PDCAW 409

File

U N C L A S S I F I E D

AGENCY FOR INTERNATIONAL DEVELOPMENT

Washington, D. C. 20523

PROGRAM ASSISTANCE APPROVAL DOCUMENT (PAAD)

INDONESIA: Agriculture and Rural Sector Support Program (497-0357)

August 28, 1987

U N C L A S S I F I E D

AID 1120-1

PAAD

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT

1. PAAD NO.: 497-0357

2. COUNTRY: Indonesia

3. CATEGORY: Budget Support and Related Technical Assistance

4. DATE:

5. TO: The Director, USAID/Indonesia

6. OYB CHANGE NO.: N/A

7. FROM: Margaret Bonner, Chief, Office of Program and Project Support

8. OYB INCREASE: N/A

TO BE TAKEN FROM: N/a

9. APPROVAL REQUESTED FOR COMMITMENT OF: $ 43,000,000

10. APPROPRIATION –

11. TYPE FUNDING	12. LOCAL CURRENCY ARRANGEMENT	13. ESTIMATED DELIVERY PERIOD	14. TRANSACTION ELIGIBILITY DATE
☐ LOAN ☒ GRANT	☒ INFORMAL ☐ FORMAL ☐ NONE	N/A	N/A

15. COMMODITIES FINANCED

16. PERMITTED SOURCE		17. ESTIMATED SOURCE	
U.S. and Indonesia:	$ 1,500,000	U.S.:	$ 1,000,000 (TA)
Limited F.W.:		Industrialized Countries:	
Free World:		Local:	$41,500,000 (Budget Support)
Budget Support:	$41,500,000		$ 500,000 (Local TA)

18. SUMMARY DESCRIPTION

The Agriculture and Rural Sector Support Program is designed to support policy changes targeted at increasing rural employment and incomes during a major economic crisis precipitated by the dramatic decrease in the price of oil, Indonesia's major export. The program will support the development and implementation of a policy agenda to increase rural employment and incomes by expanding and diversifying the agricultural sector, and planning for and initiating steps to expand and improve the efficiency of domestic financial markets. The program will also provide budget support for the Ministries of Agriculture and Finance for the implementation of policy and related institutional reforms.

This PAAD proposes the authorization of $43,000,000 in grant funds, subject to the availability of funds in accordance with the AID OYB/allotment process, of which $41.5 million will be used to provide budgetary support and $1.5 million will be used to finance the foreign exchange and local currency costs for technical and related assistance required by the program. This document describes the first tranche of the program, which will be implemented for two and one-half years under the first authorization. One or more additional years is tentatively planned with FY 89 or FY 90 authorization if conditions so warrant.

19. CLEARANCES		DATE
ARD	Martin Hanratty	8/14/87
EED	NH 11/87	8/14/87
LA	Gary E. Olson	Aug 14, 87
FIN	[illegible]	8/21/87
DD	James W. Chalmers	8/21/87

20. ACTION

☒ APPROVED ☐ DISAPPROVED

David N. Merrill — AUTHORIZED SIGNATURE — 8/28/87 DATE

Director — TITLE

ACTION MEMORANDUM FOR THE ASSISTANT ADMINISTRATOR, BUREAU FOR ASIA AND NEAR EAST

FROM: ANE/PD, Peter Bloom /s/ PW

SUBJECT: INDONESIA - Rural Sector Support Program (497-0357)

Action: Your approval is requested to delegate authority to the USAID/Jakarta Mission Director to modify, approve and authorize the $43.0 million grant-funded Rural Sector Support Program (RSSP) for Indonesia subject to ANPAC guidance. Funding will come from the Agriculture, Rural Development and Nutrition Account and will be for a two-year period beginning about July 1987.

Discussion: The RSSP is a sector program that will provide $43.0 million in Section 103 Development Assistance (DA) grant funding to the Government of Indonesia (GOI) to support policy changes targeted at increasing employment and incomes by expanding agricultural diversification and increasing domestic resources mobilization. The program will also provide budget support for the Ministry of Agriculture, the Ministry of Finance and Bank Indonesia for the implementation of policy and related institutional reform.

RSSP is a result of a late-1986 decision by the A.I.D. Administrator, with National Security Council support, to increase the FY 1987 OYB for Indonesia by $15.0 million to support and accelerate economic policy reform to open the economy, stimulate the private sector and increase efficient utilization of resources. The Mission is particularly interested in using this assistance to support appropriate policies during the "window of opportunity" presented by the collapse of oil prices and resulting economic crisis and to help Indonesian leaders engaged in the ongoing liberalizatio of the economy.

The Mission has increased the level of DA funding for RSSP to $43.0 million by increasing the FY 1987 OYB grant funding from $15.0 to $18.0 million and by adding $25.0 million in deobligated loan funds from completed and ongoing projects. The Bureau is requesting the conversion of the deobligated loan funds to grant for inclusion in RSSP as an additional incentive to the GOI to undertake policy change and to use funds more effectively to address critical short-term economic problems. The Mission will add an estimated $19.0 million in PL 480 Title I proceeds to the policy reform effort, pending availability. RSSP will provide an estimated $53.5 million in local currencies for the Ministry of Agriculture, about $7.0 million for the Ministry of Finance and Bank Indonesia and $1.5 million for technical assistance to support policy reform efforts.

This program will support the establishment of a policy agenda developed in negotiations with the GOI and reflect their understanding that progress will be assessed by USAID through a series of periodic and regular consultations. This approach parallels that used by the IBRD to assist the GOI to continue managing their economy prudently. It also reflects the excellent GOI record on policy reform and the mature U. S. Government and GOI relationship to date. GOI progress in achieving policy targets will provide the basis for a decision to authorize additional funds beyond the two-year period.

Bureau Review. The Asia and Near East Advisory Committee (ANPAC) reviewed the Program Assistance Approval Document (PAAD), raised four issues and five concerns, and approved the program subject to ANPAC guidance. The following ANPAC recommendations on issues and concerns are included in the attached guidance cable to the Mission:

Issues: (1) policy agenda. The ANPAC agreed with the Mission strategy to negotiate and obligate funds against a policy agenda with the GOI that was less directive and specific. However, prior to disbursement, the Mission, in consultation with the GOI, should prepare for internal A.I.D. use an agenda which would measure progress by (a) clarifying the benchmarks and constraints addressed; (b) indicating the linkages of agenda actions to the RSSP objectives; (c) identifying priorities among agenda items; and (d) providing the Mission's expectations for the achievement of agenda actions, the projected macro-impact on employment/incomes, the anticipated timing of actions, and the likelihood of their attainment. The agenda for internal A.I.D. use will be shared with AID/W prior to obligation and disbursement of funds.

(2) Section 103. The ANPAC instructed the Mission to strengthen the agenda on resources mobilization, linking the activities more clearly to redressing the current urban/rural investment distortions and to rural beneficiaries in general.

(3) Budget support. The ANPAC recommended: (a) That the PAAD not require the GOI to contribute to an increase in their current budget levels unless revenues increase. If revenues increase sufficiently, we would expect to see commensurate expenditure increases in our areas of interest; (b) that the local currency be provided to the ministries' budgets in combination with a GOI agreement to maintain identified line-item budgets at specified levels; and (c) that the Mission

develop a disbursement schedule that provides adequate incentive for policy change. The Bureau has also requested the Mission to develop a monitoring system adequate to track rupiah for any purpose described in the paad

(4) Private sector role. The Bureau recommended: (a) That the Mission review and, as appropriate, strengthen the agenda to articulate more clearly directions and possibilities for the inclusion of the private sector; and (b) that the Mission take opportunities during the policy dialogue to encourage GOI actions supporting an expanded role for the private sector.

Concerns. The ANPAC made these recommendations: (1) that the PAAD include a description of Mission management mechanisms; (2) that the PAAD provide more discussion on the relationship of RSSP to ongoing project activities; (3) that PL 480 funds, if available, be included in the policy support effort and co-mingled only if reporting requirements for the two sources of funds are similar; (4) that the Mission obtain a letter of request from the GOI prior to authorization; and (5) that the Mission review the covenants and conditions precedent to ensure appropriate levels of specificity.

Recommendation: That you delegate authority to the USAID/Jakarta Mission Director to modify, approve and authorize the two-year $43.0 million grant-funded Policy Support Program for Indonesia subject to ANPAC guidance by signing the attached cable to Jakarta (Tab A).

Approved ____________

Disapproved ____________

Date May 12, 1987

Attachment: A. Cable to Jakarta

Clearances:

ANE/PD:RVenezia	/s/
ANE/PD/EA:Jtennant	(draft)
ANE/EA:DMerrill	(draft)
ANE/DP:BSidman/ENelson	(draft)
ANE/TR:BTurner	(draft)
GC/ANE:HMorris	(draft)
PPC/PB:FKenefick	(draft)

NORRIS
ANE/PD/EA:JDu Rette; 13560; 4/24/87

cc: ANE/PD/PCS:File
USAID/Jakarta

ACTION MEMORANDUM FOR THE DIRECTOR, USAID/INDONESIA

FROM : Margaret Bonner, PPS Margaret Bonner

SUBJECT: Agriculture and Rural Sector Support Program (497-0357)

Action: Your approval is requested to authorize the $43.0 million grant-funded Agriculture and Rural Sector Support Program (ARSSP). Authority to modify, approve and authorize a two-year $43.0 million grant-funded policy support program was delegated to you by the Assistant Administrator, Bureau for Asia and Near East on May 12, 1987. Authority to extend the PACD to March 1990 was contained in STATE 243481.

Discussion: The ARSSP is a sector program that will provide $43 million in Section 103 Development Assistance (DA) grant funding to the Government of Indonesia (GOI) to support policy changes targeted at increasing rural employment and incomes by expanding agricultural diversification and increasing domestic resources mobilization. The program will also provide budget support for the Ministry of Agriculture and the Ministry of Finance for the implementation of policies and related institutional reforms.

The total level of DA funding is $43 million, composed of $18.38 million from the FY 1987 OYB and $24.62 million in deobligated loan funds from completed and ongoing projects. A Congressional Notification for the deobligation of $22,838,700 and conversion to grant expired without objection on July 16, 1987 (STATE 218549). PPC approval for the remainder of the funds, which were no-year loan funds, was obtained. Congressional Notification to obligate $43.0 million for the Agriculture and Rural Sector Support Program expired without objection on the same date (STATE 218850). An estimated $19 million in PL 480 Title I proceeds will be contributed by the GOI to support the policy reform efforts, resulting in a total availability of resources of $62 million. It is anticipated that $1.5 million will be used for technical assistance to support policy reform efforts, $6.5 million will be for the Ministry of Finance and $54 million for the Ministry of Agriculture.

The Bureau review of the program raised four issues and five concerns and approved the program subject to ANPAC guidance which was transmitted to the Mission (STATE 144810). These issues and concerns were addressed in JAKARTA 08901 and the Mission approach was approved with two exceptions (STATE 190376) relating to the need for a separate dollar account and increasing the number of benchmarks from two to four. Based on USAID/Indonesia's reply (JAKARTA 9841), AID/W withdrew the request to establish a separate dollar account and agreed to evaluate the achievements of the program on its own merits, rather than a targeted number of achievements.

Your delegation of authority was to approve a two-year program. During discussions on the use of funds with the GOI, it was agreed that funding should conform to the GOI budgetary year, which extends until March 1990.

AID/W was requested to authorize an extension to the program's PACD (JAKARTA 11211) and approval was provided (STATE 243481).

Recommendation: That you authorize and approve the Agriculture and Rural Sector Support Program by signing the attached PAAD facesheet.

Drafted:PPS:MBonner:cb 7/13.

Cleared:LO:GBisson (in draft 7/21)
EED:GWest (in draft 7/22)
ARD:MHanratty (in draft 7/23)
FIN:RMcClure (in draft 7/23)
ARD:RCobb (in draft 7/23)
DD:JAnderson (in draft 7/27)

6991P
(Amended PAAD)

AGRICULTURE AND RURAL SECTOR SUPPORT PROGRAM
(497-0357)
USAID/INDONESIA

August 27, 1987

ACTION MEMORANDUM FOR THE DIRECTOR, USAID/INDONESIA

FROM : Margaret Bonner, PPS

SUBJECT: Agriculture and Rural Sector Support Program (497-0357)

Action: Your approval is requested to authorize the $43.0 million grant-funded Agriculture and Rural Sector Support Program (ARSSP). Authority to modify, approve and authorize a two-year $43.0 million grant-funded policy support program was delegated to you by the Assistant Administrator, Bureau for Asia and Near East on May 12, 1987. Authority to extend the PACD to March 1990 was contained in STATE 243481.

Discussion: The ARSSP is a sector program that will provide $43 million in Section 103 Development Assistance (DA) grant funding to the Government of Indonesia (GOI) to support policy changes targeted at increasing rural employment and incomes by expanding agricultural diversification and increasing domestic resources mobilization. The program will also provide budget support for the Ministry of Agriculture and the Ministry of Finance for the implementation of policies and related institutional reforms.

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Your delegation of authority was to approve a two-year program. During discussions on the use of funds with the GOI, it was agreed that funding should conform to the GOI budgetary year, which extends until March 1990.

AID/W was requested to authorize an extension to the program's PACD (JAKARTA 11211) and approval was provided (STATE 243481).

Recommendation: That you authorize and approve the Agriculture and Rural Sector Support Program by signing the attached PAAD facesheet.

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ARD:RCobb (in draft 7/23)
DD:JAnderson (in draft 7/27).

GLOSSARY OF TERMS

AAETE	The Ministry of Agriculture Extension Agency
AARD	The Ministry of Agriculture Agency for Agricultural Research and Development
ADB	Asian Development Bank
AID	The U.S. Agency for International Development
Bappenas	The GOI State Planning Board
BI	Bank Indonesia, the GOI central bank
BIMAS/INMAS	A GOI subsidized rice inputs program terminated in 1983
Bulog	The GOI Bureau of Logistics
CDSS	The Country Development Strategy Statement for the USAID Mission
CIP	An AID-financed Commodity Import Program
DIP	The GOI annual budget plan
FID	The USAID-financed Financial Institutions Development Project
GOI	The Government of Indonesia, otherwise referred to as the government
HIID	Harvard Institute for International Development
IBRD	The International Bank for Reconstruction and Development, World Bank
IFY	Indonesian Fiscal Year
IGGI	The Inter-Governmental Group on Indonesia, formed to coordinate donor assistance to Indonesia
IFC	International Finance Corporation
ISNAR	International Service to National Agricultural Research

JCC	Joint Career Corps, a means of hiring U.S. university professionals for long-term assignments overseas
KUPEDES	A nationwide market-rate lending program for rural production under Bank Rakyat Indonesia, which is supported by the USAID Financial Institutions Development Project
MOA	Ministry of Agriculture
MOF	Ministry of Finance
NOA	New Obligating Authority
PAAD	Program Assistance Approval Document
PASA	A Participating Agency Services Agreement between two U.S. Government agencies
PRE Bureau	The AID/Washington Bureau for Private Enterprise
Rp.	Indonesian Rupiah, now valued at Rp. 1640 = U.S. $1.00
Title I	A PL 480 concessional sales program administered by the USDA and AID
USAID	The U.S. Agency for International Development Mission in Jakarta, Indonesia, or the "Mission"

CONTENTS

Pages

I. SUMMARY AND RECOMMENDATIONS

A. PROGRAM TITLE

Agriculture and Rural Sector Support Program (ARSSP)

B. ASSISTANCE PROPOSED

FY 87 Authorization:	$18.380 million Section 103 Grant NOA (New Obligation Authority)
	$24.620 million Section 103 Grant Reobligation
FY 87 Total:	$43 million
	$19 million PL 480 Title I—GOI Contribution
Grand Total:	$62 million

C. PERIOD OF IMPLEMENTATION

Two and one-half years under the first authorization. One or more additional years tentatively planned with FY 89 or FY 90 authorization.

D. SUMMARY PROGRAM DESCRIPTION

This program is intended to provide support to improve rural employment and incomes during a major economic crisis precipitated by the dramatic decrease in the price of oil, Indonesia's major export. The program will support the development and implementation of a policy agenda to increase rural employment and incomes; this agenda will be consistent with USAID policy and program objectives as defined in the CDSS. Initial policy objectives under discussion with the Government of Indonesia (GOI) include: (1) the creation of conditions conducive to expanding and diversifying the agricultural sector, including improvement of the environment for agricultural processing and trade; and (2) planning for and initiation of steps to expand and improve the efficiency of domestic financial markets. The program is supported by the USAID project portfolio and is also responsive to GOI interests and priorities.

The program's objectives are to:

1. Help the GOI identify and focus on key policy constraints affecting rural incomes and employment, particularly with respect to agricultural diversification and rural financial markets development.

2. Accelerate the momentum for reform at a critical time, taking advantage of the impetus afforded by the current economic crisis.

3. Provide tangible support to technocrats pushing for reform based on longer-term economic needs.

4. Encourage the GOI to provide sufficient levels of funding to areas directly related to the policy agenda developed.

5. By example, encourage other donors to adopt a flexible assistance stance toward the GOI during a particularly difficult time in Indonesia's economic history.

The program strategy is to use the disbursement of local currency to support adequate expenditure levels for selected budget categories, primarily in agriculture, related to the achievement of the policy agenda.

Initial disbursements will be triggered by the GOI's submission to AID of a policy agenda and illustrative benchmarks. Disbursements of AID funds will not be conditioned on progress made toward the targets; disbursement will instead reflect budgetary need. However, policy progress will be evaluated against the established benchmarks prior to authorizing funds beyond FY 87.

Approximately $1.5 million of the program funds will be contracted directly by USAID to cover costs of consultant assistance to support the analysis and management requirements of the program.

E. PROGRAM ISSUES

Issues identified in the ANPAC Review (STATE 144810) are discussed below.

1. Policy Agenda Refined, Linked to Constraints and Objectives and with Clear Prioritized Benchmarks: The agenda in Part IV.B addresses all concerns raised by the ANPAC.

2. Expectations: The program's policy agenda is designed to be responsive to priority constraints to agricultural diversification and financial markets development as a means to increase the potential for rural employment and incomes. The policy agenda represents an illustrative menu of objectives and benchmarks which have been assigned priority by USAID in terms of their potential impacts and feasibility. Although th Mission will pursue all agenda items to the extent possible, progress is expected to be better on some items than others over the next two years. Indeed, some benchmarks may be dropped entirely so that increased efforts can be focused on remaining benchmarks if we feel this will improve the chances of productive progress toward our employment and incomes objective. We have delineated in the agenda indicative steps we see as necessary for meeting each agenda benchmark so that progress can be more easily tracked and measured. We will be aiming high to show progress across a broad front on the agenda, but do have priorities that reflect our expectations of where benefits will be greatest. Particular attention will be given to the five major benchmarks: (1) reduce pesticide subsidies, (2) introduce agricultural input trade reforms, (3) eliminate copra tax, (4) liberalize banking legislation, and (5) liberalize pension and insurance legislation.

3. Impact and Evaluation: The revised evaluation plan in Section VII addresses concerns that progress be measurable.

4. FAA Section 103 Concerns: The issue of targetting domestic resource mobilization as directly as possible to Section 103 funding priorities has been addressed in the design of the financial policy agenda and budget support, bringing to bear special attention on the issues of rural finance and investments. In addition D.A. funding for the domestic resource mobilization component has been limited to $5 million. The remainder of the resources will be used to provide budgetary support for the Ministry of Agriculture ($36.5 million) and Technical Assistance ($1.5 million).

5. Additionality and Disbursement Procedures: Section IV of the PAAD indicates the requirement for additionality using AID funds, but does not require that the GOI increase its counterpart contribution except for allocating PL 480 Title I funds to the program.

6. Budget and Disbursements: Budget support has been refined to target selected directorates general within the Ministries of Agriculture and Finance. The Financial Plan reflects this approach, and clarifies the disbursement mechanism.

7. Monitoring and Controls: Funds will be monitored at the directorate general level. Monitoring will be conducted to assure that funds go to specified budgets and that required additionality is obtained. However, monitoring will be financial in nature and will not include monitoring of actual activities financed under this Program within each directorate general. Controls are specified in Section VII and involve setting up a committee system, financial reports and an annual GOI audit report.

8. Mission Management: The Mission will manage the program in accordance with the system described in STATE 144810, and contained in Section VII of the PAAD.

9. GOI Commitment: Negotiations to date indicate adequate GOI commitment to the program objectives and concept.

F. STATUTORY CHECKLIST

The statutory checklist is contained in Annex VII.

G. RECOMMENDATIONS

It is recommended that $18.380 million of Section 103 NOA grant funds and $24.620 million of Section 103 deobligated funds be authorized in FY 87 for this program. Authorization of additional funds for obligation beyond FY 87 may be requested subject to progress made under the initial authorization.

II. MACRO OVERVIEW

A. CURRENT STATE OF INDONESIA'S ECONOMY

Indonesia is beginning what will probably be a very difficult three to four year adjustment period. It is in the midst of an economic recession substantially worsened by the decline in average oil prices from $25 per barrel in 1985 to $12 per barrel in 1986. Because oil and liquified natural gas provide a major portion of Indonesian's export earnings and budgetary revenues — more than 70 percent in 1984/85 — the drastic decline in oil prices poses significant adjustment burdens on balance of payments, government budgets, growth, incomes and employment. This burden is expected to be prolonged because of the relatively unfavorable and highly uncertain medium-term outlook for oil prices and the relatively loug lead time required for structural policy adjustment measures to have substantial impact.

The World Bank (IBRD) projects that during the period 1986-90, real GDP growth will average less than 2.5 percent and that real per capita income may decline. On the basis of these projections and historical employment-output elasticities, less than 40 percent of the 10 million new entrants to the labor force during those years will find employment. This will follow the difficult period for employment and incomes growth between 1981 and 1985 when GDP growth averaged only 2.5 percent, per capita income declined an average of 0.9 percent and underemployment mounted.

Reflecting the pessimistic outlook for oil prices and the current economic recession, real budgetary expenditures, excluding debt service, may fall by as much as 40 percent, compared to 1985/6 levels, during the period 1987/8-1990/1. Real development expenditures will probably fall by more than 50 percent. The current account deficit is expected to worsen substantially, rising from $1.8 billion in 1985/6 to an estimated $4.8 billion in 1986/7 before falling to a projected $2.9 billion in 1987/8 and $1.2 billion 1988/9. External financing requirements will double to almost $7 billion by 1986/7, ease slightly to $6 billion by 1987/8, and probably stabilize between $4-5 billion 1988/9-1990/1. The growing debt service burden is a major factor in the continuing need for large amounts of external financing. See Annex I for greater detail.

In sum, during the next three to four years, the government will face significant increases in external financing requirements, major decreases in real non-debt budgetary expenditures, an average GDP growth level one-third that of the 1970s, falling real per capita incomes and growing employment pressures.

On the positive side, the Government of Indonesia has continued to respond constructively to its adjustment problems. The government carried out a highly successful devaluation in September 1986 and has backed it up with conservative monetary and fiscal policies, including a 1987/8 budget that is about 25 percent lower in real terms than in 1985/6. The government has also taken substantive policy measures addressed at the longer-term restructuring problem through the May 6, 1986 export and investment promotion policy package, and the October 25, 1986 and January 15, 1987 trade policy reform packages aimed at non-tariff barriers. It has frozen civil service wages, made further cuts in petroleum, fertilizer and export financing subsidies, and raised public transportation prices. The GOI has also initiated a review of state-owned enterprises, and has indicated interest in considering a range of options including consolidations, reorganizations and divestitures. The government has stated that additional trade policy reform measures are under consideration, and we anticipate further announcements during the coming year.

Recent USAID analyses suggest that Indonesia has taken the necessary steps for short-term adjustment and will be able to finance its balance of payments over the next two years without drawing down official reserves much below the $4.5 billion level. This outcome is critically dependent, however, upon the GOI's ability to negotiate, in a timely fashion, donor assistance now under review, on Indonesian oil prices averaging $13.50 per barrel in 1987/8 and $15.00 per barrel 1988/9, and on the absence of prolonged capital flight. These are reasonably conservative assumptions, but the margins are tight and the timing of financial flows is critical. In addition, the uncertainty and potential volatility of future oil prices make it impossible to guarantee any particular outcome.

Although Indonesia has already taken many long-term adjustment measures, their impact will not be fully felt for some time, perhaps four to five years. In the meantime, pressures on the GOI to opt for short-term solutions to ease the squeeze on employment and incomes are growing. If the GOI were to succumb to these largely political pressures, we might witness a return toward inwardly focused, highly protected and inefficient policies. This move would be a reversal of current policy trends and counterproductive to the resolution of longer-term adjustment problems. Clearly, the donor community desires to prevent this from happening. Donors can help maintain the momentum for appropriate policy changes during this period of adjustment by supporting reforms, and by reducing the uncertainty and the severity of economic contraction.

B. THE ROLE FOR DONORS

Indonesia's economic crisis offers donors an opportunity to support policy reform through a flexible assistance program directly linked to a policy agenda and by providing funding to maintain budget levels in areas important for policy formulation and implementation.

1. Momentum for Policy Adjustments

The Government of Indonesia has already made substantial progress toward improving its macro policy environment. It has undertaken one of the most comprehensive and far reaching economic policy reform programs anywhere in the world. During the last four years, Indonesia has improved its factor prices, controlled inflation at single digit levels despite two devaluations, maintained the real effective exchange rate set by the devaluations, exercised consistent budgetary austerity (including a generally ruthless approach to budgetary subsidies), shown significant restraint on new state enterprise investment, and, in general, taken several measures toward significant liberalization. Annex I discusses these reforms in more detail and identifies the role that the donor community has played in assisting the process to date.

While the weakened oil market has helped propel the reform movement, Indonesia actually began its program of macro-economic reform well before the current crisis. Reforms have been carefully thought out and, taken together, they represent a substantial liberalization and corrective movement toward a more freely operating market economy. Although important steps remain, they do not detract from the considerable progress made to date. Rather, the remaining reform steps have become more obvious given the growing absence of other major policy distortions in the economy.

The consistent nature of these reforms implies both a strong conviction about the ultimate need to liberalize the economy and the ability of knowledgeable technocrats to convince political leaders of the necessity of taking unpopular steps for the long-term good. These attributes are a relatively rare and precious commodity in most developing countries (as well as most industrial countries). The combination of a government willing and able to pursue reforms and an economic environment in which to implement them provides a clear opportunity for further progress on macroeconomic policy in such areas as agriculture, finance, trade and industry.

Continued reforms, however, will not be easily achieved or undertaken without risk. For example, the government's past policies, particularly in the area of trade and industrialization, have focused on import substitution. Industrial policy has aimed at meeting domestic demand through the encouragement of local, often heavily protected, industry. Restrictions on imports and investment, designed to spur infant industries, have created a high-cost economy for consumers and downstream producers. Recent policy reforms have sought to overcome the imbalance that restricted licensing, quotas and other non-tariff barriers have created, but more are required to decrease the high cost of the economy, increase competitiveness and reduce dependence on oil revenues. Macro policy affecting agriculture remains practically untouched, and the potential for mobilizing internal resources is still barely being addressed.

Further reforms will directly affect substantial interests at a time of dwindling resources. Just as the recession may spur the technocrats to contemplate new reforms, it may also spark greater resistance among those whose interests are affected. That resistance may be encouraged by the short-term costs some of the reforms will carry in addition to their long-term benefits. Recent policy reforms loosening import controls, for example, laid the groundwork for decreased input costs, thus increasing the potential competitiveness of Indonesia's exports on the world market. But until export production responds to the new incentives, an increase in imports will aggravate Indonesia's balance of payments problems. During this transition period, when the window for change is open, flexible donor assistance can be particularly useful in supporting the momentum for policy change by focusing attention on policy areas and providing budgetary assistance.

2. Budgetary Concerns

GOI budgets have been very much affected by the economic crisis. GOI budgets supporting programs in agriculture and rural development are of particular interest to USAID because they relate to USAID's longstanding objective of raising rural incomes and employment. Reduced budgets also affect the potential returns from GOI, AID and other donors' substantial investments in training, infrastructure and equipment related to agriculture.

An analysis of the Ministry of Agriculture (MOA) budget illustrates the problem. The nominal budget grew at an average of 16 percent per year between 1979/80 and 1985/86. It then dropped 52 percent in 1986/87, and is likely to drop further in 1987/88. Indeed, 1987/88 real development expenditures are expected to be cut to the levels of the early 1970s. (Annex III.A has a more complete discussion of the MOA budget.) The effects of these cuts on agricultural development and, in turn, on rural incomes and employment, can only be surmised. However, there is mounting anecdotal evidence that research is slowing down and that the effectiveness of agricultural extension workers is increasingly reduced by cuts in recurrent budgets for transportation, per diem and supplies. Moreover, funds for new development programs aimed at agricultural diversification are under pressure because current priorities emphasize immediate concerns rather than longer-term benefits. Ongoing AID and other donor projects are directly affected as counterpart budgets are depleted.

Even with relatively modest resources, AID and other donors can help address the growing resource gaps in the Indonesian budget. Donors can assist with the maintenance of budgets in selected areas important to rural incomes and employment and other areas in which they have interest and investment. Assistance to the GOI to maintain or establish priorities that support expenditures in these areas will be particularly timely during the next three years of expected current account deficits and inadequate budgets

III. PROGRAM OBJECTIVE AND STRATEGY

A. OBJECTIVE

This program seeks to support the formulation and implementation of GOI policies targetted at increasing rural employment and incomes and to encourage the GOI to maintain budget levels in areas crucial to this goal.

B. STRATEGY

The Mission's strategy is to provide sector assistance that (1) supports policy reforms to expand agricultural diversification and increase domestic resource mobilization and (2) offers incentives to the GOI to maintain adequate budget levels in agriculture and finance.

The strategy reflects our belief that the overriding concern for Indonesia's foreseeable future is to provide sufficient productive, spatially distributed jobs. With nearly two million new workers entering the labor force each year and high rates of un- and underemployment that are still growing, Indonesia faces a serious and potentially destabilizing problem.

Much of the problem relates to rural opportunities. Indonesia is still predominantly rural, with almost 80 percent of the workforce residing in rural areas. The incidence of poverty (44.6 percent) and underemployment (40.8 percent working less than 35 hours per week) are nearly twice that in urban areas. Because growth in rice production appears to have peaked, new jobs and income in agriculture increasingly must come from successful diversification into food and cash crops, and the development of agriculture-related businesses.

But successful diversification will require more effective mobilization of domestic resources. The impetus for diversification cannot come from government alone—the funds are no longer there. Diversification will be driven to a greater extent than any previous agricultural program by private sector financing. Because of Indonesia's increasingly tight budget situation, the subsidies of previous years will need to be curtailed, and private companies will have to raise funds on their own. Traders will need credit to create new markets, and entrepreneurs will need funds to develop new agribusiness and begin processing and marketing. A more efficient financial market capable of tapping privately-held reserves will help make these funds available.

The Mission's strategy is based on several premises: 1) the importance of focusing attention now on policies affecting agricultural diversification and domestic resources mobilization; 2) the proven capacity of the Indonesian government to consider major policy reforms to open the economy to market forces; 3) the availability of highly skilled economic planners within government committed to identifying and implementing policies to open the economy further, improve resource mobilization, increase efficiency and reduce the high costs of the economy, and strengthen value-added exports; 4) the willingness of the GOI to develop with USAID a policy agenda related to agricultural diversification and domestic resource mobilization; 5) GOI and USAID agreement on a system for regular meetings and progress reviews; 6) the need for and ability to use fast disbursing funds directed specifically to areas important to employment and incomes growth; and 7) the potential for relatively limited funding to help focus GOI commitment to continued levels of support for important policy areas.

Other considerations in the program design were:

1. <u>Sector Program versus Project Approach</u>

The current economic crisis presents both a major need and a significant opportunity to deal constructively with rural employment and income concerns. It provides strong justification for a sectoral program rather than a project approach because: (1) the economic contraction is expected to be relatively short-term (two to three years) and the policy and financial requirements are immediate; (2) the effects on jobs and incomes are exacerbated by declining government budgets and certain policies that permit inefficiencies; (3) the government has demonstrated the commitment and ability to enact appropriate policy reforms; and (4) USAID has a number of existing projects dealing with institutional development in rural areas which are also being affected by declining GOI budgets. Program assistance can provide immediate resources to encourage the maintenance of developmentally important areas of the GOI budget and provide support to establish and carry out policies that promote higher incomes and productive employment. Project assistance, however, appears too focused to deal effectively with these issues and could aggravate the problem by imposing additional recurrent costs on an already overburdened budget. The priority objective of program sector assistance, "the alleviation of fundamental constraints inhibiting the growth of sectoral output and productivity" (HB1, Part VII), appears to be well met in this instance.

2. Relationship to CDSS

Targetting rural incomes and employment through a policy-oriented sectoral approach is also consistent with the most recent CDSS which emphasizes "middle-level sectoral policy questions, primarily in the substantive areas in which the Mission has staff competence." The proposed program directly supports two of USAID's three CDSS objectives: strengthening and diversifying food production, and expanding productive off-farm employment. It is in concert with the Mission and Agency approach to policy dialogue and promotion of the private sector to attain these objectives. The program takes advantage of the considerable time and effort already invested by Mission staff to establish an analytical base for policy dialogue, particularly in the agricultural, rural development and financial institutions areas, and the excellent working relationships the Mission now enjoys with GOI planners and policy makers.

3. GOI Commitment

Recent policy discussions with GOI officials outlined in an interim cable (Jakarta 04505), indicate their receptivity and interest in the sectoral program approach because it supports continuing efforts toward policy restructuring. Also, it addresses one of their highest priority concerns: How to deal with the impact of the contracting economy on important areas of the development budget as the adjustment process goes forward. This concern is clearly shown by the GOI's recent appeal to all donors to consider appropriate budget support while minimizing new project start-ups that would add to recurrent budget needs.

4. Other Donor Assistance

Other major donors in Indonesia are making significant efforts to respond to the GOI's call for revisions in modes of donor assistance during the current financial crisis. The GOI first made a public plea for a revised approach at The Hague during the June 1986 meeting of the Inter-Governmental Group on Indonesia (IGGI).

More recently, in a formal statement to the IGGI Chairman on February 24, 1987, the IBRD noted that "prospects for the coming year, 1987-88, however, are significantly worse than we had projected a year ago" and "there is an acute shortage of counterpart funds to implement even ongoing projects, let alone to support new project proposals." The IBRD concluded, "In summary, revenues are sharply down, the government has prepared an expenditure program which reflects priorities that we would share but for which there are not enough rupiah funds. Further budget cuts or problems in meeting the substantial financing need for the balance of payments may lead to serious consequences for employment." The IBRD suggested ways donors could be more helpful in the coming year, including the increased use of program aid. The complete text of the IBRD statement is contained in Annex II.

At the 1987 IGGI meeting, donors have taken action. Both the IBRD and Asian Development Bank (ADB) have agreed to increase the local portion of project funding they would assume in project assistance. The IBRD has approved a $300 million commodity loan to support trade policy reforms and is considering other non-project assistance in its total pledge of over $1 billion. The Dutch have announced their intention to increase assistance levels to approximately $91 million in 1987/88, of which about $17 million will be for a commodity loan with proceeds used for local currency needs. The Japanese have agreed to provide $900 million in Ex-Im credits to generate local currency to support World Bank development projects. The Japanese pledged an additional $600 million in aid. Of this, 60 percent will go for local currency financing of ongoing Japanese projects. The ADB will provide $120 million for local currency support for ongoing projects in its $500 million pledge.

It should be noted that all of the above-mentioned donor initiatives are relatively unconditional, intended primarily as "bridge financing" to help the GOI meet resource needs during the difficult 1986-1989 financial adjustment period. The IBRD Trade Policy Adjustment package, for example, provides its resources on virtually unconditional terms, except for the need to present documentation on eligible imports to provide a basis for disbursements. The IBRD loan is justified as support for past policy efforts and to maintain a dialogue on future efforts which are outlined in a side letter from the GOI to the IBRD.

IV. PROGRAM DESCRIPTION AND ANALYSIS

A. THE PROGRAM

As noted earlier, the program proposes support for a policy agenda that: (1) focuses GOI attention on policies important to employment and incomes; (2) accelerates reforms during a period of economic crisis which has created a window of opportunity; (3) supports technocrats who will face increasing opposition from those concerned with the short-term political impacts of reforms aimed at long-term growth; (4) encourages the GOI to maintain adequate budget levels in key areas; and (5) encourages other donors to reexamine their assistance strategy in light of the immediate needs and opportunities.

Policy objectives under discussion with the GOI include: (1) creating conditions conducive to expanding and diversifying the agricultural sector, including improving the environment for agricultural processing and trade; and (2) planning and initiating steps to expand and improve the efficiency of financial markets.

As outlined in Section VI (Implementation), the program will establish a process during the first year to include periodic meetings and discussions documenting progress and refining directions as appropriate. Where necessary, the process will be complemented by technical assistance. A comprehensive review planned after a year or more of implementation will allow for discussions of progress, which will determine whether to seek additional funds to continue this sector program effort.

Funds proposed for authorization and obligation in FY 87 include $18.380 million in grant funds from the FY 87 NOA for Indonesia and $24.620 million of funds deobligated from the AID Indonesia project portfolio, for a total package of $43 million. Another $19 million from PL 480 Title I resources are planned to support this program approach as well. (Title I funds are viewed as an important potential resource not only because they increase the level of the program and therefore its attractiveness, but also because their inclusion in the program would involve Bulog, the State Logistics Bureau and a key player in issues relating to agriculture diversification, directly in policy discussions during the course of the program.) An additional year(s) authorization may be requested through PAAD supplements that will review progress and propose additional funding as appropriate to continue commitment to the policy objectives. For initial planning purposes, $17 million is programmed for FY 89, supplemented by a $33 million PL 480 program. These figures are only tentative. Final amounts will depend on the results of this phase I effort, future needs, and the Mission's OYB and Title I levels. No projections are made for assistance beyond FY 89 (or early FY 90) because this program is seen as a means to support policy adjustment and budgets at a time of serious economic constraints that are expected to abate after this period.

An important aspect of the proposed budget support is its planned impact on mobilizing GOI budget resources. It is intended to encourage GOI attention to key areas by highlighting their importance and to leverage continued commitment to priority budget categories. The budget analysis outlines items of particular interest for the program's income and employment objectives and describes generally how the program will support maintenance of budget funding for them.

B. THE POLICY AGENDA

The policy agenda is designed to be directly responsive to the constraints outlined in Section IV D. The Program Strategy in Section III describes our reasoning for selecting agricultural diversification and financial markets as areas of program focus. A review with the GOI of appropriate policy objectives and illustrative benchmarks was guided by the same criteria:

1. Their relevance to the overall objective of employment and incomes generation.

2. GOI interest and commitment to development in these areas.

3. Past USAID involvement in activities relating to policies in these areas, development of strong working relationships, and a foundati of expertise and experience.

4. Capability of institutions in these areas to formulate and impleme changes targetted in the policy agendas.

During the early stages of the development of the PAAD concept, a numb of alternative policy areas were considered as well. They included trade reforms, restructuring of state-owned enterprises and investment promotion. For various reasons communicated to AID/W in the interim cable (Jakarta 04505), these alternatives were dismissed.

1. Agricultural Agenda

The overall objective of the Agricultural Agenda is to promote agricultural diversification and related agro processing. Evidence suggest that the major source of past rural growth, rice production, is declining i relative importance as an engine of growth. Greater crop diversification linked to agro-industrial investments will be necessary and will lead to higher incomes as farmers increase the production of secondary crops and off-farm employment opportunities become available.

Yields of secondary crops are low and there is significant scope for improvement. Also, preliminary evidence suggests that a one million dollar increase in secondary food crop processing could generate 2725 full time jobs. Estimates indicate a one percent increase in processed agricultural output (e.g., macaroni/noodles, coconut oil, coffee, meat and bakery products) — would generate a 2.3 percent growth in national value added. Since agro processing industries tend to be close to the source of raw materials, both employment and income multipliers will benefit Indonesia's rural population, specifically small marginal farmers, rural landless and the underemployed. It is primarily these groups which continue to seek employment outside agriculture.

a. Constraints

Growth in secondary crop production and processing will not proceed at an acceptable pace unless a number of constraints are addressed. Growth in domestic and international marketing needs to be stimulated by the reductio of costs associated with production, transportation and processing of agricultural commodities and their products. Subsidies and prices for agro chemicals need to be reviewed and adjusted as necessary to encourage efficient application rates. New technologies and/or management systems need to be devised and introduced to enhance productivity and decrease the cost of production. Licenses and permits which reduce the movement of food crops and raise the cost to processors and consumers need to be reviewed and discarded, if they are not required. Cumbersome and time consuming procedures which inhibit private sector entry into agro-processing require modification. Finally, the pervasive involvement of the public sector in all aspects of production, processing and movement of agricultural products needs to be reduced and market mechanisms allowed to function to the maximum possible extent.

b. Benchmarks

Below are specific policy benchmarks that will show progress in reducing the constraints facing the sector. Benchmarks are placed in priority order with a brief explanation of the impacts they are likely to have on overall employment and income objectives. Priority was assigned based on 1) potential impact, 2) timing of returns, 3) feasibility and 4) GOI support. Specific steps needed to carry out the benchmarks are also provided.

1) Initially Reduce Pesticide Subsidies by at Least 30 Percent to Encourage Efficient Utilization Rates

High pesticide subsidies, estimated at over 40 percent, cost the GOI millions of dollars and are leading to excessive pesticide use, the destruction of a wide range of natural predators, and the encouragement of new biotypes of highly destructive pests. Some specialists suggest that the heavy use of broad spectrum pesticides on rice has led to new and virulent outbreaks of brown plant hopper, the reduction of rice production by 500,000 MT per annum, and shortened the genetic resistance of the two major rice varieties grown in Java by two to three years. Effects on secondary crop production are probably even more costly and are an important constraint to agricultural diversification.

Since pesticides make up such a small proportion (2-3 percent) of farmers' costs, subsidy reductions are likely to have little impact on farm income. Combined with a program of integrated pest management (funds from the budget support component should help finance this ongoing GOI effort), reduced subsidies should lead to a significant reduction and more targeted use of chemicals for specific pests, easier transition to more diversified cropping systems, and eventually to increased yields and income.

2) Expand Trade Reforms to Include Agricultural Inputs Needed in the Production and Provision of Agriculture Based Food and Export Items

Many of the inputs used in agricultural based processing for domestic use and export are imported. Unlike industrial imports, which benefitted from recent import liberalization policies, agricultural inputs such as high protein fish and animal feeds are still imported by a sole firm, the National Logistics Agency, at international prices and sold to processors at higher domestic prices.

The intent of this policy benchmark is to expand the provision of recent import liberalization policies to agricultural commodities used in processing, particularly for exports. Export producers would be free to directly import inputs unrestricted by import quotas and duties. This would have a significant impact on a variety of agro processors. Freely available internationally priced inputs (such as packaging materials) would significantly reduce agricultural processing costs and improve efficiency. Provision of high-protein animal feeds such as soybean meal at international prices would significantly reduce the production cost of swine now destined for the expanding Singapore market. Easy access to brine shrimp, an important feed in shrimp hatchery production, would increase hatchery output, relieve current shrimp fry supply constraints, lead to increased stocking rates and provide the production Indonesia needs to participate in the rapidly expanding international shrimp market. Growth in these agro industries, which are labor intensive and rural based, would lead to increased off-farm employment as well as greater demand for diversified agro production, increased foreign exchange earnings to offset reduction in oil revenues and expanded agricultural and improved non-agricultural rural employment and incomes.

Liberalizing imports of agricultural commodities and allowing exporters to import these items freely will clearly be a major accomplishment, with important consequences for ARSSP program objectives. Again, as with reducing pesticide subsidies, accomplishing this benchmark should more than justify the assistance under the program.

3) Reduce Transportation and Licensing Costs Associated with Secondary Crop Processing and Trade: Eliminating the Copra Tax and Analyses of Trade and Processing Licenses

A critical component in the high cost of processing and transporting agricultural commodities and their products is government licensing and taxation procedures. For example, the government currently levies a five rupiah per kg. tax on copra shipments, a small holder commodity with annual trade flows of 250 thousand tons. In addition, local governments are allowed to issue movement licensing for all agricultural commodities. In South Sulawesi, such taxes account for 15 percent of total transportation costs. On the processing side, extensive government licensing procedures increase the time and resources required to establish and maintain new industries. For example, one report indicates that 97 separate approvals from seven different agencies are required to establish an agro-processing industry. Such licensing procedures raise the cost of processing and trade, decrease farm gate prices, limit the volume of goods traded, reduce competition by limiting the number of processing facilities, and ultimately increase consumer prices and reduce demand.

Two benchmarks have been selected to show improvement in this situation: 1) In the short term, the elimination of the copra tax, and 2) in the medium term, the development of detailed inventories and analyses of specific licenses now imposed on trade and processing.

It is anticipated that eliminating the copra tax will reduce raw materials costs to coconut oil processors from Rp. 1-5 per kg, raise raw materials demand and increase the farm gate price for copra. Preparation of detailed inventories of licensing procedures will provide the necessary information and identify areas for future analyses and potential policy actions. Clearly, the elimination of the copra tax should have a significant effect on the incomes of small-holder coconut farmers in the poorer regions of Indonesia. It is accordingly considered one of the major benchmarks of the program. The inventory benchmark is a secondary benchmark and is important for long-term licensing reform.

2. Financial Markets Agenda

The Financial Markets Agenda will increase the efficiency of financial markets as a means to increase capital, particularly for investment and for use in rural areas. Appropriate changes in banking, pension, and insurance policies are expected to result in increases in the availability of productive long-term capital necessary to fuel growth and employment. The intent of AID's involvement is to ensure that rural areas will benefit from improved efficiencies in financial markets.

a. Constraints

A major constraint to effective and efficient resource allocation, and one with special impact on rural incomes and employment, is the inadequacy of Indonesia's financial institutions. Economic growth depends on the ability to raise and move capital. Indonesia lacks the appropriate financial policy environment to do so. The problem is particularly severe at the village level. Indonesia's financial sector is highly centralized and dominated by government-owned banks — the Central Bank and five state banks control nearly three quarters of all financial assets. Although state banks operate some 140 branches each, most are in provincial capitals or major district-level population centers. Foreign commercial banks are restricted from operating outside Jakarta and few of the 70 private national commercial banks operate outside major cities.

As a result, the Indonesian private sector is highly under-served by financial institutions, and the potential for mobilizing savings and creating new loan or equity finance remains large. Indonesia's ratio of money to GDP is only one-third that of India and Malaysia, for example.

There is also a need to increase the availability of long-term investment capital for the development of agro-based trade and industry necessary to create new jobs and income in rural areas. Most of Indonesia's savings are now in short-term time deposits. A strong capital market, spurred by the demand from active insurance and pension industries, can be a prime source of long-term capital.

An active capital market created by the development of insurance and pension industries could make $2-4 billion available long-term for productive investment. Effective savings mobilization programs in rural areas could move several billions of dollars into lending programs for small enterprises, trade and agribusiness, thus creating millions of new job opportunities and more income for rural areas.

USAID has been involved in the development of Indonesia's financial and capital markets through the Financial Institutions and Private Sector Development Projects. This involvement provides opportunities based on experience and established relationships for discussions of policy constraints on development of the financial sector. A larger role by USAID through the proposed program will support advances in the sector by focusing attention on specific areas for change and by providing resources to facilitate the changes required.

b. Benchmarks

Specific policy benchmarks for the ARSSP are discussed below, in order of priority:

1) Expansion of Financial Institutions and Services, Particularly in Rural Areas

This benchmark will show major progress in liberalizing financial markets to encourage the development of self-sustaining village. institutions, an increased number of branches of private and foreign banks and easier access to financial resources in rural areas. The result will be increased trade and enterprise development in rural areas.

2) Establish a Legal Framework and Appropriate Regulatory System for Encouraging the Development of Insurance and Pension Industries

This benchmark will provide a firm foundation for mobilizing long-term financing for development investment and is considered a major objective for the Financial Markets Component of the program. The steps necessary to accomplish the benchmark include:

3. Additional Benchmarks

Two benchmarks (one for the agricultural agenda and one for the financial markets agenda) are discussed here. Although these benchmarks are important enough to be included in the agenda, their effects on rural incomes and employment are indirect or long-term. They are thus considered to be secondary benchmarks.

a. Introduce Institutional Reforms in Agricultural Research and Planning Required to Better Plan and Implement Policies and Programs Aimed at Agricultural Sector Diversification

Although the Ministry of Agriculture has a large and relatively well trained core of physical and social scientists, it is constrained in its use of these resources because of a number of structural problems. In its efforts to achieve rice self sufficiency, the Ministry's manpower rapidly expanded in the 1960s and 70s. Largely organized around rice production programs, little attention was given to more effective organizational modes to increase the production of non-rice crops or to develop the analytical capacity necessary to guide multiple crop production programs. As a result, when rice self sufficiency was achieved and attention turned to other crops, the MOA had neither the organizational models nor technologies on line to address the new challenge.

A small but important body of middle and upper level managers recognize the current problem and have indicated a desire to have changes included in the Agenda. The changes most commonly referred to are the consolidation of analytical and planning capabilities under a directorate for policy and planning and reorganization of the MOA's agricultural research agency (AARD).

The institutional reforms in the research and planning area are important indicators of GOI long-term commitment to effective diversified agricultural programs and are thus included as benchmarks in this program. Although these changes are necessary, they are not sufficient to meet incomes and employment objectives directly. Therefore, the reorganization benchmark is not considered as a major benchmark because it is secondary in importance to the changes described above.

b. Continuation of Market-oriented Interest Rates Supporting Rural Areas

This benchmark will be important to mobilizing capital and maintaining the integrity of rural financial institutions. As it is already generally in effect, it is considered a secondary benchmark. But its potential effects on rural growth and employment over the long term are important enough to include it in the policy agenda, particularly because there is considerable political pressure to erode it by expanding the remaining subsidized credit programs. The only step in meeting this benchmark is to continue reviews of credit programs with the GOI.

C. BUDGET SUPPORT

Budget support will be directed to specific areas affecting rural incomes and employment, principally in agriculture. Future growth in rural incomes and employment will be related to the government's success in diversifying beyond rice, particularly its progress in developing secondary food crops, selected estate crops, livestock and fisheries. As previously noted, successful implementation of an agricultural diversification strategy will partly hinge on policy decisions affecting the macro-economic environment such as factor prices, transport, or transaction costs associated with licensing. It will also depend on the government's ability to use its existing institutional base to direct scarce resources to programs which maintain rice yields, diversify production into other commodities and, at the same time, promote technologies that improve farmer income. The policy and institutional reform milestones already outlined address some of the changes required. The budget support described below will provide resources to help effect some of these changes.

1. Agriculture

Budget support for agriculture, as analyzed in Annex III.A, will be used to maintain reasonable funding for three broad areas within the Ministry of Agriculture: agricultural research and extension, integrated pest management, and program planning and policy analysis.

The need is clear. The budget shortfalls of the past two years have seriously undermined GOI funding for agricultural research, a major program area supported by AID and one with major implications for the GOI's ability to carry out an effective program of diversification. GOI expenditures in real terms for agricultural research grew by over 11.5 percent per year between 1975 and 1983. The budget was cut by nine percent in 1984/85, however, and despite an increase of 10 percent the following year, was cut by 30 percent in 1986/87.

The case of food crops research illustrates the severity of the problem. Despite the efforts made by AARD, the research coordinating agency, to adjust allocations for food crops research, the absolute levels of funding are inadequate and will grow worse. There are 147 scientists (Ph.D and MSc holders, plus other senior researchers) working with food crops, many of whom have received degrees through USAID-sponsored training. Only $1,700 per scientist is available for research, far below the level of

$12,500 per researcher available in 1984/85 and determined in a 1985 review of AARD as the minimum required for conducting agricultural research in Indonesia. In 1987/88, 309 additional scientists are expected to return from training, compounding the shortfall. Estimates for 1987/88 place AARD's budget for operational research at 10 percent of the minimum required for most effective use of its staff.

Shortfalls in the routine budget also threaten AARD's operational capacity. Eighty percent of the routine budget goes for salaries, leaving little for operations and maintenance. During the four years prior to 1988, an estimated $120 million worth of construction will have been completed. The annual requirement for operation and maintenance of existing plus new facilities, equipment and vehicles has been conservatively estimated to be $7.3 million, equal to the entire current routine budget. Without additional funds, the useful life of buildings, laboratories, greenhouses, storage areas and shop facilities will be reduced. Spare parts for trucks, tractors, irrigation equipment, dryers, cold storage units and lab equipment cannot be purchased. Funds for fuel to operate machinery and generators will not be available. New facilities (greenhouses, laboratories, etc.) will stand idle. Indonesia's once dynamic agricultural research program will not be able to capitalize on its investment in infrastructure, facilities and scientific training.

Already, the consequences of budget shortfalls are being felt in these areas. In the Agency for Agricultural Education, Training and Extension, operating funds for extension are so limited that agents are unable to travel regularly. In AARD, field research support is very low. This recently led to the introduction of three new rice varieties without appropriate field testing. These varieties have since proven susceptible to brown plant hopper, and yield losses have been sustained by farmers.

2. Finance

The justification for limited and targeted budget support to the Ministry of Finance is based on the belief that strong financial markets will permit the mobilization of private funds required for direct investments in rural areas and in trade and agro-processing operations with real potential impact on rural incomes and employment. This institution has been at the center of the GOI's reform efforts. It needs funds not only to carry out recent reforms but also to set the priorities in the future, priorities which will have a real impact on growth, incomes and employment.

Annex III.B analyzes the budget shortfall within the Ministry of Finance in some detail. The Ministry of Finance experienced a shortfall from requested levels of 5 percent in 1986/87 in its routine budget (Rp. 4.3 billion), and projects a 14 percent (Rp. 13 billion) shortfall in 1987/88. The actual budget for 1987/88 is expected to drop 9 percent below budget levels in 1986/87.

The gap for the development budget is far more severe. The actual budget in 1986/87 (in nominal terms) dropped 60 percent below budgeted levels in 1985/86. It is projected to drop more than 50 percent further in 1987/88. As a result of declining routine and development budgets, the Ministry of Finance, until now a leader in economic reform, has no funding to conduct the research and perform the analyses necessary for continuing the reform momentum, promoting open and free markets, expanding financial services to rural areas and mobilizing the resources required for new investment, including investment in agribusiness and agro processing.

Under this program, efforts will be made to increase the baseline budgets for a number of offices within the Ministry of Finance by a total of $6.5 million over the two years. Offices affected by the program will include:

- The Directorate General of Monetary Affairs. The Office is responsible for all domestic financial institutions including banks, insurance and pensions, leasing, and non-bank financial institutions. As such it will be responsible for implementing any new legislation in insurance, pensions, banking and capital markets development. Its development budget has declined 67 percent and 48 percent in the last two years and its overall budget declines have averaged 11 percent.

- The Office of the Secretary General. The Office is responsible for the administration of all government finance responsibilities, including planning and manpower development, and payment of civil servants (the vast majority of salaried employees in or serving rural areas are civil servants — teachers, agriculture or health extension workers, government administrators). Its development budget has declined 96 percent and 32 percent in the last two years and its overall budget declines have averaged 55 percent.

- The Directorate General of Education and Training. This Office is responsible for the administration of all Finance Department training, including that related to the implementation of the new policy reforms in pension, insurance, banking and capital markets development and for finance officials serving rural areas. Its routine and development budgets have been cut 53 percent and 67 percent, respectively, in the last year. Its overall budget suffered a 56 percent decline.

3. <u>Procedures</u>

To maintain flexibility and maximize effectiveness for AID resources, it is proposed that the GOI submit a letter to AID outlining its requirements each year as a condition precedent to disbursement. These priorities are not expected to deviate significantly from the estimates made above, but in the event of a major change in oil prices between the time the PAAD is completed and the letter of request is submitted, the impact of any changes should be considered before disbursement is made. Any other justifiable revision to the above estimates will also be documented in the letter of request.

D. <u>SECTOR POLICY CONSTRAINTS</u>

The program areas selected — agricultural diversification and domestic resource mobilization — offer considerable potential in terms of jobs, rural income, and private sector development. They are also, as noted, in accordance with USAID's CDSS objectives. Further, they are areas: 1) in which USAID has particular experience and expertise; 2) of interest to progressive policy-makers in the GOI; and 3) in which there is continuing debate over policy and in which changes can realistically be expected within a reasonable period of time.

1. Potential Effects

According to IBRD reports, successful agricultural diversification in estate crops alone could provide more than a half million jobs during the next decade. It could produce several billion dollars annually in new export revenues, which is particularly important to Indonesia's balance of payments position. Increased domestic revenues, generated through more efficient financial markets administration, can make a major contribution to diversification by providing funds to private investors. Effective pension and insurance reforms could help promptly mobilize $2-4 billion in long-term funds. And active capital markets could help draw several billion dollars, now parked off-shore, back into Indonesia's economy.

A common thread running through both the diversification and mobilization of domestic resources is the increased role for the private sector. Agricultural diversification means varied and dispersed agro-industry, private seed developers, input supplies and manufacturers, processors and marketers. Financial markets development will only occur with an unleashing of private financial institutions; a greater role for private banks, insurance companies, and pension administrators; and a substantially less restricted capital market. A successful private sector will provide the jobs and incomes required to spur growth.

2. Constraints

Indonesia's past policies have focused on directing and controlling development, including investment, production and marketing by the private sector. This has been particularly so in the area of trade and industry, but is true in agriculture and finance as well. Limited or sole-source import licenses, export restrictions, a variety of licenses to set up and run a business -- 92 in the case of one retailer -- have greatly increased the cost of doing business in Indonesia, discouraging new investment and limiting trade. The GOI has recognized the costs of these policies, as evidenced by the May 6 and October 25, 1986, January 1987, and earlier reform packages.

More reforms are required. In general, policies affecting the role of the private sector in agriculture, unlike trade and industry; have not received attention from the GOI or donors, so changes in this area and in regulations of financial markets will break new ground. Few donors, if any, have the counterpart relationships or long-term involvement at the operational level that USAID has in agriculture or financial markets development. Thus the potential for job creation and improved export revenues, the relevance to USAID's CDSS objectives, and USAID's previous involvement and predominant capability, are among the major considerations which led to this program strategy. GOI interest and the potential for change, the relative newness of policy analysis (in the case of agriculture) or implementation (finance), and the potential to use the private sector to increase employment and incomes were equally important factors leading to the concentration on agricultural diversification and domestic resource mobilization.

The following sections briefly outline the constraints on growth within the agriculture and finance sectors, particularly those affecting the ability of the private sector to play a more active role, and where we expect to focus the program.

a. Agriculture

1) Background

Agriculture is at the heart of Indonesia's economy. It contributes 25 percent of GDP, employs 60 percent of the population, and provides more than 60 percent of the value of non-oil export revenues. Historically, it has been a major source of growth. Since 1969, the agriculture sector has grown at an average rate above 4 percent — in 1984 it grew at 6 percent.

Until recently, the drive toward rice self-sufficiency has dominated agriculture development. As the country's staple food crop, rice accounts for two-fifths of gross agriculture output, land use and employment. A concerted effort by the government to improve rice production has resulted in an average increase of more than 5 percent annually for almost 20 years — 8.5 percent from 1977-81 — and the achievement of rice self-sufficiency in 1984.

Success in rice did not come easily. During the early years, a variety of policy tools was used to encourage farmers to adopt the new technologies being developed as the green revolution unfolded. Major emphasis was placed on assuring that inputs — information, credit, fertilizers, irrigation water, and seed — were available to farmers through a variety of focused and highly subsidized production intensification programs (BIMAS and INMAS). The government developed a network of 19,000 extension workers, supported by banks, cooperatives and warehouses, to supply agriculture inputs. Fertilizer and pesticide use increased more than tenfold, and high yielding varieties spread to cover 70 percent of Indonesia's paddy fields.

The success of the rice program has brought new challenges. As annual per capita consumption has climbed from 99 kg in 1969 to (estimated) 137 kg in 1988, Indonesia has approached the limits of domestic demand. Meanwhile, international demand for Indonesian rice is likely to be small and exporting an unattractive option. Increases in production are likely to be more expensive as well, requiring higher cost investments in irrigation and agriculture inputs. Indonesia is reaching the point of diminishing returns on rice. Rice production in 1987 is expected to be 1.2 percent lower than in 1986 in part because of flooding and brown plant hoppers, but also because of lower farmgate prices, which dropped 10 percent in 1987. Moreover, given that major rice growing areas are producing at intensive levels (two to 2.5 crops per year), little increase in income from additional production is expected. Reliable data on employment are not yet available, but preliminary studies confirm that the enormous labor intensities of rice production have been important for agricultural employment in the past. With limited prospects for increases in rice production in the future, accelerating the diversification of agriculture and encouraging agro processing are imperative for maintaining or increasing rural employment and incomes.

To meet income and employment objectives and food consumption requirements, policy makers need a strategy that maximizes efficiency in rice production while exploiting the diversity of Indonesia's agricultural growth potential. A variety of non-rice commodities already contribute to growth in the sector. Foodcrops such as corn, cassava, grain, legumes and groundnuts constitute about 20 percent of agriculture output, and have increased by an average of 3.8 percent annually since 1969. Rubber, cane sugar, palm oil, spices, coconuts, coffee and tea, while producing another 15 percent of agriculture output, grew at 4.5 percent annually and provided one-fifth of non-oil export earnings. Fish and fish products represent 10 percent of the sector's output, and have grown by more than 4 percent per annum. Dairy and livestock, another 10 percent of the sector, have been increasing by almost 8 percent annually. The potential for increased demand for non-rice commodities and the positive impact on incomes is evident. Increased urban and rural incomes generated in the late 70s and early 80s have led to significant increases in the direct demand for livestock products and, consequently, growth in derived demand for major livestock feed ingredients. Consumers are demanding more processed foods such as cassava as snacks, starch in cakes and biscuits, and peanuts for sauces and snacks. An analysis conducted by the Directorate of Food Crops Economics in the Ministry of Agriculture has recently demonstrated the dynamic nature of secondary food crop demand and its potential contribution to increased production. The analysis suggests that a 10 percent increase in disposable income will result in only a 2.4 percent increase in the demand for rice, but a 3.5 percent increase in the demand for maize and cassava, 6 percent for sugar, and 12 and 16 percent for peanuts and mung beans. Since Indonesia is currently importing a number of these commodities - maize, peanuts and sugar - increased demand could translate into rising domestic production of both raw commodities and processed foodstuffs. This would positively influence farm incomes.

The increased demand also opens opportunities for agro-processing and employment. Unlike rice, secondary food crops undergo considerable processing prior to consumption. Cassava is converted into snacks and animal feed, and maize into an animal feed base. Industries which produce many of these products are small-scale, labor-intensive, and often clustered in dispersed areas throughout rural Indonesia. They have strong backward and forward linkages with other sectors, and employment multipliers are high. For instance, an input-output analysis produced by the United Nations suggests that for every $1 million increase in final demand for selected food products, excluding rice, edible oils, soybeans and cassava products, 8,269 person-years of predominantly rural-based employment would be generated.

Diversification into non-food commodities such as tree crops and fisheries would create employment opportunities and export revenues as well. Rubber, coffee, spices, and shrimp are already important export earners. The IBRD estimates that, assuming favorable policies, rubber exports could grow 4.7 percent annually between now and 1995, increasing revenues from $644 million in 1988 to $1.6 billion and directly producing 100,000 new jobs. Moreover, coffee could double to $1.3 billion, producing 50,000 new jobs; and shrimp could grow from $193 million to $553 million, adding 50,000 jobs. Incomes generated by these workers would have a powerful multiplier effect, creating new jobs in the trade, transportation and domestic consumer goods sectors. Jobs created indirectly would at least be equal to those generated directly. Effective agricultural diversification for export alone, therefore, could produce more than a half million new jobs by 1995.

The constraints inhibiting diversification can be divided into those directly related to macroeconomic policy and those that are more institutional in nature.

2) Macroeconomic Policy Constraints

Pricing: A major area for policy monitoring and adjustments is government pricing. Pricing programs, subsidies for agricultural inputs, and floor and ceiling prices for production have all played an important role in the GOI's drive for rice self-sufficiency. But subsidies drain limited government resources. In 1986/87, subsidies for fertilizer, pesticides, irrigation and credit were Rp. 1.2 trillion (US$ 700 million) -- 8 percent of Indonesia's total development expenditures and 56 percent of development expenditures for agriculture.

The GOI is aware of the high cost of subsidies and has begun to take action. Because of the serious drain on revenues, the government reduced the fertilizer subsidy by 70 percent from Rp. 671 billion in the 1986/87 budget to Rp. 204 billion in the subsequent year. The government's floor price for purchasing rice has increased steadily each year since the early 1970s, pausing only in 1985-87, but increasing again this year. The GOI continues to review these costs. Despite their positive actions and concern, there are other pricing and subsidy policies that require attenti

- The subsidy on pesticides is approaching US$100 million per ye Wide availability and low cost of insecticides for all crops encourages their overuse by farmers. An FAO study in late 1986 indicated that application rates were as much as five times the recommended level in many rice growing areas of Java. The resulting ecological imbalance was a major cause of serious insect resurgence this past year. Long-term human health hazards from pesticide residue are well documented. The pesticide subsidy needs immediate review.

- On May 6, 1986, the Government of Indonesia announced sweeping reforms in its import policies designed to provide internationally priced inputs to exporters. The program allows "producer-exporters," defined as those who export at least 85 percent of their total production, the option of importing inputs free of restrictions and exempt from import duties. The significance of this reform goes beyond allowing imports to be brought in duty-free; it also allows "producer-exporters" to bypass a system of government approved traders. Although this "producer-exporter" status has been granted on US$288 million worth of imports during the first four months following announcement of the reform, agricultural imports have not been affected.

- Most agricultural imports continue to be brought in only by Bulog (the state logistics agency), and distributed at domestic, not international prices. This pricing policy significantly restricts the growth of agricultural processing industries. Sugar, a critical input in fruit processing and canning, is currently purchased by Bulog for

$0.09 per pound and sold at $0.17 to canneries. The high costs of sugar and tinplate for cans severely limit the involvement of canneries in export production.

- Similar pricing policies affect exports of livestock products. Soybean cake, a key input in hog production for Singapore markets, continues to be imported at international prices but sold to feed mills by Bulog at domestic prices which are double international levels. The higher costs of hog production limit demand and restrict Indonesia's share of the Singapore market.

- Implementing price policies for secondary crops is far more difficult than for rice. Wide dispersion of secondary crop production makes procurement expensive, storage more complex, and processing is often required. Policy decisions will have a major impact on the effectiveness of any diversification strategy, and much more analysis is required of the government's pricing policies for non-rice crops and subsidies for inputs used for these commodities.

Trade Constraints: Trade constraints affecting agricultural diversification fall into four categories: 1) those affecting the import of commodities and agriculture inputs — chemicals for fertilizer, for example, or fishmeal for feed; 2) those affecting equipment or materials used in agriculture processing; 3) those affecting export; 4) and those affecting internal trade.

On the import side, only Indonesian nationals with a license from the Ministry of Trade, often state-owned companies, may import. The lack of competition among importers, most of whom are granted sole source or restricted licenses, provides opportunities for price distortions which adversely affect the potential for export of processed agriculture products. This can clearly be seen in the case of packaging materials. High import costs for paper and cardboard seriously restrict the price competitiveness of agriculture products packed in paper such as tetrapaks. For some products like spices, marketing boards control prices and limit contacts between foreign buyers and domestic producers. Export quotas also affect some agriculture products. For example, rice, sugar, fertilizers, pepper and palm oil are controlled by export restrictions.

Domestic marketing of certain products, such as cloves, is carefully regulated. All clove producers are required to sell through cooperatives. For the trade of products throughout the marketing chain, there are a range of formal and informal permits, passage fees, weight bridge fees and levies imposed on the movement of goods. In South Sulawesi, for example, a recent study found that permits and passage fees comprise 46 percent of overland shipping costs. High transport costs fragment markets and seriously restrict Indonesia's competitiveness in world markets. Transport monopolies for interisland shipping, restricted licenses for the construction of vessels, and government freight rates also add to the high costs of transport. These formal and informal licensing practices and systems of tariff seriously hamper the domestic trade and export of high-value commodities such as shrimp and coffee.

<u>Increased Role for Private Business:</u> The government's control of agricultural development over the past twenty years has limited the role for private investors in agribusiness, production, processing and marketing. At independence, the Indonesian government took over control and operation of large public and private estates growing tree and industrial crops. Over the years, public ownership of estates, both large and nucleus, has increased substantially. At the same time, the government has played a dominant role in production and marketing of agriculture inputs, seed testing and sales, fertilizer production and pesticide imports.

More recently, declining government reso ave encouraged the GOI t look for ways of increasing private investment in agriculture, particularly in nucleus estate development. The government has taken positive steps to provide incentives to private business and has begun to actively explore greater private sector participation in a range of activities from fertilizer production to fisheries.

Privatization of existing public enterprises is a sensitive area, however, and progress will be slow. There is quiet but determined movement underway to develop mechanisms and guidelines that will allow private entrepreneurs to invest in production estates and associated processing facilities. Certainly there is great potential for private sector investment in the production of the agricultural chemicals and other inputs, and new technologies for production and processing, handling and marketing. But to attract investment to these areas several constraints must be overcome.

The GOI's policies affecting industrial development have focused on import substitution, meeting domestic demand through the establishment of new industries with a high degree of protection. Licenses have been limited, and for foreign investors interested in certain areas of production, they have been impossible to obtain. The result has been the development of inefficienciest which seriously hamper the potential competitiveness of downstream producers.

Recognition by government officials of the importance of improving industrial policy to attract new investment, domestic as well as foreign, is reflected in the recent policy packages announced in May and October 1986 and in January 1987 (described earlier). Further changes are anticipated, and an important next step will be to examine and act on the potential for deregulation of agribusiness with reforms similar to those already announced for manufacturing.

The State Planning Board's request for USAID assistance in analyzing trade and industrial policy under the Development Studies Project demonstrates both the government's interest in reform and recognition that developing appropriate strategies in these areas will take time.

3) Institutional Reform Policies

An effective diversification program will also require improving the performance of the Ministry of Agriculture and its programs. The policy changes outlined in the last section can only come about with effective analysis, planning and management of personnel and financial resources.

Successful implementation of diversification will depend in part on revamped research and extension services, and better policy and program analysis in the Ministry of Agriculture.

Agricultural Research Realignment: Realignment of research priorities is needed if diversification is to occur.

The Agency for Agricultural Research and Development (AARD) has built its organization according to commodity groupings. The Agency is composed of departmental units designed for specific commodity groups--industrial crops, estate crops, food crops and fisheries. The food crops research department, in turn, is further split up by commodity mandates for specific crops and climatic zones--rice for lowland areas, upland rice for dry regions, upland rice for wet regions, and so forth. Non-rice food crops (palawija, or secondary food crops) are grouped collectively by climatic zone.

While this approach proved to be remarkably successful for rice, it is now outmoded, and prevents AARD from responding to agricultural research needs under more diversified conditions. It is oriented toward mono-cropping rather than region-specific farming systems problems. It tends to be production oriented, without consideration for quality of the crop or the implications for incomes of farmers who increasingly rely on multi-cropping as a means to expand profits and reduce risk. It tends to put scientists in competition with one another for limited funds, rather than promote multidisciplinary research. It tends to promote single commodity technologies for the extension service which, in turn, is then unable to effectively relate the mono-crop technology from research to the realities of multi-crop systems in the farmers' fields. Thus, AARD's method of research programming should be reviewed.

The time is right for such a review to take place. AARD has made remarkable progress in developing a sound research infrastructure and training scientific staff over the last 20 years. By 1990, AARD will have completed the development of its physical infrastructure, including 23 regional institutes conducting research at almost 200 stations, sub-stations, experimental sites and farmers' fields in 22 of the nation's 27 provinces. More than 100 PhD and 300 MSc holders are now in place, and the professional staff is projected to grow to 1100 post-graduate research scientists by 1990.

This rapid growth in facilities and staff, however, has not been matched by changes in administrative structure and functions. The Agency still operates with the same management information system as it did when it had seven regional institutes and a tenth of its professional staff. Twenty-three individual institute directors report directly to the Director General of the Agency. This fragmentation of overall direction and unwieldy span of control have obstructed the Agency's well trained professional staff in their pursuit of clearly defined research priorities, even under the current commodity mandate focus.

The issue of research priorities is under review by the Agency. A recent report recommends major re-definition of the national research agenda and restructuring to improve coordination of priority research, including monitoring and evaluation. Acceptance and implementation of these recommendations will require substantial negotiations within the Ministry of Agriculture.

Agriculture and Policy Analysis: A major constraint to the development of a coherent program for diversification is the lack of a strong planning capacity within the Ministry of Agriculture. The breadth and diversity of Indonesia's agriculture sector have complicated planning, policy and administration. While other sectoral ministries are usually limited to one directorate for commodity coverage, Agriculture has four (Food Crops, Estate Crops, Livestock and Fisheries) and previously had a fifth (Forestry). Moreover, the Ministry has an extremely diverse set of clients -- the farmers and fishermen of Indonesia, some 35 million households spread out over 13,000 islands.

Coordination, management, policy and administration are exceedingly difficult. Resources are lacking. The central administrative computer capacity, micro-computers, and the policy analysis capability have historically resided in AARD, but analytical capacity is also required elsewhere. However, no single component of the Ministry has been given the mandate to develop a central analytical role and policy coordinating function. The result is that until very recently, the Ministry of Agriculture simply has not been an assertive actor in policy debates related to food crop prices, subsidies or diversification.

This situation can change, and the Ministry of Agriculture has shown a willingness to examine alternative approaches. These include: drawing together analytical and planning capabilities into one unit, reorganizing along functional lines, and creating a directorate for policy and planning separate from the Secretary General's office. Until these actions are taken, however, it is unlikely that the Ministry of Agriculture's role in formulating a diversification policy and a plan to carry it out can be fully realized.

b. Resource Mobilization and Distribution

The mobilization of domestic resources through more efficient financial markets is critical to provide the investment capital to spur growth, create jobs and raise incomes in rural Indonesia. Effective rural banking institutions can raise several billions of dollars in savings. An effective capital market could immediately channel an estimated \$2-4 billion in pension and insurance assets into long-term investments such as agro-processing or other agribusiness areas. It could also help attract to Indonesia as much as \$10 billion now parked off-shore in time deposits. Developing financial markets to the level of Thailand and the Philippines could add \$15 billion to the money supply in circulation -- in currency, demand and time deposits.

Past government policy on rural-financial services, and financial and capital markets development has been restrictive in an effort to control and direct funds to priority areas, to minimize risk and to avoid the rash of bank failures that swept the countryside in the early 1960s. The result has been to constrain the development of financial institutions and stifle the capital market. AID's strategy has been to support change through project activity, to demonstrate the potential for self-sustaining banking operations in rural areas, and to work with Bank Indonesia on bank supervision and strategic planning. The proposed program builds on these efforts to focus attention on the policy changes required to realize their potential.

1) Improved Efficiency of Financial Markets

A major constraint to effective and efficient resource allocation, and one with particular impact on rural incomes and employment, is the inadequacy of Indonesia's financial systems and policies. Economic growth depends on the ability to raise and move capital. The government's ability to raise capital, at least in the short-term, has been hurt by the drop in oil prices, while the ability of the private sector to raise and use capital is inhibited by an underdeveloped financial sector.

Background: Indonesia's financial sector is dominated by banks. Bank Indonesia, the central bank, controls more than 40 percent of gross assets and, together with the five state banks, nearly 75 percent of total gross financial assets. Private banks, both foreign and local, control just over five percent of banking assets, and non-bank financial institutions, while growing in importance, represent about three percent of total assets. Other institutions including insurance, leasing, rural and savings banks make up the remainder. The stock market, launched in 1977, remains dormant. Twenty-four companies are listed on the exchange, but in 1986 fewer than 1.5 million shares worth $1.1 million were traded. A bond market opened in 1983, but to date, only three entities, all state-owned, have issued bonds. A commodity market was opened in 1984 and does minimal trading in palm oil, rubber and coffee futures.

The potential for enlarging the financial sector remains great. The ratio of money to gross domestic product is low, 16 percent in Indonesia compared to 40 and 53 percent for India and Malaysia, respectively. World Bank surveys show a formal savings growth rate between 1974 and 1980 of only one half of GNP growth. The lack of formal savings is particularly apparent in the household and informal business sector. The World Bank estimates that formal household financial assets are less than 3 percent of GDP. Studies report that households in Indonesia are saving 20 percent of their income on average, with households in the upper quartile saving as much as 40 percent, a level similar to other rural areas in Asia. Most of these savings are held in the form of property, gold, rice or other non-liquid assets. This is particularly true in rural areas where formal, secure financial institutions are scarce. A more effective financial system would be able to mobilize these savings and direct them to productive use.

At the village level, the need for "intermediation" — to accept assets from those with the ability to save and make them available to those with the ability to use them productively — is particularly acute. Formal banking institutions in Indonesia are highly centralized. State banks operate approximately 140 branches each, but most are in provincial capitals or in major population centers at the district level. Foreign commercial banks are legally restricted to Jakarta and few of the 70 private national commercial banks extend branches beyond major cities.

USAID is working with the GOI on the development of rural banking systems in four provinces and on a nation-wide system of 2500 rural branches operated by Bank Rakyat Indonesia. These successful efforts only begin to meet the demand for financial services in rural Indonesia.

Reforms: The government anticipated the need for an expanded and more efficient financial system in 1983 with a series of banking reforms which permitted the state banks to set interest rates according to demand, lifted ceilings on credit and reduced subsidies on loans from the central bank. Subsequent reforms allowed expanded activity by foreign banks in support of export development.

The government also recognized the potential for mobilization of savings in rural areas. In 1985, it began an experiment to allow Bank Rakyat Indonesia to establish a nationwide savings program. USAID has supported these efforts first through its Financial Institutions Development (FID) Project with provincial development banks and later through an amendment to FID to provide assistance to Bank Rakyat Indonesia. The results to date have been encouraging, with savings increasing up three-fold in the first two years of operation.

Potential: Despite this progress, however, there remains a serious imbalance in the Indonesian financial sector. The great majority of capital is in short-term time deposits in the modern urban sector. Very little is available for long-term investment. That which is available comes primarily from the state banks and goes primarily to state-owned corporations. The government recognizes the need to develop financial vehicles that encourage longer maturities and allow for increased availability of investment capital to private entrepreneurs. It is taking steps to reduce borrowings by state-owned enterprises and has begun to explore avenues to increase investment capital.

A major potential source of investment capital is found in the insurance and pension industry. Indonesia now has 65 insurance companies with assets of nearly $1 billion. It has more than 10 million workers covered by $4 billion in pension assets. Most of this money is now kept in time deposits, some of it off-shore in Singapore and Hong Kong. Channeling these funds into productive investment will require the development of a more active capital market and administrative and legal systems to facilitate investment while protecting individual participants in the programs. The Ministry of Finance has begun work on these systems.

USAID's Involvement: USAID's interest in the development of the financial sector grows directly out of past work under the Provincial Development Project and Financial Institutions Development Project on rural financial institutions development. This work has been complemented by efforts during the past two years to help review pension regulations and procedures, to examine possible changes which encourage capital markets growth, and to assist Bank Indonesia in bank supervision, accounting, automation and strategic planning. USAID efforts, both under FID and the Private Sector Projects, as well as special consultancies financed by the Private Enterprise Bureau, have provided an opportunity for regular participation and sustained discussions with key institutions, private as well as public, active in financial sector development. The policy program will provide a means of capitalizing on these efforts to focus GOI attention on areas of financial markets development with direct impact on rural incomes and employment.

E. INSTITUTIONAL ANALYSIS

1. Agricultural Diversification

The Ministry of Agriculture has a large pool of talent in the key areas of planning, research and extension. For example, the Ministry has more than 32,000 well-trained extension agents, nearly 800 PhD and Masters degree scientists working in the research agency alone, and 15 PhD agriculture economists throughout its organization. Although individuals are in place, the Ministry's effective utilization of this manpower remains in question. Shortfalls in the budget are clearly a major constraint. More important, the existing organizational structure seriously limits the ability of the Ministry to plan and carry out a diversification strategy.

How the Ministry should be organized to meet the challenge arising from its past success with rice is the subject of considerable debate. The Ministry is still dominated by officials who led the drive for rice self-sufficiency during the last 20 years, and who are concerned about maintaining rice levels. They continue to favor intensification programs targetted toward rice production. A number of senior economists and scientists from this group also recognize the need for diversification, but favor extending intensification approaches and production targets aimed at self-sufficiency in secondary food crops.

Increasingly, however, a growing number of Ministry officials, led by PhD and Masters degree holders in the biological sciences and economics, supported by planners in the Ministry of Finance and the State Planning Agency, are arguing for diversification strategies which emphasize farming systems and focus on farmer income and employment, not production targets. This group is interested in analyzing marketing issues, the role of factor prices, and the implications of subsidy levels and trade policy — issues which affect production and incomes, but which are beyond the normal purview of the Ministry. These people are well-respected, well placed in key positions at the senior and mid-management levels of the Ministry, and experienced in using outside consultants. For example, they are currently working with experts from Winrock and Stanford University on major issues relating to pricing and trade. With additional budget support offered by USAID's proposed program, this group will be able to focus greater attention on the diversification and institutional reforms required.

2. Financial Markets Efficiency

The Government of Indonesia has substantial institutional capacity to analyze and formulate policies for more efficient financial markets. Technocrats within the State Planning Agency (Bappenas), the Ministry of Finance and the Central Bank (Bank Indonesia) have repeatedly taken steps during the last five years to improve macro-economic management including reforms designed to facilitate financial markets development. The results of their efforts are seen in the banking reforms of 1983, and the recent reforms of May 6, October 25, 1986 and January 15, 1987. The success is reflected in the tremendous increase in time deposits, the rapid growth in savings by rural banks, the establishment of a leasing industry and the first steps toward a secondary money market.

The reforms also reflect the willingness and ability of the GOI, particularly the Ministry of Finance, to draw upon the expertise of outside consultants. Where necessary, the Ministry of Finance has contracted technical expertise directly and has included recommendations from advisors in their own deliberations. AID is providing technical assistance to rural financial institutions development, in pensions and capital markets development, and to Bank Indonesia on technical issues ranging from accounting and automation to strategic planning.

USAID expects to continue to provide such assistance on a project basis. The Mission is currently contracting for a technical team to work with Bappenas on trade and industrial issues and has just received a request for an advisor on capital markets development for the Ministry of Finance.

Nevertheless, those supporting reforms face considerable resistance, in both the formulation and implementation of new policies. The program will provide support for their efforts by focusing attention on key policy areas and through targeted budget support. Given the effectiveness of GOI financial agencies to accomplish appropriate policy reform in the past and their close collaboration with USAID through a variety of projects, the institutional base for the proposed financial markets policy support agenda appears sufficiently sound to carry out the objectives of this component of the program.

F. PROGRAM IMPACT

1. Policy Impact

The program is designed to support GOI efforts to effect policy changes in key areas relating to rural incomes and employment. As pointed out earlier, Indonesia has been engaged in macro-economic reform for some time. The program will focus attention on specific reforms. It will help assure funding levels required for effective implementation. In so doing, it will speed the process that the GOI has already begun and help provide the momentum required to resist short-term political and budgetary pressures that could hinder the achievement of long-term objectives.

The potential policy impact is apparent in the area of agricultural diversification. The potential impact of appropriate policies encouraging agricultural diversification have already been cited: the IBRD predicts more than a half million jobs and several billion dollars annually in foreign exchange revenues by 1995 from export crops alone. The structure of the institutional development taking place in agriculture, however, and the policies promulgated thus far have focused primarily on rice. The proposed program raises issues affecting diversification to a higher level. It provides a mechanism for review and analysis of cross cutting issues — targetted production programs versus those favoring comparative advantage, transportation costs, restrictive licensing, constraints on investment, extension and research priorities — and provides resources as an incentive to push forward with appropriate reforms.

In the area of resource mobilization, the government is considering policy changes to improve the efficiency of financial markets. Since the Mission began discussions with the GOI about this, efforts have been made to accelerate the drafting of legislation. This paper has already discussed what gains in this area could mean in terms of resources mobilized. Effective savings mobilization programs in rural areas could make several billions of dollars available for lending to small enterprises, trade and agribusiness. Insurance and pensions alone represent an immediate source of $2-4 billion in long-term funding for productive investment.

USAID has already played a role in this sector by conducting studies on alternative approaches to pension administration, constraints on capital markets development, bank supervision and secondary market development. It is difficult to measure accurately the impact these efforts have had on past policy deliberations or to calculate the future impact of the proposed program on rural incomes and employment. The causal relationship between policy reform and production increases, and jobs created or growth in wealth is not direct, but filtered by a variety of intervening factors. However, the changes outlined by the milestones and the objectives sought in the agreed-upon policy agenda will create conditions conducive to growth; they suggest structural changes supportive of more effective systems and better use of resources and thus contribute to development.

The benchmarks for ARSSP's policy agenda provide a basis for periodically assessing implementation and for evaluating the overall progress or success of the program. Rather than trying to estimate which benchmarks should be reached by a specific point in time, a more practical approach is to establish a general framework for ground rules for defining the adequacy of program performance or success.

The benchmarks for the financial markets and agriculture reforms can be categorized as a) reforms which constitute direct interventions into existing systems, and b) institutional reforms. It is unrealistic to expect significant progress on all policy items supported by ARSSP. But of the two categories of reform measures, those which involve direct intervention in existing systems are likely to produce a more rapid and significiant effect when enacted. This category includes the priority items for the financial markets and agriculture agenda. Progress toward enacting these reforms will largely determine program success.

It should also be noted that what constitutes adequate progress is highly contingent on the context or situation in which the program is operating. A deterioration of conditions during the course of ARSSP shoul be taken into consideration in any assessment of the program.

2. Budget Impact

Budget support provides USAID an opportunity to use relatively modest funds to encourage the GOI to reexamine budget priorities, and to elicit commitment for funding at levels high enough to affect programs critical to an effective income and employment strategy.

The needs for agriculture and finance are clear. Within the Ministry of Agriculture, the Secretary General lacks the funds which would allow a thoughtful responsive to the changing environment, specifically, the need for diversification of the agriculture sector. Research staff are falling behind on the development and testing of new varieties, and extension agents are unable to provide the training and technology packages that would stimulate proper management of inputs and cropping systems.

USAID funds will encourage the Ministry of Agriculture to review its programs, goals and priorities. It will help mobilize funding levels sufficient to carry out the new five-year plan and for programs with the goal of increasing incomes based on market driven demand for more diverse food commodities, rather than specific production targets. Larger budgets for research and extension will enable the Ministry to take advantage of the substantial investment already made in institutions and staff.

Routine and budget development assistance for the Ministry of Finance will bring levels back to the minimum required for banking and pension reforms being pursued by the Ministry.

G. IMPLEMENTATION REQUIREMENTS

1. Flexibility in ARSSP Implementation

Considerable flexibility will be necessary for effective implementation and management of ARSSP. Past experience with policy reform indicates that the process does not proceed in a smooth, steady progression. Rather, periods of apparent minimal activity, such as when proposals are being reviewed and negotiated, can be followed by comparatively swift action leading to enactment. Various factors impede or facilitate the process, such as changes in economic conditions or the appointment of individuals, who are highly supportive of the reform agenda, to key positions. This makes predicting the actual pace of implementation and the timing of when specific benchmarks will be reached more a matter of speculation than sound planning. On the other hand, a mechanism is needed to assure that the program moves ahead. Therefore, the GOI and AID will develop a memorandum of understanding or PIL which specifies a realistic schedule for reaching benchmarks for policy agenda items.

Flexibility will also be necessary in regard to the actual content of the program. Though ARSSP's policy agenda and priorities have been discussed with and approved by the GOI, this agenda should be viewed as only a starting point. As the need arises, the program will support policy-related studies and analyses in areas that have not been carefully analyzed before. Findings and recommendations from these studies may suggest modifications to the program. Once the program is underway, reforms in one area may also spur interest in related areas not initially part of ARSSP's agenda. Finally, the overall context in which ARSSP will operate may change during implementation, requiring adjustments to the program's policy agenda. In short, flexibility in ARSSP implementation will allow the program to adjust to changes in the policy environment and to maximize the utility of study findings as they become available.

2. Program Management

Because ARSSP incorporates two important components of the Mission's portfolio - agriculture and financial markets development - the policy reform program will require management by the Mission at two operational levels. Overall coordination of ARSSP will be provided by the Project and Program Support Office and by the Director's Office. The appropriate technical offices will have primary responsibility for the implementation of their respective reform agendas.

The management requirements for the financial markets and agriculture reform components of ARSSP differ. Work on reforms concerning the pension, insurance and banking industries has progressed farther toward enactment than the agriculture reforms, making the latter more management and staff intensive.

The agriculture component will be managed by the Mission's Agriculture and Rural Development Office, and in particular, ARD's senior agricultural economist. The agriculture reform agenda will entail significant management requirements, particularly at the outset of the program. Therefore, a senior policy advisor will be necessary to serve as the agriculture ARSSP manager. This individual will be funded from the technical assistance fund, either through the Joint Career Corps (JCC) mechanism or by direct contract. The program manager's responsibility will be to assist in the development of policy options and implementation strategies, monitor progress toward reform agenda benchmarks, identify the need for specialized short-term technical assistance, plan and supervise policy related studies and analyses, and serve as a liaison between the GOI and the Mission concerning on-going policy dialogue. This will require that the work schedule of the program manager be divided between the GOI — specifically Bappenas — and the ARD Office. To cope with the initial start up demands of the program, the Mission will use IQCs and/or a buy-in to the S&T/AGR Agriculture Policy Analysis Project to obtain support services until a long-term advisor is on-board.

The financial markets component will be handled by the Employment and Enterprise Development Office assisted by the Mission economist. Additional management support will be provided by a) a financial markets advisor currently on a personal services contract jointly funded by AID/Washington's PRE Bureau and the Mission, and b) a capital markets advisor from the Private Sector Project. Additional support might be available from the Harvard Institute for International Development (HIID) which is assisting the MOF (not AID funded). As the need for highly specialized, short-term assistance arises, the Mission will draw on the $1.5 million set aside specifically for this purpose.

V. PROGRAM FUNDING REQUIREMENTS AND FINANCIAL PLAN

A. COST SUMMARY

The table below summarizes the proposed GOI departments to be targetted in the budget support program. Estimates are provided for AID and GOI funds required to bring 1987/88 and 1988/89 GOI budget levels to more viable levels for the targeted departments.

iculture and Rural Sector Support Program
ary Budget Support Plan and Cost Estimates
(U.S.$000)

	AID GRANT	GOI CONTRIBUTION (PL 480 Title I)	TOTAL
I. Budget Support			
A. Ministry of Agriculture			
1. Secretary General	4,000	2,000	6,000
2. Directorate of Food Crops	10,500	4,500	15,000
3. Agency for Agriculture Research & Development	22,000	10,000	32,000
4. Agency for Agricultural Edu. Training & Ext.	-	1,000	1,000
B. Ministry of Finance			
1. Secretary General	1,000	-	1,000
2. Directorate General of Monetary Affairs	3,500	1,500	5,000
3. Dir. Gen. of Education and Training	500	-	500
II. Technical Assistance and Support	1,500	-	1,500
TOTAL	43,000	19,000	62,000

B. FINANCIAL PLAN

Approximately \$60.5 million of this \$62.0 million program will be used to provide additional local currency resources to the Ministry of Agriculture (\$54.0 million planned) and Ministry of Finance (\$6.5 million planned) during Indonesian Fiscal Years (IFY) 1987/88 through 1989/90. These amounts will be further programmed so that specified departments benefit: for MOA, the Secretary General's office, the Directorate of Food Crops, and the Agency for Agricultural Education Training and Extension will increase their budgets by approximately $22.0 million and the Agency for Agricultural Research and Development by $32.0 million over baseline budgets for the two year period. The MOF is expected to increase the budgets for the Office of the Secretary General (approximately $1 million), the Directorate General of Monetary Affairs (approximately $5 million), and the Directorate General of Education and Training (approximately $.5 million) to reach the $6.5 million total. The remaining $1.5 million under this program is reserved for technical assistance and related requirements for managing the program.

Since it is possible that conditions precedent (CPs) for disbursement will not be met until the third quarter of IFY 87/88 (IFY runs from April to March), most resources will probably flow during IFY 88/89 and 89/90 and bring budget availabilities for targeted departments in that year (in nominal terms) more in line with what was expended in IFY 85/86. The baseline to determine additionality for 1987/88 is $23.8 million for the specified departments in the MOA and $10.6 million for the MOF. These amounts are already budgeted for FY 87/88, which began in April 1987, and amounts AID provides will be additional to the baseline. Amounts indicated above for each department are tentative and actual amounts will be determined by the budget submitted as a CP to disbursement.

For FY 88/89 and FY 89/90, AID and the GOI will jointly determine the required needs for the MOA and MOF targeted departments and allocate funds from GOI resources and AID budget support accordingly. If additional resources are available, for example, if GOI revenues increase as a result of a rise in oil prices, AID and the GOI will program the AID resources to meet additional budgetary needs within the Agriculture and Rural Development sectors. This determination will be made well in advance of final draft GOI budget submissions for each year. This approach will ensure that the absorptive capacity of the selected departments is not exceeded.

The issue of targetting domestic resource mobilization as directly as possible to Section 103 funding priorities has been addressed in the design of the financial policy agenda and budget support, bringing to bear special attention on the issues of rural finance and investments. In addition D.A. funding for the domestic resource mobilization component has been limited to $5 million. The remainder of the resources will be used to provide budgetary support for the Ministry of Agriculture ($36.5 million) and Technical Assistance ($1.5 million).

To reflect the reality of the current GOI financial situation, no additional GOI resources will be required for budget baselines. However, it should be noted that Title I PL 480 generations are GOI resources, and thus may be considered as an additional GOI contribution to budget baseline levels. (They will also be considered as GOI counterpart contributions.)

It is not required that the assistance under this program finance any specified activities. USAID will accordingly only monitor that funds go to target departmental budgets and that additionality in these key budgets is obtained. However, since the massive budget cutbacks in recent years have resulted in dramatic decreases in the effectiveness of programs funded by these budgets, providing additional resources may be expected to engender new life in the programs.

C. DISBURSEMENTS AND CONTROLS

Concerning disbursement of funds and monitoring and controls, the following system is proposed:

(1) A non-interest bearing separate rupiah account will be set up by the GOI in Bank Indonesia for funds under the program prior to the first advance of funds. Notification of establishment of this account will also include a description as to how funds from this account will be allocated to implementing Ministries.

(2) AID will advance funds for the AID portion of the budget based on a maximum of 90 day rupiah cash needs budget request, with liquidation/replenishment documentation to be submitted monthly so as to maintain a 90 day advance level. Advances/reimbursements are to be in rupiahs purchased by the U.S. Disbursing Officer from authorized commercial sources in Indonesia.

(3) Advances will be liquidated or reduced based on a certified financial report showing approved budget, expenditures for the reporting period, and cumulative expenditures under the program by appropriate Directorate General budget line item. The certified financial report will include the following signed standard AID certification:

The undersigned hereby certifies:

(a) that payment of the sum claimed under the cited agreement is proper and due and that appropriate refund to AID will be made promptly upon request in the event of disallowance of costs not reimbursable under the terms of the agreement;

(b) that information on the fiscal report is correct and such detailed supporting information as AID mav reasonably require will be furnished promptly to AID on request and;

(c) that all requirements called for by the agreement to date of this certification have been met.

By ______________________

Title ______________________

Date ______________

Reported expenditures are to be for payments for contracts and other expenses, not for advances to implementing units.

(4) Since advances are to be based on GOI current estimates of cash requirements, they should be replenished <u>monthly</u> in order to maintain a 90 day advance level. Requests for replenishment of advances may be made by a separate request or may be included as a part of the financial report to liquidate the prior advance or based on a separate request. Request for advances must be reasonable in relation to the nature and duration of activities. Advance levels may be adjusted based on actual usage data.

(5) In addition to the standard AID expenditure certification, financial reports will include a statement that costs financed by AID are i addition to the GOI baseline budget and they are not for costs also being financed by other donors.

(6) Within three (3) months following the end of the Indonesian fiscal year, the Grantee will provide a separate report to AID which shows total funds budgeted and expended by each Directorate General concerned for both the GOI and AID funded portions of the development budget for the prior fiscal year.

(7) Technical assistance under the program will be available to improv financial management as necessary, although based on the Mission's long experience with project implementation in Indonesia, basic systems to ensur financial integrity are quite sound.

(8) Routine monitoring will be carried out by a GOI/AID working committee under the program steering committee and through a specified reporting system and periodic working level meetings to discuss program progress. Evaluations will cover budget support progress as well as policy progress. A discussion of the evaluation process is found in Section VII.

1. <u>Financial Implementation Concerns</u>

There are several factors that influence AID's ability to use this program effectively as an incentive to the GOI to maintain budget levels in selected categories. They include: (a) the point in the budget cycle when USAID is able to engage GOI officials responsible for the budget, (b) the officials with whom USAID is able to deal, (c) whether special mechanisms are required for USAID funds, and (d) the attractiveness of USAID funding. Each of these concerns is discussed below.

a. <u>Timing</u>

The GOI planning budget cycle essentially runs from July to April to provide funds for the following April - March fiscal year. Basic requirements are developed at the local level in July - September and submitted to concerned ministries in October for review. Then a second review, in November, involves the State Planning Agency (Bappenas), the Ministry of Finance, Bank Indonesia, local planning agencies and technical ministry representatives. During these meetings the proposed national budget is developed and sectoral allocations are made. The budget is then presented to the Indonesian House of Representatives in early January and passed back through Finance and Bappenas to the technical ministries for fund allocation. Between January and February, based on these allocations, project proposals are revised as necessary by implementing agencies. Final proposals are then reviewed by Bappenas and the Ministry of Finance. Once reviewed and formally approved by the House of Representatives, usually in March, funds are allocated and implementation begins as early as possible in the new fiscal year.

Significantly, even once budgets are established, actual expenditures against the budgets can be accelerated or slowed in a number of ways to adjust outlays against changes in revenues or priorities.

Administrative approvals and controls accordingly become ways the government can balance the budget and avoid surpluses or deficits. During the years 1980-1986, for example, total budget revenues and expenditures fluctuated between 92 percent and 111 percent of budgeted amounts. It is thus possible to influence expenditures within a fiscal year even after budgets have been approved in final form.

Given the above considerations, the USAID proposed program can potentially affect expenditures for a given fiscal year (1) during the budget preparation process, particularly up to the time when central agencies prepare the budget in November, and (2) during the fiscal year itself by encouraging administrative measures to facilitate expenditures for priority areas of the budget.

b. Counterparts

The major participants in the budget allocation and control process are Bappenas, the Ministry of Finance and the line ministries. These agencies will address budget support planning and implementation concerns. (Note: The overall administrative arrangements for this program are described in the implementation plan, Section VII.)

c. Mechanisms

As noted above, advances of AID funds will utilize a special account to provide a management system to track the use of AID funds within agreed budget categories.

d. Incentive Value

The justification for maximum grant funds for this program rests primarily on the need to provide maximum policy incentive for a minimum amount of funds. AID resources are small compared to other major donors' non-project assistance. AID can partially compensate for the limited size of its assistance by making the quality of financing more attractive -- by providing grant rather than loan funds as an incentive. Another important advantage of grant funds is that they can be disbursed by donors without having to go through the GOI budget allocation process required of ordinary

GOI revenues and donor loans. Thus grant funds carry great flexibility in timing and targeting, an attribute making a sector program a much more effective tool for accomplishing sector objectives.

2. Justification for Local Currency Disbursement Approach

From the above discussion it should be apparent that the program's impact is contingent on quick injections of local currency on highly attractive terms to provide the maximum possible incentive for policy movement and appropriate budget support. Conditions restricting the flow of funds to the budget or otherwise complicating the process reduce the incentive value of the assistance and limit the possibility for meeting the program's objectives.

3. Financial Arrangements for Consultants

The above discussion pertains to the budget support element of the program. The program also provides for a relatively small amount of funds for consultant assistance to support the analysis requirements of the program. Section VII describes these requirements in more detail. Consultants will be obtained through the Joint Career Corps (JCC) mechanism, through IQCs, and/or through personal services contracts with the AID Mission. Such contracts will provide for direct payments to the consultants with funds earmarked for such purposes under the grant.

VI. IMPLEMENTATION ARRANGEMENTS AND PLAN

A. IMPLEMENTATION ARRANGEMENTS

The program will require an administrative mechanism:

(1) to assemble the necessary budget information to justify disbursement levels, monitor accounts, facilitate disbursement and prepare quarterly expenditure reports.

(2) to allow adequate joint review by the GOI and USAID of progress under the program, to permit modifications in the program and draw upon outside technical assistance as required.

(3) to permit senior representatives to determine the program's success and to decide whether subsequent program assistance is appropriate.

Budget Reporting Requirements: Procedures for implementation and administration of foreign loans and grants are clearly laid out in the January 17, 1987 joint decree by the Ministry of Finance and Bappenas. A Bappenas representative acting as project officer for the program could ensure that the steps outlined in the decree are followed; he may be assisted by a USAID counterpart. They may draw upon the Directorate General of the Budget, Bank Indonesia, Director General of Monetary Affairs and budget officials from the technical ministries, as necessary, to prepare and process funding requests and to ensure follow-up documentation is prepared on a timely basis.

Administration: Administration of the program will be carried out by three GOI agencies, Bappenas, the Ministry of Agriculture and the Ministry of Finance. Each of these agencies will designate a representative for project implementation. These representatives, the Vice Chairman for Bappenas, the Secretary General for the Ministry of Agriculture and the Director General for the Ministry of Finance, will meet with the USAID Director at the beginning of the program to approve implementation plans and after 16 months of the program's operations to review progress and to make a determination as to the appropriateness of a follow-on program. They will also be available to meet as necessary during the course of the program to review any major problems that may arise.

Functional Working Groups: As the program proceeds, functional working groups composed of designated representatives from USAID and Bappenas and from the Ministries of Agriculture and Finance will meet periodically to track the program, assess progress and prepare documentation required for its evaluation. These groups will identify any problems in the program, call in technical assistance as required — $1.5 million in technical assistance has been set aside under the program to help address specific issues that may arise—and make any adjustments in the program's benchmarks. Although the intent of the program is clear — to support the GOI's efforts to develop a policy environment conducive to agriculture diversification and efficient domestic resource mobilization—the sector approach is new to USAID. Benchmarks, such as the passage of banking and pension legislation or reduction of subsidies, provide guideposts against which to measure progress. As the program unfolds, there may be other benchmarks that also seem appropriate, or, in some cases, the GOI and USAID may identify obstacles to the achievement of benchmarks which can be overcome through technical assistance or special studies. The role of the functional groups will be to monitor the program, suggest appropriate adjustments and call on technical assistance as needed.

Special Studies and Consultant Assistance: To provide necessary consultant support to the program, as mentioned above, $1,500,000 will be reserved for contracting U.S. and local consultants and funding related needs such as workshops and seminars. Requirements are not expected to exceed 25 person months of short-term assistance, and two long-term JCCs or PSCs. AID is expected to contract directly for TA requirements. It should be noted that while technical assistance is not generally provided under program assistance, the provision of such assistance in this case is appropriate to this sector program as a tool to help analyze policy alternatives and movement. The technical assistance thus directly contributes to the sound implementation and potential impact of the program. It also will assist in determining the program results.

B. IMPLEMENTATION PLAN

August 27, 1987	Program agreement signed with GOI.
September 1 - September 30, 1987	Completion of conditions precedent including letter from GOI indicating policy objectives and budget requirements.

October 1 - October 31, 1987	Review of GOI budget (DIP) requests and AID release of first tranche.
October 31 - December 15, 1987	Program monitoring and preparation of next assistance release request. Long-term TA contracted.
December 15, 1987	Review of progress and agreement on second advance/reimbursement request.
December 15, 1987 - March 15, 1988	Program monitoring and preparation of next assistance release request (as necessary). Preparation for new DIPs for FY88/89, including determination of departmental levels.
March 15, 1988 - May 15, 1988	Monitoring of progress.
May 15 - August 1, 1988	Preparation of new DIPs for FY 89. Major review of progress against the agendas. Meetings between GOI and USAID, review of progress reports, and decision on any new obligations.
November, 1988	Evaluation. PAAD supplement prepared if appropriate and additional funding authorized and obligated.

Early implementation efforts will focus on budget procedures and on discussions of policy targets and milestones. It is expected that necessary monitoring groups will be established by September 30, 1987, assuming general agreement by the end of August on the program approach and requirements. The establishment of the functional working groups described above will allow approval of the policy agenda and budget support components of the program, in conjunction with the execution of the Program Agreement by the end of August. Execution of the Agreement by the end of August may allow advance of funds beginning in October, assuming the GOI submits its first request and necessary supporting data to cover expenditures. These dates appear reasonable if the GOI and AID Mission continue the close collaborative relationship that has occurred on the program to date.

VII. MONITORING, REPORTING AND EVALUATION

A. MONITORING REQUIREMENTS

ARSSP differs from other policy reform programs AID currently supports in two important ways. First, ARSSP only assists the GOI to carry out its on-going policy reform efforts. ARSSP is not initiating this process, but merely supporting and facilitating it. Second, ARSSP is far less directive than other programs. The program is not based on a performance disbursement model - i.e., funds are not tied to host country compliance with specific conditions. Program conditionality would not be acceptable to the GOI, nor is it even necessary given the GOI's demonstrated commitment to making difficult reforms other countries are reluctant to undertake.

The fact that ARSSP neither initiates nor leverages specific policy reforms complicates assessing its progress and contribution to the process. An apt analogy for characterizing the situation in which ARSSP will operate is climbing aboard a moving train with the intention of keeping the train on the track and reaching the right station. In other words, the "moving train" problem for ARSSP is one of additionality - i.e., what additional contribution has ARSSP made to the policy reform process, and would the GOI have made the reforms regardless of whether the program existed or not? Careful monitoring and documentation of the program's implementation will be necessary to try to document this problem.

Initially AID program staff, and later technical advisors will have to establish a program file similar to a standard project file. But in addition to official communication concerning the program, the program file should be used as the repository for documentation of the implementation process, such as significant actions, unanticipated contributions to the GOI's policy reform activities, the GOI's use of study findings and/or suggestions from technical advisors, additions to the GOI's reform agenda, evidence of strengthening the bargaining position of GOI advocates of reform efforts, etc. This type of information will be needed for the program's evaluation. It will provide additional evidence of ARSSP's contribution, or lack of contribution, to GOI policy reform activities.

A second type of program monitoring data concerns macro-economic and sector-specific conditions which could affect the program. This type of monitoring will involve the technical assistance team, the AID program economist and AID technical office staff managing the program. This information will also be important for ARSSP's evaluation in regard to assessing the adequacy of program performance, i.e., has progress been sufficient in light of contextual factors?

Third, budgetary data showing that ARSSP funds were used in accordance with agreements with AID will be reported periodically by the GOI as part of the program disbursement mechanism. These data will also have utility for ARSSP's evaluation regarding ministerial operations and reforms supported through program funding.

B. ARSSP EXTERNAL EVALUATION

An external evaluation of ARSSP will be conducted after approximately sixteen months of program implementation (approximately November 1988). The main objective of the evaluation is to assess program progress as a basis for determining whether additional sector assistance is warranted. This determination will be based on a) whether program performance has been satisfactory, b) whether continued program assistance for policy reform is needed to advance key reform activities further, and c) whether the GOI's economic situation neccesitates a rapid disbursement mode of assistance offered by sector program support.

In general, the evaluation will review the status of ARSSP implementation in light of the benchmarks reached for policy agenda items. This assessment should consider the context in which the program has been operating. This includes economic, political and social factors that have affected ARSSP either negatively or positively.

Based on this assessment, the evaluation will estimate which policy agenda items are likely to be fully achieved by the PACD. The evaluation will discuss the importance of the reforms enacted as well as those not achieved in light of ARSSP's major objectives concerning financial markets and agricultural diversification. Special attention will be given to the program's contribution to establishing the necessary pre-conditions for financial market development and agricultural diversification. To the extent possible, the evaluation will estimate the economic benefits likely to result from the reform actions taken with ARSSP's assistance.

A second major objective of ARSSP is to provide budgetary support to the GOI to maintain activities associated with the policy reform agenda. The evaluation will review budgetary submissions to AID as required by the funding mechanism. It will be important to determine whether the GOI has used these funds for agreed upon purposes and the general utility of the activities supported.

Depending on the pace of implementation, the evaluation will examine the effects of actions taken as of November 1988. As discussed earlier, it is unlikely that significant changes will have occurred in financial markets or the agricultural sector in such a short period of time. However, it is possible that if reforms are enacted early enough in ARSSP, there might be some indication of preliminary effects of the reform measures. Data on pensions, insurance and banking operations will be provided by the MOF. Comparable types of data on agro-processing, exports and rural employment will also be made available to the evaluation team. Though highly tentative in nature, any indications of improvements in these areas should be noted.

Finally, the evaluation will determine whether ARSSP should be amended, and if so, recommend the policy agenda to be supported, the duration of the amendment, and the level of additional funding. The GOI's budgetary situation and projections during the period of the amendment should largely determine funding requirements. If the project is to be amended, recommendations concerning changes in the management of the program and other factors pertaining to improving implementation will be made. In short, if the program is to be extended, the evaluation report should aid in the preparation of an amendment.

To carry out a thorough evaluation as described here, a three person team consisting of an evaluation specialist, a financial markets economist and an agricultural economist will be needed for a minimum of twenty work days. They should have prior experience with policy reform programs, particularly the two economists. The technical assistance component of ARSSP provides funding for the evaluation.

VIII. CONDITIONS PRECEDENT AND COVENANTS

A. CONDITIONS PRECEDENT TO DISBURSEMENT

In addition to standard conditions precedent (CPs) designating authorized representatives and providing legal opinion, the GOI shall present satisfactory evidence to AID as follows:

1. First Disbursement. Prior to the first disbursement under the Grant, or to the issuance by AID of documentation pursuant to which disbursement will be made, the Grantee will, except as the Parties may otherwise agree in writing, furnish to A.I.D. in form and substance satisfactory to A.I.D., a statement of the name of the person holding or acting in the office of the Grantee specified in Section 8.2, and of any additional representatives, together with a specimen signature of each person specified in such statement.

2. Disbursement for Budget Support. Prior to disbursement under the Grant, or to issuance by AID of documentation pursuant to which disbursement will be made for budget support, the Grantee shall, except as AID may otherwise agree in writing, furnish to AID, in form and substance satisfactory to AID:

(a) For IFY 1987/1988

(1) a budget plan for the Ministries of Agriculture and Finance with projected needs per quarter for the remainder of Indonesian Fiscal Year (IFY) 1987/1988.

(2) evidence that a non-interest bearing separate special account (or accounts) has been established in the Bank of Indonesia for grant funds to be used to maintain budget levels.

(3) evidence that the Grantee has established written procedures to manage the program; including establishment of an appropriate management structure for the program, designation of responsible persons representing the Grantee for purposes of requesting funds under the program, and issuance of a system of internal controls adequate to ensure that program funds are expended solely in accordance with the terms of this agreement.

(b) For IFYs 1988/1989 or 1989/1990, budget plans for the Ministries of Agriculture and Finance with projected needs per quarter for the respective IFYs 1988/1989 and 1989/1990.

B. COVENANTS

1. Program Evaluation. The Parties agree to establish an evaluation program as part of the program. Except as the Parties otherwise agree in writing, the program will include, during the implementation of the program and at one or more points thereafter: (a) evaluation of progress toward attainment of the objectives of the Program; (b) identification and evaluation of problem areas or constraints which may inhibit such attainment; (c) assessment of how such information may be used to help overcome such problems; and (d) evaluation, to the degree feasible, of the overall development impact of the Program.

2. Additional Special Covenants. Except as A.I.D. may otherwise agree in writing, the Parties agree to the following additional special covenants:

(a) Periodic Meetings. The Parties agree on the importance of periodic consultations to discuss progress under the Program and agree to meet whenever either Party considers consultation with the other necessary with respect to the Program.

(b) Annual Audit. The grantee shall arrange for the State Audit Board (BPKP) to conduct an annual audit of the Program, with the results of the audit to be shared with A.I.D.

(c) Reports, Records, Payment Verifications and Refunds.

(1) The grantee shall:

(A) furnish A.I.D. with such information and reports as A.I.D. may reasonably request showing rupiah advanced by A.I.D. or the Grantee into th special account pursuant to Section 7.2 were used for agreed upon purposes and in accordance with agreed upon procedures and documentation;

(B) maintain supporting documentation for data required by paragraph (A) above for at least three years from the date of last disbursement by AID under the program;

(C) afford representatives of A.I.D. at all reasonable times to inspect the documentation required under paragraph (B) above to enable such representatives to make such expenditure verifications as they deem necessary;

(2) In the case of any disbursement which is not supported by documentation in accordance with the requirements of this agreement, or which is not used for purposes agreed upon hereunder, A.I.D. may require the grantee to redeposit the amount of such disbursement into the special account for such further use as the parties may agree upon in writing.

(d) Comprehensive Policy Agenda.

The Grantee agrees that it shall diligently pursue the Comprehensive Policy Agenda and its expected benchmarks submitted with the Grantee's Request for Assistance dated July 20, 1987.

ANNEX I

ECONOMIC CONSIDERATIONS

This annex will address: (i) the size and nature of the economic adjustment problem immediately facing Indonesia and (ii) the extent of external financing being arranged with donors and banks and its sufficiency.

I. SIZE AND NATURE OF ADJUSTMENT PROBLEM

A. NATURE OF PROBLEM

Indonesia has two fundamentally related but substantively different adjustment problems.1/ The first adjustment problem relates to the relatively short to medium-term macro stabilization question, with restoration of balance in the external and budgetary accounts and resumption of reasonable levels of growth the principal focus of policy considerations. The second adjustment problem relates to the question of longer-term restructuring of the economy away from its present inward-looking, low productivity, agriculturally and oil dependent status to a faster growing, more outward-looking economic structure that features greater roles for labor-intensive manufacturing, agro-processing, and non-oil exports. The two adjustment problems are related in the sense that policies beneficial to an outward looking longer-term restructuring of the economy will also tend to support shorter-term balance of payments adjustment. Similarly, policies which promote macro-economic stabilization in the short to medium-term also help to set the stage for longer-term growth and restructuring of the economy because of the positive effect on the investment climate.2/

Where the two adjustment problems substantively differ is that policies designed to achieve one set of adjustment objectives (e.g. stabilization) will not necessarily be sufficient by themselves to achieve the other set of adjustment objectives (e.g. restructuring), or at least within an appropriate time frame. For example, appropriate policies for longer-term restructuring may ultimately achieve balance in external payments, but probably not within a sufficient time frame to prevent severe disruption stemming from the balance of payments in the short to medium-term. Similarly, stabilization policies may prevent unnecessary economic disruptions in the short to medium-term but will almost never be sufficient by themselves to assure long-term economic restructuring in the face of significant policy induced distortions. Ideally, if both types of adjustment problems exist, as they do in Indonesia, policy

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1/ It also has a third related "adjustment-type" problem, of a more evolutionary nature, which might be termed the transformation problem. See footnote on following page.

2/ Although stabilization is necessary to improve the immediate investment climate, restructuring of the economy is necessary to improve long-term productivity (hence, incomes), employment, and foreign exchange earnings. Obviously, achievement of the restructuring objectives is important not only for longer-term socio-political reasons but also for the improvement of the longer-term investment climate, which in turn supports future growth.

measures to deal with both sets of questions will be formulated simultaneously since the policies tend to be complementary.. It is clear, however, that if an economy is threatening to hemorrhage that one usually worries about the tourniquet and blood plasma supplies (stabilization questions) before worrying about broken bones or conditions of malnourishment and anemia (restructuring and transformation questions). 1/

1/ By these terms the following is meant: Stabilization focuses on the achievement of internal and external balance and the restoration or maintenance of growth, principally through monetary, fiscal, and foreign exchange policies. It tends to be a smoothing process superimposed upon longer-term growth trends and is generally not designed to change the underlying fundamentals except as a by-product.

Restructuring generally focuses upon the removal of policy-induced economic distortions and significant market imperfections, working principally through deregulation and economic liberalization policies. Restructuring policies have the effect of raising longer-term productivity, growth, and employment to levels higher than otherwise would have been attained, i.e., raising the trend line itself. Restructuring helps to reset the framework and the ground rules of the economic system in which development is to be accomplished. It makes other investments in the longer-term development transformation process more productive than would otherwise been the case because these investments are working in a more efficient economic system and less likely to be misguided by distorted price signals. It also helps to provide the resources to help pay for other development transformation efforts through the efficiency savings directly generated by the act of restructuring.

Transformation focuses upon basic parameters affecting economic growth and development (other than those mentioned above) such as technological change, levels of education and training, levels of management capabilities, institutional arrangements, relationships and incentive systems, population growth rates, and levels of infrastructure development. These parameters, when positively affected, work to raise longer-term productivity, growth, and employment to levels higher than otherwise would have been attained, i.e., to also raise the trend line. Transformation parameters tend to be inherently more complicated and difficult to affect, however, and, in principle, take much longer to significantly change than reform actions initiated under economic restructuring. Nevertheless, steps taken to transform the economy make efforts to restructure the economy more productive than otherwise would have been the case and vice-versa. Transformation works through a wide variety of mechanisms and approaches, including institution building, technological transfer, training, and technical assistance, and a wide variety of policies (often cross cutting) affecting resource mobilization, access to resources, ownership patterns, levels of decision making, attitudes/tastes, incentive systems, etc.

Solutions to each of these three types of economic problems tend to be not only mutually supportive but necessary for a successful process of long-term growth and development.

As we will see later, Indonesia has tended to substantively address all three types of adjustment problems (stabilization, restructuring and transformation) during the period 1983-86. Nevertheless, this has not stopped critics, following the September 12th devaluation, from claiming that the present short-term stabilization objective will not be achieved unless certain additional longer-term restructuring issues (but most vociferously, the import licensing monopoly question) are simultaneously addressed. Although there is almost unanimous agreement among analysts on the ultimate necessity of these longer-term restructuring policy reforms, it is not true that short-to medium-term macro stabilization cannot be achieved in their absence. It is true that addressing the longer-term policy issues sooner rather than later would probably tend to assist achievement of stabilization objectives and would tend to go a long way toward preventing recurring cycles of devaluation followed by excessive external borrowing. It probably is also true that it is far easier to obtain the more politically difficult trade and industrial policy reforms required for longer-term restructuring during a period of economic crisis than after the economy has returned to some sense of normalcy. Finally, it probably is also true that too ready availability of external finance reduces pressure to take all possible adjustment steps on the part of the GOI.

Nevertheless, the current sense of urgency on restructuring reforms relates far more to assumptions about the political timing requirements of this type of policy reform (and the present perceived window of opportunity) than its absolute necessity for achievement of short- to medium-term balance in external payments or budgetary accounts. Further, a perception on the part of the GOI that imminent external financing requirements are overwhelming is more likely to be met by short-term measures, including repressive policy responses, than by corrective responses that require considerable time to take effect. Finally, since long-term restructuring reforms take time to produce desired balance of payments effects, the need for external finance will not materially change over the short-to medium term, even if we assume corrective restructuring steps are taken to the maximum extent possible. Thus, except to the extent that the political timing argument is true in some absolute sense and that the opportunity for reform will have irrevocably passed within the next 12 months (the latter argument certainly a debatable point), there is nothing inherent in the present balance of payments situation that demands that all key elements of longer-term restructuring reform be completed within some immediate time frame.

With the above thoughts in mind, we will focus exclusively on the medium-term (stabilization) adjustment problem in the remainder of this section.

B. SIZE OF THE PROBLEM

The resolution of the medium-term adjustment problem must necessarily focus on the achievement of a sustainable balance in both the external and the budgetary accounts. Because inflation tends to erode the external adjustment process, the traditional first-best prescription for

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dealing with an expected long-term external imbalance is devaluation followed by restrictive monetary and fiscal policies to reduce aggregate domestic demand, including the effective demand for imports. The adjustment process has three parts: (i) an increase in the relative price of tradeable goods compared to non-tradeable goods as achieved by the devaluation, (ii) a reduction in aggregate domestic demand, including the demand for imports, by the use of restrictive monetary and fiscal policy; and (iii) the maintenance of the effective real exchange rate established at the point of devaluation by continuing to contain domestic inflation through conservative monetary and fiscal policies.1/

In Indonesia's case, because the budget is as disrupted by the same external event (loss of oil revenues) as the balance of payments, budget expenditure reduction becomes as important as a policy goal for its own sake as it is a policy instrument for achieving balance in the external accounts. Even if the external account did not require fiscal restraint, budgetary balance would need to be restored for its own sake because of the major loss in oil derived budgetary revenues.

This section will look at two broad questions: (i) what is the likely outcome of current efforts at short- to medium-term external adjustment, and (ii) what are the likely implications over this period for the budget, given measures likely to be adopted to increase revenues or to decrease expenditures?

1. External Balance

Current Account Deficit - The September 12th devaluation, the uncertainty over future oil prices, and the continuing world-wide realignment of currencies considerably complicates projections of the current account deficit. Some of these complications, plus other topics have already been detailed in the recent USAID reports "Preliminary Assessment of the September 12th Devaluation" (9/86) and "Preliminary Views on the Post-Devaluation Economy" (10/86).

1/ Indonesia was not successful in maintaining the real effective exchange rate following the 1978 devaluation, largely because it failed to sterilize the effect of the build up of net foreign assets on the domestic money supply. But it was highly successful in maintaining the real effective exchange rate following the 1983 devaluation. This success was due to a variety of reasons, including relatively restrictive monetary and fiscal policy, massive public sector investment rephasing, a floating peg exchange rate system, and the depreciation of the U.S. dollar against other major currencies beginning September 1985. Although a certain amount of luck was involved in the timing of the devaluation (which coincided with a domestic recession and was further supported by the exogenously related U.S. dollar depreciation in 1985-86), it is also clear that the GOI has accepted the need for strong monetary and fiscal discipline to make its devaluations stick. For this reason there is strong reason to believe that the 1986 devaluation will also tend to be effectively maintained.

Table 1 lays out the current USAID thinking on the medium-term outlook for the balance of payments for the five year period 1986/7-1990/1. These projections suggest that the current account deficit, after rising to $4.8 billion in 1986/7 will quickly fall to $2.9 billion in 1987/8 and further to $1.2 billion by 1988/9. The current account is projected to be roughly in balance 1989/90-1990/1.

In considering the plausibility of these projections it should be kept in mind that the assumptions on oil and LNG are believed to be conservatively low. The assumptions on non-oil exports are believed moderately optimistic although feasible. The assumptions on imports are plausible but probably a binding constraint on growth by 1988/9 as projected here. The assumptions on net services are believed conservatively high through 1988/9. Thereafter, they are probably low if non-oil growth in the economy rises much above 3% per annum. In sum, the resultant projections of the current account deficit are believed consevatively high through 1988/9.

At oil prices in the $14-$20 range and at likely production levels of 1.33 MBD, a rough rule of thumb would suggest a $350 million change in net export revenues per $1 change in the price of a barrel of oil. This suggests a $2 swing in the average oil price, for example, would improve or worsen the current account deficit by $700 million, depending on the direction. This is considered a reasonable sensitivity test (bracketing) of the oil prices assume in Table 1.

Table 2 presents a summary comparison of projected current account deficits by the IMF, the GOI, and USAID for 1986/7 through 1988/9. The projected current account deficits range between $4.1-$4.8 billion in 1986/7, $2.5-$2.9 billion in 1987/8, and $1.0-$1.2 billion in 1988/9. Oil price assumptions differ slightly between the three projections (See Table 5) but provide only a partial explanation of the differences, as might be expected. IBRD projections, obtained subsequent to the preparation of the accompanying tables, suggest current account deficits falling about halfway within the range cited for 1986/7-1988/9 and $0.5 billion higher in 1988/9 (largely because of assumed increases in imports). In comparison with the 5 year USAID projections, the projected current account deficits of the IBRD are lower by $0.5 billion in 1986/7, $0.2 billion in 1987/8, and higher by $0.5 billion in 1988/9, and $0.9 billion 1989/90-1990/91. The difference in later years is principally due to higher import assumptions by the IBRD.

<u>Debt Service</u> - Public debt service is large and growing. Table 1 shows the USAID estimates of total public debt service for the period 1986/7-1990/1. Public debt service is projected to grow from $4.3 billion in 1985/6 to $5.8 billion by 1989/90. The USAID estimates are based on the IBRD debt monitoring system for government and state enterprises and reflect debt outstanding at 12/31/85, modified slightly for estimated increases in debt service from new debt incurred subsequent to 12/31/85. The estimates may be somewhat low because continuing depreciation of the U.S. dollar increases the burden of servicing non-dollar debt. In addition, grace periods for repayment of new debt may be slightly less generous than [illegible]

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Table 1. Revised Balance of Payment Projections, 1986/87 - 1990/91
($ billion)

	Actual 1985/6	Projected 1986/7	1987/8	1988/9	1989/0	1990/1
Gross Exports	18.6	13.4	14.5	16.2	18.3	19.8
Oil and LNG 1/	12.4	6.4	6.5	7.4	8.9	9.8
Non-Oil 2/	6.2	7.0	8.0	8.8	9.4	10.0
Gross Imports	12.5	12.4	11.8	11.4	12.0	12.6
Oil and LNG 3/	2.5	3.4	3.3	3.4	3.5	3.6
Non-Oil 4/	10.0	9.0	8.5	8.0	8.5	9.0
Net Services	7.9	5.8	5.6	6.0	6.5	7.2
Oil and LNG 3/	3.8	1.5	1.3	1.5	1.8	2.3
Non-Oil 5/	4.1	4.3	4.3	4.5	4.7	4.9
Current Account	- 1.8	- 4.8	- 2.9	- 1.2	- 0.2	0.0
Official Capital	3.4	5.2	5.8	4.3	4.0	4.0
Donor AID 6/	2.8	3.2	4.4	3.7	3.0	3.0
Non-Donor 6/	0.6	2.0	1.4	0.6	1.0	1.0
Other Capital 7/	0.6	0.8	0.2	0.2	0.2	0.2
Debt Repayment 8/	1.6	2.1	3.0	3.4	3.8	3.9
Net Errors & Omissions	0.5					
Change in Reserves (- = increase)	-	0.9	- 0.1	0.1	- 0.2	- 0.3
Memorandum						
Official Reserves	5.8	4.9	5.0	4.9	5.1	5.4
Public Debt Service 9/	4.3	4.4	5.0	5.4	5.8	5.6
Public Debt Service Ratio 10/	21.4	29.5	31.3	30.5	29.3	26.3
Assumed Oil Price ($/BBL)	25.0	12.3	13.5	15.0	18.0	20.0

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1/ Assumes oil production (including .140MBD condensate) at 1.405 MBD (1986/7), 1.300 MBD (1987/8), and 1.330 MBD thereafter. LNG production assumed at 793 MMBTU. LNG revenues will tend to be understated during later years of the projection period as production levels and exports increase. Assumes average prices ($/BBL) as follows:

	Oil	LNG
1986/86	12.3	15
1987/88	13.5	15
1988/89	15	17
1989/90	18	20
1990/91	20	22

2/ Assumes favorable initial impact from devaluation on non-oil exports during last 4 months of FY 86/87, through 1987/88, tailing off by 1988/89. Numbers roughly parallel impact of 1983 devaluation adjusted for timing. Long-term impact could be substantially greater than suggested here. Non-oil exports in 1986/7 would have been about $6.5 billion in the absence of devaluation, based on performance of first six months. World economy assumed to continue 1986/87 performance.

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

4/ Assumes that non-oil imports are only affected during last quarter of FY 86/87 because of orders in pipeline. The decreases in projected imports in following periods roughly parallel the 1983 devaluation and are considered conservatively plausible. Projected decreases are somewhat less optimistic than experienced following 1983 devaluation because imports have already been squeezed, massive rescheduling 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. The 1986/7 import projection appears reasonable based on estimated actual imports of $4.6 billion during the first six months of the fiscal year.

5/ Net non-oil service are assumed constant except for the increase in estimated debt service interest payments This appears conservative since the devaluation should actually depress service imports and stimulate exports, resulting in a net decline in non-interest non-oil services. However, the increase in interest payments may be somewhat underestimated. (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/ See Table 2 and 3 for the source of estimates. The non-donor assistance in 1986/87, 1987/8 and part of 1988/9 represents drawdown of existing commercially syndicated standby 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 based on IBRD 12/31/85 estimates for GOI direct debt plus state enterprises, except for treatment of state enterprises in 1985/6 and 1986/7. See footnote #7. A nominal increase of $200 million to $300 million was added to years subsequent to FY 86/87. The amortization for FY 87/88 and beyond may be progressively understated as repayments become due on debt incurred after December 1985. However, this is probably not a serious understatement until possibly late in the projection period, because donor borrowings generally have a 5 to 10 year grace period. It is assumed that commercial credit drawdowns have a 3 year grace period.

9/ Combined interest and principal payments on direct government debt plus state enterprise debt. Includes LNG expansion. Source is IBRD's 5/86 estimate adjusted for estimated additional payments on new commercial drawndowns subsequent to 12/31/85.

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.

Table 2. Projected Current Account Deficits, Debt Amortization and Probable Source of Financing 1986/7 - 1988/9

	PROJECTED		
	1986/7	1987/8	1988/9
Current A/C Deficits			
I M F	4.8	2.5	1.0
G O I	4.1	2.6	?
USAID	4.8	2.9	1.2
Debt Amortization			
I M F	?	?	?
G O I	2.1	2.7	?
USAID/B.I.	2.1	3.0	3.4
External Financing Requirements			
I M F (w/USAID debt amort.)	6.9	5.5	4.4
G O I (w/USAID debt amort.)	6.2	5.3	?
USAID	6.9	5.9	4.6
Source of Financing			
Donor Project AID	3.1	3.0	3.0
Commercial Standby Drawdowns	2.0	1.4	0.0
New Donor Program Support	0.1	1.4	0.7
New Commercial Loans	-	-	0.6
Miscellaneous Capital (Net)	0.8	0.2	0.2
	6.0	6.0	4.5
Implicit use of reserves			
I M F	-0.9	+0.5	+0.1
G O I	-0.2	+0.7	?
USAID	-0.9	+0.1	-0.1
Implicit Reserve Level			
I M F (w/USAID finance est.)	5.3	5.8	5.9
G O I (w/USAID finance est.)	6.0	6.7	?
USAID	5.3	5.4	5.3
G O I*	6.2	6.3	?

* official implicit forecast

Public debt service does not include private debt service, estimated by the IBRD to range from $750 million in 1986 down to $520 by 1990. In terms of the USAID balance of payment projections, it was assumed this debt is rolled over or offset by new private capital inflows. Subsequent projections received from the IBRD indicate they have made similar assumptions.

Official Capital Requirements - The current account deficit (which includes interest on debt as part of net services) plus the amortization of public debt defines the requirements for official balance of payments financing, before the consideration of net private capital flows or the possible use of reserves. Table 2 shows projected total external financing requirements ranging between $6.2-$6.9 billion in 1986/7, falling to $5.3-$5.9 billion in 1987/8 and falling further to $4.4-$4.6 billion in 1988/9. The requirements for official financing are projected somewhat lower than the above by $0.8 billion in 1986/7 and by $0.2 billion in 1987/8-1988/9 because of projected net private capital inflows. 1/ All commercial credit drawings in 1986/87 and 1987/88 (total $3.4 billion) are made from existing standby agreements. New commercial credit drawings of $600 million is assumed for 1988/89, however.

The 5 year USAID estimate of official financing requirements, as relected in Table 1 rises from $5.2 billion in 1986/7 to $5.8 billion in 1987/8 before falling to $4.3 billion in 1988/9 and to $4.0 billion in 1989/90 - 1990/91. Besides depending on the projections for the current account deficit, debt amortization and net private capital flows, the requirements for official financing also depend on the assumptions made regarding the use of reserves and the timing of that use. The USAID projections reflect the anticipated use of reserves in lieu of possible commercial loan standby draw down in 1986/7. However, if the GOI chooses to draw down the commercial standby loans in 1986/7 they could postpone the use of reserves until 1987/8. This would have the effect of raising official capital inflows in 1986/7 but decreasing the inflows in 1987/8 as shown in Table 1.

The source and sufficiency of probable official capital inflows will be discussed in a following section. However, it should be noted here that drawings on new commercial credits are assumed at $0.6 billion in 1988/9 and $1.0 billion 1989/90 and 1990/91. These levels are consistent with past borrowing levels and should be attainable if oil prices match or exceed the assumed trends and averages in Table 1. As noted elsewhere significant commercial loan rollover would be possible without increasing exposure.

Reserves - The implicit use of reserves and and reserve levels for the period 1986/7-1988/9 are shown in Table 2. These are based on both

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1/ Net state enterprise borrowing is included in the 1986/7 estimate of net other capital inflows but not in the 1987/8-1988/9 estimates. Gains on revaluation of reserves are also included in 1986/7.

the projected external financing requirements and the anticipated sources of financing. Table 2 provides a breakdown of anticipated sources of finance which will be discussed in a following section. On the basis of the projections for financing requirements and our best estimate of the financing likely to be available with reasonable certainty, reserves seem likely to decline slightly to $4.9 billion in 1986/7 and remain at that level or higher through 1988/9. It is possible that reserves will not be drawn down in 1986/7 and that draw down of commercial standby loans will be used instead. This would delay but not ultimately prevent the projected reserve drawdown shown in Table 1 and Table 2. Reserve levels reflect a $400 million currency appreciation on reserve assets in 1986.1/ Rough estimates would suggest this to be conservative. The Japanese Yen is worth about 73% more in terms of U.S. dollars that it was in February 1985. Other currencies on a trade weighted basis are worth about 59% more in terms of the U.S. dollar than in February 1985. Over the same period gold has appreciated in terms of U.S. dollars by about 30%. Official Indonesian reserves, consisting of about $1.0 billion in gold and $4.8 billion in foreign currencies, have remained roughly constant at about $5.8 billion over the period February 1985 - November 1986.

To the extent that the official reserve portfolio has been held in major non-oil U.S. dollar currencies during the latter half of 1985 and during 1986, appreciation in terms of the U.S. dollar has occured. If w were to assume that half of foreign currency reserves were held in major non-oil U.S. dollar currencies during this period this would imply appreciation gains of almost $1.5 billion in terms of total U.S. dollar reserve equivalent. Appreciation on gold might be another $0.3 billion. Currency appreciation in terms of U.S. dollars could have been much higher or much lower than suggested here. Appreciation on gold might be slightly lower.

The size of this hypothetical appreciation (about $1.8 billion) plus the fact that reasonably alert currency managers could have moved out of dollars in sufficient time to capture much of the gain from the dollar's decline, suggests that substantial reserve appreciation gains have been made by the GOI during this period. The IMF indicates in their May 1986 report that reserve valuation gains may have been $1 billion in 1985/6 and the International Financial Institute estimates valuation gains of $450 million during the first 8 or 9 month of 1986.

The IMF states that reserve valuation gains of about $1 billion were treated as part of errors and omissions in 1985/6. Implicitly, they have probably been largely offset by private capital outflows. If we accept that reserve valuation gains in 1985/6 have been fully accounted for in

1/ Currency revaluation gains are shown in other capital rather than as a direct increase in reserves.

this fashion then the smaller but still substantial valuation gains in 1986/7 must still be taken into account. The assumed $400 million valuation gain, included in other capital flows, represents a conservative 7 percent appreciation in reserve assets in 1986/7 compared to the U.S. dollar's continued depreciation during this period.[1/]

2. Internal Balance

Nominal Budgetary Levels - Table 3 shows the USAID projections of nominal budgetary levels for the 5 year period 1986/7-1990/1. Nominal budget levels are projected to rise from Rp 21.7 trillion in 1986/7 to Rp 29.3 trillion by 1990/1. The budgetary projections are consistent with the USAID balance of payments projections in Table 1. Total budgetary expenditures are assumed to equal projected revenues. Development expenditures are the assumed residual after routine expenditures, including direct government debt service, have been covered. Debt service is projected actual (based on Table 4) while routine non-debt service expenditures are assumed to be constant in real terms using the actual estimated expenditures for 1986/7 as a base.

Nominal revenue projections for oil and LNG are based on the assumed oil prices used in the balance of payments and assume that past recovery experience by the fiscal system will continue. Non-oil/LNG budgetary revenues are projected to significantly improve in 1986/7 (based on 1st semester results) and to grow slightly in real terms thereafter through 1990/1. All real growth in non-oil/LNG revenues is attributed to the VAT and income tax.[2/] Revenue projections for external assistance and credits assume that rupiah counterpart funds from the draw down of commercial standby credits will be used to finance the government budget. Except for a $120 million equivalent use in 1986/7, no rupiah counterpart funds from reserve drawn are assumed to be used to finance the budget.

1/ The GOI could also improve the budgetary outlook over the projected period by raising domestic fuel-oil prices as the international prices rise above the $15/BBL level, and by raising utility rates and cost recovery charges. It is also mildly conceivable that tax rates might be raised since he authority to do so already exists in the new tax laws.

2/ The estimated other capital inflow of $1.2 billion by the IBRD for 1986/7 provides further indirect, although inconclusive, evidence in support of this assumption. See (12/86) IBRD Trade Policy Adjustment Loan.

Table 3. Revised Budgetary Projections, 1986/87 - 1990/91 1/
(Rp. Trillion)

	Actual	——————Projected——————				
	1985/6	1986/7	1987/8	1988/9	1989/0	1990/1
Revenues 2/						
Oil/LNG	11.1	4.6	5.6	6.9	9.2	10.7
Oil	9.4	3.8	4.5	5.7	7.6	8.8
LNG	1.7	0.8	1.1	1.2	1.6	1.9
Non-Oil/LNG 3/	8.1	10.1	10.1	10.9	11.8	12.8
Income Tax	2.3	2.8	3.1	3.4	3.7	4.1
VAT	2.3	3.2	3.5	3.9	4.3	4.7
Other	3.5	4.1	3.5	3.6	3.8	4.0
Total Domestic	19.2	14.7	15.7	17.8	21.0	23.5
External AID/Credit 4/	3.6	7.0	8.7	6.3	5.8	5.8
Total Revenues	22.8	21.7	24.4	24.1	26.8	29.3
Expenditures						
Routine	11.9	13.4	15.8	16.8	18.1	18.4
Debt service 5/	3.3	5.3	7.3	7.9	8.7	8.6
Non-debt service 6/	8.6	8.1	8.5	8.9	9.4	9.8
Development 7/	10.9	8.3	8.6	7.3	8.7	10.9
Total Expenditures	22.8	21.7	24.4	24.1	26.8	29.3
Non-debt	19.5	16.4	17.0	16.2	18.1	20.7
(% of total)	(85.5)	(75.6)	(70.0)	(67.2)	(67.5)	(70.6)
Memorandum:						
Deflated Expenditures 8/	22.8	19.3	18.9	17.8	18.9	19.7
Non-debt	19.5	14.6	13.2	12.0	12.7	13.9
Development	10.9	7.4	6.6	5.4	6.1	7.3
Oil Price Assumption ($/BBL)	25.0	12.3	13.5	15.0	18.0	20.0

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Notes:

1/ Projections are post-September 12th devaluation. Average exchange rate 1986/87 assumed at Rp. 1,420. Thereafter, assumed at Rp. 1,650

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

3/ Revenues for 1986/7 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 assumed to grow at 10 percent 1987/88-1990/91. Other revenues assumed to grow at 5 percent 1987/88-1990/91. Other revenues drop in 1987/8 because of a major decline in fuel sales. These revenues decline as international oil prices rise.

4/ Assumes 44 percent of donor assistance disbursed prior to devaluation at Rp.1,125 per dollar. Assumes syndicated commercial borrowing effectively 100 percent drawn prior to the devaluation because of fungibility effect (i.e., swap facilities will be replaced). Assumes no proceeds from anticipated reserve drawn down will be used for budgetary support other than stated. Assumes that all official capital in balance of payments 1987/88-1990/91 used for budgetary support, except $0.5 billion each year for state enterprises. This means that for 1986/87 that project aid was converted at an average rate of Rp.1,420 = $1, that non-donor AID was all converted during 1st six months @ Rp. 1,125 = $1, and that a small portion of reserve drawdown counterpart funds (Rp.200 billion) was used to finance the budget. Approximately Rp.1.3 trillion counterpart funds from an estimated $0.9 billion reserve drawn down are left over and not drawn elsewhere in this projection.

5/ Debt service is based on IBRD 5/86 projections with modest increases for estimated interest and amortization on drawdown of commercial standby credits subsequent to 12/31/85. Debt service for state enterprises is not included in this projection. There is indication that in reality, however, at least some portion of state enterprise debt may be serviced through this line item.

6/ Assumes personnel, commodities, and subsidies to regions to essentially remain constant in aggregate in real terms. Assumes no routine budget subsides. Assumes increase of 5 percent per annum in nominal terms beginning in 1987/88. This implies that domestic fuel oil prices would need to be raised in 1989/90 (Rp.0.5 billion) and again in 1990/91 (Rp.0.5 billion), representing a total 10% increase.

7/ Development expenditures are taken as a residual for projected period. Residual shares of GOI development expenditures, after making allowance for assumed donor disbursements, are not necessarily consistent with likely requirements for non-project expenditures.

8/ Expenditures were deflated for inflation and the estimated September '86 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 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. 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 unprobably overstated throughout.

Real Budgetary Levels -- The September 1986 devaluation, price inflation, and the freeze of civil service wage levels seriously complicates interpretation of real changes in the total budget and particularly among budgetary components. The memorandum item in Table 3 shows that estimated real expenditures, including the rising debt service component, are likely to fall from a Rp 22.8 trillion base in 1985/6 to Rp 18-19 trillion over most of the 5 year projection period.

This result seriously masks the estimated trends in real non-debt budgetary expenditures, including the development budget, however. Given overly simplified assumptions that are likely to understate the impact, real budgetary expenditures, excluding debt service are projected to steadily fall from Rp 19.5 trillion in 1985/6 to Rp 12.0 trillion in 1988/9 before climbing marginally to Rp 13.9 trillion by 1990/1 (see Table 3). This would imply that real budgetary expenditures (excluding debt service) have fallen by 25% in 1986/7 and will fall another 18% by 1988/89 before partially recovering. The difference between estimated real expenditures (excluding debt service) in 1985/6 and projected for 1988/9 is negative 38%.

Projected real development budget expenditures will fall even more precipitously. Assuming foreign exchange expenditures are distributed equally in the budget between non-debt service routine and development expenditures, real development expenditures would steadily decline from Rp 10.9 trillion to Rp 5.4 trillion by 1988/9 before partially recovering at Rp 7.3 trillion in 1990/1. Real development expenditures are projected to fall 32% in 1986/7 and another 28% by 1988/9. This would represent a 51% decline in annual real development expenditures between 1985/6 and 1988/9. Under the projections in Table 3 real development expenditures would still be 34% below the 1985/6 levels after 5 years.

Budgetary Composition - Shifts in nominal budgetary composition have been significant between 1982/3 and 1986/7 (see Table 4). Routine expenditures have increased from 45% of the budget in 1982/3 to 66% in 1987/8 while development expenditures have declined from 55% to 34% in a total budget that has fallen (possibly 8%) in real terms over this same period. The principal explanation for this shift has been the increase in debt service (which is included in routine expenditures) from 6% of the total budget in 1982/3 to 30% in 1987/8. Nominal budgetary expenditures, excluding debt service, have decreased from 94% of the budget in 1982/3 to 70% in 1986/7. Given that the total budget is estimated to have fallen in real terms over this period, this represents a major real decrease in the non-debt portion of the budget. Examination of the projections in Table 3 suggest that these trends will continue in the future although in far less dramatic fashion.

C. OIL AS THE "X" FACTOR

All potential adjustment scenarios over the next several years depend critically upon the price and trend assumptions for oil and LNG. Even 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 by about 60% and LNG prices have tended to follow. The actual impact on the budget and balance of payments is greater, however,

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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%), 1987/8(22%)

than indicated by changes in oil prices because the relatively fixed production costs of the oil producers loom proportionately larger as sales prices fall. This means, for example, that if average oil/LNG prices are 58% lower in 1986/7, net oil/LNG export earnings will probably be 80-85% lower, after allowing for payment of cost recovery and profit sharing. The effect on the budget is far less pronounced (62% decrease) but still proportionately greater than the change in oil prices.1/

Oil price scenarios, as currently envisioned, are noticeably less optimistic than the price scenario assumed by the IBRD in its May 1986 annual report (6201-IND). This implies, other things equal, that the IBRD conclusions drawn at that time on growth and current account deficits are probably more optimistic than warranted. However, since the September 12 devaluation and the May 6th, October 25th and January 15th policy packages will tend to have a favorable impact on balance of payments and growth, it is not immediately clear whether the medium-term outlook is more/less favorable than envisioned by the IBRD at that time. It is not inconceivable that the recent policy actions of May 6th, September 12th, October 25th, and January 25th will tend to offset the impact of the lower, currently projected oil prices.

The current working assumptions of both the GOI and the IMF on oil prices are lower than the May 1986 IBRD assumptions. The price assumptions used by USAID in its September and January projections are also lower. A comparison of oil price assumptions is provided in Table 5, including the most recent projections of the IBRD (12/86). The IBRD in its latest projections is still considerably more optimistic than the IMF and slightly more optimistic than USAID.

Table 5. Average Oil Price Assumptions ($/barrel)

	1986	1987	1988	1989	1990
IBRD (5/86)	13.5	17.0	19.5	21.0	22.0
IBRD (12/86)	12.5	16.0	18.0	18.0	18.0
IMF (11/86)	12.0	13.2	13.6	14.0	NA
GOI (1/87)	13.0	15.0	NA	NA	NA
USAID (9/86)	12.0	13.5	15.0	18.0	18.0
USAID (1/87)	12.3	13.5	15.0	18.0	20.0

1/ The fixed cost recovery effect will produce similar phenomena in the opposite direction as well, i.e., the percentage change in oil prices produces more than proportional changes in net export earnings and budgetary revenues regardless of the direction of change. For example, a 50% increase in average Indonesian oil prices from $12 to $18 would result in a 140% increase in net oil/LNG export revenues and a 119% increase for oil/LNG derived budgetary revenues.

In viewing the oil price scenarios suggested above it is important to keep in mind that oil prices are highly volatile and will not necessarily move in a smooth upward trend. A change in worldwide production levels of 1.0 MBD (current free world production of about 46 MBD) can, in principle, produce a $4-$5/barrel change in oil prices in the direction opposite of the volume change. Because of this extreme sensitivity to relatively small changes in production, and the existence of substantial excess production capacity, 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.

What all of this means is that future oil price levels and trends are highly uncertain and potentially subject to considerable volatility until world-wide excess production disappears, presumably sometime in the early 1990's. The potential range in oil prices during the interim period (1986-90) is conceivably from about $8/barrel (and temporarily lower) to about the $27-$28/barrel or above that existed in 1985. Oil prices could be almost anywhere within this range (and beyond) depending on OPEC production levels, worldwide stock levels, unanticipated supply disruptions, growth in world demand, and market expectations.

If OPEC were to strictly maintain the current production quota of about 16.0 MBD, oil prices could probably be sustained at an average $18-20/barrel over the course of a year, once the current stock buildup is worked down and the market accepted the new reality. (Some believe that stocks could be drawn down to their 1985 levels by summer 1987 if adverse weather conditions in the U.S. and Europe continue). If the market believed the quota would be observed, a reduction to 15.0 MBD might see prices approaching $22-$25/barrel. In other words, if reason (and discipline) prevailed within OPEC, significant increases in total revenues could be obtained for relatively small decreases in output. Relative shares of income and power are at stake, however, and it is not clear that OPEC has yet agreed upon whom the burden shall ultimately rest. Although the recent pledges by seven non-OPEC members to decrease their combined production by 520,000 barrels per day is a hopeful sign, such an alliance must be viewed as even more fragile than the troubled OPEC group. The incentives for cheating on production agreements are large and many participants are poor and in worse economic condition than they were 2 years ago when cheating on OPEC quotas was the norm.

We agree with the IMF that prudent policy planning in Indonesia requires conservative assumptions on oil prices. In this regard the IMF oil price assumptions must be considered conservative under the circumstances and the GOI assumption for 1987/8 as reasonable. Nevertheless, low oil prices and smaller production volumes are not consistent with long-term stability in oil-dependent economies around the world and are, therefore, probably more likely to be unstable than higher prices were. A rational OPEC would conclude that although a proportionate decrease in production quotas would leave all members better off in terms of net export revenues (and consequently budget revenues) than they were in 1986, that, nevertheless, each member would still be worse off than in 1985.[1] Further, equally proportionate production cuts do not impose proportionately equal budgetary and balance of payment effects because the proportion of production exported varies considerably among the oil producers. The poorer countries with large populations tend to export proportionately less of their production and are, therefore, hurt relatively more by proportionate production cuts that at the margin must come from their exports. A humane (and ultimately intelligent) OPEC would skew the burden of production cuts largely toward the richer members on the grounds that if the poorer nations couldn't afford to abide by cartel rules even at $27/barrel and the former 16.0 MBD quota arrangement, that they will be less likely to be able to do so at $18/barrel. Nevertheless, ultimately all OPEC members probably have to accept that they will have to live on less during the balance of the 1980s — and a lot less if reasonable discipline does not prevail. Those countries currently taking adjustment measures to reduce their dependence on oil will be best positioned both to support OPEC quota discipline and to survive its absence.

II. SUFFICIENCY OF FINANCE UNDER NEGOTIATIONS

A. GOI STRATEGY

The GOI strategy in its simplest terms is to maximize program or local currency lending that will provide both immediate balance of payments support as well as local currency financing for the budget. In principle, the source of these funds can be new lending over and above present project lending levels, conversion of some portion of typical project lending levels to program loans, or reprogramming of some portion of existing undisbursed project pipeline.

Because of the seriously deteriorated public debt service ratio and current uncertainties related to oil prices, the GOI must look first to the donor community for the necessary finance to bridge the 1986/7-1988/9 adjustment period. The GOI made its initial call for support at the June 1986 IGGI meeting and has followed this up with negotiations with the larger donors first. The GOI has already undertaken or is still in the process of extensive negotiations with the IBRD, ADB, the Japanese and some of the smaller bilateral donors such as the Dutch.

1/ In the short to medium-term OPEC members must be slightly worse off even if prices were restored to their 1985 levels, assuming OPEC shoulders the necessary production cuts. This is simply because the 16.0 MBD quota of that period probably needed to be cut to 14.5 - 15.0 MBD to sustain those price levels. Price levels were only being sustained in 1985 because Saudi Arabia acted as the swing producer and the market more or less believed that quotas would be adhered to.

The GOI strongly wishes to avoid any type of IMF standby or other type of financing arrangement which is accompanied by conditionality. Similarly, the GOI strongly prefers to raise new finance rather than go through the process of an official debt rescheduling which would probably have to be accomplished by some form of an IMF arrangement with conditionality. The GOI is interested in an IMF Commodity Financing Facility (CFF), however, because it is not accompanied by conditionality and some believe it would represent an IMF stamp of approval in the eyes of the international banking community.

B. FINANCE CURRENTLY UNDER NEGOTIATION

Table 6 presents the USAID estimate of balance of payments support type assistance (program loan or local currency financing) currently under negotiation (or already negotiated) by the estimated year of disbursement. Predicted dates for final negotiation are shown in parentheses following the loan name. The loan amounts are generally (bu not always) in addition to normal project lending levels and will have grace periods ranging from 5 to 10 years. Interest rates are generally non-concessional although the Japanese terms appear generous. Memoranda of conversation prepared during the period November-December, 1986 provide greater detail on most of the loans under consideration.

Approximately $2.1 billion in program type assistance, two-thirds expected to be disbursed in 1987/8, is currently under negotiation, approaching final agreement, or has been signed. The Japanese are potentially the most important player in terms of total resources ($1.2 billion), although the IBRD is highly significant both in amount ($0.8 billion) and in terms of the moral leadership being exercised in the general endeavor to mobilize program type assistance.1/ Among the smaller donors the USG is considering a $60 million policy support loan which could be negotiated by early summer 1987 and disbursed over a two year period.

Very little of the estimated $2.1 billion of additional balance of payments support listed in Table 6 has actually been signed as of February 28, 1987. However, most of the additional financing listed is likely to be negotiated and/or signed within the next 1-4 months. Informal indications from GOI and IBRD officials are that listed loan amounts are likely to be approved. Virtually all loans under consideration are expected to disbursed within 12-18 months.

Relatively smaller program loan disbursements ($0.7 billion) are anticipated for 1988/9 at this time. Delay in negotiations could lower 1987/8 estimated levels and increase 1988/9 estimated levels, however. It is also highly probable that additional program or local cost financing loans will be requested from the IBRD, ADB, the Japanese, and others for FY 1988/9. The Japanese and the IBRD have indicated, in principle, they will be open to these requests.

1/ The estimated $0.9 billion in assistance anticipated through the Japanese EXIM Bank, for example, would be in support of rupiah counterpart funding requirements of existing IBRD project loans.

Table 6. Balance of Payments Support Currently Under Negotiation by Year of Estimated Disbursement 1986/7-1988/9 ($ million)

	1986/7	1987/8	1988/9	Total
IBRD				
Trade Policy (2/87)	-	300		300
Urban Sector (5/87)	-	100	150	250
Irrigation Sector (7/87)	-	100	150	250
	-0-	500	300	800
Japanese				
Exim/IBRD (3/87)	-	600	300	900
Exim/ADB (?)	-	?	?	?
OECF - FY87 (6/86)	30	-	-	30
OECF - FY88 (3/87)	-	160	65	225
	30	760	365	1,155
ADB				
Irrigation Projects(7/86)	10	22	?	32
Education Projects(11/86)	10	20	?	30
Other Projects (11/86)	20	38	?	58
	40	80	?	120
Other Donors				
USAID (7/87)	-	30	30	60
Dutch (87)	-	30	20	50
TOTAL	70	1,400	715	2,185

The Japanese EXIM Bank may be approached for local currency counterpart funding for existing ADB projects, analagous to the loan currently being negotiated with the EXIM Bank for IBRD project counterpart funding. It is understood that the ADB mission to Jakarta at the beginning of February was to discuss this possibility as well as potential ways the ADB might be of further direct assistance. We understand, however, that the ADB is relatively limited in what it can do in the financing of local costs and that it must essentially approach its lending on a project basis rather than a sectoral basis. It is also not entirely clear that the ADB is receptive to Japanese EXIM participation in local cost financing, particularly above an 80% total donor contribution.

It is conceivable that additional local cost financing or program type loans may be negotiated with some of smaller bilateral donors, including the U.S., during both 1987/8 and 1988/9. Although it is known that some bilateral donors may have misgivings about this type of assistance (e.g., the Dutch and Norwegians), it is likely that some sort of positive response will be forthcoming at the June IGGI meeting, given the GOI stress on its importance.

In sum, on the basis of available information at this date, the estimated assistance in Table 6 appears likely to be forthcoming in the amounts and under the timing indicated. It is also likely that additional loans of similar nature will be requested from the IBRD, ADB, and Japanese, as well as the smaller bilateral donors, for probable disbursement in 1988/9. This might easily total another \$0.5-\$1.0 billion beyond what is already under negotiation.

C. ADDITIONAL COMMENTS ON OPTIONS

As noted earlier the GOI can basically request three types of assistance that will help with its twin problems of balance of payments and budgetary rupiah counterpart funding: (i) new lending of a program or local cost financing nature over and above normal donor assistance levels; (ii) substitution within present donor assistance levels toward program or local cost financing in lieu of new project financing, and (iii) reprogramming of some portion of existing undisbursed donor project pipelines for local cost financing. To date the GOI has negotiated assistance in all three categories, although largely for new financing.

USAID has been told by GOI officials that they clearly prefer the first option of new program type loans that are additional to existing donor assistance project levels or, failing that, the second option of substituting program loans or local cost financing for new project loans within normal assistance levels. It has been indicated that these possibilities will be exhausted before reprogramming of the existing pipeline might be considered. This latter process is viewed as very time consuming and imposes dangers that deobligated funds would not be replaced and that on-going project implementation could be jeopardized. The GOI has received limited reprogramming of "excess foreign exchange" in the form of local cost financing from the ADB. However, since this reprogramming posed no threat to future project implementation it posed no dilemma.

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USAID has reviewed its own portfolio for the possibilities of reprogramming some portion of the undisbursed project pipeline and agree with the GOI both on the considerable difficulties in making assessments of what might be deobligated and the implicit danger that replenishment of funding, borrowed from on-going project implementation may not occur. USAID also concluded that the process of renegotiation of new project an legal documents would impose considerable administrative burden on both the GOI and USAID and would detract from on-going project implementation.

D. IMPLICATIONS OF UNSUCCESSFUL ADJUSTMENT

These do not need to be gone into in length but some of the possible outcomes in the event that the present adjustment effort is viewed as insufficient by the GOI, should be pointed out. Assuming the worst and that the GOI continued its past adjustment behavior, further devaluation would be likely. Depending on circumstances, official debt rescheduling might be considered, although less formal arrangements to roll over debt with individual creditors might be attempted first. It is likely that an IMF standby or extended facility arrangement would be required before formal debt rescheduling could be successfully negotiated. It is possible, depending on the circumstances, that use of IMF facilities would be sufficient by themselves. However, since the GOI is strongly adverse to taking either type of measure, if forced to go to one, the GOI might decide to go with both to ensure that the matter was done with.

It is possible, in preference to debt rescheduling or use of IMF facilities, that the GOI might revert to greater restrictiveness in its trade and exchange controls. Although temporary use of quantitative controls might be conceivable, it is considered unlikely that present reform trends would be reversed under the present technocratic leadership because of the risk that the reversal would become permanent policy. Nevertheless, it is quite conceivable that liberalization steps currently under consideration might be postponed because of their initial adverse balance of payments effect. It is also conceivable that if the present technocrat reform leadership were weakened or replaced as a result of unsuccessful adjustment (or as a result of precipitious or heavy handed donor intervention in the reform process) that, in fact, a much less enlightened and far more nationalistic or zenophobic leadership would result and that current reform trends would truly be jeopardized. It is possible under such a leadership, for example, that capital controls would be instituted.

On the budgetary side the "balanced budget" principle remains strong and likely to remain in place. It can be expected that expenditures will be reduced to meet anticipated revenues if the budget is not in balance. Although some off-budget financing (the equivalent of deficit financing) can be expected to occur, it is unlikely to materially change from present practices. Nevertheless, the pressures would be greater to seek relief from this source.

E. SUFFICIENCY OF FINANCE

On the basis of the projections summarized in Table 7, including the sources of finance drawn from Table 2 and Table 6, it is believed that the GOI has finance in hand or in advanced stages of negotiation sufficient to avoid more than a $1.0 billion draw down of official reserves over the next three years.1/ Reserves should be sustainable at the $5.0 billion level 1986/7-1988/9, assuming that the conservatively low oil price assumptions shown at the bottom of Table 7 hold true. A $2-3/barrel fall in oil prices ($0.7-$1.0 billion) compared to the projected levels in Table 7, could probably be absorbed for a year, unless it triggered major capital flight.2/

It is likely, however, that confidence in the economy will grow as the GOI's handling of the balance of payments and budgetary adjustments are better understood. This, in turn, should help insure that private capital reflows will occur, further strengthening the balance of payments. It is also possible that some commercial lenders will be willing to refinance or roll over payments falling due, without increasing their exposure. The IBRD has estimated that $1.5 billion of commercial amortization is scheduled for 1987/8-1988/9, for example. Finally, it seems likely that additional possibilities for program or local cost financing in 1988/9 and beyond, still exist among some of the donors, including the IBRD and the Japanese.

All of this suggests that, except in the case of prolonged decline in the oil price or sustained capital flight, Indonesia should be able to finance its balance of payments, at the levels projected in Table 7, with reasonable certainty.

1/ It is important to be aware that the accounting treatment of official reserves has shifted between 1985/6 and 1986/7, however. Swap facility purchases (apparently since October 1986) are now effectively included in official reserves. This implies that the actual outflow of official net foreign assets in 1986/7 is much higher that the $1.0 billion indicated above, possibly as much as $3.0 billion. Although official reserves will be nominally drawn down by $1.0 billion, total net foreign assets available to the GOI will have decreased substantially more.

2/ As a rough rule of thumb a $1/BBL change in average oil prices will result in a $350 million change in the current account deficit.

Table 7. Summary External Outlook 1985/86-1990/91 ($ billion)

	1985/6	Projected 1986/7	1987/8	1988/9	1989/90	1990/91
Current Account Deficit	- 1.8	- 4.8	- 2.9	- 1.2	- 0.2	0.0
Public Debt Amortization	1.6	2.1	3.0	3.4	3.8	3.9
Total Finance Requirement	3.4	6.9	5.9	4.6	4.0	3.9
Projected Sources of Finance	3.5	6.0	5.0	4.5	4.2	4.2
Donor project disbursements	2.8	3.1	3.0	3.0	3.0	3.0
New donor program assistance	-	0.1	1.4	0.7	-	-
Commercial loan standbys	0.6	2.0	1.4	-	-	-
New commercial borrowing	-	-	-	0.6	1.0	1.0
Net private capital flows	0.1	0.8	0.2	0.2	0.2	0.2
Change in Reserves (- = increase)	-	0.9	- 0.1	0.1	- 0.2	- 0.3
Memorandum:						
Official Reserves	5.8	4.9	5.0	4.9	5.1	5.4
Public Debt Service	4.3	4.4	5.0	5.4	5.8	5.6
Public Debt Service Ratio (%)	21.4	29.5	31.3	30.5	29.3	26.3
Total Debt Service Ratio (%)	26.0	36.9	34.4	34.3	34.3	32.9
Outstanding Public Debt	29.4	32.2	35.2	36.0	36.4	36.7
Assumed Oil Price ($/BBL)	25.0	12.3	13.5	15.0	18.0	20.0

Source: IBRD Trade Policy Adjustment Loan, IMF, and Table 3.

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ANNEX II

STATEMENT OF WORLD BANK CHIEF REPRESENTATIVE
TO IGGI CHAIRMAN
FEBRUARY 24, 1987

1. We meet this year at a time when Indonesia is in the middle of a very painful adjustment to sharply diminished financial resources. Indonesia has been relatively successful in harnessing the oil revenues of the 1970s to foster economic growth and social progress. GDP grew by 7.5 percent p.a., supported by a steady expansion of agricultural output, especially rice, and a rapidly growing manufacturing sector. The proportion of population living in poverty declined from 57 percent to 42 percent. Infant mortality fell from 121 to 101 per thousand, and access to primary education became virtually universal. However, rapid progress in these and other areas was badly hurt by the fall in oil prices over the past five years. On a net basis (i.e., after deducting related imports and service payments), oil/LNG earnings have fallen from a peak of over $10 billion in 1980/81 to below $5 billion in 1985/86 and around $2 billion in 1986/87. Commodity prices for many of Indonesia's non-oil exports have also fallen, leading to a deterioration in the terms of trade by more than 40 percent since the early 1980s.

2. The impact of this drastic loss of resources and the government's response was discussed at some length in the World Bank's economic report last year. For 1986/87, the report has been pretty close to the mark. The government took the necessary adjustment measures, including the austere budget and a 31 percent devaluation, restraining the current account deficit in the balance of payments to an estimated $4-4.5 billion. Inflation has also been held below 9 percent. Real growth has remained remarkably strong, due in part to the positive impact of increased non-oil exports. However, adjusting for the terms of trade loss, real incomes have probably fallen significantly over the past year.

3. The prospects for the coming year, 1987/88, however, are significantly worse than we had projected a year ago. Firstly, despite recent OPEC agreements, the oil price remains fragile and the oil/LNG export projections made last year now seem optimistic. Secondly, the U.S. dollar continues to weaken, adding to the real burden of Indonesia's debt service obligations. Accordingly, the debt service ratio has risen to a high level of around 38 percent, placing a strict ceiliing on the extent of new borrowing that Indonesia can undertake to smooth the adjustment process. In this context, the government's continued emphasis on budget austerity for 1987/88, as well as the recent progess on structural reforms in the area of the trade policy, are appropriate responses to a worsening external environment.

4. Because of the loss of oil revenues, most of the development budget is now for ongoing projects financed by foreign assistance. Excluding external assistance, the allocation of rupiah for development spending by departments has been slashed by more than 80 percent over the past two years. Under these conditions, there is an acute shortage of counterpart funds to implement even ongoing projects, let alone to support new project proposals. Nor is it likely that the budgetary allocations would be adequate to provide properly for the operations and maintenance of existing projects.

This outcome is not the result of inappropriate budgeting: both counterpart funds and O&M have been given high priority in the government's spending allocations. Rather, it simply reflects the massive loss of oil revenues suffered by Indonesia over the past year and the rising claim of external debt service on budgetary resources.

5. In summary, revenues are sharply down, the government has prepared an expenditure program which reflects priorities that we would share but for which there are not enough rupiah funds. Further budget cuts or problems in meeting the substantial financing needed for the balance of payments may lead to serious consequences for employment..

6. This conundrum was anticipated in the World Bank's report last year where we urged donors to show flexibility in the use of both the existing pipeline and future commitments. The extent to which donors have been able to respond to this need has varied. The Japan Exim Bank has signed a protocol last week for an untied loan of $905 million in support of rupiah counterpart of ongoing World Bank projects. This is quick disbursing money but its utilization will be limited by the pace of implementation of the 21 projects to which it is allocated. The World Bank has approved a trade policy adjustment loan in support of the recent measures, which can disburse very quickly against general imports. The ADB has provided an additional loan to increase its cost sharing of ongoing education projects. And several other donors have increased their support for rupiah expenditures associated with projects they finance.

7. While all this has been very helpful, the coming year calls for an even stronger effort, as the scope for new projects is extremely limited. There are several ways in which donors could modify the nature of their assistance so as to facilitate its effective use. For example:

   a. Donors could review projects under implementation. Delete components that are of lesser priority and provide additional support for the rapid completion of the important components of these projects;

   b. Donors could finance a larger share of rupiah expenditure on their projects, on a temporary basis, facilitating more rapid disbursements this year from existing pipeline of commitments;

   c. New projects can be designed in such a way as to support mainly rupiah expenditures in ongoing government development activities, e.g. O&M expenditures or the completion of projects previously funded entirely by government funds;

   d. Some donors may find it suitable to provide tied commodity assistance, which could be quite useful in financing ongoing imports and providing rupiah cunterpart funds for development;

   e. Finally, the ideal form of assistance is providing program aid that can finance general imports and support the budget.

8. Each donor would obviously have to consider for itself what forms of assistance it can provide, within the limits of its operating principles and procedures. The World Bank is prepared to go a long way because we are impressed by the proven determination of the government to deal responsibly with an extremely difficult economic environment.

ANNEX III

DEVELOPMENT BUDGET ANALYSIS

I. MINISTRY OF AGRICULTURE → center

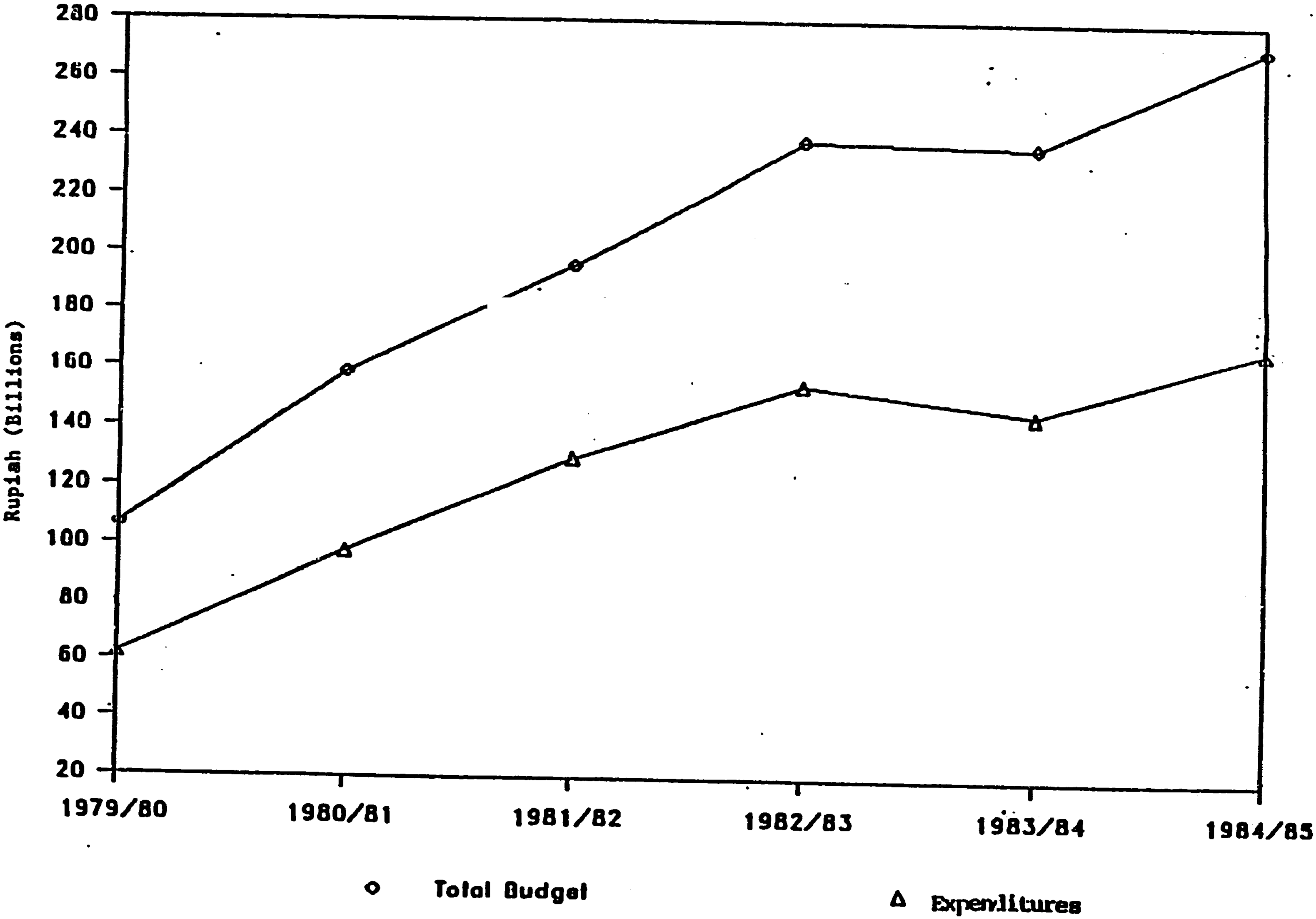
Declining oil revenues have prompted the Government of Indonesia (GOI) to institute large cutbacks in its annual budgets for the two fiscal years 1986/87 and 1987/88. Section A describes the Ministry of Agriculture's (MOA) development budget, differentiating it from the routine budget. It also demonstrates that it is appropriate to use available budget data for this analysis because GOI expenditures closely track allocations. Section B examines the distribution of the development budget between the nine divisions of the MOA. It also analyses nominal and real budget trends for the total MOA budget and selected divisions during the years 1979/80-1986/87. Section C examines budget shares and trends for the four operational categories within the MOA's Research Division (AARD). AARD is of particular interest to AID because of AID's large past investments in agricultural research in Indonesia. Section D makes projections for the three years between 1986/87 and 1988/89 based on historical trends. The real projected values can be used to make comparisons with actual budgeted amounts for those years. Finally, Section E briefly reviews the MOA's routine budget.

A. THE DEVELOPMENT BUDGET

The MOA's budget and expenditures consist of the routine budget, the development budget, and the foreign assistance supplement to the development budget. The routine budget covers operational costs including salaries and compensation, travel and operating costs for buildings, services and maintenance. The development budget is entirely project driven. It is the focus of this analysis because it represents the principal source for "counterpart" funding required in most foreign-assisted development projects. Historically, the proportion of counterpart funding to foreign assistance funding has been 40:60. Foreign assistance funding has changed little over the past two years as GOI funding has declined, leaving lower proportions available for the GOI to finance development priorities established independently. Both the actual decline in the development budget and the smaller proportion available for the GOI's own priority programs are matters of concern.

The analysis in the next section is based on budget data rather than expenditures. However, as shown in Figure 1, the budget allocation for a year (for the routine and development budgets combined) follows expenditures very closely so that the development budget is a good proxy for expenditures, even though the latter is slightly below funding levels in each case. The data used in this Annex are for the revised development budget in each case. The revised budget is the one-year development budget generally announced in the period running from October-January of the current fiscal year. It differs from the proposed development budget announced in the previous year due to policy and expenditure decisions made by the government during the year.

Figure 1. Ministry of Agriculture Budgets and Expenditures, 1979/80 to 1984/85



B. DISTRIBUTION OF THE DEVELOPMENT BUDGET

1. Total Budget

The total development budget in the Ministry of Agriculture is allocated among nine divisions: the Secretary General (Sec Gen), the Inspector General, the Directorate General (DG) Food Crops, DG Fisheries, DG Industrial Crops, DG Livestock, BIMAS (the operational agency for rice intensification and extension programs), AARD (the research coordinating agency) and the AAETE (the extension coordinating agency).

Figure 2 shows the total development budget for the MOA in nominal and real values (1984/85 = 100) for the years 1979/80-1986/87. The budgets are the revised development budgets for all years. The deflator used is the Consumer Price Index for the composite of 17 Indonesian cities. It was adjusted to a fiscal year basis for this analysis. As shown, both the nominal and real budgets grew rapidly from 1979/80 until 1982/83, then declined sharply the following year; they recovered somewhat in 1984/85 but fell even more steeply in 1986/87. In the analysis that follows, the year 1986/87 is used as a reference point to compare historical trends from 1979/80 to 1985/86. Wherever necessary, other marked trends are noted for the periods during which they occured

a. Shares of Total MOA Budget

As shown in Table 1 and Figure 3, historically, the largest budget share within the MOA has generally been for the DG of Food Crops. Over the period 1979/80 to 1984/85, DG Food Crops held a fairly constant 30 percent share of the budget, the largest of any other division. However, the proportion changed drastically in 1986/87 as the budget share for DG Food Crops declined to about 19 percent. The shares of the other DGs and the AAETE ranged between 7-11 percent over this period while that of the Secretary General ranged between 0.68 percent and six percent. BIMAS' share of the budget, which had historically ranged between 11-13.5 percent (Figure 4), more than doubled in 1985/86 to over 26 percent of the total. The value of BIMAS' budget for 1986/87 exceeded that of DG Food Crops by Rp. 6.41 billion. This was the first time that the budget for DG Food Crops was surpassed by any other division within the MOA. On the other hand, AARD's budget share declined steadily over the period, starting at about 17 percent of the total MOA budget allocation and falling to a low of nine percent in 1985/86. Although it recovered slightly in 1986/87 to 12 percent, its share declined once again and even more steeply in 1987/88.

Figure 2. MOA Development Budget, Nominal and Real (1979/80-1986/87)

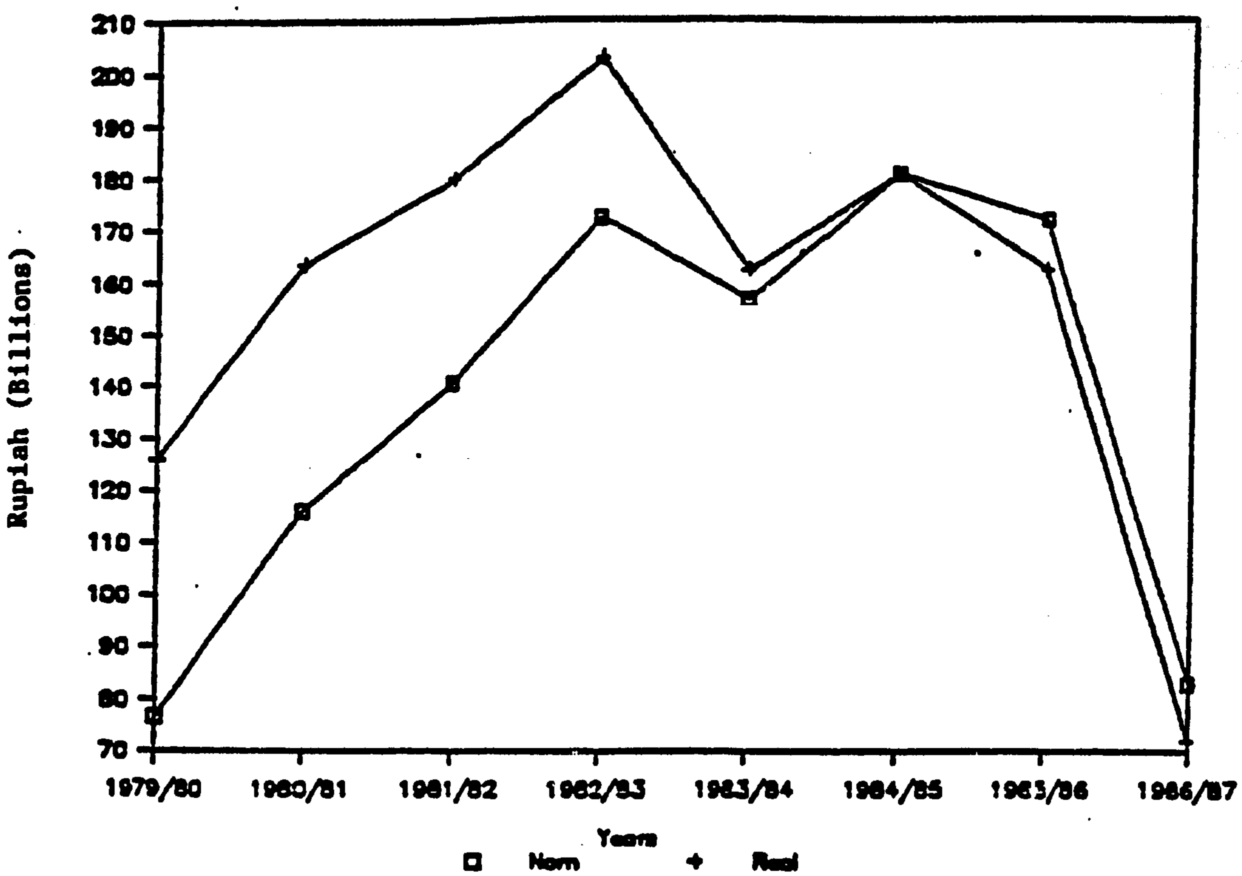
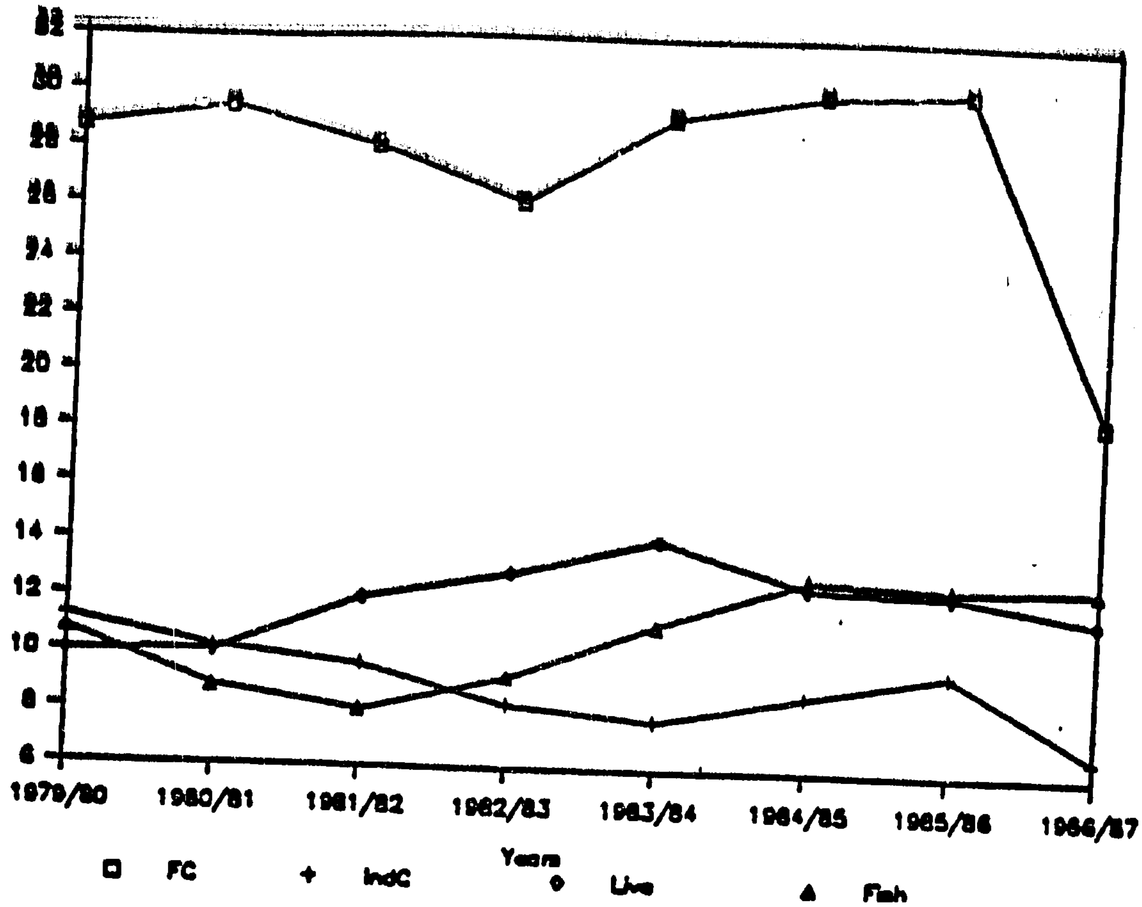


Table 1. MOA Development Budget by Division, 1979/80-1986/87 (Rupiah Billions)

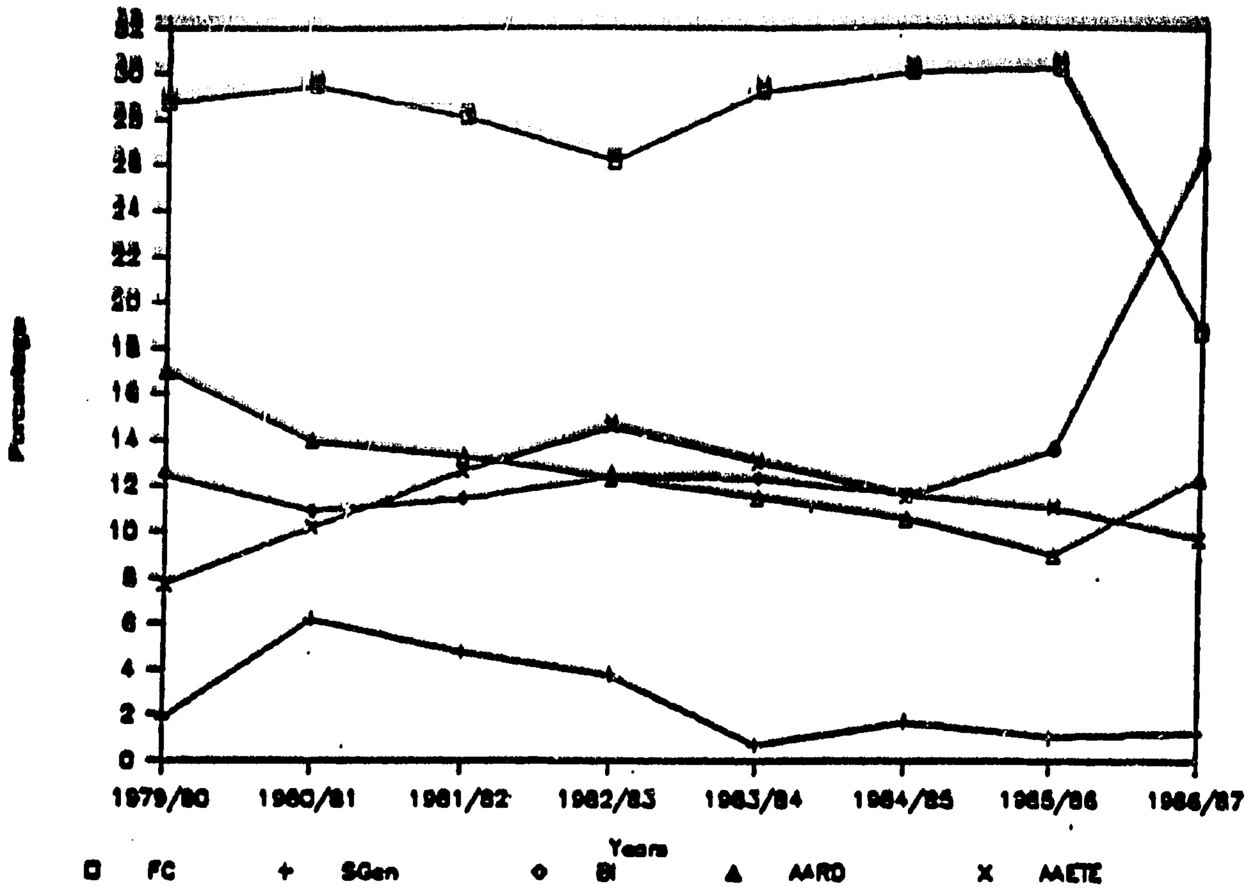
Division	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87
Secretary General	1,410,650,000	7,150,009,000	6,648,384,000	6,586,630,000	1,058,166,000	3,833,307,500	1,748,483,000	1,[illegible]
Inspector General	200,000,000	350,000,000	500,000,000	550,000,000	485,985,000	666,854,000	800,000,000	700,000,000
Directorate of Food Crops	21,984,151,500	34,220,274,000	39,515,182,000	45,052,212,500	45,704,211,000	34,242,736,200	53,926,033,000	15,498,425,000
BIMAS	9,546,216,000	12,662,662,000	16,891,939,500	21,408,711,500	19,247,328,000	20,909,498,000	23,345,292,000	21,384,233,000
Directorate of Industrial Crop	8,590,944,000	11,839,224,435	13,527,587,400	14,254,520,300	12,178,636,000	15,739,200,000	16,443,243,000	5,536,660,000
Directorate of Livestock	7,628,570,000	11,643,125,580	16,867,990,000	22,364,335,850	22,206,635,500	22,703,331,000	21,327,105,000	9,593,183,000
Directorate of Fisheries	8,259,270,000	10,205,480,400	11,296,599,000	15,950,330,000	17,494,470,000	23,304,233,000	21,715,397,000	10,550,360,000
AARD (Research)	13,000,779,000	16,179,559,000	18,645,900,000	21,270,027,500	17,933,613,000	19,035,518,000	15,465,524,000	10,233,147,000
AAETE (Extension)	5,902,053,000	11,852,034,000	17,785,350,000	25,151,617,000	20,368,325,500	20,912,765,500	19,023,410,000	3,033,698,000
Total	76,522,633,500	116,102,776,415	140,898,930,700	172,450,384,650	156,671,570,000	180,507,675,200	171,795,783,000	[illegible]

Figure 3: MOA Development Budget, Comparison of Budget Shares



FC = DG Food Crops
IndC = DG Industrial Crops
Live = DG Livestock
Fish = DG Fisheries

Figure 4: MOA Development Budget, Comparison of Budget Shares



FC = DG Food Crops
SGen = Secretary General
BI = BIMAS
AARD = Research Division
AAETE = Extension Division

1. Total Budget Trends and Recent Cuts

The nominal budget for the MOA grew at an average rate of 16 percent per annum between the years 1979/80-1985/86. The real average growth rate was about 5.6 percent per annum (see Table 2). The total budget fell sharply in 1986/87, declining by 52 percent in nominal terms over the value of the previous year. This brought the nominal budget allocation in 1986/87 down almost to the level that prevailed in 1979/80. The real value of the allocation was, of course, even lower due to inflation.

The DG Food Crops suffered the largest nominal budget cut of any other division, its budget being reduced 70 percent in 1986/87. The other DGs and the Extension Service followed close behind experiencing cuts of between 51 and 66 percent. The AARD's budget was cut by only 34 percent in 1986/87, but because it had been declining since 1982/83, the cumulative loss has been high--52 percent between 1982/83 and 1986/87.. In 1986/87, BIMAS' budget was cut only six percent, leaving it with the highest budget allocation within the MOA for that year, at Rp. 21.9 billion. The next four sections examine budget trends and implications in greater detail for the DG Food Crops, the AARD, BIMAS and the Sec Gen.

2. DG of Food Crops

The budget trends for DG Food Crops closely reflect the trends for the MOA as a whole. The nominal and real trends for the DG Food Crops are shown in Figure 5. After a steady increase until 1982/83 and a dip in 1983/84, the budget for DG Food Crops peaked in 1984/85 at Rp. 54.24 billion and then declined. The rate of nominal budget growth in the period between 1979/80 and 1985/86 averaged 17 percent per annum while the real rate of growth was slower at about six percent per annum (see Table 2). The budget started declining again in 1985/86 and fell drastically in 1986/87 to Rp. 15.5 billion. This was below the nominal budget value of Rp. 21.98 billion in 1979/80, and considerably lower in real terms, as can be seen in Figure 5.

3. AARD

Figure 6 compares nominal and real budget trends for the AARD between 1979/80 and 1986/87. The trend is significantly upward until 1982/83, although the share of AARD was declining steadily over the period. The AARD budget peaked at Rp. 21.27 in 1982/83. Thereafter, there was a sharp and fairly steady decline to 1986/87 when its budget amounted to Rp. 10.23 billion. Hence, although the nominal rate of growth averaged 4.25 percent per annum between 1979/80 - 1985/86, the real average rate actually declined 4.95 percent per annum over the same period (see Table 2). From 1982/83 to 1986/87 the rate of decline is even more rapid--an average rate of 15.5 percent per annum in nominal terms, and an even steeper average rate of 21 percent per annum in real terms. The AARD budget has fallen at a faster real rate than any other Division in the MOA.

Table 2: MOA Development Budget: Average Growth Rates, 1979/80-1985/86

	Nominal (%)	Real (%)
Total MOA	**10.12**	**3.82**
DG Food Crops	17.00	6.19
AARD	4.25	-4.95
BIMAS	17.13	6.80
Sec.Gen.	76.30	59.10

Figure 5. MOA Development Budget, Food Crops -- Nominal and Real

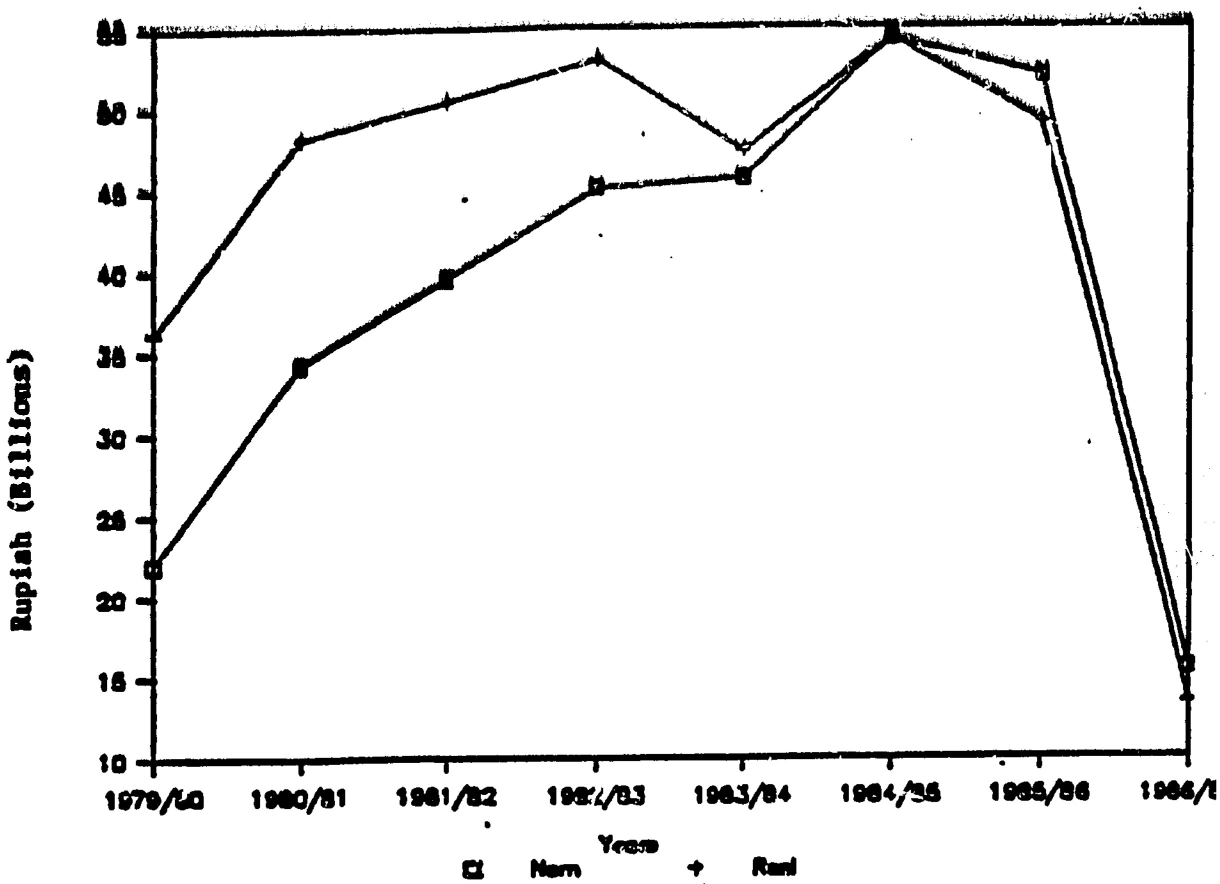
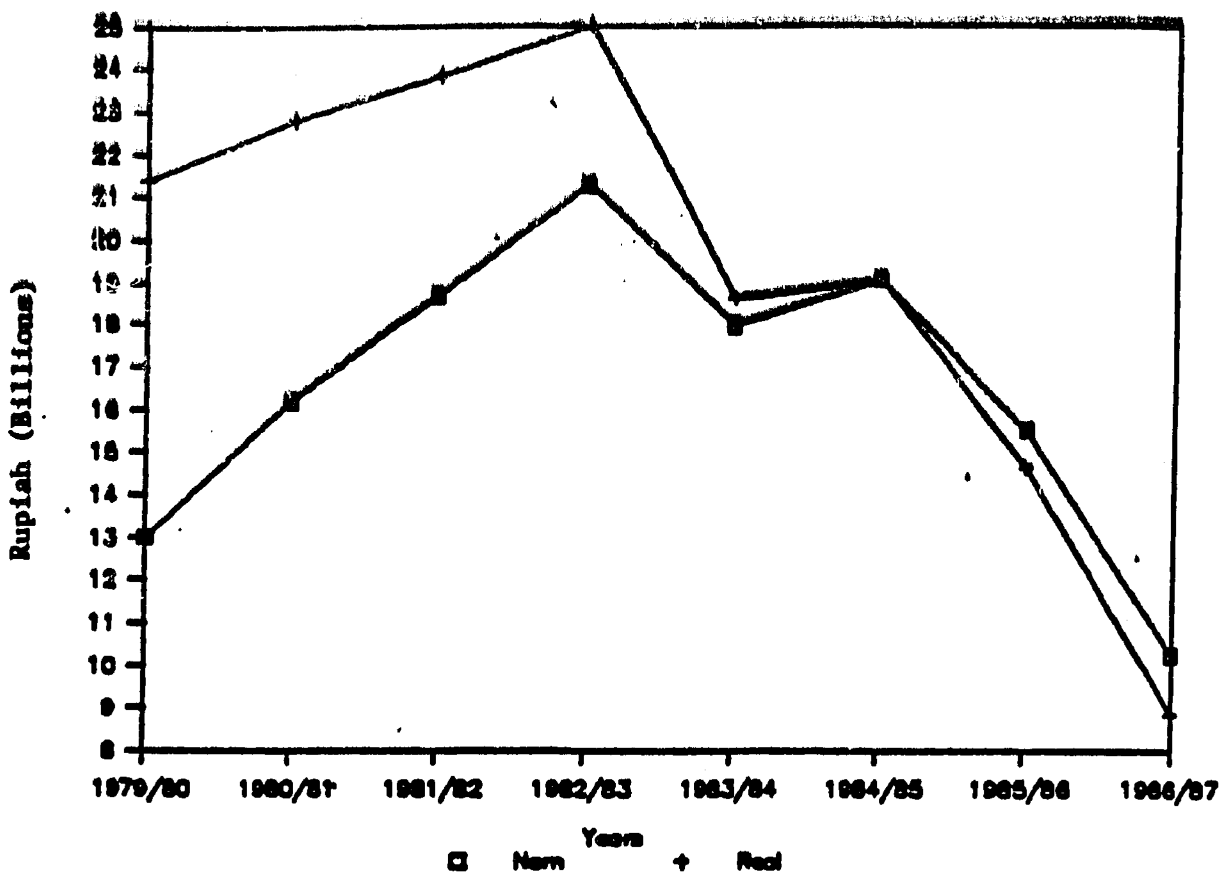


Figure 6. MOA Development Budget, AARD — Nominal and Real



4. BIMAS

BIMAS' (the agriculture intensification program) budget fared the best in the period under review when compared with the other divisions within the MOA, as shown in Figure 7. As shown in Table 2, BIMAS' average annual rates of growth are virtually identical with those of the DG Food Crops. However, in 1986/87, BIMAS' allocation was higher than that of the DG Food Crops. In fact, it was the highest in the MOA. BIMAS' allocation of Rp. 21.9 billion in 1986/87 exceeded its 1979/80 allocation by Rp. 12.36 billion, when almost all the other divisions were cut back to 1979/80 levels or below. Although rice self-sufficiency was achieved in 1983, BIMAS continues to receive a disproportionately large share of the development budget. Apparently, BIMAS is now being used both to maintain levels of rice production and to address broader problems associated with integrated pest management. It has also assumed a larger portion of the extension work that is also being done by other agencies such as the AAETE and the extension service of the DGs.

5. The Secretary General

The nominal budget trend for the Sec Gen's office is shown in Figure 7. The high average rates of nominal and real growth for the Sec Gen's office shown in Table 2 are somewhat misleading for two reasons. First, the Sec Gen's share of the total MOA budget has averaged just one percent since 1983/84. Second, most of the increase in this budget occured in one year when the budget rose from Rp. 1.4 billion in 1979/80 to Rp. 7.15 billion in 1980/81. This was a nominal increase of 407 percent. Thereafter, the budget stayed fairly stable up to 1982/83, declined sharply in 1983/84, recovered partially in 1984/85, and then fell back again in 1986/87 to slightly less than its 1979/80 level—just over one billion rupiahs.

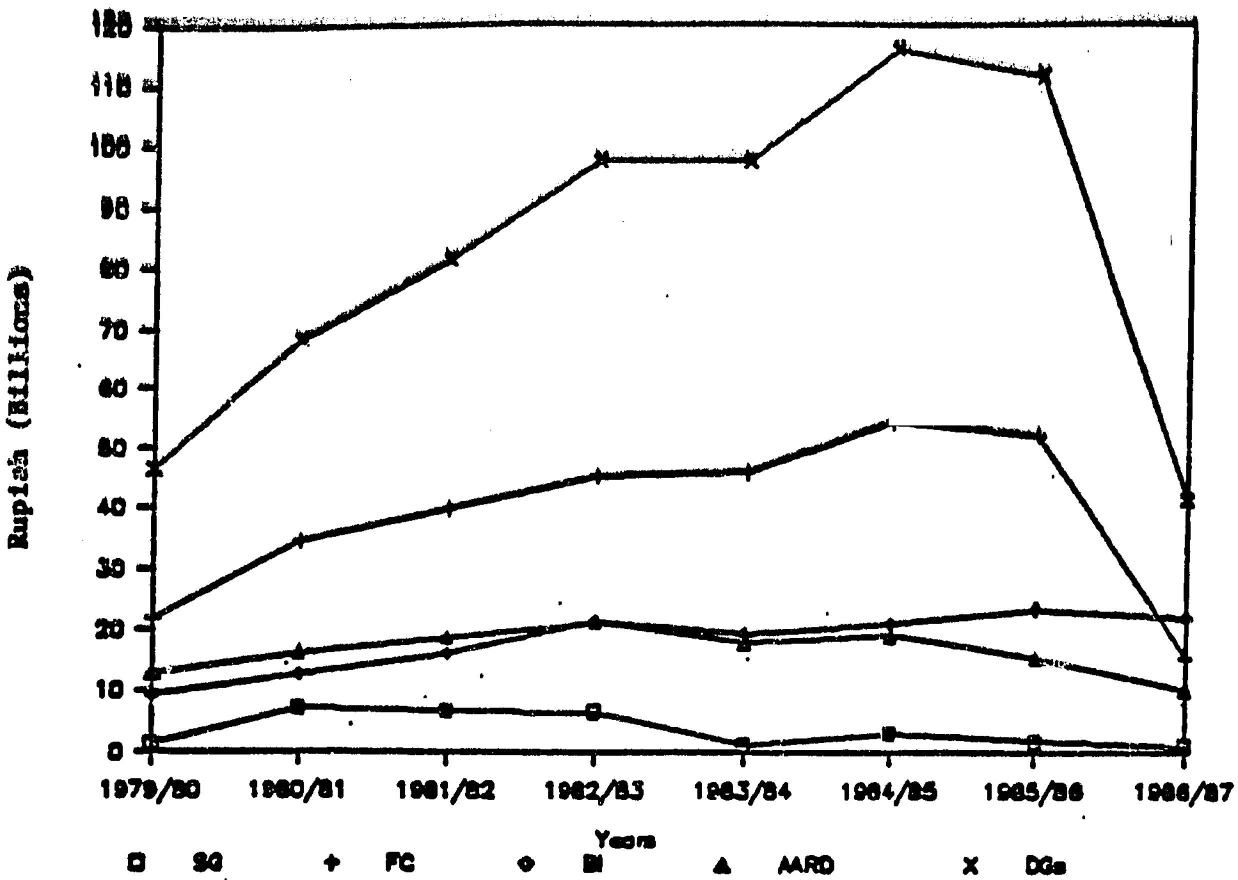
6. Summary of MOA Development Bud

- Both the total MOA and the divisional budgets rose significantly from 1979/80 to 1982/83. The total budget grew at an average annual rate of about 32 percent over the four years from 1979/80-1982/83. The rise closely mirrors the growth in oil exports and increased governmental revenues from the energy industry.

- Total and divisional budgets began to decline after 1982/83, the most significant cuts occuring in 1986/87. The effect of the last cut was to reduce nominal budget allocations to around the levels of 1979/80 for both the total development budget and most of the divisions.

- The notable exception to the recent declining trends and large cutbacks in 1986/87 was BIMAS, which received a disproportionately large and growing share of the budget. Even the six pecent cut in 1986/87 left BIMAS with a much higher allocation than it had in 1979/80. This amounted to Rp. 21.9 billion—the highest of any division in the MOA for that year.

Figure 7. MOA Development Budget, Selected Division Comparisons (Nominal)



o The AARD budget was cut 34 percent in 1986/87, but it had been declining steadily and at a faster rate than any other Division in the MOA since 1982/83.

o The DG Food Crops suffered the largest reductions of any division in the MOA in 1986/87. Its budget fell from Rp. 91.92 billion in 1985/86 to Rp. 15.49 billion in 1986/87. Its share of the budget also fell from 30 percent in 1985/86 to 18.8 percent in 1986/87.

B. AARD

This section discusses at greater length the implications of the distribution of the development budget within the AARD. Greater attention is focused on this division of the MOA because AID has made heavy investments in agricultural research in Indonesia in the past. Agricultural research is also an important focal point of AID's current portfolio. Further, as described in the preceding sections, AARD has been more seriously effected by declining budgets over a longer period than other divisions of the MOA.

The four main functional categories within the AARD are Project Administration, Research Operations, Extension, and Materials and Supplies. The budget for Project Administration is used for running experimental stations and for travel, while Research Operations include all the costs associated with supplies and operations for conducting experiments. The Extension budget is used for local verification trials while the Materials and Supplies category consists of the budget for building and equipment maintenance, office and administrative supplies, fuel, electricity, etc. As data for these functional categories were only available for 1980/81 - 1985-87, the following discussion covers this period. For 1986/87, the only available data were on aggregated Research Operations and Extension.

1. Total AARD Budget

a. AARD Categories: Share Trends

The distribution of the development budget between the four categories has varied in the period under review (see Table 3.b). In general, over 30 percent of the budget share accrued to Research Operations and this share has increased somewhat in recent years. The shares held by Project Administration and Materials and Supplies have fluctuated greatly, the latter more than the former. Overall, the budget share for Project Administration has declined from 30 percent in 1980/81 to about 19 percent in 1986/87, while that of Materials and Supplies has also decreased, but to a lesser extent, from 35 percent in 1980/81 to 26 percent in 1986/87. The share of Extension increased fairly steadily over the period from 3.66 percent in 1980/81 to ten percent in 1985/86, and was dropped from the 1986/87 budget.

Table 3a: AARD Development Budget, 1980/81-1986/87, Types of Expenditures (Nominal) ([illegible])

Categories	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87
Project Administration	4,992,000,000	4,426,400,000	3,974,109,000	3,046,900,000	2,634,900,000	3,128,000,000	[illegible]
Research Operations	5,187,900,000	6,424,300,000	7,686,400,000	8,432,300,000	7,604,000,000	7,435,000,000	[illegible]
Extension	606,400,000	760,900,000	854,700,000	1,372,200,000	1,031,600,000	1,579,100,000	
Materials and Supplies	5,777,000,000	7,034,200,000	6,735,000,000	4,573,000,000	7,765,000,000	3,381,900,000	[illegible]
Total	16,563,300,000	18,646,000,000	19,250,200,000	17,424,400,000	19,035,500,000	15,539,000,000	[illegible]

Table 3b. AARD: Proportion of Development Budget by Category, 1980/81-1986/87

Categories	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87
Project Administration	30.14	23.74	20.64	17.49	13.84	[illegible]	[illegible]
Research Operations	31.32	34.46	39.93	48.39	39.95	[illegible]	[illegible]
Extension	3.66	4.08	4.44	7.88	5.42	10.16	[illegible]
Materials and Supplies	34.88	37.72	34.99	26.24	40.79	21.76	[illegible]

b. Budget Trends and Recent Cuts

Total AARD development budget trends for the period 1980/81 - 1985/86 are shown in Figure 8. As shown in Table 4, the budget declined at an average real rate of eight percent per annum, affecting all operational categories. Comparative budget trends for the four AARD categories are shown in Figure 9. The Research Operations budget increased steadily until 1983/84 and then followed a downward path. Allocations for Project Administration show a steadily downward trend over the entire period. The budget for Supplies and Materials fluctuated a great deal but trended downward. Extension is the only category which exhibits a distinctly upward trend.

The sharp drop in allocations from 1985/86 to 1986/87 for the whole MOA is also reflected in each of AARD's functional categories, although to varying extents. As noted above, disaggregated data for the Research and Extension categories were not available for the last year. However, if we assume Extension's share of the budget was unchanged at ten percent from 1985/86 to 1986/87, the adjusted budget for Research Operations is reduced to Rp. 4.5 billion. In this case, which is quite likely, the largest reductions in the last year were in Research Operations and Project Administration which were cut by 38 percent and 39 percent, respectively. This represented a real reduction of about 44 percent over the previous year in both cases. The cuts reduced nominal amounts to below 1980/81 levels for both categories. The 20 percent drop in the Materials and Supplies budget in 1986/87 was somewhat less than for the other categories, but the nominal amount allocated for the category was half as much as in 1980/81. Data were unavailable for Extension allocations for 1986/87; however, Figure 9 shows the interpolation explained above.

2. Research Operations

The nominal and real budget trends for Research Operations shown in Figure 10 exhibit distinct upward and downward portions, with the turning point occuring midway through the period. The real budget peaked in 1982/83, a year earlier than the nominal budget, and then trended steadily downward. The average rate of budget growth as shown in Table 4 was 8.28 percent per annum over the period to 1985/86, but virtually all the growth took place in the earlier years from 1980/81 to 1982/83. The average real rate of growth for the period between 1980/81 and 1985/86 is slightly negative. However, the averages disguise the fact that the nominal budget declined steadily at an annual average rate of 6.8 percent between 1983/84 and 1986/87. The real decline was even faster at the average rate of almost 14 percent per annum. Notably, the largest cut occured in 1986/87.

Figure 8: AARD Development Budget, Nominal and Real (1984/85=100)

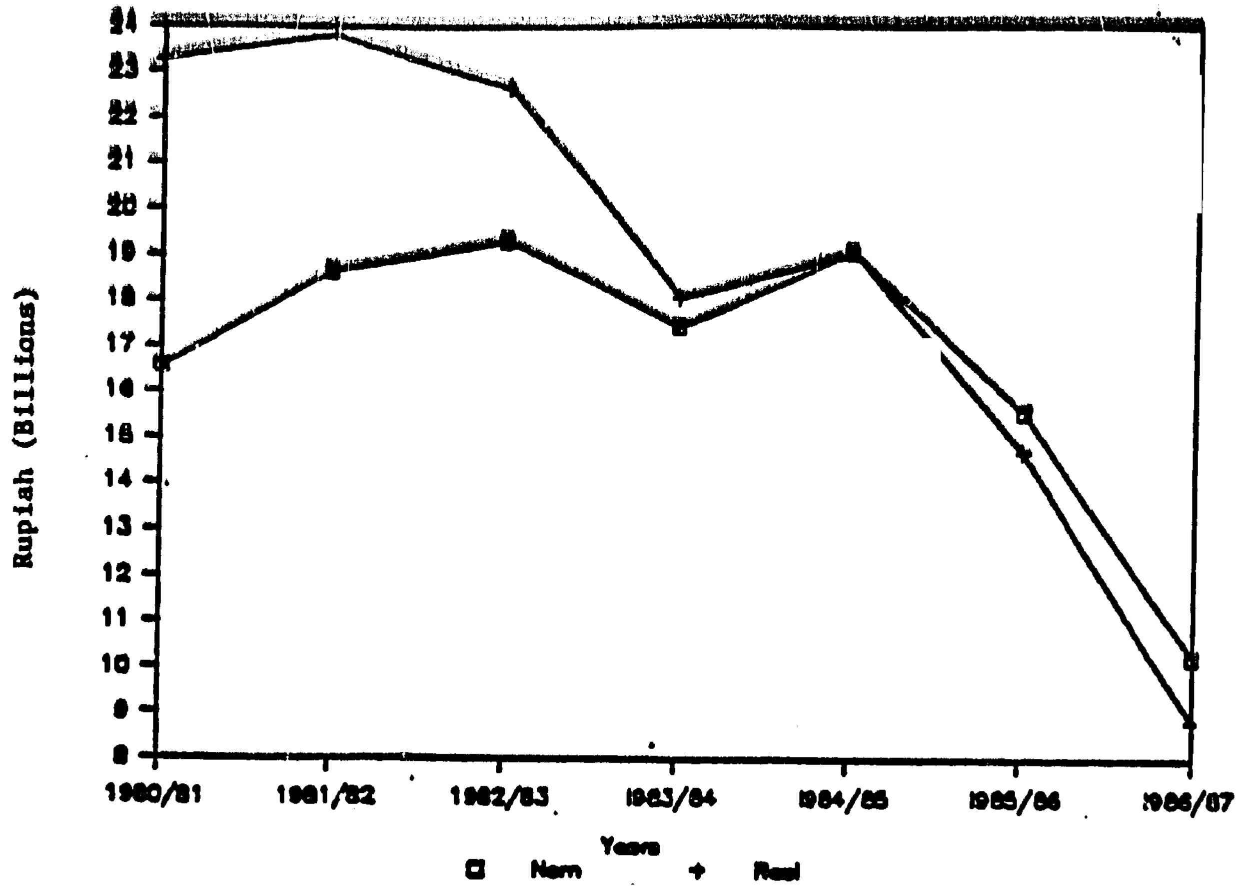
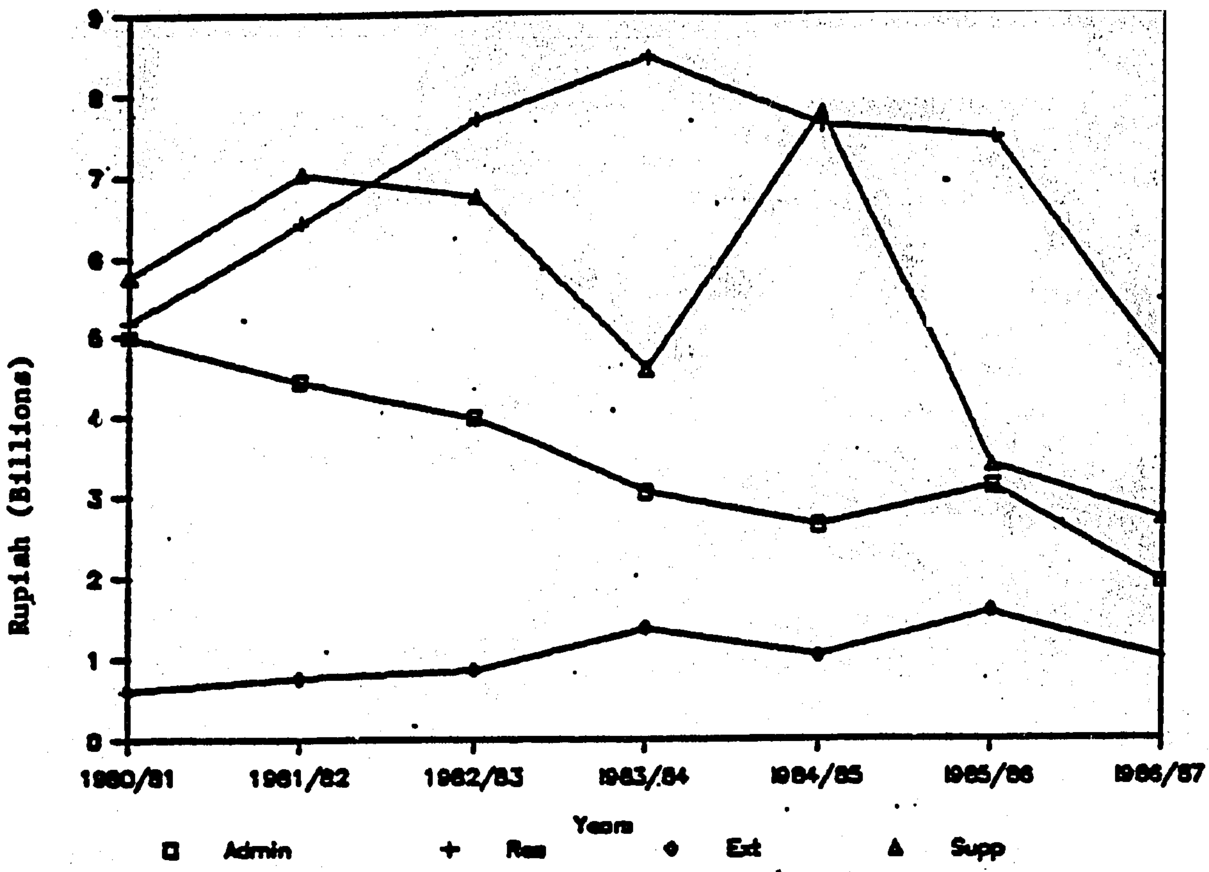


Table 4: AARD Development Budget, Average Growth Rates, 1980/81–1985/86

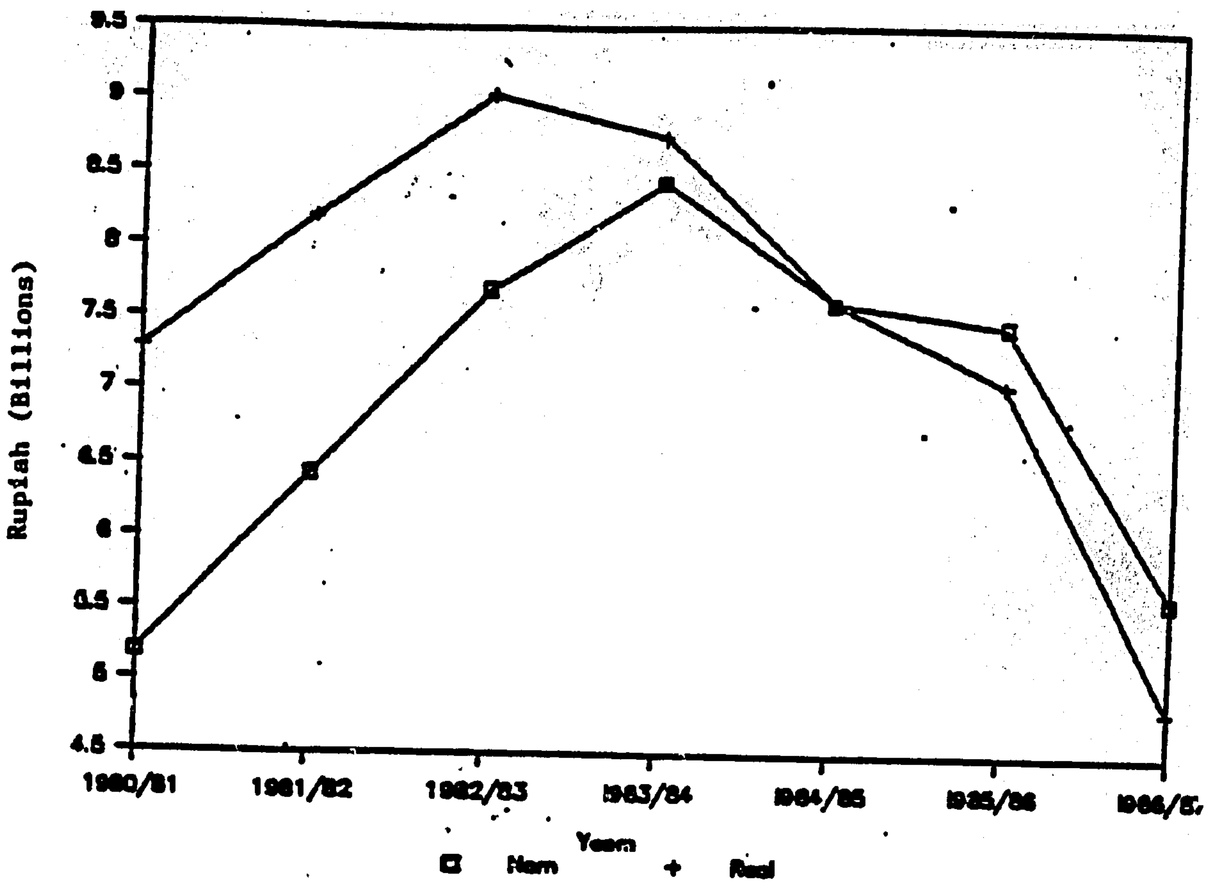
	Nominal (%)	Real (%)
Total	**-0.53**	**-8.08**
Research Operations	8.28	-0.20
Project Administration	-7.90	-14.75
Extension	25.33	15.25
Materials & Supplies	-0.20	-7.30

Figure 9. AARD Development Budget, Nominal Category Comparisons



Admin = Project Administration
Res = Research Operations
Ext = Extension
Supp = Materials and Supplies

Figure 10. AARD Development Budget, Research Operations



3. <u>Other Categories</u>

The nominal and real budget trends for Project Administration show steady declines. The nominal budget declined at an annual average rate of almost eight percent, while the real decline was even steeper at an average rate of almost 15 percent per annum (Table 4). As shown in Figure 9, the budget for Materials and Supplies also trended downward though much more unevenly. The real average rate of decline was about half that for Project Administration. The budget for Extension is the only one that shows a marked upward trend. It grew in nominal terms at an average rate of 25 percent per annum, although its share is relatively small at about ten percent.

4. <u>Summary</u>

The major conclusions and implications of the decline in the AARD's development budget are the following:

- Budgets in all categories except Extension declined over the period 1980/81-1985/86. By 1986/87, they had fallen below 1980/81 levels.
- The Project Administration budget declined the most throughout the period 1980/81 to 1986/87, at an average real rate of 14.75 percent per annum
- The Research Operations budget has been declining since 1982/83 at a real average rate of 14 percent per annum for the years 1983/84 to 1986/87. It fell an estimated 39 percent in 1986/87 from the previous year. Even with the Extension budget included in that for Research Operations, the allocation of Rp. 5.58 billion in 1986/87 represented a real decline of 34 percent from the amount in 1980/81.

The budget shortfalls of the past two years have put a serious restriction on the GOI's funding for agriculture research, a major program area supported by AID. Historically, GOI expenditures in real terms for agriculture research grew by over 11.5 percent per year from 1975 to 1983. However, as a result of the general economic downturn, the MOA budget for research was reduced by nine percent in 1984/85, compared to the previous year. In 1985/86, the MOA realigned priorities, eliminated several budget categories, and managed to increase the overall budget for agricultural research by ten percent. However, faced with continuing severe budget constraints, the agricultural research account fell again by over 30 percent in 1986/87, compared to 1985/86.

In 1986/87, the AARD received a budget of Rp. 10.2 billion, which represents 12 percent of the total MOA budget of Rp. 83 billion. Of the Rp. 10.2 billion, Rp. 5.2 billion is committed as counterpart funds to support development projects being financed by external donors. This means that AARD is left with a total budget of Rp. 5 billion to cover its own development activities, of which agricultural research is a component. Within AARD, about 40 percent of the total budget, or Rp. 2 billion, goes to food crops research institutes for administration, operation of facilities, and research. After subtracting materials and supplies costs, less than Rp. 400 million is available for operational food crops research in 1986/87.

The case of food crops research illustrates the severity of the problem. There are 147 scientists (PhD and MSc holders, plus other senior researchers) working with food crops. Thus, only Rp. 2.72 million per scientist is available for research. This is far below the level of Rp. 20 million per researcher available in 1984/85, a level that was determined by ISNAR during a 1985 review of AARD to be minimally adequate for conducting agricultural research in Indonesia. In response to this situation, the MOA adjusted resource allocations in an attempt to meet research priorities. For example, although AARD's total development budget has been reduced by 30 percent this year, AARD has set aside 54 percent of the development budget for operational research. As a comparison, 38 percent of the development budget was allocated to operational research in 1984/85.

Despite the efforts made by AARD to adjust allocations for food crops research, the absolute levels of funding are seriously inadequate. In fact, given that about 30 additional scientists are expected to return from training by budget year 87/88, the shortfall will be even greater, less than 10% of the minimum needed

D. BUDGET PROJECTIONS

In order to attempt to remedy the problems described above, projections are made in this section to forecast the budget supplements that will be needed over the next three years. Table 5 shows budget projections for the period 1986/87-1988/89 extrapolated from past trends in budget allocations for the MOA, the DG Food Crops and the AARD. Projections were also made for two expenditure categories within the AARD: Research Operations and Project Administration. The nominal and real projections are based on budget data for the years 1979/80-1985/86 for the MOA and its divisions, and for the period 1980/81-1985/86 for the categories within the AARD.

The projections were obtained by regressing the actual nominal and real budget values on a time trend. They should only be regarded as indicative of budget levels if past trends had continued. It should also be noted that no assumptions are made here about whether past budget trends and levels were appropriate or adequate or otherwise, and whether they should have been continued. With that cautionary note, the projected values may be used to compare actual budget allocations for a particular year with the projections for that year to determine shortfalls. Thus, for example, as shown in Table 5, the real shortfall for the total MOA budget in 1986/87 is Rp. 114.5 billion--the difference between the projected and actual values for that year. Once again, judgments about the nature and extent of the shortfalls must be based on carefully determined priorities established by the user of these data. It is suggested that the comparison of real values is more meaningful, and it should be noted that the analysis here is based on the value of the Rupiah in 1984/85.

Two sets of real projections are shown for the AARD total budget and for its Research Operations category. The second set of real projections is based on a shorter period when budgets were rising, from 1979/80-1982/83 for AARD and 1980/81-1982/83 for Research Operations. This was done to obtain indicators by which to increase budget levels for these categories.

Table 5. MOA Development Budget Trend Projections for 1986/87-1988/89

Budget Category	1986/87	1987/88	1988/89	Actual Budget 1986/87
		(In Billions of Rp.)		
Total MOA				
Nominal	206.49	221.87	237.24	83.10
Real	186.27	190.79	195.32	71.77
Food Crops				
Nominal	61.24	66.10	70.97	15.50
Real	55.20	56.91	58.62	13.39
AARD				
Nominal	19.14	19.58	20.02	10.23
Real	16.04	14.86	13.69	8.84
Real 2	29.77	30.96	32.15	8.84
AARD: Research Operations				
Nominal	9.14	9.59	10.07	4.56 Est
Real	7.56	7.47	7.32	3.94
Real 2	11.17	11.69	12.21	3.94
AARD: Project Administration				
Nominal	1.68	1.23	0.78	1.94
Real	0.37	0.51	-1.36	1.67

E. ROUTINE BUDGET

Although development budgets have been the focus of this analysis, a brief review of AARD's routine budget situation will provide an even clearer picture of its financial resource problem. In IFY 84/85, the routine budget for AARD was Rp. 9 billion. About 75 percent of this was for salaries. The balance was used for travel and facilities operation and maintenance. In IFY 85/86, the routine budget was increased by seven percent to about Rp. 9.6 billion, but the share for salaries increased to nearly 80 percent of the budget. The IFY 86/87 routine budget went to Rp. 11 billion and in IFY 87/88 will be an estimated Rp. 12 billion. Eighty to eighty-five percent of the budget will be utilized for salaries, with annual increases largely for scientists who have returned from training. The most critical shortfall is in the operation and maintenance of facilities. In the four year period from IFY 84/85 to IFY 87/88, an estimated $120 million worth of construction will have been completed. The annual requirement for operation and maintenance of existing plus new facilities, equipment and vehicles has been conservatively estimated to be Rp. 12 billion in IFY 86/87 and IFY 87/88, or twice its current routine budget allocation. Given this situation, the useful life of the extensive network of office buildings, laboratories, greenhouses, storage areas and shop facilities will be reduced. Spare parts for trucks, tractors, irrigation equipment, dryers, cold storage units and lab equipment cannot be purchased. Funds for fuel to operate farm development, land preparation, cultivation and harvesting machinery and generators will not be available. New facilities, greenhouses, and laboratories will stand idle. As a result, Indonesia's once dynamic agricultural research program cannot move forward and capitalize on tremendous investments in infrastructure, facilities and scientific training.

II. MINISTRY OF FINANCE

A. BUDGET CATEGORIES

As a counterpart to the financial policy agenda described in Annex IV and Section IV of this PAAD, a sectoral budget allocation from the special rupiah account is proposed to help support institutions responsible for undertaking financial policy reforms. The major influential actor in financial policy — the Ministry of Finance (MOF) — is laboring under a very constrained budget.

B. BUDGET TRENDS AND IMPLICATIONS

Ministry of Finance - The Ministry of Finance has three major budget categories: its annual routine and development budgets, and a share of a non-Ministerial development line item for special projects. The non-Ministerial budget, called Line No. 16, provides funding for state enterprises, among other projects. Because this budget item is a flow through, i.e., from the central government to non-MOF projects, we have excluded it from analysis here.

The MOF routine and development budgets support seven directorate generals — secretary general, inspector general, budget, taxation, customs and duties, internal monetary affairs, and external monetary affairs. Tables 6, 7 and 8 show the MOF routine and development budgets, with FY 84 through 88 actual levels, and the percentage changes in actual budgets compared to the prior year.

As can be seen from these tables, the routine line item comprises most (currently 90 percent) of the approved MOF budget. Routine budgets for MOF, if taken in constant dollars, have steadily declined. The overall result is an actual Ministry budget in 1987-88 which is 40 percent below the budget level in 1986-87 and 70 percent below that in 1985-86.

The nature of MOF duties is primarily staff-oriented, which translates into salaries under the routine line item. All reforms discussed under the financial policies section, including banking, tax, capital markets, and customs and duties reforms, have originated within MOF. The research, legislative development, and implementation efforts related to these reforms are staff intensive.

What has happened at MOF is similar to AID's situation — as the GOI sets strict limits on routine budget requests, pressuring staff levels, more outside consultants or contractual relationships are sought. This translates into increasingly large development budget requests from MOF for work which normally would would appear under the routine budget. Unfortunately, as the tables show, the money isn't there under the development budgets either. Thus, while the MOF has an excellent track record of initiating reforms from its own staff or through GOI-financed consulting relationships, they now must rely either on donor-financed projects or assume major delays in the implementation of proposed reforms. The recent tax reform required close to $4 million to finance its implementation. Similar expenditures will be required to finance reforms in pensions, banking and insurance to cover MOF staff training and development as well as industry training, and to establish an effective and efficient regulatory systems.

C. PROPOSED BUDGET SUPPORT

We propose a budget allocation of $6.5 million for Ministry of Finance, divided approximately as $1.0 million for the Secretary General, $5.0 million for the Directorate General of Monetary Affairs, and $0.5 million for the Directorate General for Education and Training. The Ministry of Finance allocation would provide funds for technical assistance and staff training needed to help develop and implement priority legislation in banking, pensions, tax and capital markets development; it would also be used to increase the efficiency of administrative systems directly affecting rural incomes and employment, salary payments, savings programs, banking supervision and organization.

We conclude these proposed budget items are necessary not only to proceed with reforms as already enacted and initiated by the MOF, but also to preserve progress made to date and to effectively utilize the staff and scarce resources being financed within the embattled routine budgets. Lean budgets which deprive MOF of the ability to defend legislation through parliament, train staff and implement procedures, will have a lasting negative impact on the GOI financial sector. Thus we consider the proposed AID support to be an important contribution. It should be noted that construction and other procurement programs under development budget requests have not been included under our proposed support packages, because these components are viewed as less critical to reform momentum and will carry recurrent cost burdens. These other development items will, we assume, be postponed until budgets are restored to levels sufficient for financing major capital programs.

Table 6. Budget of the Ministry of Finance (Millions of Rupiah)

Office	1984-85	1985-86	1986-87	1987-88
Secretary General				
Routine	21,766.0	26,568.0	31,573.0	10,903.0
Development	44,894.0	95,493.8	2,930.2	1,978.7
TOTAL	66,660.0	122,061.8	34,503.2	12,881.7
Education & Training				
Routine	5,897.0	5,942.0	5,033.0	2,376.0
Development	3,045.2	1,762.1	1,595.1	519.6
TOTAL	8,942.2	7,704.1	6,628.1	2,895.6
Capital Markets				
Routine	831.0	981.0	907.0	735.0
Development	0.0	0.0	0.0	0.0
TOTAL	831.0	981.0	907.0	735.0
Tax Secretariat				
Routine	101.0	128.0	136.0	112.0
Development	0.0	0.0	0.0	0.0
TOTAL	101.0	128.0	136.0	112.0
Debt Management				
Routine	2,645.0	3,639.0	3,782.0	2,498.0
Development	0.0	0.0	0.0	0.0
TOTAL	2,645.0	3,639.0	3,782.0	2,498.0
Inspector General				
Routine	907.0	1,472.0	1,385.0	1,047.0
Development	359.5	330.1	139.3	87.8
TOTAL	1,266.5	1,802.1	1,524.3	1,134.8
Director General Budget				
Routine	33,225.0	40,666.0	42,260.0	32,769.0
Development	8,609.2	12,557.7	4,243.0	1,345.2
TOTAL	41,834.2	53,223.7	46,503.0	34,114.2
Director General Tax				
Routine	30.2	37.4	44.0	26.6
Development	5.1	7.3	3.0	0.9
TOTAL	35.3	44.7	46.9	27.5
Director General Customs				
Routine	24.3	26.0	28.0	18.0
Development	5.2	14.4	1.9	0.9
TOTAL	29.5	40.4	29.9	18.9

Director General Domestic Monetary Affairs				
Routine	0.7	0.7	0.9	0.8
Development	0.3	0.4	0.1	0.1
TOTAL	0.9	1.2	1.0	0.9
Director General International Monetary Affairs				
Routine	0.5	0.6	0.6	0.5
Development	0.1	0.1	0.0	0.0
TOTAL	0.6	0.7	0.6	0.6
TOTAL				
Routine	95.5	113.2	25.3	76.8
Development	45.4	89.4	10.5	4.3
TOTAL	140.9	202.5	35.8	81.1

Table 7. Budget of the Ministry of Finance (Actual Levels)
(Millions of Rupiah)

Office	1984-85	1985-86	1986-87	1987-88
Secretary General				
Routine	13.3	16.2	19.3	6.6
Development	27.4	58.2	1.8	1.2
TOTAL	40.6	74.4	21.0	7.9
Education & Training				
Routine	3.6	3.6	3.1	1.4
Development	1.9	1.1	1.0	0.3
TOTAL	5.5	4.7	4.0	1.8
Capital Markets				
Routine	0.5	0.6	0.6	0.4
Development	0.0	0.0	0.0	0.0
TOTAL	0.5	0.6	0.6	0.4
Tax Secretariat				
Routine	0.1	0.1	0.1	0.1
Development	0.0	0.0	0.0	0.0
TOTAL	0.1	0.1	0.1	0.1
Debt Management				
Routine	1.6	2.2	2.3	1.5
Development	0.0	0.0	0.0	0.0
TOTAL	1.6	2.2	2.3	1.5
Inspector General				
Routine	0.6	0.9	0.8	0.6
Development	0.2	0.2	0.1	0.1
TOTAL	0.8	1.1	0.9	0.7
Director General Budget				
Routine	20.3	24.8	25.8	20.0
Development	5.2	7.7	2.6	0.9
TOTAL	25.5	32.5	28.4	20.8
Director General Tax				
Routine	49,521.0	61,360.0	72,110.0	43,612.0
Development	8,308.7	11,997.3	4,852.9	1,512.7
TOTAL	57,829.7	73,357.3	76,962.9	45,124.7
Director General Customs				
Routine	39,851.0	42,709.0	45,878.0	29,558.0
Development	8,598.5	23,569.7	3,113.7	1,496.3
TOTAL	48,449.5	66,278.7	48,991.7	31,054.3

Director General Domestic Monetary Affairs				
Routine	1,091.0	1,226.0	1,474.0	1,388.(
Development	456.1	699.8	228.0	118.]
TOTAL	1,547.1	1,925.8	1,702.0	1,506.]
Director General International Monetary Affairs				
Routine	834.0	920.0	967.0	880.(
Development	169.1	158.5	72.6	30.(
TOTAL	1,003.1	1,078.5	1,039.6	910.0
TOTAL				
Routine	156,669.0	185,611.0	205,505.0	125,878.0
Development	74,440.3	146,569.0	17,174.8	7,088.4
TOTAL	231,109.3	332,180.0	222,679.8	132,966.4

Table 8. Budget of the Ministry of Finance Percentage Change from Previous Year

Office	1984-85 to 1985-86	1985-86 to 1986-87	1986-87 to 1987-88
Secretary General			
Routine	22.06%	18.84%	-65.47%
Development	112.71%	-96.93%	-32.47%
TOTAL	83.11%	-71.73%	-62.67%
Education & Training			
Routine	0.76%	-15.30%	-52.79%
Development	-42.14%	-.48%	-67.43%
TOTAL	-13.85%	-13.97%	-56.31%
Capital Markets			
Routine	18.05%	-7.54%	-18.96%
Development	0.00%	0.00%	0.00%
TOTAL	18.05%	-7.54%	-18.96%
Tax Secretariat			
Routine	26.73%	6.25%	-17.65%
Development	0.00%	0.00%	0.00%
TOTAL	26.73%	6.25%	-17.65%
Debt Management			
Routine	37.58%	3.93%	-33.95%
Development	0.00%	0.00%	0.00%
TOTAL	37.58%	3.93%	-33.95%
Inspector General			
Routine	62.29%	-5.91%	-24.40%
Development	-8.18%	31.20%	-36.97%
TOTAL	42.29%	-15.42%	-25.55%
Director General Budget			
Routine	22.40%	3.92%	-22.46%
Development	45.86%	-66.21%	-68.30%
TOTAL	27.23%	-12.63%	-26.64%
Director General Tax			
Routine	23.91%	17.52%	-39.52%
Development	44.39%	-59.55%	-68.83%
TOTAL	26.85%	4.92%	-41.37%
Director General Customs			
Routine	7.17%	7.42%	-35.57%
Development	174.11%	-86.79%	-51.94%
TOTAL	36.80%	-26.08%	-36.61%

Director General Domestic Monetary Affairs			
Routine	12.37%	20.23%	-5.83%
Development	53.43%	-67.42%	-48.20%
TOTAL	24.48%	-11.62%	-11.51%
Director General International Monetary Affairs			
Routine	10.31%	5.11%	-9.00%
Development	-6.27%	-54.20%	-58.68%
TOTAL	24.48%	-11.62%	-11.51%
AVERAGE			
Routine	18.47%	10.72%	-38.75%
Development	96.89%	-88.28%	-58.73%
TOTAL	43.73%	-32.96%	-40.29%

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ANNEX IV

FINANCIAL MARKETS POLICY ANALYSIS

A. INTRODUCTION

A major lesson of economics, confirmed by experience in developing countries, is that rapid growth in employment and incomes is achieved and sustained best (or, perhaps, only) when resources are used relatively efficiently. Markets and prices provide signals and incentives for actions by entrepreneurs, traders, consumers and other participants in the economy. If markets serving rural areas are not allowed to develop or are subject to controls, quotas, ceilings or floors, restrictive licensing and monopoly, then prices will be distorted so that they do not accurately reflect costs and opportunities. The result is always waste and often stagnation. Inappropriate choices and activities will be encouraged, while genuine opportunities for productive enterprise and real growth, such as the situation being targetted in rural Indonesia, will be discouraged or made impossible to pursue.

Thus, "getting prices right" has been recognized as a key prescription for growth and development through improving resource allocation. Correct prices provide correct incentives for the efficient use of resources. Vigorous, competitive markets, without unreasonable impediments to entry or exit, assure that the signals sent out by prices are acted upon to achieve efficiency in resource use. At the same time, competitive markets will assimilate demand shifts, cost savings and new technologies and adjust prices accordingly to the correct level.

The financial sector is an important sector for developing countries. In many such countries, however, including Indonesia, it is underdeveloped or slow to develop. Financial markets and institutions should serve to facilitate and "intermediate" transactions between buyers and sellers, borrowers and lenders, and savers and investors. The financial system can provide the medium of exchange, safe and convenient means to accumulate savings and hold wealth, and a return on these savings. It thereby helps to increase the volume of savings, makes funds ("finance") available to large and small enterprises for working capital and expansion projects, pools and distributes risk, and serves as an important locus for stabilization policy. Every kind of productive activity - in agriculture, manufacturing, construction, services, infrastructure, domestic and foreign trade - requires finance in some form.

As Indonesia develops, more specialized financial markets and institutions are needed. For example, savings banks may focus on mortgage lending to support home building, rural credit programs (such as the Bank Rakyat Indonesia's KUPEDES savings program) may be created to serve farmers and other small rural businesses, managed funds are organized to take on pension commitments and hold long-term portfolios of bonds or stocks, and stock trading may be organized. The development of these institutions and markets will improve the effectiveness and efficiency of resource use and thus promote development and the growth of incomes and employment. A strong financial sector is vital to assure that savings are amassed and mobilized for a multitude of productive investment purposes throughout the economy.

Thus, the case for more effective financial institutions and more efficient financial markets is a simple but important extension of the general principle in support of market efficiency. Unless financial markets are available and work well, opportunities for productive uses of the country's manpower and other resources will be lost, retarding growth in output, income and employment.

On the one hand, for example, if interest rates on deposits are too low, potential savers may decide to spend rather than save, or may save only by acquiring relatively unproductive assets (perhaps gold). At the same time, the absence of effective, active and competitive financial intermediation will cause potentially profitable and productive employment-generating investment opportunities to be foregone.

On the other hand, an unnecessarily high bank lending rate may be the result of poor management and failure to control bank operating costs. With active competition, such inefficient banks will not be able to continue, but will lose their business to better managed banks. Yet, without such competition, the inefficient banks' large spreads and high rates may persist, with the costly consequence that productive projects will not be undertaken for lack of finance.

Finally, if interest rates on loans are kept low (perhaps by subsidy) and credit ceilings are imposed, then it is quite likely that many projects with high expected returns may fail to find finance, losing out to poorer projects in the process of credit rationing. Subsidized loan rates create the false impression that capital is cheap and labor is dear. This induces excessive use of capital at the expense of labor and the balance of payments. A more active, less restricted financial sector is needed to avoid losing opportunities for employment and income generation and to reduce such misuses of resources.

B. BACKGROUND — THE FINANCIAL POLICY ENVIRONMENT IN INDONESIA

The financial sector of the Indonesian economy is not yet well developed. The organized financial system that does exist is heavily concentrated in banking (80% of total gross financial assets). Despite this situation, Indonesia seems to be still quite undermonetized and "underbanked" in comparison with other ASEAN and Pacific Basin countries. In 1980, the monetary aggregate known as M2 (consisting of currency plus demand deposits [M1] plus quasi-money) amounted to 16 percent of GDP in Indonesia, versus about 30 percent in Thailand and Korea, 50 percent in Malaysia, and 60 percent or more in Singapore, Taiwan, Hong Kong and Japan.* In more recent years, especially since the banking reforms in June 1983, quasi-money (mostly time deposits in banks) has increased at a rapid pace. Yet, as can be seen in Table 1, the ratio of M2 to GDP reached only 25 percent in 1985.

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* David C. Cole and Hugh Patrick, "Financial Development in the Pacific Basin Market Economies." Development Discussion Paper No. 182, HIID, 1984.

Table 1. Monetary Aggregates, 1979-1986 (in trillions of Rupiah and as percent of GDP)*

	M1	Quasi-Money**	M2
1979	3.4 (9.9%)	1.8 (5.3%)	5.2 (15.2%)
1980	5.0 (10.2)	2.7 (5.5)	7.7 (15.7)
1981	6.5 (11.1)	3.2 (5.5)	9.7 (16.6)
1982	7.1 (11.4)	4.0 (6.3)	11.1 (17.7)
1983	7.6 (10.3)	7.1 (9.6)	14.7 (19.9)
1984	8.6 (10.0)	9.4 (11.0)	18.0 (21.0)
1985	10.1 (11.1)	13.0 (14.4)	23.1 (25.5)
1986 (No	11.4	16.6	28.0

* Money stock figures at year-end
** Time and savings deposits, including foreign currency deposits

Source: Bank Indonesia, Weekly Report, No. 1450, 19 February 1987

1. Banking

The banking system consists of the central bank (Bank Indonesia), five large government-owned commercial banks, 70 privately-owned commercial ban ("national private banks"), 11 foreign banks, three savings banks (one state-owned, two private) plus 28 development banks, which in fact act as commercial banks. One development bank (Bapindo) is owned by the central government, 26 are local government banks and one is private. Bapindo is usually included with the five government-owned commercial banks to form t group of "state banks."

There are also twelve non-bank financial institutions (NBFI) closely associated with banks. Almost all of these NBFIs are owned in majority share by one or more of the state banks or Bank Indonesia. The NBFIs appe to operate similarly to commercial banks and have been used as a means to enter into loans and investments not easily accessible to the commercial banks. Despite the NBFIs ostensible purpose of engaging in medium- and long-term finance, the vast majority of their approximately Rp. 2 trillion of gross assets takes the form of short-term marketable and non-marketable securities.

2. Insurance

Other organized financial institutions are active but generally still weak. The life insurance industry, for example, had aggregate gross asset of Rp. 409 billion at the end of 1985, equal to 1.5 percent of assets in t banking system. This asset value is not trivial, yet it is made much less impressive by the fact that half the industry's investment portfolio is he in bank time deposits and another 20 percent is represented by policy loans. Despite the life insurance industry's apparent long-term obligations, it has not been a substantial provider of long-term credit: only 20 percent of its portfolio is in bonds, shares and mortgages.

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The general insurance industry, writing liability and loss coverage, had assets of Rp. 778 billion and an investment portfolio of Rp. 400 billion in 1985. More than 85 percent of the portfolio was in time deposits. A single state-owned firm dominates this part of the insurance industry, accounting for more than 40 percent of assets and premiums, although there is one strong competitor among the 53 national private companies and 12 foreign/joint venture companies in the industry.

3. Pensions

Funded pension plans are also present in Indonesia. To date, most pension funds have been sponsored by the government or by state-owned enterprises. The number of registered private pension funds has been increasing in recent years, however. Presumably, this is due, at least in part, to the favorable tax treatment accorded to pension fund contributions in the new income tax law that took effect at the beginning of 1984.

TASPEN, the pension fund for state employees, is by far the largest fund, with assets of about Rp. 2 trillion. Perum ASTEK is another government fund in which participation is required for all employees of firms with more than 25 employees. It is not strictly a pension fund, because it does not make disbursements in the form of an annuity. Instead, it distributes the full cash value of a member's share at the time of his or her retirement or disablement. At the end of 1985, there were 1.8 million members, and the total value of assets was Rp. 256 billion. More than half of TASPEN investments were in time deposits, while share holdings and mortgages accounted for 13 to 14 percent each.*

Total assets in 73 other registered pension funds are estimated by Ministry of Finance officials to be only about Rp. 4.5 billion. At the end of 1985 the 20 largest of these pension funds, each sponsored by a state-owned enterprise, reported total assets of Rp. 3.7 billion, invested almost exclusively in time deposits. Obviously, these pension funds are not yet a major factor in the financial system of Indonesia.

4. Stocks and Bonds

In 1977, in an effort to establish an active capital market, the government opened a stock exchange complete with a modern building containing a spacious trading floor. Unfortunately, in an effort to insulate customers from risk, the two government agencies involved have so overregulated trading that the exchange has yet to be an attractive continuing source of finance for private national (domestically-owned) firms. Generous tax-saving incentives may have made it attractive to foreign firms early on; but, in any event, only 24 companies - the majority being foreign firms compelled or heavily pressured to offer shares - are listed. Trading, while never great, has been very low in recent years. The total market value of shares was Rp. 95 billion in early 1985. P.T. Danareksa, a state-owned "national investment trust" that has played a major role in underwriting issues and controlling trading on the exchange, held 38 percent of this total.

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* 1985 Annual Report of the Directorate for Financial Institutions, Ministry of Finance.

The bond market begun in 1983 has handled issues totalling Rp. 155 billion. All three issuers are state-owned enterprises, and their bonds reportedly have been guaranteed as general obligations of the GOI. Despite that, the buyers have been almost exclusively Danareksa and TASPEN.

5. Operation of the Financial System

Banks, as discussed earlier, dominate the financial system of Indonesia. Therefore, to assess prospects for growth in the finance sector, especially rural finance, it is important to understand the structure of the banking system.

One notable feature is the extent to which banks are government-owned. Although the government-owned banks are considerably outnumbered by the national private banks and foreign banks, the group of "state banks" (five commercial banks plus Bapindo, the state development bank) accounts for more than 70 percent of the banking business as measured by either total deposits or total credit outstanding. They have reached this size with advantages, including a captive market of more than 200 state-owned enterprises and favored access to credit from Bank Indonesia. The state banks operate branches throughout Indonesia, giving them a nationwide presence that should be manifest in a strong ability to attract deposits and demand for credit.

With few exceptions, most national private banks are small. Partly because private banks tend to be owned by or linked to business groups controlled by Chinese-Indonesians, they have met barriers to branching and expansion. Only 10 of the 70 private banks have been designated foreign exchange banks and allowed to engage in foreign exchange transactions. In addition, no foreign banks have been allowed to enter Indonesia in the past 10 years. For those already here, operations are officially confined to Jakarta and limited to two branches.

Bank Indonesia (BI) has played a broader, more interventionist role than usual for central banks. It has been a significant direct lender to non-bank enterprises (usually government agencies) and an investor in other ventures. As an "agent of development," BI has attempted not only to control the volume of domestic credit but also to determine and guide its allocation and use.

In the 1970s, the government established a series of priority programs (including Kredit Investasi, BIMAS - rice intensification, KIK/KMKP-small industry and many others) that featured lending by state banks at low, controlled interest rates. Bank Indonesia effected subsidies in support of these priority programs by granting banks generous liquidity credits at low interest rates. These priority lending programs still continue. Other priority lending (to Pertamina and Bulog, for example) was done directly by BI. The government supported these loans by not taking interest on its own deposits with BI. As oil revenues surged upward, BI was called upon to limit their monetization. In a climate of interest rate controls and subsidized priorities, credit ceilings were believed necessary to achieve the desired limitation on the expansion of domestic credit.

Necessary or not, they were effective in limiting aggregate credit expansion. Before long, these ceilings were made more detailed and sector specific with the aim of steering the available credit into "appropriate" chosen areas of enterprise.

Under these measures and policies, the banking system - indeed, the whole financial system - was repressed. It was not allowed to develop new instruments or markets, nor to respond to price and market signals of changes in the demand for finance. Government was the principal source of savings flows into the banking system. The liquidity credit system gave the privileged state banks access to funds. Combined with tight credit ceilings, liquidity credits assured that the state banks had excess reserves. The banks had little or no reason to seek additional deposits and, in fact, little potential to do so since deposit interest rates, set by BI, were kept at low levels. Private and foreign banks lacked access to liquidity credits so they did have an incentive to mobilize savings. Because BI did not regulate their interest rates, these banks could and did seek deposits by offering higher rates. However, availability of excess reserves of the state banks through the interbank funds market limited the need for this, and the private and foreign banks also faced credit ceilings.

At the same time, the system left little role for market factors in bank rationing of funds. Priority lending came first with the support of liquidity credits. Beyond that, sector-specific credit ceilings were intended to determine the activities for which one could borrow. These detailed credit ceilings were a poor idea, and it is doubtful that they accomplished very well what BI intended. One probable consequence of the sector-specific credit ceilings was to raise the borrowing rates in informal, unregulated markets. Another unintended (but likely) consequence was to encourage business conglomerates, since funds borrowed for a priority purpose could actually provide finance for other group projects in other sectors not favored by BI allocations.

6. Deregulation

A major move to liberalize this financial system was taken in 1983. Government "technocrats" had become increasingly concerned about excessive dependence on oil revenues and the negative effects of protectionist policies for non-oil exports, private investment and employment growth. The whole system was retarding financial growth in the economy with detrimental consequences for the mobilization of private financial savings to finance domestic investment. The system was also fostering waste through overly bureaucratic management of state bank operations. Finally, deterioration of the balance of payments and government revenues because of declining net oil revenues during 1982/83 had given special urgency to concerns about economic policy.

The government undertook a far-reaching banking reform on June 1, 1983. The changes were not expected to give immediate short-run relief but to initiate the development of a stronger financial system. The main reform measures were:

- For state banks, complete deregulation of interest rates on time deposits, and deregulation of lending rates for all loans except those made under priority programs for which subsidized liquidity credit was provided. (Deposits and lending rates for other than state banks were already unregulated.)

- Elimination of credit ceilings for all banks.

- The announced intention to reduce the use of liquidity credits from BI to fund priority programs.

The reforms had prompt impacts on time deposit rates and the volume of time deposits in banks. As Table 2 shows, state banks' interest rates nearly doubled to approach the average rates paid by private and foreign banks. As expected, the level of time deposits in state banks grew at an accelerated pace compared to the pre-reform period. Yet, as may be seen in Table 3, the state banks' success in attracting deposits was modest when compared to the record of the private banks. Even without substantial increases in their deposit rates, the private banks - released from fixed credit ceilings - were able to sustain rapid growth in the level of deposits, and easily outpaced the state banks. Even the foreign banks, handicapped by their inability to branch, sustained more rapid growth than the state banks.

One reason the state banks were less successful in attracting deposits in the face of active competition is undoubtedly their lack of experience. Their management and staff were poorly prepared for the more competitive environment into which the reforms threw them. Another cause may relate to BI's "administrative guidance" that reportedly has urged moderation in raising loan rates and deposit rates and in pursuing deposits in general. The state banks are not pleased by their new mandates to mobilize funds and improve credit operations. Nor has BI enthusiastically embraced all the reforms and turned eagerly to the difficult task of adjusting to the new situation.

Table 2. Interest Rates on 12-Month Time Deposits at Commercial Banks, 1979-1986

Date	State Banks	Private National Banks	Foreign Banks
1979	9.0 %	19.6 %	
1980	9.0 %	20.1 %	
1981	9.0 %	19.4 %	
1982	9.0 %	19.3 %	
1983	17.5 %	19.7 %	
1984	18.7 %	20.4 %	
1985	17.8 %	19.8 %	18.1 %
1986 (June)	15.0 %		15.9 %

Table 3. Volume and Growth Rate of Time Deposits at Commercial Banks, 1979-1986 (in Billion of Rp. at End of Year)

Date	State Banks		Private National Banks		Foreign Banks	
	Volume	Growth	Volume	Growth	Volume	Growth
1979	775	-	123	-	86	-
1980	903	16.5 %	209	69.9 %	157	82.6 %
1981	1093	21.0 %	382	82.8 %	260	65.6 %
1982	1231	12.6 %	572	49.7 %	360	38.5 %
1983	2831	30.0 %	1078	88.5 %	476	32.2 %
1984	3497	23.5 %	1750	62.3 %	696	46.2 %
1985	5337	27.0 %	2755	30.5 %	676	-2.9 %
1986 (Sept.)	6416	27.0 %	3386	30.5 %	816	27.6 %

The most telling indicators of "inertia" in the banking system are summarized in Table 4. Despite the announced intention to reduce reliance on liquidity credits, the level of such refinancing by BI has continued to grow. In March 1983, before deregulation, liquidity credits amounted to 3[illegible] percent of total commercial bank credit outstanding to private and public borrowers.* At the end of 1986 the figure was still 32 percent.**

Table 4. Liquidity Credits to Banks, Direct Credits, and Other Facilities, 1981-1987 (in billions of Rp.)

Date	Liquidity Credits	Direct Credits	Discount Windo and Special Cred	Other*	Total
March 1981	1521	2324	0	358	4193
1982	2495	2632	0	460	5587
1983	3635	2388	0	568	6591
1984	3764	2292	0	596	6652
1985	5881	938	172	981	7972
1986	6758	998	0	1058	8814
Jan. 1987	7764	1157	15	902	9838

* Relates mostly to manufacturing industry, probably for P.T. Krakatau Steel.

*) Liquidity Credits of 3635 vs Total Credit Outstanding of 11315; 3635/11315 = 0.321

**) 6758/21432 = 0.315

Of the major priority credit programs, only BIMAS was phased out or declined markedly during the period. The new export credit program begun in June 1983 grew rapidly, far outstripping the reduction in liquidity credits for BIMAS. Some of the increase in liquidity credits is the result of substituting loans through the state banks for BI credits previously extended directly to economic units (e.g., Pertamina and BULOG). But total BI credits (direct and indirect) rose each year.

Table 4 also shows how little use has been made of rediscounting and special credits to the commercial banking system. Although rediscount facilities were generally made available, BI reportedly discouraged their use.

The government needs to consider carefully its priority lending programs and the degree to which interest rates should be controlled and subsidized. Few priority lending programs have any clear feature or basis to justify their continuation, much less a subsidy to the cost of capital. Priority loans are typically made at 12 percent interest, in contrast to non-priority loans at 24 percent or more. Such differences may encourage the misuse of financial resources and thus run counter to the basic thrust of the free market, private enterprise liberalization and reform movement. Within the banking system, the growth of priority programs will continue to retard the acceptance of and adaptation to the 1983 reforms.

The impact to date of the 1983 banking reforms cannot fairly be described as dramatic. While private and foreign banks now operate in a more hospitable environment and have seized new opportunities for profitable financial intermediation, the dominant state banks have changed little and still operate in a favored, protected environment. Bank Indonesia continues to adjust to a less interventionist role. There is still much to be done to establish a more open, responsive, effective and efficient banking system. Several of the more urgent actions form the basis of the financial policy agenda.

C. PROSPECTS FOR POLICY REFORM

The Government of Indonesia has taken huge strides towards a fundamental reform of its economy. The last four to five years have been a particularly intense period of major reform actions in economic policy. But the shift in thinking and policy did not begin in 1983 and the reform process certainly must not end in 1987.

Government officials are committed to a comprehensive reform, and they understand that the process will take time and that progress will not be steady. An influential group of Ministers and economists are leading the movement toward a more open, more outward-looking economic system. From experience, they know that protection, subsidies, excessive regulation of industry, exclusive trading, monopolies and the like inhibit private enterprise, create waste, and retard the growth of income and employment.

For example, examine what occurred in the Indonesian economy in the 1970s. Indonesia experienced rapid growth of GDP and especially rapid growth of manufacturing output throughout the decade. Obviously, oil revenues were a major factor in making this possible, but they also created problems for macro-economic policy and for traditional rural industry and non-oil exports. The government managed macroeconomic policy fairly well, prudently building up foreign reserves and keeping domestic spending in check. The inflationary excesses and massive debt problems experienced by other oil exporters such as Nigeria and Mexico were thus avoided. Unfortunately, "Dutch disease" problems were not handled as well. As the rupiah become overvalued, demand for traditional export crops tended to increase slowly or decline. Zealous industrial planners pushed the import-substitution strategy hard with subsidized credit, generous tax holidays and other concessions, and excessive protection of manufacturing production for the domestic market.

Despite rapid output growth, it became increasingly clear that all was not well with the economy. Production was too capital intensive in almost a fields. The more capital-intensive manufacturing industries tended to be th most protected, and thus the ones that grew fastest. Employment growth in manufacturing and agribusiness was inadequate, far less than output growth.* Virtually no manufactured or processed goods were exported. The "high-cost economy" became a major concern. For some officials, it meant that still mo protection from foreign competition was needed, thus increasing the difficulties of those pushing reform.

Economic theory and experience strongly suggest protection and detailed government intervention are the problem, not the answer, for Indonesia. Markets can and should guide consumers' choices. Prices should be set to provide proper incentives for private action, not be controlled to thwart opportunities. Recognizing this, the government, led by the "technocrat" group, began to reverse the previous direction of policy. They began to pursue a broad program of reform aimed at strengthening market forces and establishing a positive atmosphere for domestic and foreign private enterprise. The atmosphere is becoming more hospitable to the continued growth of output and employment opportunities, and an economy and government budget less dependent on petroleum revenues.

The beginning of the reform process might be marked by the 34 percent devaluation of the rupiah on November 15, 1978. This was an historic occasion: a devaluation aimed at correct domestic pricing. The action was the first (certainly one of the few) devaluations undertaken anywhere to correct pricing rather than to correct or ease a balance-of-payments problem. By raising the price of imports and exports, the devaluation gave a boost to all local industry. In addition, by raising the relative cost of imported capital goods, it fostered the growth of labor-intensive production that woul provide more employment opportunities and better export markets. To sustain the relative price change, the government pursued a tight fiscal and monetary policy after the devaluation. Many other reform actions aimed at improving the investment climate preceded this surprise devaluation (e.g., a revision and regularization of non-oil mining contracts), yet none were as seminal as the devaluation.

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* The elasticity or buoyancy of employment with respect to manufacturing output was only about .3, meaning that a 10% growth in output was accompanied by only about a 3% increase in manufacturing employment.

Soon thereafter, study, analysis and preparation were evident in changes affecting a variety of policy matters, including a sweeping reform of the tax system; rationalization, reduction and equalization of the tarif structure; lower costs of licenses and reorientation of the BKPM (capital investment coordinating board) away from investment regulation and back toward investment promotion.

We conclude from recent experience that the GOI is committed to a long-term restructuring of its economy to promote employment and incomes, a evidenced by well-thought out agendas of policies and actions. Also, studies have not been rushed to conclusion, and proposed reforms have been drawn up carefully. Officials in charge have developed (and sold in high places) a consistent program of policy reforms more receptive to innovation and entrepreneurship in the market. The government must continue establishing "rules of the game" for healthy competition through better laws, regulations, and administration, rather than continue suffering the retarding consequences of "the game of rules."

While not all has gone smoothly -- witness the great rush into non-tariff barriers and import licensing that occurred in the early 1980s -- the current economic situation provides new incentives to the GOI to reexamine past policies and to examine new possibilities. Thus, the next two to three years should be a period of unique opportunities, wherein USAII support can be expected to make a significant contribution.

D. FINANCIAL POLICY AGENDA -- RATIONALE AND IMPACT

As reviewed in the previous section, a broad economic reform is underway now in Indonesia that is shifting attention away from the production of import substitutes and toward the increased production of manufactured exports and, simultaneously, toward much greater encouragement of private sector production and entrepreneurship. Steps have been taken on many fronts to improve the investment climate and business environment. Reform measures are being planned with holistic, long-run objectives in mind. Yet, in view of the serious problems to be faced immediately, there is danger that reform momentum will be lost, through reform actions which exacerbate short-term problems. For example, the recent customs reforms, designed to promote exports by lowering the costs of imported raw materials to export producers, carried real immediate costs to the current account. Thus, immediate budget and balance of payments problems will provide targets for opponents of reform and a challenge to those officials seeking to continue market-oriented reforms.

Several measures of special concern for the development of financial markets merit consideration. The financial policy agenda and milestones focus on several keys areas, noted below, and described further in Section IV.B of the PAAD.

1. Banking

The data and analyses show that the results of the 1983 banking reforms have not yet been fully realized. State banks and, indeed, the whole commercial banking system, are still heavily dependent on credit from Bank

Indonesia, and they are not yet as free of BI's "administrative guidance," as was intended. The extent of credit subsidization administered through the banking system ensures that the envisioned competitive, market-oriented banking system is still remote.

The problem must be attacked on several fronts: (1) The government must reassess its credit subsidy programs. Several of these programs cannot be supported on economic grounds. The tight budget may be seized as a counter to political arguments to justify reducing or stopping credit subsidies. If subsidies are to continue, then they should be open, not hidden within the banking system (2) State banks must accept a less protected position. If there is to be competition, let there be freer markets (3) Entry and branching must be less restricted to promote the rural finance sector (4) Bank Indonesia and the government must cooperate to develop new credit instruments to serve as a basis for open market operations to control reserve positions and accessibility to domestic credit.

In addition, we note the importance of policy and operational reforms at Bank Indonesia which will allow the banking system to expand and will improve bank supervision. Bank supervision in particular may involve a new charter for Bank Indonesia, and should include more in-depth analysis of bank customers' accounts, in addition to bank books. Automated check-clearing, as a means of replacing cash transactions with written records of transactions, will boost liquidity and provide necessary documentation for investors, banks and the tax department, and should, in the long run, greatly facilitate business finance in rural areas where services are limited.

Milestones for banking

- Maintain market-oriented interest rates.

- Establish a legal framework for removing narrow specialization of banks and permitting financial institutions to expand and extend the types of services they now offer.

- Revise regulations to permit the increase of securitized financial instruments and development of secondary financial markets.

2. Insurance Companies and Pension Funds

These financial intermediaries havenot developed enough to play adequate and appropriate roles in the economy. They are hindered by the legal and regulatory frameworks within which they operate. Recognizing this, government officials are making a strong effort to support and strengthen the roles for financial and capital markets institutions by creating and passing new laws and by improving regulations.

Insurance companies and pension funds amass and invest funds on behalf of policy holders, employees and other individual participants. They deepen financial markets by their roles. Individuals who, alone, would never be in a position to undertake equity investments or lend safely on long-term basis are able to do so through these institutions. At the same time, enterprises that, alone, could never organize long-term finance from many lenders are able to obtain finance through an intermediary.

Without these intermediaries, opportunities for profitable, employment generating industrial development are lost. Yet present laws and regulations inhibit the expansion of these potentially important financial sectors. For example, it is extremely difficult for new companies to enter the insurance industry. Few new firms have entered since the field was opened in 1982, and joint ventures between foreign and Indonesian companies have been extremely limited. The John Hancock company may be able to enter soon, but only after extended negotiations and legal difficulties.

In line with the general reform movement, it is expected that a new insurance law under discussion will greatly ease entry. This would allow Indonesia to benefit from the experience and knowledge of foreign insurance firms and encourage the entry of all who can demonstrate competence and adequate capitalization. A stronger insurance industry will offer "between coverages" and mobilize funds for long-term investment.

Pension funds serve a valuable social function in assuring income for the future and easing the potential implicit obligation of the government to provide support for needy retired persons. They also, as noted, provide a means of financial intermediation that can promote the efficient use of resources by improving the division of labor between savings and investment. Employees save for the future, and pension funds assure them a good return on those savings by the funds lending to investors in real productive assets.

That employers and employees wish to form pension funds to provide future security is not in doubt. Since 1984, when provisions in the new income tax law were seen to give tax advantages to pension contributions, the number of pension funds approved or in the process of being approved has more than matched the number of pension funds approved before 1984.

While tax laws encourage employee savings by their treatment of the pension funds, a new, improved pension law can provide still further impetus. For example, at present only "defined benefit" plans are allowed, through which a sponsor plan (usually an employer) must endeavor to guarantee pension amounts specified in terms of the amount to be paid in benefits upon and after retirement. This "defined benefit" is usually stated as a fraction of final or average earnings. Employers who will happily make "defined contributions" as part of an employee's wages are not always eager to assume all the risks involved in translating those contributions into an assured level of benefit.

A new pension law allowing "defined contribution" plans is under discussion and preparation; it should increase the number of pension funds offered by employers for their employees. Similarly, individual pension plans (for self-employed workers) are not now permitted, but would be available under the new law as proposed. In addition, it should be noted that the regulation of "defined contribution" plans is far easier than defined benefit funds. No actuarial calculations need be made to assure the adequacy of defined contribution funds. Responsibility for monitoring fund investments can be better left to owners (the pension law administered by a small, well-trained staff can protect the employees and the public from pension funds abuse much better than is now possible). The formulation of plans can be more straightforward and inexpensive than is the case now. And the accumulation of the ensuing pension fund assets will have a multitude of benefits.

These improvements can be achieved by the implementation of a new pension law. Work has begun, but much remains. The path will not be easy, because a short-term effect of more pension activitiy will be some reduction in tax revenue. Opponents will question the costs, even though the new law has already established the principle of favored treatment for pension funds.

Milestones for pension and insurance

- Provide a legal environment, development procedures and regulations for effective pension and insurance administration.

- Establish within the Ministry of Finance units responsible for the development and supervision of the pension and insurance adminstrati

- Develop manpower plans and training programs for Ministry of Finance officials responsible for pension and insurance administration.

- Develop industry-wide association-sponsored training for private operators in the pension and insurance industries.

ANNEX V

GOI LETTER OF REQUEST

RECEIVED
JUL. 21 1987
USAID/C&R
Jakarta

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DATE DUE 8-3
ACTION TAKEN
DATE
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MINISTER OF PLANNING/CHAIRMAN
OF THE NATIONAL DEVELOPMENT PLANNING AGENCY (BAPPENAS)
REPUBLIC OF INDONESIA

No. : 2 4 3 4/K/7/1987 Jakarta, July 20, 1987

Mr. David Merrill
Director
USAID Mission
c/o American Embassy
Jakarta

Dear Mr. Merrill,

The Government of Indonesia wishes to request $ 43 million in assistance from the USAID in support of its program to increase agriculture diversification and domestic resource mobilization. This letter provides a description of the current situation, the actions which the government has already taken, and the government's plans for further efforts in these areas.

Background : Indonesia is beginning what will probably be a very difficult three to four year adjustment period. It is in the midst of an economic recession substantially worsened by the decline in average oil prices from $ 25 per barrel in 1985 to slightly over $ 13 per barrel in 1986. Because oil and liquified natural gas provide a major portion of Indonesian export earnings and budgetary revenues -- more than 70 percent in 1984/1985 -- the decline in oil prices poses significant adjustment burdens on balance of payments, government budgets, growth, incomes and employment. This 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 required for structural policy adjustment measures to have substantial impact.

Past actions : The Government of Indonesia has responded constructively to its adjustment problems. The government carried out a highly successful devaluation in September 1986 and has backed it up with conservative monetary and fiscal policies, including a 1987/8 budget that is about 25 percent lower in real terms than in 1985/86. The Government has also taken substantive policy measures addressed at the longer-term restructuring problem -- the May 6, 1986 export and investment promotion policy package, and the October 25, 1986 and January 15, 1987 trade policy reform packages aimed at non-tariff barriers. It has frozen civil service wages, made further cuts in petroleum,

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fertilizer and export financing subsidies, and raised public transportation prices. The government has stated that additional trade policy reform measures are under consideration.

The impact of these long-term adjustment measures may not be felt for sometime. In the meantime, the GOI faces a serious increase in its current account deficit from $ 1.8 billion in 1985/86 to $ 4.1 billion in 1986/87 before dropping to $ 2.9 billion in 1987/88 and $ 1.2 billion in 1988/89.

The GOI's Program : Responding to these pressures and to the continued uncertainty in the price of oil, the GOI has planned an austere budget for the coming year; it has also taken steps to mobilize greater domestic revenues and to restrain domestic expenditure. As part of this effort, it is planning a program to examine the possibility of increasing employment and incomes through agriculture diversification and improved efficiency of resource use including broadening the role of the private sector in agricultural related development. It will be considering methods for extending trade and licensing reforms approved in the 6 May 1986 and 25 October 1986 reform packages to include agricultural commodities; it will continue efforts to reduce pesticide subsidies and will review the relationship of fertilizer subsidy levels and their impact on rice and non-rice crops. The GOI is also planning to examine regulations and licensing provisions affecting selected commodities, transportation of commodities and investment in agro-processing businesses and will be looking at institutional reforms required to support these efforts.

To increase the mobilization of domestic resources, the government is planning steps to improve the efficiency of financial markets. It will seek to improve the environment for banking services and for capital markets development through development of new legislation and implementing regulations for pensions and insurance.

The main concentration of activities will be on agricultural research and Integrated Pest Management. The present stage of agricultural development requires the stronger support of research from the analysis of the comparative advantage of the region to the formulation of integrated development program. A Substantial amount of research results particularly related to production technology has already been used in the process of improving the agricultural sector of the economy. Yet the accelerating development of this sector requires that research provides improved and better integrated technologies and information.

The experience of integrated approach to overcome pest problems particularly during the outbreak of brown plant hopper in the wet season of 1986/87 has created momentum for further improvement of pest management approach. Integrated pest managemenet is considered suitable approach te be developed on large scale basis. The program will be also expected to support the efforts to enhance the planning capacity of the agricultural sector, to generate policies related to diversification, employment and investment strategies and to improve the efficiency of financial markets.

Funds requested in this letter will support this program. They will assist the GOI in maintaining budget levels in areas of particular importance to successful agriculture diversification and increased domestic resource mobilization.

In order to facilitate implementation of this program, The GOI proposes to establish a separate account for the rupiah funds provided by USAID. Funds from the separate account could then be directed by the GOI to priority areas within the Ministry of Agriculture and the Ministry of Finance as agreed to by both parties. We anticipate GOI contribution to the program will be $ 19 million in PL 480 Title I funds under the agreement signed this year.

The GOI also proposes to outline in the program agreement objectives that it would hope to achieve during the course of the program. It is enclosed herewith, a draft outline of some of the major features of our plan and the sector support proposal which has been discussed between your staff, Bappenas and concerned agencies.

The lead agency for implementing the program will be Bappenas, with the Ministries of Finance and Agriculture as the primary technical agencies. Bappenas will establish a process for joint consultation between GOI representatives and USAID which will allow adjustment of program objectives and highlight new technical or resource requirements necessary for the success of the program.

We look forward to your favourable consideration and thank you for your kind cooperation.

Yours sincerely,

BADAN PERENCANAAN PEMBANGUNAN NASIONAL REPUBLIK INDONESIA

J.B. Sumarlin
Minister of National Development
Planning/Chairman of Bappenas

Government of Indonesia's Plans for Agricultural Diversification and Internal Resource Mobilization

Introduction

For the purpose of this Program a comprehensive policy statement covering GOI plans for diversified agriculture and improving domestic financial markets is not required. What is needed, however, is a statement of GOI plans for selected policy and institutional changes in these two areas. The list of selected changes the GOI is considering is presented below. This list has been discussed with USAID. USAID supports GOI objectives and the Program would be based on the GOI's plan as described in this list.

1. Objectives and Milestones for Agricultural Diversification

a. Program Objective: Promote agricultural diversification, related agro processing and more optimal use of resources through increased efficiency and stronger participation by the private sector.

(1) Pricing sub-objective: Establish input and output prices at levels which encourage both efficient and expanded production of food and export crops.

a. Extend and monitor trade and licensing reforms of 6 May and 25 October, 1986 to include agricultural inputs (i.e. livestock feeds, shrimp larval feeds and product packaging items) needed in the production and processing of agriculture based export items with a view to lowering production costs and increasing trade.

b. Reduce pesticide subsidies.

c. Review fertilizer subsidy levels and user rates with a view to developing and implementing a strategy to adjust downward fertilizer subsidies in a way that minimizes disruptions in fertilizer demand and crop production.

d. Assess incentive and disincentive effects of current pricing strategy for rice and non-rice crops and establish pricing levels which maintain appropriate rice production levels and encourage secondary crops production.

(2) Trade sub-objective: Reduce transportation and licensing costs associated with food and export crops processing and trade, thereby stimulating demand for and production of agricultural-processed products.

a. Reduce input costs to processing by eliminating the provincial tax on copra, a major small holder crop.

b. Review and eliminate unnecessary licenses and other policies which increase the cost of transporting agricultural products between districts and islands.

c. Review local and national licenses limiting investment in agro-business, eliminate restrictive licenses and introduce simplified procedures.

2. Objectives and Milestones for Domestic Resource Mobilization

a. Program objective: To expand and increase the efficiency of financial markets thereby increasing capital for investment.

(1) Banking sub-objective: To expand banking services at unsubsidized cost levels.

a. Continued maintenance of market-oriented interest rates.

b. Draft and introduce legislation permitting financial institutions to expand and extend services in both urban and rural areas.

(2) Pensions and Insurance sub-objective: Promote schemes that will help mobilize funds for capital markets, thereby providing additional resources for investment.

a. Draft and introduce legislation providing a legal framework and establish effective pension and insurance administration.

3. Objectives and Milestones for Institutional Changes in Agriculture and Finance

a. Program objective: Introduce institutional reforms required to improve planning and implementation of policies and programs aimed at agricultural sector diversification.

(1) Research

a. Establish a staff planning unit in AARD to review commodity mandates and propose alternative approaches.

b. Development of a management information system which will help in monitoring research performance against program priorities.

c. Implement changes required in organizational structure to improve agency management and staff performance.

(3) Planning

a. Establishment of a working group on reorganization of Ministry of Agriculture planning, management and administration functions.

b. Preparation of an analysis of international markets (prices, competition prospects) for selected agriculture commodities; plans to be incorporated in Repelita V.

c. Preparation of a plan to carry out environmental impact assessments throughout the Ministry.

b. Program Objective: Introduce institutional reforms required to improve management of policy changes related to domestic resource mobilization.

(1) Within the Ministry of Finance, establish units responsible for development and supervision of the pension and insurance industries.

(2) Develop manpower plans and training programs for Ministry of Finance officials responsible for pension and insurance administration.

ANNEX VI

CATEGORICAL ENVIRONMENTAL EXCLUSION

(A) PROJECT COUNTRY: Indonesia

(B) ACTIVITY: Agricultural and Rural Sector Support Program (497-0357)

(C) FUNDING: $43 million

(D) PERIOD OF FUNDING: FY 87-FY 89

(E) STATEMENT PREPARED BY: ANE/PD/EA, John Tennant

(F) ENVIRONMENTAL ACTION RECOMMENDED: Categorical Exclusion under AID Regulation 16, Section 216.2(C) (2) (c) (1) (ii)

(G) ACTION REQUESTED BY: Margaret Bonner, PPS, USAID/Indonesia

(H) LEGAL ADVISOR CLEARANCE: Gary B. Bisson, 3/5/87

(I) ENVIRONMENTAL OFFICER CLEARANCE: Desmond O'Riordan, PPS/DES

(J) DECISION OF USAID/INDONESIA DIRECTOR

APPROVE: David N. Merrill

DISAPPROVE

DATE: 8/28/87

EXAMINATION OF THE NATURE, SCOPE AND MAGNITUDE OF THE ENVIRONMENTAL IMPACT

A. DESCRIPTION OF THE PROGRAM:

The proposed program consists of funds provided to support Government of Indonesia budget expenditures and policy movements directed at improving rural employment and incomes. Some technical assistance will be provided to help accomplish related analyses. AID will not be directly involved in how the budget support funds are spent, other than confirming that broad budget categories receive agreed levels of GOI funding during the GOI Fiscal Year. AID will have neither knowledge nor control of specific activities within those budget categories, except for separately financed AID projects which might be included within the categories.

B. RECOMMENDED ENVIRONMENTAL ACTION:

Considering the above program approach, a categorical exclusion from AID's IEE, EA and EIS requirements is proposed. This proposal is in accordance with AID Regulation 16, Section 216.2(C) (2) (c) (1) (ii) which provides for a categorical exclusion in situations where the purpose of the program does not require AID to have "knowledge of or control over, the details of the specific activities that have an effect on the environment for which financing is provided by AID".

ANNEX VII

STATUTORY CHECKLIST

5C(1) - COUNTRY CHECKLIST

Listed below are statutory criteria applicable to: (A) FAA funds generally; (B)(1) Development Assistance funds only; or (B)(2) the Economic Support Fund only.

A. GENERAL CRITERIA FOR COUNTRY ELIGIBILITY

1. FY 1987 Continuing Resolution Sec. 526. Has the President certified to the Congress that the government of the recipient country is failing to take adequate measures to prevent narcotic drugs or other controlled substances which are cultivated, produced or processed illicitly, in whole or in part, in such country or transported through such country, from being sold illegally within the jurisdiction of such country to United States Government personnel or their dependents or from entering the United States unlawfully? No.

2. FAA Sec. 481(h). (This provision applies to assistance of any kind provided by grant, sale, loan, lease, credit, guaranty, or insurance, except assistance from the Child Survival Fund or relating to international narcotics control, disaster and refugee relief, or the provision of food or medicine.) If the recipient is a "major illicit drug producing country" (defined as a country producing during a fiscal year at least five metric tons of opium or 500 metric tons of coca or marijuana) or a "major drug-transit country" (defined as a country that is a significant direct source of illicit drugs significantly affecting the United States, through which such drugs are transported, or through which significant sums of drug-related profits are laundered with the knowledge or complicity of the government), has the President in the March 1 International Narcotics Control Strategy Report (INSCR) determined and certified to the Congress (without

Congressional enactment, within 30 days of continuous session, of a resolution disapproving such a certification), or has the President determined and certified to the Congress on any other date (with enactment by Congress of a resolution approving such certification), that (a) during the previous year the country has cooperated fully with the United States or taken adequate steps on its own to prevent illicit drugs produced or processed in or transported through such country from being transported into the United States, and to prevent and punish drug profit laundering in the country, or that (b) the vital national interests of the United States require the provision of such assistance?

(a) Yes.

(b) N/A.

3. Drug Act Sec. 2013. (This section applies to the same categories of assistance subject to the restrictions in FAA Sec. 481(h), above.) If recipient country is a "major illicit drug producing country" or "major drug-transit country" (as defined for the purpose of FAA Sec 481(h)), has the President submitted a report to Congress listing such country as one (a) which, as a matter of government policy, encourages or facilitates the production or distribution of illicit drugs; (b) in which any senior official of the government engages in, encourages, or facilitates the production or distribution of illegal drugs; (c) in which any member of a U.S. Government agency has suffered or been threatened with violence inflicted by or with the complicity of any government officer; or (d) which fails to provide reasonable cooperation to lawful activities of U.S. drug enforcement agents, unless the President has provided the required certification to Congress pertaining to U.S. national interests and the drug control and criminal prosecution efforts of that country?

(a) No.

(b) No.

(c) No.

(d) No.

4. FAA Sec. 620(c). If assistance is to a government, is the government liable as debtor or unconditional guarantor on any debt to a U.S. citizen for goods or services furnished or ordered where (a) such citizen has exhausted available legal remedies and (b) the debt is not denied or contested by such government?

   (a) No.
   (b) No.

5. FAA Sec. 620(e)(1). If assistance is to a government, has it (including any government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities?

   No.

6. FAA Secs. 620(a), 620(f), 620D; FY 1987 Continuing Resolution Secs. 512, 560. Is recipient country a Communist country? If so, has the President determined that assistance to the country is important to the national interests of the United States? Will assistance be provided to Angola, Cambodia, Cuba, Iraq, Syria, Vietnam, Libya, or South Yemen? Will assistance be provided to Afghanistan without a certification?

   No.

   N/A.

   No.

   No.

7. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, damage or destruction by mob action of U.S. property?

   No.

8. FAA Sec. 620(l). Has the country failed to enter into an investment guaranty agreement with OPIC?

   Indonesia has an Investment Guarantee Bilateral with the U.S. which entered into force January 7, 1967 (TIAS 6330).

9. FAA Sec. 620(o); Fishermen's Protective Act of 1967 (as amended) Sec. 5. (a) Has the country seized, or imposed any penalty or sanction against, any U.S. fishing vessel because of fishing activities in international waters? (b) If so, has any deduction required by the Fishermen's Protective Act been made?

   (a) No.

   (b) N/A.

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10. FAA Sec. 620(q); FY 1987 Continuing Resolution Sec. 518. (a) Has the government of the recipient country been in default for more than six months on interest or principal of any loan to the country under the FAA? (b) Has the country been in default for more than one year on interest or principal on any U.S. loan under a program for which the FY 1987 Continuing Resolution appropriates funds?

(a) No.

(b) No.

11. FAA Sec. 620(s). If contemplated assistance is development loan or from Economic Support Fund, has the Administrator taken into account the percent of the country's budget and amount of the country's foreign exchange or other resources spent on military equipment? (Reference may be made to the annual "Taking Into Consideration" memo: "Yes, taken into account by the Administrator at time of approval of Agency OYB." This approval by the Administrator of the Operational Year Budget can be the basis for an affirmative answer during the fiscal year unless significant changes in circumstances occur.)

N/A

12. FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have relations been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?

No.

N/A.

13. FAA Sec. 620(u). What is the payment status of the country's U.N. obligations? If the country is in arrears, were such arrearages taken into account by the A.I.D. Administrator in determining the current A.I.D. Operating Year Budget? (Reference may be made to the Taking into Consideration memo.)

Per FY1987 "Taking Into Consideration Memo" (TICM) at p. 5, no country likely to receive FY87 OYB is delinquent in UN obligations within the meaning of Article 19 of the UN Charter.

14. FAA Sec. 620A. Has the President determined that the recipient country grants sanctuary from prosecution to any individual or group which has committed an act of international terrorism or otherwise supports international terrorism?

No.

15. ISDCA of 1985 Sec. 552(b). Has the Secretary of State determined that the country is a high terrorist threat country after the Secretary of Transportation has determined, pursuant to section 1115(e)(2) of the Federal Aviation Act of 1958, that an airport in the country does not maintain and administer effective security measures? — No.

16. FAA Sec. 666(b). Does the country object, on the basis of race, religion, national origin or sex, to the presence of any officer or employee of the U.S. who is present in such country to carry out economic development programs under the FAA? — No.

17. FAA Secs. 669, 670. Has the country, after August 3, 1977, delivered to any other country or received nuclear enrichment or reprocessing equipment, materials, or technology, without specified arrangements or safeguards, and without special certification by the President? — No.
Has it transferred a nuclear explosive device to a non-nuclear weapon state, or if such a state, either received or detonated a nuclear explosive device? (FAA Sec. 620E permits a special waiver of Sec. 669 for Pakistan.) — No.

18. FAA Sec. 670. If the country is a non-nuclear weapon state, has it, on or after August 8, 1985, exported (or attempted to export) illegally from the United States any material, equipment, or technology which would contribute significantly to the ability of a country to manufacture a nuclear explosive device? — No.

19. ISDCA of 1981 Sec. 720. Was the country represented at the Meeting of Ministers of Foreign Affairs and Heads of Delegations of the Non-Aligned Countries to the 36th General Assembly of the U.N. on Sept. 25 and 28, 1981, and failed to disassociate itself from the communique issued? If so, has the President taken it into account? (Reference may be made to the Taking into Consideration memo.) — Yes. See p. 7 of the FY87 TICM.

20. FY 1987 Continuing Resolution Sec. 528. Has the recipient country been determined by the President to have engaged in a consistent pattern of opposition to the foreign policy of the United States? — No.

21. FY 1987 Continuing Resolution Sec. 513. Has the duly elected Head of Government of the country been deposed by military coup or decree? — No.

B. FUNDING SOURCE CRITERIA FOR COUNTRY ELIGIBILITY

1.

FAA Sec. 116. Has the Department of State determined that this government has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, can it be demonstrated that contemplated assistance will directly benefit the needy? — No. N/A

2. Economic Support Fund Country Criteria — Not ESF-funded

FAA Sec. 502B. Has it been determined that the country has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, has the President found that the country made such significant improvement in its human rights record that furnishing such assistance is in the U.S. national interest? — Although there were modest GOI improvements in some areas of human rights in 1986, problems continue in others. These do not constitute a "consistent pattern of gross violations" of human rights.

3(A)2 - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED?

Yes. See Part 5C(1), above.
Yes.

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 1987 Continuing Resolution Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project.

   A CN has been prepared. Obligation will after expiration of the notification period, without Congressional objection.

2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

   No further legislative action is required.

3. FAA Sec. 209. Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.

   No.
   N/A.
   Program is for targetted budget-ary assistance and policy support to the GOI. It is solely bilateral in nature.

4. FAA Sec. 601(a). Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.

Budgetary support will be in areas with strong employment and income impact which face continued pressure for cuts. Internal policy support object -ives are to create conditions to expand and diversify the agricultural and rural sector including improved environment for agricultural processing and trace, to help expand the GOI plan and initiate steps to expand and improve the efficiency of domestic financial markets, etc.

5. FAA Sec. 601(b). Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

The Program assistance will support Indonesian agricultural processing and trade which is largely in the private sector. A small part of the assistance will finance U.S. private TA to facilitate analysis and studies.

6. FAA Secs. 612(b), 636(h); FY 1987 Continuing Resolution Secs. 507, 509. Describe steps taken to assure that, to the maximum extent possible, foreign currencies owned by the U.S. are utilized in lieu of dollars to meet the cost of contractual and other services.

For the Program, the GOI will contribute approximately 33% of the total costs.

7. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?

No.

8. FAA Sec. 601(e). Will the assistance utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?

Yes.

9. FAA 121(d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds?

N/A.

10. FY 1987 Continuing Resolution Sec. 532. Is disbursement of the assistance conditioned solely on the basis of the policies of any multilateral institutions

No.

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund — Not ESF funded

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA? — N/A.

b. FAA Sec. 531(e). Will assistance under this chapter be used for military or paramilitary activities? — N/A.

c. FAA Sec. 531(d). Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106? — N/A.

d. ISDCA of 1985 Sec. 205. Will ESF funds made available for commodity import programs be used for the purchase of agricultural commodities of United States-origin? If so, what percentage of the funds will be so used? — N/A.

e. ISDCA of 1985 Sec. 801. If ESF funds will be used to finance imports by an African country (under a commodity import program or sector program), will the agreement require that those imports be used to meet long-term development needs in those countries in accordance with the following criteria? — N/A.

(i) spare parts and other imports shall be allocated on the basis of evaluations, by A.I.D., of the ability of likely recipients to use such spare parts and imports in a maximally productive, employment generating, and cost-effective way;

(ii) imports shall be coordinated with investments in accordance with the recipient country's plans for promoting economic development. A.I.D. shall assess such plans to determine whether they will effectively promote economic development;

(iii) emphasis shall be placed on imports for agricultural activities which will expand agricultural production, particularly activities which expand production for export or production to reduce reliance on imported agricultural products;

(iv) emphasis shall also be placed on a distribution of imports having a broad development impact in terms of economic sectors and geographic regions;

(v) in order to maximize the likelihood that the imports financed by the United States under the ESF chapter are in addition to imports which would otherwise occur, consideration shall be given to historical patterns of foreign exchange uses;

(vi)(A) 75 percent of the foreign currencies generated by the sale of such imports by the government of the country shall be deposited in a special account established by that government and, except as provided in subparagraph (B), shall be available only for use in accordance with the agreement for economic development activities which are consistent with the policy directions of section 102 of the FAA and which are the types of activities for which assistance may be provided under sections 103 through 106 of the FAA;

(B) the agreement shall require that the government of the country make available to the United States Government such portion of the amount deposited in the special account as may be determined by the President to be necessary for requirements of the United States Government.

f. ISDCA of 1985 Sec. 207. Will ESF funds be used to finance the construction of, or the operation or maintenance of, or the supplying of fuel for, a nuclear facility? If so, has the President certified that such country (1) is a party to the Treaty on the Non-Proliferation of Nuclear Weapons or the Treaty for the Prohibition of Nuclear Weapons in Latin American (the "Treaty of Tlatelolco"), (2) cooperates fully with the IAEA, and (3) pursues nonproliferation policies consistent with those of the United States? N/A.

g. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made? N/A.

h. FY 1987 Continuing Resolution. If assistance is in the form of a cash transfer to any country which receives in excess of a total of $5 million as cash transfer assistance in the current fiscal year: (a) are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds? (b) will all local currences that may be generated with funds provided as a cash transfer to such a country also be deposited in a special account to be used in accordance with FAA Section 609 (which requires such local currencies to be made available to the U.S. government as the U.S. determines necessary for the requirements of the U.S. Government, and which requires the remainder to be used for programs agreed to by the U.S. Government to carry out the purposes for which new funds authorized by the FAA would N/A.

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Nonproject Criteria for Development Assistance

a. FAA Secs. 102(a), 111, 113, 281(a). Extent to which activity will (a) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (b) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries?

N/A.

b. FAA Secs. 103, 103A, 104, 105, 106, 120-21. Is assistance being made available (include only applicable paragraph which corresponds to source of funds used; if more than one fund source is used for assistance, include relevant paragraph for each fund source):

(1) [103] for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made; (b) extent to which assistance is used in coordination with efforts carried out under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value;

Budgetary support will be in areas with stong employment and income impact which face continued pressure for GOI budget cuts. Intitial policy support objective are to create conditions to expand and diversity the agricultural and rural sector including improved environment for agricutural processing and trade, and to help the the GOI plan and make steps to expand and improve the efficiency of of domestic financial markets , particularly in rural areas, and in tax administration in a nation which is primarily rural.

improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration programs explicitly addressing the problem of malnutrition of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

(2) [104] for population planning under Sec. 104(b) or health under Sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems, and other modes of community outreach. N/A.

(3) [105] for education, public administration, or human resources development; if so, (a) extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, and strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education and training of people of developing countries in such disciplines as are required for planning and implementation of public and private development activities. N/A.

(4) [106] for technical assistance, energy, research, reconstruction, and selected development problems; if so, extent activity is: N/A.

(i)(a) concerned with data collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of research on and development and use of small-scale, decentralized, renewable energy sources for rural areas, emphasizing development of energy resources which are environmentally acceptable and require minimum capital investment;

(ii) concerned with technical cooperation and development, especially with U.S. private and voluntary, or regional and international development, organizations;

(iii) research into, and evaluation of, economic development processes and techniques;

(iv) reconstruction after natural or manmade disaster and programs of disaster preparedness;

(v) for special development problems, and to enable proper utilization of infrastructure and related projects funded with earlier U.S. assistance;

(vi) for urban development, especially small, labor-intensive enterprises, marketing systems for small producers, and financial or other institutions to help urban poor participate in economic and social development.

(5) [120-21] for the Sahelian region; if so, (a) extent to which there is international coordination in planning and implementation; participation and support by African countries and organizations in determining development priorities; and a long-term, multi-donor development plan which calls for equitable burden-sharing with other donors; (b) has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of projects funds (dollars or local currency generated therefrom)?

c. FAA Sec. 107. Is special emphasis placed on use of appropriate technology (defined as relatively smaller, cost-saving, labor using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)? N/A.

d. FAA Sec. 281(b). Describe extent to which the activity recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government. N/A.

e. FAA Sec. 101(a). Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth? Yes.