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Country Development Strategy Statement

INDONESIA

FY 1989 - FY 1993

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT
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EXECUTIVE SUMMARY

WHERE INDONESIA STANDS

The Record 1965-85

Indonesia has made remarkable economic and social progress since the change of government in 1965, when the economy was virtually in a shambles. Indonesia's record of economic and social achievements in its first twenty years under Soeharto ranks with the best in the developing world. By 1985 Indonesia had doubled its rice production to achieve a fragile self-sufficiency in rice, cut its total fertility rate by 31%, reduced its population growth rate to almost 2%, and nearly attained universal primary education. Macro-economic performance was also exceptional: between 1983 and 1986, the Government of Indonesia (GOI) undertook an unusually far reaching set of economic policy reforms, generally directed toward deregulation and a stronger market orientation, and away from governmental control.

Indonesia has transformed itself into a modernizing nation with a chance of joining the ranks of Asian success stories within the next fifteen years. It is now near the same point in its economic development as Korea was in the early 1960s, with similar potential for rapid trade-led growth and development if the right policy environment is vigorously pursued. Steps taken during the next five to ten years will be crucial in determining whether Indonesia advances within the coming fifteen years to the point where it no longer requires foreign assistance.

The Challenges

The challenges which lie ahead include:

- Employment: Indonesia must find jobs for the 20 million people who will enter the labor force over the next decade, while protecting its easily depleted natural resource base. Together with incomes, employment is considered by the Mission, the GOI and most other observers to be the overriding socio-political-economic issue facing Indonesia over the next ten years.

- Incomes: Per-capita income is estimated to be below $400 in 1987 (owing to the 1986 devaluation), a level that puts Indonesia back in the lower income country category. Future projections are for essentially stagnant real per-capita incomes unless Indonesia vigorously seeks to deregulate the economy. Over 40% of the population still live below the IBRD poverty line.

- Social factors: Life expectancy in Indonesia (55 years) is the lowest in ASEAN, while infant mortality rates (96/1000) are the highest. The human resource base needs much more development: only 1% of the work force has attended college.

- Reduced revenues: Heavy dependence on oil for government revenues has resulted in a 50% decline in real development budget expenditures during the past two years, with additional cuts likely. During the same period, Indonesia's total debt service ratio has more than doubled, to over 37%, and foreign debt stands at over $43 billion, one of Asia's largest.

The Outlook for Meeting the Challenges

Indonesia can meet its challenges in employment, incomes, health and higher education through sustainable economic growth. Such growth can occur if the GOI undertakes the necessary steps to deregulate and restructure the economy away from its present inward looking oil dependent status, and toward a strong outward looking orientation that provides greater inducements to labor-intensive manufacturing, non-oil exports, and international trade in general. Continued deregulation and reform of the trade and industry sectors will make the economy more efficient while providing employment. Related issues are how far Indonesia is willing to go toward reducing the role of monopolies, broadening and deepening capital markets, divesting state enterprises, privatizing government services, and generally opening up the economic decision making process to a broad spectrum of the society.

We believe that implementing such a deregulation and restructuring strategy could potentially give Indonesia East Asian-type growth in both GDP and trade. With such a strategy, we see excellent prospects for GDP growth of 5% in the early 1990s. We see parallel growth in trade of 5% in the remainder of the 1980s and possibly higher in the 1990s, depending on what happens with oil. As exports expand, a comparable expansion of Indonesian imports will be required to provide the intermediate and capital goods necessary to sustain the GDP growth levels suggested above. We would see such a pattern of development not only being highly beneficial to Indonesia in terms of growth, employment, and foreign exchange earnings, but also to its trading partners who were in a position to benefit from the increased purchasing power.

The program strategy outlined in this CDSS is tailored to help Indonesia meet the challenges it faces, including longer-term structural adjustments. The current policy environment is receptive. Intelligent advice and a program that is well focussed (even if small relative to the $3 billion total annual donor aid here) may actually make a difference in the course of events.

USAID STRATEGY SUMMARY

Strategy Evolution 1946-1988*

USAID's early focus on capital transfers and infrastructure evolved in the mid-1970s to a program that emphasized meeting the needs of the rural poor. The CDSS prepared five years ago focused on broad based institution building and support to national programs. It began our present involvement with policy analysis. It broadened the previous focus on agricultural productivity as the main vehicle for growth in the economy to include increasing off-farm employment, improving primary health care, completing the institutionalization of family planning, and accelerating human resources development.

As Indonesia enters a more advanced phase of development with new challenges that involve sector-wide and structural economic issues, the current A.I.D. strategy must evolve again. It must address the employment and incomes problem through an approach that places greater emphasis on sector-wide and macro-economic policy change, promotes the private sector as a major alternative to the public sector, encourages a greater voice and responsibility for a larger constituency, and is concerned with the sustainability of resources (natural resources and environmental management). At the same time, it must take into account continuing problems that cannot be ignored in a balanced long-term development strategy: human resource development, health, and family planning.

The 1989-1993 CDSS

One Goal

During the 1989-1993 period, USAID's goal is to improve long-term, <u>sustainable employment and income</u> opportunities through means which promote <u>efficiency and productivity</u>.** Rapidly increasing the <u>demand</u> for labor requires major attention to a variety of measures which increase resource efficiency, productivity, and mobilization. Similarly, improving labor <u>supply</u> requires qualitative and quantitative improvements in human productivity through education, family planning, and child survival. Figure 6 in Section II diagrams the causal relationships that underpin our strategy in an integrated and more detailed manner.

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* Figure 9 in Section II shows the expected USAID strategy evolution as Indonesia's economic development matures.

** See page 26 for the definition of efficiency and productivity.

To address our goal, we are proposing a strategy developed from the 1985 Mission employment study.* We will select our activities largely on the basis of their contribution to efficiency and productivity in the economy as the most effective support for the long-term employment and incomes goal. For this reason we will look to the significance of the efficiency/productivity impact of an activity rather than its direct near-term employment implications.

Four Sub-Goals

Our strategy will be implemented through four sub-goals (see page vii):

1. Supporting a more open, less regulated market and trade oriented economy, both internally and externally.

2. Increasing the sustainability, productivity and efficiency of the agricultural production, processing, distribution and consumption system.

3. Achieving an efficient, high quality human resources development system which effectively links system outputs to market requirements.

4. Reducing fertility and improving rates of infant and child survival.

Each sub-goal will, in turn, be pursued through selected objectives (detailed in Section II) that fit within our integrated strategy framework.

In addition, we will apply new leveraging and management effectiveness criteria to sharpen our choice, design, and implementation of activities throughout our portfolio.

Leveraging: We plan to utilize fully the funding sources available: bilateral Development Assistance, PL 480 (Titles I and II), Housing Guarantees (new), and regionally/centrally funded resources. However, AID assistance, by other donors' standards here, is small. We hope to magnify our impact by carefully screening new project or program proposals. We will select those efforts that have high potential for affecting key policy changes, strengthening critically situated institutions or agencies which have the responsibility for major budgetary or policy decisions, replication by the GOI or other donors following key demonstration/projects, or leveraging other donors' resources toward the employment-incomes problem.

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* Robert L. Rucker, A Preliminary View of Indonesia's Employment Problem and Some Options for Solving It. Jakarta: USAID/Indonesia, October 1985.

Management effectiveness: To make our staff utilization as efficient as our program, we will, in addition to our substantive objectives and leveraging criteria, emphasize those projects and programs that have lower staff intensity. Reducing staff intensity will require attention to: expanding the variety of programming modes, limiting the number of projects and management units, improving internal program complementarity, and shifting more responsibility for operational management to the GOI and the independent sector (including both the private sector and non-government organizations) where feasible. We will gradually change the mix and deployment of skills, within present staff levels, away from conventional project skills and toward macro economic, policy and budgetary analysis skills.

Programming modes will include DA program assistance as a continuing element of the program, subject to policy and budgetary need and to a positive appraisal of the current effort. Because of the synergy needed between project aid (to identify, analyze, and test policies) and program aid (to support policies in which we are confident), both modes of aid are needed to maintain a quality aid program.

The number of projects has come down from 43 in FY 1983 to 31 in FY 88. The proposed strategy, with its unifying goal of employment and incomes, provides a tighter focus for future investments: it will reduce the number of projects/programs further, to approximately 20, during the CDSS period.

Internal program complementarity is increasing. Apart from our unified goal, we have common themes throughout the portfolio. For example, we are supporting private sector activities in health, population, agriculture, and education as well as in our deregulation, trade, and private sector program. In addition, we expect a greater integration of PL 480 and Housing Guarantees with DA-funded activities.

The pipeline is expected to decrease to well below $200 million by the end of the CDSS period. This reduction will result from an increased use of program support, increases in project disbursements based on recent GOI-AID budgetary changes, and continuing attention by Mission management.

Other Reference Points

- This CDSS fits exceptionally well with the Bureau's new emphasis on trade and investment. Our current portfolio already contains a large number of trade, private sector, and investment activities. We find they are congruent with both the Bureau's emphasis and Indonesia's development objectives. We expect to expand such activities during this CDSS period.

- This CDSS contains a much more explicit strategy for the environment, which is appropriate for a country with more environmental issues than any other AID-assisted country. Resources for the environment will expand from 2% of our portfolio now to 13% by 1992.

- Through a strategy to secure sustained levels of recurrent financing for child survival and family planning programs, this CDSS will set the stage for USAID disengagement in family planning within the next CDSS period (1994-1998).

- We will continue to have many science and technology-related activities, but believe the preconditions for an effective explicit strategy in the use of science and technology for development will depend upon private sector linkages that need to be developed first. We will undertake some work during this CDSS period, dove-tailed with similar work by the ANE Bureau, to see if an explicit AID S&T strategy is appropriate to Indonesia's later development (see Annex F).

What Has Changed

The most significant changes in orientation from the previous CDSS include:

- direct focus on one unifying goal—employment and incomes—with all sub-goals and objectives tightly integrated in a reinforcing program framework;

- more focus on macro, structural, sectoral, and cross-sectoral policy;

- a greater use of program assistance;

- more attention to leveraging and management effectiveness principles;

- a greater role for the private sector, spanning the entire portfolio (health, family planning, agriculture and education in addition to our deregulation, trade, and private sector office activities *per se*);

- a smaller role for the public sector (concentrating on efficiency); and

- more conscious treatment of the role of this CDSS period in the context of the evolution and maturation of Indonesian economic development.

CDSS FRAMEWORK

GOAL:

Improve long-term, sustainable employment & income opportunities through means which promote efficiency & productivity

SUB-GOALS:

- Support a more open, less regulated market and trade oriented economy, internally and externally
- Increase sustainability, productivity and efficiency of the agricultural production, processing, distribution and consumption system
- Achieve efficient, high quality human resources development system which effectively links system outputs to market requirements
- Reduce fertility/improve rates of infant/child survival

CRITERIA:

<u>Management Effectiveness</u>

- Improve staff utilization
- Reduce staff intensity
- Expand programming modes
- Limit management units
- Increase internal program complementarity
- Shift responsibility for project management to GOI/independent sector as feasible

<u>Leveraging Potential</u>

- For affecting key policy changes
- For strengthening critically situated institutions
- For replication following key demonstration/pilot projects
- For leveraging other donor resources

PROJECTS/PROGRAMS

CONTENTS

Page

Page

TABLES

FIGURES

I. ECONOMIC AND SOCIAL ANALYSES

A. THE SETTING

Declaring "I am not an economist, I am a revolutionary," President Sukarno guided Indonesia through its first two decades of independence. He enabled the country to survive as a republic during these tumultuous years of regional rebellions and socio-religious conflict. But he left the economy in disarray. The annual inflation rate soared to over 600%, foreign exchange reserves were exhausted, incomes were below pre-WWII levels, infrastructure deteriorated, and the country was unable to feed itself. Foreign aid (U.S. aid in particular) was spurned in his famous 1965 "to hell with your aid" speech.

The abortive communist backed coup in 1965 brought an end to Sukarno's leadership and ushered in the "New Order" under President Soeharto. The new leadership faced major challenges on all fronts. Believing that the experiment with democratic politics had ended in near disaster, they looked to the army and the state bureaucracy to re-establish national unity and economic growth. Both were empowered to exercise their will and presence down to the lowest levels of village life.

1. Accomplishments 1965-85

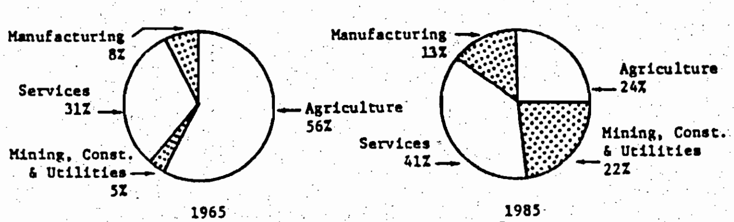
By taking strong control, the New Order government was able to start Indonesia on a growth and development path that did not materially slacken until the early 1980s. During the initial period (1966-69) stabilization and rehabilitation were needed. This required a strong central government role, not only to restore civil order but also to rebuild basic infrastructure. In the mid-1970s, basic import substitution manufacturing grew steadily along with an increasingly protected indigenous business class. With the oil boom, government revenues were plentiful and were channeled into subsidized credit for private businesses as well as state enterprises. It was a period of a centrally planned, highly subsidized and tightly regulated economy which operated with abundant government resources.

Indonesia's economic and social achievements during this period rank with the best in the developing world. By 1985 Indonesia had doubled its rice production to achieve a fragile self-sufficiency in rice, despite a population two-thirds that of the U.S. and an arable land area about the same size as California. It had cut its crude death rate by 25%, its infant mortality rate by 30%, and its child mortality rate by 40%. It increased its calorie supply per capita from 1800 to over 2500 per day and its life expectancy from 44 years to 55 years. It increased its enrollment rates for primary education by 64%, for secondary education by 225% and for higher education by 600%; literacy increased by 130%. It cut its crude birth rate by 25% and its total fertility rate by 31%. It brought the percentage of married women using contraceptives from zero to 40. These achievements are impressive, but the absolute numbers, having a weak base to begin with, are still far below the level of Indonesia's ASEAN neighbors in most respects (see Annex D).

Indonesia's macroeconomic performance was also exceptional. GDP growth averaged 7.9% between 1965 and 1980 after averaging 1.8% in the preceding five years. Although GDP growth slowed to 3.5% during 1980-85, it still averaged almost 7% annually over the entire twenty-year period. Per capita incomes averaged a strong 4.8% growth during the same time span.

Although the growth of oil and natural gas contributed significantly to this economic performance, other sectors were also important. Differences in sectoral growth rates, however, resulted in a dramatic restructuring of the economy with agriculture's share falling, while services, manufacturing, and mining, construction, and utilities rose (see Figure 1). External trade, largely as a result of oil and LNG, also grew rapidly in importance in the 1965-85 period, from 5% to 23% of GDP.

FIGURE 1: SECTORAL SHARES OF GDP, 1965-1985



Events of the early 1980s, however, seriously threatened these gains and exposed fundamental weaknesses in the domestic economy. Agricultural growth, critical for the well-being of over 80% of the population, slowed; falling oil prices drastically curtailed government revenues and reduced its ability to invest in new development initiatives; and an aging import substitution industrial strategy coupled with the creation of major new privately held monopolies prevented the manufacturing sector from growing enough to even partially take up the slack. These events underscored, in very dramatic terms, the costs associated with the government's past record of success. The "high cost" economy (agricultural subsidies alone amounted to approximately $700 million in the mid-1980s) no longer had the resources to maintain past 7%-8% growth rates.

As a result of these conditions, the government introduced major new policy reforms in the mid-1980s which demonstrated its willingness to consider a fundamental restructuring of the economy and to rethink its role in the development process. Between 1983 and 1986, the GOI undertook <u>one of the more impressive sets of economic policy reforms of any country in the world</u>. During this period, Indonesia made great improvements in its factor pricing, set in motion substantial public and private resource mobilization measures, controlled inflation at single-digit levels despite two devaluations, maintained the real effective exchange rate set by the devaluations, exerted consistent budgetary austerity, exercised significant restraint on new state enterprise investment, and in general, took measures which have moved toward greater deregulation of the market.

The measures reduced interference in commodity input and output pricing, reduced commercial and industrial regulatory and licensing barriers, reduced protective barriers to external competition, mobilized resources for public and private sector use, reduced interference in credit allocation, restrained the expansion of state enterprises, reduced direct budgetary subsidies, and officially supported private sector expansion. The generally consistent direction of policy reform and economic decision making during this period was towards a stronger market orientation.* Some evidence is available on the near-term impact of some of these measures.** For many of them, however, most of the potential gain is still to come over the long term.

2. The Present Situation

Today, Indonesia has transformed itself into a modernizing nation with prospects for joining the ranks of Asian success stories within the next decade and a half. It is now near the same point in its economic development as Korea was in the early 1960s, with similar potential for rapid trade-led growth and development if the right policy environment is vigorously pursued. The next five to ten years will be crucial in determining whether Indonesia will advance within the next fifteen years to the point where it no longer requires foreign assistance.

Although some still favor inward looking development to protect Indonesia from foreign economic dominance, the lack of resources no longer makes this a viable alternative. Indonesia is beginning to consider, and has taken some steps in support of, an outward looking trade strategy based on efficiency and international comparative advantage. Changes are also beginning to occur with the government's role in the economy and in society, as it slowly devolves control. Nevertheless, it must devolve further. The government still controls a major portion of the economy. In 1986/87 central government development expenditures equaled almost 30% of gross domestic investment,

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* See Annex E for a summary listing of most of the important measures taken. The major exception to these deregulation trends was the rapid growth of restrictive/monopoly import licensing during the early part of this period.

** For example, between 1982/83-1986/87 non-oil exports increased 69%, non-oil imports fell 36%, official reserves increased from 3.5 to 6.1 months of non-oil imports, government non-oil taxes and revenues increased 133%, banking system time deposits increased 375%, petroleum subsidies fell from Rp. 1.0 trillion to below zero, and state bank time deposit rates changed from negative to positive real rates (from 8-9% to 15-17% nominal). During 1986/87 the GOI slowly began to address the monopoly issue as import licensing restrictions were abolished or relaxed for 44% (by value) of imports previously restricted.

while state enterprise investment accounted for 36%. Subsidies to protect selected manufacturers, primarily monopolies, are high.* Figure 2 portrays the changes which have occurred in the political economy during the past decade in more detail. Special attention should be paid to those items with an asterik, which indicate directions just started or yet to be taken.

Although pressures on the economy may lessen slightly over the next three to four years, they will not subside. Such pressures will continue to act as a backdrop for arguing the necessity of timely reforms and provide the impetus to tackle some of the more important remaining macro-level constraints: deregulation of trade and industry, monopolies, and the state-enterprise privatization problem.** The employment problem will continue to loom larger and will weigh even more heavily in the argument for reform. The employment problem will not simply disappear because the GOI manages to finance its medium-term adjustment problem and the government knows this. For all of these reasons there are grounds for optimism that the reform momentum will continue.

B. ECONOMIC ANALYSIS

Indonesia has two fundamentally related but substantively different adjustment problems. The first concerns relatively short- to medium-term macro stabilization, with restoration of balance in the external and budgetary accounts and resumption of reasonable levels of growth being the principal

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* The IBRD has estimated that implicit subsidies to protected manufacturing sub-sectors in 1984 (about $2.4 billion) accounted for over one-third of overall manufacturing value added. Over 70% of the implicit subsidies accrued to sub-sectors producing only 20% of overall manufacturing value added. Other estimates indicate monopolies continue to affect $1.5 billion of goods annually.

** Present estimates indicate that there are 214 state enterprises with 1986/87 sales estimated at $19.4 billion, and 1986 investments estimated at $8 billion, over one third of Indonesia's gross domestic investment. Excluding Bank Indonesia, their average rate of return on assets was less than 1%.

FIGURE 2: EVOLUTION OF THE INDONESIAN POLITICAL ECONOMY, 1965-PRESENT

	1965 - 1969	1970 - 1982	1983 - 1985	1986 -
	STABILIZATION/REHABILITATION	CONSOLIDATION/EXPANSION	RETRENCHMENT/ADJUSTMENT	END OF OIL & RICE DRIVEN GROWTH
ECONOMIC	- Monetary/fiscal stability - Key infrastructure	- Oil boom - Import substitution industrialization development strategy - Major investments in state enterprises, highly subsidized - Emergence of new highly subsidized Indonesian business middle class - Major build up of infrastructure (schools, health centers) - Subsidized green revolution in rice	- Weakening oil markets - Reversals in primary commodity prices - Non-oil exports become increasingly important - Cutbacks in state enterprise budgets - Import monopolies established - Outward looking trade strategy introduced	- Major decline in oil prices - Rice surplus in 1985, reducing this as future potential for GDP growth - Pressure mounting against import monopolies -*Develop capital markets -*Privatization of state enterprises -*Further trade deregulation -*Privatization of many "public services" -*Improved efficiencies in "public" services
POLITICAL	- Military control	- Decision making at top by consultation/consensus	- Decision making at top by consultation/consensus - Numerous reforms undertaken (Annex E)	- Decision making at top by consultation/consensus - Continued reforms (Annex E)
ROLE OF GOVERNMENT	- Heavy control by government to restore civil order and establish infrastructure	- Centrally planned, tightly regulated economy - Decentralization Law of 1974 nominally put some decision making at lower levels	- Greater decentralization of government planning - Objectives/programs still being centrally determined	- Declines in government budgets result in less control -*Greater devolution of planning/decision making to local government -*Greater participation by independent sector (NGOs, private sector, Islamic development organizations)

* Still needed.

focus of policy considerations. The second concerns longer-term restructuring of the economy away from its present inward looking, oil dependent status to a more outward looking economic structure that features greater roles for labor-intensive manufacturing, non-oil exports, and international trade in general. It also requires major liberalization of the internal economy and expansion of the role of the private sector. Without clear progress on the longer-term restructuring of the economy, we see growth in incomes tending to stagnate and employment pressures, in terms of both open unemployment and underemployment, worsening progressively.

1. Short-Term Financial Sufficiency

Over the past two years, the GOI's strategy for financing its external balance of payments and meeting its most pressing budgetary needs has been to maximize external program or local currency lending, as opposed to project lending. This strategy provides both immediate balance of payments support and local currency financing for the budget.*

We expect Indonesia to finance its balance of payments over the next two years without drawing down official reserves below $5 billion.** This outcome is critically dependent, however, upon the GOI being able to continue to negotiate donor assistance under favorable terms and in a timely fashion, Indonesian oil prices averaging not less than $15.00/barrel, and the absence of prolonged capital flight. The need for external financing will not materially diminish over the short to medium term, even if we assume corrective restructuring steps are taken to the maximum extent possible.

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* In 1986/87 the current account deficit was $4.1 billion financed by $4.0 billion of donor funds and $1.5 billion from commercial borrowings. However, because of debt amortization, capital flight, valuation adjustments from currency realignments, and other smaller factors, official reserves decreased by a net $0.7 billion. Even with this deficit, total real budgetary expenditures declined by an estimated 13% in 1986/87.

** Present reserves are $6.2 billion and oil prices are about $17 per barrel.

2. Medium-Term Adjustment Problem

Indonesia is in the middle of what will probably be a six to seven year adjustment period. It is undergoing a structural adjustment necessitated by weakening oil markets since 1982 that culminated with the decline in average oil prices from \$25/BBL in 1985 to \$12.50/BBL in 1986, before partially recovering to \$17.50/BBL in 1987. Because export earnings and budgetary revenues are highly dependent on oil and LNG earnings (70%+ in 1984/5), the decrease in oil prices continues to pose significant adjustment burdens on balance of payments, government budgets, growth, incomes and employment.* This adjustment burden is expected to be prolonged because of the relatively unfavorable and highly uncertain medium-term outlook for oil prices and the relatively long lead time for structural adjustment policy measures to have substantial impact. The major currency realignments brought about by the falling dollar have also added significantly to the adjustment burden because of their unfavorable impact on external debt service.

The IBRD projects that real GDP growth will average less than 3.0% during the period 1986-90 and that real per capita income will stagnate. On the basis of these projections and historical employment-output elasticities, less than 40% of the 10 million new entrants to the labor force during the period 1986-90 would be expected to find employment.** This follows upon an already worsening employment and incomes situation between 1980 and 1985 when GDP growth averaged 3.5%.

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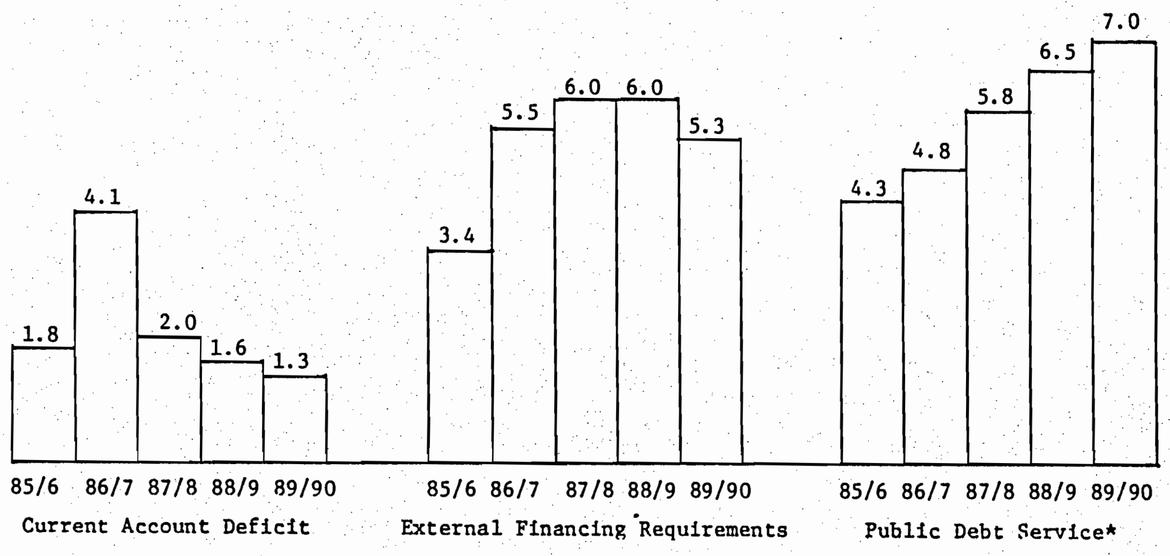
* For example, real GDP growth in the last two years has been only in the 2-3% range, the current account deficit more than doubled from \$1.8 billion in 1985/86 to \$4.1 billion in 1986/87, public debt service ratios roughly doubled between 1984/85 and 1986/87, and the government budget declined by an estimated 25% in real terms between 1985/86 and 1987/88.

** In reality, relatively few of these new entrants are likely to be openly unemployed, but rather can be expected to be absorbed into the "informal sector," possibly at growing rates of under-employment.

Symptomatic of the pessimistic outlook for oil prices and the current economic recession, real budgetary expenditures, excluding debt service, may fall by as much as 40% of their 1985/6 levels between 1987/8 and 1990/1, with the development expenditures component of the budget falling by more than 50%. The rapidly rising external debt service burden is seriously squeezing discretionary budgetary expenditures, for example, debt service as a percentage of the total budget has already risen from 6.3% in 1982/3 to 29.9% in 1987/8. It will require new external financing substantially in excess of the projected current account deficits (see Figure 3 below).

FIGURE 3: CURRENT ACCOUNT DEFICIT, EXTERNAL FINANCING AND PUBLIC DEBT SERVICE: 1985-1990
($ billion)



In sum, over the next three to four years, the government will face significant external financing requirements, major decreases in real non-debt budgetary expenditures, an average real GDP growth under one-half the level in the 1970s, essentially stagnant real per capita incomes, and significant increases in employment pressures.

* Interest for public debt service is also included in the current account deficit.

3. Long-Term Prospects for Growth

If the GOI takes the necessary steps to deregulate, both internally and externally, and restructure the economy toward a strong outward looking trade-industrialization stance now, its long-term prospects for growth within five to ten years are excellent. Despite the almost certain declining significance of oil, Indonesia has one of the richest natural resource bases in the world. Indonesia has reached a point in its human resource base comparable to Korea's in the early 1960s and has reasonable (although still weak) institutional capability in many key areas. It has excellent macroeconomic managers with relatively good access to the top political leadership. It has a government with demonstrated commitment to responsible development, which stands in stark contrast to many of the other less developed countries which have been similarly buffeted by the oil downturn.

We believe that Indonesia can resume average GDP growth rates of 5% by the beginning of the 1990s if the momentum of the 1983-86 reform movement is continued.* We believe the rates can go higher, depending on the degree and type of reform measures taken over the next few years and how soon they are taken--growth rates of 7-8% are not out of the question by the last half of the 1990s (e.g., there is considerable potential gain to be made from correcting existing distortions in the economy and dramatically improving capacity utilization of industrial investments made over the last ten years). We would see these types of growth rates as feasible, however, only if the GOI adopts a strong outward looking trade-industrialization strategy and takes substantial steps toward deregulating the internal economy.

We believe that adopting such a strategy could potentially give Indonesia East Asian type growth in both GDP and export trade. This could mean growth in trade of 5% in the remainder of the 1980s and possibly higher in the 1990s, depending on what happens with oil. A comparable expansion of Indonesian imports would be required to provide the intermediate and capital

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* Although this estimate is in line with IMF projections, the IBRD is more pessimistic and projects average real GDP growth at 4% 1990-95.

imports necessary to sustain the GDP growth levels suggested above. Under this scenario growth and imports would tend to be increasingly self-financing just as they were in the case of many East Asian countries. We would see such a pattern of development not only being highly beneficial to Indonesia in terms of growth, employment and foreign exchange earnings, but also to its trading partners who were in a position to benefit from the increased purchasing power. We could easily see Indonesian imports rising from about $11 billion in 1986 to $26 billion by the year 2000. Assuming the United States stays competitive, its position as the leading exporter to the developing world should translate into a substantial increase of U.S. exports to Indonesia, concomitant with Indonesian growth and foreign exchange earnings.

4. The "X" Factor: Oil

The above projections and speculation on future economic reform measures are contingent upon what happens with a major "X" factor in Indonesia's development: oil. Severe deviations from the "expected" would require the Mission to re-examine its proposed CDSS strategy.

All potential adjustment scenarios over the next several years depend critically upon the price and production trend assumptions for oil and LNG worldwide. As recently as FY 1984/5, oil and LNG accounted for 71% of domestic budgetary revenues and 72% of commodity export revenues. Since then oil prices have fallen from an average of $25 per barrel to $12.50 per barrel in 1986 before recovering to $17.50 in 1987.

Because of the extreme sensitivity to relatively small changes in production and the existence of substantial excess production capacity, world oil prices can easily swing by several dollars in either direction depending on the market's perception of OPEC discipline -- real or imagined -- or other extraordinary factors affecting oil supply such as the Iraq-Iran war. Future oil price levels and trends are highly uncertain and potentially subject to considerable volatility until world-wide excess production capacity disappears, presumably sometime in the early 1990s.

Perhaps even more serious, Indonesia may be facing a rapid drop in oil production capacity that would see the end of net oil export earnings by the mid to late 1990s. Although new exploration and the introduction of high-cost tertiary recovery methods in the older producing fields may help to offset this potential outcome, the longer-term trend for oil revenues definitely appears to be a downward one. Over the medium term LNG will not be able to offset this trend, although there may be some potential in the long term.

C. SOCIAL ANALYSIS

In terms of income levels and physical quality of life indicators, the basic conditions of Indonesia's low-income population appear to have improved over the past decade. In some areas, quality of life improvements have been rapid and impressive; in others, insufficient progress has been made to meet AID's internal standards (see Table 1). Further improvements are constrained by technology, and inadequate human and institutional resource bases as well as limited growth in household incomes. Equally constraining is the GOI's over-dependence on centralized planning and implementation, lack of participation and incentives at lower levels in the public sector, and too little reliance on the independent sector (private sector and indigenous NGOs).

1. Employment

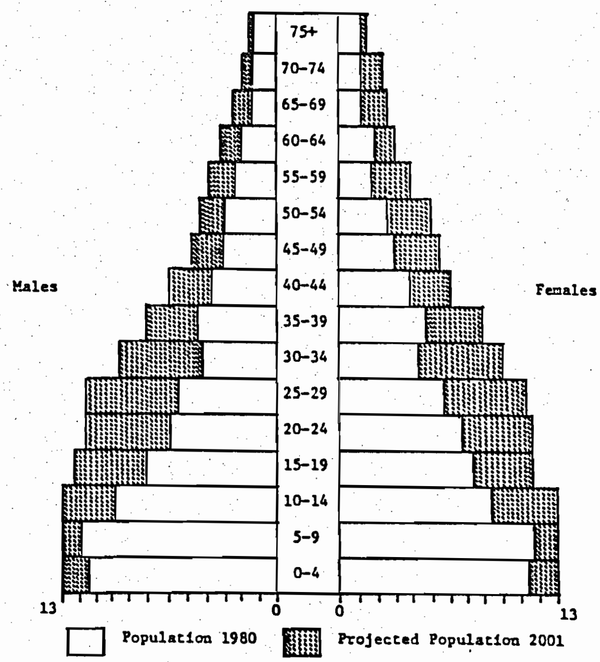
Although Indonesia has one of the best family planning records in the world, its population growth has still been quite significant over the last 25 years, resulting not only in a large absolute population (the fifth largest in the world, 170 million) but also in a very young population (67.9% are under the age of 30). As a result, the potential work force (ages 10+) will grow faster on average (2.4%) than the population as a whole (2.0%) between 1985 and the year 2000 (see Figure 4). The actual labor force is projected to grow even faster (possibly as high as 2.8%) because labor force participation rates are highest in the younger age groups and participation rates for females are expected to increase.

TABLE 1. AID OBJECTIVES AND STATUS IN INDONESIA

Target Area	AID/Washington Objective	Present Status in Indonesia
Economic Growth (annual real growth of per capita income)	$\geq 2\%$	Avg. minus 1.9% (1983-86)
Hunger		
(FAO critical intake)	$\geq 90\%$	Information not available
(children under 5 with chronic/ severe under-nourishment)	<20%	40.2% - mild 9.8% - moderate 1.3% - severe
Disease and Early Death		
(IMR)	<75/1000	96/1000
(CMR)	<10/1000	12/1000
(life expectancy)	60 years	55 years
Illiteracy and Lack of Education		
(primary school enrollment)	90%	118% *
(boys & girls completing at least 4 years of school)	$\geq 70\%$	83%
(skills training)	compatible with development needs	shortages in engineering, sciences, technology, accounting
(adult literacy)	50%	76%
Unmanageable Population Pressures		
(access to voluntary family planning services)	$\geq 80\%$	80%

* Percentage exceeds 100 because some pupils are older or younger than Indonesia's standard primary school age.

FIGURE 4: INDONESIAN POPULATION PYRAMID
1980 AND 2001 (in Millions)



The anticipated growth in the labor force (see Table 2) poses a major burden on the economy to grow sufficiently to supply jobs without depressing real wages and incomes. Estimates suggest that non-oil GDP needs to grow between 4% and 5% annually in order to provide sufficient jobs for new work force entrants (about two million per year) and to maintain real incomes.

TABLE 2: LABOR FORCE, WORKING AGE POPULATION,
AND TOTAL POPULATION 1961-2000
(millions)

	ACTUAL			PROJECTED	
	1961	1971	1980	1990	2000
Labor force	34.6	41.3	52.4	76.9	101.6
Population Ages 10+	64.0	80.5	104.4	135.8	170.6
Total Population	97.0	118.4	146.8	183.5	222.8

Source: Central Bureau of Statistics.

There are other important dimensions to the employment problem, including measures of current labor force slack, the adequacy of employment as measured by incomes and poverty, increasing education levels of the population, and changes in the source and geographical location of employment.

Open unemployment has traditionally been low in Indonesia (2-3%), although it is noticeably higher in urban areas (5-7%) and among the young and the educated. Underemployment (those working under 35 hours per week) has traditionally been high (30-40%), concentrated principally among the young and old, females, and the rural population. Discouraged workers (those who have dropped out of the work force) may be several times larger than open unemployment (USAID estimates 300%) and are probably concentrated among the young, particularly ages 15-24.

Almost all Indonesians who say they want work have employment of some kind, but there are serious doubts about its adequacy in terms of incomes (see comments on incomes below). There is some evidence, however, that unemployment among the urban young has increased substantially during the 1980s, i.e., doubled and tripled for ages 15-29, and is up to 19.2% for urban males ages 20-24 and 17.5% for females.

The income and employment situation will probably worsen in Indonesia before it improves. Over the next ten years, 18-20 million new more highly educated labor force entrants will be looking for employment, with higher expectations for income and type of employment. They will be looking for their employment principally in urban areas (small towns as well as major cities), whereas rural areas have traditionally supplied almost 80% of all jobs. They will be looking during a period of relative economic downturn over the next few years and perhaps longer. They will be trying to find their work in sectors of the economy that are still stifled, directly and indirectly, by excessive protection, regulation, and licensing. Whether the incomes and employment question is adequately addressed will be the outcome of a large number of potential actions on the part of government, but none probably more important than adopting an outward looking trade-industrialization strategy, coupled with the deregulation of the internal economy, and actively implementing the necessary policies to bring it about.

2. Incomes

Increases in disposable income at the household level are the most effective and efficient way to address basic needs. Current data indicate strong income improvements up to about 1982 with a worsening more recently. At an aggregate level, per capita income grew at 4.8% annually between 1965 and 1985. However, per capita income has declined an average of about 1% per annum during the period 1982-86 and projections by the IBRD anticipate stagnating real per capita income through 1990.

In terms of income distribution, recent data show that while significant differentials exist among income groups, income differentials are not increasing. Table 3 suggests modest improvements in income distribution between 1978 and 1984. However, even by 1984 only 21% of total income went to the poorest 40% of the population, an amount still considered "low" by the IBRD's standards.

TABLE 3: PER CAPITA INCOME DISTRIBUTION FOR 1978, 1980, 1981, AND 1984

Year	40% of Pop. with Lowest Income	40% of Pop. with Middle Income	20% of Pop. with Highest Income
1978	18.1	36.5	45.3
1980	19.6	38.2	42.3
1981	20.4	37.5	42.1
1984	20.8	37.3	42.0

Definitive data on absolute income change among the poorest segments of the population are not available. However, the portion of the population falling under the IBRD defined poverty line decreased from 57% in 1970 to 40%

in 1980.* The incidence of poverty was twice as large in rural areas (44.6%) as in urban areas (19.7%) and is noticeably greater in Java (46.9%) than in the outer islands (28.0%).

These limited data suggest that significant percentages of the population are still living at minimal income levels. This situation is likely to be exacerbated by the continuing economic downturn and by the addition of almost two million new entrants to the workforce each year.

3. Hunger

Tremendous strides have been made over the past two decades in increasing the availability of basic food staples and in reducing the incidence of hunger and undernourishment. The average daily per capita calorie supply rose from less than 1800 in 1965 to over 2500 by 1985. By 1986, 50% of children under five years old were still suffering from mild or moderate malnutrition, while those suffering severe undernourishment had been reduced to 1.3%.

The production of Indonesia's major staple, rice, has risen at an average of 5% per year over the past 15 years. By 1985, Indonesia had achieved fragile rice self-sufficiency, with current production adequate for an average of 140-145 kg/capita consumption per year. Further efforts to stabilize and improve the quality of the rice supply now consist primarily of fine-tuning production and distribution systems while reducing agricultural subsidies.

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* The definition of poverty is based on a minimum food expenditure requirement of 17.6 kg of rice per month per capita which is required to provide 2,150 calories and 30 grams of protein per day. In addition, an allowance is made for non-food basic items such as shelter and clothing, related to the consumption expenditures of households subsisting at the minimum food expenditure level. In 1980 the poverty line ranged from Rp. 5,429 per month per capita in rural Java to Rp. 6,471 in urban areas of the outer islands. The allowance for food comprised slightly over two-thirds of the total.

In the past, rapid gains in rice production and, to a lesser extent, in non-staple foods production, were achieved through a highly centralized planning system. Further increases in agricultural efficiency and productivity now require greater decentralization of decision making to local governments, increased participation by the service recipients themselves (e.g., in irrigation), and more market-driven investment allocations. An important related challenge is the need to sustain the agricultural gains already made through improved natural resources management.

The remaining problems of hunger and undernutrition, particularly among poorer segments of the population, are primarily due to inadequate incomes and lack of knowledge about improved child rearing practices. Further reductions in the incidence of hunger and undernourishment, especially among younger children, will require greater attention to these more difficult demand-side challenges.

4. Education

The 1987 IBRD World Development Report confirms the significant role that education plays in a modernizing, industrializing society. It indicates that a necessary step for an economy to embark on rapid and sustained industrial growth is a high percentage of enrollees in secondary schools and near-universal literacy of the labor force. It also demonstrates that returns to investments in education have generally been higher than returns to physical assets, suggesting that lack of education is a greater obstacle to industrialization and development than lack of physical assets.

Indonesia's accomplishments in establishing primary education and improving literacy are commendable and already exceed AID's objectives (Table 1). Primary school enrollments, as a percentage of age group, had risen from 72% in 1965 to 118%* (boys = 121%, girls = 116%) by 1984. Adult literacy is estimated to be 76% in 1987.

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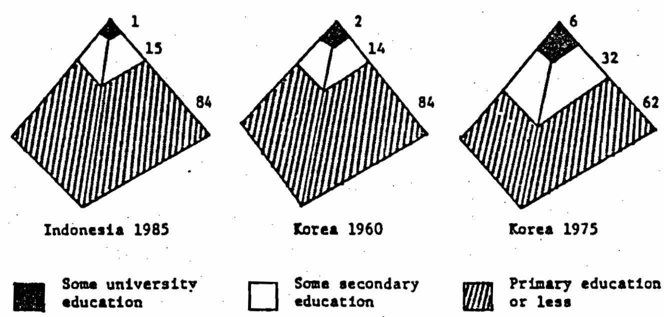
* Percentage exceeds 100 because some pupils are older or younger than Indonesia's standard primary school age.

Percentage-wise, the improvements above the primary school level are impressive, but the absolute numbers still require attention. For example, enrollment in secondary school more than tripled between 1966 and 1984, but enrollment still reached only 39% (boys = 45%, girls = 34%) in 1984. Similarly, in higher education, enrollments have soared from 10,000 in 1950 to 800,000 in 1985, but the demand for admission is still mounting at an average of 12% per year and less than 1% of the labor force has had any university education. Indonesian institutions produce only one bachelor's degree holder per year for every 3000 persons. In the fields most relevant to the demands of a modernizing/industrializing society, e.g., applied sciences, engineering, processing and communications technologies, policy analysis and business administration, the yearly output of graduates dwindles considerably. For example, only 3500 engineers graduate per year from Indonesian universities compared to almost 80,000 per year from universities in Japan.

Useful observations can be made by comparing the educational attainment pyramids of Korea's workforce in 1960 and 1975 with that of Indonesia in 1985 (Figure 5). The similarities of the educational levels of the Korean workforce in 1960 and the Indonesian workforce in 1985 are striking. The differences between Korea in 1975, when industrial take-off started, and Indonesia in 1985 are distressing. For Indonesia to achieve, by the year 2000, an educational output structure similar to Korea's in 1975 will require aggressive efforts to improve system access and system productivity.

FIGURE 5: EDUCATIONAL ATTAINMENT OF THE LABOR FORCE--INDONESIA AND KOREA (PERCENT)



To maximize its contribution to employment and to Indonesia's economic growth, the education sector must now focus on problems of efficiency (to meet the budgetary requirements of an expanded elementary and soon to grow secondary system) and quality (particularly in higher education). External inefficiency has become a pressing problem, with a lack of congruence between the fields and skills promoted by schools and the demands of the job market. University graduates in some fields (e.g., law, economics, social sciences) face increasing difficulty in finding jobs, while major manpower shortages have arisen in other critical fields (e.g., engineering, basic and applied sciences and technology, policy analysis, and accounting). Internal inefficiencies also pose serious constraints; for example, baccalaureate degree production was a mere 6% of enrollments in 1986, with the average university student taking six to eight years to graduate.

Many of the challenges facing the Indonesian educational system derive from limitations in planning and management capabilities within the system itself. Planning is highly centralized and implementation is rigidly controlled. In the intermediate term, addressing constraints will require improved efficiencies in planning and policy formulation at the top of the system to relate education to the needs of the "modernizing, industrializing economy." In the longer term, there are needs for greater input into decision-making processes from lower levels in the system, greater scope for popular participation, and greater efforts to articulate educational planning with the requirements of the marketplace.

5. Health

Major improvements have been made over the past two decades in addressing Indonesia's health conditions. Infant mortality has dropped from 138/1000 live births in 1965 to 96/1000 live births in 1985. Child mortality has dropped to 12/1000 in 1985. Life expectancy at birth has increased from 44 years in 1965 (men = 43, women = 45) to 55 years in 1985 (men = 53, women = 57). Despite these improvements, none of these indicators yet exceeds AID worldwide objectives (see Table 1). Moreover, children under five still account for 48% of all deaths, with major causes being tetanus, birth-related conditions, diarrhea, and acute respiratory infections.

Health services have expanded over this period. Although the percentage of the GOI budget allocated to health is small by international standards (2.5% in 1985), a vast system of public health infrastructure has been established. The system includes over 5000 sub-district public health centers and nearly 50,000 village integrated health, nutrition, and family planning services posts, both of which tend to serve the poorer segments of local populations. The number of health professionals has also increased dramatically (e.g., population per physician figures dropped from 31,740/physician in 1965 to 12,300/physician by 1981).

With a basic health infrastructure in place, the challenges to the health service system are changing. In 1985 and 1986, public health service budgets declined 11% and 25%, respectively. One major need now is for the GOI to reallocate a portion of its increasingly scarce health resources from curative to preventive care (35.3% is currently allocated to hospitals). A second need is to reduce costs to the government through greater efficiencies within the public health system and a more rapid movement of responsibilities for curative services into the private sector. A third need is for decentralization within the public health system, moving responsibilities for planning and implementation to lower levels of government where preventive services can be better tailored to local conditions. Finally, demand for preventive, rather than solely curative services at the household level needs to be created.

6. Population

Indonesia has been among the most successful developing nations in addressing the difficult challenges of reducing population pressures. An estimated 80% of couples of child-bearing age now have access to voluntary family planning services. The percentage of married women using contraceptives has risen from zero in 1970 to 40% in 1984, and to 63% in 1987. While population size and density remain high, contraceptive use has dramatically affected population growth rates, with crude birth rates declining by 25% between 1965 and 1985. A 1985 study indicated that as a result of its family planning efforts through 1984, Indonesia will have averted an estimated 73 million births between 1970 and the year 2000, saving the education system alone $35 billion with an investment of $300 million (some two-thirds of which came from AID).

The family planning services system is the product of strong government and donor commitments over the past eighteen years. USAID has played a major role in shaping this system. Planning and implementation are highly centralized, although high contraceptive prevalence rates have demonstrated the effectiveness of this approach in the past. However, national budgetary allocations to public family planning services are dropping with the overall budgetary decline, so that the system now faces a demand for further successes at much reduced costs; improved efficiencies within the current system are needed as well as a rapid but careful shift from public to private sector delivery of services (the government currently supplies family planning services to 80% of the acceptors). A third important need is to diversify family planning methods from over-dependence on the pill and IUD to greater use of more reliable longer-term contraceptive methods. Finally, with 24% of the total population now living in urban areas, greater attention to the development of urban family planning services is essential.

7. Natural Resources and the Environment

Indonesia's ecological and biological diversity, and the extent and depth of its resource base hold great potential and present tremendous development management problems. Four areas are critical:*

First, Indonesia's 144 million hectares of forest provide the country's most valuable non-oil exports and encompass over half of all the rain forests in tropical Asia. Yet since 1950, nearly 50 million hectares have been deforested. The country's current deforestation rate, 0.6 to 1.0

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* Tarrant, James et al. Natural Resources and Environmental Management in Indonesia: An Overview, Jakarta: USAID/I, October 1987.

million hectares annually, is the second highest in the world. At current harvest rates and practices, within thirty years, all of Indonesia's concession areas may be logged. The degradation and loss of Indonesia's tropical forests will greatly reduce future timber production and export earnings, cause an irreversible loss in unique tropical forests, result in the extinction of thousands of tropical forest species, increase downstream flooding, and exacerbate sedimentation in major infrastructures.

Second, the Indonesian archipelago contains the highest number of species and varieties of any AID assisted country in the world, and is particularly rich in endemic species. At present, biological diversity and the habitats of rare and endangered species are threatened by the conversion of forest land to agriculture. If current trends continue, an untold number of biological resources, which have potential medical and agricultural uses, could be lost.

Third is the degradation of 36 of Indonesia's 125 watersheds, in which 8.2 million hectares are considered critical. Erosion rates have reached up to 40 tons per hectare; coupled with poor management, this has caused an estimated annual loss of $139 million in farmers' incomes. This degradation is a result of the conversion of natural systems (an estimated 6.4 to 11.9 million hectares nationally will be converted for crops, transmigration and fisheries by the year 2000), use of marginal lands, and inappropriate crop and input management. The nearly 200% increase in pesticide use, in particular, since 1981 has resulted in the contamination of food and decreased effectiveness in controlling rice pests: in 1986 alone, 1 million tons of rice worth $180 million were lost to insecticide-resistant pests. The resultant switch to insect-resistant rice varieties resulted in a $210 million loss from reduced yields.

The fourth critical area is water. Water quality is deteriorating and supplies are declining as a result of poor upstream agricultural, industrial, and urban management practices. Increasing quantities of liquid, solid and toxic wastes from industrial and processing activities are reducing the amount of potable water and leading to increased morbidity and mortality from the spread of infectious diseases.

Indonesia's concern with economic problems and non-oil exports far outweighs its regard for the long-term benefits of natural resources and environmental management. Although there are some within the government and the NGO community who are cognizant of the potential ramifications, there is a long way to go before any measurable effect can be realized. At this fledgling stage, attention should be focused on policy formulation, enforcement of existing policies and regulations, and strengthening coordination and decentralization of environmental planning and management.

D. CONCLUSIONS OF THE ECONOMIC AND SOCIAL ANALYSES

Indonesia's development is well along; it is a country in the process of "modernizing." It has a number of characteristics which put it at the top of the list of lower income countries:

- The importance of trade in the economy is growing and that of agriculture is falling;
- There is a greater receptivity to the use of market forces and the private sector;
- There is more receptivity to agricultural programs shifting towards diversification and sustainability, and away from self-sufficiency;
- Population growth rates are declining; and
- Primary education is being addressed sufficiently.

At the same time, it is not yet a "modern" country. The following characteristics indicate those areas of weakness which forestall immediate graduation and in many instances place it below other "modernizing" Asian countries like India and Thailand. (See Annex D for a quantitative comparison of Indonesia with other Asian countries.)

- Over 40% of the population is living below a very modest poverty line;
- Reduced dependence on agriculture is due to oil exports and more rapid growth elsewhere in the economy;
- Industry and manufacturing still play a very small role, making Indonesia nowhere near a newly-industrialized country; manufacturing's contribution to GDP (13%) is the lowest in ASEAN;

- Policies still exist which inhibit trade, production and investment;
- Domestic savings are low given the state of the economy, and investment has been stagnant;
- There has been minimal capital markets development;
- Institutional and human capital bases are still deficient;
- Infrastructure is inadequately maintained and has pricing policies which do not allow for full recovery of services; and
- Only 7% of the current school age population is enrolled in higher education, and life expectancy (55 years) and infant/child mortality standards (IMR=96/1000) are the lowest in ASEAN. All three indices are below the average for middle income countries.

We thus project that it will be approximately fifteen years before Indonesia "graduates" from its LDC status. However, this will proceed in stages and some sectors will move faster than others. We would envision that by the mid- to late 1990s, Indonesia's family planning program will be well-institutionalized with the majority of recipients being serviced privately and a vital private sector operating. Government decision making will have devolved to the local level. Science and technology will start to play a larger role in the economy, affecting agriculture, industry and energy.

After that, we foresee health care systems following family planning service in being institutionalized, with fee-for-service programs operating. A human resource base will be established, and agro-industry, rather than agricultural production, will play a larger role in the economy (see Figure 9 in Section II).

II. U.S.A.I.D STRATEGY

A. OVERVIEW

1. CDSS Goal: Employment and Incomes

The employment-incomes problem is considered by the Mission, the GOI* and most other observers to be the overriding socio-political-economic issue facing Indonesia over the next decade and beyond. The magnitude and complexity of the problem are great (see Section I.C.1). The sheer numbers entering the labor force, the rapidly increasing educational levels and rising aspirations of new labor force entrants, the decline of agriculture as a significant source of new employment, the anticipated concentration of new labor force entrants in towns and cities, the major uncertainties surrounding future oil production and prices, and the significantly lower growth expected for the economy in general all combine to indicate the growing importance of this problem in Indonesia.

The economy needs to provide sufficient numbers of productive jobs that will support rising real wages, are appropriate to the higher educational levels and expectations of the new labor force entrants, and are spatially distributed to avoid undue migration to the big cities. The educational system, too, must adapt: it must better provide the kinds of skills required by an economy in the midst of the modernizing process.

2. Basis for Our Strategy

a. How to Tackle Employment

Our strategy is directed toward the long-term improvement of widely dispersed employment opportunities under conditions of constant or rising real

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* It is a major concern of the present Five-Year Plan (1984-1989) and is expected to assume a larger role in the next Five-Year Plan.

wage rates. We believe that promoting productive employment opportunities is consistent with both growth and equity concerns and is important to long-term economic and political stability. We believe that rapidly increasing the demand for labor is an urgent task facing the Indonesian government and one that requires major attention to a variety of measures which increase resource efficiency, productivity, and mobilization. We believe that measures on the labor supply side, which both qualitatively and quantitatively improve human productivity through education, family planning, and child survival, play an equally important role in ensuring the long-term sufficiency of employment opportunities.

To address these concerns, we are proposing a strategy developed from the 1985 Mission employment study.* This study considered a broad set of possible actions the Government of Indonesia might take to resolve the long-term incomes and employment problem. We are drawing our strategy from this broader set of actions. Figure 6 shows the causal relationships proposed. The figure shows three "solutions" to the employment problem, two of which look at demand and one at supply. There are two basic ways of increasing long-term labor demand, assuming that real incomes are maintained or increased. The first is by increasing the average labor intensity of output and the second is by increasing the rate of economic growth. Supply is effected by slowing the growth of the labor force and improving labor force productivity through appropriate investments in health, family planning and education, an integral part of a balanced long-term strategy.

Figure 6 shows numerous government policy actions that would positively support each of these potential policy goals. The indicative policy directions/activities were proposed within the context of a long-term market-oriented efficiency and productivity strategy framework and have been categorized under: improving market resource allocation and mobilization, improving government resource allocation and mobilization, improving inter-island and stabilizing urban-rural spatial distribution of population, reducing government's share of resource allocation, adopting and implementing

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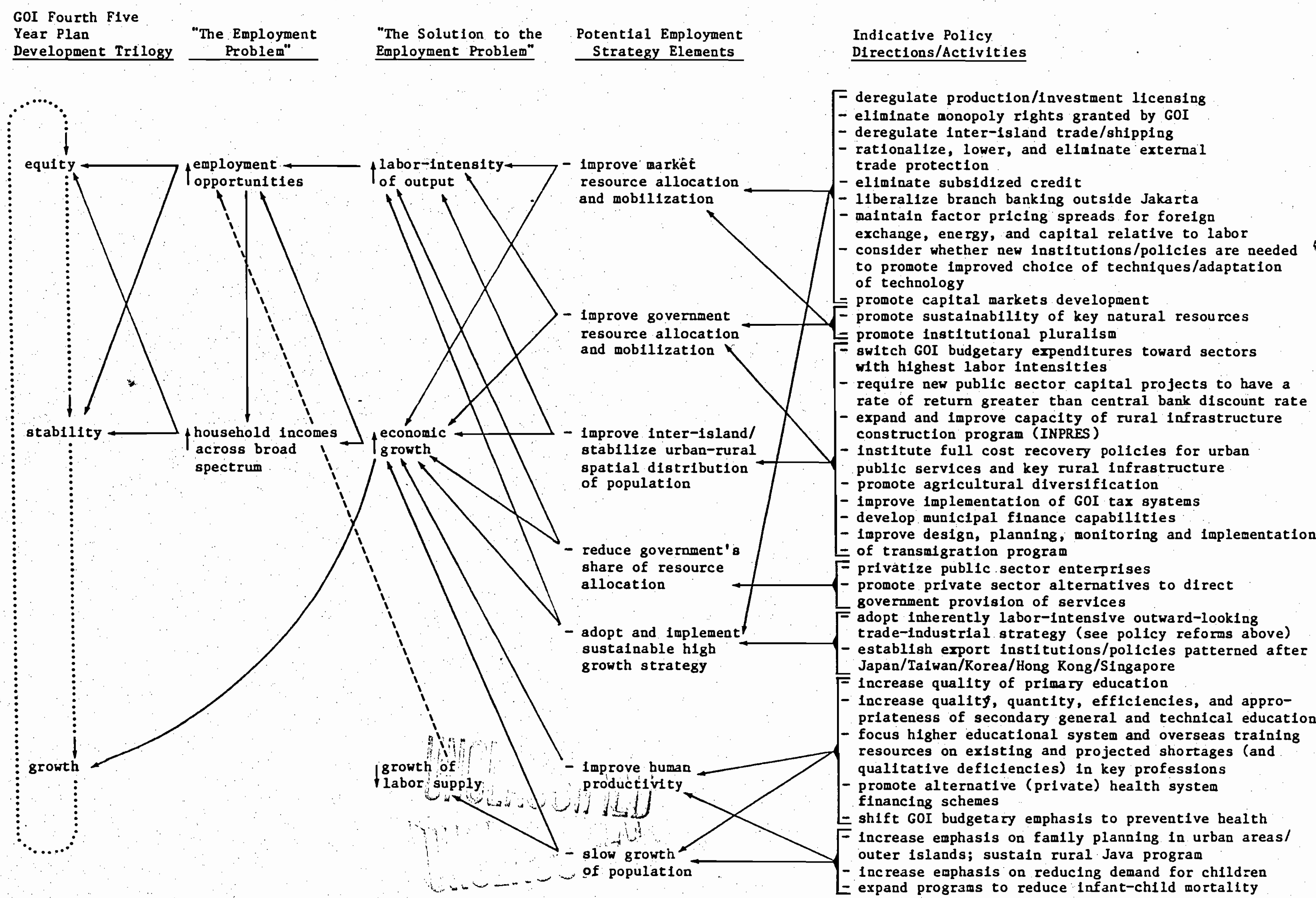
* Robert L. Rucker, A Preliminary View of Indonesia's Employment Problem and Some Options for Solving It. Jakarta: USAID/Indonesia, October 1985.

FIGURE 6: DIAGRAM OF CAUSAL RELATIONSHIPS AND POLICY IMPLICATIONS THAT UNDERPIN OUR STRATEGY OF SUPPORTING A MARKET ORIENTED LONG-TERM EFFICIENCY/PRODUCTIVITY APPROACH TO THE INCOMES/EMPLOYMENT PROBLEM



a sustainable high growth strategy, improving human productivity, and slowing the growth of population.

It is not necessary for all potential strategy elements or suggested policy directions in Figure 6 to be included in either a GOI employment strategy or a Mission CDSS strategy. The framework may be thought of as a menu from which numerous strategies might be drawn. Most of the suggested indicative policy directions and activities stand on their own and would help to improve the incomes-employment situation even if they were taken in isolation. Nevertheless, the more policy changes brought to bear on the employment problem the better. Further, it is doubtful that any strategy that systematically ignored growth could ultimately be satisfactory. Finally, it is clear that the explicit adoption of a sustainable high growth strategy would require a policy package approach that draws on several of the suggested indicative policy directions.

Improved efficiency and productivity within the context of a growing market orientation underlie both the Mission's strategy and the incomes-employment strategy framework.* We see no viable long-term incomes and employment strategy that can afford to waste resources or consciously ignore these concerns. Thus, we see the principal means of achieving these ends to be through the selection of key policies and activities that have strategic and/or major impact on resource efficiency and productivity. By selecting our program of activities largely on the basis of their contribution to efficiency and productivity we will, in fact, have provided the most effective support of the long-term employment and incomes goal. For this reason we will look to how well a proposed activity fits into the

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* Improved efficiency refers to movements toward the point of economic optimality on the existing production possibility curve. This may involve the correction of distorted prices, particularly policy-induced distortions. Improved productivity refers to expanding the boundaries of the existing production possibility curve by changing the underlying parameters (e.g., quality and level of resources, technology, institutional arrangements).

incomes and employment strategy framework and how significant the efficiency/productivity impact is expected to be rather than what the direct employment implications of an activity might be.

b. The Policy Change Process: How the Mission Will Relate Project Aid to Program Aid in the Indonesian Context

A key component of the employment strategy is policy change. To effect policy change, we must work within the Indonesian context of the policy change cycle (Figure 7):

Figure 7: THE POLICY CHANGE CYCLE

Project Mode:

Identify Constraints
↓
Studies/Research
↓
Dissemination/Presentation
↘ Pilot Tests
↙ Demonstrations
↙
Policy Discussions
↓
(Assessments)

Program Mode:

↓
Policy Advocacy
↓
Policy Changes

We believe in this approach. It is meaningless to support "policy change" unless one knows, with some precision and depth, what policy changes are desirable and why. We are at various stages within all of our following sub-goals in the policy cycle. We are most optimistic of success for change where we have already participated in the studies/research, discussed the findings, moved to pilot testing, and initiated preliminary policy discussions through projects in our portfolio. In these instances, we are ready to move ahead with policy advocacy, usually in a program mode (e.g., agricultural trade, pricing and subsidy policies, privatization of family planning, unsubsidized banking services). There are other areas, however, where we are not yet sure of the answers. In these areas, initial investigation/demonstration/pilot activities are required under a project mode (e.g., health sector financing, privatization, cost recovery in roads and irrigation, efficiencies in education). The policy lessons to be drawn from these activities are not yet clearly identified, but such projects are a necessary, preparatory part of future program development.

3. Proposed Strategy

Our proposed CDSS GOAL IS TO IMPROVE LONG-TERM SUSTAINABLE EMPLOYMENT AND INCOME OPPORTUNITIES THROUGH MEANS WHICH PROMOTE EFFICIENCY AND PRODUCTIVITY. Figure 8 is a schematic of our proposed CDSS strategy - including the goal, sub-goals and criteria for project/program selection. We propose to pursue our overall goal through FOUR SUB-GOALS:

1. TO SUPPORT A MORE OPEN, LESS REGULATED, MARKET AND TRADE ORIENTED ECONOMY, BOTH INTERNALLY AND EXTERNALLY;

2. TO INCREASE THE SUSTAINABILITY, PRODUCTIVITY AND EFFICIENCY OF THE AGRICULTURAL PRODUCTION, PROCESSING, DISTRIBUTION AND CONSUMPTION SYSTEM;

3. TO ACHIEVE AN EFFICIENT, HIGH QUALITY HUMAN RESOURCES DEVELOPMENT SYSTEM WHICH EFFECTIVELY LINKS SYSTEM OUTPUTS TO MARKET REQUIREMENTS; and

4. TO REDUCE FERTILITY AND IMPROVE RATES OF INFANT AND CHILD SURVIVAL.

Each sub-goal will, in turn, be pursued through selected objectives (which are detailed in the following section), all of which are directly or implicitly within the employment and incomes strategy framework shown in Figure 6.

The Mission is proposing significant changes in direction, emphasis, and general philosophy toward project/activity design throughout its sectoral portfolios. Two broad sets of criteria, one set concerning management effectiveness and the other dealing with leveraging potential (see Figure 8) will sharpen our future approach to project selection, design, and implementation in each sector that we address.

FIGURE 8: CDSS FRAMEWORK

GOAL:

Improve long-term, sustainable employment & income opportunities through means which promote efficiency & productivity

SUB-GOALS:

- Support a more open, less regulated market and trade oriented economy, internally and externally
- Increase sustainability, productivity and efficiency of the agricultural production, processing, distribution and consumption system
- Achieve efficient, high quality human resources development system which effectively links system outputs to market requirements
- Reduce fertility/improve rates of infant/child survival

CRITERIA:

<u>Management Effectiveness</u>

- Improve staff utilization
- Reduce staff intensity
- Expand programming modes
- Limit management units
- Increase internal program complementarity
- Shift responsibility for project management to GOI/independent sector as feasible

<u>Leveraging Potential</u>

- For affecting key policy changes
- For strengthening critically situated institutions
- For replication following key demonstration/pilot projects
- For leveraging other donor resources

PROJECTS/PROGRAMS

Management effectiveness criteria are principles that will improve staff utilization for the new program. To more effectively utilize the 41 USDH positions we have, emphasis will be given to those project and program activities which require less management time for bureaucratic pursuits, in an effort to free staff time for policy and efficiency objectives. The change required is in how we deploy ourselves, not in total overall staff levels. This change may require organizational adjustments or sharper definitions of functions across or within offices, as well as different types of skills (see Section II.D for more detailed information).

Leveraging criteria are principles that promise exceptional impact for our investment if judiciously incorporated in proposed new activities. The potential impact of an assistance activity is a function of total resources affected (not just USAID's), the degree of potential efficiency or productivity improvement, and the probability of success.

We intend to leverage our program by choosing activities which have prospects for the largest efficiency return within the broad areas indicated by our sub-goals and objectives. We hope to magnify our impact on efficiency and productivity by designing and selecting new projects and activities that have high potential for effecting key policy changes, strengthening critically situated institutions, replication following key demonstration and pilot projects, and leveraging significant other donor resources. Thus, our focus is on improving the efficient use of overall resource flows, not simply on transfering our own. The "return" to our expenditure is the change in efficiency brought about on the total resource allocation affected. As such, if we work with key elements of organizations or ministries (e.g., planning and analytical units) that have large budgets or make decisions affecting the allocation of large amounts of resources within the private sector, our potential impact on the economy can be enormous. Obviously, this is a high risk as well as a potentially high gain approach.

Indonesia's stage of mid-level development (see Section I.D) requires a more sophisticated AID strategy which moves away from "basic" development requirements (e.g., nation-wide programs, long-term basic institution building, major infrastructure) and toward promoting a more open, less controlled economy with broader participation of the population in their own development, including the private sector, NGOs, and local government.

There are several significant changes in our broad CDSS orientation. These include:

- direct focus on a unifying goal: employment and incomes, with all sub-goals and objectives tightly integrated in a reinforcing program framework,
- more attention to macro, structural, sectoral and cross-sectoral policy,
- more attention to leveraging and management effectiveness principles in general,
- a more sustained use of program assistance as a continuous feature of the portfolio to promote and implement policy change and management efficiencies,
- greater attention to utilizing and opening opportunities for the private and independent (NGO) sector,
- limiting new involvement in the public sector primarily to those areas in which it demonstrably helps the private sector, and
- more attention to building the foundation for the "maturation" of Indonesian economic development.

These changes are integrated across the program. For example, privatization and private sector activities are being supported across four sectors as well as at the macro-policy level. In family planning, we lead all other AID missions in privatization objectives, supporting the GOI goal of 80% private coverage by the year 2000; in health we will support privately owned health insurance schemes; in education we will support strengthening the private university system and a greater role for private companies in job training; and in agriculture we will support marketing and trade changes conducive to private agro-processing. From the structural standpoint, we will, if the GOI wishes, be prepared to provide policy analysis and support discreetly to decision makers regarding the ways and means of successfully privatizing state enterprises and increasing investment by the private sector in "typically" public services.

This CDSS will lay the foundation for future strategies which move us out of some areas (e.g., family planning) and into others. We expect, for example, that science and technology may play a major role in the next CDSS (see Annex F). Beyond that period we envision an association which moves away from a benefactor-recipient relationship and concentrates on cooperation between the U.S. and Indonesia, both technically and commercially. Figure 9 places this CDSS in its historical context and presents a schematic of the evolution we expect in the USAID program over the coming years.

B. SUB-GOALS

Each of our four sub-goals directly supports improvements in employment and incomes. We show under each sub-goal our specific objectives and sub-objectives for the upcoming CDSS period, the link to employment and incomes, the strategy by which we expect to achieve these objectives, our expectations for success, and the program resources we expect to utilize. In addition, we list specific benchmarks for each sub-goal in Annex B.

1. Sub-Goal: To Support a More Open, Less Regulated Market and Trade Oriented Economy, Both Internally and Externally

Objectives. Experience throughout the developing world suggests that open market, trade oriented economies are the fastest growing, create the most jobs, and may exhibit more equitable income distribution (1987 IBRD *World Development Report*). Given that Indonesia's natural and human resource base is one of the largest and most underutilized in the world, the objectives below directly address the Mission goal of increasing employment and incomes through means that promote efficiency and productivity. We believe an open market strategy will help lead Indonesia toward an East Asian growth pattern, resulting in substantial benefits for Indonesian employment and economic growth, and for mutually beneficial trade development. As part of our portfolio-wide private sector initiative, we will focus on developing an economic environment conducive to growth as follows:

FIGURE 9: POSSIBLE EVOLUTION OF USAID PROGRAM*

1946-1970	1970-1985 (transition)	1989-1993 (transition)	Mid to Late 1990s (transition)	200?
<u>STAGE I</u>	<u>STAGE II</u>	<u>STAGE III</u>	<u>STAGE IV</u>	<u>STAGE V</u>
		<u>Structural Change</u> - Deregulation - Trade - Industry - Finance - Capital markets development -Privatization		Private commercial interests operating outside AID
Infrastructure	Institution building	<u>Agriculture</u> - Diversification - Private sector alternatives - Agro business - Policy/planning analyses	Science & Technology	Public relationships for scientific and technological interchange outside of AID
			Agro-Industrialization	
	Nation-wide programs	- Selected public sector activities - cost recovery - efficiencies - Environment	Environment	
	Construction	<u>Education</u> - Policy/planning analysis - Higher education - Training	Established Human Resource Base	
	Commodity supply	<u>Health/Family Planning</u> - Privatization of F.P. - Efficiencies in ORT and immunization programs - Health sector financing - Create demand for preventive services	<u>Health</u> - Privatization of health care programs - AID family planning assistance completed	AID health programs completed
Projects	Projects	Sectoral Approach (Projects/Programs)	Revised Strategy	Different Type of Relationship than "Assistance"

* Assuming GOI pursues needed measures

(a) Support GOI efforts to deregulate trade, industry, finance and investment, both internally and externally.

- Support GOI programs to eliminate unnecessary trade licenses (e.g., monopoly import and export rights, agricultural trade barriers);
- Increase open market mechanisms for and develop financial markets, specifically, the stock, money, bond and commodity markets;
- Reduce requirements for production and investment licensing.

(b) Increase private sector trade and enterprise in key economic and productive sectors.

- Promote private sector alternatives to government provision of services throughout the portfolio: agriculture, health, population, education, and finance;
- Depending on financial market development and the policy climate, support GOI efforts to divest state enterprises;
- Promote private sector investment in and cost recovery for public services, with particular focus on municipal areas using Housing Guarantee Loans, if acceptable to the GOI;
- Support selected bilateral trade initiatives consistent with Indonesia's long-term development.

Strategy. The open market/trade objectives are the centerpiece of our private sector policy dialogue with the GOI. This policy dialogue, which is consistent with the GOI commitment to a more open economy, will be augmented by substantial AID support for follow-on policy implementation. Explicit in this strategy is a substantial move away from direct assistance to private sector businesses, management training, and long-term institutional development efforts. The key elements of our macro-policy approach will be trade and investment deregulation and the development of Indonesia's long-term financial markets. Our micro-policy approach will include trade and enterprise development activities focused on small- and medium-sized businesses, and selected sectors such as agrobusiness, family planning, and health which are critical to our program.

Trade, industry, and investment deregulation is a relatively new focus for USAID, and is predicated on substantial changes already enacted or contemplated by the GOI. Many of these actions have involved close cooperation with and substantial program support by the World Bank. We will therefore take a flexible, cooperative approach that is mutally supportive with the Bank, targeting those areas of opportunity which are most consistent with our own program, offer the greatest return within the private sector, or are otherwise well suited to AID's expertise or ability to grant finance. Of particular interest are licensing requirements for domestic industries, monopoly licenses, quota restrictions and tariffs on the import of raw materials, foreign and domestic investment restrictions, and local commercial law.

Within the deregulation "agenda," trade deregulation ranks as the highest priority and one where we already have a clear understanding of its development impact and GOI priorities, based upon the superb work of the Development Studies project. Efforts in industry and investment deregulation, which affect both domestic and foreign investors, represent a more difficult agenda which will require a relatively reactive, rather than proactive, involvement. Key issues are the extent of the need for domestic licenses, limitations on foreign firms within the services and distribution sectors, and strict divestiture regulations (ten years) for foreign investors.

Deregulation and development of financial markets,* through the development of stock, bond, money (short-term) and commodity markets is already a part of the Mission's private sector portfolio and will remain a focal point of our open-market strategy throughout the CDSS period. As part of the financial markets development strategy, the following specific policy

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* The deregulation and development of financial markets is considered of prime importance to an outward looking trade and industrial orientation because: (1) rapid growth in manufacturing will require a substantial increase in the availability of long-term investment capital; (2) financing and ownership of production facilities can thereby be made available to a broad spectrum of Indonesian entrepreneurs and investors, thus promoting more equitable economic growth; and (3) such markets are prerequisites for the successful privatization of state enterprises and of selected government services and infrastructure.

objectives are considered worthy of deeper analysis and potential support: eliminating the ceiling on bank licenses, reducing the financial requirements for establishing bank branches, allowing foreign banks to operate outside Jakarta, revising the Bank Secrecy laws, allowing secondary trading of government and private notes on an official basis, equalizing the tax treatment of time deposit and equity dividends, and deregulating investment by insurance and pension funds, Bank Indonesia's role in the money market, the trading and issuance of equity and debt instruments, and trading on the commodity market.

Privatization will require a well thought-out and sensitive approach which takes into careful account the role of state enterprises in indigenous employment, the need for broad participation in the benefits of any divestiture, and delicate social and political factors. It may require that any bilateral role be a quiet or even confidential one. If the GOI is interested and develops trust in us in these matters, we will be prepared to address privatization as a second phase of the financial markets development strategy. Privatization activities could take the form of asset valuation, financial restructuring, new financial instruments for privatization, technical assistance, employment safeguards, and adjustments for selected candidate firms.

The deregulation strategy will combine case studies analyzing the high economic cost of regulation, policy reform/implementation funding, and selected trade and investment promotion activities which reinforce our deregulation program. This program will utilize a flexible, response-oriented programming mode.

Our second area of focus will be private sector trade and enterprise development. We will closely examine the interaction between the formal and informal sectors and the policy deregulation implications for small and medium-sized businesses during this CDSS period. In conjunction with private sector activities under other sub-goals, we will encourage urban-rural linkages which promote manufacturing and agrobusiness, private sector education and training initiatives, and a greater role for private enterprise in health and population programs (see sub-goals 2, 3, and 4 below). We will tend to move gradually away from the relatively inefficient approach of supporting specific enterprises, and move more toward policies affecting the financial, infrastructure, trade and regulatory support systems required for a private sector environment in which <u>all</u> enterprises can develop. Specific policy issues considered worthy of deeper analysis and potential support include: maintaining market interest rates and savings mobilization in rural finance, creating incentives in local government infrastructure and service programs which emphasize economic efficiency/productivity and increased reliance on private sector funding, reducing local regulations and practices which restrict free trade and production, and establishing a greater, more open private sector role in promoting international trade, marketing and technology transfer.

These trade and enterprise development efforts will build on the program base already established with numerous technical ministries in support of specific programs. As a longer-term strategy, we also see this subsector as the beginning core of a program in science and technology transfer for the next CDSS period.

<u>Program</u>. Our ongoing D.A. funded projects and programs have established a solid basis for the proposed strategy in support of a more open economy. <u>Deregulation policy and promotion</u> are currently supported by the Agriculture and Rural Sector Support Program (directed at agriculturally-related deregulation), the Development Studies Project, and the Private Sector Development Project. Under our ongoing plan to strengthen USAID staff macroeconomic skills through a JCC-type mechanism within our current ceiling, and with increased coordination with the World Bank and other key donors, we will be able to cover the substantive policy analysis work required for our deregulation support strategy. To augment deregulation policy implementation, and to consolidate trade, investment and enterprise development activities, we will add a Trade and Enterprise Development Project in FY 89. This effort will straddle both deregulation policy implementation and the enterprise development strategies cited above. It will extend beyond the short-term deregulation policy period and will include trade development, deregulation at the provincial and local (rather than national) levels, and private sector trade, marketing and technology transfer related to enterprise development--

including support for agroprocessing, family planning, and health. The S&T Bureau may be a useful partner on several aspects of this effort, as will the PRE Bureau. The use of Title I (including, if possible, Section 108) proceeds will be considered. PVO Co-Financing and/or Title II sub-projects will produce case studies and test pilot activities.

Financial markets support is being provided by the Financial Institutions Development and Private Sector Development projects, ARSSP, and Title I. An FY 88 Financial Markets project is proposed to consolidate and augment current activities as well as to complement a proposed FY 88 Housing Guarantee Loan Program in support of municipal finance markets. The PRE Bureau* will play a key role in design and short-term technical assistance for financial markets and privatization activities. While AID currently plays a leading role in financial markets sector initiatives, interest by the ADB and the World Bank's International Finance Corporation in capital markets development may result in future joint projects or programs with USAID. Later in the CDSS period the privatization component should be sufficiently developed to be included in a program assistance mode along with deregulation as a follow-on to ARSSP.

2. Sub-Goal: To Increase the Sustainability, Productivity and Efficiency of the Agricultural Production, Processing, Distribution and Consumption System

Objectives. We will concentrate on agriculturally related employment and income opportunities, the more efficient use of local government resources for "public goods," and a long-term concern with Indonesia's natural resources - a prerequisite to sustainable economic development. In particular, we expect to:

(a) Increase the productivity and employment potential of diversified agricultural production.

- Improve the agro-related policy environment (e.g., reduce agricultural subsidies, revise pricing policies);

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* Through its Financial Markets, Private Enterprise Development Support and Housing Guarantee Projects, and the revolving loan fund.

- Strengthen capabilities to carry out policy analysis, selected research and technology development and program management;
- Expand the availability of market information to promote more efficient private sector production and processing.

(b) Improve the efficiency of public resource allocation/utilization, limiting new involvement primarily to areas critical to promoting/supporting private sector production and agro-based processing.

- Improve national-level policy analysis and formulation capabilities which promote more efficient local public sector support of production;
- Complete present commitments to improve rural road maintenance services and develop alternative water resource management schemes.

(c) Improve the ability of all sectors to manage natural resources and the environment more effectively.

- Promote sustainability of key natural resources;
- Promote biological diversity/forest conservation;
- Develop farming system strategies and promote agro ecosystems analysis;
- Improve watershed management policies.

Strategy. The Mission undertook a thorough assessment of its agriculture/rural development program over the past year, reviewing directions, modes of assistance and ways to move toward more policy oriented, focused and effective assistance.* We have concluded that we can best expand

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* Mehra, R. Indonesia: Inventory of Agricultural Policies. Jakarta: USAID/Indonesia, March 1987; Tabor, S. and K. Altemeier, An Economic Simulation of Food Crop Policy Alternatives, Supply/Demand Study, Sub-Study I. Jakarta: Directorate of Food Crops, Economics and Post-Harvest Processing, Directorate General of Food Crops, Department of Agriculture, August 1987; and miscellaneous internal background papers for the CDSS.

employment opportunities and income generation through evolving our focus on production to the entire agricultural production, processing, distribution and consumption system. This conclusion requires (1) movement away from subsidized, centrally planned agricultural production to market driven production based on regional comparative advantages; (2) complementary support to increase the efficiency of local governments and organizations as it relates to promoting production, processing and trade; and (3) a greatly strengthened program to support the sustainable use of natural resources in order not to deplete the resource base in the process of strengthening diversified production.

The first objective, agricultural diversification, will be pursued through key agencies in agriculture with which the Mission has long experience. We will seek to build more effective coordination and links between these agencies and other public and private sector bodies critical to greatly expanded private sector involvement in agricultural production, processing and trade. We will shift support away from broad institution building (i.e., training, construction and commodity procurement) and toward policy support and improving efficiencies within selected areas (e.g., secondary food crops, planning). This is the next logical phase beyond our objective in the previous CDSS of strengthening food production. We will now address more directly efficient management in agricultural research; more effective research and extension linkages and approaches to increase efficiency in production of secondary food crops; and strengthening of monitoring, policy analysis and formulation capabilities. We will be seeking activities that promote marketing, processing and agrobusiness, and that otherwise meet our management and leveraging criteria.

The second objective deals with a key actor in the agricultural "system," local government. A major part of our overall agricultural strategy is promoting market- and demand-driven production based on regional comparative advantage. This concept recognizes regional differences and hence the need for decentralized planning autonomy. We will thus continue efforts to improve the efficiency of local public sector resource allocation and utilization, but we will limit our involvement to reducing present bureaucratic and policy constraints to production, processing and trade rather than the previous broad-based institutional capacity building at the local level that we undertook during the last CDSS. Our remaining involvement in local government activities (roads and irrigation) will stress local responsibility and be linked to central authorities responsible for setting national procedures and policies critical to replication nationwide. We will make no new commitments in roads or irrigation.

Within the field of natural resources management, we are proposing a new strategy, necessary in a country which has the richest and most diverse biological resource base of any AID-assisted country. Drawing upon an analysis prepared by an eight-person team to address the concerns cited in the Foreign Assistance Act,* we have developed a Natural Resources Management (NRM) program that strengthens our response to the mandates in the Foreign Assistance Act sections 117, 118, and 119 (see Section II.C.3) and that supports the GOI in selected activities to promote environmental conservation and sustainable development. The NRM program is based on the precepts that (1) sustainable economic development is dependent on the relationship between employment, income generation, and the sustainable use of natural resources and (2) proper natural resources management is necessary to ensure that current economic activities will not further deplete natural resources for short-term gains at the expense of medium- and long-term needs.

The NRM strategy will support enforcement of existing policies and regulations, and strengthen coordination and decentralization of environmental planning and management. We will expand appropriate private and non-governmental sector involvement, and promote a policy environment conducive to sustainable exploitation of natural resources (e.g., ensuring that the real costs of resource use are borne by producers and users).

The proposed objectives and sub-objectives have differing chances for success. There is a high probability of success in areas where we have had long involvement and are confident of our future actions, e.g., agro-related policy. We are also confident that we will be able to develop demonstrations

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* James Tarrant et al., Natural Resources and Environmental Management in Indonesia, An Overview. Jakarta: USAID/Indonesia, August 1987.

(e.g., irrigation, rural roads maintenance, environment) that could have a nation-wide impact. Replication of these models or the adoption of related policies are less certain, but they are a necessary formative step in rational policy change. We are less confident about establishing sustainable GOI capacities to undertake policy analyses during this CDSS. Capacity building, even when done selectively, is a long effort, but is a necessary one for sustainability.

Program. Policy improvements in support of the agricultural system will be pursued through both projects and programs. Project aid will provide the information, models and expertise needed to convince GOI policy makers of the need for and feasibility of policy improvements. The program is at various stages in the policy development cycle (see Figure 7). For example, we expect to identify major constraints (e.g., agro-processing); support recommendations for improvements and changes with responsible, well researched data and information for GOI decision makers (e.g., subsidy and pricing policies); seek and, in some cases, demonstrate solutions (e.g., irrigation and roads); and encourage and support effective presentation and discussion of policy options, benefits and likely outcomes among key analysts and decision makers (e.g., diversification versus single commodity oriented approaches, pursuit of regional comparative advantage).

In areas where key GOI groups are already supportive of specific changes or directions of policy change (e.g., reducing input subsidies, introducing integrated pest management), we will support such changes and lessen their associated risks through program assistance support. Areas listed in the preceding paragraph that emerge as confident policy recommendations will move to the program support mode during the CDSS period, assuming that the present ARSSP mechanism provides satisfactory results. Additional ARSSP support is provisionally planned beginning in FY 1989.

Present support toward agricultural diversification, the first objective (currently under four projects and one policy support program), will be restructured and consolidated through a review of the current project portfolio and assistance modes prior to the beginning of the CDSS period. Our ability to reduce management units significantly (from five major units currently, plus centrally funded activities) will depend upon our success in using the program support mode of assistance. If ARSSP proves an effective mechanism to achieve intended goals, selected project activities may be subsumed under this model and several projects eliminated. This program mode change will require a shift in staffing from current project management roles to more policy and sector oriented analysis and monitoring. Based on the outcome of assessments of the current modes for promoting agrobusiness expansion and the application of our management effectiveness standards, the Mission may initiate an FY 90 or 91 project focusing on agrobusiness.

An FY 89 project, Local Development Policy, will support the second objective and the ability of the central government to analyze and revise policies that impede local governments' capability to support private sector production in the development of their regions. This project responds to prior evaluations which identified weak central policy analysis capabilities and the provision of related guidance as serious obstacles to increasing the effectiveness of local governments to support local economic activity. This project will parallel and complement similar efforts being made with support from other donors for urban areas, and potentially influence the allocation and use of nearly $700 million in GOI funds annually as well as leveraging other donor resources.

Commitments made prior to the CDSS period in the irrigation and rural roads sectors will be maintained but not expanded. We have decided to continue these efforts because of the contributions they make to developing proven models for the more efficient, cost effective and locally sustainable provision of these types of infrastructure. In addition to leveraging GOI and other donor funds for future replication, we will pursue options for lowering AID capital funding in these efforts through the participation of other donors.

The Natural Resources Management program supports the third objective and will expand efforts six fold over a five-year period (from $9.1 million* in the total portfolio in FY 87 to $55.6 million in FY 92). This enhancement will raise environmental concerns from 2% to 13% of our active portfolio, a more appropriate and certainly not undue degree of emphasis. Additional support will be provided from several AID/W projects and we have requested a portion of the expected biological diversification earmark. The NRM program will be funded initially from current Mission projects** and will have three areas of concentration: watershed management, agricultural sustainability, and biological diversity/tropical forest conservation. The program will be carried out through policy analysis, program support for institutional development, and training. A proposed FY 90 Natural Resources Management project will provide $26.5 million in development assistance and Title I funds to assist the GOI to broaden its focus on natural resources management policy making and to conserve globally significant biological reserves.

Other donor support (i.e., IBRD, ADB, Japan, the Netherlands, U.K., Canada, Australia) for the first two objectives is significantly larger than that provided by AID. Coordination is relatively good on agricultural diversification, although policy related initiatives and support have been limited to the IBRD. Overlap has been a problem in relation to local government and decentralization activities. Improving coordination is, therefore, an explicit aim under our proposed strategy. Other donor support in irrigation and rural roads is primarily oriented to capital investment, although recent projects are increasingly linked to policy reforms on cost recovery, O&M financing issues and appropriate user costs. Our objectives in these sectors are often more heavily focused on policy and procedural improvements than other donors; when it has been a "donor" issue, our joint efforts have been consistent. Coordination with ADB has significantly

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* Of the $9.1 million in life-of-project funding for natural resources management at the end of FY 87, $30,000 was for biological diversity and tropical forest conservation through matching grants to Indonesian NGOs, $6.3 million for watershed management and soil conservation, and $2.7 million for agricultural sustainability, primarily for farming systems research.

** In addition to the $9.1 million already in place, we will reorient $20 million of existing project funds.

improved in implementation since the opening of a local office in mid-1987. Coordination among a smaller group of bilateral donors on natural resource and environmental issues was, until recently, largely informal, with primary support provided by Canada and the Netherlands. However, the fact that the next IGGI meeting has environment as the special topic has increased coordination. More donors (notably the IBRD) may become involved and there have been recent coordinating initiatives by the Minister of Population and Environment. If this aspect of the CDSS is approved, we plan to announce A.I.D.'s increased support for the environment at the June 1988 IGGI meeting.

3. Sub-Goal: To Achieve an Efficient, High Quality Human Resources Development System which Effectively Links System Outputs to Market Requirements

Objectives. The following objectives support the better utilization of human resource potential:

(a) Improve efficiencies in planning and policy formulation within the Ministry of Education and Culture (MOEC).

- Strengthen policy research and analysis functions;
- Improve policies related to linking system outputs to market requirements, costs and financing of education, public vs. private delivery systems and decentralization.

(b) Address the most critical current and projected deficiencies in high-level trained manpower, through overseas training and strengthening critical programs within selected institutes of higher education.

- Emphasize policy analysis, agriculture, natural resources management, science and technology, engineering, public health and business education;
- Increase private/independent sector involvement.

The first objective focuses on longer-term labor supply as part of the employment equation (Figure 6) by promoting policy changes aimed at improving the quality of output and better linking system outputs to market demand, a necessary condition to improve employment opportunities in a market-oriented society. The second objective directly affects employment and incomes in the short long run by concentrating on supplying labor to meet the economy's present "bottlenecks," thereby allowing a smoother, quicker transformation to an industrialized society.

Strategy. AID has supported the education sector since 1956 but our work is not yet over. Serious deficiencies remain, particularly in higher education. Even though Indonesia's progress in basic education has been monumental,* the country will be very slow in "modernizing" and industrializing without a well-trained, diverse and dynamic human resources base.

The above two objectives, which are based on our landmark 1986 Indonesian Education and Human Resources Sector Review,** are entirely consistent with Agency policy, including the recent ANE/HRD strategy statement. The latter mandates working toward more efficient education systems, improving policy and planning functions, promoting decentralization and private sector/community involvement, participant training, technology transfer and, where circumstances warrant, higher education. Each of these concerns is covered under the two objectives listed above. The first three mandates are part of our institution building efforts with the key Ministry of Education and Culture (MOEC) agencies responsible for policy and planning: the Centers for Policy Research and Information. Through them we will focus on establishing a closer relationship between system outputs (particularly at the secondary and tertiary levels) and market requirements, decentralization of the education system's planning and programming functions, greater private sector and community involvement in delivery systems, and more economically justifiable

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* Literacy and primary education rates exceed Agency objectives (Table 1).

** IEES, Educational Efficiency Clearing House, Florida State University. Indonesia Education and Human Resources Sector Review. April 1986.

public financing of education. Training and technology transfer will be addressed through objective two and will focus on fields critical to Indonesia's present development needs. This will be done through participant training of individuals within the public sector and independent sector (including NGOs and the private sector). Particular emphasis will be given to upgrading university staff so that the training has a multiplier effect.

The probability of success for our second objective is high. AID's long-term support to high-level manpower development and the adoption of the U.S. university model position us advantageously among other donors to play a significant role, particularly in policy areas related to higher education. The degree of success for our first objective, which involves key institution building, is less predictable. However, since we are dealing with the agencies responsible for policy and planning within the MOEC, the potential impact is enormous, affecting over 42 million youths and a yearly GOI education budget of $1.2 billion. Being the only donor working in a significant way in the policy and planning area, we believe we are well situated to have a positive impact, especially on secondary education where system improvement and industrial growth are so closely linked.

Program. The number of education-related projects will stay relatively constant throughout the CDSS period, utilizing 10-15% of our total portfolio resources. The Education Policy and Planning project will be the major vehicle for meeting our first objective, primarily by improving policy analysis and formulation and strengthening medium- and long-term planning capabilities. An amendment in FY 89/90, with a possible follow-on project late in the CDSS period, will assist to localize education processes and programs and strengthen community involvement in the sector. The FY 88 Higher Education Development Support project will address the second objective by strengthening staff and programs, principally through overseas training, of critical units of selected public and private universities and by promoting structural and administrative reforms in the higher education system. Our general participant training program that follows General Participant Training II will broaden the candidate pool to include the private sector and NGOs, but will continue to focus on the critical areas identified in objective 2 which are currently in short supply for Indonesia's transition to an industrialized nation.

Although USAID funds in support of Indonesia's education sector have been relatively small compared to other donors, we believe we play a critical role in developing a higher education sector which is now being modeled after the U.S. system. We serve a leadership role in the EHR Donors' Forum, providing us the opportunity to influence far more funds than those which we contribute. IBRD and ADB provide $100-200 million annually (mainly for secondary education, vo-tech, teacher education, higher education and curriculum development), with major resources also coming from Japan, Canada, Australia, the Netherlands, UNICEF and UNESCO.

4. Sub-Goal: To Reduce Fertility and Improve Rates of Infant and Child Survival

Objectives. GOI and USAID targets are to reduce, by the year 2000, the total fertility rate to 2.1, the IMR to 45/1000 live births and the child mortality rate to 9/1000. Mission objectives are to:

(a) Ensure sustained levels of recurrent financing for child survival and family planning programs by reallocating GOI resources toward these programs, with a view toward setting the stage in this CDSS period for USAID disengagement in family planning within the next CDSS period (1994-1998).

- Assist with securing efficiencies and private sector involvement in health sector costs that result in a savings of government resources in the hospital and pharmaceutical sectors and their reallocation to child survival/fertility reduction;
- Demonstrate the benefits of increasing investments in child survival and fertility reduction.

(b) Encourage greater private sector involvement in financing and delivering health and family planning programs.

- Increase private commercial and professional sector family planning service delivery;
- Establish pre-paid health insurance schemes to help shift responsibility for personal health care to the private sector;

- Involve the private sector in demand generation activities for child survival and family planning programs.

(c) Improve operational efficiency of public sector child survival and family planning programs.

- Intensify efforts in communicable disease control (immunization, diarrheal disease, etc.);
- Improve quality/availability of mother-child health (MCH) programs;
- Encourage use of long-term effective contraceptive methods.

These objectives address the productivity of the work force by fostering a population which is well-planned and healthy. Although there will be some effect on family incomes in the short term, resulting from a smaller family size, these objectives primarily affect the supply side of the labor equation through a healthier, smaller population base in the future. The objectives themselves focus on the efficient use of human and financial resources, both through reallocation within the GOI budget and using the private sector so that individuals shoulder a greater portion of their own health and family planning needs.

Strategy. To achieve these objectives AID will work at two levels: policy reform focused on the structure and financing of services, and program interventions (operations research, pilot testing, demonstration and evaluation activities) which show cost-effective alternatives to present health and family planning products and services (including privatization). The programs will then be replicated by the GOI, private sector and/or other donors such as the World Bank or UNICEF. This attention to leveraging represents a major departure from our activities of the past fifteen years, during which USAID provided technical assistance and local cost funding to support nationwide coverage of health and family planning programs.

Policy objectives will focus on: operational efficiencies of government investments in health and family planning (e.g., reducing hospital subsidies, promoting cost recovery for services), changes in resource allocation policies (e.g., increasing allocations for child survival and fertility reduction as opposed to curative care), and privatization of services.

The chances for success in family planning and direct operational interventions in child survival are excellent, given our long support, established relationships and recognized expertise in these fields. We are more cautious in anticipating success in health sector financing, being new to this field. However, we believe the risks are acceptable given the potential benefits of sustaining child survival efforts without the necessity for a continuous influx of donor funds.

Program. At present USAID has eight active bilateral projects and numerous centrally funded and PVO activities which support child survival objectives. During the upcoming CDSS period, the bilateral program will be reduced to three new activities and one continuing project. An FY 88 project will address health sector financing issues, an essential prerequisite to a sustainable child survival program. This project will be the major vehicle for Mission dialogue with the GOI on health policy. As policy recommendations become more concrete, Title I resources may be used to support the more difficult policy adjustments.

In anticipation of a phase-out of USAID assistance to family planning in the next CDSS period, a new private sector family planning activity, also supportive of child survival objectives, will assist in shifting a major proportion of clients from the public to the commercial sector, NGOs and private practitioners so that the private sector will cover 80% of the clientele by the year 2000. We are far out in front of any AID program that we know of in the privatization of family planning services, but we believe, along with the GOI, that this is the logical next step. Part of this evolution is to expand the availability of long-term contraceptive technologies.

In 1990, with the phase out of four projects related to child survival, a new combined project/program support activity will strengthen decentralized planning and implementation of communicable disease control and MCH programs and apply modern marketing techniques to improve demand for and provision of child survival services. Policy objectives identified as part of our ongoing child survival activities may be incorporated as part of the program support component of this endeavor. Bilateral activities will continue to rely heavily on centrally funded population and health projects, and child-survival oriented PVO activities. The latter, funded from both central child survival funds and the Mission's PVO Co-Fi project, will provide an alternative funding mode in this important field.

Coordination on immunization/diarrheal disease programs will continue with UNICEF and WHO; and cooperation with IBRD for nationwide coverage of child survival efforts will become even more important as USAID focuses on demonstration and pilot activities.

C. OTHER STRATEGY CONCERNS

1. Institutional Pluralism

An open economy can quickly become an empty shell without the emergence of an open society. During the New Order, Indonesia's version of participatory decision-making evolved. Participation within this system is limited to a small group of established spokesmen for various interest groups, relies heavily on consultation and consensus, and leaves the President making the final decision on all significant issues.

These personal networks have dominated Indonesian political life over the past two decades and are likely to characterize Indonesian politics in the foreseeable future. Problems will arise, however, with the passing of the present generation of leaders. For the government to facilitate private initiative in the society, a broad spectrum of the society needs access to the decision-making processes affecting its ability to contribute to and share in sustained growth, i.e., the current absence of broad participation of all elements of the society in these processes limits the potential for future growth to be equitably shared throughout the society.

Our support of a more open, less regulated market oriented economy with a correspondingly larger role for the private sector (sub-goal 1) and our support to decentralized decision making (objectives under sub-goals 2 and 3) are very supportive of broadening decision making in general. But the need exists now to begin to establish an institutional setting conducive to the creation of new non-government organizations (NGOs) and a greater voice for existing NGOs in development activities, and to the development of democratic institutions. Together all of these forces constitute institutional pluralism.

We have recognized this need in the CDSS and, as indicated earlier, will support activities to decentralize development oriented decision making down to the local level. In addition, as part of our PVO Co-Financing II (and later in a $15 million follow-on) project, we will provide funds to strengthen management capabilities and train independent sector institutions including indigenous NGOs and Islamic organizations. The latter organizations are a new area of interest for USAID given their recent emphasis on development. In light of the large population they represent, we would anticipate their developmental activities playing a larger role in our NGO program support. The present PVO Co-Financing project has been reoriented to include strengthening management capabilities and training independent sector institutions as a specific objective. In addition, more emphasis is being given to institution building rather than exclusively focusing on PVO sub-grants. We would expect this focus to continue in the follow-on project.

In the past we have utilized 116(e) funds to promote human rights activities for law awareness outreach, legal assistance for women, legal literacy programs, and enhancing the effectiveness of legal and counseling foundations. We would expect to utilize these resources in the future to continue to fund activities in support of a more democratic, open society.

2. Gender Issues

Gender concerns are already factored into our program, both through projects specifically focused on women, e.g., child survival and family planning activities, and those where specific facets are directed towards women, e.g., credit and higher education (where we have not only reserved funds for women participants but have also pioneered the "spouse" training program). During the upcoming CDSS, we will continue this approach, but also take into account AID's experience with women in development,* particularly with regard to the integration of women and high female participation in "mainstream" projects. In early spring 1988, we expect to use PPC/WID resources for consultancy services to review our present "service delivery" programs in agriculture and rural development to incorporate gender concerns more effectively. As the Mission moves more towards a policy oriented portfolio, we see less need for projects targetted directly at women, with the exception of the PVO Co-Financing grants and other ongoing "service delivery" activities.

3. Natural Resources and the Environment (Additional CDSS statement required by the Foreign Assistance Act)

Section I.C.7 provides an overview of Indonesia's natural resources and environmental problems and challenges. Section II.B.2 indicates the role the environment plays in the CDSS. The following information addresses the remaining concerns in this sector that Congress requires be treated in this document.**

The major overall efforts that the GOI needs to undertake to conserve biological diversity and tropical forests in Indonesia include: (1) increased funding to inventory and classify tropical forest, wetland, and marine resources, (2) reform and enforcement of forest and reserve management policies, regulations, and practices, (3) strengthening the technical skills of Ministry of Forestry staff in nature and forest reserve management, (4) improved research strategy and increased funding for the effective regeneration of hardwood species, (5) development and implementation of a program to reforest concession areas, and (6) improving watershed management capabilities and establishing clear institutional responsibilities. These actions will require significant support from all donors, including AID.

* Women in Development: AID's Experience, 1973-1985. Washington, D.C.: AID Program Evaluation Report No. 18.

** Section 119 of the Foreign Assistance Act.

In 1986, other donor projects provided approximately $270 million in life-of-project funding for programs in forestry, water resources and watershed management, and other environment programs, and $5 million for biological diversity conservation. USAID is developing a new biological diversity activity that will provide $600,000 over three years in a matching grant to Indonesian NGOs and associated environmental study centers under the PVO Co-Financing II project. It is anticipated that the USAID PVO Co-Financing grant will leverage funding from U.S. and international environmental NGOs and may serve to strengthen relationships between these groups and Indonesian NGOs. The Mission is also designing a program to use present or future Congressionally earmarked biological diversity funds when they become available. In FY 88, with AID/W funding support, we will fully evaluate the opportunities to use PL 480 funds for nature reserve conservation and management. Tropical forestry issues can be addressed in the context of watershed policy analysis and policy studies of land use problems on outer islands. Finally, the Mission's proposed Natural Resources Management project will provide the opportunity for USAID to take a major role in donor coordination of biological diversity programs and address many of the constraints in this area.

D. RESOURCE AND PROGRAM MANAGEMENT IMPLICATIONS OF THE STRATEGY

1. Introduction

The CDSS outlines a highly leveraged program with increased attention to policy analysis and policy change. Policy support, depending on the nature of the measures, may require more funds than can be accommodated under a non-earmarked DA OYB. Also, contrary to first impressions, policy directed initiatives have their own type of staff intensity. Finally, the current number of staff-intensive projects has led to staff "burnout" mandating important changes in the Mission's current style of doing business. CDSS preparations included lengthy and spirited discussions of these management issues and resulted in recommendations for several changes, including: a much tighter program focus, working with a smaller number of qualified counterparts; greater complementarity among program resources (DA, PL 480 and HG); expansion of the variety of programming modalities, with increased attention to non-project assistance; shifting a greater degree of administrative responsibilities to the GOI, contractors and grantees through project funded management units; and eliminating efforts associated with nation-wide programs. The impacts of these changes on the composition of the portfolio, staff and technical assistance requirements, and financial resource requirements are discussed below.

2. Portfolio Composition

During the past CDSS period, the size of the Mission portfolio declined from 43 projects in FY 83 to 31 projects (including ARSSP) in FY 88. The proposed CDSS strategy, with its unifying goal of employment and incomes, provides a tighter focus for future investments and will further reduce the number of projects/programs in the portfolio to approximately 20 by FY 93.

The Mission will expand its programming modes in the coming five years to include program assistance and Housing Guarantee Loans. The current project modality is staff intensive and slow disbursing. The Agricultural and Rural Sector Support Program represents an initial attempt to experiment with non-project assistance. The effort has many obvious advantages (e.g., increasing dollar to staff management ratio) and the Mission expects it to become a continuing feature of our program. Subject to a thorough assessment of ARSSP, we are planning a $17 million follow-on in FY 89 to continue program support in areas associated with agriculture. The Mission is also examining the appropriateness of program support for other sectors, e.g., health, privatization and deregulation.

Project assistance will remain a key feature of the portfolio over the next five years. The Mission views it as the key vehicle for identifying and building commitment to appropriate policy changes that can later be integrated into program support efforts (see Figure 7). To maintain a high quality program that places primary attention on policy change, we estimate that new DA resources provided over the next five years will not be less than 50% project assistance and not more than 50% program support. Other resources such as PL 480 and HG will be linked to the greatest degree possible to program support efforts.

3. Staffing Requirements and Technical Assistance

Current staff levels are 41 USDH and 68 FSNDH, significantly down from 56 USDH and 91 FSN in FY 83. Although we may be able to reduce these levels by the end of this CDSS period, when management units are substantially decreased, we cannot sustain a decrease in the next three to four years and maintain a high quality program. We are committed, however, to stay generally within the present USDH staff levels because we do not wish to reach an unwieldly size.

Achieving the CDSS goals will require a different staff mix than currently exists. As a result of improved efficiencies in project/program monitoring, indicated above, we expect the numbers of staff required for normal implementation to decrease. This does not mean a decrease in staff size, however. Increased emphasis on policy reform and the attendant need for in-depth and up-to-date understanding of macroeconomic circumstances place a premium on the need for other types of staff: staff with economic and budget analysis backgrounds and staff with research design and evaluation experience to cover pilot and demonstration projects. USDH and FSN staff recruitment within our current levels will increasingly shift toward these skills. Consequently, we are now undertaking a program to upgrade skill levels and associated responsibilities of FSNs. In addition, the Mission plans to contract with JCC-like advisors to assist with these efforts, beginning in FY 88.

The CDSS strategy will also require changes in the allocation of staff resources within the Mission's authorized level. The Employment and Enterprise Development (EED) office, responsible for the Mission's trade and deregulation program, will require additional staff to manage its expanded policy dialogue initiatives. We will slightly reduce staff in the office of Agriculture and Rural Development and the office of Population and Health, where programs are consolidating, to allow for the increase in EED requirements. We also plan to articulate more sharply the project development function within the Program and Project Support office and to strengthen the role of the controller, legal, and contract management functions. These moves will help standardize project/program implementation, further reduce vulnerability, and assist in breaking remaining implementation bottlenecks.

4. Financial Resources

Cognizant of the increased pressure on the Agency's budget, we are requesting a straight-lining of our original FY 87 OYB of $45 million. (This is 21% less than our final FY 87 OYB of $57.4 million and barely exceeds Indonesia's annual loan repayments to A.I.D. of $37 million.) An increase in PL 480 resources from the current $15 million to $30 million will be necessary, however, to enhance the attractiveness of policy-focused program support initiatives which the Mission is considering.

a. Development Assistance Accounts

Although the proposed strategy will not require major changes in the overall DA levels, modifications within specific accounts will be necessary. As indicated in Table 4, SDA resources will increase from 8% of the total portfolio to approximately 22% and ARDN funds will shrink from 59% to 50%. Levels for the other accounts will not change significantly. The substantial increase in SDA is required for activities in capital markets, trade, investment and the private sector.

TABLE 4: DEVELOPMENT ASSISTANCE ACCOUNTS

	FY 83 - FY 88		FY 89 - FY 93			
Acc't	Planned Total	% of Total	Mortgage	Proposed Add On	Total Demand*	% of Total
ARDN	242,020.00	59%	55,849.00	56,450.00	112,299.00	50%
PN	33,900.00	9%	0.00	20,000.00	20,000.00	9%
HEALTH	51,525.00	13%	7,000.00	13,950.00	20,950.00	9%
EHR	46,265.00	11%	13,751.00	8,350.00	22,101.00	10%
SDA	33,297.00	8%	2,000.00	46,900.00	48,900.00	22%
TOTAL	407,007.00		78,600,00	145,650.00	224,250.00	

* Total demand does not include mortgages of projects/programs not fully funded by FY 83.

Table 5 lists planned investments according to the four major CDSS sub-goals. It includes mortgages of ongoing projects and estimates of funding levels for new projects and programs linked to the CDSS objectives. Preliminary plans for the use of PL 480 and Housing Guarantee Loans are also included.

b. Pipeline

The Mission's current pipeline is large by Agency standards. Many factors have contributed to our pipeline "problem" including: complex and frequently changing GOI procedures affecting project disbursements (the Mission's expenditure record, however, greatly exceeds that of the other major donors in Indonesia), major devaluations of the rupiah in 1983 and 1986 (which reduced the dollar equivalency for local financing), heavy emphasis on technical assistance, research and institutional development (all of which are valued by AID/W, USAID/Indonesia and the GOI, but are relatively slow disbursing), and the Mission's success at absorbing end-of-the-year "surplus" Agency funds which results in the forward funding of projects.

We have already taken several measures to address the pipeline situation. We deobligated over $56 million during the past four years, primarily in response to the devaluations referred to above. We increased Mission financing of local costs to speed up disbursements and respond to GOI budgetary pressures. We have sought AID/W assistance in pipeline reduction efforts. Finally, we initiated program support assistance to make the most effective use of new and reobligated funds in support of policy reform. (This latter effort expended $7.0 million in the first quarter of FY 88.)

The Mission plans to increase further its attention to pipeline issues in the near future. The effort will be spearheaded by a newly established pipeline reduction task force under the Deputy Director that will examine the pipelines of all ongoing projects and concentrate on A.I.D. and GOI system-wide as well as project-specific methods to speed up disbursements. No major deobligations are now planned.

Throughout the CDSS period the Mission expects expenditures to substantially exceed new obligations, thus resulting in significant pipeline

TABLE 5: U.S. ECONOMIC ASSISTANCE PROGRAM FOR INDONESIA, FY 89-93

(thousands of dollars)

SECTOR	MORTGAGE	PROPOSED ADD-ONS	TOTAL DEMAND*	% OF TOTAL	PL 480 I & II	HG
1. OPEN MARKET ORIENTED ECONOMY	2,000	46,900	48,900	22%		
PVO Co-Fi II	0	3,000	3,000			
Financial Markets	2,000	0	2,000			50,000
Trade and Enterprise	0	9,000	9,000			
Dereg. Priv. Sup. Dev.	0	32,500	32,500		30,000	
PVO Co-Fi III	0	2,400	2,400			
2. AGR. PRODUCT. PROCESSING DIST. AND CONSUMPTION	53,349	56,450	109,799	49%		
PVO Co-Fi II	0	1,550	1,550			
SSIMP	21,312	0	21,312			
Fisheries R&D	1,481	0	1,481			
Rural Roads	30,556	0	30,556			
ARSSP	0	17,000	17,000		30,000	
Local Policy Dev.	0	15,500	15,500			50,000
Nat. Res. Mgt.	0	16,500	16,500		10,000	
Agro-industry	0	3,000	3,000		20,000	
PVO Co-Fi III	0	2,900	2,900			
3. EFFICIENT HUMAN RESOURCES DEVELOPMENT	16,251	8,350	24,601	11%		
GPT II	4,012	0	4,012			
PVO Co-Fi II	0	750	750			
Edu. Pol. & Planning	5,500	0	5,500			
Higher Edu. Support	6,739	0	6,739			
Training 2000	0	6,000	6,000			
PVO Co-Fi III	0	1,600	1,600			
4. FERTILITY REDUCTION AND CHILD SURVIVAL	7,000	33,950	40,950	18%		
PVO Co-Fi II	0	1,200	1,200			
Health Sec. Fin.	7,000	0	7,000		20,000	
Private Sec. FP	0	20,000	20,000			
Child Survival	0	11,000	11,000		30,000	
PVO Co-Fi III	0	1,750	1,750			
Total	78,600	145,650	224,250		140,000	100,000

* Total demand does not include mortgages of projects/programs not fully funded by FY 93.

reductions. This is possible through the anticipated increased use of program support, the increase in project disbursements resulting from increased Mission financing of local costs, and the continuing attention the Mission will place on this issue. The pipeline should be well below $200 million by FY 93.

c. PL 480

PL 480 levels have been sharply reduced in the past year, from $43 million in FY 87 to a projected $15 million in FY 88. The Mission considers PL 480 resources to be an essential component of the overall program, providing an important additional incentive for program support initiatives, and requests an annual level of $30 million.

Title I: The Mission continues to recommend sizeable PL 480 Title I allocations for Indonesia. The commodities of preference will be wheat and possibly soy beans (rice would be possible only if there were a particularly bad crop year). FY 87 Title I Self Help Measures were directly linked with DA investments; a large portion of PL 480 generations financed the Mission's innovative program support package, ARSSP, significantly increasing the attractiveness of the proposed policy initiatives. The remaining Title I proceeds directly supported the FY 87 amendment to the Expanded Program on Immunization project and to finance vaccine procurement.

The Mission believes these are highly successful efforts to link Title I resources with broad program objectives and plans to maintain this close linkage in the new CDSS period. Tentative plans call for Title I support of an amendment to the ARSSP in FY 89, the Health Sector Financing and Family Planning II projects and future natural resource initiatives.

108 Program: In several meetings with the GOI, they have expressed reservations regarding their participation in a 108 initiative and cite the large up-front payment as a major obstacle. The Mission has conveyed these views to AID/W and suggested the need for greater flexibility in the 108 program to make it more attractive to recipient countries.

Title II: The Title II program supports Mission objectives through assistance to two agencies, Catholic Relief Services (CRS) and the National Cooperative Business Association (NCBA). The current CRS program has two components: mother/child welfare and food for work. The MCW efforts are directly linked to the Mission's child survival initiatives, while the FFW activities provide a productive source of employment for many rural people and thus contribute to the primary goal of the CDSS. Title II support to CRS activities will continue during this CDSS period.

The Title II monetization program with NCBA supports Mission efforts linked to rural enterprise development, off-farm employment and agricultural diversification. We plan to continue this creative use of Title II resources, if permitted, in the future with increased attention to agrobusiness.

d. Housing Guarantee Loan Program

In FY 88, the Mission hopes to enter into its first Housing Guarantee Loan program, totalling \$30-\$50 million of guarantees over two years. The funds from the U.S. private sector are directly linked to the new Financial Markets project and serve as an additional incentive for policy dialogue with the GOI in municipal financing. In the later years of the CDSS, the Mission may combine the HG resources with policy directions incorporated into the Local Policy Development project. The Mission plans to request an additional \$30-\$50 million of guarantees from HG over the ensuing two years, depending upon the experience gained in the FY 88/89 program.

e. Centrally/Regionally Funded Projects

Indonesia receives approximately \$8 million annually from centrally and regionally funded activities. These activities support many important initiatives, but at the same time can be a management burden. During the coming CDSS period, the Mission plans to continue its extensive collaboration with these projects, but will limit its efforts to those activities which directly support our CDSS sub-goals. At the present time, the Mission foresees the need to continue its collaboration with centrally and regionally funded population and education activities as well as some of the CRSPs. Additional efforts will be carefully reviewed and a positive determination to proceed made only if there is a direct link with the CDSS objectives.

ANNEX A

DONOR ASSISTANCE TO INDONESIA

Overall Program Direction: Based on funding levels, there are ten major donors to Indonesia. In descending order according to FY 87/88 IGGI pledges, they are: the World Bank, Japan, Asian Development Bank, United Kingdom, United States, France, Netherlands, Federal Republic of Germany, Canada and Australia.

Traditionally, these donors have developed their project and program assistance to Indonesia based on the priorities stated in Indonesia's Five Year Plans (Repelitas). As a result of the oil crisis, however, GOI resources have declined and donor resources have increased: today, the donor community finances over half of Indonesia's development budget.* In return, some donors (IBRD, U.S. and ADB) are initiating programs aimed at structural adjustments and policy reforms. Others (most notably Japan) still use the GOI "shopping list" for their program.

Donors' Funding Levels: For FY 87/88, Japan and the Netherlands increased their IGGI pledges substantially, while the U.S. and U.K. increased theirs slightly (discounting their respective EXIM and equipment loans). Despite its increased pledge, the U.S. position as a donor has fallen from fourth place in 1986 to fifth place today (see Table 1 and Figure 1). IBRD and ADB contributions remained the same as those for FY 86/87, and Australia, Canada and Germany realized minor funding decreases.

Current Donor Programs: With the exceptions of the Netherlands and the U.S., IGGI donors tend to concentrate their assistance in a few specific sectors. Australia is primarily involved in public works, education and agriculture; and Canada in transportation, water, natural resources/ environment, education and regional development. The ADB has 80% of its assistance in agriculture and agro industries, energy, transportation/ communications, and education; Japan's assistance centers on transportation, irrigation/flood control, and electricity; and the IBRD concentrates its assistance in agriculture, power, transportation/communications, and industry. FRG assistance centers on infrastructure, while the UK's technical and capital assistance is devoted to rural development, water, and power. The Netherlands program is more diverse, with Dutch assistance focused on water supply and sanitation, rural development, electricity, natural resources, energy, food crops, railways, planning, education and industry. Table 2 indicates donor assistance according to major sectors of involvement.

Grant/Loan Splits: In general, a higher percentage of grant assistance allows donors more program flexibility. In 1986, Australia's development assistance program was 100% grant funded, followed by the Netherlands (60%),

* Donor financing is expected to constitute approximately 25% of Indonesia's total budget, including routine, during IFY 87/88; this increased from 16% in IFY 86/87.

U.S. (45%), Canada (33.5%--as of April 1987, CIDA's assistance is 100% grant funded worldwide), and Japan (17% -- Japan's grant assistance has traditionally hovered around 6%). The others were less than 10% grant funded.

Future Donor Programs: Three donors appear to be staying within traditional assistance areas in their 1987/88 programs. Australia will concentrate on area development and agriculture, Canada on human and natural resources development, the private sector and NGOs, and the U.K. on mini-hydro, rail cars, biotechnology, gas distribution and rural electricity. The remaining six donors plan to diversify or reorient their assistance strategies. The FRG plans to broaden its sectoral strategies and place greater emphasis on policy dialogue (it plans to provide structural adjustment funds to countries with an already developed policy program, but it is not known if any of these funds will be provided to Indonesia). Japan has announced its intention to provide more development assistance, and less capital assistance funds, and some of its $20 billion of trade surplus funds may be made available to Indonesia. The Netherlands will begin providing local cost financing, while also implementing new rural development projects. The ADB will promote policy changes for trade liberalization, while also implementing projects in agricultural diversification, physical and social infrastructure, non-oil energy, and the simplification of financial procedures. The IBRD plans to promote economic efficiency in the Indonesian economy, promote non-oil exports, improve the GOI's financial system, increase domestic resource mobilization (especially through tax reforms), improve environmental management, and promote decentralization. In 1987, the IBRD made its first policy loan to Indonesia; this $300 million loan was in support of the ongoing program of trade policy adjustment.

Donor Coordination: The UNDP has taken the lead role in coordinating donor activities, with active participation by the IBRD, Netherlands, U.S., Australia and Canada. The Dutch play the lead in organizing the yearly IGGI. The Japanese have not been active relative to their assistance levels, but have recently shown increased interest in collaborating with other donors, especially the IBRD and USAID (although recently, there have been indications that this cooperation may occur further into the future rather than as originally anticipated). In addition to broad coordination, donors in individual sectors such as education and agriculture have coordination meetings.

Donor coordination for policy change is difficult. To date, in addition to USAID, only the ADB and IBRD have been willing to discuss policy change with the government and we will continue to coordinate efforts with them focused on deregulation and trade liberalization. For many countries, policy discussion is an approach with which they are not comfortable. As indicated, the Federal Republic of Germany is starting to change, but to date the Japanese are reluctant to take the next step.

TABLE 1. ESTIMATED IGGI DONOR CONTRIBUTIONS
FY 84/85 - FY 87/88
(Millions US$)

Bilateral Donors:	FY 84/85	FY 85/86**	FY 86/87**	FY 87/88 Pledges
Australia	39.8	46.0	32.49	27.9
Austria	-	-	6.41	7.7
Belgium	6.4	6.4	7.64	-
Canada	30.7	29.2	38.84	31.8
Finland	-	-	2.40	1.6
France	51.2	*	*	190.0
Germany	61.1	57.7	78.10	72.9
Italy	30.0	53.0	30.00	30.0
Japan	321.3	331.6	473.57	606.8
Netherlands	53.2	46.0	70.96	112.9
New Zealand	-	1.6	2.01	-
Switzerland	4.1	5.0	8.38	11.5
Spain	-	-	12.00	18.0
United Kingdom	5.9	18.9	67.64	208.6***
United States	115.0	100.0	86.00	190.0***
Bilateral subtotal:	718.7	695.4	916.45	1,509.7
Multilateral Donors:				
IBRD (World Bank)	1,200.0	1,200.0	1,100.00	1,000.0
Asian Development Bank	500.0	500.0	500.00	500.0
UNDP (includes WFP and UNFPA)	38.0	36.4	43.30	39.9
EEC	14.0	14.0	15.00	17.0
UNICEF	12.4	15.0	13.40	13.4
IFAD			10.00	10.0
Multilateral subtotal:	1,764.4	1,765.4	1,681.70	1,680.3
TOTAL DONOR CONTRIBUTIONS:	2,483.1	2,460.8	2,598.15	3,190.0

* Figures not available.

** These pledges are not necessarily the actual amount of subsequent negotiated Grant and Loan Agreements.

*** These figures include a one-time U.S. EXIM loan of $100 million for U.S. source science and technology activities and a one-time U.K. soft loan to procure equipment of U.K. origin.

FIGURE 1. PERCENTAGES OF IGGI ASSISTANCE; U.S., JAPAN, IBRD & ADB, 1967-1987

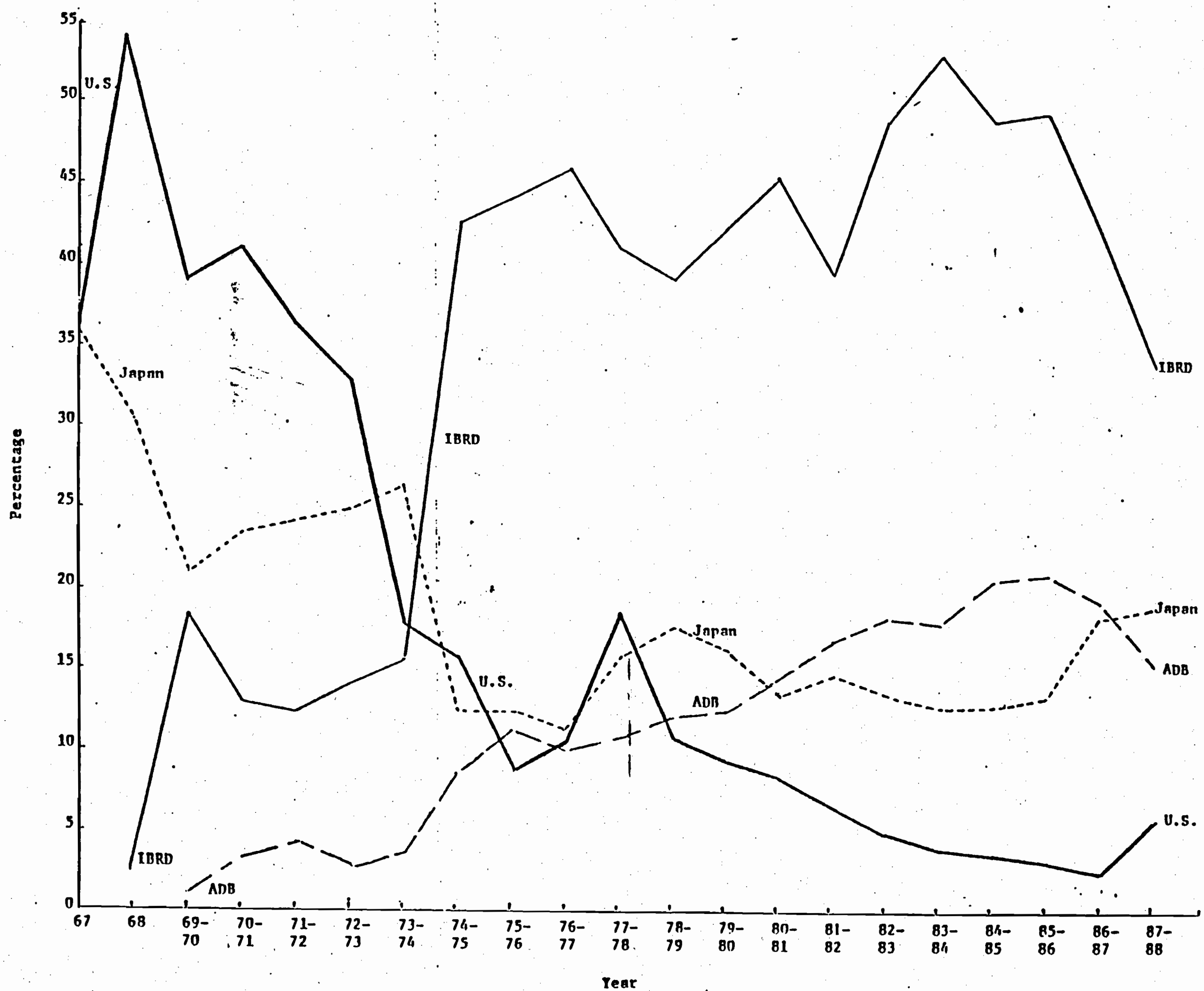

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TABLE 2. DONOR ACTIVITIES BY SECTOR

	Transport and Communications	Human Settlements	Agriculture, Forestry & Fisheries	Natural Resources	Health	Education	Industry	International Trade & Development, Finance	General Development Issues, Policy & Planning	Social Conditions & Equity	Population	Employment	Science and Technology	Culture	Humanitarian Aid and Relief
Australia	0	●	0	0		●									0
Austria	0		0			0									
Belgium	0	0	0	0		0	0		0						
Canada	0		0	0	0	●									
Germany	0	0	0	0	0	0	0		0	0			●		
Italy	0		0	0	0		0	0				0			
Japan	●	0	0	0	0	●	●		●	0	0	0		●	
Netherlands	0		0	●	0	0	0		●	0	●				
New Zealand	0	0	0	0			0								0
Switzerland		0	0	0		0									
United Kingdom	0	0	0	0		0		0	0	0					
United States	0		●	0	●	●		●	0	●	●	●	0		0
Others	0	0	0	0	0	0	0			●	0	0	0	0	0
Asian Dev. Bank	0	●	●	0	0	●			0		0				
EFD		0	0	0			0								
IBRD	●	●	●	0	●	●	0	●			●	0			
UN Organizations	0	0	0	0	0	0	0	0	0	0	●	0	0	●	●

● = Major donors. 0 = Other donors.

SUB-GOAL BENCHMARKS

The benchmarks under these subgoals are divided into two areas: those where AID will be directly involved and where our activities are the main contributors to change, and those where effects are expected but where other exogenous factors may outweigh our assistance.

Sub-Goal #1: To support a more open, less regulated market and trade oriented economy, both internally and externally.

(a) Support GOI efforts to deregulate trade, industry, finance and investment, both internally and externally.

Direct AID Involvement:

- Establish active commodity and capital markets which interact with other international exchanges.
- Develop an active secondary financial market for public and private notes and instruments.
- Liberalize Indonesian commercial law.
- Eliminate selected agricultural trade barriers.

Expected Impact:

- Increase the annual level of non-oil international trade and direct foreign investment by 100%, and total non-oil exports from 6% (average 1973-86) to 15-25%.
- Reduce the cost of local investment, production and trade licensing charges by a total of 50%.
- Double the percentage share of the "monetized" economy, so that it is at least equivalent to 25% of GDP and long-term financial instruments comprise 25% of total savings and investment.
- Increase the annual growth rate of the industrial sector to 10-15%.

(b) Increase private sector trade and enterprise in key economic and productive sectors.

Direct AID Involvement:

- Assist the GOI in initial efforts to privatize selected state enterprises.
- Establish a legal/financial system to allow private ownership and/or management of public sector infrastructure and services.
- Modernize the financial system through improvements in tax administration, automated check clearing, and bank supervision.

Expected Impact:

- Shift 20% of assets and employees from state enterprises to the formal private sector.
- Increase private sector investment in agrobusiness by 100%. Reduce constraints to gradual expansion and "formalization" of the informal sector in agrobusiness and processing firms.

Sub-Goal #2: To increase the sustainability, productivity and efficiency of the agricultural production, processing, distribution and consumption system.

(a) Increase the productivity and employment potential of diversified agricultural production.

Direct AID Involvement:

- Create strengthened and inter-linked policy analysis capabilities between the Ministry of Agriculture (MOA) and Bappenas (the national planning agency).
- Improve the agro-related policy environment (e.g., shift to a demand driven production system approach, reduce fertilizer subsidies by 25% in real terms, eliminate pesticide subsidies, revise pricing policies so that market signals more effectively guide resource allocation).
- Establish an integrated management and information system in the MOA for policy research on agricultural production and consumption.
- Expand the availability and quality of market and processing information to promote more efficient private sector production and processing to reach 75% of potential users.

Expected Impact:

- Lower unit production costs of selected non-rice commodities (e.g., corn, cassava) by 20% through public and private sector actions.
- Reduce effects of current monopoly controls on critical inputs for processing and packaging food products.

(b) Improve the efficiency of public resource allocation/utilization, limiting involvement primarily to areas critical to promoting/supporting private sector production and agro-based processing.

Direct AID Involvement:

- Develop multi-agency policy analysis and central-level programming capabilities.
- Develop or revise policies and guidelines which promote decentralized responsibility for rural and urban development activities, including local governments, NGOs, and the private sector.
- Develop proven models which increase the efficiency and cost effectiveness of local government maintenance of rural roads in two provinces.
- Complete at least five irrigation systems that will provide significant models of new technologies and management systems for the outer islands. Ensure that approaches used are disseminated and considered in revisions of standard approaches for other suitable areas.

Expected Impact:

- Central funding to local government linked to performance.
- Revised national policies for allocating responsibility and funds for rural road maintenance.

(c) Improve the ability of all sectors to manage natural resources and the environment more effectively.

Direct AID Involvement:

- Train sufficient central and local MOA staff in environmental analysis and mitigation plan development to ensure that 80% of projects/programs are dealt with responsibly.
- Achieve functioning center in the MOA for farming systems research and agro-ecosystems analysis to link extension and research on agriculture in upland and other fragile soil areas.
- Support development of a national strategy to preserve biological diversity; complete at least ten pilot projects in NGO and government managed approaches to preserving biological diversity.
- Support completion of central policies on guidelines and allocation of responsibility for watershed management in Indonesia.

Sub-Goal #3: To achieve an efficient, high quality human resources development system which effectively links system outputs to market requirements.

(a) Improve efficiencies in planning and policy formulation within the Ministry of Education and Culture (MOEC).

Direct AID Involvement:

- Establish an MOEC integrated management information system for policy related research.
- Modernize and improve efficiency of education planning at the provincial and lower levels.

Expected Impact:

- Increase internal educational system efficiencies (i.e., decrease drop-out and repeater rates) so that 65% of grade 1 entrants complete grade 6 and public university productivity rates improve by 75-100%.

(b) Address the most critical current and projected deficiencies in high-level trained manpower through overseas training and strengthening critical programs within selected institutes of higher education.

Direct AID Involvement:

- Over 1000 AID-sponsored participants return from the U.S. with post-graduate degrees.
- Influence programming/adminstration of donor overseas training resources through the Overseas Training Office.
- Significantly strengthen selected off-Java public and private university programs in fields critical to national development.

- Increase number of trained public health technocrats by 1700 by 1994.
- Establish GOI educational system capable of training 70% of all public health workers requiring at least a B.A. degree.

Expected Impact:

- Modify higher education policies/priorities to better utilize private sector resources and to channel more undergraduates to high demand areas.

Sub-Goal #4: To reduce fertility and improve rates of infant and child survival.

(a) Ensure sustained levels of recurrent financing for child survival and family planning programs by reallocating GOI resources toward these programs.

Direct AID Involvement:

- USAID assistance to family planning phased out during next CDSS period (1994-1998).

Expected Impact:

- Maintain present BKKBN budget levels throughout the CDSS period.
- Increase the proportion of the health budget allocated to child survival activities by 35% by 1995.

(b) Encourage greater private sector involvement in financing and delivering health and family planning programs.

Direct AID Involvement:

- Establish at least 10 private sector social financing schemes which offer personal health and family planning services by 1995.

Expected Impact:

- Private sector providing 80% of family planning services by the year 2000.

(c) Improve operational efficiency of public sector child survival and family planning programs.

Expected Impact:

- Increase effective contraceptive prevalence rates to 75% by the year 2000.
- Increase proportion of fully immunized children from 40% to 65% by 1993.
- Increase proportion of diarrheal episodes treated with ORT in children under 5 from 5% to 20% by 1993.

ANNEX C

ECONOMIC TABLES

TABLE 1. BALANCE OF PAYMENTS, 1985/86 - 1995/96
($ billion)

	----Actual----		Estimate	----------Projected----------			
	1985/6	1986/7	1987/8	1988/9	1989/0	1990/1	1995/6
Gross Exports	18.6	13.7	16.9	18.2	19.0	20.2	25.7
Oil and LNG 1/	12.4	7.0	9.2	9.7	9.7	10.0	9.2
Non-Oil 2/	6.2	6.7	7.7	8.5	9.3	10.2	16.5
Gross Imports	12.5	11.5	12.1	12.7	13.3	14.2	19.6
Oil and LNG 3/	2.5	2.1	2.9	3.0	3.2	3.3	3.6
Non-Oil 4/	10.0	9.4	9.2	9.7	10.3	10.9	16.0
Net Services	7.9	6.3	6.8	7.1	7.0	7.1	8.5
Oil and LNG 3/	3.8	2.3	2.6	2.7	2.5	2.7	3.7
Non-Oil 5/	4.1	4.0	4.2	4.4	4.5	4.4	4.8
Current Account	- 1.8	- 4.1	- 2.0	- 1.6	- 1.3	- 1.1	- 2.4
Official Capital 6/	3.4	5.5	6.0	6.0	5.3	5.0	6.6
Donor Aid	2.8	4.0	4.5	4.7	4.0	3.5	5.0
Non-Donor	0.6	1.5	1.5	1.3	1.3	1.5	1.6
Other Capital 7/	0.6	1.2	0.3	0.3	0.4	0.4	0.5
Debt Repayment 8/	1.6	2.1	3.4	4.0	4.4	4.3	4.7
Net Errors & Omissions	0.5	- 1.3	-	-	-	-	-
Change in Reserves (- = increase)	-	0.7	- 0.9	- 0.7	-	-	-
Memorandum							
Official Reserves	5.8	5.1	6.0	6.7	6.7	6.7	n.a.
Public Debt Service 9/	4.3	4.8	5.8	6.5	7.0	6.9	7.0
Public Debt Service Ratio 10/	21.4	31.6	31.5	33.0	34.1	32.1	25.7
Total Debt Service Ratio 11/	15.9	36.8	37.5	39.1	40.5	38.5	30.5
Assumed Oil Price ($/BBL)	25.0	12.5	17.0	17.0	17.0	18.0	25.0

1/ Assumes oil production (including condensate) at 1.35 MBD (1986/7), 1.40 MBD (1987/88-1989/90), and declining thereafter. LNG production assumed at 793 MMBTU (1986/7), rising to 1064 MMBTU by 1991/2. LNG prices are equal to their oil equivalent. Average prices ($/BBL) are as follows:

	Oil
1986/87	12.5
1987/88	17.0
1988/89	17.0
1989/90	17.0
1990/91	18.0
1995/96	25.0

2/ Nominal export growth assumed at 10% throughout period 1987/8-1995/6, on assumption that real effective exchange rates will not be materially eroded and that present trade liberalization trends will not be reversed.

3/ Produced by Embassy oil/LNG model. Consistent with export assumptions on production levels and price. Projections are not strictly comparable with either imports or services of oil/LNG in 1985/86 because of difference in GOI accounting treatment. The aggregations of oil/LNG imports and services are comparable, however.

4/ Projected decreases are less optimistic than experienced following 1983 devaluation because imports have already been squeezed, massive reschedulings of state enterprise projects are no longer a major alternative, and there are no significant food commodity imports in the import bill as there were prior to the 1983 devaluation. In nominal terms, growth in imports is assumed at 6% 1987/8-1990/1 and at 8% 1990/1-1995/6. This would allow real growth of about 3% through 1990/1 and 5% thereafter.

5/ Net non-oil services are assumed constant until 1990/1 except for the increase in estimated debt service interest payments. Thereafter, the non-interest component is assumed to grow at an 8% nominal rate. This appears conservative since the devaluation should actually depress service imports and stimulate service exports, resulting in a net decline in non-interest non-oil service imports. (Note: freight on imports is treated under services rather than imports in these projections. This lowers imports and raises services by roughly $1.0 billion.)

6/ Disbursements of donor assistance are projected to increase rapidly between 1987/8-1988/9 because of significant increases in new assistance and because donors have made major efforts to provide rapidly disbursing program lending and local cost financing. The non-donor assistance represents drawdown of existing commercially syndicated standby credits, new syndicated credits, and export credits.

7/ Other capital represents net direct foreign investment and net private borrowing, except in 1985/6 and 1986/7 when net state enterprise capital flows are included. Appreciation on currency revaluation, estimated at $400-$500 million, is included in FY 1986/7. Appreciation on currency revaluation in FY 1985/6 is assumed to be included in both "other capital" and errors and omissions. See 5/86 IMF report.

8/ Debt amortization of principal is based on IBRD 5/87 estimates for GOI direct debt plus state enterprises, except for treatment of state enterprises in 1985/6 and 1986/7. See footnote #7. To the extent that the U.S. dollar continues to depreciate, these estimates will tend to be understated.

9/ Combined interest and principal payments on direct government debt plus state enterprise debt. Includes LNG expansion. Source is IBRD's 5/87 estimate.

10/ Direct government debt plus state enterprise debt as a percentage of gross exports of goods and services. Exports of services assumed at $1.5 billion throughout projection period.

11/ Based on same calculation as above except private debt service of about $1 billion per year is added to public debt service. See IBRD 5/87.

TABLE 2. GOVERNMENT BUDGET, 1985/86 - 1995/96
(Rp. Trillion)

	Actual 1985/6	Actual 1986/7	Estimate 1987/8	Projected 1988/9	Projected 1989/0	Projected 1990/1	Projected 1995/6
Revenues 1/							
Oil/LNG	11.1	6.3	8.8	8.9	9.1	9.6	10.8
Oil	9.4	5.2	7.5	7.5	7.5	7.7	7.5
LNG	1.7	1.1	1.3	1.4	1.6	1.9	3.3
Non-Oil/LNG 2/	8.1	9.8	10.3	11.2	12.1	13.3	20.0
Income Tax	2.3	2.3	3.3	3.6	4.0	4.4	6.5
VAT	2.3	2.9	3.5	3.9	4.2	4.7	6.9
Other	3.5	4.6	3.5	3.7	3.9	4.2	5.6
Total Domestic	19.2	16.1	19.1	20.1	21.2	22.9	30.8
External Aid 3/	3.6	5.8	7.4	7.7	6.6	5.8	8.2
Total Revenues	22.8	21.9	26.5	27.8	27.8	28.7	39.0
Expenditures							
Routine	11.9	13.6	18.2	19.8	21.1	21.5	24.3
Debt service 4/	3.3	5.1	9.5	10.7	11.5	11.4	11.5
Non-debt service 5/	8.6	8.5	8.7	9.1	9.6	10.1	12.8
Development 6/	10.9	8.3	8.3	8.0	6.7	7.2	14.7
Total Expenditures	22.8	21.9	26.5	27.8	27.8	28.7	39.0
Non-debt	19.5	16.8	17.0	17.1	16.3	17.3	27.5
(% of total)	(85.5)	(76.7)	(64.2)	(61.5)	(58.6)	(60.3)	(70.5)
Memorandum:							
Deflated Expenditures 7/	22.8	19.5	20.6	20.6	19.6	19.3	19.5
Non-debt	19.5	14.9	13.2	12.6	11.5	11.6	13.8
Development	10.9	7.4	6.5	5.9	4.7	4.8	7.4
Oil Price Assumption ($/BBL)	25.0	12.5	17.0	17.0	17.0	18.0	25.0

Notes:

1/ Based on same oil price and volume assumptions as Balance of Payments, Table 1.

2/ Revenues for 1987/8 are estimated actual on the basis of performance during first six months and the past relationship between 1st semester receipts and receipts for the entire fiscal year. VAT and income tax are assumed to grow at 10 percent from 1987/88-1990/91 and 8% thereafter. Other revenues are assumed to grow at 6 percent from 1987/88-1991/95. Other revenues drop in 1987/8 because revenues from negative oil/fuel subsidies decline as international oil prices rise.

3/ Assumes that only the donor assistance portion of official capital in the balance of payments from 1987/88-1995/96 used for budgetary support.

4/ Debt service is based on IBRD 5/87 projections. Debt service for state enterprises is included in this projection (approximately $300 million per year or less), although not all state enterprise debt is serviced through this line item. See Lazard Freres et Cie for estimates of state enterprise debt service.

5/ Assumes personnel, commodities, and subsidies to regions will essentially remain constant in the aggregate in real terms. Assumes no routine budget subsides. Assumes increase of 5% per annum in nominal terms beginning in 1987/88. This implies that domestic fuel oil prices would need to be raised in 1988/89 and 1990/91 onwards, in line with rising international prices.

6/ Development expenditures are taken as a residual for projected period. Assumes no domestic deficit financing.

7/ Expenditures were deflated for inflation and the estimated September 1986 devaluation effect. Expenditures were deflated by 12.5% (1986/7), 28.7% (1987/8), and for an additional 5%, compounded annually thereafter on the 1987/8 base deflater. Inflation was assumed at 5.5% (1986/7), 9.0% (1987/8), and 5% per year (1988/9-1990/91). Real non-debt expenditures and development expenditures are assumed proportional to their share in nominal expenditures. However, because foreign exchange is not distributed equally between debt and non-debt and between development and non-debt expenditures, real expenditures will not vary proportionately to nominal shares. Real non-debt service may be somewhat overstated in earlier periods and understated in later periods. Development expenditure is probably overstated throughout.

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TABLE 3. MEDIUM- AND LONG-TERM DEBT, 1982-95 1/
(US$ billion)

	1982	1986	1987	1988	1989	1990	1995
Debt disbursed & outstanding 2/	21.7	37.3	42.6	44.9	45.8	46.1	42.7
Public debt 3/	18.5	33.5	38.8	41.1	42.0	42.4	38.8
Private debt	3.2	3.8	3.8	3.8	3.8	3.7	3.9
Amortization payments	1.8	3.1	4.2	4.8	5.3	5.3	5.7
Public debt 3/	1.1	2.6	3.4	4.0	4.4	4.3	4.7
Private debt	0.7	0.5	0.8	0.8	0.9	1.0	1.0
Interest payments	1.4	2.5	2.7	2.9	3.0	2.9	2.6
Public debt 3/	1.1	2.2	2.4	2.5	2.6	2.6	2.3
Private debt	0.3	0.3	0.3	0.4	0.4	0.3	0.3
Total debt service	3.2	5.6	6.9	7.7	8.3	8.2	8.3
Public debt 3/	2.2	4.8	5.8	6.5	7.0	6.9	7.0
Private debt	1.0	0.8	1.1	1.2	1.3	1.3	1.3

1/ Projections are based on exchange rates as of March 31, 1987.
2/ At end of period.
3/ Including the LNG expansion.

Source: IBRD: Indonesia Stratgy for Economic Recovery, 5/87, Table 2.10.

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TABLE 4. COMPARISON OF BUDGETED EXPENDITURES 1982/83 - 1987/88
(Percentage Share)

	1982/3	1985/6	1986/7	1987/8
Routine Expenditures	44.9	53.8	61.3	66.0
Civil Service	16.0	17.9	19.7	18.9
Goods Procurement	6.8	6.6	6.4	5.2
Subsidies to Regions	8.4	11.2	12.3	11.6
Debt Service	6.3	15.5	19.7	29.9
Food Stock Financing	-	-	1.9	-
Other	7.4	2.6	1.2	0.4
Development Expenditures	55.1	46.2	38.7	34.0
Rupiah Financing (GOI)	43.4	27.6	22.3	10.2
Departments	20.0	14.1	8.3	2.6
Defense	3.6	1.6	1.4	0.6
Regional Development	0.7	0.7	1.2	1.1
INPRES	9.0	6.4	6.1	4.1
East Timor	-	-	-	-
Fertilizer	3.0	2.4	3.1	0.9
Equity Investment	3.5	1.1	1.0	0.4
Other	3.6	1.1	1.2	0.5
Project AID (donors)	11.7	18.6	16.4	23.8
Total Budget	100.0	100.0	100.0	100.0
Total Budget (Rp. Billion)	15,607	23,046	21,422	22,783
Percent Domestically Financed	88.3	81.4	83.6	76.2
Nominal % Change	1/	+ 47.7	- 7.0	+ 6.4
Real % Change 2/	1/	+ 16.3	-12.3	-12.8

1/ Using FY 1982/3 as the base year.

2/ After deflating for 3/83 and 9/86 devaluations and consumer price increases. Deflationary factors were: 1985/6 (27%), 1986/7 (6%), and 1987/8 (22%).

ANNEX D

ECONOMIC AND SOCIAL INDICATORS

ECONOMIC INDICATORS

Country	Per Capita Income Rank	G D P $ Billion 1985	Growth GDP (%) 1980-85	% GDP Exports Goods & Services 1985	Structure of Production (%): Agriculture 1965	Agriculture 1985	Manufacturing 1965	Manufacturing 1985	Mining, Const. & Utilities* 1965	Mining, Const. & Utilities* 1985	Services 1965	Services 1985	Merchandise Exports $ Billion 1985	Commodity Exports $/Capita 1985
Bangladesh	02	16.1	3.6	6	53	50	5	8	6	6	36	36	1.0	9.9
India	17	175.7	5.2	6	47	31	15	17	7	10	31	41	10.3	13.5
Pakistan	29	28.2	6.0	11	40	25	14	20	6	8	40	47	2.7	281.1
Indonesia	42	86.5	3.5	23	56	24	8	14	5	22	31	41	18.6	114.8
Philippines	46	32.6	-0.5	22	26	27	20	25	8	7	46	41	4.6	83.6
Egypt	47	30.6	5.2	27	29	20	..	..	..	..	44	49	4.2	85.7
Thailand	55	38.2	5.1	27	35	17	14	20	9	10	42	53	7.1	136.5
Tunisia	66	7.2	4.1	33	22	17	9	14	15	20	54	49	1.7	242.9
Korea	85	86.2	7.9	36	39	14	19	28	7	13	35	45	30.3	739.0
Japan	114	1327.9	3.8	15	9	3	32	30	9	11	48	56	176.6	1933.0
United States	119	3946.2	2.5	7	3	2	29	20	9	11	59	67	213.1	891.6

Country	Mfg. Export % Total Exports 1985	Commodity Exports Avg. Growth (%) 1965-80	Commodity Exports Avg. Growth (%) 1980-85	Debt Service: % GNP** 1970	% GNP** 1985	% Export Goods and Services** 1970	% Export Goods and Services** 1985	Net Direct Foreign Private Investment ($ Million) 1985
Bangladesh	64.5	..	7.1	..	1.3	..	16.7	-1
India	57.4	3.7	4.6	1.1	1.4	25.1	12.7	..
Pakistan	63.2	0.5	2.3	1.9	3.2	23.4	29.5	124
Indonesia	12.7	9.7	1.1	1.7	6.1	..	25.1	271
Philippines	54.7	4.7	-2.2	4.3	4.9	22.8	19.5	-14
Egypt	9.0	2.0	3.9	..	8.5	..	33.6	1,175
Thailand	36.4	8.5	8.4	2.5	7.0	14.0	25.4	160
Tunisia	43.5	8.5	-1.8	..	..	..	..	107
Korea	91.5	27.3	13.0	3.1	6.1	19.5	15.2	200
Japan	97.3	11.5	7.3	..	..	..	..	5,810
United States	74.4	6.7	-2.8	..	..	..	..	900

.. = not available
* Imputed as the difference between "industry" and manufacturing categories, according to IBRD definitions. Includes mining (fuels), construction and utilities.
** Does not include service on short-term debt or IMF drawings in the numerator.

Source: IBRD, World Development Report, 1987, Annex: World Development Indicators.

INDICATORS OF WELL-BEING

Country	Per Capita Income Rank	Population (Millions) mid-1985	Population Growth (%) 1980-85	Avg. Life Span (Years) 1985	GNP Per Capita Dollars 1985	GNP Per Capita Avg % Gro (1965-85)	Income Distribution (% Share)* Lowest 20%	Income Distribution (% Share)* Highest 10%	Infant Mort. Rate (aged 0-1) 1985	Child Mort. Rate (aged (1-4) 1985	Population Per Physician 1981	Daily Calorie Supply - Per Capita 1985
Bangladesh	02	101	2.6	50	150	0.4	6.6	29.5	123	18	9,700	1,899
India	17	765	2.2	56	270	1.7	7.0	33.6	89	11	3,700	2,189
Pakistan	29	96	3.1	51	380	2.6	..	..	115	16	2,910	2,159
Indonesia	42	162	2.1	55	530	4.8	6.6	34.0	96	12	12,300	2,533
Philippines	46	55	2.5	63	580	2.3	5.2	37.0	48	4	6,710	2,341
Egypt	47	49	2.8	61	610	3.1	5.8	33.2	93	11	760	3,263
Thailand	55	52	2.1	64	800	4.0	5.6	34.1	43	3	6,870	2,462
Tunisia	66	7	2.3	62	1,190	4.0	..	..	78	8	3,900	2,836
Korea	85	41	1.5	68	2,150	6.6	5.7	27.5	27	2	1,390	2,841
Japan	114	121	0.7	76	11,300	4.7	8.7	28.1	6	(.)	740	2,856
United States	119	239	1.0	76	16,690	1.7	5.3	23.3	11	(.)	500	3,663

Country	Crude Birth Rate Per Thousand 1985	Total Fertility Rate 1985	% Married Women Using Contraceptives (1984)	% Adult Literacy 1980**	Number Enrolled as Percentage of Age Group: Primary 1984	Secondary 1984	Higher Educ. 1984	Percentage Labor Force: Agriculture 1980	Industry 1980	Services 1980
Bangladesh	40	3.7	25	26	62	19	5	75	6	19
India	33	3.0	35	36	90	34	9	70	13	17
Pakistan	40	4.6	8	24	42	15	2	55	16	30
Indonesia	32	2.8	40	62	118	39	7	57	13	30
Philippines	33	3.0	32	75	107	68	29	52	16	33
Egypt	36	3.3	32	44	84	58	21	46	20	34
Thailand	26	2.2	65	86	97	30	23	71	10	19
Tunisia	32	3.1	42	62	116	32	6	35	36	29
Korea	21	2.1	70	93	99	91	26	36	27	37
Japan	13	1.9	57	99	100	95	30	7	32	61
United States	16	1.9	68	99	101	95	57	4	31	66

.. = not available
* Estimates should be treated with caution for several reasons, including differing base years and "income" concepts/proxies used.
** IBRD, World Development Report 1983, Annex: World Development Indicators.

Source: IBRD, World Development Report 1987, Annex: World Development Indicators.

ANNEX E

SIGNIFICANT POLICY MEASURES 1983-1986

1983/1984

- Austere budget, elimination of food and reduction of fuel-oil subsidies, freeze on military and civil service wages
- 28% devaluation/subsequent use of managed float exchange rate system
- Rephasing of large capital-intensive public sector investments with $11 billion FX content
- Major simplification of income tax and tax administration laws; included lowering of rates, elimination of deductions, withholding at source, and self-assessment
- Major liberalization of financial system including freeing of most deposit and lending rates, elimination of credit ceilings for all banks, and substantial reduction in number of programs qualifying for new central bank liquidity credits
- Creation of new instruments of monetary control: new discount facilities and debt instruments
- Average 45% increase in domestic fuel-oil prices in January 1984 following even larger increase January 1983; domestic energy prices generally at international border prices

1984/1985

- Continued budget austerity, continued freeze on government wages
- Implementation of new VAT tax in lieu of several sales and excise taxes
- Introduction of further central bank discount facilities
- Ceilings established on official mixed credit borrowings and control placed with Coordinating Minister for Economic Affairs
- Inventories of central and provincial government licenses and licensing procedures completed
- Abolition of selected license categories in trade (17) and forestry (16)
- Simplification and rationalization of property tax, single tax law in lieu of seven existing tax laws

1985/1986

- Continuing budget austerity, with the exception of civil service wage increases that partially corrected for 3 year freeze

- Major ports, customs and shipping reforms, import and export procedures reduced to a minimum, port charges simplified and reduced, restrictions on foreign-flag vessels removed

- Restructuring and lowering of nominal import tariffs, maximum reduced from 225% to 60% with minimal exceptions

- Simplification and reduction of BKPM regulatory requirements on domestic and foreign investors; major reorganization of BKPM, reflecting change in focus from investment regulation to investment promotion

- Presidential decree requiring that issue of new licenses at central government level be approved by Team for Administrative Reform

<u>1986/ 1987</u>

- Highly austere budget (20% decrease in real terms excluding debt repayments)

- elimination of fuel-oil subsidy, drastic reduction of fertilizer/pesticide subsidies

- State enterprise investment decisions subject to prior EKUIN review and approval

- May 6th export and investment promotion reform, conditions for entry of foreign capital eased and operating environment improved, producer exporters allowed to import inputs without restriction and exempt from import duties, other exporters also allowed to import inputs with duties refunded

- 31% devaluation, composition of currency basket broadened

- October 25th investment and export promotion reforms; restrictive export licensing removed from 166 industrial imports and replaced with tariffs, licensing relaxed on another 110 items, tariffs reduced on another 152 products; licenses removed or relaxed constitute 44% of value of all restricted items; foreign investors granted more equal treatment with domestic investors in several different ways

- Ceilings removed on foreign exchange, swap facilities offered by banking system

- January 15th trade licensing deregulation, import licensing abolished or liberalized on 245 commodities (mostly textile and steel products), import duties reduced or abolished on 77 products

- January 15th announcement that state enterprises were to be reviewed for consolidation, restructuring, or privatization; announcement that unprofitable units will be considered for sale to private sector; recommendations due by September 1987.

ANNEX F

SCIENCE AND TECHNOLOGY

Mission support of Science and Technology covers a diverse array of initiatives, ranging from satellite imagery interpretation to modern management systems using computers. Most of these efforts involve support for research, both applied and basic, and are linked to specific institution building objectives of the portfolio. Defined in these broad terms, USAID/Indonesia accounts for roughly 20% of total ANE investments in S&T and has the largest bilateral S&T program in the Bureau as well as the largest centrally funded (i.e., S&T Bureau) program. (In FY 86, for example, USAID/Indonesia's S&T program totalled almost $40 million, $32.4 million in bilateral assistance and $6.9 million funded by the S&T Bureau. In contrast, Pakistan, which had the second largest FY 86 S&T program, provided $15.8 million in bilateral assistance and $1.8 from the S&T Bureau.)*

Mission S&T activities have and will continue to play an important role in achieving the broad objectives of the portfolio. Our sizeable investments in S&T activities do not, however, constitute an S&T strategy and do not address national S&T capability as a development problem in its own right. The development of an explicit S&T strategy requires an analysis of the key constraints to the emergence of a viable Indonesian system linking scientific inquiry to technological innovation and productive private sector activity. Key questions in this more problem focused strategy shift from an emphasis on technical concerns to issues related to technology policy, institutional linkages and human resource capabilities.

As part of its CDSS preparations, the Mission prepared two reports on existing S&T activities and reviewed several options for future S&T involvement.** We decided that the stage is not yet set for an effective USAID strategy which defines S&T as a specific problem area. Certain conditions must exist in the economy to allow S&T initiatives to contribute meaningfully to development progress (e.g., a well developed human resource base, an institutional framework supportive of broad participation in the development process, and an open and competitive economic system). Any S&T strategy which does not have these prerequisites in place will have a difficult "take-off" and could lead to well-equipped but inappropriate or ineffective S&T research institutes.

The coming CDSS period will concentrate on the preconditions for S&T to become a vital element of national development. Investments to strengthen the human resource base will be expanded under the new Higher Education

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* AID/ANE, Assessment of Science and Technology in ANE Strategy and Programs. Washington, D.C.: ANE, October 1987.

** Cougill, W., "Synopsis of Science and Technology Related Activities in the Indonesian Mission," Jakarta: USAID/Indonesia, October 1987, and Cole, W., "Mission S&T Activities: A Review and Outline of Options," Jakarta: USAID/Indonesia, November 1987.

Development Support and Training for the Year 2000 projects. Research emphasis throughout the portfolio will continue, as will modest efforts to strengthen the research capabilities of selected institutions. Most important, the CDSS will support the development of an open and competitive economy that promotes a greater role for the private sector in all aspects of development, including S&T.

We also expect to undertake a more thorough analysis of S&T opportunities early in the CDSS period, following the work being done in the ANE Bureau in early 1988 to formulate a Bureau-wide S&T approach.* This analysis will address the question of whether USAID should be involved in a way different from its current efforts and will seek to determine requirements for, timing of, and components in a viable S&T program. The initial steps to be undertaken in the coming year include:

- <u>National Academy of Science (NAS) Evaluation</u>: The Mission, in cooperation with AID/W, plans to examine the long history of NAS support for S&T development in Indonesia. The evaluation will include an assessment of key Indonesian S&T institutions, such as the National Research Committee and the Indonesian Institute of Science, and also examine their linkages to the private sector. The initial Scope of Work for the study was modified by AID/W to better reflect the concerns identified in the Bureau's S&T analytical framework. We plan to continue this close collaboration with the Bureau in follow-up efforts to define our S&T strategy more tightly.

- <u>Collaborative Research with the Ministry of State for Research, Science and Technology</u>: The Mission currently provides a science advisor to this influential ministry, which has responsibility for planning and executing a variety of high technology projects. (We will ensure that the science advisor function will be continued because it relates to important U.S. interests.) The economic development returns of some of the ministry's projects, however, are a subject of frequent debate. The Ministry has recently established an economic analysis division to undertake economic evaluations of planned projects. The tremendous economic significance and multi-billion dollar implications of the choice of one technology over another make this analysis function one of the highest leverage questions for Indonesia's efficient economic growth. USAID is very supportive of this development and is examining various means for ensuring that the new unit has the capability do to quality analysis.

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* AID/ANE, op. cit.

ANNEX G

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