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Indonesia: Selected Issues

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INDONESIA

Selected Issues

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List of Abbreviations and Acronyms

ADU	Asset Disposal Unit of the Indonesian Bank Restructuring Agency
AMC	Asset Management Credits of the Indonesian Bank Restructuring Agency
AMI	Asset Management Investments of the Indonesian Bank Restructuring Agency
BAPEPAM	Securities and Exchange Commission
BI	Bank Indonesia
BPK	Supreme Audit
BPKP	State Audit Board
BTO	Banks Taken Over
BULOG	National Food Logistics Agency
CGI	Consultative Group of Indonesia
FSPC	Financial Sector Policy Committee
GOI	Government of Indonesia
IBRA	Indonesian Bank Restructuring Agency
INDRA	Indonesia Debt Restructuring Agency
JITF	Jakarta Initiative Task Force
KUT	Agricultural Credit Program
MISOE	Ministry of Investment and State-Owned Enterprises
MoFEC	Ministry of Forest and Estate Crops
NPL	Non-Performing Loan
OPK	Subsidized Rice Scheme
PLN	PT Perusahaan Listrik Negara (National Electric Company)
SOE	State-Owned Enterprise
SSN	Social Safety Net

OVERVIEW

1. **The 2000 Article IV consultations provides an important opportunity to review the progress being made toward Indonesia's full emergence from crisis.** In this regard, the Selected Issues paper focuses on assessing progress, and providing background and analytical information on key aspects of the Fund-supported program in Indonesia.

2. **Banking sector restructuring has been at the heart of the reform program.** Two and a half years after the onset of the crisis, much has been done by the Indonesian authorities to stabilize and strengthen the banking system. The overall solvency of the banking system has been restored, and net earnings have become positive for the first time since the crisis. However, profitability is low, the state banks have high operating costs and low earnings potential, and the large state banks suffer from illiquidity. These remaining problems suggest that many Indonesian banks still face major challenges in implementing financial and operational restructuring. The government also needs to divest the large shareholding it has acquired in the banking system during the crisis, while concurrently strengthening the supervisory and governance framework to international standards. Against this background, Chapter I reviews the progress that has been made in restoring a well-functioning banking sector and depicts the many challenges that still lie ahead.

3. **The severity of the banking crisis in Indonesia is reflected in a sharp increase in public debt.** Indonesia's banking crisis has likely been the most severe faced by any country, and its cost to the public sector has thus been very significant. The largest element of this cost is associated with the recapitalization of a deeply insolvent banking system. The rest has resulted from the cost of bank closures and the losses from the central bank's liquidity support. Asset resolution by the Indonesian Bank Restructuring Agency (IBRA) is expected to contribute to recovering part of the cost to the government and containing the medium-term government debt dynamics—provided the macroeconomic situation remains favorable. Although the gross cost to the public sector can be gauged with some accuracy, the prospects for asset recovery are much more uncertain. Therefore, Chapter II describes in detail the sources of bank restructuring costs in Indonesia, prospects for IBRA's asset recovery, and the implications for medium-term debt dynamics.

4. **Corporate debt restructuring is critical for resumption of normal credit flows and Indonesia's full and sustainable economic recovery.** Against this, progress in this area has been the weakest part of the program. Although this is partly attributed to the voluntary nature of the Jakarta Initiative Task Force (JITF), it is also necessary to recognize that political support has been low and the legal deterrent not effective; as such, the legal system has not, thus far, helped protect and enforce commercial rights in a consistent manner. Thus, Chapter III examines the reasons for the slow progress, and provides the rationale for the new enhanced framework that includes a strengthened JITF, sanctions against recalcitrant debtors (including legal action by the Attorney General), as well as incentives for cooperating debtors and creditors.

5. **The critical link between medium-term macroeconomic performance, and bank and corporate debt restructuring is illustrated in Chapter IV**. This chapter presents two medium-term scenarios for Indonesia's economy; the first is based on the successful implementation of the core reform agenda of the Fund-supported reform program. In particular, aggressive asset recovery and corporate debt restructuring in the base scenario, in tandem with prudent financial policies, help to reduce the debt burden, restore strong growth, and entrench low inflation. The risks to this benign scenario and the fragility of the macroeconomic situation are illustrated by an alternative scenario. In this scenario, lower asset recovery and a lack of progress in bank and corporate restructuring prevent the debt ratio from falling. Also, capital inflows do not resume, putting pressure on reserves and jeopardizing Indonesia's external position.

6. **Finally, successive reform programs have aimed at alleviating the impact of the crisis on the poorest households and creating the conditions for reversing the rise in poverty**. This strategy has had several key planks. First, and foremost, was stabilizing the macroeconomic environment, especially the exchange rate and inflation, and turning around expectations of hyper inflation. Second, was ensuring the proper functioning of the rice market through augmenting supplies, closely monitoring availability, and restoring distribution channels which had weakened with the crisis. Third, was introducing a subsidized rice distribution, and expanding it in a timely way until it delivered a sizeable income transfer to about 10 million households. Chapter V, prepared by the World Bank, illustrates that these policies progressively took hold, helping reduce the absolute—and relative—price of rice from the peaks of the 1998 crisis period, and allowing the poverty rate to fall toward precrisis levels in 1999 and 2000. Entrenching this success and resuming Indonesia's long-term record of poverty reduction will depend on making social spending schemes more effective, and laying the basis for a sustainable recovery.

I. STATUS OF BANKING SYSTEM REFORM[1]

1. **This paper briefly overviews the strategy and stages of the bank restructuring program, assesses the current financial status of the banking system, and discusses key areas of reform that remain.** In response to the banking crisis in late 1997, the Indonesian authorities have put in place a comprehensive program aimed at restoring the viability of the financial sector. Two and a half years later, many of the critical elements needed to protect the core banking system and facilitate the revival of intermediation are taking root. Nevertheless, significant tasks remain to restore full functionality of the banking system and enable it to contribute to Indonesia's economic recovery.

A. Background and Strategy

2. *The comprehensive banking system reform has had three overlapping phases*—stabilization; restructuring and recapitalization; and revitalization and soundness.

Stabilization

3. **At the height of the banking crisis (late 1997 and early 1998), stabilization of the monetary and banking system was the immediate priority.** At that time, confidence had collapsed—capital was in flight, the currency was in free fall, and depositors and creditors to Indonesian banks were in full retreat (Figure 1). Bank Indonesia had extended large amounts of liquidity support (almost 20 percent of GDP) to keep banks from default and the payments system functioning. While bank restructuring would take time to implement, depositor and creditor confidence had to be secured immediately; therefore, the blanket guarantee of third party depositors and creditors was introduced in January 1998. Even then, liquidity support was further extended during periods leading into successive bank closures and at times of bank-specific instability, as well as for the payment of external arrears. By mid-1998, international creditor banks were provided with an offer to extend the term of interbank liabilities with a guarantee from Bank Indonesia. The blanket guarantee remains in place.[2]

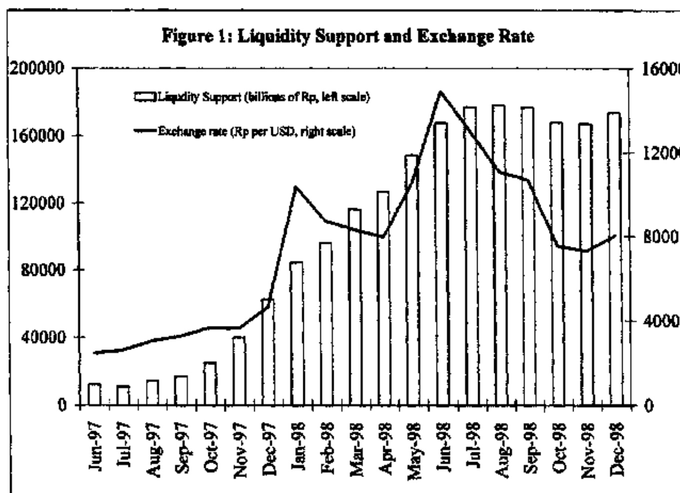

Figure 1: Liquidity Support and Exchange Rate

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[1] Prepared by Peter Dattels of the Monetary and Exchange Affairs Department. Elena Budreckaite assisted with technical preparations.

4. **Removing deeply insolvent private banks from the system, while keeping a core of private bank ownership was the next plank of the program.** A formal triage was used using bank audits and Bank Indonesia inspections, and private banks were grouped according to solvency.[3] In total, 48 banks were closed and liabilities transferred to designated receiver banks, seven private banks were jointly recapitalized, and a total of 12 systemic banks were taken over.[4] State banks, numbering seven before the crisis, were consolidated into four majors by merging four banks into a new state bank—Bank Mandiri—which now represents the single largest bank in the system with about 30 percent of deposits.[5] Later, IBRA (Indonesian Bank Restructuring Agency) reduced to five the number of banks under its management, having completed a recent merger of eight taken over banks into Bank Danamon.

5. **The end result was a dramatic change in the structure of the banking system**—the public owned share of liabilities in the banking system rose from 40 percent precrisis to 70 percent post-crisis. The total number of banks has been reduced from 238 to 157, with the number of private banks falling by one half (Text Table 1).

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[2] Before removing or changing the guarantee, the authorities must give notice to the public of at least six months.

[3] "A" banks with capital of 4 percent and above; "B" banks with capital of less than 4 percent but greater than 25 percent would be eligible for joint (private and government) capital injection; "C" banks with less than 25 percent would either be privately recapitalized enough to move them into improved categories or would be closed; finally, some banks of quantifiable importance in the "C" category would be eligible for take over by the government.

[4] This phase was particularly protracted owing to the time that was needed to establish institutional capacity in IBRA, political uncertainties which generally delayed restructuring, and continuing economic problems.

[5] To enhance financing of export related activities and, thereby, support economic recovery, the Indonesian Export Bank has been formed.

Table 1. Indonesia: Restructuring of the Banking System

	Publicly Owned 1/	Private Domestic	Foreign Controlled	All Banks
Number of banks (June 1997)	34	160	44	238
Closures		-64		-64
1997 (November)		-16		-16
1998–99		-48		-48
Taken over (BTOs)	12	-12		0
1998	3	-3		0
1999	9	-9		0
Merged or taken out of business	-11	-3	-4	-18
New banks (Export bank)	1			1
Net Change	2	-79	-4	-81
Number of banks (June 2000)	36	81	40	157
Assets—market share (in percent):				
Jun-97	42	49	8	100
Mar-99	68	19	14	100
Mar-00	72	17	11	100
Equity to assets ratio (in percent):				
Jun-97	7	9	13	8
Mar-99	-33	-6	2	-34
Mar-00	-3	5	4	-1
Liabilities—percent of GDP:				
Jun-97	37	42	7	86
Mar-99	60	13	8	81
Mar-00	61	13	9	82

Sources: Bank Indonesia; and Fund staff estimates.

1/ Includes 27 regional rural development banks.

6. **Credible actions to resolve banks and to stabilize monetary conditions are helping rebuild confidence in Indonesian banks, but depositors remain wary**. Inflation which peaked at over 100 percent (monthly at annual rates) in early 1998, has been subdued, allowing interest rates to ease from their peak in August 1998 of over 70 percent (SBI rates) to almost single digit, before the recent episode of currency instability. Regarding the banking system, rupiah deposits in real terms have stabilized, even as real interest rates have declined to precrisis levels (Figure 2). However, deposits continue to be held in very liquid form—the average deposit term is less than one month, compared with over six months before the crisis.

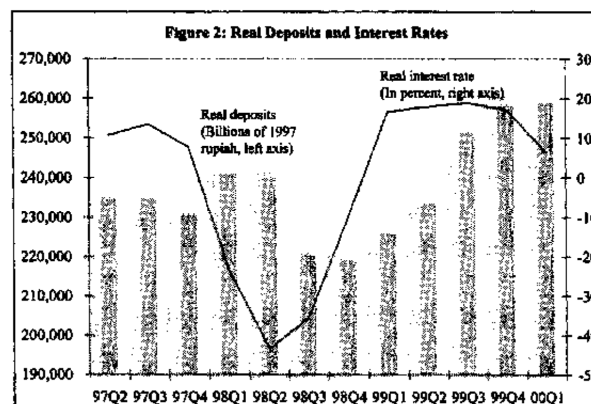

Figure 2: Real Deposits and Interest Rates

Restructuring and recapitalization

7. **Deep restructuring was required for state banks and banks taken over**. The broad approach to restructuring, which has applied both to state and taken-over banks, has been to: (i) *refocus business strategies* on core areas of competence and market niche, including significant operational restructuring and branch consolidation in addition to mergers; (ii) *imbue professional management* by placing qualified and key management personnel into banks, and contracting with management for the achievement of specific performance related goals, while supporting management's efforts with international advisors across core bank activities; (iii) *strengthen credit policies and procedures,* focussing first on loan workouts and recoveries; and (iv) *clean up balance sheets* through the transfer of nonperforming loans to IBRA, including loans connected with former shareholders, and recapitalize the bank. **Progress has been uneven and slower than anticipated, but some recent results are encouraging**:

- **State banks.** Bank Mandiri, owing to its complex merger, has faced the most difficult tasks, but has made significant progress. Early on, a professional management team was put in place and key steps taken. Through a voluntary separation scheme, the bank has shed one third (9,000) of its staff, while reducing the number of its branches by 20 percent (149). Credit work-outs are proceeding and about one-half of the value of the remaining nonperforming loans (following the transfer of loss loans to IBRA) have been restructured. Nonetheless, considerable work lies ahead in accounting and information systems, and further operational downsizing. Further, structural liquidity difficulties need to be addressed (see below). Progress has been slower in other state banks but recent strides have been made. Management of BNI was changed in February 2000 and the business plan for restructuring of operations has been approved. BRI was less affected by the crisis owing to its more specialized focus on microcredits and small and medium scale enterprises; it is to shed much of its corporate business that had attracted losses. BTN is to refocus its activities narrowly on mortgage lending, and to do so it must shed its other activities.

- **Taken-over banks.** Despite delays, the legal merger of eight taken-over banks into Danamon went ahead on June 2000. As part of the mergers, 90 percent of the staff will be retrenched, and 80 percent of the branches will be closed.[6] The eight banks collectively had been losing Rp 360 billion per month. Bank Niaga has been recapitalized and it is being prepared for privatization. Following a clean up of its balance sheet, and with new management installed, an initial public offering of BCA was made in May 2000; plans are being finalized for its early majority privatization.

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[6] The only alternative to the merger is closure, which would lead to an extended and expensive liquidation process.

8. **Recapitalization of banks has been linked to progress on restructuring—improved management, approved business plans, and operational restructuring—so as to protect against moral hazard and future bail outs.** Accordingly, state and taken-over banks were to be recapitalized in stages with acceptance of viable business plans and execution of those plans after passing of specific hurdles. However, the slow pace of restructuring of state banks and taken-over banks has resulted in a number of delays in recapitalization.

9. **The recapitalization program gives recognition to the (gross) costs of stabilizing the banking system** (Text Table 2). *Liquidity support* extended by Bank Indonesia during the crisis that could not be repaid by banks, owing to their insolvency and closure, was replaced with indexed bonds issued by the government amounting to Rp 218 trillion.[7,8] *Residual insolvency*, as well as a cleaning of the balance sheet and recapitalization of open banks, was financed by bonds purchased by banks in exchange for government equity stakes amounting to a projected Rp 453 trillion. The bulk of bonds goes to cover *nonperforming loans* (either transferred to IBRA or provisioned for loans remaining on the balance sheet). Loans were also removed from the balance sheet of banks and replaced by bonds in connection with the *settlement of connected loans* with former bank shareholders of taken-over banks.[9] *Off balance sheet exposures and net open positions* added to losses—foreign exchange losses by Bank Exim were particularly noteworthy, mounting to some $2 billion. Costs were also associated with *monetary stabilization* as interest rates on deposits were driven up well in excess of what banks were able to earn on performing loans (the so called "negative spread"), and these were absorbed in commercial bank balance sheets. Finally, *delays in recapitalizing banks* increased the amount of the bonds that were eventually needed to cover continuing and accumulated losses. Recovery of some of these gross costs will depend on progress toward revitalization of banks and recovery of loans and assets by banks and IBRA. Such recoveries are estimated at about 8 percent of GDP, implying that *net* costs would be in the order of 47 percent of GDP.[10]

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[7] The principal value of the bonds is indexed to inflation (which back loads the fiscal burden) and a 3 percent coupon is paid on the adjusted principal amount semi-annually. The bonds mature in twenty years, with amortization beginning after the first five years. These bonds are nontradeable.

[8] The claims held on banks were transferred to IBRA, and netted out during the process of recapitalization.

[9] Separately, agreements were made with the former shareholders to transfer assets to holding companies in which IBRA's Asset Management Investment (AMI) participates and oversees asset sales. The net recovery of these loans depends on the sale of assets from the AMI.

[10] A detailed account of bank restructuring costs and IBRA's asset recovery efforts is presented in Chapter II of the current *Selected Issues* paper.

Table 2. Recapitalization of the Banking System

	Trillions of Rupiah	Percent of GDP
Total bonds issued (estimated final)	671	55
Bank Indonesia	218	18
Banks 1/	453	37

Sources: Bank Indonesia; and Fund staff estimates.
1/ Includes a Rp 21 trillion contingency, partly to cover the cost of raising state banks' capital from 4 to 8 percent CAR by end-2001.

Revitalization and soundness

10. **The objective of the third phase of the banking program is to strengthen governance and safeguard soundness** while, at the same time, revitalizing credit activities and improving the performance of the banking system.

11. **To revitalize the banking system, a key policy is the injection of private capital and management into banks** (with adequate safeguards). While stabilization has involved a major shift in ownership in the banking system—from private to public—revitalization calls for the opposite—a return of banks to private ownership. Accordingly, the government's strategy for restoring vitality and soundness is to privatize taken-over banks, jointly-recapped private banks, and Bank Mandiri. For a number of these sales, capital is expected to come from foreign strategic and financial investors. After taking over Bank BCA, the largest private (and nonpublic) bank in June 1998, the bank restructuring agency has sold 22½ percent of its share in an initial offering to the general public in May 2000.

12. **To achieve targets for profitability and capital adequacy, the resumption of lending activities is vital.** Broadly, business plans of recapitalized banks rely partly on the widening of income margins, as well as on the healthy growth of credits and deposits, to generate sufficient retained earnings to build capital. Faster progress in corporate restructuring is, therefore, needed to both speed economic recovery and to put corporations on a credit-worthy footing. In this connection, IBRA plays a key role in the restructuring of the corporate sector and resolving nonperforming credits. Finally, restoration of confidence in the economy and an upswing in domestic and foreign investment would greatly ease the transition to soundness and profitability.

13. **To help safeguard the performance of the banking system, oversight and governance are to be further strengthened**. Strenuous efforts are being undertaken to bolster governance and oversight across several fronts: (i) from the outset, efforts have been made *to bring regulations of commercial banks up to international standards*—in particular, classification and provisioning rules and those regarding risk exposures to connected lending have been tightened, even if banks were not yet able to meet all standards; (ii) *to build supervisory capacity*—extensive technical assistance is being extended to Bank Indonesia to strengthen on site inspections and off site analysis of banks; and (iii) *to restore bank*

soundness—the benchmark for this being the attainment of capital adequacy standards of 8 percent by the end of 2001.

B. Present Financial Position of the Banking System

14. Substantial progress has been made in restoring the financial position of the banking system, but strains remain that need to be addressed.

Capitalization and solvency

15. **As the recapitalization program nears completion, overall solvency of the banking system has been restored** (Text Table 3). Remaining bonds are to be delivered in tranches to two state banks over the next two quarters, in line with implementation of their business plans. Following the recent legal resolution of Bank Bali and Parliamentary approval, the bank is also to be recapitalized, and the government would be the standby buyer of a rights issue, as was done for the other private recapitalized banks.

Table 3. Market Share and Solvency Position of Operating Banks, June 2000
(In trillions of Rupiah)

	Number of operating banks 1/	Liabilities1/	Share (Percent) 1/	Equity 2/		Recap Bond Issued to Operating Banks 2/	Additional Recap Needed 2/
				Positive	Negative		
State & regional dev. Banks, *of which:*	32	548	57	52	-10	256	27
Mandiri	1	312	32	18	0	178	0
IBRA banks:	12	179	18	18	-4	119	5
BTO 1998	3	122	13	8	0	81	0
BTO 1999	8	45	5	10	0	38	0
Bank Bali	1	12	1	0	-4	0	5
Private banks, *of which:*	80	143	15	12	0	22	2
Recap banks, excluding Bank Bali 3/	7	79	8	4	0	22	2
Foreign banks	40	99	10	7	0	0	0
Banking system	164	968	100	89	-14	397	34

1/ As of March 2000.
2/ Bond issuance through July.
3/ For additional recap needed for Bank Internasional Indonesia.

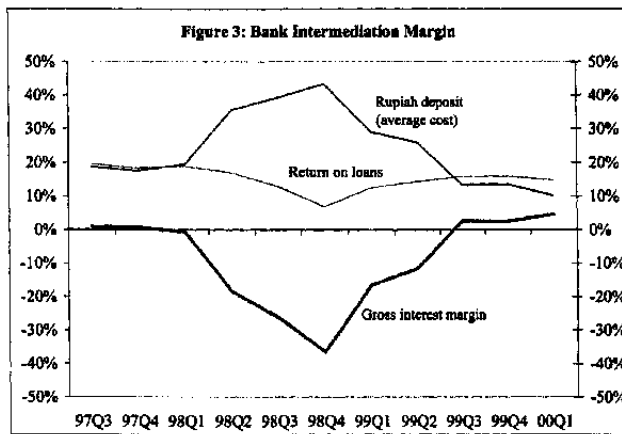
Measures of profitability

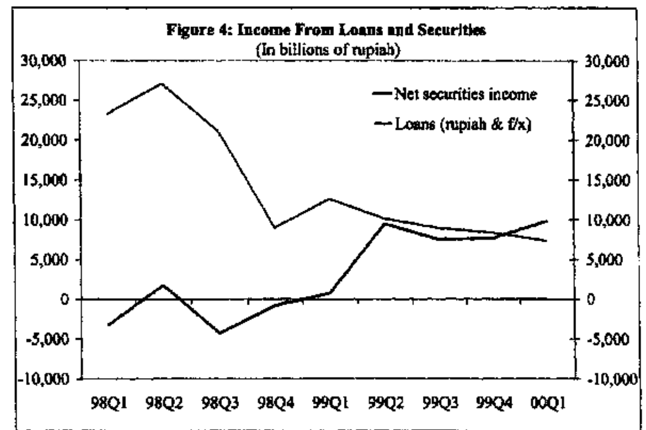
16. **For the first time since the crisis, net earnings (before provisions) of the banking system are positive** (Text Table 4). Declines in deposit rates have restored intermediation margins (Figure 3), while the recapitalization of banks has increased income from noncredit earning assets. Indeed, net income from securities has replaced loans as the single most important source of earnings (Figure 4).

Table 4. Indonesia: Quarterly Summary Income Statement - All banks
(In billions of rupiah)

	98 -I	98 - II	98 - III	98 - IV	99 - I	99 - II	99 - III	99-IV	00 - I
Net earnings	9,081	31,036	-44,719	-51,227	-16,123	-3,532	-7,061	-106	5,092
Of which: Net interest income	1,689	-7,207	-21,791	-33,257	-22,158	-12,608	-1,453	-2,310	3,095
Provisions against losses	-6,503	-19,117	-13,101	-64,001	-15,995	-21,717	-31,793	-22,705	-2,217
Operating costs	-3,979	-4,078	-4,090	-4,951	-3,737	-5,885	-3,974	-5,607	-3,517
Operating result	-1,402	7,842	-61,911	-120,179	-35,855	-31,134	-42,827	-28,418	-642

Sources: Bank Indonesia, Bank Mandiri published financial statements for September 1999, and Fund staff estimates.





17. **Provisioning against losses has declined sharply as the peak of the crisis has passed and loans undergo restructuring.** Loan provisions peaked in the fourth quarter of 1998, reflecting delays by banks in recognizing and reporting the gravity of the situation. Furthermore, loans classified as loss were removed from the balance sheets of banks undergoing restructuring and transferred to IBRA in the first half of 1999. Nevertheless, provisions made in the first quarter of 2000 absorbed almost 45 percent of net earnings.

18. **Consequently the net operating result in the first quarter of 2000 is about flat, compared to enormous losses recorded at the end of 1998 and throughout 1999.** Net earnings after provisions are positive, but this is slightly surpassed by (noninterest) costs of bank operations (overhead and salaries).

19. **Pockets of negative earnings remain in the banking system.** Banks that had yet to be recapitalized exhibited negative earnings in the first quarter of 2000, including two state banks (BNI and BRI) and a number of taken-over banks.

Asset quality

20. **Provided that the nascent economic recovery continues and corporate restructuring advances, loans would appear to be adequately provisioned.** Net of provisions, nonperforming loans as a percentage of gross loans is about 7 percent (Text Table 5). In relation to total assets, Indonesia compares favorably to other regional countries, reflecting the greater extent to which nonperforming loans were removed from balance sheets (and replaced by bonds).

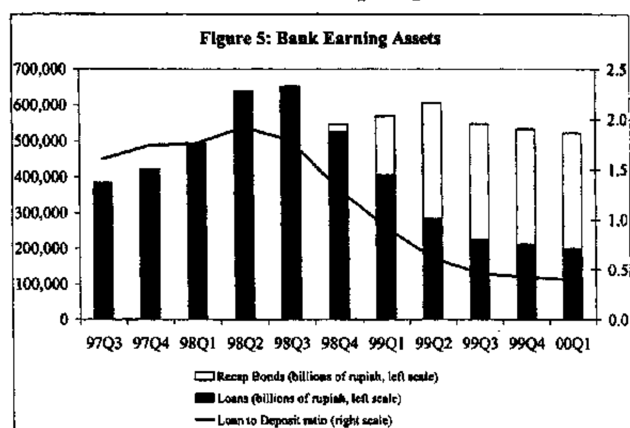
Table 5. Loan Performance and Provisions, March 2000

(In billions of Rupiah)

	Gross Loans	Nonperforming Loans	NPL (%) of Gross Loans	Provisions	Net NPL as % of Gross Loans
State & regional dev. banks	149,198	44,704	30.0%	36,823	5.3%
IBRA banks:	17,010	7,166	42.1%	6,293	5.1%
BTO 1998	7,232	1,606	22.2%	1,601	0.1%
BTO 1999	9,778	5,561	56.9%	4,692	8.9%
Private banks, *of which:*	49,387	12,952	26.2%	7,815	10.4%
Seven "recap" banks	27,758	6,821	24.6%	4,106	9.8%
Foreign banks	53,081	21,451	40.4%	16,214	9.9%
Banking system	265,515	86,273	32.5%	67,146	7.2%

Source: Bank Indonesia.

21. **However, loan performance overall continues to be very poor with nonperforming loans amounting to over 30 percent of gross loans** (after transfer to IBRA of loss loans). The situation reflects slow progress in key areas of reform—including credit practices of banks and corporate restructuring—as well as the early stage of economic recovery. Continued poor loan performance raises concerns about the prospects for restoration of bank intermediation, and underscores the need for greater progress on critical areas of loan recovery and corporate restructuring.



22. **Furthermore, the composition of bank assets reconstituted in the aftermath of restructuring and recapitalization tends to limit profitability.** The yield from recapitalization bonds offsets

satisfactorily the costs of servicing interest sensitive liabilities, but it does not provide a substantial margin to income. Meanwhile, following restructuring, loans amount to only one-third of earning assets, with recapitalization bonds almost two times as much. In other words, the coverage by profit generating loans of deposit liabilities is poor—the loan to deposit ratio is less than one-half. As a result, the return on assets is biased lower and prospects for profitability more limited (Figure 5).

Liquidity and net open position

23. **Liquidity in the banking system is not well distributed.** Private and foreign banks hold ample liquidity (Text Table 6). However, accumulating losses and insolvency in major state banks, as well as bank specific factors, have led to a drain on their liquidity. As a result, state banks offer higher deposit rates than many private Indonesian banks, which is keeping pressure on income margins of state banks. Also, deposit rates have become somewhat sticky downwards as state banks—which are price leaders in setting deposit rates—are less responsive to an easing in the monetary stance. Recapitalization bonds could be sold to raise liquidity.[11] However, in current poor market conditions, their long maturities, as well as pricing, makes them less attractive to other buyers in the absence of a discount, while, state banks either need to seek approval to sell bonds or are reluctant to do so.

Table 6: Average Deposit Rates by Group of Bank; SBI Holdings and Rates, June 15, 2000 1/

	Term Deposits			SBI holdings	Liquidity Ratio 2/
	One Month (Percent)	Three Month (Percent)	Six Months (Percent)	(Billions of Rp)	(Percent)
State Banks	10.1	11.4	12.0	2,191.0	0.5
Private Banks	10.0	10.4	10.4	50,800.0	17.5
Foreign banks	8.0	7.9	7.9	5,000.0	5.3
Difference (high less low)	2.1	3.5	4.2		
SBIs	11.4				
Total				57,991.0	

Source: Bank Indonesia (PIPU system).
1/ Based on an average of rates posted by each bank; retail amounts (less than Rp 1 billion).
2/ SBI holdings divided by deposits.

24. **The liquidity position of state banks is being addressed.** State banks have recently been recapitalized, and in time the earnings on bonds will help restore liquidity. However, additional measures are needed to address the structural component of liquidity deficits so as not to erode the financial position of state banks and disturb the overall functioning of the

[11] Banks can also borrow in the interbank market through repurchase agreements (repo) using bonds.

banking system. Under consideration are measures that include: permitting state banks to sell some of their bonds; a phasing in of some of MoF regulations governing investments of insurance and pension funds, allowing them to maintain large deposits with state banks; and the downsizing of state bank balance sheets. As well, the government plans to commence issuing to the general public shorter term government securities, while using the proceeds to purchase (and retire) from the secondary market bonds held by banks to assist in liquidity adjustment.

25. **Over time, state banks also need to unwind large open positions in foreign currency**. As many foreign currency loans stopped performing during the crisis and were subsequently transferred to IBRA, a large (short) foreign currency position opened in state and taken-over banks. Hedged bonds were issued as part of recapitalization to cover exposure in rupiah terms, while giving time to unwind positions smoothly (Text Table 7). The bonds mature at regular intervals (each quarter) and convert into regular fixed-rate rupiah bonds (over three years). Banks must, therefore, close their positions by buying dollars and draw down their rupiah liquidity—which can add stress to money and currency markets in a weak market environment.

Table 7. Net Open Position of State and Taken-Over Banks, June 2000

	Before Hedge Bonds Net Open Position 1/	Hedge Bonds Issued	After Hedge Bonds Net Open Position 1/	
	(Millions of $)	(Billions of Rp)	(Millions of $)	(Billions of Rp)
State banks	4,975	34,520	659	5,800
BTO banks	362	0	362	3,189
Total	5,337	34,520	1,021	8,989

Sources: Bank Indonesia; and Fund staff estimates.
1/ "+" equals short dollar position.

Overall assessment

26. **In sum, the overall financial position of the banking system is solvent and income margins are positive—a major milestone in the banking program** (Figure 6). However, strains remain and the system is vulnerable. Although solvent, the banking system is nevertheless undercapitalized—prudential regulation requires banks to build capital adequacy to 8 percent by end 2001. The thin capital base

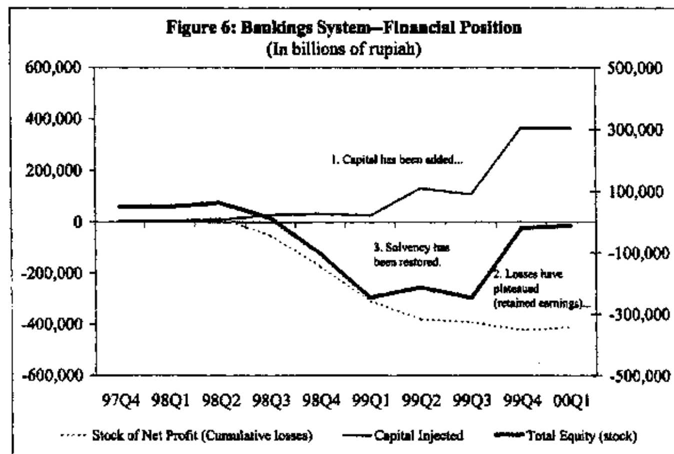


Figure 6: Bankings System—Financial Position
(In billions of rupiah)

gives little cushion to shocks—increases in interest rates or pressure on the exchange rate. While intermediation margins are now positive, overall profitability and efficiency is low. Poor loan performance and the slow pace of restructuring means that credit intermediation would continue to be weak, hampering internal generation of earnings needed to rebuild capital positions, as anticipated for in bank business plans. Strains in the banking system—liquidity deficits of state banks and foreign currency exposures—need to be addressed and monitored closely to protect the financial position of the system. **Achieving a viable and sound banking system will require additional efforts to address remaining strains in the banking system, complete financial and operational restructuring, and meet challenges of the next phase of the bank program.**

C. Restructuring Agenda Ahead

27. **Significant work lies ahead to complete banks restructuring** with the focus shifting from financial to operational restructuring, restoring soundness, and restarting credit intermediation in the third phase of the banking program.

State banks

28. **The state banks face significant challenges—high operating costs and low earnings potential.** The state banks represent half the deposit liabilities in the banking system but less than one third of the loans. Postcrisis, costs of large branch networks and staff are out of line with earning assets. Accordingly, while state banks need to restructure further their balance sheets, their business plans place great emphasis in the period ahead on strengthening management and operational restructuring to improve viability (Box A):

- **Balance sheets of state-controlled banks need to be further restructured and downsized to make them viable.** Accordingly, the bank program calls for *inter alia*: (i) faster progress by IBRA to restructure and make loans performing that can be exchanged with banks (boosting bank profitability) for bonds (lowering government debt stocks); and (ii) sales of bonds by banks to help downsize their balance sheets. Such adjustment is to be facilitated by actions to develop secondary and primary markets for government securities.

- **Cutting operating costs is an important part of an overall strategy to restore profitability.** Business plans lay out considerable work in areas involving operational restructuring; in particular, reducing and rationalizing branch and staff operations. This is especially important as credit is unlikely to grow at the pace earlier expected.

- **Business strategies need to be rationalized and professional management fully installed.** A priority area is to clarify the business strategies of the state banks and to build professional management to carry them out, coupled with adequate oversight. In this connection, some old tendencies had reemerged, such as political appointments to management of state banks. As well, in some cases, existing management of state banks have resisted efforts to refocus operations on core competencies. Stronger political

commitment to the commercial orientation of state banks is essential for restructuring to be successful.

- **State banks need to be prepared for divestment.** Privatization would help state-owned banks prepare for the pressures of globalization and better capitalized domestic banks, while also reducing the fiscal burden of the bank recap program. Work needs to move ahead for the development of a formal divestiture plan.

Joint recap banks

29. **The performance of private recap banks appears satisfactory**. Bank Indonesia continues to monitor closely the performance of the seven private banks which were jointly recapitalized (Text Table 8).[12] Through March 2000, each bank is reporting progress toward meeting business plans and earning positive incomes. Capital adequacy is generally above the 4 percent required, and in several cases above the future standard of 8 percent. However, return on equity has fallen short of business plans in several banks. While progress thus far has been satisfactory, IBRA and Bank Indonesia will need to jointly monitor developments to ensure banks remain on track, especially to meet the increased required capital by end-2001.

Table 8. Performance of Private Recap Banks, March 2000

	Capital Adequacy Ratio		Return on Equity
	Business Plan	Reported	Business Plan
Lippo	14.9	17.6	10.0
BII	5.5	5.2	2.8
Universal	4.0	5.2	10.0
Bukopin	4.0	12.4	10.0
Prima Express	4.0	5.7	10.0
Arta	4.0	9.5	10.0
Patriot	8.0	16.6	11.0

Source: Bank Indonesia.

30. There are some prospects for the sale of government ownership in private recap banks before the end of the term fixed in the recap agreement. While it is unlikely that the majority holders would exercise their right to buy the state's shareholding,[13] possible new financial and strategic investors could be brought into these banks with the sale of government shares in agreement made among the government and majority shareholders and new investors.[14]

[12] Although the government holds majority ownership of these banks, day to day operations are in the hands of the minority private owners.

[13] Share prices of private recap banks are generally below exercise prices of shares (prices were calculated based on the contribution to net solvency plus a carrying cost of the bonds).

[14] Until 2002, the majority private owners have the first option to purchase the government shares.

Box A. State-Owned Banks 1/

Financial highlights: (at June 30, 2000; in trillions of rupiah)

	Deposits	Loans/Dep.(%)	Recap Bonds (issued)	Net Income (IQ 2000)
Bank Mandiri	177	34	178.0 (100%)	6.6
BNI	85	43	61.8 (100%)	(2.4)
BRI	44	69	20.4 (70%)*	1.2
BTN	15	45	9.8 (70%)*	(1.0)

*As of July 25, 2000—remaining 30 percent expected end-October.

General issues

- **Further loan loss provisioning** may be needed and would be revealed by year 2000 audits.
- **Credit risk management**: While progress has been made in the area of establishing manuals and procedures, a new credit culture with strong checks and balances needs to be implemented and systems made fully operational.
- **Corporate Governance**: Board of Commissioners is now slated to become active but membership needs to be expanded and clear responsibilities defined (audit, HR, compensation, etc).
- **Interim performance contracts** (valid till October 2000) have been signed between MoF and the management of banks BNI, BRI and BTN. Final performance contracts to be signed upon completion of mid-year 2000 assessments.
- **Divestiture**: The government has yet to develop a full fledged plan to divest banks.

Specific issues

Mandiri
- *Management* — The Boards of Directors and Commissioners established. Priority needs to be given to the selection and appointment of key management executives including, in particular, the Chief Credit Officer.
- *Strategic focus* — Universal bank within extensive nation-wide network.
- *Consultants* — Widely engaged in core areas of banking operations.
- *Other challenges* — Branch rationalization; broadening depositor base; implementing a common accounting and IT platforms.

BNI
- *Management* — Reshuffled February 2000. New members all longstanding BNI employees.
- *Strategic focus* — Universal Bank, (corporate, SME and retail).
- *Consultants* — Working in asset rehabilitation, coordination and divestment; risk management; corporate strategy and governance, operational efficiency and IT upgrade.
- *Other challenges* — Validate past NPL restructuring and accelerate recoveries, expand BoC, downsize/close overseas branches.

BRI
- *Management* — Changed July 2000. All but one Director appointed from state-owned banks.
- *Strategic focus* — Micro, SME and retail banking; with 20 percent of the loan portfolio reserved for larger corporates (existing clients).
- *Consultants* — None, but expatriate managers hired for IT and MIS upgrades.
- *Other challenges* — Define and implement new retail lending strategy; upgrade MIS and accounting systems; HR development (37,000 staff); streamlining of branch network (3,600 units); and introduce new credit risk management systems.

BTN
- *Management* — Changed in May 2000. All Directors have state-owned bank background.
- *Strategic focus* — Housing Finance, including limited real estate development and retail banking.
- *Consultants* — None engaged.
- *Other challenges* — Identify new funding sources as the government phases out its past housing subsidy scheme; a new low-income housing policy has been accepted in principal but not yet enacted. The World Bank to propose new TA to support development of competitive products and procedures.

1/ Prepared by World Bank (Jakarta Office).

Taken-over banks

31. **Taken-over banks have now been mostly recapitalized, while restructuring is proceeding** (Box B). With the exception of Bank Bali, all taken-over banks have been recapitalized. Following the legal merger at end-June, Danamon's management plans an aggressive program to complete the required branch closures and integrate the small number of performing assets, branches, and staff to be retained from the eight banks. Danamon has achieved modest profitability so far in 2000, and its baseline forecast is for a near break-even performance after the merger. The achievement of significant profitability in the business plan is predicated on the purchase of performing loans from IBRA with recap bonds.

32. **Government divestiture would need to gain momentum and help reposition banks in the private sector**. Although by far the largest portion of the divestiture lies ahead, the initial public offering and sale of 22½ percent of BCA is an important milestone towards returning what was the largest private sector bank to the private sector. Furthermore, the government has renewed its commitment to the privatization of taken over banks and has recently announced that it will sell its entire holdings of BCA and Bank Niaga by the end of the year.[15]

Private banks

33. **Further consolidation of private banks is likely**. As the time to achieve the required 8 percent CAR by end-2001 approaches, pressures for further consolidation of the number of private banks—73 private banks, which account for some 5 percent of the system—are likely to mount. In advance of this, Bank Indonesia has been taking a proactive stance, and encouraging banks with signs of weakness to seek equity injections or merger partners. Meanwhile, foreign controlled banks continue to report a generally satisfactory financial condition. By virtue of their generally liquid positions and access to capital from their foreign parents, foreign banks are well positioned to expand their lending activity, but are unlikely to lead other banks owing to their conservative stance.

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[15] The divestiture of these banks is to be approved by Parliament at end-August.

Box B. Taken-Over Banks 1/

Financial highlights (as at 30 June 30, 2000; in trillions of rupiah)

	Deposits	loans/dep.(%)	Recap bonds (issued)	Net Income	Gov't Owned (%)
BCA**	92	7	60.9	0.61	70.3
Danamon***	30	20	48.5	0.01	98.9
Bank Niaga	13	46	9.5	(0.580)	97.1
Bank Bali	7	57	-*	(0.570)	-

* A total of Rp 4.8 trillion bonds expected to be issued to Bank Bali in October 2000.

** Bank BCA's BTO status was reverted when it was formally returned to BI on April 27, 2000.

*** Includes 8 smaller BTO banks legally merged into Bank Danamon in June, 2000.

General issues remaining:

1) *Risk Management:* An improved credit culture with strong checks and balances has been introduced at each bank. New lending has resumed as well. Moreover, both banks need to significantly improve their balance sheet structure by growing the loan portfolio, while keeping with prudent banking practices. It is also note worthy that considerable amount of loans under IBRA had gone into BTO banks for either outsourcing or sale.

2) *Interim Management and Performance Agreements:* IMPA have been signed between IBRA and the management, with the exception of Bank Bali. Compliance is monitored by a department within IBRA's Bank Restructuring Unit (BRU). Key performance indicators for the BTO banks' are published monthly by IBRA.

3) *Divestiture:* The government has agreed to dispose banks BCA and Niaga by end-2000; Bank Danamon is to be offered for sale in 2001. Bank Bali's original shareholders have dropped their past legal claims; divestment is expected in 2001.

Specific issues remaining:

BCA

- An IPO was held in May 2000, disposing 22.5 percent of government holding with proceeds of approximately Rp 927 billion. Government ownership currently account for 70 percent, which will be divested by end-2000.
- Asset portfolio dominated by low yielding government recap bonds. The bank needs to generate higher interest income by converting bonds into loans.
- Strong franchise value with 772 nationwide branches and 1,858 ATM network supported by sophisticated technology.

Danamon

- Operational mergers to be completed in October 2000.
- The bank received its second recap tranche in June 2000.
- Asset portfolio concentrated in government recap bonds, which need to be converted into loans.
- Management team led by expatriate banker.

Niaga

- Loan quality needs to be significantly improved as the NPL rate reached a high 73 percent of total loan portfolio.
- Exposure in foreign currency loans need to be decreased, as foreign exchange loans currently account for 60 percent of total outstanding loans.

Bali

- Government reached legal settlement agreement with previous owner, removing the main obstacle to recapitalization.
- While the recapitalization is now scheduled for October 2000, the bank is experiencing an average monthly loss of Rp 44 billion.
- High NPLs of 75 percent, with provisions covering 73 percent of NPL amount. Most NPLs to be transferred to IBRA prior to recapitalization.

1/ Box contributed by the World Bank (Jakarta).

D. Regulatory Framework and Governance Issues

34. **To safeguard the soundness and performance of the banking system, key areas of regulatory and governance need to be strengthened.**

Regulatory compliance

35. **The ultimate goal is to have all banks in compliance with all regulatory norms.** However, in the current economic situation, Bank Indonesia has permitted a phase-in period for banks to achieve compliance with a number of key prudential regulations, including capital adequacy requirements, legal lending limits, and foreign exchange net open position limits (Box C).[16] To reinforce the ultimate goal of compliance, banks must submit plans demonstrating that they can reach the targets within the required time frame. Some forbearance has also been characteristic of other Asian economies undergoing restructuring.

Building BI's supervisory capacity

36. **Bank Indonesia has established a master plan to upgrade supervisory capacity.** Progress has been made in important areas—comprehensive fit and proper tests of owners and managers, establishing an effective special investigations unit, and promoting transparency in the banking sector through publicly listed financial statements. However, significant work lies ahead. Even without forbearance, Indonesia would be materially non-compliant with many of the Basle Core Principles for effective banking supervision due to the current absence of regular and effective verification of banks' compliance with prudential standards. Also, the ability of Bank Indonesia to undertake a forward looking assessment of banks and the system as a whole needs to be strengthened—this calls for the adoption of a forward-looking risk-based approach compared to the more historical compliance orientation. Banks need to be given requirements that incorporate this risk-focused approach, and Bank Indonesia needs to incorporate such an approach into in its supervision and examination processes. The above weaknesses have already been identified by Bank Indonesia, and successful implementation of the supervision master plan should address these deficiencies. The authorities' efforts are being supported by technical assistance provided by IMF/MAE.

Strengthening governance

37. **Strengthening overall governance of the banking system is a key area of reform.** Commercial banks as well as Bank Indonesia have been subject to audit by external accountants. Bank Indonesia is committed to monitoring and enforcing compliance with the new prudential regulations. Parliamentary committees give approval for recapitalization, after receiving briefings by government on progress on banking system restructuring. A

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[16] Relaxation was given so as to accommodate corporate restructuring being undertaken by the JITF and IBRA.

governing Board has recently been established in IBRA. However, additional measures are needed to buttress governance, especially through the critical period ahead. These include:

- *Governance and Oversight Unit (MOF).* As stakeholder, the government needs to assume greater responsibility for the performance of state banks, their overall business strategy and for their divestment. Specific issues that need to be addressed include: (i) compliance with the banks' performance contracts (including financial and operational restructuring targets) and recommend actions or adjustments when targets are not met; (ii) the accuracy of the banks' financial reporting to MoF; (iii) make recommendations to enhance governance and shareholders' interests; and (iv) divestment. While the unit has been formed, the full mandate outlined above has yet to be delegated.

- *Onsite presence of Bank Indonesia supervisors in state banks.* Bank Indonesia has recently announced its intention to soon establish such a presence in states banks to facilitate the monitoring and improvement of (i) risk management systems; (ii) progress in achieving goals outlined in the business plan; and (iii) the flow of information between the state-owned banks and Bank Indonesia.

- *Data reporting systems.* Bank Indonesia is working to strengthen its reporting of financial data on banks. This is a critical area. Without timely and accurate information on the state of each bank, effective supervision and monitoring of the banking system would be difficult.

Box C: Regulatory Forbearance

- **Minimum total risk-weighted capital ratio of 8 percent is not required until end-2001**: The current capital adequacy ratio is 4 percent, and banks have until end-2001 to achieve an 8 percent risk-weighted total capital ratio.

- **Extension of the time period by which banks must comply with the legal lending limit if the violation is deemed unintentional**: Banks whose violation of the legal lending limit arose from the increase in value of foreign currency denominated assets relative to the value of their rupiah denominated capital have been given until May 2001 to come back into compliance. In the case of loans restructured under the JITF, a longer extension to December 2002 was granted. The legal lending limit for individual debtors or group of debtors (1) is 30 percent of capital until year-end 2001, 25 percent of capital during year 2002, and 20 percent commencing January 1, 2003 for non-connected parties; and (2) 10 percent of capital for connected parties. "Intentional violations" of the legal lending limit must be corrected within one month from the date of the violation.

- **Relaxation of the prudential rule that prohibits banks from directly owning shares in nonfinancial institutions:** Originally, if a bank acquired an equity position in a company resulting from debt restructuring, it was required to divest the equity position as soon as the company achieved profitability for two consecutive years, even though retained earnings were still negative. Equity holding arising from restructurings can now be held until the earlier of five years or the point in time when retained earnings become positive.

- **Phase in of net open position limits:** Banks were required to gradually come into compliance with the requirement that their net open foreign exchange position not exceed 20 percent of capital. While all banks are required by regulation to meet the 20 percent requirement by end-June, many banks are still reporting significant excesses.

    - From June 30, 1999, NOP is not more than 70 percent of the excess NOP reported at December 31, 1998;

    - From December 31, 1999, NOP is not more than 40 percent of the excess NOP at December 31, 1998; and

    - By June 2000, NOP is not more than 20 percent of capital.

II. BANK RESTRUCTURING IN INDONESIA: FISCAL COSTS AND DEBT DYNAMICS[1]

A. Introduction

1. **The banking crisis that hit Indonesia toward the end of 1997 is one of the most severe ever faced by any country.**[2] The steep depreciation of the rupiah triggered a loss of confidence in the banking system, which by January 1998 reached systemic proportions. Massive deposit withdrawals and capital flight by panicked investors in the face of a currency in free fall had a devastating effect on bank liquidity and, eventually, solvency. Banks and corporations alike were caught largely unprepared to deal with the dramatic depreciation of the currency. This resulted in corporations being unable to service their loans causing, eventually, very large losses to banks. Over time, these losses were compounded by banks' inability to pass on to borrowers the higher costs of funds, resulting from the steep (but delayed) interest rate tightening by the central bank.

2. **The resolution of the banking crisis has involved (temporary) nationalization of bank assets, and has resulted in very large costs for the state.** These costs mainly reflect (i) the provision of liquidity support by the central bank, which was largely not repaid by recipient banks; (ii) the honoring of the guarantee on bank deposits and other liabilities, especially for those banks that were closed or merged; (iii) the need to recapitalize a deeply insolvent banking system.

3. **However, a portion of these costs is expected to be recovered from the resolution of the distressed assets acquired by the government through IBRA** (the Indonesian Bank Restructuring Agency). These assets principally consist of bank nonperforming loans; industrial assets pledged by former owners of closed banks (who were found in violation of prudential norms); and equity stakes in banks. Recovering value from these assets is paramount to reducing the ultimate costs of the banking crisis.

4. **The large stock of financial liabilities contracted by the government to fund the costs of bank restructuring has led to a steep increase in government debt,** thereby exacerbating the vulnerability of the medium-term macroeconomic framework to shocks. Despite the fact that the government debt stock has risen by more than four times compared to the pre-crisis period, fiscal sustainability can still be assured through prudent macroeconomic and restructuring policies.

5. **This paper will discuss in detail the origins of bank restructuring costs, their implications for the medium term fiscal position, and the conditions for fiscal sustainability.** Section B will present the latest estimates of bank restructuring costs. The

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[1] Prepared by Lorenzo Giorgianni.

[2] Chapter I of the current *Selected Issues* paper discusses the background to the banking crisis and the resolution strategy adopted.

final magnitude of these costs will depend on IBRA's ability to recover value from the assets transferred to it. Therefore, Section C will focus on IBRA's asset recovery prospects. The implication of bank restructuring costs for the medium-term dynamics of government debt will be discussed in Section D. In this section, an alternative medium-term scenario for the debt profile is presented and the risks to sustainability illustrated.

B. Magnitude and Origins of Bank Restructuring Costs

6. **Latest estimates place *gross* costs of bank restructuring at about Rp 670 trillion, or 55 percent of 2000 GDP.**[3] Over ⅔ of total gross costs are connected with the recapitalization of operating banks, while the rest is principally linked to the cost of bank closures and losses from the extension of liquidity support by Bank Indonesia.[4]

Table. Indonesia: *Gross* Costs of Bank Restructuring (Indicative Estimates)

	Trillion Rp	Percent GDP	Billion $ 1/	Share
Total *gross* costs, due to:	**671**	**55**	**84**	***100***
BI losses on liquidity support to state and taken over banks	100	8	13	*15*
Bank closures (including BI losses on liquidity support)	109	9	14	*16*
Recapitalization of operating banks	432	35	54	*64*
State banks	284	23	36	*42*
Cost of insolvency (negative equity)	271	22	34	*40*
Cost of rising equity from 0 to 4 percent CAR	13	1	2	*2*
Banks taken-over (BTO)	119	10	15	*18*
Cost of insolvency (negative equity)	113	9	14	*17*
Cost of rising equity from 0 to 4 percent CAR	6	0	1	*1*
Private recapitalized banks and Bank Bali	29	2	4	*4*
Cost of insolvency (negative equity)	26	2	3	*4*
Cost of rising equity from 0 to 4 percent CAR	3	0	0	*0*
Other	31	3	4	*5*
Memorandum items:				
State bank restructuring costs	304	25	38	*45*
Private bank restructuring costs (incl. of bank closures)	336	27	42	*50*
Other restructuring costs	31	3	4	*5*

1/ Assumes an accounting exchange rate of Rp 8,000 to the dollar.

[3] These estimates refer to the *stock* of gross costs—i.e., principal costs—and exclude the *flow* of future interest costs. The cost estimates are unchanged from the one presented in January 2000, at the time of the approval of the current EFF (EBS/00/08).

[4] The recently released audit of Bank Indonesia liquidity credits by the Indonesian Supreme Audit (BPK) reveals that liquidity support was largely misused by recipient banks. The five largest beneficiaries of liquidity support were Bank Central Asia, Bank Danamon (both eventually taken over by IBRA), BDNI and BUN (both closed in 1998), and the state-owned Bank Exim (later merged into Bank Mandiri), whose liquidity problems derived mainly from foreign exchange trading.

7. **More than half of total gross costs are due to bank losses**. The insolvency, or "hole", in banks' balance sheets originated mainly from three sources:

- The need for setting aside provisions against large loan losses (including for the loans transferred to IBRA);
- The cost of writing-off loans extended to related parties in violation of banking regulations; and
- The accumulated effect of negative interest margins on bank profits.

By contrast, the cost of bringing bank equity from 0 to 4 percent CAR (currently the regulatory minimum) is only a tiny fraction of total recapitalization costs.

Table. Indonesia: Estimated Recapitalization Costs by Group of Banks

	Trillion Rp	Percent GDP	Billion $ 1/	Share
Total estimated recapitalization costs:	**432**	**35**	**54**	***100***
State banks	284	23	36	*66*
Of which: Capitalization of Bank Mandiri	178	14	22	*41*
Banks taken-over (BTO)	119	10	15	*28*
Private recapitalized banks and Bank Bali	29	2	4	*7*
Memorandum Items:				
Cost of insolvency (negative equity)	410	33	51	*95*
Cost of rising equity from 0 to 4 percent CAR	22	2	3	*5*

1/ Assumes an accounting exchange rate of Rp 8,000 to the dollar.

8. **By and large, recapitalization costs were highest among the four state banks,** with Bank Mandiri capitalization accounting for a share of over 40 percent of state bank costs.[5] It is estimated that restructuring these banks (including the small regional development banks) will eventually cost the government about ¼ of 2000 GDP, or more than 40 percent of total gross costs of bank restructuring. The main reason for these large cost estimates is to be found in the extremely poor quality of state banks' loan portfolios, especially among the four legacy banks merged into Bank Mandiri. Additional losses were also caused by state banks' deliberate policy of maintaining lower lending rates—relative to other banks—despite facing increasing cost of funds.

[5] Injections of private equity in banks are excluded from the cost estimates presented above. However, the amounts involved are small: Rp 9½ trillion in private equity was raised in 1999 by the seven jointly recapitalized private banks; and (based on partial information) an additional Rp 100-150 billion were injected into the small private "A" banks during 2000. These amounts exclude less than Rp 1 trillion in equity raised in the recent IPO for Bank Central Asia (a taken over bank).

9. **However, *gross* costs represent an upper bound of the ultimate cost to the government, as they do not take into account future recoveries** from the resolution of the assets acquired by the government (IBRA) in the process of restructuring the banking system. Asset recoveries are expected to come from (i) the sale of companies pledged to IBRA by former bank owners of closed banks; (ii) the resolution of nonperforming loans transferred to IBRA; and (iii) the privatization of banks taken over by IBRA.

10. **Nevertheless, even after taking into account asset recoveries, Indonesia's bank restructuring costs are significantly higher than those experienced by other countries.** Using the concept of *net* costs, which equals *gross* costs (amounting to about 55 percent of GDP) minus (the present value of) cumulative future asset recoveries (amounting to about 8 percent of GDP), the resolution of Indonesia's banking crisis is expected to cost to the state about 47 percent of GDP. This corresponds to close to 2½ times the cost of resolving the banking system in Mexico during 1994–99, and to more than 1½ time the estimated cost of Thailand's recent banking crisis.

Table. Restucturing Costs of Selected Banking Crises 1/

Banking crisis episode	In percent GDP
Asian countries (1997-)	
Korea 2/	17
Thailand	29
Indonesia	**47**
Chile (1981-87)	29
Mexico (1994-99) 3/	19
Sweden (1990-93) 4/	4
United States (1980-92)	2

Sources: staff estimates (Asian countries); and Lindgren, C. et al. (1996) *Bank Soundness and Macroeconomic Policy*, Washington, DC: IMF.

1/ Net costs defined as stock of liabilities contracted by the state (directly or indirectly) *minus* (the present value of) actual and projected asset recoveries.

2/ Refers to actual gross costs minus actual asset recoveries.

3/ Includes toll road support programs.

4/ Excludes asset recoveries.

Financing of bank restructuring costs

11. **Gross costs of bank restructuring are being financed by the government through the issuance of bonds**, which so far amount to about Rp 630 trillion, or 95 percent of the estimated total need (Table II.1).[6] About ⅓ of the issued amount has been placed with Bank Indonesia to cover its losses from past liquidity support, and to finance payments of claims under the guarantee on the liabilities of closed banks. The balance of bonds (over

Table. Indonesia: Actual Government Bond Issues (as of end July 2000)

	Trillion Rp	Percent GDP	Billion $ 1/	Share
Total bond issues	**631**	**51**	**79**	**100**
Variable rate bonds	226	18	28	*36*
Fixed rate bonds	151	12	19	*24*
Hedge bonds	35	3	4	*5*
Inflation indexed bonds	218	18	27	*35*

1/ Assumes an accounting exchange rate of Rp 8,000 to the dollar.

[6] The residual balance of bonds to be issued (mostly, to complete the recapitalization of the two smaller state banks and of Bank Bali) is expected to be completed by October 2000.

Rp 410 trillion) has been issued to operating banks as the government contribution towards their recapitalization. The characteristics of the government bonds are discussed in detail in Box A.

12. **Interest payments on government bonds are estimated at 4 percent of GDP in FY2000.** Interest payments are estimated to increase to 4½ percent of GDP in 2001, and to decline gradually thereafter, reaching 3 percent of GDP by 2004, as the economy recovers and real interest rates ease.

Box A. Characteristics of Bank Restructuring Bonds

Government bonds issued to finance bank restructuring operations are of four types:

- **20-year *indexed* bonds issued to Bank Indonesia**; these bonds carry a 3 percent coupon rate and their principal is revalued every year in line with actual inflation. Amortization of these bonds is gradual, starting 5 years after issuance.
- **3 to 10 year *variable rate* bonds issued to banks**; these bonds carry an interest rate linked to the three-month SBI rate and have been issued mainly to cover banks' negative net worth. This is because the variable rate feature of these bonds allows banks to match the return on assets with the cost of deposits, thereby preventing recurrence of equity shortfalls due to increases in interest rates.
- **5 to 10 year *fixed rate* bonds issued to banks**; these bonds carry coupon rates between 12 and 14 percent. Although initially they were issued in amounts equivalent to the positive capital shortfall (i.e., for the purpose of bringing the capital adequacy ratio from 0 to 4 percent), more recently fixed rate bonds have been issued in larger amounts, and have been preferred to variable rate bonds for the purpose of closing the negative equity gap. One attractive feature of fixed rate bonds is that they make government debt servicing costs more predictable.
- ***Hedge bonds*** (i.e., dollar-linked rupiah-denominated bonds), issued to banks carrying large foreign exchange net open positions. These bonds, which pay a premium of 2 percent over the SIBOR, will be converted into rupiah bonds over a period of 2–3 years, as banks gradually achieve foreign exchange cover. One attractive feature of these bonds is that they prevent the emergence of bank equity shortfalls as a result of exchange rate fluctuations. However, the cost of this hedge is carried entirely by the government. So far, two state banks (Bank Mandiri and BNI) have received hedge bonds (Rp 35 trillion).

The maturity structure of the bonds issued is back loaded, with a bunching of maturing bonds expected between year 2005 and 2010. The first significant tranche of bonds will mature in 2003 (about Rp 40 trillion). Starting in that fiscal year, and for the following 6 years, the annual bond rescheduling need ranges about Rp 60–100 trillion.

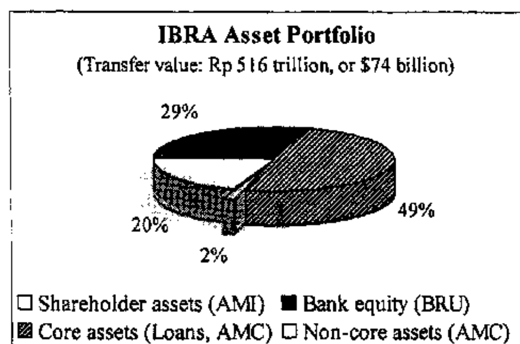
C. Asset Recovery

13. **As part of the bank restructuring program, the government has acquired through IBRA a large amount of assets**, including nonperforming loans and industrial assets pledged by former bank owners. Recovering value from these assets is paramount to reducing the ultimate costs of the banking crisis, and containing the medium term government debt dynamics. This section discusses the medium term asset recovery strategy by IBRA, and the progress made so far.

IBRA asset portfolio and medium-term recovery prospects

14. **IBRA's asset portfolio originates from four sources:**

- **"Core assets"** comprising nonperforming loans transferred from closed, taken over, and state banks, and managed by the Asset Management Credits (AMC).
- **"Non-core assets,"** including buildings and other properties, cars, office equipment, artwork, etc., acquired in the process of liquidating closed banks. These assets are also managed by the AMC.
- **"Shareholder assets"** comprising the assets (mainly industrial) pledged by former bank shareholders in settlement of claims related to their violation of prudential norms, and managed by the Assets Management Investments (AMI). These assets are placed in holding companies and their disposal is the responsibility of a specialized Asset Disposal Unit (ADU) within AMI.
- **"Equity holdings"** in banks recapitalized by IBRA (including taken over, and recapitalized private banks), and managed by the Bank Restructuring Unit (BRU).



15. **Although the book (*nominal*) value of IBRA's assets is very large** (at over Rp 515 trillion, or 46 percent of GDP), **their current *market* value is only a fraction of that**. Updated conservative estimates by IBRA place the market value of IBRA's asset portfolio (a crude measure of the potential recovery rate) at only about Rp 110 trillion, or just over 20 percent of the transfer value. This

Table. IBRA Asset Holdings

	A. Transfer value		B. Market value		C. Recovery Rate
	Tril. Rp	Bil $	Tril. Rp	Bil $	= B/A in percent
1. Core Assets (IBRA Loans, AMC)	256.2	*32.0*	53.1	*6.6*	21
2. Non-core assets (AMC)	8.0	*1.0*	4.0	*0.5*	50
3. Settlement Assets (AMI) 1/	104.4	*13.0*	35.3	*4.4*	34
4. Equity holdings in banks (BRU) 2/	147.6	*18.5*	16.2	*2.0*	11
Total (= 1 + 2 + 3 + 4)	516.2	*64.5*	108.6	*13.6*	21
In percent of GDP	*46*		*10*		

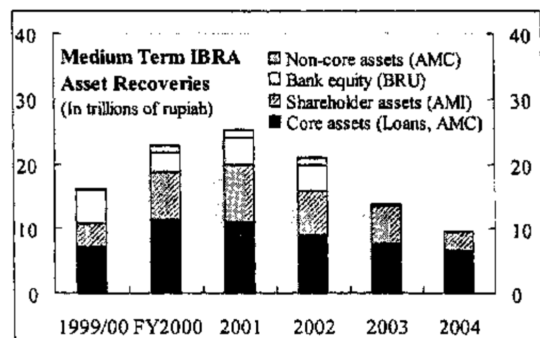
1/ Includes expected settlements of 1999 closed/BTO banks (Rp 10.5 trillion).
2/ Includes projected equity injections. Market value is equal to banks' net book value as of end-May 2000, *plus* actual recoveries to date.

is much less than previous estimates.[7]

- The bank loans representing IBRA's **core assets** correspond to over ¼ of total commercial bank credit outstanding, but they are largely nonperforming, and their recoverable value is estimated by IBRA at about 20 percent of their book value (Rp 256 trillion). This estimate is compatible with the recovery rates experienced by other countries—for example, loan sales by Thailand's Financial Restructuring Agency during 1998–99 fetched, on average, about 25 percent of book value.
- Transfers of the **shareholder assets** into holding companies have yet to be completed. However, the market value of the assets already transferred amounts to about one-third of their transfer value (or Rp 104 trillion). IBRA's ability to exercise stewardship over the pledged assets and to implement the shareholder settlements has been slowed by a complex management structure for the holding companies that left the former shareholders in effective control of their assets.
- The current book value of IBRA's **equity holdings in banks** taken over and in the seven private recapitalized banks is only a small fraction of the almost Rp 150 trillion (about 12 percent of GDP) recapitalization bond issuance, reflecting the large negative net worth of these banks prior to their recapitalization.

16. **Over the medium term, about half of IBRA's total recoveries is expected to come from the restructuring and sales of the AMC's core assets** (Rp 53 trillion). The disposition of the shareholder assets is projected to contribute Rp 35 trillion (or ⅓ of total recoveries). As for the bank equity holdings, assuming that IBRA's residual equity stakes in banks are sold at current book value (i.e., below Bank Central Asia's IPO completed in March 2000, which was priced at 1.2 times book), IBRA should be able to recover about 11 percent of the issued recapitalization bonds (equivalent to about Rp 16 trillion, or 15 percent of total recoveries).

17. **After peaking in 2001, recoveries (in cash and in form of bond retirements) are assumed to decrease gradually through 2004.** This timeframe is in line with IBRA's mandate to terminate its operations by 2004. Bank equity sales by the BRU are expected to be concluded by 2002, the deadline by which the owners of the seven recapitalized banks would be able to exercise their option of buying back the government's equity investment. Recoveries from the disposition of industrial assets by the ADU and from the resolution of the loan portfolio by



[7] For example, at the end of 1999 and according to IBRA's own estimates, the market value of IBRA's assets was over Rp 160 trillion (or 35 percent of end-1999 nominal book value).

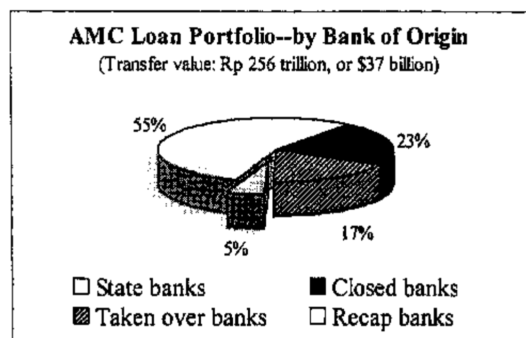
the AMC are expected to continue, albeit at a decreasing pace, through 2004.

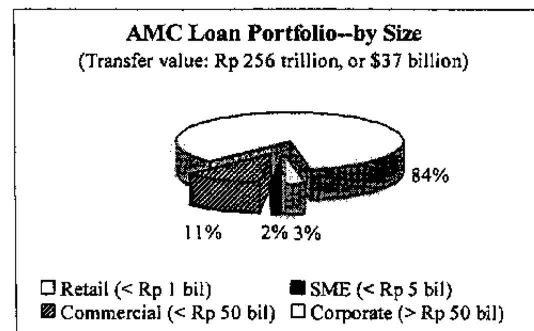
AMC loan recovery strategy

18. **IBRA's AMC has been charged with restructuring and disposal of impaired loans transferred to it by closed and recapitalized banks.** Since these loans were effectively acquired at book value, AMC's recovery efforts are particularly important to minimize final losses to the state.[8] The AMC is also charged with the sale by auction of non-core assets transferred from closed banks. After illustrating the composition of AMC's loan portfolio, this section will discuss the restructuring strategy and progress to date in loan recoveries.

Loan portfolio

19. **The book value of the loan portfolio held by the AMC is large, representing over 30 percent of total private enterprise debt, and 20 percent of GDP.** Loans in foreign currency amount to over $16 billion, and account for just less than half of the total loan portfolio (using an accounting exchange rate of Rp 7,000 to the dollar), or about 20 percent of private debt denominated in foreign currency.





20. **The overall quality of the loan portfolio is very poor, and exposure is mostly confined to the primary industry and the property sectors.** The AMC's portfolio includes the most impaired loans (category 4 and 5 loans) of recapitalized banks (state, taken over, and private recapitalized banks), and all the loans of the closed banks, which by and large were deeply impaired. More than half of total loan transfers originated from the state banks, and about ¼ from the closed banks. Loan transfers have taken place in batches, with the last one completed in March 2000.

21. **Corporate loans account for the largest share of debt held by the AMC, but they represent only a tiny fraction of debtors.** AMC has grouped its loans by size, into retail loans

[8] While the loans of closed banks were transferred at book value, those of operating banks were acquired by IBRA at zero value, as these were written off the books of the banks before being transferred. However, this operation resulted in a larger negative net worth of the banks, which was filled, in turn, by the state through the placement of recapitalization bonds. Thus, from the point of view of the state, the loans of operating banks were effectively acquired at book value (and the purchase financed with recapitalization bonds).

(with face value of less than Rp 1 trillion), SME loans (Rp 1 to 5 trillion in face value), commercial loans (Rp 5 to 50 trillion in face value), and corporate loans (with face value larger than Rp 50 trillion). It is the last category that accounts for almost 85 percent of AMC loans, although it represents only 1½ percent of IBRA's 130,000 debtors.

22. **For the purpose of monitoring progress in debt restructuring, IBRA has adopted the concept of *obligor*,** which identifies a group of *debtor* companies belonging to the same conglomerate. Since many of IBRA's corporate debtors belong to large conglomerates, the obligor concept identifies more easily the ultimate holders of IBRA's exposure. Thus, the AMC has devoted particular attention to the restructuring efforts of the largest 21 obligors. The combined debt of these 21 obligors represents about ⅓ of the AMC's loan portfolio (or Rp 88 trillion in debt); however, with just over 340 debtors, the 21 largest obligors account for less than 0.3 percent of all AMC debtors.

Debt restructuring strategy and progress

23. **AMC's strategy toward debt restructuring is to focus on the largest debtors, while outsourcing or selling small and medium-sized loans.** In particular, the smaller retail and SME loans (up to Rp 5 billion in value) are being sold through open auctions, while the medium-sized commercial loans (i.e., those of value between Rp 5 and 50 billion) are being outsourced in batches to servicing agents through a competitive bidding process. Servicing agents are expected to manage and resolve these loans within two years from the acquisition date. The fee structure under the servicing contracts provides for financial incentives for early recoveries. As for the largest corporate debtors (with principal value higher than Rp 50 billion), the approach focuses on restructuring the loans of the *cooperative* debtors, taking legal action against *noncooperative* debtors, and selling restructured loans through a competitive bidding system. More recently, following the approval of IBRA's "haircuts" policy, there has been a greater shift towards direct loan sales.

24. **IBRA's approach to debt restructuring depends on debtor cooperation and their business prospects.** Cooperative debtors with good business prospects (category A debtors), as well as those with uncertain business prospects (category B debtors) are required to enter a sequential restructuring framework which begins with a standstill agreement and ends with the implementation of an agreed restructuring plan. A critical step of the sequential approach is step 6, corresponding to the signing of term sheets (MOUs), which defines the main components of a restructuring plan. Non-cooperative debtors (category C if with good business prospects, and D if with poor prospects) are dealt with by legal means (mostly bankruptcy and foreclosure, including using IBRA's special powers to seize assets).

Table. The 8 Stages of IBRA's Sequential Restructuring Process

1	Agreement to negotiate (signing of a Letter of Commitment)
2	Execution of a standstill agreement
3	Appointment of consultants/independent advisors
4	Start of due diligence process
5	Start of restructuring negotiations
6	Finalizing restructuring proposal (signing of term sheets)
7	Implementing restructuring plan
8	Full settlement of obligations

Table. IBRA's Classification of Debtors into Ratings A, B, C, D

	No. of debtors	Debt outstanding (trillion Rp)						Share of cooperative debtors
		Total	A	B	C	D	Other 1/	
Largest 21 obligors	341	88	21	41	2	9	15	*71*
Largest 50 obligors	694	142	28	60	2	11	41	*62*
Largest 200 obligors	1,398	193	37	75	3	16	61	*58*
Total (excluding retail loans)	5,864	251	42	83	4	19	103	*50*

1/ Includes debtors for which a rating has not yet been assigned.

25. **Encouraging progress has been made so far in the resolution of the loans held by the AMC.**

- As of end June 2000, IBRA had met its target of drawing up restructuring term sheets or filing legal actions for about 35 percent of the 21 largest obligors' debt value (term sheets were signed for an equivalent of about Rp 25 trillion in loan value, or over 28 percent of the debt outstanding of the 21 largest obligors).
- Another important step forward was the completion of IBRA's first auction of corporate loans. These loans (amounting to about Rp 1 trillion in book value) were sold to three domestic and foreign investors, with an average recovery rate of over 70 percent of book value.[9]
- Progress is also being made in the resolution of the smaller loans. The AMC has completed the process of outsourcing its holdings of over Rp 20 trillion of commercial loans, which were awarded to four different consortia of domestic and foreign investors.
- The auction of a small tranche of retail and SME loans (consisting of over Rp 300 billion in mortgage loans) was completed in early July. The whole tranche was sold to Bank Danamon, which paid an average of 41 percent of original book value. IBRA expects to complete the sale of its smallest loans (accounting for a cumulative amount of Rp 11.5 trillion in book value) in three additional auctions to take place by mid-October.

26. **However, progress in dealing with noncooperative debtors by IBRA has not been satisfactory**. Thus far, IBRA has filed 11 bankruptcy petitions (for claims amounting to more than Rp 1½ trillion) and has initiated numerous foreclosure proceedings, including through the

[9] Salomon Smith Barney-Citibank was awarded over 75 percent of loan principal auctioned, while Bank Central Asia about 20 percent.

use of its special powers (PP17).[10] However, in only two bankruptcy petitions has IBRA obtained favorable rulings by the Commercial Court (one of which, was heard by a panel of judges including an ad hoc judge). In one instance, IBRA withdrew its bankruptcy filing because the debtor eventually agreed to settle its obligations in full; and in the remaining 7 cases initiated by IBRA, the ruling was in favor of the debtor. Nevertheless, with the intensified legal reforms in the program, IBRA expects to achieve cash collections from legal actions ranging between Rp 0.4 and 0.6 trillion for 2000. As for the 21 largest obligors, legal actions have been taken for about 6 percent of these obligors' total debt value. For this group of obligors, IBRA expects to initiate legal actions for an additional 8 to 10 percent in debt value by end 2000.

AMI asset recovery strategy

27. **The AMI controls, through a complex holding company structure, a large number of assets, pledged by former bank owners in the settlement of their liabilities to IBRA.** Ultimately, the AMI's ability to recover value from these shareholder assets depends on a number of factors, including bank shareholders' cooperation; the legal basis of the agreement entered into by IBRA and the shareholders; the valuation of pledged assets; and, importantly, IBRA's ability to exercise stewardship over the pledged assets.

28. **The obligations of bank shareholders to IBRA arise from losses suffered by banks, prior to being closed or taken over, as a result of legal lending limit violations.** The legal basis for settling former bank owners' obligations to IBRA is the so-called "shareholder settlement agreement."[11] Under these agreements, which are discussed in detail in Box B, former bank owners restructure their obligations to IBRA by issuing a promissory note backed with assets and companies grouped under specially created holding companies.

29. **Shareholder cooperation is critical during the execution of the shareholder agreement, including by allowing IBRA to exercise its rights to sell pledged assets.** Under the settlement agreements, the former bank shareholder continues to own and control the assets/companies under the holding company structure, although IBRA participates in the control of the holding company and its assets. More importantly, IBRA has the power, backed by the law, to sell the assets pledged under the holding companies.[12] Even so, lack of cooperation by the owners, or the company management appointed by the owners could be a key impediment to the sale of the assets/companies.

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[10] IBRA is also involved in a number of legal actions, which have been filed by other creditors.

[11] If shareholders are not cooperative, IBRA initiates legal actions, including through referrals to the Attorney General for initiation of formal court proceedings.

[12] As stipulated under Government Regulation No. 17/1999 on the Indonesian Bank Restructuring Agency.

Box B. IBRA's Shareholder Settlement Agreements

Shareholder settlement agreements provide the legal basis according to which former owners of closed and taken over banks settle their obligations to IBRA.

- Under these agreement, bank shareholders are required first to set up a holding company, and capitalize it by injecting a nominal amount of equity. Shareholders, subsequently, are required to place a number of (fully or partly owned) companies and assets under the holding company.
- The holding company issues, in turn, a promissory note to IBRA, for an amount corresponding to the size of the former bank owners' obligation. These promissory notes are backed, in the form of a pledge, by the companies (and assets) placed under the holding company.
- The formula to determine the size of the promissory notes (i.e., the size of IBRA's claim on former bank shareholders) depends on whether the bank in question was taken over or closed. In the first case, the size of the shareholder liability is equivalent to the gross book value of all loans and other credits extended by the bank to shareholders or related parties (including unpaid penalties and interest charges). In the case of closed banks, the size of the shareholder liability to IBRA is increased by the size of the negative equity.

There are two kinds of shareholder settlement agreements, depending on cooperation and ability to pledge assets: the so-called MSAA and MRA.

- When the shareholder is cooperative and has adequate assets to pledge, IBRA and the shareholder enter into a Master Shareholder Acquisition Agreement (MSAA); in the MSAA case, no personal guarantee is involved, and the shareholder is released and discharged by any further obligations, even if the value of the companies pledged drops and IBRA bears losses. However, under the MSAA, the shareholder is required to surrender a small amount of additional assets (holdback assets), to cover (at least in part) against potential losses suffered by IBRA as a result of incorrect information provided by the shareholder in the settlement process.
- When the value of the assets that could be pledged by the shareholder are insufficient to settle his liabilities to IBRA, a Master Refinancing Agreement (MRA) is sought. In the MRA, a personal guarantee is issued by the shareholder to IBRA for an amount equivalent to the shortfall in asset pledges. Holdback assets are not required under the MRA, as cover against losses by IBRA originates from the personal guarantee.
- Under both structures, the former bank shareholder continues to own and control the assets/companies under the holding company structure; although IBRA participates in the control of the holding company and its assets, and (in the case of the MSAA) retains the right to appoint the management of the holding company.

A key factor in the closure of a settlement agreement is the valuation of the assets and companies that the shareholder intends to pledge. The broad principle adopted by IBRA is to ensure that valuation is based on the potential cash realization obtained from the asset. Of course, full disclosure of encumbrances on assets/companies is a key element of the valuation process.

Another crucial aspect of the shareholder agreements is that IBRA retains the power, backed by the law, to sell the assets pledged under the holding companies. Under Government Regulation No. 17/1999 on the Indonesian Bank Restructuring Agency, the agency is vested 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.

30. **IBRA has signed a number of agreements with the shareholders of the fourteen banks closed or taken over in 1998; but, compliance with these agreements has been uneven.**[13] Thus far, only five holding companies have been formally set up, with only one being fully operative. In addition, not all the shareholders have complied with their contractual obligations of transferring assets under the holding companies. As a result, out of Rp 113 trillion of total obligations to be settled with the shareholders of the 1998 banks, the *nominal* value of the assets placed under the holding companies amounts to only around Rp 94 trillion. The largest (and fully operative) holding company is Holdiko Perkasa, accounting for about Rp 53 trillion of obligations from the Salim Group (formerly, the owner of Bank Central Asia). As for the banks that were closed in 1999, IBRA expects to conclude settlement agreements with 25 shareholders, owing about Rp 10 trillion to IBRA.[14]

31. **Latest estimates of the *market* value of the companies pledged by the shareholders are substantially lower than the *nominal* value,** as appraised at the time of the settlement. The estimated residual value of these assets is about 30 percent of the original nominal value. Various factors have contributed to this valuation change, including a likely initial overstatement of the true value of these companies, shareholder non-delivery and various encumbrances (such as, incomplete transfer of shares and land titles). Economic factors, such as fluctuations in the exchange rate and declining commodity prices (especially those of palm oil, coal and timber), have also affected company values. Nevertheless, some of the companies pledged by former bank owners are among the better managed in the country, and IBRA should still be able to recover value from their disposal. The span of sectors in which these companies operate is wide, ranging from chemical to financial services, from agribusiness to telecom, and automotive to real estate. Many of these companies are listed in the local stock market.

Actual asset recoveries and prospects for FY2000

32. **In FY2000, IBRA aims to recover Rp 19 trillion in cash (after expenses) and an additional Rp 3.7 trillion in bonds.** The ADU and the AMC—about equally—are expected to contribute about 80 percent of the total cash recovery target, with the remainder projected to come from the majority sale of banks BCA and Niaga. Other income should be sufficient

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[13] Four shareholders from the ten banks closed in 1998, with over Rp 4 trillion of obligations to IBRA, remain uncooperative. These shareholders have been referred to the Attorney General for legal actions. Also, three shareholders from the four banks taken over in 1998 were released as they had not breached any banking regulations.

[14] Four additional shareholders of the banks closed in 1999 (accounting for about Rp 4.7 trillion) remain uncooperative, and are expected to be referred to the Attorney General for legal action. The share holder settlement process for the banks that were taken over in 1999 (owing about Rp 5 trillion to IBRA) is still under way.

to offset expenses. Including last year's recoveries, by the end of 2000, IBRA will have recovered about 1/3 of total future expected recoveries.

Table. IBRA Asset Recoveries: 1999/00 - FY 2000

	1999/00		FY 2000					
	Trillion Rp	Billion $	In trillion Rp					Billion $
			Apr.-Jun.		Jul.-Sep.	Oct.-Dec.	Total	Total
	Actual	Actual	Actual	Proj.	Proj.	Proj.	Proj.	Proj.
1. Core Assets (AMC) 1/	7.1	*0.9*	3.2	2.6	4.7	4.2	11.4	*1.4*
2. Settlement Assets (AMI)	3.8	*0.5*	0.0	0.0	3.5	3.7	7.2	*0.9*
3. Equity holdings in banks (BRU)	5.1	*0.6*	0.9	0.9	0.0	2.1	3.0	*0.4*
4. Other 2/	1.2	*0.2*	0.3	-0.1	1.0	0.1	1.1	*0.1*
Total (= 1 + 2 + 3 + 4)	17.2	*2.1*	4.4	3.4	9.3	10.1	22.8	*2.8*
Cash	12.9	*1.6*	4.4	3.4	7.5	8.1	19.0	*2.4*
Bonds	4.3	*0.5*	0.0	0.0	1.7	2.0	3.7	*0.5*

1/ Includes recoveries from outsourced commercial loans and from auctions of SME and retail loans.
2/ Includes non-core asset recoveries, deposit guarantee fee, and other income (less IBRA expenses).

33. **The recovery target for the ADU is ambitious, and its feasibility will depend not only on market conditions, but also on cooperation from owners and managers.** There were no sales during the first quarter of FY2000. About 75 percent of total recoveries for the year are expected to derive from the sale of 5 companies out of 17 industrial, financial and real estate assets, in the last two quarters of the fiscal year. The authorities have sought to give credibility to the schedule by securing written commitments to sale from owners, and by engaging financial advisors. In all cases, full disposal of IBRA's ownership in these companies is sought.

34. **The AMC is, so far, on track toward meeting the recovery target for FY2000.** By end June, loan recoveries had reached over Rp 3 trillion (slightly ahead of schedule), about half from the 21 largest corporate obligors. Prospective recoveries will mainly stem from:

- Debt settlements (including refinancing agreements);
- Auction sales of over Rp 11 trillion of retail/SME loans and of a small tranche (over Rp 2 trillion) of restructured corporate loans; and
- Collections from the outsourcing agents charged with the restructuring of commercial loans.

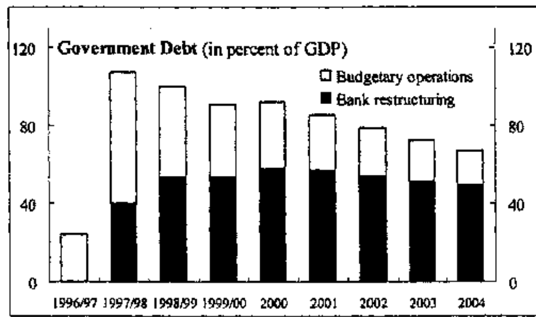
More than half of the AMC's loan recoveries is expected from corporate loan collections (Rp 6.5 trillion, of which about Rp 5 trillion is projected to be in cash). Therefore, much will depend on resolving the debt of the top 21 obligors, envisaged during 2000, as well as on IBRA's ability to call on guarantees, and offset cash pledges made available by cooperating debtors in the process of restructuring negotiations.

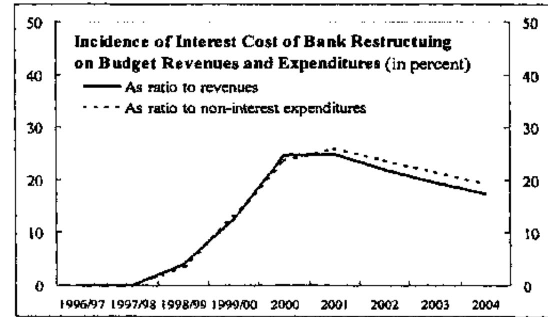
35. **The sale of IBRA's stakes in banks BCA and Niaga are crucial to achieve IBRA's cash recovery target for FY2000.** Particularly important is the strategic sale of

IBRA's remaining 70 percent stake in BCA, following on the initial divestment achieved through an IPO earlier this year (which yielded just less than Rp 1 trillion). To this end, IBRA has developed and announced (for both banks) a detailed schedule of actions to be taken in the coming months, consistent with the completion of their sales by December 2000. These actions include Parliamentary approval, and appointment of financial advisors.

D. Fiscal Impact of Bank Restructuring Costs

36. **Bank restructuring costs have an impact on the fiscal position mainly in two ways**: (i) by increasing the stock of government debt, thus raising concerns over debt sustainability (a stock effect), and (ii) by increasing expenditures for debt service and, thereby, reducing the room for discretionary fiscal policy (a flow effect).

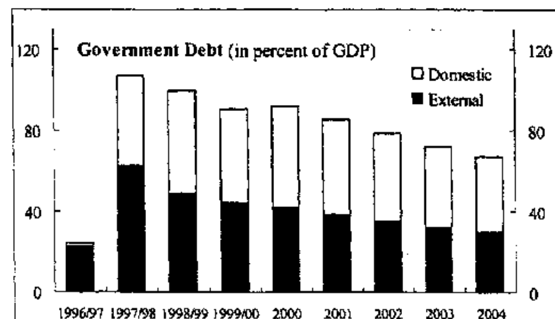




Government debt dynamics

37. **Driven by the large banking sector losses, government debt has risen sharply during the crisis, from under 25 percent of GDP to around 100 percent in 1998/99.** By that year, more than half of total debt was attributable to bank restructuring costs. For a while, however, these costs were implicit government liabilities, as issued government bonds lagged behind the growing size of (quasi-fiscal) liabilities connected with bank restructuring. Therefore, the concept of government debt referred to here is that of "imputed" debt, which is defined to include the estimated negative net worth of the banking system. Staff estimates show that imputed liabilities were in the order of 40 percent of GDP at the end of 1998/99—almost three times larger than issued domestic debt. Over time, quasi-fiscal losses have been recognized as an explicit fiscal liability through the issuance of recapitalization bonds.

38. **Bank restructuring costs, however, were only one factor, albeit an important one, contributing to the large increase in government debt.** Another critical factor was the sharp depreciation of the rupiah, which amplified the domestic value of the existing stock of external government obligations. The depreciation and some increase in external budgetary financing caused the external debt to



peak at 66 percent of GDP by end-1997/98, increasing by more than 2½ times from the previous year. However, this ratio is expected to come down to about 42 percent of GDP by the end of fiscal year 2000.

Baseline medium-term debt projections

39. **Looking forward, the ratio of government debt to GDP is estimated to decrease gradually, a fact underscoring the sustainability of the projected debt path.** Consistent with the baseline medium term outlook elaborated by the staff, the debt-GDP ratio could be reduced from the current level of over 90 percent to about 67 percent by end-2004 (Table II.2).[15, 16] However, the realization of this outlook depends on the authorities' ability to drive forward economic reforms, including in the crucial areas of bank, corporate debt restructuring, and asset recoveries, and to manage carefully fiscal risks.

40. **The projected reduction in debt under the baseline scenario is predicated on a steady improvement in the economic environment, and adherence to the medium term objectives of fiscal consolidation and asset recovery.** Thus, under the baseline program scenario, it is assumed that:[17]

- Primary surpluses will rise from this year's 1.2 percent of GDP to over 3 percent by 2004;
- Bank asset recoveries from IBRA will average about 1½ percent of GDP per year;
- Annual privatization receipts of state enterprises will average ½ percent of GDP;
- Real GDP growth will increase to 6 percent, and inflation will stay below 5 percent;
- Money market interest rates (which affect more than ⅓ of domestic debt service payments) will fall from over 12 percent assumed for 2000 to 9 percent by 2004, and the Rp/$ rate will stay constant in real terms.[18]

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[15] The medium term outlook is presented in EBS/00/155, and discussed at length in Chapter IV of the current *Selected Issues* paper.

[16] The headline government debt figures cover the liabilities of the central government, including issued and *projected* bank recapitalization bonds, but excluding other contingent liabilities (e.g., guarantees on state enterprise borrowings), or Bank Indonesia's assets and liabilities.

[17] The baseline outlook for the government debt has been revised from the estimates presented in EBS/00/08 and EBS/00/86.

[18] The weighted *average* interest rate on issued debt is expected to remain below money market rates, as about ⅓ of domestic debt carries a coupon of about 3 percent.

41. **The quantitative importance that these assumptions play in driving down the debt-GDP ratio is summarized in the table below.** Although the largest quantitative factor contributing to a *reduction* in the debt/GDP is nominal GDP growth, primary surpluses and asset recoveries are also key—cumulatively, accounting for 3½ percentage points per year. Partly offsetting these factors are budgetary interest payments which, instead, contribute to an *increase* in the debt/GDP by over 4½ percentage points a year. Thus, a key test for the realization of a sustainable debt path is met under the baseline scenario—that real interest rates do not outpace the rate of growth of real GDP.

Table. Indonesia: Central Government Debt--Contributions to Changes in Debt/GDP, 2000-2004

			Projections			
	2000	2001	2002	2003	2004	**Average**
A. Debt (in trillion rupiah)	1131	1187	1231	1269	1308	**1225**
B. Debt/GDP (in percent)	92.1	85.6	78.7	72.3	67.0	**79.2**
			(In percent of GDP)			
C. **Change in debt/GDP** (= change in B; also, = 1 + 2)	**1.2**	**-6.5**	**-6.9**	**-6.4**	**-5.3**	**-4.8**
1. **Factors contributing to an *increase* in debt/GDP**	**10.1**	**8.8**	**7.5**	**6.6**	**6.0**	**7.8**
Interest payments	2.4	6.2	5.6	5.0	4.5	4.7
Principal cost of bank restructuring	8.0	2.8	0.8	0.7	0.7	2.6
Change in rupiah value of external debt (due to changes in Rp/$)	-0.3	-0.2	1.2	0.8	0.8	0.5
2. **Factors contributing to a *reduction* in debt/GDP**	**-9.0**	**-15.2**	**-14.4**	**-13.0**	**-11.3**	**-12.6**
Real GDP growth	-3.4	-4.1	-4.5	-4.2	-3.9	-4.0
Inflation (GDP deflator growth)	-3.8	-6.4	-5.2	-4.4	-3.4	-4.6
Primary surplus	-0.5	-2.4	-2.9	-3.3	-3.2	-2.4
Bank asset recoveries (paid in cash or bonds)	-1.0	-1.8	-1.3	-0.8	-0.5	-1.1
Non-bank privatization proceeds	-0.3	-0.5	-0.4	-0.4	-0.3	-0.4

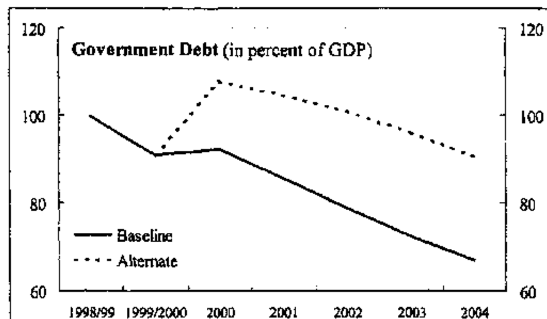
Alternate medium-term debt projections

42. **However, this benign outlook faces considerable downside risks.** In particular, under a scenario of stalled reforms, it is likely that the exchange rate would weaken considerably and investor confidence deteriorate further. In these circumstances, growth would likely also stall; the process of selling assets by IBRA would be impeded and pressures would build up for a more expansionary fiscal stance. The concurrence of these events would undoubtedly jeopardize the medium term objective of debt reduction, as it is illustrated in an alternate medium term scenario prepared by the staff.[19]

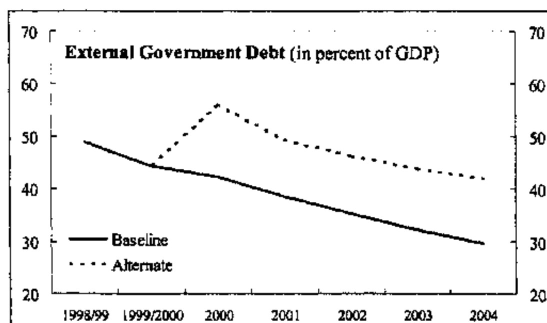
[19] See the Chapter IV of this *Selected Issues* paper on the detailed assumptions underlying the alternate medium term scenario.

43. **In the alternate medium term scenario, government debt is projected to remain at around 100 percent of GDP for the next few years, posing a threat to fiscal sustainability**. Various factors are at play here:[20]

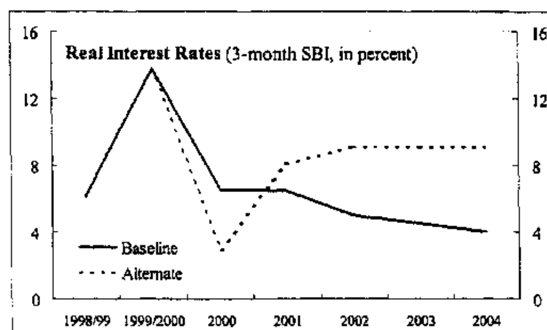
- A more depreciated exchange rate would have a large direct impact on the domestic value of government external obligations. The sharply more depreciated exchange rate assumed under the alternate scenario could result, by 2004, in a ratio of debt to GDP as much as 12 percentage points higher than under the baseline case.



- A more depreciated exchange rate would also increase foreign debt service payments in rupiah terms, as well as the cost of servicing foreign exchange linked bonds (*hedge bonds*). Further, in the face of a weaker currency, budgetary expenditures in foreign currency would likely increase more than foreign currency denominated revenues, adding pressure on the fiscal position, and ultimately on the debt dynamics.



- In the alternate case, nominal interest rates are assumed to be almost 15 percent higher than in the baseline scenario.[21] This increase affects the cost of servicing variable rate bonds, which could rise on average by as

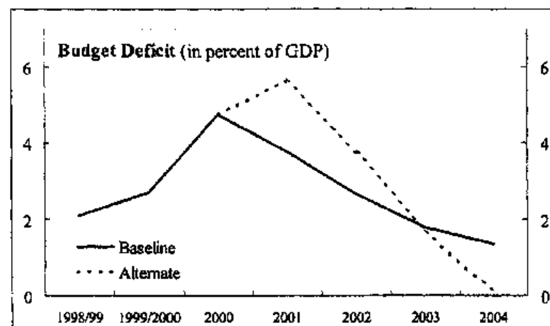


[20] It is important to point out that in the alternative scenario elaborated below gross costs of bank restructuring are assumed to be the same as in the baseline case. Although an increase in gross costs would be difficult to rule out in the face of a serious crisis of confidence, at this stage, such quantitative effects are difficult to gauge.

[21] In the alternate scenario, real interest rates are assumed to be higher by 4 to 5 percent than in the baseline case; inflation is assumed to be higher as well, by 8 to 10 percent.

much as 2 percent of GDP per year.[22]

- The fiscal position would quickly be affected by the weaker macroeconomic scenario; however, over time, the reduced sources of financing for the budget (including from official creditors) could constrain the working of the automatic stabilizers, and result in a contractionary fiscal policy stance. Therefore, under the alternate scenario, the cumulative effect of a weaker fiscal position is estimated to increase the long-term debt-GDP ratio; its quantitative effect, however, is expected to be limited by forced restraint on expenditures, and is estimated at only about 1½ percentage points.



- In a climate of lower investor confidence, a more depreciated exchange rate and higher interest rates, IBRA's ability to carry forward its asset recovery program is likely to be adversely affected. In this circumstance, loan restructuring efforts would be impeded, and sales of companies and banks would slow down. Compared to the baseline case, the lower asset recovery path assumed under the alternate scenario worsens the government debt dynamics by about 1 percent of GDP on average per year.

- In the alternate scenario, lower real GDP growth would tend to increase the debt to GDP *ratio*, even for a given *level* of debt. Over time, however, this effect is more than offset by the direct effect of higher inflation on nominal GDP growth. In fact, nominal GDP growth is assumed to be higher in the alternate case than in the baseline case. The increase in nominal GDP is the most significant factor contributing to the modest decline in the *ratio* of debt to GDP observed in the alternate case.

Other fiscal risks

44. **The fiscal risks behind the alternate scenario go beyond those related to debt sustainability**. Sustainability is clearly an important criterion in assessing the adequacy of the medium term debt profile, as it rules out the possibility of an ever-growing debt to GDP ratio. However, there are other risks to maintaining a large, albeit decreasing, debt ratio.

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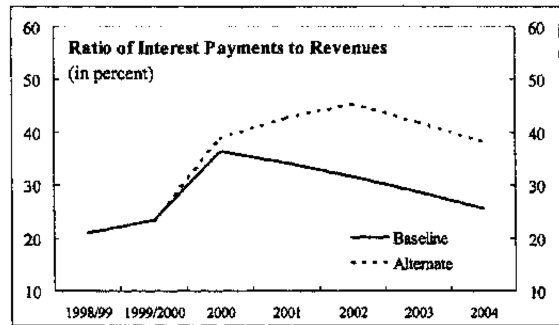
[22] However, higher short-term interest rates would not automatically drive up the cost of servicing long term fixed rate and inflation indexed bonds. In fact, this could only happen in the event of new bond issuances. The servicing cost of inflation indexed bonds would, however, increase in the face of higher inflation; but its cumulative effect on the long-run debt ratio is estimated to be rather small—about 0.2 percentage points.

- One implication of a high debt ratio is that it limits the room for active management of fiscal policy: for a given level of deficit, an increase in interest costs associated with a growing debt stock will constrain discretionary spending or, worse, impose cuts in non-discretionary spending, including possibly on essential services.

- Under the baseline case, interest payments are expected to peak in 2000 at about 35 percent of government revenues, and to decline thereafter. Even so, the ratio of interest payments to revenues is expected to stay substantially above (more than 3 times) its pre-crisis value of 8 percent. In the alternate scenario, the share of revenues needed to finance interest payments is considerably higher than in the baseline case. In the face of limited access to budgetary financing, this development would most likely imply substantial cuts in development and, possibly, non-discretionary expenditures.



- Finally, a large debt stock can imply an untenably high debt service payments. Expressed as a ratio to government revenues, debt service payments indicate the room there exists in the budget to finance government debt obligations, both in the form of interest payments and of amortization due. Under the baseline case, this ratio is broadly stable; but at around 40 percent it is 1⅓ times higher than its pre-crisis level. By contrast, under the alternate scenario debt service payments are considerably higher, at about 60 percent of government revenues.

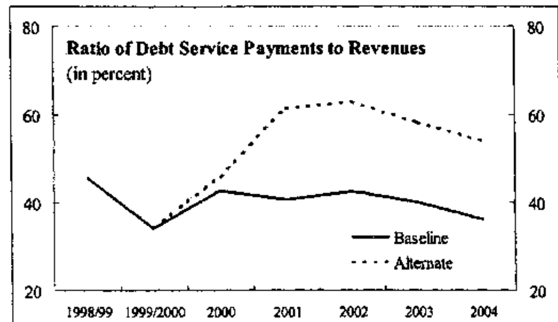


Table II.1. Indonesia: Timing of Bond Issuance for Bank Restructuring

(In trillions of rupiah, unless otherwise indicated)

Beneficiary	A. Actual Issues									B. Projected Issues			C. Grand Total (=A+B)	
	November 1998	February 1999	May 1999	October 1999	December 1999	April 2000	June 2000	July 2000	Total	October 2000	Contingency 2/	Total		*share (%)*
Bank Indonesia	**20.0**	**144.5**	**53.8**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**218.3**	**0.0**	**0.0**	**0.0**	**218.3**	*32.5*
To cover losses from:														
Bank Exim (state owned, merged into Bank Mandiri)	20.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	20.0	0.0	0.0	0.0	20.0	*3.0*
Banks closed in November 1997 (16)	0.0	11.9	0.0	0.0	0.0	0.0	0.0	0.0	11.9	0.0	0.0	0.0	11.9	*1.8*
Banks frozen in April–August 1998 (10)	0.0	57.7	0.0	0.0	0.0	0.0	0.0	0.0	57.7	0.0	0.0	0.0	57.7	*8.6*
Banks frozen in March 1999 (18 of 38)	0.0	17.3	53.8	0.0	0.0	0.0	0.0	0.0	71.1	0.0	0.0	0.0	71.1	*10.6*
Banks taken over in April–May 1998 (4)	0.0	54.6	0.0	0.0	0.0	0.0	0.0	0.0	54.6	0.0	0.0	0.0	54.6	*8.1*
Banks taken over in March 1999 (2 of 8)	0.0	3.0	0.0	0.0	0.0	0.0	0.0	0.0	3.0	0.0	0.0	0.0	3.0	*0.4*
Banks	**0.0**	**0.0**	**103.8**	**103.0**	**75.0**	**30.0**	**70.1**	**30.2**	**412.2**	**19.8**	**0.0**	**19.8**	**432.0**	*64.3*
Private banks (7 recap+Bali), of which:	0.0	0.0	**22.1**	0.0	0.0	0.0	0.0	0.0	**22.1**	**6.8**	0.0	**6.8**	**29.0**	*4.3*
BII	0.0	0.0	8.7	0.0	0.0	0.0	0.0	0.0	8.7	2.0	0.0	2.0	10.7	*1.6*
Lippo	0.0	0.0	7.7	0.0	0.0	0.0	0.0	0.0	7.7	0.0	0.0	0.0	7.7	*1.2*
Bank Bali	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**4.8**	0.0	**4.8**	4.8	*0.7*
Negative equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	3.6	0.0	3.6	3.6	*0.5*
Equity shortfall from 0 to 4 percent CAR	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.2	0.2	*0.0*
Additional losses prior to bond issuance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.1	0.0	1.1	1.1	*0.2*
Banks taken over in April-May 1998 (4)	0.0	0.0	**80.5**	0.0	0.0	0.0	0.0	0.0	**80.5**	0.0	0.0	**0.0**	**80.5**	*12.0*
BCA	0.0	0.0	60.9	0.0	0.0	0.0	0.0	0.0	60.9	0.0	0.0	0.0	60.9	*9.1*
Danamon	0.0	0.0	16.7	0.0	0.0	0.0	0.0	0.0	16.7	0.0	0.0	0.0	16.7	*2.5*
PDFCI	0.0	0.0	1.4	0.0	0.0	0.0	0.0	0.0	1.4	0.0	0.0	0.0	1.4	*0.2*
Tiara	0.0	0.0	1.5	0.0	0.0	0.0	0.0	0.0	1.5	0.0	0.0	0.0	1.5	*0.2*
Banks taken over in March 1999 (8)	0.0	0.0	0.0	0.0	0.0	0.0	**38.3**	0.0	**38.3**	0.0	0.0	**0.0**	**38.3**	*5.7*
Banks to be merged with Bank Danamon	0.0	0.0	0.0	0.0	0.0	0.0	**28.9**	0.0	28.9	0.0	0.0	0.0	28.9	*4.3*
Negative equity	0.0	0.0	0.0	0.0	0.0	0.0	25.8	0.0	25.8	0.0	0.0	0.0	25.8	*3.8*
Of which: To close net open position	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	*0.0*
Equity shortfall from 0 to 4 percent CAR	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.0	0.5	0.0	0.0	0.0	0.5	*0.1*
Additional losses prior to bond issuance	0.0	0.0	0.0	0.0	0.0	0.0	2.6	0.0	2.6	0.0	0.0	0.0	2.6	*0.4*
Bank Niaga	0.0	0.0	0.0	0.0	0.0	0.0	**9.5**	0.0	9.5	0.0	0.0	0.0	9.5	*1.4*
Negative equity	0.0	0.0	0.0	0.0	0.0	0.0	8.4	0.0	8.4	0.0	0.0	0.0	8.4	*1.3*
Of which: To close net open position	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	*0.0*
Equity shortfall from 0 to 4 percent CAR	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.2	0.0	0.0	0.0	0.2	*0.0*
Additional losses prior to bond issuance	0.0	0.0	0.0	0.0	0.0	0.0	0.8	0.0	0.8	0.0	0.0	0.0	0.8	*0.1*
Regional development banks (29) 1/	0.0	0.0	**1.2**	0.0	0.0	0.0	0.0	0.0	**1.2**	0.0	0.0	**0.0**	**1.2**	*0.2*
State banks (4) 1/	**0.0**	**0.0**	**0.0**	**103.0**	**75.0**	**30.0**	**31.8**	**30.2**	**270.0**	**12.9**	**0.0**	**12.9**	**283.0**	*42.2*
Mandiri	0.0	0.0	0.0	**103.0**	**75.0**	0.0	0.0	0.0	**178.0**	0.0	0.0	**0.0**	**178.0**	*26.5*
Negative equity	0.0	0.0	0.0	98.7	66.8	0.0	0.0	0.0	165.6	0.0	0.0	0.0	165.6	*24.7*
Of which: To close net open position	0.0	0.0	0.0	0.0	26.6	0.0	0.0	0.0	26.6	0.0	0.0	0.0	26.6	*4.0*
Equity shortfall from 0 to 4 percent CAR	0.0	0.0	0.0	4.3	4.0	0.0	0.0	0.0	8.3	0.0	0.0	0.0	8.3	*1.2*
Additional losses prior to bond issuance	0.0	0.0	0.0	0.0	4.2	0.0	0.0	0.0	4.2	0.0	0.0	0.0	4.2	*0.6*
BNI	0.0	0.0	0.0	0.0	0.0	**30.0**	31.8	0.0	**61.8**	0.0	0.0	**0.0**	**61.8**	*9.2*
Negative equity	0.0	0.0	0.0	0.0	0.0	27.8	19.0	0.0	46.8	0.0	0.0	0.0	46.8	*7.0*
Of which: To close net open position	0.0	0.0	0.0	0.0	0.0	0.0	7.9	0.0	7.9	0.0	0.0	0.0	7.9	*1.2*
Equity shortfall from 0 to 4 percent CAR	0.0	0.0	0.0	0.0	0.0	2.2	0.0	0.0	2.2	0.0	0.0	0.0	2.2	*0.3*
Additional losses prior to bond issuance	0.0	0.0	0.0	0.0	0.0	0.0	12.8	0.0	12.8	0.0	0.0	0.0	12.8	*1.9*
BRI	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**20.4**	**20.4**	**8.7**	0.0	**8.7**	**29.1**	*4.3*
Negative equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	18.5	18.5	6.7	0.0	6.7	25.3	*3.8*
Of which: To close net open position	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	*0.0*
Equity shortfall from 0 to 4 percent CAR	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.7	0.0	1.7	1.7	*0.2*
Additional losses prior to bond issuance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.9	1.9	0.3	0.0	0.3	2.2	*0.3*
BTN	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**9.8**	**9.8**	**4.2**	**0.0**	**4.2**	**14.0**	*2.1*
Negative equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	9.8	9.8	2.3	0.0	2.3	12.1	*1.8*
Of which: To close net open position	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	*0.0*
Equity shortfall from 0 to 4 percent CAR	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.3	0.3	*0.1*
Additional losses prior to bond issuance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.6	0.0	1.6	1.6	*0.2*
Contingency 2/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**21.0**	**21.0**	21.0	*3.1*
Total bond issuance (cumulative)	**20.0**	**164.5**	**322.1**	**425.1**	**500.1**	**530.1**	**608.3**	**630.5**	**630.5**	**650.3**	**671.3**	**671.3**	**671.3**	*100.0*
In percent of projected total bond need	*3*	*25*	*48*	*63*	*75*	*79*	*89*	*94*	*94*	*97*	*100*	*100*	*100*	*n.a.*
In percent of GDP	*2*	*13*	*26*	*35*	*41*	*43*	*49*	*51*	*51*	*53*	*55*	*55*	*55*	*n.a.*
Variable rate bonds	0.0	0.0	95.1	193.9	203.9	226.4	226.4	226.4	226.4	226.4	226.4	226.4	226.4	*33.7*
Hedge bonds	0.0	0.0	0.0	0.0	26.6	26.6	34.5	34.5	34.5	34.5	34.5	34.5	34.5	*5.1*
Fixed rate bonds	0.0	0.0	8.7	12.9	51.3	58.8	121.1	151.3	151.3	171.0	192.0	192.0	192.0	*28.6*
Inflation indexed bonds	20.0	164.5	218.3	218.3	218.3	218.3	218.3	218.3	218.3	218.3	218.3	218.3	218.3	*32.5*

1/ Does not include bond issues needed to bring state banks' CAR from 4 to 8 percent.

2/ Includes bonds for raising state banks' capital adequacy from 4 to 8 percent (expected by end-2001).

Table II.2. Indonesia: Central Government Debt, 1999–2004

	1999/2000	Projections 2000	2001	2002	2003	2004
A. Beginning of period stock of debt (fiscalized component only)						
Baseline Scenario	58.0	76.6	81.6	75.9	70.1	65.0
Alternate Scenario	58.0	76.1	93.9	90.3	87.3	83.4
B. Increase in debt during the year (= 1 + 2 + 3 + 4) 1/						
Baseline Scenario	25.2	20.4	4.1	2.8	2.2	2.0
Alternate Scenario	25.2	41.4	10.5	10.4	8.5	7.1
1. Central government operations						
Baseline Scenario	2.7	4.8	3.8	2.7	1.8	1.3
Alternate Scenario	2.7	4.7	5.6	3.7	1.7	0.1
Primary deficit 2/						
Baseline Scenario	-1.2	-1.2	-2.4	-2.9	-3.3	-3.2
Alternate Scenario	-1.2	-1.6	-2.7	-4.5	-5.9	-6.8
Interest payments						
Baseline Scenario	3.9	5.9	6.2	5.6	5.0	4.5
Alternate Scenario	3.9	6.3	8.3	8.3	7.5	6.9
2. Principal cost of bank restructuring (fiscalized component only)						
Baseline Scenario	30.1	19.6	2.8	0.8	0.7	0.7
Alternate Scenario	30.1	20.7	4.1	2.3	2.3	2.4
3. Asset recovery 3/						
Baseline Scenario	-1.9	-3.1	-2.3	-1.8	-1.2	-0.8
Alternate Scenario	-1.9	-1.0	-0.8	-0.6	-0.4	-0.3
4. Change in rupiah value of external debt						
Baseline Scenario	-5.8	-0.8	-0.2	1.2	0.8	0.8
Alternate Scenario	-5.8	17.1	1.6	5.0	4.9	4.9
C. End of period stock of debt (fiscalized component only; = A + B)						
Baseline Scenario	83.2	92.1	85.6	78.7	72.3	67.0
Alternate Scenario	83.2	107.7	104.5	100.7	95.9	90.4
Domestic						
Baseline Scenario	38.9	49.8	47.2	43.5	40.2	37.4
Alternate Scenario	38.9	51.6	55.3	54.6	52.0	48.5
External						
Baseline Scenario	44.3	42.3	38.4	35.3	32.1	29.6
Alternate Scenario	44.3	56.1	49.2	46.2	43.9	42.0
D. Imputed quasi-fiscal debt from bank restructuring 4/						
Baseline Scenario	7.8	0.0	0.0	0.0	0.0	0.0
Alternate Scenario	7.8	0.0	0.0	0.0	0.0	0.0
E. Imputed end-of-period stock of debt (= C + D)						
Baseline Scenario	**90.9**	**92.1**	**85.6**	**78.7**	**72.3**	**67.0**
Alternate Scenario	**90.9**	**107.7**	**104.5**	**100.7**	**95.9**	**90.4**
Memorandum items:						
Real GDP annual growth (in percent) 1/						
Baseline Scenario	3.3	4.0	5.0	6.0	6.0	6.0
Alternate Scenario	3.3	3.8	0.0	0.0	0.0	0.0
Real 3-month SBI rate (in percent)						
Baseline Scenario	13.8	6.5	6.5	5.0	4.5	4.0
Alternate Scenario	13.2	2.9	8.0	9.0	9.0	9.0
Nominal 3-month SBI rate (in percent)						
Baseline Scenario	16.9	12.3	10.7	10.0	9.4	8.9
Alternate Scenario	16.9	13.5	21.0	23.0	23.8	24.0
CPI inflation						
Baseline Scenario	9.9	4.5	5.2	4.4	5.0	4.9
Alternate Scenario	9.9	5.6	12.2	13.4	14.4	15.0

1/ For 2000, based on a 9-month FY concept.
2/ In FY1999/2000 includes repayment of 1.2 percent of GDP in arrears.
3/ Includes asset recoveries by IBRA (in cash and bonds) and state enterprises privatization proceeds.
4/ Includes the estimated recapitalization need of the banking system plus estimated losses from bank closures.

III. Corporate Debt Restructuring and Related Legal Reforms[1]

A. Introduction and Overview

1. **The aggregate debt of private enterprises in Indonesia is estimated at $110 billion, with at least 75 percent of this amount, or $82 billion, representing debt that is denominated in foreign currency** (Text Table 1). Approximately 50 percent of corporate sector debt ($54.7 billion) is owed to external creditors,[2] and a further $27 billion of domestic banking system debt is denominated in foreign currency, including $16.2 billion held by IBRA's AMC.

Table 1. Indonesia: Private Enterprise Debt

(In billions of U.S. dollars) 1/

Item	Total Value	FX Portion (with bonds)	FX Portion (without bonds)
External creditors 2/	54.7	54.7	54.7
Domestic creditors 3/	18.8	...	...
Domestic creditors FX 3/	11.1	11.1	11.1
Domestic creditors Rp 3/	7.7	...	...
IBRA AMC Rp 4/	17.9	...	...
IBRA AMC FX 4/	16.2	16.2	16.2
Bonds 5/	2.4	2.4	...
Total	109.9	84.4	82.0

Sources: Bank Indonesia; and the Indonesian Bank Restructuring Agency (IBRA).

1/ Amounts exclude any borrowings offshore by overseas subsidiaries, assets held by local nonbank financial institutions or individuals; and trade payables.

2/ As of February 2000.

3/ As of March 2000.

4/ As of July 2000.

5/ As of March 2000. The split between bonds in domestic vs. foreign currency is not available.

[1] Prepared by Rhoda Weeks of the Legal Department.

[2] It should be noted that the corporate sector debt profile of Indonesia—where foreign creditors hold a substantial portion of outstanding corporate debt—differs substantially from that of other countries affected by the Asian financial crisis, where the share of credit extended by foreign lenders was much smaller (Iskander and others, 1999, "Corporate Restructuring and Governance in East Asia," *Finance and Development*, (March)).

2. **A substantial portion of corporate sector debt is still reported to be non-performing**. This unresolved debt has a number of implications for Indonesia's economic recovery. For example, it negatively impacts the domestic financial system,[3] and the government's efforts to contain the fiscal costs of resolving the banking system crisis. It also constrains the ability of viable firms to access new sources of financing for investment, and thus to grow in a sustainable manner. Resolution of the corporate sector debt problem is thus of critical importance for Indonesia's overall economic recovery, and for the resumption of full and sustainable economic growth.

3. **As in other countries affected by the Asian financial crisis, the corporate debt restructuring strategy in Indonesia has been shaped by the nature of the outstanding corporate debt**. This has resulted in the London Approach-based strategy implemented by the Jakarta Initiative Task Force (JITF), which embodies generally accepted restructuring principles on which there is already a commercial consensus and with which external creditors are familiar. It has also led to a role for IBRA as the most significant domestic player in corporate restructuring.

4. **IBRA and the JITF have very different roles and functions**. IBRA—as a major creditor with extraordinary legal powers—has the ability to force restructuring deals.[4] The JITF, however, is never a party to restructurings and it lacks power to drive the terms of deals; rather, it is charged with administering the out-of-court framework established by the government to facilitate the negotiation and completion of restructuring transactions.

5. **It should be noted that, despite these differences, there is the potential for important synergies between IBRA and the JITF**. For example, IBRA acting as a responsible creditor can play a leadership role in persuading both debtors and other creditors to behave in a commercially reasonable manner in JITF deals in which IBRA is involved. Conversely, if the JITF succeeds in fostering a predictable and efficient process for out-of-court workouts, then process risk would be reduced for creditors generally and the secondary market value of IBRA's loan portfolio thereby increased (as purchasers would have greater confidence of being able to recover on their claims).

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[3] For example, delays in corporate restructuring limit the ability of the remaining domestic banks to resume full profitability (as there are fewer viable and performing companies to whom banks can extend credit), while also contributing to a "credit crunch" and more generally impeding the process of resource allocation (by tying up financial system resources that could be diverted to more viable borrowers).

[4] IBRA's approach to corporate debt restructuring and progress thus far are summarized in Chapter II of the current *Selected Issues* paper.

6. **The speed and effectiveness of corporate restructuring depend not only upon the parties to a restructuring and the government entities responsible for restructuring, but also upon a number of exogenous factors.** Key among these is the underlying legal system, including in particular the effectiveness of that system in enforcing and protecting commercial rights in a reasonable and predictable manner. For this reason, the corporate restructuring strategy in Indonesia has included a number of legal reform elements, including measures designed to improve the insolvency system, eliminate regulatory obstacles to restructuring, and generally strengthen the legal framework and the courts charged with implementation of the law.

7. **The rest of this chapter is organized as follows**: Section B provides an overview of the Jakarta Initiative strategy as originally formulated, and the initial legal and institutional reforms that were implemented to facilitate restructuring; Section C examines some reasons for the slow pace of restructuring, the enhanced framework that has been adopted to catalyze the process, and the results to date; and Section D reviews the remaining issues and risks to restructuring. Most issues related to IBRA's role in corporate restructuring are discussed in detail in Chapter II of this *Selected Issues* paper.

B. The Original Framework and Related Legal Reforms

8. **Outside of IBRA, the initial corporate restructuring strategy included three primary elements**: (1) launch of the Jakarta Initiative framework and establishment of the JITF; (2) legal amendments to strengthen the bankruptcy system and the legal and institutional framework for restructuring; and (3) the INDRA foreign exchange guarantee program. The dominant principle behind this strategy was that public funds would not be provided to financially troubled private corporations, but that the government would take all other steps to facilitate and encourage corporate sector restructuring. The framework for corporate restructuring was recently strengthened, as discussed in Section C; the following discussion provides a historical overview of the initial reforms.

The Jakarta Initiative and the JITF

9. Launched in September 1998, the Jakarta Initiative provides for establishment of the JITF, and sets forth an informal framework to guide, encourage, and support out-of-court debt workouts.

10. **The Jakarta Initiative consists of a set of nonbinding, London Approach-based principles that creditors (both external and domestic) and debtors are expected to adhere to in order to ensure an orderly negotiation process.**[5] Among other things, these

[5] The "London Approach" describes restructuring guidelines that were first articulated and informally promoted by the Bank of England. These principles have been developed over time and are generally regarded as the best means to rescue companies while also maximizing recovery for creditors.

principles call for the formation of creditors' committees; the sharing of all relevant information between debtors and creditors; the establishment of a voluntary "standstill" period during which creditors will refrain from pursuing their legal rights against a debtor; and the provision of interim financing by existing creditors (or the agreement of existing creditors to subordinate their claims to new funds advanced by others during a workout).

11. **As contemplated by the Jakarta Initiative, the JITF's role is to expedite the restructuring process and provide support in key areas**, including by facilitating negotiations between creditors and debtors; making available restructuring professionals to assist the parties and help design restructuring plans; expediting the regulatory approvals needed for restructuring through its "one-stop shop"; and making recommendations for additional legal, regulatory, and administrative changes to facilitate corporate restructuring. The Jakarta Initiative also established a Corporate Restructuring Advisory Committee, comprised *inter alia* of select domestic and foreign banks, local companies and IBRA, whose functions include making recommendations to facilitate successful implementation of the Jakarta Initiative.

Bankruptcy law and other legal reforms

12. **An effective, consistently-applied bankruptcy law is an essential component of a corporate restructuring framework, as the success of even out-of-court workouts depends in the first instance on the efficacy of the underlying insolvency system**. The formal (i.e., in-court) insolvency system is necessary for out-of-court workouts because the formal system helps to define the relative rights and obligations that the parties possess when they begin out-of-court negotiations. If the formal system provides clear and predictable guidelines regarding these rights and obligations, then debtors and creditors should be able to assess their respective leverage and make the commercially reasonable decisions necessary for workouts to proceed (negotiations occur "in the shadow" of the formal system).[6] Separately, the law applicable in formal insolvency proceedings is important because it often contains rehabilitation plan approval provisions that permit a court to approve restructuring agreements against the wishes of dissenting creditors, thereby preventing such creditors from derailing an otherwise viable plan or extracting "hold out" value from the other parties.

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[6] For example, a debtor will engage in serious negotiations if it knows that creditors have a real option of obtaining the involuntary liquidation of the debtor. For their part, creditors will accept a reasonable restructuring offer even if it implies some loss on their loans, if they know they run the risk of receiving even less in a court proceeding. Conversely, where the legal rights (i.e., leverage) of parties are unclear, or one side has inadequate legal recourse, there will be an insufficient basis for the parties to take negotiating positions, or one side will have nothing to gain from negotiating. In either case, out-of-court negotiations are likely to be unpredictable or nonexistent.

13. **From the start of Indonesia's Fund-supported program, there was a general recognition that the bankruptcy system was inadequate, partly because the then applicable law was outdated (it had remained unchanged since the early 1900s), but also because of inadequate enforcement of the law by the judiciary**. Consequently, relatively early in the course of Fund financial assistance, the bankruptcy law was amended with the aim of instituting measures designed both to improve judicial application of the law and to increase the chances for successful restructuring of companies. Key aspects of these amendments included: (i) the creation of a specialized Commercial Court to hear bankruptcy petitions; (ii) strengthened procedural rules designed to ensure more expeditious and transparent proceedings and limit the scope for irregularities in the handling of cases; (iii) greater protection of assets against fraudulent transfers and insider abuse; and (iv) various measures designed to enhance the prospects for restructuring, including restrictions on the ability of secured creditors to foreclose on collateral during bankruptcy proceedings, and provisions allowing court approval of restructuring plans even in the absence of unanimous unsecured creditor approval (a plan can be approved if backed by more than 50 percent of creditors holding more than two-thirds of outstanding claims).

14. **As discussed below, significant problems continue to be posed by the manner in which the judiciary has applied the amended bankruptcy law**. It should be noted, however, that some progress has been made in reforming the insolvency system. Among the more important developments: the Commercial Court was established in August 1998 and judges specially trained and assigned to it; all decisions of the Commercial Court are in writing and are easily available to the public (a first for any court in Indonesia); the extremely low salaries previously paid to judges have been raised to more reasonable levels; for the first time, private receivers and administrators have been registered to handle insolvency matters, and there is growing bankruptcy law expertise among lawyers in Jakarta; and, since the Commercial Court was established, there has been unprecedented public scrutiny and analysis of bankruptcy decisions.

15. **Prior to the amendments, only a few bankruptcy petitions had been filed during the entire several decade-long period under the original law**. With passage of the amendments, private creditors have begun to make much greater use of the bankruptcy process, and IBRA has also begun to use the system more aggressively as one means of seeking enforcement of its claims. Text Table 2 provides figures for the disposition of bankruptcy petitions filed between the time of establishment of the Commercial Court and August 8, 2000.

Table 2: Bankruptcy Petitions Filed With the Commercial Court

August 1998-August 2000

Total petitions filed	183
Bankruptcies declared and not revoked on appeal 1/	58
Suspension of payments 2/	25
Dismissals or rejections of petitions	44
Bankruptcies revoked on appeal	13
Withdrawals of petitions	36
Petitions pending at Commercial Court	7

1/ Total includes bankruptcies declared immediately after filing, bankruptcies declared after expiration of "suspension of payments" periods, and bankruptcies declared on appeal; it excludes cases where bankruptcies were revoked on appeal.

2/ Total excludes two cases in 2000 where suspension of payments petitions were filed *affirmatively* by debtors (i.e., not as a defense to bankruptcy).

16. **Separate from the insolvency system measures summarized above, a number of additional legal reforms designed to lend support to corporate restructuring have been implemented or are still ongoing.** Measures have included tax neutrality and limited tax incentives for certain kinds of restructuring transactions; securities law exemptions for certain transactions; establishment of more transparent rules regarding the creation and registration of security interests in movable property; and reforms designed to improve corporate governance, including with respect to the disclosure of financial information.

The Indonesian Debt Restructuring Agency (INDRA)

17. **An integral part of the original strategy for corporate restructuring, INDRA was established in June 1998 as part of the Frankfurt Agreements on interbank and trade debts with foreign creditors.** INDRA was designed to enable debtors and foreign creditors who reached debt restructuring agreements that met certain requirements to eliminate exchange rate risk on future debt service payments. INDRA, therefore, was intended to play a complementary role to the JITF, by providing parties with a hedge against future exchange rate risk once a restructuring agreement was concluded.

18. **The INDRA scheme was never widely used** (only one firm made use of the facility during the entire period in which it was in existence). It was reported that both debtors and creditors were generally distrustful of the program because it required them to provide resources to the government up front. In addition, the original motivation for the scheme has been rendered less relevant, as the rupiah has become more stable (at least compared with its behavior at the depth of the crisis) and interest rates have decreased to pre-crisis levels. INDRA—which was originally scheduled to expire at end-June 1999—was extended to end-June 2000, but has now been allowed to expire.

C. Key Obstacles to Restructuring, the Strengthened Strategy, and Results to Date

Primary obstacles to restructuring

19. **Progress in corporate restructuring has been slow both for transactions negotiated under the Jakarta Initiative framework and for deals completed outside the Jakarta Initiative**, despite establishment of the JITF and implementation of the reforms summarized above. A variety of factors appear to have contributed to the slow pace of restructuring.

20. **First and most important, the legal system has failed to pose a credible threat to debtors that refuse to restructure**. The threat of bankruptcy—traditionally the key tool for defining leverage and a key weapon in overcoming debtor resistance—has so far not been very effective in Indonesia. This is mainly because the courts have been unwilling or unable to apply the amended bankruptcy law against debtors in a predictable manner. Rather, a number of cases in both the Commercial Court and the Supreme Court have been decided against creditors and in favor of large debtors on grounds that, according to legal analysts, cannot be supported by the underlying law. While various factors have been cited to explain these decisions (e.g., the judges' lack of experience in handling complex commercial disputes), the widespread perception both within and outside the legal system is that many of the controversial rulings have been the result of unlawful external influences on the court. Separately, problems have recently begun to emerge in connection with alleged asset stripping by owners of even those companies that have been declared bankrupt by the courts. The issue here is again reported to be one of external influences, this time involving some of the trustees assigned by the court to oversee the estates of bankrupt companies.

21. **Relatedly, the general legal system in Indonesia is fraught with delays and governance-related problems** that make it difficult for creditors to foreclose on collateral or otherwise enforce their claims. Under these circumstances, a debtor that is not servicing its debts has very little incentive to initiate restructuring discussions, or to cooperate once negotiations begin.

22. **Second, many firms continue to perceive restructuring as contrary to their best interests under the current macroeconomic conditions.** Given the significant financial leverage of many Indonesian companies, meaningful restructuring is likely to involve not only debt rescheduling, but also a dilution of ownership (e.g., through debt for equity swaps), a result that company owners wish to avoid for obvious reasons. At the same time, many companies are reported to have little immediate need for new funds, as the de facto moratorium on debt service payments means that they can use profits to fund operations. Especially when combined with the lack of a credible threat of legal enforcement, as discussed above, these factors have resulted in a situation where creditors have limited ability to enforce their claims, even while many companies have little wish to change the status quo of "strategic" defaults. Moreover, without measures to remedy the legal deterrent problem, this situation is likely to continue until companies need deeper financing (e.g., to fund

business expansions), or until macroeconomic variables return to a level that companies perceive as being more favorable.

23. **Lack of cooperation by large, well-connected debtors, combined with a lack of political will on the part of successive governments, has further slowed the pace of restructuring**. More generally, there may also be some political resistance to restructurings that could result in external creditors acquiring large ownership positions in domestic corporations.

24. **An additional set of factors that previously slowed the pace of restructuring arose out of the operation of the JITF and IBRA**. For example, IBRA was previously constrained by government policy—mostly for political reasons—from engaging in certain kinds of otherwise commercially reasonable transactions, including in particular interest or principal write-downs. The JITF for its part was unable to function effectively because—until recently—it wholly lacked leverage to recommend sanctions against uncooperative parties. The JITF also experienced significant delays in receiving funding to meet its staffing and basic operational needs and also lacked high-level political support, all of which constrained its ability to credibly catalyze or facilitate corporate restructuring.

25. **A further obstacle identified by some participants is the lack of adequate disclosure of financial information—especially cash balances and other assets—by debtors**. Such information is vital to making informed decisions during restructuring negotiations, as it is directly related to the debt servicing capacity of the company concerned. Yet borrowers are reported to be reluctant to disclose information fully and, even when disclosure is made, creditors are often skeptical of its accuracy. As more companies become involved in restructuring negotiations, it will become possible to assess whether this is a systemic issue or merely a problem posed by a few "rogue" companies.

26. **It should be noted that reluctance on the part of creditors to take financial losses in restructuring—a significant obstacle to restructuring in a number of other countries—has not so far emerged as a serious problem in Indonesia** (other than perhaps as related to earlier constraints on IBRA's ability to take haircuts). As regards domestic banks, this may be due to the fact that the most impaired banking system nonperforming loans were acquired by the government as part of the bank restructuring program. These loans are now being worked-out by IBRA (or third party purchasers) who do not face the same regulatory capital constraints that arise when workouts are undertaken by an originating bank with inadequate provisioning and a weak capital position. As regards foreign creditors, there were previously anecdotal reports that some lenders—including especially Japanese banks—were reluctant to accept restructuring losses. This has not yet been identified as a widespread problem, however (although this could be because relatively few deals have reached a point where foreign creditors have actually been presented with proposals involving write-downs).

The enhanced restructuring strategy

27. **The new government has adopted an enhanced corporate restructuring strategy that seeks to address the reasons for lack of progress in restructuring, while at the same time retaining the basic structure and principles of the original framework.** This new strategy was elaborated in the government's January Memorandum of Economic and Financial Policies, although most elements of the strategy were implemented only over the last few months. Key components are summarized below.[7]

28. **First, the strategy strengthens the JITF's ability to administer an effective collective framework for corporate restructuring negotiations** (Box A). This has been accomplished by: (1) providing a means whereby the government can direct that strategically important cases be restructured under the JITF; (2) mandating specified conduct and the use of time-bound mediation procedures in all JITF negotiations that do not involve small- and medium-sized enterprises (SME's); (3) furnishing the JITF with leverage, in the form of the ability to recommend sanctions against parties that fail to cooperate during the restructuring process; and (4) broadening the regulatory incentives that can be made available to parties that successfully restructure under the JITF framework, and enhancing the regulatory facilitation activities of the JITF. The first three reforms are intended to move debtors away from the status quo of strategic defaults, by forcing them to conduct negotiations according to specified timeframes and imposing penalties where they fail to cooperate; the last reform provides "carrots" to balance the new "sticks" included in the framework.

29. **Second, the strategy enhances IBRA's role in restructuring.** IBRA now has express authorization to engage in the full range of commercially acceptable methods of debt restructuring, including debt and debt service reductions where appropriate. To support the new policy, the government has also implemented procedures to indemnify IBRA's directors, officers and employees who may be sued in connection with such transactions. Separately, a new governance structure has been adopted for IBRA that balances independence with accountability. An interministerial committee has also been formed to coordinate and strengthen the government's response to uncooperative debtors of IBRA and former bank owners with assets pledged to IBRA's AMI.

[7] Because creditor recalcitrance has not hitherto posed a significant impediment to restructuring in Indonesia, the enhanced framework does not include elements specifically designed to address intercreditor issues (in contrast to programs in Korea and Thailand, for example). Some aspects of the enhanced strategy, however—e.g., the use of time-bound mediation schedules, or the ability to impose penalties on uncooperative parties—will also be useful in ensuring that creditors participate in restructuring in a commercially reasonable manner.

Box A. Strengthening the Role of the JITF

The JITF's role of administering a collective framework for corporate restructuring has been strengthened in important respects:

The government can now direct strategically important cases to the JITF. The Financial Sector Policy Committee (FSPC) can direct any company to begin negotiations under the JITF collective framework if the company meets certain size and employment criteria, IBRA is not a majority creditor of the company, and the FSPC determines that the company is not otherwise progressing satisfactorily in its corporate restructuring efforts. As of July 20, 2000, 8 cases involving a total debt of $5.5 billion had been referred by the FSPC and further referrals are planned monthly, with the goal of ensuring a cumulative total of at least 12 referrals (minimum debt value of $7.5 billion) by end-September, and at least 17 referrals (minimum debt value of $10 billion) by end-December 2000.

Firm but flexible procedures govern negotiations under the JITF. Non-SME negotiations under the JITF framework are now subject to mediation procedures that, *inter alia*, require certain conduct of all parties to a negotiation and mandate the JITF to establish a tentative mediation schedule with deadlines for completion of the various stages in a restructuring (appointment of professionals, completion of due diligence, etc). The parties can comment on the tentative mediation schedule, but if they are unable to reach agreement, the JITF will determine the permanent schedule to be applied to the negotiation. The deadlines in a permanent mediation schedule are expected to be fixed, but if necessitated by the circumstances, the schedule can be amended at any time by agreement of the parties or in the discretion of the JITF. As discussed below, the permanent mediation schedules applicable to cases currently before the JITF contemplate that restructuring agreements will be reached within periods ranging from three to six months; the timing under each schedule reflects the expected complexity of the restructuring.

The JITF has leverage to recommend sanctions against uncooperative parties. The JITF can now recommend to the FSPC that punitive measures be taken against any party that fails to comply with the timeframes in a mediation schedule, or that otherwise fails to negotiate in good faith. A range of sanctions can be imposed, including (i) publication by the FSPC of the names of uncooperative parties, (ii) revocation or non-extension by relevant government ministries and agencies of licenses, concessions or other facilities previously granted to an uncooperative party, (iii) delisting of uncooperative debtors from the Jakarta Stock Exchange, and (iv) filing by the Attorney General of bankruptcy petitions against uncooperative debtors.

Additional regulatory "carrots" are available for cooperative parties. To balance the sanctions described above, and also provide further incentive for speedy restructuring, procedures are being finalized pursuant to which parties that reach a restructuring under the JITF may be provided with regulatory incentives, including tax relief, exemptions from securities law tender offer rules and related requirements, and easing of banking supervision requirements related to banks' divestiture of equity acquired in restructuring transactions. More generally, the JITF has consolidated its relationships with the government agencies responsible for regulatory issues, and has assumed a more active role in regulatory facilitation. It is scheduled to report shortly on its identification of any remaining regulatory impediments to restructuring, and its recommendations to eliminate such obstacles.

The JITF's funding processes have been improved and the bureaucratic roadblocks preventing the agency from receiving funds in a timely manner eliminated. The JITF has now been able to clear its outstanding arrears and retain additional restructuring specialists.

30. **More generally, cooperation and coordination between IBRA and the JITF have been enhanced**, both as a result of formation of the FSPC (which directly oversees both institutions), and more specifically through weekly meetings and other regular contacts between the two institutions. The FSPC has directed that IBRA participate in JITF-led restructurings whenever IBRA is a minority creditor, and has issued a decree ensuring IBRA's support for JITF-led restructurings agreed to by a majority of the private creditors in a transaction. These reforms have made the government's corporate restructuring policy more cohesive, eliminated the historically poor cooperation between IBRA and the JITF, and laid the groundwork for the realization of greater synergies between the two agencies.

31. **Finally, a critical aspect of the strengthened strategy involves more forceful measures to improve judicial application of the law, as follows.**

32. **A key reform in this regard is the establishment of a Joint Investigating Team tasked with investigating and prosecuting complex cases of corruption including—at least initially—corruption in the court system**. Led by the Attorney General, this interagency team includes members from the police force and other key ministries and agencies with law enforcement mandates, as well representatives of civil society (mainly anti-corruption "watchdog" NGOs active in Jakarta). The Joint Investigating Team was only recently established and has not yet brought any corruption cases to trial (a number of investigations are underway). When it does, its job of proving corruption in court should be facilitated by earlier amendments to the anti-corruption law, which, *inter alia*, provide that evidence of wealth in excess of a defendant's income can be used as proof of corruption.[8] It is also anticipated that a number of cases will be referred to the Joint Investigating Team by the National Ombudsman Commission, an independent body that was recently established to act upon public complaints on governance issues.

33. **A further measure involves the use of private sector professionals with expertise in commercial transactions as "ad hoc" judges in bankruptcy cases**. This reform is intended both to address judicial governance issues as well as to bring much needed commercial law expertise to the Commercial Court. However, it was only in July of this year that ad hoc judges were assigned for the first time to cases pending in the Commercial Court. The initial delays in the assignment of ad hoc judges were reported to be due mostly to judicial resistance to the reform. More recent delays arose because some of the individuals appointed as ad hoc judges were reluctant to serve unless they were allowed to publish dissenting opinions in cases where they disagree with the final decision. Although regular

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[8] Other important aspects of the amended anti-corruption law include provisions that stiffen the applicable criminal penalties; authorize investigators to obtain information on a suspect from financial institutions; and provide for establishment of an Anti-Corruption Commission with responsibility for all aspects of the investigation and prosecution of corruption cases. The Joint Investigating Team is intended to serve as an "embryo" for this broader Anti-Corruption Commission, which is expected to be established in 2001.

judges are generally not allowed to publish dissenting opinions under Indonesian civil practice, the Supreme Court recently issued a regulation clarifying that ad hoc judges are allowed to publish dissenting opinions. [9]

34. **A Commission for the Audit of the Wealth of State Officials is expected to be established soon by the President; its members have already been nominated by Parliament**. This Commission has statutory authority to require regular financial reports from, and inquire into the wealth of, judges and other high-ranking public officials, and to refer evidence of corruption to the Attorney General. It is envisaged that the information gathered by the Commission will complement the investigations and prosecutions conducted by the Joint Investigating Team. It remains to be seen, however, whether the Commission will be viewed as a credible anti-corruption vehicle (for example, there have been corruption allegations against some proposed members of the Commission). In addition, it is too early to assess whether the Commission will receive adequate financial and infrastructure support to enable it to carry out its activities effectively.

35. **The government also plans legislative initiatives as part of its court system reform efforts**. An Advocates' Law to be submitted to Parliament in September will impose a licensing requirement for all attorneys that appear before the courts, and will also require that attorneys adhere to a new uniform code of ethics as a condition for receiving and maintaining their licenses. A number of amendments will also be proposed to the Supreme Court Law in an effort to improve the credibility of the court.

36. **Beyond these specific measures, a useful recent development is that legal and judicial reform has become a matter of significant public discussion, in the wake of a series of controversial court rulings in cases of economic importance**. In response, the government has taken steps that suggest an unprecedented commitment to reform of the judiciary, including recommending to Parliament a list of nominees for vacant Supreme Court positions that includes many candidates who are not sitting judges (a departure from the normal practice, but one that experts agree is a necessary aspect of cleaning up the court system). Parliament has screened the first slate of nominees to the Supreme Court, *inter alia*, by applying a "fit and proper" test. The President has also made numerous statements about the importance of appointing a reformer as Chief Justice of the Supreme Court after the recent retirement of the incumbent.

37. **The most radical judicial reform measure to date was the government's replacement in July of approximately 70 percent of the judges serving on lower courts in Jakarta** (including a number of Commercial Court judges) with judges that had previously served outside of Jakarta. The efficacy of this move remains to be seen, especially

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[9] The government plans to submit legislation to Parliament in August that would, among other things, provide statutory authority for *all* Commercial Court judges to publish dissenting opinions.

given that some of the non-Jakarta judges are reported to have their own governance problems. However, the high priority now accorded to judicial reform is important in sending the message that court governance issues have an impact on economic recovery and will no longer be overlooked.

JITF results to date

38. Immediately before the time-bound mediation procedures discussed above became effective, approximately 150 companies (excluding SME's), representing almost $23.3 billion in foreign currency debt and Rp 14.3 trillion in domestic debt, had registered with the JITF. **Of these, 17 companies had reached some form of agreement with their creditors, involving approximately $1.8 billion in foreign currency debt and Rp 1.7 trillion in local currency debt.**

39. With the initiation of time-bound mediation, the JITF sent letters to the debtors and creditors in all of its non-SME cases informing them of the new procedures and giving them the option of either leaving the JITF or signing on to the new procedures. **As of July 20, 2000, some 46 cases (including 8 referred by the FSPC) were registered under the new mediation procedures, accounting for approximately $10.4 billion in debt; the caseload is projected to increase to $15 billion by end-2000 (excluding restructured debt).**[10] These cases are in various stages of restructuring, with permanent mediation schedules that contemplate restructuring agreements within periods ranging from three to six months, depending on the complexity of the transaction.

40. **Significantly, between May 1 and July 15, 2000, approximately $3 billion in debt was restructured under the JITF, bringing total JITF-related restructured debt to approximately $5 billion.** The JITF expects that, if favorable macroeconomic conditions can be maintained, an additional $3-5 billion will be restructured by end-December 2000, with the strategic objective of restructuring a cumulative total of $12 billion by April 2001.

41. **Given the mediation schedule timeframes, a critical mass of cases registered under the JITF should reach the stage for final agreements over the next few months.** Resolution of a significant portion of these cases would represent important progress in debt restructuring, although it remains to be seen how many cases will actually reach restructuring agreements within the expected timeframes. In this regard it is worth noting that, despite the strengthened restructuring framework, whether or not a restructuring occurs depends ultimately upon *the parties* to the restructuring. The JITF facilitates and mediates

[10] These figures exclude small- and medium-sized enterprises (defined as firms with aggregate debt of under Rp 50 billion), who may or may not use the JITF's structured mediation procedures. As of July 20, 2000, 456 SME's were registered with the JITF with a total debt of Rp 2.7 trillion. As of the same time, 84 SME's had reached final restructuring agreements with their creditors, representing debt of approximately Rp 334.7 billion.

restructuring deals, provides regulatory facilitation and other services, and is instrumental in identifying instances where a party fails to negotiate in good faith. The JITF, however, has no power to dictate the terms of restructuring deals or otherwise to force parties to agree to any particular deal terms.

D. Remaining Issues and the Risks Ahead

42. **The strengthened corporate restructuring strategy still contains a number of risks that could limit the effectiveness of efforts to rehabilitate the corporate sector.**

43. **A key risk factor is that the strategy continues to rely on the legal system to provide some of the most important forms of leverage to make parties restructure**. The new penalties under the JITF framework have yet to be tested. More generally, liquidation—the most significant sanction that can be pursued against an uncooperative firm—can only be effected in a court proceeding. Even sanctions that do not need to be imposed by a court (e.g., delisting from the stock exchange, or withdrawal of a government license) could conceivably be *challenged* in court, and thus made ineffective as a result of an improperly functioning court system. Consequently, if the courts continue to be perceived as being susceptible to external influences and—more importantly—if debtors continue to perceive that they face no real threat of legal enforcement, then the fundamental problem of debtor resistance will continue.

44. **The anti-corruption and judicial reform measures summarized above are not intended to address all of the intricate problems of the Indonesian legal and judicial system**. If implemented forcefully, however, these measures can succeed in minimizing the governance issues in the court system. The recent widespread public scrutiny and criticism of the court system may also add momentum to the process. Success, however, will require strong political will and commitment from the government, and the government itself will likely require significant technical support in carrying out these reforms. The risk therefore remains real that the legal and judicial system may remain resistant to change over the short-term, or that political pressures will otherwise limit the effectiveness of the government's legal and judicial reform efforts.

45. **A second critical factor (which directly affects not only corporate restructuring, but the economic program overall) is the risk of continued political uncertainty**, and in particular the impact of such uncertainty on the rupiah and investor confidence. Major changes in the exchange rate profoundly affect the debt servicing assumptions that form the foundation of restructuring agreements, and also adversely affect the debt servicing capacity of borrowers. Indeed, it is reported that the recent steep depreciation in the rupiah has already had a significant adverse effect on the ability of many companies to service even recently restructured debt (which raises the specter of a need for second-round restructurings even in already completed cases). Moreover, given the current uncertainties, it can be expected that at least some debtors and creditors will delay concluding restructuring agreements until they are confident of greater exchange rate stability. On the positive side, it is possible that confidence will improve once the August meetings of the People's Consultative Assembly

end with no adverse change in the political climate. Until this happens, however, political and exchange rate uncertainty will continue to pose enormous risks to the achievement of decisive results even under the enhanced restructuring framework.

46. **A separate risk factor relates to the potential for a continued lack of political commitment to restructuring, and/or continued political and other non-commercial interference in the restructuring process.** Balanced against these risks is the fact that the new government—albeit slowly—has taken decisive steps to implement the enhanced restructuring framework. The government has also firmly stated its intention to avoid interfering in IBRA's loan recovery efforts and in corporate restructuring generally. However, given the sheer magnitude and complexity of the corporate debt problem in Indonesia, large noncooperative debtors are likely to continue to perceive vigorous debt restructuring as being adverse to their interests, and these debtors may continue to hinder the restructuring process.

47. **A final risk relates to the implementation capacity of the government, including in particular the JITF and IBRA.** Even if all other elements of the strategy succeed as contemplated, the pace of corporate restructuring will be slow unless these agencies prove capable of carrying out their functions in an effective and sustained manner. This will require having not only highly experienced and motivated staff and consultants, but also a core group of leaders with the strategic vision and political independence necessary to guide the institutions in carrying out the complex tasks at hand.

48. **Despite these risks and challenges, the authorities have taken important steps in articulating a voluntary, market-based framework for corporate restructuring;** implementing necessary legal, regulatory and institutional reforms; and empowering key institutions to guide the restructuring process. The test now is whether the government's commitment can be maintained, and whether the measures taken are sufficient to deliver concrete and decisive results in the crucial area of corporate sector restructuring.

IV. Growth, the Evolution of the Balance of Payments, and External Vulnerability[1]

1. **Indonesia's potential to resume rapid growth has come under much scrutiny.** The domestic bank and corporate insolvency has been much greater—relative to GDP—than elsewhere in the region, and there have been difficulties in implementing consistently a reform agenda. Indonesia is also undertaking a historic political transition at the same time as it is seeking to recover from economic crisis. Against this background, the staff have looked at the medium-term challenges for Indonesia and the alternate time paths for resuming growth and reducing domestic and external vulnerability.

2. **This paper explores the short- and medium-term macroeconomic and balance of payments effects of implementing the current reform agenda**. It does so by presenting two medium-term scenarios. In the baseline scenario, progress on the reform agenda enhances and complements the implementation of sound financial policies. In the alternate scenario, a lack of reform leads progressively to an unstable external position and thereby creates incentives to implement ad hoc measures. The two scenarios are illustrative of the range of policies and outcomes relevant to Indonesia's medium-term outlook.

A. Background and Summary

3. **Indonesia's macroeconomic situation has greatly improved over the past year.** At the depth of the crisis, in early 1998, there was widespread economic collapse, high inflation, disruption of relations with external creditors, and a significant loss of foreign exchange reserves. In contrast, economic recovery is now underway and inflation is low. Relations with external creditors are being normalized and the reserve position has improved. The poverty situation has also improved.

4. **The current economic program seeks to solidify and extend macroeconomic stability and strengthen further the external position**. In particular, the key macroeconomic targets are to restore strong growth, entrench low inflation, and reduce the debt burden. In this regard, asset recovery has a crucial role, in conjunction with the implementation of prudent financial policies, as it will generate foreign direct investment, help restore creditworthiness, and enhance fiscal sustainability. The key external goals are to: (i) generate a current account supportive of the economic recovery; (ii) avoid further recourse to exceptional external financing; (iii) normalize relations with all external creditors, and foster new nondebt creating private inflows; and (iv) reduce external vulnerability through maintaining adequate reserves and reducing the debt burden.[2]

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[1] Prepared by Perry Perone of Policy Development and Review Department.

[2] The goals of the current program were set out in the January 2000 LOI. Since then, the baseline medium-term outlook has been updated without significantly changing the key

(continued...)

5. **The message of this chapter is that Indonesia harbors the potential for sustained medium-term growth.** It is the staff's assessment that consistent program implementation can set in motion a virtuous cycle of rising market confidence, new investment, steadily rising growth, low inflation, and reduced external vulnerability. Under such a scenario, the basis of the nascent recovery can be expected to broaden from consumption to investment, which would then drive high growth and expand capacity in the medium term. The balance of payments would reflect the pick up in growth with emerging current account deficits, as a surge in intermediate and capital goods imports outpaces strong growth in non-oil exports. External vulnerability would be reduced as these deficits are financed primarily by non-debt creating direct investment which would be possible as a result of the normalization of relations with external creditors, a healthy financial system, and a stable political environment. The reduction in external vulnerability implies, inter alia, that the capacity to repay the Fund will remain high.

6. **Conversely, there are considerable risks if the reform momentum falters.** There is considerable fragility in the macroeconomic situation, and Indonesia is still vulnerable to the onset of a vicious cycle of weak market sentiment, depreciating rupiah, high inflation, stagnant economic activity, and increasing external vulnerability. In such a scenario, relations with official creditors would be jeopardized, and net capital outflows would take place, with the risk that even large trade and current account surpluses may not be sufficient to prevent deterioration of the reserve position. **Thus, while Indonesia's current external position appears now to be relatively comfortable by standard reserve and debt measures, it is very sensitive to assumptions about the pace of structural reform and the return of net capital inflows.**[3]

7. **The remainder of this chapter** briefly describes the medium term macroframework under the two scenarios (section II), presents the two corresponding balance of payments projections (section III), and assesses Indonesia's external vulnerability (section IV).

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parameters and objectives. The most significant adjustment to the January 2000 projections was in the balance of payments. The current account surplus was increased primarily as a result of actual 1999 outturn in which import growth was weaker than expected and oil prices increased sharply resulting in a larger than expected accumulation of reserves.

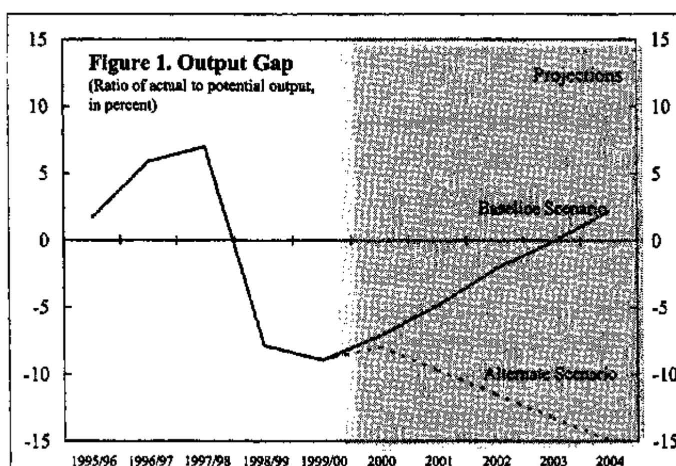
[3] Assessments of external vulnerability are implicitly forward looking and thus embody assumptions about the implementation of financial and other policies, underscoring that such summary indicators should not be applied in a mechanical way. As in the alternate scenario described below, lack of access to international capital markets could extend well beyond one year and thus the standard measure of reserve adequacy would prove to be misleading; in such an eventuality, reserves would have to cover more than one year's worth of amortization to be considered adequate.

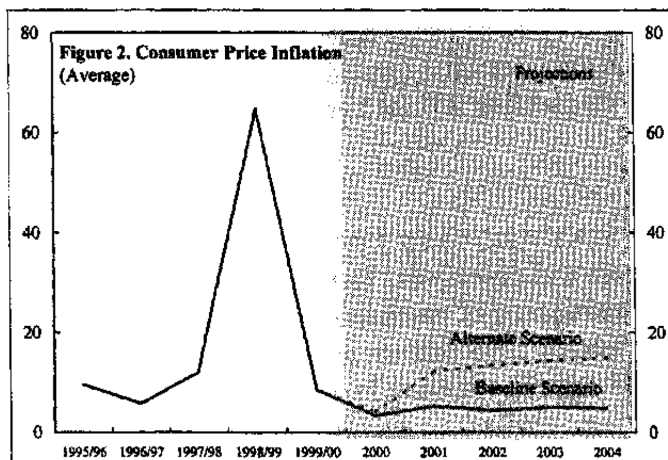
B. Macroeconomic Outlook

8. **Recent economic indicators have pointed to a recovery that has appeared to be gathering pace along with virtual price stability.** Real GDP growth in the fourth quarter of 1999 was about 5 percent year on year and the momentum was well maintained in the first half of 2000 with a growth of over 3½ percent. This delivered a real growth rate of 3.3 percent for FY1999/2000, and growth in the 3–4 percent range for 2000 remains well within reach.

Macroframework under the two scenarios

9. **The baseline projection underlying the economic program assumes a pick-up in investment in the coming years, paving the way for sustained medium-term growth.** The recovery so far has been consumption driven and, given the output gap (estimated in the range of 5-10 percent), has not put pressure on domestic supply capacity. As corporate and bank restructuring move forward, investment should pick up, spurring real growth. The output gap would close by 2002 or 2003 as real growth reaches 4 to 5 percent. Inflation is expected to stabilize in the range of 5 to 6 percent and real interest rates to fall to about 4 percent (Tables IV.1 and IV.2 and Text Figures 1 and 2).





10. **As the economy rebounds it would no longer be necessary to maintain fiscal stimulus.** Over the medium term, tax and expenditure reforms are projected to take hold, leading to lower budget deficits, despite the increasing interest costs of bank restructuring. In the baseline scenario, primary surpluses would increase from 2 to 3 percent of GDP, and overall deficits would dwindle from 5 percent of GDP to about 1 percent of GDP in the five-year period. Financing would be provided by privatization, asset recovery and modest external borrowing (including

eventual government bond issues). Asset recovery, fiscal consolidation, and the macroeconomic situation all combine to deliver fiscal sustainability.[4]

11. **In the alternate scenario, the lack of reform leads to sluggish economic growth, a weak rupiah, and high inflation**. The lack of structural reform would result in a loss of confidence and a stagnation of investment demand and economic activity. Growth potential will remain limited and the growth momentum would be low—driven principally by agricultural production. In this scenario, the staff has assumed that real GDP would fluctuate in a narrow range of 0 to 2 percent. Rupiah depreciation would feed through to domestic prices, fueling inflation in the range of 15 percent annually, keeping risk premia and real interest rates high (in the range of 9 percent).

12. **The fiscal position would come under considerable pressure from a number of sources risking disorderly adjustment**. Persistent high interest rates will exacerbate the domestic debt service burden and lack of reform would likely limit access to foreign financing. Lacking access to foreign financing, and faced with increasing interest payments (2 to 3 percent of GDP higher than in the baseline scenario), the government would be under pressure to implement across-the-board reductions in discretionary spending. Development spending would be at most risk of disorderly cuts. Moreover, part of the deficit could be financed by the accumulation of external arrears to official creditors.

C. Alternate Medium-Term Balance of Payments Scenarios

13. **This section presents the baseline and alternate balance of payments scenarios**, to illustrate the opportunities and highlight the risks in the current situation. The scenarios seek to demonstrate the powerful effects of structural reforms on the macroeconomic targets, especially on the external sector.

14. **In both scenarios external conditions are assumed to be favorable.**[5] External demand is projected to be strong and world interest rates (LIBOR) are assumed to remain in the range of 6 percent. Average real GDP growth of the advanced trading partners of Indonesia is projected at more than 3 percent in the medium-term. Real import demand for all trading partners is projected to grow by around 8 percent per annum.

15. **From a macroeconomic perspective, Indonesia's recent trade and current account surpluses are crisis-driven anomalies**. They imply that scarce national savings are being exported to the rest of the world and represent the counterpart of a lack of access to international capital markets. As a lower middle income country, Indonesia should be able to attract external capital to finance investment which will fuel rapid growth. The current

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[4] Chapter II of the current *Selected Issues* paper discusses the medium-term debt outlook, and the risks to fiscal sustainability.

[5] These assumptions are consistent with the WEO projections.

anomaly is the result of depressed levels of economic activity, low investment demand, and the disruption of relations with external creditors that followed the crisis.

16. **In the baseline scenario, structural reforms set the stage for investment-led growth, eventually turning the current account into deficit** (Table IV.3). The trade surpluses diminish as investment-led growth drives a recovery in intermediate and capital goods imports, more than offsetting rising export strength. The current account deficits are sustainably financed by private sector inflows, primarily in the form of direct investment and a return of flight capital, as relations with external creditors normalize. As a result, the reserve position strengthens over the medium term and the external debt burden is reduced.

17. **The alternate scenario assumes a lack of progress in structural reform and further deterioration in relations with external creditors.** Both factors impede capital inflows and have deleterious effects on the rupiah, economic activity, and the reserve position (Table IV.4). Trade and current account surpluses continue as disequilibrium conditions prevail. Export growth, while benefiting from relative price changes, is hampered by a lack of financing but still outpaces the growth of imports which are compressed as a result of weak economic activity. The resulting large current account surpluses risk not being sufficient to compensate for net capital outflows and the reserve position weakens. Moreover, external arrears accumulate as relations with external creditors are further disrupted.

18. **The contrast between the two scenarios is stark, particularly in the latter part of the projection period**. By 2003–04, in the baseline scenario, there are modest net inflows of private capital (especially direct investment), external debt is reduced significantly, and export growth is strong (Text Table 1). Conversely, in the alternate scenario, capital outflows remain large and large current account surpluses continue as growth is low and imports do not recover.

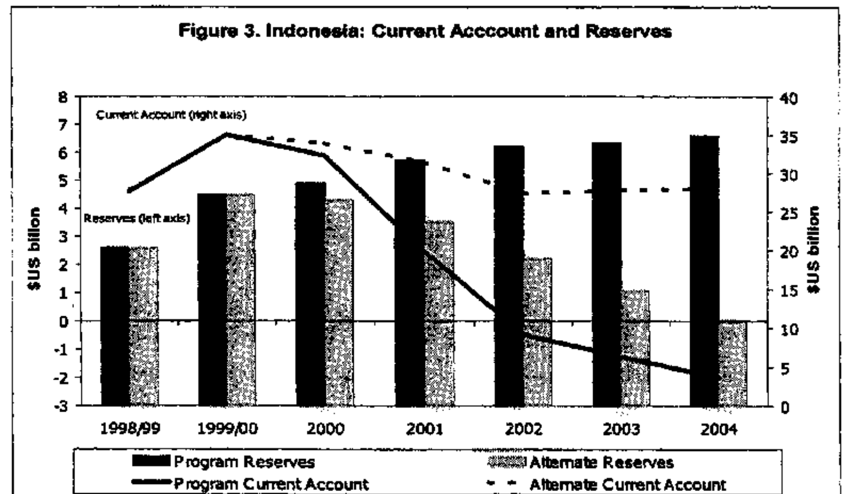
Table 1. Key Variables In The Two Medium-Term Scenarios

	1999/00 Fiscal Year	2003–04 Average	
Variables	Actual	Baseline Scenario	Alternate Scenario
Growth (percent)	3.3	5.5	0.0-2.0
GDP per capita ($)	725	1,041	690
Inflation (percent)	8.5	5.0	15.0
Govt. debt/GDP (percent)	90.9	69.7	93.2
Govt. interest payments/revenue	22.7	27.1	39.9
Govt. debt service/revenue	33.4	38.1	56.1
Current account/GDP (percent)	4.4	-0.7	3.0
Reserves ($ billion)	27.2	34.5	12.9
External debt/GDP (percent)	97.0	64.0	89.0
Import volume growth (percent)	-1.7	8.8	1.5
Export volume growth (percent)	0.3	6.8	1.8

Current account

19. **Current account developments under both scenarios hinge on the pace of recovery of non-oil exports and imports.** Their growth is affected by three factors: (i) relative price movements; (ii) economic activity; and (iii) the ability of the domestic

financial system to provide and facilitate trade financing.[6] The alternate scenario assumes that: (i) the rupiah will weaken further; (ii) economic activity will be depressed (averaging about 1 percent per annum); and (iii) structural reforms will not go forward, thereby limiting access to trade financing. Thus sluggish import growth (3-4 percent per annum) will lead to persistent and large current account surpluses (in the range of 3 percent of GDP) (Text Figure 3). In contrast, the baseline scenario assumes that: (i) there will be an initial—and equilibrating—real appreciation as structural reform improves underlying competitiveness; (ii) economic activity is vigorous; and (iii) the banking and corporate sectors begin to function normally. As such, both export and import growth will be strong (averaging about 7 percent and 11 percent respectively), with imports outpacing exports but resulting in manageable current account deficits in the out years.



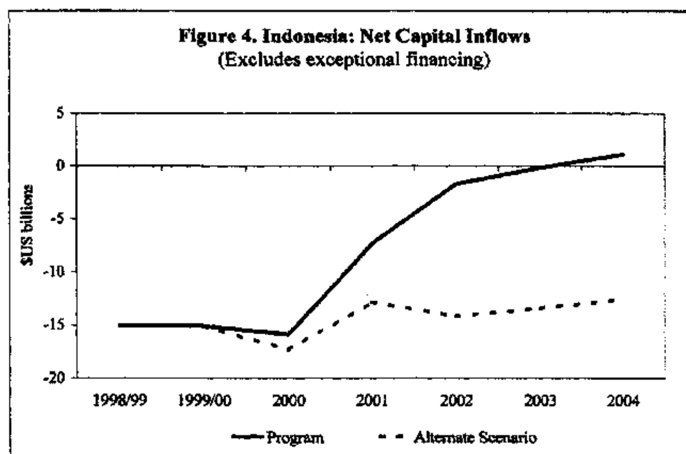
20. **The services balance is also sensitive to reforms and the market environment.** Reduced access to external markets and sluggish economic activity in the alternate scenario imply lower interest payments (higher interest premia are not offset by lower net borrowing) and sluggish growth of nonfactor service imports, respectively. Partly offsetting this is the likely slower growth of tourist arrivals in the face of instability. In the baseline scenario, nonfactor outflows are stimulated by a growing economy and private borrowing results in higher interest payments. In this scenario, services imports, such as travel, exhibit strong growth and the stable political environment implies that tourism arrivals stay constant in real terms. The difference between the two scenarios rises to $3 billion in 2004.

Capital account

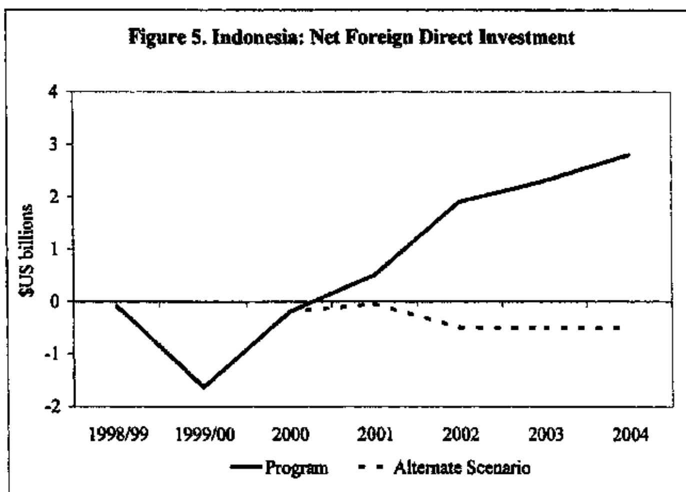
21. **The path of capital flows turns on the status of relations with external creditors and domestic political conditions.** The alternate scenario assumes that the program is not implemented, relations with external creditors deteriorate, and purchases under the Fund-supported program are interrupted (Text Figure 4). In particular, inadequate program

[6] The underlying structural trade equations are assumed to be the same in both scenarios with import price elasticities near, and import income elasticities significantly above, unity. The main explanatory endogenous variable for exports is world demand. Thus, while movements in relative prices will have a non-negligible effect on imports, the primary determinant is changes in income.

implementation interrupts the recently agreed Paris Club rescheduling and slows the disbursement of project financing.[7] In such a case, net outflows from the public sector could range from $1 billion to $2 billion, risking the accumulation of arrears. In contrast, the baseline scenario assumes that normal relations with official creditors continue, resulting in sustained inflows of project financing from multilateral institutions as well as new bilateral and trade credit facility lending. It is also likely that the government would be able to issue bonds in international capital markets to help cover amortization. Even under such assumptions, net flows to the public sector are not expected to play a significant role in financing current account deficits.



22. **The key to the return of private capital inflows is the restructuring of corporate debt but little progress in this area is assumed in the alternate scenario.** This results in limited disbursements, the accumulation of arrears, continuing capital flight, and limited direct investment inflows. The baseline projections assume that the majority of this debt will be restructured throughout 2001.[8] Even so, net flows to the corporate sector in the form of loans are not expected to be significant in the medium term although disbursements are projected to increase significantly. Rather, the normalization of relations with creditors will pave the way for a return of flight capital, new direct investment, and a reduction in the interest rate spread paid by Indonesian borrowers as market sentiment improves.



23. **Under a stable medium term path, foreign direct investment can be expected to play a significant role but, in the alternate scenario, such inflows**

[7] The 2000 Paris Club agreement stipulates that the rescheduling of amortization due starting in April 2001 is contingent upon successful implementation of the IMF program.

[8] It is now expected that the majority of corporate debt will be restructured in the context of the JITF framework rather than INDRA. Only one domestic company participated in INDRA and the scheme was allowed to expire at the end of June 2000.

do not materialize (Text Figure 5). In fact, the alternate scenario projects small outflows as subsidiaries of multi-national corporations repay intra-company debts without offsetting new investments. Conversely, the baseline scenario projects gradually increasing net direct investment flows, ranging from $2 billion to $3 billion in the out years. Thus, current account deficits will be financed without adding significantly to the debt stock.

24. **The net outflows of capital in the alternate scenario could also result from the further flight of domestic capital.** The reversal of such outflows depends crucially on political stability, transparency in economic policies, and a well-functioning legal system. These are not forthcoming in the alternate scenario and net outflows could reach as much as $6 billion per year in the form of flight capital and the non-repatriation of export receipts. Against this, in the baseline projections, net inflows rise to the range of $3 billion in the out years.

D. External Vulnerability

25. **This section assesses Indonesia's current external vulnerability using reserve and debt indicators and discusses how external vulnerability would evolve under both medium term scenarios.** While Indonesia's external vulnerability has diminished since the onset of the crisis, underlying weaknesses remain. The strength of the reserve position, although improving faster than anticipated, is sensitive to assumptions about the rate at which corporate access to capital markets is regained. The debt burden should fall in the medium term under either scenario but it will fall faster in the baseline scenario as a result of strong real GDP growth and the ability to finance emerging current account deficits with direct investment. In the alternate scenario, the fall in the debt burden is largely the result of the lack of ability to borrow and the resulting current account surpluses.

Reserve-related measures of vulnerability

26. **The authorities have made significant strides toward improving their measurement of reserves.** An external audit of Bank Indonesia was completed in December 1999 and the January 2000 MEFP included specific commitments from the authorities to address issues raised by the audit. As part of this process, a reconciliation of foreign currency assets and liabilities with net foreign exchange reserves was completed early in 2000. In addition, the authorities have begun to publish reserve data in line with the SDDS starting in May 2000. As a result, about $2 billion in assets, previously included in gross reserves but identified as illiquid, has been removed from the reported measure of reserves. This brings gross reserves in line with the concept of liquid reserves that has been used by the staff in assessing Indonesia's reserve position (and published by the authorities) since late 1998.

27. **BI has not intervened in forward markets and, thus, there is no potential drain on reserves from this source.** As of end-June 2000, the net forward position of Bank Indonesia was nil. As part of overall program design, BI has allowed the rupiah to float freely, entering into the foreign exchange market to convert foreign loans into rupiah for budget financing, while occasionally adjusting timing and amounts with a view to keep market conditions orderly.

28. **Indonesia's gross reserve position has been restored to a relatively comfortable level** (Text Table 2). At end March 2000, *reserve cover in months of imports* stood at 6 which is high by international standards. This measure, however, needs to be interpreted with caution because imports are still exceptionally depressed, and the borrowed component of reserves is high. Nonborrowed reserves were only about $8 billion.

Table 2. Indonesia: Reserve Cover

	1996 Mar.	1997 Mar.	1998 Mar	1998 Dec.	1999 Dec.	2000 Jun.
Reserves (in months of imports)	3.9	5.4	3.1	5.4	5.4	5.1
Reserves/short-term debt (in percent) 1/ 2/	69	77	27	59	71	95

Sources: Bank Indonesia; Fund staff estimates.

1/ Short-term debt calculated on a remaining maturity basis.

2/ Before rescheduling.

29. **The reserve to short-term debt ratio (a broader measure of reserve adequacy that includes potential drains on reserves emanating from the capital account) has improved faster than anticipated under the program.** At 100 percent (post Paris Club 2000 rescheduling), the ratio of liquid reserves to short-term debt meets the notional target of full coverage. Full coverage was expected by the end of the program period and has been achieved sooner partly as a result of the fortuitous effects of oil price increases on the trade balance but also because of the slower than anticipated pick up in imports.

30. **Indonesia's reserve coverage in terms of broad money is low compared with other Asian emerging markets** (Text Table 3). Money-based indicators are commonly used to assess the potential for capital flight. Such measures, however, are not particularly good as a predictor of actual capital flight. In fact, there is a weak relation between a low reserve to broad money ratio and the occurrence and depth of crises in a recent study of international crises.[9] Still, given the fact that Indonesia's recovery from deep crisis is far from complete, and the banking sector is still weak, there is potential for capital flight and, viewed from this perspective, the reserve position is not particularly comfortable.

Table 3. Indonesia: Comparison of Reserves/Broad Money, 1994–99 1/
(In percent)

	1994–96	1996–99	1999
Indonesia	18	28	23
Singapore	94	82	73
Malaysia	22	24	29
Phillippines	26	34	41
Thailand	21	23	22
Korea	16	24	32

Sources: Bank Indonesia; IFS; and Fund staff estimates.

1/ Liquid concept of reserves is not used in this table as such data was not available for all countries in the sample.

[9] See Debt- and Reserve-Related Indicators of External Vulnerability, (SM/00/65) March 23, 2000.

Debt-related indicators of external vulnerability

31. **Short-term obligations, a broad measure of external liabilities, amounted to $31 billion at end-1999, the majority of which related to private sector debt.** Some $15 billion in amortization on private sector debt will fall due in 2000 and, in addition, $9 billion in short-term debt will have to be rolled over or paid (Table IV.5). The remainder of amortization due in the year stems from the central government, public enterprises, and state bank debt amounting to some $6 billion (including Paris Club rescheduling).

32. **The majority of the private sector amortization due in 2000 is on corporate sector debt ($13 billion), much of which is not being serviced currently.** Staff projections are based on the assumption that some two thirds of these payments are not currently being serviced and that some 10 percent will be voluntarily refinanced. The remaining $3 billion is assumed to be paid.

33. **The majority of public sector obligations falling due is on central government debt,** more than half of which was rescheduled in April 2000 in the context of the Paris Club.

34. **Indonesia had a significant stock of external debt in 1996 whose burden rose sharply as the crisis reduced the dollar value of output.** Precrisis, Indonesia had relied more heavily on external borrowing than other emerging market economies in the region. Such borrowing left a legacy of a larger debt burden than other similar Asian countries (Text Table 4). The onset of the crisis necessitated considerable reliance on exceptional balance of payments support from multilateral and bilateral official sources to cushion the impact of the crisis. Taken together with the drop in the dollar value of GDP, largely stemming from the depreciation of the rupiah, Indonesia's debt ratio almost tripled between 1996 and 1998.

Table 4. Indonesia: External Debt Indicators Compared, 1996-2000
(In percent)

	1996	1997	1998	Est. 1999	Proj. 2000
External Debt/GDP					
Indonesia	55	73	142	103	92
Asian developing economies 1/	43	48	58	47	42
External Debt/exports of goods and services					
Indonesia	214	215	275	252	222
Asian developing economies	118	115	119	113	108
Debt Service Ratio 2/					
Indonesia (before rescheduling)	31	38	61	61	49
Indonesia (after rescheduling)	...	...	...	...	28
Asian developing economies 1/	16	15	20	16	15

Sources: Bank Indonesia; WEO; Fund staff estimates.
1/ Excludes China and India.
2/ Amortization and interest payments as a percent of exports of goods and nonfactor services.

35. **Debt service obligations are also significant.** Corresponding to the large stock of outstanding external liabilities, Indonesia's debt service burden has been and remains significantly higher than other similar countries in the region.

36. **Regarding debt management and currency composition issues, it appears that Bank Indonesia and the commercial banks have well-hedged positions.** The majority of Indonesia's debt is denominated in US dollars (about 30 percent) and Japanese Yen (about 25 percent). Bank Indonesia officials indicated that they hold most of their assets in U.S. dollars but adjust the currency composition of reserves with a view toward Yen obligations

falling due in the near future. Also, a portion of the capitalization bonds for commercial banks with net open foreign currency positions has been (and will be) issued in the form of foreign exchange-linked (rupiah-denominated) bonds, to enable these banks to close their positions in an orderly manner. Nonetheless, some commercial banks still have sizeable (short) foreign currency exposure as a result of foreign currency loans that became nonperforming during the crisis. Such banks have been granted some time to bring their positions within prudential guidelines.

37. **The relatively comfortable external position indicated by standard reserve and debt-based measures is highly sensitive to various assumptions as illustrated by the alternate scenario described in the previous section.** In the alternate scenario, gross reserves decline to $11 billion, reserve coverage of imports slips to two months, and short term debt coverage falls to some 40 percent by 2004. Moreover, relations with external creditors deteriorate and arrears, both official and private, continue to accumulate throughout the period. In contrast, in the baseline scenario, the current external position is fortified through increases in gross reserves (to about $35 billion), and short term debt coverage (to some 125 percent), and the maintenance of high import cover (5 months). Moreover, all external arrears are cleared early in 2001.

38. **Capital controls could not be a panacea in the alternate scenario.** It is not likely that such controls would be effective for a sustained period. Such controls require a high degree of administrative sophistication which has not yet been developed in Indonesia, which has a long history of an open capital account; it is likely that market participants would quickly learn to by-pass such restrictions. Such controls could well exacerbate and prolong problems of access to international capital markets and could increase risks to the financial system as the measures are circumvented by directing flows through less regulated channels.

39. **Moreover, the external debt profile would not be as favorable in the alternate scenario.** Gross external debt would not grow as fast in the alternate scenario as in the baseline scenario as a result of supply constraints. The debt burden in terms of GDP, however, would not fall as quickly as under the baseline scenario as a result of weak real growth. The debt to GDP ratio would, on average, be about 25 percentage points higher in the alternate scenario by the end of the projection period.

40. **Given the lingering risks highlighted above, the notional target of 100 percent reserve coverage of obligations falling due in the next year should be considered the minimum level of adequacy.** The staff anticipates that the program will continue to be implemented and the restructuring will soon gain momentum. If, however, the pace of restructuring continues to drag or net capital inflows do not materialize as quickly as assumed in the baseline scenario,[10] the external position could quickly look much less secure.

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[10] For example, the effects on foreign investment incentives of the looming fiscal decentralization are not clear; regional governments can assert their new authority in ways that weaken foreign investors' confidence.

Table IV.1. Indonesia: Medium-Term Macroeconomic Framework, Baseline Scenario, 1999/2000–2004 1/

	1999/2000	2000	2001	2002	2003	2004
Output and prices (in percent change)						
Real GDP	3.3	3 to 4	4 to 5	5 to 6	5 to 6	5 to 6
CPI inflation (average)	8.5	3 to 4	4 to 5	4 to 5	4 to 5	4 to 5
Savings and investment (in percent of GDP)						
Gross domestic investment	12.9	16.6	17.9	18.8	19.1	20.2
Private	8.4	12.4	13.4	14.0	14.2	14.9
Public	4.5	4.2	4.6	4.7	4.9	5.3
Gross national savings	17.2	20.4	19.3	18.5	18.6	19.3
Private	10.4	14.9	12.0	10.8	10.4	10.9
Public	6.8	5.5	7.2	7.8	8.1	8.5
Central government operations (in percent of GDP)						
Revenue and grants	16.7	16.8	18.0	17.7	17.6	17.7
Expenditure and net lending	18.1	21.6	21.7	20.3	19.4	19.0
Overall balance 2/	-1.5	-4.8	-3.7	-2.6	-1.8	-1.3
Payment of arrears	-1.2	0.0	0.0	0.0	0.0	0.0
Total financing	2.7	4.8	3.7	2.6	1.8	1.3
Balance of payments (in billions of U.S. dollar)						
Current account balance	6.6	5.9	2.5	-0.5	-1.3	-2.0
Trade balance	19.7	19.7	17.4	15.4	15.5	15.9
Exports	55.2	61.0	63.3	66.2	71.2	77.2
Imports	35.6	41.3	45.8	50.8	55.7	61.3
Capital account, of which:	-15.1	-15.9	-7.3	-1.7	-0.2	1.1
Overall balance	-8.5	-10.0	-4.9	-2.2	-1.4	-0.9
External debt and reserves (end-of-period, in billions of U.S. dollars)						
Gross reserves 3/	27.2	28.7	31.6	33.5	34.0	34.9
(End-of-period, in months of imports)	6.0	6.0	6.0	5.7	5.3	5.0
(As percent of short-term debt)	79.8	96.6	102.1	106.9	123.9	126.4
Medium- and long-term external debt 4/	148.6	150.2	150.2	148.5	148.2	145.9
(End-of-period, in percent of GDP) 5/	97.0	91.8	80.9	74.5	67.0	60.9
Debt-service ratio (end-of-period, in percent) 6/	31.4	28.3	26.3	34.6	34.1	29.9
Memorandum items:						
Current account balance (in percent of GDP)	4.4	3.8	1.3	-0.2	-0.6	-0.8
Government debt (end of period, in percent of GDP)	90.9	90.7	85.5	79.0	72.7	67.3
Of which: External	42.3	42.3	38.4	35.8	32.1	29.6

Sources: Data provided by the Indonesian authorities; and Fund staff estimates and projections.

1/ Fiscal years from 1997/98 to 1999/00 (fiscal year starts on April 1) and calendar years for 2000 to 2004, with the exception of the fiscal projections for 2000 which are based on the 9-mo
2/ Excludes privatization receipts.
3/ Refers to liquid reserves that are almost equivalent to the newly adopted definition of reserves data template. No historical data are yet available for the new defintion. Includes Fund purc
4/ Includes holdings of domestic securities by nonresidents.
5/ GDP converted to U.S. dollar using end of period exchange rate.
6/ In percent of exports of goods and nonfactor services.

Table IV.2. Indonesia: Medium-Term Macroeconomic Framework, Alternate Scenario, 1999/2000–2004 1/

	1999/2000	2000	2001	2002	2003	2004
Output and prices (in percent change)						
Real GDP	3.3	3 to 4	0 to 2	0 to 2	0 to 2	0 to 2
CPI inflation (average)	8.5	4 to 5	12 to 13	13 to 14	14 to 15	14 to 15
Savings and investment (in percent of GDP)						
Gross domestic investment	12.9	16.6	18.5	19.9	21.0	22.8
Private	8.4	12.4	14.0	15.5	16.8	18.6
Public	4.5	4.2	4.5	4.3	4.2	4.1
Gross national savings	17.2	21.1	22.5	22.9	24.1	25.8
Private	10.4	15.6	15.3	14.1	14.0	14.9
Public	6.8	5.5	7.2	8.9	10.1	10.9
Central government operations (in percent of GDP)						
Revenue and grants	16.7	16.7	19.4	18.3	18.0	18.2
Expenditure and net lending	18.1	21.5	25.0	22.1	19.7	18.2
Overall balance 2/	-1.5	-4.8	-5.6	-3.7	-1.7	-0.1
Payment of arrears	-1.2	0.0	6.4	4.7	2.5	0.9
Total financing	2.7	4.8	5.6	3.7	1.7	0.1
Balance of payments (in billions of U.S. dollar)						
Current account balance	6.6	6.3	5.7	4.5	4.6	4.7
Trade balance	19.7	20.1	19.5	18.5	18.9	19.2
Exports	55.2	61.0	60.5	60.3	61.6	63.4
Imports	35.6	40.9	41.0	41.8	42.7	44.2
Capital account, of which:	-15.1	-17.3	-12.8	-14.2	-13.4	-12.6
Overall balance	-8.5	-11.0	-7.2	-9.6	-8.8	-7.8
External debt and reserves (end-of-period, in billions of U.S. dollar)						
Gross reserves 3/	27.2	26.6	23.7	18.9	14.8	11.0
(End-of-period, in months of imports)	6.0	6.2	5.4	4.2	3.1	2.1
(As percent of short-term debt)	79.8	91.7	76.6	61.9	53.9	39.7
Medium- and long-term external debt 4/	148.6	149.1	144.3	137.0	133.3	127.7
(End-of-period, in percent of GDP) 5/	97.0	120.6	105.2	100.5	91.6	86.1
Debt-service ratio (end-of-period, in percent) 6/	31.4	28.1	29.4	32.6	32.9	30.1
Memorandum items:						
Current account balance (in percent of GDP)	4.4	4.5	4.0	3.1	3.0	3.0
Government debt (end of period; in percent of GDP)	90.9	90.7	85.5	79.0	72.7	67.3
Of which: External	42.3	56.1	49.2	48.1	43.9	42.0

Sources: Data provided by the Indonesian authorities; and Fund staff estimates and projections.

1/ Fiscal years from 1997/98 to 1999/00 (fiscal year starts on April 1) and calendar years for 2000 to 2004, with the exception of the fiscal projections for 2000 which are based on the 9-month
2/ Excludes privatization receipts.
3/ Refers to liquid reserves that are almost equivalent to the newly adopted definition using reserve data template. No historical data are yet available for the new definition. Includes Fund purcl
4/ Includes holdings of domestic securities by nonresidents.
5/ GDP converted to U.S. dollar using end of period exchange rate.
6/ In percent of exports of goods and nonfactor services.

Table IV.3. Indonesia: Medium-Term Balance of Payments in the Baseline Scenario

(In billions of U.S. dollars)

	1999/00	Calendar Year				
		2000	2001	2002	2003	2004
Current account	6.6	5.9	2.5	-0.5	-1.3	-2.0
Trade balance	19.7	19.7	17.4	15.4	15.5	15.9
Exports	55.2	61.0	63.3	66.2	71.2	77.2
Non-oil and gas	43.1	46.8	50.8	55.0	60.0	65.5
Oil and gas	12.2	14.1	12.4	11.2	11.2	11.7
Imports	-35.6	-41.3	-45.8	-50.8	-55.7	-61.3
Non-oil and gas	-30.8	-35.5	-40.8	-46.3	-51.2	-56.7
Oil and gas	-4.8	-5.8	-5.0	-4.5	-4.5	-4.6
Services	-13.0	-13.8	-15.0	-15.9	-16.8	-17.9
Of which: Interest payments	-9.4	-9.6	-10.4	-10.5	-10.4	-10.1
Capital account	-15.1	-15.9	-7.3	-1.7	-0.2	1.1
Nonfinancial public sector	1.2	1.0	-0.8	-0.7	-0.3	-0.2
Disbursements	5.7	6.2	5.0	4.8	5.0	4.5
Amortizations due	-4.4	-5.1	-5.8	-5.5	-5.3	-4.7
Commercial banks	-2.1	-1.8	-1.2	-0.6	-0.1	-0.2
Disbursements	2.0	1.1	1.2	0.8	0.6	0.2
Amortizations due	-4.0	-2.9	-2.4	-1.4	-0.7	-0.3
Private corporate sector	-10.7	-11.8	-6.0	-4.2	-4.2	-3.6
Disbursements	1.2	1.3	1.5	7.6	8.7	7.9
Amortizations due	-11.9	-13.1	-7.5	-11.9	-12.9	-11.5
Direct foreign investment	-1.6	-0.2	0.5	1.9	2.3	2.8
Other private sector flows 1/	-1.9	-3.1	0.2	1.9	2.1	2.3
Overall balance	-8.5	-10.0	-4.9	-2.2	-1.4	-0.9
Financing	8.5	10.0	4.9	2.2	1.4	0.9
Change in NIR	-2.6	-2.2	-3.3	-2.1	-1.4	-0.8
Gross reserves	-3.6	-3.8	-2.9	-1.1	-0.1	0.1
Reserve liabilities	0.9	1.6	-0.3	-1.0	-1.4	-0.9
Exceptional financing	11.1	12.2	8.2	4.4	2.9	1.7
Change in arrears	8.0	8.8	-24.8	0.0	0.0	0.0
Accumulation	8.0	8.8	0.0	0.0	0.0	0.0
Commercial banks	0.0	0.0	0.0	0.0	0.0	0.0
Corporations	8.0	8.8	0.0	0.0	0.0	0.0
Payment	0.0	0.0	-24.8	0.0	0.0	0.0
Commercial banks	0.0	0.0	0.0	0.0	0.0	0.0
Corporations	0.0	0.0	-24.8	0.0	0.0	0.0
Rescheduling	3.1	3.4	32.9	4.4	2.9	1.7
Commercial banks	1.7	1.1	0.2	0.0	0.0	0.0
Corporate sector	0.0	0.0	29.8	3.6	2.9	1.7
Public sector (Paris Club)	1.4	2.3	2.8	0.8	0.0	0.0
Memorandum items:						
Current account (as a percent of GDP)	4.4	3.8	1.3	-0.2	-0.6	-0.8
Medium- and long-term external debt (as a percent to GDP) eop erate	97.0	91.8	80.9	74.5	67.0	60.9
Medium and long-term external debt (in billions of U.S. dollar)	148.6	150.2	150.2	148.5	148.2	145.9
Medium- and long-term external debt (as a percent to exports G&S)	241.4	222.0	212.4	200.4	186.2	169.8
Debt service (as a percent of XGNFS)	31.4	28.3	26.3	34.6	34.1	29.9
Reserves	27.2	28.7	31.6	33.5	34.0	34.9
(In months of imports)	6.0	6.0	6.0	5.7	5.3	5.0
(As a percent of short-term debt)	79.8	96.6	102.1	106.9	123.9	126.4
Non-oil/gas export growth (percent)	4.8	14.2	8.6	8.1	9.2	9.2
Non-oil/gas import growth (percent)	0.4	22.4	15.0	13.4	10.7	10.6
Export volume growth (percent)	0.3	5.8	6.2	6.6	6.9	6.8
Import volume growth (percent)	-1.7	19.6	13.3	10.9	8.8	8.7
Oil Price (U.S. dollar per barrel)	21.1	25.0	21.8	19.4	19.3	19.9
Terms of trade (percent)	6.3	8.6	-0.3	-1.8	-0.1	0.3

Source: Bank Indonesia; and Fund staff estimates.

1/ Includes errors and omissions and $1 billion in transfers from Bank Indonesia to BEI in March–June 2000.

Table IV.4. Indonesia: Medium-Term Balance of Payments in Alternate Scenario

(In billions of U.S. dollars)

		Calendar Year				
	1999/00	2000	2001	2002	2003	2004
Current account	6.6	6.3	5.7	4.5	4.6	4.7
Trade balance	19.7	20.1	19.5	18.5	18.9	19.2
Exports	55.2	61.0	60.5	60.3	61.6	63.4
Non-oil and gas	43.1	46.8	48.1	49.1	50.4	51.7
Oil and gas	12.2	14.1	12.4	11.2	11.2	11.7
Imports	-35.6	-40.9	-41.0	-41.8	-42.7	-44.2
Non-oil and gas	-30.8	-35.1	-36.0	-37.3	-38.3	-39.6
Oil and gas	-4.8	-5.8	-5.0	-4.5	-4.5	-4.6
Services	-13.0	-13.7	-13.9	-14.0	-14.2	-14.5
Of which: Interest payments	-9.4	-9.6	-9.7	-9.3	-8.8	-8.3
Capital account	-15.1	-17.3	-12.8	-14.2	-13.4	-12.6
Nonfinancial public sector	1.2	1.0	-1.8	-2.0	-1.7	-1.6
Disbursements	5.7	6.2	4.0	3.5	3.6	3.1
Amortizations due	-4.4	-5.1	-5.8	-5.5	-5.3	-4.7
Commercial banks	-2.1	-1.8	-1.2	-0.6	-0.1	-0.2
Disbursements	2.0	1.1	1.2	0.8	0.6	0.2
Amortizations due	-4.0	-2.9	-2.4	-1.4	-0.7	-0.3
Private corporate sector	-10.7	-11.8	-5.5	-5.6	-5.5	-4.6
Disbursements	1.2	1.3	2.0	6.3	7.4	6.9
Amortizations due	-11.9	-13.1	-7.5	-11.9	-12.9	-11.5
Direct foreign investment	-1.6	-0.2	-0.1	-0.5	-0.5	-0.5
Other private sector flows 1/	-1.9	-4.5	-4.3	-5.6	-5.7	-5.6
Overall balance	-8.5	-11.0	-7.2	-9.6	-8.8	-7.8
Financing	8.5	11.0	7.2	9.6	8.8	7.8
Change in NIR	-2.6	-1.2	1.0	2.9	3.2	3.8
Gross reserves	-3.6	-1.7	2.9	5.5	4.6	4.8
Reserve liabilities	0.9	0.5	-1.9	-2.5	-1.4	-0.9
Exceptional financing	11.1	12.2	6.2	6.7	5.6	4.0
Change in arrears	8.0	8.8	5.9	6.7	5.6	4.0
Accumulation	8.0	8.8	5.9	6.7	5.6	4.0
Commercial banks	0.0	0.0	0.0	0.0	0.0	0.0
Corporations	8.0	8.8	3.6	3.6	2.9	1.7
Government		0.0	2.3	3.1	2.7	2.3
Payment	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	0.0	0.0	0.0	0.0	0.0	0.0
Corporations	0.0	0.0	0.0	0.0	0.0	0.0
Rescheduling	3.1	3.4	0.2	0.0	0.0	0.0
Commercial banks	1.7	1.1	0.2	0.0	0.0	0.0
Corporate sector	0.0	0.0	0.0	0.0	0.0	0.0
Public sector (Paris Club)	1.4	2.3	0.0	0.0	0.0	0.0
Memorandum items:						
Current account (as a percent of GDP)	4.4	4.5	4.0	3.1	3.0	3.0
Medium- and long-term external debt (as a percent to GDP) eop erate	97.0	120.6	105.2	100.5	91.6	86.1
Medium- and long-term external debt (in billions of dollar)	148.6	149.1	144.3	137.0	133.3	127.7
Medium- and long-term external debt (as a percent to exports G&S)	241.4	220.5	213.9	203.6	194.5	181.6
Debt service (as a percent of XGNFS)	31.4	28.3	29.4	32.6	32.9	30.1
Reserves	27.2	26.6	23.7	18.9	14.8	11.0
(In months of imports)	6.1	6.2	5.4	4.2	3.1	2.1
(As a percent of short-term debt)	79.8	91.7	76.6	61.9	53.9	39.7
Non-oil/gas export growth (percent)	4.8	14.2	2.7	2.1	2.7	2.6
Non-oil/gas import growth (percent)	0.4	21.2	2.3	3.7	2.7	3.3
Export volume growth (percent)	0.3	5.8	1.6	1.5	1.5	1.4
Import volume growth (percent)	-1.7	18.6	2.2	2.0	1.5	2.1
Oil Price (U.S. dollar per barrel)	21.1	25.0	21.8	19.4	19.3	19.9
Terms of trade (percent)	6.3	8.6	-0.3	-1.8	-0.1	0.3

Sources: Bank Indonesia; and Fund staff estimates.

1/ Includes errors and omissions and US$1 billion in transfers from Bank Indonesia to BEI in March–June 2000.

Table IV.5. Indonesia: External Debt 1999–2000

(In billions of U.S. dollar)

	Est. 1999	Proj. 2000
Medium- and long-term debt	148.7	150.2
Public sector	85.2	91.2
Central government	65.4	69.3
Bilateral	26.2	29.3
Multilateral	20.0	21.2
Export credit and leases	16.9	16.1
Commercial	2.4	2.6
State enterprises	5.0	5.0
State banks	4.7	4.7
Bank Indonesia	10.3	12.2
IMF	10.1	12.0
SBIs	0.2	0.2
Private sector	63.5	59.0
Private banks	6.1	5.4
Corporate sector (loans)	54.0	51.0
Domestic securities	3.3	2.6
External assets	70.6	72.3
Gross international reserves 1/	27.0	28.7
Foreign assets of commercial banks	43.6	43.6
Obligations falling due		
Before corporate rescheduling 2/	...	26.8
After corporate rescheduling	...	18.0
Short term liabilities (by original maturity)	...	9.1
Amortization of medium and long-term debt	...	17.7
Public	...	3.1
Central government	...	1.7
State enterprises	...	0.6
State banks	...	0.9
Private	...	14.5
Banks	...	0.9
Corporate	...	13.1
Other	...	0.5
Rescheduling	...	12.8
Actual Paris Club rescheduling 3/	...	2.9
Actual commercial bank rescheduling 4/	...	1.1
Possible Corporate debt restructuring	...	8.8
Of which: Reduction in arrears	...	20.4

Sources: Bank Indonesia; Fund staff estimates.

1/ Reserve data template definition.

2/ Includes effects of Paris Club rescheduling and Interbank Exchange Offer I.

3/ Includes effects of 1998 and 2000 rescheduling of debt of Paris Club creditors.

4/ Interbank Exchange Offer I.

V. Poverty in Indonesia: Trends, Features, and Strategy[1]

1. **Prior to the crisis, Indonesia's record of poverty reduction was impressive—the poverty rate declined from 60 percent in 1970 to 11.3 percent in 1996.** The crisis delivered a sharp setback to this trend. In the depths of the crisis, the poverty rate more than doubled from its precrisis level. It has declined since then, however, and is now back to where it was in February 1996, but still some 50 percent above its pre-crisis trough. As important, over half of Indonesia's households remain vulnerable to poverty in the face of the normal range of household risks. This vulnerability may have been exacerbated by many of the uncertainties that continue to bedevil the Indonesian economy. So, reduction in the poverty rate and vulnerability of the near poor continues to be a matter of high priority, especially as Indonesia's recovery has been slower than in the rest of the East Asian crisis countries.

2. **The social safety net program was a key element in the government's response toward protecting the poor from the worst effects of the crisis.** But the program has had mixed success in reaching and supporting the poor. Other coping strategies—including reliance on community and religious organizations—have been more important to the poor than government programs. And resumed growth and the declining relative price of food (especially rice) have been key to the sharp fall in the poverty rate since the depths of the crisis. Now that the economy is on the path to recovery, the government needs to switch from crisis management back to a longer-term poverty strategy. But this strategy will be implemented in an altogether different environment than in the past—one characterized by democracy, decentralization, and transparency. So special care will need to be taken to ensure that poverty reduction programs are demand-driven, and are subject to intensive oversight and high standards of transparency. This will be in addition to the more standard concerns that these programs receive adequate priority in the budget, and are reflected in the sectoral strategies adopted by individual line ministries.

A. Trends in the Poverty Rate

3. **Indonesia's high growth rate in the thirty years prior to the crisis had a significant impact on poverty.** By February 1996, the poverty rate had declined to 11.3 percent (Figure 1), compared with 60 percent in 1970.[2] Between February 1996 and

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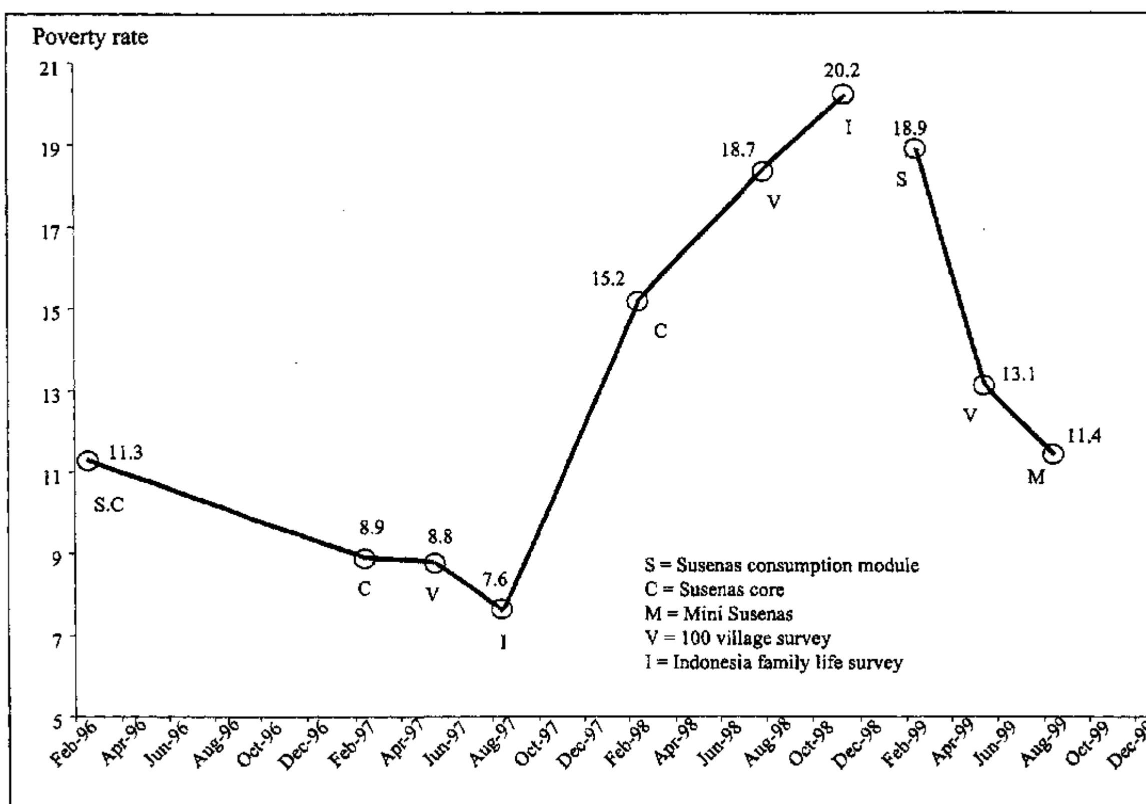
[1] Prepared by the World Bank.

[2] There have been many different poverty rates estimated and quoted for Indonesia using different poverty lines. This has caused (and continues to cause) endless confusion. For the purposes of this paper, we have taken as our starting point the poverty estimates prepared by BPS—the Central Bureau of Statistics—for February 1996. Subsequent estimates of the poverty rate reported in this paper have, to the extent possible, been made consistent with this initial definition. Adopting a different poverty line would give a different *level* in the poverty rate, but would yield the same *trend* over time. For an explanation, see Suryahadi, Sudarno,

(continued...)

Figure 1. The Evolution of the Poverty Rate, February 1996–August 1999, Using All Available Large Scale Household Surveys



Source: World Bank staff estimates.

August 1997, the economy grew at an impressive clip and the poverty rate continued to trend downward, reaching 7.6 percent, the lowest point for which there is an estimate based on a large scale household survey. Subsequent surveys indicate that the poverty rate exploded thereafter, eventually climbing to over 20 percent in September–December 1998, now considered as the nadir of the crisis-caused recession in the economy. Since then, the poverty rate has once again fallen, almost equally sharply—and the latest point for which household survey data is available indicates a poverty rate of 11.4 percent, which is close to the rate in February 1996 but almost double the precrisis trough of 7.6 percent in August 1997.

Sumarto, Suharso, and Pritchett, "The Evolution of Poverty During the Crisis in Indonesia, 1996 to 1999 (Using Full Susenas Sample)," Social Monitoring and Early Response Unit (SMERU), March 2000. The poverty rate is defined as the share of the population below a predetermined poverty line given in Rupiah. Raise the poverty line by 1 percentage point, and the poverty rate tends to climb by 0.5 percentage points (when the poverty rate is around 15 percent). The higher the poverty rate, the higher this elasticity (see Suryahadi and others, ibid.).

4. **Three factors appear to have contributed most to this sudden rise—and equally sudden fall—in the poverty rate.** The first is economic activity, as measured by GDP. The crisis-induced decline in economic activity, especially in manufacturing, led to a significant number of layoffs from urban-based firms, which swelled the ranks of the informal sector and agriculture, depressing real wages throughout the economy. Starting in 1999, however, the economy began to stabilize and, in the second quarter, began to recover—which helped to stabilize and then raise real wages. The second is the rate of inflation, which climbed very sharply in 1998—and contributed to a sharp (albeit temporary) fall in real wages and other forms of labor remuneration. Nominal wages only responded with a lag, partially restoring real wages. Third, and finally, the trend in the relative price of food, particularly rice, had a strong effect on the real incomes of the poor. Between June and September 1998, inadequate sale of BULOG-held rice stocks, a lull in official rice imports, and low private stocks following the 1997 drought—all contributed to a sharp run-up in the price of rice. While this handed rice farmers a windfall gain for their 1998 crop, it hurt rice consumers. Since there are three times as many net rice consumers as there are net rice producers among the poor in Indonesia, the increased relative price of rice had a significant negative effect on poverty. Equally, once BULOG actively began to sell its stocks on the domestic market and started a large-scale import program to bolster the supply situation, the relative price of rice began to subside and with it so did the poverty rate.

B. Other Dimensions of Indonesia's Poverty Problem

5. **The above story—told in aggregates—masks a more complex human problem.** The poor are neither a constant nor homogeneous group in Indonesia. This is hardly surprising, given the diversity within the country and the nature and complexity of the crisis—encompassing a massive exchange rate change, widespread bank and corporate insolvency, extensive forest fires in 1997 and 1998, an unprecedented drought in 1997, regional and separatist violence in East Timor, Aceh, and Maluku. The fact that the poverty rate increased did not mean that those who were poor remained poor. Nor does it mean that all those just above the poverty line fell into poverty. In fact, while many poor households did see their incomes and welfare decline further, others managed to muddle through, and yet others saw their conditions improve, in some cases dramatically. Indeed, over half the households in the surveys moved up or down at least one quintile—and a quarter saw their living standards change by at least two quintiles over the course of just one year.

Vulnerability

6. **Moreover, in the face of the normal range of household risks, vulnerability to an episode of poverty is very high.** A far larger number of households than just poor households actually experience poverty over a year. For example, more than a quarter of those measured as poor in 1998 had expenditures 50 percent or more above the poverty line in 1997. Calculations suggest that over half of all Indonesian household have over a 50–50 chance of experiencing poverty in any one year. The "consultations with the poor" study in thirteen locations around Indonesia revealed many experiences that corroborate this empirical

finding. This striking feature of poverty and vulnerability in Indonesia has important implications for the design of a poverty reduction strategy.

Rural-urban effects

7. **Another aspect of the varied consequences of the crisis on the poor is subject to more conventional logic**. Obviously, the formal sector in urban areas was hit hard—factory and bank workers comfortable in seemingly secure jobs suddenly found themselves out of jobs, having to eke out work in the informal sector. Formal sector real wages fell by 34 percent between August 1997 and August 1998.[3] But while the epicenter of the crisis was in the formal sector, these tight interconnections between the urban and rural labor markets meant that it was only a question of time before wages in rural areas felt a similar downward pressure. Many laid off urban workers moved back to their villages and were absorbed into marginal agricultural activity. Indeed, agricultural employment grew by over 13 percent between 1997 and 1998. And the effect was pervasive. A study of rural wages showed real wages declined in every one of the 14 provinces studied. Rice producers were partially protected, thanks to an increase in the relative price of rice—because of BULOG's delayed actions and also because, being a tradable commodity, rice benefited from the large currency depreciation. It was landless laborers and other service providers in rural areas who, having to compete with the influx of urban workers, were hit hardest.

Regional effects

8. **The consequences of the crisis for regional economies were remarkably heterogeneous**, caused in part by the varied nature of the crises that afflicted the country and in part by the different characteristics of individual regions. For example, NTT, NTB, and East Kalimantan were not too badly affected by the economic crisis, but suffered more from natural crises—notably the drought. Large parts of Sulawesi, a major exporter of natural resources, benefited from the depreciated rupiah, although the benefits were unevenly spread. Maluku, on the other hand, was the least affected province by the economic dimensions of the crisis, but the bitter fighting that erupted between different religious communities has dealt a devastating blow to its economy with particularly severe consequences for the poor.

Gender

9. **It is difficult to generalize the gender consequences of the crisis—linked as they are with the individual responses of households**. The direct effects of the crisis appeared to affect men and women equally. Many of the modern factories employed young, mostly unmarried women—especially in the leather, garments, and electronics sectors. But two observations suggest that women may have been hurt more than men during the crisis. First,

[3] Skoufias and Suryahadi, 1999, *Growth and Crisis impacts on Formal Sector Wages in Indonesia,* SMERU working paper.

in many households with children, women had to take on additional work for pay. Indeed, the fraction of women in the labor force actually increased in some areas. And second, as rural-urban migrations patterns reversed and laid-off workers from cities re-entered agriculture, some agricultural tasks that traditionally were performed by women were taken over by men.

Education enrollment

10. **A major concern during the crisis was the effect it would have on enrollments in school**—especially when most children who drop out of school tend never to return. This is indeed what happened in 1987–89. But in the current crisis, enrollments in basic education declined only modestly. The main effect appears to have been in junior secondary schools, and more so in urban areas than rural. But the small decline in enrollments does mask the more disturbing fact that the drop-outs were concentrated among the poor. True, these declines in enrollments were small in relation to the overall shortfalls in secondary school enrollment, but they were nevertheless an unfortunate consequence. The most recent, but preliminary, data suggest that drops in enrollment rates have been reversed and that enrollments at all levels in the 1999/2000 school year are back to roughly their pre-crisis levels. Yet this is little cause for celebration. Schools, which are heavily dependent on parental contributions for their financing, have had to waive or reduce tuition fees to keep children in school—thereby straining their already difficult financial position, which may lead to further declines in the quality of education.

Health

11. **Health and nutrition indicators collected through various surveys reveal a mixed picture of how the crisis has affected the health of the poor**. Some quite objective measures in some surveys show no indications of worsened health status.[4] Other surveys show an increase in morbidity.[5] Household surveys show no widespread rise in malnutrition as measured by standard anthropometric indicators. Some regions show modest deterioration, but others, somewhat puzzlingly, show modest improvements. Even on specific nutrients, the evidence is mixed. Surveys measuring hemoglobin levels did not find a deterioration as of August-September 1998, while others indicate a potential rise in Vitamin A deficiency.

C. The Government's Social Safety Net Programs and Other Coping Mechanisms

12. **To protect the poor from the effects of the crisis, the government launched a series of social safety net (SSN) programs**. Among the more prominent of these was the subsidized rice scheme (OPK), the school scholarship scheme, a community-based public

[4] The reference here is to the IFLS 2+ survey.

[5] The 100 villages survey.

expenditure program (PDM-DKE), and an employment-generating public works scheme (padat karya). Their performance was decidedly mixed.

The subsidized rice scheme (OPK)

13. **This was one of the more effective lifelines.** Launched in July 1998, the program was reaching 10 million households by January 1999. The scheme was simple—the delivery of 20 kg of rice a month to every poor households at Rp 1,000 per kg. As the market price of rice is between two and three times this price, this was, in essence, an income transfer scheme. Poor households were identified using criteria developed for the national family planning program.[6] But the program was, in part, self targeting, as the distributed rice was of poor quality usually consumed only by the poor. The scheme worked reasonably well on account of its simplicity and the fact that it used existing administrative structures at the local level. On the other hand, the targeting of the program on the poor households left much to be desired. The official list of poor households—prepared before the crisis—did not accommodate the impact of the crisis which, as noted earlier, had a differentiated impact on households. As important, social and political realities often intervened in the distribution of rice, with many more households receiving the rice than were on the official lists. This was less the result of corruption, and more of local leaders seeking to keep social peace by distributing the rice over a broader number of families, rather than sticking to fine distinctions of welfare between poor and near-poor households.

Scholarships

14. **This too was a relatively successful program, and was supported directly by the World Bank and the AsDB**. The program extends scholarships to the poorest 6 percent, 17 percent, and 10 percent of enrolled students in primary, junior secondary, and senior secondary schools respectively, and block grants to 60 percent of the poorest schools in each category. The scholarships were distributed through post offices dotted throughout the country, bypassing government channels and avoiding opportunities for pilferage. In choosing the recipients, the program combined administrative criteria (the same as for the subsidized rice scheme) with a decision by committee comprising the principal, the head teacher, and a representative of the community. The program was carefully monitored by an independent team. Survey results show that the scholarship scheme was reasonably well targeted, although less so than had been hoped.

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[6] These criteria used a variety of income, expenditure, and social indicators to identify poor households. While there clearly was not a strict one-to-one match with households chosen using just expenditure criteria, there was sufficient overlap to justify using available information that was well understood and listed details of households, including the name of the head of the household and the address. This helped considerably in the administration of the scheme.

PDM-DKE

15. **The results were mixed in this community-based scheme, introduced as a "crisis" program that channeled funds to local communities, and expected local community organizations to decide their use.** No restrictions were placed on the kind of project that could be supported. While some of the key features of the approach were adopted from a parallel World Bank–funded project,[7] there was inadequate time to prepare the communities for their new responsibilities and train them to make resource allocation decisions. Unsurprisingly, results have been mixed. In some locations, communities have been happy with this program and it appears to have reached the poor reasonably well. In others, the program was never even heard of. And in yet other areas, such as Jakarta, the program was so unpopular that it sparked public protests against the sponsor, the National Planning Commission.

Padat Karya

16. **The padat karya public works program was a loose collection of programs in various ministries that aimed at providing employment.** The only targeting was that the person had to be willing to work at the wage paid—which was at or slightly below the mandated legal minimum wage for the surrounding area. While there was some measure of self-selection in this approach, the large number of small individual projects created an enormous logistical problem—so much so, that the program was stopped after 1998/99 and replaced by just one program aimed at urban areas which focused on small infrastructure, repair, and maintenance.

17. **The fact that poverty climbed even when SSN programs were being implemented does not mean that these programs were a failure.** Indeed, in comparison with the overwhelming poverty problem caused by Indonesia's simultaneous crises, these programs were quite small. For example, the development budget for SSN programs in FY1999/2000 was Rp 5.6 trillion, less than half a percent of GDP. In addition, the budget for the subsidized rice scheme was Rp 3 trillion—or 0.3 percent of GDP. What is more, the allocations for some of these programs were not even disbursed during the fiscal year, as administration mechanisms were still being put in place. But even if these programs had been completely disbursed, *and* their administrative costs were low, *and* all their benefits reached the targeted poor households—all unrealistically strong assumptions in light of experience—the poverty rate would have still been only 0.6 percentage points lower than it actually was. As we noted earlier, the decline in poverty by more than half since December 1998 was largely from a restoration of stability, some recovery in economic activity, and a decline in the price of rice due to plentiful supplies in the market—but not the SSN programs implemented by government.

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[7] The Kecamatan Development Project.

Box A. Local Capacity for Collective Action in Indonesia

Despite the tendency of the Suharto regime in Indonesia to centralize development efforts, capacity at the local level has remained quite high. A study of local institutions found that:

- more than 80 percent of respondents had participated at least once in community activities to meet collective needs during the last year;
- communities had initiated 38 percent of all development activities, far more than outside groups or NGOs, and not that many fewer than government (53 percent);
- most religious facilities (83 percent) are the result of community effort; more striking is that many credit (53 percent), infrastructure (47 percent), and public facilities projects (36 percent) are the result of local initiative;
- only 67 percent of government-initiated projects were found to be reaching their intended beneficiaries, while for locally–initiated projects, the proportion was 83 percent;
- community infrastructure projects are better maintained; 85 percent of all community infrastructure projects that had created facilities were still in use, whereas this was true for only slightly more than half of government-funded facilities.

Of course, capacity across villages and communities varies widely. Not surprisingly, those with more capacity tend to have more diverse, and better quality projects. Moreover, although community projects were generally better than government-initiated activities, failed community efforts pointed to the same persistent problems: lack of information, skills, poor design, and intermittent and unpredictable funding.

18. **If SSN programs, even if fully disbursed and properly implemented, would have had such little effect, how did the poor cope**? The answer is mainly by relying on themselves and their local groups and communities (Box A). Only a quarter of the poor surveyed said they relied on the government for coping with the crisis. Another survey showed that only 15 percent of households benefited from SSN programs (excluding OPK). This limited reach of formal programs was not altogether a bad thing, because they did not undermine much larger and more important informal social safety nets that had been operating for years, albeit never under such difficult circumstances.

Table. How People Coped During the Crisis—Some Survey Results
(Percent of respondents)

	Poor	Non-poor
They reduced expenses by:		
Buying fewer clothes	68.9	62.2
Spending less on recreation	53.1	51.9
Lowering food quality	51.9	38.1
Travelling less	47.9	41.3
Eating less	38.3	22.2
Taking children out of school	2.9	1.2
They raised resources by:		
Borrowing from others	33.3	24.5
Consuming their own production	29.2	28.7
Selling valuables	10.8	8.8
Withdrawing savings	7.5	12.5
Pawning valuables	4.8	3.4
They raised incomes by:		
Doing additional jobs	44.5	36.6
Working overtime	39.2	33.3
Asking children to work	20.1	11.6
Asking other family members to work	16.6	10.0

Source: BPS

19. **The poor have, of course, relied on themselves more than they have their communities or government**. A survey in December 1998 showed they used three means to do so: reducing expenditures, borrowing, and attempting to raise

incomes (Table). They reduced expenses, by cutting clothing and recreational costs and lowering the quality and (worryingly) the quantity of food. They raised resources by borrowing, selling or pawning assets and running down savings. And they shored up incomes by working more and got other members of their family, especially children, to work. About 3 percent of those surveyed reported pulling their children out of school.

D. A Strategy for the Future

20. **As Indonesia emerges from crisis, the need for emergency assistance to the poor will diminish**. Social safety net programs can be expected to decline gradually and be replaced by strengthened mainstream poverty reduction programs.

21. **To guide future poverty reduction efforts it is important that there be a *national* poverty alleviation strategy** that can generate a common agenda and program for government, civil society and NGOs, and external donors. The government, in consultation with major stakeholders is committed to preparing such a strategy, hopefully in time for the October Consultative Group for Indonesia meeting to be held in Tokyo. This forward looking poverty strategy must take into account two factors:

- **First, the changing conception of poverty and vulnerability to poverty in Indonesia.** Although Indonesia did make substantial progress in reducing poverty, defined as a narrow and low level of consumption—the notion of poverty needs to be broadened to include the broad array of deprivations people face (in education, health, infrastructure) and to account for the vulnerability and risks households face. Seen in this light, poverty is not a narrow concern of just the welfare of a few, but rather an issue that many Indonesians face in one way or another every day. This implies the broadest range of instruments should be brought to bear to address the overarching objective of poverty reduction.

- **Second, a poverty strategy must take into account the rapidly and radically changing political system and decentralized environment** within which a poverty strategy will need to be implemented. Given these changes, for an effective set of actions on poverty to emerge from this process, it will need to do three things well:

  - first, it must ensure adequate **information** on poverty reduction programs before and during implementation. The government's monopoly in information will need to be replaced by multiple channels of communication about the content of programs, the resources allocated to them, and those who are accountable for their effective implementation.

  - second, it must give **voice** to the poor. With "voice," the poor can affect outcomes of programs that are of greatest importance to them. Where there is only one supplier of a public good—such as police services or roads—the participation of citizens should be an integral part of monitoring their performance and providing feedback. Where there could be more than one supplier of a public good or service, the participation of citizens should ensure that the chosen supplier is selected

transparently for the maximum welfare of the community. Further, women are an integral part of poverty reduction—responsible for a significant portion of earnings in addition to playing their traditional role within families and households.

➢ third, is **accountability**. Not only should citizens be given information and voice, but there should also be mechanisms available for them to hold officials accountable for their actions. Indonesia's new democratic institutions and processes from the capital of the country to its thousands of villages will need to develop such mechanisms in due course, and an integral part of this development will be the establishment of a functioning legal and judicial system.

World Bank poverty assessment

22. **To assist in the preparation of a poverty strategy, the World Bank, in cooperation with the government and other donor partners, is preparing a poverty assessment** which will lay out the various dimensions of poverty in Indonesia, assess government efforts at poverty reduction, and suggest key elements that could constitute a longer-term poverty reduction strategy. This will be an input into the broader national dialogue on poverty reduction. What is emerging in the World Bank approach is a seven-point poverty strategy.

- **Broad-based growth**. The first, and perhaps the most important, element of such a poverty reduction strategy will need to be broad-based and sustainable growth. Growth creates new opportunities, increases employment, and raises incomes. But it is also recognized that the pattern of growth must be broad-based—not restricted to Java or a few industrial groups, but supportive of small and medium enterprises, spread over Indonesia's many provinces, balanced between rural and urban areas, and concerned with employment creation. A key policy to achieve broad based growth that best supports rapid poverty reduction will be open and transparent international and domestic trade. Not only will open international trade support labor intensive export and import substitution industries, but also encourage efficient agriculture and ensure that key agricultural prices (including that of rice) are kept internationally competitive for the benefit of the poor. Keeping domestic trade free of interference will also be critically important, especially now that local governments will be empowered to raise revenue. Studies have shown that free domestic trade is at least as important as, if not more, maintaining an open trading regime. In Indonesia, an open and efficient domestic trading system is crucially important for the outer islands where incomes are already low and which depend on a narrow production base of a few agriculture and natural resource products.

- **Economic empowerment of the poor**. Poverty reduction is sustained when, by their own actions, individuals and communities can lift themselves out of poverty—for example, public employment schemes cannot be a major factor in poverty reduction as gains in labor income for the poor will mostly come from generally rising unskilled wages in the private sector. In order to do this, the poor need fair and equitable access to the basic factors of production—labor, land, capital, and natural resources—and be allowed to use those factors in a

competitive environment, free from arbitrary obstacles. This is not an agenda of redistribution of assets, rather policies in areas that actively work against the interests of the poor should be eliminated, including limitations on the activities of labor unions, the narrow allocations of timber concessions, the abuse of land policies and titling, and the distortions in formal credit markets.

- **A sound public expenditure framework.** Through better targeting—in the broad and in the narrow—Indonesia's public expenditure program can better achieve and support the overarching goal of poverty reduction. There are two broad shifts in expenditure priorities that need to be achieved. The first is a reduction in fuel and credit subsidies—the former because it is extremely expensive (3.1 percent of GDP in FY1999/2000) and benefits mainly the non-poor; and the latter because they tend to be ineffective in assisting either production or the poor. The second is to use the savings from subsidy reductions to increase allocations for health, education, and basic infrastructure—not to increase the numbers of facilities (for instance, there are already too many primary schools in Indonesia) and clinics, but to improve their quality. Even if such expenditures do not have a high direct benefit incidence for the poor, the indirect consequences are large and significant. Targeting can also be improved within sectoral programs. For example, subsidies to improve the quality of school buildings and teaching materials in poor villages and sub-districts would be particularly beneficial for the poor, as would better supplies and staff in health clinics.

- **Good governance in a decentralized environment.** Ultimately, resources only matter if they are used well. In Indonesia, the popular perception is that a large portion of the development budget leaks through corruption and does not reach its intended beneficiaries. But now that Indonesia is embarked upon a profound and tumultuous transformation into a democratic polity and a decentralized public administration, there is a huge opportunity for a fundamental change in the design of governance—including of public expenditure programs to increase accountability to those served.

- **Raising the quality of human resource investments.** In both education and health Indonesia has made substantial investments in quantity, but with decentralization there will need to be reforms for improving the quality of both health and education services. This involves many dimensions, but a key will be increasing the accountability of providers by increasing the emphasis on the "demand side"—the choice and voice of those who use these services.

- **Investments in basic infrastructure.** Not all infrastructure investments benefit the poor, but certain types of infrastructure are directly and indirectly crucial to their livelihoods and critical for economic empowerment. This involves improvements in water and sanitation, access to transport (linking remote areas to markets, schools, and health clinics), provision of basic urban infrastructure services, and the infrastructure support to raising rural incomes (for example, irrigation).

- **Continued social safety nets.** Even with all of the above, there will be individuals, groups, and regions, that cannot cope and need assistance. These types of directly targeted

transfer programs (like the crisis SSN programs) are not the dominant part, but are an important component of an overall poverty strategy. There are three major issues with safety nets. First, designing programs that can respond to a macroeconomic crisis without being a large fiscal burden in noncrisis times. Second, designing programs that can address the regional heterogeneity of economic shocks (for example, disasters, localized crop failures, unrest) even though the center has devolved most implementation functions. Third, preventing the demand by an increasingly vocal and affluent urban middle class for "social protection" from drawing attention and resources away from the poor—the experience with formal social sector insurance in developing countries has not been promising in this regard but, as Indonesia develops, the evolution of social protection schemes must be addressed.