

IMPLICATIONS FOR BUSINESS AND GOVERNMENT

KEY POINTS

- Indonesia's relatively strong, short term recovery and post crisis reforms are producing potential commercial opportunities for Australian business. With fewer foreign investment barriers and some acceleration in corporate restructuring, Indonesia could become a more attractive investment prospect.
- Export-oriented and import replacing small and medium enterprise, SME, sectors, are performing well. The weak rupiah, improving trade finance and recovery in Indonesia's trading partners favour export-oriented industries and agribusiness; and as the low exchange rate makes imports expensive, import substitution sectors are expanding to supply the local market.
- Ongoing and planned sales of state owned assets in finance, infrastructure, telecommunications, agribusiness and building materials may offer a relatively narrow window of opportunity to investors seeking to secure significant market shares.
- However, those considering such investments will need to undertake thorough due diligence assessments and employ appropriate risk management strategies.
- Australia and Indonesia's commercial, bilateral relationship largely withstood the financial crisis. However, viable Australian direct investment in the Indonesian economy would strengthen ties further.
- Increasing productive, development enhancing, people-to-people links, through student, academic and work exchanges between the two countries is important.
- Developing longer term cooperation between major Australian and Indonesian public institutions via long term training and technical assistance should aid the Indonesian Government's economic governance program.

With a population of 207 million, growth potential, strong people-to-people-links, complementary economies and geographical proximity, Indonesia will remain an important commercial partner of Australia. These factors also ensure maintaining strong commercial and political ties are an enduring foreign policy priority for Australia.

IMPLICATIONS FOR BUSINESS

While the financial crisis more seriously affected Indonesia than other East Asian economies, and the political transition has delayed restructuring, Indonesia now is experiencing a relatively strong, short term recovery. In late 2000, exports, consumption and all major sectors of the economy were growing well, and GDP should expand 5 per cent over the full year. This growth should continue into 2001, but investment dipped again in late 2000, and medium to long term growth will depend on whether the financial system can accommodate lending for new investment, which in turn, largely will depend on effective corporate sector debt workouts and restructuring.

While debt workouts accelerated in late 2000 after two years of delays, a significant majority of the corporate sector was insolvent; the Indonesian Bank Restructuring Agency, IBRA, considered 70 per cent of these debtor firms could not be restructured and would be liquidated. This difficult and possibly acrimonious process may take many years to resolve.¹ However, until this is completed, and major Indonesian commercial assets are relieved of their massive leveraging and can raise capital to expand, this will constrain growth.

As in the Republic of Korea and Thailand, efficient export-oriented firms will be the first to access new investment funds through the banks and share market, and generate growth. Currently many small and medium enterprises, SMEs, which carry little debt, also are prospering as they meet robust domestic demand, including for many previously imported goods. However, unless SMEs can access finance, they will reach maximum capacity, and this will limit their further growth.

Investment Opportunities

Both export-oriented and import replacing SME sectors can provide opportunities for Australian investors, as can ongoing and planned sales of state owned assets. Subdued foreign investment should recover as Indonesia's economic recovery gathers pace, and increased trade competitiveness and opportunities in the import-substitution sectors boost interest. Already the low real exchange rate and the recovery in Indonesia's trading partners are helping export-oriented industries and agribusiness. Consumption is rebounding but imports are costly with the weak rupiah, so import substitution sectors are in a strong position to supply the local market.

With balance sheets largely unaffected by the financial crisis, SMEs are performing particularly well. Because many successful local firms find growth constrained by lack of access to bank finance, some seek joint venture partners.

¹ Court liquidations of the much smaller number of corporates that failed during Australia's late 1980s banking crisis took about a decade to resolve.

The increasingly liberal foreign investment regime also enables 100 per cent foreign ownership in most sectors. Firms with sufficient local knowledge and experience may seek the flexibility of this ownership and management model.

The crisis severely affected sectors of the economy like banking, real estate, retailing and tourism, and the large conglomerate sector; however, increasingly these are undergoing government driven restructuring, and in some cases, liquidation. As restructuring continues, binding fiscal imperatives should ensure the Government eventually sells a significant share of these firms' assets. Many of these assets could provide good investment opportunities. However, thorough due diligence is essential to ensure assets have valid titles and are unencumbered by debt and other claims. When investors consider acquiring ongoing commercial enterprises, they need to discuss their intended business plans with existing management, workers and in some cases, landowners and the local community, to ensure support.

To date, with a few notable exceptions, Australian business has shown little interest in investing in Indonesian banking and corporate sector assets. However, in 2001, the Indonesian economy should continue to recover, and if reform and restructuring progress, the exchange rate stabilises or appreciates, and sovereign risk remains manageable, interest in these assets is likely to grow. From 1998 to September 2000, the Indonesian Bank Restructuring Agency, IBRA, earned US\$4 billion from asset sales, and interest and dividends on its assets; however, it still controls assets with a face value of US\$65 billion; 50 to 70 per cent of these may be liquidated. Given the rupiah's low value, assets in export-oriented and import replacing sectors, particularly those with a high local content, could attract Australian investors. In addition, for those seeking to secure significant market shares in major sectors like finance, infrastructure, telecommunications, agribusiness and building materials, government asset sales may represent a relatively narrow window of opportunity. Those interested in government asset sales should visit IBRA's web site, www.bppn.go.id.

Although potential investors may face variable accounting standards, related company liabilities, debt obligations on assets, non-commercial contracts, an unpredictable legal system and uncooperative management and staff, many potentially attractive assets should be for sale as the economy recovers. Austrade and major Australian legal, accounting and consulting firms operating in Jakarta can assist interested Australian investors in investigating potential investments. (See the end of this report for contact details.)

Mining

Mining provides an important source of export earnings and budget revenue. Indonesia is highly prospective, and despite recent tax increases, still has an internationally competitive tax and royalty regime. As an export-oriented sector not reliant on local financing, some mines have become more profitable since the crisis, particularly as commodity prices have recovered. However, since the crisis, security and illegal mining in the isolated regions in which mining occurs, have developed as major challenges. Recent changes to environmental regulations, which often now exceed international norms, undermine the sector's competitiveness and expose miners to regulatory and legal risks.

Political devolution also creates uncertainty for miners, including concern about the status of contracts of work, future taxation liabilities and likely changes in approval procedures. These developments increase the need for miners to monitor closely regulatory and political developments, and strengthen relationships with landowners, communities and all three levels of government.

Sectoral Export Opportunities

Significant opportunities exist for Australian exporters to consolidate and expand their presence in traditional Indonesian markets, as well as to access many new market opportunities resulting from the Indonesian Government's trade reforms.

Agricultural commodities

Reduced trade barriers, the weak Australian dollar and recovering Indonesian consumption are helping demand for Australian agricultural exports to Indonesia recover. In the medium term, demand for broadacre crops like cotton, rice, wheat, soy beans, sugar and other cereals, including animal feed, should expand well. Indonesian land allocation increasingly should favour higher value added, more labour intensive agricultural activities like tropical fruit and vegetable growing, and several plantation crops. Australia's cotton exports were very resilient throughout the crisis, and should expand further, given Indonesia's internationally competitive export-oriented textile sector. Live animal exports are recovering well from crisis induced falls and should continue to recover. Demands for greater productivity in the agricultural sector provide new opportunities for exports of fertilisers and agricultural machinery. In all these commodities, Australia compares well to major competitors like the United States.

Processed food

Improved consumer confidence, recovering middle class incomes, declining trade barriers and the weak Australian dollar have helped Australian exports of processed foods resume their pre-crisis expansion, providing new trade and investment opportunities. In the short to medium term, these factors should drive rapid growth in Indonesian imports of Australian products like frozen meat and dairy products. They also should generate opportunities to expand exports of land and capital intensive products, like temperate climate fruit juices, breakfast cereals, and canned and dried temperate climate fruits.

Transport vehicles

Since 1998, the Indonesian Government has reduced significantly tariffs on components and many vehicles, and abolished non-tariff barriers embodied in the national car plan, opening up significant export opportunities in this market. While car tariffs are still high at 35 to 80 per cent, they are well below the pre-crisis 200 per cent, and Australian car exports are increasing rapidly from a low base.

Educational exports

Australia is the largest exporter of education services to Indonesia. While the crisis cut into education exports, these are recovering strongly, reflecting the competitive Australian dollar, robust demand from

middle class Indonesians, and strong links between Australian and Indonesian educational institutions. These factors should underpin continued medium term growth, offering new opportunities for Australian educational institutions to supply vocational, undergraduate and graduate training both in Australia and Indonesia. Post crisis reforms allow foreign investment in educational institutions, including joint Australian-Indonesian campuses in Indonesia.

Other services

Fewer foreign investment restrictions also drive new opportunities in providing medical, financial, IT, legal and accounting services. Opportunities for joint private-public sector partnerships to provide support services to corporate and economic governance programs under the Australian aid program are discussed below.

IMPLICATIONS FOR GOVERNMENT

The strong commercial relationship between Australia and Indonesia largely withstood the financial crisis. Promoting this aspect of the relationship and increasing productive, development enhancing, people-to-people links are important in strengthening ties between the two countries.

ENHANCING INVESTMENT LINKS

While Australia traditionally has a strong trading relationship with Indonesia, Australian direct investment is weaker outside the mining sector. Major post crisis foreign investment reforms and government asset sales provide a historical opportunity to strengthen Australian direct investment in Indonesia, thereby securing a more significant Australian presence in Indonesian markets, and deepening commercial and people-to-people ties. The Australian Government can help Australian business recognise and access viable opportunities.

This report highlights emerging commercial opportunities in Indonesia; seminars around Australia based on this report should increase business awareness of developments. Further the Australian Government's support for IBRA's Australian roadshow in December 2000 should promote knowledge of Indonesian investment opportunities associated with asset sales. In 2001, similar events may occur. Other activities to promote business awareness of, and realistic assessment of investment opportunities also could be valuable.

Government Delegations

Australian governments could help expand Australia's trade and investment presence in Indonesia by leading high level business missions to the country. For example, in March 2000, the Australia-Indonesia Institute led a delegation of senior Australian business people to Indonesia. The delegation was welcomed by President Wahid, the Coordinating Minister for Economics, the Minister for Trade and Industry, and the Attorney General.

Encouraging Other Investment Flows

By increasing market confidence in Indonesian capital markets, ongoing Australian assistance to support Indonesia's economic and corporate governance strengthening programs also could help increase Australian portfolio and other capital flows, including bank credit and trade financing to Indonesia. Assistance to establish ratings firms and strengthen prudential controls on banks, securities and bond markets and corporate governance all could encourage more Australian institutional and private investors to consider investing in Indonesia.

STRENGTHENING PEOPLE-TO-PEOPLE LINKS

Developing people-to-people links through educational institution cooperation, and student and young worker exchanges can strengthen and deepen bilateral ties. Australia already offers considerable support for Indonesia's democratisation process, including supporting institutions with key roles in promoting civil and political rights, legal system operation and transparency.

Educational Links

Many Australian universities already have strong links with Indonesian universities at the faculty level, and expanding these could enhance bilateral ties. Australian institutions could play a valuable role in strengthening course development, assisting lecturer education and training, through long and short term courses, and helping develop and staff new postgraduate courses in Indonesian universities. Australian universities also could consider establishing Indonesian campuses, as they have in several other East Asian economies. Offshore masters courses are in particularly high demand. Assistance could fund full in-country course delivery of appropriate courses more cost effectively than bringing students to Australia.²

AusAID's TechVoc project already provides considerable assistance for delivering technical courses in Indonesia. However, Australian TAFE colleges could be encouraged to develop and deliver appropriate technical and vocational training courses, including at joint campuses, on a fee paying basis.

Student Exchanges

Several Australian educational institutions already send students to Indonesia and receive Indonesian students for periods of a semester to a year, as part of their degree courses. This is valuable for the students concerned and the host institutions, and important in increasing people-to-people links. The Department of Education, Training and Youth Affairs, DETYA, currently funds approved Australian student exchanges under University Mobility in Asia and the Pacific program grants. Thailand also contributes to this scheme to send its students to Australia, but Indonesia has not yet put funding into this scheme. DETYA already provides some facilitation services so compatible institutions can contact each other; AusAID could consider subsidising appropriate Indonesian students' fares, fees and living expenses while in Australia.

² Where Australian institutions develop appropriate graduate courses in Indonesia on a full fee paying basis, assistance could broaden the scope of courses provided and assist Indonesian students who cannot pay full commercial fees to access these institutions and courses.

Youth Work Experience Scheme

Another important means of deepening people-to-people links and future commercial ties is through youth work exchanges. The Australian Government already conducts an annual youth exchange program with Indonesia under the auspices of the Australia-Indonesia Institute. However, its scope is limited. Up to 36 participants undertake unpaid job placements and community service work from home-stay accommodation. The Australia-Indonesia Institute funds the program. The Indonesian Department of Education occasionally has made informal approaches regarding the possibility of a scheme to enable young entrepreneurs from each country to gain paid work experience and business qualifications. Australia could consider ways of expanding the Australia-Indonesia Institute program to allow more young Indonesians and Australians with relevant educational and skill backgrounds to gain knowledge of each others' countries and undertake valuable in-country work experience. This could run in tandem with internships at universities, in public agencies and with major Australian firms with a presence in Indonesia, and could enable participants to undertake paid work.

Scholarships and Training

The Australian aid program already provides around A\$27 million per year to fund scholarships for 750 Indonesian students to study in Australian universities. Scholarships provide valuable training to help gifted young Indonesians contribute more to Indonesian development, and develop important long term people-to-people linkages. Australia could consider using more of these scholarships for officers from key economic and legal institutions to support Indonesia's economic reform agenda.

Promoting Long Term Public Institutional Links

AusAID's new Australia-Indonesia Development Cooperation Program (2000-03) continues to give high priority to supporting Indonesian Government efforts to strengthen economic governance and promoting longer term partnerships between key governance institutions in the two countries (AusAID, 2000). Australia already supports many Indonesian economic governance strengthening programs; the Technical Assistance Management Facility based in Jakarta and the Government Sector Linkages Program fund most of these activities. The developmental impact of Australia's economic governance assistance to Indonesia is expected to be enhanced through targeted follow-up activities promoting longer term partnerships between major Australian and Indonesian public sector institutions. Such partnerships should progress Indonesia's aims of strengthening economic governance capacity and deepening productive long term ties between the two countries' institutions.

Examples of potential long term institutional partnerships include: Bank Indonesia and the Reserve Bank of Australia (monetary policy); Bank Indonesia and the Australian Prudential Regulatory Authority (bank supervision); Indonesia's Capital Market Supervisory Agency, Bapepam and the Australian Securities and Insurance Commission (capital market supervision); the Jakarta and Surabaya Stock Exchanges and the Australian Stock Exchange (stock market management); the Australian Competition and Consumer Commission, the Ministry of Industry and Trade, and Indonesia's anti-monopoly commission, the Business Supervisory Commission (competition policy); the Indonesian Ministry of

Finance and Australian Departments of Finance and Treasury (budget and fiscal policy); and the Indonesian and Australian Attorney Generals departments (legal reform). Consideration also could be given to expanding this program to include some state government departments, including those associated with SME development. Realistically it may be possible to establish only three to four such major relationships in the short term. Already the Technical Assistance Management Facility has initiated short term technical assistance programs with most of these Indonesian institutions, and is exploring developing links with some into larger, more long term programs. A program for closer cooperation with Bapepam is well advanced.

Developing long term links ideally would require programs to run over at least two five-year periods subject to reviews, and provide scholarships for significant numbers of young, qualified Indonesian counterpart staff to study in Australia during this period. Such training would be important in securing long lasting improvements in institutional capacity, but also to demonstrate to the senior management of these institutions Australia's long term commitment to the relationship and deepen people-to-people and institutional links. The highly successful AusAID sponsored graduate diploma course in International Economics, specially designed to train young officials from the Chinese Ministry of Foreign Trade and Technical Cooperation, by the Economics Department of Adelaide University, is an excellent potential model for this training. Several Australian institutions offer appropriate postgraduate courses in financial and prudential supervision, macroeconomic policy and financial law, which if developed, could support institutional partnership programs of this kind. Other assistance under such programs could include policy seminars for senior bureaucrats in Australia and Indonesia, IT training, and administrative system and policy development support. Usually these approaches are more successful in developing long term local capacity than short term technical assistance by Australian experts.

Promoting Private Sector Cooperation in Corporate Governance

Australia already is providing considerable development assistance to enhance corporate governance objectives in Indonesia. However, the effectiveness of these programs and commercial and people-to-people links could be enhanced and deepened by employing more frequently the Indonesian expertise and goodwill of Australian legal, accounting and auditing professional associations. Cooperation could include organising, via professional organisations, groups of Australian lawyers, judges, auditors and accountants with Indonesian or East Asian experience to help draft appropriate new commercial statutes and regulations, and provide training and seminars in legal, auditing and accounting practices, ethics and corporate governance issues. Such bodies also could be approached to provide internships for young Indonesian professionals in Indonesia and Australia.

Financial Sector Future Leaders' Forum in Australia

The Australian Government, in association with the Australian Graduate School of Management in Sydney and corporate sponsors, will support, as a contribution to APEC, a six month training forum and workshop for future APEC member country financial leaders in Australia in 2001. The forum

aims to develop multilateral approaches to common regulatory problems and networks among future financial and regulatory policy decision makers. The forum may provide a useful model for similar cooperation and training programs in other economic and corporate governance areas.

Assisting with Decentralisation

Many opportunities exist to assist the Indonesian central and regional government bureaucracies prepare for decentralisation, as this will stretch the administrative capacity of all levels of government, particularly regional levels. Assistance could include support for local officials to study short and long courses in Australia and in-country, as well as for administrative system and policy development. Australia's aid program already assists the skill development of local officials. For the long term, it may be more appropriate to use Indonesian based institutions such as the Institute for Economic and Social Research at the Faculty of Economics of the University of Indonesia, to deliver this training.

CONCLUSIONS

As Australia's largest and closest neighbour, with a long history of friendship, and strong commercial, diplomatic and strategic links, Indonesia is a country of enduring importance to Australia. As Indonesia navigates its transition to a democratic civil society and recovers from the financial crisis, Australia has a strong interest in supporting this challenging process. Throughout this period, the strong commercial and people-to-people links between Australia and Indonesia have supported the bilateral relationship.

The Australian Government has a significant interest in deepening these ties by encouraging Australian business to consider viable newly emerging trade and particularly direct investment opportunities, and promoting a wide range of educational, professional, and institutional cooperation programs and exchanges. As the Indonesian economy recovers and the political situation develops, Australian business should examine carefully new trade and investment opportunities, with a view to developing strategic and profitable long term positions in this potentially valuable market.

