



ISLAMIC DEVELOPMENT BANK GROUP

MCPS for the Republic of Indonesia for 2011-2014: Harnessing the Regional Potential



Building on past successes and lessons learnt, the MCPS Program is expected to be further augmented by knowledge and financial resources under the two major Cross-Cutting Areas: (i) leveraging Islamic finance, and (ii) mobilizing Partnerships. In particular, IDB Group will optimize its institutional knowledge to support accelerated growth of Islamic financial industry in Indonesia through the development of an Islamic financial architecture, including augmenting efforts to further deepen the Islamic capital market.

The MCPS Program will also utilize its Partnerships platform to attract bilateral donors and FDI, particularly from the GCC region, and through co-financing arrangements with other MDBs in support of the implementation of the MCPS Program in Indonesia. In addition, Capacity development, including Reverse Linkages, activities is expected to facilitate implementation of the MCPS Program and scale up exchange of knowledge and best practices between Indonesia and other member countries.

Indicative Financing and Key Success Factors

The indicative (notional) financing envelope for the MCPS period (2011-14) has been estimated in the range of \$3-3.3 billion. The regional distribution of the indicative envelope is 64% for financing programs in the three selected regions viz. Sumatra, Kalimantan and Sulawesi. About one-third of the total indicative financing is expected to be provided by the private sector financing Entities of IDB Group. Going forward, the indicative financing envelope will be firmed up during the Programming phase of the MCPS process. The size of MCPS financial envelope will be eventually determined by the borrowing appetite of the Government, identification of implementable/bankable projects, and IDB Group operational risk ceilings.

The ambitious scaling up of IDB Group support to Indonesia critically depends on a number of enabling and supportive factors, both at the policy and operational levels. A key success factor for ensuring successful implementation of the envisaged MCPS work program will be to establish a Country Office in Indonesia. This pre-requisite is necessitated by the need to operationally deal with the complex decentralized development process in Indonesia itself, the intense competition among donors with their own Country Offices, and monitoring requirements for robust implementation of projects. In addition, there will be a need to align national procurement guidelines with IDB procedures and to scale up technical assistance to help the Government agencies prepare bankable projects.

In conclusion, through a careful process of *alignment*, *selectivity* and focus with the Second Plan's Regional Strategies and Priorities and stakeholders' consultation, the MCPS framework combines the four Pillars and the four Cross Cutting Areas to address key binding constraints and support growth accelerators at the regional level; that is, contributing to harnessing the regional potential for a balanced and inclusive growth in Indonesia. In doing so, IDB Group will also seize opportunities for scaling up the role of Islamic financial intermediation, ranging from access of poor to microfinance to mobilizing resources through longer-term instruments. The Partnerships platform will be optimized to help attract foreign investments in key infrastructure sectors, export-oriented enterprises and financial sector. This platform will also be utilized to support Reverse Linkages through transfer of Indonesian expertise for augmenting development impact in other member countries.

Background¹

Indonesia is a vast archipelago comprising of about 17,508 islands with a population of 240 million. Through trading relationships, Islam arrived in northern Sumatra in early 13th century. The country gained independence from the Japanese occupation in August 1945, shortly after the end of the Second World War. Before the Japanese occupation Indonesia was a Dutch colony. Administratively, Indonesia comprises of 33 provinces divided into seven regions.

In the past five decades, Indonesia appears to have finally turned the corner from political turmoil to democracy, decentralization and economic liberalism. The political stability during the past ten years has also been marked by rapid consolidation of democratic, institutional and economic reforms. As a member of ASEAN and G20, Indonesia's political and economic weight is now increasingly perceived as an important Muslim voice in international and regional forums.

IDB Group commenced its activities in Indonesia in 1976 mainly comprising of OCR, Private Sector, and Trade Financing Operations. To date, IDB Group net approvals for Indonesia amount to about \$2 billion; of which the share of IDB-OCR is about 58% and trade financing constitutes about 42%. Financing from IDB-OCR is tilted, in regional terms, towards Java & Bali and Sumatra, and, in sectoral terms, towards tertiary education followed by agriculture and transportation.

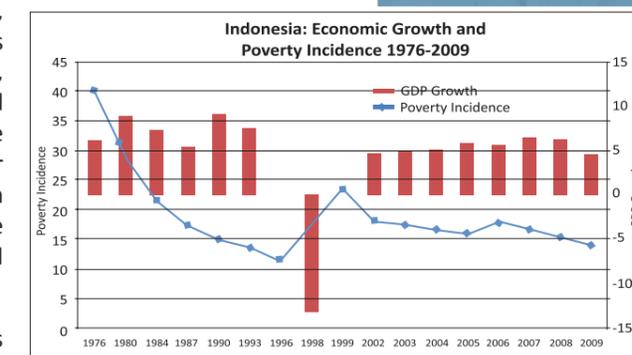
Key Developmental Challenges

With robust public finances and favourable external balances, Indonesia faced the headwinds of the global financial crisis with front-loaded fiscal stimulus. After the hiatus in 2009, economic growth is projected at 5.8% in 2010 and is expected to return to its normal rate of 6%-plus thereafter. In the medium-term, the quality of growth is expected to further improve mainly through two channels: (i) balanced growth in terms of regional economic development, and (ii) inclusive in terms of enhanced opportunities for jobs creation and poverty reduction.

Broadly, Indonesian social indicators are fairly similar to its regional East Asian peers and low middle-income group. There has been steady progress in lowering of poverty incidence. Compared to its peers, extreme poverty in Indonesia is on low side, yet relatively higher proportion of the population appears to be vulnerable and chronically poor. Fundamentally addressing this vulnerability requires skill development of the poor, especially in the rural areas.

Unless strong efforts are expended in addressing key developmental constraints, favorable macroeconomic outlook could be jeopardized and achieving the targets of the Second Medium-term Development Plan (covering the period 2010-2014) could be a formidable

¹This Outreach prepared by Mohammad Ahmed Zubair, Country Department, is based on the MCPS Main Report prepared by the IDB Group MCPS Team for Indonesia. The Report is placed on the IDB website (www.isdb.org) and limited hard copies are available with the Country Department.



IDB Group will optimize its Partnerships platform to attract donors and FDI, particularly from GCC region, in support of MCPS Program



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challenge. Funding PPP-based investments to rehabilitate and create modern infrastructure in Indonesia appears to be a promising strategy for underpinning longer-term and sustainable economic growth. However, poor institutional capacities, difficulties in land acquisitions and inadequate volume of skilled workforce have limited the efficacy of investment-led economic growth potential in Indonesia.

Reducing regional economic disparity in Indonesia presents the most important challenge for political stability and social cohesion. A critical challenge is to engender quality of growth in a way that yields greater spatial and income distribution gains. Uneven interregional economic growth has led to major differences in a variety of socio-economic indicators. Outside the Java-Bali region, economic growth, unemployment and poverty incidence are characterized by relatively high volatility. The principal reason of interregional disparities in Indonesia is the uneven investment flows. A major challenge during the Second Plan period is to foster investment activity outside the Java-Bali region by building supportive physical infrastructure and a pro-business environment.

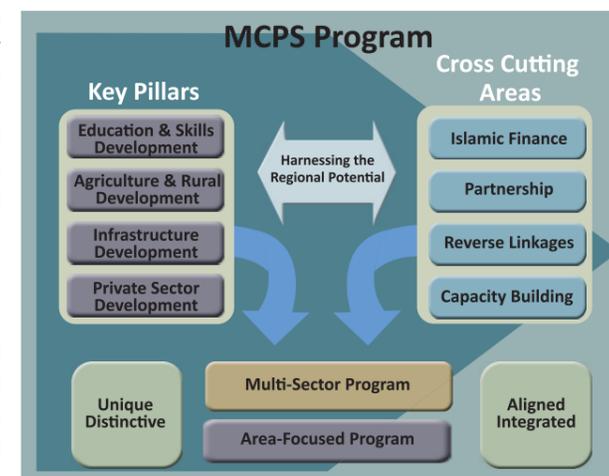
Leveraging Opportunities

For the development partners, the dictates of geography – Indonesia being a vast archipelago – makes it imperative to be highly selective in regional terms. Indonesia has faced multifaceted threats to its political, economic and social stability, which is partly due to severe interregional socio-economic disparities. Furthermore, the centrifugal forces arising from the sheer physical limits in the economic heartland of the Java-Bali region has now given rise to emerging urbanization opportunities elsewhere in Indonesia. The Second Plan goals are to accelerate regional economic growth and to deepen interregional transportation and trade connectivity. To achieve these goals, the Government policy seeks to foster *localization economies* – investments based on regions’ natural resources. Unless Government of Indonesia (GoI) policy also reinforces agglomeration economies – efficient and low cost access to production inputs – then attracting private sector investments in response to urbanization and market expansion opportunities could be limited.

Compared to many developing countries, Indonesian access to formal finance is moderate. Although, there is a highly conducive political and economic environment for the growth of Islamic finance in the country, its financial intermediation role across the entire spectrum has remained subdued. The annual growth of total assets of Islamic financial institutions, during 2006 to 2008, has ranged from 29% to 37%. Yet, in relative terms, the size of Islamic banks constitutes only 2.4% of the total banking sector assets in the country. In the short- to medium-term, there are a number of opportunities to scale up Islamic financial intermediation in Indonesia such as financial deepening through new types of Shariah-compliant modes of financing and efficiency improvements which make their financing charges competitive; building a stronger capital base of Islamic banks to further improving their resilience to shocks in the real sector; improving the quality of supervisory infrastructure; expanding skills and human capital developing; and further development of Islamic capital markets, particularly issuance of longer-term Sukuks which is critically needed for financing of PPP-based infrastructure projects.

Validation of MCPS Program through Regional Consultations

The overall MCPS Program sought *alignment and selectivity* with ‘Regional Strategies and Priorities’ of the Second Plan. It covers Java-Bali region (termed as the National-level Programs) and Sumatra, Kalimantan and Sulawesi (termed as the Regional-level Programs). Achieving *focus* was guided by four sets of inter-related considerations: (i) spread of geography and the sheer volume of required investments; (ii) identification of binding constraints, based on diagnostic studies, in Core Engagement Areas; (iii) identification of knowledge-, financing-, and partnership-based delivery mechanisms; and (iv) consultations process at different levels and stakeholders.



Diagnostics on growth, poverty and sector level challenges and priorities for Sumatra, Kalimantan and Sulawesi regions were carried out. A key insight of the diagnostics was that interregional disparities in Indonesia cannot be addressed by only basing economic activities on regions’ natural resources. In fact, supportive policies and adequate public investments are required to provide low cost access to critical inputs, such as electricity and skilled labor, force and building a highly efficient interregional connectivity to attract new industries.

On the basis of the diagnostics of binding constraints, mapping between the Regional Priorities of the Second Plan and the IDB Group Strategic Priorities, the four Pillars together with four Cross-Cutting Areas are expected to help accelerate growth drivers at the regional level.

With the support of the National Planning Agency (Bappenas) and the Ministry of Finance, five IDB-Gol workshops were organized during September 2010. In Jakarta, Inception and National Workshops were held while the three Regional Workshops were held in Palembang (South Sumatra), Pontianak (West Kalimantan) and Manado (North Sulawesi). Major objectives of these Workshops were to develop a common understanding with the stakeholders on selectivity and focus opportunities between Regional Development Strategy and IDB Group priorities; appreciation of implementation issues at the regional level; and explore partnership potential with other development partners.

The MCPS Program supports emerging developmental opportunities at the regional level in critical areas such as building of highly efficient interregional connectivity; urban development particularly focusing on well-organized urban land markets, water supply / distribution networks; achieving food security through agriculture and rural development; and assisting the private sector development, particularly the SMEs through low cost access to critical inputs such as skills development of the workforce, electricity and investment / trade financing.

MCPS Program targets emerging developmental opportunities outside the Java-Bali region by focussing on interregional connectivity and supporting development of efficient infrastructure



There are exciting opportunities to scale up the role of Islamic financial intermediation in Indonesia

