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LETTER OF DEVELOPMENT POLICY

MINISTRY OF FINANCE

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Mr. Jim Yong Kim
President
World Bank

Dear Mr. President

1. Since taking office in October 2014, the Government of Indonesia has placed a particular emphasis on infrastructure development, recognizing its crucial link with the country's economic and broader development performance. The purpose of this Development Policy Letter is to provide an overview of the Government's medium term reform agenda with regard to enhancing ports' performance, improving logistics services, strengthening trade processing and to provide an update on recent progress towards implementing the reforms.
2. On behalf of the Government of Indonesia, we would like to express our appreciation for the technical assistance provided by International Bank for Reconstruction/World Bank to logistics reforms in Indonesia over the recent and longer term. We would also like to request the support of the International Bank for Reconstruction/World Bank in the form of the First Indonesia Logistics Reform Development Policy Loan.

Indonesia's Economic and Logistics Situation

3. Following the recovery from the Asian financial crisis, Indonesia saw strong economic growth, at an average of 5.6 percent over 2001-12. However, real GDP growth has decelerated gradually since peaking at 6.5% in 2011, down to 4.8 percent in 2015 and projected at 5.1 percent in 2016. This decline has been spurred by the commodities downturn, declining exports and weakening of investment growth. The slowdown in growth and decline in commodity-related revenues increased fiscal pressures significantly in 2015 and is expected to continue to do so in 2016. Indonesia has made significant progress on reducing poverty with the national poverty rate falling from 24 percent in 1999 to 11 percent in 2015. However, the pace of poverty reduction has slowed down and nearly a quarter of the population lie slightly above the poverty line and are vulnerable to shocks. Moreover, while poverty has fallen, inequality has been rising in Indonesia.

4. Efficient logistics is vital to boost the country's competitiveness and to reduce the large price premia incurred in less connected regions – where poverty is more concentrated - vis-à-vis the country's economic core of Java. To that end the main choke-points of the fragmented logistics supply chain in Indonesia need to be addressed including at the port of entry by facilitating more efficient investments and port services; at the border through improved clearance procedures; and before and beyond the border towards the final destination of goods through better logistics services.
5. Indonesia has to improve its regulatory framework to invest in ports' infrastructure, which recent World Bank work suggests to suffer from critical gaps. While the Shipping Law has mandated the port regulator to lead the development of port infrastructure, its implementation has lagged behind. The government has also to address various restrictions to competition in logistics service markets, including freight forwarding, maritime transport and warehouse and distribution. Finally, Indonesia has to streamline regulatory requirements and improve border procedures that make trade processing cumbersome and expensive, as highlighted by the World Bank's Doing Business "Trading across borders" and *Logistics Performance Indicators* (LPI).

Government Response and the Medium-Term Reform Agenda

6. Since taking office in October 2014, President Joko Widodo has embarked on a significant reform program. The President's electoral platform – the "Nawa Cita" – has been reflected in the National Medium-term Development Plan (RPJMN) for 2015-2019, which sets out national development goals and the main directions of policy for the period. The Government's growth strategy is based on a big infrastructure push and accelerating structural reforms, with a series of economic policy packages being rolled out since mid-September 2015. The program of logistic reforms to support the national development goals of the RPJMN and the Government's growth strategy is outlined below.

Enhancing ports' performance

7. *Enabling port infrastructure investment by clarifying the role of Port Authority vis-à-vis port operators:* In line with international best practices, the Shipping Law of 2008 ruled the separation of the port regulator and port operator roles, which until then had been de facto jointly held by the State Owned Enterprises Pelindo I, II, III and IV. The government has started to clarify these roles acknowledging the Port Authorities as the port regulators through four agreements through which the main Port Authorities have concessioned out to the Pelindo's the existing infrastructure of 87 out of the 96 public ports managed by them. The concession agreement allows a Pelindo to work together with other parties in port business activities and make investments in expanding and maintaining existing port superstructure. The concession agreement also obliges the Port Authorities to provide and maintain basic infrastructure including breakwaters, access channels and navigational aid.
8. *Facilitating the entry of cargo terminal operators:* Increased port performance will also hinge on the entry of new operators bringing fresh capital and competition to the sector. The Government is creating an enabling environment for private sector investment and public-private partnerships, including issuance of regulations in 2015 to allow port authorities to engage in a wider range of contract types with the private sector, including Availability Payment Contracts that are often used in large infrastructure projects. The government believes that this scheme would incentivize the participation of the private into port investment projects by insuring the investors against the demand risk. For port infrastructure this risk applies in particular to secondary ports where initial throughput is low in comparison to the port infrastructure investments that need to be made to adhere

to shipping industry standards. Reducing this demand risk is a first step to addressing the needs of the private sector in port development and providing port services.

9. *Enhancing coordination of documentary and container examination in ports:* The government has started the implementation the electronic system that regulates the movement of containers in ports - INAPORT - and linked it to the INSW system, which should connect all of the border agencies responsible for checking documentary requirements of the shipments. Implementing INAPORT would allow cargo vessels, freight forwarders and land transport operators to exchange data through electronic platform, improving certainty in scheduling of shipment, cargo pick-up increasing the accuracy of berthing windows.

Improving logistics services

10. Improving the contestability of logistics service markets is a key step to ensure that the entire logistics supply chain runs smoothly in Indonesia. To that end the government has *improved competition in freight forwarding, storage and distribution services* by raising the foreign equity limits for these service providers. Such increases should encourage foreign investments in all four services, thus raising the rate of foreign entry in the sectors. Importantly, the foreign equity limits have all been raised from below to above the critical 50% threshold, thus making the extent of foreign investors' increased control of the Indonesian firm meaningful. The entry of foreign investors would foster competition in all these services, thus increasing their availability and reducing their prices.
11. *Improving competition in auxiliary shipping services:* The government has reduced the barriers to entry in two important services auxiliary to shipping services, i.e. shipping agents and maritime cargo handling services. The Ministry of Transportation has introduced the shipping agent license SIUKK, which eliminates the requirement of vessel ownership to operate as a shipping agency. At the same time the government has increased maximum foreign equity limit for maritime cargo handling services from 49% to 67%.
12. A substantial share of the inputs imported by Indonesian industries as well as of the products exported by Indonesia are stored in warehouses in neighboring countries, including Singapore and Malaysia. Inventory costs (as a share of manufacturing sales) are particularly high in Indonesia relative to other competitors in the region. The government has sought to *reduce inventory costs of imported materials for producers* through the establishment of bonded logistics centers, which allow for the temporary storage of imports free of duties. The goods can now be stored for a period of up to 3 years (extendable for another 3 years), within which time they can also be re-exported free of taxes should they not be sold on the domestic market. The regulations allow full control by the private sector over the ownership and operations of the centers and also allow majority foreign ownership.

Strengthening trade processing

13. *Reducing licensing requirements for imports:* The Ministry of Trade has eliminated Registered Importer (IT) and/or Producer Importer (IP) licenses for 8 categories of restricted products comprising over 10% of non oil imports. These licenses require various types of documents to be presented (from 4 different documents for cloves' IT license to 11 for tires' IP license). This simplification should reduce substantially the time and costs of documentary compliance in Indonesian international ports, which currently takes considerably longer than in neighboring countries.

14. *Facilitating traders' compliance with trade regulatory requirements:* At the end of 2015 Indonesia has standardized the administrative compliance for the imports and exports of prohibited and restricted goods (LARTAS), including the specification of the HS codes of the products. The government now requires line ministries/agencies to: (a) submit trade-related regulations for administrative-compliance review by DG Customs, prior to being posted on the Indonesia National Trade Repository by the Indonesia National Single Window (INSW); (b) use a standard template for the submission; and (c) report to the INSW Taskforce about any goods that need to be removed from the list of prohibited and restricted goods. This streamlines the procedures to post new regulations by line ministries and agencies on the INSW. As a result we would expect a more timely and complete update of trade related regulations in the INTR. In addition the new administrative checking procedure by Customs, supported by the INSW Taskforce, should ensure that trade processing is not hindered by unnecessary administrative errors and unclear postings on the INTR.
15. In addition the government has sped up the implementation of the single submission system. This will enable traders to submit all the necessary trade documentations to comply with the necessary requirements from multiple border agencies only once via the INSW. Customs Agency and the INSW Taskforce are preparing for its implementation by running a partial single submission pilot with five large firms. Participating agencies into the pilot include Customs, Quarantine Agencies and the Food and Drug Agency (BPOM). This pilot has allowed these key agencies to identify the solutions to some of the possible technical and legal problems arising from the wider implementation.
16. *Expediting the submission of required trade documentation:* The government has also made progress on the electronic submission and processing in key border agencies, which has the potential to reduce the pre-clearance time. The Food and Drugs Agency (BPOM) and the Customs have developed their own electronic systems to process declarations and import/export-related licenses. BPOM has recently issued two regulations that automate the process for applying for an Import Declaration Letter (SKI) for both food and drug products and inputs. The BPOM regulations cover food and drug products and materials that comprise 6 percent of total non-oil and gas import value in 2015 and that have typically higher processing times than average.
17. In an effort to improve risk management systems for border agencies – which is key to minimize unnecessary inspections at the border - the government has launched a program of risk management integration across border agencies/ministries. To formalize these efforts, the Minister of Coordinating Economic Affairs: (a) included the introduction of single risk management in the Government's Economic Package no. 11; and (b) as the head of the INSW board of supervisors he sent a letter to the relevant line ministers and agencies urging them to take the necessary steps for the introduction of single risk management under Customs leadership. Customs, Quarantine Agencies and BPOM have recently started exchanging information on their risk profiles and have piloted the approach.

Conclusions

18. In summary, the Government is firmly committed to the program of logistics reforms set out above in order to enhance ports' performance, improve logistics services and strengthen trade processing, which in turn can help to reduce poverty and contribute to broad-based economic growth.
19. The Government greatly values the support provided by the International Bank for Reconstruction/World Bank over the years to help finance Indonesia's development priorities and the provision of technical assistance that is helping us to identify issues and develop a comprehensive and well-coordinated logistics reform program. We look forward to your continued engagement and support in the coming years.

Minister of Finance
Republic of Indonesia



Sri Mulyani Indrawati

Cc:

1. Coordinating Minister for Economic Affairs
2. Director General of Budget Financing and Risk Management, Ministry of Finance
3. Director General of Customs and Excise, Ministry of Finance
4. Deputy Minister for Industry and Trade, Coordinating Ministry for Economic Affairs.