I. BACKGROUND

1. For the past several decades, prudent macroeconomic policies and continuing structural reforms have kept Indonesia on a path of rapid economic development. Since the 1970s, economic growth has averaged 7 percent per annum, raising GDP per capita toward the level of middle income countries, while dramatically lowering the incidence of poverty. The economic structure has become diversified, as dependency on the oil sector has declined and an export-oriented manufacturing base has emerged, led by a dynamic private sector and fueled by high domestic savings and large inflows of foreign direct investment. Meanwhile, macroeconomic balance has been maintained: the budget has been balanced; inflation has been contained at relatively low levels; current account deficits have been kept moderate; and international reserves have remained at comfortable levels.

2. Despite this strong macroeconomic performance, a number of underlying weaknesses have made the country vulnerable to adverse external shocks. Structural rigidities arising from regulations in domestic trade and import monopolies have impeded economic efficiency and competitiveness. At the same time, the relative stability of the rupiah during most of the 1990s, together with high rates of return on domestic investment, both encouraged and facilitated high levels of overseas borrowing, a significant portion of which has been private short-term debt that has been unhedged. By end-December 1997, Indonesia’s external debt stood at $140 billion (about two-thirds of GDP), of which $20 billion was short term, while its debt service has remained close to one-third of exports of goods and services. Also, the rapid expansion of the financial system since the late 1980s has left a number of banks with significant amounts of nonperforming loans, straining their liquidity and, in a number of cases, undermining their financial viability.
3. In the wake of the recent currency turmoil in the region, the exchange rate has depreciated to alarming levels. From mid-July last year to early January this year, the cumulative depreciation of the rupiah reached 70 percent, with over half of this decline occurring since the end of November, while the fall in the Jakarta stock exchange index reached 50 percent, both the largest declines in the region. The enormous depreciation of the rupiah did not seem to stem from macroeconomic imbalances, which remained quite modest. Instead, the large depreciation reflected a severe loss of confidence in the currency, the financial sector, and the overall economy.

4. The plummeting of the rupiah has led to very large increases in the rupiah debt service costs of banks and corporations that had borrowed—largely without hedging—from abroad. Moreover, since the currency depreciation has engendered a substantial rise in domestic interest rates, the burden of paying for, and collecting, domestic currency loans has also increased, further straining the position of corporations and financial institutions, particularly those that were already weak. A major concern for the government is that the process has become self-reinforcing: growing strains on firms have amplified investor uncertainty and encouraged capital flight, thereby intensifying pressures on the exchange rate and domestic interest rates.

5. From the outset of the currency crisis, the government has taken strong corrective action. To discourage speculative attacks, the exchange rate band was widened in July and, in August, in the face of continued pressure on the currency, the rupiah was allowed to float. This policy was backed by a significant tightening of liquidity conditions and an announcement that the budget surplus would be preserved by postponing major infrastructure projects, cutting low priority development programs, and extending the coverage of the luxury sales tax. At the same time, import tariffs on over 150 items (mainly raw materials and other intermediate goods) were reduced effective mid-September, while the 49 percent limit on foreign holdings of listed shares was abolished. Further trade liberalization measures, including removing monopoly restrictions on agricultural imports were announced in November last year.
These actions, however, were not sufficient to restore confidence in the rupiah and the economy.

II. THE POLICY FRAMEWORK

6. In November, in the context of an IMF-supported program, the government put in place a comprehensive policy package to restore confidence and arrest the decline of the rupiah. Fiscal policy was formulated to preserve a budget surplus of about 1 percent of GDP while monetary policy aimed at containing inflation and supporting the exchange rate. These policies were to provide the supportive macroeconomic framework for the continuing efforts to restructure the financial sector and accelerate structural reforms.

7. However, following a short-lived strengthening, the rupiah plummeted owing to a combination of contagion from currency turmoil in the region, political developments, and other uncertainties. It is now clear that the original macroeconomic targets cannot be realized. Under current volatile conditions, it is difficult to set precise macroeconomic targets. Nevertheless the program is designed to avoid a decline in output, while limiting inflation to about 20 percent, which, although high by Indonesian standards, is unavoidable given the substantial depreciation of the rupiah. At the same time, the external current account balance is expected to move from a deficit in 1997/98 to a surplus in 1998/99.

A. Macroeconomic Policies

Fiscal Policy

8. The government is fully committed to maintaining a sound fiscal policy. However, with the sharp depreciation of the rupiah and the deterioration in the economy, it is no longer feasible to aim at a surplus of 1 percent of GDP in 1998/99. The budget has therefore been framed to strike an appropriate balance between preventing undue deterioration of the fiscal position and avoiding an excessive fiscal contraction. Accordingly, the government is determined to follow its long-standing policy of a
balanced budget (in the Indonesian presentation), which avoids any recourse to
domestic financing. The corresponding deficit in the IMF presentation is about 1
percent of GDP. To realize this objective, the government has strengthened the
budget introduced on January 6 by adopting new measures.

9. To reduce economic distortions, and strengthen the fiscal position, the government
intends to adjust administered prices with the aim of gradually eliminating subsidies
on fuel and electricity. As the price increases necessary to eliminate these subsidies
are very large owing to the depreciation, it is not feasible to bring domestic prices to
the level of international prices abruptly. The government will therefore aim to
eliminate these subsidies gradually over the course of the program, starting with the
sizable initial adjustment in April 1, 1998 in fuel and electricity prices, except for
prices of kerosene and diesel fuel, where increases will be kept to a minimum so as to
protect the poor.

10. On the revenue side, the government has already announced increases in excises
on alcohol and tobacco, which will effectively raise revenue from these items by 80
percent and 10 percent, respectively. These excises will be increased further on July
1, 1998 to reflect exchange rate and price developments. In addition, effective April
1, 1998, the government will remove all VAT exemptions (apart from those on
capital goods or those explicitly mandated by law); these include, inter alia,
electricity for private companies, taxis, soybean food for cattle, sugar, personal
goods, medical equipment, and other machinery and capital equipment. All VAT
exemption arrangements will be reviewed regularly. With regard to other taxes, a 5
percent local sales tax on gasoline will be introduced on April 1, 1998 and the
number of goods subject to the luxury sales tax will be increased. The government
will also shortly increase the proportion of the market value of land and buildings
assessable for tax to 40 percent for plantations and forestry property.

11. In order to improve tax administration and the structure of the tax system, the
government has introduced a single taxpayer registration number which will come
into effect on April 1, 1998. Further planned improvements, in line with recommendations of the Fiscal Affairs Department of the IMF, to increase non-oil tax revenue, include: (i) raising the annual audit coverage; (ii) developing improved VAT audit programs to target large potential taxpayers; and (iii) increasing the recovery of tax arrears. To accelerate progress in this area, the government intends to request further technical assistance from the Fund.

12. To ensure the quality and durability of the fiscal reform, the government will move to a comprehensive and transparent system to report on the public sector financial position, particularly including quasi-fiscal operations. Accordingly, the government has decided to accelerate provisions under the Nontax Revenue Law of May 1997 which require all off-budget funds to be incorporated in the budget within five years. The accounts of the two large off-budget accounts, the Investment Fund and the Reforestation Fund, will be incorporated in the central government budget at the beginning of the 1998/99 fiscal year. In the specific case of the Reforestation Fund, the government will ensure that the funds are used exclusively for their intended purpose of financing reforestation programs, which include those outside the concessional forest areas, development of industrial forestry areas, reforestation of unproductive land, and other reforestation programs.

13. In recognition of the serious financial crisis facing Indonesia, the government has canceled 12 major infrastructure projects that had been reinstated earlier, including the Tanjung Jati-C power plant. The government has also decided to discontinue immediately any special tax, customs, or credit privileges granted to the National Car. In any event, the government will implement ahead of schedule the ruling of the WTO dispute panel. Moreover, consistent with Indonesia’s commitment to the WTO, the local content program for motor vehicles, which gives preferential tariff rates to vehicle manufacturers using a high percentage of local parts, will be phased out by 2000. It has also decided to discontinue immediately any budgetary and extrabudgetary support and credit privileges granted to IPTN projects.
Monetary and Exchange Rate Policy

14. Since the crisis began, Bank Indonesia’s monetary strategy has been to support the rupiah exchange rate, and limit any increase in inflation, by maintaining a firm monetary stance. The execution of this policy, however, has been hampered by problems in the banking system. Following the closure of 16 insolvent banks in November last year, customers concerned about the safety of private banks have been shifting sizeable amounts of deposits to state and foreign banks, while some have been withdrawing funds from the banking system entirely.

15. These movements in deposits have greatly complicated the task of monetary policy, because they have led to a bifurcation of the banking system. By mid-November, a large number of banks were facing growing liquidity shortages, and were unable to obtain sufficient funds in the interbank market to cover this gap, even after paying interest rates ranging up to 75 percent. At the same time, another smaller group of banks were becoming increasingly liquid, and were trading among themselves at a relatively low JIBOR (Jakarta Interbank Offer Rate) of about 15 percent. As this segmentation continued to increase, while the stress on the banking system intensified, Bank Indonesia was compelled to act. It provided banks in distress with liquidity support, while withdrawing funds from banks with excess liquidity, thereby raising JIBOR to over 30 percent in early December, where it has since remained.

16. Nevertheless, despite this increase in interest rates—to levels higher than in any other country in the region—the problems of the rupiah have only intensified. From early December to early January, the exchange rate lost a further 53 percent of its external value, falling from around Rp 3,700 per U.S. dollar to around Rp 8,000 per U.S. dollar. Part of the reason was that the rupiah was affected by the financial turmoil in other neighboring countries. Another factor was that markets became increasingly concerned about the deterioration in Indonesia’s economic situation, which has weakened the financial health of the banking system and the corporate
sector. Most of all, however, markets were concerned that the program originally designed in November was no longer sufficient to overcome the country’s economic predicament.

17. With the overall policy package that has recently been adopted, and set out in this Memorandum, the government is now convinced that confidence in the economic direction of the country will be speedily restored. And as this occurs, the exchange rate of the rupiah will finally stabilize. However, during the transitional period, in which confidence is taking hold, lingering concerns about exchange rate depreciation are likely to keep market interest rates at high levels. Bank Indonesia recognizes that, in these circumstances, it will need to keep its own interest rates high, as well. Accordingly, Bank Indonesia is raising interest rates on SBI (central bank) certificates across the entire spectrum of maturities, from overnight to one year, thereby bringing them in line with conditions prevailing in the money market—and sending a clear message to financial markets that it will maintain a firm monetary stance for as long as proves necessary. At the same time, Bank Indonesia is also providing full autonomy to state banks to adjust rates on credit and deposit liabilities, so that their rates could also reflect developments in money and credit markets.

18. This tight monetary stance will inevitably mean that, at least for the time being, the amount of credit available for lending to the corporate sector will remain constrained and the cost of credit will remain very high. Such a situation will place a particular burden on smaller enterprises, which rely on bank credit for their sole source of financing. To alleviate this burden, the government has introduced a temporary program under which credit will be provided to small-scale enterprises through the state banks at subsidized interest rates. The cost of the subsidy will be borne not by the state banks, but rather by the central government budget. A facility will also be established to extend credit to exporters at commercial terms. Eventually, though, these arrangements should prove redundant, since once confidence is fully restored and the exchange rate stability is regained, then funds should flow back into the banking system and the overall policy stance can be relaxed gradually, thereby
providing greater room for banks to expand credit and lower their interest rates—for all firms.

19. Bank Indonesia’s financial program has been formulated in the context of extremely uncertain financial conditions, including with regard to the demand for monetary aggregates. Over the course of 1997, the growth of broader monetary aggregates, slowed considerably, with M2 growth falling from year-on-year rates of 25 1/2 percent in June to 23 percent by November. At the same time, the money multiplier has fallen sharply, partly because there has been a marked increase in the demand for currency, as concerns grew over the scale of banking sector difficulties, but also because financial intermediation has declined, as banks become more reluctant to lend. Consequently, even though base money growth exceeded the program objective, broad money was well within the December target.

20. Bank Indonesia has established, in consultation with the Fund, a financial program for 1998, to ensure that monetary policy continues to operate within a well-defined framework, with a clear inflation objective. This program aims to contain inflation to less than 20 percent, implying that policy will ensure that there is only a limited pass through of the very substantial depreciation onto the prices of imports, and only a muted impact of the drought on food prices. To achieve this ambitious objective, Bank Indonesia plans to limit the growth of broad money to 16 percent in 1998. As in 1997, broad money growth targets will be attained by controlling base money, rather than by relying on direct quantitative lending targets.

21. This monetary strategy will be complemented by judicious foreign exchange intervention to stabilize and support the exchange rate. The scale of this intervention will be determined in close consultation with IMF staff, and will also be subject to Bank Indonesia maintaining net international reserves above the monthly and quarterly floors specified in the program. As in our previous Memorandum on Economic and Financial Policies, any sterilization of exchange market intervention
will be strictly limited so as to ensure that monetary conditions become firmer as the scale of intervention increases.

22. Bank Indonesia will immediately be given autonomy in formulating and implementing monetary policy. To ensure that the central bank remains accountable, the inflation objective will continue to be decided by the government as a whole, but the policies for achieving this objective, such as changes in official interest rates, will be determined solely by the central bank. To institutionalize the autonomy of the central bank, a draft law will be submitted to Parliament by the end of 1998, which will also include changes in the composition and mandate of the Monetary Board.

**B. Financial Sector Restructuring**

**Bank restructuring program**

23. The government has already taken decisive action to implement a comprehensive program of bank restructuring aimed at restoring the soundness of the banking system. On November 1, 1997, sixteen insolvent banks were closed. The bank closures made it clear to the market that owners would lose their stake in banks that become unviable. A number of other banks, including regional development banks, have been placed under intensive supervision by the central bank. Rehabilitation plans for some of these banks have been approved by the central bank and are being implemented, while others are still under preparation.

24. However, the continued depreciation of the rupiah, the slowdown in growth, and high interest rates since then have led to a marked deterioration of the financial condition of the remaining banks. This deterioration has been exacerbated by deposit runs and capital flight, forcing many banks to increasingly resort to central bank liquidity support. The large depreciation of the rupiah in recent weeks has raised the concern that these problems will only intensify.
25. In these circumstances, the government believes that re-establishing confidence in the ability of the banking system to meet its commitments and play its intermediation role is of paramount importance. Therefore, Bank Indonesia is working closely with the AsDB, IMF, and World Bank staff to establish and expeditiously implement uniform, transparent and equitable rules for resolving liquidity and solvency problems, of private banks. These measures will be announced shortly. The central bank will provide liquidity support to banks subject to increasing conditions, while ensuring that liquidity support extended to banks will be consistent with the program’s monetary growth objectives.

26. With technical assistance from the World Bank, the government has also taken steps to resolve the problems of the state banks and ensure their safety and soundness. The aim of this program is to improve their efficiency and subsequently privatize them. Toward this objective, the government announced in December 1997 that BTN will become a subsidiary of BNI and that four state banks, Bapindo, Bank Bumi Daya, BDN and Bank Exim, will be merged. The government will ensure that the merger process will be used to downsize the operations of the merging banks, sell redundant facilities and bank branches, reduce excessive manpower, economize on automated systems, maximize benefits from complementary strengths, and prepare the institutions for privatization. The state banks will not be recapitalized except in conjunction with privatization. The government will ensure that, until privatization, the state banks perform according to criteria detailed in performance contracts, prepared by the Ministry of Finance (Directorate General for State Enterprises) with assistance from the World Bank, by end-March 1998. These contracts will spell out the objectives of the management of each institution and form the basis for assessing performance.

27. In support of the ultimate goal of full privatization of all state banks, the government will introduce legislation by end-June 1998 to amend the Banking law in order to remove the limit on private ownership. The new bank formed from the merger of the four state banks will be staffed by new managing directors. This new
management will be in place by end-February 1998 and will formulate and implement a plan for interim operations of the four merging banks including a timetable for the final merger. Foreign strategic partners will be sought for the merged bank to assist in attracting other private sector participation and for eventual privatization. The timetable for privatization for all the state banks will be determined in consultation with the IMF and the World Bank.

28. As preparation for the mergers and acquisition process, as well as for privatization, all state banks (including those that will not be merged) will conduct portfolio, systems, and financial reviews to internationally acceptable standards using teams from internationally recognized audit firms. These reviews will be initiated by end-February 1998 and completed by end-June 1998. Subsequent reviews will be conducted annually. The portfolio, systems, and financial reviews will serve to appraise the value of the assets and establish a basis for segregation of good and bad assets, according to uniform criteria and procedures. In addition, a financial plan for funding of bad debts of the state banks will be prepared with the assistance of the World Bank by end-July 1998. A new asset resolution entity will be established by end-March 1998, and made fully operational by end-July 1998. This entity will receive the bad debts of state banks and will concentrate solely on debt recovery within a defined time schedule.

**Strengthening the legal and supervisory framework for banking**

29. The government is firmly committed to improving the supervision of the banking system. Enforcement of prudential regulation has been strengthened through establishment of a graduated system of penalties for noncompliance, culminating in the withdrawal of banking license. Capital adequacy rules are being enforced within the context of the bank restructuring strategy, and in the case of the non-foreign exchange banks, minimum capital requirements will be increased gradually to put them on par with the foreign exchange banks. New loan classification and provisioning guidelines have been prepared and loan loss provisions will be made
fully tax-deductible by end-March 1998. The reporting and monitoring procedures for foreign exchange exposure of banks have been upgraded and the limits strictly enforced. The central bank’s capacity for risk-based supervision will be further strengthened with technical assistance from the IMF and the World Bank. Beginning in March 1998, internationally-recognized specialists are to provide active support in on- and off-site supervision. Moreover, to eliminate the conflict of interest inherent in central bank ownership of banks, Bank Indonesia has established a program for divestiture of its interests in private banks, and has already made substantial progress towards this goal.

30. To further strengthen the policy and institutional infrastructure for banking, the government has taken steps to:

(a) revise the legal framework for banking operations, after a thorough review of central bank and banking laws as well the company law and liquidation regulations, which will be completed by end-September, 1998. Areas of focus will include, bankruptcy, banking disclosure, taking and realizing collateral, and regulations on financial instruments. Action plans to improve the legal framework will be prepared by the end of 1998 with the help of the IMF and the World Bank.

(b) improve transparency and disclosure in banking. To this end, the government will immediately require all banks to publish audited financial statements annually. Bank Indonesia will also review the adequacy of data provided in banks’ condensed biannual balance sheets with a view to improving the dissemination of information on the financial condition of individual banks. The government will also require banks to regularly publish more comprehensive data on their operations, after a transition period that is expected to be less than two years. Banks wishing to publish such data prior to the end of the transition period would be free to do so.

(c) level the playing field for foreign investors in banking. As part of its WTO
negotiations for liberalizing trade in financial services, the government has decided to: lift restrictions on branching of foreign banks by February 1998; in addition, it will submit to the Parliament a draft law to eliminate restrictions on foreign investment in listed banks by June 1998.

(d) eliminate all restrictions on bank lending, other than those required for prudential reasons, or those to support co-operatives and small-scale enterprises (the KUK scheme).

C. Structural Reforms

31. In November, the government set out an ambitious strategy of structural reform, aimed at bringing the economy back to a path of rapid growth, by transforming the "high-cost economy" into one which would be more open, competitive, and efficient. To achieve this transformation, the strategy called for foreign trade and investment to be further liberalized, domestic activities to be further deregulated, and the privatization program accelerated. At the same time, it envisaged that measures would continue to be taken to alleviate poverty.

32. The government has already made considerable progress toward the strategy’s objectives. In November, a major step was taken toward opening up the economy and increasing competition, when BULOG’s import monopoly over wheat and wheat flour, soybeans, and garlic were eliminated. To ensure that final consumers obtained maximum benefits from this reform, importers were allowed to market all of these products domestically, except wheat (until recently; see paragraph 44 below). Similarly, to ease the adjustment costs for farmers, tariffs were simultaneously introduced on all of these products, but these rates were limited to 20 percent or less, and will be reduced to 5 percent by 2003.

33. In addition, two other important structural measures have also been taken under the program. First, in November, the administrative retail price for cement was
eliminated, thereby improving the degree of competition in this industry, and immediately reducing prices for construction firms and consumers. Second, the medium-term tariff reduction program was extended to cover two key additional sectors, chemicals and metal products. Tariffs on most chemical products have already been reduced by 5 percentage points, effective January 1, 1998 while those on steel/metals will be lowered beginning January 1, 1999. In line with the overall program, further reductions in these tariffs are scheduled for subsequent years, so that by 2003, the maximum tariff on these products will be brought down to the medium-term target of 10 percent.

34. Despite this steady progress, the economic crisis has deepened during December and early January, making it clear that bolder, and faster, reform will be necessary to overcome the economy’s problems. Accordingly, the government has decided to reinforce its structural reform program, by accelerating some of the measures that were earlier planned, and by supplementing them with additional actions.

**Foreign Trade and Investment**

35. Over the past two months, it has become evident that the drought afflicting the country is the most severe in half a century, and requires emergency measures. Accordingly, to ensure that adequate food supplies will be available to the population at reasonable prices, the government has decided to go beyond the original program strategy, and include agricultural goods in the general program of tariff reduction (leaving motor vehicles as the only exception). As an immediate measure, tariffs on all food items have been cut to a maximum of 5 percent, while local content regulations on dairy products have been abolished, both effective February 1, 1998,. At the same time, tariff rates on non-food agricultural products will be reduced by 5 percentage points, and will gradually be reduced to a maximum of 10 percent by 2003.
36. At the same time, as another major step in assuring a level playing field, on February 1, 1998, all import restrictions on all new and used ships were also abolished. All other remaining quantitative import restrictions, other than those which may be justified for health, safety, environment and security reasons, and other nontariff barriers that protect domestic production, will be completely phased out by the end of the program period.

37. The government also intends to phase out punitive export taxes, since these can no longer be justified, given the country’s now-pressing need to augment its inflows of foreign exchange. Accordingly, on February 1, 1998, export taxes on a wide range of products—including leather, cork, ores and waste aluminum products—will be abolished. For other products, however, export taxes cannot simply be eliminated, since they serve as an important means of discouraging overexploitation of Indonesia’s natural environment. In such cases, therefore, export taxes will be replaced by resource rent taxes, which would protect the environment, while eliminating the bias against production for export, rather than for domestic use. As a first step, in March 1998, export taxes on logs, sawn timber, rattan, and minerals will be reduced to a maximum of 10 percent *ad valorem*, and appropriate resource rent taxes imposed. At the same time, similar steps will be taken for all of the remaining items currently subject to an export tax: the levies on exporting will be abolished and replaced by resource rent taxes, where appropriate.

38. The government will also eliminate all other types of export restrictions, such as quotas, by the end of three years. The only exceptions will be for those restrictions imposed for health and security reasons, as well as time-bound, temporary, measures introduced in the event of occasional domestic shortages—such as the recently imposed export ban on palm oil. This ban will need to be retained through the first quarter of 1998, to ensure adequate domestic supplies of palm oil and restrain price rises. After March, however, it will not be renewed, nor will the previous system of export quotas and punitive taxes will be reintroduced. Instead, palm oil will be subject to export taxes at rates not exceeding 20 percent.
39. Another pressing need in the current circumstances is to encourage foreign investment. Accordingly, the government has decided that in June 1998 it will issue a revised and shortened negative list of activities closed to foreign investors. As part of this process, the government has removed restrictions on foreign investment in palm oil plantations on February 1, 1998 while those on wholesale and retail trade will be lifted by March 1998.

**Deregulation and Privatization**

40. The second major thrust of the structural reform strategy will be to deregulate and privatize the economy, in order to promote domestic competition and expand the scope of the private sector. As a first, bold step, all of the existing formal and informal restrictive marketing arrangement—including those for cement, paper, and plywood—will be dissolved, as of February 1, 1998. Henceforth, no firm will be forced to sell its product through a joint marketing organization, nor be required to pay fees or commissions to it. Neither will any organization be allowed to assign exclusive marketing areas, or to dictate production volumes or market shares to individual enterprises. In the case of cement, internal and external trade restrictions have also been eliminated, so that traders are now free to purchase and distribute all brands of cement in all provinces and export without acquiring permits other than a general exporters’ license.

41. Similarly, trade in agricultural products is also being deregulated. Effective February 1, 1998, traders will have the freedom to buy, sell, and transfer all commodities across district and provincial boundaries, including cloves, cashew nuts, oranges, and vanilla. In particular, traders will be able to buy and sell cloves at unrestricted prices to all agents, effective immediately, and the Clove Marketing Board will be eliminated by June 1998. The system of quotas limiting the sale of livestock will be abolished by September 1998. Furthermore, provincial governments will be prohibited from restricting interprovincial or intraprovincial trade, effective February 1, 1998.
42. To support export expansion the government is now enforcing the prohibition of *retribusi* (local taxes) at all levels on export goods. To strengthen competition and market integration, government will develop and implement a one-year program for abolishing taxes on interprovincial and inter-district trade. Any loss of local government revenue will be addressed through a combination of local fuel taxes and transfers from the central government.

43. BULOG’s monopoly will be limited to rice. Earlier, the government had planned that, following the November 1997 liberalization of wheat imports, domestic millers should distribute their flour through BULOG for a 3-5 year transition period. Now, however, we have decided to eliminate this requirement, while flour millers will be permitted to sell or distribute flour to any agent, both effective February 1, 1998. Also, effective the same date, all traders will be allowed to import sugar and market it domestically, while farmers will be released from the formal and informal requirements for the forced planting of sugar cane. This major measure will have a number of important economic benefits. It will rationalize sugar production, enabling old and inefficient government mills to be closed. It would increase rice output, as farmers switched from growing cane on irrigated land to producing higher value-added paddy. And it would increase the efficiency and competitiveness of sugar-using industries, such as food processing.

44. In parallel with these efforts to increase private sector productivity, the government is undertaking a public sector expenditure and investment review in order to promote a more efficient use of government resources. This review, which is being carried out in collaboration with the World Bank, will be completed by June 1998 and will result in a comprehensive program to improve fiscal efficiency, and restructure state-owned enterprises and strategic industries.

45. This review will also be the basis for an accelerated program of privatization. Already, oversight of public enterprises was moved to the Ministry of Finance from line ministries and a Privatization Board has been established. A clear framework will
be established for the management and privatization (either through share flotation or negotiated enterprise sales) of government assets by April 1998, including: (i) criteria for determining whether enterprises should be closed, restructured or fully privatized; and (ii) a transparent sales process that maximizes the return to government and treats all bidders equally.

46. Within this framework, the government aims to accelerate privatization and to take decisive action to restructure or close poorly performing enterprises. Twelve enterprises will be prepared for listing during the first year of the program. In all of these cases, the government intends to go beyond the recent pattern of seeking minority shareholders in public enterprises, by selling controlling, or even complete, stakes to the private sector. In addition, further tranches of government-controlled shares in public enterprises which are already listed will be offered for sale, so that these enterprises, too, can be fully privatized.

47. As for those enterprises remaining within the public portfolio, clear profit and performance targets will be established, which will be made public and reported annually. Nonviable enterprises will be audited by end-1998 and nonviable enterprises closed. Progress in this area will be assessed at the time of the second review.

**Social Safety Net**

48. Indonesia has made significant progress in alleviating poverty over the past 30 years. Yet large numbers of poor still remain, and it is imperative that the adjustment program does not result in a worsening of their economic and social conditions. To some extent, the depreciation should benefit the rural poor by raising output prices in the export-oriented agricultural sector. Nonetheless, the poor are likely to suffer extensively from the economic crisis, particularly as it has been compounded by an unusually severe drought. In these circumstance, special government initiatives will
be necessary. In particular, the government plans to introduce community-based work programs to sustain the purchasing power of the poor in both rural and urban areas.

49. In addition, efforts to target assistance to the poor will be intensified, including by expanding the program for the least developed villages, initiated in 1994, which has proved to be cost effective in creating rural infrastructure and expanding employment opportunities for the poor. Moreover, poverty eradication and more equal income distribution are to be major themes of the next five-year development plan, which begins in 1999. In particular, budgetary allocations for social spending will be increased, so as to ensure that all Indonesians receive at least nine years of education and better basic medical services.

Environment

50. To strengthen overall environmental sustainability, the government will draft and establish implementation rules for the new environmental law by March 1998. In addition, government will review and raise stumpage fees, auction concessions, lengthen the concession period, and allow transferability by June 1998, and will implement performance bonds and reduce land conversion targets to environmentally sustainable levels by the end of 1998. To improve air quality, the government is accelerating its program for conversion to cleaner fuels, including unleaded gasoline, to meet the President’s 1999 deadline.