

EXECUTIVE SUMMARY

Since 1998, Indonesia has made notable gains in developing democracy, freedom of the press, civil-military relations and broader social participation in the political system. However, the Indonesian Government recognises the challenges ahead also are significant. Indonesia must continue to restructure its financial and corporate sectors, develop a more reliable legal framework and implement decentralisation. If it successfully builds this foundation, it would underpin more sustainable and equitable economic growth over the next decade and beyond.

This report details major post crisis developments in Indonesia to inform Australian business, governments and the community, enhance commercial, official and people-to-people relationships and contribute to Australia's development assistance to Indonesia. The report tracks Indonesia's progress in facing these challenges, focusing on major economic reforms and developments since the financial crisis. It identifies achievements, highlights the ongoing reform agenda and assesses probable timing of progress in these areas to determine the likelihood of timely and sustainable economic recovery, and signals opportunities for Australian business.

Economic Outlook

In late 1999, the Indonesian economy started a reasonably strong short term recovery, with gross domestic product, GDP, growing at about 4 per cent in the first half of 2000 and growth is likely to reach 5 per cent for 2000. All sectors are expanding, as are net exports and consumption. Wages and salaries are recovering from post crisis falls, growing at an annual rate of 17 per cent. Reflecting private bank refinancing and increasing interest margins, bank lending also is resuming, rising Rp. 12 trillion (US\$1.1 billion) in June and July 2000, or 6 per cent of bank assets, although this includes significant debt restructuring.

Inflation has been low but is rising, with prices increasing 8 per cent in the year to September 2000. Higher wages, imported inflation from rupiah depreciation, and higher utilities and oil prices are causing this rise. Furthermore, new investment, which since December 1999 had been recovering slowly from major crisis induced falls, declined again in the September quarter of 2000.

Indonesia's trade performance is recovering. Exports rose almost 28 per cent in the year to September 2000, due to higher oil prices and growing non-oil export volumes, and are now 17 per cent above pre-crisis levels in US dollar terms. While imports also are rising as exports and domestic consumption recover, and in US dollar terms were up almost 16 per cent in the year to September 2000, they were still 34 per cent below pre-crisis peaks. Hence, Indonesia ran a significant trade surplus, equal to 11 per cent of GDP in the September quarter of 2000.

However, 1999 capital account transactions were less promising; Indonesia's net private direct capital outflow of about US\$4 billion was about 65 per cent of the 1999 trade surplus of US\$6 billion. Foreign debt repayments due to loan restructuring and portfolio investment also generated large negative capital flows.

The Dual Economy

By late 2000, a marked divide, characteristic of a dual economy, was emerging between the performance of export-oriented and small and medium enterprises, SMEs, and large corporates. The low rupiah assists exporters, especially those able to access external funds for trade credit and investment, and many SMEs, previously denied access to bank credit, are debt free, and can capitalise on growing domestic and foreign demand. For example, a September 2000 survey of mostly export-oriented foreign enterprises in an industrial estate outside Jakarta, indicated output was 50 per cent above pre-crisis levels. Surveyed firms mainly used capital from foreign parent companies, and reported the estate's operating environment was highly flexible and profitable; permits were easy to obtain; and labour was cheap, plentiful and efficient.

On the other hand, most large corporates, particularly those in construction, real estate and tourism, remain mired in unreconstructed debt and are technically insolvent. Many corporates that have restructured debt may not have restructured sufficiently their operations and management, leaving them highly leveraged and vulnerable to future downturns. Progress in corporate restructuring is slow, inhibiting new borrowing and investment, and reducing the corporate sector's scope to sustain growth.

Whether healthy SME and export-oriented firms can continue to grow and be able to access credit, or whether the credit demands of over-leveraged corporates will squeeze out more successful firms, will be critical. Further, the use of public money to restructure corporates could increase the tax burden on healthy firms, constraining their growth. All these issues imply growth could remain below pre-crisis levels for at least the next two years, or until restructuring is complete.

Political Developments

In the three years since the financial crisis began, Indonesians have achieved considerable political reform, ending authoritarianism, reinstating Indonesian democracy and addressing the challenge of broadly based political, economic and military reform. A new, more vibrant polity has replaced the highly centralised New Order regime.

This political change eventually should create a fairer and more predictable investment environment for Australian business. New parties with weaker affiliations to previously powerful vested interests have constrained initial political resistance to asset sales and debt restructuring. Newly established independent auditors and, eventually, greater central bank independence should make policy implementation and governance more efficient. Also, a more active civil society gradually should increase government and other stakeholder accountability. Increased regional autonomy will decentralise many government responsibilities, in the long term potentially improving economic efficiency and community participation.

However, investors face some short term risks during the transition to a new democratic and decentralised political system. Opposition to some aspects of the reform program could become more vocal. Some newly empowered bureaucrats and political parties oppose foreign ownership, threatening the sale of corporate and state assets. Bureaucratic, union and regional resistance also hamper the reform and sale of state enterprises. Finally, devolution will affect central government revenue, and could affect the foreign investment environment by complicating transparency and consistency issues.

Largely to respond to mounting concerns about lack of progress in implementing the economic reform program, President Wahid reshuffled his cabinet immediately after the People's Consultative Assembly, MPR, annual session in August 2000. The new, smaller cabinet, including Dr Rizal Ramli as Coordinating Minister for Economics is more cohesive. At his first ministerial press conference, Dr Ramli signalled the urgent need to address key economic problems, including giving priority to selling assets the Indonesian Bank Restructuring Agency, IBRA, took over after many private banks failed. Some IBRA assets, principally those belonging to the Salim Group, now are being sold, but problems have emerged with the purchase of other IBRA assets.

Although the interaction between politics and economics is complex, business can interpret the political system's progress in implementing economic reform over 2001 and 2002, using the key indicators this report identifies.

Foreign Investment Opportunities

Unlike in other crisis affected economies, Indonesia's foreign direct investment flows are still negative. However, Indonesia's foreign investment regime is more open than before the crisis and the foreign investment outlook of export-oriented and import competing sectors is improving with the weaker rupiah and stronger macroeconomic outlook. Sales of state held assets and enterprises also should attract investors.

Post crisis foreign investment opportunities are more wide ranging, with few sectors precluding 100 per cent foreign owned firms. Already, foreigners can operate retail outlets, distribute goods produced locally, and apply to import and distribute other products. Foreign investors also can enter joint ventures for medical services and telecommunications. Agribusiness and most infrastructure sectors also are open to foreign investors, although failure to resolve disputes with independent power producers over Soeharto era contracts is reducing market confidence. In 2001 and beyond, foreign banks should be able to purchase bank equity assets from IBRA's sizeable holdings. Corporate assets under IBRA's control also will be sold. While these purchases can involve risks, buyers can reduce these by commissioning independent audits to collaborate IBRA's appraisals, completing comprehensive due diligence assessments before acquiring assets, insuring for risk and monitoring closely the Indonesian economic, political and institutional environment. New draft legislation before the parliament would further liberalise the investment environment, but opposition to its passage may be mounting.

Trade Opportunities

Since the financial crisis began, the Indonesian Government has accelerated trade reform. Indonesia now is moving towards a liberal trade regime similar to Singapore's or Hong Kong's in the 1960s and 1970s. By mid 2000, 60 per cent of tariff lines had duties of 0 to 5 per cent, and more than 70 per cent had tariffs of 10 per cent or less. The unweighted average tariff rate now is below 9 per cent. Only 1 per cent of all tariff lines have tariffs over 40 per cent. While major lines like completely knocked down and fully built motor vehicles still have tariffs of 35 to 80 per cent, even these are down from 200 per cent. Significant non-tariff barriers, like the national car project, were removed after the crisis.

The Government also extended earlier programs to reduce tariffs on agricultural products; this lowered the unweighted average tariff rate on agricultural products from 19 per cent in 1995 to 8.6 per cent in 1998. It removed many non-tariff barriers on agricultural imports, notably import licensing requirements on commodities the national logistics agency, BULOG, controlled. This liberalisation permits competitive imports and distribution of wheat, flour, sugar, soy beans and garlic. However, some less competitive heavy industry sectors and broadacre farmers oppose further trade liberalisation, and in some cases, want to reinstate trade barriers.

Australian Indonesian Business Opportunities

Despite Indonesia's financial crisis, Australia and Indonesia continue to enjoy a good commercial relationship. Indonesia ranks as Australia's tenth largest trading partner and bilateral trade is recovering. Australian exports to Indonesia rose 18 per cent in the year to September 2000 to A\$2.7 billion, but still were 26 per cent below pre-crisis peaks. Australia's share of Indonesia's import market recovered to 5.2 per cent during 1999. Before the crisis, Australia's merchandise and services trade ran an A\$1.8 billion surplus with Indonesia, but since the crisis, strong growth in Indonesia's exports to Australia has shifted the trade balance to an A\$780 million surplus in Indonesia's favour.

The strong complementarity of the two economies, recent trade liberalisation, Indonesia's growing population, recovering disposable incomes and, currently, the weak Australian dollar vis-a-vis the US dollar makes Indonesia a prospective growth market for Australian exporters. While the low value of the rupiah has undermined many export markets, good opportunities exist in agricultural commodities and manufactures, including motor vehicles, which now face much lower trade barriers. Service exports, including education, financial and IT services, also are well placed to expand, as foreign investment restrictions in these sectors decline and economic recovery continues. New direct foreign investment opportunities in the export-oriented and SME sectors, and from Indonesian Government asset sales, could deepen commercial links.

Business Environment

The Indonesian business environment is changing as the Government implements reforms. New commercial legislation and regulations, sales of major conglomerates and rising levels of foreign investment eventually could reshape the corporate environment. However, despite these changes, Indonesian business culture will continue to emphasise relationships, hierarchy and the local community. Businesses understanding and working with these features of the business environment are more likely to succeed.

In most sectors, foreign investors no longer need to enter joint ventures; their business ownership and management options are wider. However, knowledge of the local business environment is important to investors choosing between establishing a 100 per cent foreign owned business or entering a joint venture. Local partners can bring access to distribution and bureaucratic channels, create greater acceptability in the local community and assist new entrants with cultural and language issues. However, local agencies, legal notaries and business consultants also can provide some of these services, and 100 per cent foreign ownership can give greater managerial flexibility.

Financial Sector Restructuring

The new banking sector has fewer banks, more stringent capitalisation requirements and tighter bank supervision, especially of lending practices. These changes, based on international best practice, should strengthen financial sector foundations. The performance of the newly recapitalised private sector banks improved during 2000, and lending expanded modestly. While banks must raise their capital adequacy ratios from 4 to 8 per cent by the end of 2001, the capital adequacy of the seven recapitalised private banks averaged over 11 per cent by mid 2000. Most private banks also are provisioned against potential losses from remaining non-performing loans. State banks, which hold most bank deposits, should be recapitalised by the end of 2000. However, state banks have lower capital adequacy ratios, hold most non-performing loans and have undergone only limited operational restructuring.

Non-performing loan levels remain high at 30 per cent, and banks remain weak by international standards. The slow pace and inadequate operational restructuring involved in some recent corporate debt workouts could cause problems for recapitalised banks, as restructured loans may become non-performing again. Furthermore, most banks prefer to hold sovereign bonds rather than expand corporate lending in the current environment where many corporate borrowers are not servicing their loans.

The Government's efforts to refinance, restructure and reform Indonesia's financial sector have generated many opportunities for foreign financial service suppliers; ongoing debt workouts will continue to require these skills. To encourage new market entrants, the Government has relaxed foreign investment laws in the financial sector, and while sales stalled in 2000, it has affirmed it intends to complete sales of its holdings of restructured loans and bank and corporate assets before 2004. In the medium term, new prudential standards and the need for improved risk and credit management systems also generate opportunities for professional service providers in these areas.

Corporate Restructuring

IBRA estimates a large share of the Indonesian corporate sector is insolvent. Of the loans large corporates owe, at least three quarters are distressed and need restructuring. In late 2000, corporate debt restructuring was accelerating, although concerns about its depth remain. In September 2000, IBRA reported it had resolved 40 per cent of its credits with the top 21 debtors, which totalled Rp. 87 trillion (US\$10 billion) through agreed restructuring or legal action. By mid September 2000, the Jakarta Initiative Task Force also had restructured 25 cases involving around US\$5 billion of debt, out of 51 cases worth US\$10 billion actively engaged in mediation. However, operational restructuring may be less than optimal with most workouts involving long grace periods before repayments resume, lower interest rates and debt equity swaps, rather than debt write offs and management changes.

The Government recognises that to avoid another banking crisis, banks and corporates must improve their corporate governance and have better incentives to manage risk and improve investment efficiency. The Government is upgrading prudential supervision, and firms must adopt international standards in reporting their financial positions. However, developing strong supervision skills and capacity involves a long term commitment. Commercial court reforms gradually are improving how new bankruptcy laws are implemented, although this also is a long term process. Eventually, harsher penalties for illegal commercial activity, increased foreign and local competition, and new accounting requirements should lift the corporate governance standards of large conglomerates and state enterprises.

Mining

Indonesia's highly prospective mining sector, with world class reserves in leading minerals, oil, petroleum, coal and gas, significantly contributes to GDP and exports. It also helped buffer the economy during the crisis. However, the mining sector's investment environment has changed significantly since the financial crisis. Now four challenges confront the mining sector: political decentralisation, as most mines are in regional Indonesia; social stability in some regional areas; increased illegal mining; and stringent new environmental standards and forestry regulations. In the long term, political devolution may make government more responsive to local population and investor needs, but in the short term, it generates uncertainty for investors. The challenges highlight the importance of building strong relationships between mining firms, all three levels of government, landowners and local communities.

Foreign companies contribute significantly to mining sector activity, with their investment in Indonesia exceeding US\$10 billion in the last three decades. Australian firms account for about one third of foreign investment approvals in this sector and are well placed to use their mining expertise and geographical proximity to help Indonesia develop its mineral resources. Opportunities include assessing and extracting resources, refining and distributing mineral output, and exporting mining related equipment, supplies, training and other services.

Agriculture

Since 1998, Indonesia has liberalised significantly its agricultural trade and investment regimes; eventually, this should promote a more efficient use of agricultural land and resources, which will raise rural incomes. Agriculture makes a shrinking but still important contribution to the economy, generating under 20 per cent of GDP but over 40 per cent of employment. Agricultural productivity often is below world averages and invariably is below world best practice. However, the Government's new ten point plan prioritises raising agricultural productivity and farmers' welfare. Along with programs to increase rural credit facilities, infrastructure and agricultural extension services, trade and investment reforms should support this objective.

Significantly lower tariff and non-tariff barriers for key agricultural commodities also will benefit Australian agricultural exporters, and more efficient agricultural policies should generate opportunities for agricultural equipment and services exporters. Mid 1998 reforms liberalised foreign investor participation in plantations, freshwater fisheries, milk processing and agricultural product distribution.

Several regional areas offer good opportunities for agribusiness investment, usually based on technology transfer. Consequently, in 1999, Indonesian agribusiness and food sectors attracted significant foreign investment applications.

Implications

Indonesia's large population, strong growth potential, geographic proximity and economic complementarity ensure its commercial partnership with Australia will remain important. These features also mean maintaining strong political and strategic ties are an important foreign policy priority for Australia. As Indonesia becomes a more democratic civil society and recovers from the financial crisis, Australia has strong reasons to offer effective support for this challenging process.

Economic recovery, post crisis trade and investment liberalisation, the competitive Australian dollar and IBRA asset sales are generating some significant commercial opportunities in Indonesia for Australian business. While the rupiah's low value depresses overall imports, trade and investment reforms offer potential to expand traditional and new export markets in agricultural commodities, manufactures and educational, financial, IT and health services. Investment opportunities also are emerging in export-oriented manufacturing and in financial, retailing, tourism and infrastructure sectors through IBRA asset sales. While risks remain high, careful due diligence and appropriate risk management can reduce investor exposure.

Throughout the post crisis period, strong commercial and people-to-people links between Australia and Indonesia have supported the bilateral relationship. Promoting the commercial relationship and increasing productive, development enhancing people-to-people links are important in strengthening ties between the two countries. Promoting viable Australian direct investment in Indonesia would help deepen the long term bilateral commercial relationship.

The Australian Government can increase Australian business awareness of opportunities by organising and leading Australian business delegations to Indonesia, and encouraging capital flows by helping to enhance Indonesian prudential and corporate governance by offering opportunities for Indonesians and government and private sector institutions to learn from Australia's own experience in this area.

Continuing to develop people-to-people links through educational institution cooperation, student and young worker exchanges and promoting private-public sector cooperation on Australian sponsored economic governance strengthening projects in Indonesia also are valuable means of strengthening and deepening bilateral ties. Longer term partnerships between major Australian and Indonesian public sector institutions providing economic governance could enhance the effectiveness of Australia's already substantial economic governance assistance program in Indonesia. Such partnerships could help Indonesia strengthen its economic governance capacity, as well as deepen productive long term ties between the two countries' institutions.

Assuming Indonesia's economic recovery and reform continues and the political environment remains stable, Australian business would be well advised to carefully examine new trade and investment opportunities with a view to identifying profitable strategic positions in the Indonesian market.