

# Executive Summary

## Context

1. The Asian Crisis of the late 1990s affected Indonesia more deeply than any other country in that region. Ensuing political and economic changes have been difficult, thus slowing economic recovery.
2. Investments by both the public and private sectors in 2005 and 2006 were still significantly below Indonesia's pre-crisis levels. In particular, the share of infrastructure investment in GDP has declined since 1998. Capacity constraints in infrastructure services have emerged as a result.
3. Although the country's banking system has been stabilized and largely privatized since 2002, banks are unprepared to scale up their long-term lending from a base that is predominantly funded from short-term deposits. Moreover, nonbank financial institutions (e.g., life insurance, pension, and mutual funds) do not function adequately as intermediaries between the long-term savers and the long-term, private sector borrowers because of incomplete reforms in the bond market.
4. Although poverty is back down to pre-crisis levels, the rate of poverty reduction has slowed in the first half of this decade. Gains in poverty reduction depend to a large extent on the performance of the agriculture sector, which employs 45 percent of Indonesians. However, agricultural growth has been stagnating. Revitalizing the rural economy will require an emphasis on value-added processing, stronger linkages between SMEs and farming communities, and sustainable natural resources management.
5. This Country Impact Review (CIR) evaluates the effectiveness of IFC's strategic approach and operations in Indonesia before, during, and after the crisis. It covers operations undertaken by IFC over the period FY1990–2006 and is concurrent with the IEG-WB's Country Assistance Evaluation (CAE) covering operations undertaken by the World Bank in Indonesia during the period FY1999–2006. The report addresses four key evaluative questions: (i) How effective were IFC's approaches or strategies for its operations in Indonesia before the crisis? (ii) How did the crisis affect IFC's development and investment outcomes? (iii) How effective was IFC's short-term response to the crisis? and (iv) How did IFC adjust its strategy after the crisis?

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

6. Prior to FY1997, IFC's strategic priorities in support of private sector development in Indonesia were not articulated in any single document. Instead, inference from various project documents indicates that IFC gave priority to: (i) supporting tradable goods sectors such as textiles, agribusiness, chemicals, and general manufacturing; (ii) increasing and diversifying IFC's client base; (iii) supporting privatization, particularly in infrastructure; and (iv) helping deepen financial markets. In FY1996, the World Bank Group (WBG) introduced, on a pilot basis, joint World Bank, IFC, and MIGA Country Assistance Strategies (CASs). The first such joint CAS for Indonesia was submitted to the WBG's Board of Executive Directors (the Board) in June 1997—just before the Indonesian country crisis emerged—and was implemented only partially as a result.
7. Before the crisis, IFC's investment commitments averaged about US\$109 million per year. In addition, IFC was able to play a strong catalytic role by mobilizing about US\$1.4 of B-loans<sup>1</sup> for every dollar it committed. IFC was successful in supporting tradable goods sector projects and in

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

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

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

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

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

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

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

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

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

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

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

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

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

### **Overall results and implications for IFC going forward**

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

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

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

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

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

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

### Recommendations

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

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