflecting a predominance of contract and casual labor) supported a quick adjustment of wages and employment levels to shifts in labor demand. Opportunities for work in the agricultural sector and the urban informal sector enabled workers who had lost jobs in the modern sector to find alternative employment, albeit at considerably lower levels of remuneration. The absence of a meaningful social security system also implied that most displaced workers in an economic downturn were forced to find alternative income-generating occupations (even if only as workers on the family farm) as they were simply too poor to remain unemployed.

9. **Labor market conditions nevertheless began to tighten in the early 1990s** (Table 2). Growth in the labor force began to slow, despite an increase in participation rates. Urban employment growth picked up, especially formal sector employment in manufacturing and construction, though labor absorption in these sectors was relatively modest in comparison to other regional economies. Real wages rose by around 5–6 percent per annum in the non-agricultural sector over the period 1990–97. The growth in urban employment coincided with a decline in the role of agricultural employment, whose share of total employment fell sharply in the 1990s. The growth in urban employment was also reflected in rising participation rates, particularly among young women who were drawn into low-wage manufacturing jobs following the emergence of labor-intensive, export-oriented industries in the late 1980s. The rapid rise in the urban labor force in the early 1990s resulted in an increase in open unemployment, although the overall level remained low (less than 5 percent).[5]

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[5] Care needs to be taken with the historical data on unemployment as the unemployment rates prior to 1994 are not strictly comparable with more recent data.

Table 2. Indonesian Labor Market Indicators (1985–2001)

	1985	1990	1995	1997	1998	1999	2000	2001 2/
				(In percent of labor force)				
Unemployment rate	2.2	2.6	4.7	4.7	5.4	6.3	6.1	
Urban	...	...	...	7.8	9.3	10.5	9.3	
Rural	...	...	...	2.9	3.2	3.7	4.1	
Underemployment rate	34.5	30.5	31.6	33.4	35.1	33.4	31.5	
Urban	...	...	...	7.5	8.3	8.4	7.4	
Rural	...	...	...	25.9	26.8	30.2	24.0	
Labor force participation rate	62.1	63.1	65.4	66.4	66.9	67.2	67.8	
Male	81.8	82.8	84.5	83.5	83.2	83.6	84.2	
Female	43.5	44.2	46.9	49.7	51.2	51.2	51.7	
Share of employment (In percent)								
Male	64.1	64.6	64.6	61.9	61.5	61.8	61.7	
Female	35.9	35.4	35.4	38.1	38.5	38.2	38.3	
Urban	...	24.5	31.8	34.4	34.5	36.4	37.9	
Rural	...	75.5	61.2	65.6	65.5	63.6	62.0	
				(1997=100)				
Working population	73.7	84.1	95.4	100.0	102.6	104.9	106.0	
Labor force	63.8	84.1	94.0	100.0	103.5	106.2	108.3	
Employment	69.4	79.9	90.0	100.0	102.6	104.4	106.7	
Agriculture, fishery, forestry	92.2	96.9	94.9	100.0	113.1	110.9	118.9	
Industry	49.0	64.5	87.8	100.0	87.6	97.3	97.0	
Of which: Manufacturing	50.0	70.8	88.3	100.0	90.1	104.7	106.4	
Services	55.8	66.6	86.6	100.0	99.2	101.1	98.9	
Wage employment	...	68.6	93.1	100.0	94.5	96.4	96.7	
Nonwage employment	...	92.1	91.7	100.0	106.8	107.8	109.5	
Average real wages 1/								
Manufacturing	...	...	87.7	99.5	68.0	75.2	92.3	109.6
Agriculture	...	...	...	96.5	65.0	78.9	80.2	78.4
Urban informal sector	...	...	...	97.7	66.0	70.8	69.9	67.5
Minimum wage	...	...	...	94.9	61.9	70.7	84.4	100.4
(Nominal minimum wage)	...	...	...	100.0	115.6	134.8	175.9	226.2

Sources: Department of Labor, and Central Bureau of Statistics (BPS, *Sakernas Survey*, 1997-2000).

1/ End-period.
2/ End-September.

C. Impact of the Crisis on the Labor Market

10. **Contrary to earlier expectations, the sharp decline in output in 1998 did not have the catastrophic impact on unemployment that many had predicted.**[6] In the event, open unemployment increased by under 1 percentage point to 5½ percent in 1998, despite the displacement of large numbers of workers in certain sectors. In this and other respects, the adjustment of Indonesia's labor market was unique (Table 3).

Table 3: Summary of Labor Adjustment in Selected Southeast Asian Countries During the Crisis

	Severity of Crisis (1998)		Labor Market Adjustment (Percent change 1997–98)			
	Growth	Inflation 1/	Participation Rate 2/	Employment	Real Wages	Unemployment Rate 2/
Indonesia	-13.7	57.7	0.6	2.6	-35.0	0.7
Thailand	-10.0	8.1	-0.3	-2.8	-7.4	3.0
Malaysia	-7.5	5.3	-2.3	-2.7	-1.1	1.4
Korea	-5.8	7.5	-1.5	-5.3	-9.3	4.2

Sources: Gordon (2000), and Central Bureau of Statistics *Sakernas Survey* 1997–98.

1/ Annual average.

2/ Absolute change.

11. **The key features of Indonesia's relatively unique experience were as follows:**

- **Total labor-force participation rates increased marginally** suggesting that the "added worker" effect dominated the impact of "discouraged" workers leaving the labor force (Table 4).[7] The "added worker" effect entirely reflected higher female participation, particularly in the rural areas, as women were drawn into the workforce to

Table 4. Labor Force Participation, 1997–98
(In percent of working population)

	1997	1998
Participating	66.4	66.9
Male	83.5	83.2
Female	49.7	51.2
Nonparticipating	33.7	33.1
Students	8.0	8.2
Homemakers	19.2	18.2
Other	6.5	6.7
Labor force (millions)	89.6	92.7

Sources: Central Bureau of Statistics (BPS, *Sakernas Survey*, 1997–98).

[6] Estimates of the impact of the crisis, prepared in 1998, had predicted that open unemployment could rise to around 10–15 percent of the labor force and that almost half the population were expected to fall below the poverty line (ILO, 1998).

[7] The increase in labor force participation rates also does not appear to have resulted from migrant workers returning from overseas. In particular, migrant workers did not return from Malaysia in large numbers as many had feared as Malaysia weathered the crisis reasonably well, and redundant construction workers were readily absorbed into plantations and service sector employment in that country (World Bank 2000).

supplement family income. Male participation rates, on the other hand, were broadly unchanged.

- **Around 2½ million non-agricultural workers (3 percent of the labor force) were displaced during the crisis** (Table 5).[8] Most of the displaced workers were wage employees and the job losses were most severe in the manufacturing and construction sectors. About three-quarters of the job losses were in the rural areas.

Table 5. Change in Employment, 1997–98 1/
(In millions)

	National	Urban	Rural	Wage	Non-wage
Total employment	2.3	1.0	1.3	-1.4	3.7
Agriculture	4.6	1.1	3.6	0.4	4.2
Non-agricultural	-2.4	-0.1	-2.3	-2.1	-0.3
Manufacturing	-1.1	-0.3	-0.8	-0.7	-0.4
Construction	-0.7	-0.2	-0.5	-0.7	0.1
Other	-0.6	0.4	-1.0	-0.7	0.0
Tradable 2/	3.3	0.8	2.6	-0.4	3.7
Nontradable	-1.1	0.2	-1.3	-1.3	0.2
Memorandum:					
Total employment (1997)	85.4	29.4	56.0	30.3	55.1

Source: Central Bureau of Statistics (BPS, *Sakernas Survey*, 1997–98).

1/ Aged 15 and over.
2/ Agriculture, manufacturing, mining.

- **In the urban areas, most displaced workers found jobs in the informal trade and service sectors**, albeit at significantly lower levels of income. As a result, net job losses in the cities were relatively limited. Workers in the rural areas did not have the same range of options and most were forced into agricultural labor.

- **Agricultural employment increased by nearly 5 million** (5 percent of the labor force). Workers displaced by the crisis accounted for nearly half this increase in employment, with the remainder consisting of new entrants into the labor market, primarily of young workers and women seeking work to support family incomes. The bulk of the increase in

[8] The data understate gross displacement of workers as they refer to the change in employment between two points of time. The *1998 Sakernas Survey* estimated that the *gross* displacement of workers, i.e., workers who left their jobs in 1998, was around 4.3 million.

agricultural employment consisted of shared work on family-owned farms. Many workers probably failed to find much meaningful work.[9]

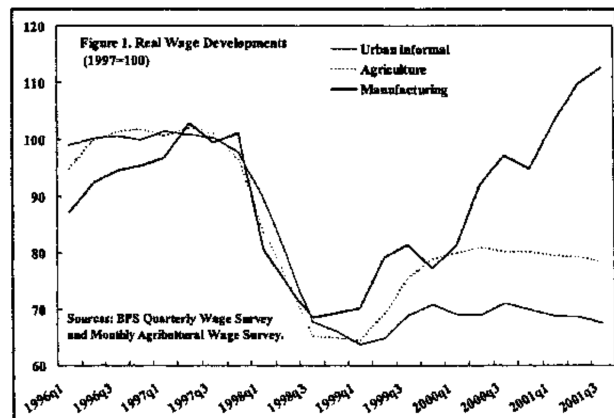
12. **The primary impact of the crisis on the labor market was on lower real incomes through reductions in hours worked and a sharp decline in real wages.** Underemployment (i.e., those working less than 35 hours) rose, while opportunities to work overtime and earn extra income declined (Table 6). The number of people working less than 35 hours increased by just under 2 percent, mainly because of a substantial increase in the number of family farm workers working shorter hours. In addition, the proportion of the labor force working more than 45 hours declined by 4 percentage points of the labor force, with men bearing the brunt of the lower overtime (women saw their share of overtime increase, primarily because they earned lower wages than men).

Table 6. Underemployment and Overtime, 1997–98
(In percent of labor force)

	1997		1998	
	Underemployment	Overtime	Underemployment	Overtime
Male	15.6	28.2	16.2	25.3
Female	17.8	10.1	18.9	9.2
Agriculture	10.3	8.0	11.3	8.2
Non-agriculture	23.1	30.2	23.9	26.3
Total	33.4	38.2	35.1	34.5

Source: Central Bureau of Statistics (BPS, *Sakernas Survey*, 1997–98).

13. **The most striking impact of the crisis was the substantial decline in real wages** (Figure 1). Real wages fell sharply in 1998 as adjustments in nominal wages failed to keep pace with the rapid rise in the rate of inflation. Between August 1997 and August 1998, the dates of the respective labor market surveys, real wages declined by close to 35 percent, as nominal wage increases of around 17 to 18 percent were dwarfed by an increase in inflation to close to 80 percent. The decline in real wages affected both the formal and informal sectors with the impact fairly evenly



[9] Output per worker is estimated to have declined by around 12 percent.

distributed across all sectors. Real wages fell by 32 percent in manufacturing, 33 percent in agriculture, and 32 percent in the urban informal sector.

14. **The crisis had a profound impact on household incomes, particularly for those at the lower end of the income distribution.** While the flexibility of Indonesia's labor markets helped to preserve overall employment levels, the sharp decline in real wages and large shift to less remunerative employment in agriculture and the urban informal sector pushed large numbers of Indonesians back into poverty: the headcount poverty index based on the national poverty line jumped from its precrisis low of 11 percent in early 1997 to a peak of 27 percent in early 1999. Moreover, the proportion of the population falling below the broader international poverty line of $2 a day per capita rose to nearly two-thirds in early 1999 from less than half before the crisis.

15. **Despite the large devaluation of the rupiah, employment failed to shift toward the tradable sector**. Although employment increased overall in tradable goods industries,[10] the dominant shift was the reallocation of jobs into agriculture (from both tradable and nontradable industries) and the shift in urban employment to the informal sector. The absence of a clear-cut shift in employment toward the production of tradables was one of the more surprising aspects of the crisis.

16. **The lack of production response to the large shift in relative prices is likely to have reflected the across-the-board economic disruption during much of 1998**. Some import substitution producers who were not heavily indebted or import dependent received a substantial boost, as did agricultural producers in the export-oriented cash crop sector. However, producers, especially those heavily dependent on imported inputs and credit arrangements, were badly hit by the financial crisis, lack of international confidence in the rupiah, and the political turmoil.

D. Recent Labor Market Trends

17. **Despite the recovery in economic activity in 1999–2000, employment generation has been relatively weak in the aftermath of the crisis, particularly in the formal sector.** The absence of a sustained recovery in formal sector employment has put upward pressure on open unemployment and prevented a recovery in real wages in the agriculture and urban informal sectors, which account for approximately 70 percent of total employment. Real wages in the manufacturing sector have shown a sustained recovery. While some recovery from the depressed levels following the crisis is justified, the more recent upward trend appears to derive mainly from the impact of labor market regulation (see below), and seems unsustainable.[11] Although relatively limited labor data are available for 2001, the continued

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[10] Agriculture, manufacturing, and mining.

[11] Effective wage increases may not have been as large as they appear as many firms dismissed their lowest paid workers and casual/contractual laborers while retaining their better-paid skilled employees. This practice would have had the effect of raising the average wage reported in the labor force surveys even in the absence of a pay rise.

stagnation of nonformal real wages suggests that there has not been a marked improvement in employment generation.

18. **Non-agricultural employment initially rebounded after the crisis, but has slowed in recent years** (Table 7). Employment increased by just under 5 percent in 1999, led by a sharp recovery in manufacturing employment, which rose by 16 percent. Wage employment, the proxy used for formal sector employment, also rebounded, but more weakly, rising by 2 percent. The recovery in non-agricultural employment faded significantly in 2000, with employment declining by around 1½ percent. Employment growth in the industrial sectors fell sharply, prompted by a decline in the growth of manufacturing employment to just under 2 percent. Service sector employment also declined.[12] Growth in formal sector employment fell to close to zero.[13]

Table 7. Employment Trends, 1997–2000

(In percent change)

	97–98	98–99	99–00
Total employment	2.6	1.7	2.2
Non-agricultural	-4.6	4.7	-1.6
Agriculture	13.1	-1.9	7.2
Industry	-12.4	11.1	-0.3
Manufacturing	-9.9	16.1	1.7
Services	-0.8	2.0	-2.2
Wage employment	-5.5	2.0	0.3

Source: Central Bureau of Statistics (BPS, *Sakernas Survey*, 1997–2000).

19. **Agricultural employment initially declined, falling by 2 percent in 1999, but later picked up as formal sector employment slowed.** The initial decline reflected in part a shift back into manufacturing and urban informal sector employment, in response to the increased employment opportunities in these sectors. This trend was reversed in 2000, as growth in non-agricultural employment slowed. Agricultural employment increased by 7 percent and as during the crisis, the bulk of the new employment consisted of shared work on family-owned farms.

20. **Participation rates have continued to rise since the crisis, while underemployment has fallen** (Table 8). Both are likely to reflect the necessity to supplement family incomes in the face of the weak recovery in real wages in the urban and rural informal sector. The decline in underemployment was strongest in the rural areas as family farms made adjustments to better utilize labor crowded in during the crisis, either by

[12] Changes in the disaggregation of the employment make it difficult to identify the sources of this decline.

[13] Employment data for 2001 is not yet available.

using existing land more intensively (e.g., by adding an additional nonrice crop in the dry season) or opening up new farm land (e.g., in the upland forests).[14]

Table 8. Participation and Under-employment, 1998–2000
(In percent of labor force)

	1997	1998	1999	2000
Participation rate	66.4	66.9	67.2	67.8
Under-employment	33.4	35.1	33.4	31.5
Of which: In rural areas	26.9	27.8	25.9	24.7

Sources: Central Bureau of Statistics (BPS, *Sakernas Survey*, 1997–2000).

21. **Real wages have shown sharply divergent trends across sectors.** In the immediate postcrisis period in 1999 there was a broad recovery in real wages across all sectors. In 1999, real wages in the manufacturing sector rose by around 11 percent, and there were also substantial increases in real wages in the agriculture and urban informal sector. However, while real wages in the informal sector have remained relatively stagnant since 1999, around 20–30 percent below their precrisis levels, real wages in the manufacturing sector have continued to increase, rising to over 10 percent above their precrisis levels in 2001. The latter has been driven largely by substantial increases in minimum wages. Manufacturing real wages have also risen sharply in foreign currency terms (Figure 2). Between 1998 and 2001, wages in the manufacturing sector deflated by the nominal effective exchange rate rose by 80 percent, although they remain around 15 percent below their precrisis levels. However, this gap will close significantly if the minimum wage increases awarded in 2002 take full effect.

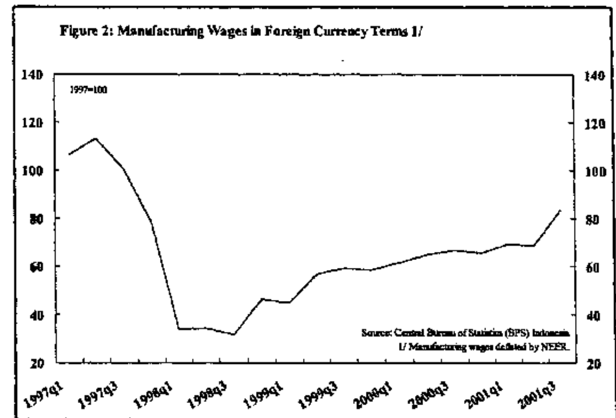


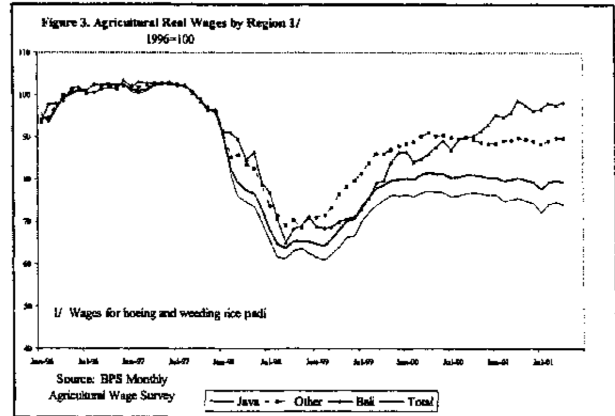
Figure 2: Manufacturing Wages in Foreign Currency Terms 1/

22. **There were also marked regional variations in real wage trends, particularly in the agricultural sector**. In densely populated Java, which accounts for about half of agricultural employment, real wages have stagnated at about 25 percent below their peak before the crisis. Real wages in agriculture have, however, recovered much faster in the less densely populated outer islands, particularly in areas where export-oriented cash crops predominate, and in Bali, where the tourism industry continues to absorb large numbers of

[14] More favorable weather conditions may also have facilitated the increased labor intensity in agriculture. During the crisis the agriculture sector was hit hard by a severe drought as a result of El-Niño weather patterns and the worst forest fires in more than a decade.

workers from the countryside (Figure 3). As a result, average real wage levels in agriculture were only about 10 percent or less below their precrisis levels outside Java in late 2001.

23. **The progress made in restoring macroeconomic stability and resuming growth also helped to reduce poverty substantially in the course of 1999/2000**. The national headcount poverty index fell from its crisis peak of 27 percent to 15 percent in early 2000, a level comparable to that of 1996. Nevertheless, large numbers of Indonesians remained "near poor" and continued to be affected by various dimensions of poverty: 58 percent of the population still fell below the $2 a day poverty line and the World Bank estimates that a similarly large proportion of the population continued to experience inadequate access to basic social services and proper nutrition. In addition, the subsequent stagnation of real wage levels in agriculture and the urban informal sector and sharp rise in the price of rice in 2001, the main dietary staple of low-income households in Indonesia, suggest that some of these gains in poverty reduction may be eroding.[15]



E. A New Approach to Labor Market Policy

24. **The flexibility of Indonesia's labor markets derived in part from the tight controls exerted over organized labor during the Suharto regime**. While collective bargaining was formally supported as a means of setting labor standards and resolving disputes, the New Order government's main labor policy objective was to minimize worker unrest in order to facilitate modern sector job creation and rapid economic growth. To this end, only one government-controlled labor union—the All Indonesia Labor Federation (AILF)—was formally recognized and, although strikes were not rare during this period, they were seldom initiated or backed by the AILF and the military frequently intervened on behalf of employers to settle labor disputes. Employers were therefore relatively free to adjust wages and employment levels in response to fluctuations in economic conditions.

25. **Labor regulation began to spread in the modern sector in the early 1990s, but was not allowed to become a significant source of rigidity**. The emergence of new export-oriented industries in the late 1980s resulted in considerable labor unrest and strong international criticism of labor standards in Indonesia.[16] Rather than relax controls over labor,

[15] Poverty estimates in Indonesia are only available with a long time lag. Most such estimates come from large household surveys which, because of their size, generally take more than a year to process.

[16] In an effort to enter new markets and retain market share, export-oriented firms in garments, footwear, and other labor-intensive industries regularly ignored the law on minimum wages, overtime, and the maximum permitted work week, eventually prompting

(continued)

the New Order government instead offered modern sector workers higher minimum wages and social security benefits. Real minimum wages were more than doubled nationally from 1991 to the eve of the Asian crisis in 1997 [17] while participation in the national social security program was made compulsory. However, these policies were weakly enforced and coverage was largely restricted to the modern sector; workers in informal sector occupations and agriculture, as well as most employees of small and medium-sized enterprises, remained uncovered.

26. **The political context of labor policy changed dramatically following the downfall of the Suharto government, resulting in a marked reorientation in favor of organized labor.** Basic labor freedoms and worker protections were quickly reaffirmed through formal ratification of a range of ILO conventions, including the convention on freedom of association, and passage of a new trade union law (Law 21) guaranteeing workers the right of assembly. More than 60 trade union bodies have now been established, and union membership is estimated to have more than doubled since the mid-1990s.[18] Industrial disputes have also increased and there is a strong sense among union membership, with considerable political support, that justice in the wake of the repressive policies imposed on organized labor during the New Order regime demands greater concessions to workers.

27. **The emergence of a more active and organized trade union movement has resulted in more concessions to workers in recent years.** Unions have demanded and received greater labor protections, including reinstatement of severance pay (Minister of Manpower Decree 150), restrictions on dismissals, and other changes to labor legislation. The recent gains in union freedoms and labor protection standards have been codified in a new labor protection law that is pending before Parliament. A new industrial relations law, which seeks to overhaul the collective bargaining and dispute resolution process, has also been submitted for parliamentary review and approval.

28. **With the collapse of real wages in the wake of the crisis, minimum wage policy has again become a key plank of labor policy.** In response to intensified demands for higher wages, real minimum wages (national average) were increased by nearly 20 percent per annum in 2000 and 2001 (Table 9). Enforcement of minimum wage laws has also been stepped up.[19] The new minimum wages that took effect on January 1 imply a further

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widespread strike activity. The fact that many of these firms were owned by foreign investors (primarily from Korea, Taiwan Province of China, Singapore, and Hong Kong SAR) also evoked nationalist reactions among workers and added to the intensity of their protests. The increased labor unrest, in turn, prompted greater international scrutiny of Indonesia's labor record.

[17] Minimum wages had been an element of government wage policy since the early 1970s, but had not played much of a role in the wage formation process prior to this period.

[18] These estimates are subject to uncertainty as unions are no longer required to report data on membership.

[19] Increased trade union assertiveness has acted as an additional enforcement mechanism.

substantial increase in real minimum wages, pushing them well above precrisis levels in most provinces. This more vigorous use of minimum wage policy signals the return of a mechanism developed during the Suharto era to compensate workers for a lack of freedoms at a time when the strict controls over unions have been lifted.

29. **As was the case in other aspects of public policy, the authority to set minimum wages devolved to the regions following decentralization in 2001.** Decentralization has made the wage setting process far less coordinated from a national perspective.[20] In particular, there has been large variability in minimum wage increases in the two years since decentralized wage setting has been in effect. Decentralization so far seems to have resulted in higher wage increases in the more industrialized regions, due in part to the more active trade union movement, and local governments have followed a variety of strategies in setting minimum wages.

30. **A recent study by the SMERU Research Institute (2001b) provides empirical evidence that the sharp rise in minimum wages is having an adverse impact on employment generation in the economy.** The study comprised a statistical analysis of national labor force data, as well as a qualitative survey, of the impact of minimum wages on market wages and employment in the urban formal sector in a number of provinces. The main findings are as follows:

- **Compliance with the minimum wage has increased steadily over time.** By 1999, average formal sector wages were clustered around the minimum rate, suggesting that the minimum wage is now binding for most workers in the urban formal sector.

- **The employment effects of minimum wage increases are significant.** The study indicates that a 30 percent real increase in minimum wages will reduce employment in the urban formal sector by some 3 percent (approximately half a million jobs) below the level that would have resulted without any minimum wage increase. The impact is greatest on the most vulnerable groups—employment losses for women, youth, and less educated workers range from 6–9 percent.

- **Higher minimum wages also depress wages in the informal sector.** Job losses in the formal sector forces some workers to seek employment in the urban informal and agricultural sectors, thereby depressing real earnings and hence income levels in these sectors by 1–4 percent for every 10 percent increase in the real minimum wage.

[20] Prior to regional autonomy, minimum wage proposals were submitted by provincial governors to the Minister of Manpower for approval, which was generally granted without revision.

Table 9: Indonesia: Minimum Wage, 1996-2002

	1996	1997	1998	1999	2000	2001	2002
				(Index 1997=100)			
Nominal							
National average	91	100	116	135	176	226	n.a
Selected regions							
Jakarta	90	100	115	134	165	246	342
Bekasi/Bogor	90	100	115	133	199	241	332
Tanggerang	90	100	115	133	199	246	341
Bandung	90	100	115	133	199	216	272
Surabaya	90	100	115	137	177	248	341
Bali	90	100	115	123	141	218	240
Real 1/							
National average	95	100	71	69	87	100	n.a
Selected regions							
Jakarta	96	100	72	69	83	110	139
Bekasi/Bogor	96	100	72	69	99	108	135
Bandung	96	100	72	69	99	96	110
Surabaya	96	100	71	70	89	110	138
Bali	96	100	71	64	71	98	98
In foreign currency terms 2/							
National average	100	100	36	51	63	70	n.a
Selected regions							
Jakarta	99	100	36	50	59	77	114
Bekasi/Bogor	99	100	36	50	72	75	111
Tanggerang	99	100	36	50	72	77	114
Bandung	99	100	36	50	72	67	91
Surabaya	99	100	36	51	64	77	114
Bali	99	100	36	46	51	68	80
CPI 3/	100	107	171	206	231	240	263 4/
Nominal Effective Exchange Rate 3/	110	100	31	38	36	31	33 4/

Source:"Minimum Wages: A Key Policy Issue for 2002" Chris Manning (unpublished) and staff estimates.

1/ Deflated by CPI.
2/ Deflated by NEER.
3/ Period average.
4/ For 2002, assumes inflation of 9-10 percent and average exchange rate of Rp 9,000 per dollar.

31. **These empirical results in turn suggest that the use of minimum wage policy to push up earnings in the formal sector may be eroding the achievements that have been made in poverty reduction.** A vigorously implemented minimum wage policy will boost the incomes of those workers who are able to retain their jobs in the modern sector, but such workers are unlikely to be living below the poverty line. Indeed, there is a large body of research that shows that the poor work mostly in the urban informal sector and in agriculture. If minimum wage policy has contributed to the reduction of formal sector employment growth below that of the working age population—and available evidence suggests it has in recent years—more workers will remain in inferior jobs in the informal sector, thereby losing an opportunity to lift themselves out of poverty. Furthermore, to the extent that informal sector wage levels are also depressed, many workers in these occupations are at risk of falling back into poverty.

F. Conclusions

32. **The adaptability of the labor market in the face of the sharp contraction in output during the crisis in 1998 was remarkable.** Unemployment rose only modestly and the economy was able to absorb substantial numbers of displaced workers in the agriculture and urban informal sectors. Although the incidence of poverty rose sharply during the crisis, as real wages and labor incomes declined, the increase was more modest than had been predicted at the height of the crisis. The flexibility of the labor market stemmed largely from the fact that, despite the rapid development of the economy in the precrisis era, the labor-market had retained many of the features of a classic labor surplus economy. The agricultural and urban informal sectors remained large and flexible real wages facilitated adjustments to large shocks to labor demand.

33. **However, growth in formal sector employment has failed to regain the momentum it generated in the precrisis period.** These trends are particularly worrying, given that formal sector employment generation is critical for a broad-based improvement in living standards. After a brief recovery in 1999, formal sector employment stagnated in 2000 and the preliminary indications are that this trend continued in 2001. The absence of buoyant employment growth in the formal sector has prevented the economy from effectively disposing of the large labor surplus generated by the crisis, with the result that the initial recovery in labor incomes has not been sustained, giving rise to fears that the early postcrisis reductions in poverty levels have begun to erode.

34. **There are also concerns that labor market policy is beginning to erode Indonesia's competitiveness and capacity to generate remunerative employment.** While the lack of buoyancy in formal sector employment reflects in part the broader fragility of Indonesia's recovery, this loss of competitiveness comes at a difficult time for the economy. A reorientation of labor policy was clearly overdue given the repressive policies of the past and the ratification of the ILO conventions are particularly welcome in this regard. However, care needs to be taken to ensure that the reform of labor policy is carried out in a manner that is consistent with preserving Indonesia's capacity to attract investment into labor absorbing industries. Two aspects of recent developments in labor policy merit particular attention in this regard:

- *Minimum wage policy.* Aggressive use of minimum wage policy not only risks undermining much needed employment generation in the formal sector, but also risks undermining the government's poverty reduction efforts more directly. As argued above, although higher minimum wages will boost incomes for those able to retain their jobs in the formal sector, they are likely to depress labor incomes in the urban informal and agricultural sectors, which employ the bulk of the poor. In this context, the large increases in minimum wages that took effect in January 2002 are of particular concern as they are likely to hit labor-intensive industries in export-oriented sectors especially hard. In the absence of sustained formal sector employment growth, poverty is not likely to be reduced quickly.

- *Industrial relations.* The authorities also need to move quickly to put in place an orderly framework of collective bargaining to ensure that the long overdue freedoms recently granted to Indonesia's labor unions can be deployed equitably and effectively with the minimum disruption to industrial relations. While the strict controls on organized labor under the Suharto regime have been removed, clear and effective ground rules for employer-employee relations in this more liberalized environment have not yet been established. Prompt passage of a sound industrial relations law would seem to be an essential first step in this regard.

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