April 26, 2006

INDEPENDENT EVALUATION GROUP

INDONESIA: COUNTRY ASSISTANCE EVALUATION

APPROACH PAPER

Country Background

1. From the mid-1960s until 1996, Indonesia was a development success story. From the late-seventies, gross national product (GNP) grew at an average of 7 percent per annum with per capita GNP reaching $1,080 in 1996. Indonesian growth kept pace with regional comparators such as Korea, Thailand and Malaysia. "The Soeharto regime, in power during this period, pursued an economic growth strategy spearheaded by well-connected industrial groupings financed in large part by directed lending from state-owned banks."[1] This said, "the resulting economic growth was both broad-based and labor-intensive. In the first stage, during the 1970s and early 1980s the focus was on agriculture and improvements in irrigation and rural infrastructure; agricultural growth averaged over 4 percent a year; the output of rice grew even faster. Since over half the population and over 80 percent of the poor depended on agriculture in the early 1970s these gains led to sustained poverty alleviation. A new stage began in the mid-1980s when the expansion of labor-intensive manufactures became the main source of growth and poverty reduction."[2] The share of the population living below the official poverty line declined from 60 percent in 1970 to 16 percent in 1996."

2. In the ten years since 1996, however, Indonesia has experienced an extraordinary series of turbulent economic, political and natural events. The turning point was the East Asian crisis starting in mid-1997. In December 1997 and January 1998 the Indonesian rupiah lost 75 percent of its value in relation to the US dollar. Within weeks this became a full-fledged economic, social and political crisis with a 60 percent rise in the Consumer Price Index and growing unemployment depressing the incomes of the poor. Increasing social unrest led to public outcries against corruption and President Soeharto resigned on May 21, 1998.

3. The collapse of the Indonesian economy in 1998 brought into sharp relief the underlying structural weaknesses, which had been discounted in the context of the rapid economic growth of the previous decades. First, Indonesia's banking system was riddled with systemic problems: a high share of non-performing loans, connected lending, misleading accounting standards and weak supervision. Second, despite the widespread impact of rapid growth a large number of Indonesians were 'near poor' clustered just above the poverty line. In 1996 more than 50 percent of the population was estimated to be living on less than $2 a day. Third, there was widespread corruption. Indonesia generally ranked near the bottom of the various corruption perception indices prepared by independent observers.

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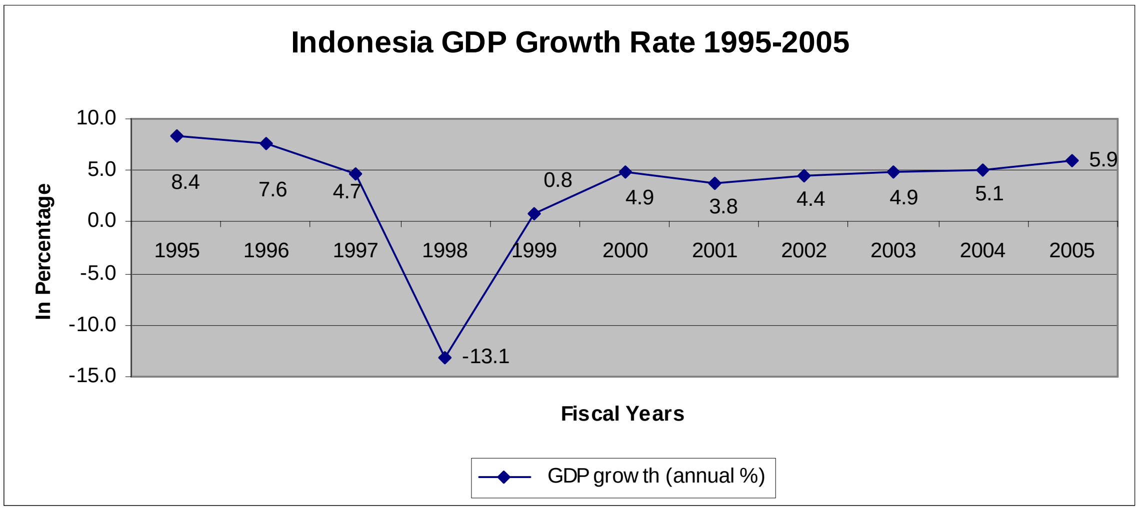
[1] International Monetary Fund, Indonesia: 2005 Article IV Consultation and Third Post-Program Monitoring Discussions; Staff Report; Staff Supplement; and PIN on the Executive Board Discussion; Statement by the Executive Director for Indonesia; Country Report 05/326; June 21, 2005, Page 5.

[2] Independent Evaluation Group, 1999. *Indonesia: Country Assistance Note*, Report No. 19100, Washington DC: The World Bank.

4. Since 1999 the Indonesian economy has struggled to regain the ground lost in the crisis years. The post-Soeharto political adjustment has seen four different governments, though on the positive side this included successful democratic changes of government. Democratic change intensified civil strife in East Timor (which became independent in 2002) and Aceh province. Terrorist bombings have taken place both in Jakarta, the capital, and on the island of Bali. The impact of the Tsunami of December 2004 on Aceh province was the most devastating of the Asia region and ranks as one of the most destructive of all natural disasters. This is the background against which the achievement of a modest 4 to 5 percent annual growth over a five year period must be measured. Recovery has been at a much slower rate, however, than for the other Asian economies impacted by the 1997/8 crisis.



5. Indonesia's successive governments since 1998 have struggled to restore macro-economic stability and to deal with the underlying structural issues. To address the over-centralization of power during the Soeharto period, a major decentralization was undertaken in 2001 with 2 million civil servants reassigned to regional governments. Measures were also put in place for institutional strengthening of financial management in the central government. A program of financial sector reform was implemented to strengthen banking supervision and improve the condition of the major financial institutions. While the period has seen progress in lowering public sector deficits and stabilizing inflation, by end 2005, real per capita income was still below levels reached in 1996, unemployment remained a concern, levels of both foreign and domestic investment were well below regional comparators, and the economic outlook was still characterized by major uncertainties.

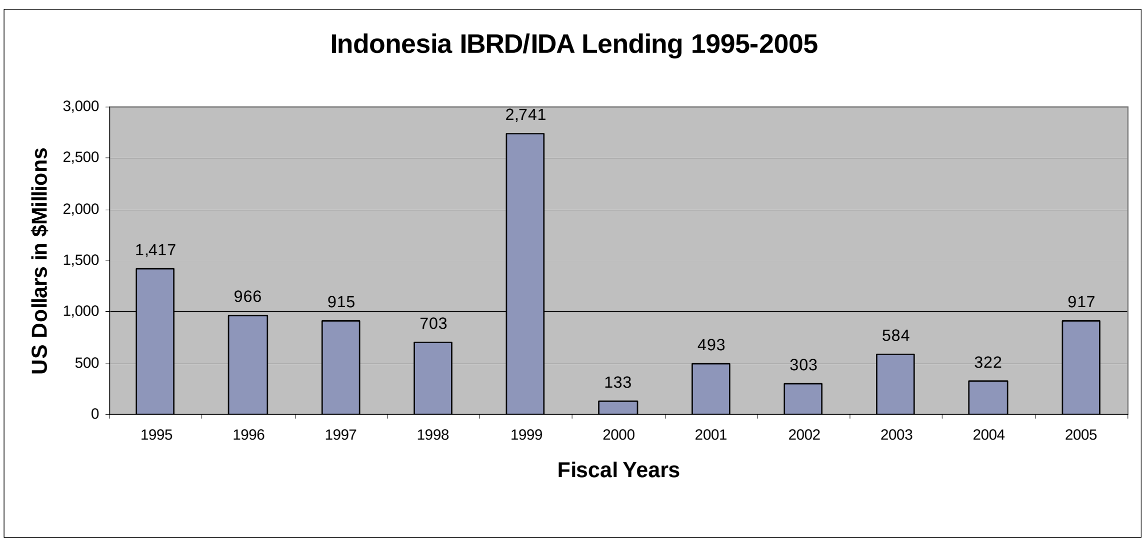
The Bank Program

6. The Bank's first operation in Indonesia was approved in 1968. In the subsequent three decades the Bank committed over $25 billion to Indonesia for 278 projects. Over the years the Independent Evaluation Group (formally Operations Evaluation Department) ratings for projects in Indonesia were consistently among the highest for any country in the Bank. Indonesia had one of the Bank's largest resident missions with

relatively substantial decentralization of responsibility to the field, and there was a close relationship between Bank staff and their counterparts in the Indonesian administration. The Bank's program covered all the key economic sectors.

7. A Country Assistance Note (CAN) issued by IEG in March 1999, provides a detailed discussion of the role of the Bank in the years immediately preceding the crisis and during 1998. It points out that before 1998 "World Bank involvement in the country's development efforts was pervasive and the achievements were many. Between 1969 and 1996 the Bank helped Indonesia boost agricultural production and improve power, transport, urban and village infrastructure, health services and skills for the fast-growing economy. It was catalytic in getting the government to focus on decentralization as a key to improvement in service delivery. In support of all the above, a major contribution of the Bank was a vast array of solid economic and sector work and numerous policy notes to advise government on development priorities."[3]

8. The closeness of the relationship meant that, in the eyes of the Indonesian public, and indeed of many outside observers, the Bank was implicated in the financial and economic crisis of 1997 and 1998. The CAN concludes that "while the Government's development strategy has had remarkable positive results, issues of poor governance, social stress and a weak financial sector were not addressed and contributed to the depth of the crisis. The Bank's neglect of those same issues and its underestimation of the risks and lack of contingency planning dampened the overall effectiveness of its assistance."[4]



9. Since 1999 the Bank has attempted to re-position itself in Indonesia, with much lower levels of new lending compared to the past - about $470 million a year since 2000, compared with well over $1 billion a year in the 1990s - and with a program which

[3] Independent Evaluation Group, 1999. *Indonesia: Country Assistance Note*, Report No. 19100, Washington DC: The World Bank.

[4] Independent Evaluation Group, 1999. *Indonesia: Country Assistance Note*, Report No. 19100, Washington DC: The World Bank.

emphasizes local service delivery and community development. An internal Bank memorandum leaked to the press during the crisis period, had claimed that a significant proportion (20 to 30 percent) of resources provided by the Bank had been siphoned off rather than contributing to project objectives. A major effort has therefore been devoted to ensuring that Bank resources are not misused. The Bank program has also emphasized much closer partnership with the Non-Governmental Organization (NGO) community and a broader group of stakeholders than previously. The Country Assistance Evaluation (CAE) will examine the Bank's efforts to regain the trust of stakeholders in the good faith of the institution.

Focus and Methodology

10. The Country Assistance Note of March 29, 1999, discusses the events leading up to the crisis and the post-crisis support provided by the Bank, in particular the large Structural Adjustment Loans (SALs) in the course of 1998. Given the proximity to these events the CAN suggests that further work be done on the Bank's response to the crisis. This was subsequently augmented by Project Performance Audit Reports on the SALs and the accompanying Technical Assistance Loan, and an OED review of Financial Sector Reform which looked at Indonesia among other countries. In addition Indonesia was among the three case studies examined in "The IMF and Recent Capital Account Crises" issued by the IEO in 2003. The background section of the CAE will draw on these sources supplemented by further analysis if needed, to discuss the factors leading up to the crisis, and the Bank's response. One of the criteria in evaluating the relevance of the Bank's strategy will be whether it was designed to deal with the structural weaknesses which contributed to the crisis and is helping put in place institutions which can avert, or at least mitigate, potential future crises.

11. The outcome evaluation of the Indonesia CAE will cover the seven years from January 1, 1999 to December 31, 2005. Since the baseline is the point at which the decline from previous production levels was greatest, the CAE will also identify an earlier point for comparison with pre-crisis achievements. During this period, the Bank produced a Country Assistance Strategy (CAS) in January 2001, a CAS Progress Report in July 2002, and, most recently, a CAS in October, 2003. The strategy has evolved over the period with an emphasis in the earlier years on re-building the Bank's credibility through a focus on governance, and on poverty reduction at the local level, to a more broad-based support for growth programs during the later years. Four broad strategic objectives were reflected in the Bank strategies over the period:

i) *Helping the Indonesian government to restore growth and maintain macroeconomic stability*: The financial crisis strained Indonesia's fiscal capacity and together with large fluctuations in the value of the currency, this resulted in increases in the Consumer Price Index of 58 percent in 1998 and 21 percent in 1999. The Indonesian government moved quickly to stabilize the situation with Fund and Bank support. The Bank's emphasis has been on private sector development to generate the employment needed to reduce poverty. With a somewhat more stable situation, albeit with inflation still edging into double-digits, the Bank increased its focus on growth and particularly on raising the sluggish levels of foreign and domestic investment through efforts to enhance the investment climate. Starting in 2004 the Bank expanded its lending program including providing support for tackling infrastructure constraints. A substantial program of Bank analytic work addressed issues such as financial sector reform, enhancing infrastructure and streamlining investment procedures. The Bank also focused attention on the constraints to the expansion of Indonesian exports.

ii) *Supporting poverty reduction programs*: Although the resumption of growth has lowered income poverty back to pre-crisis levels, the provision of basic services and non-income dimensions of poverty, such as the maternal mortality rate, continue to be weak relative to other countries in the region. The Bank's focus has been on improving the quality of service delivery to the poor. This has been pursued both through community-level development projects such as the Kecamatan program (see point iv below) and through support to national ministries.

iii) *Supporting efforts to combat corruption:* A centerpiece of the Bank strategy during the period was the struggle against corruption which was at the core of the political downfall of the Soeharto regime. The Bank worked at a number of different levels: First, at the macro-level to assist civil service reform and address corruption issues in areas such as public expenditure and procurement, and the legal system; second, in the context of decentralization to help local governments and communities to put in place fiduciary controls and to work with NGOs to monitor those controls; and third, at the project level to try to ensure that the Bank's own projects set an example of effective financial controls and management which could avoid a future attack on the Bank as being 'part of the problem rather than the solution'. In addition, since Indonesia's environmental problems were essentially linked to corruption with the destruction of primary forests through illegal logging, the Bank also addressed governance issues in this area.

iv) *Helping to strengthen government institutions at the central and decentralized levels*: The Bank was a consistent voice pre-1999 for greater decentralization and starting in 1998 has provided support for the Kecamatan (the local administrative unit—similar to counties or municipalities) development program. When the Indonesian government decided on a 'big bang' decentralization program in 2001, the Bank re-positioned its program to provide analytic support in areas such as expenditure and tax assignments, intergovernmental transfers, and sub-national borrowing and to support projects at the local level, which, inter alia, try to ensure continuity of social sector service delivery and help develop the institutional base of the local governments. At the same time the Bank worked with the central government to strengthen public expenditure analysis, public financial management, and long-term debt management.

In addition a fifth area was significant in 2005, and merits separate treatment.

v) *Supporting disaster relief and management*: Following the Tsunami of December 2004, the Bank assisted Indonesia with immediate relief and putting in place the new housing and infrastructure needed by the population of Aceh.

12. The CAE will first examine the relevance of these objectives to sustainable growth and poverty reduction in the Indonesia context. As part of this, the CAE will explore the adequacy of the treatment of environmental sustainability, given the special importance of Indonesia's forest resources in the global context. The CAE will then examine the degree to which these objectives have been achieved and what role the Bank's support has played in this achievement. In each of the above areas the CAE will use a set of indicators, using a pre-crisis baseline at the end of 1996, and a second baseline at the end of 1998, to evaluate the achievement against these indicators by the end of 2005. These indicators are mainly, but not exclusively drawn from the Bank's strategy documents.

13. In addition to the thematic presentation, the CAE will examine the process aspects of the Bank's role in Indonesia. This is particularly important given the weight in the Bank's strategy of re-positioning the Bank and developing a new mode of engagement with the Indonesian authorities, with civil society and NGOs and with donors and partners. The CAE will evaluate the policy dialogue, the relevance of the Bank's objectives, portfolio quality and knowledge services. Portfolio implementation, particularly fiduciary aspects and safeguard issues, have been an important part of the Bank's efforts in Indonesia between 1999 and 2005, and the CAE will look closely at the progress in these areas. The CAE will also examine the Bank's role in the broader context of international and NGO support for Indonesia's program.

14. The evaluation will integrate the findings of other IEG studies, both thematic studies which cover Indonesia such as those on Community Driven Development, Natural Disasters and Financial Sector lending as well as specific Project Performance Audit Reviews on the Indonesia portfolio. The evaluation will also include a review of other relevant documents, and interviews with the staff of the Bank and other key donors, representatives of the government, NGOs and civil society.

CAE Output and Timetable

15. The CAE will be issued to the Committee on Development Effectiveness in the second quarter of FY07. The task team will consist of Basil Kavalsky (Team leader), Jane Hwang, David Pearce, Steven Radelet, Uma Lele, Jeffrey Telgarsky and Manuel Hinds. The team will work under the direction of Kyle Peters (Senior Manager, IEGCR). Consultations with the Government will take place before issuing the report. Peer reviewers are Pradeep Mitra (ECAVP) and Shahrokh Fardoust (DECVP).