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INDEPENDENT EVALUATION GROUP

IFC in Indonesia: 1990 - 2006

An Independent Country Impact Review

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Photo: Indonesian girls in the national costume. Photograph courtesy of IFC office in Jakarta.

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Abbreviations

ADB	Asian Development Bank
AS	Advisory Services
BDB	Bank Dagang Bali
CAS	Country Assistance Strategy
CIR	Country Impact Review
CIVs	Collective Investment Vehicles
EPO	Equity put option
EHS	Environmental, Health, and Social
ESHS	Environmental, Social, Health and Safety
FDI	Foreign direct investment
FIAS	Foreign Investment Advisory Services
FMTAAS	Funding Mechanism for TAAS
GDF	Global Development Fund
GDP	Gross Domestic Product
HF/WSJ	Heritage Foundation/Wall Street Journal Index of Economic Freedom
IAS	International Accounting Standards
IBRA	Indonesia Bank Restructuring Agency
IICCR	Institutional Investor Country Credit Rating
ICRG	International Country Risk Group
IEG-IFC	Independent Evaluation Group-IFC
IEG-WB	Independent Evaluation Group – World Bank
IFRS	International Financial Reporting Standards
IICCR	Institutional Investor Country Credit Rating
IMF	International Monetary Fund
MDB	Multilateral Development Bank
MFIs	Microfinance institutions
MIGA	Multilateral Investment Guarantee Agency
NAFTA	North America Free Trade Agreement
NISP	Bank NISP
PCR	Project Completion Report
PENSA	Program for Eastern Indonesia Small and Medium Enterprise Assistance
PLN	P.T. Perushaan Listrik Negara (National Electricity Generating and Transmission Company)
Rp	Rupiah
SME	Small and medium enterprise
SOE	State-owned enterprise
SSX	Surabaya Stock Exchange
TATF	Technical Assistance Trust Funds
WBG	World Bank Group
XPSR	Expanded Project Supervision Report

Definition of Evaluation Terms

Investment operations:

Company:	The entity implementing the project and, generally, IFC's investment counterparty
Investment:	IFC's financing instrument(s) in the evaluated operation: loan, guarantee, equity, underwriting commitment, etc.
Operation:	IFC's objectives, activities, and results in making and administering its investment
Project:	The company objectives, capital investments, funding program, and related business activities being partially financed by IFC's investment selected for evaluation
Example:	"Through this operation IFC provided $55 million for the company's $100 million cement manufacturing expansion project in the form of a $20 million A loan, a $30 million B-loan from commercial banks, and a $5 million equity investment"
Financial markets projects:	All projects where the company is a financial intermediary or financial services company, including agency lines and private equity investment funds
Non-financial markets projects:	All other projects, sometimes referred to as "real sector" projects
Non-investment operations:	Advisory Services previously called technical assistance and advisory services
Outcomes of non-investment operations:	Outcomes refer to implementation of recommendations or advice
Impacts of non-investment operations:	Impacts refer to the changes that occur following the implementation of recommendations
Example:	"An advisory services operation recommended that the country amend the leasing law to incorporate best practice in similar markets in the region. Outcome: the country amended the leasing law in accordance with the recommendation. Impact: the leasing industry"

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Foreword

The Asian Crisis of the late 1990s affected Indonesia more severely than any other country in that region. The ensuing political and economic changes have been difficult, thus slowing the country's economic recovery. This Country Impact Review (CIR) evaluates the effectiveness of IFC's strategic approach and operations in Indonesia before, during, and after the crisis and covers operations undertaken by IFC over the period of fiscal years (FY) 1990–2006. For most of this period, Indonesia ranked among IFC's ten largest country exposures.

The evaluation concludes that before the crisis IFC had broadened its support to the Indonesian private sector to include more local sponsors and second-tier companies. During the crisis, IFC successfully restructured most of its client companies in financial distress. Post-crisis, IFC began to develop new clients and also increased its support to financial intermediaries focused on SMEs. However, IFC has made little progress in supporting a larger private sector role in infrastructure and in helping deepen the financial markets.

IFC investment projects evaluated over the whole period show a development outcome success rate of 47 percent—well below IFC-wide average of 59 percent, but on par with the average of 45 percent achieved in the rest of East Asia (excluding China). In terms of environmental, health, and social (EHS) outcomes, Indonesian projects have demonstrated far less satisfactory performance (50 percent) than the IFC average (67 percent). Starting in 2002, IFC Advisory Services in Indonesia expanded substantially, with the establishment of the Program for Eastern Indonesia Small and Medium Enterprise Assistance (PENSA). However, there have been limited linkages between IFC's advisory services and investment operations, and most advisory operations were established too recently to be evaluated.

This evaluation calls for a stronger IFC role in infrastructure development going forward, including by strategically and operationally partnering with the World Bank and other multilateral development banks (MDBs) to help dovetail sector reforms and investments. The CIR also recommends that IFC focus on helping Indonesia develop a long-term, local currency debt market while scaling up its support to small and medium enterprises (SMEs) in underserved regions of the country through regional SME-oriented commercial banks. The evaluation also recommends better IFC environmental, health, and social supervision to improve compliance and foster development effectiveness.

The lessons and recommendations in this CIR are consistent with and complement those in the Indonesia Country Assistance Evaluation (CAE) prepared by the Independent Evaluation Group of the World Bank, circulated on June 28, 2007.

Vinod Thomas
Director-General, Evaluation

Executive Summary

Context

1. The Asian Crisis of the late 1990s affected Indonesia more deeply than any other country in that region. Ensuing political and economic changes have been difficult, thus slowing economic recovery.

2. Investments by both the public and private sectors in 2005 and 2006 were still significantly below Indonesia's pre-crisis levels. In particular, the share of infrastructure investment in GDP has declined since 1998. Capacity constraints in infrastructure services have emerged as a result.

3. Although the country's banking system has been stabilized and largely privatized since 2002, banks are unprepared to scale up their long-term lending from a base that is predominantly funded from short-term deposits. Moreover, nonbank financial institutions (e.g., life insurance, pension, and mutual funds) do not function adequately as intermediaries between the long-term savers and the long-term, private sector borrowers because of incomplete reforms in the bond market.

4. Although poverty is back down to pre-crisis levels, the rate of poverty reduction has slowed in the first half of this decade. Gains in poverty reduction depend to a large extent on the performance of the agriculture sector, which employs 45 percent of Indonesians. However, agricultural growth has been stagnating. Revitalizing the rural economy will require an emphasis on value-added processing, stronger linkages between SMEs and farming communities, and sustainable natural resources management.

5. This Country Impact Review (CIR) evaluates the effectiveness of IFC's strategic approach and operations in Indonesia before, during, and after the crisis. It covers operations undertaken by IFC over the period FY1990–2006 and is concurrent with the IEG-WB's Country Assistance Evaluation (CAE) covering operations undertaken by the World Bank in Indonesia during the period FY1999–2006. The report addresses four key evaluative questions: (i) How effective were IFC's approaches or strategies for its operations in Indonesia before the crisis? (ii) How did the crisis affect IFC's development and investment outcomes? (iii) How effective was IFC's short-term response to the crisis? and (iv) How did IFC adjust its strategy after the crisis?

How effective were IFC's approaches or strategies for its operations in Indonesia before the crisis?

6. Prior to FY1997, IFC's strategic priorities in support of private sector development in Indonesia were not articulated in any single document. Instead, inference from various project documents indicates that IFC gave priority to: (i) supporting tradable goods sectors such as textiles, agribusiness, chemicals, and general manufacturing; (ii) increasing and diversifying IFC's client base; (iii) supporting privatization, particularly in infrastructure; and (iv) helping deepen financial markets. In FY1996, the World Bank Group (WBG) introduced, on a pilot basis, joint World Bank, IFC, and MIGA Country Assistance Strategies (CASs). The first such joint CAS for Indonesia was submitted to the WBG's Board of Executive Directors (the Board) in June 1997—just before the Indonesian country crisis emerged—and was implemented only partially as a result.

7. Before the crisis, IFC's investment commitments averaged about US$109 million per year. In addition, IFC was able to play a strong catalytic role by mobilizing about US$1.4 of B-loans[1] for every dollar it committed. IFC was successful in supporting tradable goods sector projects and in

diversifying and increasing its client base in Indonesia. However, despite giving high strategic priority to supporting a larger private sector role in infrastructure and deepening financial markets, IFC's investment in infrastructure was quite limited, and its financial market operations supported only small and medium enterprises (SMEs) through financial intermediaries. IFC was selective in choosing its partners in Indonesia, as evidenced by the smaller proportion of projects with high-risk intensity at approval (48 percent), as compared with IFC-wide sample evaluated by IEG (58 percent). Importantly, IFC avoided doing business with groups closely associated with President Suharto. Its lower risk intensity would prove to be a key factor in the performance of IFC's portfolio during and after the crisis. These factors all contributed to the overall results described further below.

How did the crisis affect IFC's development and investment outcomes?

8. During the crisis years (1998–2000), IFC focused on restructuring its problem investments and protecting them from contentious sponsors or uncooperative creditors. IFC's investment operations averaged only one project per year with an average financing commitment of US$16.9 million. These investments were mainly in the export-oriented agribusiness and textile sectors. No B-loans were mobilized during the crisis years.

9. The development outcome of the Indonesia portfolio was adversely affected by the prolonged recovery of the country from the crisis. In particular, projects with weak sponsors (generally the smaller projects) and those that had minimal or no export revenue, suffered most among IFC projects. Projects in financial distress that took a long time to restructure (i.e., more than two years) also had low development outcomes. Several non-exporting IFC projects with foreign currency loans were nonetheless successfully restructured and achieved satisfactory development outcomes because of low debt leverage at the onset of the crisis.

10. IFC's investment outcome success rate in Indonesia was depressed by the crisis, with the impact on IFC's loan portfolio being particularly severe. Because of the inclusion of a high proportion of high-quality sponsors, however, IFC's equity portfolio was less severely damaged. Compared with the projects evaluated in Eastern Europe and Central Asia, which were affected by the Russian Crisis of 1998–99, the Indonesian projects underperformed in terms of both development and IFC investment outcomes. The most likely explanation for this difference is the quicker recovery of the Russian economy and its impact on the neighboring countries, in addition to the factors discussed below relating to the country's and IFC's own response.

How effective was IFC's short-term response to the crisis?

11. As local businesses began to experience the full effects of the crisis, IFC focused its activities on addressing the need to restructure the liabilities of existing clients and provide them with working capital, rather than on developing new clients or financing capacity expansions. The restructuring strategy categorized clients according to the likelihood of a need for restructuring, the size of their IFC exposure, and the complexity of the case. The objective was to resolve the easiest cases first, and within this group, give priority to clients with large IFC exposures. An important element of the restructuring strategy was cooperation with the World Bank to focus the Government's attention on systemic restructuring issues faced by private sector companies that required government intervention.

12. IFC had 41 client companies at the onset of the country crisis and undertook rescheduling and restructuring operations involving 16 client companies, of which 11 are considered successful, with a total original IFC net commitment of about US$900 million. In the remaining five cases, IFC, the company sponsors, and other creditors did not reach an agreement for a financially viable recovery plan. The five failed restructurings led to bankruptcy or liquidation of the companies, with some limited recovery of IFC's senior loans, but a total loss of IFC's equity investments. Reasons

for the failed restructuring attempts included low-quality or fraudulent sponsorship in an environment of a weak judiciary, crop disease, and natural disasters. IFC ultimately wrote off 55 percent of the total net commitment to these five companies.

How did IFC adjust its strategy and operations after the crisis?

13. During the post-crisis years (2001–06), IFC continued to focus on supporting existing clients still in the recovery or initial expansion stage, but also began to develop new clients, particularly in more recent years. IFC has also increased its support to financial intermediaries focused on SMEs. This support has so far been focused on the more developed island of Java, and significant potential exists to expand activities to less developed parts of the country through regional SME-oriented commercial banks. Export-oriented agribusiness and textile industry clients continued to receive support, but IFC still has no investment operations in the infrastructure and extractive industry sectors. This is largely because the Indonesian Government has not issued clear regulations for awarding infrastructure and mining projects to private sector companies and has not bid out many such contracts to date. Likewise, IFC has not increased its involvement in the area of capital market development, including the corporate bond market, because of incomplete reforms.

14. IFC's investment operations during the post-crisis years have averaged four projects and US$103.3 million in commitments, including US$7.7 million of equity per year. An average of US$4.7 million of B-loans has been mobilized per year—still low compared to the pre-crisis level and IFC-wide average. IFC has recently increased its investment staff in Indonesia in anticipation of increased investment operations, particularly in the infrastructure and the financial market sectors.

15. IFC Advisory Services in Indonesia increased substantially in FY2002 with the start-up of the multi-donor-funded Program for Eastern Indonesia Small and Medium Enterprise Assistance (PENSA) facility to assist SMEs. During the review period, IFC has implemented 80 advisory services projects aggregating to about US$26 million of funding commitments. Most advisory services operations are too recent to evaluate; however, there have been limited linkages between IFC Advisory Services and investment operations. A consulting firm undertook a mid-term review of PENSA in 2006 and recommended changes in organization, processes, and advisory services product lines. As a result, IFC consolidated regional offices and product lines to increase synergies and reduce overhead costs. At the same time, IFC opened PENSA offices in Aceh and Nias to help with the post-tsunami economic recovery.

Overall results and implications for IFC going forward

16. IFC's mature Indonesian investment projects show a development outcome success rate of 46 percent (by number of projects)—well below IFC-wide average of 60 percent but comparable to the East Asia (excluding China and Indonesia) average of 45 percent. The lower rate is largely explained by the crisis as well as the nature of the country's and IFC's response.

17. In terms of EHS outcomes, Indonesian projects have demonstrated far less satisfactory performance (55 percent) than IFC average (68 percent). There is no valid reason for the Indonesian portfolio's poor EHS compliance rate to continue six years after the crisis. Better IFC EHS supervision of the Indonesian portfolio is crucial to improving EHS compliance and fostering development effectiveness.

18. IFC's investment outcomes in Indonesia reflect the impact of the crisis. IFC's loan portfolio has had a 58 percent success rate compared to IFC-wide average of 74 percent in terms of the proportion of loan investments being paid with interest according to the original or rescheduled terms. IFC's equity portfolio in Indonesia has had an investment success rate of 33 percent—comparable to IFC-wide average of 31 percent, but significantly worse than the East Asia success

rate (excluding China and Indonesia) of 43 percent. The similarity with IFC-wide average can be attributed to the relatively high proportion of low-risk (or high-quality) project sponsors, some of whom honored IFC's equity put options despite the crisis. The lower success rate relative to East Asia is partly due to the longer recovery period from the crisis in Indonesia. The equity investment performance helped make IFC's Indonesian portfolio marginally profitable during the review period.

19. Looking ahead, some of IFC's recent activities have the potential for strong development impact and need to be scaled up. Thus, IFC's post-crisis agribusiness projects have been designed to strengthen supply chain linkages, including independent farmers, while IFC financial intermediary clients have been successful in reaching out to SMEs. IFC can build on these efforts in the agribusiness and SME sectors to foster linkages to environmentally sustainable agriculture and forestry practices.

20. On the other hand, IFC has not been able to contribute to the development of infrastructure and the long-term bond market in Indonesia. These areas are emerging as constraints to growth in the country. Without progress on reforms, IFC will continue to have limited opportunities to support private participation in infrastructure and corporate bond issuances. Cooperation needs to improve between the World Bank, IFC, and other multilateral development banks (MDBs) active in Indonesia to focus the Government's attention on these issues.

Recommendations

21. Going forward, the evaluation calls for a stronger IFC role in infrastructure development by strategically and operationally partnering with the World Bank (and other MDBs) to pursue and help dovetail sector reforms and investments. The report recommends that IFC target its support to helping Indonesia develop a long-term, local currency debt market while scaling up support to SMEs in underserved regions of the country through regional SME-oriented commercial banks. The evaluation calls attention to the poor EHS compliance of the Indonesia portfolio and recommends better IFC EHS supervision to improve compliance and foster development effectiveness. Finally, the report recommends that IFC scale up its agribusiness project operations with greater attention for environmentally sustainable forestry and agricultural outcomes and stronger linkages with SMEs, the farm population, and rural communities.

22. The lessons and recommendations in this CIR coincide with, and complement, those in the Indonesia CAE. Both reports suggest that the WBG's activities in Indonesia focus on helping the country improve its business environment for sustained performance, allowing higher levels and a better quality of private sector investment, including in the infrastructure sector.

Rangkuman Eksekutif

Konteks

1. Krisis Asia pada akhir tahun 1990an berdampak lebih besar pada Indonesia dibandingkan negara lainnya di wilayah tersebut. Perubahan-perubahan politik dan ekonomi yang menyusul adalah sulit, dengan demikian memperlambat pemulihan ekonomi.

2. Investasi oleh sektor publik dan swasta di Indonesia pada tahun 2005 dan 2006 masih jauh di bawah tingkat sebelum krisis. Khususnya, porsi investasi infrastruktur di dalam GDP menurun sejak tahun 1998. Akibatnya, muncul kendala-kendala di dalam layanan infrastruktur.

3. Kendatipun sistem perbankan negara telah menjadi stabil dan sebagian besar diswastanisasi sejak 2002, bank-bank tidak siap untuk meningkatkan pemberian pinjaman jangka panjang mereka dari suatu basis yang sebagian besar didanai dari deposito jangka pendek. Lagi pula, lembaga-lembaga keuangan nonbank (contohnya, asuransi jiwa, dana pensiun, dan reksa dana) tidak berfungsi secara memadai sebagai perantara antara penabung jangka panjang dan peminjam sektor swasta jangka panjang karena reformasi tak lengkap di pasar obligasi.

4. Kendatipun kemiskinan kembali ke tingkat sebelum krisis, tingkat penurunan kemiskinan melambat dalam paruh pertama dekade ini. Keberhasilan dalam penurunan kemiskinan tergantung sebagian besar pada kinerja sektor pertanian, yang mempekerjakan 45 persen penduduk Indonesia. Namun demikian, pertumbuhan pertanian mengalami kemandekan. Revitalisasi ekonomi pedesaan harus menitikberatkan proses yang meningkatkan nilai tambah, meningkatkan hubungan yang lebih erat antara UKM dan komunitas pertanian, serta manajemen sumber daya alam yang berkelanjutan .

5. Country Impact Review (CIR) ini mengevaluasi keefektifan pendekatan dan operasi strategis IFC di Indonesia sebelum, selama, dan setelah krisis. Ini meliputi operasi-operasi yang dilaksanakan oleh IFC selama periode fiskal 1990–2006 dan bersamaan dengan CAE dari IEG-WB yang mencakup operasi-operasi yang dilaksanakan oleh World Bank di Indonesia selama periode fiskal 1999–2006. Laporan tersebut menjelaskan empat pertanyaan evaluasi kunci: (i) Seberapa efektif pendekatan atau strategi IFC untuk melaksanakan operasi-operasinya di Indonesia sebelum krisis? (ii) Bagaimana krisis mempengaruhi hasil pembangunan dan investasi IFC? (iii) Seberapa efektif tanggapan jangka pendek IFC terhadap krisis? dan (iv) Bagaimana IFC menyesuaikan strateginya setelah krisis?

Seberapa efektif pendekatan atau strategi IFC untuk operasi-operasinya di Indonesia sebelum krisis?

6. Sebelum Tahun Fiskal 1997, prioritas-prioritas strategis IFC yang mendukung pengembangan sektor swasta di Indonesia tidak dijelaskan di dalam suatu dokumen tunggal. Sebaliknya, kesimpulan dari berbagai dokumen proyek menunjukkan bahwa IFC memberikan prioritas untuk: (i) mendukung sektor barang dagangan seperti tekstil, agrobisnis, kimia, dan manufaktur umum; (ii) meningkatkan dan mendiversifikasi basis klien IFC; (iii) mendukung swastanisasi, terutama di dalam infrastruktur; dan (iv) membantu menajamkan pasar keuangan. Dalam periode fiskal 1996, World Bank Group (WBG) memperkenalkan, berdasar percontohan, gabungan World Bank, IFC, dan Country Assistance Strategies (CAS) MIGA. Gabungan CAS pertama untuk Indonesia dikirimkan kepada Dewan Direksi Eksekutif WBG (Dewan) dalam

bulan Juni 1997—tepat sebelum krisis negara Indonesia muncul—dan sebagai akibatnya hanya dilaksanakan sebagian.

7. Sebelum krisis, komitmen investasi IFC rata-rata sebesar US$109 juta per tahun. Di samping itu, IFC dapat memainkan suatu peranan katalitis yang kuat dengan memobilisasi lebih kurang US$1.4 dari pinjaman-B untuk setiap dolar yang menjadi komitmennya. IFC berhasil di dalam mendukung proyek-proyek sektor barang dagangan dan di dalam mendiversifikasi dan meningkatkan basis kliennya di Indonesia. Namun demikian, kendatipun memberikan prioritas strategis yang tinggi untuk mendukung suatu peranan sektor swasta yang lebih besar di dalam infrastruktur dan memperdalam pasar keuangan, investasi IFC di dalam infrastruktur agak terbatas, dan operasi-operasi pasar keuangannya hanya mendukung usaha kecil dan menengah (UKM) melalui perantara keuangan. IFC bersikap selektif di dalam memilih mitra-mitranya di Indonesia, sebagaimana dibuktikan oleh porsi proyek-proyek yang lebih kecil dengan intensitas risiko tinggi yang disetujui (48 persen), jika dibandingkan dengan sampel skala IFC yang dievaluasi oleh IEG (58 persen). Selain itu, IFC menghindari melakukan bisnis dengan kelompok-kelompok yang berkaitan erat dengan Presiden Suharto. Intensitas risiko yang lebih rendah akan terbukti menjadi suatu faktor utama di dalam kinerja portofolio IFC selama dan setelah krisis. Faktor-faktor ini semuanya memberikan sumbangan kepada hasil-hasil keseluruhan sebagaimana dijelaskan lebih lanjut di bawah.

Bagaimana krisis mempengaruhi hasil pembangunan dan investasi IFC?

8. Selama tahun-tahun krisis (1998–2000), IFC fokus pada restrukturisasi investasinya yang bermasalah dan melindunginya dari para sponsor yang tidak baik atau kreditur yang tidak kooperatif. Operasi investasi rata-rata IFC hanya satu proyek per tahun dengan suatu rata-rata komitmen pembiayaan senilai US$16,.9 juta. Investasi-investasi ini terutama adalah di sektor agrobisnis dan tekstil yang berorientasi pada ekspor. Tidak ada pinjaman-B yang dimobilisasi selama tahun-tahun krisis.

9. Hasil pengembangan portofolio Indonesia sangat dipengaruhi oleh pemulihan krisis yang berkepanjangan pada negara. Khususnya, proyek-proyek dengan sponsor yang lemah (pada umumnya proyek-proyek yang lebih kecil) dan yang mempunyai pendapatan ekspor yang sangat kecil atau tidak mempunyai pendapatan ekspor, adalah yang paling menderita di antara proyek-proyek IFC. Proyek-proyek yang berada dalam kesulitan keuangan yang memerlukan waktu yang lama untuk membaik (yaitu, lebih dari dua tahun) juga mempunyai hasil pembangunan yang rendah. Beberapa proyek-proyek IFC yang tidak melakukan ekspor dengan pinjaman dalam mata uang asing namun demikian berhasil melakukan restrukturisasi dan mencapai hasil pembangunan yang memuaskan karena kemampuan membayar utang yang rendah di awal krisis.

10. Tingkat keberhasilan hasil investasi IFC di Indonesia dipengaruhi oleh krisis, yang berdampak cukup besar terhadap portofolio pinjaman IFC. Karena dimasukkannya proporsi sponsor dengan kualitas tinggi, namun demikian, portofolio saham IFC tidak terganggu terlalu parah. Dibandingkan dengan proyek-proyek yang dievaluasi di Eropa Timur dan Asia Tengah, yang terkena dampak akibat dari Krisis Rusia tahun 1998–99, proyek-proyek Indonesia menunjukkan kinerja yang rendah dilihat dari hasil investasi IFC dan pengembangannya. Penjelasan yang paling mungkin untuk perbedaan ini adalah pemulihan ekonomi Rusia yang lebih cepat dan dampaknya terhadap negara-negara tetangga, di samping faktor-faktor yang dibicarakan di bawah berkaitan dengan tanggapan negara dan IFC sendiri.

Seberapa efektif tanggapan jangka pendek IFC terhadap krisis?

11. Ketika bisnis lokal mulai mengalami efek-efek penuh dari krisis, aktivitas IFC difokuskan pada upaya memenuhi kebutuhan untuk mengatur kembali kewajiban-kewajiban dari klien-klien yang ada dan memberikan modal kerja kepada mereka, dan bukan dengan mengembangkan klien-klien yang baru atau memperluas kapasitas pembiayaan. Strategi restrukturisasi mengatur kategori klien-klien sesuai dengan kemungkinan perlunya restrukturisasi, besarnya eksposur IFC mereka, dan kompleksitas kasus. Tujuannya adalah menyelesaikan kasus-kasus yang paling mudah terlebih dahulu, dan di dalam kelompok ini, memberikan prioritas kepada klien-klien dengan eksposur IFC yang besar. Suatu elemen yang penting dari strategi restrukturisasi adalah kerja sama dengan World Bank untuk memfokuskan perhatian Pemerintah pada masalah-masalah restrukturisasi sistemik yang dihadapi oleh perusahaan-perusahaan sektor swasta yang membutuhkan campur tangan pemerintah.

12. IFC mempunyai 41 perusahaan klien di awal krisis dan mengupayakan operasi-operasi penjadwalan kembali dan restrukturisasi 16 perusahaan klien, 11 di antaranya dianggap berhasil, dengan suatu total komitmen bersih IFC asli lebih kurang US$900 juta. Pada lima kasus lainnya, IFC, sponsor perusahaan, dan kreditur lainnya tidak mencapai suatu kesepakatan untuk suatu rencana pemulihan yang dari sisi keuangan layak. Lima restrukturisasi yang gagal mengakibatkan kepailitan atau likuidasi perusahaan-perusahaan, dengan beberapa pemulihan terbatas terhadap pinjaman lama IFC namun menjadi kerugian investasi saham IFC. Alasan-alasan kegagalan upaya restrukturisasi di antaranya adalah kualitas sponsor rendah atau tidak jujur dalam suatu lingkungan judisial yang lemah, penyakit tanaman, dan bencana alam. IFC pada intinya menghapuskan 55 persen dari total net komitmen terhadap kelima perusahaan ini.

Bagaimana IFC mengatur strategi dan operasi setelah krisis?

13. Selama tahun-tahun setelah krisis (2001–06), IFC terus fokus untuk mendukung klien-klien yang ada dan masih dalam tahap pemulihan atau perluasan awal, tetapi juga mulai mengembangkan klien-klien yang baru, terutama di tahun-tahun terakhir. IFC juga telah meningkatkan dukungannya terhadap perantara keuangan yang difokuskan pada UKM. Dukungan ini difokuskan pada pulau Jawa yang lebih maju, dan mempunyai potensi besar untuk mengembangkan aktivitas ke bagian-bagian yang belum berkembang melalui bank-bank umum dengan orientasi kepada UKM di daerah. Klien-klien industri agrobisnis dan tekstil yang berorientasi pada ekspor terus menerima dukungan, tetapi IFC masih belum mempunyai operasi investasi di sektor infrastruktur dan industri ekstraktif. Ini umumnya dikarenakan Pemerintah Indonesia tidak menerbitkan peraturan-peraturan yang jelas untuk menyerahkan proyek-proyek infrastruktur dan pertambangan kepada perusahaan-perusahaan sektor swasta dan hingga saat ini tidak mentenderkan kontrak-kontrak tersebut. Demikian pula, IFC tidak meningkatkan keterlibatannya di lingkup pengembangan pasar modal, termasuk pasar obligasi perusahaan, karena perbaikan yang tak lengkap.

14. Operasi investasi IFC selama tahun-tahun setelah krisis rata-rata adalah empat proyek dan dengan nilai komitmen sebesar US$103,3 juta, termasuk US$7,7 juta investasi saham per tahun. Rata-rata US$4,7 juta pinjaman-B telah dimobilisasi per tahun—masih lebih rendah dibandingkan dengan tingkat sebelum krisis dan rata-rata skala IFC. Baru-baru ini, IFC telah menambah jumlah staf investasinya di Indonesia untuk mengantisipasi meningkatnya operasi investasi, terutama di sektor pasar keuangan dan infrastruktur.

15. Advisory Services IFC di Indonesia meningkat tajam selama periode fiskal 2002 dengan dimulainya fasilitas Program for Eastern Indonesia Small and Medium Enterprise Assistance (PENSA) yang didanai oleh banyak donor untuk membantu UKM. Selama periode kaji ulang, IFC telah melaksanakan 80 proyek advisory services dengan total komitmen pendanaan lebih

kurang US$26 juta. Sebagian besar operasi advisory services baru saja dimulai sehingga tidak dapat dievaluasi; namun demikian, ada tautan terbatas antara Advisory Services IFC dan operasi investasi. Sebuah perusahaan konsultasi melaksanakan suatu kaji ulang skala menengah terhadap PENSA pada tahun 2006 dan merekomendasikan perubahan-perubahan dalam organisasi, proses, dan produk advisory services. Akibatnya, IFC mengkonsolidasikan kantor-kantor regional dan lini produk untuk meningkatkan sinergi dan mengurangi biaya overhead. Pada saat yang sama, IFC membuka kantor-kantor PENSA di Aceh dan Nias untuk membantu pemulihan ekonomi pasca-tsunami .

Hasil-hasil keseluruhan dan implikasi terhadap kemajuan IFC

16. Proyek-proyek investasi IFC di Indonesia yang matang memperlihatkan suatu tingkat keberhasilan hasil pembangunan sebesar 46 persen (dilihat dari jumlah proyek)—jauh di bawah rata-rata skala IFC sebesar 60 persen tetapi sebanding dengan rata-rata Asia Timur (tidak termasuk Cina dan Indonesia) sebesar 45 persen. Tingkat yang lebih rendah sebagian besar dijelaskan sesuai dengan krisis maupun kondisi negara dan respon IFC.

17. Dari sisi hasil EHS, proyek-proyek Indonesia telah memperlihatkan kinerja yang kurang memuaskan (55 persen) daripada rata-rata IFC (68 persen). Tidak ada alasan yang sah mengenai tingkat kepatuhan EHS yang rendah dari portofolio Indonesia sampai terus berlanjut enam tahun setelah krisis. Pengawasan EHS IFC yang lebih baik atas portofolio Indonesia adalah sangat penting untuk memperbaiki kepatuhan EHS dan mendorong keefektifan pembangunan.

18. Hasil investasi IFC di Indonesia menunjukkan dampak dari krisis. Portofolio pinjaman IFC mempunyai tingkat keberhasilan 58 persen dibandingkan dengan rata-rata skala IFC sebesar 74 persen dari sisi proporsi investasi pinjaman yang dibayar dengan bunga sesuai dengan syarat-syarat asli atau yang telah dijadwalkan ulang. Portofolio saham IFC di Indonesia mempunyai suatu tingkat keberhasilan investasi sebesar 33 persen—sebanding dengan rata-rata skala IFC sebesar 31 persen, tetapi jauh lebih buruk daripada tingkat keberhasilan Asia Timur (tidak termasuk Cina dan Indonesia) sebesar 43 persen. Kesamaan dengan rata-rata skala IFC dapat dikaitkan dengan proporsi yang relatif tinggi dari sponsor proyek dengan risiko rendah (atau kualitas tinggi), sebagian di antaranya merupakan equity put option dari IFC terlepas adanya krisis. Tingkat keberhasilan yang lebih rendah relatif terhadap Asia Timur sebagian karena periode pemulihan yang lebih lama dari krisis di Indonesia. Kinerja investasi saham membantu membuat portofolio Indonesia dari IFC secara marjinal menguntungkan selama periode kaji ulang.

19. Melihat ke depan, sebagian dari aktivitas IFC akhir-akhir ini mempunyai potensi berdampak terhadap pengembangan yang kuat dan perlu ditingkatkan. Dengan demikian, proyek-proyek agrobisnis setelah krisis telah dirancang untuk memperkuat tautan rantai pasokan, termasuk petani independen, sementara itu klien-klien perantara keuangan IFC berhasil menjangkau UKM. IFC dapat mengupayakannya di sektor agrobisnis dan UKM untuk mendorong tautan ke praktek-praktek pertanian dan kehutanan yang ramah lingkungan.

20. Sebaliknya, IFC belum mampu memberikan sumbangan kepada pembangunan infrastruktur dan pasar obligasi jangka panjang di Indonesia. Area-area ini muncul sebagai kendala-kendala bagi pertumbuhan di suatu negara. Tanpa adanya kemajuan dalam reformasi, IFC hanya akan mempunyai kesempatan yang terbatas untuk mendukung partisipasi swasta di dalam infrastruktur dan emisi obligasi perusahaan. Kerja sama perlu diperbaiki antara World

Bank, IFC, dan bank-bank pembangunan multilateral lainnya (MDB)yang aktif di Indonesia untuk memusatkan perhatian Pemerintah kepada masalah-masalah ini.

Rekomendasi-rekomendasi

21. Ke depan, evaluasi mensyaratkan suatu peranan yang lebih kuat dari IFC dalam pembangunan infrastruktur yang bermitra secara strategis dan secara operasional dengan World Bank (dan MDB lainnya) untuk mengupayakan dan membantu mencocokkan perbaikan sektor dan investasi. Laporan merekomendasikan agar IFC menargetkan dukungannya untuk membantu Indonesia mengembangkan suatu pasar utang mata uang lokal jangka panjang sambil meningkatkan dukungan terhadap UKM di daerah tertinggal melalui bank-bank umum dengan orientasi kepada UKM di daerah. Evaluasi meminta perhatian terhadap tingkat kepatuhan EHS yang rendah terhadap portofolio Indonesia dan merekomendasikan pengawasan EHS IFC yang lebih baik untuk memperbaiki kepatuhan dan mendorong keefektifan pembangunan. Pada akhirnya, laporan merekomendasikan agar IFC mendorong operasi-operasi proyek agrobisnisnya dengan perhatian yang lebih besar kepada hasil kehutanan dan pertanian yang ramah lingkungan dan tautan yang lebih kuat dengan UKM, masyarakat pertanian, dan masyarakat pedesaan.

22. Pelajaran-pelajaran dan rekomendasi-rekomendasi di dalam CIR ini bertepatan dengan, dan melengkapi yang ada di dalam CAE Indonesia. Kedua laporan menyatakan bahwa aktivitas WBG di Indonesia terfokus untuk membantu Indonesia memperbaiki lingkungan bisnis untuk mendukung kinerja yang berkelanjutan, sehingga memungkinkan investasi sektor swasta ke tingkat yang lebih tinggi dan berkualitas lebih baik, termasuk sektor infrastruktur.

IFC Management Response to IEG-IFC

IFC in Indonesia: 1990–2006

An Independent Country Impact Review

(January 14, 2008)

I. Introduction

1. Management acknowledges IEG's independent review of IFC's operations in Indonesia over a period of over 15 years, a time which severely tested both the country's political and economic institutions and IFC's responsiveness as a development partner before, during, and after the financial crisis. The report is well structured and presents important lessons of experience. It demonstrates the challenging environment to all investors, including IFC, to enforce the legal rights of the creditors in the aftermath of the crisis. Overall, Management agrees with the general direction of the report and finds its recommendations largely consistent with recent IFC initiatives in the country.

2. The report notes that IFC's operations in Indonesia had gone through three broad phases corresponding with major developments of the economy. Prior to the crisis, IFC approached the rapidly rising industrial sector with caution because of the risks associated with the close links of major companies with the political establishment. The report rightly points out that good project risk management at entry reduced the impact of the Asian crisis on IFC's portfolio despite Indonesia getting hit harder than most other affected countries.

3. The onset of the Asian financial crisis in Thailand in July1997 and Indonesia a few months later resulted in serious financial distress for sixteen client companies. This absorbed much of IFC's country focus. The IEG report shows that restructuring efforts for two-thirds of the firms were successful, including non-exporting enterprises with large foreign currency loans. While IFC concentrated on restructuring its client companies in distress, the report also notes that its micro-economic and legal work helped both its sister institutions and the Indonesian government in tackling several important institutional weaknesses of Indonesia's economy and judicial system. The report also suggests that the financial crisis had an adverse impact on the projects' environmental performance as companies placed top priority on financial survival and recovery over routine matters such as environmental reporting and compliance.

4. During the post-crisis years, IFC continued to "focus on supporting existing clients in the recovery and initial expansion stage". The report indicates that this strategy resulted in keeping the risks at entry well-managed, and provided breathing space for pursuing new clients. At the same time, Management also realizes that crises offer new and often unexpected investment opportunities.

5. Management notes that IEG data show clear improvements in project development impact, including environmental performance. However, the degree of improvement may be less clear given that the sample of evaluated crisis and post-crisis projects is still relatively small (12 crisis and post-crisis projects versus 41 projects approved before the crisis). As indicated in the specific response to Recommendation 5 below, IFC is taking steps to improve the environmental performance of its projects in the country.

6. The report also concludes that IFC's pursuit of infrastructure and extractive industry investments have been constrained by slow policy reforms and legal problems. Management believes that in light of the urgency of the tasks and the government's recent efforts to accelerate privatization programs in those areas, IFC is well-positioned to provide significant support, ranging from assistance in project preparation and structuring to finding credible sponsors and providing long-term local currency finance. In addition, investment opportunities in this sector will increase the scope for IFC-World Bank collaboration beyond the strategy formulation level.

7. Management recognizes the fact that there are still a range of issues and shortcomings in the financial sector in Indonesia. Management also emphasizes that the aftermath of the financial crash led to a cautious strategy, particularly in pursuing larger projects in this and other fields. This was the only possible strategy given the lack of reliable judicial processes at that time, which led IFC to work with credible sponsors it could trust. At the same time, the IEG report is appreciative of IFC's increased emphasis on financial sector activities and projects which are closely linked to the small and medium enterprises (SME) and microfinance sector. In that context, the report also mentions IFC's efforts in advisory services.

8. We particularly note the following conclusions, which support IFC's strategy in Indonesia:

- To reduce the percentage of people in poverty and vulnerable economic conditions, Indonesia will need to substantially increase efficient investments, most of which will have to come from the private sector at all levels of economic activities;

- The two problem areas of the Indonesian economy with little engagement of IFC investments have been the infrastructure sector and specific financial markets sub-sectors; fields in which IFC has increasingly turned its attention to in the last few years; and

- While Indonesia has a long tradition in SME lending, which has shown to be more robust during the financial crisis than the commercial banks serving larger enterprises, the report's recommendation of continuing IFC support for SMEs and microfinance fits well with IFC's current multiple efforts in those fields.

9. Subject to the elaborations in the following section, Management generally agrees with the report's recommendations and is pleased to note that we are already effectively implementing them.

II. Response to Specific Recommendations

10. Recommendation 1: IFC should develop and follow a more systematic medium-term (three- to five-year horizon) country approach to identifying investment opportunities in areas of high impact, country competitive advantage, and unmet demand in order to channel IFC investments into projects with the greatest potential development impact and demonstration effect.

***Management Response*:**

11. IFC agrees that competition and transparency is central to achieving the type of efficient infrastructure services that Indonesia's development needs, and that this is particularly important during the contracting process. IFC is committed to supporting infrastructure development and was

one of the major sponsors and organizers in an "Infrastructure Summit" held in Jakarta in November, 2006, attended by top government officials and representatives of the private sector. Among the outcomes was proposal by the Government of Indonesia to have IFC prepare and structure the first 10 infrastructure projects in cooperation with the country's Project Planning Department (KKPPI). IFC has been working with the World Bank and the Government in identifying model transactions to be prepared for examination, and the quality of the procurement process is a key issue for joint review with the Government.

12. IFC believes that the reforms are most likely to be adopted broadly when the benefits are demonstrated through actual projects. IFC is in the final stages of agreeing on a major advisory services mandate to bring infrastructure best practice to the bidding for a large power project. IFC is also working on other advisory roles in the power sector and is cooperating with the World Bank and the Government of Indonesia to establish a specialized financial institution, currently called the Indonesian Infrastructure Financing Facility (IFF). Those activities and transactions will seek to demonstrate the gains from transparent and competitive contracting processes.

13. Recommendation 2: IFC should seek to work in sequence and/or in parallel with IBRD to address remaining privatization priorities, especially large enterprises and infrastructure, with IBRD policy work and IFC post-privatization funding, and use existing joint mechanisms, such as the Sub-National Finance Department to promote public-private partnerships and provide funding to municipal utilities projects.

<u>Management Response:</u>

14. In the financial sector, IFC has been supporting the consolidation and strengthening of the banking sector, and strengthening the capacity of rural banks and microfinance institutions. IFC has disbursed nearly $150 million in long-term Rupiah loans, most of which will be used for local credit to SMEs.

15. With respect to the local currency bond market, the World Bank, the Indonesian Ministry of Finance, and the Capital Market Supervisory Authority (BAPEPAM) have held a series of conferences and a policy dialogue on non-bank financial markets, including Rupiah bonds in 2007. The dialogue has revealed a number of policy and capacity issues for which IFC can play a role in filling the gaps. These include tax policy, the lack of an active secondary market, the lack of liquid repurchase and derivative markets, and a need to strengthen mechanisms for registration, trading and settlement, Addressing these issues will help build the confidence of institutional investors in the local currency bond market, thereby increasing its liquidity particularly for corporate issuers. IFC will consider how it can effectively play a role in building these markets through demonstration transactions as well as advisory support.

16. Recommendation 3: IFC can scale up and diversify its agribusiness operations and continue to focus on stronger linkages with SMEs, farmers and communities, while ensuring sustainable environmental, health, and safety (EHS) practices.

<u>Management Response:</u>

17. Management agrees and is strongly supporting linkages between SMEs and lead firms in key domestic commodity based sectors, focusing on supply chains in agriculture, fisheries and forestry. IFC will expand its focus on value chain approaches in all International Development Association

(IDA) countries in East Asia starting with Vietnam, but extending to Indonesia and Cambodia, as the benefits both in terms of development impact and investment are clear. In that context, IFC will make sure that those projects will pursue environmentally sustainable practices.

18. In Indonesia, the linkages advisory work has led to increased sales in markets for several agricultural products. As an example, IFC has supported a cluster of 20 SMEs to increase sales of acacia furniture based on sustainable harvested wood. IFC will seek to scale up this work in other agribusiness supply chains. To ensure focus, the Country Manager is now responsible for both investments and advisory services.

19. Recommendation 4: IFC can scale up its support to SMEs in underserved regions of the country through regional SME oriented commercial banks.

Management Response:

20. IFC has a focus on this area. Management considers rural banking crucial, and it will ensure that greater attention is given to SME development in "non-Java" regions of the country. Management has started in Java as there are financial intermediaries that can be utilized.

21. Efforts are being undertaken to reduce or eliminate policy impediments to effective rural banking, including restrictions on support from foreign parties and limitations on the number of branches per province. Similar to the commercial banking sector, IFC is working on efforts to consolidate the many small and weak institutions into more effective ones that can make the technology and human capital investments needed to effectively serve SMEs sector in the regions. Only in the event that the Government improves these policies (on which IFC is providing help) will IFC be in a position to scale up SME operations in outlying areas. Until then, IFC's involvement will be limited.

22. Recommendation 5: IFC can improve the EHS compliance rate of the Indonesian portfolio with better EHS supervision.

Management Response:

23. In Indonesia, a number of investments went into jeopardy during and post crisis, and legal action had to be sought against sponsors. This has contributed to the lower than average EHS compliance rates. Management agrees that improvements in supervision can be gained and it has been implementing an increased supervision program for the past 18 months. Management is increasing the number of projects physically visited and has been steadily increasing the knowledge of the portfolio. The on-going decentralization is expected to further strengthen client contacts and help collect, monitor and improve EHS in the client companies.

Chairperson's Summary: Committee on Development Effectiveness

IFC in Indonesia: 1990–2006

An Independent Country Impact Review

(Meeting of January 23, 2008)

1. On January 23, 2008, the Informal Subcommittee of the Committee on Development Effectiveness (CODE) considered the IEG reports on *The World Bank in Indonesia, 1999-2006: Country Assistance Evaluation*,[1] and *IFC in Indonesia:1990 – 2006. An Independent Country Impact Review (CIR)* together with the draft IFC Management Response.

2. **Indonesia Country Impact Review (CIR).** The CIR evaluated the effectiveness of IFC's strategic approach and operations in Indonesia between fiscal years (FY) 1990 and 2006. The CIR described the shift in IFC's operations before, during and after the Asian financial crisis. IEG found that IFC's strategic priorities have been aligned with the country's strategy for private sector development. Among the areas supported, IEG noted that more work is needed in supporting a larger private sector role in infrastructure, and in boosting the financial markets. IEG also emphasized the need to strengthen the environmental, social, health, and safety (ESHS) compliance of projects, which have had lower satisfactory performance in Indonesia than the overall IFC average. Some other recommendations were: (i) strategically partner with the World Bank and other multilateral development banks (MDBs) to introduce sector reforms and investments to promote the role of private sector in infrastructure and to develop a long-term local currency debt market; (ii) scale-up and diversify its agribusiness operations, working more closely with small and medium enterprises (SMEs), farmers and communities; and (iii) scale up support for SMEs in underserved regions through regional SME-oriented commercial banks.

3. **IFC Management Response.** IFC management agreed with the thrust of the findings and recommendations, which were being incorporated into its operations. In the areas of infrastructure and the financial sector, Management elaborated on its ongoing activities and its work with the World Bank. Management commented on its work in supporting the linkages and supply chains in the agriculture sector and plans to expand value chain approaches in International Development Association (IDA) countries in the East Asia region. It assured that greater attention would be given to SME development in remote areas, but also remarked on the need for the government to improve policies to enable greater IFC involvement. To improve ESHS compliance rate, Management said supervision is being increased, and with the decentralization of IFC operations, IFC would strengthen its client contacts and monitoring.

4. **Comments from the Government.** A statement on behalf of the Indonesian authorities was circulated for the meeting. The government welcomed the CIR, which they considered constructive. For IFC's role, the Government encouraged efforts to increase the private sector role in infrastructure, including in the transportation sector. It noted the need to improve the link between IFC Advisory Services and investment operations. Scaling-up and diversification of support to agribusiness was welcomed, taking into consideration the importance of ensuring food security.

5. **Main Conclusions and Next Steps.** CODE members welcomed the opportunity to consider the CAE and the CIR together, which provided a comprehensive review of the Bank and IFC activities. With regards to IFC operations, issues of ESHS compliance and link between IFC

Advisory Services and investment were raised. A few members stressed that the Bank and the IFC needed to address the constraints in infrastructure, which was noted by the two World Bank Group institutions.

6. The need to strengthen ESHS compliance was emphasized. A member stated that IFC ought to better understand the reasons for weak compliance in this area and Management should outline the steps being taken to address them. *IFC management believed that the main reason for the lower ESHS compliance was the Asian financial crisis when a large number of companies experience financial distress. While IFC helped to restructure many clients, a few involved litigations. In the process, IFC supervision was affected and there was impact on ESHS compliance It was also noted that IFC is strengthening the overall oversight of ESHS with the revised policies for environment and social development, better understanding of ESHS issues in the financial sector, and more proactive supervision including for Category B projects.* The member insisted that according to IEG the problem of compliance is not confined to projects active at the time of the Asian crisis but it includes the entire study period in addition to the most recent years, a fact which IEG confirmed.

7. **Link Between IFC Advisory Services and Investment Operations.** A member sought more information on the need to link advisory services and investment operations and actions being taken to address the matter. *IFC management responded that while advisory services and investment operations were not well-coordinated in the past, the situation has changed more recently. It elaborated on the role of the Country Manager in delivering a coordinated and aligned package of advisory services and investment. Likewise, in the area of infrastructure and the private sector, IFC management emphasized the attention given to coordination with the World Bank.*

8. **Crisis Management.** A member asked whether IFC has systems in place in anticipation of a crisis, based on lessons learned in Indonesia and other countries. *IFC said that since the Asian and Russian crises, it has established a more formal portfolio management system where the credit risk ratings of projects are assessed every quarter. This provides early signals about a deteriorating situation. In addition, IFC said that if there are macroeconomic issues in a country, its portfolio is subjected to a periodic stress-test to determine the potential impact of a crisis and to consider mitigating actions.*

Jiayi Zou, Chairperson, CODE

1. Introduction

The review period covering FY1990–2006 is divided into three subperiods: the pre-crisis subperiod of FY1990–97, the crisis subperiod of FY1998–2000 (related to the Asian Crisis of 1997–98), and the post-crisis and political transition subperiod of FY2001–06. This evaluation addresses four key evaluative questions about IFC's operations in Indonesia approved during the review period. They are as follows: (a) how effective were IFC's approaches or strategies for its operations in Indonesia before the country crisis in late 1997; (b) how did the crisis affect IFC's development and investment outcomes; (c) how effective was IFC's short-term response to the crisis; and (d) how did IFC adjust its strategy after the crisis? The evaluation assesses both IFC's investment projects and advisory services operations.

During the review period, IFC had 79 approved and committed investment projects, which involved 103 transactions and a total of US$1,436 million of commitments, including US$217 million of equity. IFC also implemented 80 advisory services projects—about US$26 million of funding commitments from IFC and donors in aggregate, of which US$13 million was spent through June 30, 2006. Since the early 1990s, Indonesia has been among the 10 countries with the largest IFC investment portfolio.

Evaluation objective

1.1 The objective of this evaluation is to answer four key evaluative questions about IFC's strategies and operations in Indonesia during the review period. This review period is marked by three distinct subperiods: the pre-crisis years of 1990–96; the Indonesian country crisis years of 1997–99 (precipitated by the Asian Crisis of 1997–98); and the post-crisis and political transition years of 2000–06. These three subperiods have substantially different features from an economic, business (private sector), and political perspective, as briefly described in chapter 2. IEG[1] purposely chose to evaluate this period to: (a) highlight the major underlying issues for the development of the private sector during the pre-crisis period that contributed to the severity of the crisis and that continue to hinder private sector investments, economic growth, and employment creation; (b) highlight IFC's responses, in terms of strategies and operations in Indonesia, during and after the country crisis, which can provide a rich source of experiences and lessons for IFC going forward; and (c) assess the impacts of the country crisis on IFC's investment projects approved before the crisis that had reached operational maturity (i.e., with at least two years of operating results) just before or during the crisis. The four evaluative questions addressed by this review are:

- How effective were IFC's approaches or strategies for its operations in Indonesia before the crisis?
- How did the crisis affect IFC's development and investment outcomes?
- How effective was IFC's short-term response to the crisis?
- How did IFC adjust its strategy after the crisis?

Review scope and methodology

1.2 To answer the questions above, this evaluation:

- Identifies the approaches, priorities and strategies that guided IFC's investment and advisory services operations in Indonesia during the study period;
- Identifies the universe of operationally mature IFC investments[2] and evaluates these for development outcomes, IFC investment outcomes, and IFC work quality throughout the project cycle (i.e., appraisal, supervision as well as IFC role and contribution, or "additionality") using the project level evaluation methodology used in IFC's Expanded Project Supervision Report (XPSR)[3] system administered by IEG. Investment projects that are not yet operationally mature, but approved in FY2004–05, are partially evaluated for IFC's appraisal quality and for project risk intensity at approval, to look into the trend in these two variables between the pre-crisis and the post-crisis projects;
- Compares the performance of the Indonesian mature investment portfolio with those of the East Asia Region and IFC-wide results for projects evaluated under the XPSR system;
- Identifies the factors affecting the outcomes of the investment projects and, to the extent that data is available, also the outcomes and success drivers for completed IFC Advisory Services[4] operations; and
- Identifies the aspects of the business climate that currently hinder private sector development in general.

1.3 During the review period, IFC had 79 approved and committed investment projects, which involved 103 transactions[5] and US$1,436 million of commitments, including US$217 million of equity. Of the 79 projects, 61 were operationally mature at the end of FY2006, of which 16 had been evaluated under the regular XPSR system. The other 45 operationally mature projects without XPSR evaluations were evaluated directly by IEG for this review using the XPSR system evaluation framework.[6] IEG also evaluated, just for IFC appraisal quality and for project risk intensity at approval, the remaining eight projects approved in FY2004–05 that were not yet operationally mature. The latter evaluations were used to see the trends in the project portfolio appraisal quality and risk intensity between the pre-crisis and the post crisis period. These 69 evaluated investment projects involved a total of US$1,204 million of IFC commitments, including US$217 million of equity.

1.4 During the review period, IFC also implemented 80 advisory services projects aggregating to about US$26 million of funding commitments from IFC and various donors, of which US$13 million had been spent through June 30, 2006. Seventy percent (by amount) of the advisory projects have been undertaken since FY2003 as part of the Program for Eastern Indonesia Small and Medium Enterprise Assistance (PENSA)[7] initiative. These advisory services operations were funded through four different instruments as follows: (i) PENSA – 27 operations involving US$6.8 million (53 percent); (ii) Technical Assistance Trust Funds (TATF) – 24 operations involving US$4.3 million (33 percent); (iii) Foreign Investment Advisory Services (FIAS) – 19 operations involving US$1.5 million (11 percent); and (iv) Funding Mechanism for Technical Assistance and Advisory Services (FMTAAS) – two operations involving US$0.4 million (3 percent). IEG reviewed the completed advisory services operations with IFC self-evaluations and validated the performance ratings using its advisory services evaluation framework.

1.5 Based on the findings of the evaluation, the review identifies the challenges for IFC in Indonesia going forward, and makes recommendations on how IFC can meet these challenges to help address the current economic and private sector development needs of the country.

1.6 For this evaluation, an IEG team visited Indonesia in December 2006 and met with IFC clients, government ministries and agencies, and legal and accounting firms to discuss various aspects of IFC's operations, the business climate and trends, and issues constraining private sector investments and growth in general. IEG also held discussions with IFC and World Bank staff in Jakarta.

Report structure

1.7 Chapter 2 of this report briefly describes the Indonesian country context during the review period, particularly those private sector-related aspects that contributed to the severity of conditions in Indonesia and those that will continue to pose challenges to the government and IFC going forward. Chapter 3 describes IFC's strategies and their implementation through investment, advisory, and restructuring operations. Chapter 4 summarizes the main findings and conclusions of the evaluation, and Chapter 5 lists the main recommendations for IFC management.

2. Evaluation Context

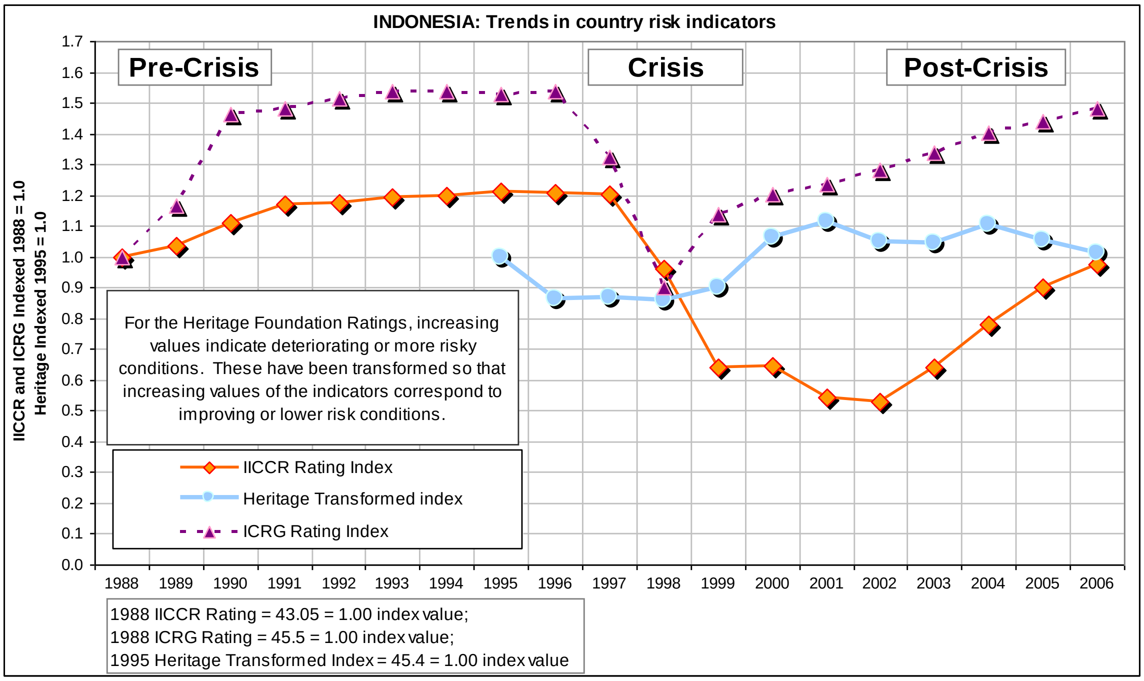
The Asian Crisis of 1997–98 affected Indonesia more severely and for a much longer period of time than any other Asian country. The Indonesian country crisis persisted over the period 1997–99 and helped end the 30-year Suharto Government in 1998, which in turn led to a democratic and decentralized system of government. But the ongoing political and economic transitions have been difficult, thereby constraining the rate of economic recovery up to 2006. Spending for infrastructure has declined as a proportion of GDP since 1998. Emerging capacity constraints in infrastructure services are increasing costs for businesses and also limiting economic growth. While the banking system has been reformed, stabilized, and largely privatized since 2002, the greater proportion of private commercial bank funds are either loaned to consumers or invested in government securities because banks cannot lend to corporations on a long-term basis, given their funding base of mainly short-term savings deposits and short-term time deposits. Non-bank financial institutions (e.g., life insurance, pension and mutual funds) are unable to function as intermediaries between long-term savers and long-term private sector corporate borrowers because a liquid long-term local currency corporate bond market has not yet developed, even though the Government began to issue long-term local currency bonds in 2002.

Indonesia is among the ten largest IFC country investment portfolios

2.1 The Asian Crisis of 1997–98 affected Indonesia more severely and for a much longer period of time than any other Asian country. The Indonesian country crisis persisted over the period 1997–99 and helped end the 30-year Suharto Government in 1998, which in turn led to a democratic and decentralized system of government. The severity of the Indonesian country crisis was largely due to weaknesses in the financial structure and the terms of the liabilities of the private corporate sector and the banking sector. The persistence of the Indonesian country crisis, compared to Korea, Thailand, and the Philippines, for example, was partly the result of the Indonesian political transition after 1998, but mainly due to the weak and corrupt Indonesian judiciary and government agencies involved in the restructuring of the commercial banks and their main private corporate borrowers, who experienced financial distress due to the crisis. It is in this context that IFC adjusted its strategies and operations during the review period.

2.2 The Indonesia country risk indicators showed an improving business climate before the crisis, deterioration during and following the crisis, and improvements only after 2002. Figure 2.1 shows three independent country risk or business climate indicators for Indonesia: the Heritage Foundation/Wall Street Journal Index of Economic Freedom (HF/WSJ); the Institutional Investor Country Credit Rating (IICCR);[1] and the International Country Risk Group (ICRG). These independent indices all showed some improvement during the period 1991–96, with the IICCR showing a medium country-risk level throughout the early 1990s, some deterioration from 1996 until about 1998–99, and improvements during the period 2002–06. All three risk ratings indicated a high-risk country situation in 1998 due to the continuing security and political risks associated with the Asian Crisis. The IICCR rating stayed at high-risk from 1999 to 2003, and improved to the threshold of medium-risk only in 2004.

Figure 2.1: Three independent country risk indicators for Indonesia show deterioration in the late 1990s during the Asian crisis and improvement after 2002



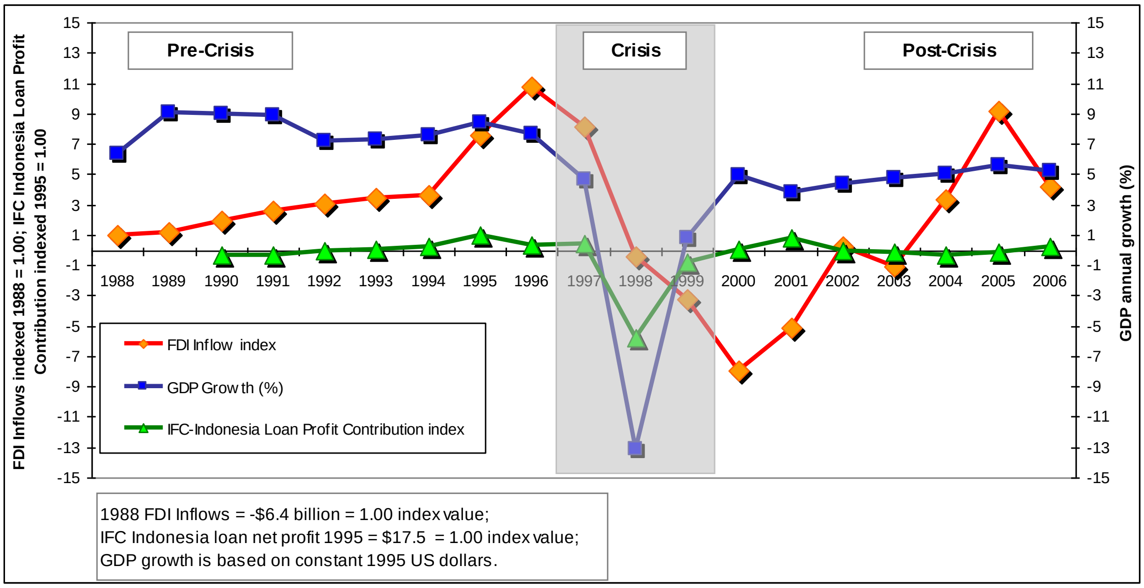
Note: The three indicators (IICCR, HF/WSJ, and ICRG) range from 1 to 100. IFC's corporate strategy and IEG's evaluation practice considers as high-risk an IICCR rating of less than 30, or an HF/WSJ rating lower than 60. The ICRG composite country risk score is not routinely used by IFC, but is used by other international financial institutions, with a score of less than 50 considered very high-risk.
Source: Independent Evaluation Group

The pre-crisis subperiod (1990-96)

2.3 Indonesia's economic performance during 1990–96 was remarkable and mirrored the rise of the Asian "tiger economies". Its GDP grew at a consistently high annual rate that averaged about 8.0 percent (in real terms) within a narrow range of 7.2 percent to 9.0 percent per year. GDP per capita also increased steadily from US$612 in 1990 to US$878 in 1996 in constant 2000 US Dollars. The foreign exchange rate depreciated gradually each year. The economy also underwent a slow but steady change with the share of agriculture in GDP falling from 19.1 percent in 1990 to 16.7 percent in 1999, while the share for industry increased from 39.1 to 43.5 percent. Economic growth was fueled by high investment levels with total gross fixed capital formation at an average of almost 28 percent of GDP. Despite a relatively high gross domestic savings rate, slightly higher than the total gross fixed capital formation rate (as percent of GDP), investments were funded to a significant extent by foreign borrowings because of their availability and comparably lower interest rates. In addition to the good economic performance of Indonesia, the Government also appeared very stable under an authoritarian and centralized political system that provided comfort to foreign private commercial lenders. Both the Indonesian private corporate sector and the Government had accumulated large amounts of mostly short-term foreign debts estimated to have reached 25 percent of GDP and 166 percent of foreign currency reserves by the end of 1996. These short-term foreign debts set the stage for the foreign exchange and financial crises that emerged in Indonesia in the second half of 1997, following the start of the Asian Crisis in Thailand in May 1997.

2.4 Foreign Direct Investment (FDI) flows to Indonesia increased during the pre-crisis period spurred by high levels of domestic investment in the service and agribusiness sectors and by foreign investment in the paper, printing, and textile sectors. FDI inflows declined during the crisis period and resulted in a net outflow during the period 1999–2001. The overall slow economic growth and country risk trends since 1997 were reflected in IFC's Indonesia loan portfolio profitability trend (figure 2.2).

Figure 2.2: FDI flows and IFC's Indonesia loan portfolio profitability mirrored the movement of GDP growth



Source: Global Development Finance database, World Bank

The crisis subperiod (1997-99)

2.5 Indonesia suffered the deepest GDP contraction (negative 13.1 percent GDP growth in 1998, and an average of negative 2.5 percent for 1997–99), and the longest recovery period, among the countries affected by the Asian Crisis (table 2.1). Economic recovery was prolonged because of the political crisis and transition triggered by the financial crisis, starting with the end of the Suharto Government (after 32 years in power) in May 1998. In the following three years, Indonesia had three presidents, one appointed and two democratically elected, and eventually adopted a drastic government decentralization plan in 1999. The plan devolved a substantial amount of governmental authority to the local government units, including fiscal and economic decision making and delivery of government services. However, these local government units had little capacity to address economic development and business issues, as well as civil service management challenges.

2.6 The economic costs of the Indonesian crisis were substantial, with poverty rates increasing from 17.7 percent of the population in 1996 to a peak of 23.4 percent in 1999, before gradually dropping to 16.7 percent in 2004. GDP per capita declined 42 percent (in nominal US dollar terms) between 1996 and 1999, before recovering to the 1996 level in 2004. Bank loan defaults by the corporate sector were very high due to their large debts, which were mainly short-term, both in local and foreign currency. The financial distress in the corporate sector in turn caused the majority of banks to also fail because of the high non-performing local currency loans held by the corporate sector. The rebuilding of the Indonesian banking sector also took longer than in Korea and in Thailand because of alleged corruption and conflicts of interest among key officials in the Indonesian Bank Restructuring Agency (IBRA), the entity charged with the task of restructuring the distressed banks, as well as the high incidence of cross-ownership between banks and corporate borrowers.[2] Investors, including IFC, faced serious challenges enforcing their legal rights in a weak judicial system.

Table 2.1: Indonesia suffered the deepest GDP decline and the slowest recovery among countries affected by the Asian Crisis of 1997–98

	Annual GDP growth rates of countries impacted by the Asian Crisis									
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Indonesia	**7.6%**	**4.7%**	**(13.1%)**	**0.8%**	**4.9%**	**3.8%**	**4.4%**	**4.7%**	**5.1%**	**5.6%**
Thailand	5.9%	(1.4%)	(10.5%)	4.5%	4.8%	2.2%	5.3%	7.0%	6.2%	4.5%
Malaysia	10.0%	7.3%	(7.4%)	6.1%	8.9%	0.3%	4.2%	5.7%	7.2%	5.2%
Korea	7.0%	4.6%	(6.8%)	9.5%	8.5%	3.8%	7.0%	3.1%	4.7%	4.0%
Philippines	5.8%	5.2%	(0.6%)	3.4%	6.0%	1.8%	4.4%	4.9%	6.2%	5.0%
Vietnam	9.3%	8.2%	5.8%	4.8%	6.8%	6.8%	7.1%	7.3%	7.7%	8.4%

Source: Global Development Finance database, World Bank

The post-crisis and political transition subperiod (2000-06)

2.7 Post-crisis economic recovery focused on rebuilding the banking sector, a process that included the privatization and recapitalization of the once dominant government-owned banks, reducing cross-ownership between banks and industrial business groups, and providing a government guarantee of all savings deposits in order to restore confidence in the banks. Smaller banks were merged and several banks attracted foreign private sector investors. The rebuilding of the banking sector was essentially completed by 2004, at which time the IMF-supported crisis program was closed. However, commercial banks have not yet significantly increased their medium- and long-term lending to corporations. Instead, commercial banks have increased primarily their lending to consumers and households, while maintaining their large holdings of government bonds related to the bank recapitalization program. This commercial bank lending pattern is partly due to their short-term funding base in the form of demand or savings deposits, partly due to many bank managers still having pending legal cases related to bad corporate loans made prior to the crisis, and partly due to the slow reduction in non-performing loan rates in their corporate loan portfolios.

2.8 The fiscal deficit that reappeared in 1998 and continued up to 2005 prompted the Government to substantially reduce fuel subsidies in 2005 in an attempt to have a more balanced budget. The sustained difficult fiscal situation and the low levels of local private sector and foreign investment during the period 2000–05 resulted in a declining total gross fixed capital formation from an average of about 28 percent of GDP during 1990–97, to an average of about 20 percent of GDP during 2000–06. In particular, there was a significant lack of infrastructure investment, which contributed to the low GDP growth rates in the post crisis subperiod. Indonesia's post crisis investment in the infrastructure sector as a percentage of GDP is much lower than for other middle-income countries (Appendix C).

2.9 The political transition from an autocratic centralized government to a democratic and decentralized government was to be implemented over two years (2001–02), with a focus on local government unit capacity building. However, the program still has a long way to go with respect to the decentralization of the fiscal and economic functions, particularly in terms of local government capacity and implementing rules and regulations. This has resulted in much uncertainty within the private sector.

2.10 Many non-exporting Indonesian businesses are avoiding foreign currency debts because of the concomitant foreign exchange risks, and foreign banks have not yet resumed significant lending to Indonesian businesses because of the perceived high country risks. At the same time, local businesses have limited access to long-term local currency loans needed to fund investments in long-term assets. Incomplete reforms related to issuance and trading of corporate bonds, investment by pension funds and life insurance companies in corporate bonds, and local commercial banks' reluctance to provide long-term corporate loans contribute to this limited access. In addition, government decentralization had led to uncertainty about government regulatory approvals and oversight of private investments. Finally, substantial underinvestment in infrastructure since the start of the country crisis has led to serious infrastructure constraints, such as electricity shortages, that adversely affect business activities and costs. These factors have contributed to a slow recovery of private sector investments and economic growth, and pose major challenges for the government.

2.11 Recently, many manufacturing companies, including some IFC clients, have installed their own captive electricity generation facilities because of the unreliable electricity supply from the national grid. Furthermore, export-oriented industries with very competitive foreign markets have invested in labor savings technologies to remain internationally competitive, because of the rigidness of the labor regulations. These private sector actions reflect both new or post-crisis and old or pre-crisis issues that are obstacles to higher levels of investment, economic growth, and employment creation during the post-crisis period. Other major concerns of the Indonesian private sector today include the following:

- The rigidness of labor laws that makes it very difficult and expensive for companies to dismiss employees;
- Inadequate infrastructure (electricity, transport, water supply, etc.);
- The lack of long-term local currency financing for those earning only local currency revenues and not in a position to hedge the devaluation risk associated with foreign currency loans;
- Unclear legal and regulatory requirements for private sector investments, particularly foreign investments, in many sectors, including infrastructure, mining, and non-bank financial institutions; and
- Unresolved solvency problems experienced by several non-bank financial institutions (e.g., life insurance and pension institutions). (See Appendix C).

Box 2.1: Underinvestment and low levels of private sector participation in infrastructure are challenges for Indonesia

World Bank Indonesia Public Expenditure Review 2007: Key Findings on Infrastructure:

- Indonesia invests too little in infrastructure and needs to increase infrastructure spending by the equivalent of about 2 percentage points of GDP;
- The water and electricity sectors are in crisis. A decade of low investment has resulted in insufficient capacity and power shortages in the electricity system and deteriorating piped water services; and
- Private investments in infrastructure have declined sharply since 1997, particularly in the water, energy, and transport sectors. Before the crisis, private sector investment commitments were on average equivalent to 30-40 percent of government development spending for infrastructure. During the period 2003–04, it declined to less than one-fourth of government spending, despite the low levels of public investment in infrastructure. Since 2000, about 90 percent of private sector investment in infrastructure was in the telecommunication sector. It has been difficult to attract private investments into sectors traditionally dominated by state-owned enterprises due to uncertainties related to the legal system, the absence of a government strategy for investment guarantees and contingent liabilities, and fundamental issues behind underpricing of infrastructure services for social and political reasons.

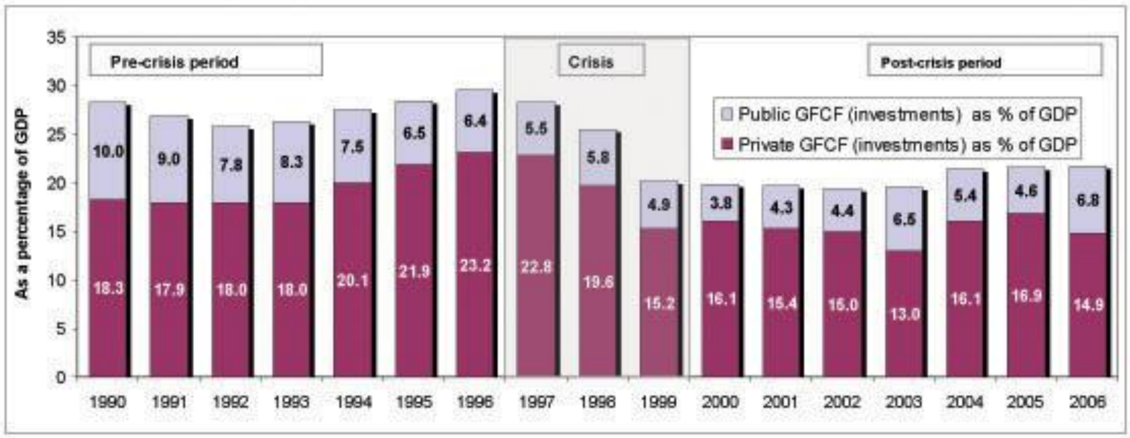
Source: Spending for Development: Making the Most of Indonesia's New Opportunities – Indonesia Public Expenditure Review 2007, World Bank (second edition), June 2007, page 74

Post-crisis investments have remained below the pre-crisis levels

2.12 Indonesia's investment levels during the post-crisis subperiod, as measured by the gross fixed capital formation (GFCF) as a percentage of GDP, have remained below pre-crisis levels as shown in figure 2.3. Public sector investment, or GFCF, during 2000–06 averaged 5.1 percent of GDP, which is about 2.5 percentage points lower than the pre-crisis average of 7.6 percent of GDP. Likewise, private sector investment during 2000–06 averaged 15.3 percent of GDP, which is about 4.7 percentage points lower than the pre-crisis average of 20.0 percent of GDP during 1990–2007. The step-increase of about 2.0 percentage points in total GFCF from 2003 to 2004 is encouraging, but even the total GFCF in 2006, equivalent to 21.7 percent of GDP, is still about 5.9 percentage points below the average for 1990–97 of 27.6 percent of GDP. The inability of the Indonesian economy (i.e., GDP) to grow much faster than the 4 to 6 percent annual rate during 2003–2005 (table 2.1), despite buoyant international economic conditions, is largely explained by continuing low levels of total investment in the country.

2.13 Low post-crisis investment in Indonesia, particularly by the private sector, has serious implications for IFC's ability to pursue and implement its strategic priorities and objectives in the country. As explained further in the next chapter, the level of IFC's investment operations, and to varying degrees its advisory services operations, are driven by demand from the private sector. If the level of private sector investment in a country is low (relative to GDP), then the opportunities for IFC to undertake investment and advisory services operations will also be limited. This is because IFC will find it more difficult to find suitable private sector investments that meet IFC's investment criteria for financing, strategic priorities, and the requirement of an IFC value-added role (or "additionality"). Furthermore, adequate public sector (or private–public partnership) investment in infrastructure services, such as electricity supply and transport services, is also needed to encourage broader private sector investments. Thus, the low levels of both public sector and private sector investment in Indonesia during the post-crisis subperiod are major impediments to IFC's implementation of its country assistance strategies and priorities.

Figure 2.3: Indonesia's post-crisis investments are still below pre-crisis levels



Note: GFCF is Gross Fixed Capital Formation. During 1990–97, the average private sector GFCF was 20.0 percent of GDP and the average public sector GFCF was 7.6 percent of GDP, for an average total GFCF of 27.6 percent of GDP. During 2000–06, the average private sector GFCF was 15.3 percent of GDP and the average public sector GFCF was 5.1 percent of GDP, for an average total GFCF of 20.4 percent of GDP.
Source: Central Bank of Indonesia, Ministry of Finance, Global Development Finance database, World Bank; Indonesia Public Expenditure Review 2007.

Conclusion

2.14 In summary, the Asian Crisis of 1997–98 precipitated an Indonesia country economic crisis that was deeper and lasted longer than in any other Asian country. The Indonesian country crisis also led to the end of the 30-year autocratic Suharto Government and ushered a transition to a democratic and decentralized government system. Since the crisis started, investment levels in the country have fallen significantly below pre-crisis levels and have not fully recovered, even up to 2006. In particular, Indonesia has underspent on infrastructure, and capacity constraints in infrastructure services have emerged. Non-exporting businesses are avoiding foreign currency loans because of devaluation risks, but there is no long-term local currency corporate bond market, and commercial banks have limited capacity for providing long-term loans because their funding base comes mostly from short-term deposits. They are also still cautious about corporate lending because of the legacy of the crisis, and instead, favor consumer loans. This is the context in which the relevance, implementation, and performance of IFC's strategies and operations during the review period, as well as challenges and opportunities going forward, are evaluated.

3. IFC's Strategies and Operations in Indonesia

Before FY1997, IFC's strategic priorities in Indonesia were: support export-oriented and import-substituting projects; increase and diversify IFC's client base; support privatization, particularly in infrastructure; and deepen the financial markets. IFC had very limited investments in infrastructure, and its financial markets operations were limited to supporting the small and medium enterprises (SMEs), without any initiatives geared toward deepening the financial markets. However, IFC had succeeded in supporting the agribusiness and SME sectors.

IFC's investment commitments averaged about US$109 million per year before the crisis, dropped to about US$17 million per year during the crisis, and increased to about US$103 million per year after the crisis. Before the crisis, IFC mobilized about US$1.42 of B-loans (i.e., financing by third parties through IFC intermediation) for every US$1.00 it committed on its own. Since the crisis, IFC mobilized only US$0.05 of B-loans per US$1.00 of IFC commitment.

The development outcome success rate of 46 percent (by number of projects) of IFC's mature Indonesian investment projects is comparable to the East Asia average success rate (45 percent excluding China and Indonesia), but below IFC-wide average (60 percent), because of the crisis. The Indonesian portfolio development outcome success rate could have been worse, had IFC not successfully rescheduled or restructured 11 out of 16 projects that were in financial distress because of the country crisis. IFC's equity portfolio in Indonesia, however, has a comparable investment success rate (33 percent) to IFC-wide average equity success rate (31 percent), despite the country crisis. The equity portfolio performed worse than the East Asia equity success rate (43 percent excluding China and Indonesia) because of the relatively slower post-crisis economic and stock market recovery in Indonesia. As a result, IFC's Indonesian combined loan and equity investment project portfolio was marginally profitable during the review period. However, Indonesian projects success rate for environmental, and social (EHS) effects was lower than IFC average.

IFC Advisory Services in Indonesia increased substantially starting in FY2000 with a significant increase in donor trust funds, followed in FY2002 with the start-up of the multi-donor-funded Program for Eastern Indonesia Small and Medium Enterprise Assistance (PENSA) facility to assist SMEs. During the review period, IFC implemented 80 advisory services projects aggregating to about US$26 million of funding commitments. Most advisory services operations were implemented too recently to be evaluated.

Private sector demand and IFC corporate strategic priorities drive IFC country operations

3.1 IFC's investments in a country, and in varying degrees its advisory services, are driven by private sector demand as well as IFC's corporate strategic priorities and investment guidelines, which among others, require a value-added role and contribution by IFC in a project. Thus, IFC's country assistance is not defined by any predetermined investment or advisory services program for a specified future time period (e.g., the next three fiscal years), because IFC cannot tell in advance which private sector entities will seek its support and among these, which investments (or advisory services operations) will meet IFC's operational guidelines. Rather, IFC establishes corporate strategic priorities by sector and theme, based on their potential for high development impacts and consistency with IFC's overarching mission to facilitate private sector development, improve people's lives, and reduce poverty. IFC also establishes guidelines for investment projects (or advisory services operations) to ensure that they meet minimum country development and investment outcome expectations, and that IFC has some value-added role and contribution that a commercial lender or private sector investor cannot provide. IFC's annual and two-year indicative corporate strategies, work program, and budget, approved annually by IFC's Board of Directors, are implemented in a decentralized manner through IFC's regional and sector departments, that have their own strategies, work programs, and budgets. Based on these regional and sector strategies, work programs, and budgets, IFC establishes country-level strategic priorities and an indicative range of investment levels it hopes to achieve in a country, as well as the intended sector distribution of these investments during the next three fiscal years. However, the investments and advisory services operations that materialize depend on demand from the private sector for IFC support.

IFC's Strategies

IFC's pre-crisis strategies were not articulated in a strategy document; joint Country Assistance Strategy (CAS) papers started only in FY2007

3.2 Before FY1996, IFC did not articulate its country strategies in a single document, and they must be inferred from: (a) IFC's overall corporate strategies approved by the Board; (b) the sector strategies and the regional strategies of the various IFC sector departments and regional departments; and (c) the various project appraisal documents submitted to the Board. To illustrate, the following strategic factors or guiding principles for IFC's operations in Indonesia can de deduced from IFC project documents sent to the Board during FY1990–96, and from discussions with IFC operations staff:

- Supporting export-oriented projects in agribusiness, and textiles where Indonesia has a comparative advantage, and import-substituting projects in chemicals and general manufacturing to help diversify the economy;
- Expanding IFC's client base with new, and particularly second-tier, companies;
- Supporting privatization, particularly in infrastructure;
- Supporting financial markets development; and
- Avoiding business with groups or sponsors closely associated with politically affiliated parties.

3.3 Starting in FY1996, the World Bank Group (WBG) introduced joint Country Assistance Strategies (CASs) on a pilot basis. The first WBG joint CAS for Indonesia was prepared in FY1997, and issued just as the Asian Crisis began in Thailand in May 1997. This joint CAS articulated the following strategic focus for IFC's operations in Indonesia for the FY1998–2000 period:

- Supporting a larger private sector role in infrastructure;
- Supporting the deepening of financial markets by further development of the equity and long-term corporate bond markets, and by strengthening housing finance companies and second-tier banks that lend to micro, small, and medium industries;
- Supporting agribusiness development;
- Supporting human capital development, particularly management training, private provision of higher education, and development of the health services infrastructure; and
- Supporting institutional capacity building of SMEs, particularly outside the main island of Java.

3.4 The emergence of the Indonesia country crisis later in 1997 made the June 1997 CAS obsolete. During the crisis subperiod (1997–99), IFC shifted its focus to restructuring its projects facing financial distress, protecting its investments, and supporting its viable existing clients with working capital loans or term loans to complete ongoing projects.

3.5 The two subsequent CASs of January 2001 and October 2003 during the post-crisis and political transition subperiod defined IFC's roles and priorities as discussed below. However, these only partially materialized.

3.6 The 2001 joint CAS summarized the WBG private sector development strategy, that was presented in a parallel report—Indonesia: World Bank Group Private Sector Development Strategy. The strategy was as follows:

- Helping Indonesia accelerate and complete the recovery from the crisis through banking and corporate restructuring;
- Addressing structural weaknesses in the economy through advisory services, policy advice, and partnerships, as well as ongoing WBG projects to: (a) improve public governance and reduce corruption, (b) improve corporate governance, (c) reform legal and judicial systems, (d) develop a modern competition policy framework, (e) promote foreign direct investment, and (f) reduce the role of the state through privatization of state-owned enterprises;
- Promoting long-term sustainable growth through: (a) development of the SME sector, including provision of policy advice on the business environment, piloting innovative programs, helping establish SME support services, and building financial intermediaries, through IFC investment and capacity building initiatives, (b) promoting the role of the private sector in rural and urban development, through ongoing investment projects and planned adaptable program loans in water and urban sectors, (c) promoting private delivery of infrastructure and services in health and education, initially through analytical work on the potential for private provision of health services, (d) promoting sustainable private development of Indonesia's forest and mineral resources, and (e) preparing Indonesia for the knowledge economy by helping create the legal, institutional, and regulatory framework for the new information and communications technologies, in part through assistance from an ongoing World Bank information technology project.

3.7 Within the 2001 CAS private sector development strategy, IFC's role was to: (a) restructure its client companies in distress; (b) invest to recapitalize selected banks; (c) invest in restructuring funds or similar specialized entities that are developing a market for distressed debt; (d) help deepen and diversify the financial markets (encompassing microfinance, non-bank financial intermediaries, life insurance, e-banking, brokerages, pension fund management entities, housing finance (by facilitating long-term local-currency funding)), support the creation of credit bureaus, and provide liquidity support to the bond and swap markets; (e) pilot innovative support programs for SMEs through decentralized facilities; (f) invest in private education and health projects; and (g) invest in internet-related and e-commerce projects.

3.8 The 2003 joint CAS continued the basic framework of the 2001 private sector development strategy, with IFC's activities focusing on: (a) strengthening of banks, (b) deepening the financial sector, (c) supporting export-oriented companies, mainly in the agribusiness sector (d) supporting infrastructure investments in power and telecommunications, and (e) supporting SMEs, particularly through the new SME development facility PENSA (see paragraph 1.4).

IFC's investment operations

IFC's investments in Indonesia, which were among the ten largest country portfolios were concentrated in a few sectors

3.9 During the review period, IFC had 79 approved and committed investment projects, which involved 103 transactions and US$1,436 million of commitments, including US$217 million of equity. These commitments raised Indonesia's rank from the 18th largest IFC country portfolio at the end of FY1990, to among the 10 largest country portfolios by the end of FY1995 and through the end of FY2005 (table 3.1). As can be seen in table 3.2, IFC was largely successful in supporting export-oriented projects in the agribusiness and textiles sectors and was moderately successful during the post-crisis subperiod in finding SME-oriented financial intermediaries, but was not successful in supporting commercial bank restructurings. In particular, IFC was not successful in finding infrastructure and extractive industry projects to support.

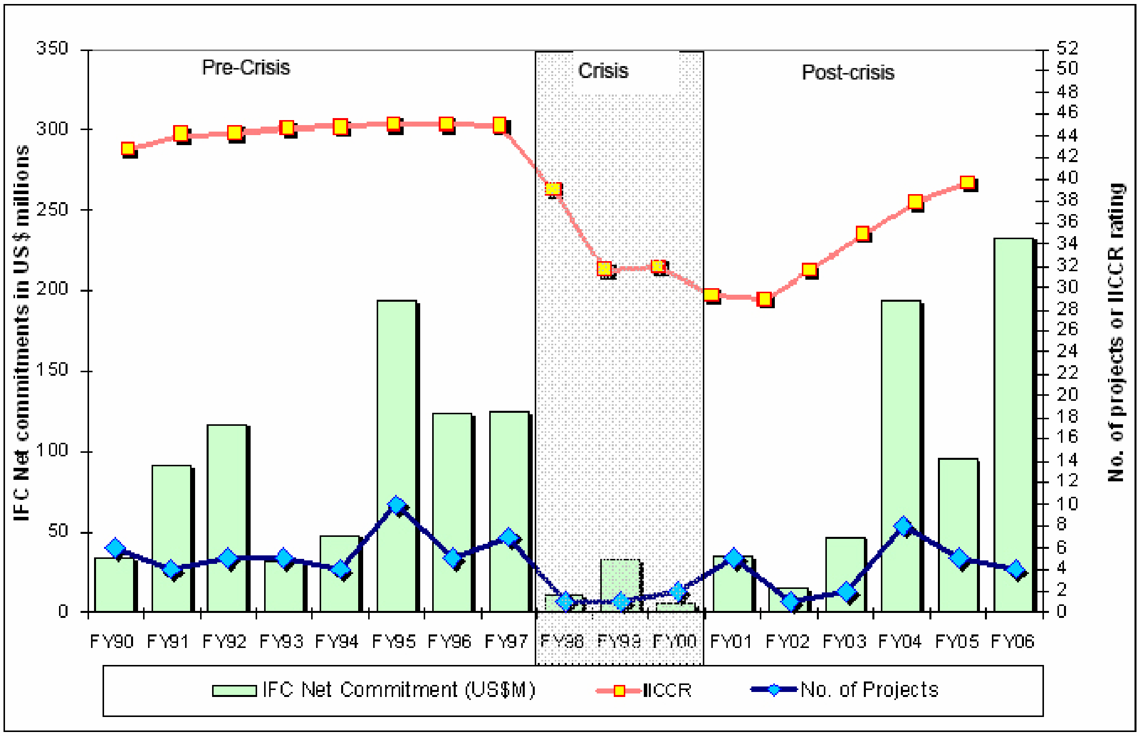
Table 3.1: Indonesia has been among the 10 largest IFC country portfolios during the review period

	Indonesia committed outstanding relative to IFC total			
	End FY1990	End FY1995	End FY2000	End FY2005
Indonesia loan and equity portfolio rank among IFC client countries	18th largest	7th largest	6th largest	8th largest
Indonesia loan and equity portfolio as % of total IFC loan and equity outstanding	1.4%	5.0%	3.6%	2.6%
Indonesia equity portfolio rank among IFC client countries	11th largest	4th largest	6th largest	12th largest
Indonesia equity portfolio as % of total IFC equity portfolio outstanding	3.1%	6.3%	4.1%	2.0%

Source: International Finance Corporation

3.10 Figure 3.1 illustrates the slow recovery, taking about four years after the crisis subperiod, for IFC's investment operations (in terms of both commitments and number of projects per year) to reach and exceed the pre-crisis levels.

Figure 3.1: IFC's post-crisis investment commitments in Indonesia took several years to recover to their pre-crisis level



Note: IFC net commitments (original commitments less cancellations) are shown in approval fiscal year. Institutional Investor Country Credit Rating (IICCR) scores are in calendar year.
Source: International Finance Corporation

3.11 IFC also provided a total of US$13 million for advisory services during the review period, which is discussed in more detail in paragraphs 3.54 through 3.57. The pattern of investments and advisory services operations in Indonesia adjusted to unexpected changes in the economic, business, and political environments brought about by the crisis and subsequent political transition, as discussed below.

3.12 Under the stable political conditions and trend of high GDP growth rates during the pre-crisis subperiod (averaging 8 percent per year), IFC's investment operations increased and focused mainly on the import-substituting general manufacturing industries, the chemicals industry, and the export-oriented textiles industry, with only modest investments in the financial and the agribusiness sectors. Within these sectors, IFC's financing went mainly to new clients. IFC's average annual investment commitment in Indonesia during the FY1990–2006 period of about US$85 million, included an average of US$13 million of equity, through some five projects per year.

3.13 IFC's pre-crisis portfolio in Indonesia had a smaller proportion (48 percent) of projects with high risk intensity at approval,[1] compared to IFC-wide sample evaluated by IEG, with 58 percent rated as having high risk intensity at approval (table 3.6). In general, compared to IFC-wide evaluated XPSR sample, Indonesian pre-crisis projects had a lower proportion of high-risk (i.e., low-quality) sponsors, a lower proportion of high-risk debt service burden or financial structures, a lower proportion of projects in high-risk sectors, and a lower proportion of projects with distorted or high-risk markets. The lower risk intensity at approval of the pre-crisis Indonesian projects compared to IFC-wide evaluated sample would be a key factor in the performance of IFC's Indonesian portfolio during and after the crisis, as discussed briefly in paragraph 3.30 and more fully in.

3.14 Throughout the review period, there was a notable lack of IFC investment operations in the infrastructure[2] and extractive industry sectors, and to a lesser extent, the financial market sector, despite serious efforts by IFC to find projects in these sectors. During the pre-crisis subperiod, IFC made an investment in a cellular telephone project, but this was subsequently nationalized. IFC also made an investment in an SME-oriented second-tier commercial bank. The reasons for the absence or low level of IFC investments in these sectors during the pre-crisis subperiod were mainly: (a) the lack of transparency in the government's licensing and franchising of infrastructure projects and awards of mining concessions; (b) the large role of public sector enterprises in both the financial sector and the infrastructure sector; (c) the lack of clarity on the regulations and regulatory oversight practices in the financial sector; and (d) IFC's decision to avoid doing business with groups closely associated with the president of the country because of governance, transparency, anti-competition, and corruption concerns.

3.15 During the crisis years (FY1998–2000), IFC focused on restructuring its problem investments and/or protecting its investments from contentious sponsors or uncooperative creditors to its client companies who were not interested in following the principle of fair burden sharing among financiers of companies in financial distress. While the contentious relationships were few, in some of the cases IFC faced serious challenges to enforce its legal rights in a weak judicial system. IFC's new investment operations during the crisis years were limited to supporting existing client companies with either working capital or with term financing to complete ongoing projects whose original financing plan could not be followed because the banking system had collapsed during this period. During the crisis years, IFC's investment operations averaged only one project per year and an average financing commitment of US$16.9 million, including US$4 million of equity, per year. These investments were mainly in the export-oriented agribusiness and textiles sectors. No B-loans were mobilized during the crisis years. Finally, IFC actively supported the IMF and the World Bank in their efforts to help Indonesia formulate and adopt a more effective bankruptcy regime.

3.16 During the post-crisis and political transition years (FY2001–06), IFC continued to focus on supporting existing clients still in the recovery or initial expansion stage, but also began to develop new clients, particularly in recent years. IFC also began to increase its financing of financial sector projects, particularly financial intermediaries focused on SMEs and the privatized banks. IFC also continued to support export-oriented agribusiness and textile industry clients. However, IFC still had no investment operations in the infrastructure and an extractive industry sector because the government has not yet issued new and clearer regulations and transparent guidelines for awarding infrastructure and mining projects to private sector companies and has not bid out many such contracts to date. During the post-crisis years, IFC's investment operations averaged four projects and US$103.3 million of commitments per year, including US$7.7 million of equity. An average of $4.7 million B-loans was mobilized, but the mobilization ratio was still low. The post-crisis IFC projects as a group have on average fewer high-risk factors compared to the pre-crisis projects, reflecting a similar trend IFC-wide, but in a more pronounced way.

Resource mobilization for investment projects

3.17 Over the period of FY1990–97, IFC had mobilized an average of US$136 million of B-loans per year (i.e., financing by third parties through IFC) for the Indonesia portfolio, representing a mobilization ratio of US$1.42 of B-loans per US$1.00 dollar of IFC commitment. During FY1998–2000, IFC was unable to mobilize any B-loan funds and mobilized only small amounts during FY2001–06, with a ratio of US$0.05 of B-loans per US$1.00 of IFC commitment. IFC was still unable to mobilize significant B-loan funds in the most recent six years (FY2001–06) of the review period. Nonetheless, for the overall review period (FY1990–2006), IFC's Indonesia portfolio B-loan mobilization ratio was US$0.78 of B-loans per US$1.00 of IFC commitment, higher than IFC-wide average of US$0.53 over the same period.

The sector distribution of IFC's investment commitments reflected the limited business opportunities in the infrastructure and extractive sectors

3.18 The sector composition of IFC's Indonesia portfolio is compared with IFC-wide and the East Asia region portfolio composition in table 3.2. IFC has no infrastructure or forest industry investments and only one small extractive industry investment. In Indonesia, most projects are in general manufacturing and agribusiness, with only a few in the financial markets sectors. IFC's cumulative net commitments in Indonesia (FY1990–2006) for real sector projects were concentrated in the agribusiness, textiles, and chemicals sectors, with very little invested in infrastructure and extractive industries sectors, compared to IFC's portfolios in the East Asian region and worldwide.

Table 3.2: Sector composition of IFC's investments (in percent) in Indonesia versus the East Asia Region and IFC-wide

	Food & Agribusiness	Textiles & Leather	Chemicals	Infra-structure	Extractive Industries	Other Manufacturing & Services	Health & Education	Total Real Sector	Total Financial Sector	**GRAND TOTAL (US$M)**
Cumulative Net Commitments (Loan and Equity) FY1990–2006										
1.Indonesia	**18%**	**17%**	**14%**	**7%**	**0.1%**	19%	1.0%	76%	**24%**	1,436
FY1990–97	10%	15%	20%	13%	0.2%	30%	1.6%	89%	11%	766
FY1998–2000	**0%**	65%	**0%**	**0%**	**0%**	25%	**0%**	90%	10%	51
FY2001–06	28%	15%	9%	**0%**	**0%**	5%	0.4%	58%	42%	620
2. East Asia	8%	5%	10%	15%	1%	25%	1%	66%	34%	7405
3. All IFC	8%	3%	6%	17%	9%	24%	1.0%	68%	32%	49,092
Total Outstanding Balance (Loan and Equity) End-FY06										
1. Indonesia	29%	20%	18%	**0%**	**0%**	14%	0.3%	81%	19%	325
2. East Asia	9%	4%	8%	21%	0.2%	25%	2%	69%	31%	1933
3. All IFC	8%	1%	4%	20%	7%	21%	1%	63%	37%	13,841

Source: International Finance Corporation

Some sectors and/or subsectors are under-represented in IFC's Indonesia portfolio

3.19 There is a high concentration of investments in a few sectors of IFC's Indonesia portfolio, such as food and agribusiness, textiles, and chemicals. The pre-crisis financial sector commitments were also concentrated mainly in equity funds, investment banking, and leasing, and only the post-crisis financial sector projects included SME-oriented commercial banks. On the other hand, several sectors and subsectors are under-represented in IFC's Indonesia portfolio. These include infrastructure, extractive industries, non-metals, primary metals, and health, with no projects approved during FY1998–2006; and other sectors such as education, information technology, plastics, and rubber, with only one project approved in each sector or subsector during FY1990–2006. Moreover, there were no projects approved in the utilities, construction, pulp and paper sectors, or in the mining, ports and highways, housing finance, microfinance, and insurance subsectors.

3.20 The overall IFC portfolio in Indonesia during the review period (FY1990–2006) can be broadly characterized by the following features: (a) a similar proportion of equity commitments (53 percent based on number of projects, 15 percent based on amount committed) as the IFC-wide portfolio (52 percent with equity based on number of projects, 17 percent based on committed amount); (b) a balanced mix of new and repeat clients as well as of second-tier and first-tier sponsors; (c) substantially more concentrated investments in the agribusiness, general manufacturing, and textiles sectors, and very little in the infrastructure and extractive industry sectors compared to IFC-wide portfolio; and (d) slightly less concentration in financial markets compared to IFC-wide portfolio.

The proportion of equity in IFC's Indonesia commitments was comparable to IFC-wide average

3.21 Equity investments worldwide have been the major source of IFC's net income during the review period, particularly during the last several years. Thus, the proportion of equity commitments in the Indonesia country portfolio and the performance of these equity investments could be expected to largely determine whether or not the Indonesia country portfolio had a positive contribution to IFC's net income during the review period (see paragraph 3.35). The performance of the Indonesia equity portfolio in turn depends on its sector composition because some sectors, such as the financial sectors and the infrastructure sectors, tend to have better equity investment performance compared to other sectors. As noted earlier, IFC's Indonesian portfolio has few infrastructure projects, so the portfolio's contribution to IFC's net income will depend on the proportion of equity commitments in the financial sectors and how these investments performed. Table 3.3 shows that over the review period, the proportion of equity commitments in the Indonesia portfolio (15 percent) is comparable to IFC average (17 percent), but is substantially less than the East Asia Region proportion of 26 percent (excluding China and Indonesia). As shown in table 3.4, the East Asia Region (excluding China and Indonesia) has substantially more equity investments in collective investment vehicles (CIVs) such as private equity funds, mutual funds, investment funds, restructuring funds, etc. compared to the Indonesia portfolio, which accounts for the substantial difference in portfolio composition. Finally, during the crisis and post-crisis subperiods, the proportion of equity in IFC's investment commitments in Indonesia declined to just 9 percent, compared to 21 percent during the pre-crisis period, reflecting the cautious private sector attitude towards investments in the country.

Table 3.3: Comparative loan and equity commitments: 1990–2006 (amounts in US$ million)

	Loans & Guarantees		Equity		Total Commitments	
	Amount	Percent	Amount	Percent	Amount	Percent
Indonesia FY1990–2006	1,219	85%	217	15%	1,436	100%
(a) Pre-crisis (FY1990–97)	607	79%	159	21%	766	100%
(b) During and after crisis (FY1998–2006)	612	91%	58	9%	670	100%
East Asia without China & Indonesia	2,318	74%	806.0	26%	3,124	100%
All IFC (FY1990–2006)	35,512	83%	7,126	17%	42,638	100%

Source: International Finance Corporation

Equity commitments initially were concentrated in the real sectors, shifted mostly to financial sectors

3.22 IFC's equity investments in Indonesia during the review period were predominantly in the real sectors (73 percent), with about 22 percent in financial sectors and 4 percent in CIVs (table 3.4). On the other hand, a substantial portion of IFC's equity investments in the East Asia Region (excluding China and Indonesia) were in CIVs (49 percent), with about 26 percent in real sectors and about 25 percent in financial sectors. IFC-wide equity commitments had 44 percent in real sectors, and 28 percent each in financial sectors and CIVs. Within the Indonesia equity commitments, there was a significant shift in the proportion of equity commitments in real sectors from 91 percent during the pre-crisis subperiod, down to 24 percent during the subsequent two subperiods (i.e., during and after the crisis).

Table 3.4: Comparative IFC equity investments in real and financial sectors: 1990–2006

	Real Sectors		**Financial Sectors**		**Collective Investment Vehicles (CIVs) a/**		**All Sectors**	
Net Commitments in US$ millions and (%)	**No.**	**Commitment**	**No.**	**Commitment**	**No.**	**Commitment**	**No.**	**Commitment**
Indonesia FY1990–2006	30	159 (73%)	7	48 (22%)	5	9 (4%)	42	217 (100%)
(a) Pre-crisis (FY1990–97)	24	145 (91%)	3	4 (3%)	5	9 (7%)	32	159 (100%)
(b) During and after crisis (FY1998–2006)	6	14 (24%)	4	44 (76%)	0	0 (0%)	10	58 (100%)
East Asia without China & Indonesia		211 (26%)		204 (25%)		391 (49%)		3,124 (100%)
All IFC		3,156 (44%)		2,003 (28%)		1,968 (28%)		7,126 (100%)

Note: a/ Collective Investment Vehicles (CIVs) are funds pooled from different investors and invested/managed by a manager, such as private equity funds, mutual funds, investment funds, and restructuring funds.

Source: International Finance Corporation

Implementation of strategic objectives allowed for multiple value-added roles with varying success

3.23 IFC's investment projects in Indonesia sought to support one or more IFC corporate strategic objectives and priorities but with varying degrees of success (figure 3.2). The six most common strategic objectives and priorities, most of which also translate into IFC's main value-added contributions, were as follows:

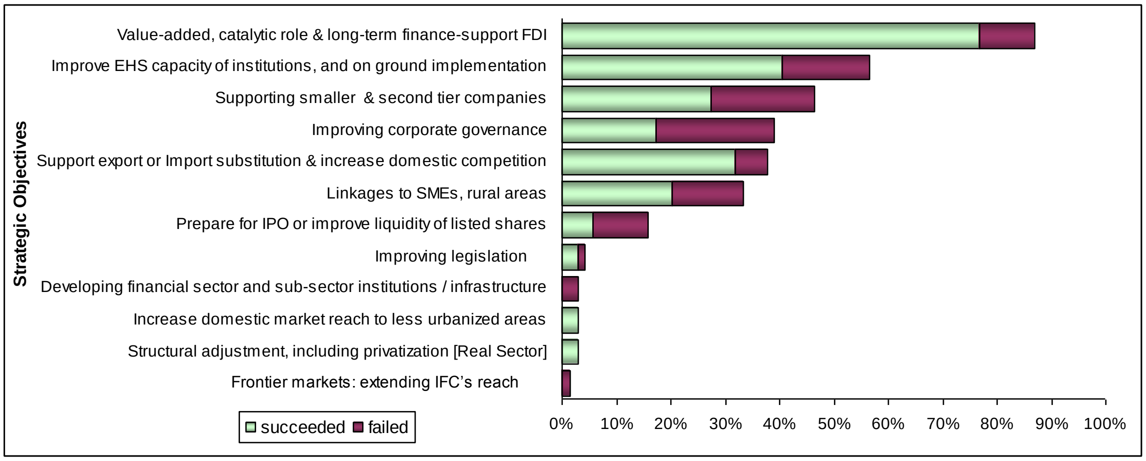
- **Mobilize long-term finance:** About 85 percent of investment projects had this objective, with a 70 percent success rate. As mentioned earlier, most of the B-loans were mobilized during the pre-crisis period, with a very low mobilization rate during and after the crisis;
- **Improve EHS compliance capacity and performance:** About 55 percent of investment projects had this objective, with a 70 percent success rate;
- **Support second-tier companies in the industry:** About 45 percent of investment projects had this objective, with about a 55 percent success rate;
- **Improve corporate governance:** Almost 38 percent of investment projects had this objective, with a 45 percent success rate;
- **Support export- or import-substituting projects and increase domestic competition:** About 37 percent of projects had this objective, with an 86 percent success rate; and
- **Support linkages to SMEs and rural areas:** About 32 percent of investment projects had this objective, with a 65 percent success rate.

3.24 The three most notable differences in investment project objectives between the projects approved during the pre-crisis period and those approved during as well as after the crisis were the following: (a) a significant decrease, from about 67 percent (pre-crisis) to about 43 percent (post-crisis), in the projects pursuing the EHS capacity building and compliance objective, brought about by the focus on restructuring during the crisis and the post-crisis period, as well as a focus on supporting existing clients through repeat operations; (b) a marked increase, from about 42 percent (pre-crisis) to about 63 percent (post-crisis), in the projects pursuing support for second-tier companies; and (c) an increase from about 31 percent (pre-crisis) to about 38 percent (post-crisis) in the number of projects pursuing linkages to SMEs and rural areas. This change was brought about by IFC's increasing focus on SME development in the late 1990s and early 2000s, and to create synergies with IFC's major advisory services project development facility, which was established in 2003 (PENSA).

About two-thirds of the sponsors of investment projects in Indonesia supported by IFC were local entrepreneurs

3.25 Local entrepreneurs comprise about 66 percent of the main project sponsors in IFC's investment projects in Indonesia during the review period. A comparable proportion held during both the pre-crisis subperiod and the subsequent crisis and post-crisis subperiods, as well as between real sector projects and financial sector projects, as indicated in table 3.5. Finally, about two-thirds of IFC equity investments were also in projects sponsored by local entrepreneurs (see table 3.5).

Figure 3.2: IFC's Indonesian investment projects supported one or more IFC strategic objectives or priorities with varying degrees of success



Source: Independent Evaluation Group analysis

IFC's projects in Indonesia had a lower risk profile at project approval compared to two IFC samples

3.26 IEG has developed a methodology that defines a project's risk profile or intensity at the time of project approval, based on eight risk factors that have been identified through the XPSRs and other IEG studies as contributing to the outcomes of projects (see endnote 1, chapter 2). Overall, IFC's projects in Indonesia have a lower risk profile compared to two IFC samples assessed for risk intensity by IEG, as shown in table 3.6. About 41 percent of the projects in Indonesia approved during FY1990–2005 are considered to have been high-risk at the time of approval, that is, they had four or more (out of eight) risk factors rated as high-risk. In comparison, an IFC-wide sample of projects approved during FY1995–98 and evaluated with XPSRs, had 59 percent of projects rated as high risk at approval. A second sample of IFC-wide projects approved during FY2002–04 had 47 percent of projects rated as high-risk at approval. Compared to the two IFC-wide samples, the Indonesian projects in general had a lower proportion of high-risk sponsors, a lower proportion of high-risk debt service burden (debt leverage), a lower proportion of high-risk or distorted markets, and a lower proportion of projects approved at the time when the country risk was considered high. They also had a lower proportion of high-risk non-repeat projects (i.e., new sponsors), and a slightly lower proportion of high-risk greenfield projects, which more than offset the slightly higher proportion of high-risk sectors, as well as a higher proportion of projects with low IFC review intensity, which is high-risk. The high proportion of high-quality sponsors among the Indonesian projects (about 85 percent), and the high proportion of low-risk debt service burden or debt leverage (slightly above 80 percent), were the two most important factors that helped IFC successfully restructure most of its Indonesian projects that were significantly adversely affected by the country crisis (see paragraph 3.35).

Table 3.5: About two-thirds of project sponsors in Indonesia were local entrepreneurs

Subperiod & Sectors	Local Sponsors		Foreign Sponsors a/		All
Pre-crisis subperiod (FY1990–97)	Number	Percent	Number	Percent	Number
Real sector projects	23	68%	11	32%	34
Financial sector projects	8	67%	4	33%	12
All projects	**31**	**67%**	**15**	**33%**	**46**
Projects with IFC equity	17	65%	9	35%	26
During and after crisis (FY1998–2006)					
Real sector projects	9	60%	46	40%	15
Financial sector projects	5	71%	2	29%	7
All projects	**14**	**64%**	**8**	**36%**	**22**
Projects with IFC equity	4	57%	3	43%	7
Entire review period (FY1990–2006)					
Real sector projects	32	65%	17	35%	49
Financial sector projects	13	68%	6	32%	19
All sector projects	45	66%	23	34%	68
Projects with IFC equity	21	64%	12	36%	33

Note: a/ Foreign sponsors will often partner with a local sponsor as a junior partner.

Source: International Finance Corporation

Indonesia project portfolio development and IFC investment outcomes were comparable to the rest of East Asia (excluding China), but below IFC average

3.27 The Indonesian project portfolio evaluated achieved only a 46 percent success rate for development outcomes based on the number of projects, but achieved a 63 percent success rate based on the amount committed. In comparison, IFC-wide development outcome success rate is 60 percent based on the number of projects and 68 percent in terms of amount committed for projects evaluated with XPSRs and approved during the same period. This indicates that larger projects in Indonesia and IFC-wide were more successful compared to smaller projects (table 3.7). While the Indonesian crisis of 1997–99 largely explains the below-average development outcome success rate of the Indonesia portfolio, the sector composition of the Indonesia portfolio also influenced the portfolio development results. The below-average proportion of IFC projects in the infrastructure sector and the financial sector in Indonesia partly explain the comparatively lower development and investment outcome success rate of the Indonesia project portfolio. Globally, the development outcomes and investment outcomes of infrastructure projects and financial sector projects tend to be above average for all IFC sectors. Furthermore, the development outcomes of the Indonesia portfolio were adversely affected by the prolonged recovery of the country from the crisis of 1997–99. In particular, projects with weak sponsors (generally the smaller projects), and those that had very little or no export revenues, suffered most among IFC projects. Projects in financial distress that took a long time to restructure (i.e., more than two years) also had low development outcomes. Many non-exporting IFC projects with foreign currency loans were nonetheless successfully restructured and achieved satisfactory development outcomes, despite the country crisis, because of low debt leverage at the onset of the crisis.

Table 3.6: The Indonesian project portfolio has a lower proportion of high risk projects compared to two IFC-wide samples

	Indonesia project portfolio			IFC-wide samples	
	46 projects pre-crisis (FY1990–97) a/	15 projects during and post-crisis (FY1998–2005)	All 61 projects (FY1990–2005)	Sample 1 329 projects with XPSRs (FY1995–99)	Sample 2 210 projects (FY2002–04)
High-risk projects (four to eight high-risk factors)	48%	20%	41%	59%	47%

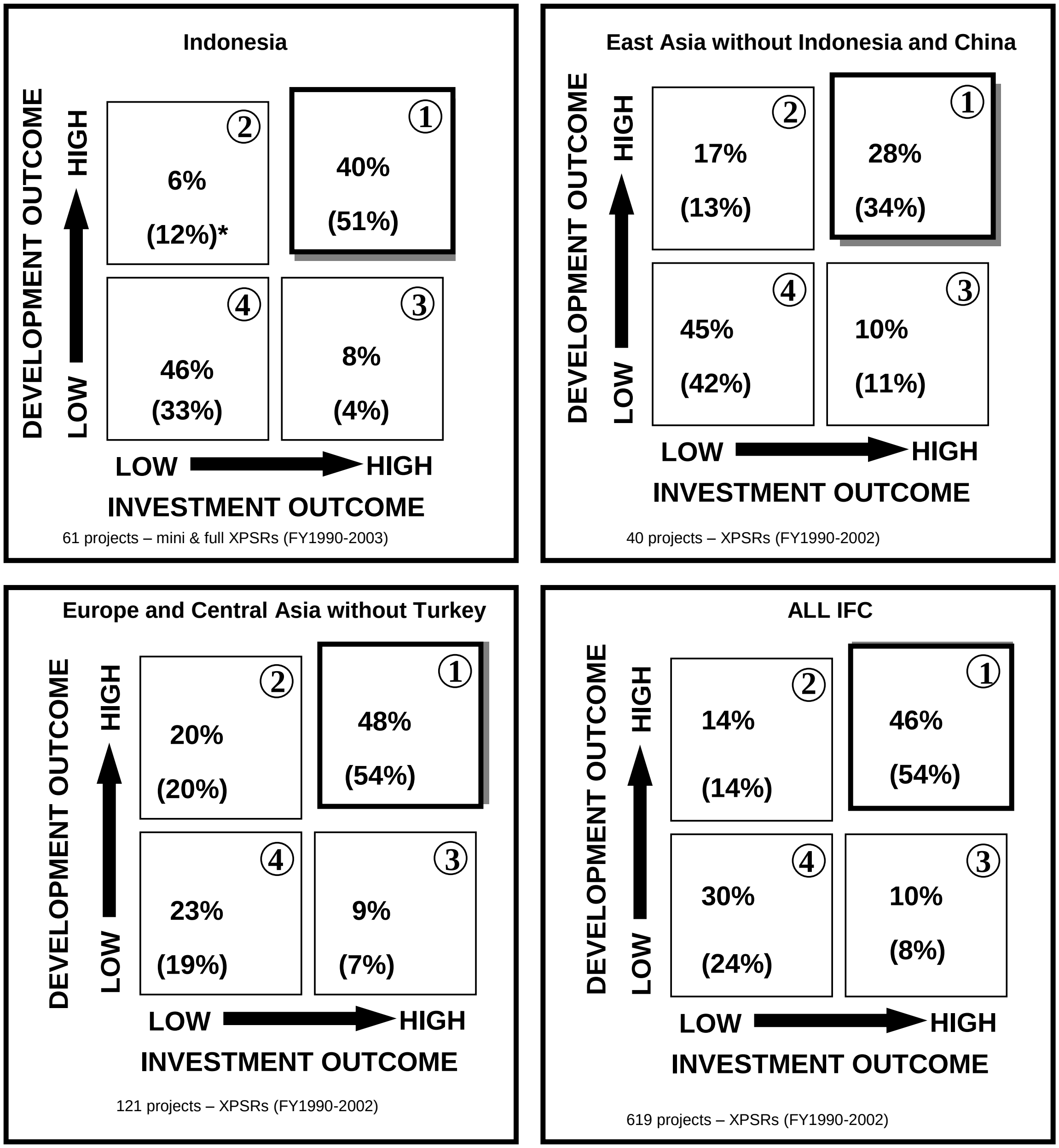
Note: a/ The fiscal years of project approvals are shown in parenthesis.
b/ See endnote 1for a description of the eight risk factors.

Source: Independent Evaluation Group analysis based on World Bank Group Board reports, Project Supervision Reports

3.28 All three IFC infrastructure projects in Indonesia achieved both high development and investment outcomes. Two-thirds of IFC's agribusiness projects in Indonesia (six out of nine), and also two-thirds of its textile projects (six out of nine), all export-oriented, achieved high development outcomes, higher than IFC-wide average for projects in these two sectors respectively when evaluated with XPSRs. However, only one-third of the agribusiness and textile projects achieved high IFC investment outcomes because of the underperformance of IFC's equity investments, caused by slow economic and stock market recovery in Indonesia. In particular, the post-crisis agribusiness projects reflected lessons learned from IFC's earlier agribusiness investment, and had better linkages with farmers, SMEs, and the rural economy. While only one-half (four out of eight) of IFC's banking sector projects achieved high development outcomes, (less than IFC-wide average in this sector), the three SME-oriented banking projects all achieved both high development and investment outcomes. Finally, three-fifths (three out of five) of IFC's health and tourism/hospitality projects in Indonesia achieved high development outcomes, while four-fifths achieved high IFC investment outcomes, both success rates higher than IFC-wide averages. However, all these sector-level success rates in Indonesia are based on a small number of projects and cannot be compared in a statistically meaningful way with IFC-wide averages.

3.29 Likewise, IFC investment outcome success rate for the Indonesia portfolio is only 48 percent based on the number of projects, but 55 percent based on the amount committed. In comparison, IFC-wide investment outcome success rate is 56 percent based on the number of projects and 62 percent in terms of the amount committed. IFC investment outcome success rate in Indonesia was deeply depressed by the severe impact of the crisis on IFC's loan portfolio in the country, which only had a 58 percent success rate compared to IFC-wide average loan success rate of 74 percent (see table 3.8). The Indonesian loan and equity portfolio had a peak reserve for losses in FY1998 equivalent to about 35 percent of the aggregate outstanding amount, but the proportion of loss reserves is not as high as in some other country portfolios that experienced a country crisis after 1995 (e.g., Thailand – peak of about 45 percent in 2000; Russia – peak of about 48 percent in 2000; and Argentina – peak of about 55 percent in 2002).

Figure 3.3: Comparison of Indonesia's development and investment outcomes



Note: Numbers in parenthesis are by volume of commitments.
Source: Independent Evaluation Group

3.30 Compared to IFC's evaluated projects in the East Asia Region (excluding Indonesia and China), the Indonesia project portfolio achieved both a comparable development outcome success rate (45 percent versus 46 percent), as well as loan portfolio investment outcome success rate (59 percent versus 58 percent, see table 3.8). However, equity investments in the East Asia Region (excluding China and Indonesia) had a higher success rate (43 percent) compared to the Indonesia equity investment success rate (33 percent). The lower equity success rate of the Indonesian portfolio is mainly due to the slower post-crisis economic and stock market recovery in Indonesia compared to that of the rest of the Asian countries that were affected by the Asian Crisis, and the more severe impact of the crisis in Indonesia in terms of decline in GDP growth brought about by the crisis, compared to the rest of East Asia. The comparable loan portfolio investment outcome success rate of the Indonesia projects when compared to the East Asia region (excluding China and Indonesia) was mainly due to successful loan rescheduling or financial restructuring of most of the Indonesian projects carried out by a full-time team of restructuring specialists relocated to Jakarta by IFC; the cooperative attitude of most project sponsors towards IFC's restructuring efforts; and the lower debt leverage of many of IFC's clients in Indonesia at the onset of the crisis, which made loan rescheduling or restructuring more viable. The higher success rate of the Indonesian equity portfolio compared to the rest of East Asia (excluding China and Indonesia) was due to better equity investment structuring and more credit-worthy Indonesian sponsors as equity put option obligors.[3]

3.31 Larger IFC project commitments (implying larger projects) tend to have better IFC work quality and better development outcome success rates in the Indonesian projects and in IFC-wide projects evaluated with XPSRs, as indicated in table 3.7 below. Small IFC commitments (i.e., less than US$2 million) tend to be mainly equity-only commitments, which, by their nature, are riskier than senior loans.

Table 3.7: Projects with larger IFC commitments tend to have a higher development outcome success rate

	IFC commitment amount (in US$ millions) per project				
Indonesia projects (FY1990–2003)	**< 1.0**	**≥ 1.0 < 5.0**	**≥ 5.0 < 10.0**	**≥ 10.0 < 20.0**	**≥ 20.0**
Development outcome success rate	0% of 1	0% of 10	38% of 8	41% of 17	72% of 25
High IFC work quality	0% of 1	20% of 10	25% of 8	53% of 17	64% of 25
All evaluated IFC projects (FY1990–2002) a/					
Development outcome success rate	53% of 34	48% of 92	57% of 136	59% of 166	68% of 199
High IFC work quality	58% of 34	55% of 91	57% of 133	68% of 165	77% of 197

Note: a/ Based on 627 (619 randomly selected XPSRs plus 8 discretionary) XPSRs of projects approved in FY1990–2002 and evaluated during CY96–06. Of the 627 XPSRs 7 were not rated for IFC work quality ratings.

Source: Independent Evaluation Group analysis of XPSRs

3.32 Compared with the projects evaluated in Eastern Europe and Central Asia, which were affected by the Russian Crisis of 1998–99 at the same time as the Indonesian crisis, the Indonesian projects underperformed in terms of both their development outcome success rate and IFC investment outcome success rate. The most likely explanation for this is the quicker recovery of the Russian economy from its crisis, a recovery that positively impacted the economies of the neighboring countries of the former Soviet Union.

Table 3.8: The Indonesian evaluated projects approved during and after the crisis performed better than the pre-crisis projects and IFC average

	Total No. of Projects	% with high development outcome				
			Investment outcome			
			Loans	Equity		
Indonesia Projects (approved FY1990-2003)	61	46%	58% of 50	33% of 33	42%	48%
(i) Projects approved pre-crisis (FY1990-97)	46	39%	56% of 39	27% of 26	35%	41%
(ii) All other projects approved FY1998-2003	15	67%	64% of 11	57% of 7	71%	67%
Projects in East Asia (excluding China & Indonesia) with XPSRs a/, c/	40	45%	59% of 32	43% of 21	48%	50%
Projects in Eastern Europe & Central Asia (excluding Turkey) with XPSRs a/	121	68%	71% of 85	34% of 68	69%	79%
All IFC commercial bank projects w/ XPSRs a/, b	86	60%	78% of 63	56% of 32	75%	64%
All IFC infrastructure projects with XPSRs a/	55	82%	86% of 49	43% of 28	82%	87%
All IFC general manufacturing & services projects with XPSRs a/	172	53%	67% of 157	25% of 79	58%	60%
All IFC projects with XPSRs a/	619	60%	74% of 465	31% of 321	64%	66%
(i) Projects in frontier countries at approval	321	61%	74% of 235	34% of 176	67%	66%
(ii) Projects in non-frontier countries	298	59%	73% of 230	28% of 145	59%	66%

Notes: a/ Projects approved in FY1990-2002 and randomly evaluated 1996-2006.

b/ Excluding microfinance institutions.

c/ Korea, Philippines, Thailand, Vietnam

Source: Independent Evaluation Group analysis

3.33 By their nature, equity investments are riskier than senior loans. For IFC-wide projects evaluated with XPSRs, the success rate for IFC loans is 74 percent, while the success rate for IFC's equity investments is 31 percent (table 3.8), the latter being more similar to the equity success rate of venture capital funds.[4] IFC's equity investments worldwide in particular face the following equity risks generally unique to IFC as a US dollar and development-oriented investor:

- Devaluation and remittance delay risks. IFC invests in US dollars, but exits its listed equity in local currency, and may also exit its unlisted equity through equity put options, typically to the sponsors as put obligors, in local currency unless specified otherwise in the equity put option agreement. Conversion of equity exit proceeds to US dollars is more subject to exchange rate volatility and remittance regulations compared to debt service payments on IFC loans;
- Equity acquisition price (or conversion price from loan to equity) over-payment risk. The risk of IFC paying "too much" in acquiring the equity shares can arise from a number of scenarios: an overvaluation of existing business; IFC's negotiation of an equity put option (EPO) formula that inadequately compensates IFC for its risks; or an investment by IFC near the peak of the business cycle, when share/asset prices are highest (companies approach IFC for financing projects near the peak of the business cycles). Valuation of an existing business/asset (and/or comparable listed companies being used as market references) should be based on financial statements and information prepared according to International Accounting Standards (IAS) or according to International Financial Reporting Standards (IFRS). To the extent that local accounting standards diverge from IAS or IFRS, profits and asset values are generally higher than under IAS or IFRS. Using comparable

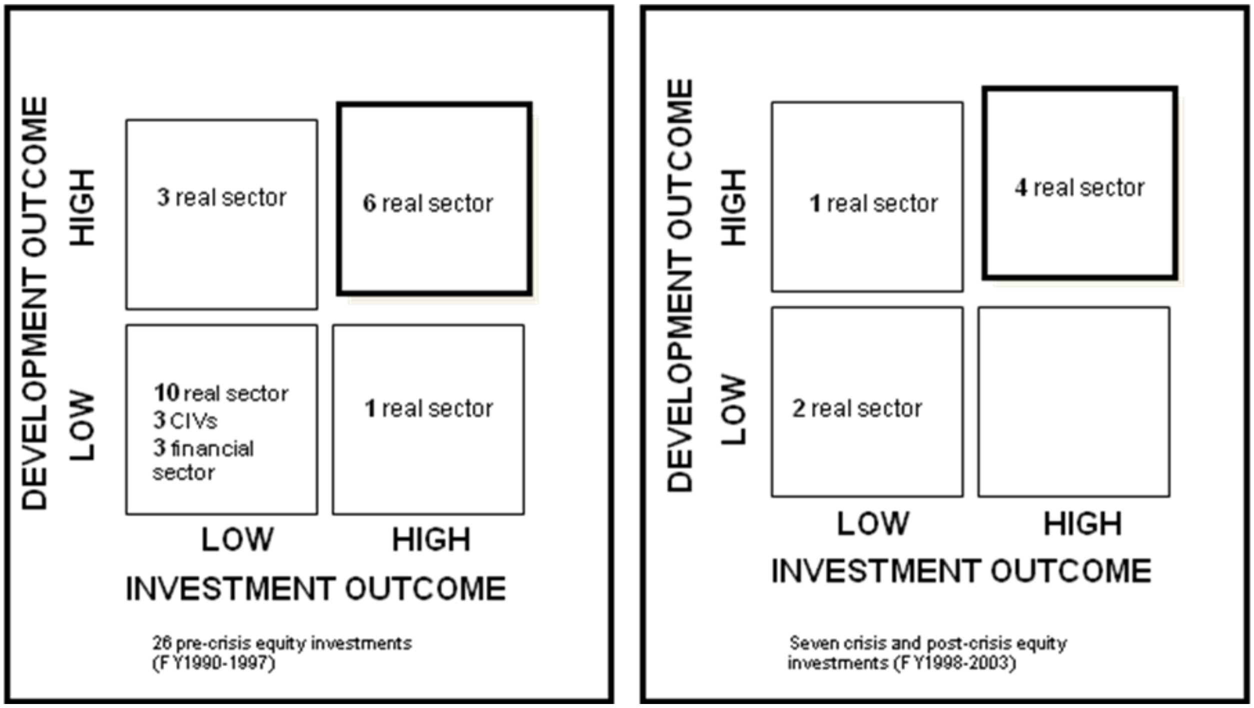
listed companies as asset price references should also adequately reflect a liquidity premium for the listed shares;

- Exit risks due to illiquid markets (for listed shares); difficulties in enforcing/realizing equity put options; or difficulties in selling a small equity stake to strategic investors. Equity put options are IFC's main exit mechanism because of its policy limiting shareholding, while private equity and venture capital investors take substantial minority or majority stakes and seek listing or sale of the company or their shareholding to a strategic investor;
- Minority portfolio investor risks, mainly from potential sponsor mismanagement, diversion of company assets, self-dealing, or conflicts of interests; and
- Potential conflicts in IFC's roles as lender (with B-loan participants or other syndicated lenders) and as shareholder when a company experiences financial difficulties. In such cases, IFC first acts as a lender, and subordinates its interests as an equity shareholder.

Despite the crisis, IFC's equity portfolio investment success rate in Indonesia is comparable to IFC average

3.34 The comparative performance of IFC's equity portfolio in Indonesia is noteworthy, with a success rate of 33 percent for the entire period, comparable to the 31 percent success rate for all IFC-evaluated equity investments. However, pre-crisis equity investments in Indonesia had only a 27 percent success rate, with successful equity investments existing only in the real sectors, and all financial sector collective investment vehicle equity investments, being unsuccessful. In contrast, the seven equity investments approved during and after the crisis had a 57 percent success rate, although the difference in success rates is not statistically significant because of the small number of equity investments approved during and after the crisis. Financial sector projects are highly debt-leveraged by nature, and a major economic crisis can easily wipe out their equity. Financial sector projects earn mainly local currency revenues and can be exposed to local currency devaluation risks on their foreign loans unless they can hedge or pass on the devaluation risks to customers. The latter is only effective, however, if customers can withstand a substantial local-currency devaluation and do not default on loans in the first place. Non-deposit-taking financial intermediary projects, such as leasing entities, also need access to local-currency loans to replace maturing IFC and other foreign loans in order to continue or expand their operations. In the absence of access to local-currency loans when the Indonesian crisis unfolded, these non-deposit-taking financial intermediary projects collapsed. Furthermore, financial sector projects are mostly regulated entities, with regulators intervening whenever the financial entity experiences financial distress. These three factors (i.e., high debt leverage, lack of access to local-currency loans, and regulatory intervention) make a creditor-led or sponsor-led restructuring of financial sector projects more difficult. Thus, the pre-crisis financial sector projects were all unsuccessful equity investments for these and other reasons. The pre-crisis collective investment vehicle projects, such as private equity funds, also failed because their equity investments in second-tier companies and new ventures collapsed with the crisis, and the returns on their mainly foreign currency equity capital were substantially depressed (in foreign currency terms) because of the substantial devaluation of the *Rupiah*(Rp).[5] Finally, the successful pre-crisis equity investments in the real sectors had equity put options to creditworthy sponsors, with some equity put options specifying minimum US dollar-based returns for IFC's investments; while the minimum returns on the equity put options were not high for equity investments, they mainly protected IFC's equity investments from devaluation risks. The sector patterns of successful and unsuccessful equity investments in Indonesia are illustrated in figure 3.4.

Figure 3.4: IFC's equity investment success patterns by main sectors in Indonesia



Note: Collective Investment Vehicles (CIVs) are pooled financing from several investors managed and invested by a manager such as private equity funds, mutual funds, and investment loan funds.
Source: Independent Evaluation Group

IFC's portfolio was slightly profitable because of an effective crisis response to equity investments in companies with high-quality sponsors

3.35 Over the entire review period, the Indonesian loan and equity portfolio had a net income contribution equivalent to about 0.5 percent of the average loan and equity investment outstanding (excluding unrealized capital gains on active equity investments). The Indonesian portfolio's net income contribution fell substantially below IFC-wide average net income, equivalent to 4.4 percent of the average loan and equity outstanding for the same period (FY1990–2006), and was mainly due to the country crisis. Post-crisis (FY2001–06) net income contribution of the Indonesia portfolio improved to 6.4 percent of the average loan and equity outstanding (excluding unrealized capital gains on active equity investments), the same as IFC-wide average for the same period, partly because of the lower risk intensity at project approval of post-crisis Indonesian projects, and partly because of the gradually improving country economic performance and GDP growth. The impact of the Indonesian crisis on IFC's project portfolio was significantly mitigated by the successful restructuring of most projects that were severely affected by the country crisis, which in turn, was facilitated by the significant proportion of high-quality (or low-risk) sponsors, the relatively lower debt leverage of pre-crisis Indonesian projects at the time of project approval (compared to IFC average), and an effective IFC restructuring strategy involving a full-time restructuring staff that moved to Indonesia for this task. Finally, despite the crisis, the high quality sponsors honored IFC's equity put options, many of which were denominated in US dollars to remove devaluation risks and had some minimum return provisions.

Pre-crisis agribusiness projects had limited linkages to farmers and SMEs, but post-crisis projects were better designed for broader rural development impacts

3.36 The five pre-crisis agribusiness projects in Indonesia were not originally designed at appraisal to have significant linkages to farmers as sources of agricultural product inputs, relying instead on company-owned plantations for sources of raw material. Two projects used a large number of retail outlets to market their products, while the other three exported the majority of their products. Nonetheless, during the project operation phase, some agribusiness companies began to develop supply chain linkages with farmers and SMEs, but in a limited and experimental manner. In contrast, most of the eleven post-crisis agribusiness projects, particularly the 10 approved over the period FY2003–06, were designed during appraisal to have more supply chain linkages to farmers and SMEs, thereby enhancing their rural development impacts.

IFC's two SME-oriented commercial bank projects successfully financed a large number of SMEs

3.37 IFC's indirect financial support to SMEs through two SME-oriented financial intermediaries (see box 3.1 and paragraphs 3.52 and 3.53) has largely been successful in reaching a large number of SMEs. The key to this success was the SME focus on financial intermediaries, coupled with IFC equity, loan, and advisory services[6] to the financial intermediaries. IFC equity provided the additional capital base to support a larger lending program and to meet prudential capital adequacy requirements; IFC's term loan helped match longer maturities for some bank borrowers that needed term loans; and advisory services helped the banks build institutional capacity to reach out to SMEs and to improve internal processes for risk management.

3.38 Indonesia has the most extensive network of non-profit and for-profit microfinance providers among developing countries operating within a supportive regulatory regime[7] and fostered by very active local microfinance industry advocacy groups and associations. However, SMEs in Indonesia still encounter obstacles in access to financing partly because of existing collateral requirements for loans, and partly because most commercial banks prefer to serve larger corporations, which are more profitable and less labor-intensive to serve. They are also confronted with banks' preference for investing funds in government securities, which provide an acceptable profit margin above the savings deposit rates. Thus, there is still a large scope for improving access to financing for SMEs in Indonesia.

The environmental performance of the projects in Indonesia was below IFC average

3.39 Only 54 percent of the 41 pre-crisis projects in Indonesia that were evaluated received a satisfactory environmental, and social effects (EHS) rating. Twelve of these projects, which were approved during and after the crisis, received only a marginally better satisfactory rating of 58 percent. These ratings are both below IFC-wide average satisfactory rating of 68 percent for projects evaluated with XPSRs, as shown in table 3.9. Among the pre-crisis projects evaluated, all four of the leasing company projects and two of the four private equity fund projects had unsatisfactory environmental and social effects ratings. The 32 real sector projects evaluated were approved during the pre-crisis period and received an environmental and social effects satisfactory rating of only 59 percent. Although the three post-crisis financial markets projects evaluated had a 67 percent satisfactory rating, the nine post-crisis real sector projects evaluated still had a low satisfactory rating of 56 percent. While companies in financial distress during and immediately after the crisis may place priority on solving their financial problems and avoiding bankruptcy rather than on EHS compliance, there is no reason why EHS compliance should continue to be substantially lower than IFC's average six years out of the crisis. In particular, better IFC's EHS supervision can help improve EHS compliance of the Indonesian portfolio.[8] Five of the pre-crisis projects evaluated had insufficient EHS information and their environmental and social effects could not be rated; two of these were investments through an international investment fund (a collective investment vehicle) that did not provide IFC with EHS information in two real sector investments in Indonesia before the fund was closed following the crisis.

3.40 The sector composition of the Indonesian portfolio partly explains the below average rating for environmental and social effects (table 3.9). The Indonesian real sector projects operated mainly in the agribusiness sector, the general manufacturing sectors, and the chemicals sectors— three sector groups that have below average satisfactory environmental and social effects ratings IFC-wide. In contrast, infrastructure projects receive above average ratings IFC-wide, but the Indonesian portfolio includes only a very small proportion of these. Finally, pre-crisis financial market projects in Indonesia had a low environmental and social effects rate, principally because of non-compliance with process requirements (e.g., the implementation of an environmental monitoring system) and tardy reporting to IFC. However, post-crisis financial market projects in Indonesia have a slightly higher environmental and social effect ratings compared to all IFC's financial markets projects worldwide evaluated with XPSRs.

Table 3.9: Environmental and social effects ratings of Indonesian projects are below IFC and East Asia (excluding China and Indonesia) averages

	Number with ESHS Category C or N/A a/	Number with NOP b/ rating	Satisfactory EHS ratings
Indonesia Projects (approved FY1990–2003)	3	5	55% of 53
1. Projects approved pre-crisis (FY1990–97)	3	5	54% of 41
(a) Real sector projects	0	1	59% of 32
(b) Financial market projects	2…c/	2	43% of 7
(c) Collective Investment Vehicle projects (CIVs)	1…d/	2	0% of 2
2. Projects approved during and after the crisis (FY1998–2003)	0	0	58% of 12
(a) Real sector projects	0	0	56% of 9
(b) Financial market projects	0	0	67% of 3
(c) Collective Investment Vehicle projects (CIVs)	0	0	No projects
Projects in East Asia (excluding China and Indonesia) with XPSRs	3	3	67% of 36
Projects in Eastern Europe and Central Asia (excluding Turkey) with XPSRs	2	6	77% of 115
All IFC projects with XPSRs e/	15	35	68% of 577
(i) Projects in frontier countries at approval	9	16	64% of 279
(ii) Projects in non-frontier countries	4	16	72% of 280

Note: a/ N/A means Not Applicable. Projects with minimal EHS effects (such as credit rating bureaus and mutual funds that invest in listed shares) are given a Category C designation and have no EHS compliance and reporting requirements.
b/ NOP means No Opinion Possible (on EHS performance) because of lack of EHS information in IFC project files.
c/ One project was incorrectly designated a Category C project and should have been required to comply with IFC's EHS requirements.
d/ This project was incorrectly designated a Category C project and should have been required to comply with IFC's EHS requirements.
e/ 627 projects (619 randomly selected XPSRs and eight discretionary XPSRs) approved in FY1990–2002 were evaluated with XPSRs, of which 23 were global or regional operations and were not assigned either a frontier or non-frontier designation. Of these 23 global/regional operations, 18 were evaluated for environmental and social effects, 2 were designated as N/A, and 3 as NOP.

Source: Independent Evaluation Group analysis

3.41 IFC supported five agribusiness companies in Indonesia with plantation operations (palm oil, rubber, banana) through six investment operations (one company had a repeat investment). One company was established to acquire and operate existing agribusiness plantations and processing operations, but IFC's loan was repaid within one year of disbursement and there was not enough environmental information to rate. The other four agribusiness companies had expanded both their plantations and their processing capacities through IFC-supported projects. All the expansion plantations complied with IFC's forestry policies and guidelines, and involved secondary growth and scrub forests in previously logged areas that have been cultivated to varying degrees by small farm holders. There were also no significant resettlement issues. However, the processing facilities of all four companies had non-compliance issues in one or more of the following areas: wastewater effluent quality; air emissions quality; industrial noise; and worker health and safety. EHS reporting to IFC has also been tardy, resulting in ratings for all four companies of partly unsatisfactory. This illustrates the typical EHS performance of IFC's Indonesian manufacturing and processing projects.

3.42 Projects in the agribusiness, chemicals, and manufacturing sectors are mainly designated Category "B" projects for EHS risk purposes, meaning that they pose medium-level EHS risks in the sense that they have limited potential adverse social or environmental impacts that are few in number, generally site-specific, largely reversible, and readily addressed through mitigation measures. In contrast, EHS Category "A" projects, such as extractive industries projects (and most infrastructure projects), pose high EHS risks in the sense that they have potentially significant adverse social and environmental impacts that are diverse, irreversible, or unprecedented. Projects with low EHS risks, such as those in the industrial services and education sectors, are designated Category "C" projects, meaning they have no or only minimal adverse potential social and environmental impacts. Finally, Category "FI" projects are those in the financial markets. IFC's EHS supervision priority focuses on Category "A" projects,[9] with Category "B" projects supervised less frequently unless a serious EHS deficiency has been identified. IFC's revised safeguard policies, standards, and procedures, approved by the Board in early 2006, address many of the shortcomings of their earlier incarnations. Coupled with IFC's "mainstreaming EHS" initiative, which requires that investment officers understand IFC's EHS policies, standards and procedures and be able to assist the staff of the Environmental and Social Development Department in supervising EHS compliance and other EHS oversight functions, they are expected to result in better EHS supervision and performance of projects in the future.

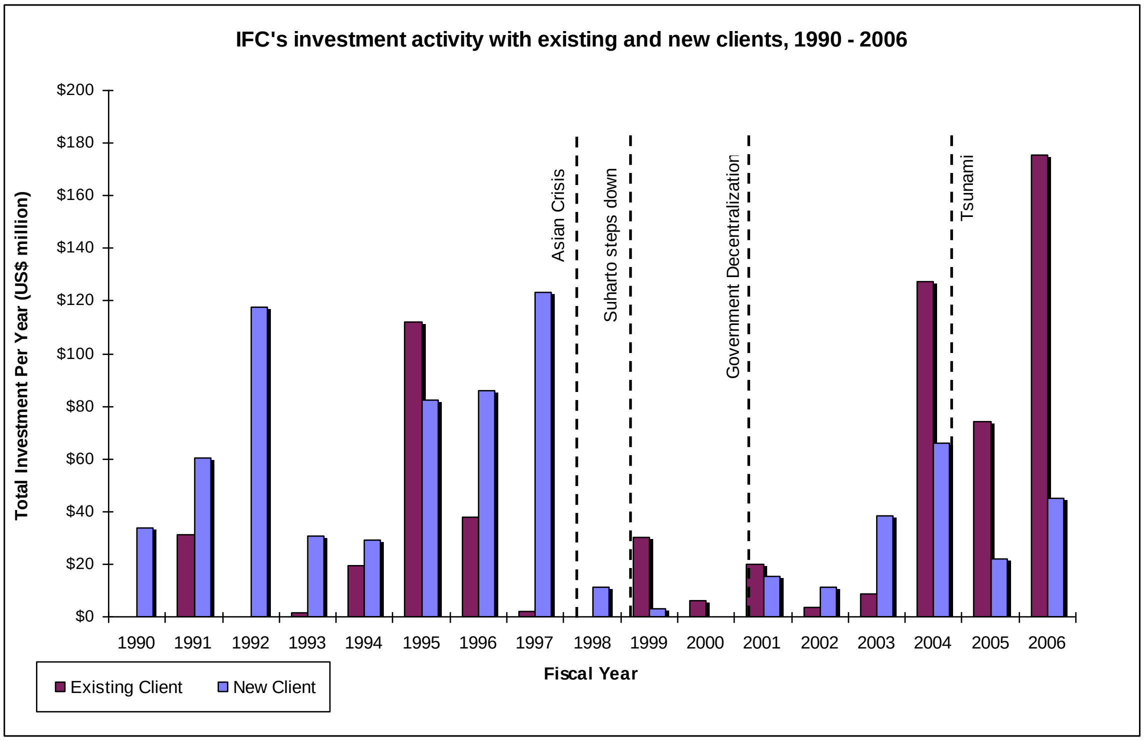
IFC's short-term response to the country crisis

Restructuring financially distressed project companies and lessons learned

3.43 As local businesses began to experience the full effects of the country crisis, IFC adjusted its investment activity, focusing less on new client development and more on helping its existing client companies cope with the crisis. Figure 3.5 shows the steep decline in IFC investment activity with both new and existing clients during FY1998–2002 and particularly negligible investments with new clients during FY1999–2000.

3.44 During and immediately after the crisis, Indonesian businesses suffered, not only because the large domestic corporations were heavily exposed to short-term foreign debts and because the *Rupiah* had substantially depreciated, but also because of the political uncertainty surrounding President Suharto's ability to rule due to his deteriorating health in 1998. During the years immediately preceding the crisis, large Indonesian corporations had borrowed heavily in foreign currencies to take advantage of much lower interest rates compared to local-currency loans, with the expectation that the *Rupiah* would not significantly depreciate. In addition, Indonesian commercial banks had insufficient lending capacity to meet the needs of their corporate clients. The latter was partly driven by the fact that there was little confidence in the banking system, which was dominated by government-owned banks and which, in turn, hampered banks' ability to attract a significant deposit base. Corporations were also wary of their relationships with domestic banks because of the absence of confidentiality regulations and the fear that sensitive financial and corporate information could find its way to third parties. In any event, Indonesian corporations did not need to rely on domestic banks because of the easy availability of loans from foreign lenders.

Figure 3.5: IFC's pre-crisis investment commitments were mainly with new clients, while in the post-crisis period, they were primarily with existing clients



Source: International Finance Corporation

3.45 Popular protests in early 1998 against government corruption and mismanagement culminated in large-scale riots and violence in which nearly 1,200 people perished. The exchange rate collapsed by more than 50 percent, from Rp8,000 per US dollar in early May 1998 to over Rp16,000 by June 1998. The foreign exchange market experienced unusually low trading volumes, with virtually no one supplying US dollars, and there was pressure for capital flight. The collapse of both the economy and the financial markets led to President Suharto's resignation in May 1998.[10] As a result of the unprecedented political uncertainty and lack of confidence in Indonesian financial markets, IFC's client companies had few viable options for accessing increasingly scarce working capital.

3.46 The level of political uncertainty remained high following President Suharto's resignation as Indonesia had four subsequent heads of state between 1998 and 2004. During this period, Indonesia grappled with the transition from an authoritarian to a democratic system. Much decision-making authority was decentralized to the regional and local levels in an attempt to give greater voice to civil society and to foster transparency. However, there was a widespread lack of local capacity to govern and of governance systems throughout the country.[11]

Short-term response to crisis: loan restructuring, equity injection, and working capital to existing clients

3.47 During and immediately after the crisis (1999–2003), there was a sharp decline in private sector investment (figure 2.3), leading to an almost complete lack of demand for IFC's financing of investments. Therefore, rather than develop new clients, IFC focused its activities on addressing the needs of existing clients through the provision of working capital and the rescheduling of loans to address the fact that there was no access to short-term loans from local banks. IFC also worked to restructure the liabilities of clients in serious financial distress due to unsustainable debt levels. Other activities included the provision of equity for the recapitalization of clients with unsustainable leverage or for those who failed to meet prudential capitalization levels. IFC's restructuring strategy centered on establishing a full-time team of "work-out" or restructuring specialists from its Special Operations Department to work on rescheduling or restructuring in Indonesia exclusively over a period of several years, with strong legal support from both external and IFC lawyers. The restructuring strategy also involved categorization of clients, first according to the degree of feasibility of restructuring, then according to the size of IFC exposure and the complexity and likely time needed to arrive at an agreed restructuring plan with the company. The objective was to restructure the easiest cases first, and within this group, give priority to clients with large IFC exposures. It was also necessary to decide on the liquidation or company sale options for potentially "hopeless" cases in instances where it was estimated that the expected financial recovery of creditors would cost less than restructuring efforts. Another element of the restructuring strategy was cooperation with the World Bank staff in Indonesia and the Region to help focus the government's attention on systemic restructuring issues faced by private sector companies that required government intervention or action. Significant benefits of utilizing a separate, specialized restructuring staff to work on distressed companies, as opposed to drawing on the sector department's transaction and supervision staff, are the ability to obtain a "fresh set of eyes and perspective", their specialized restructuring skills and experience, as well as the absence of prior relationships that could potentially affect the restructuring options to be considered.

3.48 IFC's response was largely driven by the fact that its real sector clients no longer had access to short-term bank borrowings for working capital or trade finance, and its financial markets clients had lost so much equity capital that they no longer met prudential capital adequacy requirements. Non-exporting companies in the real sector with foreign currency debts were the hardest hit. Their situation was particularly acute if they relied on imported raw materials as the *Rupiah* had rapidly depreciated in value relative to the main foreign currencies used in international lending. At the onset of the crisis, IFC had active investments in 41 Indonesian companies. IFC undertook rescheduling and restructuring operations involving 16 of these client companies, of which 6 were loan reschedulings, 6 were restructurings of real sector companies, and 4 were restructurings of financial markets companies. Eleven of the 16 reschedulings and restructurings, involving a total original IFC net commitment of about US$899 million, are considered successful. Five are considered failed restructurings as IFC and the company sponsors and/or other creditors did not reach an agreement that provided a financially viable plan for recovery of the company. The five failed restructurings, of which three were real sector companies and two were financial markets companies, led to bankruptcy or liquidation of the companies. Fifty-seven transactions have been identified as directly linked to these sixteen restructurings as shown in table 3.10. It is interesting to note the difference in the type of IFC transaction response between financial sector and real sector clients.

Table 3.10: Sixteen Indonesian projects were restructured mainly through straight debt restructuring for real sector projects and equity support for financial sector projects (1997–2002)

	Total Number of Restructuring Transactions	Equity Injection	Debt Restructure	Working Capital Loan	Swap (Currency Hedge)	Debt to Equity Conversion	Waiver of Fees or Penalties	Loan Forgiveness (.50%)	Debt to Quasi Equity Conversion
Restructurings (16 projects)	57	12	17	5	6	8	3	2	4
Financial Markets (4 projects)									
Number of Transactions by Type -Financial Markets	21	4	5	0	0	7	0	1	4
FM Transactions as a % of Total IFC Transactions		7%	9%	0%	0%	12%	0%	2%	7%
Transaction Type as a % of Financial Markets Total Transactions		19%	24%	0%	0%	33%	0%	5%	19%
Real Sector (12 projects)									
Number of Transactions by Type - Real Sector	36	8	12	5	6	1	3	1	0
Real Sector as a % of total IFC Transactions		14%	21%	9%	11%	2%	5%	2%	0%
Transaction Type as a % of Real Sector Total		22%	33%	14%	17%	3%	8%	3%	0%

Source: International Finance Corporation

3.49 Due to the nature of their operations, real and financial sector companies required unique combinations of restructuring and new financing interventions from IFC. As a result, the four principal transaction types for real sector clients were debt restructurings, equity injections, working capital loans, and currency swaps. Financial institution clients differed in that IFC also employed debt-to-equity swaps and conversion of straight debt to quasi equity, in addition to equity injections, which more directly impacted capital adequacy and capital structure.

3.50 Among the reasons for the five failed restructuring attempts were low-quality (high-risk) or fraudulent sponsor/management, an unreliable judiciary, complete market collapse, crop disease, and natural disaster.

Supporting the recovery and privatization of commercial banks

3.51 IFC was instrumental in helping Bank NISP weather the financial crisis. At the time, NISP's portfolio was concentrated domestically on SMEs and its loans were predominantly denominated in *rupiah*. Many of the larger banks were either exposed to highly leveraged SOEs and large domestic enterprises or were themselves undercapitalized and heavily exposed to short-term foreign currency debt.

Box 3.1: Commercial bank support – Bank NISP

Bank NISP (NISP) was founded in 1941 in Bandung and grew to become one of the largest savings banks in Indonesia. It was upgraded to the status of a commercial bank in 1967, obtained a foreign exchange license in 1990, and was listed in the Jakarta Stock Exchange in 1994.

IFC identified Bank NISP's SME sector development potential and in 1997 approved a $10 million five-year loan (disbursed in two equal tranches) to assist Bank NISP expand its SME financing—particularly for exporters needing trade finance. A further appraisal of NISP's performance and needs culminated in IFC's second operation in January 2000 involving: (a) a $5 million equity investment, (b) conversion of the first $5 million loan tranche to equity; (c) transformation of the second $5 million loan tranche into a convertible loan; and (d) an advisory services package to improve risk management. In 2004, IFC undertook a third operation involving a US$35 million five-year senior loan designed to help NISP diversify its liability structure, reduce maturity mismatches, and provide further support to its SME core lending activities. This loan also helped NISP expand its other activities (e.g., mortgage lending), which required longer-term funding. At that time, almost all of NISP's activities were funded by short-term deposits (85 percent of total liabilities). By providing longer maturity debt, IFC would help reduce the duration and maturity gap, thereby reducing NISP's interest and liquidity risks.

Through its financing and advisory services operations, IFC aimed to improve the capital structure, corporate governance, and risk management systems of NISP and in so doing increase its competitiveness, thereby developing a more robust Indonesian banking system. IFC's investments would not only help NISP withstand the country crisis, but would also position it to play a larger role in a more consolidated and competitive post-crisis banking sector. IFC's strategy included the following goals: (1) strengthen NISP's equity base, (2) shelter NISP from continued uncertainty over the extent of the country crisis, and (3) send an important signal of confidence to other investors to encourage their participation in a private sector-led recapitalization.

NISP was one of the few banks that survived the country crisis without a government bailout, partly because of IFC's investments, and partly because of NISP's small loan exposure to the large corporations adversely affected by the country crisis; NISPs main clients were SMEs that were less adversely affected by the country crisis. NISP was thus perceived by the market as a sustainable and high-quality bank, and it increased its deposit base during and after the country crisis as savers sought well-capitalized and profitable banks into which to deposit their savings. During the worst of the crisis period, NISP's non-performing loans (NPLs) peaked at a relatively modest level, compared with the widespread collapse suffered by most of its competitors that were overexposed to large, highly leveraged corporations and state-owned enterprises (SOEs). Over the period 2001–03, NISP's loan portfolio grew two and half times more than its peers. Since the beginning of IFC's involvement with Bank NISP in 1997-2006, the number of branches increased dramatically from about 50 to 168.

NISP, a relatively small but successful bank that had US$1.8 billion dollars of assets as of December 31, 2004 (or 1.6 percent of the total financial sector), nonetheless attracted the interest of OCBC of Singapore, which acquired 51 percent of NISP's shares in 2005. This event occurred nine years after IFC began its support to NISP, a period that also witnessed consistent growth in NISP's SME loan portfolio.

3.52 IFC recently committed to supporting the expanded operations of another Indonesian bank, Bank Danamon (Danamon),[12] through the provision of a seven-year *Rupiah*-denominated loan. Danamon is Indonesia's fifth largest commercial bank and along with NISP, a market leader in SME and consumer finance. Longer-term financing will help Danamon meet the local demand for medium- and long-term financing from the underserved SME market. The fact that the loan is in *rupiah* reduces the banks exposure to the same-currency risk that brought most of the large commercial banks to their knees during the financial crisis.

3.53 There continues to be unmet demand among the lower- and middle-tier SMEs in Indonesia for medium- and long-term local currency financing. Although the government has been promoting consolidation of commercial banks and has made great strides in stabilizing the banking industry, domestic commercial banks are hesitant or unprepared to target smaller regional businesses as a meaningful customer base. Most Indonesian banks rely heavily on collateral-based lending and often require high collateral-to-loan coverage ratios of up to 2:1. In order to properly serve SME clients, which typically lack the type of collateral of large corporations (i.e., large fixed assets), domestic banks must shift to cash flow or business lending. IFC's advisory services unit, Program for Eastern Indonesia SME Assistance (PENSA), is currently working with Indonesian commercial banks to help them better serve the domestic SME market.

IFC Advisory Services operations

Restructuring financially distressed project companies and lessons learned

3.54 IFC increased the use of advisory services in Indonesia starting in FY1999, at the end of the crisis subperiod and into the post-crisis subperiod, focusing mainly on providing access to finance to SMEs and capacity-building services for SMEs through the PENSA facility. IFC had 80 committed advisory services[13] operations in Indonesia during the review period, aggregating to about US$26 million of funding commitments, of which about 5 percent (excluding IFC staff costs) is funded by IFC, with the balance of 95 percent funded by various donors; a total of US$13 million was spent through June 30, 2006. The 80 advisory services operations were funded as follows: PENSA – 33 operations involving US$8.1 million (62 percent); Technical Assistance Trust Funds (TATF) – 21 operations involving US$2.9 million (22 percent); Foreign Investment Advisory Services (FIAS) – 23 operations involving US$1.5 million (11 percent); and Funding Mechanism for Technical Assistance and Advisory Services (FMTAAS) – 3 operations involving US$0.6 million (4 percent). Most of the advisory services operations (74 percent) were undertaken only since FY05, from a combination of the PENSA initiative and IFC's own Funding Mechanism for Technical Assistance and Advisory Services (FMTAAS).[14]

3.55 About 80 percent of IFC's advisory services commitments are concentrated in three areas: (a) around 34 percent are in the financial sector, mainly facilitating access to finance for SMEs; (b) about 25 percent are in agribusiness, mainly for supply chain sustainability as well as supply chain linkages between farmers or SMEs and larger processors or exporters; and (c) about 21 percent are for technical services, mainly for SME institutional capacity building as well as production and marketing-related assistance. Despite the large percentage of the advisory services funds going to the financial markets (34 percent) and the agribusiness sectors (25 percent) in which IFC also has significant proportions of its investments (24 percent financial markets and 18 percent agribusiness), there have been limited linkages between advisory services operations and investment operations in Indonesia. While this is largely due to the difficulty in synchronizing the timing of advisory operations and investment operations, this situation may also be partly explained by the small proportion of advisory services funds coming from IFC's own resources through FMTAAS (4 percent). Donor-funded advisory services through TATF (22 percent of advisory services funding) and PENSA (62 percent of advisory services funding) may be more difficult to link to IFC's investment operations because of the diverging of donors' priorities or focus away from IFC's investment opportunities.

3.56 Based on the broad sector coverage and generally satisfactory advisory services supervision ratings of the projects, the advisory services objectives in Indonesia have been largely achieved in line with the in-country regional strategy, through both direct and indirect support. Direct support to clients was provided through governance, upstream linkages, and risk management advisory services operations; while indirect support was accomplished through advisory services operations for improving the general investment climate. Although the primary advisory services focus was on SME capacity building and access to finance, there were other company-focused advisory services operations on social and environmental issues, as well as diagnostics to improve the business-enabling environment, through regulation, investment policy, and removal of administrative barriers to foreign direct investment inflows.

3.57 The supervision self-evaluation results for the 35 active advisory services projects with ratings as of June 30, 2006 are as follows: around 43 percent of ongoing advisory services projects are self-evaluated by IFC staff as "on track" to meet all performance categories; about 54 percent as having some areas of underperformance; and about 3 percent as demonstrating significant underperformance. For the 30 projects (out of 35) with available expenditure information, the total estimated expenditures were $3.4 million, up to the time of self-evaluation in 2006 or 17 percent of the total advisory services project committed funding of $19.9 million under all programs (i.e., PENSA, FIAS, TATF).

3.58 For completed advisory services projects, IFC produces a project completion report (PCR) that contains a self-evaluation of the projects' development effectiveness synthesis ratings from the following five sub-indicators: (i) strategic relevance, (ii) output achievement, (iii) outcome achievement, (iv) impact achievement, and (v) efficiency, as well as IFC's role and contribution. The first set of pilot PCRs was completed in FY06 and the second set in FY07. IEG-IFC validated all of the PCRs in these two sets of pilot groups and will validate future groups of PCRs annually on a sampling basis. There were nine advisory services projects in Indonesia with PCRs validated by IEG-IFC under the two pilot groups. All nine Indonesian advisory services project PCRs showed strategic relevance and about 80 percent were rated satisfactory in terms of output and outcome achievement as well as efficiency; however, only about half were rated as having satisfactory overall development effectiveness. Nonetheless, given the small number of PCRs, no reliable conclusions can be drawn as yet about the advisory services program overall in Indonesia. It is worth noting, however, that the mid-term review of PENSA by IFC management (undertaken by a consulting company), supervision ratings for 35 ongoing advisory services projects, and validated development outcome ratings of nine PCRs, when taken altogether, indicate that some adjustments to the Indonesia advisory services program and/or its implementation may be warranted. In response to the PENSA mid-term review, IFC consolidated the original five regional PENSA offices into three and dropped one product line. The office consolidation was intended to promote better synergies and cross-learning, as well as to reduce overhead expenses since much of the work had shifted to Jakarta. Prior to this consolidation, IFC added a PENSA office in Aceh and Nias to assist in the post-tsunami economic recovery in those two areas.

IFC has increased staff capacity in Indonesia in anticipation of growth in operations

3.59 IFC has recently increased its investment staff in Indonesia, mainly through local recruitment, from three investment officers and one analyst in FY2002 (and a country manager), to six investment officers and two analysts in FY2006, and finally to nine investment officers and three analysts in FY2007. These increases were intended, initially, to replace and take over responsibility for supervision from the special operations staff who had returned to headquarters after the restructuring of IFC's clients facing jeopardy, and subsequently, in anticipation of increased investment operations, particularly in the infrastructure sectors and the financial market sectors.

3.60 IFC had no advisory services staff based in Indonesia prior to FY2002. With the start-up of the PENSA project development facility in February 2003 (paragraph 3.54), IFC recruited mostly local staff to help implement PENSA activities; reaching just over 100 staff by FY2007, located in five regional offices across Indonesia.

Conclusion

3.61 In summary, IFC succeeded in supporting the agribusiness sector and SMEs in Indonesia, but because of the country crisis was unable to pursue its other strategic objectives of increasing the private sector role in infrastructure and of deepening the financial markets. The development outcome success rate of IFC's mature projects in Indonesia is lower than those of IFC and East Asia (excluding China and Indonesia) because the crisis was more severe and lasted longer in Indonesia than in other Asian countries. However, the Indonesian loan and equity investment project portfolio was marginally profitable during the review period because IFC successfully restructured 11 of 16 client companies in financial distress, resulting in a success rate similar to IFC average. IFC's short-term response to the Indonesian crisis focused on helping existing clients rather than on developing new ones, which helped to mitigate losses to IFC's Indonesian investment portfolio. Though most of IFC's advisory services operations in Indonesia were established too recently to be evaluated, the PENSA mid-term review, supervision ratings by staff, and validated project completion reports (PCR) ratings, when taken all together, indicate that some adjustments to the Indonesia advisory services program and/or its implementation may be warranted. Following the mid-term review, IFC made some changes in the PENSA program and increased its Indonesia-based staff, initially to replace and take over from the special operations staff and to supervise the restructured IFC clients, and subsequently in anticipation of a rapid growth in operations.

4. Main Study Findings, Challenges, and Opportunities

The Indonesian crisis exposed weaknesses in the corporate and government sectors and was precipitated in part by a mismatch in both the currency and the tenor of corporate liabilities and assets (or revenue). Companies are now avoiding such mismatches, but the absence of a liquid long-term local currency corporate bond market is a major obstacle, and thus limits private sector long-term investments. In addition, infrastructure capacity constraints are beginning to increase production costs and limit economic growth. Indonesia has passed several laws to facilitate the role of the private sector in infrastructure development, as well as laws that will facilitate the development of a corporate bond market; however, the implementing rules and regulations, as well as the regulatory oversight capacity for these laws, are incomplete, lacking, or deficient. IFC (and the World Bank Group in general) has an important role to play in helping the government put in place the necessary implementing rules and regulations, as well as regulatory oversight capacity. Cooperation between the World Bank, IFC, and other multilateral development banks (MDBs) active in Indonesia aimed at focusing the government's attention on addressing these issues is necessary, otherwise, private sector participation in infrastructure development will be significantly delayed, to the detriment of the country. Likewise, failure to develop a long-term local-currency corporate bond market will frustrate the efforts of Indonesian companies to avoid mismatches in the tenor and currency of their assets and liabilities. If companies must rely too heavily on foreign currency loans and have little or no export revenue to hedge against a devaluation of the *Rupiah*, their growth and contribution to employment creation will be limited and they will risk exposure to unnecessary financial risks. Moreover, without progress on reforms in the infrastructure sectors and the local-currency bond market, IFC will continue to have limited opportunities to support investment in these sectors. Hence, IFC's post-crisis agribusiness projects were designed to establish strong supply chain linkages, including with independent farmers, and to demonstrate more potential rural development impacts. Furthermore, two out of three IFC financial intermediary clients were also successful in reaching out to SMEs. IFC can build on these successes in the agribusiness and SME sectors.

The Indonesian crisis helped identify factors that contribute to the successful recovery of private enterprises

4.1 Several systemic weaknesses in both the corporate and the government sector were exposed by the country crisis. However, factors that contributed to successful restructuring of projects or companies in financial distress were also identified through the crisis. Among the more important observations are the following:

- The currency and tenor mismatch of the corporate sector debt (i.e., a large proportion of liabilities in the form of short-term foreign currency debts against a small proportion or absence of exports in the revenue base) was a major contributor to the Indonesian country crisis;
- Foreign lenders' confidence in the ability of the government to avoid a crisis, or to work through a crisis, can help avoid or mitigate a crisis, or can help recover quickly from a crisis;
- Weaknesses in the judiciary and regulatory agencies hampered restructuring efforts and recovery by lenders;
- Commercial banks that focus on lending mainly to MSMEs will not have substantial increases in non-performing loans during a country crisis, but may have to be recapitalized

to maintain prudent capital adequacy ratios if they have significant foreign currency loans (and assuming the crisis causes a devaluation of the local currency).

4.2 MSMEs that have no foreign currency debts, and do not rely on imported inputs or exported outputs, are generally not significantly affected by a country crisis, as long as they continue to have access to local currency loans.

A restructuring strategy for distressed clients (resulting from country crises) is needed to quickly resolve problems and put project assets back into full utilization, thereby reducing economic losses

4.3 During and immediately after the crisis (i.e., FY1998–2002), rather than develop new clients, IFC focused on addressing the need to restructure the liabilities of existing clients, and provide them with working capital, in order to minimize disruptions of operations and economic losses. IFC's restructuring strategy centered on sending a dedicated team of "work-out" or restructuring specialists from the Special Operations Department to work full-time in Jakarta over a period of several years. While the restructuring team was focused on transaction restructuring, IFC's senior management, in cooperation with the World Bank and IMF, helped focus the government's attention on systemic restructuring issues faced by private sector companies that required government intervention or action. Foremost among the myriad of issues was the low quality of the judiciary.

The main drivers of success for IFC's Indonesian investment projects were sponsor quality, low debt leverage, and an effective IFC strategy for restructuring distressed projects

4.4 IFC's projects in Indonesia approved before, during, and after the country crisis demonstrated low risk intensity at approval (i.e., had fewer high-risk factors on average) when compared to IFC-wide average. In particular, there was a lower proportion of high-risk (i.e., low-quality) sponsors/management groups and a lower proportion of high-risk debt service burdens at the year of first principal repayment on IFC's loan. These two features of IFC's Indonesian project portfolio, coupled with IFC's decision to send a specialized team of restructuring specialists to Jakarta to work on problem projects and remain full time over several years, all helped mitigate the adverse impact of the crisis on the companies, as well as on IFC's Indonesian loan and equity portfolio. It should be noted that the then prevailing conglomerate structure of Indonesian corporations complicated the work-out and restructuring process and was easily abused by uncooperative sponsors who wished to divert funds from one subsidiary to another.

4.5 Among the 41 portfolio companies at the onset of the country crisis, 16 required significant restructuring, with 11 successfully restructured into going concerns, while 5 had to be liquidated or sold because of one or more of the following reasons: fraudulent or uncooperative sponsors/management, unreliable judiciary, collapse of the company's market, crop disease (for agribusiness projects), or natural disasters.

Inadequate infrastructure is limiting economic growth; a large role by the private sector in infrastructure investments is necessary but not likely without affirmative actions by the government

4.6 Indonesia has underinvested in infrastructure for over a decade and is facing an infrastructure crisis that will further limit economic growth. Indonesia needs to increase infrastructure investment by the equivalent of at least 2 percentage points of GDP over a sustained period to arrest the decline in infrastructure services. Such investments can be partly financed by the private sector through public-private partnerships. What is needed is to implement clear policies, laws, and regulations to promote such partnerships.

Long-term local currency financing could facilitate private infrastructure investment and the pursuit of IFC's other strategic priorities

4.7 Private corporations, including financial intermediaries, have not yet been able to issue long-term local currency bonds to a significant extent because the existing regulations are too restrictive and uneven. There is a large and increasing demand for highly rated long-term local currency corporate bonds as investment assets by the life insurance industry, the private pension plans, and the mutual fund industry, whose businesses are growing. However, deficient government regulations stand between the demand and supply for long-term local currency corporate bonds. Correction of these regulatory deficiencies will unleash the long-term local currency savings now trapped in low return short-term bank deposits and government securities, and channel most of the savings into highly rated and higher return long-term local currency corporate bonds that will help support fixed asset investments, particularly in infrastructure. Such a development will also allow IFC to offer long-term local currency loans, or to provide guarantees for long-term local currency private sector bond issues, that will increase support for SMEs, social sectors, and other IFC strategic priority sectors in the country. IFC's ability to effectively respond to the demand for long-term local currency financing needs of the non-exporting Indonesian enterprises and projects, including SMEs, will depend largely on whether the required reforms in the long-term bond market, as well as in the investment operations of the nonbank financial sectors, and, in particular, the life insurance and pension industries, materialize in order to allow these industries to invest in highly rated long-term local currency corporate bonds.

Projects in the agribusiness sector have the potential to produce better rural development impacts

4.8 IFC's five pre-crisis agribusiness projects in Indonesia were not originally designed at appraisal to have significant linkages to farmers as sources of agricultural product inputs, relying instead on company-owned plantations as sources of raw materials. In contrast, most of the 11 post-crisis agribusiness projects, particularly the 10 approved during the period FY2003–06, were designed during appraisal to have more supply chain linkages to farmers and SMEs, thereby enhancing their rural development impacts. Agribusiness projects have the potential to produce better rural development impacts when expressly designed at appraisal to have significant linkages to farmers and the rural economy.

Box 4.1: Synopsis of findings and recommendations of the IEG-WB Indonesia Country Assistance Evaluation

The IEG-WB Indonesia Country Assistance Evaluation (CAE) evaluates the World Bank's program in Indonesia during FY1998–2005 overall as moderately satisfactory, based on the rates of achievement of the following four main program objectives or pillars:

- Restoration of growth and investment: The CAE finds the outcomes in this area *moderately satisfactory* relative to the World Bank's objectives. Indonesia's crisis was more severe and lasted longer than in other crisis countries, with the exception of Argentina. This situation highlighted the institutions' weaknesses and the policies that did not recognize these weaknesses. The restoration of growth during 2000–05, though still below pre-crisis levels, has reversed the increase in the poverty rate and the decrease in the income per capita that were caused by the crisis. However, growth has not yet accelerated sufficiently to significantly boost employment and benefit the half of the population earning less than US$2 a day, which *would require a substantial increase in efficient private investment.* However, the investment climate must improve significantly before Indonesia can attract the necessary higher levels of both foreign and domestic private investments. There is still ambivalence in Indonesia about private ownership in infrastructure, and the private sector has not filled the shortfall in infrastructure investments. Indonesia is therefore accumulating a large infrastructure deficit. Finally, the sustainability of growth is a concern and Indonesia's tropical forests, in particular, are at risk of depletion.
- Improving governance and building institutions: The World Bank's advisory and analytical services were the main instruments used to achieve these objectives. Progress toward these, however, has been slow and is rated *moderately satisfactory.* The most troubling obstacles lie in the failure of efforts so far and the absence of a clear strategy to address legal and judicial corruption. Another key objective in the overall governance agenda was to build institutional and managerial capacity in local government units, including the establishment of accountabilities and fiscal arrangements between the central government and the local governments. More progress on these areas is needed.
- Poverty reduction and social service delivery: This is rated *satisfactory.* The World Bank program in the social sectors was modest compared to pre-crisis levels, and was carried out mainly through a series of loans for community-driven development. Between the central government's social programs and the World Bank-supported community-driven social programs there exists a void at the district and provincial levels. Poverty rates have been reduced to pre-crisis levels, although at a slow pace.
- Disaster and natural resources management: Progress on these two objectives is collectively rated as *moderately satisfactory.* Disaster management was not part of the World Bank's objectives in the CASs under review. The tsunami disaster in December 2004, which completely destroyed the provinces of Aceh and Nias, gave rise to requests for disaster management from international donors and the Government of Indonesia. The World Bank coordinated donor assistance and helped manage reconstruction and recovery efforts. The reconstruction of Aceh and Nias is proceeding effectively under the leadership of the new Post-Tsunami Rehabilitation and Reconstruction Authority, which was established with higher standards and salary levels than the regular civil service. Progress on the disaster management objective is, therefore, rated as *satisfactory.* Natural resource management and environmental protection was an objective in the FY2001 CAS and focused on forestry and water resource management through policy advice, institutional capacity building, and anti-corruption efforts. While the FY2004 CAS did not identify natural resource management as a distinct objective or pillar, it showed how this would be addressed through the other three objectives or pillars described above. The outcome under this objective is rated *moderately satisfactory,* despite lack of progress in the forestry sector.

The CAE recommends that the World Bank enhance its strategic focus by defining more specific outcomes and focusing on cross-sectoral efforts on the achievement of those outcomes, with the main objective of reducing the proportion of the population living in extreme poverty and the large population that remains economically vulnerable. This, in turn, *will require more efficient investments in both physical and human capital.*

IFC's two SME-oriented commercial bank projects successfully provided financing to a large number of SMEs

4.9 IFC's financial support to SMEs through projects with two SME-oriented financial intermediaries has been largely successful in reaching a significant number of SMEs. The key to this success was the SME focus of the financial intermediaries, coupled with IFC equity, loan, and advisory services. While Indonesia has the most extensive network of non-profit and for-profit microfinance providers among developing countries, SMEs in Indonesia still have difficulties accessing financing, partly because of unclear land titles and the collateral requirements for loans, and partly because most commercial banks prefer to serve larger corporations, which are more profitable and less labor intensive to serve, and to invest funds in government securities, which provide an acceptable profit margin above the savings deposit rates. Thus, there is still a large scope for improving SMEs' access to financing in Indonesia.

Environmental, health, and social performance below IFC average

4.10 The Indonesian portfolio's below-average rating for environmental, health, and social (EHS) compliance may be partly explained by its sector composition. Indonesian real sector projects were carried out mainly in the agribusiness, general manufacturing, and chemicals sectors—three sector groups that have below average EHS ratings IFC-wide. In contrast, infrastructure projects IFC-wide have above-average EHS ratings, but these make up only a very small proportion of the Indonesian portfolio. Nonetheless, six years into the post-crisis subperiod should have provided more than enough time for IFC to take actions to improve the EHS performance of its Indonesian portfolio. To ensure better EHS supervision and performance of projects in the future, IFC revised, and in early 2006 received Board approval for, its safeguard policies, standards, and procedures. IFC also decentralized its operations to field offices and established a "mainstreaming EHS" initiative, which requires that investment officers understand IFC's EHS policies, standards, and procedures and be able to assist the staff of the Environmental and Social Development Department (CES) in supervising EHS compliance and other EHS oversight functions.

Most of IFC advisory services operations in Indonesia were established too recently to be evaluated

4.11 Most of IFC's Advisory Services in Indonesia were established too recently to be evaluated. However, the PENSA mid-term review, the supervision self-ratings by staff for 35 ongoing advisory services projects, the validated self-ratings for nine completed advisory services projects, when all taken together, indicate that adjustments to the Indonesia advisory services program and/or its implementation may be warranted. IFC consolidated the five original regional offices into three in order to increase efficiencies and because much of the work had shifted to Jakarta. Prior to this consolidation, IFC added offices in Aceh and Nias to assist in the post-tsunami economic recovery in these two areas.

Increases in IFC staff in Indonesia in anticipation of growth in operations poses risks

4.12 IFC has increased its operational staff capacity in Indonesia (in terms of investment officers and analysts, but excluding staff dedicated to restructuring efforts) through local recruitment, initially to replace departing Special Operations Department staff who supervised the problem projects, and subsequently in anticipation of higher levels of investment operations. There is a risk to IFC that if reforms in the infrastructure sectors and the financial sectors that are required to attract higher levels of private sector investments do not materialize, IFC could find itself over-staffed in Indonesia.

Implications, challenges, and opportunities for IFC going forward

4.13 The IEG-WB CAE, (see box 4.1) finds that to reduce the percentage of people in poverty and in vulnerable economic conditions, Indonesia will need to substantially increase efficient investments, particularly by the private sector, in both physical and human capital. Improving access to economic opportunities by the poor and the economically vulnerable, partly through higher levels of private sector investments, is therefore essential for the success of the WBG's development aspirations for Indonesia. Indonesia's private sector development needs and IFC's strategic priorities for its middle-income country clients share substantial common ground, which provides the strategic base for an important IFC role going forward in supporting further private sector development in the country. The major areas of country need which match IFC's own corporate strategic priorities include: (i) infrastructure development, particularly in the electricity subsector; (ii) development of a long-term local-currency corporate bond (debt) market; (iii) development of environmentally and socially sustainable mineral extractive industries and forestry industries; (iv) enhancement of the rural development impacts of agribusiness operations; and (v) support for the development of SMEs, in particular their access to local currency loans and other financial services. Indonesia has considerably underinvested in infrastructure development since the start of the Asian Crisis, and infrastructure constraints are further limiting economic growth. The lack of access to long-term local currency loans is also limiting the investment and growth of non-exporting enterprises that are averse to taking on foreign currency loans with their significant attendant exchange rate risks. The environmental sustainability of Indonesia's mining and forestry industries has reached crisis levels and could further limit the opportunities for more investment in these industries. IFC needs to partner with the World Bank and other development institutions to encourage further reforms that will reduce the impediments to, and stimulate, higher levels of private sector investment.

4.14 Indonesia needs to enhance the efficiency of its businesses in order to compete in a global economy, create employment, and sustain economic growth. Two areas of inefficiency and/or lack of capacity are the infrastructure sectors and the financial market sector. Despite substantial government subsidies for energy and transport, the lack of transport and electricity capacity translates to higher costs for infrastructure services or their alternatives (such as self-generation of electricity by businesses). Notwithstanding the progress made in stabilizing and privatizing the commercial banking sector, it cannot yet function as an efficient or competitive intermediary between savers and commercial borrowers. Two challenges faced by the Government and the international development aid institutions active in Indonesia (and on which consensus must be reached so that actions can be taken) are the need for more and better infrastructure services and the need for more long-term local currency financing by businesses. The World Bank has produced a detailed report on infrastructure-related reforms and regulations that are needed, and another report on the reforms and regulations needed to develop the non-bank financial markets, that among others, will help create a long-term local currency bond market. The government has also passed laws reforming the financial markets, although important regulatory issues still need to be addressed. What is needed now is action toward implementation. The World Bank Group, and IFC in particular, have important roles to play in these endeavors. However, it is not sufficient for the World Bank, IFC, and MIGA to cooperate, but also for the government to mobilize political support for such reforms, particularly in the area of infrastructure.

Responding to client and country needs for long-term local currency loans

4.15 Indonesian businesses have limited access to long-term financing, and the long-term financing that is available is typically reserved for the largest and more established companies. Foreign banks have been steadily entering the Indonesian market via acquisition and partnering, but have been cautious in their lending operations. One of the main issues banks face in Indonesia today is that of maturity mismatches. This is the same issue facing domestic insurance and pension funds and is similar to the pre-crisis lending environment.

4.16 During the period preceding the crisis, large Indonesian corporations had easy access to foreign loans because of the perceived stability of the *Rupiah* and the low international interest rates that made foreign loans attractive. In addition, local commercial banks had insufficient lending capacity to meet the needs of their clients. This was partly caused by the fact that there was little confidence in the banking system, which was dominated by state-owned banks; the lack of confidence in turn hampered the banks' ability to attract a significant deposit base. As a result, the larger corporations, including state-owned enterprises, became dependent on foreign debts. In the period leading up to the country crisis, the average term of foreign debt began to shorten and up until July 1997, borrowers had grown accustomed to rolling over these short-term obligations as the preceding period instilled a sense of security due, in part, to a large differential in domestic and international interest rates and a predictable exchange rate.

4.17 IFC could use credit guarantees to support bond offerings of well-run and reasonably capitalized Indonesian corporations. This is, however, only a quick fix for a much larger challenge of deepening the capital markets. Recently, IFC extended relatively long-term financing to one of the larger commercial banks (five-year payback with an initial two-year grace period). The loan is denominated in *Rupiah* and could serve as a demonstration to other potential providers of medium- and long-term local currency financing. IFC provided the financing with the understanding that the borrower would in turn offer medium-term financing to local SMEs. As the capital markets continue to develop, and if the *Rupiah* remains relatively stable, it will become increasingly easier to offer local currency debt.

Responding to client and country needs for better infrastructure services

4.18 Many private sector companies are not able to rely on the national grid for steady power supply and are responding by investing in captive power plants. IFC financed several of these projects and they have been quite successful in assisting in the growth of operations; two recent examples are Indorama and Pacific Viscose. From a financial perspective, this strategy is not available to small companies that have limited access to capital and are therefore reliant on the national grid. This places them at a disadvantage.

4.19 Two of IFC's investments in captive power generation are located east of Jakarta in the town of Purwakarta. Under the Suharto regime, Purwakarta was selected to be center of textile production, mainly because of a local dam project that would provide a steady supply of water and power. However, as time went on, it became clear that the power supply to the growing region was unreliable. As a result, the larger manufactures realized that there was a need for a dedicated supply of power. This need was particularly critical for manufacturers that concentrated on exports and were competing in the international markets.

4.20 Although captive plants are viable short-term fixes to the current unreliable power supply, their proliferation could be a disincentive for eventual private participation in large-scale power generation. This is because the large-scale industrial consumers, which are the most attractive segment of the utility's customer base, will continue to shrink, leaving a disproportionate number of residential consumers. Not only is it more expensive to service and collect from these customers, but there are often government-mandated tariff structures that require the delivery of power at below-market rates.

4.21 Telecommunication services received some positive attention in the post-crisis period when a new law adopted in 1999 fostered the progressive introduction of competition in all market segments. The resulting growth in the number of mobile subscribers since 1997 has been accompanied by solid increases in the number of fixed lines in service, public payphones, teleshops, and internet shops. Nonetheless, Indonesia continues to have a very low telephone density rate (4 percent in 2002) and poor rural coverage.[1]

Scaling-up and diversifying agribusiness operations to assist WBG strategies for rural development

4.22 IFC's major agribusiness investment activities mainly focused on rubber, palm oil, and banana plantations, all for export. However, IFC was also active in downstream agricultural processing and manufacturing. Investments ranged from slaughtering and meat processing and seafood processing to packaging and palm oil processing. The large pre-crisis plantation projects were not designed to have significant linkages with independent farmers or the rural economy, other than as a source of employment. However, the large post-crisis agribusiness projects have been designed to use raw material supplies from farmers as well as other linkages with MSMEs in the supply chain.

Continuing support to SMEs

4.23 Indonesia is no newcomer to microfinance and is the home of microfinance institutions that have been in operation for over 100 years. The microfinance industry in Indonesia is characterized by its commercial nature.[2] Deposit mobilization is high, particularly in rural areas; Bank Dagang Bali (BDB), for example, has a deposit-to-loan ratio of more than 300 percent. According to an Asian Development Bank (ADB) report, the rural poor tend to value safety, liquidity, and convenience with respect to factors that drive their banking needs. Low-income households typically require savings instruments that enable them to manage household liquidity.

4.24 At the other end of the spectrum are the large commercial banks, which have been restructured since the crisis and have been steadily gaining strength. The Bank of Indonesia has been steadily raising capitalization requirements for the banks with the intention of encouraging the merger of smaller, thinly capitalized banks with their larger peers.

4.25 IFC has supported three "second-tier" or medium-sized banks as SME lenders, and two have been successful in their SME outreach. However, most of the other commercial banks tend to "cherry pick" SME customers who have good collateral and these banks are limited as to how far down the credit curve they will go, given that small enterprises and most medium enterprises do not have the quality and amount of collateral required by the banks. Development and regulatory acceptance of efficient credit scoring and cash flow lending techniques will enable more banks to broaden and deepen their SME reach.

Improving EHS compliance of the Indonesian portfolio

4.26 With six years of post-crisis recovery efforts, there is no reason for IFC's Indonesia portfolio to have a below-average EHS compliance rate. Better EHS supervision by IFC is the key to better compliance, particularly in the absence of strong local EHS regulatory institutions and enforcement. The global/local initiative of IFC is expected also to decentralize the EHS specialist staff that could, in combination with the EHS mainstreaming initiative, strengthen the EHS supervision efforts.

Conclusion

4.27 In summary, the major areas of country needs that match IFC's own corporate strategic priorities include: (i) infrastructure development, particularly in the electricity subsector; (ii) development of a long-term local-currency corporate bond (debt) market; (iii) development of environmentally and socially sustainable mineral extractive industries and forestry industries; (iv) enhancement of the rural development impacts of agribusiness operations; and (v) support for development of SMEs, in particular their access to local-currency loans and other financial services. IFC can, therefore, help Indonesia in several areas in need of more investment and, in particular, private sector involvement.

5. Recommendations

5.1 IFC can help Indonesia expand the role of the private sector in infrastructure development by advocating public-private partnerships with more transparent contracting practices, and partner with the World Bank and other MDBs to pursue contracting process reforms.

Background

Indonesia has underinvested in infrastructure since the country crisis and infrastructure constraints are limiting economic growth. A larger private sector role in infrastructure through public-private partnerships is the best solution, but will not happen without adoption of more transparent and politically sustainable contracting practices (paragraphs 4.6, 4.13-4.14, 4.18-4.21; box 4.1).

Recommendation 1

IFC can help enlarge the role of the private sector in infrastructure development by advocating more transparent contracting practices and by partnering with the World Bank and other MDBs to pursue contracting process reforms to make these transparent and politically sustainable.

5.2 IFC can help Indonesia develop its long-term local-currency debt market. To do so, IFC can work with the World Bank and other development partners to encourage reforms in the bond market and the asset management aspects of the life insurance and pension systems.

Background

Although the government has issued large volumes of long-term local-currency bonds, the corporate sector has not been able to do so because of incomplete reforms in the bond market and the asset management aspects of the life insurance and the pension industries. Long-term local-currency loans and bonds are: (a) essential financing sources with which most non-exporting business investments and infrastructure projects can reduce the foreign exchange risks associated with long-term foreign currency loans; and (b) essential for developing foreign currency hedging products that local businesses will need to compete globally (paragraphs 4.2, 4.7, 4.13-4.17).

Recommendation 2

IFC can focus on helping Indonesia develop a long-term local-currency debt market, but to do so, it needs to work with the World Bank and other development partners to encourage further reforms in the bond market and the life insurance and pension systems.

5.3 IFC can scale up and diversify its agribusiness project operations and continue to focus on stronger supply chain linkages with SMEs, farmers, and rural development, while insuring sustainable EHS practices.

Background

IFC has designed most of its post-crisis agribusiness projects to have significant supply chain linkages, particularly to the rural economy. This supports rural development and poverty reduction. There is significant potential for scaling up of such operations in Indonesia, while ensuring sustainable EHS practices (paragraphs 4.8, 4.13, 4.22).

Recommendation 3

IFC can scale up and diversify its agribusiness project operations and continue to focus on stronger linkages with SMEs, farmers, and rural communities, while ensuring sustainable EHS practices.

5.4 IFC can support more SMEs in underserved regions of the country through regional SME-oriented commercial banks.

Background

Indonesian SMEs continue to have difficulties accessing financial services from the banking system. IFC has supported two SME-oriented commercial banks that have achieved both a large SME outreach and sustainable operations. These types of projects can be replicated in other regions of the country where SMEs continue to have major difficulties in accessing financial services from the banking system (paragraphs 4.2, 4.7, 4.9, 4.13, 4.17, 4.23-4.25).

Recommendation 4

IFC can scale up its support to SMEs in underserved regions of the country through regional SME-oriented commercial banks.

5.5 IFC can improve EHS compliance of its Indonesian portfolio.

Background

The EHS compliance rate of the Indonesian portfolio is below IFC average. With six years having passed since the end of the country crisis, there is no reason for this to continue. Better EHS supervision by IFC is necessary (paragraphs 4.10, 4.13, 4.26).

Recommendation 5

IFC can improve the EHS compliance rate of the Indonesian portfolio with better EHS supervision.

Appendices

Appendix A: List of Indonesia Investment Operations: 1990-2006

Project Short Name	Approval FY	Commit-ment FY	Project Id	Project Status Name	Project Size	Greenfield Expansion Code	IFC Sector	B LOAN	NET LOAN	NET EQUITY	Total Net Commitment
PT ASTRA 1	1990	1990	1153	Active	117,000	E	Industrial Products	0	0	12,500	12,500
NOMURA JAK. FUND	1990	1990	1180	Closed	30,000	G	Funds	0	0	2,998	2,998
BANK NIAGA-AL	1990	1990	2205	Closed	15,000	G	Finance	0	4,300	0	4,300
BANK UMUM-AL	1990	1990	2207	Closed	20,000	E	Finance	0	10,000	0	10,000
RAJA BLOCKS	1990	1991	2208	Closed	32,600	G	Extractive	0	0	1,878	1,878
PT INDO-RAMA	1990	1990	2211	Closed	74,000	E	Textiles	0	12,000	0	12,000
PT ARGO PANTES	1991	1991	2212	Closed	140,000	E	Textiles	53,000	30,000	13,000	43,000
PT KIA	1992	1992	2217	Active	23,700	E	Cement & Construction	10,000	5,400	1,573	6,973
PT ASAHI CHEMICA	1991	1992	2445	Closed	23,000	E	Textiles	0	4,000	1,441	5,441
PT BAKRIE KASEI	1992	1992	2466	Closed	335,100	G	Chemicals	95,000	30,000	9,630	39,630
PT INDO-RAMA II	1991	1991	2566	Active	54,700	E	Textiles	0	15,000	6,175	21,175
SEAVI Indonesia	1991	1993	2580	Closed	5,000	G	Funds	0	0	1,500	1,500
PT RIMBA PARTIKE	1991	1992	2643	Closed	40,400	G	Industrial Products	10,000	9,624	600	10,224
PT ASTRA BOND	1991	1991	2670	Closed	125,000	E	Industrial Products	0	0	9,850	9,850
PT SAMUDERA	1993	1993	2986	Closed	54,700	E	Infrastructure	3,000	12,000	5,000	17,000
PT SWADHARMA	1992	1992	2995	Closed	177,000	G	Tourism	51,000	35,000	0	35,000
NIAG-PT NUSANTA	1992	closed	2205	Closed	15,000	E	Tourism	0	0	0	0
PT MITRACORP	1992	1993	3116	Closed	208,000	E	Technical Services	0	15,870	0	15,870

Project Short Name	Approval FY	Commit-ment FY	Project Id	Project Status Name	Project Size	Greenfield Expansion Code	IFC Sector	B LOAN	NET LOAN	NET EQUITY	Total Net Commitment
ING-MLF1-PT CITR	1993	closed	1205	Closed	62,500	E	Technical Services	0	2,000	0	2,000
PT VISCOSE	1992	1993	3306	Closed	92,000	E	Chemicals	25,000	20,000	0	20,000
PT B. Danatama 1	1993	1993	3405	Active	15,000	E	Finance	0	5,000	0	5,000
PT NUSANTARA	1993	1993	3484	Active	31,400	G	Food & Agribusiness	7,000	8,578	0	8,578
PT SARIPURI 2	1994	1994	3504	Closed	68,000	G	Tourism	24,000	8,000	0	8,000
PT BAKRIE PIPE	1995	1995	3745	Closed	99,500	E	Metals	0	37,295	0	37,295
PT HOTEL SANTIKA	1995	1996	3828	Closed	40,000	E	Tourism	0	11,750	0	11,750
PRUDENTIAL ASIA	1994	1994	4174	Closed	45,000	G	Funds	0	0	4,185	4,185
SASEKA Restruct	1993	1994	3835	Closed	12,200	E	Finance	0	1,520	0	1,520
ING-PT KABIL	1993	closed	1205	Closed	62,500	E	Technical Services	0	0	0	0
BAKRIE KASEI II	1995	1995	4020	Closed	210,000	E	Chemicals	0	30,000	3,000	33,000
P.T. BAKRIE PET	1995	1995	4021	Closed	68,900	G	Chemicals	0	12,000	2,000	14,000
KDLC BALI	1994	1994	4060	Closed	44,700	G	Finance	0	15,000	1,151	16,151
PT PAMA	1994	1994	4174	Closed	4,990	G	Funds	0	0	713	713
PAMA Mgmt	1994	1994	4174	Closed	10	G	Funds	0	0	1	1
PT INDORAMA III	1995	1995	4375	Active	279,400	E	Textiles	67,500	30,000	2,540	32,540
PT CITIMAS CAPITAL	1995	1995	4390	Closed	9,100	G	Finance	0	0	1,348	1,348
NAIG-PT SINAR	1994	closed	2205	Closed	15,000	E	Food & Agribusiness	0	0	0	0
LYON-MLF-IBIS HL	1994	closed	2434	Closed	5,400	G	Tourism	0	0	0	0
PT ASTRA - RI	1994	1994	4505	Active	320,000	E	Industrial Products	0	0	10,999	10,999
PT LANTAI-RI	1994	1994	4528	Active	9,500	E	Cement & Construction	0	0	1,404	1,404
PT MITRACORP RI	1994	1995	4648	Closed	46,500	E	Technical Services	0	2,796	4,113	6,909
BUNAS FINANCE	1995	1995	4664	Closed	16,000	G	Finance	6,000	10,000	0	10,000
PT VISCOSE II	1995	1996	4711	Active	127,000	E	Chemicals	35,000	25,000	0	25,000
PT KIA SERPIH II	1995	1995	4891	Active	106,100	E	Cement & Construction	55,000	15,000	6,240	21,240
PT KSP	1997	1997	4973	Active	161,500	E	Food & Agribusiness	6,000	20,000	15,000	35,000

Project Short Name	Approval FY	Commit-ment FY	Project Id	Project Status Name	Project Size	Greenfield Expansion Code	IFC Sector	B LOAN	NET LOAN	NET EQUITY	Total Net Commitment
PT DHARMALA	1996	1996	5065	Active	66,000	E	Food & Agribusiness	15,000	20,000	0	20,000
PANCA FINANCE	1995	1995	5106	Active	17,400	E	Finance	8,000	6,000	1,928	7,928
Lippo-Siloam	1996	1997	7023	Closed	48,000	G	Health	10,300	11,900	0	11,900
PT KIA Keramik	1996	1996	7101	Active	173,500	E	Cement & Construction	81,000	16,509	6,213	22,722
Pramindo	1996	1997	7108	Closed	624,156	E	Infrastructure	300,000	50,000	3,937	53,937
PT B. Danatama 2	1996	1996	7109	Active	50,000	E	Finance	35,000	15,000	0	15,000
PT Bank NISP	1997	1998	7497	Closed	5,000	E	Finance	0	10,000	0	10,000
P.T. Sayap	1997	1998	7508	Active	62,100	G	Chemicals	27,990	10,002	0	10,002
PT Alumindo - 2	1997	1997	7789	Active	97,400	E	Metals	20,000	15,000	0	15,000
BKC/BKP Restructuring	1997	1998	2466	Closed	0	E	Chemicals	0	0	2,000	2,000
PT BLT	1997	1998	7978	Active	120,000	E	Infrastructure	68,000	8,152	20,000	28,152
PT Grahawita	1997	Sub-project	3828	Active	0	E	Tourism	0	0	0	0
Astra Graphia	1997	closed	3116	Closed	2,560	E	Technical Services	0	0	2,530	2,530
PT Ades Alfindo	1997	1998	8275	Closed	97,400	E	Food & Agribusiness	46,000	10,286	3,679	13,965
P.T. Megaplast	1998	1999	8377	Active	56,000	E	Plastics & Rubber	0	8,750	2,500	11,250
P.T. Wings	1997	1998	7508	Active	58,700	G	Chemicals	27,010	8,682	0	8,682
Astra Otoparts	1997	restr	3116	Active	1,800	E	Industrial Products	0	0	0	0
P.T. Karabha	1997	restr	3116	Active	17,000	E	Trade	0	0	0	0
P.T. Indorama	1999	1999	8960	Closed	30,000	E	Textiles	0	30,000	0	30,000
ITCF	canceled	2000	8995	Closed	140,000	G	Finance	0	0	0	0
SMP PT Indorama	1999	1999	9455	Active	3,500	E	Textiles	0	0	3,089	3,089
NISP Equity	2000	2001	9613	Active	5,000	E	Finance	0	0	5,000	5,000
ITF-SCB	2001	2001	9984	Closed	125,000	G	Finance	0	0	0	0
Dianlia	2001	2001	9987	Closed	10,400	E	Extractive	0	0	0	0
Wings Oil Palm	2002	2003	10233	Active	49,000	E	Food & Agribusiness	10,000	11,500	0	11,500
Ciluluk Village	2000	2001	10308	Closed	45	E	Textiles	0	39	0	39

Project Short Name	Approval FY	Commit-ment FY	Project Id	Project Status Name	Project Size	Greenfield Expansion Code	IFC Sector	B LOAN	NET LOAN	NET EQUITY	Total Net Commitment
Sunson	2001	2002	10310	Active	36,100	E	Textiles	8,249	12,407	0	12,407
PT Makro RI	2000	2000	10395	Active	42,500	E	Trade	0	0	1,333	1,333
ITF-SB	2001	2001	10609	Closed	125,000	G	Finance	0	0	0	0
Indorama Facility	2001	2001	8960	Active	203,000	E	Textiles	0	20,000	0	20,000
Sigma Group	2001	2001	10737	Active	6,500	E	Technical Services	0	0	3,000	3,000
Astra Otoparts 2	2005	2005	10771	Active	53,700	E	Industrial Products	0	24,000	0	24,000
NISP RI	2002	2002	11652	Active	35,000	E	Finance	0	0	3,629	3,629
Indorama Swap II	2003	2003	10633	Active	23,050	E	Textiles	0	5,000	0	5,000
Ecogreen	2004	2004	8414	Active	80,000	G	Chemicals	0	30,000	0	30,000
Verdaine	2003	2003	20103	Closed	200,000	G	Food & Agribusiness	0	14,000	0	14,000
Buana Bank	2003	2003	20300	Closed	20,000	G	Finance	0	0	15,361	15,361
PT Astra-RI	2003	2003	20309	Active	150,000	E	Industrial Products	0	0	3,568	3,568
Wilmar Trading	2004	2004	20348	Active	33,330	G	Food & Agribusiness	0	33,000	0	33,000
SMM	2003	2003	20103	Closed	0	G	Food & Agribusiness	0	9,000	0	9,000
Indorama Captive	2004	2005	8960	Active	67,000	G	Textiles	0	48,000	0	48,000
SPV III	2004	2004	21967	Active	20,000	E	Textiles	0	9,500	0	9,500
NISP Bussan	2005	2005	9613	Closed	54,000	G	Finance	0	25,000	0	25,000
NISP Bank II	2004	2004	22962	Active	35,000	E	Finance	0	35,000	0	35,000
Wings Noodle-PAS	2004	2004	7508	Active	0	G	Food & Agribusiness	4,800	16,900	0	16,900
Medan NP School	2004	2004	20562	Active	0	G	Education	0	1,750	0	1,750
BonaVista School	2004	2004	20562	Active	0	G	Education	0	1,000	0	1,000
Wings Noodle-KAS	2004	2004	23013	Closed	100,500	G	Food & Agribusiness	5,200	18,100	0	18,100
ANJ Finance	2005	2005	23896	Active	20,000	G	Finance	0	2,000	0	2,000
Ecogreen II	2005	2005	11696	Active	50,000	G	Chemicals	0	25,000	0	25,000
PT WOM/BII	2005	2005	24050	Active	23,000	G	Finance	0	0	20,000	20,000
KSP - Euromax	Sub-project	Sub-project	4973	Active	0	E	Food & Agribusiness	0	0	0	0

Project Short Name	Approval FY	Commit-ment FY	Project Id	Project Status Name	Project Size	Greenfield Expansion Code	IFC Sector	B LOAN	NET LOAN	NET EQUITY	Total Net Commitment
Bank Buana SWAP	2006	2006	20300	Active	0	E	Finance	0	5,000	0	5,000
Bank Danamon Tbk	2006	2006	24524	Active	200,000	G	Finance	0	150,000	0	150,000
Centralpertiwi	2006	2006	24558	Active	0	E	Food & Agribusiness	0	45,000	0	45,000
PT KAS	Sub-project	Sub-project	23680	Active	0	G	Food & Agribusiness	0	0	0	0
Wings Noodle II	2006	2006	24849	Active	0	G	Food & Agribusiness	0	20,000	0	20,000
Danamon Swap	2006	2006	24524	Active	0	E	Finance	0	5,000	0	5,000
Wings - TAS	2006	2006	24904	Active	15,000	G	Food & Agribusiness	0	7,000	0	7,000
PT Makro RI 2	2006	2006	25109	Active	0	E	Trade	0	0	648	648
103 operations								**1,114M**	**1,219M**	**217M**	**1,436M**

`*Note:* The 103 transactions consist of 76 project investments; 8 equity rights issue; 11 financing operations related to restructurings; 1 project cancelled after 4 years of operation; 2 cancelled and undisbursed projects; and 5 transactions related to supplemental financing either for project scope changes or changes in financing plan.
Source: International Finance Corporation

Appendix B: List of IFC Advisory Services in Indonesia

FACILITY	Project Name	Fiscal Year	Sector Group Name	Estimated Total Funding
PENSA	Integrated Poultry	2005	Agribusiness	**1,000,000**
PENSA	Cocoa	2005	Agribusiness	**850,000**
PENSA	Business Development Services Provider Support	2005	Finance	**800,000**
PENSA	Business Association Development	2005	Technical services	**52,000**
PENSA	Bank and Finance Training	2005	Finance	**325,000**
PENSA	Commercial Bank Capacity Building	2005	Finance	**250,000**
PENSA	PEAC (Provision of Enterprise Access to Credit)	2005	Finance	**360,000**
PENSA	PENSA ADB Projects	2005	Agribusiness	**$500,000**
PENSA	Seaweed Industry Linkages Program	2005	Agribusiness	**$1,518,000**
PENSA	OGM/SME Business Linkage Development	2005	Extractive	**$1,168,500**
PENSA	OGM Enabling Environment Support	2005	Extractive	**$657,500**
PENSA	Eco-Tourism	2005	Tourism	**$465,000**
PENSA	Handicraft Producer Development	2005	Manufacturing	**$887,364**
PENSA	Indo SME Banking	2005	Finance	**$6,000,000**
PENSA	Sustainable Wood	2005	Agribusiness	**$1,155,000**
PENSA	Access to Finance Policy : BPRs/MFIs & Collateral & Leasing	2005	Finance	**$148,845**
PENSA	Sharia Banking Development	2005	Finance	**$200,000**
PENSA	Microfinance & Alternative Channels	2005	Finance	**$1,224,000**
PENSA	Access to Finance for Women	2005	Finance	**$200,000**
PENSA	Handicraft Market Linkages	2006	Manufacturing	**$594,522**
PENSA	Sustainable Finance New Ventures	2006	Technical services	**$132,253**

FACILITY	Project Name	Fiscal Year	Sector Group Name	Estimated Total Funding
PENSA	ADB Marine Aquarium Fish	2006	Technical services	**$192,380**
PENSA	Municipal Simplification	2006	Technical services	**$430,150**
PENSA	SME Tool Kit	2006	Information	**$49,000**
PENSA	Business to Business Directory	2006	Information	**$31,000**
PENSA	Women & Business	2006	Technical services	**$69,979**
PENSA	National Level Policy Reform	2006	Technical services	**$100,000**
PENSA	Aceh Investment Promotion (SUBCOMPONENT OF 540423)	2006	Technical services	**$167,000**
PENSA	CCF PENSA Forest	2006	Agribusiness	**$61,016**
PENSA	SRsp PENSA Sustainable Seaweed (CCF PENSASeaweed)	2006	Agribusiness	**$69,680**
PENSA	Indonesia - Sub-National Investment Promotion Intermediaries	2006	Technical services	**158,000**
PENSA	National OSS Guidelines	2006	Technical services	**400,000**
PENSA	Aceh World Hotel Link	2006	Tourism	**43,600**
FMTAAS	Global Credit Bureau Program	2003	Finance	**$125,000**
FMTAAS	PT Bank NISP	2002	Finance	**$368,000**
FMTAAS	PT NISP TA Strengthening	2002	Finance	**$170,000**
FIAS	Promotion strategy	1990	Agribusiness	**80,000**
FIAS	Institutions	1991	Technical services	**80,000**
FIAS	Investment policy	1995	Technical services	**80,000**
FIAS	Backward linkages	1995	Technical services	**20,900**
FIAS	Backward linkages II	1996	Technical services	**179,000**
FIAS	Institutions: FDI database	1996	Technical services	**221,680**
FIAS	Administrative Barriers	1998	Technical services	**125,000**
FIAS	Investment policy: Approvals/Licenses	1999	Technical services	**113,300**
FIAS	Administrative Barriers	2000	Technical services	**93,600**
FIAS	Investment policy/Institutions	2001	Technical services	**35,400**
FIAS	Diagnostic	2001	Technical services	**28,340**

FACILITY	Project Name	Fiscal Year	Sector Group Name	Estimated Total Funding
FIAS	Investment policy: Law	2002	Technical services	**3,000**
FIAS	Starting a Business International Comparisons	2005	Technical services	**$15,000**
FIAS	Mini Diagnostic	2006	Technical services	**$47,000**
FIAS	Sector Policy Solution Design (shrimp and textiles)	2006	Technical services	**$190,000**
FIAS	Linkages Mining	2006	Extractive	**$70,000**
FIAS	Investment Law Implementing Decrees	2006	Technical services	**$125,000**
FIAS	Investment Incentives Review (small project)	2006	Technical services	**$15,000**
FIAS	Aceh Investment Law	2006	Technical services	**$85,000**
FIAS	Investment Law Decrees	2006	Technical services	**$125,000**
FIAS	Administrative Barriers: Redesign of Implementation project for East Indonesia	2001	Technical services	**28,340**
FIAS	Institutions: National Investment Team	2003	Technical services	**30,000**
FIAS	FOREST MNGMT-INS	2006	Agribusiness	**126,150**
TATF	TOGNANA/KIA Porcelain/Ceramic Tableware Project	1990	Cement & Construction	**85,000**
TATF	Paddy Straw Mushroom Pilot Operation (Hi Tech, Controlled Climate)	1990	Agribusiness	**50,000**
TATF	GEMCO/PT Granada Alloy Iron & Steel Foundry: Feasibility Study (INS-RR01#502830)	1991	Manufacturing	**80,000**
TATF	FABRIK KERTAS TJIWI KIMIA Pulp/Paper Mill: Study on Environmental and Social Factors	1993	Pulp & Paper	**50,277**
TATF	PT ARGO PANTES Textiles: Technical Assessment of Modernization Options	1994	Textiles	**77,519**
TATF	LIPPO/GLENEAGLES Hospital Project	1994	Health	**50,277**
TATF	Diversified Ceramic Tiles Manufacturing (INS-VV01#502648)	1995	Cement & Construction	**37,500**
TATF	Conversion of Pineapple Wastes to Methane	1996	Chemicals	**86,000**
TATF	Corporate Restructuring Initiatives	2000	Finance	**462,000**
TATF	Trade Enhancement Facility	1999	Finance	**265,100**
TATF	Study of Private Investment Opportunities in the Health Care Sector	2000	Health	**70,000**

FACILITY	Project Name	Fiscal Year	Sector Group Name	Estimated Total Funding
TATF	Study of an Indonesian Cellular Operator's NMT 450 Analog Network (MOBISEL)	2000	Information	**20,000**
TATF	Tayan Bauxite / Alumina Refinery Development (INS-0401)	2000	Manufacturing	**150,000**
TATF	Provision of Business Development Services (BDS)	2001	Technical services	**100,000**
TATF	Eastern Islands SME Country Mapping and SME Facility Business Plan (IEDF Indone)	2001	Technical services	**150,000**
TATF	Strengthening Supply Chain Linkages	2003	Extractive	**70,000**
TATF	Indonesia Health Care Sector Study	2006	Health	**$100,000**
TATF	SELF (B) IFC/TATF - INDONESIA SME Credit Line Facility	2006	Finance	**$500,000**
TATF	IFC/JAPAN TATF - Design and Export Promotion Centers in Cambodia and Indonesia	2006	Technical services	**$455,000**
TATF	Disease Control in Shrimp Farming (CPB)	2006	Agribusiness	**$89,000**
TATF	Market Study for Student Financing Pilot in Indonesia	2006	Education	**115,000**
80				**25,902,173**

Source: International Finance Corporation

Appendix C: Indonesia's private sector development needs and IFC's corporate strategic priorities have common grounds

More efficient investments, particularly by the private sector, are needed to reduce poverty in a large portion of the Indonesian population

The Indonesia Country Assistance Evaluation (CAE)[1] by the Independent Evaluation Group – World Bank (IEG-WB) finds that to reduce the large percentage of people still in poverty and who are vulnerable to adverse economic conditions, Indonesia will need to substantially increase efficient investments, particularly by the private sector, in both physical and human capital. Private sector investment can help create opportunities for the poor and economically vulnerable. Improving access to economic opportunities for the poor and the economically vulnerable, partly through higher levels of private sector investments is therefore essential for the success of WBG's development aspirations for Indonesia.

Indonesia's private sector development needs and IFC's strategic priorities for its middle-income country clients have substantial common ground, which provides the strategic basis for IFC's role going forward in supporting further private sector development in the country. The major areas, which match IFC's own corporate strategic priorities the following areas: (i) infrastructure development, particularly in the electricity and the transport industries; (ii) development of a long-term local-currency corporate bond (debt) market; (iii) development of an environmentally and socially sustainable mineral extractive and forestry industries; (iv) enhancing the rural development impacts of agribusiness operations; and (v) supporting the development of SMEs, particularly with regard to their access to local-currency loans and other financial services.

Underinvestment in infrastructure is limiting economic growth

Despite incurring budget deficits during the crisis and post-crisis sub-periods (in contrast to budget surpluses during 1994-97), Indonesia has not invested sufficiently (as a percentage of its GDP) in infra-structure since the crisis began and during the post-crisis sub-period compared to other developing countries as shown in table 1. Rather, Indonesia spent more on education and health, and reduced its sovereign foreign debt (as a percentage of GDP)[2] throughout 2000-06. Furthermore, an increasing proportion of the government debt is in local-currency borrowings, mainly long-term *Rupiah* denominated bonds purchased mainly by local life insurance companies, pension funds, mutual funds, and commercial banks, thereby, partly competing with the private sector, is accessing local-currency loan funds. The consistently low levels of infrastructure investments during and after the crisis up to 2006 is adversely affecting economic growth and the international competitiveness of Indonesia's manufactured exports. In addition, infrastructure investments, particularly transport (land, water and air) and inter-island communications, are needed for the economic and political integration of a multi-island country, such as Indonesia. To prevent the fiscal deficit from increasing, the government substantially reduced subsidies for fuel, electricity, and transport in 2005, although, they were still significant in 2006 and in the planned 2007 budget (see endnote 2). It may be politically difficult to reduce these subsidies further in the near term, limiting the government's ability to pursue both high public sector infrastructure investments and high social spending.

The private sector had a substantial role in infrastructure development during the pre-crisis sub-period, but this role has diminished significantly since the onset of the financial crisis, and had not yet recovered by 2004. Private sector infrastructure investment during 1994-97, which averaged about 1.6 percent of GDP, made up about 41 percent of total infrastructure investment in Indonesia. During 1998-2002, private sector investment in infrastructure had dropped to an average of just 0.7 percent of GDP, accounting for only 27 percent of total infrastructure investment. Finally during 2003-04, private sector investment in infra-structure had dropped further to an average of only 0.4 percent of GDP, accounting for just 13 percent of total infrastructure investments.[3] (see endnote 2 source)

Box 1. Under-investment in infrastructure, and the low level of private sector participation in infrastructure, are challenges for Indonesia

Key Findings on Infrastructure: World Bank's Indonesia Public Expenditure Review 2007:

- Indonesia is investing too little in infrastructure. Indonesia needs to increase infrastructure spending by the equivalent of about 2 percentage points of GDP;
- The water and electricity sectors are in crisis. A decade of low investment has resulted in insufficient capacity and power shortages in the electricity system and deteriorating piped water services;
- Private investment in infrastructure has declined sharply since 1997, particularly in the water, energy and transport sectors. Before the crisis, private sector investment commitments were on average equivalent to 30-40 percent of government development spending for infrastructure. During 2003-04, it declined to less than one-fourth of government spending, despite the low levels of public investment for infrastructure. Since 2000, about 90 percent of private sector investment in infrastructure was in the telecommunication sector. It has been difficult to attract private investment into sectors traditionally dominated by state-owned enterprises due to uncertainties related to the legal system as well as the absence of a government strategy for investment guarantees and contingent liabilities. Other issues, such as the under-pricing of infrastructure services for social and political reasons, have also kept private investment at bay.

Source: Spending for Development: Making the Most of Indonesia's New Opportunities – Indonesia Public Expenditure Review 2007, World Bank (second edition), June 2007, page 74.

The private sector can still play a large role in developing Indonesia's infrastructure in the future. However, the Government of Indonesia is ambivalent about private sector, particularly foreign, ownership or control of infrastructure assets and operations. Likewise, the private sector is not inclined to invest in infrastructure unless the policy, legal and regulatory frameworks are clear and enforceable. The judicial and regulatory authorities must be relied upon to be professional and honest in enforcing laws and regulations. Indonesia (and other developing countries) had learned a bitter lesson in the 1990s about the risks to the government of guaranteeing the minimum revenue of private sector infrastructure projects such as that for electricity supply under build, own and operate supply contracts. However, Indonesia has yet to devise a more balanced risk-sharing alternative that would entice the private sector to undertake infrastructure investments. This has led to an impasse: with Indonesia declaring its desire to attract private sector investment in infrastructure, but with the private sector waiting to see further development of the clear and enforceable policies, laws, regulations and implementing arrangements. This impasse needs to be resolved now, before

Indonesia falls behind further in its capacity to provide infrastructure services, which will continue to unfavorably impact economic growth and international competitiveness.

One hard lesson learned by Indonesian private companies as a result of the crisis, is the importance to avoid a serious mismatch between the currency of an enterprise's revenues and liabilities (i.e., debts) as well as a mismatch between the maturity (or tenor) of its debts and productive life of the assets financed by these debts. The scarcity of long-term local-currency financing has therefore contributed to the reluctance of private enterprises to invest in infrastructure projects, which are long-term investments with local-currency revenues. Such investments are best suited to local-currency financing be it in the form of equity or long-term debt.

The business climate in Indonesia has not yet recovered to the point where investors, both domestic and foreign, are prepared to make large long-term investment commitments in the country. In particular, the absence of a clear policy on foreign ownership of infrastructure assets, the lack of transparency in infrastructure related regulations, and the unclear coordinating mechanisms and processes at various government levels, serve as impediments to a greater private sector role in infrastructure investment. In addition, the cumulative impact of many years of under-investment in infrastructure has created shortages in electricity supply, congestion in transport and lack of water and sewer capacity that further deters private sector investors. A 2004 World Bank report on the state of infrastructure in Indonesia describes the situation in fairly stark terms as shown in box 2 below.

Box 2. Infrastructure services are still not available to a large segment of the Indonesian population

Roughly 90 million people do not have an electricity connection, the vast majority of who are the poor. Only 14 percent of the population is serviced through water utilities and only 1.3 percent has access to a sewage network. Indonesia's fixed-line tele-density (4 percent) reduces its competitiveness, and the lower rural coverage is increasing development disparities. Congestion has increased on the road network, but little capacity has been added. Maintenance of existing stock is neglected, particularly on the district network where almost 50 percent of the roads are classified as in "poor or bad conditions.

Source: Indonesia – Averting an Infrastructure Crisis: A Framework for Policy and Action, World Bank, June 2004

Although multiple laws have been passed to support infrastructure development and investment, many still lack adequate implementing rules and regulations. There also remain some questions about foreign participation in the energy and telecommunications sectors. Additionally, the uncertainty surrounding jurisdictional authority vis-à-vis local, regional and national bodies, provides little incentive for private investment. For example, some infrastructure systems cover multiple local government jurisdictions. The government's decentralization and the general lack of local government institutional capacity has added to the uncertainty in the business climate as it makes coordination across multiple local jurisdictions much more difficult.

Box 3. Indonesia reversed its in initial attempt to increase the private sector role in telecommnunications

The two largest telecoms companies in Indonesia are Telekomunikasi Indonesia (Telkom) and Indosat, which are 65% and 16% state-owned respectively. Although both have some level of private ownership, there remains a 49% cap on foreign ownership of telecoms companies. The sector was formerly a monopoly under Telkom until 1995 when the government attempted to liberalize the sector by issuing five exclusive concessions to private companies to operate basic fixed line telecommunications services in five distinct regions of Indonesia. The projects, called 'KSOs' (Kerja Sama Operasi), were structured as quasi-build-own-operate and transfer (BOOT) projects with annual rental payments to Telkom over a 15-year period. The companies were supposed to transfer all assets to Telkom at no cost at the end of the 15-year period.

Although the KSO implementation represented a positive step towards greater private sector activity and investment in the telecommunications sector, investments and expansions of the KSOs almost ground to a halt in 1998. First, the Asian Crisis caused massive devaluations and a serious economic recession. Second, the changes in the political leadership in the Government led to turmoil within Telkom which permitted forces opposed to the KSO program to obstruct operations. For example, KSO tariff increases to reflect rising costs were denied which caused operating losses, and local KSO managers followed instructions from Telkom rather than from the KSO owners. Given the deterioration of relations between the KSOs and Telkom in addition to the economic, social and political problems in the country, KSO investments in new network capacity virtually stopped.

Private sector investments through the KSO's did not materialize in any substantial extent despite growing market demand due to political issues within the government and Telkom. Therefore, in an effort to encourage new investment and create efficiency in the telecommunications sector, the Government again attempted a second initiative involving a sector restructuring and liberalization plan. As a result, the KSO assets were transferred to Telkom and the government created a duopoly by giving both Telkom and Indosat similar licenses and removing exclusivities in the fixed or land line business segment and allowing a third operator in the wireless or mobile telephone business segment. This was only a minor improvement to the monopoly of pre-1995. In 2005, because Telkom had a substantial majority of both the fixed line and the wireless business segments respectively, and remained the dominant fixed line and wireless telephone service provider. In the mid-2000s, there were a total of 10.2 million fixed-line subscribers, equivalent to just 4.6 fixed lines per 100 people.

In recent years, mobile or wireless telephone subscribers have surpassed fixed-line subscribers because wireless service does not require the same heavy investments in infrastructure. By 2006 the number of mobile subscribers rose to an estimated 65 million, compared to 6.5 million in 2001. Telkomsel, the mobile telephone division of Telkom, is the largest operator and had approximately 35 million subscribers in 2006. Indosat is the second-largest, with 16 million subscribers, followed by Excelcomindo with 9 million.

Personal computer (PC) penetration remains low by regional standards. Data from an industry body, the Indonesian Computer Association, suggest that PC penetration was as low as 11.4 per 1,000 population in 2005. Computers are assembled locally but Chinese-made PCs have recently entered the market and are considerably cheaper than either locally made computers or competing imports from Japan and the US. Interestingly, there are 40 Internet service providers (ISPs) in Indonesia. Of these, 97% are located in Jakarta and provide services such as web-hosting, e-commerce and VoIP (voice over Internet protocol). The use of the Internet for trade transactions is still low. In addition to the low internet penetration rate, the cash-based nature of the Indonesian economy and the low level of credit-card use inhibit the growth in e-commerce. Concerns about the legality of transactions, intellectual property, consumer protection and import duties also deter use of the internet for trade.

IFC has had only two investments in the telecommunications sector in Indonesia since 1990; one with a company that won a KSO concession and the other with a software development company. The combination of challenging geography (densely forested archipelago), the dominance of state-controlled companies and corruption makes Indonesia less attractive to private investors when compared to its peers. As a result, Indonesia has not been at par with technology developments that have been adopted by its neighbors, e.g., the 3G market at the end of 2006 was only 1.7% of entire mobile market. As investment climate fears subside and if liberalization continues in the industry, the sector may once again be attractive to private investors.

Table 1: Indonesia has under-invested in infrastructure (as a percent of GDP) compared to other developing countries

	Average infrastructure investment as percent of average GDP			
Country	**1990-1996**	**1997-1999**	**2000-2006**	**1990-2006**
Jordan	14.8%	15.3%	15.5%	15.0%
Senegal	12.6%	13.3%	15.1%	13.8%
Morocco	13.5%	14.0%	13.3%	13.4%
Egypt	11.4%	10.0%	13.1%	11.9%
South Africa	11.3%	11.3%	11.0%	11.2%
Mexico	10.1%	11.1%	10.9%	10.7%
Croatia	9.3%	10.1%	11.6%	10.4%
Chile	9.2%	9.6%	9.9%	9.6%
Kenya	6.9%	9.5%	10.2%	9.0%
Argentina	8.4%	10.1%	8.6%	8.9%
Philippines	7.5%	8.0%	10.3%	8.8%
Malaysia	8.8%	9.8%	7.9%	8.6%
Tajikistan	6.9%	7.8%	3.5%	8.5%
Thailand	9.6%	10.7%	5.8%	8.3%
South Korea	7.9%	8.2%	8.2%	8.0%
Hungary	9.8%	12.1%	5.4%	7.8%
Indonesia	**7.9%**	**6.9%**	**5.9%**	**6.8%**
Ethiopia	6.2%	6.5%	7.5%	6.7%
Vietnam	3.3%	2.8%	3.2%	5.6%
Venezuela	8.8%	9.0%	8.1%	3.1%

Source: International Finance Corporation

Some recent IFC investments in industrial manufacturing included support for in-house electricity generation by clients because unreliable electricity supply from the grid is causing low capacity utilization of their manufacturing facilities. The unreliable electricity supply has had a negative impact on profitability and competitiveness. Furthermore, there already was 14,600 mega watts (MW) of self-generation capacity in industrial and commercial enterprises in 2005, of which over 60 percent utilizes diesel as fuel. The price of diesel fuel had increased by a total of 175 percent after fuel subsidies were reduced in two steps over the period March to October 2005. The 14,600 MW of self-generation capacity was equivalent to 52 percent of the 27,940 MW installed capacity owned or controlled[4] (see endnote 2 source) by Perusahaan Listrik Negara (PLN) (the government-owned national electricity generating and transmission company) as of the end of 2006. If the trend towards electricity self-generation by manufacturing industries becomes even more widespread, it will be more difficult in the future to develop an efficient regional electricity grid. This is because industrial manufacturing enterprises comprise most of the base-load electricity users;[5] and if they have electricity self-generation capacity, they will need electricity from the regional grid only for back-up power and for peak power demand purposes and not on a regular or base-load basis. This will reduce the average capacity utilization rates of the electricity generating, transmission and distribution supply chain and will result in higher supply costs.

Private sector participation in infrastructure was mainly in electricity generation and in telecommunications

The private sector participation in Indonesia's infrastructure sectors has been mainly in electricity generation and telecommunications, with very little in transport and in water supply and sanitation, as shown in table 2 below. In local currency terms, private sector annual average investment in telecommunications after the crisis increased by about 22 percent above the pre-crisis average, while the combined annual average investment in energy, water and transport decreased by about 38 percent from the pre-crisis level. In US dollar terms, however, private sector participation in all infrastructure sectors decreased after the crisis as shown in the table below. The three sectors– energy (mainly electricity); water and sanitation; and transport are the most critical sectors that require more investment if Indonesia is to achieve the higher GDP growth rate, employment creation, and poverty reduction the government is currently targeting.

Table 2: Private sector participation in infrastructure during and after the crisis decreased in US dollar terms from the pre-crisis levels

		Private sector investments in infrastructure (US$ billions)				
Year	**Average exchange rate *Rp*/USD**	**Energy**	**Water & Sanitation**	**Transport**	**Telecommunications**	**Total**
1994	2,160	0.216		0.109	1.119	1.444
1995	2,247	2.462	0.199	0.270	1.844	4.776
1996	2,336	3.361			1.773	5.134
Annual Average (1994-96)	**2,248**	**2.054**	**0.066**	**0.125**	**1.587**	**3.833**
1997	2,856	2.661	0.127	0.724	0.533	4.046
1998	10,211	0.150	0.287		0.040	0.477
1999	7,867	0.124		1.020	0.480	1.625
Annual Average (1997-99)	**6,978**	**0.483**	**0.157**	**0.482**	**0.273**	**1.395**
2000	8,397				0.156	0.156
2001	10,245		0.037		0.879	0.916
2002	9,333	0.207		0.648	1.801	2.656
2003	8,577				0.932	0.932
2004	8,932	0.121		0.003	0.898	1.023
Annual Average (2000-04)	**9,097**	**0.066**	**0.008**	**0.134**	**0.949**	**1.157**
Cumulative Average 1994-2004	73,162	0.369	0.056	0.233	0.814	1.472
As a percent of Total		**25.0%**	**3.8%**	**15.8%**	**55.3%**	**100%**

Note: In local-currency terms (i.e., in *Rupiah*), which is the currency unit used in the public expenditure review, the infrastructure average spending in 2000-04 for the different sectors increased over the 1994-96 averages but decreased in US dollar terms because of the large devaluation of the *Rupiah* relative to the US dollar

Source: Spending for Development: Making the Most of Indonesia's New Opportunities – Indonesia Public Expenditure Review 2007, Word Bank (second edition), June 2007, table 5.9, and page 81.

Indonesia's corporate long-term bond market remains shallow because of regulatory deficiencies

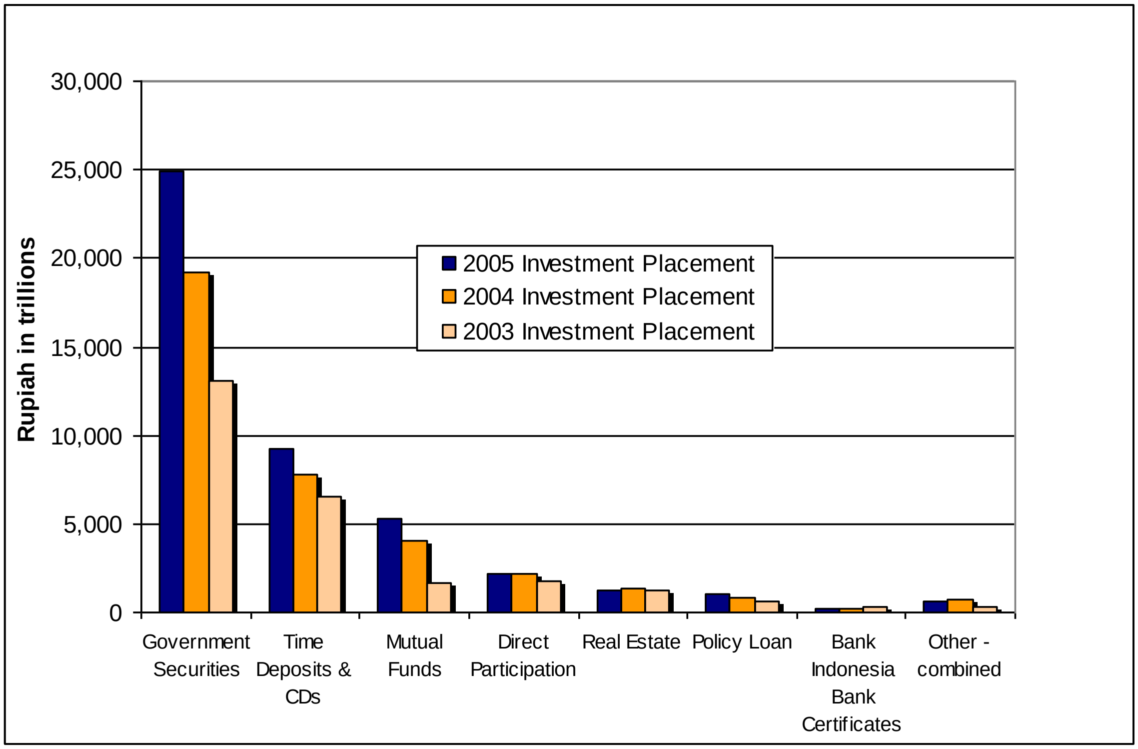
Indonesians are increasing savings through the life insurance and pension fund systems and through the nascent mutual fund industry, but these institutions are limited in their choice of long-term financial assets in which they may invest.

In the mid-1980s, IFC correctly identified the expanding insurance and pension systems' ability to mobilize long-term savings that could be used for long-term capital for investments. This steady growth in long-term savings through the life insurance and pension systems would catalyze the demand for a wide variety of financial assets and investment options, and thereby help deepen Indonesia's capital markets. A long-term corporate bond market and an equity stock market for example, could both be supported by the life insurance and pension industry's growing demand for a more appropriate mix of liquid assets and investment vehicles. The liabilities of life insurance companies and pension funds (i.e., payments to beneficiaries and retirees) are long-term in nature. These long-term liabilities should generally be matched with long-term liquid assets. Insurance companies (and pension funds) can have a considerable impact on development of the domestic fixed income, as well as the equity markets.[6]

As indicated by the recent life insurance company portfolio data in figure 1 below, well over 70 percent of assets held by Indonesian life insurance companies are in the form of Indonesian government securities and bank deposits. As a result, Indonesia's life insurance industry and the pension industry have not been able to realize their potential to channel the long-term savings they mobilize towards supporting private sector investments, particularly those needing long-term local-currency financing such as infrastructure projects. In addition, the life insurance industry and the pension industry at present have limited options in how they may spread investment risks and earn potentially higher returns, thereby limiting their ability to potentially reduce insurance or pension premiums, which in turn, could induce more life insurance and pension business, and more long-term savings.

The current Indonesian capital markets continue to have relatively short maturities for corporate debt instruments, and as a result, poorly match the terms of the insurance industry and the pension industry products (or liabilities) [see endnote 6]. Furthermore, the yields or returns on these short-term corporate debt instruments and the long-term government bonds are generally lower than what would be expected from long-term corporate debts or bonds. As the life insurance and pension industries continue to grow in Indonesia, the need for more diversified and high-quality long-term investment assets becomes increasingly more urgent. This can be remedied with the passage of clear investment guidelines that allow portfolio managers to invest in a broader array of investment products.

Figure 1: Insurance company investment placement is heavily concentrated in government securities and bank deposits (2003-2005)



Note: As of 02/15/07 USD$1 = 9035 *Rupiah*
Source: Indonesian Life Insurance Association, "The 2004 Life Insurance Business Performance" and "The 2005 Life Insurance Business Performance"

Reforms and new institutions are needed to create and grow a liquid and efficient long-term local currency debt market

The development of a long-term corporate debt (or bond) market will necessarily require supporting institutions to ensure efficiency and transparency in the market. Financial intermediaries with specialized investment banking experience would be required for corporate bond pricing and for assessing the market for structuring and planning of a corporate debt issue. These institutions would also perform the standard underwriting and syndications functions. Additionally, expanded rating agency services would be needed to not only properly price a debt issue but to instill investor confidence. As volumes of bond issues grow, and the market becomes more liquid, brokerage services would be required for the buying and selling on the open market.

Current life insurance and pension fund regulations limit portfolio managers' discretion in making investment decisions along the conventional risk and reward spectrum. Pension funds can invest in listed government and corporate bonds. Life insurance companies can invest in government bonds without limit, and in corporate bonds that have at least an A rating up to a limit of 20 percent of their total investment for each issuer. The regulations do not specify whether or not the bonds must be listed, and/or regularly re-rated, in order for life insurance companies to invest in them. This ambiguity forces insurance companies to seek investment opportunities in listed bonds to be certain that they comply with the standing regulations. Although the intent of the requirement to have bonds listed on an exchange is the enforcement of adequate disclosure and credit rating standards and the promotion of transparency, it adds unnecessary costs and inconvenience. This is because corporate bonds, more so than government bonds, are generally traded in the over-the-counter market and not on exchanges. Finally, pension funds are prohibited from investing in offshore assets of any kind, thus limiting their investment options, potential profits, and ability to better match the maturity of assets and liabilities. On the other hand, life insurance companies can invest up to a ceiling of 10 percent of total investment assets in offshore bonds.

The listing requirements for corporate bonds in the Surabaya Stock Exchange (SSX) are prudent but deficient. Currently, bonds must have an investment grade rating, have a minimum issuance of Rp50 billion (approximately $5.2 million), and the corporate issuer must have three years of financial statements and show positive growth prospects. Current regulations, however, only require bonds to be rated at the time of issuance, and do not require regular updating of these ratings, which puts investors at a disadvantage when purchasing bonds in the currently thinly traded secondary bond market. Regular re-rating of corporate debt securities that are traded (whether listed or not) is necessary for market liquidity.

Box 4. Mexican pension and life insurance reforms – The case for transparency and competition

The Mexican insurance industry has been one of the fastest growing segments of the Mexican financial sector. Since 1997, the average annual growth in real terms has been 7.7 percent; more than double that of the economy as a whole. This impressive performance can be explained by the structural changes brought about by reforms that took place since the early 1990s under a policy environment characterized by deregulation and liberalization. By 1997, the legal framework for annuities (pension insurances derived from the social security laws) was introduced. In this sense, it was established that the insurance companies that wanted to offer such products should be specialized carriers (monoline companies).

One of the major structural changes that had significant implications was the North America Free Trade Agreement (NAFTA), which took effect in January 1, 1994. As part of this agreement, Mexico opened up the insurance market for carriers from the United States and Canada. Other agreements like the one signed with the European Union in 2001, permit companies based in jurisdictions from the European Union, to enter the Mexican market with 100 percent or wholly-owned subsidiaries. This more open and dynamic market has favorably impacted competition.

In 1994, there were 48 insurance companies, but by September 2005 the number had increased to 87. The major increases in the absolute number of companies took place over two periods: between 1994 and 1997 with 22 entrants, and between 2000 and 2003 with 15 entrants. The first period's increase can be explained mainly by the entrance of 17 subsidiaries because of NAFTA. The second period can be explained by three additional structural changes: the establishment of insurance companies specialized in annuities, the regularization process of insurance companies specialized in health insurance, and the growing trend in the industry that creates incentives for new carriers to be set up. The impact of increased competition can be seen in the average operational cost as well. By the end of September 2005, average operational costs had been reduced by 46 percent compared to those in 1994.

In 2001, additional modifications were made to the investment regulations governing the SEIFORES (specialized retirement mutual funds) that enabled them to invest in debt instruments (either domestic or foreign currency), credit institutions and private companies. Under these new guidelines, up to 35 percent of SIEFORES' total assets can be held in bonds issued by private companies. For the period 2001-06, the corporate debt investment capacity of the SIEFORES had increased from approximately US$6.7 billion to US$21.0 billion.

As a result of the reforms in the pension and life insurance systems, a long-term local-currency bond market developed in Mexico that allowed IFC to increasingly offer, directly or indirectly (through guarantees and risk management products), local-currency financing as illustrated by the following examples:

<u>Microfinance intermediary project</u>

- An IFC partial guarantee supported two local currency bond issuances (in 2004 and in 2005) with five-year maturities aggregating to about US$43 million equivalent by a non-deposit taking microfinance intermediary. These were followed in 2006 by an IFC local-currency loan of US$10 million equivalent.

<u>Housing finance projects</u>

- IFC provided credit enhancement to enable the issuance of over $200 million equivalent in residential mortgages.
- IFC provided US$69 million equivalent peso-denominated senior loan to a mortgage provider focused on the low-income housing sector.
- IFC provided a US$100 million equivalent peso-denominated revolving warehouse line to help a national mortgage provider enter the low-and middle-income housing sector.

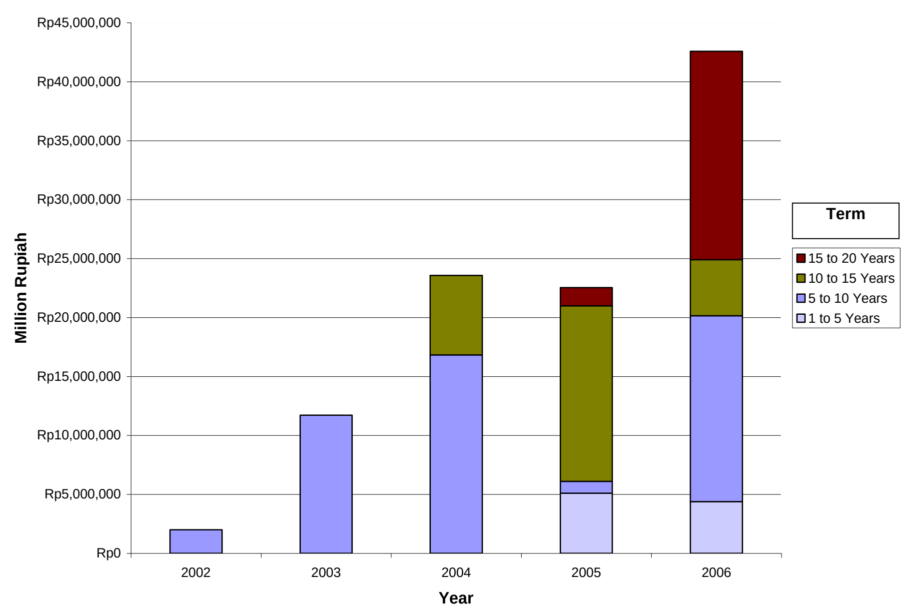
The Indonesian life insurance and pension industry regulations stand in sharp contrast to that of Mexico's. As described above, Indonesia's portfolio and asset investment guidelines are often not clearly defined, and are silent in many areas, thereby causing additional confusion. Furthermore, portfolio managers are hesitant to enter into certain, potentially more profitable investments due to the lack of guidance found in the current regulatory scheme. Equally important is the lack of regulatory coordination as evidenced with the requirement to have corporate bonds listed on an exchange that is rarely used for secondary trading, thereby making financial intermediation more cumbersome and less efficient.

In contrast, the existence of a more rational and transparent regulatory environment has allowed IFC to support local currency denominated operations in Mexico in several ways including straight debt, bond purchase, guarantees and other risk management products such as currency swaps. One high pro-file recipient of an IFC partial credit guarantee is Financiera Compartamos, which began as a non-deposit taking microfinance intermediary that had financial operations limited primarily to the provision of micro loans funded by long-term loans from, or guaranteed by, shareholders.

Interestingly, IFC's use of guarantees and risk management products were concentrated on the microfinance, utilities, mortgage finance and construction materials sectors in Mexico. All of these projects are non-exporting, which makes longer term local currency financing a key to their success. An example of IFC's leveraging effect is when IFC provided a prominent US mortgage provider with a credit enhancement for the issuance of mortgage backed securities. These credit enhancements helped support the issuance of over US$200 million equivalent in residential mortgage financing in Mexico. Once again, a reasonably well-defined capital market allowed for a transaction that was among the first of its kind and thereby helped deepen the Mexican capital markets.

Figure 2 shows that the average term of Indonesian government bonds issued since 2005 has been increasing. These longer-term government bonds will help corporate bond issuers to benchmark their rates thereby providing additional transparency to an Indonesian corporate bond market should it eventually develop.

Figure 2: The maturities of Indonesian Government debt issues have been increasing (2002-06)



Note: Rp is Rupiah
Source: Bank of Indonesia

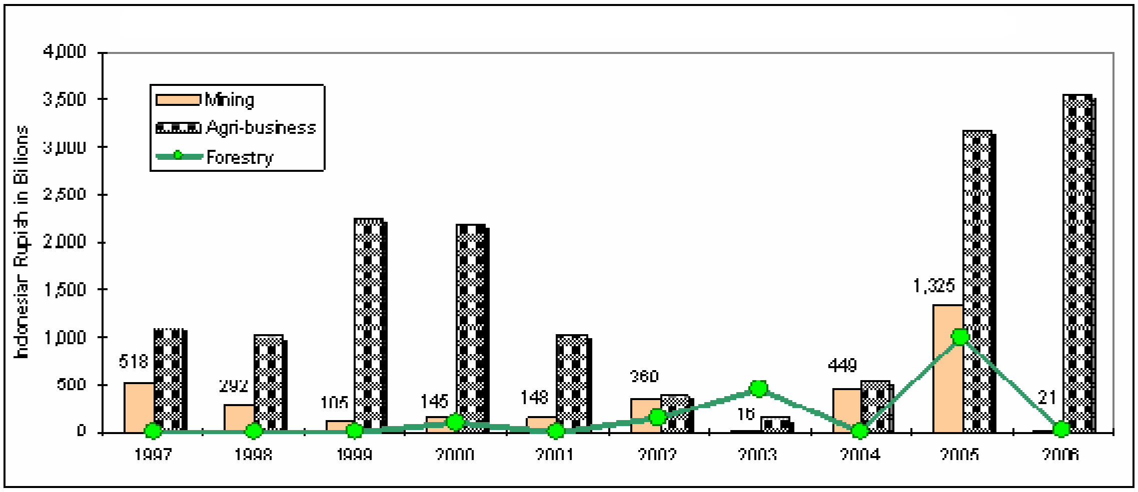
According to a World Bank report, [see endnote 6] new and enhanced enabling legislation is required for the development of a corporate bond market in Indonesia. The government must relax the portfolio holding requirements of life insurance companies and pension funds in order to allow them to invest more of their capital in highly rated and higher return corporate bonds (compared to government bonds). Furthermore, ratings should be required to be updated on a periodic basis so investors are more informed about the issuing companies whose bonds they buy or hold. As demonstrated in figure 3, over Rp4 trillion (or $3.7 billion at the February 15, 2007 exchange rate of Rp9, 035 per USD) is invested by Indonesian life insurance companies in government securities and short-term bank deposits. Approximately Rp5.5 trillion is invested in mutual funds but these are in turn mainly invested in government bonds and bank deposits. An increasingly large amount of capital is "trapped" in investment assets yielding less than alternatives such as corporate bonds and that also fail to closely match the maturity of the insurance companies' and pension funds' long-term liabilities.

A long-term bond market has recently developed in Indonesia but so far, it is mainly the government that is issuing long-term local currency bonds. Private corporations, including financial intermediaries, have not yet been able to issue long-term local currency bonds to a significant extent because the existing regulations are too restrictive and uneven. There is a large and increasing demand for highly rated long-term local-currency corporate bonds as investment assets by the life insurance industry, the private pension plans and the mutual fund industry whose businesses are growing. Standing between the demand and supply for long-term local-currency corporate bonds are deficient government regulations. Correcting these regulatory deficiencies will free the long-term local-currency savings now trapped in low-return short-term bank deposits and government securities. Such a development will also allow IFC to offer long-term local-currency loans, or to provide guarantees for long-term local-currency private sector bond issues, that will increase support for SMEs, social sectors and other IFC strategic priority sectors in the country.

Investments in Indonesia's mineral extractive industries, agribusiness and forestry industries after the Asian Crisis have been low despite rising commodity prices due to legal and political uncertainties

Indonesia's investments in mining, agribusiness and forestry have been erratic or volatile during 2000-06 (figure 3), although agribusiness investments reached record highs in 2005 and 2006 fueled by high agricultural commodity prices. Mining and forestry investments, however, did not show consistent trends despite the high mineral and forest product commodity prices of recent years. These reflect the high-risk country business climate due primarily to political uncertainty related to the government de-centralization and policies in these two sectors, as in the case of the infrastructure sectors.

Figure 3: Indonesia's investments in mining, agribusiness and forestry



Note: Agribusiness is comprised of food crops and plantation, livestock and fishery
Source: Indonesia Investment Coordinated Boards.

Box 5 below shows that Indonesia's production of minerals, other than coal, has not increased or changed significantly during the period 2001-05.

Box 5. The development of Indonesia's mineral extractive and forestry industries is beset by much legal and political uncertainty

Indonesia enjoys abundant mineral resources, and foreign investment has been encouraged in the mining sector because of capital intensity and expertise required for mineral ventures. However, many high-profile mining projects have been affected by the rise in political risk that followed decentralization, and have subsequently become embroiled in legal and contractual disputes with district and provincial governments. Additionally, past land acquisitions have also resurfaced in numerous disputes with local communities. Contradictions between mining law, the 2001 law on regional autonomy, and the 1999 law on forests have compounded existing legal uncertainty in the sector and have lead to a 90 percent fall in exploration spending by mining companies since 1997.

Aside from coal, there has been no significant expansion in mineral resources production since 2001. The direct result shows Indonesia being unable to fully exploit the current high mineral commodity prices, which limits the potential contribution of the mining sector to the country's balance of payments. The table below shows minerals production in Indonesia from 2001 to 2005.

Minerals Production ('000 tonnes unless otherwise indicated)

	2001	2002	2003	2004	2005
Coal	71,073	105,539	113,526	128,480	149,665
Nickel ore	2,474	2,121	2,420	2,025	1,861
Copper	2,418	2,651	2,306	1,803	2,646
Bauxite	1,237	1,283	1,263	1,332	1,182
Silver ('000 kg)	334	282	272	255	327
Gold ('000 kg)	149	140	138	87	143
Tin	69	80	74	73	74

Note: *Estimates
Source: Statistics Indonesia (BPS)

Mineral resources in Indonesia are often exploited in a destructive, polluting and unsustainable manner. Wealth generated from the exploitation of natural resources is neither distributed equitably, nor has it been wisely reinvested in the country. Environmental laws are openly flouted by the private sector, often in collusion with local and provincial government officials. For example, a report in 2004 by a professor of environmental science at University of Nevada and a specialist in mining reported that some 33 tons of mercury that should have been collected and sent to a legal processing center were dumped into the environment over a four-year period by one of the biggest multinational mining companies in Indonesia. About 17 tons were sent into the air and 16 more tons were released into Buyat Bay. Surrounding communities reported illness due to these emissions and lodged a legal case against the company. This further tarnished the sector's image and made potential foreign investors uneasy.

IFC made only one commitment in extractive industries between 1990 and 2005. The committed amount was how-ever not disbursed as the deal structure changed and was inconsistent with IFC's previously proposed operation. Improvements in the legal framework and environmental and social standards are needed in order for Indonesia to start seeing improvements in the level of private sector investments in the extractive industries.

In summary, private sector investments in infrastructure, extractive industries sector, and the forestry sectors have been erratic and low compared to the country's potential, because of political uncertainty, unclear government policies, and continued issues with government contracting procedures and practices for the award of franchises or concessions in these sectors. Additionally, clear and well-defined legislation and regulations promoting transparency are needed to help continue the development of the fledgling corporate bond market.

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Endnotes

EXECUTIVE SUMMARY

[1] B-Loan is a loan for which IFC is the lender of record and in which commercial banks or other financial institutions acquire participations. Participants take the same risk as IFC on a pro rata basis. IFC will syndicate a B-Loan for the account of participants only when it makes an A-loan for its own account. The interest, or participation, of the banks in the B-Loan is always non-recourse to IFC.

CHAIRPERSON'S SUMMARY: COMMITTEE ON DEVELOPMENT EFFECTIVENESS

[1] The World Bank in Indonesia, 1999 – 2006: Country Assistance Evaluation (CAE) note was prepared by IEG-WB and will be available at www.ieg.worldbank.org after it is disclosed.

CHAPTER 1

[1] Unless specifically noted, IEG means IEG-IFC in this document.

[2] See Appendix A for a list of IFC investment projects in Indonesia approved during the study period.

[3] See http://www.ifc.org/ifcext/ieg.nsf/Content/EvalProcess for a brief description of the XPSR system evaluation methodology. For Indonesian investment projects that were evaluated under the XPSR system before FY2006, IEG updated, as appropriate, the original XPSR ratings to reflect new information since the original XPSR was completed, for purposes of this report only.

[4] Information on Advisory Services results is limited to operations completed during the period FY2005-06.

[5] The 103 transactions consist of 76 investments, 8 equity rights issues; 11 financing operations related to restructurings; 1 project cancelled after 4 years of operation, 2 cancelled and non-disbursed projects, and 5 transactions related to supplemental financing either for project scope changes or changes in financing plan.

[6] The regular XPSR system covers a stratified random sample of committed and disbursed projects approved five years earlier (at least 50 percent of the population) and consists of a self-evaluation by the investment department followed by validation by IEG. Direct evaluation by IEG of projects is referred to by IEG as "mini-XPSRs", to differentiate from the regular XPSR two-step process. "Mini XPSRs" are used by IEG for studies that require the evaluation of entire project populations that are not completely evaluated under the XPSR system.

[7] PENSA was originally known as the Indonesia Enterprise Development Facility (IEDF), which started operations in September 2003 with a five-year funding commitment totaling US$21.4 million from several donors. It is administered by IFC and was renamed the Program for Eastern Indonesia Small and Medium Enterprise Assistance (PENSA) to introduce the Indonesian words *Pengembangan Usaha*, which mean "developing business". PENSA is funded by IFC, the Asian Development Bank, and the governments of Australia, Canada, Japan, the Netherlands, and Switzerland.

CHAPTER 2

[1] In 2006, Indonesia's IICCR rating was 41.95 (medium risk), and its HF/WSJ rating was 54.1 (high-risk). Ever since the HF/WSJ rating was started in 1995 up to the most recent 2006 rating, Indonesia's HF/WSJ rating has mostly been in the high-risk range, with values ranging from 49.2 to 60.8. Between 1988 and 1997, Indonesia's IICCR rating was medium-risk. But the rating dropped from 51.70 in 1997 to 41.40 in 1998 and tumbled to a high-risk rating of 27.65 in 2003. Starting 2004, the IICCR rating changed to medium-risk of 33.50, and by 2006, Indonesia's IICCR rating further improved to 41.95.

[2] Prior to the country crisis, most private sector commercial banks controlled by local investors belonged to Indonesian business groups with the group banks serving mainly the members of the group, thereby creating potentially serious cross-ownership conflicts of interest. The post-crisis banking system reform largely reduced these cross-ownerships between banks and industrial business groups.

continued⇨⇨⇨

CHAPTER 3

1 IEG has developed a framework for assessing the risk intensity profile of a project at the time of approval involving the following eight risk factors: (1) sponsor quality; (2) market distortions; (3) debt service burden (related to financial structure); (4) project type (expansion versus greenfield, with the latter being high risk); (5) sector risk (high-risk sectors have high price or supply volatility, or are affected by weather, such as agribusiness and tourism); (6) country business climate at approval; (7) IFC project review intensity; and (8) non-repeat project (i.e., a project with a new client company is high-risk, while a repeat project with an existing or former client is low-risk). A project with four or more high-risk factors (out of the eight) is considered to have high risk intensity.

2 MIGA provided guarantees to two power generation projects in Indonesia approved in June 1994 and in February 1996 respectively. The power purchase agreements of these two projects, as well as all the other private sector power generation projects, were renegotiated by PLN following the country crisis.

3 Whenever IFC invests equity in a company whose shares are not listed in a stock exchange (or if listed, not liquid because of low trading volumes), IFC will generally negotiate an equity put option to the main sponsor that obligates the sponsor to purchase IFC's equity shares at IFC's option, based on an agreed price formula, as a means of an assured equity investment exit for IFC within a specified time period (typically five to ten years) after disbursement of IFC's equity subscription. The equity put option terminates if the shares are listed before the put option is exercised.

4 IFC's equity investments worldwide (in all projects evaluated with XPSRs to date) show that roughly 33 percent have negative returns (by number of projects), 36 percent have positive but low returns, and 31 percent have satisfactory or better IRRs. The XPSR system satisfactory IFC equity IRR cutoff level is project specific, and equals the senior loan fixed rate interest for the project plus an equity premium (ex-post) of 500 basis points (i.e., 5 percentage points), and typically varies between 9 percent and 13 percent in nominal terms. Note, however, that within IFC's overall equity portfolio, 21 percent of investments have very high or excellent equity returns (i.e., IRRs that are at least 800 basis points (ex-post) above the senior loan fixed rate interest), which contribute to a better overall internal rate of return for the entire IFC equity portfolio. The IFC aggregate equity portfolio success rate based on the XPSR evaluations has proven to be very stable between the time of XPSR evaluation and the time of IFC investment exit, despite the high volatility of the individual project equity IRRs and the aggregate IFC equity portfolio IRR.

5 Rupiah is the local currency used in Indonesia.

6 This is consistent with the findings in IEG's recent study, *Financing Micro, Small and Medium Enterprises: with Financial Intermediaries in Frontier Countries. An Independent Evaluation of IFC's Experience.*

7 *Sources:* The Asian Development Bank study Commercialization of Microfinance – Indonesia, 2003 by Stephanie Charitonenko and Ismah Afwan (consultants), and The Microfinance Revolution – Sustainable Finance for the Poor, by Marguerite S. Robinson, May 2001, published by the World Bank and the Open Society Institute. The Central Bank of Indonesia regulates microfinance institutions. The present regulations do not allow for the presence of foreign shareholders in microfinance institutions, which explains the absence of IFC equity investment in such institutions. Most microfinance intermediaries are also deposit-taking institutions with savings deposits largely funding lending operations, which explains their limited need (if any) for foreign loans.

8 An internal IEG report in 2003 identified five drivers of good ESHS performance in the sector namely: (i)strong corporate/sponsor EHS commitment and policies; (ii) inclusion in the project scope and financing plan of all environmental protection and safety-related facilities; (iii) good government EHS regulations and enforcements; (iv) inclusion of all EHS requirements in the legal documents for the projects; (v) close IFC follow-up and EHS supervision. Likewise, the report of the Compliance Adviser Ombudsman, *"Review of IFC's Safeguard Policies",* dated January 2003, had similar findings— " Safeguard policies are most effective when the sponsor is committed, when communication about what is expected is clear with good teamwork between investment and environmental and social staff, and where the national regulatory framework is strong and enforced."

9 The current Environment and Social Development Department program for supervising IFC projects set out to: (a) annually visit Category A projects that are under construction, or if operating already, have an unsatisfactory EHS performance; and also Category B projects in operation with unsatisfactory Environmental and Social Risk Rating (ESRR) based on annual monitoring reports; (b) visit category A projects in operation with satisfactory ESRR every 2 years; (c) visit Category B projects in operation with satisfactory ESRR risk ratings every 3 years; (d) visit financial intermediary projects in

operation on the basis of the risk profile of the loan portfolio and deficiencies in the intermediary's environmental management system as needed.

10 Indonesia in Crisis, A Macroeconomic Update, the World Bank, Washington, DC, July 16, 1998.

11 Country Assistance Evaluation for Indonesia, Asian Development Bank, Dec. 2005

12 Bank Danamon collapsed in 1997 and was placed under the control of the Indonesia Bank Restructuring Agency (IBRA) for recapitalization. Bank Danamom was subsequently merged with other banks (with the merged entity retaining the Bank Danamon name. Temasek, an investment arm of the Singapore government, is now the majority shareholder of Bank Danamon.

13 IFC has a major SME development advisory services program (PENSA) and a special advisory services operation for tsunami recovery in Aceh province that are considered pre-mature to evaluate and are not evaluated in this study.

14 FMTAAS is an internal IFC fund established by the IFC Board in FY04 to support advisory services operations and is funded by an allocation by the Board from IFC's net income.

CHAPTER 4

1 World Bank 2004, Indonesia, Averting an Infrastructure Crisis: A Framework for Policy and Action, 2004.

2 Charitonenko Stephanie and Afwan Ismah, Commercialization of Microfinance – Indonesia, Asian Development Bank, November, 2003.

APPENDIX C

1 The Indonesia Country Evaluation (CAE) note was prepared by IEG-WB and is available at www.ieg.worldbank.org.

2 The debt (external and domestic) of the Government of Indonesia declined from the equivalent of 80 percent of GDP in 2000 to 47 percent of GDP in 2005. Government spending for education and health increased from the equivalent of 3.6 percent of GDP in 2001 to 6.9 percent of GDP in 2006 (and budgeted to be 5.3 percent of GDP in 2007). Government subsidies (for fuel, electricity and transport) declined from the equivalent of 5.6 percent of GDP in 2001 to 3.9 percent in 2006 (and budgeted to be 3.1 percent of GDP in 2007). Source: Spending for Development: Making the Most of Indonesia's New Opportunities – Indonesia Public Expenditure Review 2007, Word Bank (second edition), June 2007.

3 The total infrastructure investments as a percentage of GDP in this source is slightly lower than the percentages shown in Table 1 for Indonesia because of differences in the primary data sources and methodology, but the downward trend in total infrastructure investments as a percentage of GDP are similar or consistent.

4 The PLN installed capacity of 27,940 MW in 2006 includes 3,450 MW of generation capacity installed by private sector inde-pendent power producers under long-term power supply contracts to PLN. The available generating capacity, however, is only about 24,000 MW (because of unreliability and old age of some units), which is only about 11 percent more than the aggregate peak demand of about 18,900 MW in 2004. This does not leave sufficient reserve capacity in the system even in terms of the 2004 peak demand, and is grossly insufficient in terms of the expected 2006 peak demand.

5 Base-load electricity users are those who use more or less the same amount of electricity over at least 16 continuous hours per day (i.e., operates during at least two eight-work shifts), in contrast to the peak load users who uses most of their electricity demand during two or three brief periods (i.e., 2 to 5 hours) during the early morning hours (5:00 AM to 9 AM), and/or the noon time hours (11:00 AM to 2:00 PM), and/or the early evening hours (5:00 PM to 10:00 PM). The higher the proportion of base load users compared to peak load users in an electricity grid (in terms of maximum megawatts demanded), the higher is the average utilization rate of the power generating stations, the power transmission system, and the power distribution system, leading to lower cost of electricity supply.

6World Bank, Unlocking Indonesia's Domestic Financial Resources: The Role of Non-Bank Financial Institutions, Dec 1996.