

Indonesia: Selected Issues

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INDONESIA

Selected Issues

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I. INDONESIA'S RECOVERY¹

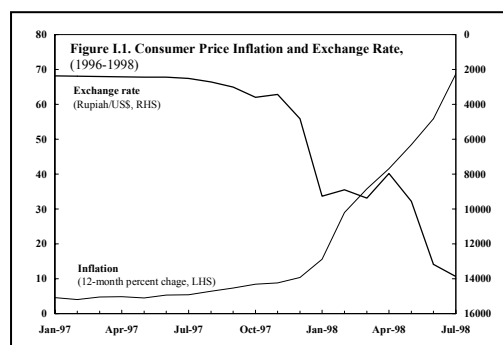
A. Introduction

1. **This Selected Issues paper takes stock of the progress made in meeting the objectives under Indonesia's Extended Arrangements (1998-2003).** This chapter addresses progress in achieving the programs' core macroeconomic objectives, with an emphasis on how Indonesia's economic recovery compares to those of the other major Asian "crisis" countries.²

2. **A major theme of this and the following chapters is that, while significant progress has been made against many of the key objectives of the arrangements, Indonesia's overall economic performance has lagged behind others in the region.** On the macro front, inflation has fallen to around 5 percent and the exchange rate has stabilized; the external position has improved with a significant build up in gross reserves; and public debt levels have fallen. Moreover, as described in the following chapters, considerable progress has been made in restoring the corporate and banking sectors to health, although fragilities remain. Against these achievements, however, Indonesia's economic growth remains lower than others in the region. Going forward, the main challenge for the authorities is to place the economy on a higher growth path in order to achieve sustained reductions in poverty and unemployment.

B. Background

3. **The fallout of the Asian financial crisis was the most severe in Indonesia of all the major countries affected.** The economic impact was exacerbated by political and social upheaval. Real GDP contracted by 13 percent in 1998 (compared to 10½ percent in Thailand, the next largest decline), and by July 1998 the rupiah had depreciated by about 80 percent from the previous year and inflation had accelerated to about 70 percent per annum (Figure I.1). The banking system came under severe stress as many corporate borrowers defaulted on loans, and a general loss of confidence in the banking system resulted in several bank runs.



¹ Prepared by Ashok Bhundia.

² Events in the early stages of Indonesia's crisis (July 1997 to July 1998) have been covered extensively in other papers; see IEO (2003) and Ghosh et al. (2002).

4. **Facing a significant depletion of reserves and loss of investor confidence, the authorities turned to the international community for official financial support.** Initial support from the IMF took the form of a Stand-By Arrangement in November 1997, followed by two Extended Arrangements (EFF) beginning in August 1998, as it became clear that more deep-seated structural weaknesses needed to be addressed (Box I.1).

5. **The Extended Arrangements aimed to restore macroeconomic stability and external viability, and lay the foundations for a durable economic recovery.** The principal objectives were to:

- *Restore price and exchange rate stability.* Inflation was targeted to fall to single digits by 2000, by reining in rampant monetary growth associated with the emergency liquidity support extended to distressed banks by Bank Indonesia;
- *Restore external viability.* Reserves were targeted to increase to \$30 billion or over 100 percent of short-term debt by 2002, through a drawdown of exceptional financing and by stemming capital outflows;
- *Restore fiscal sustainability.* Public debt to GDP was targeted to fall to 65 percent of GDP by 2004, through an adjustment in the primary surplus, facilitated by an expected gradual decline in interest rates and appreciation of the exchange rate;
- *Restructure and revitalize the financial and corporate sectors.* This was to be achieved by facilitating debt restructuring and providing public support to the banking system;
- *Restore economic growth.* GDP growth was projected to rise to 5-6 percent by 2002, underpinned by a pick up in private investment and exports.

C. Progress Under the Extended Arrangements

Restoring Price and Exchange Rate Stability

6. **Indonesia's slow progress in restoring macroeconomic stability on a sustained basis contrasts with that of the other Asian crisis countries** (Figures I.2. and I.3.). The peak in inflation and extent of exchange rate depreciation was much larger in Indonesia. In part, this reflected the political turmoil and weak economic policy implementation in the immediate post-crisis period. More generally, progress in restoring macroeconomic stability over time has been relatively uneven, unlike the other crisis countries which were able to maintain macroeconomic stability once it had been restored.

Box: I.1 Brief Overview of the Fund Supported Programs

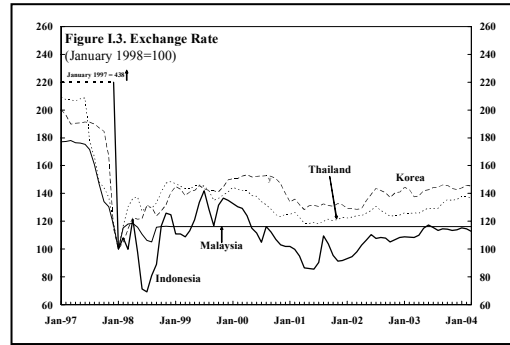
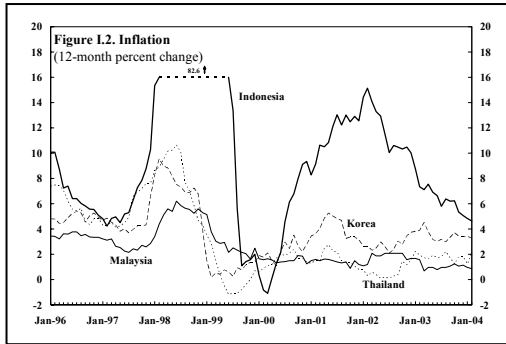
On November 5, 1997 a three-year Stand-By-Arrangement was approved by the Executive Board of the IMF, equivalent to US\$10 billion (SDR 7.34 billion or 490 percent of quota). As well as restoring confidence, the objectives of the arrangement were to limit the depreciation in the exchange rate by maintaining a moderately tight monetary policy, supplemented by limited foreign exchange intervention if needed. At that stage, output growth was still expected to be positive, enough to accommodate a restrictive monetary stance to support the currency. The arrangement included measures to address problem banks, although it did not at that stage include a comprehensive bank restructuring plan. Other structural measures were designed to improve efficiency and transparency of the corporate sector.

Major slippages in policy implementation and political developments meant that the crisis deepened soon after the Stand-By-Arrangement was agreed. For example, backtracking on the closure of some banks connected to the President damaged the credibility of the Fund-supported program and did little to restore confidence in the banking system. The turbulent political background, which culminated in the resignation of President Suharto in May 1998 added to the confluence of factors that created deep uncertainty and undermined confidence.

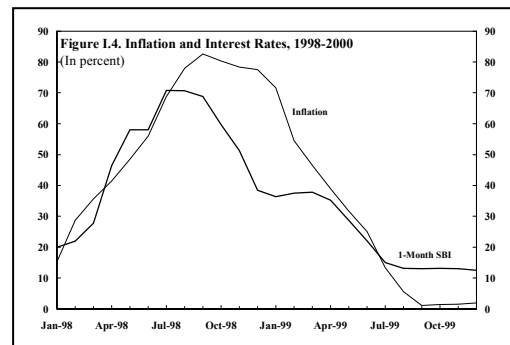
Against a background of deep crisis, on 25 August 1998, the IMF Executive Board approved the authorities request to replace the Stand-By-Arrangement with an Extended Fund Facility equivalent to US\$6.2 billion (SDR 4.7 billion) through November 2000. Replacing the Stand-By Arrangement with an Extended Fund Facility reflected a realization that wide-ranging and deep-seated structural reform was needed to restore Indonesia to a path of sustained economic recovery and to close the financing gap for the balance of payments.

In early 2000, the authorities requested that the 1998 Extended Arrangement be replaced with a new extended arrangement to support the government's new economic program developed in conjunction with the new and first democratically elected Parliament. The request was approved by the IMF Executive Board on February 4, 2000. This program envisaged continuity in monetary and exchange rate policies that were designed to deliver low inflation, a strengthened rupiah, and allow for declining interest rates, once risk premia declined in line with rising confidence. The fiscal deficit accommodated some room for supporting the recovery whilst also beginning the process of fiscal consolidation.

At the core of the Extended Arrangement were a set of structural reforms that included banking sector reform, corporate restructuring, deregulation of monopolies, the privatization of state-owned enterprises, and improved governance designed to support the macroeconomic objectives. The comprehensive strategy in the banking sector was to provide fresh capital to sound banks and merge or close weak banks while maintaining the comprehensive deposit guarantee. The state banks were to be restructured and recapitalized. Objectives for the corporate sector included setting up an effective bankruptcy system, including a framework for financial restructuring of the viable corporate entities. Several key state-owned enterprises were to be privatized and audits of key enterprises were to be undertaken to determine their financial health.

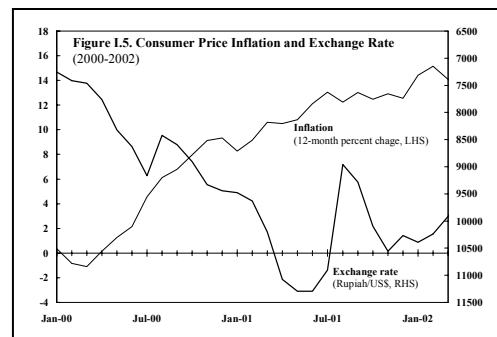


7. **Beginning in mid-1998, Indonesia made encouraging progress in restoring macroeconomic stability.** The government launched a stabilization program that was anchored by an aggressive tightening of the monetary stance. With the help of two new monetary instruments—weekly auctions of central bank SBI securities and direct intervention in the overnight interbank market—Bank Indonesia started to take firm action to regain monetary control. Base money and net domestic assets were held unchanged in nominal terms and Bank Indonesia intervened aggressively in the interbank market driving short term interest rates up to over 70 percent (Figure I.4).

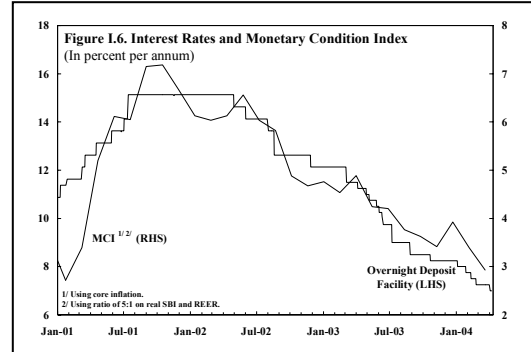


8. **By mid-1999 macroeconomic stability was beginning to take hold.** With the restoration of political stability and positive progress under the extended arrangement market sentiment improved significantly, with the exchange rate appreciating from close to Rp 12,000 per dollar in mid 1998 to around Rp 7,000 per dollar by mid 1999. Inflation also declined sharply, aided by improved supplies of key commodities such as rice and cooking oil, falling to low single digits by the end of that year. With inflation subdued, interest rates were brought down progressively, falling to around 12 percent by early 2000.

9. **However, the early gains in macroeconomic stability began to unravel in 2000 and 2001** (Figure I.5). Slippages in reforms and an increasingly uncertain political climate—culminating ultimately in the impeachment of President Wahid in mid 2001—raised risk premia and contributed to renewed downward pressure on the rupiah, which fell to Rp 12,000 per dollar by early 2001. Partly as a result, domestic price pressures reemerged, with inflation rising steadily throughout 2000 and back into double digits in 2001. Bank Indonesia was initially slow to respond to the emerging inflation threat, reflecting partly concerns about the effects of higher interest rates on economic activity, the banking system, and the budget. Its ability to raise interest rates during this period was also constrained by pressures to change the central bank law and remove its senior management.



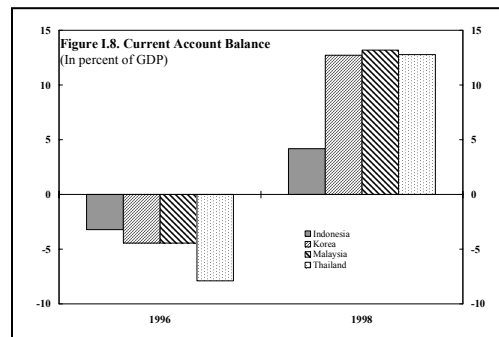
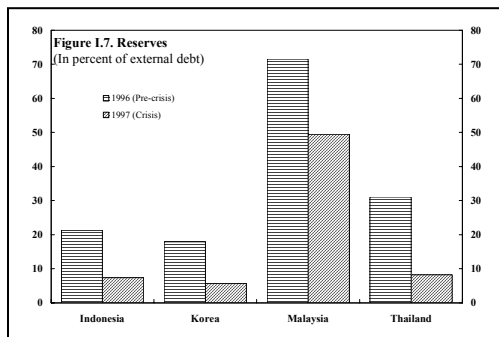
10. **Bank Indonesia started to tighten monetary conditions more aggressively in mid-2001** (Figure I.6). This partly reflected further moves by Bank Indonesia to raise its key policy interest rates to over 15 percent by end-2001. In addition, the improvement in market sentiment as the new government started to implement economic reforms contributed to a marked recovery in the rupiah. Since mid-2002, the rupiah has traded below Rp 9,000 per dollar.



11. **Macroeconomic stability has since been restored.** Having peaked at around 15 percent in early 2002, inflation has fallen steadily, declining to around 5 percent by early 2004. The decline in inflation has, in turn, allowed Bank Indonesia to progressively adopt a more accommodative monetary stance, and policy interest rates have accordingly been brought down steadily to a current level of around 7 percent. More generally, the authorities have been successful in re-establishing the virtuous circle that had existed in 1998-2000, in which strengthened policies bolstered confidence in the rupiah, providing stable financial conditions that have enabled monetary policy to become more supportive of economic activity.

Restoring External Viability

12. **Indonesia, like the other Asian crisis countries, experienced a massive capital outflow during the crisis.** Foreign reserves fell sharply as national central banks intervened to try to support their currencies, and indicators of external vulnerability deteriorated sharply (Figure I.7). The sharp increase in external vulnerability occurred despite a substantial turnaround in the current account balances of the crisis economies in the aftermath of the crisis, as a result of the collapse in output and import demand (Figure I.8).



13. **The strategy to restore external viability hinged largely on reversing the capital outflows that had been precipitated by the crisis.** The immediate aim was to raise external reserves from their post crisis low of around \$11 billion to around \$30 billion by the end of the extended arrangement. The objective was to provide sufficient reserves to cover at least 100 percent of short-term debt or around 5-6 months of imports. The expectation was that, with strengthened economic policies under the extended arrangements, private capital flows would reverse sufficiently and, with the aid of exceptional financing from the Fund and external creditors,³ there would be sufficient easing of the external financing constraint to enable a rebound in imports and a progressive narrowing of the external current account surplus.

14. **In the event, the improvement in Indonesia’s external position exceeded expectations** (Table I.1). The accumulation of net foreign assets routinely exceeded program targets, often by significant margins, and by the end of the second extended arrangement in 2003, external reserves had risen to \$36 billion, sufficient to cover over 150 percent of short-term debt and over 7 months of imports.

	2000		2001		2002		2003	
	Program	Actual	Program	Actual	Program	Actual	Program	Actual
Current account	3.3	8.0	1.0	6.9	-0.2	7.8	-1.3	8.0
Capital account	-7.5	-6.8	-2.1	-9.8	3.0	-7.0	-0.2	-7.5
<i>Of which : private capital</i>	-8.1	-6.0	-0.6	-7.2	-0.5	-3.3	0.1	-3.7
Gross reserves (end period)	26.5	29.4	28.4	28.0	31.7	32.0	34.0	36.2
(In percent of short-term debt)	89.1	98.4	91.5	84.6	103.7	134.3	126.4	154.2

Sources: Data from the Indonesian authorities; and Fund staff estimates.

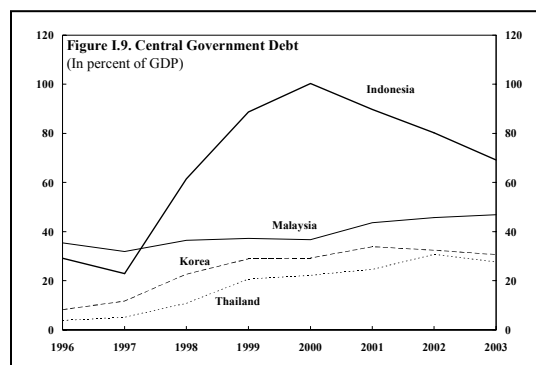
15. **The composition of the adjustment in the external accounts has, however, differed significantly from the original program design.** In particular, the reversal in capital flows has been much slower than expected, with significant net private capital outflows persisting throughout the arrangements. In contrast, the surpluses on the external current account have proved to be stronger and longer-lasting than expected. This has reflected in part the impact of higher-than-expected oil prices. Unfortunately, however, with the growth in non-oil exports generally lagging expectations, the strength of the external

³ Indonesia signed three agreements with Paris Club creditors—in 1998, 2000, and 2002—to reschedule debt service falling due to external official creditors. Under the agreements, relief was provided on debt service of about \$3 billion per year between 2000 and 2003. Obligations to commercial banks amounting to some \$6.4 billion were also rescheduled under the First and Second Exchange Offers, which exchanged bank credits for securities guaranteed by the government.

current account surpluses has to a large extent reflected a much smaller rebound in imports, consistent with a weaker recovery in economic activity.

Restoring Fiscal Sustainability

16. **Indonesia's public debt burden rose far more sharply than in the other Asian crisis countries** (Figure I.9). At its peak in 2000, total government debt had risen to over 100 percent of GDP from a pre-crisis level of 25 percent of GDP. The sharp increase in public debt did not reflect the impact of expansionary fiscal policies. Indeed, Indonesia had a long history of prudent fiscal management, anchored by a balanced budget rule which had kept public debt at low levels. Rather, the increase in debt reflected the following combination of factors:



- **Recapitalization of the banking system.** Most of the increase in public debt resulted from the issuance of bonds to finance the costs of bank restructuring. About Rp 650 trillion in recapitalization bonds were issued, raising domestic debt to over 50 percent of GDP (from zero prior to the crisis).
- **Depreciation of the rupiah.** External debt roughly doubled as a percent of GDP, largely reflecting the impact of the depreciation of the rupiah. In U.S. dollar terms, the increase was relatively modest.

17. **The crisis more generally imposed a heavy burden on Indonesia's public finances.** The increase in public debt resulted in a large increase in interest costs, which rose from less than 10 percent of government revenues, to over 30 percent by 2001. The budget also absorbed additional costs associated with the provision of subsidies to lessen the social impact of the crisis. The fiscal decentralization process, launched in 2001, added to the burden on the central government budget: despite the original intention that decentralization should be fiscally neutral, the subnational governments received a net transfer of resources of about 1½ percent of GDP in 2001.

18. **The primary fiscal objective under the program was to restore Indonesia's public debt to a more sustainable footing.** Specifically, the program aimed to reduce the government debt to GDP ratio to around 65 percent by 2004. The strategy for achieving the objective rested on fiscal consolidation and the mobilization of resources through IBRA asset recoveries and privatization to reduce the debt burden. The achievement of sustainable debt dynamics also hinged on maintaining a favorable macroeconomic environment, in particular a stable rupiah.

19. **By the end of the extended arrangement, significant progress had been made against the program’s main fiscal objectives (Table I.2).** By 2004 public debt had fallen to a little above 65 percent of GDP, although the decline reflected in large part the impact of the appreciation of the rupiah, and to a lesser extent the success in mobilizing resources from IBRA asset sales and privatization. Significant progress was made in advancing fiscal consolidation, although performance on the primary balance and the overall deficit fell

	Fiscal years				
	1999	2000	2001	2002	2003
Original program targets					
Central government deficit	-5.0	-5.0	-3.8	-2.7	-1.5
Primary balance	-0.9	1.5	2.0	2.4	2.8
Non-oil primary balance	-5.2	-2.6	-1.8	-1.3	...
Government debt	89.3	93.5	87.3	79.5	71.7
Actual					
Central government deficit	-1.5	-1.1	-3.7	-1.8	-2.3
Primary balance	2.4	4.0	2.9	3.8	1.7
Non-oil primary balance	-2.9	-4.6	-4.3	-1.0	-2.8
Government debt	88.6	100.3	90.9	80.3	66.5

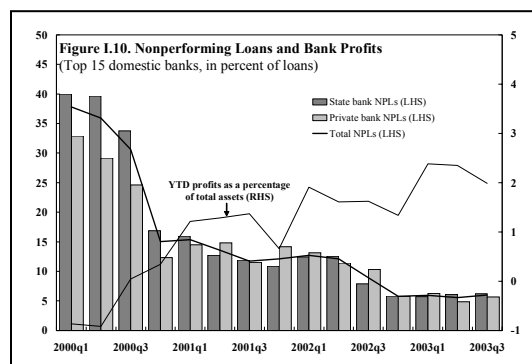
Sources: Data from the Indonesian authorities; and Fund staff estimates.

somewhat short of the original program targets. Progress was also made in mobilizing non-oil revenues and reducing ill-targeted subsidies, although, with oil revenues projected to decline over the medium-term, further effort in both these areas will be critical to sustaining the gains made in placing the budget on a sound footing.

Restoring the Financial Sector to Health

20. **The banking strategy is described in chapter II.** The main objectives of the strategy were to recapitalize and restructure the banks, and to reform the financial architecture to address pre-crisis weaknesses. As part of the strategy, a blanket guarantee on bank liabilities was adopted, and the Indonesia Bank Restructuring Agency (IBRA) was established.⁴

21. **Good progress has been made in reforming the banking system over the period of the extended arrangements.** The financial condition of the banking system has improved markedly, with NPL ratios down sharply and indicators of profitability rising (Figure I.10). After a slow start, most of the banks taken over by IBRA have been returned to private ownership (the last remaining IBRA bank is scheduled for divestment later in 2004). There have also been significant



⁴ Chapter III assesses IBRA’s performance.

advances in reforming the financial sector safety net, with the preparation of deposit insurance legislation and the development of a lender of last resort facility at Bank Indonesia. With the key elements soon to be in place, a gradual phase out of the blanket guarantee can commence.

22. **Despite these advances, financial sector restructuring remains incomplete.** The state bank sector remains a particular source of vulnerability. While state bank financial indicators have improved, asset quality and capital remain weaker than at private banks, and state banks continue to suffer from poor governance. Initial minority stakes have been sold in the state banks, but further steps are needed to increase private sector participation and improve state bank operations.

Corporate Sector Revitalization

23. **The economic crisis decimated the corporate sector.** As in other Asian economies, the Indonesian corporate sector was marked by relatively high debt ratios and weak liquidity. Indonesian corporations had rapidly increased their foreign currency borrowing prior to the crisis, with the external debt of private Indonesian companies rising from \$34 billion in early 1996 to over \$60 billion in early 1998. The collapse of the rupiah severely affected corporate balance sheets, and by 1999, the majority of corporate debts had become distressed.

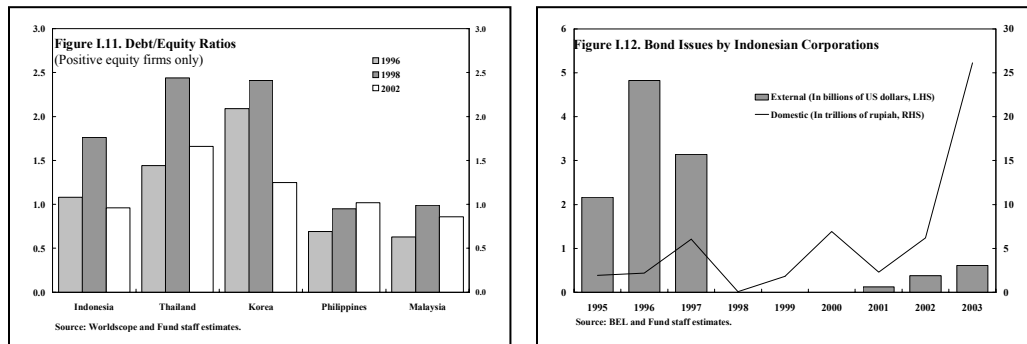
24. **Initial efforts to revitalize the corporate sector focused on promoting effective restructuring.** IBRA would take the lead in restructuring onshore debts which it had acquired as part of the bank recapitalization strategy. For external debts, the Jakarta Initiative Task Force (JITF) was established to mediate out-of-court restructuring agreements between Indonesian corporations and foreign creditors.⁵

25. **In the event, progress in corporate restructuring was very slow.** IBRA made slow progress in restructuring its portfolio, and by early 2002 had shifted the emphasis to selling unstructured loans. Initial restructurings under JITF were also very slow, as the agency was unable to compel debtors to participate in negotiations, and creditors were unable to press their claims through the court system. Over time, as the agency's role was strengthened (notably through its ability to report uncooperative debtors to a high-level ministerial committee) and creditor expectations were lowered, the pace of restructurings increased. By the end of its mandate at end-2003, JITF had completed restructurings of over \$20 billion in debt and had helped mediate cases involving an additional \$9 billion dollars in debt. More

⁵ In addition, the Indonesia Debt Restructuring Agency (INDRA) was established to provide foreign exchange guarantees for domestic corporations that had reached restructuring agreements with creditors. INDRA lapsed in 2000, with only one firm making use of the facility.

generally, market-based restructurings have advanced, as secondary market activity has increased (driven in part by debtors repurchasing their debts at steep discounts).

26. **Available indicators suggest that the health of the corporate sector has improved in recent years.** For listed companies with positive equity, debt burdens have declined, with the average debt-equity ratios in 2002 having returned to pre-crisis levels, broadly in line with the experience of other Asian economies (Figure I.11).⁶ Access to domestic and foreign debt markets has increased sharply for the top corporations in recent years (Figure I.12).



Elevating Growth

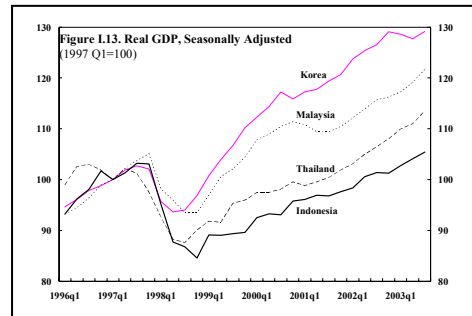
27. **It was originally hoped that restoring macroeconomic stability and addressing key structural weaknesses would help bring about an early economic recovery.** Revitalizing the corporate and banking sectors and improved governance of key public institutions were seen as key to restoring growth to its potential. The program consequently aimed to restore economic growth to around 5–6 percent on a sustained basis. It was expected that the recovery would be driven initially by private consumption and restocking, but that over time, as reforms took hold, the recovery would broaden with investment and exports starting to make a significant contribution.

28. **To date less progress has been made on this front than with the other macroeconomic objectives under the program.** Despite a promising beginning, when the economy initially rebounded by 4.8 percent in 2000 above the 3-4 range assumed under the program, the recovery has since been modest. Economic growth has averaged only 3-4 percent since 1999. This is significantly below the growth levels needed for a sustained reduction in poverty and to absorb new entrants into the labor market.

⁶ This overstates the improvement in corporate health, as over 10 percent of Indonesian listed companies reported negative equity in 2002.

29. **The recovery in economic activity has also lagged behind the other the other countries hit by the 1997/98 economic crisis.** Not only did Indonesia suffered a deeper downturn in GDP than other Asian countries affected by the crisis, the subsequent recovery has been significantly slower (Figure I.13).

Moreover, in contrast to expectations growth has been narrowly based, driven largely by private consumption, with investment and exports remaining weak. From the supply side, production across all industrial sectors and the service sector has been much weaker since the crisis—for example, from 1998 to 2003 manufacturing grew by an average of only 1.5 percent, compared to 12.8 percent over the period 1994-96.



30. **Chapters V and VI explore in greater depth some of the key factors behind Indonesia’s relatively slow economic recovery.** However, the dominant feature of the economic recovery to date has been the weak investment and export performance compared to other Asian economies (Table I.3). While there is no single factor behind the weak investment and export performance, the analysis suggests that the following principal factors:

	Indonesia	Korea	Malaysia	Thailand
GDP	118	136	127	126
Private consumption	119	135	131	127
Investment	103	134	118	123
Exports	92	174	135	147

Source: CEIC.

- **Investment climate.** One important impediment to growth has been the weak investment climate, arising from continued structural weaknesses in taxation and regulation, labor relations, and the legal system. Many of these weaknesses existed prior to the crisis, when the growth performance was much stronger. However the absence of strong institutions needed for the efficient functioning of a market economy was becoming evident even then. The crisis has heightened market scrutiny of these structural weaknesses.
- **Foreign direct investment.** The impact of weaknesses in the investment climate has been particularly evident in foreign direct investment, which has collapsed since the crisis. The sharp decline in foreign direct investment to export sectors has been one of the principal factors behind Indonesia’s relatively poor export performance.
- **Cost competitiveness.** Recent trends in unit labor costs suggest that much of the improvement in competitiveness in the immediate post-crisis period has been eroded in the last couple of years, by rising formal sector wages and the appreciation of the rupiah. While the rise in unit labor costs is not currently considered a binding constraint on either investment or exports—labor costs have risen from a very low level—cost competitiveness could become a strong deterrent to manufacturing exports in particular if recent trends are sustained.

D. Conclusion

31. **The authorities in Indonesia have made significant progress toward the macro-critical goals of the extended arrangements.** Significant progress has been made in restoring macroeconomic stability, and the authorities have demonstrated that when firm policy action is taken, including in the area of structural reform, that the gains are robust to shocks. The fiscal position has improved significantly and the external position is now much stronger than at the time of the crisis, and continued progress in these areas should mean that vulnerability to future shocks is reduced.

32. **Nonetheless, important challenges remain, most notably to elevate growth through higher levels of productive investment and exports.** The government's economic program for the post-program period, as outlined in its White Paper issued in September 2003, recognizes that this is now the main economic priority. In addition to maintaining macroeconomic stability and continuing the restructuring of the financial sector, the focus is on creating a conducive business climate by addressing key structural weakness in taxation and regulation, labor market rigidities, and a weak and inefficient legal system.

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II. ASSESSING INDONESIA'S BANKING SECTOR REFORMS¹

A. Introduction

1. **This paper examines the measures taken to deal with the banking crisis and assesses their success in stabilizing and restructuring the banking sector.**² It also examines the steps taken to develop an effective bank supervision regime and progress made to date in replacing the blanket guarantee with a financial sector safety net. The paper concludes by identifying the remaining challenges to further strengthen the banking sector.
2. **Prior to the 1997–98 financial crisis, Indonesia's financial sector was characterized by poor governance and widespread directed and related-party lending.** State banks accounted for 40 percent of banking assets in 1997 and carried high levels of problem loans stemming from directed lending operations. A small number of family-owned conglomerates were the dominant owners of private banks, which were used as vehicles to finance nonfinancial companies owned by the same controlling shareholders. Private banks expanded rapidly in the 1990s, lending heavily to related parties beyond prudentially prescribed lending limits, in foreign currencies, and to the real estate sector.³ Foreign bank penetration remained low, with only 8 percent of banking assets under foreign control.
3. **Prudential regulation and supervision were also extremely weak.** Rules on loan classification and provisioning allowed for easy restructuring and evergreening of loans, while enforcement actions were not taken against widespread violations of legal lending limits. Also absent was an exit mechanism for failing banks and a deposit insurance system for small-scale depositors. Close ties between bank owners and the political elite deterred supervisory authorities from taking corrective actions against weak and noncompliant banks.
4. **The lack of political commitment and transparency both contributed to the crisis and undermined initial steps to stabilize the financial sector in late 1997.** At the outset of the crisis some initial steps were taken to address the weaknesses in the banking sector. Sixteen banks (representing 2½ percent of system assets) were identified for closure and liquidation, with another 34 (representing 22 percent of system assets) placed under Bank Indonesia (BI) supervised rehabilitation programs. The government also announced a

¹ Prepared by Steven Seelig, Michael Taylor, and Cem Karacadag.

² See Cole and Slade (1998), Enoch et al. (2001), and Pangestu and Habir (2002) for comprehensive overviews of Indonesia's banking crisis and initial stabilization and reform efforts.

³ The number of private banks number grew from 101 to 182 between 1988 and 1991 (Pangestu and Habir, 2002), and peaked at 240 in 1994 (Enoch et al., 2001). The share of foreign currency and real estate loans more than doubled to 20 percent and 21 percent, respectively, by mid-1997.

guarantee on deposits of up to Rp 10 million, accounting for 90 percent of depositors, but only 25 percent of deposits. The credibility of the authorities' program to stabilize the banking sector was shattered when one of the closed banks reopened under a new name, and the fate of the 34 banks under rehabilitation programs was not clearly articulated to the public. Contagion from other crisis countries, the rapid deterioration of the corporate sector, and rumors about the President's health deepened the crisis of confidence, triggering widespread bank runs and prompting BI to extend massive amounts of emergency liquidity loans equivalent to 15 percent of GDP in 1998.

Crisis Strategy

5. **In early 1998, the government adopted a new bank restructuring strategy founded on four main pillars.** These included: a blanket guarantee for all depositors and creditors of banks; the creation of the Indonesian Bank Restructuring Agency (IBRA); a recapitalization program for private and state-owned banks; and an out-of-court debt restructuring mechanism. These four elements were designed to stop the runs on banks, close and restructure insolvent banks and dispose of the assets from the failed banks, restore the state bank sector to health, and facilitate financial restructuring in the corporate sector.

6. **Once the credibility of the blanket guarantee had been established it was successful in ending bank runs and in stabilizing the system.** The guarantee fully protected all depositors and creditors, but not shareholders, in both rupiah and foreign currency. Although the guarantee was announced in January 1998, runs continued until the authorities took action in April of that year and closed 14 banks and promptly transferred protected deposits to other institutions or suspended shareholder rights and replaced management (the latter were referred to as "banks taken over" or BTO banks). Subsequently, bank runs became rare and were primarily a response to idiosyncratic events affecting specific banks. Measures were adopted to limit the moral hazard of the guarantee, including additional prudential restrictions on and enhanced surveillance of banks with guaranteed deposits. Banks were required to pay a premium of 0.5 percent of total deposits to partially defray the future costs of the guarantee. A cap was also placed on the interest rate that could be paid on deposits covered by the guarantee.

7. **IBRA was given particularly broad powers and responsibilities.** (An assessment of IBRA's success is provided in the next chapter.) IBRA's responsibilities included the rehabilitation and liquidation of failed private banks, the management and sale of nonperforming loans, the recapitalization and divestment of the BTO banks, and the negotiation of settlements with shareholders. IBRA appointed new management for BTO banks, in line with the goal of returning ownership and management control to the private sector. The government also implemented a recapitalization program for private banks not taken over by IBRA. Seven banks were jointly recapitalized by their owners and the government. The private owners of jointly recapitalized banks were allowed to retain management control to avoid a complete nationalization of the system and to give owners an incentive to inject new equity into the banks. IBRA had the responsibility for administering the government's majority shares in these banks.

8. **The strategy for rehabilitating state banks revolved around a single merger and massive recapitalization.** Four insolvent state banks were merged to create Bank Mandiri, which was subsequently recapitalized with Rp 175 trillion in recapitalization bonds during 1999–2000. Since its creation, Bank Mandiri has remained Indonesia’s largest bank, with a 23 percent market share in 2003, more than double its nearest competitor, state-owned BNI.

Post-Crisis Stabilization Strategy

9. **In the period following the crisis, financial sector reforms focused on fostering structural changes that would lay the groundwork for the recovery of the banking system and prevent a recurrence of a banking crisis.** In recent years the emphasis has been on addressing weaknesses in governance and balance sheet vulnerabilities by improving bank supervision and prudential regulation, and providing a framework for dealing with bank failures that enables banks to exit from the system smoothly. The strategy was directed toward achieving longer term reforms that would result in a sound and well-capitalized banking system that would be led by the private sector, and developing a financial safety net to replace the blanket guarantee. While significant progress has been made by the authorities in each of these areas, the process remains incomplete.

B. Progress in Rehabilitating the Banking System

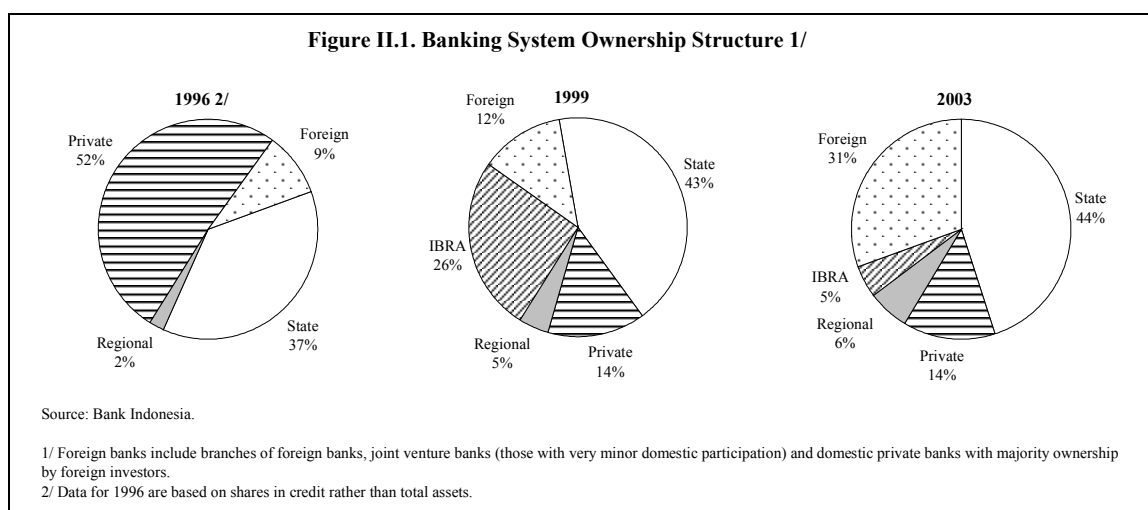
10. **Banking sector reforms were implemented against the background of a difficult political transition, weak institutional capacity, and an unreliable legal framework.** The reform strategies introduced during the crisis were based on well-tested principles. However, reform suffered from a lack of consistent implementation. The condition of the banking sector has nonetheless shown significant improvement, although vulnerabilities remain.

11. **The measures taken to stabilize and recapitalize the banking sector achieved their goal, and overall financial indicators have shown a marked improvement.** Asset quality, however remains a concern and, as described below, there remains a significant dichotomy between private and state banks. In part, the asset quality deficiencies at some of the state banks stems from loans purchased from IBRA. Efforts to privatize the state banks have succeeded in raising revenue for the government, but the process has been partial, with the government retaining sole voting control of these banks.

Ownership structure

12. **Systemic restructuring efforts have led to a dramatic change in the ownership structure of the banking sector.** The number of banks has been reduced from 238 in 1997 to 138 at end–2003. IBRA’s privatization of banks has returned over 20 percent of banking assets to the private sector, primarily to owners that were not affiliated with the mismanagement of the banks in the run-up to the crisis (Figure II.1). The sale of banks BCA, Danamon, Niaga, and BII to strategic investors represented particularly important milestones in increasing the private sector orientation of the financial sector. Privatization also raised the share of banking assets under foreign management which has brought much needed know-how and competition to the financial services industry.

13. **Nevertheless, the banking system is highly concentrated and state banks maintain a dominant presence.** The 10 largest banks account for 70 percent of banking assets and future mergers and acquisitions could raise concentration even further. Moreover, state banks retain a high share of banking assets, which, at 44 percent of the total, is above its pre-crisis level. The fast-growing regional development banks account for another 6 percent of banking assets. Hence, one-half banking assets are under state control.



Financial condition

14. **The financial condition of the banking system has improved sharply since the crisis.** This has been due primarily to a massive recapitalization by the government and the transfer of NPLs to IBRA. The government injected Rp 425 trillion in bonds into the banks (and another Rp 230 trillion into BI) as the counterpart of around Rp 400 trillion in loss loans transferred to IBRA, in one of the world's costliest banks recapitalization operations, at 50 percent of GDP. The replacement of nonearning assets with high-yielding government bonds and the gradual resumption of lending, particularly to the high-margin consumer sector, has underpinned a steady improvement in financial soundness indicators. The improved macroeconomic environment has also supported bank financial performance by facilitating reductions in provisioning and increases in operating margins. From 1999 to September 2003, nonperforming loans declined from 20 to 6 percent of total loans, after-tax profits rose to 2 percent of assets from a loss of 9 percent, and liquidity has remained high.⁴ Over the same period, the capital adequacy ratio (CAR) increased to 23 percent (from a negative value), owing largely to the low share (40 percent) of risk-weighted assets in total

⁴ Indicators of financial soundness are based on the top 16 banks, accounting for 75 percent of banking assets.

assets.⁵ Equity as a percent of total assets, while less robust at 9 percent, has risen from a negative of 5 percent in 1999.

15. **Private banks have shown the greatest improvement in financial conditions.** Measures of asset quality, earnings, liquidity and capital are all relatively better for the private banks (Table II.1). These banks have been more aggressive in cleaning-up their loan books and positioning themselves to expand in various niche markets. Many of the purchasers of IBRA banks have replaced management with bankers who have had international experience.

	1999		2001		2003 1/	
	State Banks	Private Banks	State Banks	Private Banks	State Banks	Private Banks
	(In percent)					
Asset structure						
Recap bonds-to-total assets	59.9	43.7	52.1	44.7	43.1	24.2
Net loans-to-total assets	18.1	14.1	22.1	22.0	30.6	31.4
Asset quality						
Reported NPLs-to-total loans	14.8	35.3	10.0	12.7	6.2	5.6
Compromised assets-to-total loans 2/	...	...	33.4	21.7	23.9	11.2
Loan loss reserves-to-compromised assets	...	...	31.7	43.9	36.8	69.2
Earnings						
Net interest income-to-average assets	-3.8	-4.5	3.2	3.5	4.2	4.3
Net profits-to-average assets (ROA)	-9.6	-6.8	1.2	-0.2	1.9	2.1
Capital adequacy						
Equity-to-total assets	-8.9	2.2	4.7	6.3	7.5	10.1
Capital adequacy ratio (CAR)	-10.4	6.2	19.0	17.1	21.4	24.9
Net compromised assets-to-tier 1 capital			181.6	94.9	92.3	17.2
Liquidity						
Liquid assets-to-total assets	15.2	34.5	14.5	18.3	12.9	28.0

Source: Bank Indonesia.

1/ End-September data.

2/ Compromised assets include reported NPLs, restructured loans classified as pass or special mention, and foreclosed real estate and equities. The denominator "loans" includes foreclosed real estate and surrendered equities.

16. **Nevertheless, important fragilities remain in the banking system as the state banks remain in a weak financial condition.** State banks face weaker liquidity and capital positions than the private banks. A particular concern is that, while reported NPLs have fallen, they understate the level of problematic assets, reflecting high levels of restructured loans, some of which were purchased from IBRA.⁶ The bulk of restructured loans are

⁵ It should be noted that CARs are overstated due to the assignment of a 50 percent risk weight to loans extended to state-owned enterprises (international standards call for a 100 percent weighting).

⁶ As of September 2003, restructured loans accounted for 20 percent of total loans in state banks, compared with 3 percent at private banks. While some restructured loans were purchased from IBRA at steep discounts, often at 20 percent of face value, many have not been returned to paying status. Some banks are writing down the purchase value to reflect the lack of recoveries on these loans.

categorized as pass or special mention, despite indications that they may still be impaired. Some loans have been kept “current” by rolling over maturing repayments or through “cosmetic” restructurings, involving changes in repayment terms without corresponding payments to the banks. In addition, some banks carry large amounts of real estate assets or equities in troubled companies, acquired as collateral or in debt-for-equity swaps, at values on their balance sheets that do not reflect current market values. Overall, the ratio of “compromised assets” to loans stood at 24 percent in September 2003 at the state banks, almost four times the reported NPL ratio and over double the figure for private banks.⁷ Although this ratio has declined from 33 percent in 2001, this is attributable mainly to charge-offs and the expansion in total loans, rather than recoveries. While state banks are well-provisioned with respect to reported NPLs, provisions are sufficient to cover less than half of their broader compromised assets.

State bank restructuring

17. **Following the merger and recapitalization of the state banks, efforts have focused on improving their governance structures.** One of the main weaknesses has been that state banks are under the joint oversight of the Ministry of State Owned Enterprises and Ministry of Finance. The authorities have taken some steps to improve oversight of the state banks through the appointment of commissioners and the preparation of annual business plans. However, these steps have been only partially effective and governance and accountability remain weak, with insufficient procedures in place to ensure that lending policies are fully consistent with sound banking practice.

18. **The next step in the process of state bank restructuring is to increase private sector management.** To date, this has taken the form of the divestment of 30 percent stakes in Mandiri and BRI. While these moves may have led to increased transparency and market scrutiny of the banks’ operations, they have not significantly affected the banks’ operations, as the divested shares are nonvoting. To further strengthen the state banks, more fundamental moves towards private-sector management are needed, through the divestment of majority voting stakes or private management contracts. This will be particularly important as the large state banks compete directly with the private banks.⁸

Credit developments

19. **During the past two years credit growth has been strong, especially in the SME and consumer loan sectors.** Annual credit growth exceeded 20 percent in both 2002 and 2003, with the rate of expansion in consumer loans even faster. In the latter loan category,

⁷ Compromised assets include reported NPLs, restructured loans currently categorized as pass or special mention, foreclosed real estate, and equities obtained under debt-equity swaps.

⁸ State bank BRI is the dominant micro-finance lender and does not compete with private banks for this business.

credit practices have been strengthened, and given the spreads on these loans, banks have shown great interest in expanding into this market.⁹ At the same time, however, the strong interest shown in the retail and consumer market reflects the high risks of lending to larger borrowers. Heightened risk aversion has prompted many private banks to shift lending away from large-scale manufacturing companies toward smaller scale firms in trade and services and towards consumers.

20. Credit risks in the economy are still high, exacerbated by a weak legal system with poor enforcement of creditor rights, especially against large corporate borrowers. At the same time the capacity to price risk is limited. Margins on lending to the comparatively few good corporate borrowers are very thin, and may be below risk-adjusted rates. In addition, loan concentration may be very high at some banks. Available data for selected banks suggest that some are exposed to a relatively small number of borrowers, with the top 20–25 borrowers accounting for 30 percent or more of total loans.

21. Enhancements to the financial infrastructure would facilitate financial intermediation and encourage prudent loan growth. The lack of systematic credit information makes it difficult for banks to properly assess prospective borrowers and manage and price credit risk. This, in turn, leads to higher interest costs for creditworthy borrowers and weakens the prudential basis for lending decisions. Specifically, the absence of a credit bureau deprives banks of sufficient information on prospective borrowers and this in turn is reflected in the pricing and availability of credit.

C. Prudential Regulation and Supervision

22. Prudential regulations have generally been brought in line with the Basel Core Principles. In 1998–99, BI issued new regulations on loan classification and provisioning, related-party lending, capital adequacy, and foreign exchange rate risk, among others.¹⁰ Subsequently, BI developed a master plan to address the deficiencies identified in a Basel Core Principles for Bank Supervision (BCP) assessment. New regulations have been issued and the supervisory skill set has shown marked improvement over the past two years (Box II.1). A recently completed BCP self-assessment showed compliance with 16 of the core principles. This assessment outlined the remaining steps needed to reach full compliance. The number of full-scope bank examinations has increased five-fold since 1999, and BI has placed on-site examiners at the larger banks to improve the quality of supervision at these banks.

⁹ Bank Danamon, for example, has recently acquired a large finance company to gain a greater foothold in consumer lending for the purchase of automobiles and motorbikes.

¹⁰ For a full discussion of the changes to the regulatory framework that began during the crisis see Enoch et al. (2001).

Box II.1. Enhancements to Bank Regulations and Bank Supervision

A. Enhancements to Bank Regulations (1998–1999)

- Loan classification rules were tightened by shortening the time period for nonrepayment in determining the various levels of classification of NPLs. In addition, borrower repayment capacity and cashflow analysis were made part of the classification process.
- Provisioning requirements were adjusted to conform to new classification rules, and collateral valuation procedures were refined to reflect difficulties in foreclosure.
- Rules on debt restructuring were tightened by establishing formal procedures for restructuring, reporting, and monitoring, applying clear accounting rules, and placing special restrictions on the restructuring of connected loans.
- Banks were required to report cashflow projections and a maturity-gap analysis, including off-balance sheet items.
- Quarterly publication of financial statements was required.
- Net open position limits on foreign exchange risk were reduced.
- The concept of “related party” was better defined and expanded.
- Limits on foreign ownership and control of banks were removed.

B. Enhancements to Bank Supervision (2000–2003)

- Completion of a risk-based supervision manual.
- Development of risk management and internal control guidelines.
- Availability of banking data on the BI web site.
- Issuance of a “Know Your Customer” regulation.
- Issuance of regulation to limit risks associated with the purchase of loans from IBRA.
- Regulation on equity investments by banks to give BI greater control over expansion into nonbanking activities.
- An expanded bank licensing regulation.
- Increasing the minimum capital adequacy ratio to 8 percent.
- The issuance of a market-risk capital charge that will be fully implemented in 2004.

23. **Risk-based banking supervision is gradually taking hold.** BI's implementation of its "Master Plan to Enhance Banking Supervision" has resulted in a much improved supervisory process. Bank examiners are now better trained and effective in identifying major weaknesses in banks. Classifications are no longer solely based on applying past-due criteria but also reflect the examiner's evaluation of the likelihood of repayment. As a result, examiners frequently diverge from bank management on loan classification and provisioning, though there is no mechanism or timeframe for resolving outstanding differences. Formal supervisory actions, such as memoranda of understanding and cease and desist orders, are in the early stages of development, and supervisors still rely on more informal communications, where sanctions against noncompliance are sometimes unclear or enforced inconsistently. Going forward, enforcement and implementation need to be strengthened. Also, while the regulatory framework provides the foundation for excellent supervision, regulations for consolidated supervision should be adopted and the regulations governing legal lending limits need to be tightened.

D. Financial Safety Net

24. **The blanket guarantee was successful in stabilizing the banking system, but was intended as a short-term crisis management measure.** After the system had stabilized there was a need to replace the guarantee with a financial safety net that could provide a flexible structure to respond to emerging instability while limiting moral hazard. Prior to the crisis, Indonesia lacked such a structure, as BI's lender of last resort function (LOLR) was ill-defined and there was no explicit deposit insurance. The proposal recently developed jointly by BI and the Ministry of Finance provides the needed framework. The safety net will have three elements: the creation of a deposit insurance agency and the implementation of a deposit insurance scheme; an explicit granting of LOLR powers to BI, subject to certain restrictions; and the creation of a Joint Committee to coordinate the government's actions with regard to systemically important institutions experiencing difficulty.

25. **Progress has been made in obtaining legislative approval for the financial safety net.** The necessary amendments to the BI Law giving LOLR powers to BI have been passed by Parliament and an enabling Memorandum of Understanding between BI and the Ministry of Finance has been signed. The memorandum will govern procedures until the end of 2004, by which time a Financial Safety Net law is to be passed that both formalizes these procedures in law and clears up any inconsistencies between statutes. In addition, the draft deposit insurance law was recently submitted to Parliament and, once it is passed, the authorities envision a calendar driven phase out of the blanket guarantee over a two year period. In the interim, with IBRA having ceased operations, the responsibility for the blanket guarantee has passed to a new unit in the Ministry of Finance.

E. Conclusions and Remaining Reforms

26. **The measures undertaken at the height of the banking crisis have by and large been successful.** Public confidence was restored with the blanket guarantee and banks have been recapitalized. The return of banks to the private sector and the infusion of professional management with foreign bank experience bode well for financial intermediation and the effective operation of private banks.

27. **However, as the system remains dominated by the state banks, the strategy has not fully succeeded in fostering a market oriented commercial banking system.** Only one state bank, BRI, serves a public policy goal (microfinance and SME lending in rural areas) and undertakes it profitably. The other state banks compete head-to-head with private banks both for funding and loans, and their dominance has distorted competition in these markets. Consequently, the bank restructuring process is incomplete. Moreover, the most significant fragilities that remain in the banking sector are primarily found in the state banks. Addressing these will require significant improvements in governance at these banks.

28. **All banks face a legal system that is not favorable to creditors.** Weaknesses in the legal structure and corruption in the courts have tilted the system in favor of borrowers who have the resources to fight creditors through the legal system. The response of many of the private banks has been to focus their lending on consumers and SMEs, and to lend only to corporate borrowers who were able and willing to service debts incurred during the crisis. Reform of the legal system, therefore, is a critical element of banking sector reform that remains unfulfilled.

29. **Bank Indonesia has achieved a marked improvement in its bank supervision capabilities and regulatory regime, but there is scope for further improvement.** In particular, additional regulations are needed, particularly with respect to consolidated supervision, and to enforce the regulations that are in place, in order to bring BI into full compliance with best international practice as embodied in the Basel Core Principles.

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III. WAS IBRA SUCCESSFUL?¹

A. Introduction

1. **The Indonesian Bank Restructuring Agency (IBRA) was established in January 1998 to handle government efforts to recover from the banking and economic crisis.** The crisis decimated the banking and corporate sectors, and resulted in a widespread loss of public confidence in the banking system. To address the crisis and its aftermath comprehensively, IBRA was tasked with three key objectives:²

- *Stabilizing and revitalizing the banking system.* IBRA would restructure and recapitalize banks, and rapidly return them to private ownership. In addition, it would restore confidence in the banking system through its administration of the blanket deposit guarantee program.
- *Maximizing recoveries from taken-over assets.* Recoveries would offset the Rp 650 trillion cost of the banking crisis.
- *Revitalizing the corporate sector.* Restructuring corporate debt and returning taken-over assets to private ownership would support real sector recovery.

2. **With IBRA having ceased operations upon expiration of its official mandate in February 2004, now is an opportune time to assess whether it was successful in meeting these objectives.**³ To a certain extent, IBRA's performance was determined by a number of outside factors. As IBRA recognized early in its mandate, strong support from the legal and judicial system, as well as the absence of outside interference, would be essential for it to implement its mandate successfully.⁴ Though IBRA was broadly successful in meeting its three key objectives, in the end it was hampered by weak support from these outside factors.

B. Stabilizing and Revitalizing the Banking System

3. **IBRA assumed responsibility for managing a significant share of the banking system.** After IBRA's initial (unpublicized) move to place a number of distressed private banks under special supervision proved ineffective, more comprehensive measures were taken. In early April 1998, IBRA took over seven banks (representing 16 percent of the

¹ Prepared by Andrea Richter Hume and Alexander Wolfson.

² Chapters II and III of IMF Country Report 00/132 and Chapter III of IMF Country Report 02/154 provide a fuller description of IBRA's responsibilities and institutional structure.

³ See Annex III.1 for a timeline of key events at IBRA.

⁴ IBRA, "Strategic Plan, 1999-2004", mimeo (October 1999), p. v.

banking system),⁵ and closed seven deeply insolvent small banks, with deposits moved to a designated state bank. The smooth implementation of these measures was well-received and helped provide confidence that a comprehensive banking reform strategy had been adopted. (By contrast, the poorly-implemented closure of 16 banks in October 1997 failed to strengthen market sentiment.) Following detailed examinations of the condition of other troubled banks, IBRA undertook further interventions. By early 1999, IBRA had taken over nine additional banks—including BCA, Indonesia’s largest private bank (12 percent of liabilities), which had suffered relentless bank runs—and closed another 45 banks (including three which it had previously taken over). In addition, IBRA became the majority shareholder in seven banks that were recapitalized jointly with the original private owners.

4. **IBRA’s objective was to return taken-over banks to private ownership as early as possible.** It was originally expected that the divestment of IBRA banks would begin in 1999 and would occur gradually over IBRA’s life. However, bank divestment only began in 2002 with the completion of the sale of BCA (which had been long-delayed since its launch two years earlier). While part of the slow start reflected delays in recapitalizing and formulating business plans for the banks, it also reflected a lack of political support for bank divestment. The momentum increased following the BCA sale, and all but one of IBRA’s banks had been divested by early 2004. While it was originally envisaged that the original owners of the joint-recap banks would exercise their right to acquire IBRA’s stake (financed in part by recoveries from nonperforming assets removed from the banks), only one bank was resolved in this way (the others were handled in the same manner as the taken-over banks).

5. **The bank divestment strategy generally worked well, but the stakes probably should have been divested sooner.** The process used for divesting government holdings in taken over and joint-recap banks was transparent and market-based, and adequate recoveries were achieved (see below).⁶ However, IBRA was not always effective in addressing structural deficiencies or liquidity problems that emerged in the banks under its control. For example, structural weaknesses at bank BII (a joint-recap bank that was subsequently taken over) were not addressed early enough, due to a lack of political support for closure of the bank. Though BII’s financial condition eventually improved, this required repeated capital injections from the government.

C. Maximizing Recoveries from Taken-Over Assets

6. **Recovering value from the assets and obligations transferred to IBRA was critical for offsetting the cost of the banking crisis and reducing public sector debt.** IBRA was tasked with recovering value from three major asset groups:

⁵ As part of this operation, one state bank was taken over (representing 8 percent of banking system liabilities). This bank was later merged into the new state-owned bank Mandiri.

⁶ Strategic stakes in IBRA banks were sold through public auctions. Short-listed bidders were vetted by Bank Indonesia to ensure they satisfied fit-and-proper requirements.

- *Nonperforming loans* transferred from closed, taken over, or state banks;
- *Industrial assets and debt obligations* pledged by former bank shareholders in settlement of claims related to their violation of legal lending limits; and
- *Equity holdings in banks* recapitalized by IBRA, and *other bank assets* (e.g., buildings, land, cars, and office equipment) acquired in the process of liquidating closed banks.

Nonperforming loans

7. **The original strategy for recovery from nonperforming loans was tailored to the size of the obligation** (Table III.1). *Retail and SME loans*, which were large in number but small in total value, were targeted for resolution through cash settlement (with interest and principal discounts) and through direct sales.

Nearly 80 percent of these loans (by principal) were settled, at an average recovery rate of 33 percent, while the remainder was sold. Overall, recoveries from these loans were about 30 percent of the

	Definition (Principal)	Accounts (Number)	Debtors (Number)	Total principal (In trillions of rupiah)
Retail/SME	< Rp 5 billion	313,760	294,414	29.4
Commercial	Rp 5-50 billion	7,239	1,996	27.0
Corporate	> Rp 50 billion	52,626	1,867	290.3
Total		373,625	298,277	346.7

Source: IBRA (2004), "IBRA's Accountability Report, 1998-2004," p. 18.

original principal. The majority of *commercial loans* were outsourced for debt servicing (and restructuring) to private banks, so as to allow IBRA to focus its restructuring efforts on corporate loans. However, as little progress was made by banks in resolving these loans, they were eventually returned to IBRA management and offered for sale with corporate loans.

8. **For corporate loans, the original strategy aimed to enhance their value by restructuring and repackaging them before offering them for sale.** The expectation was that IBRA, as a government agency with special enforcement powers, would be better placed to conduct restructuring negotiations than private creditors. The strategy was also motivated by the desire to return only solid (i.e., restructured) loan assets to a still-weak banking system. In order to reach comprehensive debt settlements for business groups, restructuring of individual corporate loans was done under the group concept, with particular emphasis placed on restructuring loans related to the largest debtors. To enhance loan value, IBRA aimed to improve corporate governance and managerial control in the debtor companies during the restructuring process. In addition, the adoption of industry-specific resolution strategies was expected to add further value to the distressed loan assets.

9. **The strategy of restructuring corporate loans before their sale is likely to have unnecessarily delayed asset recovery without significantly enhancing asset value.** Difficulties related to working out such a large number of loans, many of which involved complex provisions and/or lacked appropriate documentation, were compounded by poor

cooperation from debtors, who had little incentive to advance the restructuring process.⁷ In addition, unstable macroeconomic conditions, with high interest rates and exchange rate volatility, complicated the assessment of a company's debt servicing capacity. These factors considerably delayed the restructuring process, and hence asset recovery.

10. **The restructuring process also raised governance concerns.** In 2000, the granting of generous restructuring terms to some of IBRA's largest debtors, most notably Texmaco,⁸ evoked strong criticism both domestically and from the international financial institutions. Subsequently (in April 2001) the government adopted more stringent Corporate Debt Restructuring Principles. In addition, IBRA's Oversight Committee (OC) was tasked with carrying out an independent review of the largest corporate restructuring transactions before they were submitted to the government for final approval.⁹ Though the recommendations of the OC were not binding, the fact that they were published meant that the final restructuring terms agreed by the government would be subjected to somewhat greater public scrutiny.

11. **A fundamental change in strategy occurred in early 2002, when IBRA essentially ceased restructuring all but the largest corporate loans, and began to offer unstructured loans for sale.** This strategic decision was based on the realization that the restructuring progress had stagnated, and had put at risk IBRA's ability to complete the asset recovery process before the expiry of its mandate. In addition, IBRA was of the view that shifting the restructuring responsibility to the private sector would increase asset recovery, as investors would place value on the added flexibility to restructure the assets in accordance with their own financial and strategic considerations.

⁷ For owners of heavily indebted companies, reaching a restructuring agreement could precipitate an effective loss of control, as those purchasing the restructured loans were likely to convert the debt into equity, or take other steps to assert effective ownership control.

⁸ In the case of Texmaco, these terms included long repayment maturities, low interest rates, and leaving the debtor companies under full operational and financial control of the debtor. In addition to being IBRA's largest corporate debtor (\$3 billion principal), Texmaco is also considered one of the most recalcitrant ones; its debt has yet to be resolved.

⁹ The Oversight Committee was established in July 2000 to monitor IBRA's performance, in particular its compliance with principles of sound corporate governance and transparency.

12. **Consequently, the pace of corporate loan sales, picked up significantly in 2002** (Table III.2). In contrast to its first auctions, in which IBRA had offered only restructured loans for sale; “unsustainable debt” positions began to be offered for sale.¹⁰ In 2002, loans with a combined principal of Rp 110 trillion were sold, nearly five times the total between 1998 and 2001. Controlling for underlying loan quality, IBRA has assessed that the move to sell unstructured loans did not adversely affect recovery rates. Until IBRA’s closure, the strategy remained to sell as many loans as possible, subject to a floor price determined by an in-house assessment of each loan’s fair market value.¹¹ Loan sales were generally conducted in a transparent and market-based fashion, though some governance concerns arose related to the possibility that original owners were buying back their debts (through third parties). However, there was little that IBRA could do to prevent this from occurring; while IBRA required all bidders to affirm that they were in no way related to the original debtor, the agency was not in a position to verify or enforce this requirement.

Table III.2. IBRA Loan Sales, 1999-2004

	Principal (In trillions of rupiah)	Proceeds 1/ (In trillions of rupiah)	Recovery rate (In percent)
1999	0.08	0.04	51.2
2000	7.5	2.9	38.7
2001	19.7	9.3	47.3
2002	109.3	27.9	25.6
2003	65.7	7.4	11.2
2004	6.6	0.5	7.2
Total	208.8	48.0	23.0

Source: IBRA (2004), p. 22.
1/ Includes bond receipts.

13. **In part reflecting the delay in loan sales, the recovery rate for these assets has been somewhat weaker than those for other Asian crisis economies**

(Table III.3). In addition, the stock of assets acquired by IBRA’s asset management unit (as a proportion of total loans) was greater than for other countries. Including

debt service and proceeds from the sale of nonloan bank assets, recoveries have amounted to 29 percent of the original loan principal transferred to IBRA.

Table III.3. Recovery from NPLs in Asian Countries

	Indonesia 1/ (IBRA)	Korea 2/ (KAMCO)	Malaysia 3/ (Danaharta)	Thailand 4/ (FRA)
NPLs transferred to agency (in billions of US\$)	30.6	92.8	13.8	16.2
Recovery rate (percent)	28.5	27.5	42.7	37.7
Memorandum items:				
NPLs as a percent of total loans	64	17	11	14
NPLs as a percent of GDP	30	16	16	8

Sources: Data from national AMCs; and Fund staff estimates.
1/ IBRA (2004). Based on all proceeds of IBRA's AMC unit, i.e., debt service, cash settlement, and sales proceeds from NPLs and nonloan bank assets.
2/ "Korea Asset Management Corporation: 2003 Annual Report."
3/ "Danaharta - On Track," Danaharta press release, March 5, 2004.
4/ There is also a substantial stock of NPLs at bank AMCs and TAMC.

¹⁰ Debt restructuring operations generally resulted in a “sustainable” portion of debt (which could be serviced given the company’s business prospects) and an “unsustainable” portion, which was converted into equity or quasi-equity (convertible bonds).

¹¹ In some cases, particularly for firms where employment or other sociopolitical concerns were relevant, IBRA floor prices were considerably above the true market value.

Bank shareholders' industrial assets and debt obligations

14. **Unlike other Asian crisis economies, Indonesia sought recovery from bank owners whose use of emergency liquidity credits had violated prudential norms.** The government reached out-of-court settlements under which the bank losses attributed to the breach of legal lending limits would be repaid. A total of 44 agreements were reached with major shareholders of banks, for obligations amounting to Rp 130 trillion (including five agreements, with total debt of Rp 0.2 trillion, that were settled upfront in cash). Another ten shareholders disputed their liabilities and refused to sign a settlement agreement. The cases of these shareholders were forwarded for legal action to the relevant branches of government.

15. **The settlement terms depended primarily on bank shareholders' ability to meet the obligation in kind.** Nine agreements were reached in 1998 and 1999. For the five shareholders with assets (corporate holdings, property, shares, etc.) of sufficient value to meet the entire obligation, an agreement (MSAA) was reached under which these assets were transferred to effective government ownership. For the other four shareholders who could only partially meet their obligation in kind, the obligation net of the pledged assets was converted into a four-year debt agreement (MRNIAs), backed by a "personal guarantee". In 2000, another thirty shareholders concluded pure debt agreements (APUs), which were designed to plug perceived loopholes that had arisen in the earlier agreements.

16. **IBRA aimed to maximize recovery from the pledged industrial and property assets by designing a well-timed sales program.** Although IBRA had originally planned to manage the assets itself, the agency eventually decided that this was outside its mandate and that the value of the assets would remain highest if the original management teams were left in place.¹² To safeguard its interests, IBRA placed representatives on the boards of these companies. The sales program was to be carried out in stages, to avoid competition and potential value reduction from the simultaneous sale of similar assets.

17. **Rather than enhancing asset value, however, the decision to leave the pledged assets under the control of the original owners eroded asset value and delayed asset recovery.** IBRA representatives were generally ineffective in ensuring sound corporate governance, which left significant scope for asset-stripping. IBRA's desire to avoid a fire sale of assets may also have undermined asset recovery, as the longer the assets remained under the control of the original owners, the greater the scope for value erosion. This erosion of value was compounded by the slower-than-expected recovery of the Indonesian economy. Finally, in many cases asset sales were delayed by obstruction from the original owners.

18. **With regard to bank shareholders' debt obligations, IBRA did little to enforce the terms during 1999-2001.** Although the obligations entailed regular payments of principal and interest, recoveries were essentially zero during this period. While IBRA had powerful enforcement actions at its disposal, the fact that many of the bank shareholders were

¹² Most pledged assets were transferred to IBRA-owned holding companies.

prominent individuals (with strong political connections) appears to have inhibited IBRA from taking such actions.¹³ In addition, because of the unusual legal nature of the agreements, having the defaults validated judicially would be very challenging, especially given serious governance problems in the courts.

19. **A comprehensive “get tough” enforcement policy was adopted in late 2002 as the maturity of the agreements neared.** A deadline of March 2003 was set for shareholders to come into full compliance with their obligations. For those who did not meet the deadline, strong enforcement actions would be taken. The policy also entailed the following:

- For MSAAs (fully collateralized agreements), a full legal assessment would be undertaken to assess whether (i) all pledged assets had been legally transferred to IBRA, and (ii) there had been any misrepresentation of the transfer value of the pledged asset. Full compliance would require the shareholder to remedy any outstanding irregularities.
- The same legal assessment would be undertaken for MRNIAs (partially collateralized agreements). The collateralized debt obligations would be offered for sale.
- APU debtors (with pure debt obligations) were offered a principal reduction of roughly one-third and full interest forgiveness.

20. **Though the new policy led to increased compliance, in the end recoveries under the shareholder settlement agreements only reached one-quarter of the original obligations** (Table III.4). At the time of IBRA’s closure, 28 shareholders had essentially met their obligations, six others were expected to come into full compliance, and ten remained uncooperative and were in various stages of legal enforcement.¹⁴ In addition, one of the original ten noncooperative shareholders had also reached settlement, while the others were still being handled by the legal authorities.

	Agreements (Number)	Obligation (In trillions of rupiah)	Recoveries 1/ (In trillions of rupiah)	Recovery rate (In percent)
Agreements concluded in 1998/99	9	112.0	25.9	23.1
Sufficient assets (MSAA)	5	88.1	23.5	26.7
Insufficient assets (MRNIA)	4	23.8	2.3	9.8
Agreements concluded in 2000 2/ 3/	35	18.3	3.3	18.2
Total	44	130.3	29.2	22.4

Sources: IBRA; and Fund staff estimates.

1/ For 1998/99 agreements, recoveries are based on repayment of promissory notes. For 2000 agreements, recoveries include cash payments (Rp 2.5 trillion) and certificates of entitlement (Rp 0.8 trillion).

2/ Five of these agreements (obligations of Rp 0.2 trillion) had previously been settled upfront in cash.

3/ The original obligation of these banks, Rp 18.3 trillion, was reduced in 2002 to Rp 12.3 trillion. Based on the revised obligation, the recovery rate was about 27 percent.

¹³ Under Indonesian law, nonpayment of a debt owed to the state could be punished with civil detention. In addition, IBRA’s extrajudicial powers would have allowed it to seize shareholder assets to meet the outstanding obligation.

¹⁴ Depending on whether the underlying violation is civil (e.g., corruption) or criminal (e.g., violation of banking law or embezzlement), the cases will be handled by the Attorney General’s office or the police, respectively.

Once shareholders have come into full compliance with their obligations, they receive a closing letter from the government stating that they have met all the terms and conditions of their agreement. The recovery rate varied significantly across shareholders: while recovery under the largest agreement was about 37 percent, it was nearly zero for several of the other large debtors (especially those with only partially collateralized agreements).

21. **With hindsight, earlier efforts to enforce the settlement agreements—by taking full control of the pledged assets, and ensuring timely repayment of the debt obligations—would probably have enhanced asset recovery.** Until 2002, IBRA was of the view that taking such a route would compromise asset recoveries, given that enforcement actions were unlikely to succeed. However, this only highlights the underlying reason that recoveries were so poor, namely the lack of political support for enforcing the agreements. Even after the government decided to adopt a get-tough policy, recoveries might have been higher if the handling of the agreements had been turned over to the appropriate legal and police authorities. However, given the serious governance and other institutional weaknesses in these branches of government, implementation of the agreements would likely have remained problematic.

Bank equity and other bank-related assets

22. **Recoveries from the sale of IBRA’s banks have been reasonable in relation to their book values.** Majority stakes were divested through transparent auction mechanisms (in some cases, auctions were cancelled when bids were below IBRA’s reservation price). In addition, minority stakes have been sold directly into the market, or as blocks to the majority owner. To date, the divestment of IBRA’s banks has raised over Rp 15 trillion, with banks generally sold for above book value (Table III.5). IBRA has also earned about Rp 4 trillion in dividends from its holdings of bank equity. This compares with Rp 9 trillion originally required to bring the banks from zero to positive capital, and subsequent injections of about Rp 9 trillion to address liquidity shortfalls at banks BII and Permata. The strategy for recovery from other bank-related assets—offering them for sale in public auctions—was appropriate for maximizing recovery. Sales began early (April 2000), and returned over 5,500 properties and other assets to private ownership, raising Rp 5.1 trillion.

Table III.5. IBRA Recoveries from Bank Divestment 1/

Bank	Date	Stake (In percent)	Method	Recoveries (In trillions of rupiah)	Price/Book 2/
BCA	Mar-02	51	Strategic sale	5.6	1.1
Niaga	Nov-02	51	Strategic sale	1.1	1.5
	Multiple 3/	20	Market placement	0.5	1.6
Danamon	May-03	51	Strategic sale	3.0	1.3
	Jul-03	20	Market placement	1.1	1.4
BII	Dec-03	51	Strategic sale	2.1	1.3
	Dec-03	20	Market placement	0.8	1.5
Lippo	Feb-04	52	Strategic sale	1.2	1.0

Sources: IBRA; World Bank; and Fund staff estimates.

1/ Excludes February 2004 sale of minority stakes (1-8 percent) in the banks, which raised Rp 1.5 trillion.
 2/ Book value as of December before sale, except Niaga (December 2002) and Lippo (September 2003).
 3/ July-October 2002 and July-September 2003.

Remaining stakes and total recoveries

23. **At the time of IBRA’s closure, assets with a face value of roughly Rp 275 trillion remained in government hands.** However, only Rp 108 trillion of these assets were held “free and clear” (including bank equity and NPLs of some of IBRA’s largest debtors), while Rp 166 trillion represented assets in various stages of litigation. A new holding company,

with a five-year mandate, was established in March 2004 to restructure and eventually sell the unencumbered assets. Assets in litigation will be handled by a high-level inter-ministerial team (headed by the Minister of Finance). IBRA expects recoveries from all remaining assets to yield about Rp 15 trillion.

24. Through March 2004, recoveries from IBRA assets totaled roughly Rp 150 trillion, nearly one-quarter of the government's gross outlays during the banking crisis. Recoveries from NPLs accounted for nearly two-thirds of the total (Table III.6). The net cost of the crisis at this stage therefore stands at about Rp 500 trillion, or 40 percent of 2000 GDP. Even including further recoveries from IBRA's remaining assets, Indonesia's banking crisis is likely to remain the most costly of all the Asian crisis cases (Table III.7).

Cash recoveries (gross)	132.9
NPLs (incl. debt service)	75.9
Loan sales	38.9
Shareholder settlement agreements	26.8
Bank equity	19.0
Other	11.2
Operational expenses (-)	7.2
Cash recoveries (net of expenses)	125.7
Bond recoveries (from loan sales)	18.2
Total recoveries (cash and bond) in percent of 2000 GDP	12.0

	Gross Outlay	Recovery	Net Cost
Indonesia, 1997-present	51.4	12.0	39.4
Korea, 1997-2000	31.2	8.0	23.1
Malaysia, 1997-2000	7.2	3.2	4.0
Thailand, 1997-2000	43.8	9.0	34.8

Sources: Hoelscher and Quintyn (2003), p. 41; and Fund staff estimates for Indonesia.

D. Revitalizing the Corporate Sector

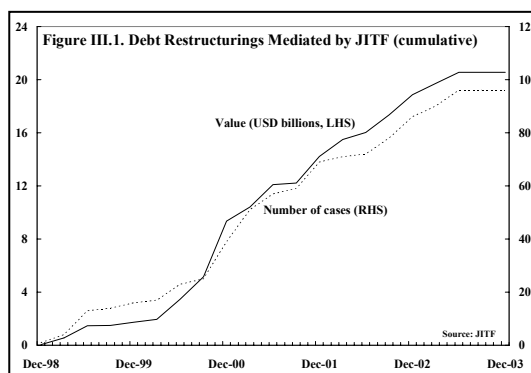
25. Given the significant scale of its distressed debt holdings, IBRA was expected to play a prominent role in revitalizing the corporate sector. Prior to the crisis, the corporate sector was marked by relatively high debt ratios and weak liquidity, in line with other regional economies (Table III.8). The crisis pushed much of the corporate sector into insolvency. At the height of the crisis, almost 75 percent of banking system loans became nonperforming (by far the highest ratio in the region). IBRA's holdings represented over 90 percent of all onshore distressed debt, and IBRA was involved in 40 percent of the (offshore debt) cases mediated by the Jakarta Initiative Task Force (JITF).

	Indonesia	Korea	Malaysia	Philippines	Thailand
Liquidity indicators:					
Current ratio 1/	2.08	0.94	1.08	1.45	1.13
Quick ratio 2/	1.56	0.62	0.76	1.02	0.71
Solvency indicators:					
Debt/equity	1.09	2.09	0.63	0.69	1.44
Debt/assets	0.34	0.50	0.27	0.32	0.50
Interest coverage	8.95	2.31	5.97	7.20	3.08

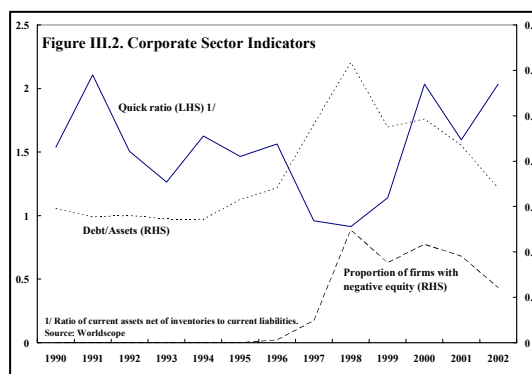
Sources: Thompson Worldscope; and Fund staff estimates.
1/ Ratio of current assets to current liabilities.
2/ Ratio of current assets (net of inventories) to current liabilities.

26. **However, IBRA’s efforts to support corporate sector recovery through its restructuring of distressed debt were largely ineffective.** It was hoped that IBRA’s extrajudicial powers would give it more leverage than private creditors to achieve substantive corporate restructuring. However, debt restructuring was very slow: by June 2000, only 23 percent (by face value) of the largest loans had finalized restructuring plans, and only 2 percent had begun implementing restructuring agreements. Moreover, IBRA was subject to considerable political interference, and in some cases restructuring agreements appeared to focus on meeting employment or national interest concerns, rather than placing the firm on a commercially viable footing. In any event, as discussed above, by early 2002, IBRA had shifted its focus from concluding restructuring agreements to selling unrestructured loans.

27. **In addition, IBRA’s restructuring activities were not fully coordinated with those of other government agencies.** In particular, in the immediate post-crisis years, IBRA often worked at cross-purposes to the JITF. While the agencies were supposed to coordinate their corporate debt policies, in a number of cases IBRA reached bilateral agreements with debtors. These agreements were often motivated by IBRA’s revenue collection concerns, rather than broader corporate restructuring goals.¹⁵ This served to undermine the JITF’s ability to facilitate transparent global debt resolutions. Coordination was improved in early 2000, when it was decided that the terms of all major restructurings would be overseen by a high level ministerial committee. Following this and other reforms to the JITF framework, the pace of restructurings accelerated (Figure III.1).



28. **Over time, the corporate sector began to revive as the pace of market restructurings advanced.** The corporate sector remained relatively frozen in the initial aftermath of the crisis, with very little improvement in financial indicators. Most companies ceased servicing their debts, and creditors realized that deficiencies in the legal system limited their ability to press their claims. As debtors and creditors adjusted to the situation, restructuring activity through the JITF increased. This was supported by parallel developments in the secondary debt markets (it is widely believed that debtors were able to buy back their debts on



¹⁵ “JITF Final Report” (December 2003), pp. 26-32.

the secondary market). IBRA's decision to proceed with large-scale asset sales in 2002 also promoted private-sector restructurings, as buyers of distressed assets would work out arrangements with the debtors. Indicators of corporate sector health have improved in recent years (Figure III.2). While this reflects a number of factors, including a strengthened macroeconomic environment, it may also reflect increased market-based restructuring following IBRA's sale of unstructured assets.

E. Conclusion

29. **Overall, IBRA was successful in achieving its key objectives.** It performed particularly well in stabilizing the banking system, by rapidly restoring the public's confidence, efficiently closing over 50 banks, and merging, recapitalizing, and then returning to private ownership banks accounting for about 25 percent of the banking system. IBRA performed less well in maximizing asset recoveries, as the slow pace of asset sales probably compromised returns. Finally, IBRA's role in supporting corporate sector recovery was mixed, with initial emphasis on restructuring loan assets proving largely ineffective and delaying real sector recovery.

30. **The absence of an effective legal and judicial framework compromised asset recoveries.** Despite the introduction of a new bankruptcy law and other relevant reforms after the crisis, the legal and judicial framework remained weak.¹⁶ In the case of loan assets, this undermined IBRA's position in debt restructuring negotiations, and also reduced the market value of its NPLs. The impact on recoveries under the shareholder settlement agreements was also significant, as few effective steps were taken by the relevant authorities to enforce the agreements. Although the creators of IBRA had anticipated such problems, and therefore vested the agency with extrajudicial powers to facilitate asset recovery, the agency only availed itself of these powers on a few occasions, as its enforcement efforts were stymied by judicial opposition.

31. **However, the most important constraint on IBRA's effectiveness was the absence of clear political support.** During the first few years of its existence, IBRA's operations were hamstrung by conflicting views within government regarding how best to maximize asset recovery, and a reluctance to sell assets at discounts to their principal or assessed values. Beginning in 2001, government support for IBRA's asset recovery efforts increased, and asset sales accelerated as a result. However, the continued absence of strong political backing for the enforcement of the shareholder settlement agreements is likely to have undermined recoveries from these obligations.

¹⁶ Chapter IV presents an assessment of recent legal and judicial reforms in Indonesia.

Timeline of Key IBRA Activities

1998–99

- *Overall*: IBRA established in January 1998; assets transferred to agency.
- *Bank restructuring (BRU)*: Initial rounds of bank take-overs, mergers, and closures.
- *NPLs (AMC)*: Transfer of NPLs to IBRA; sale of credit card debt portfolio (May 1999).
- *Bank shareholder settlement (AMI)*: Settlement agreements signed with nine bank shareholders; establishment of holding companies to manage pledged assets.

2000–01

- *Overall*: Oversight Committee established to monitor IBRA's performance.
- *BRU*: Eight taken-over banks merged into Bank Danamon (September 2000); first (minority) divestment of an IBRA bank (BCA, May 2000).
- *AMC*: Sale of restructured corporate loans initiated (June 2000); adoption of Corporate Debt Restructuring Principles to ensure good governance (April 2001).
- *AMI*: Settlement agreements (APU) signed with 30 bank shareholders (2000); sale of pledged assets initiated (March 2000).

2002

- *Overall*: Asset recovery accelerates.
- *BRU*: Majority divestment of banks BCA (March) and Niaga (November); merger of five IBRA banks into Bank Permata (December).
- *AMC*: Sale of unstructured corporate loans initiated; NPL disposal accelerates dramatically while restructuring efforts are scaled back.
- *AMI*: Adoption of strengthened enforcement policy for settlement agreements.

2003

- *Overall*: Efforts geared towards completion of asset disposal ahead of closure.
- *BRU*: Majority divestment of banks Danamon (May) and BII (November).
- *AMC*: All remaining NPLs offered for sale; some of IBRA's largest corporate loans (including Texmaco) remain unsold.
- *AMI*: Enhanced recoveries under new policy, though payment deadlines repeatedly slip.

2004

- *Overall*: IBRA closed at end-February. Unsold assets with clear legal title transferred to new government-owned asset-management company; unsold assets in litigation handled by high-level team.

Table A.1. Indonesia: Timeline of IBRA's Majority Bank Holdings 1/

Date	Action	Number of Banks	Running Total
1998	Initial banks taken over (BTO)	7	
	BCA taken over	+1	
	Closure of 3 BTO banks	-3	5
1999	Second set of banks taken over	+8	
	Merger of one BTO bank with Danamon	-1	
	Initial joint recap banks 2/	+6	
	State bank EXIM restructured as part of Bank Mandiri	-1	
	Bank Bali taken over	+1	18
2000	Merger of 8 smaller banks with Danamon	-8	10
2001	Bank Bukopin successfully completes joint-recap program	-1	
	BII taken over	+1	10
2002	Majority divestment of BCA and Niaga	-2	
	Merger of 4 banks with Bank Bali (creating Permata)	-4	4
2003	Majority divestment of Danamon and BII	-2	2
2004	Majority divestment of Lippo	-1	
	Permata transferred to post-IBRA agency (for divestment in 2004)	-1	0

1/ Includes banks taken over and banks jointly recapitalized with the participation of private owners.
 2/ Excludes Bank Bali and BII, which were subsequently taken over.

IV. LEGAL, JUDICIAL, AND GOVERNANCE REFORMS¹

A. Introduction and Overview

1. **Following Indonesia's 1997-98 financial crisis, the government's economic recovery programs supported by the IMF have included a range of legal, judicial, and governance reforms.** The immediate focus of the reforms was to address the large overhang of corporate debt, which had been a major factor in the collapse of the banking system.² In this regard, the initial priority was to adopt a modern bankruptcy law, establish a new specialized Commercial Court, and develop a framework to facilitate out-of-court corporate debt workouts, to complement the work being undertaken by IBRA (see Chapter III). At the same time, reforms aimed to address systemic governance and corruption problems in law enforcement. Over time, the reform agenda has broadened, with increasing attention paid to improving the overall legal environment for business by strengthening areas such as commercial law, secured transactions, corporate governance, accounting, competition, and capital markets. This chapter, however, focuses on the initial reforms directed towards corporate debt restructuring, in which the IMF took the lead role. Many of the reform measures undertaken in this regard drew significantly from local expertise and studies, including the seminal diagnostic study on law reform funded by the World Bank and completed in 1997 shortly before the crisis started.

2. **Looking back, the results of the reforms undertaken are mixed.** The legal and institutional framework for corporate debt restructuring was successfully put into place. In particular, the out-of-court negotiating framework contributed substantially to debt resolution. The Commercial Court has also begun to play a significant role in debt restructuring and in judicial reform, but continues to suffer a negative image due to some high profile controversial decisions. While some progress has been made in governance and other institutional reforms in the legal and judicial sectors, the impact of these reforms, so far, remains limited. Overall, a comprehensive reform framework is now in place. Effective implementation is now needed.

3. **The rest of this chapter is organized as follows:** Section B discusses the adoption of a modern bankruptcy law and the creation of the Jakarta Initiative Task Force (JITF) to provide a framework for out-of-court settlements. Section C looks at the Commercial Court, while Section D examines long-term, institutional reforms in the judiciary. Reforms to governance are reviewed in Section E and Section F provides an overall assessment and identifies the major outstanding issues and challenges.

¹ Prepared by Ceda Ogada.

² At the time of the crisis, nonfinancial corporate sector debt exceeded \$100 billion, split broadly evenly between foreign and domestic creditors, and almost three quarters of the debt was denominated in foreign currency. With the collapse of the rupiah, most companies became unable to service their foreign currency debt, and by mid-1998, almost half of all corporations were thought to be insolvent.

B. Bankruptcy Law and the Jakarta Initiative Task Force

A New Bankruptcy Law

4. **The 1904 Bankruptcy Ordinance, in force at the time of the crisis, was outdated and ineffectively applied.** The reforms introduced in the 1998 Bankruptcy Law were designed to meet two broad objectives: (i) create an effective credit enforcement mechanism to provide the right incentives for debtors to restructure their debt, and (ii) support rehabilitation of debtor companies by addressing inter-creditor issues. These features were also intended to support the out-of-court restructuring process discussed below that would be spearheaded by the Jakarta Initiative Task Force and by IBRA.

5. **The main focus was on addressing institutional deficiencies in the bankruptcy framework.** The old law was little-used because creditors and debtors alike lacked confidence in the institutions charged with its implementation. The civil servants in charge of administering complex insolvency proceedings as receivers and administrators were viewed as ill-equipped for the task. There were also problems in the judiciary, which was perceived as ineffective and corrupt. Among the important institutional and procedural changes introduced in the new law were: private sector receivers and administrators; a specialized Commercial Court, which was required to publish its decisions and articulate the legal reasoning used; ad hoc judges of the Commercial Court comprised of expert, independent persons; and strengthened rules to promote more expeditious and transparent proceedings.

6. **In terms of more substantive provisions, a number of key features common in the insolvency laws of other jurisdictions were introduced to modernize the law, including:** a clearer standard for commencing bankruptcy petitions;³ increased protections and sanctions against fraudulent transfer of assets and insider abuse detrimental to creditors; and provisions addressing inter-creditor issues such as restrictions on the ability of secured creditors to foreclose on collateral during bankruptcy proceedings, interim priority financing, and the ability to bind-in dissenting unsecured creditors following approval by the Commercial Court of a debtor's restructuring plan agreed to by the requisite majority of creditors.

7. **Legal observers agree that the new Bankruptcy Law is a sound law and that the legal framework for bankruptcy is now on a strong footing.** However, there have been problems with implementation. To correct some of the problems, amendments were submitted to Parliament in late 2001. Among other things, the amendments, which are yet to be adopted, seek to add various definitions and clarifications, increase safeguards on spurious bankruptcy petitions against financial institutions, allow for ad hoc judges at the Supreme Court level, and

³ To commence a petition, a debtor should have two or more creditors and have failed to pay at least one due and payable debt. Some observers believe that the threshold is too low, unfairly exposing viable companies. However, the often suggested alternative—the insolvency test, a measure of the value of assets relative to liabilities—has its own problems, including the difficulty faced by creditors in obtaining evidence on assets and liabilities.

further improve transparency of judicial decisions, including dissenting opinions. Although the amendments would strengthen the law, the problems of implementation, as discussed in Section C below, now require institutional, rather than legislative, action.

The Jakarta Initiative Task Force⁴

8. **An out-of-court negotiating framework was critical for resolving the corporate debt overhang, as the large number of insolvencies would have overwhelmed the judiciary.** Thus, provisions to accommodate out-of-court negotiations were built into the 1998 Bankruptcy Law and the JITF was inaugurated in November 1998. Both debtors and creditors, with some concerns, were generally supportive of the JITF's establishment.

9. **The JITF was modeled on workout techniques followed in the United States and Europe.**⁵ However, two of its primary roles were unique to local circumstances. First, without authority to dictate terms, the JITF was actively involved in facilitating deal-making, including through professional staff experienced in restructuring and mediation who were lacking in Indonesia. Second, the JITF was designed to be a "one-stop" forum for facilitation of regulatory applications required for restructuring plans. In this role, it would also recommend incentives for restructuring and removal of disincentives regarding, for example, taxation, legal lending limits, disclosure of financial information, and divestiture by banks of equity acquired in restructuring transactions. The central idea was that public funds would not be provided to distressed firms, but the government would take all other steps to encourage restructuring.

10. **Corporate restructuring, both within and outside the JITF framework, faced a number of obstacles.** The legal system failed to pose a credible threat to debtors that refused to restructure in good faith. In particular, a number of controversial rulings by the Commercial Court in favor of debtors also served to shape some debtors' recalcitrant attitudes. Also, the informal nature of the JITF negotiating framework did not work well in such an environment, it proved difficult to turn the "one-stop" forum into a reality, and coordination with IBRA was initially poor. On the economic front, many debtors were uncooperative about disclosing financial information. Further, weak macroeconomic conditions encouraged some debtors to delay restructuring in the hope that the rupiah would appreciate, thus reducing their foreign currency debt, while the rupiah's steep depreciation in 2000 had a significant impact on the ability of companies to service even recently-restructured debt. Moreover, all of these

⁴ For a fuller account on the JITF, see Government of Indonesia, *JITF Final Report*, 2003.

⁵ Based on the London Approach, the JITF framework embodied generally accepted restructuring principles. Among other things, these principles called for creditors' committees; sharing of relevant information; voluntary "standstill" periods during which creditors refrain from pursuing their legal rights; and interim priority financing.

problems played out in the context of political resistance to the acquisition by external creditors of large ownership positions in domestic companies.⁶

11. **In January 2000, the establishment of an inter-ministerial committee, the Financial Sector Policy Committee (FSPC), helped strengthen the JITF framework.** The FSPC reinforced negotiating procedures by issuing regulations that introduced time-bound mediation, rules on the conduct of parties, and authorization for the JITF to recommend sanctions for “bad faith” behavior.⁷ Also, in order to direct more cases to the JITF, the FSPC was empowered to direct certain cases deemed to be of strategic importance for restructuring under the JITF. In addition, it was charged with overseeing the JITF and IBRA to ensure better cooperation between the two agencies.

12. **The effectiveness of JITF mediation improved markedly after the changes.** Creditors began to use the JITF more and more parties reached agreement. Nonetheless, the changes did not lead to unqualified success. A core group of large debtors continued to be impervious to the incentives and sanctions offered and many cases involving them were eventually de-registered from the case load. Also, some creditors continued to maintain that the JITF process allowed uncooperative debtors to buy time on real restructuring. In addition, the sustainability of many of the deals reached were questioned since only about half the dollar amount restructured involved robust measures like debt-equity swaps, buy-backs, write-offs, and cash payments.

13. **On balance, the JITF framework can be considered a success.** JITF mediated over 150 cases, involving close to \$30 billion of debt. JITF’s importance lay in the fact that, in the absence of a credible legal system and within a difficult political environment, it provided a predictable, neutral, transparent forum for restructuring. It has also helped develop a wider recognition in Indonesia of the usefulness of alternative dispute resolution mechanisms. As an example of this, many former JITF staff are involved in the new mediation center announced in September 2003, which will provide general mediation and training. The center will cooperate with the judiciary, which now requires commercial disputes to be mediated prior to litigation. The JITF process also played an important role in improving the secondary debt market as some of the restructuring deals involved debt buy-back schemes.

⁶ Also, JITF’s effectiveness was impeded by long delays in getting it operational, owing mainly to lack of strong political backing. Thus, although launched in November 1998, it was not until a year later that the JITF began to obtain sufficient budget, staffing, and infrastructure. By that time, some of the initial momentum and goodwill towards it had dissipated and doubts about its effectiveness were raised.

⁷ The JITF could recommend, for example, that: names of “bad faith” parties be published; licenses and concessions be revoked or not renewed; a company be delisted from the stock exchange; and that the Attorney-General file bankruptcy petitions against uncooperative debtors. About 40 cases were referred to the FSPC, with most resulting in no enforcement.

C. The Commercial Court

14. **Given the lack of confidence in the judiciary, there were serious concerns about how the new bankruptcy law would be implemented.** There was general consensus that a specialized body would be required to deal with the complex issues raised in the implementation of the bankruptcy law, but there was less consensus on what form that body should take. Although some international experts suggested that implementation should be assigned to an independent, administrative panel outside of the judiciary, such a panel raised a number of intractable constitutional and legal issues, and it was decided that a Commercial Court be established instead as a special chamber of the existing district courts.

15. **A major challenge was how to insulate the Commercial Court from the major problems in the judiciary.** These included in particular a lack of professionalism, transparency and accountability as well as weak administration and inadequate funding. It was decided to address these problems in the implementing regulations of the Bankruptcy Law. Among the measures to be addressed were providing the Commercial Court with its own premises, special certification (in terms of integrity, competence and training) for its judges, better salaries and benefits, larger budgetary resources, special court fees, and licensing of receivers and administrators.

16. **However, there were numerous delays in issuing the various regulations and, once issued, implementation was often slow and weak.** As a result, the Court has acquired some of the same problems as the wider judiciary. Nonetheless, the Court remains at the forefront of judicial reform and has been the source of many positive innovations now widely accepted in the judiciary. These innovations, discussed below, include, for example, structured training, ad hoc judges, publication of decisions (including dissenting opinions), time-bound procedures, comprehensive reform blueprints, financial needs assessments, and coordinated donor assistance.

Strengthening Professionalism—Training and Ad Hoc Judges

17. **The main goal of training was to improve knowledge of the bankruptcy and other commercial laws by judges and insolvency professionals such as receivers.** To improve professionalism more generally, training also encompassed broader issues such as the role of law and courts in economic development, the role of insolvency professionals, practical commercial issues, procedure, and decision-making. The focus was to move from ad hoc training to systematic, institutional training. The training is recognized as having substantially improved understanding of the basic features of bankruptcy and other commercial laws.

18. **Despite the positive impact of the training provided, a major gap remains.** The effectiveness and sustainability of training has been reduced by the regular rotation of judges from the Commercial Court to other courts. Accordingly, there is little accumulation of the experience necessary for internalization of knowledge within the institution. This issue cannot be resolved without establishing a more specific career stream for judges handling Commercial Court cases. The issue of career streams is addressed in both the Court's blueprint discussed below and the Supreme Court blueprints discussed in Section D.

19. **In addition to training, the authorities sought to strengthen professionalism by instituting a system of ad hoc judges at the Commercial Court level.** The original rationale for the system was that the judiciary lacked the requisite expertise, but other justifications soon became apparent. For example, on the subject of decisions, the first set of ad hoc judges contributed to increased transparency and accountability by insisting that they would not serve unless their dissenting opinions could be published.⁸ Also, in time, because they were removed from the systemic governance problems of the judiciary, ad hoc judges came to be seen as a means of enhancing the integrity of judicial panels.

20. **The system of ad hoc judges has resulted in mixed success because of implementation problems.** Although the system was instituted in 1998, it was not until July 2000 that the first ad hoc judges were utilized and not until 2003 that all of the necessary regulations were in place. On the positive side, majority opinions in which ad hoc judges joined and published dissenting opinions have played a critical role in shaping interpretation of the law. Further, considering that the newly-established Human Rights and Anti-Corruption courts have ad hoc judges, ad hoc judges appear to have been accepted as critical to judicial reform. The Commercial Court Blueprint calls for improvement of the system.

Blueprint for the Development of the Commercial Court

21. **The Commercial Court Blueprint charts the areas for reform, including administration, transparency, funding, and enforcement of court decisions.** The initial blueprint was completed in 2001 and an updated version and an action plan were published in January 2004. The collaborative process among judges, policy-makers, civil society, and donors in achieving consensus on the way forward has been important in fostering ownership. The blueprint also provides a coherent framework for discussions among donors; several donors have funded components of the blueprint.

22. **A number of reforms envisaged under the blueprint have recently been initiated.** A Manual on Commercial Court Administration containing standardized forms and operating procedures was published in July 2003 to replace the previous ad hoc procedures. The authorities are also seeking to enhance administration and performance by increasing transparency and accountability through systematic evaluation of Court performance and needs. As a first step, in mid-2003, an assessment of Commercial Court decisions by a team of Indonesian experts was published with the intention of fostering critical public debate on the Court's performance. Other efforts include a website, plans to prepare, for the first time, annual reports and annual budgets, and the establishment of an information office and a public complaints system. Another measure being undertaken is a realistic assessment of the Court's financial needs. In the past, budgets allocated for the courts have had no direct relationship to actual financial needs. The resulting inadequate funding, combined with weak budgetary

⁸ At the time, the law did not permit publication of dissenting opinions and judges were sensitive to changes that would allow publication. The practice is now accepted in a number of other courts.

management, has led courts to resort to off-budget means, thus further complicating governance problems. The initial needs survey was completed in March 2003.

23. **The blueprint also covers enforcement of court decisions, an area rife with problems and delayed implementation of reforms.** Bankruptcy rulings cannot be properly enforced without the active involvement and professional conduct of receivers, administrators, asset evaluators, auctioneers, the Police and the Public Prosecutor. In this regard, insolvency professionals are often insufficiently-qualified and suffer from poor institutional infrastructure, self-regulation, and court oversight. Some progress has, however, recently been made, resulting in an amended Code of Ethics and Work Standards of the Indonesian Association of Receivers and Administrators (AKPI), an AKPI ethics and disciplinary committee, and Guidelines on the Relationship Between Judges and Receivers and Administrators. On law enforcement, the Court and the insolvency professionals need to work better with the Police and the Public Prosecutor to ensure that criminal enforcement penalties in the Bankruptcy Law are used effectively.

Performance of the Court

24. **Despite the important reforms and innovations that the Commercial Court has pioneered in Indonesia, public perception of the Court is distinctly negative.** Although the Court's image remains poor, studies have found that up to 70 percent of its decisions are in fact based on sound or defensible legal reasoning. It is the remaining 30 percent or so of, usually, high profile controversial decisions that continue to tarnish the Court's reputation. Many observers believe these decisions could only have been reached as a result of external influences. Moreover, observers also note that much of the Court's perception problems originate from the Supreme Court, where some cases properly-decided at the Commercial Court have been wrongly-decided on appeal. The following section looks at the link between the Commercial Court and developments in the Supreme Court and the broader judiciary.

D. Long-Term Institutional Reform of the Judiciary

25. **From the outset, it was recognized that implementation of corporate debt restructuring would not be effective without broader judicial reforms beyond the Commercial Court.** The judiciary suffers from structural weaknesses that directly impact on Commercial Court performance and on the prosecution of governance and corruption cases. The judiciary has grouped these weaknesses into four main areas, namely poor supervision of judicial conduct, the absence of an integrated personnel management system, weak financial management and accountability, and the lack of a permanent education system for judges. Following the appointment of a new chief justice in May 2001, the authorities started to elaborate plans to address these long-term issues.⁹

⁹ The preparation of the plans was supported by the IMF's Netherlands Technical Assistance Subaccount.

An Independent Judicial Commission

26. **A constitutional amendment passed in 2001 mandates the formation of an independent Judicial Commission for improving governance of the judiciary.** The primary responsibilities of the commission are to nominate justices for the Supreme Court and to “maintain and uphold the dignity, honor and conduct of judges”, including by overseeing professional discipline. Based on preparatory work by the Supreme Court, draft legislation for establishment of the commission was introduced in Parliament at the end of 2003. In general, the draft legislation appears to strike acceptable balances on the profound and difficult issues involved. Although Parliament has indicated that the legislation is being treated with priority, it has not yet been debated. If properly implemented, the Judicial Commission represents a promising opportunity to achieve real and lasting reform in the governance of the judiciary.

Supreme Court Blueprints on Long-Term Institutional Reforms

27. **To fulfill the broad mandate to “maintain and uphold the dignity, honor and conduct of judges”, the Supreme Court has finalized comprehensive policies in three key areas.** The policies on personnel management, financial management, and the permanent education of judges are expressed in three blueprints published by the Court in July 2003. In addition, the Asia Foundation, an international NGO, supported an audit of the Supreme Court’s independence, functions, and organization, resulting in a blueprint also published in 2003. Since the effective and sustainable reform of any large institutional system rests on a proper assessment, prioritization and planning of long-term needs, the completion of the blueprints is a major milestone. The blueprints have been well-received by academics, NGOs, donors and other interested observers; the real challenge now lies in their successful implementation. To achieve this, legal commentators emphasize that the Court needs to strengthen its management of the reform process.

E. Addressing Structural Weaknesses Related to Governance and Corruption

28. **From the beginning, it was also clear that implementation of corporate debt restructuring would be hampered by systemic governance and corruption problems in law enforcement.** Accordingly, the authorities amended the corruption law in 1999 to, among other things, stiffen applicable criminal penalties and direct that an independent Anti-Corruption Commission (ACC) be established. The authorities also agreed to set up a wealth declaration framework and to make use of public interest bankruptcy petitions. Pending the enabling legislation for the ACC, the authorities created by regulation an ad hoc task force, the Joint Investigation Team (JIT) within the Attorney-General’s Office.¹⁰

¹⁰ The Asian Development Bank (ADB) and the World Bank took the lead role on governance issues. ADB focused on the ACC, the Attorney-General’s Office, anti-money laundering, and decentralization. The Bank focused on public administration and financial management. See The World Bank, *Combating Corruption in Indonesia, Enhancing Accountability for Development*, 2003.

Efforts to Strengthen the Attorney-General's Office (AGO)

29. **The authorities hoped that an external expert team to assist in corruption cases would strengthen the effectiveness of the AGO.** However, in its work, the JIT experienced great difficulty since, while nominally autonomous, in practice, it depended on the AGO in administrative and budgetary terms. In September 2000, the authorities requested and received IMF technical assistance (TA) to make the JIT more effective. Fund TA was also requested and provided to the JIT on draft legislation for the establishment of a specialized anti-corruption court. Events, however, overtook the JIT's efforts to reinvigorate itself. The JIT had brought a corruption case against three Supreme Court justices. The case was dismissed and, in a counteraction filed by the suspect justices, the JIT was declared unconstitutional. A key contribution of the JIT was that the public debates about the problems it faced with the AGO and the judiciary, and the work it did on the anti-corruption court, crystallized public consensus on the need for an independent anti-corruption commission and a specialized anti-corruption court.

30. **Following the strengthening of the JITF and IBRA frameworks in 2000, the authorities committed to use the AGO's authority to file bankruptcy petitions in the public interest.** Since the AGO had not previously handled bankruptcy cases and thus lacked the expertise to process and prosecute them, it requested Fund TA, which was provided in late 2000. Despite its enhanced capacity following the TA, several cases referred to it by the FSPC, and its own undertakings to do so, the AGO has to-date not filed any public interest petitions.

31. **The difficulties in trying to strengthen the AGO stem from deep-rooted institutional problems, which require a more comprehensive approach.** According to a study commissioned by the ADB, the AGO lacks sufficient independence from the government and the military, and is overly centralized and hierarchical in nature (thus limiting the operational independence of individual prosecutors).¹¹ The study also notes that prosecution of cases is weakened by poor cooperation with the Police, which is responsible for investigating and documenting cases for prosecution. On funding, the study finds that inadequate budgetary resources and weak budget management encourage resort to off-budget financing that, in turn, promotes governance problems. The study concludes by recommending comprehensive reform of the office, emphasizing that the task requires the highest level of political will. So far, no plans for implementing its recommendations have been announced, although Parliament is apparently considering legislation for reform of the AGO.

Commission for the Audit of the Wealth of State Officials (KPKPN)

32. **KPKPN, now in the process of merging with the ACC, was charged with receiving and auditing wealth declarations of high-ranking public officials.** Despite a slow and difficult start due to lack of sufficient funding, staffing and infrastructure, KPKPN became one

¹¹ See ADB, *Indonesia Country Governance Assessment Report*, 2002.

of the more effective anti-corruption institutions. Through its annual publication of wealth declarations, KPKPN succeeded in developing an embryonic culture of accountability regarding wealth and conflicts of interest.

33. **Observers have noted that the weak point in the work of KPKPN was its commission.** It is said that the top-heavy and politicized structure of the commission, with 32 commissioners nominated by political parties, generated tensions with what was generally regarded as a professional secretariat. The tensions were apparently compounded by the lack of effective working procedures between the commission and the secretariat, leading to a situation in which nonexpert, politicized commissioners insisted on undertaking audits of wealth declarations instead of leaving such technical work to the professional secretariat. Inevitably, the integrity of the audit process came into question, limiting the ability of KPKPN to reach its full potential. In late 2002, KPKPN initiated steps to strengthen its internal structure and working procedures, but the work was interrupted after the passage of the ACC enabling law, which requires that KPKPN be merged into the ACC.

34. **A major challenge for the authorities is to ensure that the merger of KPKPN into the ACC preserves, and even enhances, the integrity of the wealth declaration framework.** The authorities need to take advantage of the much smaller, hopefully much more independent, ACC commission of five, to address the organizational problems that KPKPN faced.

An Independent Anti-Corruption Commission

35. **After numerous delays recognized as stemming from weak political will, the ACC legislation, which represents a major milestone in legal reform, was adopted in late 2002.** Although the law has some important shortcomings, it does provide a statutory and institutional avenue through which corruption can be independently tackled. The shortcomings in the legislation could cause delays in its implementation and hinder the effectiveness of the ACC. The deficiencies include the lack of clarity in the relationship of the ACC to the Police and AGO and uncertainty regarding the wealth declaration framework. To limit implementation problems that have occurred with other agencies, the authorities need to address the shortcomings and ensure adequate and timely budgetary resources, staffing and infrastructure. In the end, the critical determinant of the ACC's effectiveness will be the credibility, integrity and competence of the commissioners appointed in December 2003. If properly supported by the authorities, the ACC has a historic chance to make a real difference.

A Specialized Anti-Corruption Court

36. **The ACC law provides for the establishment of a specialized anti-corruption court as a section of the Central Jakarta District Court.** Unlike the Commercial Court, which was established rapidly in the middle of an economic crisis, there has been more time to think through the establishment of the court. First, as noted above, the JIT was tasked with assessing this issue. Second, the experience of the Commercial Court is available for consideration. Third, there has been time to elaborate a blueprint and action plan for the court before its establishment. Fourth, based in part on the preliminary methodology developed in the needs

assessment of the Commercial Court, it appears that a reasonable budget has been allocated for the court. The authorities have committed to a deadline of June 2004 for the Court to be fully-operational.

Strategy on Governance Reforms

37. **In hindsight, the reform strategy would have been more effective had broad governance reforms been undertaken earlier in tandem with the 1998 measures on the Bankruptcy Law and the JITF.** At that time, however, the program was already extremely full. As a result, while governance issues did become an increasingly important part of the program, they initially remained secondary to issues directly involving macroeconomic stabilization.

F. Overall Assessment and Remaining Issues and Challenges

38. **Considerable success was achieved in establishing the legal framework to help in stabilizing and strengthening the corporate sector.** A modern, comprehensive legislative framework for insolvency and debt restructuring was put in place, and under the JITF framework, about one-third of the corporate debt in distress as a result of the crisis was restructured. In addition, the JITF process substantially contributed to the development in Indonesia of debt restructuring expertise, use of alternative dispute resolution, and the improvement of the secondary debt market.

39. **Although with mixed results, the Commercial Court also played a significant role in corporate restructuring.** Prior to its establishment, there were very few cases of bankruptcy litigation in Indonesia and there was thus very little jurisprudence in this area. While a number of its decisions are viewed as controversial, the majority of the Court's decisions are recognized as having contributed positively to the development of jurisprudence on bankruptcy. Moreover, through the many innovations that it has introduced, the Court has had a positive impact on the direction and substance of judicial reform in Indonesia. Many of these innovations were initially met with strong resistance in the judiciary but have now been accepted beyond the Court. Further, the visibility of the Court continues to spark public debate on the role of the courts, thus serving an important role in keeping alive the issue of judicial reform. While it cannot yet be said that the goal of implementing the Bankruptcy Law in an efficient, predictable and impartial manner has been met, significant progress in this regard has been made and a home-grown, comprehensive blueprint for the way forward has been elaborated. What remains now is effective implementation of the blueprint.

40. **In the broader judiciary, comprehensive reform plans have been prepared.** As the plans were developed by the Supreme Court, ownership is relatively strong. However, implementation of the plans could reignite vested interests that have so far played along. Implementation also faces substantial challenges of management and technical capacity and, ultimately, depends on the complementary support of the political branches of government and donors.

41. **On governance issues, reforms in law enforcement agencies have been weak and slow.** There has been little movement in the Attorney-General's Office and no action seems forthcoming in the near future. Although the Anti-Corruption Commission has now been established, it is not yet fully operational, particularly because a head for its secretariat has still not been appointed by the executive branch. In addition, the future of the wealth declaration framework, which was one of the more successful reforms in governance, remains unclear. On the new, specialized Anti-Corruption Court, there is some hope that the authorities will use its establishment to demonstrate that decisive reform is possible. Moving decisively on these issues is key to achieving real and lasting reform of the legal and justice sector in Indonesia.

42. **As is clear from the preceding sections, many of the goals of legal and judicial reforms have not yet been met.** Given the daunting problems of governance in the judiciary and law enforcement agencies, the institutional limitations, and the ambitious objectives of reform, this is perhaps not a surprising result. Real institutional reform is a challenging endeavor, even in advanced countries with better circumstances. Moreover, the horizon for realizing lasting effects of such reform is much longer than the short- to medium-term horizon of Fund-supported programs. Nonetheless, much has been achieved under the successive programs and a comprehensive framework for reform is now in place. What remains to be done is active and sustained implementation of the reform framework. This will require increased political commitment, implementing capacity, funding, donor coordination, and involvement of civil society.

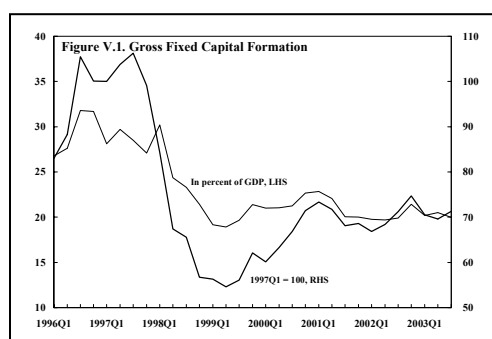
V. INDONESIA'S INVESTMENT CLIMATE¹

A. Introduction and Summary

1. **This paper examines the factors underlying Indonesia's relatively poor investment performance in recent years, and policies to enhance the investment climate.** In business surveys, investors commonly cite a number of factors that impede investment, including the potential for a return of macroeconomic instability, institutional weaknesses that contribute to uncertainty and weak policy implementation, and inadequate infrastructure. In order to attract the levels of investment that Indonesia requires to meet its poverty reduction and employment objectives, it is widely recognized that the government will need to develop a supportive legal and institutional environment. Key aspects of such an environment include significantly reduced corruption, legal and policy certainty, improved revenue administration, and a competitive and flexible labor market.

B. Indonesia's Investment Performance

2. **Investment in recent years has remained weak.** After a strong recovery in 2000-01, following a precipitous decline after the crisis, investment has remained relatively flat. The share of investment in GDP has averaged around 20 percent since 2001, down from a peak of over 30 percent before the crisis (Figure V.1).



3. **Foreign direct investment (FDI) similarly collapsed after the crisis and there have only recently been some signs of recovery.** FDI inflows have fallen dramatically, averaging 1-2 percent of GDP in the post-crisis period, compared to above 5 percent prior to the crisis. Indonesia's balance of payments have recorded persistent net outflows of FDI between 1998 and mid-2002, although net FDI turned positive in the second quarter of 2003.² While comparability of FDI data across countries is complicated by definitional differences, the balance of payments data indicate that Indonesia has been significantly less successful than its neighbors in attracting FDI (relative to GDP).

¹ Prepared by Yougesh Khatri.

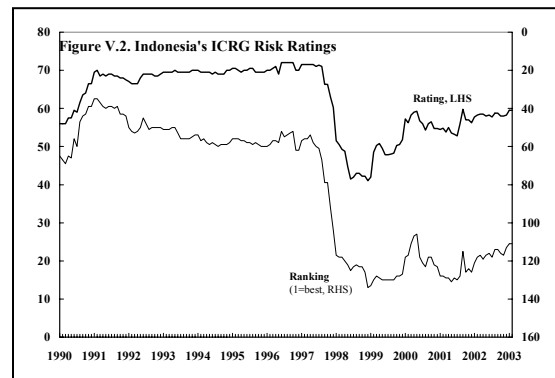
² The FDI series has been revised to include divestment and IBRA asset sales to non-residents. Moreover, from 2002 onwards, the official FDI series changed its methodology, reducing the ownership threshold from 50 percent to 10 percent. Net FDI is defined as FDI into Indonesia less FDI by Indonesia abroad.

4. **Investment approvals remain at or below their post-crisis average, although they show some improvement from the lows of 2002.** Domestic and foreign investment approvals increased in 2003, albeit from a low base (domestic approvals almost doubled, while foreign approvals rose by 50 percent). Nevertheless, overall approvals in 2003 were still at or below their post-crisis averages.

C. Summary Indicators of the Investment Climate

5. **Various summary indicators of competitiveness and the investment climate for 2003 place Indonesia in the lowest quartile of all countries ranked** (Table V.1). These indicators consistently place Indonesia below its regional competitors as well. In the pre-crisis period, the International Country Risk Guide (ICRG) ranked Indonesia in the top half of all countries, but below the other Asian crisis countries (Figure V.2).

With the onset of the crisis, the disparity between Indonesia's ranking and that of the other Asian crisis countries and its neighbors further widened. In recent years, however, there has been some improvement in the ICRG rating for Indonesia. For example, Indonesia's ranking in A.T. Kearney's FDI confidence Index rose to 25 (out of 64) in 2003 its best ranking since the crisis, and various rating agencies have upgraded Indonesia a number of times since mid-2002.



6. **The regulatory environment for doing business in Indonesia is considered to be less conducive than in neighboring countries.** The World Bank's *Doing Business Database* provides indicators of the cost of doing business by focusing on regulations that enhance or constrain business investment, productivity and growth (Table V.2). According to the database, starting a business in Indonesia requires more procedures and time, but generally costs less, than in neighboring countries (and also compared to the broader averages in Asia). The laws relating to hiring and firing suggest that the Indonesian labor market is typically less flexible than in the rest of Asia.³ Contract enforcement requires fewer procedures and takes less time than in some neighboring countries, although it costs more. Finally, closing a business takes on average 6 years (again, higher than in neighboring countries), and costs 18 percent of the estate (about the same as the regional average).

³ These indices do not take into account the new implementing regulations of the Manpower Act (March 2003) and the Dispute Resolution Act (January 2004) which are in the process of being issued.

D. Key Areas of Concern

7. **The crisis resulted in a prolonged period of macroeconomic instability, and a sweeping “regime change.”** The resultant environment has been marked by a change in the “rules of the game,” with less predictability for businesses. In this context, the areas below—consistent with the findings of a number of recent assessments, and international comparative indicators—are highlighted as the key factors retarding investment in Indonesia (Box V.1).⁴

Macroeconomic Stability

8. **The large swings in exchange rates, interest rates, inflation, and domestic demand severely impacted the Indonesian corporate and banking sectors.** Despite a restoration of macroeconomic stability, the volatility of these indicators in recent years remains fresh in the minds of investors and financiers. It is thus not surprising that macroeconomic stability tops the list in the recent World Bank-AsDB survey of investor concerns, and still ranks high among concerns of international investors.

The Institutional Environment

9. **Legal, institutional, and governance indicators for Indonesia compare unfavorably to neighboring countries** (Table V.3). Measures of the quality of public institutions, government efficiency, and the regulatory environment place Indonesia near the bottom of all countries ranked, and consistently below neighboring countries. For example, Transparency International’s Corruption Perception Index ranks Indonesia 122 out of 133 countries, well below its peers. On measures of efficiency, integrity and effectiveness of the legal environment, Indonesia is again rated significantly below the rest of the sample. Political risk, according to the ICRG index, has increased significantly compared to the pre-crisis period, and Indonesia was ranked at 127 (of 140 countries) as of early 2003.

10. **Uncertainty stemming from the institutional environment translates into uncertain investment returns.** The relatively poor legal and institutional environment, together with the dramatic change in the rules of the game (accompanying the political change in 1998) help explain why the crisis was so severe and protracted in Indonesia relative to the other crisis countries. With these changes came reduced coordination and proliferation in illegal “charges,” with a common perception that that these have increased in recent years. Survey results indicate that such corruption related costs are high in comparison to neighboring countries (World Bank) and are difficult to avoid, as a large share are accounted for by the payments to courts and the police.

⁴ A broad array of other issues may also have affected investment in Indonesia: security concerns, separatist movements and regional conflicts; and high profile disputes involving multinational corporations and defaults on international borrowing.

Box V.1. Assessing Indonesia's Investment Climate

Various recent studies have highlighted areas of concern regarding Indonesia's investment climate:

A joint World Bank-Asian Development Bank private investment climate study is currently being prepared from surveys of investors in Indonesia. Preliminary results, based on responses of 400 firms mainly in Java, suggests that investors are most concerned about macroeconomic instability, policy uncertainty, and corruption, although other important concerns include tax rates and tax administration, cost of financing, the legal system, labor regulations and electricity. Decentralization has exacerbated the concerns of firms, particularly with regard to corruption and policy uncertainty, but to business licensing and labor regulations as well.

Regional Autonomy Watch (KKPOD) recently announced the results of its survey of over five thousand domestic and foreign firms located throughout Indonesia, and in various sectors of the economy. The survey identifies illegal fees as a major problem of doing business in Indonesia. It notes, moreover, that as the major recipients of these fees are the courts and police, businesses are unable to avoid paying them. The survey finds that 85 percent of responding firms reported having paid illegal fees, and that: (i) the average of illegal fees was around 2 percent of total production costs, and in the case of 3 percent of the respondents, was in the range 8–10 percent of the total production costs; (ii) illegal fees were on average around 60 percent of legal cost in government service agencies; and (iii) of the total fees paid, 13.1 percent were paid to court officials, 11.5 percent to security officers, 8.5 percent to community groups, and 6.1 percent to “thugs.”

A recent Japanese Bank for International Cooperation (JBIC) study notes that Indonesia has slipped to the sixth largest recipient of Japanese investment in 2003 (from fourth place in 2000), as Vietnam and India took the fourth and fifth places, respectively. The study cites the key factors discouraging investment as “the unstable political and social conditions, the local labor difficulties, as well as currency and price stability.”

A White Paper Monitoring Committee (consisting of groups representing domestic and foreign investors and independent economists) has been set up to monitor implementation of the elements of the White Paper of interest to the business community. The committee has highlighted three priority areas of (i) legal reforms; (ii) development of SMEs; and (iii) increasing labor force skills and empowering the poor.

Decentralization

11. **While the decentralization process has generally been orderly, there have been some adverse consequences for the investment climate:**

- Survey results and discussions with entrepreneurs suggest that subnational regulations have created additional costs for business. Many subnational governments have increased the number of local taxes—as allowed under Law 34/00 which defines subnational taxes as an open list—leading to a proliferation of small ad hoc taxes and fees.⁵ The central government is given 30 days to review regional regulations and annul those that are in conflict with higher regulations/statutes. However, given the sheer volume of regulations submitted, only a fraction of these have been assessed within the required period, resulting in overlapping taxes and charges that are an additional burden on business.
- **Problems of corruption, policy uncertainty, business licensing, and labor regulations have been exacerbated**, according to the preliminary findings of a World Bank-AsDB survey. Moreover, a recent study of the Regional Autonomy Watch reports that 20 percent of respondents indicate that regional regulations cause problems for them, with a vast majority (86 percent) indicating they were not involved in the formulation of regional regulations. Surveys also suggest that decentralization has created opportunities for new rent seeking at the subnational government level.

Tax Policy and Administration

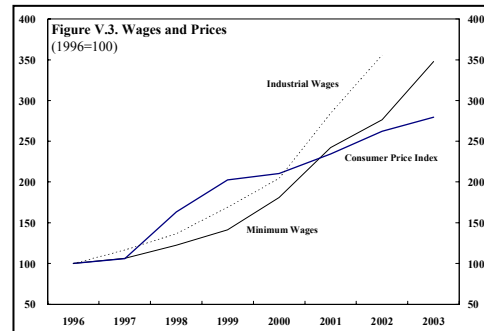
12. **While notable progress has been made in improving tax administration in recent years, this area still ranks high among the concerns of investors.** Indonesia's tax rates are generally at levels comparable to neighboring countries, but businesses often complain about uncertainty, particularly with respect to the amount of their tax liabilities, and that the appeals processes can be costly, complicated and ineffective, leaving them little protection.

⁵ The new taxes include fees for ID cards for expatriates, local taxes on heavy equipment, and charges for timber in addition to the fees already paid to the central government for the Reforestation Fund.

Labor Issues

13. **According to investors, in recent years the Indonesian labor market has become less flexible, more costly, and more uncertain.**

Minimum and industrial wages (the latter is an indicator of wages in the formal sector) have increased rapidly in recent years, significantly outpacing inflation and productivity growth (Figure V.3).⁶ The devolution of minimum wage setting to the regions in 2001 resulted in wide variations across regions and has led to a loss of policy coordination. In the aggregate, labor inputs in Indonesia are judged to be less productive relative to competitors; nonwage costs are higher as well.⁷



14. **Based on various indicators, the formal labor market in Indonesia is less flexible than in much of Asia.** The new labor legislation is a step forward as it provides a basic framework for labor relations, but care will need to be taken in devising the implementing regulations to ensure that the labor market does not become even less flexible. In particular, retrenchment and severance pay provisions under the new legislation must be defined carefully to ensure adequate flexibility while protecting workers' basic rights. The same is true for employment provisions under the new bill.⁸

Infrastructure

15. **The state of Indonesia's infrastructure compares unfavorably to the region, and has deteriorated since the onset of the crisis.** In 2003, Indonesia's technology ranking (according to the Global Competitiveness Report) was at 78 of 102 countries, while its infrastructure ranking (according to IMD) was last among the 30 countries considered with populations greater than 20 million.⁹ The crisis contributed to the worsening of the problems

⁶ Taking the growth in income per worker averaged over the period.

⁷ Value-added per worker in Indonesia compares unfavorably to India and China in key sectors such as electronics, textiles and garments (World Bank, 2003a); and severance costs in Indonesia are a multiple of those in Vietnam or China.

⁸ For example, short fixed-term contracts are only permissible if the job is "temporary by nature or seasonal," and outsourcing is restricted for activities that are not strictly auxiliary to the activities of the enterprise. Varying interpretations of these various provisions could act to limit firms' flexibility in employment and production arrangements.

⁹ A bright spot appears to be telecommunications sector which, following liberalization in 1999, has seen significant growth in mobile phone users.

in the infrastructure sectors, with infrastructure projects being postponed and scaled back, and some of the factors discussed above have also adversely affected infrastructure investment. For example, decentralization increased uncertainty regarding responsibilities for infrastructure provision, and weakened coordination mechanisms. The recent World Bank Report on Infrastructure (World Bank, 2003b) provides a more detailed assessment of the key problems and policy priorities in the infrastructure sector.

E. Government Policies to Attract Investment¹⁰

16. **In the context of its White Paper, the government has adopted a number of policies to increase investment, exports and employment.** These are summarized in Table V.4, and include the following key areas:

- **A proposed new investment law**, which includes provisions to ensure the equal treatment of domestic and foreign investment; a one-stop shop for investment approval; removal of the requirement that foreign-owned companies divest part of their shareholdings to national shareholders; and allowance for foreign investors to repatriate most funds (subject to tax obligations having been settled).¹¹
- **Improvements to the decentralization framework**, through the revision of the decentralization laws.
- **Revenue administration reforms**, including tax law amendments to strengthen policy and administration (focusing on extending the large taxpayer office model, providing better taxpayer services, improving governance, and medium-term modernization); and improving customs administration, with a particular emphasis on strengthening governance, facilitating trade, combating smuggling, and improving valuation control.
- **Completion of the new legal framework for labor issues.**
- **Improvements to infrastructure**, encompassing transportation, communications, energy, power, and water resources (with action plans in the form of projects, and the development of appropriate legal and regulatory frameworks).

¹⁰ Currently, the Capital Investment Coordinating Board is the main body responsible for promoting foreign investment and approving investment proposals. Other mechanisms to promote investment and exports include the Bonded Zones and Integrated Economic Zones.

¹¹ The proposed law is meant to be an umbrella for investment activities outside of upstream oil and gas, and financial services, which come under separate law. Note that nearly three years after passing the current oil and gas, some of the necessary implementing regulations have yet to be issued.

- **Institutional/governance reforms**, encompassing legal reforms, enhancements to security and law and order, and improved provision of public services (such as health, education, and sanitation).

17. **A number of challenges will need to be addressed with the design and implementation of these policies.** For example, to strengthen the decentralization framework, the related law amendments will need to be accompanied by reforms to enhance the governance framework, along with efforts to improve institutional capacity at the local government level and to ensure adequate coordination among the various levels of government. Indonesia's infrastructure needs will require large investments over the medium term, with private sector participation which will, in turn, increase the importance of providing greater investment certainty through improved enforcement of property rights and contracts. Important legal reforms aimed at combating corruption and improving the functioning of the judiciary, commercial courts, and law enforcement will need to be complemented by the appointment of adequate professional staff and sufficient budget allocations.

F. Conclusion

18. **With a number of major legislative changes in the pipeline, the priority going forward should be to improve policy certainty and coordination.** Implementation of the reforms noted above will be key. For example, the revisions to the decentralization laws will need to be accompanied by appropriate structural reforms such as a strong governance and coordination framework. With regard to the labor laws, much of the detail remains to be fleshed out through a large number of implementing regulations.

19. **Priorities over the medium terms include key legal and public administration reforms in support of a conducive policy environment.** The legal reform priorities include enforcing property rights and contracts, together with creating an efficient judiciary, with the aim of bolstering legal certainty in the implementation of commercial law. In the area of public administration, the challenge is to improve governance and efficiency, particularly in the areas of tax and customs administration.

Table V.1. Investment Climate Indicators

Countries	Growth Competitiveness Report		IMD World Competitiveness Yearbook Overall Ranking				International Country Risk Guide Composite Index Based Country Ranking					A.T. Kearney FDI Confidence Index Rank	
	Overall Ranking		Population >20 Million		Population <20 Million		Country Ranking					Index Rank	
	2001	2003	1999	2003	1999	2003	1995	1997	2000	Feb-03	Jun-98	Sep-03	
Indonesia	63	72	25	28	...	...	58	66	117	111	18	25
Philippines	48	66	12	22	...	...	64	51	71	64	25	...
Thailand	33	32	16	10	...	...	38	43	41	50	15	16
Malaysia	30	29	9	4	...	...	25	37	36	42	22	23
Vietnam	59	60	...	...	...	...	96	67	72	65	...	21
Singapore	4	6	...	...	2	2	8	3	1	4	24	...
China	39	44	11	12	...	...	56	45	52	42	3	1
India	56	56	19	20	...	...	62	65	86	78	5	6
South Korea	23	18	21	15	...	...	23	27	28	26	21	18
Number of countries ranked	75	102	30	30	29	29	129	129	140	140	...	64	

Sources: International Institute for Management Development; International Country Risk Group; and A.T. Kearney.

Table V.2. Doing Business in Indonesia, 2003

Country	Starting a Business			Hiring and Firing Workers				Enforcing Contracts			Closing a Business		
	Number of Procedures	Duration (Days)	Cost (Percent of GNI per capita)	Minimum Capital (Percent of GNI per capita)	Flexibility of Hiring Index 1/	Conditions of Employment Index 1/	Flexibility of Firing Index 1/	Number of Procedures	Duration (Days)	(Percent of GNI per capita)	Procedural Complexity Index 1/	Actual Time (In years)	Actual Cost (In percent of estate)
Indonesia	11	168	14.5	302.5	76	53	43	0	225	269	67.4	6	18
Philippines	11	59	24.4	9.5	58	73	50	28	164	103.7	75	5.7	38
Thailand	9	42	7.3	0.0	78	73	30	19	210	29.6	53	2.6	38
Malaysia	8	31	27.1	0.0	33	26	15	22	270	19.4	41	2.2	18
Vietnam	11	63	29.9	0.0	43	77	48	28	120	8.5	45.8	..	..
Singapore	7	8	1.2	0.0	33	26	1	23	50	14.4	48.6	0.7	1
China	11	46	14.3	3,855.9	17	67	57	20	180	32	52.1	2.6	18
India	10	88	49.8	430.4	33	75	45	11	365	95	49.7	11.3	8
Korea, Rep.	12	33	17.9	402.5	33	88	32	23	75	4.5	50	1.5	4
Group averages													
East Asia Pacific	8	66	56.8	646.8	45	60	30	19	193	66.3	55.2	2.8	17
South Asia	8	44	76.3	86.1	39	68	39	19	358	92.6	55.3	5.4	9
OECD	10	57	91.9	301.0	49	69	37	25	307	38.3	57.7	3.2	13
Low income	11	73	204.4	341.6	49	73	40	27	296	68.3	56.6	3.7	13
High income	7	31	9.7	102.3	48	56	27	18	264	8	50.7	2	9

Source: World Bank Doing Business database (see www.rti.worldbank.org/DoingBusiness/SnapshotReports/Country.aspx?regionalid=90).

1/ Lower values of the index indicate greater flexibility.

Table V.3. Legal, Political, Institutional and Governance Climate

Countries	Global Competitiveness Report Public Institutions Ranking 2003	IMD World Competitiveness Yearbook Government Efficiency Ranking (Population >20 million) 1999	Transparency International		International Country Risk Guide Political Risk Index Ranking 1997 Feb-03		CLSA Emerging Markets: Ranking From 1 (worst) to 10 (best)							La Porta et al.		
			Corruption Perception Score 1/ 2003	Country Ranking 2003	Country Ranking 1997	Country Ranking Feb-03	Rules & Regulations 2003	Enforcement 2003	Political & Regulatory Environment 2003	Adoption of IGAAP 2003	Institutional Mechanisms & Corporate Governance Culture 2003	Country Score 2003	Legality 2/ 1998	Shareholder Rights 3/ 1998	Judicial Efficiency 4/ 1998	
Indonesia	72	25	27	1.90	122	86	127	4.5	1.5	4	5	2.5	3.2	9.14	2.00	2.5
Philippines	66	11	21	2.50	92	52	67	6.5	2	2	6	4	3.7	3.00	3.00	4.8
Thailand	32	9	5	3.30	70	40	50	7.5	3	4	6	4.5	4.6	2.00	2.00	3.3
Malaysia	29	6	3	5.20	37	35	50	9	3.5	4	7	6.5	5.5	4.00	4.00	9
Vietnam	60	...	...	2.40	100	57	67	...	...	...	...	...	...	...	...	...
Singapore	6	...	...	9.40	5	7	12	8.5	7.5	6	9	8	7.7	4.00	4.00	10
China	44	10	9	3.40	66	63	63	5	4	5	5	3	4.3	...	...	...
India	56	17	19	2.80	83	77	106	8	7.5	6	9	8	7.7	12.78	5.00	8
South Korea	18	22	18	4.30	50	32	35	7	3.5	5	7	6	5.8	2.00	2.00	6
No. of countries ranked	102	30	30		133	129	140									

1/ Relates to perceptions of the degree of corruption as seen by business people, academics and risk analyst, and range between 10 (highly clean) and 0 (highly corrupt).
 2/ Index of legal and economic development constructed by Berkowitz et al.(2002) as a weighted average of Efficiency of the Judiciary, Rule of Law, Corruption, Risk of Expropriation & Risk of Contract Repudiation. Lower score="better."
 3/ The sum of dummies that identify one-share one-vote, proxy by mail, unblocked shares, cumulative vote/proportional repr, preemptive rights, oppressed minority and % of share to call an ESM. Higher score="better."
 4/ Assessment of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms" (La Porta et al., 1998), produced by Business International Corporation (a rating agency). Higher score="better."

Table V.4. Key Initiatives in the White Paper to Improve the Investment Climate

Policy/Action Plans	Outputs	Date
<i>From Section 1: Improving Macro Stability</i>		
Tax reform	Submit draft law to parliament	Jan-04
Tax and customs administration reforms (see also below)	Miscellaneous targets	Sep-03-Mar-04
Improve fiscal decentralization framework	Draft amendments to laws 22/1999; 25/1999; and 34/2000	Sep-04
<i>From Section 3: Increasing Investment, Exports and Employment</i>		
<i>I. Improving the Investment Climate</i>		
Provide legal certainty to business: revise negative investment list and present a new draft of the investment law	Presidential decree/draft law	Dec-03
Simplify the licensing process: set up a one-stop shop	Presidential decree	Oct-03
Eliminate obstacles to investment and exports: set up a team to address key problems (basically those cited in Section 4 above)	Presidential decree	Oct-03
<i>II. Promoting Industry and Trade</i>		
Increase exports through increased promotion and market penetration	Miscellaneous actions	Nov-03-Jun-04
Restructuring business support agencies	Pilot project/draft laws	Nov-03-Dec-03
Simplify procedures for exports and imports	Get the system on-line	Dec-03
Increase competition and transparency in government procurement	Presidential decree	Oct-03
<i>III. Developing Small and Medium Enterprises, and Cooperatives</i>		
Increase access of SMEs and cooperatives to productive resources	41,600 land certificates	Ongoing
Create a conducive environment for SMEs and Cooperatives	Amend law/draft law	Jul-04; Aug-04
<i>IV. Improving Tax and Customs Service to the Community</i>		
Tax reform: Improve tax administration, through large taxpayer offices and increased quality of service to taxpayers	Improved services/MoF decree	Dec-03 and ongoing
Customs reform: improved clearance information systems; improve services to exporters; extend priority lanes; improve (risk-based) selection process; enhance coordination to stop smuggling; improve the price database to reduce undervaluation; improve quality	Improved services	April-03; Jan-04; ongoing
<i>V. Legal Reform</i>		
Eliminate Corruption: ACC, training of judges, blueprint on role of Judicial System in reducing corruption, Judicial Commission Law, revise law on the Attorney General, Issue law on Freedom of Information.	Presidential decrees; amended/new laws; and misc.	Sept-03; Dec-04; ongoing
Improve Commercial Court performance	Law/blueprint	
Harmonize regional regulations	Ministerial decree	ongoing
Improve capacity and performance of law enforcement officers	Improved professionalism	ongoing
<i>VI-X: Infrastructure</i>		
	Miscellaneous	Dec-03 to -2007; ongoing
<i>XI. Security, Law and Order</i>		
	Increased security/law&order	ongoing
<i>XII. Improved Public Service</i>		
	Laws/Min. decrees	Dec-03-2004
<i>XIII. Employment</i>		
Improve the employment climate: finalize Dispute Settlement and Protection of Overseas Workers bills; finalize implementing regulations for the Manpower Law	9 Presidential decrees; 26 Min. of Manpower Decrees; and 9 draft Government Decrees	Oct-03-July-04

Source: Data provided by the Indonesian authorities.

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World Bank, 2003a, "Indonesia: Beyond Macro-Economic Stability," World Bank Brief for the Consultative Group on Indonesia.

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World Bank, 2003c, "Maintaining Stability, Deepening Reforms," World Bank Brief for the Consultative Group on Indonesia.

VI. INDONESIA'S EXPORT COMPETITIVENESS¹

A. Introduction

1. **As described in the previous chapters of this Selected Issues paper, Indonesia's export performance since the Asian crisis has not matched that of its peers.** This chapter documents the extent of this underperformance, reviews some of the main explanatory factors, and assesses medium-term export prospects in light of recent evidence.
2. **A number of factors has contributed to Indonesia's relatively weak export performance in recent years.** Cost competitiveness—as measured by trends in the real effective exchange rate and unit labor costs—has deteriorated in the past two years, contributing at least in part to the weak non-oil export growth witnessed during this period. However, cost considerations alone do not fully explain Indonesia's relative underperformance in the region. Indeed, a longer perspective suggests that exports have been held back by relatively weak external demand for Indonesia's mix of export products, by a collapse of foreign investment that was much sharper in Indonesia than elsewhere in the region, and by constraints that appear to have weighed more heavily on labor-intensive manufacturing exporters. Looking ahead, the current external environment is favorable for a rebound in exports. Whether domestic conditions can be equally supportive will depend on Indonesia's ability to attract new foreign investment into export industries and create a conducive environment for labor-intensive manufacturing sectors.

B. Export Performance Since the Asian Crisis

3. **Prior to the Asian Crisis, Indonesia registered some of the fastest export growth rates in the region.** For the 1970–96 period, export earnings rose by an average of 18 percent per year in Indonesia, similar to growth rates recorded in China, Thailand, and Malaysia. Indonesia's export growth during the 1970s and 1980s was driven by non-oil exports, which increased six-fold, from around \$6 billion in the early 1980s to \$37 billion just before the Asian crisis. While there appears to have been a slowdown of export growth in the early 1990s (see below), Indonesia's exports were still growing at double-digit rates at the onset of the Asian crisis.
4. **However, Indonesia's export performance since the Asian crisis has lagged that of its regional comparators in several respects** (Table VI.1). Growth in export earnings has been among the lowest in the region. Indonesia's cumulative export growth during 1998–2003 amounted to only 26 percent (and just 12 percent for non-oil exports), while cumulative growth rates for Thailand, Korea, and Malaysia averaged 46 percent, and those for China and Vietnam exceeded 100 percent. Moreover, although available volume data are not very reliable, the evidence suggests that Indonesia's export volumes were negative or flat during the 1998–2003 period, in contrast to the double-digit volume growth rates registered by virtually all its comparators.

¹ Prepared by Helaway Tadesse.

	Historical Export Growth Rates (Annual average growth rates)		Trend in Regional Exports, 1998 = 100 (Based on U.S. dollar export values)					
	1970-1996		1998	1999	2000	2001	2002	2003
	Indonesia, total	18.4		100	102	130	114	117	126
Indonesia, non-oil	24.0		100	95	117	104	108	112
China	18.6		100	106	136	145	177	239
India	11.8		100	108	127	131	149	173
Korea	22.9		100	110	133	115	124	152
Malaysia	17.4		100	117	137	123	130	140
Philippines	13.4		100	116	126	106	117	119
Thailand	19.4		100	107	128	120	126	148

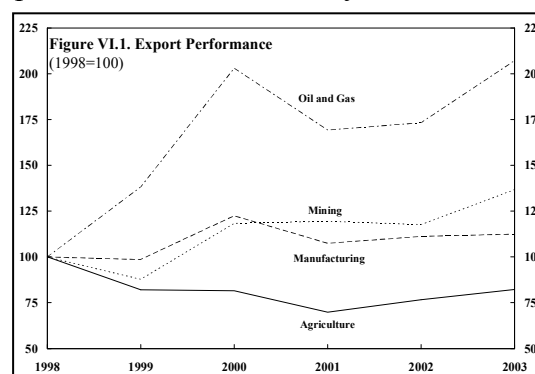
Sources: World Economic Outlook; Bank Indonesia for Indonesia data on non-oil and gas exports.

5. **Indonesia’s market share in key export destinations has fallen or been flat since the Asian crisis.** Indonesia held on to its roughly 1 percent share of worldwide imports between 1996 and 2002, but this contrasts with most of its regional comparators who registered gains in market share during this period. A loss of share for Indonesia occurred in three key markets, namely in the United States, Japan, and China. In the latter case, while exports to China rose more than 20 percent since end-2001, other countries in the region registered even stronger growth.

6. **A sectoral review of exports reveals the following trends (Figure VI.1):**

- Almost two-thirds of export value growth in the post-crisis period has relied on oil and gas receipts, which in turn reflected price effects. Oil export volumes fell by a quarter between 1998 and 2003, while gas export volumes were broadly flat.

- Also, exports of other mining products—mainly coal, copper, and aluminum—have played a role in boosting non-oil exports, contributing about a third to non-oil export growth in the same period.



- Manufacturing exports as a whole did relatively poorly. While they drove non-oil sector exports in the late 1980s and early 1990s, they grew by a meager 3 percent per year, or only 13 percent cumulatively between 1998 and 2003.

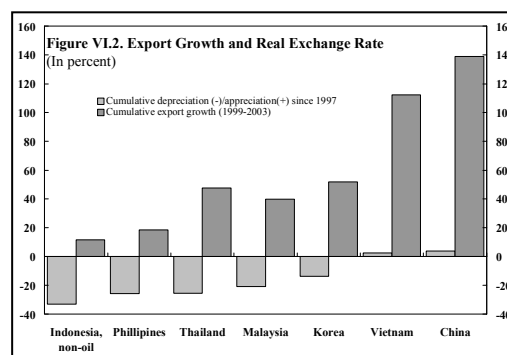
- The vast majority of manufactured export sub-sectors have grown at much lower growth rates than prior to the crisis (Annex VI.I, Table A.1), with the exception of a few mineral-based manufactured goods. Furthermore, a number of the large-value manufactured exports, those generating at least \$0.5 billion per year, showed a marked slowdown in export growth in 2002–03 compared to the immediate post-crisis years. Such sectors include apparel and clothing, textiles, electrical equipment, office machines and computer equipment, telecom equipment, footwear, and furniture.

C. Explaining the Underperformance

7. **The various aspects of Indonesia's underperformance reviewed above all point to a distinct shift from the pre-crisis trajectory of exports.** These developments raise questions as to the relative dominance of cost versus noncost factors and of domestic versus external factors, as well as whether the underperformance of exports is likely to be temporary or permanent. The review below suggests that: (i) cost competitiveness was not the major deterrent to exports during most of the post-crisis years, although it is now an emerging issue; (ii) the weakness in exports reflects both external and internal factors; and (iii) in the absence of longer-term shifts in the composition of Indonesia's exports, the underperformance compared to others in the region may be prolonged.

Trends in Relative Cost Competitiveness

8. **Measured by the CPI real effective exchange rate (REER), cost competitiveness improved sharply following the depreciation of the rupiah in 1998, and still remains more favorable than pre-crisis levels.** The level of the REER for the 1998–2003 period as a whole was around 30 percent below the pre-crisis years, a period when Indonesia's exports, including non-oil exports, were performing well. From a cross-country perspective, and considering the post-crisis period as a whole, Indonesia experienced the largest REER depreciation among its peers (Figure VI.2).² This has not, however, translated into dynamic non-oil export growth. Indeed, Indonesia and the Philippines, the two countries with the sharpest depreciations following the Asian crisis, have registered the lowest subsequent export growth rates. A CPI-based measure of the REER as a proxy for cost-competitiveness is thus clearly not adequate to explain Indonesia's relative underperformance.



9. **Recent trends in (U.S. dollar) wages and unit labor costs (ULC), however, show greater deterioration in cost competitiveness** (Table VI.2). Indeed from this perspective the gains realized in the immediate post-crisis period have been fully eroded. While Indonesian manufacturing sector wages in rupiah terms more than doubled between 1997 and 2001, the sharp depreciation of the currency kept wages in dollar terms well below pre-crisis levels during this period. Recently, however, dollar wages are estimated to have returned to pre-

² Consistent with the above, the level of the exchange rate has generally not been regarded as an impediment by exporters, even after the more than 20 percent real appreciation (from extremely low levels) of 2002-03. Discussions with trade associations indicates that they view the levels in recent years as broadly appropriate and that they have greater concern with stability in the exchange rate.

crisis levels, despite falling productivity. In fact, after accounting for productivity trends in the manufacturing sector, unit labor costs in currency terms are now estimated to be 35 percent above pre-crisis levels.³ Of course, the one-third decline in measured productivity is likely to partly reflect cyclical factors, but this is unlikely to change the basic story.

Table VI.2. Unit Labor Costs in the Manufacturing Sector, 1993-2003
Index 1993 = 100

	Manufacturing Output [1]	Manufacturing Labor Force [2]	Manufacturing Wage [3]	Unit Labor Cost in Local Currency Terms [4 = {3}/{1/2}]	Exchange Rate (\$/Rp) [5]	Unit Labor Cost in US\$ [6= {4}/{5}]	Manufacturing Wages, in US\$
1993	100	100	100	100	100	100	100
1994	108	123	105	120	104	116	101
1995	118	115	121	119	108	110	113
1996	118	123	142	147	112	131	127
1997	125	128	168	172	139	123	121
1998	102	113	172	190	480	40	36
1999	104	131	224	282	376	75	59
2000	108	133	297	365	404	90	74
2001	107	138	374	483	492	98	76
2002	99	138	469	652	446	146	105
2003 (est.)	101	138	500	682	411	166	122

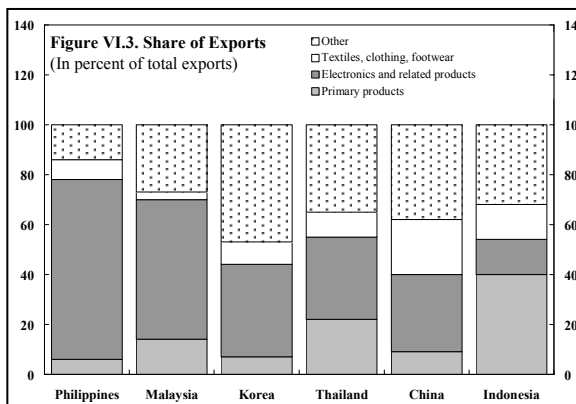
Sources: BPS statistics (through CEIC database) for manufacturing output, employment, and wages. Data for 2003 are preliminary based on partial (Jan-July) data for some series, and estimates for others.

10. **The deterioration of wage-based competitiveness has the potential to become a strong deterrent to manufacturing exporters.** In principle, the sharp increase in labor costs observed in the past few years need not necessarily reduce competitiveness, as the rise has taken place from extremely low post-crisis levels; more generally, some increase in cost competitiveness can be absorbed by exporters if labor is not their dominant expense or if wage increases are accompanied by improvements in other dimensions of business operating conditions. However, labor is an important cost component in several export sectors and progress in many (nonwage) business conditions is unlikely to have been adequate (as discussed in the preceding chapter on the investment climate); for such exporters, the sharp increase in unit labor costs over the past two years would thus have played a part in holding back exports from levels they might have otherwise attained.

³ Most of the increase took place in 2002-03 during which the ULC index rose by 69 percent (data for 2003 are estimated).

Export Composition and External Demand

11. **Despite some diversification over the past quarter-century, Indonesia’s exports are still relatively skewed toward primary products** (Figure VI.3). Even after their exceptional growth in the early 1990s, manufactured exports comprise only 55-60 percent of total exports compared to around 85-90 percent for most of its regional peers, including Thailand, Malaysia, Korea, Philippines and China. Moreover, among the various manufacturing sub-groups, Indonesia’s exports are more strongly dominated by products such as textiles, apparel, footwear, and furniture.



12. **External demand conditions for Indonesia’s export mix during 1998-2002 was noticeably different from that of its peers** (Table VI.3). In particular, world import growth for the goods that dominate Indonesia’s export composition has been much lower than for the goods exported by its peers. Between 1997 and 2002, for example, cumulative world import growth for primary products, textiles, clothing and footwear (which collectively represent about a two-thirds of Indonesian exports) was in the 2-7 percent range, while world demand for electronics and related products (a category that makes up almost half of peers’ exports) rose by a cumulative 15 percent. Similarly, a review of the 15 largest (SITC) export categories of Indonesia and its regional comparators reveals that external demand was lowest for Indonesia’s top exports.

	Primary Products	Textiles & Footwear	Electronics Products	World Imports
1992-1997	34.5	30.4	90.6	50.1
1997-2002	6.8	2.2	15.2	10.4

Source: WITS database.

13. **To the extent that the export composition of Indonesia’s peers are concentrated in sectors with faster-growing world demand, Indonesia could find it increasingly difficult to match the export growth rates of its neighbors** (Table VI.4). A revealing example is seen in the exports of electronics related categories (SITC 75-77), which includes a wide range of electrical and “high technology” products (office machines, computers, television, radios, telecoms equipment, electric circuits, and related electrical equipment). Global growth in this sector has been high in the post-crisis period, and was even higher in the early 1990s. However, at the

	1990 (In billions of US\$)	Export Share 1990 (In percent)	1997 (In billions of US\$)	2002 (In billions of US\$)
Indonesia	0.2	1	3.7	7.9
Korea	16.6	26	40.1	59.9
Malaysia	9.1	31	40.0	52.1
Philippines	2.4	27	15.5	25.3
Thailand (2001)	4.1	18	17.6	20.6

Source: WITS database.

start of the 1990s, such exports accounted for less than 1 percent of Indonesia's exports while they already accounted for 20 percent of exports in Thailand, and nearly a third of total exports in Philippines, Malaysia and Korea. Such exports now constitute around 14 percent of Indonesia's exports, compared to around 50 percent for its four peers, but still generate a comparatively modest \$8 billion in export receipts, compared to around three times as much in Philippines and Thailand, and six times as much in Malaysia and Korea.

14. **While the above signals that Indonesia's relative underperformance has an exogenous and structural component, it also highlights the potential gains in moving towards the higher-growth sectors that have become dominated by its peers.** In the short-term, the structure of a country's exports is relatively rigid, but a combination of a favorable environment for private sector initiatives and supportive public policies can help steer production toward faster growth sectors. The growth of foreign investment—together with the new technology and product mix associated with it—can offer substantial benefits in this regard, although this is precisely the area in which Indonesia has done very poorly compared to its own historical record and to the current record of its peers (see below).

Exports and Foreign Direct Investment

15. **Strong growth in foreign investment, and in the share of investment geared towards exports, was a notable feature of the pre-crisis economic period.** Foreign direct investment in Indonesia showed rapid increases prior to the crisis, with both approvals and actual recorded inflows rising about four-fold between the early 1990s and 1997 (from \$8 billion to \$34 billion for annual approvals, and from \$2.5 billion to \$10 billion for actual inflows). Indeed, FDI played a key part in the export growth of the 1990s, as seen in the share of output of foreign firms produced for export (from less than 20 percent in 1990 to almost 40 percent by 1997). Studies on foreign ownership shares across Indonesian industries have also shown that sectors with high foreign ownership consistently exported a higher share of their output.⁴

16. **There are several indications that the post-crisis slowdown in manufactured export growth is closely linked to the sharp decline in foreign investment.** From a general cross-country perspective, empirical evidence suggests a statistically significant correlation between exports and FDI.⁵ In Indonesia's case, the decline in investment inflows between the pre- and post-crisis periods (by roughly 50 percent) has coincided with a near halving of

⁴ World Bank 2003 and Ramstetter 1999. Other country experiences are also similar. For example, over three-quarters of China's electronics exports (one of the largest and fastest growing sub-sectors) are generated by foreign firms.

⁵ Indeed, for developing countries as a whole, a 1 percent rise in per capita FDI is associated with a 0.45 percent rise in total exports and an even stronger (0.78 percent) rise in high technology exports (see UNCTAD 1999). While not proving causality, the robustness of this finding across various groupings is highly suggestive.

export growth rates. Sectors that had lower declines in foreign investment approvals (wood, chemicals, and pharmaceuticals) generally tended to show a more limited slowdown in export growth, while sectors with sharper falls in FDI (textiles, paper and printing) have tended to show the most severe export slowdowns. These observed correlations suggest that export growth could benefit significantly from higher rates of FDI.⁶

17. **In addition to declining levels of foreign investment, the type of new investment taking place in recent years may also have contributed to the export slowdown.** Based on the submissions of new foreign investors, their planned or “potential” exports constituted 77 percent of the value of prospective investments in 2000, but this ratio fell steadily to just 47 percent in 2003, suggesting a decline in Indonesia’s attractiveness as an export base.

Manufacturing Exports and Factor Intensity

18. **A decomposition of Indonesia’s exports reveals that capital-intensive industries (chemicals, plastics, and electronic goods) have performed better than labor-intensive industries (textiles, apparel, and footwear) (Table VI.5).** While it is not possible to attribute this divergence solely due to labor-related issues, the consistently large differences that emerge irrespective of alternative labor-intensity indicators used, as well as the fact that world demand for labor-intensive goods as a group was, on average, no worse than that for capital intensive goods, suggests that labor-related issues may be having an impact on export performance.⁷

	1998-2003	2002-03
	(Average annual growth rates)	
Unskilled labor intensive exports	9.3	-10.9
Physical-capital and tech-intensive exports	20.4	14.8
More-labor intensive manufacturing exports	8.4	-4.7
Less-labor intensive manufacturing exports	19.8	14.4
	1997-2002	2002
Exports of ISIC sectors with low value-added per worker (labor-intensive proxy)	5	-5
Exports of ISIC sectors with high value-added per worker (capital-intensive proxy)	17	7

Sources: WITS database, and labor intensity measures as described in footnote 7.

19. **It is quite plausible that more difficult operational conditions are being faced by labor-intensive manufacturers and thus contributing to their weaker export performance.** As already noted, the substantial rise in unit labor costs since end-2001

⁶ For example, if elasticities from cross-country regressions are used as a guide, raising FDI from its \$3 billion level in 2004 to \$4.2 billion in 2006 could translate into an 18 percent increase in manufactured exports, or a near 10 percent increase for overall exports over the two years.

⁷ Labor intensity measures are taken from Aswicahyono and Pangestu 2000 and from Voon 1998. Both studies have applied labor-intensity measures to review the sectoral export performance of Indonesia and other ASEAN countries in the 1980s and early to mid-1990s, when labor-intensive exports were among the strongest performers; the data provided here updates these measures up to 2003.

represents an increase in operational expenses faced by labor-intensive businesses. But in addition, a wide range of noncost labor-related hurdles may have become serious obstacles for manufacturers where labor is the main operational expense. These concern the hiring and firing of workers (particularly the costs of retrenchment), various conditions of employment (regulations on overtime pay, part-time work and contractual labor), and the number of production days lost from strikes and labor disputes. In all these categories, Indonesia's labor policies and practices are rated as the most onerous in the region, an outcome that deters new foreign investment and consequently export generation capacity.

Medium-Term Export Prospects

20. **The government's White Paper emphasizes a number of policies to improve export performance.** Particular emphasis is being given to the promotion of non-oil exports in nontraditional markets, through the use of trade promotion centers (ITPCs), the arrangement of trade missions, and the increased delivery of export-related services in the regions through improved information systems and training. To operationalize some of these objectives, planned near-term activities include the signing of trade deals, fielding trade delegations, and participation in trade exhibitions.

21. **In addition, the government has recently identified 15 export sectors for special promotion.** The list is dominated by manufactured goods, including furniture and related products, electrical machinery and parts, pulp and paper, and various apparel, textile, and clothing categories. It is also notable for inclusion of a variety of primary products such as fish and seafood, animal and vegetable oils, coffee and tea, and cocoa and cocoa preparations (Annex VI.I, Table A.2). The government's promotion efforts in the latter area aim to encourage more processing in domestic industries, in order to increase value-added.

22. **A review of the export sectors selected for promotion reveals the following characteristics:**

- On the basis of Revealed Comparative Advantage (RCA),⁸ a commonly used measure of products in which a country can be said to have a "comparative advantage," the targeted sectors are generally appropriate. The majority of selected sectors have shown high and rising RCA values in recent years, indicating areas where Indonesia has outperformed average worldwide growth.

⁸ A country is said to have a Revealed Comparative Advantage in a product category if the RCA index for a given product is greater than one. The RCA index is based on the share of given product's exports in a country's total exports expressed as a proportion of the share of that product's worldwide exports to total worldwide exports. RCA is a commonly used measure in analyzing country export performance and has been applied to 1989-1999 Indonesian data by, among others, Aswicahyono and Pangestu 2000 and World Bank 2003.

- The list of exports identified for promotion includes many sectors with encouraging prospects for further growth judging from their post-crisis performance. In particular, there is considerable overlap with sectors that had the highest post-crisis growth rates, the best gains in world market share, and the strongest over performance compared to peers' export growth rates in the same product category (Annex VI.I, Table A.2).
- While the textiles and apparel sector has been identified for special promotion, not least because of its large size, its prospects can be described as mixed. There are several factors suggesting that Indonesian exports may be under pressure in this area: (i) while export growth for the sector as a whole has been strong in the immediate post-crisis period, there has been a slowdown in the most recent three-year period, reflecting as noted earlier, the cumulative impact of a sharp drop in FDI in that sector as well as difficult domestic conditions (Box VI.1); (ii) world demand in this sector is increasingly being met by one dominant supplier, China; and (iii) the sector faces unique challenges with the expiration of the Multifiber Agreement (MFA) in 2005.
- The promotion of the electronics and electrical machinery sector can potentially offer substantial gains, as world import growth in this sector has been consistently stronger than for Indonesia's traditional manufactured exports. Although Indonesia is not yet a dominant supplier in this area, some sub-categories within this sector have raised their world market share and built a comparative advantage over the past decade, at least as measured by the RCA index (e.g., telecoms, SITC 76). Increased foreign investment in this sector could accelerate this trend.

23. **While the White Paper has focused on nontraditional export sectors, there remain many potential opportunities in the oil, gas, and mineral export sectors that merit equal attention.** Traditional export sectors continue to generate a significant share of export earnings, and while trends in some areas are showing a secular decline in export volumes (e.g., oil), there are promising prospects in other sectors such as natural gas and minerals (nickel, coal, copper, and gold). In the latter cases, export performance will depend heavily on addressing a number of issues related to the awarding of new concessions, the resolution of pending legal disputes, the clarification of regional powers, and the maintenance of adequate security conditions.

Box VI.1. Indonesian Textile Exports

Indonesian export performance in the textile and apparel sector has been under pressure in recent years owing to a combination of factors. A recent study, (James et al 2003) noted a wide array of domestic challenges: rising labor costs, particularly since 2001; increased infrastructure costs (with cost increases in 2001–02 of 102 percent for electricity, 52 percent for fuel, 159 percent for diesel, 27 percent for water, and 32 percent for transport); increased regional fees and nuisance taxes; a new VAT on certain imported inputs such as cotton; and an ageing capital stock, with the average age of most machinery more than 15–20 years old as a result of limited new investment. Reflecting these factors, as well as a slowdown in external demand, annual export growth fell from an average of near 20 percent in the pre-crisis period to 9 percent for the post-crisis period as a whole (and -4 percent for 2002–03).

However, export performance in the sector has not been uniformly weak. Indeed, of the fourteen sub-sectors that constitute textiles and apparel exports (on a Harmonized System basis, HS 50–63), eleven have outperformed world import demand for their respective sectors, six have shown high and rising RCA levels, and four have been successful enough to match or exceed the export growth rates of China in the respective sector. Included among the latter are sectors covering synthetic textile products (that utilize raw materials from Indonesia’s petro-chemical industries) as well as the large apparel sector; these categories collectively generate around \$4 billion, or almost 10 percent of non-oil exports. The wide variation in growth rates of various sub-sectors attests to the fact that there are specific destinations, products, and niches on which Indonesia can capitalize.

With respect to the Multi-Fiber Agreement (MFA), studies suggest that most countries stand to lose market share to China, although a definitive assessment is difficult given the wide range of variables whose outturns are not certain (USITC 2004). The precise impact of the MFA’s expiration will depend, among other things, on product differentiation among exporter countries, supply responses in China, growth in U.S. and EU demand, and any potential safeguard measures that could still be imposed against China.

For Indonesia, the evidence suggests strong pressures will be faced. This is despite the fact that only around 50 percent of textile exports are currently exported to quota-limited countries, a much lower share than for some other affected countries. Some guidance can be drawn from the 2002 removal of selected U.S. quotas (the so-called “third phase” removal), after which Indonesia’s affected textile and apparel exports to the U.S. market fell by almost 40 percent (IMF 2004); if a similar impact holds in all quota-constrained destinations, then such exports could decline by as much as 18 percent in 2005, implying a drop in total exports of near 2 percent. Such calculations are only crude extrapolations based on performance in 2002-03. Nonetheless, longer-term indications are also generally not favorable. For example, a comparison of textile and apparel exports to Japan, a market without quotas, shows that Indonesia’s exports have been broadly flat in the decade up to 2002, while those of China have more than doubled.

24. **Finally, making greater efforts to take advantage of the China-led Asian recovery offers scope for substantial gains in the period ahead.** While external conditions in general are expected to improve—with rising commodity prices and an expected tripling (to 6 percent) of world import growth in 2004 and 2005—regional demand conditions should also be favorable for an improvement in Indonesia’s export growth. A strengthening recovery in two of Indonesia’s largest trading partners (Japan and Singapore), rising demand from ASEAN countries, and the continued high import growth of China all offer substantial opportunities in this respect (Box VI.2).

D. Conclusion

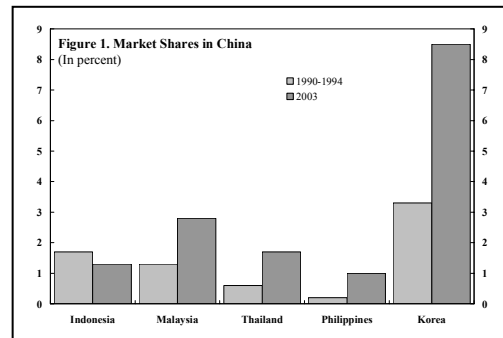
25. **The preceding review shows that, when set against the record of other Asian economies, Indonesia’s recent overall export performance has been disappointing.** While there have been positive developments in a few areas, several weaker aspects stand out. These including modest growth in non-oil exports, a declining market share in key destinations, and a significant slowdown in the growth of many large-value manufactured exports in 2002–03. While cost competitiveness was not a major deterrent to exports for most of the post-crisis period, it may now be an emerging factor in light of recent developments in the REER, and unit labor costs. On the external front, the lower demand for Indonesia’s mix of export products has also been a factor. And finally, the weak investment climate and associated low level of FDI inflows have served to undermine export growth.

Box VI.2. China: Opportunities and Challenges for Indonesian Export Performance

The phenomenal growth of the Chinese economy presents both opportunities and challenges for Indonesia, as it does for several other countries in the region. As an export destination, China has absorbed a rapidly increasing share of Indonesian exports, from 3 percent in the early 1990s to near 6 percent in 2003. Exports to China grew by a cumulative 80 percent during the post-crisis period (1998-2003), the fastest growth recorded to any major destination. Products exported to China have been relatively diverse, with only a quarter consisting of oil and gas and the remainder comprised of wood, pulp, and wood-based products (25 percent), chemicals (12 percent), palm oil (7 percent), and electrical components (4 percent). The unprecedented demand China has shown in recent years for primary commodities and various manufactured inputs (e.g., iron and steel) bodes well for Indonesia's near-term export prospects.

However, Indonesia has not been as successful as other countries in the region in taking advantage of the Chinese market. The 80 percent growth to China in the 1998–2003 period is modest compared to average growth of 311 percent

for Malaysia, Thailand and Korea (data based on Chinese import statistics for all countries). Moreover, Indonesia's market share in the Chinese market has fallen slightly, in contrast to its peers who have gained substantial market share in China in recent years (Figure 1). One factor is that Indonesia's exports are skewed towards primary products rather than exports of higher technology components used by China as inputs for eventual reexports to third markets.



Compared to others in the region, there is a stronger similarity between Indonesia and China in terms of labor-intensive goods exported to third country markets. In both countries, “apparel and clothing” constitute the largest single manufacturing export category (SITC two-digit classification basis), while textile fabrics and footwear are also among their other top manufactured exports. Chinese export growth in these three categories as a whole has exceeded that of Indonesia, although it is notable that Indonesian export growth has still generally exceeded world demand growth in these sectors, and that China's record has virtually no match. Looking at the specific sub-sectors in which China and Indonesia compete, the gap between the two has become particularly large in footwear, where Indonesian exports have shown a secular decline since the mid-1990s, while China's footwear exports have risen by more than 30 percent over the same period. Within the textile and apparel industry, which collectively generate \$62 billion in export receipts for China and \$7 billion for Indonesia, China outperformed Indonesia substantially in textiles, while Indonesia has outperformed China in the export growth of its apparel products (SITC 84), where growth between 1998 and 2002 has been 50 percent compared to China's 37 percent, and within which particularly strong performance was seen in synthetic fibers and filaments. Moreover, in some other manufacturing export categories, Indonesia has shown stronger export growth; one notable characteristic of these sectors is that they were generally in areas where a domestically available primary product served as a key input, e.g., furniture and furnishings, mineral-based manufacturing products, processed vegetable oils and fats (palm oils) and wood-based products.

Table A.1. Indonesia's Largest Export Products and Their Growth Performance 1/

Rank	Export Category (By SITC)	Export Value (In billions of US\$)	Annual Average Growth Rates 2/		
			Pre-crisis	Post-crisis	Most recent
1	Petroleum and products (33)	7.2	3.2	13.5	4.1
2	Gas, natural & manufactured (34)	6.1	9.0	13.9	8.4
3	Apparel, clothing, and accessories (84)	4.3	19.3	11.4	-4.0
4	Telecomms equip, incl TV/radios (76)	3.3	78.9	25.7	-6.9
5	Textiles: yarn,fabric, made-uparticles (65)	3.1	22.0	5.1	-4.9
6	Cork & wood manuf, incl plywood (63)	2.9	10.5	0.2	-4.4
7	Electrical equipment (77)	2.5	49.1	25.1	8.4
8	Office machines, incl computers/parts (75)	2.3	620.5	32.2	-5.4
9	Fixed veg oils/fats, incl palm oil (42)	2.1	21.7	24.9	49.5
10	Metal ores, incl copper/nickel/alum (28)	2.1	18.7	10.3	7.5
11	Paper and paperboard articles (64)	2.1	31.0	8.1	-0.9
12	Coal and related products (32)	1.7	51.3	8.8	11.2
13	Fish,shellfish, crustaceans (03)	1.5	12.6	-1.4	-1.1
14	Furniture and furnishings (82)	1.5	30.7	52.9	-0.4
15	Footwear (85)	1.4	46.5	0.8	-11.7
16	Misc manufacturing, incl toys/records (89)	1.3	30.9	-5.5	0.1
17	Organic chemicals (51)	1.1	32.5	10.4	6.3
18	Coffee, tea, cocoa, and spices (07)	1.1	6.9	-3.1	17.4
19	Crude and synthetic rubber (23)	1.1	11.7	7.9	33.8
20	Nonferrous metals (68)	1.0	5.2	15.7	17.0
21	Nonmetal mineral manufacturing (66)	0.8	8.7	23.0	-0.7
22	Pulp and waste paper (25)	0.7	77.1	6.5	17.1
23	Road vehicles & vehicle parts (78)	0.5	57.3	17.1	18.7
24	Plastics in primary form (57)	0.5	49.9	0.3	-5.7
25	Metal manufactured misc items (69)	0.5	27.5	5.8	-8.3
	Top 25 exports 3/	52.6	24.6	12.6	4.9

Sources: World Integrated Trade Solution (WITS) database, derived from UNCTAD statistics; and BPS statistics.

1/ Categories are based on Standard International Trade Classifications (SITC), in brackets. Export value is based on average annual value in the past four years (2000-03). Top 25 export categories shown above represent 90 percent of Indonesia's total exports.

2/ Pre-crisis refers to 1990-96, post crisis to 1999-2003, and most recent years to 2002-03.

3/ Weighted average (excluding one extreme outlier, i.e., SITC 75).

Table A.2. Export Products Selected for Special Promotion 1/

Export Category (Harmonized system, 2-digit basis)	Export Value (In billions of US\$)	RCA 2/		Average Annual Growth Rates 3/		
		1996-97	2001-02	Pre-crisis	Post-crisis	Most recent
1 Furniture; bedding, mattress, matt	1.5	1.3	1.9	22.7	63.6	5.2
2 Wood and articles of wood; wood ch	3.3	7.5	5.1	8.2	3.5	-4.0
3 Coffee, tea, matn and spices.	0.5	6.8	4.7	6.8	-12.8	3.1
4 Cocoa and cocoa preparations.	0.5	3.2	5.1	20.0	14.6	44.6
5 Rubber and articles thereof.	1.4	3.7	2.6	17.7	3.8	27.5
6 Apparel, textiles, and clothing	7.3	1.8	2.3	13.9	15.4	-2.7
7 Electrical machinery equipment parts thereof	6.0	0.5	0.7	58.7	29.9	0.2
8 Iron, steel, machinery and equipment	4.1	0.3	0.5	39.8	14.2	7.8
9 Pulp of wood/of other fibrous cellu	0.6	2.4	3.3	71.1	5.9	12.3
10 Paper & paperboard; art of paper products	2.0	0.9	2.0	37.3	11.5	0.8
11 Organic chemicals.	1.0	0.4	0.7	32.4	12.6	6.8
12 Footwear, gaiters and the like; par	1.3	4.5	3.3	27.1	0.9	-8.9
13 Fish & crustacean, mollusc & other	1.4	4.6	3.8	9.8	-1.8	-1.8
14 Animal/veg fats & oils & their clea	2.2	8.5	10.0	27.4	18.8	42.3
15 Plastics and articles thereof.	1.0	0.3	0.6	34.2	14.8	0.8

Sources: National Agency for Export Development, Ministry of Industry and Trade; and WITS database.

1/ Export categories are on an Harmonized System basis.

2/ RCA refers to Revealed Comparative Advantage index; values greater than 1 indicate comparative advantage in that product.

3/ Pre-crisis refers to 1990-96, post crisis to 1999-2003, and most recent years to 2002-03.

Table A.3. Indonesia's "Over-Achieving" Export Sectors Based on Alternative Measures

Large Value Exports with Highest Post-Crisis Growth Rates (In percent)	Large Value Exports with Best Gains in Worldwide Market Share (In percentage points)	Large Value Exports with Best Outperformance versus Peers' Export Growth (In percentage points)			
Furniture/furnishings	52.9	Fixed veg oils/fats	2.9	Furniture/furnishings	308.4
Office/dat proc machines	32.2	Coal/coke/briquettes	1.5	Telecomms etc equipment	140.9
Telecomms etc equipment	25.7	Paper/paperboard/article	1.1	Office/dat proc machines	139.1
Electrical equipment	25.1	Pulp and waste paper	0.8	Fixed veg oils/fats	127.9
Fixed veg oils/fats	24.9	Furniture/furnishings	0.4	Electrical equipment	104.4
Nonmetal mineral manuf.	23.0	Textile yarn/fabric/art.	0.4	Cork and wood	103.8
Road vehicles	17.1	Cork and wood	0.4	Non-metal mineral manuf.	98.1
Nonferrous metals	15.7	Office/dat proc machines	0.3	Apparel/c lothing/access	54.5
Gas natural/manufactured	13.9	Non-metal mineral manuf.	0.3	Metal ores/metal scrap	45.4
Petroleum and products	13.5	Organic chemicals	0.3	Coal/coke/briquettes	34.1
Apparel/clothing/access	11.4	Apparel/clothing/access	0.3	Gas natural/manufactured	31.3
Organic chemicals	10.4	Metal ores/metal scrap	0.2	Non-ferrous metals	30.5

Sources: WITS database; and BPS statistics.

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