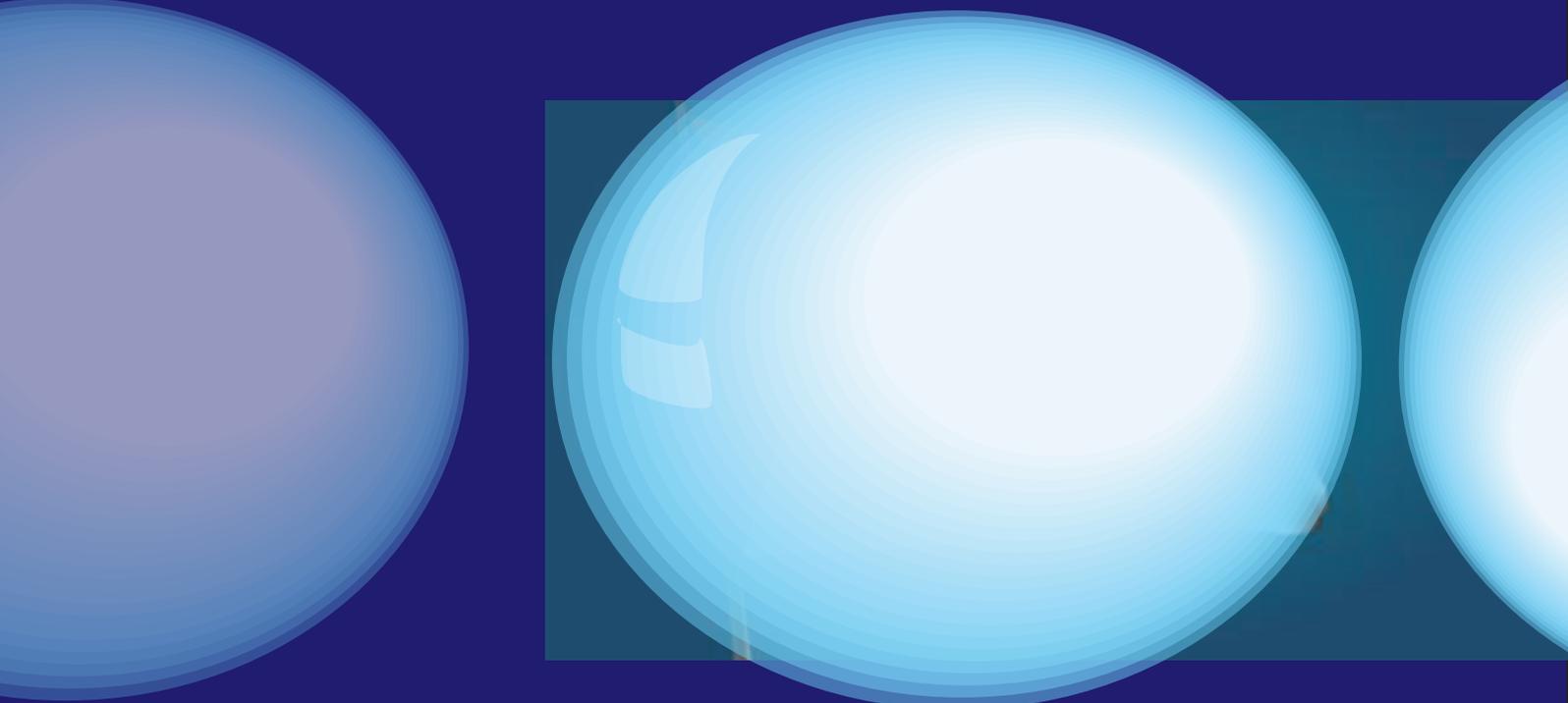


September 2005



Indonesia- What is different this time?

By Sanjeev Kumar

Sponsored by



A growing population of over 222 Million with a total GDP of over US 233 Billion (based on 2004 figures) will always be of significant importance to the Global Economy.

During the period of 80's and early 90's before the Asian crisis Indonesia was considered a major locomotive for growth in the emerging Asian Economies. After the Asian crisis things have changed as investors have left Indonesia for safer markets and some are still reluctant to get back into Indonesia.

The previous Governments have made efforts to put Indonesia back on the path of reform and growth but it has not been enough to build the confidence back in investors.

So what is different this time?

The new administration has a stronger mandate from the people. Last year's election was the country's first-ever direct presidential election. President Dr. Susilo Bambang Yudhoyono's (SBY) hold on legislature was given the much needed boost with the nomination of Vice-President Jusuf Kalla as the new Golkar party chairman. This should reduce the possibility of the opposition alliance hindering major legislation and reform.

Investors Concern

The areas of concern for investors has been many; political uncertainty, macroeconomic instability, corporate governance, weak judiciary and related legal framework, labour laws, transparency, corruption, fraud, inconsistencies in tax administration and local laws that conflicts with the central government laws.

Corporate Governance in Indonesia is still in its infancy stage. It is seen primarily as a compliance issue rather than a means of enhancing the performance of an institution. Fraud and insider transaction are frequent occurrence, disclosure has been weak. A weak bankruptcy and judicial system gives the creditors a very little leverage over their debtors. State owned companies have been subject to significant intervention by the government in business decisions. Bank Indonesia (Central Bank) has been weak in monitoring non systemic banks and as a result several banks have failed in the past. During the crisis, banks were exposed to excessive levels of unhedged foreign debts and credit allocation by banks showed very little regard for future debt servicing. Indonesian companies were predominantly family owned and highly leveraged with substantial unhedged short-term foreign debts and low profitability. Governments set entry barriers and monopolies that made sure there was no competition.

All these factors were the major contributors to the crisis.

Measures taken by Governments so far

The million dollar question is "have the successive Indonesian governments learned their lessons from the past?"

The advent of Dr. Susilo Bambang Yudhoyono's (SBY) government has significantly reduced the political uncertainty. Public confidence has been boosted by SBY campaign platform of anti-corruption, rapid economic development and greater accountability.

December 2003 saw the creation of the long-awaited anti-corruption commission (KPK) by the previous administration. The commission has powers to try corruption cases over US 106,300 to coordinate corruption prevention, to oversee the investigation and trial of corruption cases by prosecutors and police, to order banks to disclose suspicious transactions and freeze accounts, and to order a high - ranking public official under investigation to be released from his or her post.

The recent trials of Aceh's governor and CEO of Bank Mandiri will only bolster public confidence in the government's sincerity in dealing with corruption. Indonesian Military Force (TNI)'s involvement in business activities is to be clamped down in five years.

The current government has set out a reform programme to improve investment climate, increase labour market flexibility, re-examine manpower act which imposes high costs and restrictions on hiring and firing, reduce corruption, remove obstacles to investment by reducing its role, and removing uncertainty through deregulation.

The government has laid down a 100 day plan to tackle the issues that concerns most investors and the public.

The government's objectives in its 100 day plan will be to improve labour market condition by revising the existing regulation for a flexible labour market, improve regulation on investment, wage, redundancies and compensation. To improve the investment climate, the government will be reducing the VAT on dividend income from 20% to 10%, reduce maximum corporate tax from 30% to anything in between 25-28%, provide tax incentives for FDI, liberalise export sector and improve the concession negotiation framework in the oil gas sector. There are proposals to accelerate infrastructure development, welfare for the poor and maintain macroeconomic stability.

President's economic team has taken initiative to resolve high-profile legal disputes with ExxonMobil, Cemex SA and KBC.

Recently Vice-President Mr. Jusuf Kalla made statements in the press that the dispute with ExxonMobil is almost resolved

To encourage FDI in the oil and gas sector, the government has promised to open up the sector by the end of 2005.



Obstacles and weaknesses

Reforms and privatization of state owned enterprises has been slow. Uncertainty in the legal and judicial system stills remains. There has been a lack of investment in the natural resource sector in the recent years and the non-oil tax revenues remains weaker then expected.

Structural problems and the severe cash flow squeeze at the state-owned oil and gas company PT Pertamina have resulted in complications to Bank Indonesia (BI)'s exchange rate management and the central government's budget. The cash flow squeeze is a result of PT Pertamina's obligation to import petroleum products for local distribution, at a time of higher then expected oil prices. Pertamina's dollar requirements to finance its imports have been increasing year-on-year and along with its cash flow problems contributed to volatility in the foreign exchange market. On the budget front, Pertamina has been delaying transfer of dividends and retained income from its production sharing contracts to the central government to ease its working capital problems. This has resulted in weak oil and gas non-tax revenues.

Steps taken to deal with the weaknesses

Last year (2004) Pertamina managed to renegotiate the way the government pays for subsidies on domestic fuel sales. Previously the government paid 70% of the budgeted subsidy (regardless of import prices) but now it has agreed to reimburse Pertamina with 95% of the actual amount spent on oil imports on a monthly basis, with the final 5% paid on clearance from the state audit agency.

Recently (in September 2005) SBY's government took a bold decision to start cutting the subsidies on petroleum products. Pertamina raised the prices for liquefied gas and high grade gasoline by 41% in December 2004 and another price hike is expected in September and November 2005.

These steps will help Pertamina improve their cash flow position.

Current Economic Condition

There will be pressure on the government and the authorities to strike the right balance in managing upward inflationary and interest rate pressure.

In August 2005 Bank Indonesia (BI) raised the benchmark rate from 8.75% to 9.50% the rates were then raised to 10% in the Board of Governors' Meeting convened on September 6, 2005. BI might have to raise the rates to 11% sometime in the near future. This decision was based on an assessment of the latest macroeconomic conditions and the economic and monetary outlook for the coming months, and takes account of efforts to achieve the medium-term inflation target. BI's Board of Governors' assessment of the economy on September 6, 2005 indicates that the economy is facing conditions of rising

expectations of future inflation due to the soaring world oil prices that could bring about a further round of increases in administered prices and trigger weakening in the rupiah.

CPI inflation in August 2005 reached 8.33% year-on-year, this is slightly above the historically based projection of 0.4%.

The rupiah has sustained considerable pressure with the average exchange rate for the first three months of Q3/2005 sinking to Rp 10,500 to the US dollar. The challenges to rupiah's stability are posed by rising international oil price and a strong US dollar. These challenges might not be more than a short blip but if the government and BI fails to deliver policies aimed at fixing the sources of weakness of rupiah then there might be a further decline in the currency.

Since April 2005 the government has been dipping into its foreign exchange reserves and buying US dollar to support rupiah. There has been a steady decline in the reserves from US 36 Billion to US 32 Billion on 23 August 2005. The rising fuel price will have a significant impact on the reserves. Forex reserves have declined US 300 Million for every US 1 rise in the price of Oil.

The Board of Governors of BI estimates that inflationary pressure will remain strong for the rest of 2005. CPI inflation is predicted to reach about 9%, while core inflation for 2005 is expected to come in the range of 7% with +/- 1% deviation

Bank Indonesia (BI) will continue the management of banking liquidity through Open Market Operations (OMO), using SBIs, the FASBI, and FTO (Fine Tune Operations) to support the implementation of the BI Rate. In addition, calibrated actions will be taken to sterilize foreign currency flows as needed to assist in absorbing liquidity while also minimizing rupiah volatility on the forex market. The central bank will maintain a close coordination with the Government in the effort to stabilize the value of the rupiah.

Will the measures taken by BI and the government be enough?

Initiatives taken by BI and the government have delivered some stability to rupiah. This stability might be short lived if Bank Indonesia (BI) and the government fail to manage every facet of currency exchange rate management policy and deliver macroeconomic stability by fixing the sources of weakness of rupiah. The central bank might have to tighten monetary policy further sufficient enough to convince the market that it would reduce inflation, despite rising international oil prices. This might stabilize rupiah further.

Does Indonesia 2005 bears parallels to the Asian financial crisis of 97 and 98?

There has been a steady decline in Indonesia's public

debt burden. It is predicted to drop below 54% of the GDP in 2005, from a peak of 102% in 2000. The gross public debt is also expected to fall below 34%, thanks to debt repayments. The external debt service ratio has declined from 63% in 1999 to below 30% of current external receipts in 2005.

The deficit for the financial year 2004 was around 1.6% of the GDP slightly above the planned 1.2% of the GDP. The recent government decision to cut back on oil subsidies might help Indonesia strengthen its fiscal position as the fuel subsidies account for 23% of the government's routine expenditure, which is 2% of the GDP.

Finance minister Mr. Jusuf Anwar has prioritised eradicating smuggling and budget leakage in order to boost revenue collection. According to Transparency International report Indonesia loses about 40% of its tax revenues through budget leakage.

The governments plan to remove contingent liabilities, such as blanket guarantees on bank deposits (replaced by a deposit insurance scheme) will lower the fiscal risk further.

The countries forex reserves continue to cover 100% of Indonesia's short-term external debts and about 6-7 months of imports. Indonesia's gross external financing requirement is expected to be below 40% of foreign exchange reserves in 2005.

The balance sheets of Indonesia's major bank remains solid, thanks to strong retained earning in the recent years. Banks' NPL/Loans ratio was below 7% down from 13% at end of 2001. Special mention credits (pre-crisis loans) were below 10% down from 21% at the end of 2001. Improvement in these ratios has been due to loan growth and write-offs.

Gross fixed capital formation (GFCF) has increased by over 11% year-on-year during the first three quarters of 2004, boosted by improving business sentiments.

Private consumption accounting for 62% of the GDP has seen a steady increase year-on-year. Industrial and commercial sector electricity consumption rose by over 10% in 2004. Domestic consumption of cement in May 2005 rose by 14% year-on-year and sales of both car and motorcycles continue to grow strongly.

Taking all these factors into account, Indonesia is better placed to deal with any external shock or liquidity crisis.

What's next?

The government should strive to learn from the regional economies in Asia as well as other emerging economies. Focus should be on tapping the regional investor's base from countries like China, South Korea, Malaysia, Australia and India instead of being focused on European or US based investors. Chinese companies including those of SINOPEC, SINOCEM and CNOOC are already looking at Indonesia as their strategic market for growth. Sinopec has recently announced its investment interest in Indonesia. China Huadin Corp is financing a power plant project in the country in collaboration with its Indonesian partner. Companies from Malaysia and Singapore such as

Malaysia Telekom and Polaris of Singapore have already started investing in telecom sector in Indonesia. Private Banks in Malaysia have already started buying stakes in private banks in Indonesia

A recent trip by Vice-President Mr. Jusuf Kalla to China yielded about US 20 billion for financing infrastructure projects over the next 15-20 year period.

The government is looking to set up an infrastructure fund to help finance projects worth US 150 billion through joint public-private partnership. Concern is that the government might be tempted to pressurise the state owned banks into utilising their excess liquidity to finance public investment projects. This might be a wrong move by the government if they decided to go ahead with it at a time when its fiscal position is still fragile. The government should instead work with state-owned banks and multilateral agencies such as the Asian Development and World Bank to set up an infrastructure fund, where the government along with the state-owned banks and multilateral agencies can keep some equity in the fund while the remaining is placed with foreign investors.

Conclusion

Policy credibility will remain the key to macroeconomic stability. Government's failure to exploit this current window of opportunity will be discouraging and it will erode the market confidence and creditworthiness of the country over time.

Sanjeev Kumar, CEO of Delamore & Owl Group of Companies and Managing Director of Delamore Consulting Ltd. Contact the writer at sanjeev@delamorgroup.com

