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Indonesia
Country Assistance Note

March 29, 1999

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Acronyms

ADB	Asian Development Bank
ASEAN	Association of South East Asian Nations
BAPEDAL	Indonesia's Environmental Management Agency
BI	Bank Indonesia
BULOG	The public enterprise with responsibilities for import and distribution of essential food items
CAS	Country Assistance Strategy
CBS	Currency Board System
CEM	Country Economic Memorandum
CGI	Consultative Group of Indonesia
CPPR	Country Portfolio Performance Review
DAU	Disbursement Audit Unit
ESW	Economic and Sector Work
GOI	Government of Indonesia
HNP	Heath Nutrition and Population
ICR	Implementation Completion Report
KADIN	National Chamber of Commerce and Industry
LOI	Letter of Intent
NGOs	Non-governmental organizations
OED	Operations Evaluation Department
PIP	Portfolio Improvement Plan
PLN	State Electricity Corporation
PRSL	Policy Reform Support Loan
QAG	Quality Assurance Group
RSI	Resident Mission in Indonesia
SAL	Structural Adjustment Loan
SBD	Standard Bidding Documents
UNDP	United Nations Development Programme
WDR	World Development Report

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MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

INDONESIA: Country Assistance Note

For almost three decades, Indonesia was a development success story. Rapid income growth elevated the country from one of the poorest in the world to lower middle-income status by 1996, when per capita GNP reached $1,080. Poverty was reduced and most social indicators showed great improvement.

World Bank involvement in the country's development efforts was pervasive, and the achievements were many. Between 1969 and 1996, the Bank helped Indonesia boost agricultural production and improve power, transport, urban and village infrastructure, health services, and skills for a fast-growing economy. The Bank's support and development of the State Electricity Corporation was highly significant. Transport sector projects in ports, railways, roads, and highways achieved their objectives. Much benefit to the physical environment came from the Bank's urban projects. The Bank also played a major role in Indonesia's highly successful family planning program. It was catalytic in getting the Government to focus on decentralization as a key to improvement in service delivery. In addition to project lending, the Bank supported Indonesian adjustment efforts with $1.2 billion of adjustment lending after oil prices collapsed in the early 1980s. In support of all of the above, a major contribution of the Bank was a vast array of solid economic and sector work and numerous policy notes to advise Government on development priorities. The outcome and sustainability of Bank project and adjustment assistance evaluated to date was rated highly by OED.

At the same time, some important structural problems—a weak financial sector, a fragile social situation, major issues of governance and corruption—persisted. The Bank knew of these problems; some were documented in Bank reports. But the enthusiasm associated with rapid growth created a "halo" effect in country relations. This was also true of other donors. Equally, OED's highly positive project and adjustment assistance ratings proved to be overly optimistic. Through late 1997, Bank management sent ambiguous messages to the Indonesian Government: praise for Indonesia's many notable achievements was issued side-by-side with strongly worded policy notes.

As the 1997 regional financial crisis turned into a full-fledged economic and social crisis, the country's structural flaws were exposed. A weak financial system and excessive foreign borrowing were at the root of the crisis. Governance weaknesses and social tensions were the main reasons why Indonesia was especially hard hit. The Bank, like many others, was taken by surprise. It could not have predicted the timing and the severity of the crisis, but it could have been better prepared, had past successes not bred overconfidence.

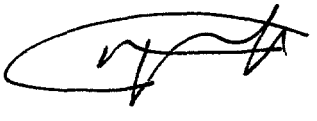
The crisis has to be seen in perspective. Much has been achieved over the past 30 years, but the crisis has revealed that some of the achievements were not sustainable. While objectives in individual loans were met, basic flaws in the institutional framework remained unaddressed. On balance, the outcome of the Bank's strategy over the past decade, the Bank's performance as well as the Government's performance are all rated as marginally satisfactory. It is clear that Indonesia, with

significant Bank support, has achieved major real progress over time, despite the recent setback as a result of the crisis. However, while the Government's development strategy has had remarkable positive results, issues of poor governance, social stress and a weak financial sector were not addressed and contributed to the depth of the crisis. The Bank's neglect of those same issues and its underestimation of risks and lack of contingency planning dampened the overall effectiveness of its assistance.

One important conclusion emerges from this country assistance review: a broad-based development strategy including social development and structural reform calls for long-term institutional development. The crisis has provided the opportunity for the Bank to begin tackling some of these issues. A sustained effort over an extended period will be required for success.

A monitoring mechanism for social, governance and financial sector issues should be instituted to complement the IMF's macroeconomic monitoring. In addition, the Bank should strengthen its risk analysis, including political developments, and carry out more explicit assessments of the risks and rewards of Bank operations. This analysis should be undertaken for large borrowers even when their economies are performing well. Monitoring should inform contingency plans.

This report suggests that the Bank needs to address several issues that have arisen during the crisis. First, what is the role of the Bank in crisis situations? The Indonesian review has revealed that there is a need to establish clear guidelines on this role. It is particularly important to clarify the preconditions for using adjustment lending in crisis situations and the instruments needed to sustain engagement on longer-term institutional reforms. Second, what communication mechanisms and incentive structures are needed to allow for a frank discussion of issues among staff at all levels? Third, how can the Bank reconcile partnerships with major clients while conveying tough messages? While the client-driven Bank strategy had merit, as best exemplified by the adjustment lending episode of the late 1980s and early 1990s, it could not overcome Government resistance to implementation of some crucial reforms. The Indonesia experience shows that true partnership should go beyond putting the client at the center. It also requires the timely provision of clear and uniform advice to Government and other development partners.



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René Vandendries was the Task Manager for this report. It was prepared with contributions by Poonam Gupta (OEDCR) and Louis Goreux (Consultant). Geri Wise provided administrative support. The report also profited from the findings of a Workshop on Indonesia held on June 23-24, 1998, under the auspices of OED, attended by representatives of the Government of Indonesia, by academicians and by long-term observers of Indonesia.

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Preface

Indonesia is in the midst of its worst crisis in the last 30 years. Many exogenous factors are at the root of the crisis, mainly protracted recession in Japan and unfettered speculation in global capital markets. But domestic conditions and policies also contributed to bringing this crisis about and to its depth. Much is being written and debated about these factors. The focus of this study is the role and influence of the World Bank on Indonesia's domestic conditions and policies and the resulting development achievements and shortfalls. The analysis covers the past three decades up until the crisis. More work will need to be done to analyze the Bank's crisis management performance in Indonesia as well as in other countries, including the Bank's relationship with the IMF and with the Government. It is still too soon to reach conclusions on these matters.

The draft report was sent to the Government for comments; the comments received from the Government, and OED's response, are attached as Annex 1. Government comments have received full consideration in the final report.

The report was distributed to the Committee on Development Effectiveness (CODE) on February 5, 1999, as CODE 99-6, and was discussed at a meeting of CODE on February 19, 1999. The Report from CODE is attached as Attachment 1. Comments from the Region, and OED's response, are attached as Attachment 2.

1. The Setting

Superb Past Economic Growth Performance, Substantial Poverty Reduction

1.1 Indonesia's economic growth performance and its success in reducing the incidence of poverty over the past 25 years have been impressive. Growth averaged 7 percent per annum during 1979-96, with per capita GNP reaching $1,080 in 1996. Income per capita in Indonesia was only two-thirds that of India and Nigeria in 1970; but, by 1996 it had become four and a half times that of Nigeria and almost three times that of India. The share of the population living below the official poverty line declined from 60 percent in 1970 to 11 percent in 1996: in absolute numbers, the incidence of poverty declined from 70 million to 22.5 million. As shown in Table 1.1, Indonesia compares favorably with other well-performing major countries in the region.

Table 1.1: Selected Indicators

Country	*GNP per capita 1996 ($)*	*Population 1996 (million)*	*Annual change, 1970-96 (%)*	
			Growth in per capita GDP	*Decline in poverty incidence**
Indonesia	1,080	197	4.9	2.0
Philippines	1,160	72	1.0	0.7
Thailand	2,960	60	5.4	1.4
Malaysia	4,370	21	4.7	1.6

*Subperiods dictated by data availability: Indonesia, 1970-90; Philippines, 1971-91; Thailand, 1962-88; Malaysia, 1973-87.
Source: World Bank data.

1.2 Economic growth was broad-based and labor intensive. In the first stage, during the 1970s and early 1980s, the focus was on agriculture and improvements in irrigation and rural infrastructure; agricultural growth averaged over 4 percent a year; the output of rice—a staple food item in large parts of the country—grew even faster. Since over half the population and over 80 percent of the poor depended on agriculture in the early 1970s, these gains led to sustained poverty alleviation. A new stage began in the mid-1980s when the expansion of labor-intensive manufactures became the main source of growth and poverty reduction.

1.3 In addition to trade liberalization, financial sector liberalization began in 1983 with a second important round of reforms starting in 1988. The 1988 measures included among others a reduction in reserve requirements and the reopening of licensing for new private banks and foreign joint-venture banks. In 1989, controls on foreign borrowing by banks were eliminated but were reintroduced two years later because of concerns about excessive borrowing. However, and most significant, Indonesia continued to liberalize inflows to corporations, allowing borrowing for trade finance, sales of securities to non-residents, and foreign investment in the domestic stock market.

1.4 On the whole, growth was sustained without excessive reliance on foreign savings. By the early 1990s, domestic investment rates reached nearly 30 percent, but they were financed almost wholly with national savings. Continued prudent budgetary management helped to avoid fiscal imbalances. The Ministry of Finance, the Planning Ministry and the Central Bank maintained fiscal discipline, aided by a balanced budget rule adopted in 1968, which precludes domestic financing.

1.5 Poverty alleviation was associated with improvements in human resource development. Universal primary enrollment was achieved in the early 1980s. Secondary school enrollments increased almost threefold between 1970 and 1996. Basic social indicators (infant mortality, life expectancy at birth, adult illiteracy, and fertility) generally improved at a faster rate than in other Asian countries (Annex 2, Table 5). Life expectancy at birth is now comparable to other ASEAN countries, a substantial achievement compared with the early 1970s, when Indonesia lagged considerably behind.

1.6 The extent of income inequality appears to be lower in Indonesia than in other ASEAN countries. In Indonesia, the Gini coefficient remained broadly constant at about 0.34 since 1970. Inequality, as measured by the Gini coefficients, was higher in Malaysia (0.48 in 1989) and in the Philippines (0.41 in 1991).

Hidden Weaknesses

1.7 Indonesia's exceptional growth performance led most observers to downplay or discount some fundamental obstacles to long-term sustainable growth. There are at least three areas of concern, brought to light by the crisis.

An Ailing Banking System

1.8 Indonesia's banking sector is riddled with systemic problems: a high share of nonperforming loans, especially of the state banks; insolvent banks; large exposure of the banks to the property sector; weak compliance with prudential regulations; and an inadequate legal framework.

1.9 The estimate of nonperforming loans held by state banks was always high, at 11-20 percent of the portfolio; the estimates for the whole of the banking sector vary between 9 and 14 percent. Moreover, these numbers underestimate the problem because a loan could classify as performing as soon as one payment was made, irrespective of the anticipated future payments' stream on the loan. This led to underprovisioning.

1.10 The adequacy of bank loan-loss provisions was difficult to determine because of widespread connected lending, misleading accounting standards and weak supervision. The speed at which the banking system fell apart is illustrated by several Indonesian banks, especially state owned banks, that were illiquid at the end of 1997 with a loans-to-deposits ratio of almost 150 percent, against a recommended ratio of around 70 percent.

1.11 While Bank Indonesia introduced stronger prudential regulations starting in 1988, and strengthened the prudential framework substantially in the first half of the 1990s, compliance levels were low. Violations of prudential rules were rarely sanctioned and sanctions were not applied in a transparent manner. Legal problems impeded the Government's ability to fully privatize state banks and enforce loan contracts.

Continued Fragile Social Situation

1.12 While the number of people living below the official poverty line declined rapidly, large numbers were "near poor," clustered just above the line.[1] In *East Asia Road to Recovery*, the Bank estimated that raising the poverty line by 25 percent would more than double the headcount index, from 11 to 25 percent in 1996. Aggregate reductions in poverty also masked variations within and across regions. In some states in eastern Indonesia the incidence of poverty was around 20 percent and in East Timor it was nearly 40 percent. Despite little change in the overall Gini coefficient, there were perceptions that disparities had increased, in part because of ethnic disparities and the rapid enrichment of groups close to President Suharto.

1.13 The rapid improvements in social indicators do not tell the full story. UNDP data suggest that health and education indicators improved at a slower rate than would be consistent with Indonesia's per capita growth (Annex 2, Table 6). The Human Development Index (a composite measure based on life expectancy at birth, adult literacy, primary and secondary enrollments, and real per capita income) showed that in a sample of 174 countries, Indonesia ranked 88th in real per capita GDP, but only 102nd in the HDI. The Capability Poverty Measure (evaluating access to basic necessities measured by the percentages of children under five years of age who are fully nourished, births attended by trained personnel, and women aged 15 years and above who are literate) for Indonesia was below that of a number of countries with lower per capita incomes. In other words, while Indonesia made more rapid progress in improving social indicators than other Asian countries, it lags behind its potential, even given its still relatively low per capita income. This made Indonesia particularly vulnerable in times of economic downturn. Maternal mortality rates and female illiteracy rates remain especially high, despite considerable progress in the last 20 years.

Widespread Problems of Governance

1.14 Survey data indicate that corruption has been—and continues to be—a problem in Indonesia. A direct measure of corruption (the *Corruption Perception Index*), compiled by *Transparency International and Gottingen University in Germany* for 85 countries, showed that in 1998 Indonesia was 80th (with countries ranked in ascending order of corruption). It ranked below all other South East Asian countries included in the sample.[2]

1.15 The ingredients missing in Indonesia to combat corruption include: an efficient and effective civil service, an independent judiciary, a transparent and competitive incentive framework, a transparent fiscal framework, and good oversight mechanisms (including a free and open press). Indonesia did not develop a merit-based recruitment and promotion system for civil servants. Political loyalty and patronage largely determined their career paths.

1.16 Rules for competitive bid tendering and evaluation, for divestiture; and for granting of concessions, fees, and royalties in the environment sector lacked transparency. Accounting and

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1. According to one estimate, that population was nearly 30 percent of the total (60 million people). M. Cohen, "Indonesia: Twisting Arms for Alms," *Far Eastern Economic Review*, May 1996, pp. 25-27.

2. The variance of the estimate for Indonesia was very low suggesting uniform results from various surveys. The poor scores for Indonesia are confirmed from other sources as well: the *International Country Risk Guide* published by *Political Risk Services,* the annual survey of business executives conducted by the *World Economic Forum,* and the *Institutional Capability Index* prepared for the 1997 WDR.

auditing practices in both the public and private sectors did not measure up to international standards.

1.17 Indonesia lacked formal oversight mechanisms. It did not have public-private deliberation councils and client surveys, which allow businesses and civil society a voice in state activities, and permit external stakeholders to provide input and oversight and exert pressure for change. The National Chamber of Commerce and Industry (KADIN) was usually headed by individuals acceptable to the government. One important exception was the "environment," where the right to speak out became enshrined in both law and common practice. Environmental organizations outside the government provided a nationwide basis for fact-finding and action. The political framework, however, continued to be state-structured and highly restrictive. One-fifth of the total parliamentary seats were reserved for presidential appointees. Opposition groups, both inside and outside the parliament, had very little power.[3] Increasing demands for more transparency and openness by a growing middle class; mounting intolerance of human rights abuses by the Government (for example, jailing of labor leaders and dissidents, breaking-up of political opposition parties); and expectations of more self-determination, decentralization of decisionmaking, and reform of the political system contributed to social stress.

1.18 A lack of well-established institutions enabled politicians and bureaucrats to benefit by providing protection and patronage to entrepreneurs. It was common practice for a firm seeking to invest in Indonesia to seek out members of Suharto's family as shareholders in a project not only to seek protection in the insecure legal environment, but also to reduce costs of gathering, organizing, and communicating information.[4] A personalized and informal system of rent allocation was prevalent whereby private businesses provided cash, stocks, and company directorships to powerful members of the political elite, who in turn, gave assurances against expropriation. The business/Government nexus (crony capitalism) was evident in the project to develop a national car, in the formation of large business groups, and in management of the physical environment among others. Large conglomerates accumulated rents from protection in the form of barriers to trade and entry; noncompetitive bidding procedures on large contracts; preferential access to credit; and a weak legal and accounting framework. Many conglomerates that were growing rapidly were run by members of the president's family.

1.19 Environmental problems were closely linked to poor governance.[5] Indonesia lacked a framework to address inadequacies in resource taxation, the environmental and depletion effects of subsidies, and other economically perverse incentives. Delays over the years in addressing subsidy removals created social unrest when fuel prices rose. Insufficient budgetary resources were allocated for environmental management and restoration, and those that were allocated were partially misused. For instance, monies from the Reforestation Fund, which had received mandatory levies on logging concessions since the early 1980s, were partly diverted to finance a national airplane and a loan to a prominent Suharto supporter to build a pulp mill. Forestry, mining, agricultural plantation, and other resource concessions established patron relations at both the central and more local levels of administration.

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3. See *"Growth Through Compromise: The Indonesian Case During the Windfall Years,"* Migara De Silva, September, 1994, Business Law and Economic Center, Washington University, St. Louis, Missouri.

4. The Suharto family controlled 25 foundations, dozens of large companies, ranging from flour mills, fertilizer factories, toll roads and timber concessions to oil palm plantations.

5. Based on a paper presented by Arthur Hanson, President, International Institute for Sustainable Development, at the June 1998 workshop on Indonesia organized by OED.

2. The Bank and the Emerging Crisis

2.1 The East Asia crisis came into the open when the baht was floated on July 2, 1997. But the collapse of the Indonesian economy was not yet foreseen. In fact, the stock market in Indonesia peaked on July 8, 1997, 15 months after it peaked in Thailand, non-oil exports peaked in July 1997, 21 months later than in Thailand, and Moody downgraded the Indonesian debt in December 1997, 15 months after they downgraded the Thai debt (Annex 2, Table 2). But when the crisis struck, it was virulent. In less than two months (from end-November to January 23), the rupiah lost 75 percent of its value in relation to the US dollar, a loss far exceeding that of the Republic of Korea and Thailand. Instead of rising by 7.8 percent in 1998 as foreseen in the CAS, Indonesia's real GDP fell by 15 percent.

The Pre-Crisis Period

2.2 In the two years preceding the crisis (1995/96 and 1996/97), private investment rose to 26 percent of GDP (from 20 percent in 1992/93), GDP annual growth reached 8 percent and the economy overheated. The current account deficit increased to 3.3 percent of GDP (from 1.7 percent in 92/93-94/95), but it was easily financed by rapidly rising capital inflows. As a matter of fact, the overall balance of payments recorded a surplus equivalent to 3 percent of GDP in 1996/97 and gross foreign reserves reached their peak in July 1997 (Annex 2, Table 1).

2.3 With a boom in Jakarta and a weakening economy in Japan, investing in Indonesia appeared attractive to foreign banks, and borrowing abroad was an excellent deal for Indonesians. Since the exchange rate was expected to remain within a narrow band, unhedged offshore borrowing was very attractive, and it became common practice, even for industries producing exclusively for the domestic market. Excessive borrowing offshore led to the weakening of Indonesia's competitive position and generated a real estate boom.

2.4 Bank Indonesia became concerned with overheating in 1996, but tightening monetary policies did not provide the appropriate solution. Raising domestic interest rates increased the spread between onshore and offshore rates, which stimulated short-term capital inflows. With a fixed exchange rate, an open capital account, a poorly regulated banking system, and large capital inflows, Indonesia virtually lost control of its monetary policies. Fiscal tightening was a better way of cooling off the economy, but its use was somewhat limited by the balanced budget rule.[6]

2.5 Risks appeared lower in Indonesia than in Thailand in some respects. Indonesia had a low current account deficit, and political stability. But on other grounds, risks were higher,

6. In spite of this limitation, the budget deficit equivalent to almost 1 percent of GDP in FY92/93-93/94 turned into a surplus of the same magnitude in FY95/96-96/97 (Annex 2, Table 1). In addition, privatization receipts were used to make advanced payments on public debts carrying high interest rates, including debts to IBRD. The Bank and the IMF had been arguing for more fiscal effort, but it was not politically appealing when inflation was declining on the eve of the crisis. According to the 1968 Balanced Budget Rule, a budget deficit could not be financed by borrowing from the domestic banking system. Budget balances quoted here are measured in accordance with IMF-Bank methodology by showing "off budget accounts" above the line and privatization proceeds below the line. In 1995-97, prepayments of the public debt amounted to $3.2 billion (of which $1.5 billion to IBRD), which was equivalent to 5 percent of the public debt and 1.7 percent of annual GDP.

including dependency on Asian trade and excessive external debt, especially short term.[7] However, as long as export earnings were increasing and foreign capital was pouring in, the fundamental weakness of the financial system did not seem to matter. But the Indonesian economy was vulnerable to a shift in investors' confidence.

The Emerging Crisis[8]

2.6 In presenting the Indonesian CAS to the Board on July 10, 1997 (eight days after the float of the Thai baht), the staff gave an upbeat assessment of the economy. In response to several Executive Directors who criticized the CAS for being too optimistic, the staff confirmed its confidence in the robustness of the Indonesian economy and argued its case by noting that the currencies of Malaysia and the Philippines had been adversely affected by the float of the baht while the rupiah had not moved. The following day, on July 11, Bank Indonesia enlarged the intervention band from 8 percent to 12 percent and the rupiah depreciated, instead of appreciating as it had done on previous occasions when the band had been enlarged. By July 21, the rupiah had lost 8 percent of its value in relation to the dollar, which signaled a change in market sentiments (Annex 3, Figure 1).

2.7 As the rupiah remained under pressure, the authorities floated the currency on August 14, and tightened monetary policy. After discussions with IMF management during the Hong Kong annual meetings, the Government announced on October 8 that it was seeking IMF assistance. The first letter of intent (LOI) was signed on October 31, and the second on January 15, 1998. From the day Indonesia made its preliminary contacts with the IMF to January 23, within four months, the rupiah lost 80 percent of its value in relation to the US dollar and the economy collapsed (Annex 3, Figure 1). Based on this sequence of events, a number of observers concluded that the Indonesian crisis was aggravated by the tightening of monetary policy. But, contrary to the view publicized by the media, monetary policy was not tight during this four-month period.

2.8 The first LOI announced the closure of 16 banks (at least two of these were managed by relatives of the president) and measures affecting the "national car" (a project also managed by a relative). But the president's inner circle did not want the measures to be implemented. Shortly after the bank managed by the second son of the president had been officially closed, it was reopened under another name. As to the other bank owned by a relative of the president, an appeal was filed and closure was revoked by an administrative tribunal. Moreover, on December 8, shortly after the bank supervision department had moved into a new building, a fire damaged several floors, making it difficult to consult documents. On December 22, four of the

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7. The external current account deficit was lower in Indonesia (3.3 percent of GDP) than in Thailand (8 percent of GDP) and political stability appeared greater in Indonesia than in Thailand in mid-1997. President Suharto had remained the undisputed leader for over a quarter century, while Thailand had witnessed the succession of six finance ministers and the resignation of two central bank governors from January 1996 to November 1997. At the same time, the country was more dependent on trade within Asia: 27 percent of Indonesia's export earnings came from Japan and another 37 percent from the rest of Asia (Annex 2, Table 3), while the corresponding shares were only 18 percent and 32 percent for Thailand. Total external debt was equivalent to 200 percent of Indonesia's export earnings in 1996, compared with only 100 percent for Thailand. Short-term debt over gross reserves was higher in Indonesia than in Thailand (160 percent versus 135 percent).

8. The objective in this chapter is not to analyze all factors which may have contributed to the crisis. Rather, the study focuses on the role of the Bank, its preparedness up to the crisis and its preliminary response. the chapter also does not purport to discuss the relationship between the IMF and the Bank in dealing with the crisis.

seven managing directors of Bank Indonesia (BI) were fired by the president. Two of the four directors fired were in charge of the banking supervision department.

2.9 The reform of the banking sector launched in November did not go as smoothly as expected. Far from restoring investor confidence, it created a climate of uncertainty which was aggravated when President Suharto canceled a foreign trip for health reasons on December 5. Uncertainty induced a flight to security from risky to safe banks and from rupiahs to dollars. Massive liquidity support was extended to the banking system in an attempt to avoid panic, but with the effect of feeding capital flight. Within two months (December and January), the injection of liquidity support was equivalent to almost 10 percent of GDP and currency in circulation rose by one-third. Over the period from October through February, interest rates on one-month BI certificates remained at their lowest levels since the float of the rupiah: they were set at 20 or 22 percent a year, while the rupiah was falling rapidly and the monthly inflation rate reached 14 percent in February (Annex 3, Figure 7). By end-March, base money was at twice the level specified by the IMF performance criteria. Far from tight, monetary policies accommodated massive capital flight. From end-September to end-January, net international reserves fell from $25 billion to $15 billion (Annex 3, Figure 3), foreign exchange deposits fell by $8 billion (Annex 3, Figure 4) and the rupiah lost 80 percent of its value in relation to the US dollar (Annex 3, Figure 1).

2.10 As the crisis deepened, the relations between the IMF and the presidency grew tense. They reached the stage of open confrontation in late January, after the IMF opposed the establishment of a currency board system (CBS). The Bank fully supported the IMF on this issue. It was feared at the time that the CBS was a device for allowing a few well-connected individuals to acquire dollars at the bargain price of 5,000 rupiah and that the BI could lose most of its remaining reserves in a matter of days. The BI governor also took position against the CBS, which contributed to his being fired February 12.

2.11 What started as a financial crisis had become a full-fledged economic, social and political crisis in early 1998. With the sharp depreciation of the rupiah, corporations with foreign debts unhedged could not generate the profits needed to service their debts, which generated a vicious circle. With more loans becoming non-performing, more banks became insolvent and those few which remained solvent did not want to lend to enterprises unable to service their loans. Without working capital, enterprises had to close and urban unemployment soared. The purchasing power of those remaining employed fell since nominal wages barely moved while the cost of living rose sharply; the price of rice more than doubled in four months. The political situation became increasingly fragile, and although President Suharto was unanimously reelected to his seventh 5-year term on March 10, he was no longer the uncontested leader and had to resign on May 21, leaving a major political vacuum.

2.12 Neither the Government nor the Bank foresaw the crisis. However, with a large and well established mission in Jakarta, Bank staff were aware of the country risk. The mission had easy access to senior officials and frequently prepared confidential policy notes. Thus, in the last quarter of 1995, the mission addressed strongly worded confidential notes to the authorities highlighting features of the Indonesian economy that were similar to those prevailing in Mexico before the 1994 crisis.

2.13 The problems of the financial sector were also known to the Bank and deserved consideration of a contingency plan. A report issued in June 1996 stated: "In particular, there is a concern that—in the worst-case scenario—the sector would magnify any serious disturbance, spreading shockwaves throughout the economy, with de-stabilizing feedback effects on the macro economy."[9]

2.14 Financial sector problems and risk factors were frequently mentioned in Bank statements at the Consultative Groups (CGI 95, 96 and 97) and in Country Economic Memoranda (CEM 95, 96 and 97). In particular, the 1997 CEM, written for the 1997 CGI, stated in front: "...problems in other East Asian economies could spill over into Indonesia. These factors, *inter alia,* risk a reversal of capital inflows, a risk that is magnified by Indonesia's large external debt and the increasing sensitivity of global capital flows to changes in indicators."[10] The IMF staff report on the 1997 Article IV Consultation issued at about the same time[11] was more forceful; but the circulation of the IMF report was restricted, while that of CEMs and CG reports was not.

2.15 In commenting on a draft of the CAS circulated in February 1997, the office of the Bank Chief Economist stressed that risk factors had been underestimated, that the Bank's strategy should not be limited to the optimistic base-case scenario, and that a "downside analysis" was needed in view of the high country risks. The composition of the lending program was also criticized for not including quick-disbursing instruments, contingent credit lines, and private sector safety nets. But, in the final version of the CAS issued in June, the focus was on the base-case scenario, with a steady 7.8 percent real GDP growth through the year 2000. "High growth with equity" and "Sound macroeconomic management" were the headings of the first two sections. In the following section, risks were considerably underestimated. The subsection dealing with risks of regional spill-overs concluded: "Indonesia is relatively well equipped to cope with any spill-over effects of such a (regional) crisis because of the wide exchange rate bands, increasing and high levels of foreign exchange reserves, a fiscal surplus, and initial steps being taken by Bank Indonesia to strengthen the financial sector. In addition, Indonesia is making great efforts to diversify and strengthen its export performance." The "Low-case scenario" subsection began: "The probability of a severe economic shock is currently very low." The low-case scenario was subsequently ignored in outlining the Bank's assistance strategy. Among the 46 projects listed in the FY98-00 base case lending program, none dealt with the financial sector. During Board presentation of the CAS, reservations about the strategy voiced by some EDs were downplayed by management: these concerns included, among others, the absence of a link between the policy challenges and the Bank's proposed lending program, the lack of an explicit statement of the Bank's position and program for engaging the Government on governance issues, and the need for a more cautious judgment about Indonesia's near future.

2.16 By mid-August, the rupiah had lost 20 percent of its value, risks were growing and could no longer be ignored, and political tensions were on the rise. But the Bank did not formulate a contingency program in case the situation deteriorated. In fact, a memo from Bank management to the Board on August 20 affirmed that the contagion effect had been limited and that there was no cause for concern, in view of Indonesia's extraordinary record of swift responses to macroeconomic difficulties.

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9. Indonesia: Financial Sector: A Strategy for Development, Executive Summary, page i, 6/17/96.

10. Indonesia: Sustaining High Growth with Equity, Executive Summary, page xxi, Report No. 16433-IND, 5/30/97.

11. SM/97/158, June 20, 1997.

2.17 An unfortunate combination of staff turnover, some of it a result of policy disagreements, and the 1997 reorganization complicated the ability of the Bank to respond to the crisis. During the first half of 1997, some key staff (lead economist, financial sector specialist) left the Region to work in other parts of the Bank; the country operations division chief retired on July 1, 1997; the director left on sabbatical in March 1997: the position remained for administrative purposes until July 1, 1997, when a new director was appointed, as the position of director was combined with that of resident representative; the vice president for East Asia and the Pacific was newly appointed in January 1997, the previous one having retired in September 1996; in other words, substantial institutional memory was lost. The far-reaching 1997 reorganization detracted attention from economic development issues. For the East Asia and Pacific Region as a whole, roughly two-thirds of the management team was new as of July 1. In addition, in September 1997 the Bank's Managing Director for the Region retired from the Bank. Discontinuity in top management, and crisis in other countries in the region, also led to some disruption in management's dialogue with the Resident Mission.

2.18 Ironically, the crisis provided an opportunity for the Bank to get action on many of the necessary structural changes. By January 1998, Bank staff had managed to incorporate into the IMF programs most of the reforms it wanted. But the run on the banks might have been avoided or at least slowed down, if the 16 banks had been closed in the context of a comprehensive bank restructuring program providing appropriate safety nets. The purpose of the $20 million technical assistance project in December 1997, was to finance audits of the banking system; it was a simple request, similar to the one made for Thailand in September, that could have been made earlier, when the stand-by was submitted to the IMF Board. The measures to restructure the banking system, put in place rather hastily in late January, could have been announced in November. In short, if the Bank had started working out contingency plans during the summer of 1997, it would have been better prepared by October.

2.19 By October, 1997, it was clear that the assistance strategy presented to the Board in July did not apply. Starting in October, regional management briefed the Board periodically on developments in East Asia and in Indonesia, but only in the most general terms. It was only by the end of March 1998, and especially in July 1998, when the $1 billion structural adjustment loan (PRSL) was approved, that there was a Board discussion of a new strategy in more concrete and realistic terms. This discussion was followed by the presentation of "Indonesia in Crisis" and "East Asia: The Road to Recovery."[12]

2.20 During the December 1997 discussions of the Banking Sector Technical Assistance project, the Board was critical of the lack of a comprehensive framework for the Bank's assistance strategy in the financial sector. It was then informed that an additional financial sector operation and a SAL would be prepared. Because the GOI's willingness to undertake fundamental reform of the financial sector was not yet clear, and the depth of the problem was not yet agreed upon, the financial sector operation was not processed. There was, however, a Bank commitment to deliver funding and as a result, the PRSL (with a financial sector component) of $1 billion was approved in July 1998. In retrospect, even if there had been evidence of political will, it appears questionable whether the PRSL was an appropriate vehicle to address Indonesia's systemic problems in the financial sector. Although financial sector

12. "*Indonesia In Crisis: A Macroeconomic Update,*" July 16, 1998. "*East Asia: The Road To Recovery,*" August 20, 1998. Three other documents were tabled at the CGI held in Paris July 29-30, 1998: "Indonesia's Road to Recovery", "Addressing the Social Impact of the Crisis in Indonesia," and "Resolving the Crisis of the Financial Sector".

conditionality in a SAL may provide greater credibility for Board approval, a quick-disbursing loan generally provides a poor vehicle for implementing and monitoring needed reforms that require both political and institutional changes as all-encompassing as those needed in Indonesia. In addition, a quick-disbursing loan provides little opportunity to track disbursements—as may be appropriate given past allegations of improprieties in Indonesia. What is needed in the financial sector is not quick-disbursing assistance, but dialogue and technical assistance if there is evidence of commitment at the highest level. This would be indicated by the willingness of the Government to address past tolerance of unviable enterprises and the large number of insolvent banks—many of which had violated prudential requirements with impunity.

2.21 The Bank should have been better prepared for the crisis, but it could not have prevented it. The financial system needed to be overhauled and thoroughly cleaned up. The negative reaction of the president's inner circle to the bank closures in late 1997 showed that serious reforms could not have been made without rocking the boat. Although it was not the original intent of the IMF program, the boat was rocked in early 1998, and the Bank had to join efforts with the IMF in damage control. It was clear that the Bank had to play the leading role in the social sectors. But in financial matters, the borderline between the roles of the two institutions was unclear.

2.22 Restoring the health of the financial system was very difficult for two reasons. First, the Paris and London clubs, which provided convenient channels for public debt rescheduling, could not be used to reschedule private debt because of the multitude of creditors.[13] Second, recapitalizing the banks without solving the corporate sector problem upstream could not do much good. The IMF and the Bank assisted in amending fiscal regulations and judicial procedures with a view to removing obstacles to corporate restructuring. But neither the IMF nor the Bank are well equipped to deal with non-financial corporations. The September 1998 Jakarta initiative provided a framework for negotiations between Indonesian corporations and their domestic and foreign creditors, but progress was slow through December.

2.23 As mentioned earlier (para. 2.18), the crisis has provided an opportunity for the Bank to move on structural reforms. These have included, among others: elimination of all restrictions on foreign investment in retail and wholesale trade; abolition of the monopoly of the state trading agency, BULOG, over the importation and distribution of essential food items; opening up clove marketing to private sector competition; dismantling restrictive marketing arrangements for cement, paper, and plywood; strengthening the transparent and competitive bidding for the private provision of infrastructure; and ensuring that reforestation funds are used exclusively to finance reforestation programs. Several other actions in the IMF's Letters of Intent drew on past Bank work, including drafting and implementing rules for the new environmental law; accelerating programs for converting to cleaner fuels; auctioning and transferability of forestry concessions, and reducing land conversion targets to environmentally sustainable levels.

2.24 The Bank has been monitoring the social impact of the crisis. A special monitoring unit (SMERU) has been set up. A key preliminary finding has been that the crisis has had a much greater impact on the urban than the rural areas; furthermore, while average urban spending fell by 34 percent, the median fell by only 5 percent. In rural areas, average spending fell by 13 percent, versus 1.6 percent for the median. The regional impact has been heterogeneous, with

13. This problem has been addressed in the "Report of the working group on international financial crisis" and recommendations were presented to governments of G-7 countries in October 1998.

some regions experiencing much greater difficulties than others. The Bank responded to the social impact in its July 1998 PRSL, in the June 1998 Kecamantan Development Project, and in its health and education portfolios. New loans in the education portfolio include an Early Childhood Development project and a West Java Basic Education project. A central part of the Bank's assistance in education has been support and development of the Government's back-to-school program, a nationwide campaign with scholarship and school grant support for poor children and schools. In health, Health V was designed to raise the health status of the poor by improving quality and ensuring access of basic health services. Two regional development projects aimed at promoting rural development and economic growth in two of the poorest areas were approved in March 1998. The Bank's partnership with non-governmental organizations (NGOs) has intensified since the crisis. NGOs are being consulted on the planning and implementation of poverty-targeted projects and have collaborated with the Bank on monitoring the social effects of the crisis.

2.25 The economic crisis and allegations of corruption in Bank projects have attracted intensive scrutiny by the Bank's senior management, as well as the local and foreign media. Two missions visited Indonesia to review: (a) the macroeconomic and governance implications of corruption; (b) allegations by the media and civil society about corruption in Bank operations in Indonesia; (c) the financial management systems, procurement, and disbursement procedures in place in RSI and their effectiveness; and (d) the changes necessary in the Bank process and procedures to enhance the credibility of the Bank. The outlines of a new long-term strategy have been articulated, and many of the components are being defined.

Portfolio Management

2.26 The crisis provoked a major deterioration in the Bank's portfolio (para. 3.7) in Indonesia, which showed an undisbursed balance of about $4.4 billion by end-1997.[14] The Region's response began with a joint Country Portfolio Performance Review (CPPR) with the ADB in December 1997. The main outcome was a joint GOI-Bank decision to meet emergency needs and to restructure the portfolio in a timely manner. In January 1998 the Region approved an increase in disbursement percentages to meet shortfalls in counterpart funds and the reallocation of loan funds to support crisis-related priorities. In August 1998, an agreement was reached with the GOI that involved cancellation of US$1,000 million from the commitments, and reallocation of US$980 million for the increased disbursement percentages and new crisis-related activities. As of September 30, 1998, $138.6 million had been cancelled, and out of the $980 million, $428 million had been reallocated.

2.27 A country Portfolio Improvement Plan (PIP) has been prepared. The main goal of the PIP is to achieve a satisfactory turnaround of problem projects. Two sectors will be key in achieving this—Energy and Rural Development. The December 1998 CPPR has been completed, with a clear understanding on time-bound actions.

14. The Government suggests that the backlog in the portfolio was also, in part, due to excessive optimism on the part of the World Bank on individual loan disbursements.

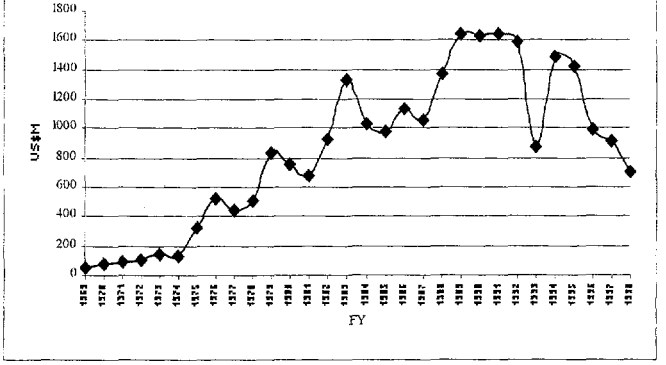
3. Bank Assistance Strategy Before the Crisis

3.1 Indonesia joined the World Bank in 1954. High inflation, budget deficits and unresolved compensation issues for former Dutch property led the Bank's first field mission in 1955 to recommend that lending operations await the stabilization of political and economic conditions. A decade later, and following a change in government in 1965, the new Suharto administration requested international support to help stabilize and develop the economy. In April 1967 Indonesia rejoined the World Bank, from which it had withdrawn in August 1965. A large Bank mission in late 1967 was followed by an agreement to create a Resident Mission in Indonesia (RSI). RSI, with wide powers and responsibilities, was formally established in September 1968, the same month that the Bank's first lending operation (for irrigation rehabilitation) was approved.

Bank Assistance

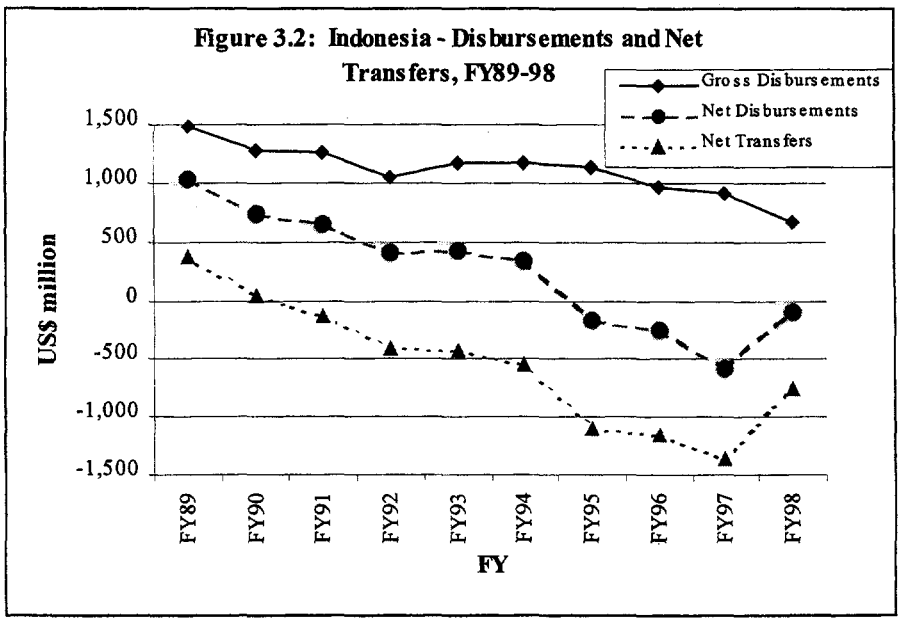
3.2 Over the past three decades, and through FY98, Bank commitments to Indonesia were about $25 billion for 278 projects. Annual commitments grew from about $100 million during the early 1970s, to around $800 million by the early 1980s, and to $1.6 billion by the early 1990s, followed by some decline during the past few years, partly because of insufficient project preparation on the part of Indonesia and their lack of commitment to a portfolio review, and partly because the Bank's portfolio was changing rapidly and moving to smaller, more diversified projects.[15] Indonesia's share of all IBRD debt outstanding and disbursed exceeded 10 percent by the early 1990s. Gross disbursements averaged 1.1 billion per year during the past decade (FY89-98),[16] but they have declined over time. Net disbursements became negative in 1995 and net transfers in 1991 (Figure 3.2).

Figure 3.1: Indonesia - Commitments by FY (FY69-98)



15. The Government suggests that there are more complex reasons for this slowdown, including exposure considerations.

16. Indonesia's GDP in 1996 was equivalent to about $230 billion.



3.3 On a sectoral basis, infrastructure (electric power, telecoms, and transport) absorbed the largest share, at 40 percent of the total, followed by agriculture at 19 percent; education, health, nutrition and population at 13 percent; and urban, water supply and sanitation at 10 percent (Table 3.1). Over time there have been important shifts in composition: the share of agriculture has decreased dramatically in favor of increasing shares for infrastructure, education, health, nutrition and population, urban, and water supply and sanitation. A review of CAS documents during the 1990s shows that some of these major shifts were not part of a strategic plan. Thus, the actual allocation for agriculture has been consistently far below the amount in the CAS. For instance, planned commitments for FY95-97 for agriculture/environment were 14 percent of the total, but actual commitments were 6 percent.

Table 3.1: Sectoral Distribution of Bank Lending (Fiscal Years)

	US$M	*Percent*			
Sector	*1969-98*	*1969-98*	*1969-79*	*1980-89*	*1990-98*
Infrastructure[a]	10,196	40.2	36.9	34.3	46.9
Agriculture	4,880	19.2	34.8	24.7	9.5
Education/Health, Nutrition & Population	3,301	13.0	7.3	11.6	16.0
Urban/Water Supply & Sanitation	2,624	10.4	6.1	6.6	15.1
Finance	1,818	7.2	6.6	10.4	4.2
Adjustment	1,200	4.7	0.0	8.7	2.2
Other	1,351	5.3	8.3	3.7	6.1
TOTAL	25,370	100.0	100.0	100.0	100.0

a. Electric power, oil and gas, telecommunications, and transport.
Source: World Bank.

3.4 Lending has been combined with extensive economic and sector work (ESW). In FY92-97, there were 31 formal economic and sector reports. ESW encompassed a broad range of issues, and the reports have been of high quality. Typically, four areas of reform have been covered in depth: (a) macroeconomic management; (b) the incentive framework; (c) human resource development and infrastructure; and (d) institutional development. Since FY95 the share of resources allocated to ESW has been below the regional average and mirrored the declining trend in the region: resources for ESW in Indonesia fell from 26 percent of the total in FY94 to 16 percent in FY97.

Past Evaluation Findings

3.5 Through August 26, 1998, 203 projects valued at $15.9 billion had been evaluated by OED. In all respects (percent of commitments with satisfactory outcomes, likely sustainability, and substantial institutional development impact) Indonesia ranks high: the ratings are similar to the average for East Asia and generally above Bankwide averages. The development effectiveness index, combining the three main ratings, is 7.23 for Indonesia, on a scale of 2 to 10, compared with 7.18 for East Asia and 6.37 Bankwide. On the whole, this picture holds true across sectors. There are exceptions: projects in Indonesia generally scored extremely well in the education, electric power, and transport sectors. At the same time, sustainability of projects was judged to be less likely than in East Asia or Bankwide in agriculture, urban development, and water supply and sanitation. Their institutional development impact also was judged less significant in those same sectors, as well as in finance. Most of this is accounted for by projects approved relatively recently in those sectors, and reflected in the overall ratings in Table 3.2(b).

3.6 To a large extent, the favorable project ratings for Indonesia reflect the satisfactory performance of the economy, at least until recently: individual project outcomes tend to be more successful when the overall macroeconomic environment is sound. Thus, it is significant that the outcome ratings of projects implemented in recent years, although evaluated after mid-1997, that is, during the crisis period, have continued to be highly positive (Table 3.2(c)). At the same time, and because of the crisis, the sustainability ratings during FY98/99 have dropped considerably.

3.7 The crisis has had a similarly predictable impact on portfolio risk ratings by the Quality Assurance Group (QAG). Of the 64 projects in the portfolio as of January, 1998, 10 were rated at risk (6 actually, and 4 potentially, at risk) making up 12.5 percent of commitments. This compared with 11.5 percent of the regional portfolio and 21 percent of the portfolio Bankwide. In contrast, of the 71 projects in the Indonesian portfolio as of October 1998, 38 were rated at risk (19 actual and 19 potential) making up 48.3 percent of commitments. This is far above the percentage at risk either for the Region (23.1 percent) or Bankwide (22.6 percent).

Table 3.2: OED Evaluation Findings (through August 26, 1998)

(a) All Evaluated Projects

	Number	Net commit. (US$M)	Satisfactory Outcome (%)	Likely Sustainability (%)	Substantial Inst. Devt. Impact (%)
Indonesia	203	15,920	88	70	49
East Asia	809	48,618	87	75	48
Bank-wide	4,761	229,799	74	56	36

(b) Recent Projects (Approved FY90-98)

	Number	Net commit. (US$M)	Satisfactory Outcome (%)	Likely Sustainability (%)	Substantial Inst. Devt. Impact (%)
Indonesia	20	3,107	90	55	41
East Asia	86	8,757	84	67	45
Bank-wide	481	47,585	83	60	44

(c) Recently Evaluated Projects in Indonesia (Evaluated during FY94-FY98/99)

	Number	Net commit. (US$M)	Satisfactory Outcome (%)	Likely Sustainability (%)	Substantial Inst. Devt. Impact (%)
FY94	17	1,585	99	82	54
FY95	18	1,779	89	73	37
FY96	14	1,792	94	93	67
FY97	9	1,380	96	81	31
FY98/99[a]	18	2,322	86	35	37

a. Combined because only 4 projects have been evaluated thus far in FY99. All percentages are based on dollar value of net commitments.
Source: OED.

Achievements and Shortcomings of the Bank's Assistance Strategy

3.8 Ever since the creation of the Bank Resident Mission in 1968 (the first of its kind), a close relationship has existed between the Bank and Indonesian counterparts. Both partners learned from one another and came to appreciate realities and constraints of the partnership. The Indonesians valued the Bank's advice (as well as that of other outside advisers), particularly in macroeconomic and development planning areas. The Bank provided advice through its economic and sector work, particularly the country economic memoranda, and in recent years produced numerous short policy notes to bring key issues to the attention of the Government. The special relationship was well illustrated by the Bank's adjustment lending during the late 1980s and early 1990s, when no "policy conditionality" was attached to the loans because there was an understanding that the Government's prior actions were part of a medium-term program that would be implemented.

3.9 In view of the progress made by the Indonesian economy over time, the client-driven Bank strategy and full Bank support certainly seemed justified. Through its dialogue, ESW, and lending, the Bank's contribution to many of Indonesia's achievements was impressive, as discussed in paras. 3.11-3.26.

3.10 The special relationship also had drawbacks as it created a situation where the Bank did not succeed in persuading the Government to heed some crucially important, but unwelcome, messages to the country, let alone impose unwanted policies, lest the relationship be broken. This was clear in the late 1970s, when President McNamara suggested to the President of Indonesia in no uncertain terms that prevailing corruption (a major issue for the Bank since the beginning of the relationship) was eating away at society and needed to be dealt with, but the message was ignored. In the 1990s, the country's continuing strong economic performance; a reduction in Bank leverage (relatively low lending levels at the sectoral level, despite a large lending program in the aggregate); a shift toward smaller, decentralized projects; and political continuity made it even more difficult to address critical policy issues and potentially destabilizing factors. Foremost among these, in the years before the crisis, were financial sector insolvency, overheating of the economy, and social stress. Clear warnings sent by staff to management a full year before the crisis were pushed aside. At the ministerial level, an excellent dialogue continued, but the dialogue lost its effectiveness because top management was sending mixed signals to the Government. While many of the main issues were always on the table for some managers, others tended to downplay them in the interest of maintaining a good relationship. These shortcomings of the Bank's assistance strategy are discussed further in paras. 3.27-3.46.

Achievements

3.11 Traditionally, more than 20 percent of the Bank's financial assistance to Indonesia has been devoted to *electric power* development. The Bank's impact through support and development of the State Electricity Corporation (PLN) has been highly significant. PLN's capacity grew fivefold between 1978 and 1992, as its sales grew at an annual average rate of 16 percent. Over a 10-year period (1983-92) PLN's transmission and distribution losses decreased from 21 to 12 percent. The Bank also had a substantial institutional development impact through improvements in PLN's project implementation, operational, and managerial capabilities. Through the Bank's ESW and the resulting dialogue with the Government, a consensus has been built regarding future development priorities and policy changes necessary to ensure efficient long-term development of the power sector: further removal of transmission and distribution bottlenecks, improved PLN efficiency and reliability and quality of power supply, private sector participation, and regulatory reform.

3.12 The *transport* sector absorbed close to 15 percent of the Bank's total lending program. Included are projects in several modes—ports and shipping, railways, roads, and highways—but especially the latter two, since they play a dominant role in medium- and long-distance freight transport. The original emphasis was on road reconstruction, after many years of neglect, followed by efforts to strengthen institutions and then road sector strategy (restoration, upgrading, maintenance of national and provincial roads), to which the Bank contributed substantially.

3.13 More recent projects have focused on maintenance, rehabilitation, and increases in the capacity of the urban road network through construction of new roads, upgrading, and development of traffic management schemes. The physical objectives of these projects were invariably met, and in some cases surpassed. Thus, the overwhelming majority of evaluated transport sector projects received satisfactory outcome ratings. Institutional development objectives, designed to increase the capacity of central and local government institutions responsible for road management, were modestly successful.

3.14 *Urban Development* absorbed almost $2 billion of total commitments in FY74-97. Urban lending operations progressed from demonstration projects in Jakarta to more programmatic investments in other large cities, and to sector lending with an agreed policy and institutional framework. The Bank provided assistance for urban and village infrastructure, including road and footpath construction, building improvement, sanitation, clean water, drainage, solid waste management, traffic management, training, and small business microcredits. A key contribution of the Bank's urban development projects of the 1990s has been in operationalizing the decentralization objectives of GOI's Urban Policy Statement, issued in 1987. The recently completed ICR of the East Java Bali Urban Development Project reported that the main project objective to improve urban infrastructure expenditure programming, financial planning, and information management by local governments was substantially achieved. The Bank's urban lending experience underpins the current dialogue on decentralized service delivery and governance in other sectors.

3.15 Much benefit to the *physical environment* has come from the Bank's urban projects. In the area of ESW, the Bank completed a major report in 1994: *Indonesia Environment and Development.* In capacity building in environmental management, the Bank supported BAPEDAL (Indonesia's Environmental Management Agency, which regulates environmental pollution at central, provincial, and municipal levels) through TA lending.[17] In 1997, under the BAPEDAL project, the Bank funded the drafting of the new Environmental Management Law to strengthen environmental enforcement powers. Past Bank environmental work and the crisis have provided a new opportunity to move on some of the critical issues. The Bank was able to quickly draw on its work to formulate conditionality on the environment and natural resources for the IMF's Letters of Intent (para. 2.23).

3.16 Bank assistance to *agricultural development*, which accounted for about 20 percent of all lending during FY69-98, has declined significantly over time: from 35 percent of the total during FY69-79 to less than 10 percent during FY90-98. Apart from infrastructure, the emphasis in Indonesia's first three five-year development plans (Repelita) was almost exclusively on rural development, and especially on self-sufficiency in rice and irrigation. The Bank's primary focus was irrigation development, with a total of 19 projects. The Bank's impact on agricultural development during those years was significant. OED has estimated that Bank-financed projects contributed 60 percent to incremental palm oil output during 1974-80, 16 percent to incremental sugar production, and 6 percent to the production increase in rice and rubber.[18]

3.17 A Bank Agricultural Sector Survey (published in 1974) prompted Indonesian planners to take a fresh look at their failing transmigration program, which had been designed to redress the unbalanced distribution of land and labor in the country. Even though seven Bank loans were made in support of transmigration, the Bank's financial contribution to the program was relatively minor, yet its catalytic role in revitalizing the program was substantial. Unfortunately, environmental impact concerns were not on the agenda at that time.

3.18 Because of Bank insistence on policy conditionalities that the Indonesians were unwilling to accept, GOI stopped borrowing for forestry projects from the Bank. GOI's reluctance to take

17. However, the effectiveness of the BAPEDAL project has been limited because of internal BAPEDAL communication and collaboration problems.

18. OED, Indonesia: Sector Operations Review – The Agricultural Program, Report No. 02166, August 1978.

meaningful reforms in forestry and agriculture-related areas, together with the decline in the focus on transmigration, largely explain the decline in lending for the agricultural sector. Most notable in recent years in the Bank's agricultural portfolio have been regional development projects centered on specific provinces with substantial involvement of regional governments in preparation and implementation. The projects have generated location-specific upland farming technologies, contributed to the development of local institutions, experimented with approaches for cooperation with project-area NGOs, and fostered operational linkages between research and extension.

3.19 The Bank's *educational* lending to Indonesia has been its largest education portfolio in the world, although for Indonesia it has formed a modest portion of its education budget.[19] Between FY69-98, 41 projects, totaling over US$2.6 billion, were approved. After a modest start during the 1970s, commitments for education averaged 11 percent of the total through FY98, covering all subsectors.

3.20 Most notable among the Bank's achievements are: (a) the provision of textbooks and teacher training at the primary and secondary levels; (b) support for nonformal education to help mitigate past inequities in educational opportunities by improving the literacy and incomes of the poorest segment of the community (the focus was on expanding and strengthening the delivery system and increasing coverage to all 27 provinces) and (c) helping the country meet its manpower requirements for skilled and semi-skilled workers. Through its Polytechnic projects the Bank helped Indonesia develop a good-sized technician training system with broad geographical coverage. The Bank also supported human resource development in selected ministries and in nonministerial government institutions. A key area of Bank support was providing fellowships. Most evaluated projects had satisfactory outcomes (96 percent); in many cases project targets were exceeded.

3.21 In HNP, the Bank contributed to Indonesia's *Family Planning Program* with several operations, largely to provide basic program infrastructure: buildings, equipment, and vehicles. The Bank financed headquarters and supply warehouses not only in Jakarta and the 27 provincial capitals, but also in the 301 district capitals. In the 1990s, based on earlier completed sector work, the Bank tried to address critical institutional issues. The recently initiated Safe Motherhood Project reflects the Bank's continuing emphasis on this issue. Indonesia's program has been highly successful, the fertility rate declined from 5.4 in the early 1970s to 2.6 in the early 1990s, or by 60 percent.

3.22 The Bank was a catalyst in getting the Government to focus on decentralization as a key to improvements in health service delivery and educational outcomes. Because of resistance to change, the Government and Bank agreed first on a pilot project in two outer provinces before deciding on a full scale effort in other provinces. Increased participation of local communities and improved management of drugs and equipment are integral parts of these efforts to improve delivery systems. Both education and health lending have been reoriented to build up regional capacities.

3.23 A major contribution of the Bank in *social sector* development in Indonesia was a vast array of solid ESW. In the health sector, there were analyses of health financing (1989),

19. OED, Indonesian Education and the World Bank: An Assessment of Two Decades of Lending, Report No. 9752, June 1991.

including a review of the distortionary effect of the Government's fragmented budgetary process; and of future directions for population policy (1990) and of health work force issues, which opened up the question of public/private roles in the delivery of social services (1994). In education, ESW ranged from reviewing basic education issues (1989) to analyzing human resource shortages in a fast-growing economy (1996) and devising an education strategy for the future (1997). Poverty issues have been reviewed in a 1990 Poverty Assessment; in a 1993 study on public expenditures, prices and the poor; papers prepared for a labor markets study in 1996; a study of intergovernmental fiscal relations in 1996; and in the 1997 CEM.

3.24 The Bank set up a special unit in RSI in 1993 (the first of its kind) to establish consistent policy and its application to Indonesia in the environmental and resettlement areas, and to reach out to NGOs. The unit included anthropologists on its staff and reflected the Bank's attempts to expand the dialogue beyond macroeconomics. President Wolfensohn chose Indonesia's NGO program as the first winner in East Asia of his "NGO Flagship Award" program in 1994. However, because the Indonesian political system did not favor NGOs, the Bank engaged NGOs in selected, individual projects to the extent possible, but overall did not wish to jeopardize its relationship with the top level Government.

3.25 When oil prices collapsed in the early 1980s, Indonesia's response was swift: devaluation, a reduction in public spending, and improved resource mobilization through comprehensive tax reforms in 1983. Renewed macroeconomic difficulties starting in 1986 were again countered by a decisive Government response, this time supported by *adjustment lending* from the Bank; two trade policy adjustment loans and two private sector development loans, for a total of $1.2 billion between 1987 and 1991. Among the major reforms promoted and successfully implemented were improvements in the trade regime, including a further shift to a tariff-based regime with lower maximum tariffs and less dispersion; reduced restrictions on foreign participation in domestic businesses; regulatory reform; financial market development; public enterprise reform; and privatization.

3.26 The Bank's approach to promoting reform through these loans departed from conventional practice in that no conditionality was imposed. Needed reform measures were taken by the Government prior to the loans, based largely on the results of earlier Bank economic and sector work. The approach also reflected Bank confidence in Indonesia's economic management in view of its past record.

Shortcomings

Financial Sector Strategy

3.27 As suggested earlier, the special relationship between the Indonesian Government and the Bank had serious drawbacks. Nowhere was this more visible than in the Bank's strategy in the financial sector. With Bank support, financial sector reforms had started in 1983 with the liberalization of most interest rates. Subsequent reviews of the experience of the early 1980s in some Latin American countries has indicated the dangers of liberalizing interest rates in poorly regulated banking systems. By 1992, Bank ESW warned that deregulation in the financial sector had moved faster than the development of the legal and accounting structures and the capacity to supervise. The concerns ranged from the high level of nonperforming loans, largely a result of politically directed lending backed only by implicit guarantees, to excessive growth of lending to

the property sector, weak compliance with prudential regulations, and the slow pace of liquidation of problem banks.

3.28 Bank lending to the financial sector during FY90-98 made up 4 percent of all lending: ESW on finance issues was 5 percent of the total during FY94-98. The largest project, the FY93 Financial Sector Development Project, was to support recapitalization and improvements in the operations of the State Commercial Banks (about half of the banking sector), as well as technical assistance to the Central Bank. The project was rated unsatisfactory on both achievement of development objectives and implementation progress as early as in 1995. A thorough supervision effort in August 1996 not only found the project outcome to be unsatisfactory on all counts, but concluded that Indonesia's State Banking Sector was in disarray, riddled with insolvency. Even with inadequate loan classification criteria, bad debts of the participating banks exceeded 25 percent, credit performance monitoring was found to be lax, and the project was found to have had no institutional development impact. The mission recommended cancellation of the remainder of the loan, as well as independent external audits of the state banks. Staff also proposed in-depth financial sector work.

3.29 In parallel with weak government commitment to financial sector reform, the Bank downplayed the evidence presented in the supervision report and rejected the proposed cancellation of the remainder of the loan for several months (cancellation was postponed until a new Banking Reform Assistance project was approved in November 1997), arguing that such action would do serious damage to the Bank-Government relationship. This process also triggered perceptions of unjustified penalties to career prospects of some Bank staff who had brought the issues to light. The staff proposals for in-depth sector work were shelved; ESW in the finance sector dropped from 1.76 staffyears in FY95, to 0.55 in FY96, and 0.10 staffyears in FY97. Coverage of financial sector issues in the July 1997 CAS was minimal. The Bank's readiness to address the subsequent financial crisis in Indonesia was seriously impaired.

Poverty and Social Development

3.30 Prior to the crisis, complacency created by high growth rates and declining poverty trends led the Bank to de-emphasize poverty analysis, although some work was done in the context of a labor markets study in 1996 and a study on intergovernmental fiscal relations in 1996 (para. 3.23). In 1993, consistent national and regional profiles were generated using 1990 surveys. These estimates were partially updated with survey data from 1993 as part of the study on labor markets. There was also analysis pertaining to regional development, inequality, and regional targeting of fiscal transfers in the Intergovernmental Fiscal Relations study. Although results from the 1996 surveys were available, the Bank did not systematically update its analysis to 1996 to allow for consistent interregional (including rural-urban) comparisons between 1990 and 1996. It also did not analyze the "near poor," and to what extent they differed from those identified as poor; nor did it deepen its understanding of how well-targeted and effective the Government's poverty programs were, nor the international experience with targeted mechanisms and programs. The Bank's poverty work in Indonesia relied exclusively on traditional survey methods. "Subjective" poverty lines based on people's own assessments of the adequacy of their consumption would have provided interesting insights, especially since there has been a perception that the existing poverty line was "too low." In lending, prior to the crisis, the Bank did not focus on those commitments and projects that were important for poverty alleviation. While these were shortcomings of the Bank's assistance, there is no basis for the accusation that

the Bank manipulated its analysis of poverty, particularly the Bank's estimates of the number of poor (Annex 4).

3.31 In April 1997, work to update poverty information systematically through the identification of near-poor and the impact of targeted programs was proposed, but East Asia was in the process of a change management, and all work programs were in a state of flux. The work was again proposed in October 1997, but again lacked support, to the disappointment of Bank staff who had argued the case for more accurate data gathering on poverty conditions. The pressing immediate needs of the crisis took precedence over longer-term substantive work.

3.32 The 1990 Poverty Assessment had asked for a deliberate focus on poverty alleviation in the design and operation of agricultural projects; special educational efforts for the poor, including financial support for schooling, and improved quality of education and nonformal education; improved access to health, water supply, and sanitation in the rural areas, with particular emphasis on sanitation, and more emphasis on women, because evidence suggested that the poorest households were headed by women. Subsequent to the poverty assessment the Bank's work did highlight the lagging social indicators, but despite substantial progress, and high-level commitment within the Bank in poverty-related work, little hands-on work was done in Indonesia. The CEMs in 1995-97 and policy notes prepared by the RSI alluded explicitly to the vulnerabilities of the Indonesian economy to macroeconomic shocks, but they did not attempt to show how such shocks might be transmitted through the economy and what their impact would be on poverty. None of the analytical documents mentioned the inefficiencies and leakages in poverty programs (now a concern of the Bank), which precluded consideration of their implications for the Bank's work.

3.33 The agricultural strategy was subsequently articulated in *Indonesia: Agricultural Transformation Challenges and Opportunities*. This document addressed regional differences in poverty and favored an integrated approach to rural development, but three management changes within the agricultural group in five years led to some lack of consistency in lending strategy. The agricultural projects that were approved in the FY91-97 period did not, as a group, have a focused poverty alleviation objective. Women were targeted in only 3 of the 13 projects. Project documents have been largely silent on the many distortions, cartels, and weaknesses in the rural policy framework. However, recently RSI has done substantial ESW on these highly complex issues (e.g., work on inter-island trade tax distortions in 1997, a study of deregulation of inter-island agricultural trade in 1998). Nevertheless, simply eliminating the most egregious of the distortionary trade taxes is unlikely to be adequate in the absence of more comprehensive reform of government revenue policy and central-local revenue relations. A recent review of East Asia's rural development portfolio (excluding China) indicated that during supervision, "task managers are obviously reluctant to give projects an Unsatisfactory rating, often on the basis that progress on the "investment" component is much more critical than resolution of policy and institutional issues." Project evaluations (including supervision reports) rarely addressed poverty impacts in the sense of how much the activities reduced poverty, or even if they reached the poor at all. The Outer Island based development projects approved in FY96 and FY98 have attempted to build on the positive lessons from the three earlier projects approved in FY80, FY86, and FY91 but several obstacles remain: difficulty in interagency coordination; difficulty in inter-sectoral coordination; general lack of institutional capacity at the local level; scarcity of regional expertise; difficulty of lending to smallholders and availability of provincial/local counterpart funds. These problems were noted in the earlier projects but they have been accentuated under

the Bank's more participatory, decentralized approach. The agricultural sector currently has the largest number of ongoing projects at risk.

3.34 Subsequent to the poverty assessment, during FY91-97, 42 percent of educational commitments continued to be allocated to projects other than primary and secondary schooling, and included capacity building in administration (centralized and decentralized), universities, and research to develop skills and apprenticeship in industry. Although the Region wanted the lending program refocused on education per se, Indonesians wanted lending for capacity building and skills development. After the crisis, the Bank refocused its pipeline and new projects on basic education in order to help preserve the country's earlier gains in this area. While the gender gap in enrollment had declined sharply across all education levels, the gender ratio (females to males) at the tertiary level was about 70 percent. The OED evaluative memorandum of the Professional Human Resource Development Project (FY90) noted that only 15 percent of the beneficiaries of the post-graduate training program in the project were women, but its completion report omitted a discussion of issues affecting female participation. Lending in the water supply and sanitation sector focused 88 percent on urban areas, and the sanitation subsector received a third of commitments for this sector.

3.35 Increased and more efficient allocation of resources to the social sectors and the need for institutional changes were brought to the attention of the GOI in CEMs, and remain at issue. Key recommended actions by the Bank in its 1997 CAS to reduce development expenditure on telecommunications and power generation and to increase public expenditures on education were lost in the large number of proposed strategies/actions in the matrix (114). OED has warned in its audits against having too many actions without prioritization.

Governance

3.36 Responsibility for good governance lies with the client. For its part, the Bank has consistently raised governance and corruption concerns in CEMs and can assist clients in five key areas: reform of the civil service, measures to increase fiscal transparency (openness toward the public at large about government structures and functions), reform of the judiciary, improving the transparency and competitiveness of the incentive framework, and strengthening of oversight mechanisms.[20] The Bank did little on three of the above (civil service reform, fiscal transparency, oversight mechanisms). It did address judiciary reform in ESW, as well as transparency in incentives. But CAS discussions of the issues were meager. At the project level the Bank did not uniformly apply Bank procedures/standards.

3.37 **Civil service reform:** The Region sent a mission to Indonesia in February/March 1993 to study Indonesia's civil service but the report remained in draft form. There has been no additional major work on civil service issues, largely because the Region was unable to determine a focus for the work.

3.38 **Fiscal transparency**: Fiscal transparency (defined in Annex 5) was dealt with in a somewhat ad hoc manner. A few tentative statements were sprinkled across ESW. The issues were occasionally discussed in endnotes. A document prepared for the GOI presenting the World Bank's perspective on priorities for the latest development plan, Repelita VI, presented a somewhat clearer discussion, but there was no systematic follow up.

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20. See WDR 1997.

3.39 **Reform of the legal framework/judiciary**: The discussion of reform of legal infrastructure was confined to the business sector. These discussions (e.g., on commercial and bankruptcy law) began after 1991, and ESW from that point on has focused on reform of the legal framework. The Bank's dialogue may account for the legal reform in Repelita VI. The CEM of 1997 outlined more fundamental reforms in the judicial system. The Bank also provided technical assistance for legal reform, starting in 1995.

3.40 **Transparency in rules for market activity and competitiveness in the incentive framework**: The Bank has consistently tried to draw the attention of the GOI to this issue in its ESW, with relatively little success (see the Bank's report "Industrial Technology Development for a Competitive Edge" for example). ESW in the last five years has focused repeatedly on reform of the trade regime and price controls, on factor markets flexibility, on transparency of rules for private entry and investment approval, rules for competitive bid tendering and evaluation, rules for divestiture, and on strengthening accounting and auditing practices. Explicit references to nontransparent activities, however, were lost in the large number of issues that the CEMs covered (CEMs typically exceed 100 pages). Attention was even more diluted in lending operations. While the ESW provides evidence of progress in trade reform, there is little on progress made in establishing transparent market rules (accounting, auditing, the legal framework, competitive public awards, and transparency in disclosure of ownership links).

3.41 **Strengthening oversight mechanisms**: In other countries (Singapore, Thailand, Korea, and Malaysia) deliberation councils institutionalized the flow of information between the public and private sectors and were often critical in the formulation of policies, rules, and regulations that govern a sector, industry, or, in some cases, the macroeconomy. Little of this was apparent in Indonesia, with one main exception: the Bank did spearhead the creation of a High-Level Privatization Council, which is now functioning.

3.42 Although many bilaterals have been active in Indonesia in the three decades since the first consortium was established in 1966, they have not used the CGI to discuss sensitive social and political issues. This is not to suggest that these issues were not raised outside the CGI or that the CGI is necessarily the right forum. However, partnerships have to find a way to discuss broader institutional issues important for the country's development.

3.43 **Project level**: At the project level, the Portfolio Management Unit in Indonesia has made considerable progress in portfolio management (Annex 6), and a recent Bank mission (September 1998) has come up with specific recommendations to address corruption in Bank projects. Ex-post audits carried out by the RSI portfolio management unit revealed that the selection among bidders on several contracts (not subject to prior review), executed by subnational Governments, was not transparent.[21]

3.44 Beginning in 1993, the RSI's Portfolio Management and Implementation Unit had been continuously asking the GOI to accept the World Bank Standard Bidding Documents (SBD). The Bank's waiver of this requirement expired in April 1996, but without further agreement, the

21. The PAR (cluster audit on Indonesia transport projects, Report No. 18099, June 19, 1998) found that the prequalification for provincial-level projects favored bidders who had invested ex-ante on building a relationship, which led to underperformance by cutting costs, covering up substandard work, and sometimes renegotiating the contract(s).

Bank continued to negotiate new loans and complete negotiations on others. The matter was eventually resolved in August 1997, when Indonesia accepted SBD clauses.

3.45 Finally, the issue of adequate resources for portfolio management was not adequately addressed. Although the portfolio management staff in RSI has been strengthened over the years, in the RSI Disbursement/Audit (DAU) subunit there was one disbursement officer, one financial officer (accounts/Audit) and two disbursement assistants-to manage a portfolio of about 75 projects, about US$9 billion in loans, and annual disbursement ranging from US$1 billion to US$1.2 billion, including about 12-14 new operations. The position of the DAU subunit should improve with the addition of one new financial officer in January 1999.

4. Conclusions and Recommendations

4.1 The current crisis in Indonesia has to be seen in perspective. Much has been achieved over the past 30 years, but the crisis has revealed that some of the achievements were not sustainable and that there are major flaws in the Indonesian institutional framework. It also brought to light shortcomings in Bank strategy.

4.2 On balance over the past decade, the outcome of the Bank's strategy, the Bank's performance as well as the Government's performance is rated as marginally satisfactory. It is clear that Indonesia, with significant Bank support, has achieved major real progress over time, despite the recent setback as a result of the crisis. However, while the Government's development strategy has had remarkable positive results in many ways, issues of poor governance, social stress and a weak financial sector were not addressed and contributed to the accentuation of the crisis.

4.3 The Bank needs to develop a comprehensive strategy for the medium-term to deal with the structural weaknesses that not only allowed the regional crisis to spin out of control in Indonesia, but whose resolution is also a prerequisite for long-term sustainable development and a reduction in income poverty as well as human capital poverty. The three main recommendations below follow from the findings of this evaluation. It is encouraging to note that, during the past few months, the Bank and the GOI have begun to implement several of the recommendations on structural reforms.

(a) Structural Reforms

- A concerted effort is needed, including appropriate ESW, to help restore banking sector soundness. The SAL approved after the crisis did not adequately address financial sector issues.[22]

- In the social sectors, the Bank should revisit poverty issues: systematically update its poverty and income distribution data and analyze the factors determining the incidence of poverty, and determinants and perceptions of inequality. The Bank should rethink its long-term intra-sectoral commitments, with the aim of supporting poverty alleviation more directly than it had in the past 10 years.

- In the area of governance, the Bank should strengthen its support to the Government in reforming the civil service, improving fiscal/budget transparency, and strengthening of oversight and voice mechanisms. Attention to judicial reform in ESW should be continued. Despite the Bank emphasis on enhancing the transparency and competitiveness of the incentive framework, the Government has not yet shown commitment to undertake fundamental reform in this area. The Bank could sharpen the focus on this issue, which is also important for improving private sector confidence.

22. The Government suggests that working its way out of the crisis will be more difficult for Indonesia than for Thailand or Korea because the debt overhang is dominated by foreign lending to private domestic and foreign-related non-financial companies. This was partly the result of Bank Indonesia's efforts to control foreign borrowing by the banking system.

- The Bank should continue to incorporate the environment and sustainable development in its policy dialogue at the highest levels of decisionmaking. It should recognize the impact of economic policy on Indonesia's natural resource base and environmental conditions: there is a danger of a fire-sale of resources. A monitoring program should be put in place that provides rapid feedback on the state of the environment.

(b) Country Monitoring

- The Bank needs mechanisms on behalf of the Board, to monitor structural performance on a regular basis (similar to the macro monitoring carried out by the IMF in its Article IV). The IMF's monitoring cannot substitute for the Bank's own monitoring activities, including external and internal short-term/long-term debt, financial sector performance, governance, the political environment, social conditions, and vulnerability to external and domestic shocks. The CEMs have not been able to adequately fulfill this role because they have not been sharply focused on this. The Bank's CASs in Indonesia have also not served this function as was evident from the 1997 CAS. But these are both public documents, and therefore need to be supplemented with other structured channels to inform senior management of warning signals. The current efforts to develop such a system warrants top priority. Monitoring should inform contingency plans. Effective monitoring also implies major changes in the Bank's internal culture. The rosy perceptions of Indonesia's performance were not shared by all. Yet warning signals were either ignored or played down by senior managers in their effort to maintain the country relationship. Some Bank staff feared the potential negative impact on their career opportunities that might result from challenging mainstream Regional thinking. If the Bank is to become a true "knowledge Bank," it is essential to foster an open dialogue for staff at all levels.

(c) Country Relationship

- In all of the above, Bank strategy should look at the importance of the issues to the country's development, and not at whether the country relationship may be jeopardized. Partnership should not mean that the Bank cannot address structural issues of great relevance to the country's well-being. In addition, there must be clarity and uniformity in expressing the Bank's position on these issues to senior government officials. A mixture of consistent praise by some staff with strong warnings about pressing issues by others is unlikely to prompt action on the latter.

(d) Further Study

- This report suggests that the Bank needs to address key questions that have arisen as a consequence of the crisis, not only in Indonesia, but in other countries as well. First, what is the role of the Bank in crisis situations? The Indonesian review has revealed that there is a need to get clear guidelines on this role. In particular, it is important to clarify the preconditions for using adjustment lending in crisis situations and the instruments needed to sustain engagement on longer-term institutional reforms. Second, what communication mechanisms and incentive structures are needed to allow a frank discussion of issues among staff at all levels? Third, how can the Bank reconcile partnerships with major clients while conveying tough messages?

- OED welcomes the increased attention given to monitoring of progress in the draft CAS report. However, additional work is needed to give more specificity to the proposed indicators.

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Comments Received from the Government

Minister of State
For National Development Planning /
Chairman of National Development Planning Agency
Republic of Indonesia

January 28, 1999

Our Ref. : 451/MK/01/1999

Dr. Dennis De Tray
Country Director, Indonesia
The World Bank
Resident Staff in Indonesia
JSEB Tower 2, Jl. Jend. Sudirman Kav. 52-53
Jakarta 12190

Dear Mr. De Tray,

Thank you very much for sending us a draft copy of the "Country Assistance Report" and for giving us the opportunity to review the draft at this stage. I am pleased to attach our comments and hope that they will prove useful to the Bank as it prepares the final version of the Report.

As noted in our comments, we agree with the purpose of the review and welcome the proposed steps that should allow us to move towards a more productive working arrangement between the Government of Indonesia and the World Bank. What we found most important were OED's thoughts on how the Bank might refocus our partnership in the future. While we may not always agree with OED's analysis of events, its frankness in admitting not only the Bank's own errors but in pointing out areas where OED feels that we have not been doing enough is appreciated. We are confident that if we are to have a productive future partnership, it must be built on candor and on a frank expression of criticisms, no matter how difficult.

In this same spirit of openness, we want to state at the outset that we do not accept some of the analysis in the Report. In particular, we feel that at various times the analysis seems to lack a full understanding of the nature of the crisis and its causes, often excluding relevant insights that can be drawn from analysis carried out by the Bank's own staff. Moreover, some of the conclusions drawn by the Report appear to be premature. In particular, we do not share the conclusion that the Bank's program, as well as the totality of our relations stretching back for more than thirty years, has been only "marginally satisfactory." With the assistance of the Bank, Indonesia managed to achieve a long period of high growth. This provided us with the means and resources to improve the welfare of large parts of our population. Admittedly, the current economic crisis has eroded some of these gains. But by no means do we accept the Report's conclusion that much of the progress achieved over the last thirty years in reducing poverty, in raising literacy, in improving health, and in creating a strong physical infrastructure, has been lost. And while

we recognize that our policies may not always have been optimal and that our institutional infrastructure needs to be strengthened, we do not believe that our policies and institutions were as seriously flawed as described in the Report.

The Report's recommendations that future lending should focus more on poverty alleviation efforts and on improving governance matches our own priorities. However, such efforts must be based on concrete proposals that reflect an awareness of the situation in situ, that are within the Bank's ability help us design and implement, and that are within our ability to effectively operate. Only then can we be sure that the desired objectives will be attained.

Finally, we would add a brief comment about the issue of conditionality. The nature and use of conditionality is a sensitive issue, but one that is touched upon a number of times in the Report. We accept that current conditionality is a cost of the Bank's efforts to assist us under difficult circumstances. But we believe that we are making a good faith effort to work with the Bank, as well as with the IMF and other donors, to develop a recovery and reform program that will be acceptable to a broad cross-section of Indonesian society. For any reform program to succeed, it must be a joint effort that is consistent with the nation's own goals and objectives. Under such conditions, the people of Indonesia will enbrace the program as their own, ensuring that it is effectively implemented and sustained. Such a reform program will lead to a stronger Indonesia and to a renewal of sustainable growth.

Parliament's right to question and modify agreements reached must be respected, and similarly we respect the Bank's right to review their programs pending the outcome of those deliberations. The best partnership, as the Report notes, is one based upon candid criticism and, we would add, combined with deserved praise. Both the criticism and praise should be voiced openly but with respect for each partner's view on how development is best achieved.

In closing, let me thank you again for giving us the opportunity to express our views on this important review. Please do not hesitate to contact me if there is need for further clarification of our position or if you wish to discuss our comments.

Best regards.

Sincerely yours,

BOEDIONO

COUNTRY ASSISTANCE REVIEW*

This attachment contains the Government of Indonesia's comments on the *Country Assistance Review* of January 6, 1999.

The *Country Assistance Review* raises some interesting and thought provoking issues. While we are in agreement with many of the ideas, we feel that the review is somewhat harsh in its assessment of the World Bank's past contribution to Indonesia's economic development. We are also concerned that the basic theme of the Country Assistance Review contains ambiguities that require clarification and that merit more careful analysis.

Our comments, presented in some detail below, fall into three sets. The first set addresses the broader issues raised in the Report, focusing on what we see as the main theme and key messages of the CAR. The next set focuses on more specific issues raised in certain sections of the Report, organized by paragraph. The final set focuses on the conclusions and recommendations in the fourth chapter of the CAR and considers the Report's implications for out future working relationship.

THE MAIN THEME AND KEY MESSAGES OF THE CAR

1. The role of international development agencies

The basic message of the Report, as we understand it, is that the World Bank did not push hard enough for fundamental reform in Indonesia, including the establishment of a democratic political system, free and open elections, a free press, respect for human rights, and broad-based participation of the civil society. In other words, the Bank did not insist on a complete change to the political system as a condition for financial assistance. This message is conveyed in the Evaluation Summary on the opening page, where the Report faults the Bank for not having dealt effectively with "a fragile social situation, major issues of governance and corruption..." and recommends that "A surveillance mechanism for social and governance issues should be instituted to complement macroeconomic monitoring [that] may require more systematic analysis of political developments..." The message is made more explicit in paragraph 3.43 which states:

> *The Consultative Group of Indonesia (CGI) meeting of 1996 was attended by representatives from 29 countries and multilateral agencies but only four asked for promotion of democratization and broad-based participation of the civil society. The CG under the chairmanship of the Bank in other countries (in Africa, e.g.) has been viewed by bilaterals as a valuable opportunity to collectively condition their aid to leverage changes in such areas as a government's electoral policies, human rights practices, and the treatment of the media and civil society organizations, but this was not the case in CGI (paragraph 3.43, page 25).*

From the context, it is clear that the authors of the CAR believe that similar "leveraging" should have been applied to Indonesia, emulating the success in Africa.

**Paragraph numbers in the Government comments may not coincide with those in the report, because the Government comments were made on an earlier draft. The comments have received full consideration in the final version and a number of paragraphs have been rewritten.*

This raises some difficult questions about the proper role of official multilateral lending agencies. The Report appears to take the position that economic development cannot proceed in the absence of political democracy, including free and open elections, a free press, respect for human rights, and broad-based civil participation. It therefore argues that the World Bank should insist on fundamental social and political reform as a condition for assistance. However, the authors of the Report do not make clear what action they feel the World Bank should take in cases where the recipients of development assistance have fundamentally different views about the appropriate social and political institutions for their country. If the client refuses to accept sweeping political reforms as a condition of World Bank assistance, should the assistance continue, with the Bank trying to effect change at the margin using an "evolutionist" strategy, or should the Bank take an "all or nothing" approach? The Report faults past World Bank activity in Indonesia for not having used financial assistance to leverage social and political change, but does not deal with the consequences if such leveraging efforts had failed. By avoiding this obvious issue, the CAR suffers from a fundamental ambiguity in its assessment of the World Bank's role in Indonesia's economic development.

The consequences of a possible termination of Bank activity in Indonesia are not explored. However, the Report makes clear that on important occasions when the Bank did press for fundamental institutional reform, it met insurmountable resistance at the top level of the Indonesian government. The failure of the Bank's Financial Sector Development Project, initiated in 1993 to restructure Indonesia's state banks, is a case in point. The history of that project's failure makes it clear that, although the World Bank was well aware of the fragile condition of Indonesia's banking system and expended great effort in an attempt to resolve the problems, it was prevented from doing so by the unwillingness of top political leaders to approve reforms that would harm certain economic interests. This political reality appears to have been recognized at upper levels of the Bank (see paragraph 3.30) where it was probably also understood that key donor governments did not support open confrontation with Indonesia's political leadership.

Open confrontation between the World Bank and the Government of Indonesia would have been very damaging to investor confidence in Indonesia and would have undermined economic growth, causing poverty to rise. As long as Indonesia was experiencing annual growth rates of 7% - 8% and was projected by all serious analysts to continue to do so for many years to come, it made little sense for the World Bank to openly confront the political leadership over the issue of "good governance." If an open confrontation had taken place, the Bank would have been accused, with good reason, of following a political agenda rather than an economic development agenda.

In addition to not making the consequences of their recommendations clear, the authors of this Report also avoid dealing with the host of complex issues raised by attaching political strings to economic development assistance. The CAR is ambiguous, for example, about whether it believes that the Bank can "do good without doing everything." Can the Bank promote economic development without insisting on total political reform, or is political democracy a prerequisite for economic development? Is an evolutionist approach, in which the Bank pushes for changes at the margin without directly challenging the fundamental weaknesses of the system, doomed to fail? If the authors of the Report genuinely believe that the Bank should have leveraged its aid to insist on electoral reform, a free press, and government transparency, they should clarify whether they believe that this

approach should be applied consistently in all countries, including the Bank's second biggest client in Asia.[1] If, on the other hand, the authors believe that demands for political reform should be made proportional to the ratio of the Bank's assistance to the total amount of funds available to the client government, this should also be made clear.

To the extent that the Report argues that the World Bank should have pushed harder for institutional reform, reform of the civil service, and "clean government," we find the analysis and suggestions reasonable and appropriate. However, the CAR could be interpreted as a call to make economic development assistance conditional on the establishment of a particular social and political model, including a democratic political system, free and open elections, a free press, and respect for human rights. While advice is always welcome, fundamental change must come from within. It is unlikely that developing countries will welcome assistance that comes with onerous political strings, and open confrontation between multilateral lending agencies and host governments over such basic issues as a nation's social and political framework could be counterproductive. There is a danger that blunt "leveraging," while successful in the short term, could spark a nationalist reaction. A more gradual "evolutionist" approach could accomplish more in the long run. Moreover, international development experience is not unambiguous with respect to the relative merits of democratic and authoritarian forms of government. One need only consider the relative success of China and India at combating poverty, or compare Indonesia's accomplishments with the somewhat qualified success in Africa, to see that a host of very complex issues have been swept under the rug in this *Country Assistance Review*.

To summarize, the underlying theme of the Report is that the Bank did not do enough to press for improvements in governance problems. Certainly, the authors of the CAR would agree that such important changes must be mainly the result of local decisions, and while Bank activities can and should encourage improvements, the Report at time seems to suggest that the Bank's role is more central to the process than we would accept. For example, the final phrase in chapter 4.1., on page 27, states "The Bank .. could not get the Government to deal with pervasive governance problems." This phrase, and others on the governance issue, at times appear to blur the line dividing what is the Bank's responsibility and what is the Government's responsibility. The Government of Indonesia recognizes that the Bank can and will play an important role in supporting the improvements in governance that need to take place. Our only concern here is that the CAR, in highlighting problems of the past, may improperly characterize the Bank's role in that process.

2. The Report downplays past success

On a number of occasions the Report appears to go too far in downplaying the successes and overstating the failures of the past. In the Evaluation Summary, for example, the "perspective" offered seems misleading when it says that "much has been gained over

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[1] According to the World Bank's 1997 Annual Report, the countries with the greatest cumulative IBRD and IDA borrowing as of June 30, 1997 were India ($48.8 billion), China ($28.3 billion), and Mexico ($27.3 billion). It would be interesting to know whether the authors of the CAR favor making assistance to China conditional on the establishment of a democratic political system, a free press, electoral reform, and broad-based participation of the civil society.

the past 30 years. All is not lost ..." Stating that "all is not lost" implies that *most* may have been lost. In fact, *most* has not been lost, whether considered in terms of growth in GDP, reduction in poverty, or any other economic or social attainment.

Consider GDP per capita as an example. A balanced assessment would note that even with the 13.7% drop in real GDP in 1998, real GDP per capita measured at constant prices was slightly higher in 1998 than in 1993. Thus, of the 32 years of growth under the New Order regime, no more than five have now been "lost." From a poverty perspective, this suggests that poverty in 1998 was no worse than in 1993.[2] While a few aspects of Indonesia's growth process may have been illusory, the most important were not. The Report, however, falls prey at times to the common temptation to overstate the plight of Indonesia in the midst of the crisis, and even if the intent here is primarily self-criticism, it is important to keep the appraisal on an objective and fair basis.

The Report also goes too far in characterizing the Indonesian economic miracle as a "myth" (paragraph 2.1). The enormous improvement in living standards during the 32 years of the New Order regime, as measured by improvements in caloric intake, life expectancy, infant mortality, literacy, and a host of other indicators, was no myth. Real GDP per capita quadrupled between 1965 and 1996, an accomplishment matched by few other nations and well-deserving of the term "miracle," even though it was in fact the product of enormous human effort.

By asserting that Indonesia's economic miracle was a myth, while simultaneously highlighting the economic flaws existing prior to the onset of the crisis, the document implies that the susceptibility of the Indonesian economy to contagion effects, and the much greater severity of the crisis in Indonesia than elsewhere in the region, was due to internal weaknesses which should have been foreseen and prevented by the Bank. Challenging the notion that Indonesia ever was an economic miracle suggests that it may in fact have been an economic house of cards that was bound to collapse under the slightest breeze.

Internal weaknesses may be the primary cause of Indonesia's current economic crisis, but given that the causes of economic crises are still poorly understood and hotly debated, the World Bank might want to at least consider other possible explanations. In particular, consideration might be given to the possibility that the current crisis was essentially a bad accident. Most of the weaknesses identified in the Report had existed for many years and yet Indonesia had recorded thirty years of unprecedented economic growth. It is difficult to believe that this thirty-year record was an accident. In fact, the East Asian economic crisis may be similar, in some respects, to the Great Depression in the United States. As a well known American economist recently pointed out, "Most modern economists - to the extent that they think about it at all - regard the Great Depression as a gratuitous, unnecessary tragedy"[3] (but a tragedy which ushered in twelve years of economic stagnation and misery).

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[2] The fact that real per capita income was slightly higher in 1998 than in 1993 means that the Indonesian economy produced more goods and services per person in 1998 than it had in 1993. Given this fact, the only way that poverty in 1998 could have been higher than in 1993 is if the distribution of those goods and services across the population worsened. In fact, preliminary results from the recent UI/RAND Indonesian Family Life Survey, analyzed for the World Bank, indicate that between 1997 and 1998, expenditure at the upper end of the spending distribution dropped far more than in the middle of the distribution. This strongly suggests that the distribution of expenditure, which is the basis for measuring poverty, improved between 1997 and 1998.

[3] Paul Krugman, "The Return of Depression Economics," Foreign Affairs, January/February 1999, page 57.

It would go against the tide of popular opinion to characterize Indonesia's current economic crisis as "a gratuitous tragedy," but if the Indonesian economy had not been hit by an enormous external shock in mid-1997 who is to say that it could not have experienced another ten or fifteen years of rapid growth, despite its many shortcomings? Continued strong economic growth would have made the inevitable political transition much easier, allowing many of the weaknesses identified in the Report to have been gradually overcome. The World Bank's "accommodationist" strategy would then have received a much more favorable review. Thus, the implication in the CAR that Indonesia's current economic difficulty was primarily caused by long-standing internal weaknesses in the economy - by Asian "crony capitalism," if you will - is not a balanced assessment. Although it is now clear that the Indonesian *political* system was extremely fragile prior to the outbreak of the crisis, the Indonesian *economy* was no house of cards and the real economy has in fact proved remarkably resilient in the face of the external onslaught to which it has been subjected.

3. **A "marginally satisfactory" rating is excessively harsh.**

The CAR, like the IMF's recent assessment on Indonesia, Thailand and Korea, catalogues the places where the authors of the Report feel that the World Bank or the Government of Indonesia did not perform as it should have. There is nothing wrong with this; constructive introspection and criticism is always useful. However, Indonesia's social and economic crisis is a very complex story. We are concerned by the assessment that the Bank's performance in Indonesia was only "marginally satisfactory;" which appears in the Executive Summary and again in the Conclusion (paragraph 4.2).

This seems like a particularly hash judgement and one that reflects an abrupt turn-around from literally decades of consistently positive assessments by both the Bank and the GOI. The Bank is, of course, entitled to award itself any grade that it sees fit, but the extensive involvement of the World Bank in Indonesia's development will lead many to interpret the Bank's grade as our grade, as well. The argument in the CAR appears to be that the GOI and the Bank not only failed in our response to the crisis once it had hit, but that our mutual failure was far more deep rooted, going back decades. The review argues that fundamental problems with an ailing banking system, social fragility, and governance were responsible for the excessively poor response to the crisis in Indonesia. This is not the place to debate what triggered the crisis nor what has prolonged it or made it so deep. The Government urges, however, that a broader and deeper perspective be taken in the Report. Indonesia is now at the bottom of a terrible crisis, and as we look around we see problems everywhere. It is difficult to sort out which of these were always problems and which have been created by the crisis itself. The CAR reflects this confusion.

As the Report points out, as late as July 1997 the Bank was awarding Indonesia excellent grades. Per capita income was rising rapidly, as were most social indicators. Although there were areas where we were not achieving progress at the rate we would have liked, even in these areas progress was rapid by regional and developing country standards. The CAR notes that the crisis originated from the contagion effect of events in Thailand. These events in Thailand were anticipated by both Bank staff and government officials who had been watching the situation there for some time. Nevertheless, every review of Indonesian macro-indicators, not just the World Bank's, came away with virtually the same story - that the current account deficit was lower than in Thailand, that the pressure on the

rupiah was to appreciate, that inflation was falling and reserves rising. Even bad debt, a perennial problem in Indonesia (and elsewhere), was generally judged to be declining. Once the crisis hit, the long stability in the rupiah-dollar exchange rate that had led to extensive borrowing in foreign exchange aggravated the crisis, which ultimately spread to the banking system, where it was worsened by the policy mistakes involved in the closure of a number of banks.

We also need to keep in mind that Indonesia was often described as "ground zero" for El Ni o. At the start of the crisis, the drought had been quite severe for a number of months and was adding immensely to people's suffering and to the rate of inflation. Moreover, Indonesia's economic crisis eventually became a political crisis and it is clear that the political system did not respond well, so that problems continued to mount until the crisis was a truly a disaster.

The CAR argues that a different strategy on the part of the Bank, a strategy that *centered* on issues of governance and political reform, would have created an Indonesia better situated to deal with the crisis when it hit. This is far from certain. As mentioned above, a strategy of this type would have met strong resistance at the top level of leadership in Indonesia and could have backfired. In fact, when one of the donors raised many of these same issues, the relationship was severed. This may well have been the choice faced by the World Bank. What progress would Indonesia have made in the past thirty years without Bank assistance, perhaps as an international pariah?

When the economy recovers, even two or three years from now, and moves back to real growth at or above 5% per annum, Indonesia will still have a very impressive record of delivering growth, poverty reduction, and social welfare over an extended period.

In sum, we agree that we should have done better in improving governance, and especially in creating political flexibility. But we do not accept that the roads, schools and hospitals built, and the people educated, healed and trained, merit a "marginally satisfactory" rating. Further, we believe that the reform program we are building together will, over time, deliver exactly what has been missing and will allow us to build on the foundations created in partnership with the World Bank in the past.

ADDITIONAL COMMENTS ON SPECIFIC PARAGRAPHS

Evaluation Summary, Paragraphs 2-3: In describing the unfolding of the crisis, not a single mention is made of the importance of external events. Although the discussion of domestic developments is accurate, any preliminary depiction needs to at least mention how problems in the region (particularly Thailand, the Philippines and South Korea) contributed to the escalation of the crisis.

Paragraph 1.6 According to the *1997 World Development Report*, the Philippines, Thailand, and many other developing countries use household expenditure to measure inequality, as does Indonesia. This calculation for Indonesia is drawn from the same data set as described for the poverty calculations in Box 1.

Paragraph 1.12 is partly true but implicitly reflects the estimates of the increase in poverty that were being done early in the crisis. Recent bank estimates indicate that in spite of a very severe crisis, poverty has risen from 11% to less than 20%. This does not appear to be consistent with the implicit Bank assumption in this paragraph. Moreover, to say that "aggregate reductions in poverty also masked variations within and across regions" appears to suggest that some areas did not experience poverty reduction. In fact, even the poorest areas saw their poverty rates fall.

Paragraph 1.14: In general, this description of how economic progress did not translate into entirely successful outcomes on some social indicators appears reasonable, but the cross-country comparison in the final sentence seems unnecessary. The list of countries in Table 7 is rather abbreviated, and at least on illiteracy a comparison with Malaysia produces a more positive impression.

Widespread Problems of Governance

This discussion is helpful, and we accept that weakness here undoubtedly contributed to the severity of the crisis. Reforms in politics and governance are central to our current effort. We look forward to concrete proposals and programs in this area. It should be noted, however, that many of the criticisms of Indonesia in this section might apply to any developing country with similar levels of education and income.

Paragraph 2.3: The final sentence is unclear. The assertion that "excessive offshore borrowing drove the prices of non-tradables up ..." could be explained better, in particular the relationship between borrowing and reduced competitiveness. The effect on the land and property markets is rather straightforward, but the sentence seems to suggest at least one other non-tradable (perhaps a segment of the labor market?) was affected by this borrowing and resulted in a weaker position for Indonesian industry. Further elucidation of the logic and the evidence would be helpful here.

Chapter 2. The Crisis and the Bank

Paragraphs 2.6 - 2.11: The section labeled "The Crisis" presents an excellent account of the first four-to-five months of the IMF's intense efforts to stabilize the economy, following the approval of the first LOI at the end of October 1997. The section makes clear that the Fund did not impose a tight monetary policy on Indonesia "contrary to the view publicized by the media." Interest rates on the benchmark one-month SBI were lowered from 30% in August 1997 to 22% in mid-September 1997 and were maintained in the range 20%-22% through late March 1998, nearly five months after the first LOI took effect. The Report could also point out that the IMF did not impose a tight fiscal policy either, since the 1% surplus recommended in the first LOI was less than the surplus already being run by the Indonesian government and did not involve any additional spending cuts or tax increases. The major fiscal contraction had already been implemented by the Indonesian Government in September 1997 through *Keppress* 39, long before the IMF was asked for assistance.

This section also makes clear that the closure of the 16 banks on November 1 failed to improve the banking situation in part because "the President's inner circle did not want

the measures to be implemented." The Bank and the Fund should perhaps be faulted for not having made contingency plans in the event of sabotage.

Paragraph 2.8: The next to last sentence in this paragraph states: "On December 22, four of the seven BI's managing directors were fired by the Presidency and replaced by friends of the President's relatives." This sentence implies that four of Bank Indonesia's current managers attained their positions because they were friends of the former President's relatives. This should be substantiated.

Paragraph 2.11: The chronology given here for rice prices suggests that the drought was responsible for rapidly rising rice prices. In fact, the drought was long over and the main harvest for 1998 was late, but not devastated by the drought, by the time that prices escalated as described in this paragraph. At this time, food experts generally believe that the price patterns reflected more the market's effort to equilibrate domestic rice prices with world prices, which were out of line because of prolonged weakness of the rupiah, rather than drought or real supply issues.

Paragraph 2.15 – The suggestion that future lending programs should always have some quick disbursing programs available is a good one and should be followed up.

Paragraph 2.17 – Was there really a prediction of a smooth political transition on the part of the Bank or the Government, if so where?

Paragraph 2.21 – This seems unnecessarily harsh. In December 1997 the crisis was looking to be very severe and appeared to be driven by private sector capital flight. Getting foreign exchange into the system while filling a massive fiscal deficit dominated the analysis.

Paragraph 2.27 – The backlog in the portfolio is also, in part, due to excessive optimism on the part of World Bank on individual loan disbursements. The response under the CPPR was quite effective on the part of the Bank and the GOI.

Paragraph 3.2 – The Government does not accept the CAR's characterization that declining lending on the part of the Bank was due to poor preparation and a lack of commitment to a portfolio review. This is a period when the Bank's portfolio was changing rapidly and moving to smaller, more diversified projects, while at the same time it was at or close to its country limit in lending to Indonesia. The reason for this slowdown is more complex than indicated.

Paragraph 3.10 – This does not seem to be a fair reading of the record. The dialogue between the Bank and the GOI did succeed in pushing reforms, and virtually every year reforms were put in place that successively opened the economy to increasing competition as described in paragraphs 3.25 and 3.26.

Paragraph 3.31: The self-recriminations on poverty analysis seem particularly unwarranted. To our knowledge, no other country has received the same amount of scrutiny regarding the changing conditions of its poor population than Indonesia, and much of the best work has been done by Bank staff. To say that more *could* have been done is undoubtedly true, but all resources have an opportunity cost, and the amount of time and other resources that were spent on poverty research in Indonesia seemed more than adequate at the time. It seems

unfair to look back now with perfect hindsight and say that more *should* have been done. Moreover, experimentation with subjective poverty lines, while definitely of academic interest, would seem to have little practical value in the context of a crisis. Is such work being done elsewhere that would allow for a cross-country comparison of relative subjective changes? If not, it is unclear how the quantification of subjective changes in status would help improve the formulation of crisis mitigation strategies.

CONCLUSIONS AND RECOMMENDATIONS

This section contains general comments about the conclusions and recommendations in the CAR, which will undoubtedly influence the Bank's thinking about where we need to go next.

Paragraph 4.1: We agree that the crisis revealed short-comings in the Indonesian institutional structure and especially the financial system. However, we do not feel the Report gives sufficient credit to attempts by Bank Indonesia to control the flow of foreign funds into the banking sector. In fact, one of the ways the crisis in Indonesia differs from that in Thailand or Korea is in the nature of the foreign debt overhang. The debt overhang in Indonesia is dominated by foreign lending to private domestic and foreign-related non-financial companies. This was partly the result of Bank Indonesia's efforts to control foreign borrowing by the banking system, but it has subsequently made working our way out of the crisis more difficult.

Many of the social sector concerns raised in the CAR have been exacerbated by the crisis and present a problem in determining what is cause and what is effect. For example, the CAR points to areas where Indonesia lags behind its GDP per capita expected levels, according to UNDP criteria. Indonesia's extremely rapid growth in recent years would have made it almost impossible to keep growth in many of these indicators (acknowledged to be high in the CAR) in line with the growth in our per capita income.

Paragraph 4.2: We have already commented on the CAR's "marginally satisfactory" rating.

Paragraph 4.3: We agree with the need for a comprehensive strategy for the medium-term to deal with structural weaknesses. However, the Bank needs to be realistic. Institutions in Indonesia are set into a matrix of existing infrastructure, both physical and human, and there are numerous and complex constraints on our ability to change as fast as we might like. Further, there are and will continue to be political and social constraints, as well. All in all, we need to be careful, and to learn from the recent experience about our ability to implement reform programs. Thus, we need to choose our priorities well and consider the sequencing carefully.

a) Structural Reform

- Clearly, solving and funding the solution for banking sector problems is now at the center of our recovery effort, and we await comment.

- We agree with the focus on poverty, but this paragraph may reflect bank thinking prior to the most recent research presented at the January Interim CGI indicating

that poverty levels may have been significantly overestimated post-crisis. It is important in both commenting now and designing programs later to maintain perspective on the magnitude of the crisis.

- Again we agree with the Bank recommendation that there should be a stronger focus on governance and legal development. However, we do not agree that there is a difference of opinion between the Bank and the government about undertaking fundamental reform in the areas of transparency and competitiveness. In many areas (e.g., the budget), we have already taken great strides to make more and better information available and to bring off-budget items on budget. We are moving to pass laws in many areas to enhance competition. These laws are now in process in Parliament and we have to accept the political process and the compromises it brings.

- The government agrees that we have to keep our focus on environmental issues and to avoid a "fire sale" of resources during the crisis. Further we believe that we have been taking steps in line with our beliefs in these areas.

b) Country Monitoring

The kind of monitoring indicated is not without cost, especially in terms of senior management time. Thus the Government would like to understand better from the Bank the nature of the monitoring they propose and its expected benefits. We need to be very careful in proposing an additional vehicle to the existing CEM and CAS at a time when senior management time is very scarce.

c) Country relationship

- It is worrisome to read in this paragraph that the authors of the CAR would like bank officials to take clear and uniform positions and to avoid "mixing constant praise with strong warnings". This is unlikely to reflect complexities on the ground. High growth, declining poverty and improving social indicators could not have been ignored without the Bank losing credibility, and we anticipate that this will once again be the situation in the future.

- The GOI accepts that the Bank has the responsibility to safeguard the funds that have been put in its safekeeping for lending. However, the GOI should be fully involved in assessing issues that relate to national development. We believe that the best system for partners is one of open and frank praise and criticism, where warranted.

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

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February 4, 1999

His Excellency Mr. Boediono
Minister of State for National Development Planning/
Chairman of National Development Planning Agency
Republic of Indonesia

Your Excellency:

Indonesia: Country Assistance Note

We thank you for your perceptive comments and we appreciate your endorsement of OED's recommendations that future Bank operations should focus more on poverty alleviation and on improved governance. We also welcome the Government's view that partnership implies candid criticism combined with deserved praise. The final report has given full consideration to your concerns. Key comments (in italics) and our response are shown below.

Conditionality and good governance: OED agrees that responsibility for good governance lies with the borrower. The report does not support "open confrontation" between the Bank and its borrowers. Such issues are best dealt with in a spirit of partnership. However, the Bank is mandated to provide objective advice on critical development issues. Prior to the crisis, some of the Bank's messages to Indonesia lacked coherence and clarity. While some managers were willing to discuss the main issues, others tended to downplay them. In this context, we appreciate that the Government recognizes that the Bank could have pushed harder for institutional reform, reform of the civil service and "clean government." We would like to emphasize that the report is not recommending political conditionality. The text has been revised as the earlier phrasing may have conveyed the wrong impression.

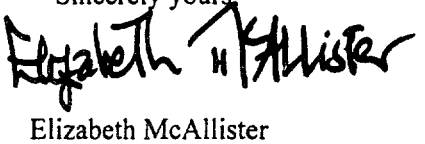
Much or most of the progress has not been lost: While the crisis has undoubtedly eroded some gains, we would not like to convey the impression that all or even most of the gains have been lost. Indonesia's strong performance has been noted up front in Chapter 1, and Chapter 3 documents the success of Bank assistance, along with the failures. Chapter 2 notes that the crisis has had a greater impact on the urban than the rural areas.

Lack of full understanding of the nature and causes of the crisis: The report was not intended to provide a definitive account of the nature of the crisis, its causes or its management. OED's main purpose was to evaluate Bank performance up until the crisis. The Memorandum to the Executive Directors explicitly states that the timing and the severity of the crisis could not have been predicted but that the Bank could have been better prepared.

Marginally satisfactory rating: Both the Government's and the Bank's performance during the first 20 years of the relationship was fully satisfactory. The marginally satisfactory performance rating refers to outcome and performance in the past decade, that is the period up until the crisis, as is now made clear in the report. The basis for this rating is: good performance but neglect of some serious structural issues.

Please accept our sincere thanks for the spirit of cooperation and partnership reflected in your comments.

Sincerely yours,



Elizabeth McAllister
Acting Director-General
Operations Evaluation

cc: Mr. Dennis de Tray, Country Director for Indonesia, World Bank

Statistical Appendix

Table 1: Indonesia - Economic and Financial Indicators, 1992/93-1998/99[1]

Nominal GDP(1997):	$211 billion
Population (1997):	202 million
GDP per capita (1997):	US$ 1,047

	1992/93	*1993/94*	*1994/95*	*1995/96*	*1996/97*	*1997/98 (Est)*	*1998/99 (Program)*
Macroeconomic Indicators			**Increase in percentage per year**				
Real GDP Growth	7.2	7.3	7.5	8.2	8.0	4.6	-15.0
CPI Inflation[2]	5.0	10.2	8.9	9.0	6.6	11.6	80.0
Credit to the private sector	10.9	25.3	23.8	21.5	23.8	14.1	15.9
Broad money	22.2	20.8	22.1	28.0	26.7	10.4	20.8
Base money			22.0	34.0	16.5	70.8	25.6
Total exports			15.3	13.5	9.2	7.6	-.6.0
Non-oil exports	30.6	9.5	16.4	17.4	5.7	16.2	4.2
Non-oil gas imports	9.7	6.6	20.4	23.4	9.4	-5.0	-13.1
Terms of trade	0.1	-0.2	3.0	0.6	4.6	-1.2	2.6
Savings and Investment[3]				**As percent of GDP**			
National Savings	27.3	27.6	29.3	29.0	28.8	27.3	17.9
Private savings	19.2	20.0	21.6	22.0	21.9	21.7	19.3
Domestic Investment	29.5	29.5	31.1	31.9	32.1	29.1	24.2
Private investment	20.3	21.1	23.4	25.7	26.5	22.5	9.2
Central government operations							
Revenues and grants	16.6	16.5	16.2	14.8	15.1	16.2	15.7
Oil/gas revenue	5.2	3.6	3.4	3.4	3.6	4.6	5.2
Non-oil/gas revenue	11.2	12.7	12.7	11.3	11.4	11.6	10.5
Expenditure and net lending	18.0	17.0	16.0	13.9	13.9	16.9	24.2
Overall balance	-1.3	-0.5	0.2	0.9	1.2	-0.9	-8.5
External current account	-1.6	-1.7	-1.8	-3.2	-3.3	-1.8	1.6
Total external debt	58.9	55.8	56.1	52.6	50.5	98.6	164.0
Balance of payments, reserves and debt				**In US$ billion**			
Current account balance	-2.3	-2.7	-3.3	-6.8	-7.7	-2.5	1.4
Trade balance	5.0	4.2	4.2	1.7	1.3	8.2	14.8
Capital account[5]	1.7	2.0	1.9	10.2	13.8	-10.8	-1.4
Direct Investment	1.7	2.0	2.6	5.4	6.5	1.8	0.5
Overall balance	4.8	0.3	-1.4	3.4	6.1	-13.3	-
Gross official foreign assets	18.3	18.6	17.1	20.6	26.6	16.4	24.1
Total external debt	83.7	89.3	101.2	105.8	112.7	137.9	148.1
Overnight JIBOR rate (percent per annum)[2]			16.0	16.0	16.5	47.1	58.5[4]
Exchange rate (Rupiah/US$)[2]	2,071	2,143	2,276	2,344	2,403	10,200	10,000
Nominal effective exchange rate (1990=100)2	96.1	96.7	86.8	86.5	90.2	25.9	
Real effective exchange rate (1990-100)2	102.7	101.9	94.7	100.5	108.4	35.8	

[1] Fiscal year starts on April 1. [2] End of the period.
[3] National accounts and price data are on calendar year basis (e.g., 1996/97 corresponds to 1996).
[4] As of August 31, 1998. [5] Inclusive of monetary movements of commercial banks and errors and omissions.
Sources: IMF, Art. IV for 1992/93-1993/94 and projections for 1998/99; EBS/98/164 for 1995/96-1996/97 and 1998/98; EBS/98/73 for 1994/95.

Table 2: Signs of Emerging Crisis Appeared Earlier in Thailand than in Indonesia

	Thailand	*Indonesia*	*Months Delay*
Debt Downgrading by Moody	9/96	12/21/97	15
Peak in:			
Stock Market	6/95	7/8/97	24
Manufacturing Activity	9/96	11/97	16
Export (non oil in US$)	10/95	7/97	21
Net foreign reserves	6/96	5/97	11

Table 3: Indonesia's Export Earnings Valued in US$, 1995-97

	1995	*1996*	*1997*
Growth of Total Exports (percent of previous year)	13.3	9.7	7.3
		Percent	
Share by Destination	100	100	100
Asia	64.0	63.6	64.0
(Japan)	(27.1)	(25.9)	(23.3)
(Other)	(36.9)	(37.7)	(40.7)
USA + EU	28.5	28.6	28.0
Other	7.5	7.8	8.0

Source: Derived from Table 3.3 "Indonesia in Crisis" World Bank, 7/9/98.

Table 4: Indonesia: Trends in Poverty Incidence, 1976-96

	Number in millions			*Percent of Population*		
	Urban	*Rural*	*Total*	*Urban*	*Rural*	*Total*
1976	10.0	44.2	54.2	38.8	40.4	40.1
1978	8.3	38.9	47.2	30.8	33.4	33.3
1980	9.5	32.8	42.3	29.0	28.4	28.6
1981	9.3	31.3	40.6	28.1	26.5	26.9
1984	9.3	25.7	35.0	23.1	21.2	21.6
1987	9.7	20.3	30.0	20.1	16.4	17.4
1990	9.4	17.8	27.2	16.8	14.3	15.1
1993	8.7	17.2	25.9	13.5	13.8	13.7
1996	7.2	15.3	22.5	9.7	12.3	11.3

Note: Number of people and percent of population in poverty is in relation to the official poverty line.
Source: Indonesia-Recent Economic Developments, IMF, 1997.

Table 5: Selected Countries: Social Indicators, 1970-96, Latest Single Year

	1970-75	*1980-85*	*1990-96*	*1970-96 (% change)*
Infant Mortality Rate (per '000 live births)				
Indonesia	**114**	**75**	**49**	**57%**
India	132	101	65	51%
Malaysia	42	21	11	74%
Philippines	64	47	37	42%
Thailand	65	41	34	48%
Vietnam	90	49	40	56%
Life Expectancy at birth (yrs)				
Indonesia	**49**	**51**	**65**	**33%**
India	50	52	63	26%
Malaysia	63	63	72	14%
Philippines	58	59	66	14%
Thailand	60	66	69	15%
Vietnam	58	56	68	17%
Adult Illiteracy Rate				
Indonesia	**43**	**28**	**16**	**63%**
India	66	56	48	27%
Malaysia	42	26	16.5	61%
Philippines	17	12	5.4	68%
Thailand	21	9.3	6.2	70%
Vietnam	n.a.	16	6.3	
Fertility Rate				
Indonesia	**5.4**	**3.6**	**2.6**	**52%**
India	5.8	4.4	3.1	47%
Malaysia	5.4	4.1	3.3	39%
Philippines	6.4	4.4	3.6	44%
Thailand	5.5	2.7	1.8	67%
Vietnam	5.9	4.2	3.0	49%

Source: WDI, 1998.

Table 6: Selected Asian Countries: Human Development Index (HDI) and Real GDP Per Capita, 1993

	HDI (1)	*Real GDP Per Capita (2)*	*(2)-(1)*
Hong Kong	22	6	-16
Korea, Republic of	29	39	10
Singapore	34	13	-21
Thailand	52	50	-2
Malaysia	53	45	-8
Philippines	95	102	7
Indonesia	**102**	**88**	**-14**
China	108	110	2
Vietnam	121	147	26
Pakistan	134	118	-16
India	135	141	6
Lao People's Democratic Republic	138	135	-3
Bangladesh	143	139	-4

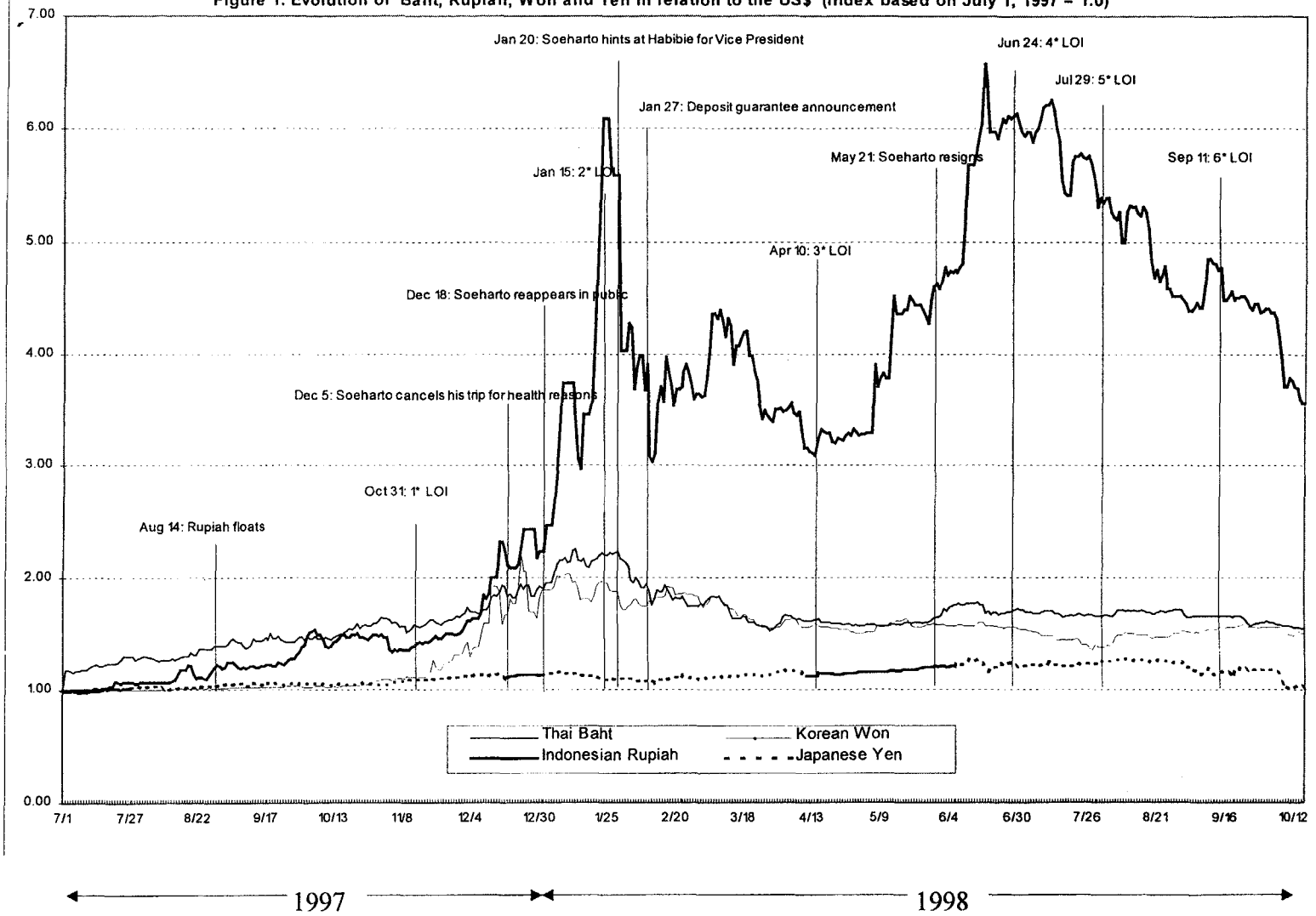
Source: UNDP, *Human Development Report.*

Table 7: Comparative Indicators, 1990s

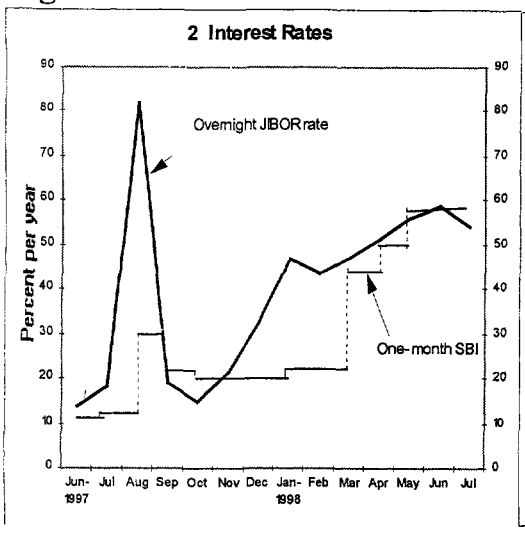
	Illiteracy Rate (% of females 15 and above)	*Maternal Mortality Ratio (per 100,000 Live Births)*
Indonesia	**22 (10.4)**	**390**
India	62 (34.5)	437
Malaysia	22 (10.9)	43
Philippines	6 (5.0)	208
Thailand	8 (4.0)	200
Vietnam	8.8 (3.5)	105

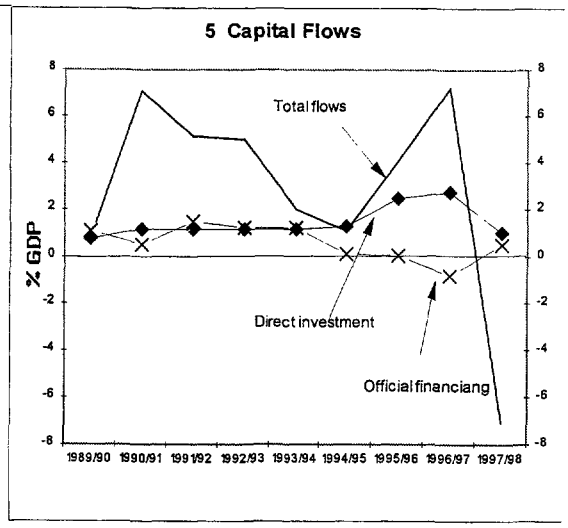
Note: Male illiteracy is in parenthesis in first column.
Source: WDI,19 98.

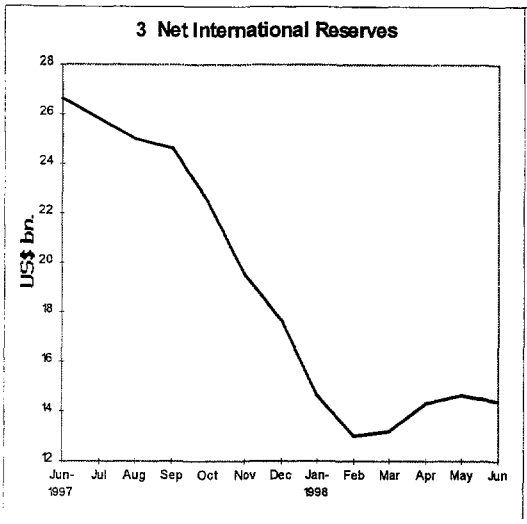
Figure 1: Evolution of Baht, Rupiah, Won and Yen in relation to the US$ (Index based on July 1, 1997 = 1.0)

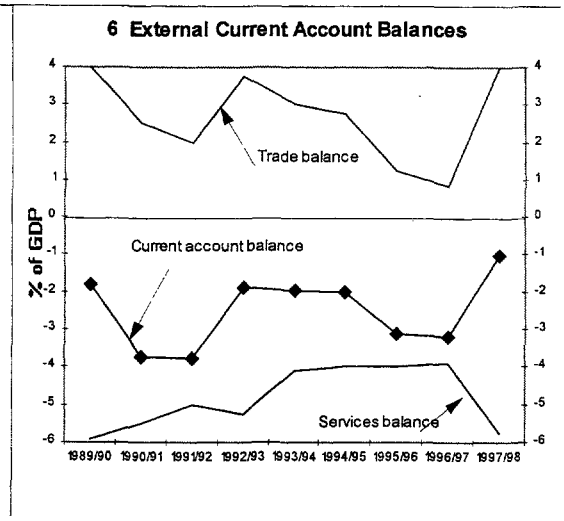


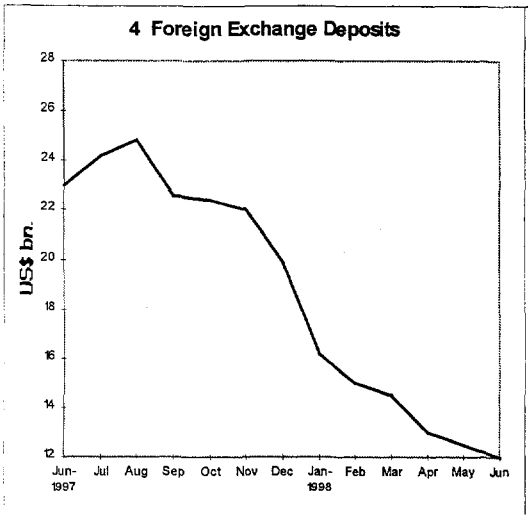
Figures

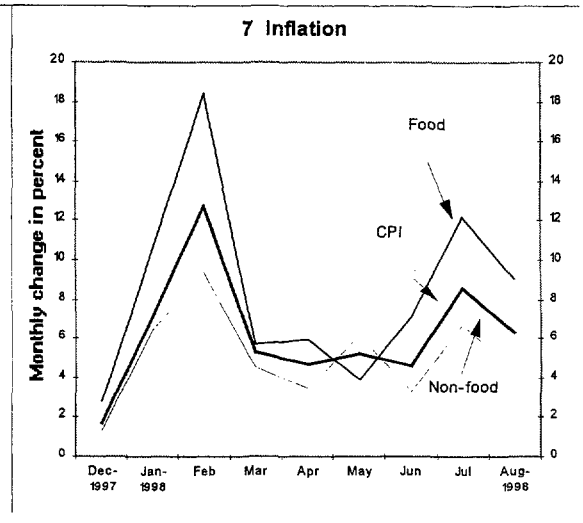

2 Interest Rates
Overnight JIBOR rate
One-month SBI
Percent per year
Jun-1997
Jul
Aug
Sep
Oct
Nov
Dec
Jan-1998
Feb
Mar
Apr
May
Jun
Jul


5 Capital Flows
Total flows
Direct investment
Official financiang
% GDP
1989/90
1990/91
1991/92
1992/93
1993/94
1994/95
1995/96
1996/97
1997/98


3 Net International Reserves
US$ bn.
Jun-1997
Jul
Aug
Sep
Oct
Nov
Dec
Jan-1998
Feb
Mar
Apr
May
Jun


6 External Current Account Balances
Trade balance
Current account balance
Services balance
% of GDP
1989/90
1990/91
1991/92
1992/93
1993/94
1994/95
1995/96
1996/97
1997/98


4 Foreign Exchange Deposits
US$ bn.
Jun-1997
Jul
Aug
Sep
Oct
Nov
Dec
Jan-1998
Feb
Mar
Apr
May
Jun


7 Inflation
Food
CPI
Non-food
Monthly change in percent
Dec-1997
Jan-1998
Feb
Mar
Apr
May
Jun
Jul
Aug-1998

Different Poverty Estimates, But Same Conclusions About Poverty Trends[1]

The accusations that the Bank manipulated its analysis of poverty in Indonesia, particularly the Bank's estimates of the number of poor, are unfounded. The Bank's analytical work on poverty was thorough and subject to considerable public and academic scrutiny. The Bank's preferred method of measuring poverty in Indonesia differed from the Government's. The final version of the Bank's first Poverty Assessment for Indonesia, "Indonesia: Strategy for a Sustained Reduction in Poverty" (World Bank Country Study, 1990) placed primary emphasis on the Government's official estimates of poverty. This decision allowed the Bank to focus its dialogue with the authorities on the key issues of who the poor were and where they were located, rather than on any specific point estimate of the number of the poor.

However, the Bank did not hide its own estimates of poverty, nor was there an attempt to hide the differences between the Bank's numbers and the Government's. The report "Indonesia: Strategy for a Sustained Reduction in Poverty" presents both official estimates and the Bank's own estimates. Table 1.4 (p. 11) gives the Government's estimates of poverty for the 1980s, while Table 1.5 (p. 12) gives the Bank's estimates (and a third estimate based on a method proposed by a prominent Indonesian economist). The methods employed and the reasons for the differences between the two estimates are explained in detail in Annex III of the report, and in subsequent Bank reports and papers. These papers explain why the estimates differ, and why the Bank prefers its own method. The key difference is in the geographic and sectoral structure of poverty (which typically matters far more to policy than the level of the overall poverty rate).[2]

It is true that the Bank's methods yielded a higher incidence of poverty than the Government's (e.g. in 1987, 22 percent versus 17 percent). But both sets of numbers indicated a substantial reduction in poverty during the 1980s. Indeed, the Government's showed a slightly lower proportionate decline than did the Bank's; the official poverty rate declined by 39 percent between 1980 and 1987, while the Bank's numbers indicated a decline of 46 percent (comparing Tables 1.4 and 1.5 of the above report). So the Bank's estimates did not suggest that the Government's claims about falling poverty were "inflated", as has been recently asserted in the press. If anything the opposite was the case.

Finally, it is important to emphasize that the Indonesian Government's statistics office (the Central Bureau of Statistics) has been very open about its poverty data. For example, Indonesia was one of the first developing countries to release publicly the entire raw household level survey data (the "SUSENAS") on which all the Bank's analytical work was based. The survey covered about 50,000 households, with very detailed consumption and other data. These data were made available to the Bank as soon as they had been computerized, and these are the data that have been used in all the Bank's poverty work on Indonesia over the last 10 years.

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1. *Source:* Kyle Peters, Lead Specialist, EASPR.

2. Monika Huppi and Martin Ravallion, "The Sectoral Structure of Poverty During an Adjustment Period: Evidence for Indonesia in the Mid-1980s," *World Development*, Vol. 19, No. 12, pp. 1653-1678, 1991; Indonesia: Public Expenditures, Prices and the Poor, Report No. 11293-IND, The World Bank, August 31, 1993; "Measuring Changes in Poverty: A Methodological Case Study of Indonesia during an Adjustment Period," by Martin Ravallion and Monika Huppi, *The World Bank Economic Review* (Vol. 5, No. 1, 1991); "A Regional Poverty Profile for Indonesia," *Bulletin of Indonesian Economic Studies*, by Benu Bidani and Martin Ravallion, Vol. 28, No. 3, December 1993; and "How Robust is a Poverty Profile?," *The World Bank Economic Review*, Vol. 8, No. 1, pp. 75-102, 1994.

Summary of Good Practices in Institutional Transparency[1]

Overall structure and functions

Clear demarcation of functions between public and private sectors (limit private rent-seeking activities in the public domain by enforcement of conflict-of-interest legislation)

Delineation of the boundaries of the operations of state-owned non-financial enterprises and financial institutions from those of the general government; and provision of information on the costs of quasi-fiscal activities performed by such enterprises and institutions, as well as any financial rescue operations funded by the government.

Clear assignment of responsibilities and resources among national and subnational levels of government (limiting the scope of case-by-case negotiation).

Clear statement of the rationale for, and the extent of, extrabudgetary fund operations.

Establishment of an independent review agency with wide investigative authority over government operations. The agency should be accountable to the legislature and the public at large.

Budget process

Detailed public explanation of fiscal targets and priorities in the draft budget.

Open legislative debate and approval (should be open to public and the outcome published).

Transparent execution and control (should inform the public and the legislature about the budgetary outcome and how it compares with the objective. Should also include open public procurement, contracting, and employment).

Public disclosure of results of performance and financial audits.

Tax treatment

Explicit statutory basis (instead of discretionary tax concessions or negotiated tax liabilities between tax officials and taxpayers).

Clear administrative procedures, information requirements, taxpayers' rights and obligations, and tax officials' code of conduct.

Estimates of tax expenditure budget (that is, revenue foregone because of tax preferences should be an input for the debate of the draft budget).

Financing operations

Disclosure of terms (interest yields and maturity) and sources of government deficit financing.

Specification of policy criteria as well as terms and conditions of government lending decisions (directly or indirectly through financial institutions).

Regulation

Open legislative and administrative process (e.g., hearings, approval).

Clear and simple statutes and implementation.

Estimates of regulatory costs.

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1. *Source:* Kopits, George and Craig Jon (1998). "Transparency in Government Operations," IMF Occasional Paper, 158, January 1998.

Indonesia Portfolio Management[1]

Until recently, all ICB and TA procurement issues were handled exclusively by headquarters. The resident mission had responsibility only for NCBs. Part of ICB and all disbursement is now delegated to the resident mission, under technical guidance and quality control of LOAAS.

Audit compliance has been good, but there was little evaluation of the quality of the audit. Ex-post project reviews generally show satisfactory procedural compliances. There were, however, many cases where the Bank detected glaring irregularities and sanctions—withholding of no-objection letters, misprocurement and cancellations—were taken. There was resistance initially on some cases by task managers concerned about disbursement ratios, legal staff who wanted staff to substantiate their reservations, and by high government officials, who even lodged a complaint with the office of the Indonesia Executive Director on sovereignty grounds. But there is more coherence and determination in the application of sanctions now.

The bulk of attention and actions by the Bank (jointly with GOI) on portfolio management has focused in recent years on the major areas of concern: procurement and technical assistance issues. Accomplishments on the NCB procurement front (both on policy and integrity of NCBs) and ICB documentation were substantial.

New pressures have surfaced as the implementation authority and procurement handling in GOI has shifted to lower government levels (mostly to districts/cities), with weak administrative capability and institutions. The lending scenario also shifted, in response to GOI demands, its decentralization policy and new priorities in Bank lending, away from the traditional infrastructure projects and more towards the social, urban, rural, and environmental sectors. This new generation of projects (which are increasing in the portfolio) generally comprise thousands of minuscule, widely dispersed activities (very small contracts, payments etc.) that are not liable to classical Bank reviews and controls. These loans have different disbursement and flow of funds characteristics from the traditional project. However, project designs are being changed for programmatic loans under sub-national governments in order to engage stakeholders in monitoring/reporting on project performance and results on the ground. The Resident Mission is beefing up its staffing with the addition of one procurement officer.

1. *Source:* EACIF (Portfolio Management & Implementation Unit in the Resident Mission).

Limited Fiscal Options

Indonesia's medium-term fiscal strategy is established in the five year development plan and implemented principally through the annual central government budget. While a series of safeguards helped to preserve financial discipline, the balanced budget rule limited the role of fiscal policy in demand management. Modification of this rule would have improved the effectiveness of fiscal policy.

The balanced budget rule could exaggerate the strength of the central government financial position for two main reasons, making it politically more difficult to tighten policy. First, the budget balance was achieved by including external financing as revenue, in contrast to standard practice. Second, the rule was confined to official budgetary accounts and some government transactions, mainly for investment and net lending purposes, were conducted through extra-budgetary accounts.

Surpluses were only permitted in special circumstances, mainly to build up reserves in periods of unusually high revenue, and to permit prepayment of external debt. Reserves were accumulated in special accounts for use in future years after the first and second oil shocks. More recently, efforts have been made to prepay external obligations so as to improve debt indicators. However, the rule made it difficult to accomplish sizable surpluses and sustain them for a number of years. This was because additional revenue accruing from policy measures, automatically provided scope for new spending initiatives. Moreover, spending could be reduced below budget levels only if revenue was less than expected, although lower foreign borrowing provided scope to cut expenditures during the year (or vice-a-versa as in the current situation).

The constraints on the framework of fiscal policy and excessive reliance on monetary policy as a tool for demand management had become apparent seven years earlier in 1990-91, and an OED audit of the Private Sector Development Loans alluded to the need to modify budgetary procedures.

The Bank's ESW since 1992 has emphasized the role of fiscal policy in demand management in Indonesia but it does not make explicit the fiscal inflexibility associated with the balanced budget rule (although according to the audit the constraints imposed by budgetary procedures were well-known to RSI). The Bank's recommendations for tightening fiscal policy have included, raising non-oil revenues, avoiding off-budget spending, and using revenues from privatization to pre-pay high interest external debt. The Non-tax Revenue Law of April 1997 is a useful step toward broadening the balanced budget rule's coverage by bringing on-budget various non-tax revenue items that were previously excluded. But the Bank could have emphasized modification of the rule to require the achievement of balance as a minimum, allowing surpluses to built up on a consistent basis. This would have helped to promote economic stability in the face of sustained private capital flows. There was evidence that fiscal tightening achieved in the past through Bank's advice had not been sufficient. Earlier in 1990-91 and then in FY94/95. In the latter case comparators with significantly lower inflation at that time had managed to tighten fiscal policy even more.

March 5, 1999

CODE99- 13

Report from CODE

Committee on Development Effectiveness

Indonesia Country Assistance Note

The Committee met on February 19, 1999 to discuss the Indonesia Country Assistance Note (CODE99-6), prepared by the Operations Evaluation Department (OED) together with the Government's and Management's response to the CAN. The Committee welcomed the report and commended the overall package, including the comments by the Government, and by the Region (CODE99-6/1). The Committee noted the unfortunate leak of the Indonesia Country Assistance Review (CAR) in Jakarta, and OED's decision to reclassify the report from a CAR to a CAN, and agreed to take up process issues of CARs and CANs at a separate meeting. The specific circumstances of preparation and unauthorized public disclosure of this CAN will also be pursued separately with Management by CODE, to better understand what occurred and accountabilities in this case. The following issues which emerged from the discussion are summarized as background for the upcoming review of the CAS Progress Report.

- **Assessment of Bank's Performance.** The Committee recognized the Bank's many positive contributions to Indonesia in such sectors as infrastructure, agriculture, education, and population over a period of 30 years, but also noted weaknesses and missed opportunities, especially in areas of banking and financial sector reform, governance and poverty reduction. While members acknowledged that there was little the Bank could have done to prevent the crisis, it was stressed that had the Bank more publicly identified and addressed these weaknesses, the impact of the crisis might have been less severe. However, several speakers commended the Bank's response to the crisis in very challenging circumstances. Most members agreed with OED's conclusion that the Bank's contribution in Indonesia over the decade leading up to the crisis overall has only been marginally satisfactory, despite accomplishments acknowledged in the CAN. Some found this conclusion overly harsh.

- **Bank/Government of Indonesia (GOI) Partnership.** Several members stressed the complexities of the Bank/GOI relationship and noted the tension between respecting country "ownership" and the need for transparency and "calling it as it is". They stressed the central role of the CAS and the need for the CAS to be transparent about risks and candid about the critical trade-offs in managing the, partnership. Some members subscribed to the view that the Bank should have cut Bank lending when the GOI failed to follow the Bank's policy advice.

- **Country Monitoring.** The Committee noted and encouraged the recent ad hoc Management practice of briefing the Board on country conditions, but some members indicated that the structure needs to be strengthened whereby staff would regularly inform Management of the risks and evolving situations in countries, and in turn Management would apprise the Board of significant country developments. However, one member emphasized caution in turning the Bank into a "quasi-surveillance" body.

- **Bank Response to Crisis.** The Committee discussed the Bank's response to the crisis in Indonesia. It stressed the importance of portfolio restructuring. It also agreed on the need to further review Bank lending instruments used in response to such crisis situations.

- **Internal Culture and Staffing.** The Committee expressed serious concern about the CAN's sense that staff may have felt inhibited in raising governance and other concerns regarding the Bank's engagement with Indonesia. In response, the Region stressed its present efforts to ensure an open communications culture, although noting that more needs to be done. Staff should be able to be critical without fear of retribution. Staff also need guidance and support from Management in dealing with sensitive issues in client countries. With these changes, staff would be able to address structural issues and contribute to the quality of the Bank's relationship with the country. Another area of concern to the Committee was the way in which the Bank's 1997 reorganization led to a lack of staff continuity and institutional memory at a critical time, with no resilient arrangements to ensure continuity in operational work.

Jan Piercy
Chairperson

Comments by the East Asia and Pacific Region on the Indonesia Country Assistance Note*

I. Introduction

Between 1970-1996, the Indonesian economy sustained rapid growth which saw a decline in the share of those living in poverty from 60 percent in 1970 to 11 percent in 1996. Starting in 1997, one of the perceived great success stories of post-war development has also experienced one of the most profound economic downturns, with GDP declining by 13 percent in 1998, and little prospect for immediate recovery. The economic decline has been accompanied by profound social and political changes whose impacts cannot yet be foreseen.

The speed, scale, and severity of Indonesia's economic crisis defied prediction.[1]. Where did Indonesia go wrong? Where did the Bank go wrong? What are the lessons? These are questions that the Bank needs to study with diligence and deliberation, and we welcome the CAN as a useful first step in this regard.

At this stage, two messages seem clear. First, Indonesia's crisis was not principally a crisis of bad macroeconomic management. For three decades Indonesia's policymakers followed conventional wisdom -- ensure a stable economy, invest in human resources, especially basic education, develop according to comparative advantage, stay competitive by keeping borders reasonably open -- and it paid high dividends. The great failure was a failure of microeconomic, financial sector, and governance policies. The causes of the crisis included the rapid build-up of short term, unhedged private external debt combined with shortcomings in the banking system. Second, the many successes of Soeharto's government, coupled with a lack of public debate, fueled an internal complacency that led to its demise. Good news pre-empted bad news. The authorities were deaf to proposals for serious institutional and political reform. Critics were rebuffed. Nobody seemed able to argue with a sustained seven percent growth, including the Bank which had difficulty making some of its tougher policy advice heard.

In successive country reports, meetings of the Consultative Group on Indonesia, and policy discussions, the Bank was at once congratulatory on Indonesia's macroeconomic progress and increasingly cautionary over the gathering risks -- a weak banking system, growing inefficiencies in the economy created by high-level government interference, and increased borrowing abroad by corporations. Where we failed was in not pushing harder the message that sustainable development requires not only good economic policies, but good institutions and governance as well. When the regional crisis

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[1] A recent study of the predictability of economic crises ("Economic Crisis: Evidence and Insights from East Asia", Furman and Stiglitz, November 1998) shows Indonesia as having the largest gap of any East Asian country between the predicted likelihood of economic crisis as defined by what we knew in the first half of 1997 and the actual outcome of the crisis. Indeed, all East Asian countries except the Philippines scored low in terms of prospects for crisis, but Indonesia was in a class by itself.

**Distributed to CODE as CODE99-6/1 dated February 17, 1999.*

hit, Indonesia's weak institutions were simply not capable of responding quickly and effectively enough to assure investors of the country's ability to weather the crisis.

We now recognize that the Bank should have been more assertive in its policy dialogue with Government in some areas. Our failure was best highlighted in the financial sector. The Bank conducted a continuous policy dialogue with Government on financial sector issues alongside a series of lending operations that began in the mid-1980s. By the mid-1990s, however, the final loan in that series, the Financial Sector Development Project (approved in FY93), had run into serious difficulties. It was poorly implemented, lacked government commitment, and was cancelled only after long delay. Earlier cancellation might well have sent a stronger signal.

On governance and corruption, the Bank often raised concerns at the highest levels. But in public statements it often diluted the message by euphemisms such as "high-cost economy," "leakage," and "inadequate accounting." Government and Indonesian civil society understood our meaning clearly, but it was not until the 1997 CEM and CGI meeting that "corruption" entered our explicit public vocabulary. We should have done that sooner.

During the past 18 months, we have undertaken a comprehensive review and adjustment of all aspects of our Indonesia program, while undertaking a major reorganization as part of the Bank's process of institutional renewal. Fast breaking economic and political developments, uncertain country conditions, and the depth, severity, and complexity of the crisis have tested our Indonesian team. During the May, 1998 riots leading to the overthrow of Soeharto, the Bank's Jakarta office was closed and staff were evacuated. A mere ten days later, staff were once again intensely involved in assisting the new cabinet with containing the economic fallout and developing the reform program.

It is clear that things went very wrong in 1997, and it is equally clear that the Bank, in company with virtually the whole of the rest of the world, did not adequately predict the onset of the crisis. Four clear lessons are emerging which are guiding our current strategy in Indonesia. (The Executive Directors will have further opportunities to review the Bank's response in the upcoming discussions on the CAS Progress Report.) We will need to pay special attention to: (i) an effective early warning system that measures and monitors key, known triggers of economic crises, including the financial health of banks and corporations; (ii) good governance and transparency in the private sector and government, including the strengthening of oversight and voice mechanisms; (iii) absorbing political, institutional, and social dimensions more fully into our country assessments (but keeping within the boundaries set by the Bank's Articles) and supporting poverty alleviation programs more directly than before; and (iv) ensuring greater clarity, coherence, and integrity in the messages we give government and markets.

Our remarks on the CAN are divided into two sections—some comments on the CAN's conclusions and recommendations and an Annex which contains further detailed comments on the text.

II. The CAN's Conclusions and Recommendations

The Indonesia Country Assistance Note (CAN) attempts to analyze the Bank's performance over the last three decades in Indonesia. The preamble to the document notes that it is still too soon to discuss the Bank's crisis management performance in Indonesia and elsewhere.[2] In this section we focus on the conclusions and recommendations in Chapter 4. The headings below reflect the CAN headings in that Chapter.

OED rates the Government and Bank performance over the previous two decades as fully satisfactory, and over the last decade as marginally satisfactory on the ground that issues of poor governance, social stress and a weak financial sector were not adequately addressed. We agree that with hindsight these should have received more attention, and the linkages between good governance, a strong financial sector and sustained development are now clearer that they were even a decade ago. However, it also has to be recognized that Indonesia achieved 30 years of sustained growth with these conditions largely absent. On average, GDP growth was even higher in the last ten years than during the previous decade, and, as was noted in the Government response to the draft CAR, of the 32 years of growth under the New Order regime, no more than five have now been "lost".

Understanding the precise triggers of the crisis will keep academic institutions busy for some time to come. As the CAN notes, the Bank could not have prevented the crisis. Nor is it by any means certain that greater attention to the above issues would necessarily have improved our capacity to predict it. As was noted in footnote 1, recent research suggests that we do not yet have the tools to make these predictions. In a recent paper[3] Sachs and Radelet also support this view: "*a final and humbling lesson from the Asian predicament is that the world simply does not understand financial crisis very well. This crisis was almost completely unpredicted, even after all the research and commentary that followed the Mexico/Argentina crisis of 1994/95...The rapid development of new financial instruments, such as hedge funds, complicate the situation, since there is only a basic understanding of the magnitude and systemic risks of such transactions....Unfortunately, financial crisis in emerging markets are likely to be a recurring phenomena in coming years, the only questions being where and when.*"

Indeed, Sachs and Radelet address only the difficulties of predicting crisis triggers in the financial sector. Other triggers may come from social and political upheaval and even from events in neighboring countries or far away regions. Predicting the next financial/social crisis will require simultaneous surveillance of the political, social,

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[2] Paragraphs 2.6 to 2.25, however, focus on the Bank's policy during the second semester of 1997 and first semester of 1998, the height of the crisis.

[3] "*Next Steps in the Asian Financial Crisis*". Partially sponsored by the Office of Emerging Markets, Economic Growth Center, Bureau for Global Programs, Field Support and Research, U.S. Agency for International Development under the Consulting Assistance on Economic Reform (CAER) II Project

financial and economic issues in the financial centers of the world, in the paddy fields and the capital of the country and its neighbors. This is not an easy task.

Structural Reforms

We agree that a concerted effort be made to restore banking sector soundness. Single tranche loans would certainly not be appropriate vehicles for supporting major institutional reforms if used alone. However the PSRL approved in July 1997 (which had a number of policy objectives, including increasing the efficiency and transparency of public sector operations, improving governance and shielding poor and vulnerable groups by providing budgetary support) was supported by a TA loan for the banking sector approved in December 1997. The CAN notes that the PSRL single tranche mechanism was a poor vehicle for implementing and monitoring broad based institutional reform. In fact, the PSRL was seen as the first of a series of single tranche SALs designed to give us the necessary flexibility to face a very fluid regional and local situation, for which two-tranche operations were seen as inappropriate. Since the PSRL was approved, new instruments such as the PSAL have become available to allow the Bank to respond more flexibly to such situations.

In addition, the Bank has been providing extensive technical assistance and the government has also received TA from the IMF, ADB and bilateral donors. By the end of FY99 we expect to have used over $1.2m of our own resources ($380K in FY98) provided by the Special Financial Unit (SFU) and EAP to assist the Indonesian Banking system. Progress has been predictably slow, as entirely new institutions are being constructed during a time of political uncertainty, and the Bank has had to build its expertise in this area virtually from scratch.

We also agree with the recommendation to focus on poverty issues. We completed a major poverty sector report in FY98; brought a HQ senior staff member to RSI in early late FY98 to focus on social policy and poverty and created the SMERU social impact monitoring and response team in early FY99. We have also produced at least two influential papers on social impacts, one for the July CGI and one for the Interim CGI which took place in Jakarta in February, 1999.

We also have no disagreements with the recommendations on governance and environment. Our strategy on governance in particular is to lay the groundwork through adjustment lending and ESW for a concerted and long-term effort with the new government which will assume power after the June elections. A major mission in September, 1998, with a follow up mission this month has started work on civil service reform. In addition, we have also made progress on fiscal/budget transparency. For example, the Reforestation Fund is now on budget. Lack of agreement on this reform in the early 1990s led us to cancel all work and lending in the forestry sector. Similarly, the abolition of various cartels under the PSRL will improved governance.

Country Monitoring

EAP regional management is vigorously promoting the knowledge culture and an open atmosphere where staff are able to challenge accepted wisdom. New Bank instruments such as the Social and Structural Policy reviews are now being introduced into the region to provide better surveillance mechanisms. The proposed Comprehensive Development Framework will also provide new opportunities for better surveillance alongside our development partners. But as we noted above, no one should be complacent about the challenges ahead, particularly in Indonesia.

Country Relationship

The CAN raises important issues and questions concerning the role of the Bank in addressing sensitive issues. We agree with the general thrust of the recommendation, but suggest that the issue is perhaps more complex than the authors suggest. At the heart of the problem lies the difficulty of gaining the attention of a government which had consistently achieved high levels of growth over many years, where our message was competing with that of investors only too willing to participate in the success story.

The CAN suggests that developing structured channels for informing senior management of country risks is a priority, and we do not disagree. At the same time, the CAN notes the need to highlight risks and provide tough messages to the authorities when warranted. We agree, but suggest that in the open environment in which the Bank now operates, certain questions need to be answered up front. How willing would the authorities be to share sensitive information under these circumstances? Would the Bank be blamed when the crisis occurred, if and when sensitive information reaches the press? Should we reduce our assistance program and our presence when our messages go unheeded? If so, what would be the likely outcome in terms of our capacity to deliver the tough messages? How would we then be positioned to help when the crisis hits? In other words, how do we maintain our leverage in good times?

Annex 1

DETAILED COMMENTS ON THE CAN

In paragraph 2.2, the report states that in the two years before the crisis, the economy overheated. The problem was in fact that the Indonesian economy did not show signs of overheating relative to other East Asian countries, and this made our macroeconomic policy dialogue with the GOI difficult and less effective than it might have been during this period.

In the discussion of the emerging crisis (paras. 2.6-2.25) the CAN notes correctly that the July 1997 CAS gave an upbeat assessment of the economy. However, there was a serious discussion between the government, the Bank and the donors at the CG meeting in Tokyo in July 1997 of the risks facing the Indonesian economy. Moreover, the Bank's country director in Jakarta played a very active role in the policy dialogue with the government which resulted in the Government seeking IMF assistance. The CAN does not recognize the major behind-the-scenes discussion which took place from the onset of the crisis.

Contrary to the view expressed in the CAN that we were too lenient on the government, the Bank resisted considerable pressure to move quickly into adjustment lending. The first adjustment loan (PSRL) was only approved by the Board in July, 1998, one year after the crisis began. Para. 2.21 leaves the false impression that the PSRL was simply developed to meet a "Bank commitment to deliver funding". In late 1997 it was anticipated that there would be two adjustment operations during the first half of 1998 -- a financial sector SECAL, and a SAL. Financial sector reform had fallen short of being truly comprehensive and aggressive, and it was therefore decided in early 1998 not to proceed with the financial sector SECAL.

However, there had been sufficient progress on financial sector reform for this to be recognized in the PRSL. The PRSL was developed: (a) to support what was widely recognized as substantial structural reforms (e.g. clove and plywood monopolies, national car, broadening import tax reform, reducing export taxes, BULOG reforms, palm oil financial sector etc); and (b) to provide much needed budget support. It is important to recognize that without this budget support, the government would have been forced to either curtain social programs further (thereby exacerbating poverty) or risk inflationary pressures by resorting to domestic financing.

The last sentence of paragraph 3.24 concerning Bank-NGO relations is somewhat misleading. During the 1980s and early 1990s the authorities were not entirely monolithic with respect to NGOs. We had some good NGO relations even in the 1970s, mostly in rural and urban development. By the early 1990s we were pushing for NGO engagement in a number of fields, not only environment, and some key GOI officials responded favorably. Our NGO Flagship effort got some good results and when we did have to make concessions on the involvement of NGOs, it was usually at the request of NGOs themselves.

Paragraph 3.29 seems to imply that ESW in the financial sector was shelved during the years preceding the crisis. Major reports, however, were released between 1994 and 1997, including: Non-Bank Financial Sector Study (1994); Bond Market Study (1995); and Pension Study (1996).

The CAN implies (para. 3.34) that the Region did not adequately support primary education before the crisis. In fact, basic education (primary and junior secondary) was the major focus of our assistance after the issuance of the 1989 Basic Education Report. This led to a major operation in 1991, and many follow up projects (primary school teachers, books and reading, the major series of junior HS projects), three major Junior Secondary Education projects, and finally, the West Java Basic Education project. All these projects started well before the crisis. The refocusing of the pipeline referred to in the CAN was a shift within projects and between categories so that we could provide fast disbursing assistance to poor families. The only important change to our work in the education sector concerns our lending in the university sector, which was slowed post-crisis. In fact it was precisely because our assistance program was well focused on basic education that we could respond so rapidly after the crisis occurred.

Para. 3.35 perhaps implies too strongly that (a) the CAS and CEMs are the only, or even the most important means for delivering messages on investment and priorities and (b) such messages would have been more effective if the CAS matrix had contained fewer and better prioritized recommendations.

We would argue that we raised issues with the Government and advised on priorities using a variety of instruments. For example, in the power sector, we started to flag mounting concerns about over-investment in generation and bottlenecks in transmission and distribution in early 1994. These were raised at a meeting with Economic Ministers in July 1994, when GOI nonetheless decided to proceed on a "repeat-order" basis with construction of 2,250MW of PLN combined cycle plant. In November 1994, a letter was sent to the DG of Electric Power spelling out estimates of the likely scale of excess capacity and its economic costs. This letter was leaked and received extensive domestic press coverage. The 1995 CEM contained a two-page box on the power sector, which again drew attention to the risks and to the dangers of GOI support for private power deals. To reinforce the message, the conditionalities for the Second Power Transmission and Distribution Project, approved in early 1996, included a requirement that PLN reduce the system reserve margin on Java-Bali to below 30 percent by end-1999 (it will now exceed 80 percent). In early November 1997 -- when the crisis had already hit and the power sector was facing enormous problems -- the Bank learned that GOI was pushing PLN to sign yet another PPA. A letter was sent to key Ministers flagging the dangers and indicating that proceeding with this deal would preclude further Bank lending. Nonetheless, a PPA was signed at end-December.

To summarize, GOI knew very clearly the Bank's position (there was no need for a different CAS matrix), as also did the private power developers and the banks that were financing them. GOI elected to ignore the messages, while the private investors and their financiers were confident that the GOI support letter meant their projects were risk-free.

The statement in para 3.36 that at the project level the Bank did not uniformly apply Bank procedures/standards is not substantiated in the elaboration in paras. 3.43-3.45. These paragraphs (and Annex 6) are generally positive regarding our portfolio management activities, except with regard to the delay in Indonesia's acceptance of the revised Standard Bidding Document (SBD). GOI started using SBDs in 1994, but included waiver clauses related to: (a) the requirement to pay interest to contractors for delayed payments; and (b) extra costs incurred due to events beyond the contractors' control. The government contended that both clauses would require amendment of the Basic Treasury law which was subject to parliamentary approval. GOI did not formally accept the new revisions until August 1997, and the Bank continued to process new loans and procurement activities during the 16-month period when Indonesia was not in full compliance with the SBD requirement. The CAN acknowledges that we consistently pressed GOI for adoption of these revisions and makes no case for any other lack of "uniformity" in our project administration.

It is also important to note that the phase-in of use of the revised SBDs, has generally taken three to four years to complete in borrower countries. Indonesia was no exception. Final agreement on the SBDs was only reached with China in June 1997 and in Indonesia in August 1997. Nor was Indonesia the last country to comply. As of the same month, there was still no agreement with the Indian Government over the arbitration clause in the works SBD.

Para 3.39 inaccurately states that the discussion of legal infrastructure prior to the crisis was confined to the business sector. In fact, an IDF Grant Agreement in the legal and judicial reform area was signed in 1995, and included: (a) the preparation of a strategy for human resource development for the legal profession; (b) an evaluation of the capabilities of legal institutions and other means of dispute resolution; (c) an assessment of the judicial system with a view to identifying measures to improve efficiency and equity. The final report developed recommendations in all three areas, both short-term and long-term. In mid-1997, it was being discussed in an internal consultative process in Indonesia; the last seminar was in September 1997, before the crisis took over our discussions. The IDF recommendations, however, will serve as a basis for post-crisis judicial and legal reform work under the governance umbrella.

OED's Response to Comments by the East Asia and Pacific Region on the Indonesia Country Assistance Note (CODE 99-6/1, February 17, 1999)

1. The Region's comments suggest that the Region shares the major findings and recommendations of the CAN. There are still some differences in judgment on relatively minor issues, which is not unusual for such a complex situation. The following are a few observations on the Region's DETAILED COMMENTS ON THE CAN.

2. With regard to the statement in the CAN in paragraph 2.2 that in the two years before the crisis the economy overheated, this fact was well known to the Bank. Bank policy notes sent to Indonesian authorities, as well as the attachment to a letter from Mr. Wolfensohn to Mr. Suharto, clearly warned about overheating in 1995. Furthermore, in the discussion of the emerging crisis in paras. 2.6-2.25 of the CAN, the CAN does recognize in para. 2.14 that major behind-the-scenes discussions may have taken place from the onset of the crisis, but, at the same time, no evidence was found of contingency planning. Also, the leniency on the Government discussed in the CAN refers to the pre-crisis period.

3. With regard to ESW in the financial sector (para. 3.29 of the CAN), there is clear evidence that proposed ESW in the financial sector and relevant to the crisis was shelved just prior to the crisis. This included proposed work on Financial Sector Risk Monitoring, Restructuring of the Banking Sector and Capital Markets Development.

4. With regard to the adequacy of Bank support for primary education (para. 3.34 of the CAN), it is necessarily a judgment call whether the allocations are adequate and efficacious. In OED's case, this judgment is based on: (a) Bank's own ESW including the poverty assessment which highlighted poor quality of primary and limited access of secondary education; (b) that despite 7 percent growth, there was a large percentage of near poor and education was the means to empower them; (c) the Bank's past intra-sectoral allocations (30 percent of total commitments for education—primary, secondary and non-formal—in FY80-90); and (d) discussions with some Bank and non-Bank staff.

5. With regard to the role of the CAS and CEMs in the policy dialogue (para. 3.35 of the CAN), there are clearly other important means for delivering messages on investment and priorities. The CAN suggests that the CAS is the major vehicle for discussing these with the Board and that an excessive number of matrix policy actions dilutes attention warranted to the major ones.

6. With regard to the uniform application of Bank procedures/standards (para. 3.36 of the CAN), OED agrees that the CAN's statement in para. 3.36 is no longer substantiated in paras. 3.43-3.45. This is because the latter paras. were changed to accommodate Regional sensitivities. In particular, internal memos over the course of almost a year from within the Region state that Indonesia was the only one of 158 borrowers not to have complied. This reference has now been deleted from the text.

7. Finally, the alleged inaccuracy referred to in para. 3.39 of the CAN, which states that the discussion of reform of legal infrastructure was confined to the business sector is rather a question of terminology. The word "business sector" was used in order to exclude issues of human rights, free speech and the like.