

**Country Assistance Program
for
the Republic of Indonesia**

Government of Japan

November 2004

Japan's Country Assistance Program for Indonesia

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The development of Indonesia's politics, economy and society has experienced major transitions since the Asian currency and financial crisis in the late 1990s and undergone the regime change after more than 30 years of Suharto's *Orde Baru* ("New Order"). Domestic and international conditions surrounding Indonesia raise various difficult problems which impede development in each field.

Japan's assistance to Indonesia over the past half a century has made major contributions to Indonesia's current development. Japan made significant contributions to putting in place the basic foundation for its development, particularly the economic infrastructure and human resource development needed to support agricultural development and facilitate industrialization, as well as policy assistance and to support for Indonesia's financial position through special yen loans and debt deferral during the Asian currency and financial crisis. In fact, Japan has given a large amount of assistance - primarily yen loans - to Indonesia than to any other countries (for example, the amount of yen loans given to Indonesia were 2.2 trillion yen out of the 11.2 trillion yen, the amount Japan had lent worldwide as of the end of fiscal 2002), and naturally, Japan has been the largest donor for Indonesia. On the other hand, there were room for improvement in Japan's ODA to Indonesia. They are the coordination between the government of Indonesia, other donor countries and organizations and NGOs, as well as the coordination between assistance schemes. The problem of coordination is the a key issue in efforts to improve the assistance.

Especially Japan should continue to provide assistance for sustainable development through economic growth lead by private sector - the greatest development challenge facing Indonesia which leads to poverty reduction and assistance for building democratic and just society through further reforms. Japan ought to provide assistance, in particular, to upgrade and maintain infrastructure to stimulate the economy driven by the private sector and to create the foundation for a wide array of economic activities, including economic systems and infrastructure necessary for facilitating investment. This is essential for the sustainable economic growth which helps to realize poverty reduction. Ensuring peace and stability is vital for both sustainable growth driven by the private sector and the creation of a democratic and just society.

1. Principles and Objectives

- (1) Japan's peace and prosperity depend on political stability and economic development in East Asia. In the political sphere, East Asia faces several destabilizing factors and regional disputes, while in the economic sphere, the region with different economic scales and different degree of economic development, has overcome the economic crises and slumps in the 1990s, to obtain a new dynamism. Currently, Japan's economy is inseparable from East Asia's economic networks, and thus, encouraging East Asia's economic dynamism will contribute to Japan's economic

success in the region.

- (2) Among countries in the East Asian economic zone, the Association of South East Asian Nations (ASEAN) countries recover from economic crises are advancing to establish their nations and societies, and are making steady progress for regional integration in a broad range of areas, including economy, society, policy and security. They also aiming to strengthen relationships with other countries in East Asia. Reinforcing relationships and promoting co-existence and co-prosperity with ASEAN are indeed the foundation of Japan's diplomacy with Asia.
- (3) Under these circumstances, Indonesia is the largest ASEAN country in terms of land, population and resources, and holds a central position in ASEAN. Indonesia is also home to the world's largest population of Muslims, and encompasses sea lanes which are crucial to international maritime voyages, such as the Strait of Malacca. Indonesia's political stability and economic development are crucial to the peace and prosperity of all members in East Asia, and supporting its stability and balanced development is extremely important for the entire region, including Japan.
- (4) In addition, Indonesia is an important partner for Japan in the region both in politics and economics. Indonesia and Japan's citizens have historically enjoyed friendly relationships. Also, the two countries are mutually interdependent in trade and investing. Indonesia is an important source of natural resources particularly in energy, and also is a key market and manufacturing base for Japan. In this respect, providing assistance for Indonesia's economic development is significant for Japan.

2. Conditions Affecting Indonesia's Development (Current Status of Economic and Social Development and Outlook)

- (1) The Suharto regime made progress in liberalizing the economy, opening the door to foreign capital, adopting development policies prioritizing industrialization and increased food production, and in implementing macroeconomic equilibrium policies to hold down inflation and the fiscal deficit. Enjoying new prosperity from higher oil revenues after prices hiked during the oil shock in the 1970s, the government poured money into agriculture, education and health and reaped the benefits. From the second half of the 1980s, Indonesia implemented major system and policy reforms in trade, foreign direct investment, tax revenues and foreign currency policies in order to alleviate its over-reliance on primary commodities, while continuing to capitalize on oil and natural gas resources. This resulted in export promotion, particularly of light manufacturing products, and increased investment from foreign countries. This series of reforms were supported by assistance from the World Bank, the Asian Development Bank and developed nations such as Japan. The success of these development policies and a strong international economy resulted in high economic growth (average annual growth of 7% from the

1970s to the mid 1990s) that earned Indonesia the title of “miracle of East Asia.” This economic growth significantly contributed to the poverty reduction, reducing the poverty population from roughly 50 million (about 40% of the total population) in 1976 to approximately 20 million (about 11% of the total population) in 1996. In addition, the infant mortality rate fell significantly from 145 persons per 1,000 to 46 per 1,000 during the same twenty-year period. However, institutional building for governance related to system development in the financial sector and overall administration did not yield adequate results.

- (2) Indonesia’s economy suffered from severe consequences of the Asian currency crisis that started in August 1997 and was primarily attributable to mismanagement of foreign debt. The real economic growth rate fell to negative 13% in 1998, and the exchange rate plummeted from 2,890 rupiah to the dollar (1997 average) to 10,210 rupiah to the dollar (1998 average). Subsequently, Indonesia followed the IMF’s economic reform program and stabilized its macroeconomic environment and made steady progress in reforming the financial system. As a result, real economic growth has been stabilized in the 3-4% range since 2000. The rupiah has also been stabilized at 8,000-10,000 to the dollar. Given the stability of this macroeconomic environment, the Indonesian government had graduated from the IMF program by the end of 2003.
- (3) Despite macroeconomic stability in recent years, the Indonesian economy still continues to face many problems. First, the current economic growth is supported by growing consumer demand, and both foreign direct investment and domestic investment remain stagnant with little sign of a full-fledged recovery. Indonesia is currently confronted by investment crisis. In particular, problems in the investment environment include i) a judicial system marred by a lack of transparency, ii) government corruption and bribery, iii) unstable security situation, iv) confusion caused by decentralization, v) lack of clarity in the labor system, vi) failure to build up infrastructure, and vii) delays in implementing policies to promote investment. The second issue relates to problems in the corporate sector and the banking sector, which are an integral part of the aforementioned investment. Although the corporate and banking sectors have recovered from a crisis, by restructuring corporate debt and writing off non-performing loans, the banking function as a financial intermediary has not restored yet. Third, government finances are in trouble by huge amounts of government bonds which were issued to rescue banks. Indonesia began repaying foreign debt in 2004 and domestic debt redemption will also reach full proportions in the near future, and thus government finances have managed to avoid a crisis for the moment through fiscal restructuring, government bond management measures, the sale of assets and the privatization of government-run companies. An important issue from this point is ensuring sustainable government finances by increasing the annual government revenue, including tax reforms, in addition to appropriate fiscal policy.
- (4) In addition to these internal factors, there are major changes occurring in the global economic

environment that made East Asia's miracle possible in the past. Japanese and US markets are important for East Asian countries, but China's economic growth and its integration with the global economy are also giving significant effect to these countries' economic activity. While China's sharp economic growth provides major economic opportunities for East Asian countries, it also forces them into harsh competition. While Indonesia can expect some degree of mutual interdependence with China due to China's demand for imports of energy and timber resources, it is also facing harsh competitive relationship with China in attracting companies to set up manufacturing bases and in the export and domestic production of industrial commodities. Also, compared with other founding ASEAN countries such as Singapore and Thailand, Indonesia has been slow to get involved in the Free Trade Area (FTA).

- (5) Indonesia's potential growth remains high due to its past achievements, its rich work force and natural resources. However, the various problems faced by the domestic economy and the changes in the global economic environment involving Indonesia could potentially slow down Indonesia's economic growth.

3. Indonesia's Development Issues

(1) Development Issues

- (A) For Indonesia, a country that has stabilized macroeconomic conditions, the most important issue in the near term is to put its economy on the track of pursuing sustainable growth, which is driven by private sector investment, departing from economic growth led by the current private-sector consumption. It is also an important issue for Indonesia to reduce poverty through the sustainable growth. Poverty remains a serious problem and income discrepancies has become an important political issue. The unemployment rate is also high, having more than 21 million unemployed (note: this figure is the sum of those who are completely unemployed and those who are unemployed but are still seeking work). However, the Indonesian economy absorbs about 2.5 million new workers every year, and the current 3-4% economic growth rate is not high enough to absorb new entry workforce and to reduce poverty. At a minimum, a 6% growth rate would be needed to make a dent in poverty. It is extremely important that Indonesia draw on its potential growth capacity to achieve the sustainable growth for poverty reduction.
- (B) Also, after the Suharto regime's "New Order" collapsed, the political and economic systems that abetted the excessive concentration of authority and corporate ownership needed to be redressed, and several reforms are being required: i) the firm settlement of democracy in politics, ii) the participation of citizens in society and decentralization, iii) consolidation and reorganization of banks and major corporations. Promoting the creation of democratic and fair society through such reforms is a long-term issue.
- (C) These issues can be divided into short-term, medium-term and long-term issues depending on the period of time required for their impact and effect to be recognized.

(Short-term issues)

Indonesia will continue its efforts under the IMF's economic reform program to i) maintain macroeconomic stability and ensure fiscal sustainability, ii) reform the financial sector and iii) reform the corporate sector (including the privatization of nationalized corporations) in order to throw off the heavy burden of the Asian currency crisis. In other words, it means that Indonesia implement Part I and Part II of its "Economic Policy Package" as it is planned, which Indonesia announced in September 2003 as the economic strategy after graduating from the IMF programmes.

(Medium-term issues)

The medium-term issue is to overcome the current investment crisis to realize sustainable economic growth driven by the private sector and create employment. Specifically, defunct and inadequate economic infrastructure should be overhauled, the subsidiary industry and small and medium-sized enterprises (SMEs) should be fostered and the legal framework for the economy should be put into place to improve the investment environment.

Also, governance in government administration and the judiciary (particularly commercial courts) must be reformed and improved.

(Long-term issues)

Long-term issues are the creation of a democratic and fair society through social development by reducing poverty through economic growth (raising salaries and improving public services in education and health) and establishing a highly transparent governance structure in the overall government sector (administration, judiciary, legislation, and central and local government relationships).

(Issues related to all time frameworks)

Throughout these periods, Indonesia needs to address the prerequisite for creating a democratic and fair society such as the maintenance of national integration, environmental conservation, disaster prevention, peace building and stability serurement in conflicted regions such as Aceh, Maluku and Papua, and implementing measures to combat terrorism and piracy .

(2) Problems in Pursuing Development Issues

(A) The Indonesian government has not always grappled with short-term, medium-term and long-term issues in consistency with its development strategy.

As explained above, short-term issues have been addressed so far under the IMF's economic reform program, and are now being implemented as part of the "Economic Policy Package."

At the same time, regarding the realization of the medium-term issue in creating sustainable economic growth, its importance has begun to be emphasized since the Indonesian Aid Conference in 2003. This issue has subsequently become a common awareness among the Indonesian government, major donor countries and international organizations. Nevertheless,

the Indonesian government continued to lack a comprehensive and specific medium-term development strategy. In order to achieve further economic development, Indonesia needs strategies to determine the course of industrialization it will pursue, the amount of economic infrastructure it will require for that course, the role of SMEs and local industries in that transition, the normative direction of agricultural development and regional development, and the ways how the balance between the development of natural resources and nature conservation and land preservation should be maintained (identifying the priority area for resource development). There have been constant calls for governance reform in the government sector since Suharto's "New Order" collapsed, but the direction of these reforms and the specific strategies remain unclear.

The Indonesian government has finally begun its efforts to achieve the "Millennium Development Targets" in accordance with the long-term issue of poverty reduction. Further, it will take some time for the government to reach internal consensus on the "Poverty Reduction Strategy Paper" (proposal) which was established in May 2004.

- (B) Under these circumstance, assistance from other donor countries and international organizations, due to the limits of assistance methods and modality as well as assistance scope all give its priority on issues, especially poverty reduction and governance reform. Also, they tend to concentrate entirely on social or regional infrastructure in programs to set up infrastructure. As a result, assistance is not being used to build the economic infrastructure necessary for improving the investment environment - the most important issue in the near term. The Indonesian government has large amount of debts, and is therefore unable to adequately carry out public works programs such as the development of economic infrastructure. The provision for the establishment of investment environment is exactly the area, where failed to be addressed in the Indonesian development sterategy .
- (C) Further, in Indonesia the "New National Medium-Term Development Plan 2005-2009" (tentative name: REPANAS) is being prepared for taking the place of the National Development Plan (Propenas). This plan will be approved and implemented by the new administration to be inaugurated in October 2004. However, the responsibilities for formulating the plan are dispersed among various implementing organizations along with decentralization process and the changes in the authority of the central bureaucracy, and the government does not have a sufficient role in planning and adjusting the development plan. Planning and adjustment functions for a unified development strategy need to be built within the government as soon as possible.
- (D) In addition, the role that the central government and regional governments are supposed to play in the national development should be clarified. As a result of the enforcement of the Local Self-Government Law in 2001, the central government stopped directing local administrations, and local governments are responsible for drafting and implementing their own development

plans and providing with the administrative services. However, burden-sharing in specific areas is often unclear, and there are problems in the administrative capabilities of local governments, local financial resources and accountability. It is urgent that these problems be solved to ensure the smooth implementation of development policies. Simply strengthening local governments will not redress the socio-economic problem of regional disparity. The further decentralization goes, the more important the central government's role in planning the grand design for development and coordinating between regions becomes.

(Reference: Indonesia's development issues and assistance policies of major international organizations)

Development Issues in Indonesia's Five-Year Development Plan (2000-2004)

In addition to incorporating the afore-mentioned basic conditions, all major issues are included.

- (A) Building a democratic political system and maintaining national integration and solidarity
- (B) Establishing the rule of laws and good governance
- (C) Economic rebuilding and strengthening sustainable and equitable development foundation (reducing poverty, revitalizing SMEs, economic and financial stabilization and expanding investment and exports, strengthening international competitiveness, establishing infrastructure, protecting and managing environment, etc.)
- (D) Improving citizens' welfare, improving religious life, creating vital culture (education, scientific technology development, health and sanitation, labor protection, protection of the weak, improved position for women, etc.)
- (E) Promoting regional development (developing local governments capacity, redressing regional disparities, developing residents' capacity and promoting their participation)

World Bank's Country Assistance Strategy (CAS) (2004-2007)

The primary factors behind Indonesia's failure to reduce poverty are considered as inadequate domestic and foreign investment caused by governance problems and poor public services. Based on this understanding, the CAS considers governance problems as its core issue, and decided that "improving the investment environment" and "providing public services for the poor" would be the two main targets of its assistance program.

The World Bank's policy for "improving the investment environment" advocates cooperation focusing on i) stabilizing the sustainable macro-economy, ii) strengthening the financial sector, iii) fostering a competitive private sector, iv) establishing economic infrastructure and v) creating earnings opportunities for the poor and farmers.

Regarding "providing public services for the poor", the CAS provides assistance in creating a system that can more effectively provide public services such as education and public health to primarily poor beneficiaries of such services.

The assistance will be implemented through the four platforms described below in order to achieve

the objectives.

- (A) Expansion in development of community bodies (approximately 25% of total budget)
- (B) Assistance for local governments (approximately 40% of total budget)
- (C) Public services (water sector, etc.) (approximately 15% of total budget)
- (D) Assistance for central government (tax collection, infrastructure, higher education, etc.) (approximately 20% of total budget)

Asian Development Bank's Country Strategy and Program (CSP) (2003-2006)

The CSP has set five medium-term issues to achieve economic growth: i) improving governance, ii) addressing local needs in light of decentralization, iii) human resources training, iv) environmental management and sustainable utilization of resources, and v) raising long-term growth estimates and economy's potential growth capacity.

The ADB's policy with loans is to provide exclusively on the primary areas (agriculture and natural resources, energy, transportation, industry and finances, social infrastructure, etc.), and to restrict the number of projects, and regions while maintaining a balance between poverty reduction and economic growth.

ADB policy also advocates the concentration of grants on technical cooperation to reform governance, strengthen civil society, improve regulators' monitoring ability and eradicate corruption.

Note: The World Bank and Asian Development Bank are the largest assistance organizations after Japan, and are involved in close dialogue with Japan.

4. Direction of Japan's Assistance

(1) Major Issues for Japan's Assistance

Since the currency crisis, Japan has implemented its assistance with focus on emergency assistance to address the short-term issues described above. Subsequently, however, as the macro-economy stabilizes, Japan shift its emphasis for its assistance to address medium-term issues and long-term issues.

In the near term, Japan should emphasize assistance for realization of the sustainable growth driven by the private sector, with the creation of Indonesia's sense of ownership. While other donor countries and international organizations are directing their assistance primarily toward direct poverty reduction and governance reform, it is extremely important that Japan focus its assistance on the sustainable growth driven by the private sector - the prerequisite for poverty reduction. At the same time, it is also essential to provide steady assistance for the creation of a democratic and fair society in the interest of long-term goals, as well as assistance for the peace and stability that is prerequisite for economic growth and society creation.

(2) Priority Areas for Assistance to Indonesia

As explained above, Japan prioritizes the three areas of “sustainable growth driven by the private sector,” “creation of a democratic and fair society,” and “peace and stability” when giving aid (the “three pillars”), and provides as much assistance as possible for the Indonesian government’s self-reliant efforts. For the significance of Japan’s assistance to Indonesia (please refer to “1. Philosophy and Objectives”) as well as for the interest of maintaining Japan’s diplomatic and economic presence suitable to the scale of its assistance, Japan provides assistance in a broad array of sectors within these “three pillars,” as described below. When doing so, Japan narrows down the priority areas, in terms of the significance in Indonesia’s development, the significance of providing assistance for Japan, the response from other donor countries and international organizations, Japan’s resource capacity to provide assistance, and human’s personal security, in accordance with the principle of “selection and concentration” under the operation of each sector, and then identifies these areas as priority issues (for more specifics, please see the Appendix).

(A) Assistance to realize sustainable growth driven by private sector

To ensure fiscal sustainability, establish economic infrastructure to improve the investment environment, revitalize the subsidiary industry and SMEs, create economic systems and reform the financial sector

(B) Assistance for the creation of to create a democratic and fair society

Poverty reduction (by creating employment opportunities through development in agricultural and fishing communities, improving incomes and welfare, and improving public services in education and health and medicine, etc.), governance reform (reforms in the judiciary and the police service, assistance for decentralization, etc.), environmental preservation, disaster prevention, etc.

(C) Assistance for peace and stability

To assist to build peace and reconstruct Aceh, Maluku and Papua, ensure law and order (measures against terrorism and piracy and strengthening of maritime security system), etc.

(3) Effective Use of Assistance Modalities and Strengthening Affiliations

Japan’s ODA must be used efficiently and effectively to achieve these major issues. The distinct characteristics of Indonesia’s assistance needs and assistance modality (yen loans, grant assistance and technical cooperation) should be used, and the most appropriate assistance modality should be combined. For this reason, coordinating between each assistance is extremely important for the priority areas and development issues and programs for modality. Also, the Indonesian government’s appropriate macroeconomic policies and its formulation of sector measures is also important in ensuring that its assistance is implemented effectively and efficiently; assistance needs should be confirmed in light of these points so that it can be provided with flexibility and agility. Points to consider are outlined below for each assistance modality.

- (A) Yen loans (loan assistance cooperation) has played an extremely important role in Japan's assistance for Indonesia, and has been directed at a wide range of areas including economic infrastructure, health, education and human resource training. In the future, assistance helping to achieve the aforementioned "sustainable growth driven by the private sector" of the "three pillars" will be emphasized, and providing economic infrastructure (electricity, roads, ports, airports, railways, etc.) to improve the investment environment will be a priority area for assistance. This will also involve integrated coordination with other assistance modality.
- (B) Grant assistance has played a major part in helping the Indonesian economy avoid its collapse after the Asian currency crisis through general project grants, emergency grants with immediate results and non-project grants. In the future, grant assistance will emphasize aid to realize "the creation of a democratic and fair society" and "peace and stability" of the "three pillars," and cooperation will focus primarily on health, education and agricultural and fishing community development relating to poverty reduction as well as governance enhancement and peace building ..
- (C) Technical cooperation has been implemented in a wide array of areas, from human resource training to policy assistance. In the future, emphasis will continue to be placed on the priority areas under the aforementioned "three pillars." At the same time, human resource training will focus on human resources training in the politics and economics fields, to perform as leaders being familiar with Japan as well as personnel being capable of policy formation that can become a bridge between Japan and Indonesia, and in industry and regional positions. In policy assistance, it will continue to target a wide range of areas. In particular, assistance could be more vigorously targeted at governance, such as reforms in the judiciary and police system.
- (4) Assistance Methods Suiting Needs
- While accurately identifying changing assistance needs in Indonesia, the optimum assistance method will be examined and assistance modality will be utilized effectively to respond with flexibility. Efforts to coordinate between the various assistance modality is particularly important. First, a comprehensive approach involving a needs survey, policy formulation, plan formation, system creation and human resource training in each field is essential, and assistance should be implemented as part of a larger program (rather than simply implementing assistance as a single project, defining assistance as a program encompassing policy formulation, plan formation, project selection, system creation and human resource training in each field). For example, assistance to establish economic infrastructure should not only involve the hard aspects, but should consist of a full package of assistance in line with sector reforms. Assistance to improve public services such as local governments' health and medical services and education should involve comprehensive sector assistance that encompasses the central government and the local governments so that both the central and local governments fulfill their functions appropriately. Second, assistance should be targeted directly to local

governments now that decentralization has given local governments the primary responsibility for almost all public services. In these cases, “model regionalization”, keeping the spread of successful cases in mind would be promoted. Also, individual projects should be implemented in manner of in mind leading to stronger governance in that area, and in this respect technical cooperation will be adequately utilized.

(5) Strengthening Policy Dialogue

In forming and selecting specific projects, projects that best meet the assistance need are actively formulated and proposed by confirming demand for assistance in policy consultation, while utilizing Japan’s experience, superior technology and knowledge. For example, it would be beneficial to utilize Japan’s development surveys and the knowledge of Japanese companies located in Indonesia to establish economic infrastructure with yen loans.

5. Points to Consider with Assistance Implementation

(1) Emphasis on Partnership

(A) Policy Dialogue with Indonesian Government

It is important that Japan discuss policy issues closely with the Indonesian government concerning Indonesia’s medium-term development strategies and near-term development issues, Japan’s country assistance policies, and the formation, selection, implementation, management, and evaluation of specific projects. This kind of policy dialogue not only strengthens Indonesia’s sense of ownership, but is also important for assessing needs in a good time. Policy dialogues have been held as annual consultations, but from now on these policy dialogues should be held more frequently in order to develop assistance methods better suitable for Indonesia’s needs and to formulate specific projects jointly with the Indonesian government. In addition, it would also be effective if these policy dialogues took place more frequently and, through multiple channels. For this purpose, the effective use of the local ODA taskforce (comprising of embassy, JICA office, JBIC office) and the implementation of policy advice provided by the intellectuals would be important.

(B) Cooperation and coordination with other donor countries and international organizations

Many donor bodies, primarily Japan, the World Bank and the Asian Development Bank, are involved in assistance activities in Indonesia. The Consultative Group on Indonesia (CGI) and the area-specific working groups play an important role in coordinating between donor bodies. In terms of the effective use of resources, it is crucial that all donor bodies share a common understanding of Indonesia’s development issues and cooperate in implementing assistance. Japan should play an even more active role in coordinating between donor bodies in order to contribute to the joint projects conducted between these donor bodies and also to obtain appropriate appreciation of Japan’s assistance.

(C) Coordination with those involved in private-sector economy

In order to appropriately assist Indonesian governmental effort to realize sustainable growth driven by the private-sector, it is essential to cooperate with those involved, particularly with companies, a main actor of the private investment. There are approximately 1,000 Japanese companies operating in Indonesia, providing direct employment for over 200,000 people. Given that most of these Japanese companies are in the manufacturing industry, the impact these companies have on the local economy is considerable, as we can also factor in the indirect employment these companies create via the subsidiary industry and related industries they support including its subsequent increase in tax revenue. It is extremely important to deepen dialogue with economic groups such as the Jakarta Japan Club (JJC) and local Japanese companies and to provide assistance in terms of both hard aspects and policy assistance considering the need to establish infrastructure and a legal system and advice on these issues. This will ensure that assistance helps i) the Indonesian government efficiently create an environment conducive to investment and reduce poverty through growth propelled by increasing investment of private-sector and job, and ii) raise the level of Indonesian industry through technology transfer to the subsidiary industry and related industries and create a foundation for future developments.

(D) Coordination with NGOs and civil society

After Suharto's "New Order" regime collapsed, NGOs and civil society have increasingly taken bigger roles in development. Also, a method has been introduced by which development takes place in dialogue with NGOs and civil society. This is very important in terms of its role in offsetting the inadequacies of development plans at the central and local level. Japan should elicit opinions from local residents at the planning stage as much as possible and attempt to reflect these views when formulating specific projects in order to promote participation. Also, Japan should make use of NGOs' strong points and strengthen affiliations with them as donor partners when implementing assistance.

(2) Strengthening Implementation and Management and Promoting Implementation

(A) System for Project Implementation

Until now, Indonesia's national development planning agency, called BAPPENAS, has served as Japan's assistance window, and Japan has formulated, selected, implemented and managed projects in coordination with the related government agencies and organizations. However, decentralization and revisions to the authority held by central ministries and agencies led that authority has now been dispersed between local governments, individual government agencies and the Ministry of Finance. This has made it very difficult to implement assistance in a unified manner that would encompass planning, project formulation, selection, implementation, management and evaluation. Japan seeks for reinforcing a comprehensive coordination function by the national development planning agency, which works from formation of assistance policy and project selection to implementation, management and assessment. In addition, in order to

promote project implementation, Japan should encourage the Indonesian government to strengthen assistance implementation bodies such as the Ministry of Finance's Budget Office so as to clarify and speed up the survey process, and to conduct dialogue with a diverse group of stakeholders from early in the project formulation stage to achieve consensus. Further, in addition to requesting rapid implementation of projects by a steady exercise of the measures mentioned above on such occasion as policy consultations, Japan should also consider cooperating as much as possible with system and policy assistance to facilitate the Indonesian government's efforts.

(B) Addressing decentralization

Due to decentralization, authority in implementing local development projects is considerably transformed to the local government, however, there is still confusion concerning the roles and responsibilities of the central and local government in aspects of selecting the specific project and implementing and managing. Also, saving environmental problems related to projects and problems involving resident transfers have become even more complicated. Dialogue with local governments in addition to adequate dialogue with the central government is also increasingly important. Assistance necessary for improving local governments' capacity to formulate projects and implement and manage projects is also essential.

(C) Implementing transparent and appropriate projects

Indonesia's Audit Board (BPK) and other groups have indicated inappropriate use of development budgets in the past. Japan should adopt the measures outlined below to ensure that assistance is implemented in a transparent and appropriate manner.

- i) Grant assistance and yen loans are strictly monitored to ensure that appropriate procurement procedures are followed in accordance with the procurement guidelines mandated by each of the Japan International Cooperation Agency (JICA) and the Japan Bank for International Cooperation (JBIC). In the event of any impropriety, strict measures are taken. Guidance is given to consultants on project management as necessary.
- ii) Appropriate guidance is given to employees of the Indonesian central government and local governments by holding briefings on the procurement system for Japan's assistance.
- iii) Japan should actively encourage the Indonesian government to create systems such as establishing a National Procurement Office, currently being considered by the Indonesian government as well as establishing government procurement laws.
- iv) A monitoring system for projects involving equipment provision should be established in coordination with international organizations and NGOs as much possible to ensure that the equipment is used appropriately.

(D) Consideration for environmental, social and gender issues

When formulating and implementing development projects such as economic infrastructure establishment, environmental and social issues should be duly considered at an early stage of

the planning process in accordance with JICA and JBIC's environmental guidelines, since it may influence badly the environment and society. When implementing assistance, gender issues should also be considered while respecting the views of the local society, for example encouraging the active participation of women in development and ensuring that they enjoy the benefits of the development.

(E) Strengthening monitoring and evaluations

It is essential that the project be adequately monitored and evaluated after implementation to determine whether assistance are being used appropriately and the project is having the expected effect, in cooperation with the national development planning agency and other related organizations for this purpose. In particular, the evaluation should not only be applied to individual project, but should go to the evaluation at the level of policy and programmes, from such perspectives as the ripple effect on the overall area and whether improvement is seen in aspect of governance in that area. Since this kind of monitoring and evaluation mechanism is very significant when determining the direction of future assistance, it should be vigorously reinforced through adequate consultation from the Indonesian side.

(F) Strengthening public relations

Japan's assistance has a major impact on Indonesia, and Japanese and Indonesian citizens should be informed about the assistance provided up to the present and to be implemented in the future. This will promote understanding of the relationship between the two countries.

Priority Areas and Issues for Assistance to Indonesia

1. Assistance to Realize Sustainable Growth Driven by Private Sector

An environment which promotes the private-sector investment needs to be created in order to realize sustainable economic growth. In particular, given economic globalization, movements toward ASEAN's economic integration and China's economic expansion, it would be difficult to retain and attract the private-sector investment without competitiveness in the investment market. When reflecting back on Indonesia's past experiences, we should not forget that steady economic growth playing a major role in reducing poverty. Assistance to build up the infrastructure facilities necessary for improving investment environment and return to the economy to the path of medium-term growth will also contribute significantly to the solving of Indonesia's poverty problem.

Japan's priority areas for assistance to Indonesia are i) ensuring fiscal sustainability, ii) building up economic infrastructure, iii) fostering the subsidiary industry and SMEs, iv) establishing a legal system related to the economy and ensuring its appropriate enforcement, and v) reforming the financial sector.

(1) Ensuring Fiscal Sustainability

(a) Maintaining sound finances is important in terms of its role in promoting investment because it stabilizes the macro-economy and lowers country risks. In fiscal year of 2003, the refund redemption of government bonds which were issued to control the confusion after the economic crisis increased, although Indonesia managed to secure other refinance resources, Indonesia's graduation from the IMF program means that in the future foreign debt repayments will increase heavily and government finances could become even more tight. Indonesia succeeded in avoiding a crisis situation by reforming its fiscal structure, establishing government bond management policies, selling assets and privatizing government-run companies, but it needs to improve the health of its finances in a sustainable manner.

(b) Japan will provide assistance such as policy advice and human resource training for the creation of a structure and system for fiscal reform such as strengthening the annual government revenue, reinforcing development planning functions and appropriate management of government expenditures based on an well-considered development plan.

(2) Building Economic Infrastructure

(a) After the economic crisis, the decline in private-sector investment in the economic infrastructure due to higher country risk and the suspense of the Indonesian government's own efforts to build economic infrastructure due to its difficult fiscal situation, made Indonesia's lag behind other ASEAN countries such as Thailand and Malaysia in terms of its

investment environment very conspicuous. As a result, Indonesia became less an attractive country as the direction of investment, and new investment continued to decrease. The delay in building basic infrastructure for economic activity in the fields of energy, transportation, information communications is particularly serious. In the energy field, the Java-Bali power system needs to be augmented by the amount of more than 2,000MW a year. Also, most of Indonesia's natural resources such as natural gas and geothermal power have not yet been developed, and they need to be utilized effectively. In the transportation field, transportation and distribution efficiency has been falling due to chronic traffic jam caused by a rise in traffic volume, lack of ports, airports, and railway facilities, and their inefficient operation. In addition to maximizing the efficient use of existing infrastructure, transportation infrastructure such as highways, railways, ports and airports must be built. In the information communications field, Indonesia has been slow to meet growing demand for telecommunications technology, and the telecommunications network must be expanded. Overcoming these issues and improving the investment environment is the most important issue confronting Indonesia, and for this purpose it is essential to define the separate rules for ODA and other financial systems such as OOF (Other Official Flows such as export financing and investment financing) and coordinate them.

- (b) In light of policy dialogues with Indonesian authorities, Japan will use yen loans and provide its assistance with an emphasis on i) increasing power generation capacity, focusing on the Java-Bali power system and ii) building highways, ports, airports and railways as well as improving their operation. Since the Indonesian government is currently building the information communications infrastructure through private-sector investment, Japan will provide appropriate assistance based on this situation.

When implementing assistance, Japan will also consider providing assistance to improve comprehensive skills in operating economic infrastructure, including human resources training in formulating policy and working out plans.

(3) Fostering the Subsidiary Industry and SMEs

- (a) Most SMEs in Indonesia are small, and not enough effort is being put into fostering a subsidiary industry with superior technology and production scale capable of supporting Japan's manufacturing industry. A concentration of subsidiary industries has become increasingly important in encouraging overseas investment, and competitive SMEs must be fostered, with an emphasis on fostering the subsidiary industry. Encouraging SMEs is also important given their role in job creation and export promotion.
- (b) Japan will continue policy assistance to encourage the Indonesian government to grapple with the issue of fostering the subsidiary industry. Japan will also assist in building frameworks and systems such as the creation of a SME industry's mechanism and human resource development based on Japan's policy advice up until this point so that the subsidiary

industry and SMEs can be fostered without Japan's assistance.

(4) Establishing a Legal System Related to the Economy and Ensuring Appropriate Enforcement

(a) Indonesia must deal with the issues of improving various legal systems related to private-sector business activities such as customs, tax systems and labor laws and ensuring that they are operated in a transparent and appropriate manner. The Indonesian government is engaged in i) operating the tax systems in a transparent and fair manner, ii) operating the custom systems quickly and transparently, iii) constituting labor laws and implementing them appropriately, iv) establishing an intellectual property rights and a legal system related to standards certification as well as system harmonization and appropriate implementation, and v) establishing and implementing business-related legal system such as other investment laws, such as bankruptcy laws and competition laws.

(b) Japan will provide policy assistance for the Indonesian government's efforts. Also, it will provide assistance in developing the human resources needed to build and operate systems.

When implementing assistance, Japan should coordinate its assistance with efforts in the private-sector economy and the efforts of governments such as the establishment of economic cooperation agreements and take notice of ensuring multi-tiered and effective cooperation.

(5) Reforming the Financial Sector

(a) Governance of financial institutions and risk screening abilities are inadequate in Indonesia, and financial intermediation functions are weak. In addition, the capital market is not yet developed in terms of the scale of issuance and the scale of liquidity, preventing the private-sector companies from raising the capital they need to energize their investment activities. The Indonesian government is engaged in i) strengthening the financial structure of financial institutions, ii) setting up supervisory functions in the financial sector, iii) fostering SME financing, iv) arranging for trade financing and v) cultivating a sound capital market.

(b) Japan will assist the Indonesian government's efforts in these areas by providing assistance in building systems and developing human resources. In particular, cultivating a sound capital market will contribute to the initiative to foster bond markets in Asia, and Japan will continue to provide assistance for this.

2. Assistance to Create a Democratic and Fair Society

(1) Poverty Reduction

Alleviating regional discrepancies, eradicating urban slums and addressing other issues related to the income gap have become a major political issue for Indonesia.

The Indonesian government formulated the "Poverty Reduction Strategy Paper" (Provisional) in May 2004. This strategy paper stated that two approaches were necessary to reduce poverty: raising income by improving the productivity of the impoverished and reducing lifestyle-related

expenditures such as education and health and medical services. To achieve this, the government is moving forward with four policies: i) creation of job opportunities, ii) community empowerment, iii) capacity building such as human development and iv) social security.

In order to assist these efforts to reduce poverty, Japan will provide assistance for the priority areas of development in agricultural and fishing communities to create employment and raise income and benefits as well as improve basic public services in education and health and medicine.

(A) Development in agricultural and fishing communities

(a) Productivity is still low in agricultural and fishing communities because the management scope of the agricultural and fishery industry is small, infrastructure such as irrigation facilities and fishing ports are inadequate, and farmer/fishermen organizations, popularization organizations, financial systems and systems for the processing and distribution of agricultural and maritime products have been under development. About 65% of Indonesia's poor live in agricultural regions, so job creation and better income and benefits are essential to reducing poverty.

(b) Japan will focus its assistance on strengthening the operation of farmer/fishermen organizations, building and managing related infrastructure, improving productivity, and securing processing and distribution systems with the intention of creating jobs and raising the income and benefits of agricultural and fishing households by revitalizing the agricultural and fishing industry, which is the main indigenous industry. Also, we will actively introduce programs and "model regionalization" when providing assistance to comprehensively develop agricultural and fishing communities and create processing and distribution systems for agricultural and fishing products.

(B) Education

(a) Structural problems such as the poor management of local governments to establish education systems and structures, inadequate administrative abilities and expanding gaps between regions in education budgets have occurred under the current decentralization process. As a result, the school attendance rate at the middle school level (73% in 2002) has not grown. In these conditions, the Indonesian government is aiming for nine years of mandatory education and is working to raise the school attendance rate, improve the skills of teachers and reform education operation methods. Also, it is important to develop human resources for industry in order to achieve economic growth.

(b) Based on decentralization, Japan will provide assistance in the area of basic education to improve educational administration at the local level, improve the quality of education (raising the quality of teachers and improving school operation) and raise the school attendance rate. Also, Japan will provide assistance that will contribute to the training of personnel for industry in higher education.

(C) Health and medicine

- (a) Gaps between regions have expanded under decentralization, and there has also been some confusion in medical services as well as a decline in quality in local health and medical organizations due to the consequences of decentralization. Further, Indonesia has not introduced a health and medical system that would cover all citizens, so the impoverished that are unable to pay the costs do not receive adequate medical care. For these reasons, Indonesia's major health statistics, namely the infant mortality rate (45 per 1,000 births in 2000), the maternal mortality rate (373 per 100,000 births in 1995), the malaria infection rate (920 per 100,000 people in 2000) and the tuberculosis infection rate (321 per 100,000 people in 2000) are all higher than those same rates in neighboring countries. Recently, the number of people infected with HIV and the AIDS virus has increased rapidly, and most of those infected are of working age and are wage earners. Accordingly, a dramatic rise in these numbers would have a significant effect on the economy (a total number of 90,000 - 130,000 people in the 2002 estimated population).
- (b) Japan will focus its assistance on i) improving basic health and medical services and ii) measures to combat infectious diseases in light of the high infant mortality rate, maternal mortality rate and malaria and tuberculosis infection rates.

(D) Improving basic public services

- (a) The public goods so indispensable to local development are inadequate and in many cases the quality and quantity of public services are inadequate due to the lack of a system to maintain and manage these services. This impedes sustainable development.
- (b) In order to facilitate local sustainable development, Japan will provide assistance to set up the public goods (water, sanitation, roads, electricity, etc.) necessary for village development and local development as well as to improve the maintenance and management systems for these public services and assist in developing measures to combat natural disasters such as frequent flooding, mud slides and droughts.

(2) Governance

Governance reform is extremely important in order to improve the investment environment as well as to create a democratic and fair society. In particular, KKN (the abbreviation for corruption, collusion and nepotism; examples include collusions between government officials and companies, misuse of public funds by government officials, lack of transparency in the finances of government organizations, corporate corruption, the closed nature of corporate information and lack of transparency in accounting systems, and inadequate government oversight) is rampant in every public sphere from the judiciary, administration, legislation, military and companies. Eradicating KKN, reforming the judicial system, making administration more efficient and transparent, improving the administrative abilities of the local government and improving corporate governance are all important issues.

Japan will focus on i) judicial reform and police reform and ii) decentralization. In particular, Japan will coordinate with other donor countries and international organizations to provide more active assistance to address the former issue.

(A) Judicial reform and police reform

(Judicial reform)

- (a) Judicial reforms focused on eradicating corruption in the judiciary and building up a legal system are extremely important in terms of gaining the trust of Indonesian citizens and the international society. The issues here are establishing a court to deal with corruption, fixing the personnel systems of judicial organizations, eradicating the corruption of people involved in the judiciary, addressing new legal problems with reforms in commercial courts, introducing an equitable and efficient incident management system and shifting authority over judicial administration to the Supreme Court. The Supreme Court has demonstrated its willingness to actively engage in judicial reforms.
- (b) Japan will focus its assistance on i) ensuring the equitable and effective operation of the system for lawsuits and ii) developing human resources for the legal profession.

(Police reform)

- (a) The national military and national police force were separated from 2000 as part of the democratization of the Indonesian government. In addition, the police system was reformed, which include establishing police-related legislation and reorganizing the police system. However, due to the actual conditions and police officers' own perceptions, further improvements are still needed to democratize the police force and change it into a citizen police force.
- (b) Thus far, Japan has provided assistance to improve investigational abilities and restructure awareness (ensuring allegiance to government by law) in order to democratize and improve the abilities of the national police force. In particular, Japan is currently implementing a project to introduce citizen police activities, including a police box system, with the Jakarta suburbs as the test case. Japan will continue to provide assistance to democratize the police force and strengthen its abilities.

(B) Assistance for decentralization

- (a) Decentralization was rapidly conducted on a large scale in terms of authority, employees and financial resources in accordance with the January 2001 Decentralization Law and the Law to Balance Finances of Central and Local Governments. However, since decentralization took place without adequate preparation, various problems occurred, such as i) in regard to the transfer of authority, a lack of clarity in division of responsibilities between central and local governments and inadequate skills of local government employees, ii) in regard to transfer of employees, a large number of surplus employees in local governments and a failure on the reorganization of local governments, and iii) in regard to the transfer of

financial resources, an expansion in the gap in financial resources between local governments and disorganized use of tax levying authority to obtain independent local revenue. On the other hand, despite the importance of clarifying the country's role and the importance of formulating policy drafts at the national level, the central government did not adequately address these issues.

- (b) Japan will provide assistance for the priority areas including i) improving the skills of local government employees , ii) improving local administrative systems (budgets, organizations, implementation of operations, etc.) and iii) making a recommendation to central government policy on decentralization in order to improve establishment and implementation of development plans by the local government as well as to enhance various public services. This type of assistance is important in ensuring the smooth implementation of Japan's local development projects, which are expected to increase from now on.

(Reference)

Status of Decentralization in Indonesia (as of November 2003)

1. In accordance with the enforcement of the Decentralization Law (1999 Law No. 22), the Law to Balancing Finances of Central and Local Governments (1999 Law No. 25) in January 2001, and the Local /Tax Law(2000 Law No.34)in December 2000, decentralization was carried out on a large scale and primarily involved the aspects outlined below.
 - i) Transfer of authority: All authority was transferred from the central government to the local government, with the exception of diplomatic relations, national defense and law and order, the judiciary, finances, public finances, religion and others (national planning, general assembly planning and operation on a macro level, etc.).
 - ii) Transfer of employees: Central government agencies were reorganized into local government organizations and over 2 million national civil servants were transferred to positions as local government employees.
 - iii) Transfer of financial resources: The local governments' financial resources expanded from the independent revenue and presidential subsidiaries earmarked for specific purposes they previously relied on to local independent revenue, grants and local loans. Grants expanded significantly from 17.1% of the central government budget in 2000 to about 32% in 2002.
2. However, decentralization took place without an adequate preparation period, and as a result the transfer of authority, employees and financial resources resulted in many problems, including confusion in the local governments concerning the transferred authority, a huge surplus of employees in local government, inadequate administrative skills of local government employees, greater discrepancies in the financial resources of local governments, and disorganized use of tax levying authority.
3. Currently, the Interior Ministry is revising the Decentralization Law, the Law to Balancing Finances of Central and Local Governments and the Local Tax Law to address these problems created by the rapid

decentralization. The laws related to decentralization will be revised by September 2004 in accordance with the 2003 Presidential Directive No. 5. It appears that the revised proposal would revise regulations on state, province and city authorities, human resource regulations governing local government employees, regulations concerning administrative and council methods, the introduction of a direct election system for a local government head, and regulations concerning local finances and tax systems.

(3) Environmental Conservation and Disaster Prevention

- (a) Indonesia is rich in natural resources, and is blessed with a natural environment of forests and coral reefs as well as water resources and mineral wealth such as oil and natural gas. Given these riches, it is extremely important that consideration be given to the environment. Environmental destruction and deterioration has taken a rapid turn for the worse due to the confusion generated by decentralization and weaker governance following the economic crisis and the collapse of Suharto's "New Order." In terms of sustaining economic growth, it is crucial that Indonesia's rich natural resources are managed appropriately and used effectively and also that the urban environment remains at a certain level.
- (b) Japan will provide assistance for the appropriate management of natural resources (including measures to combat global warming) as well as assistance for the conservation of the urban environment. Specifically, assistance will be provided by improving the administrative abilities and strengthening the systems of the central and local governments involved in natural resource management, developing human resources, and spreading environmental education to Indonesian citizens. In addition to assistance for environmental administration and environmental management, including the establishment of a system to monitor atmospheric pollution and water contamination, Japan will provide assistance to improve the urban living environment, including that in urban slums (including countermeasures for natural disasters).

3. Assistance for Peace and Stability

The peaceful resolution of disputes and the eradication of terrorism to ensure peace and stability are essential to ensuring sustainable growth driven by the private sector and the creation of a democratic and fair society.

Japan will give as much assistance as possible to the priority areas of i) peace-building and reconstruction and ii) ensuring public order (strengthening measures against terrorism and piracy and strengthening of maritime security system) while coordinating with other donor countries.

(1) Assistance for Peace-Building and Reconstruction

- (a) Although the situations in the territorial disputes in Aceh, Papua and Maluku differ, political agreements for peace must be reached and maintained, allowing refugees to return home, local communities to be rebuilt and infrastructure to be restored and reconstructed. In particular, the peace accord collapsed in Aceh in December 2002 and emergency martial law

was introduced in the region. This was later eased to emergency civil law in May 2004, but there is no sign of peace yet.

- (b) Japan will offer humanitarian assistance to refugees in these disputed regions, and also provide assistance to i) rebuilding local communities, building local infrastructure and promoting restoration to create jobs and ii) developing local human resources so that they can take charge of their own recovery, while keeping in mind the progress made in peace accords and security conditions.
- (c) When providing assistance, Japan will identify the need for assistance in the disputed territories and effectively implement comprehensive assistance to cover multiple areas needed for local reconstruction, while cooperating with the Indonesian government, related international organizations, other donor countries and NGOs.

(2) Securing Law and Order

(Measures to combat terrorism)

- (a) Indonesia has experienced several terrorist incidents, such as the bombing in Bali (October 2002) and the Marriot Hotel bombing in Jakarta (August 2003), and we must admit the possibility of terrorist activities in Indonesia in the future. Although Indonesian security officials have redoubled their efforts, Indonesia suffers from basic problems such as an insufficient number of police officers and inadequate facilities and equipment. Further, it will not be easy to resolve the terrorism problem, given the geographical conditions (broad land area and a long coastline, etc.) and social conditions (a large number of impoverished and unemployed people).
- (b) While coordinating with the Indonesian government's measures to combat terrorism, Japan will provide assistance with an emphasis on i) strengthening investigative abilities, ii) airport and seaport safety measures and iii) reinforcing ability to address terrorism by offering seminars and training.
- (c) It is particularly important that Japan coordinate effectively in the donation of materials and equipment and the soft aspects of aid related to terrorism countermeasures.

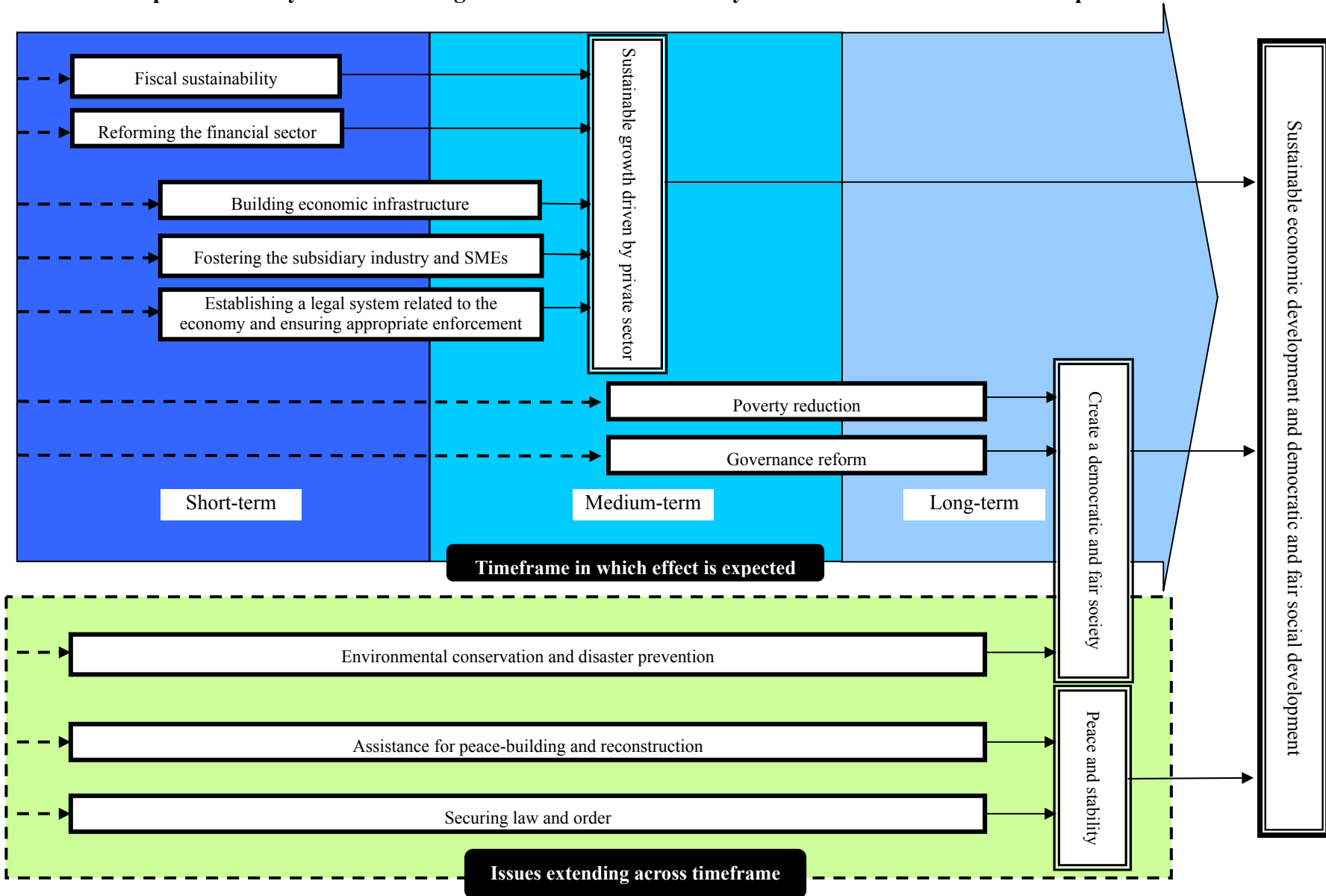
(Strengthening piracy countermeasures and maritime security system)

- (a) Piracy is a frequent occurrence in the waters surrounding Indonesia, and about 1 out of 4 total piracies take place here (2003). Despite the Indonesian government's effort to strengthen countermeasures, it is difficult to adequately regulate the broad maritime area due to inadequate equipment and employees. Particularly, many of the approximately 14,000 Japan-related ships traveling through the Straits of Malacca every year experience damage. Securing the safety and security through the waters surrounding Indonesia is extremely important in terms of protecting the lives and property of Japanese citizens. In addition to piracy, there are innumerable illegal actions such as smuggling, which makes the reinforcement of legal enforcement structure at sea an extremely urgent issue. Further, it is

important to strengthen the maritime security structure including a system to prevent disasters at sea as well as a search and rescue system.

- (b) Accordingly, based on Indonesian government's current efforts to form a new coordinating body for maritime security,, Japan will provide assistance to law enforcement organizations stationed for anti-piracy measures, and will also provide appropriate assistance to strengthen information communication systems.

Japan's Country Assistance Program for Indonesia: Priority Areas for Assistance and Development Issues



Note: The timeframe divides the period into divisions during which effects are expected, assuming that the input is carried out with the principle of “selection and concentration”.