



Japan International Cooperation Agency

**Socioeconomic Study
for Assisting Formulation of
New JICA's Country Assistance Strategy for Indonesia**

Executive Summary

**Indonesia Study Team
Institute of Development Economies(IDE-JETRO)**

Background Paper No.1

for

JICA-IDE Joint Workshop on
Indonesia's Development Strategy and
Future Direction of JICA's Assistance in Indonesia

Jakarta, Indonesia

22 May 2008

Socioeconomic Study for Assisting Formulation of
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Abstract: Japan's assistance to Indonesia in the past has largely been consistent with Indonesian development policy and has achieved effects in developing infrastructure, developing human resources, and creating systems. However, the effects were low and unsustainable where the recipient had low commitment. It was also important not to easily continue projects. From now on, it is vital for Japan to assist Indonesia enable to graduate from ODA appropriately for its economic level in around 2020. Development issues for Indonesia are to achieve high growth and high employment to reduce poverty and disparity. A "double two-faceted strategy" comprised of a "two-faceted growth strategy by region" and a "two-faceted strategy of growth and poverty reduction" is effective for attaining the best scenario. Based on these strategies, the study explores priority assistance areas in which Japan's strengths are leveraged. It recommends that Japan and Indonesia should change the donor=recipient mindset to one of "collaboration (*kerjasama*)", and that Japan should change the way of assistance considering Indonesia's future graduation from ODA.

Keywords: Indonesia, Japan, ODA, JICA, graduation, development strategy, sustained growth, poverty reduction, stability

* This paper is an English version of an executive summary of the final report (in Japanese) submitted to the Japan International Cooperation Agency (JICA) in August 2007. Financial support for the research project is provided by JICA. We are grateful to discussion with the staff of JICA at the various stages of draft making. We are also grateful to other related Japanese organizations including the Japan Bank for International Cooperation (JBIC) and the Embassy of Japan in Jakarta, as well as many Indonesian people who kindly accepted our interviews when we conducted study in Indonesia. The views expressed in this publication are, however, neither of JICA, of Institute of Developing Economies (IDE), nor any other interviewees. Any remaining errors should be responsible for the authors.

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Introduction

This paper is an executive summary of the result of “Socioeconomic Study for Assisting Formulation of New JICA’s Assistance Strategy for Indonesia”, which the Japan International Cooperation Agency (JICA) commissioned the Institute of Developing Economies (IDE-JETRO) to conduct from April to August 2007.

Indonesia is the largest recipient of ODA from JICA as well as the Japan Bank for International Cooperation (JBIC), two of which are merged in October 2008. In this occasion, JICA needed a comprehensive analysis on Indonesian development and Japanese ODA for formulating a country-based policy of the New JICA for Indonesia. The purpose of this study, therefore, is to analyze effects and defects of Japan’s assistance to Indonesia by reviewing Japan’s assistance with Indonesia’s development policy over the past 40 years, and based on lessons from the past to recommend in what and how Japan should assist Indonesia in accordance to Indonesia’s mid-term development issues.

In this study, we extract the three policy objectives which have been consistent throughout the past 40 years of Indonesia’s development policy, that is, *sustained growth, distribution and poverty reduction*, and *stability and security*. We look at past and future development policy in Indonesia and ODA from Japan in this three-pillar framework, and analyze them combining a qualitative approach of area studies with quantitative tools of development economics.

This paper comprises two parts. Part I reviews and learns from the past. Section 1 provides a view on Japanese ODA and that for Indonesia. Section 2 and 3 examine Indonesian development policy and its achievements respectively. Section 4 discusses the consistency of Japanese ODA with Indonesian development policy and analyzes effects and defects of Japanese ODA. Part II deals with the future issue. Section 5 provides an outlook toward Indonesia’s graduation from ODA and formulates development issues to make the best scenario reality. Section 6 applies a quantitative economic analysis to explore the mechanisms of growth, employment generation, and poverty reduction and identifies desirable development strategies. Section 7 discusses in what and how Japan should provide assistance to Indonesia, taking Indonesia’s graduation from ODA into account. Lastly, we present conclusions and recommendations.

I. What Can We Learn from the Past?

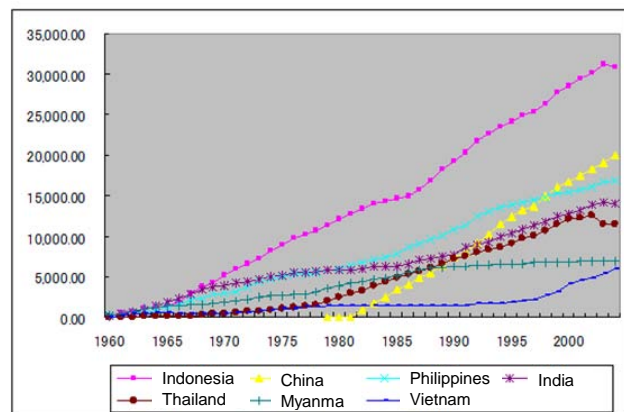
1. Japanese ODA and Assistance for Indonesia

Since 1997 Japanese ODA has been on the decline, and “selection and concentration” is becoming more important. ODA for Indonesia, however, has consistently been the largest in the cumulative amount. Despite the ODA reductions in recent years, there have been no changes in the significance of the Indonesia’s position (Figure 1.1).

The significant positioning of Indonesia is due to the fact that Indonesia is a major power within the Association of Southeast Asian Nations (ASEAN), has a long history of friendly relations with Japan, has close trade and investment relationships with Japan, is a supplier of energy and natural resources, and is located on a strategic international sea lane for Japan.

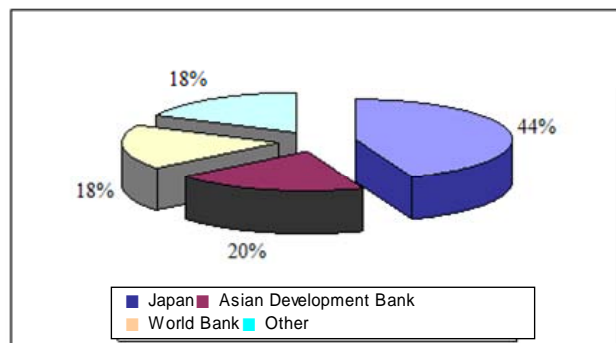
For Indonesia, Japan is the most important partner with respect to trade, investment and ODA. Japan not only stands out in terms of the amount of bilateral ODA provided, but also provides the largest amount when multilateral ODA is included. The main donors to Indonesia are Japan, the Asian Development Bank (ADB) and the World Bank (IBRD and IDA), but Japan has the largest share of Indonesia’s external public debt at 44 percent as shown in Figure 1.2.

Figure 1.1 Cumulative ODA from Japan to Major Asian Countries, 1960-2004
(Units: millions of dollars, net expenditure based on 2003 prices)



(Source) Created by Takahashi based on the Ministry of Economy, Trade and Industry website (<http://www.meti.go.jp/report/tshaku2006/2006honbun/excel/i3129000.xls>)

Figure 1.2 Share of External Public Debt from Overseas by Country/Organization (End of 2007 Q1)



(Source) Created by Takahashi based on Bank Indonesia, *Indonesian Financial Statistics*.

2. Transformation of Development Policy in Indonesia¹

A macroscopic view on Indonesia's development policy in the past 40 years from the early time of the Soeharto administration until the current Yudhoyono administration shows that the country has pursued the goal of simultaneously overcoming the issues of *sustained growth, distribution and poverty reduction, and stability and security*. Each of the three issues encompasses ideology conflicts. These are the conflicts between liberalism and nationalism in growth policy, between socialism and familism in distribution policy, and between democracy and authoritarianism in stability policy.

Table 2.1 Policy Conflicts and Changes in Development Policy of Indonesia

Policy Category	Sustained Growth		Distribution and Poverty Reduction		Stability and Security	
Ideology	Liberalism	Nationalism	Socialism	Familism	Democracy	Authoritarianism
Object of Gaining Support	All people	State, Pribumi	All people	Pribumi, specific groups	All people	Political elite
Subject of Policy	Private capital (foreign, ethnic Chinese)	State-owned enterprises Private capital	Lower and poorer classes	Pribumi entrepreneur, small and medium enterprises, cooperatives	Electorate, political parties, government, legislature, judiciary	President, bureaucrats, military
Policy Tools	Macroeconomic policy Agricultural development policy Deregulation policy Export promotion policy	Agricultural policy Protection of domestic industry (Import substitution policy) Regulatory policy	Social policy (Education, health, population) Poverty reduction, rural development	Protection of domestic industry Regulatory policy Regional development policy	Democratic elections Separation of powers Rule of law Decentralization	Restriction of political freedoms Depoliticization of the people Monitoring by security organizations Control by administrative organizations
Implementation Period	1950- Remnants of colonialism 1950s 1960s 1966- Economic recovery 1970s 1975 Pertamina crisis 1980s 1983- Structural adjustment 1984 Rice self-sufficiency achieved 1990s 1997 Financial crisis 2000- 2004- Economic recovery 2020	1959- Nationalization and regulation 1971 Establishment of Krakatau Steel 1974 Oil boom 1976 Asahan project started 1978- Development of strategic industries 1989 Set-up of Strategic Industries Management Agency (BPIS) 1990- High growth 2003- Economic recovery	1969- Inpres (Villages, regencies, schools) 1974- Inpres (Provinces, health, market, etc.) 1984 Compulsory elementary education introduced 1994- Inpres for less-developed villages	1950- Party politics 1959- Sukarno's politics 1974- Foreign investment restrictions, priority given to Pribumi 1980 Priority given to Pribumi 1990- Eastern Indonesia development Transfer of shares to cooperatives Priority given to Soeharto's Family	1950- Parliamentary democracy 1965 New Order 1974 Malari Incident 1989 Debates on opening politics 1996 July 27 Incident 1998- Democratization 2001 Decentralization 2004 Presidential election 2005 Election of regional heads	1959- Guided Democracy 1966- Suharto's regime 1973 Forced merger of political parties 1985 Five political laws passed

(Note) The shaded areas denote period in which the policy shown was effective.

(Source) Created by Kawamura.

¹ For details of discussions in the Section 2, see Kawamura [2008].

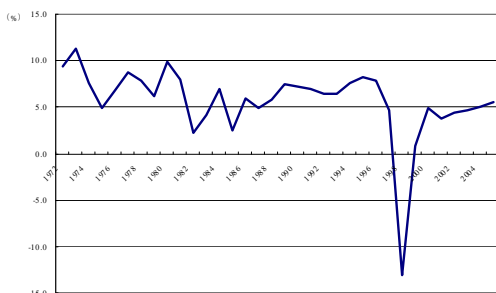
While liberalistic growth policy is adopted in economic downturns, nationalistic growth policy is implemented along with socialistic and familistic distribution policies in economic booms when fiscal funds are plentiful. As can be seen in Table 2.1, the pendulum swung towards the latter policy set twice ----- during the oil boom from 1974 to the early 1980s and during the high growth period from the end of the 1980s up to the Asian Monetary Crisis.

In the three-pillar framework, the growth policy has consistently remained the center of development policy despite the conflict between liberalism and nationalism. In contrast, the distribution policy played a large part only in favorable economic conditions, though consideration has always been given to socialistic policy. Stability policy has been the underpinnings for implementing growth policy and distribution policy. When the underpinnings was significantly shaken in the transitional period of democratization after the collapse of the Soeharto government in 1998 up to the direct presidential election in 2004, the normal implementation of growth policy and distribution policy was difficult.

3. Achievements of Development in Indonesia

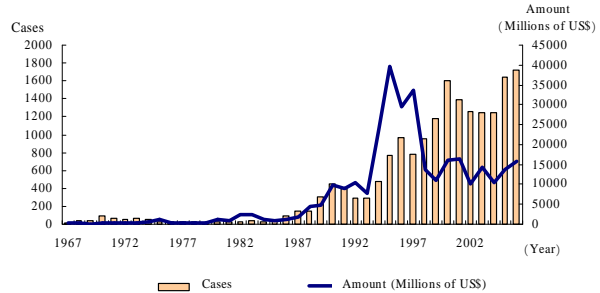
Let us review Indonesia's development achievements from the aspects of growth, distribution and stability. Under the Soeharto government, Indonesia continued an average annual growth rate of 7 percent for approximately 30 years (Figure 3.1). This growth performance was achieved because an appropriate policy framework was established when the government was launched and macroeconomic stability was maintained. Contributors to the sustained growth were the agricultural sector that developed ahead of industrialization to attain food self-sufficiency, the industrial sector that drove the growth, and increases in industrial exports and foreign investment after the late 1980s (Figure 3.2). Active infrastructure development also supported economic

Figure 3.1 GDP Growth Rate 1972-2005



(Source) IMF, *International Financial Statistics*, various year, created by Michida.

Figure 3.2 Foreign Direct Investment (Approval) 1967-2006



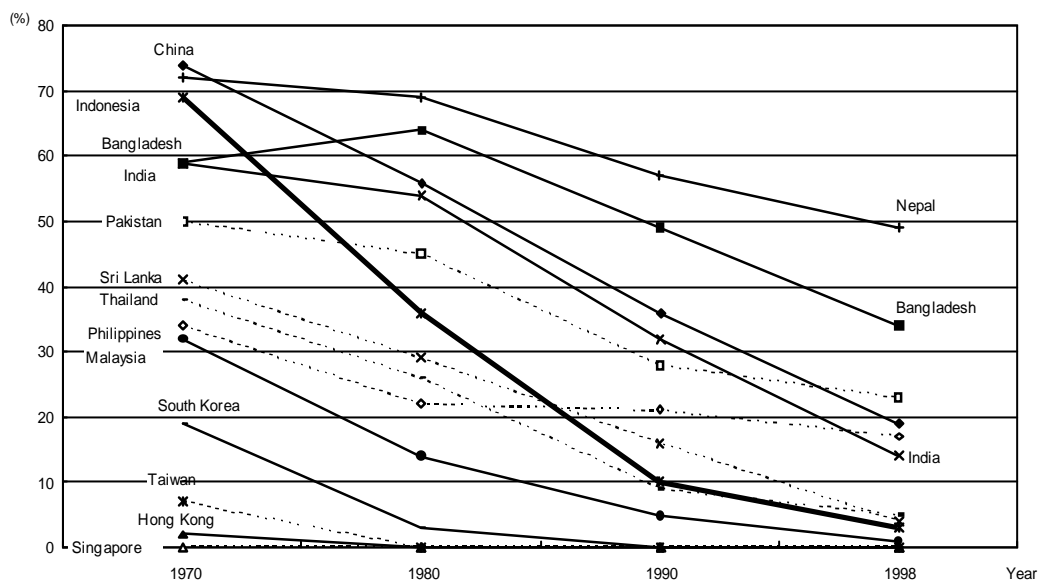
(Source) Investment Coordinating Board (BKPM) website (<http://www.bkpm.go.id/>), created by Kawamura.

activities. However, efforts in environmental conservation were insufficient.

The 1997 Asian Monetary Crisis and the subsequent large-scale political upheaval significantly hampered economic growth, leading to the “lost seven years”. GDP growth rates did not reach 5 percent in the period between 1997 and 2003. The recovery after the crisis was delayed by sluggish industrial exports and foreign investments partly because Indonesia had been late to join the regional production networks in Asia.

Poverty reduction along with high growth was another achievement under the Soeharto government (Figure 3.3). Through implementation of various *Inpres* (Presidential Instructions), social development in rural areas in such sectors as education and healthcare steadily progressed. Meanwhile, income disparity and regional disparity became issues from the late 1980s. Statistically, however, the expansion of the disparity cannot be confirmed when looking at gross regional domestic production (GRDP) per capita without oil and gas (Figure 3.4). It is more accurate to say that the disparity neither grew nor shrunk, and remains preserved without being eliminated. The development of “East Region of Indonesia” (KTI: Kawasan Timur Indonesia, i.e. Kalimantan, Sulawesi, Nusa Tenggara, Maluku and Papua) for correcting regional disparity with western Indonesia as advocated by President Soeharto and Cabinet Minister Habibie in the 1990s is regarded to take on a political nature.

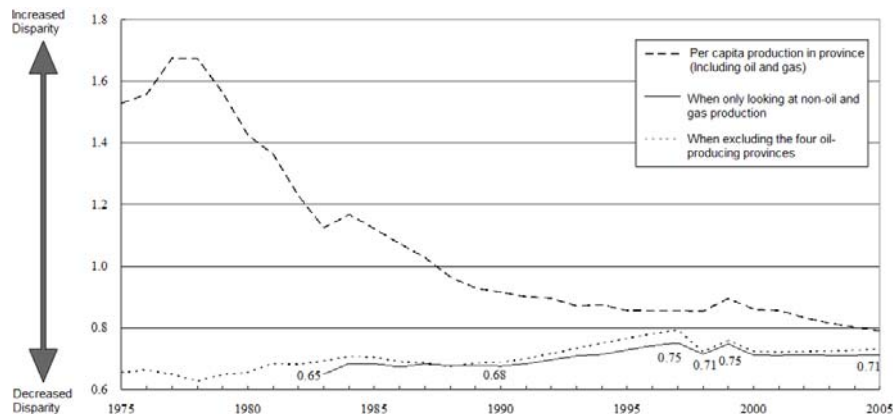
Figure 3.3 Comparison of Poverty Rates in Asia (Less than 2 USD Per Day)



(Note) As the poverty rate is zero for many countries when calculated as being 1 USD per day, 2USD was used as the poverty line in this comparison.

(Source) Excerpt from Higashikata and Yamagata [2007] (based on Sala-i-Martin [2002]).

Figure 3.4 Regional Disparity Measured by the Coefficient of Variation



(Note) The “four oil-producing provinces” refer to Aceh, Riau, East Kalimantan and Papua, which have a high proportion of oil and gas in gross production within the province.

(Source) The population of each province was calculated based on the population census. Gross production within each province was calculated using the Produk Domestik Regional Bruto Propinsi-Propinsi di Indonesia menurut (BPS) in 1993 prices. Created by Higashikata.

Stability under Soeharto rule was achieved by the national governance system comprising three elements of military security organizations, bureaucrat administrative organizations, and Golkar, but the system changed significantly after democratization. Four constitutional amendments brought about a new political system. The key points in these amendments are political liberalization, the institutionalization of political competition and participation, and the institutionalization of the separation of power (Kawamura [2003]). The separation of power included horizontal separation from power concentration on the president to power separation of the three branches and vertical separation from centralization to regional decentralization. Both forms of separation advanced excessively, resulting in confusion, but systems were later revised with the aim of stability.

4. Effects and Defects of Japan’s Assistance to Indonesia

4.1 Reorganization of Assistance Projects

This study attempts to reorganize Japan’s ODA projects under the three objectives of Indonesia’s development policy over time (Table 4.1), not necessarily given the classification in “Country Assistance Program (CAP)” and “JICA Country Program for Indonesia”.

Table 4.1 Three Purposes of ODA Operations:

Comparison of JICA Categories and Categories in this Study

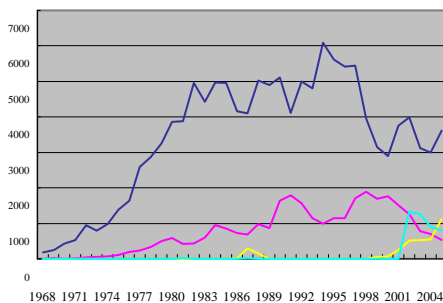
JICA Categories		Categories in this Study	
Priority areas	Program/sub-program	Purpose of aid project	Sector
Sustainable growth driven by private sector	Improvement of economic infrastructure: traffic, information, urban centers	Sustained growth	Improvement of infrastructure
	Improvement of economic infrastructure: energy		Energy
Democratic and equitable society creation	Private-sector development	Distribution and poverty reduction	Private-sector development (industry/ mining)
	Economic, fiscal and financial policy support		Tourism
	Poverty reduction: education		Economic policy support
	Poverty reduction: health		Agriculture: increased food production
Peace and stability	Poverty reduction: improvement of village infra.	Stability and security	Irrigation / flood management
	Poverty reduction: stable supply of food, increased income in farming and fishing villages		Environmental conservation and improvement
	Poverty reduction: development of eastern Indonesia		Education
Others	Governance reform	Other	Health
	Environmental conservation		Improvement of village infrastructure
Peace and stability	Peace and stability (reconstruction and security)	Stability and security	Agriculture: increased income in villages
	Aid coordination, Japanese research, etc.		Regional development
Others	Disaster prevention	Other	Rehabilitation and security
	Tourism		Governance reform
			Disaster prevention
			Aid coordination, Japanese research, studies, etc.
			Program loans

(Source) JICA categories were taken from “JICA County Program for Indonesia”, 2006, p6. Created by Sato.

4.2 Consistency of Japan’s Assistance with Indonesia’s Policy

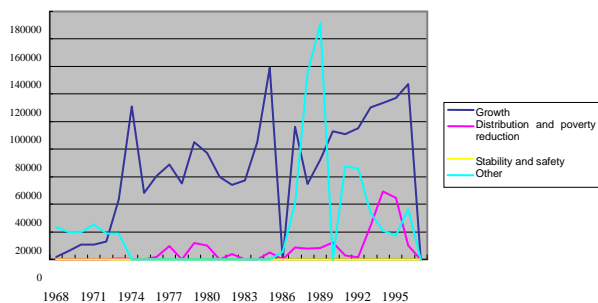
According to the classification used in this study, assistance provided by JICA and JBIC was mainly for growth objective, as shown in Figure 4.1 and Figure 4.2. When the Indonesian government placed an emphasis on distribution and poverty reduction policy for the second time from 1990 onwards, JICA and JBIC acted in concord and increased assistance for distribution and poverty reduction. From 2000 onwards, JICA newly added assistance for stability and security, required along with Indonesia’s turnaround toward democracy.

Figure 4.1 JICA Projects by Objective



(Source) Created by Matsui based on database provided by JICA

Figure 4.2 JBIC Projects by Objective

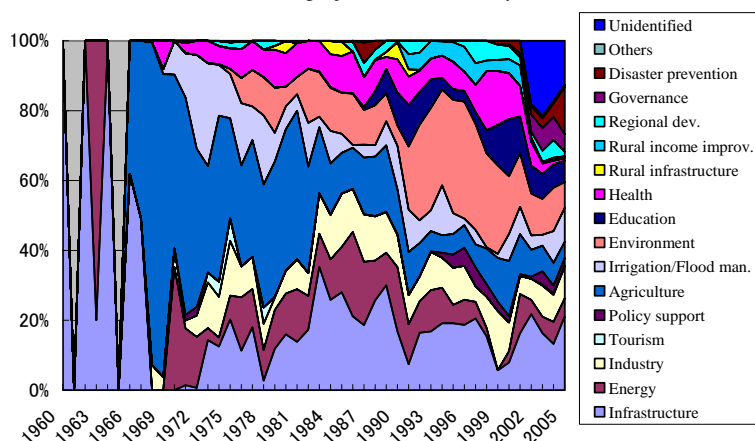


(Source) Created by Matsui based on JBIC Jakarta [1999] database

By sector, Japan’s assistance for growth has been implemented in accordance with Indonesia’s growth policies of increased food production, industrialization, and

infrastructure development (see Figure 4.3 and Figure 4.4). The main sectors of JICA's growth assistance changed from food production to infrastructure, energy, industry (the private-sector development), and environmental conservation. Assistance provided by JBIC focused on the three growth supporting sectors, i.e. infrastructure, energy, and irrigation/ flood management. In the 1990s, JICA increased assistance for education, village income improvement, and regional development, while JBIC increased assistance for education and rural infrastructure, all of which aimed for distribution and poverty reduction.

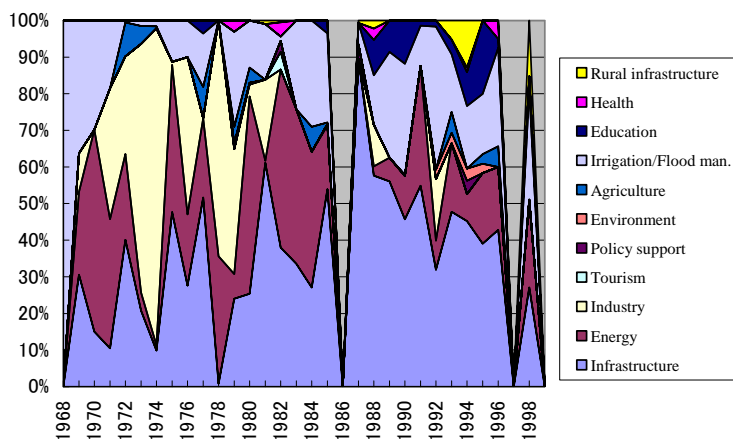
Figure 4.3 JICA Projects by Sector
(807 projects, 168.1 billion yen)



(Note) Monetary base.

(Source) Created by Sato based on database provided by JICA.

Figure 4.4 JBIC Projects by Sector
(243 projects, 3.339 trillion yen)



(Note) Monetary base. Excludes program loans.

(Source) Created by Sato based on database provided by JBIC Jakarta [1999].

Looking at regional distribution of assistance projects, JICA placed a certain degree of weight on Sulawesi, and the weight particularly increased in the 1990s when assistance for distribution and poverty reduction was increased. JBIC consistently centered on Java and Sumatra, reflecting that growth assistance is its main focus.

Overall, it is regarded that Japanese assistance has been implemented to be consistent with transformations in Indonesian development policy, with the exception of distribution policy in the 1970s. As a result, the coverage of JICA's assistance spread over time, while JBIC's assistance centered on growth policy.

4.3 Effects of Assistance in Main Sectors

Next, we analyze effects of Japanese assistance in some main sectors, such as infrastructure development, industry, agriculture, environmental conservation, education, healthcare and regional development.

Looking at the history of the assistance, we can observe conceptual evolution in every sector. For example, there has been evolution from “hardware” assistance (provision of facilities and equipment) to inclusion of “software” assistance (personnel training and system creation for operation and maintenance); from infrastructure construction to comprehensive environmental resource management; from Japan-led initiative to greater Indonesian ownership; from Java to outer islands; from Sumatra to East Indonesia; and from discrete to interlinked project development.

It is difficult to precisely measure effects of assistance, but our analysis observed some variations in the effect of assistance by sector. Effects were confirmed in infrastructure construction, food production, education, healthcare and regional development, while issues remained in infrastructure maintenance, industry, agriculture, and environmental conservation. In the sectors where assistance was effective, the conceptual evolution stated above performed well. For instance, participatory methods seen in regional development and healthcare sectors, and pro-competitive management adopted in the Higher Education Development Support (HEDS) have contributed to promote Indonesian initiative and ownership.

In the agricultural sector, in accordance with Indonesia's rice self-sufficiency policy, Japan introduced integrated assistance combining water resource development with the promotion of rice production and made certain contribution. However, after the rice self-sufficiency was achieved in the mid 1980s, the directions of Japan's assistance in the agricultural sector diffused. The significance of Japanese agricultural assistance has now become unclear in the context of Indonesian development policy.

Infrastructure maintenance, industry, and environmental management are sectors that require not only the acquisition of operating techniques for facilities and equipment, but also applied skills to maintain them and to make modifications to suit conditions in Indonesia. This requires positive motivation on the Indonesian side and would lack effectiveness unless the conditions such as policy, legal systems and market needs are right for motivation. The development of the Brantas River Basin has produced many Indonesian civil engineers, and has been highly recognized as “Brantas created people”. But even the Brantas is not in a state in which dam maintenance and cross-generational dam construction technology are being conveyed. In the industrial sector dominated by the private sector, our study observed problems such as the mismatching of technological assistance and market needs, and obsolescence of provided technology.

4.4 Cross-Sector Issues

Examining factors that determine the effects of assistance across sectors, there are three categories of factors; factors on the receiving side, those on the Japanese side and between the two sides, and problems of project design and management.

The most important among factors on the receiving side is the strength of the receiving side’s commitment. There were many cases mentioning a lack of commitment as being the cause of low effectiveness. The level of commitment is shown by the receiving side’s motivation, personnel assignments, budget allocation, policies, organizations/institutions and systems.

The major problems on the Japanese side and in the interrelationships are resource availability on the Japanese side, smooth communicability between the two sides, and an appropriate balance of input from the both sides. When input from the Japanese side was too large, the effect of assistance could not be sustainable in many cases.

The key points in designing projects are compatibility between plans and actual conditions, appropriateness of setting the scope of projects, and appropriateness of selecting objects. With regard to project management, success factors in many examples are the introduction of economic incentives, compatibility with local needs, and the promotion of participants’ initiatives.

Of the factors mentioned above, the level of commitment on the receiving side is particularly important as a determinant on effectiveness of assistance. It is necessary to assess the level of commitment in the preliminary investigations. If the commitment is low, we should not provide assistance. If the commitment is at the medium level, we

should incorporate how to boost up the commitment in the project design.

Another problem made evident from cross-sector observations is the weak logic regarding the need to continue projects. Project evaluations tend to state that the project needs to be continued, either because targets have not yet been reached, or because targets have been reached. Arguments such as “because the project is important” and “because there are strong requests from the Indonesian side” are often used as reasons to continue a project. This suggests there is an interdependent relationship between the side that wants to receive and the side that wants to provide assistance. Considering the current need for “selection and concentration,” it is necessary to rebuild a system for ascertaining the need for continuing projects.

4.5 Indonesia’s Perception of Japanese Assistance

In this study, we conducted interviews to Indonesians in various circles in Indonesia including government agencies, parliament, intellectuals and NGO personnel regarding perception of Japanese assistance.

While some Indonesians recognized the characteristics of Japanese assistance, most of interviewees did not. They did not distinguish Japanese assistance from other foreign assistance, or they merely viewed Japanese Yen loans as the cheapest source of funds available.

Interviewees that were aware of the characteristics of Japanese assistance have mostly been involved in Japanese projects in some way. These people generally acknowledge the significance of Japanese assistance and specifically mentioned the superiority of Japanese assistance. The superiority that several people indicated is developing infrastructure, developing human resources, creating systems, combining these, and Japan’s reliable project management and evaluation systems.

However, they were also aware of the defects of Japanese assistance. The defects they pointed out were concentrated on project management rather than the contents of assistance. Several people mentioned the closed nature of Japanese projects that the implementation process is almost monopolized by Japanese vendors. There were comments such as “Japan keeps the core technological parts a black box,” and “Japan should trust Indonesia more and let us handle part of the implementation process.” In addition, some pointed out a lack of assistance incorporating the private sector and NGOs, the tendency of Japan-led assistance, and the longwinded and rigid decision-making process. Some expressed a desire for more local authority to speed up decisions, and some commented that the publicity of Japanese assistance is weak

compared to actual results.

4.6 Lessons Learned from Past Assistance Projects

In Part I, we presented a brief view on Indonesia's development policy and achievements, and examined Japanese assistance in light of consistency with Indonesia's policy, and its effects and defects. Based on our analysis, we draw the following three lessons from the past experiences to put to good use in the future.

First, it is important to make the most of the accumulated knowledge over the past 40 years as an asset of the two countries, recognizing that Japanese assistance has been implemented mostly in line with Indonesia's policy and produced results. Japan's advantages as perceived by the Indonesian people that recognize Japanese assistance lie in developing infrastructure, developing human resources, creating systems and combining these. Japan needs to further advance these advantages. Japan should also make the required improvements by responding to such voices as "We want the assistance implementation process to be more open to the Indonesian side."

Second, in order to make assistance effective, it is crucial to ascertain that commitment on the receiving side exists at the medium level. In less effective projects and sectors, we observe common problems that it is difficult to acquire applied skills to maintain and modify technology learned due to weak commitment to actively acquire such skills and due to no incentives for maintaining such commitment. It is vital for JICA to establish principles that assistance is not provided if commitment is low, and that assistance is not required if commitment is sufficiently strong. For sustaining the effects of assistance, it is useful to involve the receiving side from the early stage of project formation to foster commitment through the implementation process.

Third, it is necessary to rebuild the system for ascertaining the need to continue projects. Sectoral diffusion of JICA assistance over time indicates that the sectors of assistance have been diversified but not been scrapped. In order to avoid easy continuation of assistance, it needs two things; to cut off less effective projects, and to let go off projects that have had effect and monitor the sustainability of the effect. In addition, the method for designing the project term suited to the nature of projects should be also reviewed.

II. What should be Done in the Future?

5. The Future of Indonesian Development Policy²

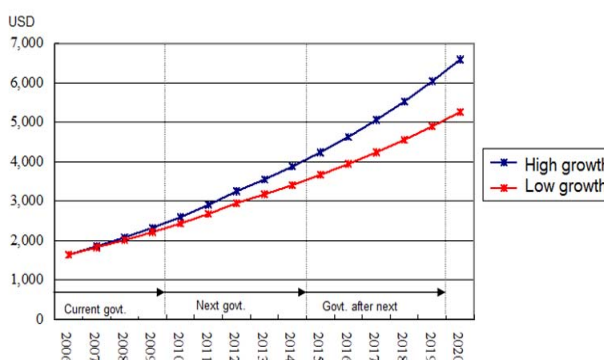
5.1 Outlook toward Indonesia's Graduation from ODA in 2020

In Part II, we illustrate a desirable picture of the future of Indonesia and explore what the Indonesian government and Japan should do in order to make the picture reality.

We forecast Indonesia in 2020 to look at long-term trends across changes in administrations. Figure 5.1 shows forecasts of the economic level of Indonesia in 2020 in a high-growth scenario and a low-growth scenario. The high-growth scenario presents an upper limit of the range attainable.

The low-growth scenario assumes that the growth trend below 6 percent during 2000-2006 continues in the future.

Figure 5.1 Growth Forecast: Development of Per Capita Nominal GDP



Assumptions in the High-Growth and the Low-Growth Scenarios

	Real GDP Growth	Inflation Rate	Population Growth Rate	Exchange Rate
High-growth Scenario	6.7%→6.2%	6%→4%	1.2%→1.1%	1US\$ = 9000 rupiah
Low-growth Scenario	5.0%→4.5%			

Reference: The inflation rate in 2006 was 6.6%, and the average exchange rate for 2006 was 9,159 rupiah.

The population growth rate between 2000 and 2005 was 1.34% according to BPS.

(Source) Created by Sato.

According to this forecast, per capita nominal GDP will exceed 2000 US dollars during the current government, and exceed 6600 US dollars by 2020 in the high-growth scenario and reach 5200 US dollars even in the low-growth scenario. This is almost equal to the level of Malaysia in 2006 (5770 US dollars). In terms of Japan, this is the same level as 1975. Japan spent 13 years as a recipient and concurrently a donor of ODA before graduating from receiving ODA in 1966. Although Japan and Indonesia cannot be discussed on equal terms, the general image is that the period between now and 2020 in Indonesia is equivalent to the high-growth period experienced by Japan before and after it graduated from receiving aid.

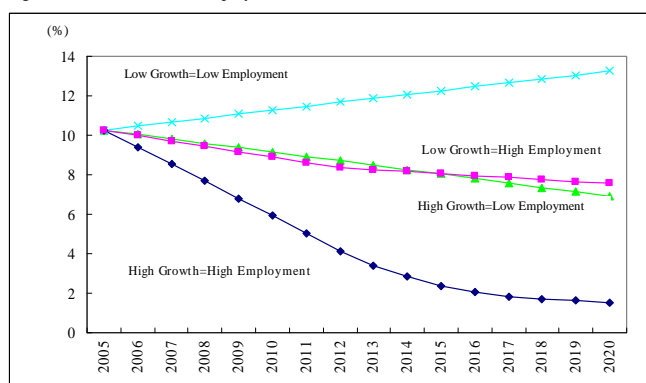
In this study, we present the outlook of Indonesia's graduation as follows. Indonesia will reach an economic level at which it can graduate from receiving ODA by

² For details of discussions in 5.1 and 5.2, see Sato [2008]. For 5.3, see Kawamura [2008].

2020. The periods covered by the next two administrations can be regarded as a preparation period for graduation and a transition period from a recipient to a donor of ODA. At the start of the next administration, Indonesia will make the transition to a Group III lower-middle-income country by the World Bank's Financing Standards, which signifies that Indonesia moves toward the end of IDA loans and Japanese grant aid. During the next administration, the Indonesian government will begin preparations with an eye to graduation, and during the administration after the next, the government will more clearly recognize the transformation to an aid donor.

However, even if the economic level rises, graduation from ODA could be difficult unless growth is accompanied by improvements in distribution and poverty. If employment is created along with growth, unemployment will be reduced, leading to poverty reduction. Figure 5.2 forecasts unemployment rates assuming a high-employment scenario and a low-employment scenario.

Figure 5.2 Forecast of Unemployment Rate



Assumptions in the High-Employment and the Low-Employment Scenarios

	Employment Elasticity ¹⁾	Reference Period (year)	Number of Jobs Created per 1% of Growth based on 2006 (1000 persons)	Population Growth Rate	Labor Participation Ratio
High-Employment	0.39→0.28	1985-95	369→267	1.2%→1.1%	0.48%→0.52%
Low-Employment	0.28	1985-95/2000-05	267		

Note: 1) Growth rate in jobs per 1% of GDP growth.

(Source) Created by Sato.

In the high-growth=high-employment scenario, the unemployment problem will be solved in the period of the administration after the next. However, in the high-growth=low-employment scenario and in the low-growth=high-employment scenario, the unemployment rates stayed high at 7-8 percent. In the low-growth=low-employment scenario, unemployment continues to rise. Therefore, unless high growth and high employment are achieved at the same time, unemployment will stay high in the long term, and poverty may remain. In the high-growth=low-employment scenario, ODA could be still needed to eliminate poverty and disparity, while reaching an economic level at which graduation is possible.

5.2 Indonesia's Development Issues Looking Toward 2020

Indonesia's development issues for achieving the most desirable picture in 2020

can be organized as follows in line with the three policy objectives of *sustained growth*, *distribution and poverty reduction*, and *stability and security*.

- (1) The issue for *sustained growth* is to realize the high-growth scenario. Sustained growth here includes achieving both growth and environmental conservation.
- (2) The issue for *distribution and poverty reduction* is to realize the high-employment scenario to reduce poverty and disparity. For regions and groups that the high-growth=high-employment mechanism does not reach, it is needed to implement more direct measures to reduce poverty and disparity.
- (3) The issue for *stability and security* is to ensure the stability and security that is a prerequisite for the realization of the high-growth=high-employment scenario. This means establishing a stable democratic system in Indonesia and upgrading the governance capabilities required to achieve this.
- (4) As the highly populated Indonesia becomes a more advanced developing country and its presence in international society increases, contributing to international society will become a new issue for Indonesia. It will be required for Indonesia to contribute to *stability and security* inside and outside Asian region, and to contribute to *sustained growth* and *distribution and poverty reduction* in the world's less developed regions by utilizing its own experiences.

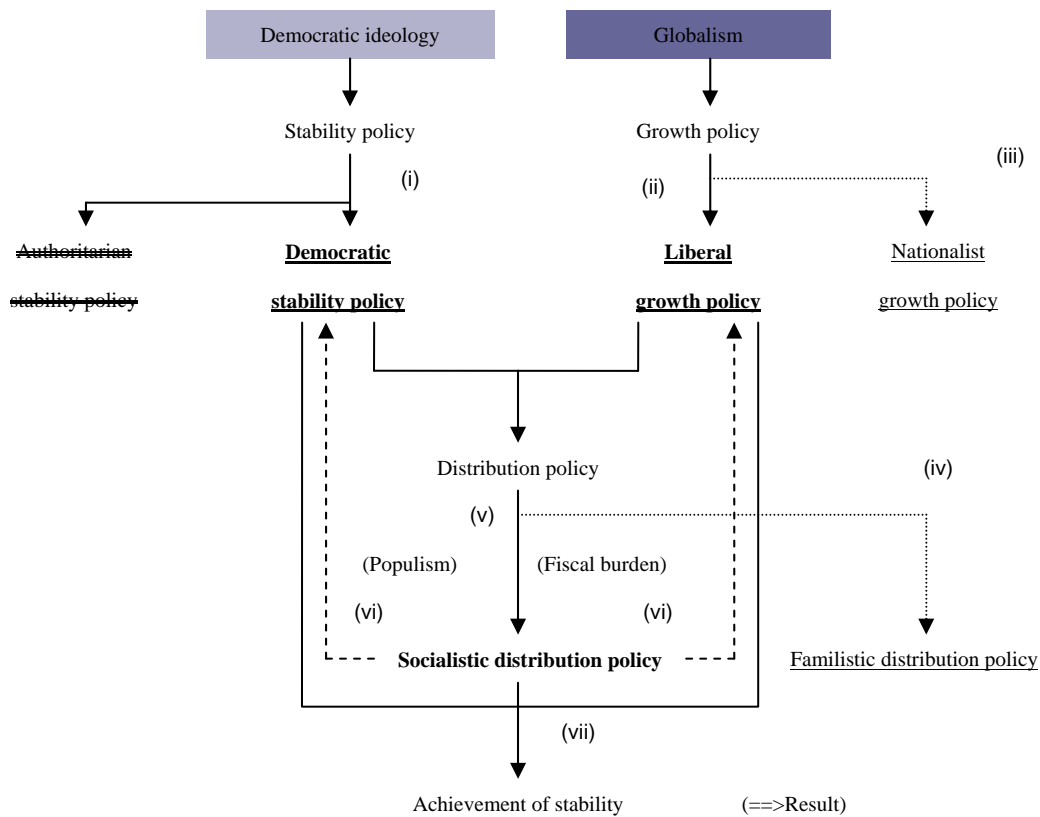
Of the above issues, Section 6 explores (1) and (2), applying econometric analysis. Section 7 examines in what and how Japan should assist Indonesia, assuming Indonesia challenging the issues (1) to (4).

5.3 Future Direction of Indonesia's Development Policy

Let us position the future direction of Indonesia's development policy to address the above issues in a historical transformation of policy orientation.

In the time of Soeharto administration, the adoption of authoritarian stability policy was tolerated during the Cold War. It was possible to implement growth policy and distribution policy after ensuring stability. The government obtained support from the people by fruits of growth and poverty reduction, and support from the elite through nationalistic and familistic policy, creating a cycle in which greater stability enabled to implement further growth and distribution policy.

Figure 5.3 Relationship between the Development Trilogy after Democratization



(Source) Created by Kawamura.

In contrast, in the future development policy, only democratic policy will be allowed as stability policy as democratic ideology is becoming globally universal (Figure 5.3). The return of authoritarianism is very unlikely considering Indonesia's present power structure. In growth policy, liberalistic policy has become orthodoxy amid the current economic globalism. Therefore, the given direction is the adoption of democratic stability policy and liberalistic growth policy. However, the nationalistic growth policy deep-rooted within Indonesia will gain momentum in economic upturns. Familistic distribution policy is also deep-rooted, but its implementation will be limited compared to in the past because of the mainstream values of fairness and market-emphasis. Socialistic distribution policy takes an important position, but will impair growth policies if socialistic distribution is over-emphasized with the aim of obtaining political support. In this structure of development policy after democratization, stability is not a given. Stability is only achieved when the government produces an appropriate balance between growth policy and distribution policy.

5.4 Future Direction of Indonesia's Foreign ODA Policy

How will the Indonesian government utilize foreign ODA in addressing the above-stated development issues? For Indonesian fiscal authorities, foreign ODA is the lowest-cost source of funds that cannot be immediately replaced by government bonds. The fiscal need for foreign ODA is expected to continue for some time under the condition of lowering the ratio of public external debts in terms of the GDP. The Indonesian government requires foreign ODA not only for financing the fiscal gap, but also for upgrading capabilities needed for resolving development issues.

However, in another dimension from the development requirement, a political imperative may require graduation from ODA. For national leaders directly elected by the people, it is significant to make an appeal to the people about departure from dependence on foreign countries. In the current administration we can already see indications of such claims made by national leaders and positive response from a parliament and public opinion. Foreign donors should be aware of the gap between fiscal needs and political imperatives, and should begin preparations taking account of Indonesia's future graduation from foreign ODA, in order to make the effects of assistance sustainable.

6. Quantitative Analysis of Indonesia's Short-term and Long-term Development Strategies³

Of the development issues faced by Indonesia looking ahead to 2020, we focus on the issue of realizing high growth → high employment → elimination of unemployment and poverty, and consider effective strategies based on quantitative analysis of economics.

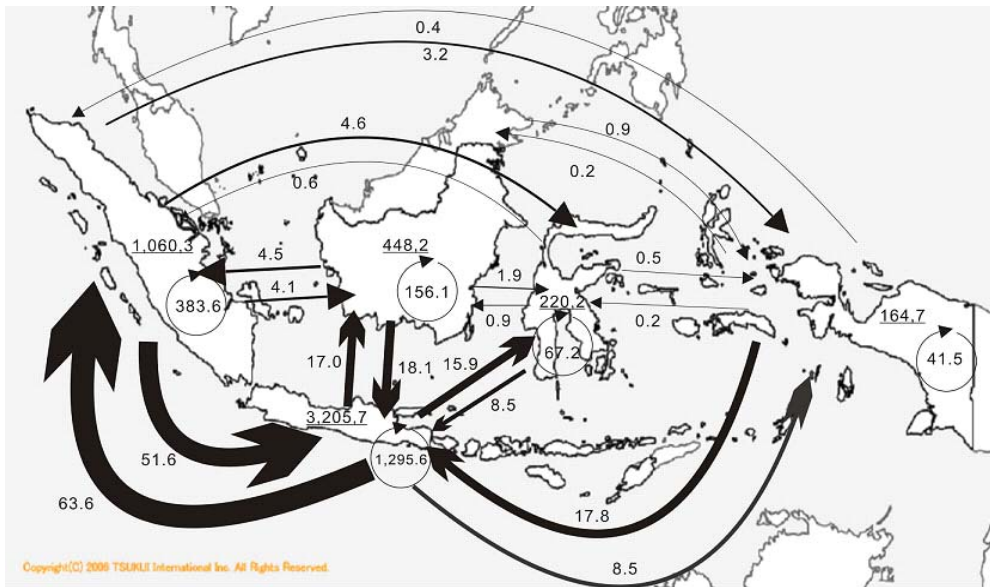
6.1 Mechanisms of Growth

First, we estimate contribution ratios of four production factors (physical capital, human capital, number of workers, and level of technology) to economic growth in the period from 1985 to 2005. The result is that the contribution ratio of physical capital is the highest. It indicates that it is most effective to raise the growth rate of physical

³ For details of analysis in the Section 6, see Higashikata, Michida and Takahashi [2008].

capital that has been in the low level since the Monetary Crisis.

Figure 6.1 Production and Transfers of Each Region, 2005 (Units: trillion rupiah)



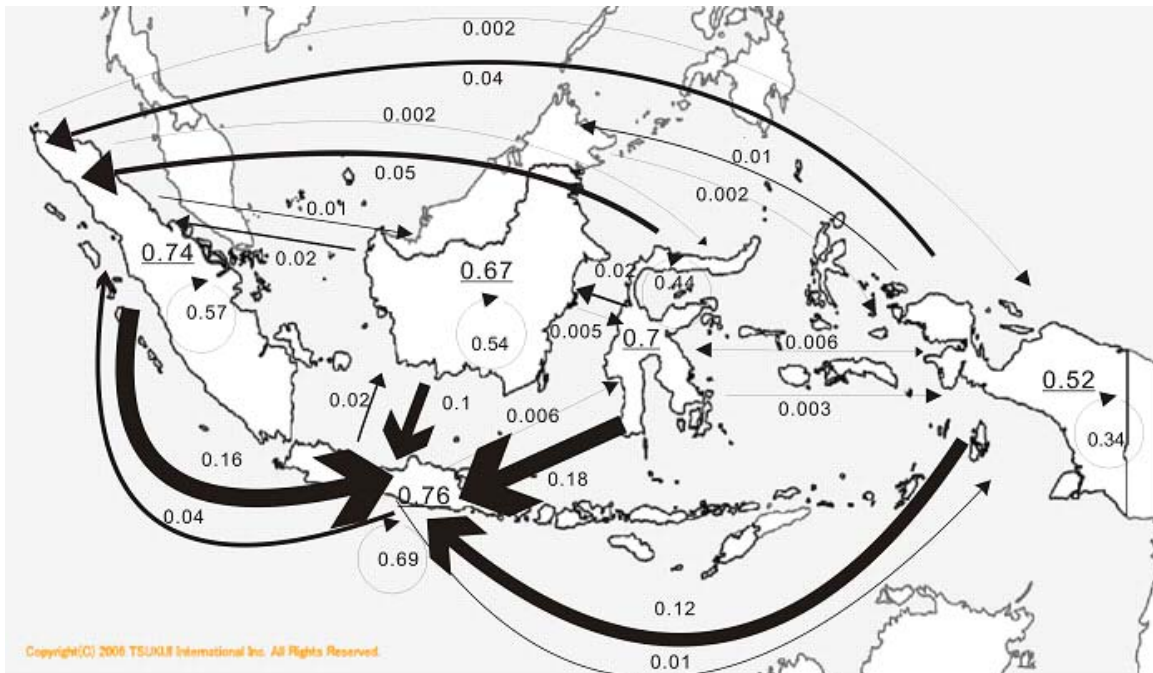
(Note) The arrows denote transfers between the five regions of Java, Sumatra, Kalimantan, Sulawesi, and other parts of eastern Indonesia. The underlined figures within each island denote gross production, and the figures inside circles with arrows denote intermediate input within the island.

(Source) Michida[2008].

Next, we explore growth mechanisms viewed by region. Figure 6.1 displays gross production values by region and the volume of inter-regional trade of goods and services, calculating from regional input-output tables (35 industries in 2005). It shows that the production values and the trade volume are overwhelmingly high in Java and Sumatra, which form a major economic bloc, and that Sulawesi and other parts of eastern Indonesia are not susceptible to influences from other regions.

Figure 6.2 shows the economic spillover effect when final demand increased in each region by one unit (the figures in the circles with arrows show the spillover effect within the region, the arrows show the spillover effect outside the region, and the underlined figures show the total spillover effect when the two are combined). Spillover effects refer to the effect of increased production in regions supplying intermediate input when demand for intermediate input is induced by an increase in final demand in a certain region.

Figure 6.2 Spillover Effect of Growth, 2005



(Source) Michida[2008].

When final demand increases by one unit in each region, the spillover effect on the whole country is larger in order of Java (including Bali), Sumatra, Sulawesi, Kalimantan, and other parts of eastern Indonesia. Therefore, creating final demand in Java and Sumatra has the largest spillover effect and is the most efficient as a growth strategy. However, even if final demand increases in Java and Sumatra, the spillover effect on other regions is not large. That is why the growth strategy centered on Java and Sumatra tends to enlarge regional disparity. In order to promote growth outside Java, there is a greater impact when the final demand is increased in each island outside Java.

The spillover effect of growth can be calculated not only by province, but also by industry in a certain region. According to the results, industries with a high nationwide spillover effect are electrical, electronics and textiles in Java and Sumatra; oil palm and rubber in Sumatra; resource processing (food and beverages, and wood products) in Kalimantan, Sulawesi and Sumatra, and resource processing (mineral processing and marine product processing) in other parts of eastern Indonesia.

6.2 Mechanism of Employment Creation

Does the above growth strategy by region and by industry efficiently create employment?

Table 6.1 Impact on Domestic Employment by Region and by Industry
(Growth in Jobs Created by One Percent of Growth in Each Industry)

Relative rank within region	Java		Sumatra			
	1	Wholesale and retail	0.061	Agriculture, forestry and fisheries	0.037	
2	Manufacturing	0.039	Wholesale and retail	0.012		
3	Agriculture, forestry and fisheries	0.038	Manufacturing	0.007		
4	Social services	0.023	Social services	0.007		
5	Construction	0.021	Construction	0.006		
6	Transportation and telecommunications	0.017	Mining and quarrying	0.004		
7	Mining and quarrying	0.006	Transportation and telecommunications	0.004		
8	Finance and insurance	0.006	Finance and insurance	0.001		
9	Electricity, gas and water	0.000	Electricity, gas and water	0.000		
Relative rank within region	Kalimantan		Sulawesi		Other parts of eastern Indonesia	
1	Agriculture, forestry and fisheries	0.014	Agriculture, forestry and fisheries	0.013	Agriculture, forestry and fisheries	0.021
2	Wholesale and retail	0.005	Wholesale and retail	0.004	Manufacturing	0.002
3	Manufacturing	0.002	Social services	0.004	Wholesale and retail	0.002
4	Social services	0.002	Manufacturing	0.001	Social services	0.002
5	Mining and quarrying	0.001	Construction	0.001	Construction	0.001
6	Construction	0.001	Transportation and telecommunications	0.001	Transportation and telecommunications	0.001
7	Transportation and telecommunications	0.001	Mining and quarrying	0.000	Mining and quarrying	0.000
8	Electricity, gas and water	0.000	Electricity, gas and water	0.000	Electricity, gas and water	0.000
9	Finance and insurance	0.000	Finance and insurance	0.000	Finance and insurance	0.000

(Source) Calculated by Higashikata based on GDP by region and industry (at 1993 prices) and number of labor (population census, labor statistics).

According to Table 6.1, the manufacturing industry in Java and Sumatra that has a large spillover effect has also a large impact on employment creation. Conversely, in Kalimantan, Sulawesi and other parts of eastern Indonesia, the manufacturing industry including resource processing has not so large impact of employment. However, its relative rank is high when compared to other industries in the same regions. Also, as growth of the resource processing industry increases demand in the upstream agriculture, forestry and fishery industry that have the largest impact on employment in these regions, the resource processing is expected to have the effect of creating a cycle in which growth leads to employment.

6.3 Four Scenarios of Economic Growth

We have so far analyzed growth and employment strategies by assuming that the industrial structure remains unchanged. Here we discuss economic growth scenarios

until 2020 assuming four types of change in industrial structure. These are four combinations of West High/Low and East High/Low; high growth of capital-intensive manufacturing industries including machinery industry in Java and Sumatra (West High), low growth in the same industries (West Low), high growth in resource processing industries in Kalimantan, Sulawesi and other parts of eastern Indonesia (East High) and low growth in the same regions (East Low).

Table 6.2 Economic Growth Scenarios for Indonesia in 2020

	<i>Base Line</i>			<i>A. W High + E High</i>		<i>B. W High + E Low</i>		<i>C. W Low + E High</i>		<i>D. W Low + E Low</i>	
	Actual Values		Forecast	Assumed	Forecast	Assumed	Forecast	Assumed	Forecast	Assumed	Forecast
	2006	2006	2020	Average	2020	Average	2020	Average	2020	Average	2020
	Growth	Share	Share	Growth	Share	Growth	Share	Growth	Share	Growth	Share
Agriculture	3	14.2	9.7	3	9	3	9	3	10	3	11
Oil, gas, mining	2.2	9.1	5.6	2	5	2	5	2	6	2	7
Manufacturing	4.6	27.8	24.5	6~9	30	6~7	28	4~5	24	1~3	18
Resources	3.8	12.9	9.8	6~7	11	1~2	7	6~7	14	1~2	8
Labor Intensive	1.4	3.1	1.8	1	2	1	2	1	2	1	2
Capital Intensive	6.5	11.8	13	8~12	17	8~12	19	1~4	7	1~4	8
Service, etc	7.4	48.9	60.1	7	55	7	58	6~7	61	6~7	64
Growth Rate	5.5	100	6.1	6.7→6.2		6.5~6.0		5.3~4.8		5.0→4.5	

(Note) Resource processing industries includes, oil and gas production, food/beverages/tobacco, wood/wood products, paper/printing, cement/nonferrous minerals. Labor intensive industries include textiles/leather/shoes, and other manufacturing. Capital intensive industries include fertilizer/chemicals/rubber products, iron/steel, and machinery/transportation equipment.

(Source) Actual values for 2006 are GDP statistics using the BPS website (July 1, 2007).

Simulation results show that a high-growth scenario can be achieved with West High + East High (Table 6.2). West High involves the formation of agglomerations of capital-intensive industry in Java and Sumatra and increased participation into the production network throughout Asia. East High envisages the growth of resource processing industries in Kalimantan and further east, backed by growing global demands for resources, while considering resource reusability and environmental conservation. When both of West High and East High are achieved, regional disparity is reduced and employment is efficiently created through growth, bringing about a virtuous cycle of high growth = high employment.

Analysis of short-term and long-term growth strategy revealed the effectiveness of a “two-faceted growth strategy by region”. This means that the most efficient way to promote growth is to strengthen the capital-intensive industries expected to grow in Java and Sumatra, but considering the spillover effect of growth and the effect of employment creation, growth of the resource processing industry in Kalimantan, Sulawesi and other parts of eastern Indonesia must be promoted in parallel to establish a

balance between East and West.

6.4 Overcoming Poverty and Inequality

Even if the “two-faceted growth strategy by region” is successful, our analysis shows that there are some regions where the spillover effect is hard to reach. That is why direct poverty reduction measures are required for such least susceptible segments to the growth mechanism. We call this as a “two-faceted strategy of growth and poverty reduction.”

First, we performed quantitative analysis to identify the sources causing poverty and inequality. The results revealed that the inequality between urban and rural areas is greater than the inequality between regions, islands and provinces. From the perspective of distribution and poverty reduction, it is important to reduce urban-rural disparity regardless of the region, island, or province.

Next, we investigated the sources of urban-rural disparity. It was confirmed that there is disparity in the level of education of household heads, and sanitation and economic infrastructure such as toilets, hospitals, paved roads and financial institutions.

Then we conducted a poverty determinant analysis to identify effective poverty reduction measures by urban/rural area and by east/west region (the regional division here includes Kalimantan in the west, and Sulawesi and eastward in the east based on statistical verification). The analysis revealed that effective poverty reduction measures on a nationwide level are assisting secondary and tertiary education, making clean water available, and building sewage systems such as toilets. Basic infrastructure such as paved roads is also important nationwide, but especially effective in rural areas in Sulawesi and eastward. The same can be said for increasing employment opportunities for women and promoting small and medium enterprises. By region, improved access to hospitals in urban areas in the west, and improved access to clinics (*puskesmas*) in rural areas in the east are effective for reducing poverty. In addition, access to banks in the east significantly reduces poverty.

6.5 Policy Implications Derived from the “Double Two-Faceted Strategies”

Through the quantitative analysis, we have found the necessity of “double two-faceted strategies” in order to realize a high-growth=high-employment scenario. The “double two-faceted strategies” comprise two-faceted effective growth strategy by regions ---- in Java and Sumatra and in Kalimantan and eastward ----, and direct poverty

reduction measures in regions where the growth mechanisms do not reach. The policy implications obtained from our analysis are summarized in Table 6.3.

Table 6.3 Policy Implications

	Java/Bali	Sumatra	Kalimantan	Sulawesi	Nusa Tenggara	Maluku/Papua
Growth	Accumulation of capital and improvement of investment climate through public investment and improvement of infrastructure					
	Development of industry personnel through secondary and tertiary education assistance					
	Promotion of manufacturing industry (Textiles and machinery industries)		Promotion of resource processing industry (Food beverages, etc.)			
Employment	Promotion of manufacturing industry (Textiles and machinery industries)		Promotion of resource processing industry (Food beverages, etc.) Promotion of agriculture Promotion of service industry (Wholesale, retail, social service industries)			
Distribution and Poverty Reduction	Secondary and tertiary education assistance					
	Improvement of sanitation (clean drinking water and sewage systems for toilets)					
	Improved access to hospitals (especially in cities)			Improved Puskesmas (especially in villages)		
	Improvement of basic infrastructure such as sealed roads			Improvement of basic infrastructure such as sealed roads (Especially in villages)		
	Increased job opportunities for women (especially in villages)					
	Promotion of small and medium enterprises			Promotion of small and medium enterprises (especially in villages)		
	Improved access to banks					

(Source) Created by Takahashi.

7. Future Direction of Japan's Assistance to Indonesia

This section considers in what and how Japan should provide its assistance to Indonesia, taking account of Indonesia's future graduation from ODA. First, we look at the widest potential scope of future assistance to Indonesia, and then narrow down the items that Japan should assign priority to.

7.1 Potential Scope of Assistance to Indonesia

We list up the following 6 areas and 24 items as the potential scope of future assistance to Indonesia. It is possible for Indonesia not to need assistance from foreign donors. These are the items necessary to be addressed in order that Indonesia achieves the most desirable picture in 2020, either with or without utilizing foreign ODA.

(1) Assistance contributing to *sustained growth* and *distribution and poverty reduction*

As shown in the above quantitative analysis, the followings are required to make high-growth=high-employment mechanisms function:

- ① Promotion of growth of the most important factor, i.e. physical capital → infrastructure development, improved investment climates
- ② Improvement of the next most important factor, i.e. human capital → secondary and tertiary education, development of industrial human resources
- ③ Improvement of competitiveness of the textiles and machinery industries in Java and Sumatra → transportation and urban infrastructure development, improvements of customs, tax and labor systems, promotion of supporting industries, productivity improvement of enterprise and industrial human resources
- ④ Promotion of resource processing, agriculture and service industries in Kalimantan and eastward → improvement of market, information and transportation infrastructure, increased added value in local industries; environmental conservation and improvement

To reduce poverty in regions less affected by growth mechanisms, the following are required:

- ⑤ Poverty reduction in all less affected regions → secondary and tertiary education, improvement of sanitary conditions (water)
- ⑥ Poverty reduction particularly in rural areas → promotion of employment for women
- ⑦ Poverty reduction in less affected regions in Java, Sumatra and Kalimantan → basic infrastructure development, promotion of small and medium enterprises, improved access to hospitals in urban areas
- ⑧ Poverty reduction in less affected regions in Sulawesi and eastward → improved financial access, improved rural clinics, basic infrastructure development, establishment and promotion of small and medium enterprises

(2) Assistance contributing to *stability and security*

In order to ensure the stability and security that are prerequisites of growth and poverty reduction, it is necessary to improve capabilities of national governance for establishing democracy in Indonesia, particularly capabilities that had not been cultivated under the authoritarian regime.

- ⑨ Upgrading of capabilities in the legislature and the judiciary
- ⑩ Building of security organizations suited to democracy

- ⑪ Establishment and sound development of local governance

(3) Assistance for becoming a more advanced developing country

Viewing the period until 2020 as being the period in which Indonesia becomes a more advanced developing country, the following items can be listed by referring to Japan's assistance experiences to Thailand and Malaysia.

- ⑫ Promotion of more advanced manufacturing, improved productivity, and improved technological capabilities in supporting industries
- ⑬ Improved telecommunications and information technology, and research and development capabilities
- ⑭ Environmental technology such as environmental conservation and improvement, recycling and energy saving
- ⑮ Energy-related technology and energy-related infrastructure
- ⑯ Improvement of urban living environments
- ⑰ Fiscal autonomy (tax collection, government bond market and institutions)
- ⑱ Improvement of social security and social welfare systems

(4) Assistance for utilization of global assets held by Indonesia

Tropical natural resources on the equator are not only Indonesia's strength, but also a global commons for all of humankind. It is crucial to keep a balance of biofuel and food production, and to preserve tropical resources as a global asset while utilizing in a sustainable manner. This is an issue that should be addressed collectively by the Indonesian government and international society.

- ⑲ Conservation and sustainable utilization of tropical rainforests
- ⑳ Research and technological development of tropical agriculture
- ㉑ Research and development on tropical diseases and infections

(5) Assistance for resolving regional problems beyond the border of a single country

As Asian regional integration progresses, a variety of regional problems that cannot be addressed by a single country have occurred. These include various illegal acts, pandemics, environmental pollution and wide-area security issues. Indonesia is one of the major sources of regional problems such as avian flu, air pollution, piracy, and human trafficking. Improvement of Indonesia's capability to address these problems is essential for stability and security in the Asian region, and in the establishment of regional order such as the creation of an East Asian Community.

- ㉒ Improvement of Indonesia's capability to resolve regional problems extending

beyond national borders

(6) Assistance for establishing strategic relationship between ASEAN and Japan

In future diplomacy of Japan toward Asian nations, it is extremely important to strategically advance the relationship with ASEAN, which has long maintained friendly relationship with Japan, and has contributed to political economic stability in the Asian region. Assistance for establishing a strategic relationship between ASEAN and Japan include:

㉓ Development of norms having high affinity for Japan within ASEAN

㉔ Expansion of human networks between ASEAN and Japan

㉓ does not mean to force the application of Japanese norms. Instead, it is desirable that the ASEAN nations create their norms with mutual cooperation and participation referring positive aspects of Japanese norms⁴. ㉔ refers to form human networks within the region using Japan as a mediator, by increasing the number of people in a broad range of communities who know Japan and the Japanese as a way for Japan-based norms to be accepted. Amid such efforts, Indonesia is believed to be in a significant position as a major power within ASEAN.

7.2 What should Japan Assist?

When narrowing down items that Japan should assist from the potential scope of assistance, we can use the following four criteria.

- (1) The assistance is important and effective for Indonesia, and Japan has an advantage over other donors;
- (2) The assistance is strategically important for Japan;
- (3) There is commitment on the Indonesian side at the medium level; and
- (4) Japan has resources to provide the assistance.

Of these criteria, this study mainly uses (1). After narrowing down priorities using (1) and (2), (3) and (4) become important criteria in the phase of forming specific projects. The tasks of setting priorities using (2) and of selecting out projects with (3) and (4) should be carried out by the Japanese government and JICA/JBIC (the new JICA) utilizing the knowledge that have systematically accumulated over the years.

This study selected the five highest priority items, two priority items, and four items for consideration as shown below.

⁴ Norms here mean standards of behavior in the form of practices, institutions, systems etc.

- (1) Assistance that should be assigned the highest priority
 - (i) Infrastructure development
 - (ii) Improved industrial competitiveness in Java and Sumatra
 - (iii) Secondary and tertiary education
 - (iv) Linking of growth and poverty reduction assistance through a regional approach
 - (v) Conservation and sustainable utilization of Indonesia's global assets
- (2) Assistance that should be assigned high priority
 - (vi) Environmental technology such as environmental conservation and improvement, recycling and energy saving
 - (vii) Improvement of urban living environments
- (3) Assistance that should be given consideration
 - (viii) Fiscal autonomy (tax collection, government bond market and institutions)
 - (ix) Improvement of social security and social welfare systems
 - (x) Building of security organizations suited to democracy
 - (xi) Resolution of regional problems extending beyond national borders

(i) and (ii) are assistance for growth that is essential to achieve a high-growth scenario. (ii) should be linked to transportation and urban infrastructure development in (i), with the aim of effectively incorporating Indonesia's manufacturing industry into the regional production network in Asia. (iii) is the most universal item shared throughout the entire "double two-faceted strategies." It is preferable to take a gradual approach with the eventual aim of contributing poverty reduction in less developed regions. (iv) is selected because this study recognized the effectiveness of regional approach that is across objectives, across sectors, includes hard and soft aspects, and promotes local participation, and also because growth mechanisms and effective poverty reduction measures vary depending on the region. Regarding (v), considering that Indonesia has one of the world's largest deposits of tropical resources alongside Brazil and Congo, it is regarded significant that Japan as a developed Asian nation contributes to the sustainability of global assets in Indonesia. (vi) and (vii) are assistance required for Indonesia becoming a more advanced developing country. It is desirable to carefully investigate Indonesia's commitment or acceptability beforehand, and after starting, to link them to other sectors such as infrastructure development. (ii), (iii), (vi) and (vii) are meaningful in light of utilizing Japan-based norms and systems.

(viii) to (xi) are items to be considered in more detail with respect to whether Japan should offer assistance. The main reasons for this are that problems are complex

and manifold, and that the commitment for receiving assistance has not matured or is sufficiently subjective.

7.3 How Should Japan Provide Assistance to Indonesia⁵

From now on, it is vital that Japan provides assistance with the aim of Indonesia reaching an economic level enabling it to graduate from receiving ODA in 2020. Figure 7.1 is a roadmap of the transition process moving toward graduation.

Figure 7.1. Roadmap of the Transition Process Aimed at Ending ODA

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
			General election. Presidential election.					General election. Presidential election.					General election. Presidential election.	
Yen Loans	While continuing to accept Indonesian requests (for large-scale infrastructure projects, etc.), a clear position of pushing for the use of financing through commercial loans and government bonds should be made.								Japan should push so that the Indonesia government can finance its projects using commercial loans and government bonds, and the total value of Yen loans should be gradually reduced.					
	Yen loans should be used to push for Indonesian financial independence. In particular, to make sure that loans don't become an instrument of the central government, when being targeted for regional projects, they should be paired with technical cooperation projects.													
Technical Cooperation with Indonesia (including sending experts)	Reevaluation of current projects: - Reason for Japan to provide the aid - Benefit for both Japan and Indonesia ->Set end date for each project ->Schedule a handover so that the Indonesian side can run the project itself.			Identify areas and resources where Japan and Indonesia can provide aid to other countries. - Develop Indonesian trainers and experts. - Develop project management skills. - Start sending trainers and experts to other countries - Promotion of current JICA training programs in other countries and ownership from the Indonesian side.								Technical cooperation aid projects led by Indonesia, Joint technical cooperation aid projects with Japan.		
Joint cooperation (Aid for other countries)	-Possibility of providing joint cooperation													
Human Resource Development /Training	Elite training -Talented people should be selected as candidates to become trainers			Training should focus on training of trainers (ToT) -Development of personnel that have the ability to train other trainers -Training management skills should also be developed						Training should be handled by the Indonesian side, with monitoring from JICA			Indonesia should perform training independently (and also start to train resources in other countries)	
Grants	End of Grants													
JICA Offices	The focus should gradually shift to expanding grass root partnership aid projects and promoting mutual cooperation projects by private sector, citizen and NGO groups as well as joint cooperation projects to other developing countries.													
	JICA local officers should be trained and the number of resident Japanese staff should be gradually reduced.													
	JICA field offices should be established and operations left to local officers													

(Source) Created by Matsui

Given the transition process toward graduation, the first thing that Japan should do is to review ongoing projects. Japan needs to start preparations for withdrawing from projects where Japan's participation is valued to be less significant, referring to the above criteria. For continued projects, it is needed to set a term of final completion and to formulate exit schedules until Indonesia can implement the project on its own. It is preferable that this review is completed by the time the next government is launched in 2009, as which time the direction toward the future graduation should be acknowledged

⁵ For details of discussions in 7.3, see Matsui [2008].

by Indonesia.

Demand for Yen loans is expected to remain due to large-scale infrastructure projects as well as policy-based program loans. However, the amount provided needs to be gradually reduced while promoting a shift to bond financing and commercial loans. Another conceivable method is to utilize Yen loans as a way to encourage Indonesia's self-sustainability, such as expansive deployment of JICA pilot projects and pump-priming funds for promoting rural industries.

Human resource development should focus on training of trainers (TOT). The goal that should be reached at the time of graduation is to establish a human resource reproduction mechanism, in which Indonesian trainers can implement training by themselves to develop human resources.

The issues that Japan should address in this transition process are shown below.

- (1) From teaching to noticing: If the relationship of “teaching=learning” becomes entrenched, this will lead to problems such as having a lack of applicability once technology is transferred, and skilled personnel not being reproduced once skill is learned. It is important that both Japan and Indonesia cast off the “teaching =learning” mind-set, and that Japan adopts a style of encouraging “noticing” on the Indonesian side in collaboration between the two sides.
- (2) From individual projects to linkages between projects: An evolutionary linkage framework will become more and more important. This includes not only a linkage between schemes and between hard and soft aspects, but also linkages between sectors, between regions, a regional approach combining these linkages, and comprehensive development programs involving links with the private sector.
- (3) Consideration of the center-local relationship after decentralization: It is not desirable that foreign ODA becomes an interest of the central government and is not appropriately provided to local areas that need assistance. To avoid such situations, Japan should go directly to local areas to collaborate with local governments in drawing up projects, and promote a bottom-up approach to propose projects from local to the center. This approach does not only improve the effectiveness of assistance, but also enhance the ownership of local governments, making it an effective way of supporting decentralization in Indonesia.
- (4) Expansion of mutual cooperation on a grassroots level: The transition to graduation from ODA does not signify a reduction in the relationship between Japan and Indonesia. As assistance from the government is phased out, it will be necessary to further develop cooperation between the private sector, universities, citizens and NGOs in the two countries. It is preferable to expand equal relationships like JICA's

grassroots partnerships.

- (5) Japan moving to assist the developing world with Indonesia: In the process of Japan assisting Indonesia's future graduation from ODA, joint cooperation to the third country has great significance. It is not only meaningful as the first step Indonesia takes toward being a donor, but also the effect of Japan's assistance is expected to be increased due to utilization of appropriate technology and understanding of recipients' mind. For Japan, working with Indonesia is significant because Indonesia has accumulated the most experiences receiving assistance from Japan. As Indonesia is a tropical country that has the largest amount of territory transected by the equator, it will serve as a reference for assistance to other tropical countries. Forming a partnership with Indonesia, which is highly friendly to Japan, will be an effective way of drawing attention to pro-Japan views in Asia, and of gaining the respect and trust of more developing countries worldwide.

Conclusions and Recommendations

- Japan and Indonesia have had the largest donor=recipient relationship for the past 40 years. In future, it is necessary to change this donor=recipient mindset to one of "collaboration (kerjasama)." Japan's true assistance to Indonesia is to assist the country enable to graduate from ODA appropriately for its economic level in around 2020.
- Japanese assistance in the past has largely been consistent with transformations in Indonesian development policy. However, some variation was observed in the effects of assistance. In sectors where assistance was effective, there was advancement from hard to more comprehensive soft assistance. The Indonesian side perceived that Japan's strengths were developing infrastructure, developing human resources, creating systems and combining these. Sectors and projects in which assistance was less effective taught the lesson that assistance should not be provided where the recipient has a low level of commitment. It was also important not to easily continue projects.
- Development issues for Indonesia looking toward 2020 are to achieve high growth and high employment, to reduce poverty and disparity, and to ensure the stability and security as a prerequisite to achieve these. A "two-faceted growth strategy by region" and a "two-faceted strategy of growth and poverty reduction" are effective for achieving the best scenario. We explored the potential scope of assistance based on the double two-faceted strategies, and narrowed down the priority areas in which

Japan's strengths are leveraged. The selected priority areas are infrastructure development, improving industrial competitiveness in Java and Sumatra, secondary and tertiary education, a regional approach linking growth and poverty reduction assistance, and the conservation and sustainable utilization of natural resources as global assets.

- Considering Indonesia's future graduation from ODA, this study recommends that JICA and the new JICA proceed with the following efforts.
 - Review the need to continue ongoing projects. Establish a term of final completion for continued projects.
 - Gradually reduce Yen loans. Promote localization of design, construction and maintenance of infrastructure. Utilize Yen loans in a way that encourages Indonesia's self-sustainability.
 - Establish a human resource reproduction mechanism through training of trainers.
 - Emphasize not only government-to-government relationship, but also mutual cooperation involving the private sector, universities, citizens, and NGOs.
 - Initiate Japan-Indonesia joint cooperation to other developing countries.
 - Shift operational authority of JICA (New JICA) on-site, localize operations and human resources, establish more field offices and to transfer authority to them.
- Indonesia has moved into a period of political stability and economic growth after the landmark direct presidential election was implemented in 2004. CGI was dissolved in 2007, and a Japan-Indonesia Economic Partnership Agreement (EPA) is expected to come into effect in 2008. It is hoped that in this opportunity Japan and Indonesia establish a more comprehensive bilateral policy-dialogue framework. The objectives of the new framework will include the joint monitoring of the implementation of "cooperation" within the EPA and the joint operation of Indonesia's transition process toward graduating from ODA. In order to increase the effectiveness of bilateral collaboration, it is desirable that the policy dialogue involves the private sector.

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Japan International Cooperation Agency

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