USAID/INDONESIA
ECONOMIC GROWTH STAKEHOLDER WORKSHOP
JULY 8-10, 2008

FINAL WORKSHOP REPORT

OUTLINE

I. EXECUTIVE SUMMARY

Background

As part of the process to develop a new five-year (2009-2014) strategy for Indonesia, the Economic Growth Office (EGO) of USAID/Indonesia sponsored a workshop July 8-10, 2008 for the purpose of gathering key stakeholders to discuss emerging economic issues in Indonesia and develop a set of recommendations for USAID to consider under its new strategy. Over 100 stakeholders, from the Government of Indonesia (GOI), private sector, donor community, civil society, USAID implementing partners, and other U.S. Embassy sections, participated in the workshop.

Given the sheer number of participants and diverse organizations they represented, USAID decided to structure the breakout sessions of the workshop in the following broad sectors:

- Agriculture
- Business development
- Financial markets
- Trade and investment
- Cross-cutting issues

Each breakout session consisted of approximately 25 participants. The purpose of the breakout sessions was to: a) discuss emerging issues, challenges, and/or opportunities in that particular sector, b) outline GOI plans and priorities in that particular sector, and c) offer recommendations to USAID for interventions in that sector under the 2009-2014 strategy for Indonesia.

Key Presentations

The workshop was opened by Walter North, USAID/Indonesia Mission Director, who highlighted some of USAID's recent accomplishments in the economic growth area and asked for continued collaboration with key stakeholders as USAID develops its new strategy. Mr. North was followed by remarks from Pak Sidqy Suyitno, Director of Financial Service and Monetary Analysis at BAPPENAS, who discussed thanked USAID for support in the economic growth arena and highlighted some of the GOI's plans in this arena.

Two keynote speakers also made remarks. Dr. Gus Papanek, President of the Boston Institute for Developing Economies (BIDE), made a presentation on "The Indonesian Economy and USAID's Comparative Advantage." During his presentation, Dr. Papanek argued that while Indonesia has recovered from its 1997 financial crisis and been steadily growing ever since, its type of growth is risky as it has been heavily reliant on commodity exports when Indonesia is not a resource-rich country and almost 2/3 of the value of Indonesian commodity exports have been based upon rapid price increases for Indonesia's major export earners. Consequently, according to Dr. Papanek, commodity exports do not create sufficient jobs. In fact, he claimed that since the 1997 crisis, 20 million workers have been added to the labor force but only three million real jobs have been created—hence, recent Indonesian growth can be hailed as "no jobs growth." In order to combat this situation, Dr. Papanek recommended that policies and programs be developed to expand labor demand and that USAID should continue focusing on institutional capacity building, in coordination with BAPPENAS and the Coordinating Ministry for Economic Affairs, as well as focus on policies and programs that help to reduce poverty, especially in relation to rice price policy.

Dr. Papanek's presentation was followed by a discussion on "Economic Policy Priorities for Indonesia" by Dr. M. Chatib Basri of the University of Indonesia's Institute for Social and Economic Research. In his presentation, Dr. Basri gave an overview of how recent developments in the global economy—related to the spreading global financial crisis, spillover effects of slow growth within advanced economies, surge in food and oil prices—are impacting developing economies such as Indonesia. He also discussed GOI priorities in the areas of trade and investment, labor, infrastructure, fiscal and monetary policy, and job creation and poverty alleviation, and concluded his presentation by recommending that USAID develop programs that address the issues related to energy and food price increases, local government support, trade and services, and trade logistics.

Overall Findings

During the presentations of each breakout session, a consensus began to emerge as to the key issues facing Indonesia's economy:

- Poor state of transportation infrastructure (e.g., roads and ports)
- Lack of sufficient access to electrification, especially in rural areas, and alternative sources of energy
- Inadequate capacity and skill levels within critical private sector and government partner organizations
- Lack of access to financial services, especially for small farmers and micro-entrepreneurs
- Insufficient attention paid to the potential role of Non-Bank Financial Institutions (NBFIs)
- Lack of transparency and continued corruption in several areas including the government procurement process
- Insufficient levels of foreign investment flows into Indonesia due to poor transportation networks, labor policies, and corruption

As mentioned above, the sections that follow provide a detailed summary of a) these key issues, opportunities, and/or constraints; b) GOI priorities; and c) recommendations for USAID intervention under the 2009-2014 strategy. It should also be mentioned that these sections offer a summary of issues discussed by a broad range of participants from a myriad of organizations and with varied viewpoints. Therefore, what follows describes the consensus reached by these participants in their particular sections and should not necessarily be accepted as statements of fact.

II. AGRICULTURE

Issues, Opportunities, and/or Constraints

According to the *Central Statistics Agency* (BPS), 63% of the 37.2 million Indonesians defined as poor work in the agricultural sector. Other organizations, such as the World Bank, claim that 57% of the poor work in rural areas. Therefore, based on the data, focusing upon the agricultural sector is necessary in order to address the issue of poverty.

In the breakout session, the discussion was centered upon the agricultural sector in general and not on specific sub-sectors. Several issues were raised in relation to how the agricultural sector can generate economic growth and help to alleviate poverty. In the short-term, the agricultural sector is seen as a sector that can hardly create new employment or erase poverty quickly. However, in the long-term, it has the potential to boost the Indonesian economy if all aspects of the sector—from government policy to infrastructure to supply to market—are improved. In addition, GOI agriculture development programs to date have not sufficiently reached those small farmers who are also becoming the majority of Indonesian farmers.

The issue of *agricultural technology* surfaced in the discussion. Today, the majority of Indonesian farmers still use conventional/traditional technology in cultivating their farming fields. On the other hand, farmers in countries where the agricultural sector has developed more successfully use modern technology. The limited use of modern technology can be caused by several factors such as the lack of information, government support for field research, and access to finance. The U.S. experience shows how government support for agricultural research spurs the development and use of modern technologies. This can be seen with the establishment of a land grant university, an institution focusing on agricultural research. Such as institution has produced many new technologies that are regularly used by U.S. farmers.

Infrastructure was another issue raised in the discussion. There are a lot of poor roads and irrigation systems throughout rural areas. The poor state of rural infrastructure hinders production, marketing, and sales. According to a World Bank study, 72% of rural roads are in "poor" condition and only 19% are in "good" condition. The study reveals that poor infrastructure creates high transaction costs. As a result, farmers only get 25-30% of the gross value of their high-value products[1]. According to GOI representatives in the breakout session, 80% of irrigation systems in Indonesia are damaged and need government attention[2]. Furthermore, although local governments have mechanisms to involve the local community, including farmers, in designing local infrastructure development plans, these mechanisms have yet to effectively improve agricultural infrastructure because the farmer's bargaining position is low compared to the government representative at the village level.

[1] http://siteresources.worldbank.org/INTINDONESIA/Resources/Publication/280016-1106130305439/617331-1110769011447/810296-1110769073153/agriculture.pdf

[2] GOI prediction on the irrigation condition in Indonesia

The role of *private sector participation* in agriculture in Indonesia is still low in contrast with the U.S. agricultural sector which is dominated by private sector participation, leading to a good bargaining position in agricultural policymaking. According to the BPS, private sector contribution to agriculture is only 12.5%. Hence, the government needs to implement policies that support private participation in agriculture such as tax incentives, licensing facilities, adequate infrastructure, and access to credit.

Supply side dynamics, particularly related to crop seed prices and fertilizer, are another issue. The government subsidy for seeds, especially rice seeds, is has not reached the farmers. Farmers are generally unable to secure subsidized fertilizer. Although the price of agricultural products, especially rice, is high in the international market, Indonesian farmers do not enjoy the benefits of increased prices.

Indonesian *farmer organizations* are considered weak due to the lack of capacity to manage such organizations and the high number of people from non-agricultural sectors active in these organizations for political purposes or other interests. U.S. experience shows that farmer organizations have the potential to influence government policy in agriculture. In addition, they can also provide technical services, management and marketing support for their members. Hence, it is critical for all parties, including the government, to improve the capacity of Indonesian farmer organizations.

Access to credit is another key issue. The main obstacle to accessing credit is the physical guarantee required, although credit insurance and warehouse receipts are being developed as alternatives to the guarantee. In 1998-99, the government launched an agricultural credit program (called *kredit usaha tani*) that involved formal banks. However, the program failed because loans were disbursed without proper due diligence since the loan funds were provided by the government but disbursed through participating banks. As a result, the banks had no incentive to conduct proper checks on creditworthiness of potential borrowers. Later, in October 2006, the government launched an agricultural credit scheme called *SP3* that provided a guarantee of 225 billion rph. to five banks. However, this program also failed to reach small farmers because participating banks risk aversion. Hence, there is a need for assisting the government to create financing schemes that can be enjoyed by all farmers, including small ones, such as the establishment of farmer banks, improving the capacity of banks to conduct proper credit assessments of potential borrowers, improving the availability of credit risk information, and the further development and empowerment of micro-finance institutions.

The limited capacity of rural infrastructure, especially roads, is a major obstacle to marketing and sale of agricultural goods. In addition, marketing channels, such as agribusiness sub-terminals, have not effectively given added value to the marketed agricultural products. Sub-terminals widely constructed today mostly function as the pooling places of agricultural products not as the points for added value. Furthermore, the role of agro-industry in Indonesia is still limited. Other country experience shows that agro-industry can produce benefits such as: (1) creating added value to domestic agricultural products, (2) creating employment, especially switching the workers from the agricultural sector to agro-industry sectors, (3) increasing foreign exchange earnings through agro-industry exports, (4) improving the income share for farmers, and (5) increasing development of agricultural fields.

In terms of *agricultural policy* issue, government representatives admitted there is no clear roadmap. Although the GOI has an agriculture development program for 2005 – 2025, it has no practical regulatory instruments that can help achieve targets identified in the program. Many developed countries, especially in Europe, have agricultural roadmaps in place through 2020. Indonesia, by contrast, implements roadmaps for only periods of five years at a time and the government is often not consistent because it often amends the roadmaps. Existing policies today are more for addressing short-term crises such as the increase in rice prices and other basic commodity price hikes. The government is also prone to offering subsidies without making any improvements to the overall agriculture sector. In this decentralization era, where the role of local government is quite substantial in all development sectors in their regions, many local governments do not realize that developing agricultural sector will also increase the economic growth of their regions. This attitude makes many local governments to not have effective agricultural policies in place. As a matter of fact, in this decentralization era, local governments should play a very significant role in developing the agricultural sector.

International dynamics also influence the agricultural sector in Indonesia. Market liberation and unfair trade practices challenge the development of agricultural sector. The revolutionary changes in international agricultural production management also challenge the Indonesian agricultural sector to compete with agricultural products from other countries in the global market. International food scarcity and bio-energy issues are two international aspects influencing the agricultural sector in Indonesia. The information technology revolution in this sector also demands that the agricultural sector in Indonesia be managed professionally.

Based on the discussion above, there are eight areas in which the Indonesian agricultural sector can develop: (1) effective government agriculture policies, (2) increased power and influence of farmer organizations, (3) clear information systems, (4) availability of adequate infrastructure, (5) easier access to financial services, (6) availability of R&D services, (7) agro-industry development which is integrated with the development of agricultural sector in rural areas, (8) policymaking that includes private/public dialogue with farmers and agribusinesses, and (9) good governance at all government levels.

Government of Indonesia (GOI) Priorities

The GOI's 2005-2025 agriculture development program focuses on the following areas: (1) agriculture development based on rural industrial development; (2) food security based on food estate; (3) job creation; and (4) poverty eradication with farmer income reaching U.S. $2500 per capita per year. To achieve these goals, the GOI developed a midterm (2005-09) program focusing on: (1) increasing production to more than 90% of domestic demand, especially in rice, corn, and sugar exports; (2) food and energy diversification; (3) availability of protein resources; (4) increasing value added and competitiveness; (5) enhancing production and export of products including horticultural goods.

In 2008-2009, the government will also launch a rural agribusiness development program, targeting the development of agribusiness in 11 thousand poor villages nationwide. With this program, every village will receive 100 million rph. through farmer groups. With associate supervisors, management of farmer groups and extension workers, the target of this program includes "on-farm" (e.g, food crop, horticulture, animal husbandry and plantation) as well as "off-farm" (e.g., home industry, micro-scale marketing of products).

The government now is also faced with food security as an agricultural issue and is trying to boost rice production to secure the existing food stock. It is also required to keep the prices stable by providing enough basic food stock, especially rice. Private sector participation should be taken into account to draw new investments into the agriculture sector, especially into rice production.

Recommendations for USAID

1. Assist the GOI in policy/regulatory reform and advocacy for farmers and agribusinesses, resulting in institutional reform on extension and research services.
2. Establishing and strengthening professionalism of farmer organizations or associations by capacity building programs and best practices case studies.
3. Improving value added for agriculture products which have market value through technical assistance on processing, packaging, certification, and branding.
4. Promoting rural infrastructure (e.g, irrigation, rural road, water, electricity and communication) development with local governments through advocacy and effective lobby by farmer associations.
5. Improving access to financial services.

III. BUSINESS DEVELOPMENT

<u>Issues, Opportunities, and/or Constraints</u>

Indonesia's overall macroeconomic picture is stable and improving as it has made remarkable economic progress since the financial crisis by recapitalizing the banking sector, improving oversight of capital markets, and taking steps to stimulate growth and investment. GDP growth has steadily risen this decade from 5.4% in 2000 to 6.3% in 2007. By 2004, real GDP per capita returned to pre-financial crisis levels. Poverty levels (i.e., those living on less than $1 per day) have reduced in recent years from 17.8 to 16.6% and unemployment has decreased from 10.3 to 9.1%.[3]

However, much remains to be done. Despite President Yudhoyono and his economic ministers' repeated intention to improve the climate for private sector investment in order to raise the level of GDP growth and reduce unemployment, corruption and legal uncertainty remain. A number of the factors often mentioned for reducing Indonesia's competitiveness include: corrupt and inefficient customs services; non-transparent and arbitrary tax administration; inflexible labor markets that have reduced Indonesia's advantage in labor-intensive manufacturing; increasing infrastructure bottlenecks; and uncompetitive investment laws and regulations. A new policy package announced in 2007 to improve the investment climate in Indonesia for both domestic and foreign investors has not been fully implemented.

According to a 2006 ADB study on private sector development policies in Indonesia, there are an estimated 40 million small-and medium-sized enterprises (SMEs) in operation, employing approximately 73 million people. However, most of these enterprises are micro or cottage enterprises rather than SMEs in the strict sense of the word and the largest percentage are in the agricultural sector. According to a 2006 World Bank rural investment climate survey, there are nearly 16 million micro- and small-enterprises that employ more than 50% of all non-farm workers in Indonesia.

Five major issues were identified by the group of participants in the breakout session: human resources, energy, transportation infrastructure, microfinance, and the environment. Three cross-cutting issues were also raised: land, local private sector initiatives, and corruption related to the procurement process.

Human resources – The group agreed that existing models of training programs run largely by governments are driven by what is budgeted rather than what is needed. Such programs are not sustainable. There is little linkage between what training there is and what the industry needs and consequently, such programs are considered a government subsidy with no obligation to pay back.

Energy – The group agreed that the major concern for businesses at the moment is the cost of energy and how it's distributed. The cost of electricity has soared following the

[3] The World Bank, "Indonesia: Economic and Social Update, April 2008"

global fuel price hikes. This is further exacerbated by lack of transparency in the provision and distribution of electricity.

Transportation infrastructure – The group felt that there are numerous issues with infrastructure but that the most common concern relates to transportation infrastructure, particularly the provision and maintenance of roads and ports. The key challenge to the road issue is to overcome various constraints to new investment/provision.

Access to credit – Donors should move away from traditional direct provision models as there are already over 80,000 microfinance institutions (MFIs) in Indonesia. The group did not recommend any new donor effort on MFIs and instead donors should focus on developing what is already functioning. One of the key regulatory issues is the draft Microfinance Law (RUU LKM) which has been under preparation by the GOI for the past several years. Passage of this bill will allow MFIs to mobilize lower cost funds and hence be able to provide lower cost loans.

Environment – The most pressing issue discussed was to develop measures to translate environmental constraints into business opportunities (eco-business)**.**

Cross-cutting issues – Three areas were noted by the group as critical cross-cutting factors that affect business development in Indonesia: 1) land acquisition, ownership and title, and its overall regulatory framework; 2) community private sector initiatives such as small-scale electricity generation should be encouraged; and 3) public procurement transparency should be encouraged and regulated. Corruption cases, especially at the local and regional levels, should be tried and widely publicized to act as a deterrent.

Government of Indonesia (GOI) Priorities

Given that most of the participants in the breakout session were from the private sector and civil society, there was little discussion on GOI programs and priorities except in relation to transportation infrastructure.

Transportation infrastructure: On the issue of land, special attention is drawn on the new interest that the GOI, through BAPPENAS, is reviewing the possible adoption of some sort of "land market mechanism". With regard to Ports, with the recent issuance of the new Shipping Law, there have been new opportunities to promote investment and foster greater competition.

Recommendations for USAID

1. *Human resources*: New models of training are required. Donors can assist in building market institutions such as the use of vouchers, link vocational schools with industry, and provide an inventory of both training needs and training programs.

2. *Energy*: The group recommends further development of local energy supply through community-based green initiatives (e.g., utilizing bio-fuels, wind power) and that any

surplus electricity be sold to others in the region or into the main grid. USAID could focus assistance on a number of activities that provide technology and "know-how," improve local connectivity to the electrical grid, and address institutional and regulatory constraints.

3. *Transportation infrastructure*: The group recommended the following areas of intervention: 1) new mechanisms to assist with land acquisition (*pembebasan tanah*) and to address speculation problems, 2) investment facilitation and exploring Sharia/Sukuk financing; 3) assisting local governments with investment implementation (rather than keeping funds in bank accounts), and 4) addressing congestion in major cities through travel demand management programs (e.g., congestion pricing, public transport etc).

4. *Access to credit*: Key activities to address these issues would include: 1) generating necessary momentum to push through DPR then disseminate it; 2) assisting with prudential regulation and oversight; 3) assisting with ratings of MFIs; and 4) exploring the potential of "angel investors."

5. *Environment*: Make better use and development of green certifications. Such measures would include: 1) group based volume discounts, 2) land area/zone based certifications, and 3) development of certifier supplier market.

6. *Cross-cutting issues*: Helping to improve land acquisition and related regulatory framework; 2) promotion of small-scale electricity generation activities; and 3) advancement of public procurement transparency.

IV. TRADE & INVESTMENT

Issues, Opportunities, and/or Constraints

Job creation is still a key problem in Indonesia. Indonesia's official unemployment rate, among the highest in Asia, is approximately nine percent in 2007 according to the Indonesia Central Bureau of Statistics. Despite high rates of economic growth over the past five years, Indonesia is still lacking in employment opportunities, particularly in the manufacturing sector. In order to do that, Indonesia needs new investment. However, new investors do not know how to do business in Indonesia. Legal uncertainty remains, along with corruption and lack of adequate infrastructure. Indonesia has a new investment law but some aspects (e.g., related to the "negative list" of sectors not open to investment) are widely considered controversial and some implementing regulations are unclear. The law still overlaps with regulations produced by technical ministries or other local level regulations known as "perda" which sometimes make the investment climate worse in certain areas.

In addition, the *cost of labor* has greatly increased since the 1980s when Indonesia started its current industrialization phase. In addition, most of this labor is not highly skilled. The costs of labor have greatly increased because of increased living costs caused by increases in the gasoline price due to reduced government subsidy. The GOI needs to invest more in education and vocational training to increase skill levels. Worker salaries have increased but GOI investment in worker education and training has not. Also, severance payments in Indonesia are widely considered one of the central deterrents to greater foreign investment.

Regarding *infrastructure*, the problem lays in the fact that Indonesia is unable to provide public goods to its people (in education and access to land) as well as to investors (in skilled labor and physical infrastructure). In addition, the GOI lacks an effective Industrialization Plan or Investment Development Policy and local governments lack effective incentives to attract investment in infrastructure. Inadequate physical infrastructure leads to higher transportation costs which strain domestic trade. There are unsupportive *perda* on trade between provinces and districts. Market infrastructure is inadequate, especially for storage. Access to information is limited in international trade and international best practices and knowledge. There are also technical barriers for export-oriented products and export promotion. Lastly, problems abound in public procurement as well as the competitiveness of Indonesian products.

Government of Indonesia (GOI) Priorities

The Ministry of Trade has been working and/or would like to continue working in the following areas to support domestic and international trade:

1. Implementation of a National Single Window for customs (currently a trial operation)
2. Creation of faster and more transparent licensing procedures

3. Conducting trade and investment promotion including export promotion and development of an import strategy
4. Implementation of ASEAN Economic Cooperation (free trade among ASEAN countries) and Free Trade Agreements with U.S., Japan, India, and Australia
5. Establishment of the Batam-Bintan-Karimun special economic zone
6. Promotion of market expansion / export diversification
7. Development of a blueprint for a creative economy (the idea is for one village to have one specific product that can be traded)
8. Developing capacity for SMEs through training and international exhibitions
9. Conducting bilateral meetings to overcome barriers for export
10. Expansion of market penetration through the opening of trade promotion offices abroad
11. In cooperation with JICA, conducting market intelligence research

BKPM, the GOI's investment promotion organization, is focused upon the following to improve the investment climate:

1. Publishing guidance on investment that is scheduled to be completed in June 2008 and followed by a road map at the end of this year.
2. Finishing the implementing regulations of the 2007 Investment Law.
3. Implementing regulation on One Stop Shops in terms of shifting and delegating authority, due in 2008.
4. Finalizing the draft law on the Special Economic Zone for Batam-Bintan-Karimun.

Participants also think that a roadmap for investment is needed, especially for certain commodities, sectors, and areas. Related to investment, PEPI, the GOI's investment policy coordination entity, thinks that the government needs to clarify which GOI organization should be responsible for which investment activities. This is true especially for inter-agency work and it needs to be made clear as to who should be taking the lead for certain actions.

Recommendations for USAID

1. Assist GOI to synchronize conflicting trade and investment laws and regulations pertaining to such areas as mining and gas, the 2007 Investment Law, the 2007 Corporate Law, and 2003 Labor Law. A mechanism should be developed and put into place to deter conflicting regulations.
2. Capacity building for local government on investment services. Not all local governments are able to provide good public services such as a One Stop Shop.
3. Assistance to reduce transaction costs (e.g., local levies, poor roads) for domestic trade and to exporters to improve their market opportunities and meet international standards.
4. Assist GOI to develop the National Single Window on customs.
5. Assistance in addressing trade logistics
6. Assistance in drafting *perda* conducive to domestic trade

7. Continued capacity building to technical / line ministries
8. Strengthen GOI inter-agency coordination on trade and investment matters.
9. Judicial and legal capacity building
10. Assistance in developing effective competition regulations
11. Assistance in developing an effective infrastructure policy
12. Creation of internet-based export promotion facilities
13. Improving transparency of public procurement system
14. Promoting labor law reform and labor policy reform
15. Further development of Special Economic Zones
16. Improving capacity of local and regional governments on transparency and combating corruption
17. Developing a draft law on land acquisition for public purpose (will need to support a comparative law study)
18. Adoption of ISO to address problems of technical barriers for SMEs
19. Developing alternative energy sources
20. Assisting importers to comply with trade obligations, deal with competition (cartel, exclusive import, and licenses), access financial services, etc.
21. Improving inter-agency coordination (facilitation role and networking)
22. Assistance in analytical-based policy development to better prepare GOI in policy and regulation drafting
23. Improving transparency of public services (e.g. public procurement process, support for local governments to set up OSS, etc.)

V. FINANCIAL MARKETS

Issues, Opportunities, and/or Constraints

Both Banking and Non-Bank Financial Institutions (NBFIs) play important roles in Indonesia today and in future Indonesian development. However, according to BAPEPAM-LK, 80% of all financial sector assets are in the banking sector whereas NBFIs, such as insurance firms, pension funds, mutual funds, leasing and venture capital companies, and capital markets (including equity and bond market) only hold 20% of all financial sector assets. To date, donor support has been heavily concentrated on the banking sector rather than the NBFI sector.

Based upon this, the majority of the discussion was centered upon the potential role of NBFIs. It was agreed that insufficient attention is being paid by the GOI on the role of NBFIs. As a result, there is lack of incentive for NBFIs and insufficient investment in the financial sector which limits of the availability of critically needed long-term financing opportunities. It was also mentioned that the average Indonesian did not fully understand the importance and concept of NBFIs such as insurance and pension funds.

Representatives of various NBFIs stated that reliable and standardized information systems at the Ministerial level are much needed. Access to such information would make the NBFIs better able to provide service to their customers. It is also necessary to have capable human resources both in the Central Bank and in the NBFIs to access and maintain such systems. Moreover, one of the key issues raised, especially in relation to NBFIs, is that they lack sufficiently trained personnel both at the regulatory level as well as within the NBFIs themselves. Hence, effective capacity building and training is necessary.

Lastly, it was also mentioned that access to finance at the local level was still seriously lacking. The local bank, or Bank Pembangunan Daerah (BPD), which is supposed to provide access to financial services to local communities, is playing only a limited role. Such local banks lack capacity to provide and expand access to financial services and access to micro insurance. In addition, Central Bank regulations on microfinance need to be cleared up to improve BPD performance and enhance their capacity to provide financial services to local communities.

Government of Indonesia (GOI) Priorities

Some of the GOI priorities discussed are as follows:

- Developing Financial Sector Architecture (Arsitektur Sektor Keuangan Indonesia – ASKI) to better integrate banks and NBFIs. Currently, the banking sector is controlled by Bank Indonesia while the NBFI sector is controlled by the Ministry of Finance.

- Another priority is developing a financial sector "Early Warning System." The system is a database that contains all indicators related to the financial sector and would be used to predict the financial situation a few months in advance.

- Strengthen the weak regulatory system for NBFIs. For the banking sector, the Indonesian Deposit Insurance Agency (LPS – Lembaga Penjamin Simpanan) will guarantee deposits up to 100 million rph in the event of bank failure but no such system is in place if NBFIs, such as insurance companies, were to collapse. As a result, NBFIs are able to operate without sufficient supervision or regulation.

<u>Recommendations for USAID</u>

Based on the discussion, the following five priority areas for USAID consideration were developed:

1. Assist GOI to generate additional capital to maintain financial sustainability
2. Promote the role of NBFIs especially in life insurance, pensions, and venture capital
3. Strengthen the capacity of BAPEPPAM-LK as the financial sector supervisor and regulator
4. Assist in the passage and establishment of the proposed microfinance regulatory framework
5. Support development of other service sectors

Generate Additional Capital to Maintain Financial Sustainability
The 1st priority is to generate additional capital to maintain financial sustainability. Actions to be taken include:

1. Broaden investor base
2. Encourage financial institutions to provide long-term financing opportunities with incentives related to tax, accounting, or regulations
3. Support regional/city borrowing to facilitate capital markets development (e.g., municipal bonds)
4. Develop borrowing strategies for the regions and cities

Promote the Role of NBFIs
As mentioned, Indonesian society does not fully understand the importance of NBFIs, especially relating to insurance or venture capital. Therefore, the group agreed that introducing the concept of insurance by doing a public awareness campaign, including introducing it in school curriculum, is important. Improvements are also necessary to the insurance industry itself including an assessment of policy holder protection and the role of consumers versus investors. Training is also needed to improve the quality of human resources. It was also suggested to expand the operation of STIMRA, the Indonesian Risk Management Institute, beyond Jakarta. Working more closely with the Indonesian chapter of the International Association of Insurance Supervisors (IAIS) was also raised as a critical point. The IAIS represents insurance regulators and supervisors in more than 130 countries, consisting of 97% of the world's insurance premiums, includes the world's

leading insurance companies as observers. The IAIS aims to contribute to improved supervision of the insurance industry in order to maintain efficient, fair, safe, and stable insurance markets for the benefit and protection of policyholders. Active Indonesian participation in IAIS would demonstrate to the world that Indonesian authorities are committed to improving the working of the insurance industry in Indonesia. On policy issues, in order to address the needs of "ordinary" citizens, new systems to deal with the labor intensive nature of such businesses are needed. Costly investment in that area should be encouraged through incentives. One of the GOI's plans in the financial sector is to strengthen the weak regulatory body of NBFIs that could address this issue.

Strengthen the Capacity of BAPEPAM-LK
The 3rd priority recommended is to strengthen BAPEPAM-LK and the regulatory environment. This would include:

1. Strengthening the quantity and quality of staff
2. Revisiting the standards structure for oversight within the current laws
3. Consolidating all insurance activities under one roof
4. Enhancing availability of data on markets, earning statements, balance sheets, transactions, etc.
5. Guaranteeing uniform enforcement and supervision
6. Protecting policy holders, investors, and consumers
7. Improving the regulatory environment for microfinance

Establish Microfinance Regulatory Framework
Coordination among GOI entities (Ministry of Home Affairs, BAPPENAS, Ministry of Finance, and Bank Indonesia) and NGOs for development of an effective regulatory framework and standardization is necessary. The group believed that the BPD should be examined as the possible vehicle for delivering financial services at the local level.

Support Other Service Industries
The group agreed that NBFIs should support other service industries such as tourism and health. Both industries are labor-intensive and can contribute to job creation and foreign exchange earnings. Successful tourism and health industries can also attract foreign investment.

Capacity Building
Capacity building was seriously raised several times. The consensus is there is not enough well-trained personnel in middle and upper management. The group agreed that continued training and capacity development are urgently needed and that training facilities be made available outside of Jakarta and in the various regions.

VI. CROSS-CUTTING ISSUES

Issues, Opportunities, and/or Constraints

Three cross-cutting issues were identified in this particular breakout session: infrastructure, labor, and corruption.

Infrastructure

Completion of several major *infrastructure* development projects, including toll roads, irrigation dams, and transmission lines, have been delayed by the GOI due to land acquisition issues. Although new regulations such as Presidential Instructions (Perpres) No. 36/2005 and later Perpres No. 65/2006 were issued, they have not been effective in addressing land acquisition issues.

There are two kinds of infrastructure needed by GOI: soft infrastructure and hard infrastructure. Soft infrastructure refers to sound policies, regulations, strategies and programs to address different economic problems facing the country. Hard infrastructure refers to roads, energy, irrigation systems, and other capital that is necessary for successful economic development at the national and local levels.

However, Indonesia has been experiencing many difficulties in developing and reforming both soft and hard infrastructure. Inconsistency of economic development policy, poor regulations, and legal uncertainty remain key challenges. Indonesia also has insufficient energy supply and increased logistics cost caused by bad transportation infrastructure which inhibit development.

Labor

The population of Indonesia exceeds 230 million and the workforce constitutes approximately 100 million of the total population. Despite an abundance of labor, Indonesia has witnessed tough labor market conditions since the 1997 financial crisis. Many workers are not fully employed because they work less than 35 hours a week. Much of the labor force in Indonesia is experienced in the resource-based economy rather than a knowledge-based economy. According to one of the participants, the majority of Indonesian labor is employed in agriculture rather than the industrial or services sectors.

Corruption

Corruption is one of the biggest challenges facing Indonesia. Although the GOI has taken action to combat corruption through the creation of the Corruption Eradication Commission (KPK) and other measures, corruption persists at both the national and regional levels.

Government of Indonesia (GOI) Priorities

Except for one KPK employee, none of the participants in this breakout session were GOI employees. Rather, they came from the private sector or civil society. Hence, the discussion on GOI priorities was limited to the following:

Infrastructure

In the need for soft infrastructure, the group agreed that the central government should focus its efforts on developing sound policies and regulations and improving coordination with and cooperation among various GOI institutions.

Labor

It was mentioned that the GOI is improving efforts to improve the quality of the labor force through vocational training.

Corruption

Civil service reform was cited as the key GOI priority in combating corruption.

Recommendations for USAID

Overall: Strengthen GOI institutional capacity.

Infrastructure

- Improve legal and regulatory framework for land acquisition
- Develop oversight or regulatory body to address pricing issues for energy
- Promote public-private partnerships to raise capital necessary for building of new or improvement of existing transportation networks
- Promote development of municipal finance
- Pay greater attention to environmental impacts of infrastructure projects
- Assist GOI to establish cost-recovery and cost-structure mechanisms

Labor

- Improve database of skills needed by industry
- Enhance existing educational/training programs and facilities to target and meet industry skill needs
- Provide more vocational training
- Improve enabling environments for micro-, small- and medium-sized enterprises

Corruption

- Strengthen the capacity of existing GOI institutions such as KPK, among others, to combat corruption through human resource development and improvements in information communications technology.