As Indonesia recovers from its severe financial crisis, new opportunities for Australian trade and investment are emerging. To attract foreign investors to government sales of banking and corporate assets the Indonesian Government has significantly reduced barriers to foreign investment. Dramatically lower trade barriers in most sectors, but especially in agricultural product and automotive markets, will assist growth in the traditionally strong commercial relationship between Australia and Indonesia.

This balanced report helps Australian business face the commercial challenge in Indonesia. It analyses economic reform progress including bank and corporate sector restructuring, highlights on-going reform agendas and risks, assesses recent and projected economic performance, explores the business environment and identifies key opportunities for Australian investors and exporters.
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Located within the Department of Foreign Affairs and Trade, the East Asia Analytical Unit has undertaken 25 studies on major issues related to Australia’s trade policy interests in the region. From 2000, the East Asia Analytical Unit commenced a new series covering important emerging markets outside East Asia.

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Reports and briefing papers produced by the unit are intended to assist analysts and decision makers in business, the Australian Government and the academic community.

Full copies of previous reports and executive summaries now can be downloaded from the Internet. See web site details below.

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<td>ADU</td>
<td>Asset Disposal Unit.</td>
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<tr>
<td>AFTA</td>
<td>ASEAN Free Trade Area.</td>
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<tr>
<td>AIBC</td>
<td>Australia-Indonesia Business Council.</td>
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<tr>
<td>AIDA</td>
<td>Australia-Indonesia Development Area.</td>
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<td>AMC</td>
<td>IBRA’s Asset Management Credit Unit.</td>
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<td>AMI</td>
<td>IBRA’s Asset Management Investments.</td>
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<td>APEC</td>
<td>Asia Pacific Economic Cooperation; a cooperative grouping of Asian, North American, Latin American economies and Australia and New Zealand.</td>
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<td>APRISINDO</td>
<td>Indonesian Footwear Association.</td>
</tr>
<tr>
<td>ASEAN</td>
<td>Association of South East Asian Nations.</td>
</tr>
<tr>
<td>AusAID</td>
<td>Australian aid program.</td>
</tr>
<tr>
<td>Bapepam</td>
<td>Badan Pelaksana Pasar Modal, Capital Market Supervisory Agency.</td>
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<tr>
<td>Bappenas</td>
<td>Indonesia di Badan Perencanaan Pembangunan Nasional, National Planning Agency.</td>
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<tr>
<td>BBKU</td>
<td>Banks frozen by IBRA.</td>
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<td>BIS</td>
<td>Bank for International Settlements.</td>
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<tr>
<td>BKPM</td>
<td>Badan Kordinasi Penanaman Modal, Investment Coordinating Board.</td>
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<tr>
<td>BPK</td>
<td>Supreme Auditor’s Board.</td>
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<td>BPPC</td>
<td>Badan Penyangga dan Pemasaran Domestic Clove Monopoly.</td>
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<tr>
<td>BPS</td>
<td>Badan Pusat Statistik, Statistics Indonesia.</td>
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<tr>
<td>BULOG</td>
<td>Badan Urusan Logistik, Indonesia’s national logistics agency.</td>
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<td>Capital Account</td>
<td>A process of removing capital controls and restrictions on the convertibility of currency.</td>
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<td>Liberalisation</td>
<td>A risk management concept requiring financial institutions to have sufficient capital to protect their counterparties and depositors from on- and off-balance sheet risks, including non-performing loans. Capital adequacy requirements tend to be simple mechanical rules. Ability to provide banking services to the public while maintaining the legally required ratio of capital to assets.</td>
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Capital Adequacy Ratio  A ratio of capital to a financial institution’s risk weighted assets, used in financial sector regulation. The minimum Bank for International Settlements capital adequacy ratio is 8 per cent of risk weighted loans.

CBU  Motor vehicle that is completely built up.

CEPT  Common effective preferential tariff.

cif  Cost-insurance-freight.

CKD  Motor vehicle that is completely knocked down.

Depnaker  Department of Manpower.

DPDE  Departemen Pertambangan Dan Energi, Department of Mines and Energy.

DPR  Dewan Perwakilan Rakyat, People’s Representative Assembly.

EU  European Union.

FDI  Foreign direct investment; investment in overseas branches, subsidiaries or associated companies in which the investor owns 10 per cent or more equity.

fob  Free on board.

FSPC  Financial Sector Policy Committee.

FY  Fiscal year.

Gaji Pokok  Basic wage.

GAPIPA  Indonesian Association of Steel Pipe Producers.

GBHN  Broad Guidelines of State Policy.

GDP  Gross domestic product; the value of all goods and services produced in an economy in a specified time period.

IBRA  Indonesian Bank Restructuring Agency.

IMF  International Monetary Fund.

INDRA  Indonesian Debt Restructuring Agency.

I$  International dollars; provide parity based international comparisons of the purchasing power of national incomes.

IPO  Initial public offer.

IT  Information technology.

Jamsotek  Government funded worker insurance scheme.

JITF  Jakarta Initiative Task Force.

KADI  Indonesian Antidumping Committee.

KAPETS  Integrated economic development zones.
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<tr>
<td>KPKPN</td>
<td>Office for Audit of State Officials.</td>
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<td>Lebaran</td>
<td>Annual Islamic holiday.</td>
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<tr>
<td>LNG</td>
<td>Liquefied natural gas.</td>
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<tr>
<td>MPR</td>
<td>Majelis Permusyawaratan Rakyat, People’s Consultative Assembly.</td>
</tr>
<tr>
<td>Musyawarah</td>
<td>Local approach to dispute settlement.</td>
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<tr>
<td>National Interest Provisions</td>
<td>Australian Government agreement to act as insurer of last resort for payment for exports, usually bulk agricultural commodities, to nations with poor credit ratings.</td>
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<td>NCCG</td>
<td>National Committee on Corporate Governance.</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development.</td>
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<tr>
<td>OPEC</td>
<td>Organisation of PetroleumExporting Countries.</td>
</tr>
<tr>
<td>PAN</td>
<td>Partai Amanat Nasional, National Mandate Party.</td>
</tr>
<tr>
<td>PDI-P</td>
<td>Partai Demokrasi Indonesia, Indonesian Democratic Party of Struggle.</td>
</tr>
<tr>
<td>Pegawai negeri</td>
<td>National officials.</td>
</tr>
<tr>
<td>PKB</td>
<td>Partai Kebangkitan Bangsa, National Awakening Party.</td>
</tr>
<tr>
<td>PPP</td>
<td>Partai Persatuan Pembangunan, United Development Party.</td>
</tr>
<tr>
<td>PPP</td>
<td>Purchasing power parity; estimated by determining the number of units of a country’s currency required in-country to buy a standard bundle of goods and services that US$1 would buy in the United States. This information then is used to adjust the country’s US dollar per capita income to better reflect its actual purchasing power.</td>
</tr>
<tr>
<td>Refinancing</td>
<td>Using new financing to pay off or extend an old loan.</td>
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<td>Rp.</td>
<td>Rupiah; Indonesian currency unit.</td>
</tr>
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<td>SE</td>
<td>State owned enterprise.</td>
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<td>SMEs</td>
<td>Small and medium enterprises.</td>
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<tr>
<td>TAFE</td>
<td>Australian tertiary institution for technical and further education.</td>
</tr>
<tr>
<td>TNI</td>
<td>Indonesia’s military.</td>
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<td>VAT</td>
<td>Value added tax; a tax on value added at each stage of industrial production, wholesaling and retailing.</td>
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<td>WTO</td>
<td>World Trade Organization.</td>
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• rely on their own enquiries, skill and care in using the information
• check with primary sources in respect of third party submissions
• seek independent advice.
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.
The 1997 financial crisis interrupted two decades of impressive economic growth, which lifted Indonesia’s per capita income from US$310 in 1976 to US$1,144 in 1996.

After contracting sharply in 1998, Indonesia’s economy returned to positive growth in 2000 led by stimulatory macroeconomic policy, a low exchange rate, stable prices, lower interest rates and stronger private consumption. Export-oriented and small and medium enterprises, SMEs, have grown well since the crisis.

GDP should grow by about 5 per cent in 2000 and at least 4 per cent in 2001. Indonesia’s short term recovery prospects therefore are relatively good.

Strong growth beyond 2001 requires investment in new capacity. The Government’s new Ten Point Recovery Program recognises the importance of repairing the banking sector and restructuring the large stock of debt major corporates currently owe, to ensure new investment can occur.

The Government also is implementing a new framework of bank and corporate governance to reduce the economy’s vulnerability to another financial crisis. Progress in these areas will determine medium to long term economic prospects.

The Government’s economic reform program is opening up new opportunities for Australian business through selling assets currently held by the Indonesian Bank Restructuring Agency, lowering barriers to investing in most sectors and liberalising trade.

Investors should remain well informed about developments in key government reform areas, including corporate debt and bank restructuring, corporate governance, devolution and legal reform. These developments could guide decisions on when to best invest in Indonesia.
Throughout 1999, Indonesian authorities stabilised inflation and the exchange rate, enabling the economy to rebound from the deep recession of 1998. Slowly increasing consumption, relaxed monetary and fiscal policy, and a low exchange rate expanding exports are driving a modest expansion in gross domestic product, GDP. Lifted by strong growth in the September quarter, GDP should increase by close to 5 per cent in 2000, with an increase of at least 4 per cent likely in 2001. While this is less than growth in most other crisis affected economies in Asia, it is a marked improvement on 1998 economic performance when output fell 13 per cent, and 1999, when growth was negligible. These forecasts indicate the environment and prospects for Australian exporters and investors are improving.

Export-oriented and smaller firms less affected by the financial crisis increasingly drive much of the recovery, benefiting from the low exchange rate, their lower reliance on the banking system and recovering consumption. However, the Government recognises a recovery in investment is essential for Indonesia to regain pre-crisis growth (Coordinating Ministry for Economic Affairs, 2000). The Government is attempting to restructure bank and corporate sector balance sheets damaged during the crisis, improve corporate and banking sector governance, and strengthen legal and economic institutions. While economic recovery is still fragile, this reform process also should present major new opportunities to Australian business, especially through the sale of corporate and banking assets, which the Government recently took over. (See Chapter 3 - Foreign Investment.)

This chapter first analyses the nature of the current recovery, and the relatively favourable outlook for short term growth, focusing on its sustainability. It then considers medium to long term growth prospects. To do this, it examines the continuing legacy of the crisis, highlighting the impact of economic governance in the financial, corporate and public sectors, and briefly examines government efforts to sustain the recovery by addressing bank and corporate sector insolvency. Finally, the chapter assesses the implications of this outlook for Australian business and the new opportunities it provides.
GOVERNMENT'S TEN POINT PLAN

In September 2000, the new Coordinating Minister for Economics, Dr Rizal Ramli, issued a ten point economic recovery plan, stressing the importance of repairing the financial sector, and accelerating banking and private sector restructuring. The plan emphasises the need for corporates to reduce debt and expand equity to avoid future crises. It also emphasises the importance of small and medium enterprises, SMEs, and agriculture in improving economic efficiency and equity outcomes. The recovery program indicates the Government’s ten top priorities are to:

1. create stability in the financial sector
2. increase revenue levels from non-oil exports
3. increase agricultural productivity and the welfare of farmers
4. accelerate banking and private sector restructuring
5. emphasise equity based rather than loan based recovery
6. use a value-creation approach in privatising state owned assets
7. meet economic decentralisation targets through an orderly and phased transition
8. optimise the use of natural resources
9. expand the development of micro, small and medium scale enterprises
10. increase employment generation, particularly in rural areas.


Key Economic Indicators

The financial crisis interrupted two decades of strong growth that produced major structural changes in the Indonesian economy, and made real gains in raising living standards and reducing poverty (Table 1.1). Per capita GDP rose from US$310 in 1976 to US$1 144 in 1996, but by 1999 had slipped back 40 per cent to US$694 due to the 70 per cent depreciation of the rupiah since 1997 and falling GDP in 1998. Purchasing power parity, PPP, estimates of per capita GDP fell by a smaller but still substantial 24 per cent, from I$3 700 to I$2 800.¹

¹ International dollars, I$, measure average per capita income of a country in terms of its purchasing power in the US economy; that is, in 1999 the average Indonesian received income sufficient to buy US$2 800 worth of goods and services at US prices. Because nominal exchange rates do not always reflect international differences in relative prices, PPP rates are used to allow a standard comparison of real price levels between countries and hence allow better comparisons of average income levels between economies.
### Table 1.1

**Crisis Interrupts Two Decades of Growth**

Summary of Key Economic Indicators, 1980-1999

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<td>87.2</td>
<td>114.4</td>
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<td>201.8</td>
<td>226.9</td>
<td>212.7</td>
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<td>642</td>
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<td>1 033</td>
<td>1 144</td>
<td>1 056</td>
<td>490</td>
<td>694</td>
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<tr>
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<td>na</td>
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<td>3 140</td>
<td>3 800</td>
<td>3 310</td>
<td>3 390</td>
<td>2 790</td>
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<td>Private consumption</td>
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<td>26</td>
<td>26</td>
<td>26</td>
<td>51</td>
<td>35</td>
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<tr>
<td>Current account balance</td>
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<td>-2.2</td>
<td>-2.6</td>
<td>-1.5</td>
<td>-3.4</td>
<td>-3.4</td>
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<td>Agriculture</td>
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<td>17</td>
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<td>Mining</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>10</td>
<td>9</td>
<td>9</td>
<td>9</td>
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<td>Services and other</td>
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<td>50</td>
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<td><strong>Current account</strong></td>
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<tr>
<td>Exports: goods and services (US$ billion)</td>
<td>26.7</td>
<td>20.1</td>
<td>29.9</td>
<td>36.6</td>
<td>47.5</td>
<td>50.2</td>
<td>56.3</td>
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<td>Imports: goods and services (US$ billion)</td>
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<td>46.2</td>
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<td>na</td>
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<td>2.0</td>
<td>4.3</td>
<td>6.2</td>
<td>4.7</td>
<td>-0.4</td>
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<tr>
<td>External debt (US$ billion)</td>
<td>20.9</td>
<td>36.7</td>
<td>69.9</td>
<td>89.2</td>
<td>124.4</td>
<td>128.9</td>
<td>136.1</td>
<td>150.9</td>
<td>136.2</td>
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<tr>
<td>External debt (per cent of GDP)</td>
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<td>42</td>
<td>61</td>
<td>56</td>
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<td>57</td>
<td>64</td>
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<td>103</td>
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<td><strong>Real growth rates (per cent)</strong></td>
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<tr>
<td>Real GDP</td>
<td>8.7</td>
<td>3.5</td>
<td>9.0</td>
<td>7.3</td>
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<td>7.8</td>
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<td>7.6</td>
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<td>Gross fixed capital formation</td>
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<td>16.1</td>
<td>13.5</td>
<td>14.0</td>
<td>14.5</td>
<td>8.6</td>
<td>-33.0</td>
<td>-19.9</td>
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</table>

Note: PPP is purchasing power parity.
I$ is international dollars.
na Means not available.

After 1998, monetary authorities regained control of the money supply and inflation, and lowered interest rates, giving rise to a modest but broad based recovery in GDP starting in mid 1999 (Figure 1.1).

All sectors resumed positive growth in the year to September 2000 (Figure 1.2). Output growth in construction, transport and communications grew strongly, and output in some manufacturing areas is close to pre-crisis levels (World Bank, 2000).

The recovery mainly reflects the impact of the favourable exchange rate on exports, improved macroeconomic policy management and returning consumer confidence.
Figure 1.2

All Sectors Show Growth in 2000, but Volatile

Real Sectoral Growth Rates, Year Ended, Per cent

Exports Responding

Exports now are recovering very strongly, growing 17 per cent in the third quarter of 2000 from a year earlier in constant price rupiah terms (Figure 1.3). In US dollar terms, exports in the year to September 2000 were 28 per cent higher than a year earlier and higher than pre-crisis peaks (Figure 1.4).

Throughout 1998, reduced trade finance and flight of skilled human capital caused exports to drop, but in 1999 and 2000, as more businesses accessed trade finance, the rupiah’s earlier depreciation started to boost export growth. The central bank, Bank Indonesia, and selected private banks now guarantee letters of credit exporting firms issue. Furthermore, subsidiaries of foreign firms form a large part of the export sector. These firms can access trade finance through their parent company, and are not constrained by the Indonesian banking sector. For example, a September 2000 survey of firms in an export-oriented industrial estate found output was 50 per cent higher than the pre-crisis peak (World Bank, 2000). As Indonesia is a net oil exporter, higher oil prices also boost the value of exports.

However, some analysts express concern about the small number of firms accessing these schemes.
Reflecting the recovery in exports and domestic consumption, imports also are recovering from crisis driven lows, to be around 13 per cent higher in the September 2000 quarter than a year earlier, in real rupiah terms (Figure 1.3). In US dollar terms, imports rose over 15 per cent in the year to September 2000 over the level a year earlier, to reach US$28.8 billion (Figure 1.4). Despite this increase, imports are still 34 per cent below the pre-crisis peaks of March 1997 in US dollar terms. In the September quarter of 2000, Indonesia enjoyed a trade surplus equal to around 11 per cent of GDP.

**Figure 1.3**

**Exports and Imports Recovering Well**

**Growth of Indonesian Exports and Imports, Real Rupiah Terms, Year Ended, Per cent**

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3 The World Bank’s cited trading partner data on exports to Indonesia show even stronger growth in imports than Indonesian customs import data (Figure 4.5 and World Bank, 2000).
The Indonesian budget is highly sensitive to oil prices. Higher oil prices in 1999 and 2000 almost doubled the Government’s non-tax oil and gas revenues between the 1999-2000 and 2000 fiscal years, and by late 2000, these revenues were 21 per cent of total revenues. Higher oil prices also increase fuel subsidy spending, but this is less than the rise in revenue. Expenditure on fuel subsidies in 2000 was almost twice that of the previous fiscal year, and now comprises around 11 per cent of total expenditure. Higher oil prices will reduce the 2000 fiscal year deficit below its targeted 4.8 per cent of GDP to between 2.5 and 3.9 per cent (World Bank, 2000).4 Rising oil prices also will affect the 2001 budget outcome; the draft 2001 budget anticipates revenue will rise another 50 per cent. Although the Government has started reducing subsidy rates, expenditure on fuel subsidies still will increase by over 60 per cent in 2001.

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4 Indonesia is changing its fiscal year to the calendar year in 2000. Much of the deficit has reflected increased spending on interest payments to banks holding bonds issued under the bank restructuring program. While an increase in these outlays provides a net fiscal stimulus, the second round effects of these outlays is lower than from outlays in other areas, including public works and safety net projects.
Inflation Contained

Despite rising towards 8 per cent by the end of 2000, inflation is well below levels reached during the crisis. After peaking at 78 per cent in October 1998, inflation fell dramatically through 1999-2000 in line with restrained growth in money supply (Figure 1.5). Lower inflation helped reduce downward pressure on the exchange rate, building consumer confidence and allowing Bank Indonesia to reduce interest rates. Falling inflation also supports social and political stability, enhancing the foreign investment environment.

Interest Rates Fall

Throughout 1999, as the rupiah stabilised and inflation declined, Bank Indonesia lowered interest rates from 36 to 12 per cent, where they broadly remain; this supported a recovery in consumption and investment over 1999 and early 2000. The mild increase in inflation to 8 per cent has lowered further the level of real interest rates, assisting private sector activity.
Figure 1.6

Interest Rates Fell Sharply

Various Short and Long Term Interest Rates, 1996-99

Note: SBI is the Bank Indonesia Certificate.

Consumers Resume Spending

The combination of stable prices, rising wages, falling unemployment, lower interest rates and the peaceful transition to a new government boosted consumer confidence in 1999. Real consumption grew by close to 3 per cent in 1999, leading the recovery in output in 2000. In the first six months of 2000, retail sales were 11 per cent higher than for the corresponding period a year earlier (Coordinating Ministry for Economic Affairs, 2000).

SMALL FIRMS PROSPERING

SMEs’ impressive performance has underpinned the recovery. Following the crisis, many large firms remain burdened with excessive borrowing, often denominated in appreciated foreign currencies, but SMEs hold less than 2 per cent of non-performing loans (Coordinating Ministry for Economic Affairs, 2000). This is because they had limited access to bank credit before the crisis; of 320 SMEs surveyed recently, only around 2.5 per cent had access to bank loans (Asia Foundation, 2000). Hence, most SMEs are unencumbered by insolvency and bad debt problems.
Mostly, SMEs are supplying recovering domestic demand. Output from small domestically oriented firms recovered strongly in 2000 in response to the pick up in local consumption, and the low exchange rate helped small export-oriented firms during 1999 (Asia Foundation, 2000).5 However, constraints in accessing capital are likely to limit SME output growth. Internally generated funds finance most SME investment, and this limits scope for rapid expansion. A recent survey indicated almost 50 per cent of the garment manufacturers in Central Java and nearly 75 per cent of furniture producers in South Sulawesi interviewed, were constrained financially (Asia Foundation, 2000). To boost their output since the crisis, SMEs have cooperated to obtain finance, as well as access to raw materials, production processes and marketing (Asia Foundation, 2000). While the Government's ten point plan prioritises SME development, recognising the need for credit schemes and other facilities, it also acknowledges repairing the large corporate sector is central to restoring medium term economic growth (Coordinating Ministry for Economic Affairs, 2000).

**RECOVERY SET TO CONTINUE IN SHORT TERM**

The relatively stable macroeconomic environment and weak rupiah should ensure the economy continues to expand in the short to medium term. The Indonesian Government and IMF forecast GDP will grow by between 4.5 and 5 per cent during 2000 (Table 1.2). Private sector economists currently forecast 3.8 per cent growth in real GDP in 2000 and 4.3 per cent in 2001 (Consensus Forecasts, 2000). GDP data for the September quarter suggest 2000 growth will be closer to 5 per cent, and 2001 growth could be more than 4 per cent.

As real GDP is still about 10 per cent below its pre-crisis level and unused capacity remains high, except in rapidly growing export sectors, modest short term GDP growth could occur in 2001 without much new investment, but will be constrained after that if investment does not recover. Forecast growth levels, while modest, should improve the environment for foreign investors and boost trade flows.

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5 These firms included Balinese furniture makers and garment producers in West Sumatra. However, as the exchange rate appreciated and stabilised in 1999, growth in these firms' output moderated.
### Table 1.2

**Modest Recovery Forecast to Continue**

**Actual and Forecast Sectoral Real GDP Growth, Year Ended Percentage Change**

<table>
<thead>
<tr>
<th></th>
<th>1999 Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>1999 Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>2000 Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>2000 b</th>
<th>2001 b</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross domestic product</strong></td>
<td>−7.7</td>
<td>3.7</td>
<td>1.2</td>
<td>5.0</td>
<td>0.4</td>
<td>4.0</td>
<td>4.5</td>
<td>5.1</td>
<td>3.8</td>
<td>4.3</td>
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<tr>
<td><strong>GDP by sectors</strong></td>
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<tr>
<td>Agriculture</td>
<td>8.8</td>
<td>9.8</td>
<td>−6.2</td>
<td>−4.0</td>
<td>−0.5</td>
<td>−5.8</td>
<td>−3.2</td>
<td>6.5</td>
<td>na</td>
<td>na</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>−2.2</td>
<td>−0.3</td>
<td>1.3</td>
<td>−5.5</td>
<td>−1.3</td>
<td>1.8</td>
<td>4.6</td>
<td>2.0</td>
<td>na</td>
<td>na</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td>−7.1</td>
<td>9.0</td>
<td>1.1</td>
<td>8.5</td>
<td>2.8</td>
<td>6.5</td>
<td>5.9</td>
<td>4.4</td>
<td>na</td>
<td>na</td>
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<td></td>
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<tr>
<td>Electricity, gas and clean water</td>
<td>4.3</td>
<td>9.5</td>
<td>10.1</td>
<td>8.8</td>
<td>8.1</td>
<td>9.8</td>
<td>5.6</td>
<td>5.4</td>
<td>na</td>
<td>na</td>
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<tr>
<td>Construction</td>
<td>−23.4</td>
<td>1.8</td>
<td>9.7</td>
<td>12.5</td>
<td>−0.4</td>
<td>12.2</td>
<td>10.5</td>
<td>8.3</td>
<td>na</td>
<td>na</td>
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<tr>
<td>Trade, hotels and restaurants</td>
<td>−15.3</td>
<td>1.0</td>
<td>4.4</td>
<td>11.6</td>
<td>0.2</td>
<td>5.9</td>
<td>5.6</td>
<td>5.4</td>
<td>na</td>
<td>na</td>
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<tr>
<td>Transport and communication</td>
<td>−17.8</td>
<td>−2.1</td>
<td>9.7</td>
<td>11.7</td>
<td>0.2</td>
<td>11.6</td>
<td>10.7</td>
<td>8.3</td>
<td>na</td>
<td>na</td>
<td></td>
<td></td>
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<tr>
<td>Finance, leasing and business services</td>
<td>−22.4</td>
<td>−7.1</td>
<td>−4.8</td>
<td>5.8</td>
<td>−6.2</td>
<td>5.7</td>
<td>5.6</td>
<td>5.4</td>
<td>na</td>
<td>na</td>
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<tr>
<td>Services</td>
<td>1.2</td>
<td>1.6</td>
<td>2.3</td>
<td>2.0</td>
<td>1.8</td>
<td>4.2</td>
<td>4.1</td>
<td>3.7</td>
<td>na</td>
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<tr>
<td><strong>GDP by expenditure</strong></td>
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<td></td>
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<tr>
<td>Household consumption</td>
<td>0.6</td>
<td>2.4</td>
<td>6.0</td>
<td>2.9</td>
<td>2.5</td>
<td>2.6</td>
<td>2.5</td>
<td>2.8</td>
<td>3.4</td>
<td>4.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government expenditure</td>
<td>−3.9</td>
<td>10.2</td>
<td>−0.4</td>
<td>−2.8</td>
<td>0.3</td>
<td>2.9</td>
<td>2.3</td>
<td>13.6</td>
<td>na</td>
<td>na</td>
<td></td>
<td></td>
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<tr>
<td>Total consumption expenditure</td>
<td>0.2</td>
<td>3.1</td>
<td>5.5</td>
<td>2.4</td>
<td>2.3</td>
<td>2.6</td>
<td>2.5</td>
<td>3.7</td>
<td>4.0</td>
<td>4.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>−35.6</td>
<td>−21.6</td>
<td>−18.5</td>
<td>3.5</td>
<td>−16.5</td>
<td>10.1</td>
<td>16.2</td>
<td>13.9</td>
<td>8.2</td>
<td>6.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>−18.8</td>
<td>−4.4</td>
<td>−5.6</td>
<td>17.1</td>
<td>−0.4</td>
<td>39.1</td>
<td>32.1</td>
<td>24.8</td>
<td>14.1</td>
<td>7.4</td>
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</tr>
<tr>
<td>Imports of goods and services</td>
<td>−22.9</td>
<td>−2.0</td>
<td>−9.5</td>
<td>−12.7</td>
<td>−12.2</td>
<td>18.0</td>
<td>20.4</td>
<td>41.9</td>
<td>11.1</td>
<td>14.7</td>
<td></td>
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</tr>
</tbody>
</table>

**Note:**

a GDP and components data are 1993 constant prices.
c Exports and imports in US$ terms.
na Means not available.

Consumer spending should continue to support economic expansion in 2000 and 2001, boosting durable goods sales (Danareksa Research, 2000). Private sector economists forecast private consumption should expand by close to 4 per cent in 2000 and 2001. This will continue to underpin modest GDP growth. Indonesian exports also should continue to expand with the lower rupiah and more accessible trade finance. Private sector economists forecast exports will increase by almost 15 per cent in 2000 and about 7 per cent in 2001 (Table 1.2 and Consensus Forecasts, 2000).

Macroeconomic policy, on balance, should support expanding demand, creating a more positive outlook for foreign investment and trade. Despite the impact of higher oil prices, fiscal policy should provide a small stimulus in 2000, although its flow on effects will be limited. The increase in inflation towards the end of 2000 may require Bank Indonesia to tighten monetary policy, raising interest rates to defend its inflation target of 5 to 7 per cent; this may dampen growth. A recent acceleration in wages and depreciation in the rupiah pose added risks to inflation in early 2001. Nevertheless, the economy’s large excess capacity suggests additional rises in inflation should be limited, and any interest rate increases by Bank Indonesia should be too moderate to derail the recovery.

By 2001, increasing demand probably will deplete stocks in the manufacturing sector, boosting production and absorbing excess capacity. Probably by late 2001 and 2002, higher production levels will require investment in new facilities across the economy. Economic performance then will depend on how successfully the government restructures corporate debt, so the banking system can resume lending.

LEGACY OF THE CRISIS REMAINS

The financial crisis affected Indonesia’s economy significantly more than other East Asian economies (International Monetary Fund, 2000a). Weak banking sector regulation and easy access to foreign credit at a fixed exchange rate led to a build up of foreign liabilities, making Indonesia vulnerable to deteriorating international investor sentiment. Implicit government guarantees of bank deposits, a fixed exchange rate, lack of bank supervision and poor incentives for sound corporate investment, all contributed to this exposure. When confidence in the economic structure of some Asian economies sharply deteriorated, the rupiah’s value plunged in early 1998 (Figure 1.7). This vulnerability transformed a sharp exchange rate depreciation into a major financial crisis by mid 1998 (Feridhanusetyawan and Anas, 2000). In November 2000, the rupiah still remained over 70 per cent below its June 1997 level of Rp. 2 450 : US$1 at approximately Rp. 9 200 : US$1, making foreign loan repayments impossible for many highly leveraged debtors.

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6 Consumer confidence dropped from April to August 2000, but recovered in September. Throughout this period, however, the number of optimists consistently outnumbered pessimists.

7 A renewed weakness in the rupiah may increase pressure for Bank Indonesia to increase interest rates, although in the past, this policy was largely ineffective; Bank Indonesia is more likely to actively purchase the rupiah in currency markets.
Figure 1.7

Exchange Rate More Stable but at a Much Depreciated Level


Rupiah Depreciation Still Hurts Borrowers

The falling rupiah caused the value of foreign debt in rupiah terms to escalate sharply, reducing the solvency of corporations holding large foreign exposures and their capacity to repay debts to the domestic banking system. Deterioration in the quality of loan portfolios and the banking system’s unhedged exposure to foreign borrowing severely damaged banks’ capital adequacy levels. Several bank closures contributed to depositors’ loss of confidence; a series of bank runs sparked widespread investor panic (Radelet and Sachs, 1998). While debtors accelerated rescheduling and repaying foreign debts in 2000, these were still worth US$58 billion at the end of June 2000 (World Bank, 2000).

Lower Output Hit the Corporate Sector

The sharp drop in output following the crisis also damaged corporate balance sheets and affected turnover and profitability. After growing at around 7 per cent per year in the two decades preceding the crisis, Indonesian output contracted 15 per cent over the year to the June quarter of 1998.

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Many depositors believed the government would protect deposits if a crisis occurred, reducing their discernment in choosing banks, and undermining some banks’ commitment to risk management. The rupiah’s relatively stable value against the US dollar over the 1990s led domestic borrowers to underestimate foreign exchange risk when borrowing overseas. These factors deterred bank self-regulation and adequate enforcement of prudential controls.
Expenditure shrank, with contraction most marked in private investment, as undercapitalised banks virtually ceased extending credit to corporates. Falling investment and diminishing confidence reduced consumption, further damaging investment and employment prospects. As in most severely affected crisis economies, the lower exchange rate did not immediately benefit exports. However, activities based on natural resources largely withstood the crisis.

**Investment Remains Weak**

Investment started to recover in late 1999 and early 2000, but fell again in the September quarter of 2000 (Figure 1.8). Spending on investment, adjusted for price movements, remains over 40 per cent below pre-crisis peaks. The drop in investment spending in September underscores the importance of improving the condition of the banking sector and repairing corporate balance sheets.

**Figure 1.8**

**Investment Faltering at Low Levels**

**Index of Real Gross Investment, March 1993=100**

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9 Exports continued to decline well into 1998, due to an international rejection of Indonesian letters of credit; a lack of working capital and capacity to buy imports reduced some exporters’ capacity to meet delivery deadlines and fill orders (Pardede, 1999). By 1999, as trade finance became more available, export-oriented sectors could capitalise on the low exchange rate and grew strongly.

10 In particular, minerals and energy relied less on bank financing and external creditors, and their costs benefited from the lower exchange rate. In 1997 and early 1998, agriculture suffered from El Nino induced drought, but later recovered.
Having achieved macroeconomic stability by adopting appropriate monetary and fiscal policies, the Government realises sustaining this growth will require new investment in productive assets, and now is focusing on repairing the banking and corporate sectors, as its new ten point plan indicates (Coordinating Ministry for Economic Affairs, 2000). The Government purchased many non-performing loans from the banking system in return for bank equity; this effectively nationalised most of the banking sector. The Government has begun selling these banks to the private sector. The corporate sector remains heavily indebted to banks and foreigners, but government efforts to restructure these loans now are moving ahead.

The following sections briefly discuss progress on the main restructuring and reform priorities, as this directly affects Indonesia’s macroeconomic prospects. (Details of bank and corporate restructuring are discussed in Chapter 7 - Financial Sector Restructuring and Chapter 8 - Corporate Restructuring.)

Banking System Repair
The Indonesian Bank Restructuring Agency, IBRA, established in January 1998 to oversee banking sector rehabilitation, soon will have reviewed, closed, merged, recapitalised or taken over all private and state banks. The Government has announced that by 2004, it will have completed banking sector restructuring and returned nationalised banks to private owners, including foreign investors.\(^{11}\) However, this timetable suffered some delays in 2000; the Government has indicated IBRA is waiting for market conditions to improve.

Restructuring the Corporate Sector
Current estimates suggest around 70 per cent of Indonesia’s corporate sector is insolvent. However, the Government has prioritised rescheduling outstanding debt, so the corporate sector can undertake new investment. As creditor to some Rp. 235 trillion (US$37 billion) of corporate debt, IBRA plays a central role in this process. After delays in 1998 and 1999, the Government is addressing the obstacles to more rapid debt restructuring, including the weak legal system, and corporate restructuring is starting to accelerate.

Medium Term Forecasts
Indonesia’s growth prospects depend largely on the pace of corporate and financial restructuring. As the timing of restructuring is uncertain, considering alternative growth scenarios is useful (Figure 1.9). The baseline scenario reflects the situation if no crisis had occurred, and assumes GDP growth of 7 per cent per year from 1996 to 2010, roughly equal to Indonesia’s potential long term growth rate. This provides a benchmark against which to estimate output lost due to the crisis. Under the baseline scenario, 2006 GDP is about double 1996 GDP and 2010 GDP is roughly two and a half times higher than 1996 GDP.

\(^{11}\) These sales could provide opportunities for Australian business seeking to enter the Indonesian financial sector.
Provided the Government can resolve rapidly banking and corporate sector problems, rapidly sell IBRA and state enterprise assets, and maintain social stability in 2000 and 2001, the recovery in output evident in the first three quarters of 2000 should improve and be sustained. Analysts expect this ‘V’ shaped recovery would create growth of 5 per cent in 2000 and 2001, 5 to 6 per cent in 2002 to 2003, then 7 per cent per year in 2004 and beyond. Under this fast recovery scenario, GDP would return to pre-crisis levels in 2002 and output would be only 25 per cent lower in 2010 than under the baseline scenario (Figure 1.9). A ‘V’ shaped recovery generally describes the experience of the Republic of Korea and Malaysia, which quickly removed non-performing loans from bank balance sheets, refinanced banks and moved to restructure corporate debts (Centre for Strategic and International Studies, 2000).

If prolonged delays occur in corporate debt and bank restructuring and IBRA asset sales, growth is likely to be slower. Under such a slow recovery scenario, output may grow by only 2 to 3 per cent per year until 2003, then by 4 to 5 per cent until 2008, before regaining its potential rate of 6 to 7 per cent in 2009 and 2010. In 2010, real GDP would be about 45 per cent below that in the baseline scenario. The worst case scenario, a ‘W’ shaped recovery, implies serious problems implementing the reform program and a relapse into recession. Pre-crisis GDP would be surpassed only in 2007 (Figure 1.9).
SOCIAL IMPACT OF THE CRISIS

Despite the generally negative impact of the crisis on employment and consumption, some parts of the community adapted to the crisis (known as krismon) better than others. Living standards fell sharply between 1996 and 1998, with the number of people living below the poverty line increasing by around 65 per cent, from around 11 to 18 per cent of the total population, depending on the survey. However, this was still well below the poverty rate of 40 per cent recorded in the 1970s.

The flexible labour market provided a buffer to shrinking output, employment and profits, with the agricultural sector absorbing a large share of workers dismissed from the urban economy. Rural employment growth increased from 0.6 per cent before the crisis to 2.3 per cent after it. Growth in urban employment, which had averaged around 5 per cent between 1990 and 1996, slowed dramatically (Feridhanusetyawan, 1999; and Sakernas, various issues). Many urban workers also moved into the informal sector, where employment grew by around 7 per cent during 1997-98, to 65.4 per cent of total employment (Feridhanusetyawan, 1999).

REQUIREMENTS FOR LONG TERM GROWTH

To achieve rapid, longer term growth, Indonesia will require new investment in public infrastructure, education and institutional capital; required investment in public infrastructure alone is estimated to be around US$100 billion over the next ten years (Younger, 2000). Indonesia also faces human capital constraints with international comparisons showing investments in public primary and secondary education are low. Government’s new obligations to service the greatly expanded public debt are likely to constrain its investment in these areas. The IMF estimates the ratio of public debt to GDP is 93 per cent in 2000 (International Monetary Fund, 2000a, 2000b and 2000c).

REFORM INDICATORS FOR BUSINESS

Business needs to remain informed of government reforms in key areas, including corporate debt and bank restructuring, asset sales, corporate governance and legal reform. These could guide when it is best to invest in Indonesia.

Corporate Restructuring, Asset Sales and Bankruptcy Functioning

A key indicator is the success of debt restructuring, as this is critical to restoring the economy’s long term prospects. Business should interpret government success in prosecuting major debtors who refuse to participate in the debt restructuring process as a sign that the investment environment will improve. Investors also should interpret positively announcements of sales of major IBRA assets and a continuation of recent, more rapid progress in debt workouts, particularly if they generate viable long term restructuring.
Successful Bank Restructuring and Corporate Governance

IBRA has nearly recapitalised the banking sector, and is readying banks for sale to the private sector. Timing of these sales and willingness to offer banks to capable private investors, including well qualified foreign banks, indicate important reform progress.

The Government has passed many new laws to improve corporates’ reporting and accounting standards, directors’ obligations and minority shareholders’ rights. Success in enforcing new requirements, including by prosecuting non-compliers, will indicate a likely improvement in corporate governance standards and an enhanced investment environment.

**IMPLICATIONS**

The Indonesian economy is experiencing a short term macroeconomic recovery from the crisis, but the Government clearly understands more work needs to be done to sustain it (Coordinating Ministry for Economic Affairs, 2000). Sustaining growth depends on successfully restructuring corporate balance sheets and the banking sector. Limiting risks to investors and achieving sustainable economic growth also requires an efficiently functioning legal system, political stability and maintenance of basic security.

Indonesia is trying to establish these foundations for sustainable growth. This is occurring in an environment of rapid political change, adding to this challenge, and at times reducing the pace of necessary economic and institutional reform. Hence, plausible scenarios indicate medium term economic growth could be slower than in other crisis affected economies.
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Younger, S., 2000, Information supplied to the East Asia Analytical Unit by Mr Scott Younger, Director of Business Development, Thames Water International, February, Jakarta.
• The Government recognises economic recovery and political survival are inextricably linked, so delivering economic recovery is a priority; the August cabinet reshuffle emphasises this.

• The new Indonesian polity has more stakeholders, promises more transparent and active policy making, and is devolving more power and responsibility to regions.

• Increased political participation also increases the importance of convincing the electorate and stakeholders that foreign investment and free trade promote growth and equity objectives. Many interests presently do not recognise these links.

• In the long term, devolution of power to the regions could generate benefits if regional governments become more responsive to investor and local population needs.

• However, in the short to medium term, the investment climate in the regions could deteriorate as the Government decentralises revenue, expenditure and many aspects of decision making. Investors need to monitor the effects of this transition closely, and be aware that regional level agencies may need time to develop their capacity.
The commercial viability of Indonesia for foreign business rests largely on the Government’s success in implementing its economic reform program. This chapter reviews recent political events and the historical interplay between Indonesia’s political system and economic outcomes. It assesses how recent political reforms affect the economic reform program, particularly the sale of foreign assets and corporate restructuring, and provides indicators to measure the Government’s progress in achieving political outcomes that will support economic reform.

A NEW CABINET

In August 2000, the Wahid administration appointed a new cabinet. It is smaller and more cohesive, potentially reducing the power struggles that characterised the previous cabinet. The President also agreed to increase the powers of Vice President Megawati Sukarnoputri to supervise and coordinate the day-to-day management of the economic reform program. The Coordinating Minister for Economics, Dr Rizal Ramli, has said he will increase efforts to resolve key economic problems, stressing the priority of IBRA asset sales. (See Chapter 1 - Economic Developments.)

Delivering economic recovery is a key priority for the Wahid Government, reflecting the close historical relationship between economic outcomes and political survival.

ECONOMIC AND POLITICAL STABILITY LINKS

The Wahid administration, the first democratic government for two generations, is attempting to build its economic credentials with an increasingly empowered electorate. However, the transition to a new political system and its associated political instability complicates the implementation of the economic reform program in the short term, while holding out the promise of more effective and open governance over the longer term.

Sukarno’s Guided Democracy (1957-1966)

Responding to the political volatility of the early 1950s, Sukarno’s regime was highly centralised and executive dominated; it restricted political rights in the name of national stability and unity. However, increasingly strident anti-western rhetoric and the forced nationalisation of Dutch enterprises slowed foreign investment and depressed the economy. Poor economic outcomes aggravated tensions between the Communist Party, the army and Islamic groups, culminating in the abortive coup of September 1965. Soon after, Soeharto led the military dominated New Order regime.


For over 30 years, Soeharto’s New Order regime sustained high rates of economic growth by encouraging foreign investment, adhering to IMF structural adjustment policies and appointing western trained technocrats to key positions in the government and state enterprises. Although Soeharto restricted political freedoms, manipulated the electoral process and parliament, and suppressed the press, the delivery of ever increasing living standards quelled agitation for political reform.
The longevity of the regime provided investor certainty, encouraging investment and economic growth. However, the highly centralised political system with increasingly patronage driven economic policies produced a weakly governed economy that was vulnerable to the 1997-98 regional financial crisis.

**The Demise of Soeharto**

The financial crisis, *Krismon*, dashed Soeharto’s legitimacy, culminating in the fall of the New Order. Unable to respond effectively to the crisis, an ailing Soeharto resigned as civil unrest increased, and support from within the military and cabinet crumbled. Vice President Habibie took over in May 1998. Implementing the IMF program, Habibie quickly stabilised the macroeconomy, restored the value of the rupiah and reduced inflation. He lifted restrictions on the press, freed political prisoners and introduced regional autonomy laws.¹ The first free and fair general elections in 44 years were held in June 1999.

**The Rise of Wahid**

Despite his economic achievements, Habibie never enjoyed widespread support within the political elite or general community. Facing almost certain defeat at the presidential election of October 1999, Habibie withdrew his nomination, leaving Abdurrahman Wahid and Megawati Sukarnoputri as the main contenders.

Wahid became President, with support from Islamic parties, Golkar and the military. The newly formed national government comprised Megawati’s PDI-P with 34 per cent of the vote, Golkar with 22 per cent, Abdurrahman Wahid’s PKB with 13 per cent, PPP with 11 per cent and Amien Rais’s PAN with 7 per cent. Wahid drew his first 34 member cabinet largely from PKB, PDI-P, PAN, Golkar and the Armed Forces, TNI.²

Since the election, support for the Wahid Government has fallen, in part because the Government has not implemented effectively the economic reform program. This partly reflects the ambitious nature of the economic program, but the transition to a new political system exacerbates policy implementation, making it more complicated than in the past.

**A CHANGING POLITICAL LANDSCAPE**

Political power within Indonesia gradually is ebbing away from the largely Jakarta based civilian and military elite Soeharto’s New Order favoured, towards a more fragmented array of players, including newly elected representatives, their respective parties, and bureaucrats. This increases the number of stakeholders in the economic reform program and in the long term, promises more transparent and active policy making, but also introduces new obstacles to achieving economic reform and recovery.

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¹ Habibie abolished permits for publishing and substantially reduced the intimidation of journalists.
² PKB is the National Awakening Party; PDI-P is the Indonesian Democratic Party of Struggle; PAN is the National Mandate Party; and PPP is the United Development Party.
The August 2000 Cabinet rectifies some of the problems of coordinating Wahid’s initial governing coalition (Appendix Table 2.1). Significant doubts persist, however, about the enthusiasm and ability of the bureaucracy to implement the economic reform program. Devolving economic responsibility to the regions will further complicate this.

**Rise of Political Parties**

New political parties and more stakeholders in the economic reform program increase pressure on the administration to deliver on policies outlined in IMF Letters of Intent. By demanding a more accountable government and using parliament’s authority to amend or reject government bills, the parties create a hybrid presidential parliamentary system. This contrasts with the ‘rubber stamping’ of government bills in the Sukarno and Soeharto eras. The ruling coalition is pressing to implement the economic agenda, as the August People’s Consultative Assembly, MPR, session demonstrated. There, they strongly criticised Wahid’s performance on economic matters.

### INDONESIA’S ELECTORAL AND POLITICAL SYSTEM

Indonesia has a five year election cycle, beginning with parliamentary elections and followed by a general session of the MPR. The MPR is Indonesia’s supreme decision making institution. It elects the president and vice president, and sets the Broad Guidelines of State Policy, GBHN, which provide the blueprint for executive government. It also can amend the constitution and impeach a president who has violated the constitution or the GBHN. Following a constitutional amendment in 1999, the MPR now meets annually.

The People’s Representative Assembly, DPR, has 500 members; 462 are popularly elected and 38 are appointed representatives of the armed forces and the police. The DPR meets regularly throughout the year.

The electoral system used in the 1999 election was a complex mix of proportional and district representation. Each province formed an electoral region, but a party’s performance in districts (kabupaten/kota madya) within the province affected seat allocation. For example, a party winning 25 per cent of the vote in a province, theoretically was entitled to one quarter of the seats. It then gained seats in districts where it recorded its highest vote. In practice, the system has many anomalies and outcomes do not necessarily reflect the intention of the legislation.

Over the next few years, the political and electoral systems could change significantly. Support has grown for district based elections. Most major parties supported a constitutional amendment at the August 2000 MPR session allowing for direct presidential elections. However, this and other major constitutional issues were deferred for further consultation and negotiation because of a lack of consensus among the parties. PDI-P in particular remains opposed to the idea. The MPR would be weakened substantially under direct presidential elections, but probably would retain its powers of impeachment and constitutional amendment.
On assuming the presidency, President Wahid acted quickly to curtail the influence of the military in political life, appointing reform minded officers to strategic positions and weakening the dominance of the army by appointing naval officers to senior posts. The dismantling of key elements of the military’s intelligence network also weakened its power base. The military’s role in provoking riots in 1998, human rights abuses and failure to contain regional social unrest further diminished its public standing.

However, the military is far from a spent force politically. Considerable representation in national and regional parliaments provides the military with substantial leverage, and civilian politicians and parties are wary of alienating it. A new constitutional amendment extending the military’s tenure in the legislature until 2009 was a victory for Soeharto loyalists and the military (Australian, 8 September 2000, p. 6).

The Bureaucracy

While the bureaucracy is required to implement the economic reform program, its resolve and ability to achieve this is in doubt. Many parts of the bureaucracy do not understand the need for reform and perceive that many proposed changes threaten established patterns of operating. Although the Government has tried to boost administrative capacity through harnessing international aid programs to improve internal processes, levels of training and technology, and raise bureaucratic governance through public audits, shortages of high quality human resources cannot be overcome rapidly. Also, despite recent pay increases for senior bureaucrats, corruption remains a serious problem.

Increasing Power to the Regions

In the longer term, more regional autonomy could make the political system more responsive to regional needs; however, in the short term, competition in formulating policy and problems in devolving government powers threaten economic reform implementation. Regional devolution could increase the complexity of the regulatory environment, affecting foreign investment and slowing corporate restructuring.

IMPACT OF POLITICAL CHANGE ON ECONOMIC RECOVERY

Political change and reform have assisted several aspects of economic reform. First, many new parties are less affiliated to powerful vested interests than was the case during the New Order. Secondly, newly strengthened independent auditors and greater central bank independence should make policy implementation and governance more efficient.

Nevertheless, the transition to a new political system creates short term risks for many key aspects of the Government’s programs. Elements of the bureaucracy and some political parties oppose foreign ownership, threatening the sale of corporate and state assets; such sales are vital to reducing the fiscal debt and restoring economic activity. Bureaucratic, union and regional resistance also hampers the reform and sale of state enterprises. Involvement of all key stakeholders therefore is necessary to ensure positive outcomes for intending investors.
Asset Sales

While some aspects of political reform assist in economic restructuring, the transition to a new political system also creates new obstacles to asset sales. For example, newly formed and independent bureaucracies such as IBRA and the Jakarta Initiative Task Force, are at least notionally free from political interference in their efforts to restructure loans and divest assets. However, some parts of the bureaucracy resist rapid sales of government held assets to foreigners. Even IBRA and the Ministry of Finance increasingly favour a gradual sale of assets, claiming this will maximise revenues for retiring the large stock of government debt. However, this approach is likely to delay these assets’ return to productive use within the market economy, and many assets are deteriorating while in limbo (World Bank, 2000). Further, the Government still has to convince many in the electorate of the need for and benefits of foreign investment (Fealy, 2000).

Reform of State Enterprises

Nationalist sentiment within the Wahid Government also affects the sale of state enterprises. Bureaucrats within the Ministry of State Owned Enterprises increasingly seek to financially rehabilitate these enterprises before their sale, delaying privatisation. Newly empowered regional governments also want local state enterprises to be transferred to regional public ownership, preventing their privatisation. Various interest groups, representing industry and labour, argue some enterprises are strategically significant and should be retained as national assets. Countering this resistance will require strong leadership, and key economic cabinet members will need to understand the importance of these reforms.

Reducing Corruption

Reducing corruption is critical to solving Indonesia’s economic problems; however, it will require strong political will. The move to a new political system is a good start. Further, the Wahid administration strengthened the role and independence of the Supreme Auditor’s Board, BPK, and a freer press now scrutinises politicians and officials, who are more aware that public exposure of corruption can jeopardise their careers.

At the same time, the rise of political parties and regional devolution create new forms of patronage. Many elements of the business sector, the bureaucracy, community groups and the military have realigned with one or more parties, allowing parties to expand their financial bases and widen their community support. At the regional level, patronage is particularly acute, resulting in little internal cohesion within parties and unexpected electoral outcomes.

Reducing Inequality

Policy makers face a key challenge of reducing income inequality by region and class (Figure 2.1). Greater democracy and the rise of new parties is likely to increase the pressure for more equitable outcomes in future. The two largest parties in the Wahid Government, PKB and PDI-P, favour directing resources to less privileged communities to reduce the prospect of attacks on Sino-Indonesian and foreign businesses, and lessen the risk of politically motivated unrest against the Government.
However, regional autonomy may increase the wealth gap between regions. Resource-rich provinces, which have outperformed other provinces since the crisis due to high export prices, appear likely to receive proportionally more revenue than at present. The soon-to-be-established Financial Equalisation Council is expected to have less money to allocate to poorer provinces than was the case before the reforms. New domestic and foreign investment is likely to favour provinces with natural resources and large, cheap and relatively skilled workforces, such as on Java and North Sumatra; wealthier regions also could be better placed to provide infrastructure to attract foreign investment than poorer regions.
The Government of Indonesia is decentralising many key responsibilities to the regions, redefining the role of government in Indonesian society. Increased regional autonomy will decentralise many government responsibilities, potentially improving economic efficiency and community participation. However, devolution also will affect the revenue available to the centre and could affect the foreign investment environment.

The Government of Indonesia has responded to the regions’ demands for greater control of decisions affecting them by decentralising revenue, expenditure and decision making over many areas of government to the provinces, starting in January 2001. Devolution could create significant economic and social benefits for Indonesia. Local government often can better respond to local needs and be more accountable to local people, supporting the development of democracy and improving development outcomes. Citizens also are more likely to identify with local government objectives, increasing their willingness to pay taxes. The Government is aware building the necessary bureaucratic capacity of many provinces will take time, particularly at the district and sub-provincial level. Foreign investors should remain sensitive to the transition to a more decentralised environment.

This section assesses the likely impact of the new decentralisation laws, including their potential long term economic and political benefits, and issues for foreign investors.

Devolution Laws

Two laws defining the devolution program come into effect on 1 January 2001. The regional government law No. 22/1999 increases regional political autonomy. Law No. 25/1999 on the fiscal balance between the centre and the regions increases the share of royalties of resource-rich provinces like Aceh, Irian Jaya, and East Kalimantan, and increases regions’ spending responsibilities for routine items. The recently established Regional Autonomy Advisory Council, and a coordinating team will implement the laws.  

Political Autonomy

These laws will change the relationship between the centre, the provinces (dearoh tingkat satu) and the districts (kabupaten) (Booth, 1999). Law No. 22/1999 provides for the election of regional parliaments at the provincial and district level. Representatives will be accountable only to their own parliaments, not to a central body.

Decentralisation may encourage more local participation in policy making and government responsiveness to people’s needs. Already some local elections have changed significantly the local political environment.

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3 Presidential Decree No. 49, No. 52/2000, 7 April 2000 established these bodies. The Regional Autonomy Advisory Council, a national consultative forum reporting to the President, became operational in July 2000.
**Economic Devolution**

These laws also delegate significant responsibility to districts and regions for public expenditure and revenue raising. The regions are expected to spend an estimated 8 to 9 per cent of GDP, and well over 40 per cent of general government spending, once devolution takes place (World Bank, 2000). Law No. 22/1999 makes districts or sub-provincial levels responsible for a large range of tasks, including public works, health, education and culture, agriculture, communications, industry and trade. The central government retains responsibility for international relations, defence, justice, monetary and fiscal policy, and religious matters.

Additional regulations in mid 2000 clarified the authority of the central and regional governments. Additional supporting regulations should govern the relocation of personnel and management, and define local government accountability, financial management practices and information systems, local tax bases and procedures for asset transfers.

The Government is conducting negotiations with provinces and districts on transfers of current projects, revenue shares, required reporting and auditing standards, and domestic borrowing rules (to ensure consistency with the macroeconomic framework). The coordinating team and the Regional Autonomy Advisory Council are cooperating with relevant ministries, provinces and districts to coordinate these negotiations.

Economic decentralisation provides funding to the regions comprising general and special allocations, supplemented by equalisation grants. Under general allocations, to be used for routine budget expenditures, at least 25 per cent of central government domestic revenues amounting to an estimated 4 per cent of GDP will go to lower levels of government; 90 per cent of this will go to districts and 10 per cent to provinces (World Bank, 2000). Special allocations from the central budget will be based on the development needs of the region. Regions also will receive 15 per cent of their net oil revenues, 30 per cent of their natural gas taxes and 80 per cent of their tax revenue from other mining, forestry and fishery activities conducted within their regional borders. Regional governments will be able to borrow, but a ceiling for total debt and debt services will apply for each region. Foreign loans will require approval by the Ministry of Finance (World Bank, 2000). Regional allocations under the draft 2001 budget suggest a gradual transition towards new revenue arrangements.

**ISSUES FOR INVESTORS**

In the long term, devolution may benefit foreign investors. As autonomous regions develop, competition between regional governments for foreign investment should grow. Regions offering the most favourable taxation rates, infrastructure and regulatory environment will be best placed to attract new investment. Local responsibility for public works could make infrastructure provision more responsive.

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4 For example, Decree No. 25/2000 on the Authority of the Central Government and of Provinces as Autonomous Regions, dated 6 May 2000.

5 Whether this revenue will accrue to the district or provincial level is unclear.
More governments may provide potential investors with more regulatory environment choice. Also, regional areas the central government neglected may achieve higher governance standards and public investment under regional administrations.

However, the transition to a new system of government will take time, and investors need to be aware of several issues that may affect their activities over the short term. Devolution may temporarily increase the time taken to process applications as new agencies at the regional level will take time to develop their capacity. Consequently, compliance costs may increase, especially where regulatory responsibility is unclear. While the Government also is ensuring new regional laws do not conflict with central laws, this could take time.

**TRACKING PROGRESS**

Although the interaction between politics and economics is complex, some key indicators should help business signpost the political system’s progress in implementing economic reform over 2001 and 2002. Flows of Sino-Indonesian capital, stock prices and exchange rate movements provide useful short term indicators of the Government’s success in managing the economy. A consortium comprising Singapore’s Cycle and Carriage recently acquired a 39.5 per cent share in Astra, IBRA’s largest sale so far, suggesting greater interest in Indonesian assets by regional investors. The composition of the Cabinet, especially the inclusion of relevant experts, also signposts the likely direction of policy. The appointment of Dr Rizal Ramli, a US educated economist as Coordinating Minister for Economics was, on balance, viewed positively.

The longer term capacity of the political system to implement economic reform depends partly on prospective constitutional reforms that may include direct presidential elections, and measures to strengthen the executive’s accountability. Achieving these goals also would represent positive developments.

**CONCLUSION**

A year after Indonesia’s historic 1999 democratic election, the political environment remains very fluid. Although it has delivered macroeconomic stability and the beginnings of a broader economic recovery, structural reforms represent a more complex challenge and will require strong political will. The transition to democracy eventually should help in developing a proactive civil society, including a robust press and vocal middle class, who will support the creation of stronger, more transparent institutions, and eventually underpin consensus support for more equitable and sustainable economic growth. However, in the short term, shifting alliances and the resulting power vacuum in many parts of the bureaucracy, may allow the state owned sector and provinces to undermine efforts to achieve economic reforms and recovery, and permit opportunistic behaviour by a minority.

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6 While data on Sino-Indonesian capital inflows are not available officially, evidence of overseas Chinese and Singaporean interest in asset sales forms a good proxy.
### Appendix Table 2.1

**Composition of the Abdurrahman Wahid Cabinet**

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abdurrahman Wahid</td>
<td>President</td>
</tr>
<tr>
<td>Megawati Sukarnoputri</td>
<td>Vice President</td>
</tr>
<tr>
<td>Lt Gen (Ret) Susilo Bambang Yudhoyono</td>
<td>Coordinating Minister for Political, Social and Security Affairs</td>
</tr>
<tr>
<td>Dr Alwi Shihab</td>
<td>Minister of Foreign Affairs</td>
</tr>
<tr>
<td>M. Mahfud</td>
<td>Minister of Defence</td>
</tr>
<tr>
<td>Dr Rizal Ramli</td>
<td>Coordinating Minister for Economics, Finance and Industry</td>
</tr>
<tr>
<td>Prijadi Praptosuhardjo</td>
<td>Minister of Finance</td>
</tr>
<tr>
<td>Dr Purnomo Yusgiantoro</td>
<td>Minister of Energy and Mineral Resources</td>
</tr>
<tr>
<td>Luhut Panjaitan</td>
<td>Minister of Industry and Trade</td>
</tr>
<tr>
<td>Dr Bungaran Saragih</td>
<td>Minister of Agriculture and Forestry</td>
</tr>
<tr>
<td>Sarwono Kusumaatmadja</td>
<td>Minister for Maritime Affairs and Fisheries</td>
</tr>
<tr>
<td>Agum Gumelar</td>
<td>Minister for Transportation and Telecommunications</td>
</tr>
<tr>
<td>Alhilal Hamdi</td>
<td>Minister of Manpower and Transmigration</td>
</tr>
<tr>
<td>Dr Achmad Sujudi</td>
<td>Minister of Health and Social Welfare</td>
</tr>
<tr>
<td>Dr Yahya Muhaimin</td>
<td>Minister of National Education</td>
</tr>
<tr>
<td>Tolchah Hasan</td>
<td>Minister of Religious Affairs</td>
</tr>
<tr>
<td>Erna Witoelar</td>
<td>Minister of Settlement and Regional Infrastructure</td>
</tr>
<tr>
<td>Lt Gen (Ret) S. Soedirdja</td>
<td>Minister for Home Affairs and Regional Autonomy</td>
</tr>
<tr>
<td>Gede Ardika</td>
<td>Minister for Culture and Tourism</td>
</tr>
<tr>
<td>Lt Gen (Ret) Luhut Binsar Pandjaitan</td>
<td>Minister for Trade and Industry</td>
</tr>
<tr>
<td>Dr Yusril Ihza Mahendra</td>
<td>Minister for Justice and Human Rights</td>
</tr>
<tr>
<td>Zarkasih Nur</td>
<td>State Minister for Cooperatives, Small and Medium Enterprises</td>
</tr>
</tbody>
</table>
### Appendix Table 2.1 (continued)

**Composition of the Abdurrahman Wahid Cabinet**

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Soni Keraff</td>
<td>State Minister for the Environment</td>
</tr>
<tr>
<td>Dr Ryaas Rashid</td>
<td>State Minister of Administrative Reform</td>
</tr>
<tr>
<td>Khofifah Indar Parawangsa</td>
<td>State Minister for the Empowerment of Women</td>
</tr>
<tr>
<td>Dr Muhammad A.S. Hikam</td>
<td>State Minister for Research and Technology</td>
</tr>
<tr>
<td>Cacuk Sudarijanto</td>
<td>Junior Minister for the Restructuring of the National Economy</td>
</tr>
<tr>
<td>Dr Nur Mahmudi Ismail</td>
<td>Junior Minister for Forestry</td>
</tr>
<tr>
<td>Manuel Kaisiepo</td>
<td>Junior Minister for the Development of Indonesia’s Eastern Regions</td>
</tr>
</tbody>
</table>

**Note:** Several officials not in the Cabinet hold positions of equivalent rank. These are Marzuki Darusman, Attorney General; Admiral Widodo, Commander of the Armed Forces; Marsilam Simanjuntak, Cabinet Secretary; and Djohan Effendi, State Secretary.
REFERENCES


FOREIGN INVESTMENT OPPORTUNITIES

KEY POINTS

• Indonesia’s foreign direct investment, FDI, has not yet recovered from post crisis falls. However, its foreign investment regime is more open than before the crisis, generating potential opportunities in an environment of ongoing reform.

• Already, investors can operate 100 per cent foreign owned enterprises in most sectors and no longer need to sell down equity at a later date. Only a few sectors restrict foreign investment; in most of these joint ventures are possible.

• The outlook for foreign investment in Indonesia also is assisted by the sale of state held assets and enterprises, more competitive export-oriented and import substitution sectors due to the weaker rupiah and a more open economy.

• Opportunities are diverse. Foreign investors can purchase assets from IBRA’s sizeable bank equity holdings, operate retail outlets, distribute goods produced locally and apply to import and distribute other products. They also can enter joint ventures to supply educational, medical and infrastructure services including telecommunications.

• The sale of corporate assets under IBRA’s control also should generate significant foreign investment opportunities. The Government also is selling many state enterprises.

• Major issues for investors include the difficulty of valuing distressed assets given weak accountancy standards, workforce management and sometimes political resistance to sales, and legal and sovereign risks.

• Buyers can manage risks by commissioning independent audits to corroborate IBRA’s risk appraisal, completing comprehensive due diligence assessments before acquiring assets, insuring against risk and monitoring closely the local social and institutional environment.
Unlike other crisis affected economies in East Asia, direct investment flows to Indonesia were still negative by the second quarter of 2000 (the latest for which data are available). However, recovery of the export and small and medium enterprise, SME, sector, government asset sales and relaxed foreign investment laws may assist a recovery in FDI inflows as the macroeconomic recovery gathers strength and the political situation develops. Potentially rewarding investments exist for those prepared to undertake due diligence assessments and remain sensitive to local shareholder concerns.

This chapter details FDI prospects in the short to medium term flowing from significantly relaxed sectoral access restrictions for foreign investors, sales of IBRA’s asset holdings and other state owned assets, and strong competitiveness of export-oriented and import substitution sectors due to the rupiah’s depreciation. It also examines key changes to foreign investment laws, then appraises the current benefits and risks of investing in Indonesia.

**FUTURE TRENDS IN FDI**

The crisis severely reduced Indonesia’s FDI inflows (Figure 3.1). However, analysts anticipate a recovery in FDI inflows by up to 20 per cent per year between 2001 and 2003 (Economist Intelligence Unit, 2000). Ongoing sales of corporate and financial assets should offer significant opportunities in the short term, and liberalised access for wholly foreign owned enterprises to most sectors should underpin FDI growth in the medium to long term. However, doubts over economic and social stability, and an underdeveloped legal system deter more rapid growth in new investment in Indonesia.¹

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¹ Fears of instability has deterred several high profile investors; for example, in 2000 Taiwan’s China Steel cited political uncertainty in explaining its decision to delay a planned US$1.4 billion joint investment with Pt Krakatau Steel.
**Sectoral Distribution of FDI**

Pre-crisis, FDI inflows were mainly to manufacturing, but the crisis affected these more adversely than inflows to services (Figure 3.2). Although approvals somewhat overstate eventual flows, they indicate sectors hit hardest by changing sentiment. Further, the time lag between the approvals stage and actual implementation can be up to three years.

**Figure 3.2**

*All Sectors down, but Particularly Manufacturing*

**Sectoral Distribution of FDI Approvals in Indonesia, 1995-99**

In 1999, industrial FDI approvals were concentrated in the chemicals, electricity, gas, water and paper sectors (Table 3.1). While traditionally these have attracted strong interest, several state enterprise and restructured assets sales featured in 1999 inflows.

*Note:* Data are for approvals only, and significantly exceed eventual investment flows.

**Table 3.1**

**Heavy Industry Dominates Industry FDI**

Industrial Foreign Investment Approvals by Sectors, 1999

<table>
<thead>
<tr>
<th>Sector</th>
<th>Projects</th>
<th>Total (US$ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chemicals</td>
<td>75</td>
<td>3,266</td>
</tr>
<tr>
<td>Electricity/gas/water</td>
<td>2</td>
<td>2,310</td>
</tr>
<tr>
<td>Paper</td>
<td>15</td>
<td>1,412</td>
</tr>
<tr>
<td>Food industry</td>
<td>48</td>
<td>681</td>
</tr>
<tr>
<td>Metal goods</td>
<td>85</td>
<td>593</td>
</tr>
<tr>
<td>Basic metals</td>
<td>9</td>
<td>501</td>
</tr>
<tr>
<td>Plantations</td>
<td>17</td>
<td>284</td>
</tr>
<tr>
<td>Trade</td>
<td>348</td>
<td>279</td>
</tr>
<tr>
<td>Textiles</td>
<td>121</td>
<td>240</td>
</tr>
<tr>
<td>Food crops</td>
<td>10</td>
<td>224</td>
</tr>
<tr>
<td>Other</td>
<td>357</td>
<td>1,101</td>
</tr>
<tr>
<td>Total</td>
<td>1,164</td>
<td>10,891</td>
</tr>
</tbody>
</table>

*Note: Data are for approvals only and do not include oil and gas, and financial and insurance sectors.*

*Source: Deacons, 2000.*

**FOREIGN INVESTMENT REGIME REFORMS**

To attract foreign capital to post crisis asset sales and boost foreign exchange reserves, the Government significantly liberalised foreign investment laws, extending the liberalisation started in the mid 1990s. A new draft foreign investment law released in October 2000 would allow wholly foreign owned enterprises to invest in most sectors of the economy. Although opposition to its passage may be mounting, the new draft law only requires investors to register, rather than seek approval for new investment. This law also proposes the removal of all regulations that discriminate against foreign firms, introducing full national treatment of foreign investors (Investment Review Board, BKPM, 2000).

**Liberalising Investment Access to Sectors**

Even without the new draft law, foreign companies can own all the issued capital of a newly established Indonesian company and need not divest a majority of shares at some future date. FDI is restricted in a few sectors because of national interest; in those sectors, investors need only sell a nominal percentage of equity after 15 years. These reforms augment successive changes since 1994 to Indonesia’s 1967 foreign investment law.
Reforms in 1998 allowed foreign companies to operate retail outlets in Indonesia, with some restrictions, and fully opened the distribution sector to foreign investment. Foreign manufacturers now can distribute goods produced locally and apply for permits to import and distribute other products.\(^2\) Foreigners can establish holding companies to facilitate debt restructuring in local businesses.

In August 2000, the foreign investment law’s negative list was amended to allow foreign investors to enter joint ventures with local partners for medical services and telecommunications.\(^3\) Maximum permissible foreign ownership is unspecified as yet, but expected to be 95 per cent. If passed, the Government’s new draft law would reduce further the number of sectors prohibiting foreign investment.

Since 1994, Indonesia has allowed foreign investment in infrastructure sectors including sea ports, electricity generation and distribution for public use, shipping, airlines, drinking water supply, public railways and nuclear power generation. These projects require a joint venture with the Indonesian partner holding at least 5 per cent of shares in the investment.

Indonesian law does not recognise freehold land rights. Instead, the Government holds all land under a system of land titling. Hence neither foreigners nor nationals can own land, but they take out long term leases which grant the right to use or improve the land. Investors take over an existing lease when investing in commercial property.

**Streamlining the Application Process**

In early 2000, the Government streamlined licensing procedures for foreign investment; this reform promises to reduce the number and duration of application procedures. Approved applications remain valid for up to three years without being implemented, instead of only one year under the previous law.

Despite recent reforms to foreign investment regulation and laws, implementation is lagging. The Investment Review Board, BKPM, still applies conditions before approving foreign investment applications. BKPM often requires foreign buyers to reserve a percentage of shares for local or original owners. If the local firm is distressed, BKPM may ask foreign buyers to inject capital in addition to assuming outstanding loans. In certain sectors, foreign investors also must cooperate with small and medium sized firms through partnerships.

**OPPORTUNITIES IN THE EXPORT SECTOR**

Indonesia’s competitively valued exchange rate and large supply of relatively low cost labour is generating good investment prospects in export-oriented industries. Large industrial estates across Indonesia, but particularly concentrated on Java, are enjoying rapid export growth and already play host to a wide range of foreign operators. These investors report they are unaffected by banking sector problems because they can access offshore funds, and their output and profits have risen significantly since 1998. Locating close to population centres ensures a good supply of workers. The approval process for investing in these estates also is very efficient (World Bank, 2000).

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\(^2\) Companies involved in distribution cannot retail directly, but can form separate foreign investment retail companies to do this.

\(^3\) The negative list defines sectors closed or partially closed to foreign investment; prior to August 2000 it was last revised in July 1998.
SALE OF IBRA'S ASSETS

Before 2004, the Indonesian Bank Restructuring Agency, IBRA, responsible for most government asset sales, plans to sell up to 80 per cent of the Rp. 564 trillion (US$65 billion) of assets it holds; this equals around 57 per cent of Indonesia’s GDP (World Bank, 2000). As domestic savings are insufficient to purchase these assets, foreign investment will be crucial for the success of this program.

IBRA's assets fall into three categories:
- government equity in recapitalised and taken over banks, Rp. 139 trillion (US$16 billion)
- non-performing and performing loans, and associated collateral transferred from recapitalised, state owned, frozen and taken over banks, Rp. 298 trillion (US$34 billion)
- corporate assets transferred by banks to IBRA in return for Bank Indonesia liquidity credits, Rp. 127 trillion (US$14.6 billion).

SALE OF BANK EQUITY

Despite delays in 2000 with some planned bank sales, the ongoing sale of IBRA’s sizeable bank equity holdings may present good opportunities for foreign banks and other investors wishing to expand into Indonesia. New regulations allow foreign investors to acquire up to 99 per cent of bank equity. IBRA has removed the non-performing loans of transferred banks and is close to fully recapitalising them; it hopes to sell them via public offerings of shares and private placements with strategic investors. Australian banks are efficient, large by international standards and have high standards of prudential and risk management; they should be well placed to access these opportunities.

In October 2000, the Government announced the planned sales of Bank Central Asia and Bank Niaga would be delayed until 2001. IBRA previously had announced it would complete all

ASSET OPPORTUNITIES FOR AUSTRALIAN BANKS

While the Asian financial crisis severely weakened most Indonesian banks, Australian financial institutions and investors still can acquire sound Indonesian banks. In late 1999 and early 2000, ANZ increased its share in Bank Panin from 4.9 to 11 per cent, and holds an option to increase its share further to 28 per cent. ANZ also has a technical service agreement to support Panin in human resources, information technology, trade and risk management (Asia Pulse, 15 April 2000). In addition, in May 1999, ANZ acquired the credit card operation of Bank Papan Sejahtera from IBRA for US$4 million.

nationalised bank sales by 2001, including selling majority equity in Bank Danamon. IBRA also intends to sell some of its interests in the seven recapitalised private banks now their performance has improved.  

(See Chapter 7 - Financial Sector Restructuring.)

SALE OF NON-PERFORMING LOANS

Opportunities also exist to buy non-performing and performing loans from IBRA’s loan portfolio. In mid 2000, IBRA outsourced management of commercial loans worth between Rp. 5 billion and Rp. 50 billion (US$0.58 million to US$5.8 million) totalling Rp. 24.7 trillion (US$2.8 billion) to domestic and foreign banks, including ANZ-Panin Bank (Economist, 8-14 July 2000). In December 2000, it will sell all retail loans under Rp. 5 billion in an open tender (International Monetary Fund, 2000) and eventually will sell all loans under Rp. 50 billion by October 2001 (World Bank, 2000).

SALE OF CORPORATE ASSETS

IBRA’s sale of corporate assets under its control also could generate significant foreign investment opportunities. IBRA owns these assets because former bank owners transferred corporate assets to IBRA to repay liquidity support from Bank Indonesia and debt workouts often involve debt equity swaps.

Recent direct sales of IBRA corporate assets include auctions of hotels, office buildings and industrial estates throughout Jakarta, Bali Bintam and Batam, worth around US$12.6 billion. Smaller investors may want to acquire individual assets rather than large bundles of assets. So far, few Australian investors have participated in these assets sales, with most interest coming from Singaporean, European and US investors (Hong, 2000).

To expedite sales, IBRA’s Asset Management Investment Unit has established five holding companies to manage more than 200 companies under its control with assets of Rp. 109 trillion (US$12.6 billion) (Figure 3.1 and Appendix Table 3.1). For example, the largest holding company, PT Holdiko Perkasa, owns and supervises all assets transferred from the Salim Group, including shares, exchangeable bonds, convertible bonds and inter-company debts from 107 subsidiary companies valued at Rp. 52.6 trillion (US$6.1 billion). 

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6 These are BII, Bank Lippo, Universal, Patriot, Artemedia, Prima Ekspress and Bukopin Banks.
7 These loans remain on IBRA’s accounts but their management is outsourced. To outsource tranches of smaller loans, IBRA calls for expressions of interest from financial institutions and selects a servicing agent. It selects banks according to their technical capacity, reputation and expertise.
8 IBRA plans to restructure or liquidate the debts of the largest debtors, particularly the largest 21 debtors.
9 Other large workouts have resulted in original shareholders retaining ownership of their corporate assets, as was the case with three large restructuring deals the Government announced in early October 2000. These involved the debts of Texmaco Group, PT Chandra Asri and Tunggal Group.
10 Shops, warehouses and residences in Jakarta and Bekasi, West Java, valued at around Rp. 15 billion (US$1.7 billion) were auctioned in May 2000.
11 These companies are in agribusiness, the largest share, followed by property portfolios, including hotels, industrial estates, office properties and shopping centres located throughout Jakarta, Bali, Bintan, Batam and the rest of Indonesia.
12 Detailed information on PT Holdiko Perkasa and the assets it is managing is set out in a preliminary information memorandum dated December 1999. PT Cakrawala Gita Pratama holds mainly property sector assets in nine companies transferred by the Modern Group. PT Kiani Wirudha holds mainly financial and timber processing sector assets of 30 companies transferred by the Hasan Group. PT Bentala Kartika Abadi owns mainly finance and property assets transferred from the Danamon Group. PT Tunas Sepadam Investama owns the mainly agribusiness and chemical sector shares and assets transferred by the Gadjah Tunggal Group. (See details of these holding companies and their assets on the East Asia Analytical Unit web site, www.dfat.gov.au/eaau/indonesia.)
Independent accounting firms under IBRA’s direction have valued all corporate assets IBRA controls and determined appropriate sale prices. However, IBRA has indicated it will not offer ‘fire sale’ prices and will wait until the market improves before offering many assets for sale; the August 2000 sale of a package of Bank Central Asia shares demonstrates this approach.\(^\text{13}\)

IBRA’s disposal of corporate assets started in 1999 and will continue until 2004 and include:

- initial public offers, selling shares to the public through the Jakarta or Surabaya Stock Exchanges
- share placements, selling shares to identified purchasers
- asset sales, selling specific assets to third parties
- settlement with joint venture partners, selling shares in companies under IBRA’s control to joint venture partners, such as shares in PMA company to joint venture partner, Dow Chemical Company
- strategic sales, involving the sale of shares to identified strategic buyers, where purchasers need particular expertise in the relevant business (Indonesian Bank Restructuring Agency, 2000b).

Asset sales to strategic investors are more likely to maximise revenue than other approaches, so increasingly IBRA may favour this strategy. IBRA recommends investors interested in specific sectors

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\(^{13}\) IBRA stated it would set a fair price for the public offering (\textit{Jakarta Post}, 29 April 2000). The sale price of Rp.1 400 per share was at the lower end of the indicated range of Rp. 1,350 to Rp. 1,750 per share.
register their interest with it, so it can inform them of relevant upcoming asset sales. IBRA does not recommend prices for assets on sale, encouraging prospective investors to undertake detailed accounting and legal due diligence of assets.

**ISSUES FOR INVESTORS**

Although purchasing IBRA’s assets can be risky, especially for investors unfamiliar with Indonesia, buyers can apply strategies to minimise risk. Major risks include the distressed nature of many assets, and lack of financial information, especially potential undisclosed liabilities. Independent auditing in collaboration with IBRA’s own appraisal can help manage risks. While IBRA encourages investors to complete comprehensive due diligence assessments before acquiring assets, in some cases, incomplete record keeping makes this a time-consuming process, particularly if former owners are uncooperative. Other risks relate to the broad uncertainty surrounding the future of the Indonesian social and institutional environment, and the volatility of the rupiah.

**Political Stability**

The Wahid administration, the first democratic government for two generations, is attempting to build its economic credentials with an increasingly empowered electorate. However, the transition to a new political system and its associated political instability complicates the implementation of the economic reform program in the short term, posing risks to the investment environment. (See Chapter 2 - Political Developments).

**Valuing Distressed Assets**

Complex financial relationships, including inter-firm obligations, often feature in corporate assets originally part of an industrial conglomerate. Detailed financial information on assets generally is not publicly available. Once the asset is sold, investors can face third party claims. Normally, obtaining the information on claims on assets is difficult, given the level of enforcement of financial disclosure before the crisis; however, IBRA independently assessed assets under its control and fully discloses claims on assets to interested investors. IBRA also ensures investors receive full title when purchasing an asset; this reduces the risks of third party claimants.

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14 IBRA holding companies have sent to investors more than 200 requests for bids, with approximately 50 per cent expressing interest. Around 20 per cent have submitted preliminary bids, with around 80 per cent of these from investors in Singapore, Malaysia, Japan, Germany, UK and the United States (Indonesian Bank Restructuring Agency, 2000a).

15 The relevant holding company appoints a financial advisor for each asset disposal, who prepares a detailed information memorandum on the asset and distributes this to all interested parties. However, all parties must sign a confidentiality agreement before conducting due diligence of the asset. As of October 2000, IBRA had valued assets of PT Holdiko Perkasa, but its information memorandums are not yet publicly available.

16 In the case of equity, investors can conduct due diligence to confirm the legitimacy of the title. IBRA also provides indemnity in some cases, as reflected in the asset price. IBRA signed Asset Transfer Agreements with all debtors when assets were transferred, so it has sole ownership. However, this process ultimately relies on the willingness of courts to enforce these titles. In some instances, such as Bank Bali, the court failed to do so.
Potential investors should seek access to shareholder agreements drafted between IBRA and the original owners; these define the assets transferred to IBRA and strategies for meeting debts owed to banks IBRA took over or closed down. ¹⁷ A new compliance team for each holding company monitors individual companies and identifies specific problems. IBRA also intends to adopt a corrective action program, including changing company management. Potential investors must ask company directors about undisclosed tax liabilities, as these need to be factored into the asset’s purchase price.

Worker and Management Resistance

Remaining sensitive to the interests of stakeholders, including the workforce, is critical to a smooth transition of asset ownership. Existing management retains considerable influence in many companies. Unions, long suppressed under the New Order regime, now operate more freely and are becoming very active. Consequently, a successful investment would include existing management, labour representatives and possibly the local community in the acquisition process. It would advise them of the long term management strategy, stressing the likely benefits of the takeover, including financial rehabilitation of the company, employment maintenance and creation, management and marketing expertise, and technology transfer.

Legal Risks

Because courts have questioned IBRA's ownership of assets, investors must confirm the transfer of assets to IBRA was legitimate. To overcome past problems in this area, the Government is working to improve the legal system. Amendments to Indonesia’s bankruptcy law and a new commercial court system aim to improve outcomes, especially the prosecution of debtors. The Government also has responded by establishing an official watchdog, the Ombudsman Committee, to oversee IBRA transactions. ¹⁸

Importantly, foreign investors may be restricted to acquiring a minority of a company’s shares, depending on the terms of the shareholder agreement reached between IBRA and bank shareholders. Potential investors should investigate this issue before registering their interest. Where such restrictions do not apply, smaller investors are advised to form consortiums with other interested investors to secure a controlling interest, as occurred in the sale of Astra.

Foreign investors buying shares must ensure shares are not the subject of third party claims, and the relevant company was incorporated properly and approved by the Ministry of Law and Legislation. ¹⁹

¹⁷ In all cases, original shareholders committed not to reduce the value of the holding company assets. However, IBRA is not yet legally obliged to supply these agreements to prospective investors. Further, where shareholders provide IBRA with a fiduciary transfer (a form of Indonesian security over tangible and non-tangible assets), they cannot sell or transfer the assets to third parties without IBRA’s consent. IBRA confirmed in the July 2000 Letter of Intent, it would exercise greater control over the pledged assets and take steps to preserve the value of companies in the holding companies.

¹⁸ The Ombudsman Committee monitors the conduct of IBRA’s employees and is chaired by individuals of high standing. The Ombudsman Committee collects and processes public and internal complaints.

¹⁹ The difficulties faced by Canadian insurer Manulife in buying the shares of its bankrupt joint venture partner illustrate some of the obstacles to purchasing corporate assets.
Indonesia does not have a complete central Register of Companies, so the onus is on purchasers to confirm these conditions are met. Investors taking over a going concern also must ensure all operating licences are valid, particularly if investors plan to expand or diversify the business.

**CASE STUDIES OF ASSET SALES**

**Astra**

Building on lessons learned from the failed sale of Bank Bali, IBRA’s sale of 39.5 per cent of Astra to a foreign consortium was highly transparent, sought to include key stakeholders, and generally was welcomed by the market. IBRA adopted a strategic bidding process involving several rounds and including the winning consortium, led by Singapore’s vehicle distributor Cycle and Carriage Ltd, US Newbridge Capital and Gilbert Global Equity consortium. By March 2000, PT Astra International was IBRA’s biggest sale.

**Bank Central Asia**

In May 2000, IBRA divested 22 per cent of Bank Central Asia, one of Indonesia’s largest private banks, previously owned by the Salim family. The sale was highly transparent, via an initial public offering that was fully subscribed. Foreign investors including from Hong Kong, Europe and Singapore, purchased 25 per cent of the 662.4 million shares offered, exceeding the 20 per cent sales target for foreign investors (Asia Daily News, 26 May 2000). IBRA rejected strategic offers by investors, publicly stating that to maximise transparency, it would only offer shares through the initial public offering. While the offer was successful, it achieved only 13 per cent of the book value of the shares (World Bank, 2000).

**TIMETABLE FOR IBRA ASSET SALES**

The Indonesian Government has directed IBRA to complete its assets sales by 2004. IBRA plans to sell assets worth Rp.18.9 trillion (US$2.2 billion) in the nine month financial year to the end of December 2000; Rp. 16.3 trillion should come from corporate and banking asset sales. It had realised Rp. 12 billion by the end of September (World Bank, 2000). While IBRA delayed asset sales in 1999 and into 2000, including shares in Bank Central Asia and Bank Niaga, in the belief that flooding the market would lower prices, it plans to reach its target by substituting other assets for sale (Table 3.2).

IBRA now is trying to attract foreign investors using road shows. Sale timetables are on IBRA’s website, www.bppn.go.id. IBRA is targeting a range of assets sales over 2000-01 (Appendix Table 3.1).

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20 The consortium also included Batavia Investment Management Ltd; Lazard Asia Fund, a unit of the French group Lazard Freres; PT Bhakti Investama; and the Government of Singapore Investment Corporation, GSIC.

21 Bank Central Asia booked a net profit of Rp. 641.29 billion (US$85 million) in 1999 compared to a loss of US$5 billion in 1998.

22 Road shows to Singapore, Hong Kong, the United States and Europe took place in mid 2000. One to Australia is planned for early December 2000.
Table 3.2

**Upcoming Asset Sales**

**IBRA’S Planned Sale Details and Methods**

<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>Method of Sale</th>
<th>Advisor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indomarket</td>
<td>Mini market chain</td>
<td>Initial public offering</td>
<td>Danareksa, Nikko Securities</td>
</tr>
<tr>
<td>Indomilk/Indolakto</td>
<td>Milk processing</td>
<td>Strategic sale</td>
<td>Chase Jardine</td>
</tr>
<tr>
<td>Indomiwon</td>
<td>Food seasoning</td>
<td>Strategic sale</td>
<td>KPMG</td>
</tr>
<tr>
<td>Indosiar</td>
<td>Television station</td>
<td>Loan refinancing, initial public offering</td>
<td>PWC, Trimegah Securities</td>
</tr>
<tr>
<td>Mosquito Coil Group</td>
<td>Mosquito repellant coils</td>
<td>Strategic sale</td>
<td>Chase Jardine</td>
</tr>
<tr>
<td>Salim Oleochemicals</td>
<td>Chemicals</td>
<td>Strategic sale</td>
<td>Chase Jardine</td>
</tr>
<tr>
<td>Salim Palm Plantation</td>
<td>CPO palm oil plantations</td>
<td>Strategic sale</td>
<td>Goldman Sachs</td>
</tr>
<tr>
<td>Salim Coal</td>
<td>Mining</td>
<td>Strategic sale</td>
<td>BNP Peregrine</td>
</tr>
<tr>
<td>Sulfindo</td>
<td>Chemicals</td>
<td>Strategic sale</td>
<td>Chase Jardine, Bhakti Investama</td>
</tr>
<tr>
<td>Pangansari Utama</td>
<td>Industrial catering</td>
<td>Strategic sale</td>
<td>Deloittes</td>
</tr>
<tr>
<td>Puri Imperium Apartment</td>
<td>Property</td>
<td>Auction</td>
<td>na</td>
</tr>
<tr>
<td>Bentala</td>
<td>Property</td>
<td>Auction</td>
<td>na</td>
</tr>
<tr>
<td>Diners Jaya Indonesia</td>
<td>Credit card</td>
<td>Strategic sale</td>
<td>na</td>
</tr>
<tr>
<td>Ficor Sekuritas</td>
<td>Securities</td>
<td>Strategic sale</td>
<td>AAJ Associates</td>
</tr>
<tr>
<td>Bank Hanvit Indonesia</td>
<td>Bank</td>
<td>Sale of minority interest</td>
<td>na</td>
</tr>
</tbody>
</table>


In 2000, the Singaporean Government and Singaporean investors showed strong interest in acquiring assets, including hotels and buildings. To encourage Singaporean interest, the Singaporean Government pledged US$500 million in loan facilities for its investors to acquire IBRA assets and another US$400 million in guarantees for its businesses investing in Indonesia.

**SALE OF STATE ENTERPRISES**

Another opportunity for investment arises from the Government’s privatisation program. In 1999, to increase enterprise efficiency and fund expensive financial sector restructuring, the Indonesian Government committed to privatising around 140 state enterprises, SEs. SEs operate alongside private businesses in all major sectors, including natural resources, infrastructure, finance, agriculture and transport (Table 3.3). A government masterplan outlines the firms to be privatised, preferred method of privatisation and sales timetable.
Table 3.3

**Bulk of SE Assets in Banking**

Value of SE Assets and Turnover by Sector, 1998

<table>
<thead>
<tr>
<th>Sector</th>
<th>Number of SEs</th>
<th>Turnover 1998 (Rp. trillion)</th>
<th>Per cent of total turnover</th>
<th>Assets 1998 (Rp. trillion)</th>
<th>Per cent of total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agri-industry and consumer goods</td>
<td>33</td>
<td>20.2</td>
<td>14.0</td>
<td>26.3</td>
<td>5.6</td>
</tr>
<tr>
<td>Energy</td>
<td>3</td>
<td>14.3</td>
<td>9.9</td>
<td>70.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Tourism</td>
<td>10</td>
<td>13.9</td>
<td>9.6</td>
<td>13.0</td>
<td>2.8</td>
</tr>
<tr>
<td>Strategic industries</td>
<td>13</td>
<td>8.4</td>
<td>5.8</td>
<td>14.7</td>
<td>3.1</td>
</tr>
<tr>
<td>Telecommunications and media</td>
<td>4</td>
<td>8.8</td>
<td>6.1</td>
<td>28.8</td>
<td>6.2</td>
</tr>
<tr>
<td>Financial services</td>
<td>19</td>
<td>61.1</td>
<td>42.4</td>
<td>271.5</td>
<td>58.2</td>
</tr>
<tr>
<td>Logistics</td>
<td>32</td>
<td>8.1</td>
<td>5.6</td>
<td>20.3</td>
<td>4.3</td>
</tr>
<tr>
<td>Mining</td>
<td>4</td>
<td>3.9</td>
<td>2.7</td>
<td>5.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Construction and building materials</td>
<td>18</td>
<td>3.4</td>
<td>2.4</td>
<td>13.0</td>
<td>2.8</td>
</tr>
<tr>
<td>Forestry, paper and wood products</td>
<td>8</td>
<td>1.9</td>
<td>1.3</td>
<td>3.2</td>
<td>0.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>144</td>
<td>144.0</td>
<td>100.0</td>
<td>466.6</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Deacons, 2000a.

Although this timetable has been delayed, the Government recently recommitted to majority privatisation of all state owned assets.

**Assets for Sale**

The Government’s stated strategy is to sell first the SEs foreign investors find most attractive. It intends to delay selling a majority of individual SE’s shares in key sectors, and accelerate sale of other SEs allowing foreign majority ownership.

In addition to eight SEs shortlisted for privatisation (Table 3.4), the Government plans significant telecoms privatisation. It will sell a further 8 per cent of domestic telecom operator, PT Telkom, leaving it with a 58 per cent share.\(^\text{23}\) The Government plans to maintain majority ownership in PT Telkom, but will allow foreign investors to buy a majority share in international telecom company, PT Indosat, currently listed on the Jakarta and Surabaya Stock Exchanges, and its subsidiary, PT Satelindo. These companies currently hold the exclusive right to provide international telecom services until 2004.

\(^{23}\) Telkom has a monopoly over private domestic fixed line telecom services until 2010 and domestic long distance services until 2005.
Table 3.4

Major SE Asset Sales Planned
Shortlisted SEs for Early Sale

<table>
<thead>
<tr>
<th>State enterprise</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>PT Pupuk Kaltim</td>
<td>Fertiliser maker</td>
</tr>
<tr>
<td>PT Bukit Asam</td>
<td>Coal mining</td>
</tr>
<tr>
<td>PT Aneka Tambang</td>
<td>Coal mining</td>
</tr>
<tr>
<td>PT Perkebunan Nusantara PN III</td>
<td>Plantation</td>
</tr>
<tr>
<td>PT Perkebunan Nusantara PN IV</td>
<td>Plantation</td>
</tr>
<tr>
<td>PT Indo Farma</td>
<td>Pharmaceuticals</td>
</tr>
<tr>
<td>PT Kimia Farma</td>
<td>Pharmaceuticals</td>
</tr>
<tr>
<td>PT Angkasa Pura II</td>
<td>Airport operator</td>
</tr>
</tbody>
</table>

Source: Deacons, 2000a.

In both cases, the Government plans to rationalise their telecom operations, including reviewing their non-core business before their privatisation (International Monetary Fund, 2000).

Sales Strategy

Eventually, the Government is expected to sell a majority of all state assets. As part of the revised masterplan, the Government set out the criteria for selecting suitable privatisation methods for each SE.

Initial public offering

SEs will seek to sell shares through initial public offerings on the stock exchange to attract new capital for debt refinancing or business expansion, and when business prospects are relatively strong. Before listing, firms must record positive profits for two consecutive years, and the Capital Markets Regulator, Bapepam, must determine the SE’s accounts comply with capital market laws.

Strategic sales

The Government will pursue strategic sales if a SE is deemed profitable, has good prospects, and needs a particular technology, marketing network or professional staff. In the bidding process, it will favour firms offering these qualities.

Liquidation

When a SE’s business prospects are poor and declining; it has a high and unsustainable level of gearing; and it is projected to be consistently loss making, the Government is likely to liquidate it. Firms that are difficult to restructure or lack qualified management also are more likely to be liquidated. The Government will consider the possible effects on public service provision before it decides whether to liquidate.
Employee buy outs

Employee buy outs will be used where the SE is profitable or has reasonable business prospects, owns a relatively low level of fixed assets, and has relatively highly skilled employees and/or management.

Financial Restructuring

The Government retains its in principle commitment to improve SEs’ financial structures before sale. Steps include replacing directors, improving internal governance and reviewing existing contracts. The Government is auditing boards of commissioners and, especially for SEs likely to remain in government hands, developing statements of corporate intent. SEs also will be publicly audited and announce their financial statements through a company registry. The Government indicated it will consider the costs and benefits of restructuring to determine if this will increase the asset’s attractiveness to investors. Also, the Government recently canvassed having a long term, share buy back option in profitable SEs (Jakarta Post, 5 September 2000).

Timetable

The US$400 million raised from privatising five SEs24 by the end of 1999-2000 was considerably less than the US$1.5 billion originally targeted from selling 12 enterprises. This shortfall is due to government attempts to restructure SEs before sale, poor market conditions that threatened to reduce prices and resistance from SE management.

ISSUES FOR INVESTORS

Managing risks is critical to investing successfully in SEs. Potential investors must thoroughly audit accounts and explain their intentions to shareholders, workers and managers.

Corporate Governance

The Government advises potential investors to conduct due diligence before registering their interest in assets, as information on SEs’ financial position is difficult to access. Prevailing accounting standards and potentially uncooperative management may make SE due diligence complex.

Potential investors must examine closely a SE’s viability before outlaying large amounts of capital. Contracts between the enterprise and third parties may not be commercially viable; consequently, investors need to clarify their right to nullify these before purchase. New government laws ensuring access to relevant financial information, and government efforts to restructure and clarify the financial position of these enterprises should help.

24 These included part sale of PT Telkom, PT Semen Gresik, PT Pelindo and PY Krakatau Steel.
Management Control
As most government assets are slated for selling in stages, full control of a SE may not be a medium
term option. Before purchase, investors will need to clarify and formalise their rights to manage the
financial affairs of the enterprise, if they hold a minority share. Investors also should ensure
management agrees to their business plan before the purchase.

Support from Previous Management
Investors must consult with and include existing management in new initiatives. Privatisation must be
transparent to avoid shareholder, staff or public accusations that foreigners are being favoured.
Selling the benefits of the privatisation to the community and labour groups is an important part of
this process.

CASE STUDIES
The following case studies highlight the importance of managing these issues when investing in a SE.

PT Pelindo II and III
Privatisation of Indonesia’s leading ports at Jakarta and Surabaya was transparent and inclusive,
and received widespread public and management support. P&O Ports Australia successfully bid for
Surabaya port operator, PT Pelindo III, from a field of four foreigners, see box below (P&O Ports
Australia, 2000a). Hong Kong based Hutchison Whampoa acquired a 51 per cent interest in Pelindo II,
outbidding the AP Moller Group, International Container Terminal Services of the Philippines,
P&O Ports Australia, Peony Investment SA and a joint venture between US based Stevedoring Services
and the locally controlled shipping line, Samudera Indonesia.

PT Krakatau Steel
Poor transparency prevented the sale of PT Krakatau Steel to foreigners. Dutch company, Ispat
International NV, signed a memorandum of understanding with Krakatau Steel allowing it alone to
conduct a due diligence of the company (Ispat, 1998). This feature of the sale, along with concerns
the share price was too low, and considerable labour and management resistance, caused the
privatisation to be abandoned.

PT Semen Gresik
Labour resistance also thwarted the majority sale of Semen Gresik. Mexican company Cemex secured
a 35 per cent share in the company following the first round of bidding, and expected to purchase a
further 16 per cent in a second bidding round that included three other firms. Workers at Gresik’s
Semen Padang unit in Sumatra protested against majority foreign ownership, forcing the Government
to sell only a further 14 per cent to Cemex.

25 These were American Samudra Indonesia, Fountain Head of France, International Container Terminal Services of the
Philippines and P&O Ports Australia.
26 Ispat decided not to proceed with the terms of its memorandum of understanding to conduct the due diligence.
27 These included Germany’s Heidelberger Zement, Switzerland’s Holderbank and France’s Lafarge Asia Pacific.
P&O INVESTING IN PORTS

P&O Ports acquired 49 per cent of the SE container terminal at Tanjung Perak, Surabaya in 1999, resulting in a joint venture company, PT Terminal Petikemas Surabaya. This follows P&O’s joint venture investment in APT Kuala Pelabuhan Indonesia in Irian Jaya in 1995, to perform logistics functions at the Freeport Copper and Gold Mine.

An international bank administered the public bidding process that led to the Surabaya port investment. P&O carefully sought to understand the needs of stakeholders, including the partner company, management and employees, to ensure the sale was a success. As a result, management, labour and existing shareholders have cooperated since the investment was made. While some delays occurred in government approval of a necessary stevedoring tariff rise, this rise was approved. P&O advise investors interested in Indonesia to research the market carefully and seek advice from many sources to ensure they form a balanced view.

Source: P&O Ports Australia, 2000b.

DEVOLUTION AND FDI

Devolving government responsibilities to the regions introduces new complexities to the investment application process, and companies should remain sensitive to increasing decision making authority in the regions. The increasing prominence of regional agencies in the investment process introduces potential inconsistencies. New regional levies and charges could be introduced. (See Chapter 2 - Political Developments.) For most potential investments in Java, investors are reasonably protected from many of these risks; however, infrastructure and mining companies are likely to be affected.

OTHER EMERGING SECTORS FOR FDI

Rapidly growing demand for infrastructure, education and health services reflects Indonesia’s development priorities and provides scope for foreign investment.

Infrastructure

FDI opportunities are emerging in privately provided infrastructure, given expanding demand and the Government’s reduced capacity to fund new infrastructure over the medium term. Priority areas include transport, public sanitation, water treatment, telecommunications and possibly electricity (Table 3.5). However, ongoing disputes with foreign joint venture independent power producers over US dollar denominated power supply contracts signed by the Soeharto Government will reduce market confidence in Indonesia unless a mutually acceptable outcome can be negotiated. The Government recently announced it would continue to implement 27 infrastructure projects suspended in 1997. It has identified a further 190 priority project proposals costing a total of Rp. 5.3 trillion (US$6.2 billion) (BAPPENAS, 2000).

---

28 A few of these power producers are selling power to the Indonesian electricity authority, PLN, but for well below the contracted price. Electricity demand is expected to exceed supply again reasonably soon, so incentives will increase to reach a solution to outstanding IPP contract disputes.
Table 3.5

Infrastructure Opportunities Significant
Major Infrastructure Projects Requiring Funding, 2000

<table>
<thead>
<tr>
<th>Type</th>
<th>Description of project</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 toll roads</td>
<td>Building toll roads to connect Cikampek to Padalarang, Cileunyi to Nagreg, Cikampek to Padalarang, Cileunyi to Nagreg, Gompol to Pandaan, Pondok Aren to Serpong, Semarang to Batang, as well as a toll road in Semarang.</td>
</tr>
<tr>
<td>6 communications projects</td>
<td>Improving meteorological and geophysical equipment, improving the automated frequency management system, procuring and installing airport security equipment for 50 airports, procuring and installing VHF extended range communication system and ATC Radar facilities, phase II, and procuring SAR communication systems.</td>
</tr>
<tr>
<td>2 Pelindo II Projects</td>
<td>Constructing and operating coal and general goods terminals in North Sumatra, and constructing a terminal pier in Gresik Port, East Java for logs and general goods.</td>
</tr>
<tr>
<td>PT Semen Tonosa</td>
<td>Constructing a cement factory.</td>
</tr>
</tbody>
</table>

Source: Asia Pulse, 16 May 2000.

Education

1998 reforms allow foreign educational institutions to invest in universities and other non-school educational facilities. This liberalisation could provide significant opportunities for Australian education and training providers to cooperate with Indonesian institutions in expanding available courses. Decentralising education responsibility to the regions also should provide opportunities for educational service providers to help establish new institutions in undersupplied regions. Some Australian universities already are providing services in this sector. (See Chapter 5 - Australian Opportunities.)

Health

Foreigners have been able to invest in hospitals since 1990. Over the medium to long term, significant investment opportunities for Australian health service providers exist in private hospital development and management projects, provision of private health insurance schemes, export of medical and hospital equipment, provision of health worker training and promotion of Australia as a health care destination.
GOVERNMENT INCENTIVES

Due to fiscal pressures, the Government is reassessing many foreign investment incentives. However, it has shelved plans to abandon tax concessions in the Batam free trade zone, at least for the present; and new tax exemptions encourage investment in pioneer industries, including machinery and electronic products. So these incentives do not favour entrenched interests, the Government only allows new companies to apply for tax exemptions. Tax exemptions can last up to eight years for companies located outside Java and Bali, and up to five years for companies located in Java and Bali. An additional year may be granted if companies:

- employ at least 2,000 Indonesians once commercial production is underway
- have at least 20 per cent ownership by cooperatives
- invest more than US$200 million in assets other than land and buildings.

A project must be completed within five years of government approval. The tax exemption takes effect when the company completes project development and begins commercial production. Foreign investors and local investors must apply to the Minister of Trade and Industry for these exemptions.

IMPLICATIONS

Recent foreign investment regime liberalisation and major IBRA and SE asset sales expected from 2000 to 2004 should provide foreign investors with good opportunities to acquire some strategic shares in Indonesian industries. While social instability in some provinces and the need for ongoing economic and legal reforms may affect the assessment of investment opportunities, investors undertaking thorough due diligence and negotiating sensitively with stakeholders may make valuable acquisitions.

While IBRA and SE asset sales were delayed in 1999 and 2000, progress should be steadier in 2001 and beyond. Potential investors need to be prepared by completing their due diligence, so they can participate as asset sales proceed.

29 Pursuant to Presidential Decree No. 7/1999.
### Appendix Table 3.1

**IBRA Assets Cover All Sectors**

Sectoral Distribution of IBRA’s Five Holding Companies

<table>
<thead>
<tr>
<th>Holding companies</th>
<th>Sectors represented</th>
<th>Number of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>PT Holdiko Perkasa</td>
<td>Chemicals</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>Coal and granite</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>Communications</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Food and consumer products</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>Multi industry</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Oil and fats</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Palm plantations</td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>Plywood</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Property</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Publicly listed companies</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Sugar</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Textiles and garments</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Trading</td>
<td>3</td>
</tr>
<tr>
<td>PT Cakrawala Gita Pratama</td>
<td>Hotels and resorts</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Property</td>
<td>8</td>
</tr>
<tr>
<td>PT Kiani Wirudha</td>
<td>Catering and food distribution</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Glue and chemicals</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>Timber/logging</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>Financial services and others</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>Plywood</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Pulp</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Shipping</td>
<td>2</td>
</tr>
<tr>
<td>PT Bentala Kartika Abadi</td>
<td>Financial services/related business</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>Property</td>
<td>12</td>
</tr>
<tr>
<td>PT Tunas Sepadan Investama</td>
<td>Automotive/tyre</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Chemical/petrochemical</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>Agribusiness/shrimp aquaculture</td>
<td>12</td>
</tr>
</tbody>
</table>

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PT Kiani Wirudha, 2000, Preliminary Information Memorandum, Jakarta.

PT Tunas Sepadan Investama, 1999, Preliminary Information Memorandum, Jakarta.


Since the onset of the financial crisis, 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 over 70 per cent had tariffs of 10 per cent or less. The unweighted average tariff rate now is below 9 per cent.

Tariff reductions include agricultural products; these reductions lowered the unweighted average tariff rate on agricultural products from 19 per cent in 1995 to 8.6 per cent in 1998.

The Government has removed many non-tariff barriers on agricultural imports, notably import licensing requirements on commodities the national logistics agency, BULOG, controlled, permitting competitive imports and distribution of wheat, flour, sugar, soy beans and garlic.

Reductions in tariffs and local content requirements also are boosting prospects for Australian car exporters in Indonesia.
In response to the financial crisis and its participation in multilateral trade reforms, the Indonesian Government has accelerated its trade reform program since 1995. By encouraging labour intensive manufacturing, increased openness to international markets complements other post crisis government reforms to improve efficiency in the Indonesian business sector and promote more equitable development. Lower trade barriers also benefit Australia, as it is a natural trading partner with Indonesia, with complementary resource and human capital endowments.

This chapter briefly reviews the history of trade policy in Indonesia. Although in the past, economic down turns and oil price volatility often forced Indonesia to liberalise trade, its renewed free trade agenda in the mid to late 1990s reflected a growing regional consensus favouring trade liberalisation, as expressed through Asia Pacific Economic Cooperation, APEC, and ASEAN Free Trade Area, AFTA, resolutions.

The chapter also identifies opportunities for Australia, through Indonesia’s market opening, and concludes by assessing the risks associated with current liberalisation efforts.

**CRISIS AND REFORM**

Trade barriers have declined markedly over recent decades due to consecutive reform efforts. The 1997 financial crisis promoted bold trade liberalisation. While other regional governments also are adopting freer trade arrangements, Indonesia currently has one of East Asia’s most liberal trade regimes, outside Hong Kong and Singapore.

**Crisis-led Reforms**

Indonesia’s first major trade reforms occurred in 1985 when falling oil prices and concerns about its high cost economy resulted in the Soeharto Government lowering tariff ceilings to 60 per cent and reducing the number of tariff levels from 25 to 11. These reforms also converted several import licences, which at their peak covered 43 per cent of tariff lines, into tariff equivalents (Centre for Strategic and International Studies, 2000). The 1985 recession and 1986 collapse of oil prices prompted more aggressive trade reforms, which reduced the unweighted tariff rate from 27 per cent in 1986 to 20 per cent in 1991 (Figure 4.1). Other reforms abolished import monopolies for plastic, steel and cotton, and introduced a more transparent quota system for textiles. In 1990, the Government also reduced non-tariff barriers to electronics imports, and removed import bans on cold rolled steel, sheets and tin plates. These reforms underpinned Indonesia’s rapid economic growth in the late 1980s and 1990s.
However, through the early 1990s, trade liberalisation slowed and the unweighted tariff rate remained steady. Propylene and ethylene tariffs increased and the national car, the Timor, was made exempt from the 35 per cent domestic luxury tax and protected by extensive non-tariff and tariff barriers. These developments fuelled doubts about the resolve of the Soeharto Government to continue trade reform.

By the mid 1990s, concerns about Indonesia’s deteriorating external trade balance spurred renewed liberalisation, and the unweighted average tariff rate again declined (Figure 4.1). Importantly, in 1995, the Government committed for the first time to a schedule of tariff reductions; this anticipated a maximum tariff rate of 10 per cent by 2003, excluding automotive related products, and tariffs on most items falling to between 0 and 5 per cent (Table 4.1). Successive packages substantially reduced non-tariff barriers; by 1995, tariffs covered 65 per cent of items.
In July 1997, in line with previous unilateral announcements and to meet World Trade Organization, WTO, and APEC commitments, the Government again reduced tariffs on 1,600 items, lowering the unweighted tariff rate to 11.7 per cent. Over 50 per cent of Indonesian tariff codes then were within the 0 to 5 per cent range, and over 60 per cent were at 10 per cent or less (Table 4.2). The Government also removed a series of non-tariff barriers, including on new and used shipping imports.

### Table 4.1

**Major Tariff Reforms Promised in 1995**

**Tariff Reduction Commitments, 1995-2003**

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
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<td></td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
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<td>5</td>
<td>5</td>
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<td>15</td>
<td>10</td>
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<td>5</td>
<td>max 5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>15</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>max 10</td>
<td></td>
</tr>
<tr>
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<td>30</td>
<td>25</td>
<td>20</td>
<td>15</td>
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<td></td>
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<td>30</td>
<td>25</td>
<td>25</td>
<td>20</td>
<td>20</td>
<td>15</td>
<td>15</td>
<td>10</td>
<td>max 10</td>
</tr>
<tr>
<td></td>
<td>40</td>
<td>30</td>
<td>25</td>
<td>25</td>
<td>20</td>
<td>20</td>
<td>15</td>
<td>15</td>
<td>10</td>
<td>max 10</td>
</tr>
</tbody>
</table>


### Table 4.2

**Trade Reforms Accelerate Post Crisis**

**Indonesia’s Import Tariff Structure, 1997-99**

<table>
<thead>
<tr>
<th>Tariff</th>
<th>0 to 5 per cent</th>
<th>0 to 10 per cent</th>
<th>0 to 20 per cent</th>
<th>25 to 35 per cent</th>
<th>40 per cent or higher</th>
<th>Total tariff lines</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>July 1997</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total tariff lines</td>
<td>3 688</td>
<td>4 563</td>
<td>6 151</td>
<td>1 032</td>
<td>80</td>
<td>7 263</td>
</tr>
<tr>
<td>Per cent</td>
<td>51</td>
<td>63</td>
<td>85</td>
<td>14</td>
<td>1</td>
<td>100</td>
</tr>
<tr>
<td><strong>1998</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total tariff lines</td>
<td>4 266</td>
<td>5 188</td>
<td>6 973</td>
<td>167</td>
<td>72</td>
<td>7 212</td>
</tr>
<tr>
<td>Per cent</td>
<td>59</td>
<td>71</td>
<td>96</td>
<td>2</td>
<td>1</td>
<td>99</td>
</tr>
<tr>
<td><strong>1999</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total tariff lines</td>
<td>4 289</td>
<td>5 226</td>
<td>7 055</td>
<td>135</td>
<td>69</td>
<td>7 259</td>
</tr>
<tr>
<td>Per cent</td>
<td>59</td>
<td>72</td>
<td>97</td>
<td>2</td>
<td>1</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Asia Pacific Economic Cooperation, 1999.
TRADE LIBERALISATION SINCE THE CRISIS

Responding to the financial crisis, the Government further accelerated trade regime reform efforts, especially eliminating non-tariff barriers for agricultural products and measures to protect the national car. The rupiah’s dramatic 80 per cent depreciation in the year to mid 1998 made most Indonesian products very competitive at world prices, so many trade barriers became redundant. As the rupiah was unlikely to rebound quickly, the crisis offered an opportunity to remove many remaining trade barriers. Indonesia now is moving towards a liberal trade regime similar to that of Singapore or Hong Kong in the 1960s and 1970s.

These developments clearly benefit Australia as lower tariffs offer Australian exporters better access to the Indonesian market.¹

Tariff Reductions since the Crisis

Building on Indonesia’s WTO and APEC commitments, the four-year IMF program recommended a three-tier tariff structure by 2003, with rates of 0, 5 and 10 per cent for all items except cars and alcohol. The Government committed to reducing immediately high tariff rates on some items not previously slated for liberalisation, including reducing tariffs of 15 to 25 per cent on iron and steel by 5 percentage points to reach 10 per cent by 2003. It also committed to reduce tariffs on chemical, metal and fishery products to 5 to 10 per cent by 2003.

By mid 2000, 60 per cent of tariff lines had tariffs of 0 to 5 per cent, and more than 70 per cent had tariffs of 10 per cent or less; this reduced the unweighted average tariff rate to below 9 per cent (Figure 4.1 and Table 4.2).

Post 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. Tariffs on food-related agricultural products fell to 0 to 5 per cent and non-food agricultural tariffs fell by 5 percentage points from prevailing levels. By 2002, the maximum tariff on non-food agricultural products will be 10 per cent.

As major exporters of agricultural products and manufactures to Indonesia, Australian producers will benefit from tariff reductions (Table 4.3).

Tariff reductions behind schedule

Despite these successes, actual tariff reductions are behind targets set in the May 1995 trade liberalisation package. Even after the December 1999 trade reform package, which reduced rates on 232 tariff lines, 2 142 lines remain above the 1995 target.

¹ Foreign suppliers should observe newly established anti-dumping measures in Indonesia.
Table 4.3
Few Barriers to Australian Exports
Tariff Rates on Major Indonesian Imports from Australia, 1999-2000

<table>
<thead>
<tr>
<th>Item</th>
<th>Export value 1999-2000 (A$ million)</th>
<th>Tariff rate (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Confidential items (mainly wheat)</td>
<td>560.2</td>
<td>na</td>
</tr>
<tr>
<td>Cotton</td>
<td>390.0</td>
<td>0</td>
</tr>
<tr>
<td>Aluminium alloys and aluminium ingots and products</td>
<td>139.8</td>
<td>0 to 20 depending on level of processing</td>
</tr>
<tr>
<td>Live animals</td>
<td>106.9</td>
<td>0 (5 if over 350 kg)</td>
</tr>
<tr>
<td>Iron and steel milling equipment</td>
<td>39.8</td>
<td>5</td>
</tr>
<tr>
<td>Frozen bovine meat</td>
<td>37.6</td>
<td>5</td>
</tr>
<tr>
<td>Zinc</td>
<td>32.9</td>
<td>5</td>
</tr>
<tr>
<td>Woodchips (not conifers)</td>
<td>23.6</td>
<td>0</td>
</tr>
<tr>
<td>Passenger motor vehicles</td>
<td>22.4</td>
<td>35 to 80, see box</td>
</tr>
<tr>
<td>Milk powder</td>
<td>21.8</td>
<td>5</td>
</tr>
<tr>
<td>Petroleum oils and products</td>
<td>39.1</td>
<td>0 (crude), 5 (refined)</td>
</tr>
<tr>
<td>Flour</td>
<td>20.9</td>
<td>0</td>
</tr>
<tr>
<td>Mining machinery parts</td>
<td>19.7</td>
<td>0</td>
</tr>
<tr>
<td>Motor vehicle parts</td>
<td>19.1</td>
<td>15</td>
</tr>
<tr>
<td>Copper cathodes</td>
<td>18.0</td>
<td>0</td>
</tr>
</tbody>
</table>

Note: na Means not available.
Source: Department of Foreign Affairs and Trade, 2000.

Non-tariff Barriers
Before the crisis, trade reform somewhat neglected non-tariff barriers. Some barriers prevented or severely limited the importing of certain items. Since the onset of the crisis, the Government has removed many of these barriers, especially exclusive licences for importers of agricultural products. The Government has announced it will remove all remaining non-tariff barriers by 2002, except those relating to health and environmental concerns. Removal of these barriers will significantly enhance local investment and production efficiency, and present Australian producers with significant opportunities.

Licensing requirements
In early 1998, the Government committed to removing all import licences, including agricultural import licences, which fell outside previous WTO commitments. The complexity of these licences impeded exporting to Indonesia, and monopoly import arrangements often raised domestic prices.
Government reforms have improved significantly foreign producers’ access to the Indonesian car market, despite an exemption for car imports under the three-tier tariff structure targeted for 2003. The June 1999 automotive deregulation package substantially cut tariffs on completely knocked down, CKD, and completely built up, CBU, vehicles from 5-200 per cent to 0-80 per cent (Table 4.4). In early 1998, the Government also abolished special tax, customs and credit concessions to the national car project, implementing ahead of schedule the WTO panel ruling on this case. In addition, by the end of 2000, the Government agreed to phase out the motor vehicle local content program that gave preferential tariff rates to manufacturers using a high percentage of local parts.\(^2\) As the economic recovery gathers momentum, Australian manufacturers of vehicles and automotive parts will be well placed to access the opportunities these reforms provide.

### Table 4.4

**Reforms Drive Vehicle Tariffs Lower**

**Tariff Reductions on Vehicle Imports since June 1999**

<table>
<thead>
<tr>
<th></th>
<th>Tariff rates</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Completely built up, CBU</td>
<td>Completely knocked down, CKD</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Old</td>
<td>New</td>
<td>Old</td>
<td>New</td>
</tr>
<tr>
<td>Sedans less than 1500 cc</td>
<td>200</td>
<td>65</td>
<td>65</td>
<td>35</td>
</tr>
<tr>
<td>Sedans 1500 cc-3000 cc</td>
<td>200</td>
<td>70</td>
<td>65</td>
<td>40</td>
</tr>
<tr>
<td>Sedans higher than 3000 cc</td>
<td>200</td>
<td>80</td>
<td>65</td>
<td>50</td>
</tr>
<tr>
<td>Minibuses</td>
<td>105</td>
<td>45</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Jeeps</td>
<td>105</td>
<td>45</td>
<td>25</td>
<td>45</td>
</tr>
<tr>
<td>Buses</td>
<td>70</td>
<td>40</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Trucks with GVW less than 24 tons</td>
<td>70</td>
<td>40</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Trucks with GVW higher than 24 tons</td>
<td>5</td>
<td>5</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>


The Government agreed to liberalise the importing of many items, including agricultural commodities that previously only government agencies imported, and industrial inputs, including polystyrene and polyethylene.\(^3\)

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\(^2\) These policies complemented the June 1999 abolition of the national car program and local content scheme for automotive products.

\(^3\) In both cases, only state owned producers could import these.
After November 1997, the Government removed import licensing requirements on commodities the national logistics agency, BULOG, controlled. This liberalisation permitted import competition for wheat, wheat flour, soy beans and garlic, the sale and distribution of flour, and the importing and marketing of sugar. This major reform should reduce prices of these commodities for consumers, and has obvious benefits for Australian exporters.

In late 1998, the Government opened rice imports to competition. However, in January 2000, because of the sharp fall in world rice prices, the Government placed a temporary Rp. 430 per kilogram import tariff on rice to protect local farmers’ incomes; this is due for review in 2001 (International Monetary Fund, 2000a). As a regional exporter of rice, Australia is well positioned to take advantage of this liberalisation.

To smooth the transition to a fully open market, tariffs replaced import licences on some products, including for soy beans and dried garlic (which have a 20 per cent tariff) and wheat flour (which has a 10 per cent tariff). These tariffs are slated to fall to 5 per cent or less by 2003. A 25 per cent tariff on sugar also should be phased out by 2003.

In January 1998, the Government dismantled controls on wood panel exports and shipments, and on dairy product imports; these are markets in which Australia is very competitive. The Government also disbanded Badan Penyangga dan Pemasaran Cengkeh, BPPC, and its monopoly over the domestic marketing and distribution of cloves.

As part of the June 1999 automotive deregulation package, the Government permitted general importers to import completely built up vehicles. Given Australia’s increasing success in exporting cars, this represents a major opportunity for Australian vehicle manufacturers.

**Local content requirements**

In addition to reforms in the car market, in February 1998, the Government announced the phasing out of local content requirements for dairy products, well ahead of Indonesia’s commitment under the Uruguay Round, again offering opportunities for Australian exporters.

**REGIONAL TRADE LIBERALISATION**

Indonesia’s participation in multilateral trade groupings, including the WTO, AFTA and APEC, also influences the pace of Indonesian trade liberalisation.

**WTO COMMITMENTS**

Indonesia joined GATT in 1947, but like other developing economies, was not actively involved in GATT negotiations until 1986. In the Uruguay Round, Indonesia offered trade liberalisation commitments including binding new tariffs (Appendix Table 4.1). It bound 6,714 tariffs or 72 per cent of all manufactured import tariff lines, agreed to eliminate quantitative restrictions, opened up trade in services and liberalised foreign direct investment by offering to apply national treatment by 2000.
Before the crisis, the Government offered exporters incentives to locate within the Batam Island, Rempang and Galang special economic zones, by exempting all products produced and imported there from value added tax and import duties. These concessions, and the zones’ proximity to Singapore, attracted significant foreign direct investment; this rose from US$684 million in 1990 to US$2 332 million in 1999. Exports from the region increased from US$568 million in 1992 to US$3 152 million in 1998, with non-oil exports increasing through the crisis years. Because of concerns about the fiscal cost of these concessions, in July 1999, the Government indicated it would commission a comprehensive study to review the tax free status of Batam, Rempang and Galang islands. However, objections by Batam residents and businesses delayed the removal of the tax exemptions to the beginning of 2001, at the earliest.

The Government also has reviewed tariff exemptions for all capital equipment, machinery and raw materials for businesses in export processing zones or export-oriented manufacturing entrepot. This scheme was based on firms’ self assessment of imported value, and despite random government audits, was prone to corruption. In January 2000, the Government committed to remove all such import duty exemptions by May 2000. However, this equipment only carries a 5 per cent import duty.


However, Indonesia was disappointed by relatively limited concessions western economies offered to liberalise the Multi Fibre Agreement, and many of Indonesia’s tariffs were bound at well above existing applied levels. Other concessions Indonesia made were relatively modest compared to previously announced unilateral trade liberalisation.

Indonesia started implementing Uruguay Round tariff commitments to reduce general tariff schedules in June 1996 (World Trade Organization, 1998). By 2000, Uruguay Round commitments had reduced the maximum applied tariff to 15 per cent (Table 4.1). Indonesia also committed to removing 96 non-tariff barrier measures, meeting its remaining Uruguay Round non-tariff barrier commitments by 2004, although post crisis reforms supersede many of these. These involved simplifying import licensing and gradually eliminating producer-importer and trade-importer licensing.

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4 These were signed on 22 July 1999 and 20 January 2000.
5 In January 2000, the Government also announced it would remove all tax exemptions currently applying to the integrated economic development zones, KAPET, especially income and indirect tax concessions (International Monetary Fund, 2000a). Businesses within KAPET no longer will receive duty exemptions on their import of capital goods, raw materials and other equipment directly related to production activities. Value added tax and luxury sales taxes on domestic purchases also are applied now.
6 Australia is not a member of the Multi Fibre Agreement and hence does not use it to restrict clothing and textile imports.
7 By April 1996, Indonesia had eliminated 75 non-tariff barriers, 77 per cent of its Uruguay Round commitments, and by June 1996, had abolished 83 non-tariff barriers, over 80 per cent of its commitments. Indonesia will continue to reduce export taxes on logs, sawn timber, rattan and minerals to achieve these goals.
AFTA

At the fourth ASEAN summit in 1992, the six ASEAN economies, Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand agreed to establish the ASEAN Free Trade Area, AFTA. Since 1992, Vietnam, Laos, Cambodia and Myanmar have joined ASEAN and AFTA. AFTA aims to achieve free trade among the ASEAN economies, reducing intra ASEAN tariffs to 0 to 5 per cent and removing non-tariff barriers by 2002. ASEAN members regard AFTA as complementing WTO and APEC trade and investment liberalisation commitments, not substituting for them.

AFTA tariff reductions only apply to tariff items ASEAN members designate as ‘included’. Included items carry the common economic preferential tariff; initially, this comprised 41 147 tariff lines, with 3 321 tariff lines placed on a temporary exclusion list and another 523 tariff lines permanently excluded on the general exception list. Since then, the inclusion list has increased to 53 144 tariff lines, covering 83 per cent of tariff lines. Unprocessed agricultural products were included in 1994. AFTA helped increase regional integration and intra ASEAN trade from 19 per cent of ASEAN trade in 1992 to 25 per cent in 1997. The crisis has not reduced commitment to AFTA, although recently, Malaysia indicated it would exclude its car tariffs from common effective preferential tariff, CEPT, reductions.

The success of AFTA also inspired ASEAN members to strengthen, streamline and harmonise non-border measures to facilitate intra ASEAN and international trade and investment. For example, the 1995 Bangkok Summit Declaration agreed to enhance cooperation in liberalising trade in services, and synchronise national regulations to improve members’ access to markets for financial services, maritime transport, telecommunications, air transport, construction and business services. In 1998, ASEAN members agreed on protocols to implement their 1995 trade in services liberalisation commitment. Indonesia, along with other ASEAN members, submitted details of service sectors it was ready to liberalise. However, little practical progress has occurred on services trade liberalisation; most ASEAN members are reluctant to move quickly in this sector.

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8 Indonesia joined ASEAN in 1967, and since 1976, has participated actively in its economic cooperation.
9 Members agreed at the sixth ASEAN summit in 1998 to accelerate AFTA, achieving free internal ASEAN trade by 1 January 2002. This shortened the initial 2008 target.
10 Submitting products for liberalisation under AFTA is voluntary. When AFTA was first initiated, all members submitted their lists of products under each category: included, temporarily excluded and general exception lists, based on each member’s willingness to liberalise. Items under the temporary exclusion list initially included sensitive products such as paper and paper products, transport equipment, including motor vehicles, iron and steel, certain electrical products and petroleum products. They gradually were phased into the included list between January 1996 and January 2000, in five equal instalments of 20 per cent of the list.
11 In 1999, the AFTA Council agreed to implement AFTA according to schedule.
AFTA Commitments

By January 2000, Indonesia had 7,173 tariff lines in the CEPT inclusion list, leaving 21 tariff lines in the temporary exclusion list, four on the sensitive list (mostly unprocessed agricultural products, such as rice, sugar, tobacco and meat products) and 68 on the general exception list.\(^\text{12}\)

Indonesia’s original CEPT-AFTA schedule was similar to its Uruguay Round commitments. However, in 1998, ASEAN economies agreed not to apply tariffs over 20 per cent to products on the inclusion list; this was more liberal than Indonesia’s Uruguay Round commitment (Table 4.5). By 2000, with the 1998 CEPT package and IMF liberalisation, Indonesia’s average CEPT tariff was below 5 per cent, hence falling within AFTA’s target band two years ahead of schedule. AFTA included items now represent 98.7 per cent of all Indonesian tariff items.

<table>
<thead>
<tr>
<th>Table 4.5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia Ahead of AFTA Liberalisation Schedule</td>
</tr>
<tr>
<td>CEPT-AFTA Tariff Reduction Schedule, 1995-2003, Per cent</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>5</td>
<td>5</td>
<td>max 5</td>
<td>max 5</td>
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<tr>
<td>10</td>
<td>5</td>
<td>max 5</td>
<td>max 5</td>
<td></td>
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<tr>
<td>15</td>
<td>10</td>
<td>max 5</td>
<td>max 5</td>
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<tr>
<td>20</td>
<td>15</td>
<td>max 5</td>
<td>max 5</td>
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<tr>
<td>25</td>
<td>20</td>
<td>max 20</td>
<td>max 10</td>
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<tr>
<td>30</td>
<td>25</td>
<td>max 20</td>
<td>max 10</td>
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<tr>
<td>35</td>
<td>30</td>
<td>max 20</td>
<td>max 10</td>
<td></td>
</tr>
<tr>
<td>40</td>
<td>30</td>
<td>max 20</td>
<td>max 10</td>
<td></td>
</tr>
<tr>
<td>Average CEP Tariff (2000-03)</td>
<td>2000</td>
<td>2001</td>
<td>2002</td>
<td>2003</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4.77</td>
<td>4.36</td>
<td>3.73</td>
<td>2.16</td>
</tr>
</tbody>
</table>


\(^{12}\) AFTA has four categories of products. Firstly, Inclusion List products are subject to preferential tariff reductions and should reach 0 to 5 per cent in 2002. Secondly, Temporary Exclusion List products are temporarily excluded from the tariff reductions schedule but items in it should be phased into the Inclusion List in five instalments. Thirdly, Sensitive List products are declared sensitive, mainly unprocessed agriculture products such as rice, sugar, tobacco and meat products, and will take longer to be phase into the Inclusion List. Fourthly, General Exception products excluded mainly to protect human, animal or plant life, or artistic, historical or archaeological values and for national security and public morality reasons; examples include arms, ammunition and narcotics.
**APEC TRADE LIBERALISATION**

APEC’s goals are to achieve free and open trade and investment by 2010 for developed member economies, and by 2020 for developing member economies. In contrast to WTO and AFTA agreements, which are legally binding, APEC agreements are based on consensus and are not legally binding. In its 1999 individual action plan, Indonesia committed itself to further liberalise trade and investment, progressively reducing tariffs to achieve the APEC goal by 2020 (Table 4.6). It also committed to reducing progressively non-tariff barriers, simplifying import licensing, and harmonising customs and other procedures to facilitate trade (Yamazawa, 1997).

**Table 4.6**

**APEC Reforms Reflect Ongoing Liberalisation**

**Summary of Indonesia’s APEC Individual Action Plan**

<table>
<thead>
<tr>
<th>Area</th>
<th>Current status</th>
<th>Short term</th>
<th>Medium term</th>
<th>Long term</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tariffs</strong></td>
<td>Indonesia announced a schedule of tariff reductions on a most favoured nation basis for each year between 1995 and 2001 to reduce:</td>
<td>Indonesia will continue to reduce its tariffs on a most favoured nation basis until 2001, in line with its schedule of tariff reductions. Indonesia will actively participate in the APEC tariff database and regularly update its tariff data.</td>
<td>Indonesia will continue its deregulation efforts to further liberalise trade and investment, and progressively reduce tariffs.</td>
<td>Indonesia will progressively reduce tariffs to reach the APEC free trade goal by 2010-2020.</td>
</tr>
<tr>
<td></td>
<td>• tariffs of 20 per cent or less in stages to 0 to 5 per cent by 2000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• 1995 tariffs of more than 20 per cent in stages to 0 to 20 per cent by 1998, and to 0 to 10 per cent by 2001.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Non-tariff measures</strong></td>
<td>Indonesia has already eliminated 75 non-tariff barriers which are 77 per cent of its Uruguay Round commitments. In June 1996, it eliminated nine non-tariff barriers; eight belonged to the Uruguay Round commitments.</td>
<td>Indonesia will continue to reduce export taxes on logs, sawn timber, rattan and minerals to achieve APEC goals. It will continue to eliminate by 2004, the remaining non-tariff barriers that are part of its Uruguay Round commitments, and will continuously update its non-tariff measures data in the APEC tariff database.</td>
<td>Indonesia will progressively reduce non-tariff measures, and further simplify import licensing.</td>
<td>Indonesia gradually will eliminate producer-importer and trade-importer licensing, except where it is justified.</td>
</tr>
</tbody>
</table>

Source: Asia Pacific Economic Cooperation, 1999.
POLITICAL OBSTACLES TO TRADE LIBERALISATION

Trade reform may threaten significant existing interests in industries like broadacre agriculture, iron and steel, petrochemicals, flour milling, sugar and transport equipment, as Indonesia is less internationally competitive in these sectors. These interests have sought to rally government support and nationalist sentiments to retain trade barriers. While democracy has weakened the influence of some vested interests, import competing constituencies, including farmers and capital intensive manufacturers, still seek to influence trade policy outcomes.

In particular, liberalisation of certain agricultural commodity imports arouses considerable opposition. For example, rice farmers concerned about the market penetration of lower cost, foreign rice called for rice tariffs to jump from 30 per cent to between 90 and 120 per cent. Sugar industry representatives also argued the 20 to 25 per cent tariff on sugar was too low compared with some developed country tariffs of 140 to 240 per cent (Bisnis Indonesia, 30 May 2000). Steel industry representatives, led by state owned Krakatau Steel, argue strongly to maintain indefinitely steel tariffs at 25 per cent, claiming Japanese, Chinese and Korean imports often are dumped (Centre for Strategic and International Studies, 2000). The Indonesian Association of Steel Pipe Producers, GAPIPA, also is calling for an anti-dumping duty on steel pipe imports (Jakarta Post, 5 April 2000). The petrochemical industry, led by Chandra Asri, the country’s largest ethylene producer, continues to oppose trade liberalisation, seeking to maintain indefinitely its tariff at 25 per cent (Jakarta Post, 10 May 2000).

Even labour intensive manufacturers like the Indonesian Footwear Association, APRISINDO, demand import duties on Chinese footwear, again because of suspicions of dumping; despite rupiah depreciation, prices for Chinese footwear are 25 per cent lower than domestic prices. The Indonesian Antidumping Committee, KADI, currently is investigating the issue.

RECENT TRADE TRENDS

Trade reforms throughout the 1980s and 1990s drove rapid trade growth; exports grew from 23 per cent of GDP in 1985 to 35 per cent in 1999. In most years, net exports (exports minus imports) significantly contributed to Indonesian GDP growth. The Indonesian Government recognises the importance of net exports to sustaining medium term economic growth. Before the crisis, Indonesia had run trade deficits but by the September quarter of 2000, Indonesia enjoyed a trade surplus equal to around 11 per cent of GDP.

13 Four Java based sugar cane farmer associations and members of Asosiasi Petani Tebu Rakyat expressed these concerns in May 2000. However, their proposal to ban raw sugar imports was rejected (Republika, 4 May 2000). In April 2000, at the regional multilateral level, the Asian Farmers Group for Cooperation demanded the WTO respond to its demands for greater agricultural protection, especially on key staples including rice (Suara Karya, 19 April 2000).

14 The Minister for Trade, Luhut Pandjaitan announced an investigation into ways to curb Chinese imports, where unfair business practices or smuggling is evident. He emphasised that any measures must not disturb bilateral relations between the two countries (Jakarta Post, 29 June 2000).
Export Trends

By late 2000, the low rupiah, improving trade finance for established exporters and recovering oil prices were driving a rapid recovery in Indonesian exports. Export volumes rose 17 per cent in the third quarter of 2000 over a year earlier (Figure 1.3). Exports bottomed at US$48 billion in the year to July 1999 but rebounded to almost US$60 billion in the year to September 2000 (Figure 1.4) (CEIC, 2000). This is 17 per cent above pre-crisis export levels of about US$51 billion. A competitive currency and continuing strong oil prices are expected to boost exports at least a further 7 per cent in 2001 (Consensus Economics, 2000).

Excluding oil, between 1995 and 1999, the fastest growing major exports were chemicals, up 11.5 per cent to US$2.3 million, machinery and transport equipment, up 6 per cent to US$5.3 billion, and vegetable oils and fats, up 5.3 per cent to US$1.8 billion (Figure 4.2).

Oil prices over US$30 per barrel will see oil export revenues increase to US$7.7 billion in 2000, up from only US$2.8 billion in 1998, when oil averaged US$12.18 per barrel.15

Figure 4.2
Manufactured Exports Growing Strongly Post Crisis


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15 This estimate uses the average August 2000 spot price for Minas (Sumatran) crude, compared with the 1998 Dubai average price, which is the marker price for East Asian oil prices. Export volumes are assumed to remain the same; 630 000 barrels per day, although higher prices and demand may induce higher supply (International Energy Agency, 2000; and United States Department of Energy, Energy Information Administration, 2000).
Merchandise Import Trends

By late 2000, imports also were recovering slowly. During the crisis, much of the adjustment in Indonesia’s balance of payments came through imports, which bottomed at US$24 billion in the year to December 1999, down from their peak of almost US$44 billion in the year to March 1997 (Figure 1.4). Capital goods and cars led the decline (Figure 4.3). However, reflecting the recovery in exports and domestic consumption in the year to September 2000, imports rose almost 16 per cent over a year earlier. Despite this increase, in September 2000, imports were still 34 per cent below pre-crisis peaks at US$28.8 billion (Figure 1.4).

Indonesia’s major import suppliers, Japan and the European Union, saw their annual exports to Indonesia fall by 65 and 54 per cent respectively between 1997 and 1999. Partially due to depreciation of several of these currencies, and the composition of their exports, imports from ASEAN, China, the Republic of Korea and Australia experienced more modest declines (Figure 4.4). ASEAN exports to Indonesia fell by just 14 per cent, China’s by 19 per cent, Australia’s by 41 per cent and the Republic of Korea’s by 43 per cent. However, all countries’ exports to Indonesia are recovering in 2000. (See Chapter 5 - Australian Opportunities.)

16 Capital goods imports fell by 67 per cent from US$17.5 billion in 1997 to US$5.7 billion in 1999. Manufactures also fell 57 per cent over the same period, from US$6.5 billion to US$3.5 billion. This decline parallels the fall in investment. Other imports, particularly inputs for the export sector, fell less markedly; chemicals fell by 24 per cent, and ores and other crude materials fell by 14 per cent.
Figure 4.4

**Japan and EU Exports Suffered Most**

Imports Supplied by Indonesia’s Largest Import Suppliers, 1990-99

Indonesia’s Missing Imports Signal a Free Trade Zone Boom

Although official Indonesian Customs Department data (which, in general, exclude duty free imports by free trade zones) show imports fell from mid 1997 to January 1999, major trading partner data show imports began to increase from April 1998, and have almost doubled since. The significant discrepancy between official and partners’ trading data has widened since the crisis (Figure 4.5) (World Bank, 2000). Import categories with the most pronounced difference between official and partners’ import data are products used in export processing zones, such as textiles, electronics parts and machinery for specialist industrial applications; bulk commodities, ores and motor vehicles, which typically are not imported to duty free zones, do not exhibit this gap. This supports the hypothesis that the widening import data gap is due to the increasing importance of export processing zones as a destination for Indonesia’s imports.
Figure 4.5

Widening Gap between Official and Partners’ Import Data

Imports Data from Indonesian Customs and Indonesia’s Trading Partners


Turning the Corner in 1999 and into 2000

Some of the fastest growing import categories in 1999 included agricultural inputs such as seeds and fertilisers (122 per cent), cereals (21 per cent), metallic ores and scrap (21 per cent), transport equipment excluding cars (16 per cent), and pulp and waste paper (6 per cent) (Figure 4.6). Over 2000, imports of manufactures and crude materials recovered also, in line with the recovery in consumption and exports.
Figure 4.6

Some Imports Surging


Implications

Indonesia has achieved major trade reforms since the crisis, building on liberalisation over the past two decades and moving it rapidly towards its free trade objective. These reforms will assist greatly Indonesia’s growth prospects as it recovers from the crisis, reducing costs for producers and consumers, and encouraging efficient allocation of new investment. Significant tariff and non-tariff liberalisation also will improve market access for Australian exporters supplying the Indonesian market. However, as trade liberalisation focuses on more sensitive and less competitive sectors, resistance to further reform is emerging. Australia’s experience with trade reform indicates failure to explain adequately to the Indonesian public the benefits of free trade could threaten continuing trade liberalisation.
Appendix Table 4.1

Many Tariffs Bound, but at High Levels
Indonesia’s Uruguay Round Market Access Offer

<table>
<thead>
<tr>
<th>Tariff lines</th>
<th>Number</th>
<th>Per cent of tariff lines</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Tariff binding</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Total bound manufactures</td>
<td>7 537</td>
<td>80.3</td>
</tr>
<tr>
<td>Existing bindings</td>
<td>823</td>
<td>8.8</td>
</tr>
<tr>
<td>New bindings</td>
<td>6 714</td>
<td>71.6</td>
</tr>
<tr>
<td>2. Total agriculture (all bound)</td>
<td>1 341</td>
<td>14.3</td>
</tr>
<tr>
<td>3. Exceptions</td>
<td>504</td>
<td>5.4</td>
</tr>
<tr>
<td>Total</td>
<td>9 382</td>
<td>100</td>
</tr>
<tr>
<td>B. Agriculture</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Tarification and binding of all items</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Duty reduction of 10 percentage points by tariff line over ten years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Elimination of local content requirement for milk products</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Agreed access of 70 000 tons of rice imports annually</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Removal of non-tariff barriers on bound tariff items</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-tariff barriers on 98 industrial tariff lines affecting A$358 million of imports to be removed within ten years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Elimination of import surcharges on bound tariff items</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Surcharges ranging from 5 to 25 per cent on 159 tariff lines affecting A$838 million of imports to be removed within ten years</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Appendix Table 4.2

**Trade Related Policy Actions under the IMF Program**

<table>
<thead>
<tr>
<th>Policy action</th>
<th>Target date</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tariffs</strong></td>
<td></td>
</tr>
<tr>
<td>Reduce tariffs on items currently subject to tariffs of 15 to 25 per cent</td>
<td>31 March 1998</td>
</tr>
<tr>
<td>by 5 percentage points</td>
<td></td>
</tr>
<tr>
<td>Cut tariffs on all food items to a maximum of 5 per cent</td>
<td>1 February 1998</td>
</tr>
<tr>
<td>Reduce tariffs on non-food agricultural products by 5 percentage points</td>
<td>1 February 1998</td>
</tr>
<tr>
<td>Gradually reduce tariffs on non-food agricultural products to a maximum of</td>
<td>2003</td>
</tr>
<tr>
<td>10 percentage points</td>
<td></td>
</tr>
<tr>
<td>Reduce tariffs on chemical products by 5 percentage points</td>
<td>1 January 1998</td>
</tr>
<tr>
<td>Reduce tariffs on steel/metal products by 5 percentage points</td>
<td>1 January 1998</td>
</tr>
<tr>
<td>Reduce tariffs on chemical, steel/metal and fishery products to 5 to 10 per</td>
<td>2003</td>
</tr>
<tr>
<td>cent</td>
<td></td>
</tr>
<tr>
<td><strong>Import restrictions</strong></td>
<td></td>
</tr>
<tr>
<td>Abolish import restrictions on all new and used ships</td>
<td>1 February 1998</td>
</tr>
<tr>
<td>Phase out remaining quantitative import restrictions and other non-tariff</td>
<td>End of program</td>
</tr>
<tr>
<td>barriers</td>
<td></td>
</tr>
<tr>
<td><strong>Export restrictions</strong></td>
<td></td>
</tr>
<tr>
<td>Abolish export taxes on leather, cork, ores and waste aluminium products</td>
<td>1 February 1998</td>
</tr>
<tr>
<td>Reduce export taxes on logs, sawn timber, rattan and minerals to a maximum</td>
<td>First step by</td>
</tr>
<tr>
<td>of 30 per cent by 15 April 1998, 20 per cent by end of December 1998, 15</td>
<td>22 April 1998</td>
</tr>
<tr>
<td>per cent by end of December 1999 and 10 per cent by end of December 2000</td>
<td></td>
</tr>
<tr>
<td>Phase in resource rent taxes on logs, sawn timber and minerals</td>
<td>First step by</td>
</tr>
<tr>
<td></td>
<td>22 April 1998</td>
</tr>
<tr>
<td>Replace remaining export taxes and levies by resource rent taxes as</td>
<td>Over program period</td>
</tr>
<tr>
<td>appropriate</td>
<td></td>
</tr>
<tr>
<td>Eliminate all other export restrictions</td>
<td>Over program period</td>
</tr>
<tr>
<td>Remove ban on palm oil exports and replace with export tax of 40 per cent.</td>
<td>22 April 1998</td>
</tr>
<tr>
<td>Review the level of the export tax based on market prices and exchange rates,</td>
<td></td>
</tr>
<tr>
<td>and reduce to 10 per cent by end of December 1999</td>
<td></td>
</tr>
</tbody>
</table>
**Appendix Table 4.2 (continued)**

**Trade Related Policy Actions under the IMF Program**

<table>
<thead>
<tr>
<th>Policy action</th>
<th>Target date</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Local content regulations</strong></td>
<td></td>
</tr>
<tr>
<td>Abolish local content regulations on motor vehicles</td>
<td>2000</td>
</tr>
<tr>
<td>Abolish local content regulations on dairy products</td>
<td>1 February 1998</td>
</tr>
<tr>
<td><strong>Free trade zones</strong></td>
<td></td>
</tr>
<tr>
<td>Review the tax free status of Batam, Rempang and Galang Islands, based on a comprehensive feasibility study. Defer plans pending the completion of the study</td>
<td>Based on feasibility study completed by 31 August 1999</td>
</tr>
<tr>
<td>Review the effectiveness of policies for the integrated economic development zones, KAPETS, especially the fiscal concessions</td>
<td>Based on study completed by 31 December 1999</td>
</tr>
<tr>
<td>Start collecting value added tax from Batam Island</td>
<td>1 April 2000</td>
</tr>
<tr>
<td>Review whether to maintain the income tax facilities and abolish the indirect tax facilities for the integrated economic development zones</td>
<td>Complete review by 1 February 2000; implement measures by 1 April 2000</td>
</tr>
<tr>
<td><strong>Value added tax</strong></td>
<td></td>
</tr>
<tr>
<td>Limit VAT zero-rating of domestically supplied goods to businesses in proportion to their exports</td>
<td>Upon implementing the new VAT law</td>
</tr>
<tr>
<td>Review VAT exemptions on specified capital goods, agricultural inputs and public services, and identify those that should be revoked to avoid cascading</td>
<td>30 September 1999</td>
</tr>
<tr>
<td>Prepare draft amendments to the VAT law to provide prompt refunds for all excess credits of exporters and enterprises purchasing large amounts of capital goods</td>
<td>1 March 2000</td>
</tr>
<tr>
<td>Eliminate VAT exemptions on capital goods</td>
<td>Upon implementing the new VAT law</td>
</tr>
<tr>
<td><strong>Customs administration</strong></td>
<td></td>
</tr>
<tr>
<td>Prepare draft amendments to the customs law and issue implementing regulations to provide for penalties and interest on unpaid duties, and implement short, issue oriented audits</td>
<td>31 October 1999</td>
</tr>
</tbody>
</table>

**Note:** a Several of these target dates have been postponed.
## Appendix Table 4.2 (continued)

### Trade Related Policy Actions under the IMF Program

<table>
<thead>
<tr>
<th>Policy action</th>
<th>Target date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Develop and implement a plan to combat valuation fraud by:</td>
<td>31 October 1999</td>
</tr>
<tr>
<td>• strengthening physical inspections</td>
<td></td>
</tr>
<tr>
<td>• establishing special valuation units in the regions</td>
<td></td>
</tr>
<tr>
<td>• undertaking special valuation audits</td>
<td></td>
</tr>
<tr>
<td>• developing a valuation database to help detect fraud</td>
<td></td>
</tr>
<tr>
<td>Reduce exemptions to import tariffs on capital goods; rationalise and make transparent the remaining exemptions</td>
<td>1 April 2000</td>
</tr>
<tr>
<td>Dissolve restrictive marketing arrangements for cement, paper and plywood</td>
<td>1 February 1998</td>
</tr>
<tr>
<td>Eliminate price controls on cement</td>
<td>3 November 1997</td>
</tr>
<tr>
<td>Allow cement producers to export with only a general export licence</td>
<td>1 February 1998</td>
</tr>
<tr>
<td>Allow free traders to buy, sell and transfer all commodities, including cloves, cashew nuts and vanilla, across districts and provincial boundaries</td>
<td>1 February 1998</td>
</tr>
<tr>
<td>Eliminate the Clove Marketing Board</td>
<td>30 June 1998</td>
</tr>
<tr>
<td>Abolish quotas limiting the sale of livestock</td>
<td>30 September 1998</td>
</tr>
<tr>
<td>Prohibit provincial governments from restricting trade within and between provinces</td>
<td>1 February 1998</td>
</tr>
<tr>
<td>Enforce prohibition of provincial and local export taxes</td>
<td>January 1998</td>
</tr>
<tr>
<td>Take effective action to allow free competition in:</td>
<td></td>
</tr>
<tr>
<td>• wheat, wheat flour, soy bean and garlic imports</td>
<td>30 September 1998</td>
</tr>
<tr>
<td>• flour sale or distribution</td>
<td>30 September 1998</td>
</tr>
<tr>
<td>• sugar imports and marketing</td>
<td>31 December 1998</td>
</tr>
<tr>
<td>• rice imports</td>
<td>Ongoing</td>
</tr>
</tbody>
</table>

Source: International Monetary Fund, 2000b.
REFERENCES


Department of Foreign Affairs and Trade, 2000, Stars Database.


AUSTRALIA-INDONESIA BUSINESS OPPORTUNITIES

KEY POINTS

• In the long term, Indonesia’s ongoing trade liberalisation, complementary economy, growing population and disposable incomes create a very prospective market for Australian exporters. Despite the fall in Australian exports during the crisis, Australia’s share of total Indonesian imports recovered to 5.2 per cent during 1999.

• Total two-way Australian-Indonesian goods and services trade was A$6.9 billion in the year to June 2000, ranking Indonesia as Australia’s tenth largest trading partner. Before the financial crisis, the balance of merchandise and service trade was heavily in Australia’s favour, but since the crisis, strong Indonesian exports to Australia and lower imports have shifted the trade balance in Indonesia’s favour.

• Significant export opportunities exist in manufactures especially with the relatively low value of the Australian dollar vis-a-vis the US dollar. Trade reforms are providing new opportunities in agricultural exports. Exports of services, including education and financial services, also are well placed to increase.

• A rapidly growing export sector, government asset sales through the economic reform program and a liberalised investment regime create new opportunities for Australian investment in Indonesia. This would deepen the commercial relationship. However, adopting appropriate risk management strategies is important.
Despite Indonesia’s financial crisis, Australia and Indonesia continue to enjoy a good commercial relationship. Trade is recovering from crisis induced falls, and with their complementary economies and ongoing trade liberalisation, this should continue. Further, new direct foreign investment opportunities in the strong export and small and medium enterprise sectors, and from Indonesian government asset sales could deepen commercial engagement between the two countries.

This chapter briefly describes the current bilateral trade and investment relationship, then explores emerging trade and investment opportunities for Australian business that Indonesia’s ongoing economic reforms and recovery present.

AUSTRALIAN-INDONESIAN TRADE FLOWS

Australia and Indonesia enjoy a strong trading relationship. Based on 1999 merchandise trade flows, Indonesia ranked as Australia’s tenth largest trading partner. Before the financial crisis, the balance of merchandise and service trade was strongly in Australia’s favour, with rapid growth and the relatively strong rupiah pushing up Indonesian import demand. However, with the crisis, Indonesian domestic demand contracted sharply and the rupiah depreciated, cutting Indonesian imports and boosting Indonesian exports to Australia. This shifted the trade balance strongly in Indonesia’s favour (Figure 5.1). Increasing manufactures and services trade since the crisis indicates a more sophisticated trading relationship.

CRISIS’ IMPACT ON TRADE

Following the crisis, Australia’s exports to Indonesia fell by more than 15 per cent and imports rose by 8 per cent between 1997-98 and 1998-99 (Figure 5.1). By June 1999, Australia held a A$780 million trade deficit with Indonesia, a significant turnaround from the 1996-97 surplus peak of A$1.8 billion.

---

1 Total two-way trade in goods and services in the year to September 2000 was A$6.9 billion.
Trade composition also changed with the crisis, as rural exports like cotton and wheat held up strongly. Following the crisis, manufactures and services recovered as a share of Australian exports to Indonesia. Manufactures also rose as a share of Indonesian exports to Australia. However, it may be too soon to establish if these trends will continue. Over the decade, Australian service exports also grew strongly, increasing their share of total exports from 19.6 per cent in 1992 to 28.2 per cent in 1999 (Figure 5.2).
Throughout the 1990s, Australia supplied about 5 per cent of Indonesia's imports, peaking at 5.6 per cent in 1996. Despite the absolute fall in Australian exports in 1998 and 1999, and the decline in market share in 1997 and 1998, Australia's market share recovered to 5.2 per cent during 1999 (Figure 5.3).
In 1999, merchandise and service exports from Australia to Indonesia started to recover from sharp falls during the crisis, and continued to grow through 2000.

**Merchandise Exports**

After a decade of rapid growth, in 1998, the financial crisis and ensuing recession severely reduced Australia’s merchandise exports to Indonesia. Between 1992 and 1997, Australia’s merchandise exports to Indonesia rose at an average annual rate of almost 14 per cent. Rural, resource and manufactured exports to Indonesia all performed strongly, with annual growth rates averaging over 10 per cent. However, plummeting Indonesian demand following the crisis and a sharply depreciating rupiah cut Australian merchandise exports to Indonesia by over 30 per cent between 1996-97 and 1998-99, with resource, rural and manufactured exports all hit hard (Figure 5.4). All Australia’s major merchandise exports to Indonesia, except cotton, experienced negative or zero growth during 1998. Merchandise exports to Indonesia fell from around 4.0 per cent of Australia’s total merchandise exports at the end of 1997 to around 2.5 per cent by the end of 1999.
In 1999, exports of live animals, meat, road vehicles, iron and steel, and non-ferrous metals led export growth. Cotton exports held up very well during the crisis and while they fell slightly through 1999, remained at historically high levels. However, Australian exports of petroleum products remained depressed throughout 1999, reflecting continuing low levels of economic activity in Indonesia. Throughout 2000, Australia's merchandise exports to Indonesia recovered strongly, with annual merchandise exports growing by around 18 per cent in the year to September 2000.  

Changing Composition of Merchandise Exports

During 1996-99, Australian exports shifted from resources towards rural commodities and manufactures (Table 5.1 and Figures 5.2 and 5.4). Rural exports grew the fastest, led by cotton. In 1999, manufactures comprised six of the ten fastest growing exports; many had grown from very low bases, indicating new markets (Table 5.2). This may reflect the depreciation of the Australian dollar vis-a-vis the US dollar; the United States is Australia’s main competitor in the manufactures market. Whether this is an emerging trend is unclear at this stage. Nevertheless, the crisis may have provided an opportunity for Australian companies to penetrate new markets, providing a beachhead for future trade opportunities.

---

2 Exports of coal briquettes, wheat, sugar, motor vehicles and furniture parts led export growth in 2000.
Table 5.1

Rural Exports Growing Fastest
Sectoral Contributions to Growth of Australian Exports to Indonesia, 1996-99, Per cent

<table>
<thead>
<tr>
<th>Sector</th>
<th>1996 (per cent)</th>
<th>1997 (per cent)</th>
<th>1998 (per cent)</th>
<th>1999 (per cent)</th>
<th>Share of total exports 1996 (per cent)</th>
<th>Share of total exports 1999 (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rural</td>
<td>9.5</td>
<td>4.8</td>
<td>-10.6</td>
<td>6.3</td>
<td>26.3</td>
<td>34.5</td>
</tr>
<tr>
<td>Live animals</td>
<td>3.0</td>
<td>0.0</td>
<td>-5.8</td>
<td>2.4</td>
<td>6.9</td>
<td>3.2</td>
</tr>
<tr>
<td>Meat</td>
<td>0.6</td>
<td>0.6</td>
<td>-1.8</td>
<td>1.6</td>
<td>1.8</td>
<td>2.1</td>
</tr>
<tr>
<td>Dairy products</td>
<td>0.9</td>
<td>0.3</td>
<td>-1.0</td>
<td>0.9</td>
<td>2.3</td>
<td>3.0</td>
</tr>
<tr>
<td>Sugar</td>
<td>1.0</td>
<td>0.5</td>
<td>-1.7</td>
<td>0.0</td>
<td>1.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Textile materials</td>
<td>4.1</td>
<td>3.1</td>
<td>1.8</td>
<td>-0.7</td>
<td>10.3</td>
<td>21.5</td>
</tr>
<tr>
<td>Cereals</td>
<td>0.2</td>
<td>-0.1</td>
<td>0.0</td>
<td>1.0</td>
<td>0.4</td>
<td>1.3</td>
</tr>
<tr>
<td>Other rural</td>
<td>-0.1</td>
<td>0.4</td>
<td>-2.1</td>
<td>2.1</td>
<td>3.5</td>
<td>4.6</td>
</tr>
<tr>
<td>Manufactures</td>
<td>5.4</td>
<td>2.8</td>
<td>-10.6</td>
<td>3.9</td>
<td>23.6</td>
<td>25.1</td>
</tr>
<tr>
<td>Road vehicles</td>
<td>0.4</td>
<td>-0.2</td>
<td>-0.5</td>
<td>2.9</td>
<td>1.3</td>
<td>3.7</td>
</tr>
<tr>
<td>Other transport</td>
<td>0.5</td>
<td>2.0</td>
<td>-2.0</td>
<td>0.4</td>
<td>0.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Electric machinery</td>
<td>0.1</td>
<td>-0.6</td>
<td>-1.5</td>
<td>-0.7</td>
<td>3.2</td>
<td>0.7</td>
</tr>
<tr>
<td>General machinery</td>
<td>1.9</td>
<td>-0.8</td>
<td>-0.9</td>
<td>0.3</td>
<td>3.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Other manufactures</td>
<td>2.5</td>
<td>2.4</td>
<td>-5.7</td>
<td>1.0</td>
<td>15.4</td>
<td>17.6</td>
</tr>
<tr>
<td>Resources</td>
<td>-0.7</td>
<td>1.8</td>
<td>-11.2</td>
<td>1.1</td>
<td>23.3</td>
<td>19.4</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>-1.4</td>
<td>1.6</td>
<td>-2.9</td>
<td>1.3</td>
<td>2.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Non-ferrous metals</td>
<td>1.9</td>
<td>-0.6</td>
<td>-3.7</td>
<td>1.8</td>
<td>11.0</td>
<td>10.9</td>
</tr>
<tr>
<td>Petroleum</td>
<td>-1.4</td>
<td>0.7</td>
<td>-3.8</td>
<td>-3.6</td>
<td>8.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Natural gas</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.9</td>
<td>0.0</td>
<td>0.9</td>
</tr>
<tr>
<td>Other resources</td>
<td>0.1</td>
<td>0.1</td>
<td>-0.8</td>
<td>0.8</td>
<td>1.2</td>
<td>1.5</td>
</tr>
<tr>
<td>Other (including confidential)</td>
<td>14.7</td>
<td>0.5</td>
<td>-4.1</td>
<td>-11.7</td>
<td>26.8</td>
<td>21.0</td>
</tr>
<tr>
<td>Total</td>
<td>28.9</td>
<td>9.9</td>
<td>-36.5</td>
<td>-0.3</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: a Contribution to growth is calculated as the percentage change in the item’s exports multiplied by its share in total exports.
Source: Department of Foreign Affairs and Trade, 2000.
Figure 5.5

Rural Exports Still Dominate, Manufactures Significant

Composition of Australian Merchandise Exports to Indonesia, 1999

Table 5.2

<table>
<thead>
<tr>
<th>Export</th>
<th>Share of total merchandise exports (per cent)</th>
<th>Sector</th>
<th>Growth (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquefied propane and butane</td>
<td>0.89</td>
<td>Manufactures</td>
<td>132 879</td>
</tr>
<tr>
<td>Road vehicles</td>
<td>0.02</td>
<td>Manufactures</td>
<td>53 000</td>
</tr>
<tr>
<td>Steam and other vapour turbines</td>
<td>0.01</td>
<td>Manufactures</td>
<td>3 025</td>
</tr>
<tr>
<td>Men’s or boys’ clothing (knitted)</td>
<td>0.00(^a)</td>
<td>Manufactures</td>
<td>2 600</td>
</tr>
<tr>
<td>Heavy transport vehicles</td>
<td>1.50</td>
<td>Manufactures</td>
<td>2 517</td>
</tr>
<tr>
<td>Other cereal flours</td>
<td>0.00(^a)</td>
<td>Rural</td>
<td>1 550</td>
</tr>
<tr>
<td>Other non-ferrous base metals</td>
<td>0.01</td>
<td>Resources</td>
<td>1 393</td>
</tr>
<tr>
<td>Flour</td>
<td>1.00</td>
<td>Rural</td>
<td>1 177</td>
</tr>
<tr>
<td>Jewellery</td>
<td>0.01</td>
<td>Manufactures</td>
<td>995</td>
</tr>
<tr>
<td>Confectionery</td>
<td>0.02</td>
<td>Rural</td>
<td>922</td>
</tr>
</tbody>
</table>

\(a\) Means rounded down to zero.

Source: Department of Foreign Affairs and Trade, 2000.
**Service Exports**

Australian service exports to Indonesia grew at an annual average rate of over 20 per cent between 1991-92 and 1996-97, well above merchandise trade growth. Exports of education, tourism, financial and banking services, insurance, IT services and technology transfers were particularly strong (KPMG, 2000). During the crisis, service exports fell, but by less than merchandise exports, declining 10.5 per cent in 1997-98 (Figure 5.6).

**Figure 5.6**

Service Exports Stable after Crisis, Stronger before

Australian Service Exports to Indonesia, Financial Year, A$ million

Education services, and to a lesser extent, other travel, dominate Australian service exports to Indonesia, with 68 per cent of total service exports in 1999. Transport services comprised 16 per cent of service exports by value, and all other services including financial and business services, comprising 16 per cent, were the other major service export successes (Figure 5.7).
Indonesia’s more severe crisis caused Australia’s exports to Indonesia to fall more than exports to other ASEAN economies (Figure 5.8). In the three years before the crisis, Australia’s exports to Indonesia grew by around 30 per cent annually, exceeding the growth in exports to Thailand, Malaysia, Philippines and Singapore. However, during the crisis, exports to Indonesia fell more sharply than those to its ASEAN neighbours.
Weaker oil prices contributed to the lacklustre performance of Australian merchandise imports from Indonesia in the early 1990s; they fell by around 17 per cent between 1992 and 1994. However, they grew annually by an average of around 30 per cent between 1994 and 1997, again largely due to oil prices (Figure 5.9).

**Figure 5.9**

Imports Grew Strongly after Crisis

Value of Australian Merchandise Imports from Indonesia, Financial Year, 1992-2000

The rupiah’s sharp depreciation during the crisis increased the competitiveness of Indonesian merchandise exports. Consequently, Australia’s imports from Indonesia rose by around 75 per cent, between 1996-97 and 1998-99 led by an 82 per cent growth in manufactures (Figure 5.9). However, during 1999-2000, as the rupiah appreciated and Indonesian domestic demand recovered, Australian merchandise imports from Indonesia fell by over 17 per cent from 1998-99 (Bank Indonesia, 2000). A more stable rupiah saw annual merchandise imports from Indonesia grow by a modest 2.7 per cent over the year to September 2000 (CEIC, 2000).
Changing Composition of Merchandise Imports

Australia’s post crisis imports from Indonesia comprise more manufactures and other imports, including confidential and non-monetary gold, than before the crisis. Paper imports drive the increase in manufactures. However, it is too soon to determine whether this trend is likely to continue. Resource imports, mainly petroleum, remain the largest component of imports. By 1999, resources and manufactured imports accounted for around 80 per cent of Australia’s merchandise imports from Indonesia (Table 5.3 and Figure 5.10).

Table 5.3
Manufactured Imports Increasing in Importance
Contributions to Growth of Australian Imports from Indonesia, 1996-99

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rural</td>
<td>-1.6</td>
<td>0.7</td>
<td>1.3</td>
<td>0.3</td>
<td>8.0</td>
</tr>
<tr>
<td>Rubber</td>
<td>-1.0</td>
<td>-0.4</td>
<td>-0.3</td>
<td>0.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Paper</td>
<td>0.1</td>
<td>0.1</td>
<td>0.5</td>
<td>0.5</td>
<td>0.2</td>
</tr>
<tr>
<td>Wood</td>
<td>-0.4</td>
<td>0.1</td>
<td>0.0</td>
<td>-0.1</td>
<td>1.6</td>
</tr>
<tr>
<td>Coffee</td>
<td>-0.3</td>
<td>0.2</td>
<td>0.8</td>
<td>-0.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Other rural</td>
<td>0.1</td>
<td>0.6</td>
<td>0.3</td>
<td>0.3</td>
<td>2.4</td>
</tr>
<tr>
<td>Manufactures</td>
<td>5.9</td>
<td>10.0</td>
<td>29.0</td>
<td>-9.1</td>
<td>37.2</td>
</tr>
<tr>
<td>Paper manufactures</td>
<td>2.7</td>
<td>1.8</td>
<td>3.1</td>
<td>1.8</td>
<td>4.4</td>
</tr>
<tr>
<td>Furniture</td>
<td>0.3</td>
<td>1.0</td>
<td>0.4</td>
<td>0.1</td>
<td>3.0</td>
</tr>
<tr>
<td>Explosives</td>
<td>0.1</td>
<td>1.0</td>
<td>1.6</td>
<td>-0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Other manufactures</td>
<td>2.7</td>
<td>6.3</td>
<td>23.9</td>
<td>-10.6</td>
<td>29.4</td>
</tr>
<tr>
<td>Resources</td>
<td>27.5</td>
<td>16.0</td>
<td>3.5</td>
<td>-3.4</td>
<td>54.0</td>
</tr>
<tr>
<td>Petroleum</td>
<td>28.1</td>
<td>13.5</td>
<td>4.5</td>
<td>-3.3</td>
<td>51.8</td>
</tr>
<tr>
<td>Other resources</td>
<td>-0.7</td>
<td>2.5</td>
<td>-1.0</td>
<td>-0.1</td>
<td>2.2</td>
</tr>
<tr>
<td>Other (including confidential)</td>
<td>-4.5</td>
<td>6.0</td>
<td>23.0</td>
<td>-9.6</td>
<td>0.8</td>
</tr>
<tr>
<td>Total</td>
<td>27.3</td>
<td>32.6</td>
<td>56.9</td>
<td>-21.7</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: Contribution to growth is calculated as the percentage change in the item’s exports multiplied by its share in total exports.
Source: Department of Foreign Affairs and Trade, 2000.
Service Imports

Until the crisis, service imports from Indonesia also grew at an average annual rate of around 20 per cent, albeit from a lower base, with strongest growth in travel and transport imports. In contrast to merchandise imports, service imports fell by around 15 per cent in 1998-99, reflecting less Australian travel to Indonesia.

In 1999, Australian service imports from Indonesia comprised mainly travel (around 45 per cent) and transport (around 35 per cent). Almost 40 per cent of Australian travel to Indonesia was for business (Figure 5.11).
The Australia-Indonesia Development Area, AIDA, was launched on 24 April 1997 by Australian Foreign Minister, Mr Downer and Indonesian Coordinating Minister for Production and Distribution, Mr Hartarto. AIDA aims to develop closer economic relations between Australia and the eastern provinces of Indonesia, and improve the environment for private sector trade and investment in the region. AIDA covers Australia and the Indonesian provinces of West Kalimantan, Central Kalimantan, East Kalimantan, South Kalimantan, Bali, North Sulawesi, Central Sulawesi, South Sulawesi, South-East Sulawesi, West Nusa Tenggara, East Nusa Tenggara, Maluku and Irian Jaya.

The private sector is the key player in AIDA projects, and organises special working groups for implementing projects on a sectoral basis. These groups identify and explore sectoral trade and investment opportunities in the AIDA region. This collaborative work has identified several priority areas and established working groups in mining, agriculture and fisheries, tourism, education and transport. These working groups report their findings to meetings of government officials.

Recent trends in Australian exports to Indonesia indicate an emerging comparative advantage in manufactures and service exports. At the same time, Indonesia has liberalised domestic agricultural markets, dramatically improving access and opportunities for Australian agricultural exporters.

**Manufactured Exports**

Manufactures were the fastest growing Australian merchandise exports to Indonesia in 1999, reflecting in part increased competitiveness from the depreciated Australian dollar. Rising domestic demand and a recovering rupiah boosted Australia’s manufactured exports to Indonesia by 19 per cent in 1999, to A$538 million. Indonesia’s manufacturing sector also is recovering from the crisis, recording growth of 2.2 per cent in 1999, raising its share of GDP to around 26 per cent (KPMG, 2000).

**Vehicle related exports**

After the Government lifted tight controls on vehicle imports, they increased five fold in 1999, boosting Australia’s manufactured exports to Indonesia (Table 5.4). The June 1999 automotive deregulation package allows Indonesia to import completely built up vehicles, providing a major opportunity for Australian car manufacturers. By the end of 2000, preferential tariff rates for manufacturers using a high percentage of local parts also will be phased out, further benefiting Australian exporters.³

Indonesian demand for cars is expected to rise by 10 per cent per year between 2000 and 2005, well above the projected average for ASEAN economies (Tables 5.4 and 5.5).

**Table 5.4**

**Car Exports to Indonesia Boom in 1999**

**Australian Exports of Road Vehicles to Indonesia, A$ Thousands**

<table>
<thead>
<tr>
<th>Export sub-category</th>
<th>1998</th>
<th>1999</th>
<th>Growth in 1999 (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passenger motor vehicles</td>
<td>6 587</td>
<td>22 947</td>
<td>248</td>
</tr>
<tr>
<td>Heavy transport vehicles</td>
<td>1 211</td>
<td>31 697</td>
<td>2 517</td>
</tr>
<tr>
<td>Other road motor vehicles</td>
<td>1</td>
<td>531</td>
<td>53 000</td>
</tr>
<tr>
<td>Motor vehicle parts</td>
<td>7 038</td>
<td>19 917</td>
<td>182</td>
</tr>
<tr>
<td>Motor cycles</td>
<td>85</td>
<td>364</td>
<td>328</td>
</tr>
<tr>
<td>Trailers and semi-trailers</td>
<td>795</td>
<td>3 086</td>
<td>288</td>
</tr>
<tr>
<td>Total</td>
<td>15 717</td>
<td>78 542</td>
<td>400</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit, 2000.

³ These policies complemented the June 1999 abolition of the national car program and local content scheme for automotive products.
Table 5.5
Good Prospects for Indonesian Demand for Cars
Forecasted ASEAN Vehicle Sales, 2000-05, in Thousands

<table>
<thead>
<tr>
<th>Export sub-category</th>
<th>2000</th>
<th>2005</th>
<th>Average annual growth (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>348</td>
<td>493</td>
<td>7</td>
</tr>
<tr>
<td>Thailand</td>
<td>273</td>
<td>472</td>
<td>11</td>
</tr>
<tr>
<td>Indonesia</td>
<td>167</td>
<td>271</td>
<td>10</td>
</tr>
<tr>
<td>Philippines</td>
<td>86</td>
<td>147</td>
<td>11</td>
</tr>
<tr>
<td>Singapore</td>
<td>71</td>
<td>49</td>
<td>-7</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit, 2000.

Pharmaceutical products and medical equipment

Although pharmaceutical and medical products account for only 0.4 per cent of Australian merchandise exports to Indonesia, the share of these exports grew by around 50 per cent in 1999; this is significant in a market Japanese and US suppliers dominate. Indonesia’s large population and rising incomes should continue to expand demand for these products. The Government uses most of the medical equipment and supplies (KPMG, 2000).

PHARMACIA AND UPJOHN PERTH

Pharmacia and Upjohn, P&U, Perth, export pharmaceutical products to Indonesia, concentrating on products used to treat cancer. Before becoming part of the merged Pharmacia and Upjohn company in 1995, Pharmacia and Upjohn Perth used the services of a local agent to promote and distribute their products in Indonesia. They believe identifying and grooming an appropriate local agent is critical to succeeding in Indonesia.

Geographic proximity, the presence of numerous other Australian companies and promotion by the Western Australian Government of Indonesia’s market opportunities encouraged P&U Perth to enter the Indonesian market. P&U Perth believes the key to succeeding in Indonesia is to choose an appropriate local agent. The highly price sensitive market and weak rupiah also make competitive pricing critical to success.

P&U Perth acknowledge economic and political instability since the crisis have damaged business. Also, increasing price sensitivity and new strict product standards have reduced profit margins. Consequently, P&U Perth sees the scope to expand in Indonesia as minimal, at least in the short term.


During the crisis, imports of medical equipment fell by more than 50 per cent in US dollar terms.
Consumer ready food products

Australia gained considerable market share in consumer ready food products after the crisis, reflecting lower prices than major competitors such as the United States offered (KPMG, 2000). In 1999, Australian exporters recorded excellent sales growth in meat (around 300 per cent), fruit (80 per cent), and vegetable and dairy markets (50 per cent), mainly to the middle classes. Providing Australia maintains its relative exchange rate advantage over competitors, continues to produce at competitive prices and Indonesian incomes improve, growth in this export sector should continue.

Security and safety equipment

The Indonesian security and safety equipment market continues to offer good potential for Australian exporters. According to 1998 estimates, Australia dominates the foreign players in Indonesia’s security and safety equipment sector, holding around 30 per cent of the import market.\(^5\)

Industrial, commercial, oil/gas and mining sector demand for this type of equipment is forecast to increase over the next five years (KPMG, 2000). Particularly active sectors include equipment relating to personal security, fire fighting and building protection.

Agricultural

During the crisis, Indonesia’s agricultural imports were relatively durable, resisting the recession, increasing their interest to Australian business (Australia-Indonesia Business Council, 1999c). Significantly reduced barriers to agricultural imports are part of the post crisis economic reform program, further supporting opportunities.

Grains

In November 1997, the Government removed import licensing requirements on commodities the national logistic agency, BULOG, previously controlled; consequently, private imports of wheat, wheat flour and soy beans, and the sale and distribution of flour, now are allowed, with obvious benefits for Australian exporters. To smooth the transition to a fully open market, tariffs have replaced import licences; a tariff of 20 per cent applies to soy beans and 10 per cent to wheat flour. These tariffs should drop to 5 per cent or less by 2003.

In late 1998, the Government opened rice imports to competition, but applied a temporary import duty of Rp. 430 per kilogram. As a regional exporter of rice, Australia is well positioned to take advantage of this liberalisation. (See Chapter 10 - Agriculture.)

Australia remains Indonesia’s major supplier of wheat. Wheat-flour based industries, particularly millers and downstream manufacturers of pasta, noodles, bread and biscuits, have considerable potential; Australian producers are well placed to invest in these sectors (KPMG, 2000).

\(^5\) This is well above the market shares of Australia’s major competitors such as the United States (with 17 per cent), France (with 11 per cent) and Singapore (with 10 per cent).
Cotton
With a large textiles industry and negligible domestic cotton production, Indonesia remains the world’s largest cotton importer (KPMG, 2000). Despite Australian exports of cotton falling slightly in 1999, they have performed particularly well in the past few years, with annual growth averaging around 20 per cent since 1995, and particularly strong growth in 1997 and 1998. With the depreciated rupiah, the export-oriented textiles sector will continue its high demand for cotton.

Fishing vessels, handling and processing
Deregulation has lifted bans on importing fishing vessels, and fishing industry liberalisation is ongoing; both moves provide significant opportunities for Australia. Demand for new fishing vessels should grow considerably over coming years and fishing sector liberalisation provides excellent opportunities for Australians to provide post-catch handling facilities such as refrigeration (Australia-Indonesia Business Council, 1999d).

Sugar
A 25 per cent tariff on sugar is set to drop to 5 per cent or less by 2003. Australia, with a highly efficient sugar industry, is well placed to take advantage of this opportunity. Australian sugar and wheat exports to Indonesia are classified as confidential because of the small numbers of exporters involved.

Dairy and other sectors
In January 1998, the Indonesian Government dismantled controls on dairy product imports and wood panel exports and shipment, industries in which Australia has considerable comparative advantage. Local content requirements for dairy products were phased out in February 1998, well ahead of Indonesia’s Uruguay Round commitment. These developments offer significant opportunities to Australian exporters.

Mining
Indonesia is Australia’s most important market for mining equipment and services, absorbing exports of A$300 million annually (Australia-Indonesia Business Council, 1999a). The presence of a strong Australian mining network provides a foundation to expand Australian mining technology, service and equipment exports (Indonesia-Australia Business Council News, May 2000, p. 1). The mining sector accounts for around 10 per cent of Indonesia’s GDP and, after contracting by only 1.5 per cent in 1999, should rebound strongly in 2000.6 Austmine, comprising several leading Australian mining equipment exporters, supports industry exports. However, ongoing security issues may constrain mining sector growth. (See Chapter 9 - Mining.)

Services
As the Indonesian economy continues its reform process, the trend of strong growth in Australian service exports should continue.

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6 Mining activity declined by 2.8 per cent in 1998 (CEIC, 1998).
Financial services

Australia’s financial service professionals, with considerable expertise in risk management and regulatory compliance, are well placed to assist in the reform of Indonesia’s financial sector. Demand is strong for corporate finance professionals who can help Indonesia attract new partners and strategic alliances (Colley, 1999). Several Australian financial service providers are pursuing merger and acquisition opportunities in Indonesia.

For example, in November 1999, ANZ increased its 4.9 per cent share in Bank Panin to 10 per cent (with an option to increase its share to 28 per cent). ANZ also has a technical service agreement supporting Bank Panin in developing human resources, information technology, trade and risk management (Asia Pulse, 19 November 1999).

Legal, accounting and consulting services

Indonesia’s demand for legal and accounting services presents significant opportunities for professional firms in Australia. Major opportunities exist in corporate debt restructuring, particularly providing corporate recovery and due diligence services. Australian firms are at the forefront of debtor/creditor negotiations and use Australian personnel to provide these services. Australia’s legal and accounting professionals also can contribute to developing Indonesia’s judicial and corporate governance systems.

As debt restructuring concludes over the medium term, demand will increase for consultants assisting in implementing new accounting and risk management systems, establishing business plans and preparing feasibility studies (Colley, 1999).

Environmental services

New regulations rating manufacturers by their compliance with environmental standards offer opportunities for Australian operators in this field. Rising demand by Indonesian firms to control pollution presents an opportunity for Australian exporters, especially in construction, waste water treatment, water supply and solid waste disposal facilities. For example, the South Australian Water Corporation provided technology and expertise to the West Java Government to help it develop and manage water resources, water supply and waste water treatment (Australia-Indonesia Business Council, 1999b).

IT services

The number of Internet users in Indonesia is expected to increase from 1 million in 1999 to 1.5 million in 2000 (KPMG, 2000). Although it still is in its infancy, Indonesia’s e-commerce industry should increase nearly ten fold between 2000 and 2003 (KPMG, 2000). The Government recently allowed IT start-up companies to raise capital on the Jakarta Stock Exchange. Australia possesses the technological capabilities and human capital necessary to contribute to this expansion.

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7 The Government publicises these ratings. Around 300 firms participate in this program, but the Government aims to raise this to 750 firms by the end of 2000 (KPMG, 2000).
**SURPAC SOFTWARE INTERNATIONAL**

Perth based Surpac Software International produces, markets and sells mining software in Indonesia, via an agency which Australians and Indonesians staff. Indonesia is a critical market, with a sizeable proportion of South East Asia’s modern mines. The Surpac brand is well known in Indonesia, especially among Australian mining companies, and Surpac’s Perth headquarters ensures relatively easy access to the Indonesian export market.

Surpac provides regular upgrades and product support for its main software to its Indonesian clients, and sales demonstrations to prospective clients. Perth based sales and support staff regularly visit Indonesia. Surpac also trains its technical staff.

Surpac started to export to Indonesia in the mid 1980s. Initially, it undertook all marketing and support services from Perth, making frequent visits to Indonesia to learn about the market. Then it combined marketing trips with local staff training, to cover travelling costs. However, to market its technical products, Surpac realised it needed more permanent local support. After deciding against establishing a joint venture with a local firm, it tried to establish a joint office with another Australian company, but this option proved untenable as the financial crisis progressed. Finally, an established Australian surveying contractor, PT Globecon, familiar with Surpac’s product, agreed to assist with marketing. The marketing agent receives a commission for seeking out new clients, and Surpac provides quotations and sales support, including sales presentations.

Surpac believes flexibility is critical to succeeding in Indonesia, particularly in marketing strategies. Technical aspects of the product were adapted to Bahasa Indonesian. Commitment to client service and after sales service were important, and local Indonesian support was vital to understand the subtleties of doing business in Indonesia.

Political instability remains a concern. Civil unrest disrupts marketing and sales trips, especially in regions where the mining sector is concentrated. The weak rupiah makes Surpac’s products, invoiced in Australian dollars, much more expensive than before the crisis. Lack of language training and poor English amongst Indonesians can be a problem. Nevertheless, Surpac generally is comfortable with the prospects for its current Indonesian operations.


**Education services**

Australian educational institutions’ good reputation, effective marketing strategies and relatively low tuition fees mean Australia attracts around 40 per cent of all Indonesian students pursuing overseas studies; this proportion is higher than any other education provider achieves (Table 5.6). In one innovative approach, Monash University and University of New South Wales in conjunction with an Indonesian company, have opened pre-university classes in Jakarta, guaranteeing placements for graduates at either institution.
**Table 5.6**

**Australia Is Main Exporter of Education Services**

Exports of Education to Indonesia in 1998

<table>
<thead>
<tr>
<th>Exporter</th>
<th>Estimated number of students</th>
<th>Market share in terms of number of students (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>17,462</td>
<td>43</td>
</tr>
<tr>
<td>United States</td>
<td>13,282</td>
<td>32</td>
</tr>
<tr>
<td>Germany</td>
<td>3,400</td>
<td>8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>2,000</td>
<td>5</td>
</tr>
<tr>
<td>Other</td>
<td>4,856</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>41,000</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>


Prospects for exporting education services from Australia remain excellent, given Australia’s geographic proximity and established reputation within the region.

**TRENDS IN DIRECT INVESTMENT**

Opportunities stemming from the financial crisis should boost traditionally small investment flows between Australia and Indonesia. Sales of assets to repair Indonesia’s bank and corporate sectors provide opportunities to increase significantly Australian direct investment in Indonesia. Australian investment in Indonesia drives bilateral investment flows, with overall investment around A$1.2 billion in 1997-98; close to A$800 million of this was direct investment. Around 400 Australian companies have a permanent presence in Indonesia, including BHP, Rio Tinto, ANZ, Commonwealth Bank, Amcor and Telstra.

**AUSTRALIAN DIRECT INVESTMENT IN INDONESIA**

Indonesia’s population (the fourth largest in the world) and market size, relatively low cost labour, abundance of natural resources and geographical proximity traditionally have attracted Australian investment. Although Indonesia ranks twenty second as a destination for Australian investment, accounting for only 4 per cent of total foreign investment, it attracts more Australian investment than any other ASEAN economy except Singapore (Directory of Australian Business in Indonesia, 1999). In April 2000, Australia ranked as Indonesia’s ninth largest source of accumulated direct investment (KPMG, 2000). This is concentrated in mining, utilities and chemicals (Table 5.7).

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8 Compared to other ASEAN economies, Indonesia (at 22) ranks ahead of Malaysia (at 23), Thailand (at 26) and Philippines (at 31). It also ranks ahead of Taiwan (at 29). See Australian Bureau of Statistics (2000) for more details.

9 Although Australian investment in Indonesia mostly comprises direct investment in companies, total foreign investment also includes portfolio and other investment.
Table 5.7
Mining Investment Dominates Australian Foreign Investment
Cumulative Approvals of Australian Direct Investment in Indonesia, 1967 to 31 May 2000a

<table>
<thead>
<tr>
<th>Sector</th>
<th>Per cent share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining</td>
<td>34</td>
</tr>
<tr>
<td>Utilities</td>
<td>26</td>
</tr>
<tr>
<td>Chemical industry</td>
<td>20</td>
</tr>
<tr>
<td>Construction</td>
<td>4</td>
</tr>
<tr>
<td>Other services</td>
<td>4</td>
</tr>
<tr>
<td>Other sectors</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
</tr>
</tbody>
</table>

Note: a Data are approvals only and do not include oil and gas, and financial and insurance sectors.

Direct Investment in the Pre-crisis Period
Between 1991-92 and 1996-97, the level of Australian direct investment in Indonesia increased more than eight fold (Figure 5.12). Most was concentrated in the resources and construction sectors.

Figure 5.12
Australian Direct Investment Has Fallen Slightly since the Crisis
Australia's Flow of Foreign Investment in Indonesia, 1992-98

Mining companies BHP and Rio Tinto are particularly active in Indonesia. They established large scale operations for mining coal, gold and tin; BHP alone employed around 4 000 people in Indonesia by 1996 (BHP, 2000a). Indonesia’s extensive infrastructure requirements also generated significant investment opportunities for Australian infrastructure and construction companies during this period. As tariffs decline, clothing, footwear and textile manufacturing enterprises, increasingly attract Australian investment.

**BHP’S INDONESIAN COAL OPERATIONS**

BHP has a significant coal mining presence in Indonesia. In Kalimantan, PT Arutmin Indonesia (80 per cent BHP, 20 per cent PT Bakrie and Brothers) operates the Senakin and Satui mines, and North Pulau Laut coal terminal. PT Kendilo Coal (80 per cent BHP, 20 per cent Mitsui Mining Company) manages the Petangis mine, also in Kalimantan.

BHP’s Indonesian mines exported 6.8 million tonnes of coal in 1999, up 15.7 per cent on the tonnage exported in 1998. The Satui mine was constructed in 1989 and the Senakin mine, constructed in 1991, was expanded in 1994 to increase its capacity to 4 million tonnes per year. The Petangis deposit, developed in 1994, produces 1 million tonnes per year.

Source: BHP, 2000b.

**MANUFACTURER XYZ**

Manufacturing firm XYZ, a prominent Australian company, has maintained a direct investment presence in Indonesia since the mid 1970s, producing both for the local market and export. Manufacturer XYZ is a joint venture with two local partners; it holds a majority, but not a controlling interest. Since the financial crisis, XYZ’s profit has increased. This is because the depreciated rupiah increased export competitiveness, and the company’s access to foreign currency funding during the financial system collapse gave it a significant competitive advantage. Access to capital allowed the company to guarantee clients of product supply, a priority when doing business in Indonesia. Manufacturer XYZ maintains close relationships with business partners and the local community who highly regard the Australian manager. Manufacturer XYZ has learned to deal effectively with intra-firm politics.

Manufacturer XYZ points out companies now entering Indonesia may face legal uncertainty and difficulties in obtaining finance, even from foreign institutions. It also considers slowing economic reforms a concern.


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10 Other Australian companies with substantial investments in Indonesia in mineral exploration and production include Aberfoyle Ltd (copper and gold), Aurora Gold Ltd (gold), Laverton Gold (gold), Meekatharra Minerals (gold and silver), Newcrest Mining Ltd (gold and silver), Pelsart (gold), Placer Pacific (gold and base metals), Wesfarmers Coal Pty Ltd (coal), North Ltd (gold) and WMC (coal). (See Australia-Indonesia Business Council web site, OzIndo Online).

11 This firm’s name was suppressed at the request of the company for commercial-in-confidence reasons.
Several financial institutions, including ANZ and Colonial have established banking and insurance joint ventures.

**COLONIAL ACTIVE IN INDONESIA’S INSURANCE SECTOR**

With the life insurance market’s strong recovery from the financial crisis, Astra CMG Life, a joint venture between Australia’s Colonial Mutual Group and the Astra Group, saw income from premiums jump 55 per cent in 1998. By the end of 1998, the company had 315,000 customers and 1,500 employees. In 1999, to respond to strong growth, Astra CMG Life opened five new branches, adding to the existing branch network of 20 offices.

The low coverage of the national pension scheme and a growing middle class generate considerable growth opportunities for insurance companies in Indonesia that now can be 100 per cent foreign owned. Life insurance requires a long term strategic commitment; Colonial Mutual Group’s commitment is based on market potential. The current penetration of life insurance is less than 3 per cent of the Indonesian population; in other Asian neighbours, the penetration rate is more than 20 per cent. Indonesia’s population is large; the economy is improving; and consumers’ disposable income is increasing. Therefore, the life insurance industry should flourish. Consumer awareness of the value of creating wealth for retirement and family protection is increasing rapidly; this also strengthens confidence that the growth potential for the life insurance industry in Indonesia is strong.

Astra CMG Life, a 50:50 joint venture of the Colonial Group (Australia) and Astra International (Indonesia), was established in October 1992, after a two year market appraisal. As the life insurance market matured, Astra CMG Life expanded, and developed new products and services to meet the changing needs of the Indonesian market, providing savings, investment, health and traditional risk products. The joint venture offers the strong branding, consumer awareness and success of a large local partner that survived the financial crisis and Colonial’s financial strength. Colonial contributes growth via shareholder capital injections and its international experience, allowing transfers of state-of-the-art products, systems and services to Indonesia.

Despite the financial crisis, Astra CMG Life grew by more than 20 per cent per year, and recorded profits in both 1998 and 1999. Unlike in other Asian economies, the insurance industry does not suffer excessive legal and regulatory restrictions. However, the rupiah continues to be volatile, and tools such as currency swaps and options to hedge against currency fluctuations are limited.

Consumers and businesses overwhelmingly support foreign financial service companies which offer secure investments. Therefore, Astra CMG Life believes growth opportunities in this market are equal to or better than those elsewhere. From the Indonesian Government’s perspective, foreign financial service companies help retain savings in Indonesia.

Direct Investment since the Financial Crisis

With increased perceptions of risk, Australians divested A$40 million from Indonesia in 1997-98, reducing the level of Australian direct investment by around 5 per cent (Figure 5.12).

In 1999, programs reforming the financial and corporate sectors bolstered investor confidence, although sensitivity to slippage in implementation remains. A low exchange rate and assets sales encouraged Australian investors to return to Indonesia. In 1999, Australian companies gained approval for 54 new investment projects and expansions on existing investment valued at US$2.5 billion, placing Australia second in terms of the value of approvals.12 In October 1999, P&O Ports (Australia) invested US$170 million acquiring a 49 per cent share in the Surabaya Tanjung Perak port container (Buchannan, 2000). Australian firms continue to pursue new investments in 2000, with approvals for 34 new projects worth a total of US$32 million given between January and July 2000. In July 2000, BHP announced it had reached agreement with Falconbridge Limited to form a joint venture which may develop the Gag Island nickel laterite project (BHP, 2000c).13

Foreign investor confidence appears to be increasing; Indonesian balance of payments show foreign direct investment approvals during the third quarter of 1999 exceeded all 1998 approvals. Foreign interest was concentrated in the chemicals, electricity, gas, water and paper sectors; these traditionally have attracted strong interest. (See Chapter 3 - Foreign Investment, particularly Table 3.1.)

INDONESIAN DIRECT INVESTMENT IN AUSTRALIA

Official data indicate Indonesia’s direct investment presence in Australia was A$55 million in 1997-98 and has risen somewhat since the crisis (Figure 5.13). Low investment levels partly reflect Indonesian investor preference for Australian portfolio and other financial assets. Also, some Indonesian investment may arrive via Singapore, and be included in Singaporean data.

INDONESIAN DIRECT INVESTMENT OUTLOOK AND OPPORTUNITIES

The Economist Intelligence Unit forecasts foreign direct investment in Indonesia will grow by 20 per cent per year between 2001 and 2003 (Buchannan, 2000). A dynamic and competitive export sector provides an ideal environment for start-up investment. Ongoing sales of corporate and financial assets also promise new opportunities for Australian investment in Indonesia. Australia is well placed to consolidate its commercial presence in the mining sector, as well as increase its presence in the infrastructure, manufacturing and financial sectors. However, doubts over economic, political and social stability, and an underdeveloped legal system could dampen new direct investment prospects. (See Chapter 3 - Foreign Investment.)

12 However, approval for a large waste water project in Riau province, worth US$2.2 billion, was the main reason for this very sharp increase.

13 At this stage, the basis of the agreement is that Falconbridge would spend US$75 million to gain a 37.5 per cent interest in the Gag Island project, with BHP and PT Aneka Tambang holding 37.5 per cent and PT Aneka Tambang holding 25 per cent interests in the project. Currently, BHP holds a 75 per cent interest in the project and PT Aneka Tambang holds the remaining 25 per cent.
The rupiah’s low value and trade reform are stimulating export sector activity, providing Australian business with a potentially attractive manufacturing base from which to serve the Asian market. The Government’s ongoing asset sales also should encourage Australian companies to consider investing in Indonesia. Survey evidence suggests Australians established in Indonesia anticipate their operations will expand, although levels of risk remain moderate to high.

**Investing in the Export Sector**

Indonesia’s competitive exchange rate and the recovery in its trading partners’ economies is creating a dynamic export sector. Liberalised foreign direct investment laws have made this sector more accessible to foreign firms, which increasingly are locating to large export-oriented industrial estates across Java and elsewhere in Indonesia. Access to foreign funds reduces these firms’ reliance on the domestic banking sector (World Bank, 2000).
Asset Sales

The Indonesian Bank Restructuring Authority, IBRA, currently holds Rp. 564 trillion (US$65 billion) of the economy’s productive assets. While some will be returned to previous owners through debt workouts, many eventually should be sold through share market floats, open tenders, auctions, liquidations and sales to strategic buyers. IBRA sales target foreign investors with marketing skills and technological knowledge (KPMG, 2000). When IBRA lists assets for sale, it provides an information memorandum, detailing the assets and relevant financial information. This allows all potential purchasers to conduct thorough due diligence assessments on assets.

Further, many Indonesian firms not attached to IBRA also seek partners to inject equity, provide access to new markets and increase efficiency (Allan, 1999).

Increasing Australian Investor Confidence

Over 80 per cent of recently surveyed Australian businesses in Indonesia plan to expand their operations, even though over 90 per cent consider risks moderate to high (Table 5.8). Many observers remain optimistic about the prospects for Australian investment in Indonesia.

Table 5.8
Australian Businesses Plan Expansion
Investor Confidence and Risk

<table>
<thead>
<tr>
<th>My firm’s future business operations in Indonesia will:</th>
<th>The level of risk associated with Indonesia is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expand</td>
<td>Contract</td>
</tr>
<tr>
<td>80 per cent</td>
<td>0 per cent</td>
</tr>
</tbody>
</table>


Improving Corporate Governance

New government reforms offer a more transparent corporate and financial sector. Improved accounting systems and disclosure requirements eventually should ensure more information is available on prospective investments, reducing the level of risk. Government reforms of the legal system and tighter supervision of capital markets also should help improve corporate governance. New foreign investment is likely to disperse the level of industrial concentration, increase competition and improve the quality of resource allocation, strengthening the operating environment for new firms.

14 This survey was conducted in May 2000 by KPMG Chartered Accountants on behalf of Australia-Indonesia Business Council. All 45 survey respondents were council members. Council members represent a cross-section of Australian organisations directly involved with Indonesia; therefore, their knowledge of Indonesian conditions and opportunities is extensive.

15 Managing director of the Australian Trade Commission, Austrade, Charles Jamieson believes ‘there could hardly be a better time than now to reinforce our commitment to this market and our bilateral relationship’ (Indonesia-Australia Business Council News, May 2000, p. 1).
INVESTOR ISSUES TO EVALUATE

However, Indonesia’s rapidly changing environment introduces uncertainties that may weigh on foreign investment flows. These include decentralisation and the possibility of higher taxes.

Decentralisation of the Approval Process

Regional devolution is shifting responsibility for reviewing foreign investment applications to regional foreign investment boards, raising the risk that new taxes and charges may be introduced, making the application process more complex. (See Chapter 2 - Political Developments.)

Fiscal Uncertainty

The need to reduce government debt incurred to refinance the banking sector may lead to higher corporate tax rates in the medium term, possibly deterring foreign direct investment. However, higher oil revenue in 2000 and 2001 should help the fiscal situation.

Weaknesses in the Legal System

While recent commercial court developments have been encouraging, the Government’s reform of the legal system will take time, and some foreign investors may defer investments until the new system is functioning fully.

AUSTRALIAN BUSINESS LINKS WITH INDONESIA

The Australia-Indonesia Business Council is the main industry group promoting business relationships between the two countries, and comprises more than 700 members including large corporations, medium and small enterprises. The council aims to represent the interests of members in bilateral commercial and trade matters relating to Indonesia, and foster friendship and cultural understanding between the business communities and people of Australia and Indonesia.

Each year, the council and the Indonesia-Australia Business Chamber of Commerce, based in Indonesia, hold a joint business conference, alternating between venues in Australia and Indonesia. Business people from both countries and officials from both governments attend this conference. Contact details of the Australia-Indonesia Business Council are at the end of the report.

IMPLICATIONS

Australia’s proximity and complementarity to Indonesia’s economy suggest significant potential for further developing the already healthy commercial relationship. A flourishing export and small and medium enterprise sector provide new opportunities for Australian investment. New laws further opening the Indonesian economy to trade and foreign investment, coupled with the program of asset sales, provide a unique opportunity for the Australian business community to increase its engagement with Indonesia. A growing middle class points to new opportunities for a range of Australian producers and service providers. Appropriate risk management strategies continue to be important.
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Department of Foreign Affairs and Trade, 2000, Stars Database, accessed on 23 November 2000.


DOING BUSINESS IN INDONESIA

KEY POINTS

• The Government’s reform program, including measures addressing corporate governance and the legal system, is changing the business culture.

• The Indonesian market rewards Australian businesses that take time to develop strong personal relationships and community ties.

• Managing a business in Indonesia requires a sound understanding of the culture’s influence on hiring, training and managing staff.

• Navigating Indonesia’s legal and regulatory system is best done with the aid of a notary; consulting a notary when setting up a company, obtaining approval for foreign investment and drafting a contract is strongly advised.
Operating successfully in Indonesia requires patience and an understanding of influences affecting business culture, and legal and regulatory environments. Many promising changes underway in the Indonesian business environment eventually should help Indonesia emerge as an attractive investment destination and profitable market for Australian companies.

This chapter analyses cultural influences on business and identifies ways to use these to commercial advantage. It assesses the possible impact on the commercial environment of reforms introduced since the financial crisis. Finally, the chapter analyses significant aspects of the changing regulatory and legal environment relevant to undertaking business.

**INDONESIAN BUSINESS CULTURE**

Businesses understanding and capitalising on cultural influences are more likely to succeed than those simply ‘coping’ with them. This section identifies how foreign firms can use local approaches to their advantage.

**Importance of Building Relationships**

Investing in relationships is critical to succeeding in Indonesia. Establishing a relationship requires time, preferably with face-to-face contact with a person of similar age and status. Demonstrating loyalty and trustworthiness is critical to maintaining a relationship. The longer term returns of investing in relationships can be significant and include:

- expediting bureaucratic processes where the relationship is with a government official
- accessing information and distribution networks
- opening joint venture opportunities, especially in manufacturing.

Relationships can determine many facets of commercial life, including granting credit, placing orders and awarding contracts. A longstanding obligation between two people can affect commercial outcomes. Showing patience and flexibility in commercial dealings builds trust and improves the chances of a successful outcome; contrasting expectations can have adverse consequences. Australian business people should not ‘force’ a relationship, or overestimate its depth.

Variables including age, gender, educational and marital status, also affect how easily personal and commercial relationships are formed. Western firms may find it more productive to send older, more mature executives rather than young personnel to negotiate or work in Indonesia. Men especially are not considered mature until they are 40 years old, and younger people can be excluded from decision making processes. In all spheres, younger people defer in language and attitude to older people, even if the age difference is negligible.
Business as Part of a Community

The group’s welfare predominates in Indonesian culture, so the local community is very important. Foreign businesses fulfilling their obligations to those living and working in their immediate neighbourhood stand to gain significant advantages.

The local community centres around the neighbourhood council, comprising a group of five to 40 houses (a RT or Rukun Tetangga), that together form a larger unit (a RW or Rukun Warga). Informal meetings of RT and RW are held monthly, and businesses are expected to notify each of these bodies of their arrival in the local community.¹

The neighbourhood council can assist local firms, including:

- expediting bureaucratic processes, such as obtaining permits
- resolving disputes through the musyawarah, an important process of conflict resolution involving all concerned parties. A policeman convenes the musyawarah, and the results are based on community consensus. Its concluding communiqué outlines the consensus decision. Its decisions have a very strong legitimacy in the community, as all parties have been consulted and involved in the process. An official materai (tax stamp) is often affixed, increasing this legitimacy
- forming the first line of defence against acts of crime through surveillance and information sharing.

Businesses in Indonesia are well advised to develop a genuine awareness of their surrounding community. Demonstrating a business contributes to community welfare helps ensure the community has an interest in protecting the business. Unless a venture seeks local community involvement, providing employment and investment will not ensure good relations or security.

The concept of traditional land ownership remains strong across Indonesia, and irrespective of contractual rights the Government may award, local communities will act to protect their environment. Hence, mining companies adopting consensus based approaches to secure their rights are more likely to receive local community support than those relying on legal solutions.²

IMPACT OF RECENT REFORMS ON THE BUSINESS ENVIRONMENT

Government and broader society are responding to the financial crisis and the ending of the New Order regime, and gradually changing business practices. Indonesians are increasingly proactive in championing social justice and transparency.

New government reforms and laws passed since 1997 governing corporations are changing the business environment. For example, new corporate financial reporting and shareholder accountability laws increase business transparency and information, especially for those seeking to invest in existing

¹ These meetings commonly are held on the seventeenth of each month.
² Under the Soeharto regime, local communities often were by-passed in the consultation process for projects, or were pressured to accept very unfavourable terms. Foreign mining companies often were unaware of this, and many are shocked by recent developments at their mines.
ventures (Jakarta Post, 28 April 2000). New bankruptcy and capital market laws conform with international best practice, clarifying firms’ obligations to creditors and shareholders. Newly introduced laws covering anti-competitive behaviour also protect new entrants from predatory behaviour by existing market players. Recent audits of government institutions and investigation of state officials and bureaucrats eventually should improve the quality of the public service. Indonesian Bank Restructuring Agency, IBRA, sales of Indonesian corporations and banks may dilute the concentration of asset ownership in the economy over coming years, especially through increasing foreign ownership and competition between companies and industrial groups. (See Chapter 8 - Corporate Restructuring.) Nevertheless, implementing these new laws will take time and resources, so gains will not be immediate; the Government recognises this is the case with legal system reforms.

MANAGING A BUSINESS IN INDONESIA

The gradual change in business culture since the crisis generates both opportunities and uncertainties for foreign managers. Basic features of society are likely to adapt to, rather than be replaced by new approaches to doing business. Corporations investing in training and language skills are best placed to take advantage of these opportunities.

Approaches to Management

Firms should devise management systems to interface as far as possible with local approaches, accommodating hierarchy and encouraging social interaction in the workplace. While these may appear less efficient from an Australian perspective, they usually suit the Indonesian environment.

Firms need to recruit carefully at all levels, as unsatisfactory performance is not sufficient reason to dismiss a worker. Dismissal for misconduct can occur only after issuing three warnings, spaced three months apart. More culturally acceptable ways of dismissing a worker include negotiating, facilitating a face-saving exit or paying a lump sum. As a preventative step, firms can engage employees on pre-agreed one to three month contracts. 3

Remuneration packages usually have several components, a basic wage (gaji pokok) and allowances for transport, meals, attendance, and occasionally, productivity. Sometimes, married men with children receive an additional sum. Annual bonuses equal to one month’s wages are paid either just before Lebaran (the annual Islamic celebration) or Christmas, depending on the worker’s religion. Foreign owned companies generally pay higher wages. 4

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3 The Department of Manpower, Depnaker, regulates employment practices in Indonesia, including conditions of employment and labour-employer relations. Work contracts for groups and individual workers are common in Indonesia; the Depnaker approves them, and typically they operate for one to three years.

4 Worker insurance is very underdeveloped; Jamsostek, the government backed insurance scheme, only nominally protects workers for accidents, health and old age pensions. Premiums add 7 to 11 per cent to total wage bills. As Jamsostek’s compensation rarely covers medical or living expenses, the employer supplements the payment if an accident occurs (Depnaker, 1997).
PT OKUSI MARBLE IN EAST JAVA

Okusi Marble, a small Australian owned enterprise, successfully accesses local East Javanese artisans by carefully managing cultural issues. The firm manufactures highly ornate marble fireplaces for export to the US market. The workshop in a small village in rural East Java is strongly traditional, with social structures centred around village leaders.

The workshop employs more than 40 people, nearly all from the village or neighbouring areas, including artisans, carvers, saw and lathe operators, and polishers. By employing people who live locally, the firm reduces the incidence of absenteeism that can disrupt operations in Indonesia.

Okusi Marble’s managers always seek to balance their commercial needs with worker and local community priorities. Its methods for dealing with conflict complement local approaches, and are largely successful. By ensuring the local community benefits from the firm’s prosperity, Okusi Marble ensures its managers are well positioned when negotiating with the local community. To retain local community support, at times, the firm has accepted practices that, in the west, may seem inefficient.

Its managers are well educated Yogyakarta graduates, and its less educated workforce is comfortable taking directions from them, minimising the chances of conflict. Because the managers speak Indonesian and labourers speak ‘low’ Javanese, the foremen act as intermediaries, communicating with both groups.

Source: Dean, 2000.

Training and Staff Morale

Whilst low labour costs induce businesses to locate in Indonesia, often workers need training to optimise productivity. To train successfully, firms need to be culturally sensitive and willing to adapt. Companies that train bright new graduates in basic skills, including computing and report writing, usually are rewarded with loyal and productive employees. Across Indonesia, the ability to speak English increases a person’s status; consequently, this training engenders loyalty and productivity in employees.

A failure to provide an appropriate social environment in the workplace may lead to absenteeism. A more clinical business style with separate business and social activities usually is inappropriate in the Indonesian setting.

The Bureaucracy

Developing relationships with government officials is particularly useful in streamlining the application process for obtaining licences, permits and information. Bureaucrats or ‘national officials’ (pegawai negeri) traditionally are treated with respect and deference. Government initiatives have brought real and significant improvements in recent years to the way the bureaucracy works, making it easier for firms wanting to conduct business in Indonesia (Dean, 2000). Nevertheless, pay levels remain low and transparency is still a major issue.
THE REGULATORY ENVIRONMENT

Recent government initiatives have streamlined the regulatory environment for western firms, through relaxing laws governing foreign company structures and simplifying the processes for forming a company. Despite these initiatives, traditional notaries are vital in legal and regulatory matters, especially in drafting contracts. Business contracts should be seen in their broader cultural significance, and are more likely to be adhered to where key relationships are maintained.

Legal System

Indonesia’s new bankruptcy, capital market and company laws now are based on international best practice, but the Government is aware implementation needs to be improved. In several instances, courts failed to prosecute prominent figures of the New Order regime, often on technical grounds. (Straits Times, 6 April 2000; and Straits Times, 12 April 2000). Hence the Government’s new initiatives include appointing ad hoc judges to commercial courts to improve the operation of the legal system. (See Chapter 8 - Corporate Restructuring.) Together, these initiatives aim to provide greater certainty to creditors and investors across the Indonesian corporate sector.

Role of Notaries

Hiring a notary, or local legal expert, is the most efficient way of navigating the Indonesian legal and regulatory system. These government registered legal officers play an important role in commercial dealings in Indonesia; companies should invest in building a relationship with a reputable notary. Apart from understanding the law, notaries have extensive networks of contacts and high social standing; they can expedite many bureaucratic processes. Notaries can obtain investment approvals, incorporate a company, and secure licences and permits to operate a company. While most of this paperwork does not legally require a notary, often one person can more conveniently handle all these matters. A contract drawn up and co-signed by a notary carries more legitimacy than one drawn up by a non-notary. Elaborate signing ceremonies have important symbolic value and increase the contract’s prestige and legitimacy.

However, many notaries are unfamiliar with processes relevant to foreign investors, and their knowledge and fee structures vary considerably. Provincial offices of the Investment Coordinating Board, BKPM, can suggest notaries experienced in foreign investment, although their rates often are higher than those of other notaries. Indonesian based business consultants normally use their own experienced notaries.

Role of Contracts

Contracts have a very important place in Indonesian business, although their role may differ from western practice. Individuals are unlikely to breach contracts reached through consensus with a group of distinguished peers. Compared with their foreign counterparts, many Indonesian contracts
are less detailed and the negotiations are more likely to influence their meaning. While contracts often outline specific details, including obligations and dates, Indonesians commonly assume contracts will be subject to ongoing negotiation and interpretation, if circumstances change.

To honour contractual obligations, firms cannot simply rely on a signed document. They also must maintain relationships at many different layers of business, government and the community. To secure binding business agreements, social pressure is more important than legal documents.

Contracts generally are in Indonesian, except where large Indonesian corporations are involved; here English often is used. Firms should obtain more than one English translation.

**Foreign Business Structures**

Recent legislation allows 100 per cent foreign owned companies to operate in most sectors. In many cases, however, foreign investors may seek joint venture partners to complement their skills and resources. (See Chapter 3 - Foreign Investment.) The foreigner’s depth of knowledge of the local business environment should influence the level of local cooperation sought. Local partners generally have knowledge of the Indonesian economy and society. However, those already familiar with the local business environment often choose outright foreign ownership. The need to access local distribution channels, and business and bureaucratic contacts also will influence a decision to enter a joint venture.

In some instances, businesses opt for long term, performance based contractual arrangements with Indonesian companies rather than joint ventures. Fully owned structures allow complete control by the foreign entity, and remove the potential for disagreement inherent in joint ventures and partnerships.

In many joint ventures, Indonesian partners with local expertise exercise on-the-ground control, although the Australian partner maintains an important presence. Joint ventures require careful research, as mistakes can be costly and withdrawal difficult. However, well chosen joint venture partners should provide access to local expertise and cultural knowledge, distribution networks and links to the corporate sector and bureaucracy. When seeking a joint venture partner, Australian companies should seek Indonesian partners with a similar company structure and culture, although these may not be common. Major differences in perceptions and expectations amongst foreign and local partners are common, with disagreement over the organisation and management of the joint venture most problematic (Dean, 1999).

**Setting up a Company**

Recent reforms streamline procedures for foreign firms establishing operations. Investors must submit a brief business plan and outline the proposed structure of the company to the provincial office of the BKPM; approval takes at least ten working days. However, a good relationship between the investor and the relevant bureaucrat helps reduce processing time. Local officers undertaking the preliminary

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6 The firm then receives a letter of agreement (surat per cetujuan).
work may request a very small processing fee. Once the company structure is approved, the investor
must apply for licences from local authorities, a process often fraught with bureaucratic chicken and
egg situations. For example, before obtaining company articles of association with the central office
of the Law Department in Jakarta, a firm must provide documentary evidence that it has deposited
share capital in its bank account. However, to open a company bank account, a firm must produce
registered articles of association. Depending on the quality of the relationship between the investor
and BKPM officials, the latter can assist in these processes.

IMPLICATIONS

Understanding Indonesian culture and applying it to management and negotiating situations can
generate substantial commercial and personal benefits for foreign businesses operating in Indonesia.
Given the time required to establish relationships and networks, business people should plan for
longer horizons to achieve returns. Also, with the rapid economic and political change currently
underway, firms must remain responsive to the evolving business culture.
REFERENCES


INDONESIA

FACING THE CHALLENGE
KEY POINTS

• 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 provide firm foundations for the future.

• The Government’s determination to repair and reform Indonesia’s financial sector and ensure the economic recovery continues is generating opportunities for foreign financial institutions and service suppliers.

• These opportunities stem from the Government’s sale of restructured loans, and bank and corporate assets it currently holds, as well as the relaxation of foreign investment laws in the financial sector.

• Performance of the newly recapitalised private sector banks improved over 2000, and they resumed modest credit expansion.

• However, the banks’ non-performing loan levels remain high at 30 per cent, and the slow pace and in some cases, shallow nature of corporate restructuring is slowing a return to health. State banks, which hold the majority of the bank deposits, should be recapitalised by the end of 2000, but they have the highest share of non-performing loans and concerns exist regarding the extent of their managerial restructuring.
The Government recognises repair and reform of Indonesia’s financial sector is key to restoring sustainable economic growth, and drives the significant changes occurring in this sector. The Government has announced it will use the reform process to re-position Indonesia’s financial sector in line with international best practice, adopting substantial measures to reduce and limit exposure to risk, introduce international capital adequacy ratio, CAR, standards, sell assets to the private sector and increase sector-wide supervision using an independent agency. As these reforms are implemented, the financial sector should become more transparent, open and regulated. However, in the short term, the Government is balancing national concerns about employment and maximising returns on assets with these longer term objectives.

By late 2000, the Government’s major program of restructuring and refinancing the banking system was essentially complete, and in 2000, some banks were starting to extend new loans. Bank Indonesia reported new bank lending in June and July 2000 reached 6 per cent of bank assets, although this also included restructured loans (World Bank, 2000a). However, this refinancing program was expensive, costing at least 75 per cent of GDP.

Central to restoring banking sector efficiency is the Government’s return of nationalised bank assets to efficient private ownership. Australia’s financial institutions and dynamic financial sector are well placed to access these opportunities and provide support for associated reforms. This chapter describes the impact of the crisis on the financial sector, and details the Government’s response. It outlines the opportunities for foreign direct investment in Indonesia’s financial sector and exports of financial services to Indonesia.

**IMPACT OF THE CRISIS**

The Asian financial crisis much more severely affected the Indonesian banking sector, and through it, the corporate sector, than occurred elsewhere in the region. Inadequately monitored deregulation intensified the banking sector’s vulnerability to crisis and the crisis’ effects on the sector.

**Banking Sector Vulnerability**

The rapid growth of undercapitalised banks and their lack of supervision made the Indonesian banking sector highly vulnerable to the crisis. As the financial sector was deregulated in the 1980s, bank numbers more than doubled from 111 in 1988 to 240 in 1994. Large conglomerates founded many banks to serve their own commercial funding requirements and often to lend to related parties. Where lending was at arm’s length, collateral values rather than credit and cash flow analysis determined loan suitability. Expectations of persistent strong economic growth and ever increasing asset prices encouraged and disguised risky lending practices. Finally, many banks undertook significant unhedged, short term foreign currency liabilities.

As in many other regional economies in the 1990s, and Australia in the 1980s, bank deregulation inadvertently weakened banking system prudential controls. For example, when regulators removed controls on banks’ foreign borrowing and asset allocations, some banks did not increase their own risk management strategies, exposing themselves to risky foreign borrowing and domestic lending. Regulations allowed banks to minimise reporting of under-performing loans in their portfolios through

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1 Capital adequacy ratio is the ratio of bank equity to total bank assets, weighted by assets’ level of risk.
various practices, including reclassifying loans as performing after only one payment (International Monetary Fund, 2000a). Banks made limited provisions against non-performing loans and were significantly undercapitalised, increasing their vulnerability to a deterioration in loan quality.

**Impact on the Financial Sector**

The Asian financial crisis quickly exposed these financial sector weaknesses. By early 1998, the rupiah’s 70 per cent depreciation had damaged most banks’ balance sheets. Firstly, it increased dramatically the domestic value of banks’ own unhedged foreign currency borrowing. Secondly, the corporate sector’s over-exposure to short term foreign currency debt impaired its ability to service domestic loans, causing non-performing loans to escalate. This reduced further banks’ CARs, in many cases to negative values. Thirdly, throughout early 1998, as Bank Indonesia lifted interest rates on deposits in response to the depreciating exchange rate, bank revenue flows fell as banks could not pass higher rates on to distressed corporate borrowers. During most of 1998, this resulted in negative interest rate spreads, reducing banks’ net income and damaging their capital adequacy.

**RESPONSES TO THE CRISIS**

Initially, the Government responded to the crisis with an ‘emergency’ program to guarantee bank deposits and quickly repair the banking system using public funds to recapitalise it. The Government’s longer term, ongoing response is to restructure non-performing loans in the banking sector, return the nationalised banks and associated assets to the private sector, and thoroughly overhaul the regulations governing the financial system.

**Initial Response**

In January 1998, the Government announced its immediate priorities were to:

- restore confidence in the financial system by guaranteeing deposits\(^2\)
- consolidate the banking industry by liquidating insolvent banks which failed to meet minimum CAR and non-performing loan standards
- recapitalise banks with weak CARs, but which met minimum capital adequacy levels.

To implement the first objective, Bank Indonesia allocated large amounts of liquidity support to banks facing runs on their deposits. To achieve the remaining objectives, the Government established the Indonesian Bank Restructuring Authority, IBRA, under a January 1998 presidential decree.

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\(^{2}\) In an attempt to boost depositor confidence and demonstrate a commitment to reform, the Government liquidated 16 insolvent private domestic banks in November 1997. However, the announcement of bank closures intensified runs on private domestic banks, threatening a collapse of the banking system in early 1998. Bank Indonesia responded with liquidity support to the affected banks, and in January 1998, the Government announced a blanket guarantee for all depositors and creditors of domestically incorporated banks. Presidential Decree No. 26 stipulated the Government Guarantee for Commercial Bank Liabilities, pledging all payments related to the liabilities of commercial banks would be covered, including inter-bank transactions and trade finance (Indonesian Bank Restructuring Agency, 2000).
Establishing IBRA

On behalf of the Government, IBRA oversees financial sector rehabilitation. Its role is to:

- assess the adequacy of bank capital, and restructure viable banks through merger and recapitalisation, starting with private banks then state banks
- close non-viable banks and take over their assets; these functions were delegated to the Bank Restructuring Unit, BRU
- manage and sell corporate assets received as collateral for Bank Indonesia liquidity support; this function was delegated to IBRA's Asset Management Unit, Investments, AMI, with asset sales undertaken by the Asset Disposal Unit, ADU
- transfer non-performing loans from banks' balance sheets to its Asset Management Unit, Credits, AMC, to manage and maximise recovery of these loans.

Restructuring Private Banks

During 1998, IBRA employed international accounting firms to assess the capital adequacy of all private banks. Then banks were classified as:

- category A, with CAR above 4 per cent, which were deemed healthy and not needing recapitalisation
- category B, with CAR between 4 and –25 per cent, which the Government decided to recapitalise providing they could demonstrate sound management and future viability; those unable to do so were liquidated
- category C, with CAR below –25 per cent, which were liquidated immediately.

IBRA classified 74 banks as category A banks, mainly small foreign joint ventures, holding only 5 per cent of total deposits. Of the 36 banks classified as category B, 21 subsequently failed to meet the IBRA's sound management criteria and were liquidated; IBRA took over a further seven banks; and the Government and their private owners identified a further eight for merger and recapitalisation. Seventeen banks, accounting for 0.9 per cent of total banking assets, fell into category C, and were liquidated immediately; their assets were transferred to IBRA in March 1999 (East Asia Analytical Unit, 1999).

Capital Adequacy Ratios and Non-performing Loans

The Government continues to determine whether a bank will come under IBRA supervision by using the minimum 4 per cent CAR. By the end of 2000, all Indonesian banks will be subject to this requirement. If a bank's CAR falls below 2 per cent, it will be transferred to IBRA. By the end of 2001, bank CARs must reach 8 per cent and non-performing loans must fall below 5 per cent. This requirement could continue to restrain banks' willingness to lend in 2001.

In March 2000, Bank Indonesia also required banks with non-performing loans exceeding 35 per cent of their outstanding loans to be placed under IBRA surveillance. In late 2000, average non-performing loan levels were 30 per cent of bank assets (Figure 7.1). If a bank's non-performing loan level exceeds 35 per cent, IBRA will monitor the bank for three to six months. By the end of 2001, bank non-performing loans must fall below 5 per cent.
Refinancing Banks

Bank refinancing has been very costly; the Government has issued about Rp. 650 trillion (US$75 billion) of sovereign bonds, equal to about 76 per cent of 1999 GDP. Around Rp. 268 trillion (US$31 billion) of these went to refinance state banks, and this program requires a further Rp. 18 trillion by the end of 2000 to complete it. IBRA also issued sovereign bonds worth Rp. 158 trillion (US$18.3 billion) to refinance 11 category B private banks and 12 regional development banks to raise their CARs to 4 per cent. Before receiving capital injections, banks must receive IBRA acceptance for their business plans and sign a performance contract.

A LEANER BANKING SYSTEM

The Asian financial crisis has profoundly affected the Indonesian banking sector, reducing the number of banks from 237 to 161 (Table 7.1). Government control of around 70 per cent of banking system deposits in Indonesia compares with 40 per cent in the Republic of Korea. Four state banks, Mandiri, BNI, BRI and BTN represent 50 per cent of banking system assets. In addition, through recapitalisation, the Government holds significant shares in private banks. Despite banks transferring Rp. 256 trillion (US$30 billion) of non-performing loans to IBRA, non-performing loans still represent 30 per cent of bank assets (Figure 7.1). However, banks have provisioned for 94 per cent of these (World Bank, 2000a).

In 2000, banks were beginning to lend again, and some were even starting to show profits. A June 2000 Bank Indonesia survey of 15 banks representing 75 per cent of total deposits showed these banks had extended Rp. 15.8 trillion (US$1.8 billion) new loans since the beginning of 2000, representing 5.7 per cent year to year growth. However, as this included restructured loans, the extent of new lending is unclear (World Bank, 2000a).

Restructuring State Banks

The Government anticipates state banks, which account for over 70 per cent of bank deposits, will be recapitalised by late 2000. State banks also have the highest share of banking system non-performing loans, reflecting weak credit analysis, risk management and accounting practices. Ongoing efforts have yet to produce adequate operational restructuring, including cutting staff and branch numbers or strengthening senior management teams. IBRA merged into Bank Mandiri, four state banks under its initial surveillance; this alone required Rp. 178 trillion (US$20.5 billion) in recapitalisation. Recapitalisation of the other state banks, including BRI, BNI and BTN followed. These banks’ non-performing loans were transferred to IBRA’s AMC.

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3 Around Rp. 220 trillion (US$25 billion) of this was used to cover Bank Indonesia liquidity to the banking system (World Bank, 2000b).

4 The Government also issued Rp. 218 trillion (US$25 billion) in bonds to honour its guarantee of bank deposits, including reimbursing Bank Indonesia for the liquidity support it issued to banks at the height of the crisis (World Bank, 2000b).

To refinance undercapitalised private banks, IBRA issued banks with government bonds in return for government equity in these banks and a proportion of their non-performing loans; these were transferred to IBRA.

5 In April 1998, IBRA merged eight nationalised banks into Bank Danamon, which had a CAR of 32.5 per cent.
### Table 7.1

**State Banks Now Dominate Rationalised Banking System**

Structure of Indonesian Banking System, 1997 and 2000

<table>
<thead>
<tr>
<th></th>
<th>Number of banks</th>
<th>Share of deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>State owned</td>
<td>34</td>
<td>43(^a)</td>
</tr>
<tr>
<td>Private</td>
<td>160</td>
<td>79</td>
</tr>
<tr>
<td>Foreign and joint venture</td>
<td>43</td>
<td>39</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>237</strong></td>
<td><strong>161</strong></td>
</tr>
</tbody>
</table>

Note: \(^a\) Of the 43 state owned banks in mid 2000, four were state owned before the crisis, 12 were nationalised recently, 26 were rural development banks and one was the export import bank.


### Figure 7.1

**Non-performing Loan Levels Falling, but Still High**

Banking System Assets, Rp. trillion

IBRA’S ASSET SALES

Now bank sector restructuring is nearly complete, IBRA’s priority is to sell its large stock of assets to the private sector to return them to productive use and reduce government debt accumulated through bank recapitalisation. However, IBRA does not intend to sell assets unless it receives what it regards as a fair price, and the sale does not threaten employment and output in the economy. Consequently, the Government has delayed asset sales. If IBRA asset sales resume in 2001 as announced, they should generate significant opportunities for foreign financial institutions and service providers.

Scope of IBRA Assets

IBRA’s assets have a face value of Rp. 564 trillion (US$65 billion). This includes loan portfolios transferred as part of bank restructuring (categories 1 to 4), non-performing loans (category 5), and equity in recapitalised banks and corporate assets, including banks, pledged as collateral for liquidity support (Table 7.2). Compiling, valuing and transferring these assets, with international accounting firm assistance, involved considerable effort and took IBRA until 2000 to complete.

IBRA recently enhanced its control over these assets by establishing compliance teams to monitor individual enterprises and identify specific problems. It also replaced the management of several enterprises under its control to maximise their sale value.

Table 7.2

**IBRA is Indonesia’s Biggest Creditor**

**IBRA Assets by Category, October 2000**

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value (Rp. trillion)</th>
<th>Value (US$ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category 1 to 4 loans transferred from frozen banks&lt;sup&gt;a&lt;/sup&gt;</td>
<td>40</td>
<td>4.6</td>
</tr>
<tr>
<td>Category 5, non-performing loans transferred from recapitalised, state owned, taken over and frozen banks&lt;sup&gt;b&lt;/sup&gt;</td>
<td>258</td>
<td>29.7</td>
</tr>
<tr>
<td>Indonesian government investment in recapitalised and taken over banks</td>
<td>139</td>
<td>16.5</td>
</tr>
<tr>
<td>Assets from shareholder loan settlements for Bank Indonesia liquidity credits</td>
<td>127</td>
<td>14.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>564</strong></td>
<td><strong>65.0</strong></td>
</tr>
</tbody>
</table>

Note:  
<sup>a</sup> IBRA categorises loans into five groups. Category 1 to 4 loans range from normal to special notice, but essentially currently perform, using the five-tier international criteria.  
<sup>b</sup> Category 5 loans are non-performing, having interest and capital outstanding for more than six months.


<sup>6</sup> Asset sales so far suggest the real value is significantly lower.
Sale of Banking and Financial Assets

The sale of IBRA’s sizeable bank asset holdings may present good investment opportunities for those seeking to enter the Indonesian banking sector. IBRA favours a market driven approach to sell fully recapitalised banks, using initial public offerings and private placements with strategic investors. Most banks under IBRA’s supervision are listed on the Jakarta Stock Exchange and hence will be relatively easy to sell. The size and high prudential and risk management standards of Australian banks should help them to access these opportunities. (See box on ANZ’s part purchase of Panin Bank, Chapter 3 - Foreign Investment.)

Since its inception in 1998, IBRA has generated revenue of Rp. 35 trillion, or about 8 per cent of its assets, via asset sales and interest earnings. Its asset recovery target for the nine month financial year 2000 is Rp. 18.9 trillion; it had realised Rp. 12 trillion of this by September 2000. In June 2000, IBRA sold off 22 per cent of Bank Central Asia’s shares realising 13 per cent of their book value.

IBRA intends to complete the sale of all nationalised banks by 2001, including selling a majority share of Bank Danamon. IBRA has indicated it remains committed to completing the privatisation of nationalised Bank Central Asia and Bank Niaga, despite deferring these sales in October 2000. Since the performance of seven recapitalised private banks improved in early 2000, IBRA also will sell some of its interests in these banks (Table 7.3).7

Table 7.3
Private Bank Non-performing Loans, Profitability Improving
Key Performance Indicators of Seven Recapitalised Private Banks

<table>
<thead>
<tr>
<th>Key indicators</th>
<th>Average percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital adequacy ratio, CAR</td>
<td>10.4</td>
</tr>
<tr>
<td>Ratio of loans to deposits</td>
<td>43.0</td>
</tr>
<tr>
<td>Ratio of non-performing to total loans</td>
<td>27.5</td>
</tr>
<tr>
<td>Provision for loan loss/total loans</td>
<td>11.1</td>
</tr>
<tr>
<td>Growth of total assets</td>
<td>0.6</td>
</tr>
<tr>
<td>Growth of total loans</td>
<td>7.4</td>
</tr>
<tr>
<td>Growth of total equity</td>
<td>1.7</td>
</tr>
<tr>
<td>Growth of operating expenses</td>
<td>3.2</td>
</tr>
<tr>
<td>Net interest margin</td>
<td>0.2</td>
</tr>
<tr>
<td>Return on assets</td>
<td>0.1</td>
</tr>
<tr>
<td>Return on equity</td>
<td>2.7</td>
</tr>
</tbody>
</table>

Note:  a As at 31 July 2000.

7 These comprise the BII, Bank Lippo, Universal, Patriot, Artemedia, Prima Ekspress and Bukopin Banks.
Bank Recapitalisation Bonds

Bank recapitalisation bonds now are on sale on the secondary market, clearing the way for banks to reduce their bond holdings as opportunities arise to increase lending. The coupon rate on these bonds ranges from 12 to 14 per cent, providing reasonable returns for potential foreign investors. However, the current thin trading in recapitalisation bonds reflects bank reluctance to sell interest bearing assets, given limited opportunities to lend to viable firms.

IBRA DEBT RESTRUCTURING

Another IBRA priority is to negotiate restructuring and repayment of over Rp. 298 trillion (US$33 billion) in debts transferred to it as part of bank restructuring. While IBRA has sought to restructure large loans itself, it sells most smaller loans to the private market.⁸ The sale of loans may provide opportunities for Australian business experienced in debt restructuring (International Monetary Fund, 2000b). The Government’s AMC aims to collect Rp. 10.3 trillion (US$1.2 billion) in fiscal year 2000, mostly from selling restructured loans (Indonesian Bank Restructuring Agency, 2000).⁹ (See Chapter 8 - Corporate Restructuring for IBRA’s progress in this area.)

Potential for Securitisation

As the restructuring of non-performing loans advances, banks increasingly could use securitisation of their under-performing loan portfolio to improve their capital adequacy ratios. Australia possesses significant expertise in asset securitisation, and is well placed to assist with this emerging business.

IMPROVING FINANCIAL SECTOR GOVERNANCE

The Government has indicated it aims to establish a sound and resilient financial sector to increase the long term growth potential of the Indonesian economy and safeguard against future financial shocks. It has implemented substantial financial sector reforms since the crisis, including improving prudential supervision, financial reporting and relevant commercial laws. Australia also can assist in the ongoing process of strengthening Indonesia’s financial system, and access commercial opportunities.

PRUDENTIAL SUPERVISION

The Government is upgrading its prudential regulatory and supervisory framework in response to the crisis. To achieve this, it has relied on a mix of self regulation, to tighten loan classifications, reporting requirements and capital adequacy standards, and direct prudential supervision to deter high risk lending practices.

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⁸ The AMC loan portfolio crosses a range of industries, including primary industry (41 per cent), trading and distribution (11 per cent), building and construction (9 per cent) and real estate and finance (8 per cent each).

⁹ The remainder comes from payment of interest on debts to IBRA.
**Capital Adequacy**

Ensuring capital adequacy is crucial to protect depositors and other creditors from excessive risk taking. To assist bank rehabilitation and promote lending, the Government temporarily lowered minimum bank CARs to 4 per cent during the crisis, but banks must reach the minimum internationally acceptable CAR of 8 per cent by the end of 2001.

**Loan Classification and Provisioning**

Bank Indonesia now requires banks to adopt more stringent loan classifications, more closely in line with internationally accepted practice. Banks must classify loans into four categories: normal, special mention, doubtful and loss (East Asia Analytical Unit, 1999).  

**Bank Supervision**

Bank Indonesia already has strengthened bank supervision and plans further improvements. It now conducts annual on-site inspections of all banks. Further, all banks must employ a compliance director to ensure daily compliance with prudential regulations. Bank Indonesia has established a permanent supervisory presence at all banks and is monitoring, on a quarterly basis, all banks’ progress against their business plans, including ensuring they will achieve 8 per cent capital adequacy by the end of 2001. If a bank cannot comply, Bank Indonesia will take prompt corrective action in accordance with recently enacted criteria (International Monetary Fund, 2000d).

The Government also introduced laws establishing a new independent bank supervisor, the Financial Supervisory Agency, to supervise banks from the end of 2002. As well as banks, the Financial Supervisory Agency will supervise insurance companies, pension funds and other non-bank financial institutions (East Asia Analytical Unit, 1999).

The Government also established a special unit monitoring state owned banks within the Ministry of Finance. It will conduct quarterly reviews of banks’ compliance with their performance contracts, including business plans, and monitor closely data on financial activities, including credit and loan restructuring activities. It will tender publicly annual audits of state owned banks to international firms (International Monetary Fund, 2000c).

**Exposure Limits**

Limiting financial institutions’ exposure to foreign and related party transactions is critical to prevent another crisis like the 1997 crisis. Authorities are keen to discourage widespread, short term, unhedged foreign currency exposures. Since March 2000, all banks have had to report foreign exchange transactions exceeding US$10 000 to Bank Indonesia, and detail the financial relationship between sender and receiver. Regulations controlling related party lending accord with best practice. Bank Indonesia also is working to increase its supervision capacity.

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10 IBRA uses a five-tier classification but Bank Indonesia uses a four-tier system. Special mention loans are overdue from 1 to 90 days, requiring provision of 5 per cent; doubtful loans are overdue more than 180 days, requiring provision of 50 per cent; and loss loans are overdue more than 270 days, requiring 100 per cent provision.
NEW CENTRAL BANK ACT

The new Central Bank Act, enacted in May 1999, is designed to establish Bank Indonesia as an independent central bank. The new act gives Bank Indonesia the exclusive authority to:

- design and implement monetary policy, including:
  - determining monetary targets to achieve the inflation target of 5 to 7 per cent
  - conducting open market operations in the money market
  - stipulating discount rates
  - setting banks’ minimum reserve requirements
  - managing credit and financing
- regulate and safeguard the smooth operation of the payments system
- regulate and supervise banks.


The Government stresses that maintaining tolerable credit risk, market risk and operational risk systems is critical to banks’ future successful functioning. Australia’s world class risk management professionals could help Indonesian banks in their transition to risk management based operating systems.

Deposit Insurance

By replacing its blanket guarantee on deposits with a deposit insurance scheme, the Government plans to limit its potential exposure to future financial system failures, and clarify the incentive structure under which banks and depositors operate. The Government has not yet formally announced details of its proposed deposit guarantee scheme (KPMG, 2000).

TRANSPARENCY

The Government is aware that to promote trust in the financial system and ensure its efficient functioning, depositors and other creditors need access to sufficient information to distinguish between well managed and solvent, and badly managed and insolvent institutions. Bank Indonesia has developed a range of measures to improve financial system transparency (Reserve Bank of Australia, 1997).

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Credit risk is risk of default on loan repayments; market risk is risk of trading losses from unfavourable movements in market prices; and operational risk is risk from poor management practices.
Since April 1999, banks must publish quarterly financial statements. They also report fortnightly on their consolidated global operations, outlining their domestic and foreign currency liquidity profile and any need to cover potential liquidity shortages (International Monetary Fund, 2000d). Bank Indonesia also introduced significant penalties for non-compliance.  

**CAPITAL MARKET REFORM**

Well functioning capital markets compete with the banking sector as a source of investment funding, encouraging banks to operate more efficiently and prudently. Significant regulatory reform of Indonesian capital markets is underway, although increasing the depth of these markets will be gradual.

**Stock Market**

Since late 1997, the Government has augmented the power of Bapepam, the capital market supervisory agency, to encourage broader participation in the share market through strengthening minority shareholder rights and attracting institutional investors to the market. A new code of conduct, as well as more staff, should help to enforce these new laws. Bapepam also intends to improve coordination with other capital market players, including the Indonesian stock exchanges (Bapepam, 2000a).

To improve corporate sector risk management, both the Jakarta and Surabaya Stock Exchanges offer options and futures products. This should increase corporate participation in the equity market (Bapepam, 2000b).

Technology upgrades are improving Indonesia’s stock markets. The Jakarta Stock Exchange has over 500 personal computers and a sophisticated computer facility enables remote trading for brokers. These facilities, wide use of email and high quality corporate web pages suggest significant potential for e-commerce business. Since June 2000, the Jakarta Stock Exchange has traded in Internet start up companies, further boosting e-commerce. Australian e-business operators can help the Jakarta Stock Exchange exploit these opportunities.

**Bond Markets**

In 1995, the Government significantly improved the corporate bond market’s regulatory regime, bringing it into line with international best practice. Bapepam is taking steps to better enforce these regulations.

Banks’ short term reluctance to lend to companies should encourage larger, more reputable corporates to seek access to other forms of finance, including the domestic corporate bond market. In the Republic of Korea and Thailand, the economic crisis promoted corporate bond market growth, as larger, more reputable corporates have better credit ratings than most banks, still suffering from high non-performing loans.

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12 Australia’s legal and accounting professionals and banks have significant expertise in sound financial reporting, providing them with opportunities to assist their Indonesian counterparts in implementing these requirements.
However, without a deep secondary market and investor confidence, the bond market offers limited competition to the banking sector. The development of a government bond market, as banks sell their sovereign recapitalisation bonds, should support creation of a benchmark yield curve, assisting corporate bond market development. In the medium to long term, corporate restructuring and ongoing economic recovery should improve Indonesian corporates’ credit ratings, promoting local bond market growth.

**Improving the Payments System**

An efficient payments system is important in restoring confidence in the Indonesian financial system. Bank Indonesia plans to replace the current manual settlement system with a real time gross settlement system by the end of 2000 (Deacons, 2000).

Improvements in the payments system should encourage credit card market development. Only 4 per cent of Indonesians hold a payments card, well below the 20 per cent average for the Asia Pacific region. As ANZ recognised, this could provide opportunities for Australian business to develop the credit card market (Jakarta Post, 14 July 1999, p. 8).

**PROSPECTS**

Indonesia’s financial system, particularly its banking system, was highly exposed in 1997-98, and nearly collapsed as a result of bank runs. However, over the past three years, the Government has succeeded in restructuring and refinancing a viable group of private banks. Government recognises the main problems remain the slow pace of restructuring corporate non-performing loans and the continuing problems in the state banking sector. Also, while Bank Indonesia has raised prudential control standards, in many cases to international levels, in the short term, limits on human resources and operational effectiveness may affect supervision.

In the medium term, as the Government implements more effectively new prudential standards, and completes bank and corporate asset sales, significant commercial opportunities may emerge for Australian financial institutions and service providers.

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13 During the 1990s, most South East Asian economies moved to an electronic payments system to reduce systemic and settlement risk. Bank Indonesia planned to move to a real time gross settlement, RTGS, system in 1997, but the Asian financial crisis put this plan on hold.
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on 17 April 2000.
KPMG, 2000, ‘Report to the East Asia Analytical Unit on Financial Sector Restructuring’ Sydney, July.
Restructuring corporate sector debt is a priority for the Government and a key component of its ten-point economic plan.

A significant share of Indonesia’s corporate sector is estimated to be insolvent, with debts of about US$120 billion. The Government has improved the capacity of its main debt restructuring agencies, IBRA and the Jakarta Initiative; by late 2000, the pace of debt restructuring was accelerating.

However, the Government remains concerned about the ability of the legal system to implement properly new bankruptcy laws, and has embarked on a program of legal reform; this program has started to achieve success, but progress is slow.

The Government is strengthening and upgrading its corporate governance framework by strengthening enforcement of company law, reducing entry barriers for new firms and selling restructured assets; again, implementation will take time.

These reforms eventually should create a more competitive and efficient corporate sector that can sustain stronger economic growth.
In late 2000, after a slow start, the pace of corporate debt restructuring is accelerating somewhat. Some debtors and creditors have started to reach agreements under the Indonesian Bank Restructuring Agency, IBRA, and the Jakarta Initiative Task Force, JITF. IBRA also has started winning some important bankruptcy cases in the courts, increasing incentives for debtors to negotiate debt restructuring. While taxation, regulatory and bankruptcy system weaknesses continue to impede efforts to accelerate restructuring, the Government is attempting to address these problems. Nevertheless, concerns exist about the depth of recent debt restructuring agreements, as superficial workouts are likely to leave the corporate sector over leveraged and exposed to future default.

Government policy makers recognise they must ensure massive non-performing corporate debt is restructured, as restoring corporate sector health is key to sustaining economic recovery in 2001 and beyond. The Government acknowledges the weak legal system has impeded the progress of key government initiatives, particularly IBRA and JITF. Hence, since the crisis, Indonesia has upgraded significantly its bankruptcy system and corporate governance framework. Reducing barriers to entry for new firms, selling government assets to foreign and domestic investors, and introducing anti-trust legislation also will boost competition and corporate sector efficiency. Together, these reforms eventually should create a business environment able to sustain strong economic growth and improve Indonesia’s attractiveness as a destination for foreign business.

Restructuring non-performing corporate debt is important for many reasons. First, firms with non-performing loans usually cannot borrow new funds or invest; this constrains economic growth. (See Chapter 1 - Economic Developments.) Second, high levels of unrestructured debt and the expectation much collateral will be sold makes assets less attractive to potential investors, and inhibits the Government from selling assets it holds to reduce public debt. Finally, the banking system cannot recover until corporate debts are restructured or written off (See Chapter 7 - Financial Sector Restructuring.) Hence completion of corporate debt restructuring is essential for Indonesia’s recovery.

Improving macroeconomic conditions are likely to expedite negotiations on outstanding debts (International Monetary Fund, 2000a). As the economy recovers, asset sales will be more feasible and rewarding, and companies will need new loans to fund investment.

This chapter maps the scale of Indonesia’s corporate debt restructuring task, and assesses the efficacy of recent efforts to accelerate corporate restructuring. It details the strengthening of Indonesia’s corporate regulatory framework and analyses the economic reform program’s likely impact on corporate performance. Finally, the chapter draws out the implications of these developments for Indonesia’s economic prospects and opportunities for Australian business.

LEVELS OF INDEBTEDNESS

In the aftermath of the crisis, analysts estimated a majority of Indonesia’s corporate sector was technically insolvent. The sector still carries debts of about US$120 billion (World Bank, 2000). Large corporates owe US$85 billion of this, and state enterprises and small firms owe the remainder
(Table 8.1). Of the total debt, 49 per cent is owed to foreign creditors and 72 per cent is denominated in foreign currencies. Three quarters of large corporates’ debt is distressed and needs restructuring (World Bank, 2000). Most of these debts are not being serviced.

**DEBT RESTRUCTURING PROGRESS**

By late 2000, the pace of debt restructuring was accelerating. IBRA reported it tentatively 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 JITF also had restructured 25 cases involving around US$5 billion of debt, out of 51 cases worth US$10 billion actively engaged in JITF mediation (World Bank, 2000).

In 1998 and 1999, macroeconomic instability and political uncertainty deterred many debtors and creditors from participating in debt restructuring, or preparing for restructuring by assessing asset values and cash flows. In early 2000, to accelerate the pace of debt restructuring, the Government increased political and resource support for the operations of the two agencies responsible for restructuring domestic debts, IBRA and the JITF.¹ These agencies now have more resources to track debtors and creditors, and more legal sanctions to increase debtor incentives to participate in restructuring. The corporate sector’s domestic debts mainly were owed to troubled domestic banks, but the bank restructuring program transferred many of these loans to IBRA. (See Chapter 7 - Financial Sector Restructuring.) IBRA therefore negotiates directly to restructure debt or liquidate firms for which it is the main creditor. In other cases, including firms in which IBRA is a minority creditor, negotiations occur under the JITF.

Table 8.1

**Large Private Corporates Are Major Debtors**

| Liabilities and Assets of Major Debtors and Creditors, 1999, US$ billion |
|---------------------------|-----------|-------|-------|-----------|---------|-----|
|                           | State banks | IBRA Asset Management Unit | Other local banks | Foreign banks | Securities holders | Total |
| State enterprises         | 3.5        | 1.7   | 0.5   | 5.3       | 1.0     | 12.1 |
| Large private corporations| 4.0        | 22.9  | 3.4   | 50.7      | 4.1     | 85.0 |
| Small and medium enterprises| 7.2        | 4.2   | 8.3   | 2.4       | 0.5     | 22.6 |
| Total                     | 14.7       | 28.8  | 12.2  | 58.4      | 5.6     | 119.7|


¹ Cooperation between these schemes and their implementation has improved now the high level Financial Sector Policy Committee oversees both initiatives and reports directly to the President.
Legal System Constraints on Restructuring

Despite changes in 1998 to the bankruptcy laws, only around one third of debtors appearing before the commercial courts by late 2000 had been found bankrupt (Table 8.2). This has meant the threat of bankruptcy has been minimal, and debtors had little incentive to enter debt restructuring processes.

By mid 2000, frustrated by these outcomes, the Government and IBRA demanded the commercial court assign cases to ad hoc judges, leading to the replacement of around 70 per cent of judges in Jakarta courts. Commercial court judges’ dissenting opinions now are published to improve the court system’s credibility and transparency. Four new commercial courts will open in regional areas to accelerate the corporate debt restructuring process. Finally, the President is appointing well regarded judges to the Supreme Court, including a new Chief Justice.

To improve legal outcomes, the Government and IBRA threatened to invoke government Decree 17 of 1999 and seize the assets of recalcitrant debtors. In mid 2000, it established the inter-ministerial Committee for Resolving the Cases of Recalcitrant Debtors to coordinate a strategy for IBRA’s difficult debtors, including prosecuting them and imposing administrative sanctions on their firms. The Government also issued a regulation providing IBRA staff with indemnity from personal lawsuits filed against them for restructuring bad debts.²

Table 8.2

Bankruptcy Laws Have Mixed Results

New Commercial Court Findings on Bankruptcy Cases, April 2000

<table>
<thead>
<tr>
<th>Number of cases</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>37</td>
<td>Bankruptcy</td>
</tr>
<tr>
<td>27</td>
<td>Debt moratorium</td>
</tr>
<tr>
<td>45</td>
<td>Rejected/not accepted by the court</td>
</tr>
<tr>
<td>5</td>
<td>Void</td>
</tr>
<tr>
<td>6</td>
<td>Withdrawn by applicant</td>
</tr>
<tr>
<td>2</td>
<td>No jurisdiction</td>
</tr>
</tbody>
</table>

Source: Deacons, 2000a.

² However, analysts argued an October 2000 decision to halt bankruptcy proceedings against three large corporate debtors because of their export contribution was counter productive, even though the announcement stressed this decision would not affect smaller bankruptcy cases.
NEW BANKRUPTCY LAWS

August 1998 legislation amending the 1905 Bankruptcy Ordinance provides for two insolvency regimes, bankruptcy and debt moratorium, and a recognised procedure for debtors to suspend payments. The new laws introduce claw-back provisions, enabling creditors to void transactions, establish a panel of professionals to act as receivers and administrators, and impose tighter timetables for hearing petitions and granting judgements. To successfully file a bankruptcy petition, the debtor must fail to pay at least one debt that is due and payable, and have two or more creditors. A bankrupt debtor cannot control and manage its assets. The laws also established a commercial court to hear bankruptcy proceedings.

Despite the amendments, the new bankruptcy law creates several uncertainties as it fails to:

- establish clear criteria for establishing whether a debt is due and payable
- introduce a concept of insolvency as a prerequisite to bankruptcy proceedings. It is sufficient only to show the debtor has more than one creditor and has failed to pay at least one debt
- prevent minor creditors from commencing bankruptcy proceedings contrary to the wishes of more significant creditors.

Source: Deacons, 2000a.

The Government established the Independent Commission for the Audit of State Officials to prosecute corrupt officials, and has increased judges’ salaries. Under new laws, a new Joint Investigating Team can refer corrupt officials to the Attorney General for prosecution. The National Ombudsman Commission, an independent body established to act on complaints from the public relating to governance issues, also can refer cases to the Joint Investigating Team.

As a result of these measures, some positive developments are apparent. In July 2000, the Supreme Court overruled an earlier Jakarta commercial court verdict rejecting bankruptcy on technical grounds for PT Bakrie Finance Corporation, one of Indonesia’s largest conglomerates. In July 2000, the Jakarta commercial court declared PT Landasan Terus Sentosa bankrupt for failing to pay Rp. 270 trillion (US$30.8 billion) in debts to IBRA.

Taxation Constraints on Restructuring

The taxation law also hampers effective debt restructuring, by taxing any capital gains debtors make in reducing their liabilities under debt workouts. Recognising this, in late 2000, the Government approved amendments to the taxation law, effective January 2001, which should reduce debtors’ tax burdens on debt equity swaps and debt forgiveness agreements by about Rp. 600 billion (US$70 million) (Ha, 2000). Measures also include removing withholding taxes on accrued but unpaid interest, transferring duties on debt/asset swaps involving real estate and reducing limits on the carry-forward of net operating losses.
The Government has committed to address capital market regulations that impede debt restructuring, including rules that prevent new equity raising and par value restrictions on the issue of new equity. Regulators also have waived some regulations on new issues to expedite IBRA’s equity sales to strategic investors. Together, these government reforms should improve the quality of debt restructuring outcomes.

**Quality of Debt Restructuring**

As new government incentives and legal powers accelerate the pace of debt restructuring, some concerns about its quality are emerging. Corporate Indonesia still is highly leveraged. At the end of 1999, the 135 non-financial companies listed on the Jakarta Stock Exchange had a collective debt to equity ratio of 1046 per cent. Among restructured firms, debt to equity ratios remain high (World Bank, 2000). A sample of 34 cases involving debts of US$8 billion showed 59 per cent were resolved using a combination of reduced interest rates, extended loan terms and grace periods; 38 per cent through conversions of debt to equity; and only 3 per cent through debt write offs. Hence most workouts only rescheduled debt, rather than improving internal operations or significantly reducing leveraging. A reluctance to write off debt, sell assets or seek equity injections maintains debt to equity ratios at high levels, and leaves corporate balance sheets vulnerable; cash flows may be insufficient to service debts once grace periods expire (World Bank, 2000). Hence in the future, restructured loans could become non-performing again. Most insolvent firms continue to operate under their original management, often limiting operational restructuring.  

**IBRA’S ASSET MANAGEMENT UNIT, CREDITS**

The Asset Management Unit, Credits, AMC within IBRA is the largest creditor in the economy, managing all non-performing loans transferred to IBRA from banks the Government took over. AMC presides over total debts with a face value of Rp. 281 trillion (US$32 billion), mainly owed by large debtors (Table 8.3). Its stated objective is to restructure or auction these non-performing loans or dispose of collateral backing them by court initiated liquidation proceedings, so as to maximise returns to the taxpayer.
### Table 8.3

**Large Loans Dominate IBRA Portfolio**

Classification of IBRA Loans by Debtor Size, May 2000

<table>
<thead>
<tr>
<th>Number of debtors</th>
<th>Total amount outstanding (Rp. trillion)</th>
<th>Per cent of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than Rp. 50 billion (US$7 million)</td>
<td>1 820</td>
<td>232.5</td>
</tr>
<tr>
<td>Between Rp. 5 billion and Rp. 50 billion (US$0.7 to $7 million)</td>
<td>2 093</td>
<td>33.6</td>
</tr>
<tr>
<td>Between Rp. 1 billion and 5 billion (US$0.12 to $0.7 million)</td>
<td>2 206</td>
<td>5.4</td>
</tr>
<tr>
<td>Less than Rp. 1 billion (US$120 000)</td>
<td>129 924</td>
<td>9.5</td>
</tr>
<tr>
<td>Total</td>
<td>136 043</td>
<td>280.9</td>
</tr>
</tbody>
</table>


To expedite results, IBRA has prioritised restructuring the loans of the 21 largest debtor groups. Together these account for around 36 per cent of all IBRA's loans (about US$10.2 billion) and involve around 340 individual companies (Table 8.4) (International Monetary Fund, 2000b).

### Table 8.4

**IBRA Targets 21 Largest Debtor Groups**

Value of Debts of 21 Largest Debtors, September 2000

<table>
<thead>
<tr>
<th>Debtor</th>
<th>Debts (Rp. billion)</th>
<th>Debtor</th>
<th>Debts (Rp. billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Texmaco</td>
<td>16 966</td>
<td>Raja Garuda Mas</td>
<td>2 376</td>
</tr>
<tr>
<td>Barito Group</td>
<td>7 521</td>
<td>Bahana Pembinaan Usaha Indonesia</td>
<td>2 989</td>
</tr>
<tr>
<td>Humpuss Group</td>
<td>5 689</td>
<td>Dharmala Group</td>
<td>2 732</td>
</tr>
<tr>
<td>M Hasan</td>
<td>5 212</td>
<td>Ongko Group</td>
<td>2 490</td>
</tr>
<tr>
<td>Bakrie Group</td>
<td>5 932</td>
<td>Gunung Sewu Group</td>
<td>2 833</td>
</tr>
<tr>
<td>PSP Group</td>
<td>4 280</td>
<td>Danamon Group</td>
<td>3 451</td>
</tr>
<tr>
<td>Tirtamas Group</td>
<td>3 195</td>
<td>Nugra Santana Group</td>
<td>2 149</td>
</tr>
<tr>
<td>Napan Group</td>
<td>3 678</td>
<td>Kodel Group</td>
<td>1 847</td>
</tr>
<tr>
<td>Tirtobumi</td>
<td>2 902</td>
<td>Rajawali Group</td>
<td>2 677</td>
</tr>
<tr>
<td>Djaajanti Group</td>
<td>2 853</td>
<td>Argo Pantes</td>
<td>1 924</td>
</tr>
<tr>
<td>Bimantara</td>
<td>3 362</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>87 059</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Indonesian Bank Restructuring Agency, 2000g.
Reflecting the poor quality of state bank assets, over half of all IBRA non-performing loans were transferred from state banks (Figure 8.1).

**Asset Quality and Restructuring Strategies**

IBRA assessments indicate debtors with good business prospects and intending to participate in debt restructuring comprise 32 per cent of all debtors and hold 30 per cent of debts by value (Indonesian Bank Restructuring Agency, 2000b). IBRA is restructuring these debts, with shareholders injecting new equity to improve debt to equity ratios. Debt equity swaps provide IBRA with an asset it can sell later. Creditors, including IBRA, are expected to hold 20 to 40 per cent of equity in many well known corporations as a result of ongoing restructuring (World Bank, 2000).

Debtors with poor business prospects but intending to cooperate in debt workouts comprise 53 per cent of all debtors and hold 56 per cent of debts by value (Indonesian Bank Restructuring Agency, 2000b). IBRA intends to sell these firms’ assets and encourage voluntary liquidation, helping these firms to exit and repay a portion of their debts to IBRA.

IBRA intends to force debtors with poor business prospects and little intention of cooperating into bankruptcy and liquidation. These cases comprise 13 per cent of all debtors and hold 11 per cent of debts by value. The 3 per cent of commercially sound firms not willing to cooperate with IBRA face litigation and foreclosure through the court system (Indonesian Bank Restructuring Agency, 2000g).

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4 Under debt equity swaps, IBRA converts non-performing loans to equity in the debtor corporation.
Cooperating debtors enter meetings with creditors, led by IBRA, and sign a letter of commitment to participate in negotiations. Often debtors agree to sign a ‘stand still agreement’ that freezes the firm’s operations, although this is optional. Once IBRA and its private sector subcontractors conduct due diligence, debts can be restructured. Negotiations with viable businesses culminate in debtors and creditors signing a debt restructuring agreement.

Restructuring Progress

By September 2000, IBRA reported over 40 per cent of the value of debt owed by the top 200 debtors had entered the final stage of negotiation. Restructuring of close to three quarters of the value of debts owed by the top 21 debtors was complete or close to completion (Table 8.5). Debt restructuring has accelerated due to IBRA’s more vigorous and flexible approach, enhanced government support for prosecutions, and government action to improve the operation of the courts.

Table 8.5

Large Debtor Cases Most Advanced
Resolution of IBRA Credits, 30 Sep 2000, Rp. trillion (Per cent of total in brackets)

<table>
<thead>
<tr>
<th>Debtors</th>
<th>Early stage$^a$</th>
<th>Middle stage$^b$</th>
<th>Late stage$^c$</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 21</td>
<td>8.3</td>
<td>16.5</td>
<td>62.3</td>
<td>87.1</td>
</tr>
<tr>
<td>Top 21 (9)</td>
<td></td>
<td>(19)</td>
<td>(72)</td>
<td></td>
</tr>
<tr>
<td>22 to 200</td>
<td>21.7</td>
<td>52.1</td>
<td>13.1</td>
<td>86.9</td>
</tr>
<tr>
<td>22 to 200 (25)</td>
<td></td>
<td>(60)</td>
<td>(15)</td>
<td></td>
</tr>
<tr>
<td>Top 200</td>
<td>30</td>
<td>68.5</td>
<td>75.4</td>
<td>173.9</td>
</tr>
<tr>
<td>Top 200 (17)</td>
<td></td>
<td>(40)</td>
<td>(43)</td>
<td></td>
</tr>
</tbody>
</table>

Note: 
$^a$ Includes initial negotiations, stand still agreements or legal processes not initiated.

$^b$ Includes assignment of advisers, due diligence and restructuring negotiations.

$^c$ Includes finalising of restructuring memorandums of understanding, implementation, full payment or commencement of legal action.


By August 2000, IBRA had initiated legal proceedings against around 450 debtors, accounting for less than 4 per cent of the total value of debt. IBRA seeks to bankrupt around 50 of these and pursue another 150 in civil courts. It has indicated it intends to reach agreement or initiate legal action against all 21 large debtors by the end of 2000. In late 2000, out of some 340 companies the top 21 debtors owned, the AMC was prosecuting 16 non-cooperative borrowers, with total debts over Rp. 6 trillion (US$685 million).

Workout Terms

Depending on the firm’s projected cash flows, IBRA can reschedule repayments for up to ten years and allow grace periods of up to two years. IBRA also indicates it encourages asset sales, injections of capital by existing shareholders and debt buy outs by new investors to create acceptable debt to equity levels. IBRA waives interest payments for large borrowers only under special circumstances.

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5 Also in mid 2000, IBRA used 1999 regulations to threaten to seize assets from Mas Murnia, a large conglomerate debtor with debts totalling US$44 million, which refused to enter debt workout negotiations.
providing the financial accounts show no irregularities. However, for small loans under Rp. 5 billion, it has launched an accelerated settlement scheme waiving all interest and fees owed by small and medium enterprise and retail borrowers (except home, car and credit card borrowers) who repay the full principal due (World Bank, 2000).

**Subcontracting Smaller Loans**

In mid 2000, to speed debt restructuring, IBRA outsourced the servicing of around 2 000 commercial loans worth between Rp. 5 billion and Rp. 50 billion with a total face value of Rp. 30 trillion (US$3.4 billion) to refinanced banks through competitive bidding. While these loans remain on IBRA books, it believes commercial banks could collect and restructure these loans more actively, before their planned sale by October 2001. IBRA also intends to dispose of all its loans worth below Rp. 5 billion totalling around Rp. 8.43 trillion (US$960 million) and involving 127 461 debtors by the end of 2000 (Indonesian Bank Restructuring Agency, 2000b; and World Bank, 2000). Its first two tranches of mortgage loans sold via open public tender for US$140 million, or close to 40 per cent of face value. It also sold a smaller group of larger restructured commercial loans; to date, the average recovery value of commercial and retail loans is 57 per cent.

**THE JAKARTA INITIATIVE TASK FORCE**

The JITF coordinates debt restructuring when IBRA is not a majority creditor. The initiative, established in September 1998, facilitated out-of-court voluntary corporate debt restructuring. Mainly private sector officers staff it and since January 2000, the Government has boosted significantly its resources to improve its capabilities.

Initially, each debtor has to form a steering committee with major creditors to agree on a debt restructuring strategy. The debtor submits a financial rescue plan to the steering committee that all creditors must accept. If a minimum number of creditors and the debtor cannot agree, a ‘pre-negotiated’ plan, which new bankruptcy laws define, then comes into force. A task force of senior representatives from relevant ministries and agencies, and advised by a private Advisory Restructuring Committee, removes regulatory and tax obstacles, and provides a one stop shop to approve filings (International Monetary Fund, 2000c).

In April 2000, debt restructuring delays caused the Government to initiate time-bound processes under JITF, and improve incentives and sanctions to encourage debtor participation. Reforms included establishing the Financial Sector Policy Committee; all relevant ministers sit on this. The committee now oversees corporate and bank restructuring, and refers major cases to the JITF for action, instead of relying on debtors to volunteer for the scheme. The committee also can refer uncooperative debtors to the Attorney General’s office to initiate bankruptcy proceedings. Where necessary, the task force now assists debt restructuring on IBRA’s behalf. Government tax incentives for debt forgiveness,

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6 Under the early form of the JITF, progress was very slow; it attracted only 25 companies by November 1998, in its first two months of operation.

7 The Financial Sector Policy Committee also can act on the Jakarta Initiative Task Force’s recommendation to impose other sanctions against recalcitrant debtors, including publishing the names of non-cooperative debtors and requesting relevant government agencies to revoke or refuse to extend licences, concessions and other facilities uncooperative parties previously held.
debt to asset and equity swaps, and easier requirements for banks to swap non-performing debts for
equity also assist task force debt restructuring (International Monetary Fund, 2000c).

These new government initiatives have markedly improved JITF outcomes. The task force now
carries a case load of close to US$10 billion (Rp. 87.6 trillion), projected to increase to over
US$15 billion (Rp. 131 trillion) by the end of 2000, due to eight cases with debts totalling Rp. 48 trillion
(US$5.5 billion) that the Financial Sector Policy Committee referred. After restructuring debts worth
US$5 billion (Rp. 26 trillion) by July 2000, it should complete restructures worth a further US$3 billion
by December 2000 and a total of US$12 billion by April 2001 (International Monetary Fund, 2000c
and 2000d). The task force aims to restructure each debt within three to six months, depending on
the complexity of the case, and releases quarterly surveys monitoring the progress of corporate
restructuring (International Monetary Fund, 2000c and 2000d).

**Foreign Debt Restructuring**

By late 2000, building on earlier initiatives, foreign banks indicated agreements with several large
debtors either have been reached or were imminent (World Bank, 2000). Nearly half the corporate
sector debt owed to foreigners is being restructured under the JITF.

**CORPORATE GOVERNANCE**

The Government also is embarking on a program to strengthen corporate regulation and governance.
It recognises improving corporate governance not only will support corporate debt restructurings
but should help prevent another round of bad investment decisions and banking crises. While laws
governing Indonesian companies generally are sound, the Government believes a weak legal system
and lack of surveillance capacity results in generally poor corporate compliance. Therefore, the
corporate governance enhancement program centres on increasing court system and bureaucratic
capacity by augmenting their financial and human resources. The Government also is aware that
returning the corporate sector to private hands will increase market competition, enhancing corporate
governance. A National Committee on Corporate Governance established in 1999 drives corporate
governance reform. Its 20 public and private sector members represent legal and accounting
professionals, banks, state enterprises, private corporates and some government agencies.

**Improving Legislation and Supervision**

Although Indonesian corporate legislation is relatively sound, the Government is aiming to bring
corporate regulations closer to best practice. Efforts focus on improving minority shareholders’ rights
and majority shareholders’ responsibilities; better defining the functions and responsibilities of
management, directors and the company secretary; and increasing management and financial
disclosure requirements.

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8 This progress builds on previous government efforts to resolve private foreign debts. In June 1997, the Government and a
group of international private creditors entered the Frankfurt Agreement, requiring Indonesian debtors to pay trade credit in
arrears and restructure some inter-bank and corporate external debt.
Proposed government amendments to the company law and the company registration law would make firms’ ownership and financial performance more transparent. Amendments to the capital market law require listed companies to have at least one independent director; this should increase the board’s commitment to maximising the wealth of all shareholders, not merely the main shareholder’s wealth. Regulations governing reporting requirements for new share issuers also have been tightened.

Increasing resources for the Capital Market Supervisory Board, Bapepam, to supervise the stock market and introducing international standards to supervise pension, insurance and finance companies will improve capital markets’ governance. Sanctions against listed companies failing to report financial performance and conduct independent audits are tighter, and prosecution of criminal conduct by Bapepam increased significantly over 2000. The Jakarta Stock Exchange has introduced specialised trading boards for established companies, start up companies and companies offering stocks with a nominal value below Rp. 500 per share. With capital market listing for second tier companies to be relaxed, start up companies will be better placed to raise funds to enter the corporate sector.9 The Government intends to establish a new consolidated supervisory body for banks and non-bank financial institutions in 2002.

**MARKETS GOVERNING CORPORATIONS**

Increasing corporate sector competition should complement improving formal regulations to strengthen corporate governance. Selling bankrupt conglomerate assets, improving new entrants’ access to capital, including by developing stock and bond markets, introducing new laws prohibiting anti-competitive behaviour and reducing the role of state corporations all should boost competition.

**Asset Sales**

The Government’s and IBRA’s break up and sale of large corporate conglomerates should reduce substantially the degree of concentration within the corporate sector, improving the level of competition. Removing banks from large scale conglomerate structures should stop the channelling of funds to related companies. Asset sales to new domestic and foreign company entrants promise to increase competition across most sectors. In particular, foreign companies entering the market should offer price, product innovation and marketing competition, as well as generally higher standards of corporate governance. Increasingly, markets should discipline firms in their use of credit and other scarce resources.

**Developing Capital Markets**

Developing corporate equity and bond markets provide new sources of corporate credit; they also will enforce commercial discipline. As corporates and banks compete more for savings, funds are more likely to be allocated to more viable investments, reducing the risks of a new banking crisis. Increasing share ownership should increase turnover in corporate ownership, discipline corporate

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9 Under pre-existing regulations, only well established companies with adequate financial records could use the market to raise funds; however, enforcement was relatively weak.
investment practices and separate ownership from management. With so many government bonds
issued as part of bank restructuring, a deeper government bond market eventually should emerge,
providing a benchmark yield curve that supports corporate bond market development (East Asia
Analytical Unit, 1999).

**Fewer Entry Barriers**

Many other post crisis reforms should reduce market entry barriers, increase competition and
strengthen market discipline on corporate behaviour. Lower tariffs and improved access to import
licences should increase competition from foreign suppliers. In reforming and privatising state
enterprises, the Government has removed monopolies in several sectors, reduced subsidies to
inefficient state enterprises and improved access for new entrants. In October 2000, as part of its
overall policy to increase business competition, the Government released a draft new foreign
investment law. (See Chapter 3 - *Foreign Investment.*) If this law overcomes resistance in the
legislature, the more liberal foreign direct investment environment would allow new entrants in many
previously protected industries. By eliminating preferential treatment for the national car program
and the national aircraft industry, the Government also has improved access for new entrants in
these sectors (Deacons, 2000b).

**Anti-trust Legislation**

The anti-monopoly and unfair competition law passed in 1999 aims to prevent anti-competitive business
activities and agreements (Deacons, 2000b). 10 The Business Supervisory Commission which enforces
the law is accountable to the President. The commission concentrates on listed companies; up until
October 2000, it had investigated 29 companies for manipulating prices and insider trading, and
exonerated 11 of these (*Jakarta Post*, 19 April 2000).

**IMPLICATIONS**

The Government is aware that restructuring the corporate sector’s huge non-performing loans must
continue speedily if new investment is to occur and the recovery is to continue. New government
initiatives, including action to increase the integrity and capacity of the legal system, are encouraging
many more corporates to participate in debt restructuring programs. However, this process is ongoing
and corporate debts remain huge. Concerns about the depth of operational restructuring also are
emerging as the pace of workouts accelerates.

The Government’s new corporate governance framework, drawing on new legislation and supported
by stronger market competition, should ensure better corporate governance standards in future.
While major improvements in corporate culture and governance will take some time to achieve,
eventually these reforms should provide a corporate environment which will support more efficient
investment and improve Indonesia’s investment standing.

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10 The law was issued on 5 March 1999, but only became effective a year later.
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Ha, Jiming, 2000, East Asia Analytical Unit interview with Senior Economist, Resident Representative, Jakarta Office of the International Monetary Fund, Jakarta, October.


___ 2000e, Information supplied to Deacons, April, Jakarta.


With world class reserves in leading minerals, oil, petroleum, coal and gas, Indonesia’s mining and oil sector generates significant exports and foreign currency. This helps buffer the economy against downturns and makes the sector critical to Indonesia sustaining economic growth.

Four key challenges confront Indonesia’s mining community: devolution, as most mines are in regional Indonesia; social stability in some regional areas; increased illegal mining; and new regulations on environmental standards. These challenges highlight the importance of strong relationships between mining firms, all three levels of government and local communities.

Foreign companies contribute significantly to mining sector activity, with their investment exceeding US$10 billion in the last three decades. Australian firms account for about one third of this foreign investment.

Australian firms are well placed to use their geographical proximity and mining expertise to help Indonesia develop its mineral resources. Opportunities include assessing resources, refining and distributing mineral output, and exporting mining related equipment, supplies and services.

As in other sectors, potential investors should undertake thorough due diligence assessments. The need to modernise, improve management and create financial transparency may be major issues.
Australia’s ongoing participation in Indonesia’s mining sector contributes significantly to the bilateral commercial relationship. Indonesia is a major international producer of oil and gas, as well as several metallic minerals and coal; this contributes significantly to Indonesia’s GDP and balance of payments, providing a major source of foreign currency.

The investment environment in the mining sector has changed rapidly since the financial crisis. Political devolution, for example, may make government more responsive to the needs of local investors, but generates uncertainty. Miners also have concerns about social stability in some regional areas, stringent new environmental requirements and illegal mining.

This chapter briefly surveys Indonesia’s mineral resource endowments, outputs and exports, then analyses post crisis developments in the mining sector. After discussing the likely impact of new regulatory and fiscal measures on mining, it reviews Australian business opportunities in the sector.

**KEY ROLE OF THE RESOURCES SECTOR**

Indonesia enjoys world class reserves in leading minerals, coal, oil and gas. Sizeable reserves, as yet unproven, may lie in remote and less accessible eastern Indonesia. Proven oil reserves, mainly onshore, amount to 5 billion barrels. Oil production from new, smaller fields has increased over recent years, offsetting the decline of larger, more mature oil fields. Oil exploration is concentrated in the frontier regions, particularly eastern Indonesia (Energy Information Administration, 2000). Joint offshore petroleum cooperation areas between Indonesia and Australia offer mutually beneficial prospects. Indonesia’s total proven natural gas reserves amount to 72.3 trillion cubic feet; the domestic gas market remains underdeveloped; and opportunities to provide a distribution network and pipeline infrastructure are likely to attract Australian interest (Energy Information Administration, 2000). Indonesia’s significant coal reserves have a sulphur and ash content of less than 1 per cent and are close to major Asian markets. Copper and gold reserves also are substantial, and already attract significant investment.

The mining and oil sector contributes a large share of Indonesia’s exports and foreign currency earnings, and provides an important buffer against economic downturns. Hence, the sector’s health is critical to Indonesia’s medium term economic outlook.

**Mining during the Crisis**

In 1998, the value of mining sector output declined by much less than GDP, somewhat buffering the economy from the crisis (Figure 9.1). The output value of non-oil and gas mining grew 38 per cent between 1997 and 1999, largely driven by export-oriented coal, gold, copper and silver production. Overall mining and energy sector output contracted mildly, because of a 6 per cent fall in oil and gas production, a response to low oil prices, and falling extractive quarrying due to reduced construction activity (Figure 9.2 and Appendix Table 9.1).

However, the output volume of most other minerals and precious metals has risen significantly since 1994 and continued to rise even during the crisis (Figure 9.2).
Figure 9.1

Mining Sector Largely Resists the Crisis

Growth of Real Mining Production and GDP, 1993-99


Figure 9.2

Coal, Gold, Copper and Silver Dominate Output Advance

Production Growth of Selected Minerals and Energy Commodities

Note: a is based on an average of January to April 2000 only.

Exports

Since the crisis, mineral exports have remained relatively strong, underpinning mining sector output (Figure 9.3). Volumes of mineral exports rose more than their US dollar value because the US dollar prices of oil and most minerals fell during the crisis. Since commodity prices recovered in 1999 and 2000, export values also have risen.

Figure 9.3

Mining and Petroleum Exports Held up Well during the Crisis

Value of Mining, Petroleum and Other Exports, 1995-99

**RECENT DEVELOPMENTS**

Four new developments are challenging the mining community. First, devolution is likely to have significant effects as most mines are in regional Indonesia.\(^1\) Consequently, investors are encouraged to develop fresh strategies during the transition to a new, decentralised political system. Second, issues of social stability and security concern mine operators in several regions. Third, the increase in illegal mining since the crisis concerns both the Government and the mining community. Fourth, the Government has introduced stringent new regulations on environmental standards, some of which exceed international norms.

**REGIONAL DEVOLUTION**

Devolution eventually may improve the investment environment for miners. It offers the regions a greater share of mining revenues, ensuring local communities benefit more directly from mining activity. In future, local governments, rather than the central government may sign miners’ contracts of work, potentially strengthening local support for miners (Millane, 2000). Devolution delegates the issuing of permits for mining investment and exploration to the regions; eventually this may reduce the cost of obtaining approval. It also requires local government to conduct environmental inspections (Department of Mines and Energy, 2000). Devolution may encourage regions to compete for new foreign investment, benefiting miners.

However, the transition to a new system of government is raising some concerns amongst miners. Miners are uncertain whether contracts of work drawn up between mining companies and the central government will remain relevant.\(^2\) Devolution may reduce coordination between neighbouring districts, increasing administrative costs for mining projects encompassing more than one district. The central government is seeking to quell these concerns. New Ministry of Mines and Energy regulations establish procedures for provinces to issue mining permits for investment, exploration and production in areas lying within two or more districts and up to 12 miles offshore from their coasts. Initially, some regions may find it difficult to meet previous standards in issuing permits and inspecting environmental performance. If some regions are unable to control the environmental degradation associated with illegal mining, this could undermine public support for the operations of legitimate miners.

Some analysts also are concerned transparency issues at the local government level may increase risk (Transparency International, 2000). As the allocation of taxation responsibilities between central and local governments is not fully clarified, concerns exist local governments may seek to impose ad hoc taxes.

During the transition phase, investors should seek to strengthen relationships with all three levels of government and local communities. New firms should seek assistance from firms with established networks of contacts and information.

\(^1\) Unlike manufacturing and service sectors, which mainly centre on Java, oil and natural gas are concentrated in Riau and Aceh, in Sumatra, and East Kalimantan, on the island of Borneo; copper is concentrated in Irian Jaya, which has one of the world’s largest copper mines, PT Freeport Indonesia.

\(^2\) Some local interest groups are using the transition period to devolution to urge the rewriting of contracts of work with foreign mining companies.
Contracts of Work for Minerals

Individual contracts result from negotiations between the state and company, but ultimately are at the government’s discretion. Contracts assign to the contractor full commercial and operational risks. Contractors relinquish rights to all areas examined during exploration and evaluation, and the government must receive the results of work done. Contractors must employ Indonesian nationals to the maximum extent possible and implement training programs. Companies also must include Indonesian capital as soon as production begins and commonly must transfer 51 per cent of company shares to Indonesian ownership after ten years. Contracts last 30 years but can be extended by mutual agreement. The contract defines royalties and rents payable, in addition to normal corporation and general sales taxes.

Source: Millane, 2000

Increasing demands for greater autonomy in many provinces where mines are located has given rise to civil unrest and some instances of violence, adversely affecting mining operations and the safety of workers. Although regional devolution may reduce some of these tensions, miners need to remain sensitive to these risks.

Illegal Mining

The increase in illegal mining since the crisis is concerning the Government and the mining community alike. Illegal mining is most serious in the gold, coal and diamond sectors; estimates of its value vary widely, but in the case of gold, range from 12 to 33 per cent of output (Kuo, 1999). For example, in 1992, state mining company PT Aneka Tambang, Antam, reported large numbers of illegal miners had arrived and by 1998, they had halved output and exports from its Pongkor gold and silver mine (Millane, 2000; and Antam, 1998). BHP’s subsidiary, PT Arutmin, in South Kalimantan, also suffers from large scale illegal mining.

3 Indonesian Constitution, Article 33, paragraph 3.
The Government is attempting to reduce illegal mining by warning against the purchase of illegal output and banning the use of government roads to transport illegally mined material. It also has introduced tough new environmental regulations in response to the damage caused by illegal operators. Emerging regional institutions could reduce the incidence of illegal mining over the medium term. New reforms redistributing mining royalties to regions also should increase incentives for district governments and their communities to eradicate illegal mining.

Mining companies can assist the Government reduce illegal mining by working with authorities to detect and eradicate illegal mining. Some miners are pooling their surveillance and security resources. Mining companies also should maintain good relationships with local communities and authorities, so they can actively deter illegal miners.

**LARGE SCALE ILLEGAL MINING DEVALUES COAL RESOURCE**

Illegal mining often is large scale. BHP’s subsidiary, PT Arutmin, in South Kalimantan, is subject to illegal miners who use a fleet of 200 trucks and 16 excavators. They transport their output using a road and a jetty built across environmentally sensitive coastal marshlands. Illegal miners account for as much as 4 million of the 22 million tonnes of coal mined in South Kalimantan annually; this represents a loss of output worth A$92 million at current prices. Much of the province’s illegal coal comes from the mine area PT Arutmin owns. Industry sources report an environment of intimidation and threats of violence.


**NEW LEGISLATION**

The Government is negotiating several important mining sector laws, including new environmental and contract laws. Mining companies should watch closely these developments.

**New Environmental Laws**

Public reaction to the damage caused by illegal miners has prompted tighter environmental legislation (Department of Mines and Energy, 2000). The Environmental Protection Agency, BAPEDAL, issued Decree PP18 in February 1999, imposing stricter standards on waste discharge. The 1999 forest law reserves large areas for water catchment and limits new mining activity in these areas. These new standards in some cases exceed international norms. The Government has provided assurances the law does not seek to restrict established exploration or mining agreements. Mining companies should improve contact with local environmental bodies, including non-government organisations, to reassure these groups about the firm’s environmental credentials, and share information on environmental strategies.

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4 In Indonesia, often mining occurs in rainforests with up to 180 cm of rainfall per year, so soil erosion, sediment, contamination of offsite water bodies and land reclamation for post-mining uses are important issues. Another environmental issue in coal mining is the loss of fine coal particulates; here loss of coal revenue and royalties can be up to 20 per cent of production, and mining can pollute water supplies (Hamilton, 1998).
ENVIRONMENTAL GOVERNANCE IN INDONESIA

The Ministry of Environment requires firms to prepare environmental impact assessments for activities which may affect the environment, and enforces environmental quality standards (Millane, 2000). However, under devolution, these responsibilities will be delegated to regional governments. The Bureau of Environment and Technology reviews, develops and coordinates environmental policies and regulations within the Ministry of Mines and Energy. The Directorate of Technical Mining, also within the ministry, inspects and enforces environmental policy. Both agencies will retain their roles after regional devolution.

NEW TAXES AND ROYALTIES

Contracts of work signed since the financial crisis include higher royalty rates on key minerals, although in most cases, these continue to be offset by the lower costs of exploration and corporate tax rate in Indonesia (Figure 9.4 and Table 9.1). For example, under Regulation No. 13 of 2000, gold royalties rose to 3.75 per cent from between 1 and 1.5 per cent, and copper royalties rose to 4 per cent from 2 per cent. Indonesian investment guidelines provide a refund of the 10 per cent value added tax, VAT, paid on imported mining capital equipment. The Government is aware that some mining firms have expressed concern about difficulties in obtaining this refund (Aurora Gold, 1999). As devolution occurs, potential investors should watch carefully developments in taxation and royalties applied to mining revenues.

Figure 9.4
Effective Tax Rates Rise

Net Mining Return and Effective Government Tax Rate, 1994-98

Note: a Calculated as share of gross profit (after interest) paid as tax.
Table 9.1

Indonesia Retains Competitiveness Despite Higher Royalties
International Comparison of Fiscal Regimes for Mining, 1998

<table>
<thead>
<tr>
<th>Factor</th>
<th>Indonesia</th>
<th>Australia</th>
<th>Philippines</th>
<th>Chile</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalties on gold and</td>
<td>3.75 per</td>
<td>2.50 per</td>
<td>2.00 per</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>copper (gold)</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>4 per cent</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exploration dead rent</td>
<td>0.35</td>
<td>0.30</td>
<td>1.30</td>
<td>2.90</td>
<td>Nil</td>
</tr>
<tr>
<td>US$/ha/yr</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mining dead rent US$/ha/yr</td>
<td>1.50</td>
<td>10.00</td>
<td>1.30</td>
<td>2.90</td>
<td>Nil</td>
</tr>
<tr>
<td>Corporate tax rate</td>
<td>30 per</td>
<td>36 per</td>
<td>35 per</td>
<td>15 per</td>
<td>15 to 35 per</td>
</tr>
<tr>
<td></td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
<td>per cent</td>
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</tbody>
</table>

Source: Jakarta Post, 22 May 2000.

FOREIGN INVESTMENT

Foreign companies contribute significantly to mining sector activity, investing a cumulative US$10.8 billion over the last 30 years. Of this, US companies account for US$6.4 billion while Australian mining investment approvals to 31 May 2000 account for US$3.2 billion (34 per cent of total applications). US mining company, PT Freeport Indonesia, one of the largest foreign investors in Indonesia, accounts for the bulk of US investment in the mining sector (Millane, 2000).

Applications to invest in the mining sector, excluding oil and gas, have declined significantly since 1996 (Table 9.2). If this trend continues over the medium term, replacement investment may be insufficient to maintain current production levels. The Department of Mines and Energy reports foreign and domestic mining investment intentions falling sharply in 1999. Imports of surface mining equipment fell from US$815.4 million in 1997 to US$650.3 million in 1998, corroborating this. In 1999, oil and gas sector investments improved slightly, reflecting higher oil prices. However, foreign oil producers, who produce 95 per cent of petroleum output, increased their total investment to an estimated US$5.3 billion from US$4.3 billion in 1998 (Millane, 2000).
Table 9.2

Mining Investment Approvals Declining
Domestic and Foreign Investment in Mining, 1995-99

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Domestic investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-metallic mining investment, Rp. billion</td>
<td>9 009</td>
<td>7 965</td>
<td>11 639</td>
<td>3 469</td>
<td>Less than 1 000</td>
</tr>
<tr>
<td>Mining share of domestic approvals</td>
<td>12.9 per cent</td>
<td>7.9 per cent</td>
<td>9.8 per cent</td>
<td>5.7 per cent</td>
<td>Less than 2 per cent</td>
</tr>
<tr>
<td>Foreign investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mining approvals US$ million</td>
<td>Less than 2 487</td>
<td>1 457</td>
<td>237</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Mining share of foreign investment approvals</td>
<td>Less than 415</td>
<td>8.3 per cent</td>
<td>4.3 per cent</td>
<td>1.7 per cent</td>
<td>1.5 per cent</td>
</tr>
</tbody>
</table>

Note: Capital Investment Coordinating Board investment data exclude the oil and gas and financial sectors.
Source: Capital Investment Coordinating Board, as quoted in Millane, 2000.

MOST AUSTRALIAN MINING MAJORS INVOLVED

Australia’s largest mining investments in Indonesia include:

- Australia Kelian CRA
- PT Indo Muro Aurora (gold, silver)
- PT Multi Harapan Salim/Newhope (coal)
- PT Arutmin (BHP coal)
- PT Adaro (Newhope coal)
- PT Kaltim Prima (CRA/BP Amoco)
- PT Utah e Lakali (BHP coal)
- Lateritic nickel project on Gag Island (BHP nickel)
- Allied Indonesia Coalfields Pty Ltd (coal)
- Iluka Resources
- Lone Star Exploration
- Meekatharra Minerals Ltd.
AUSTINDO RESOURCES VENTURE WITH INDOONESIAN PARTNERS

In 2000, Australia’s Austindo Resources Corporation, ARX, formed a strategic relationship with the Austindo Group of Indonesia. ARX holds 63 per cent of a high grade epithermal gold vein system at Cibaliung, 150 km south-west of Jakarta in West Java, in a joint venture involving PT Aneka Tambang and International Antam Resources Ltd. ARX exploration inferred resources equal to 312 230 ounces of gold and 1.83 million ounces of silver; the company wants to confirm these results and explore possible extensions.

ARX has strengthened its capacity to manage government and community relations over recent years, improving its effectiveness in coping with new regional devolution laws. The company’s strategic relationships within Indonesia help it manage its operations effectively.

Despite the crisis, ARX has maintained its focus on Indonesia, hoping to benefit from economic revival and recovering gold prices. The company expects Cibaliung to become a major new gold mine.


LONG TERM OUTLOOK FOR MINING

Australia’s proximity to Indonesia and mining expertise position it well to assist Indonesia develop its mineral resources. Opportunities range from assessing resources through to refining and distributing mineral output, as well as supplying mining related equipment, supplies and services.

Exploration

Opportunities exist across the archipelago, particularly in the rugged eastern reaches. Australian expertise in identifying resources, mapping geology and collecting geophysical data, particularly in remote areas, suits these conditions.

Contracting and Support Services

Providing contracting and support services to other mining companies reduces exposure to risks associated with mining. Services include the design and construction of mines, materials handling, environmental engineering, infrastructure provision, and supply of mineral transport systems and mining equipment. Major Australian companies, including Theiss and Clough, have large contracts to operate mines, although they face stiff competition from US firms.

Training Requirements

Local partners and bureaucracies have rising human resource needs; these generate opportunities for providing training in mining technologies, mine operation and environmental monitoring.
Oil Sector Opportunities

The abolition of Pertamina's monopoly on oil production and liberalisation of oil refining and distribution offer substantial opportunities for Australia. New arrangements proposed in 1999 allow the Department of Mines and Energy to award private companies oil production contracts which Pertamina currently undertakes.

Energy Reforms

In January 2000, after initial delays, the Government initiated a panel to oversee the reform of Pertamina, including installing new management. In September 2000, the Government reaffirmed its strong commitment to reform comprehensively the energy sector, submitting to the legislature two new laws to privatise and reform the electric power and the oil and natural gas sectors (Energy Information Administration, 2000; and International Monetary Fund, 2000).

Privatisation Opportunities

Privatisation may offer opportunities for Australians to acquire established mining enterprises. Australian mining investors could assist these firms with business management, technical and accountancy expertise.

Two state mining enterprises will be sold in 2000 or early 2001. PT Aneka Tambang, specialising in gold and nickel mining, currently is 65 per cent government owned. A further small share will be sold in 2000 or 2001, and eventually the balance will be sold. PT Tambang Batubara Bukit Asam, specialising in coal mining, currently is 100 per cent government owned, with a minority share earmarked for privatisation. Shares in both enterprises will be sold either through initial public offerings or by attracting a strategic partner. In addition, the remainder of mining company, Antam, partially floated on the Sydney stock exchange in August 1999, eventually will be sold under commitments to privatise the majority share of all state enterprises. A standby list of state mining enterprises for sale includes PT Tambang Timah (tin mining), currently 65 per cent government owned.

However, as in other state enterprise privatisations, potential investors should undertake thorough due diligence assessments of enterprises offered for privatisation. Minority ownership may constrain efforts to modernise and improve management, and financial transparency may be lacking. Investors may need to convert current exploration and mining titles to contracts of work, especially if they acquire majority foreign ownership.

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5 Pertamina, the state company responsible for distributing oil and gas throughout Indonesia, also is involved in crude oil production.
NEWCREST’S GOSOWONG PROJECT ON TARGET

Newcrest Mining Ltd set up a small office in Jakarta in 1991 and explored the Halmehera region in cooperation with local firm, PT Aneka Tambang. Newcrest holds 82.5 per cent of the joint venture. They discovered the Gosowong gold deposit in September 1993, and the Government approved a sixth generation contract of work in April 1997. Between September 1997 and November 1998, with a sound understanding of the application process and good communications with relevant government agencies, the venture acquired the necessary permits. Construction started late in 1998 and the plant was commissioned in July 1999.

The project achieved its targets despite the financial crisis of 1997-99, and exceptionally heavy rainfall during construction. The firm gave priority to recruiting and training local people, fostering local business development, and carefully managing environmental issues.

The Gosowong project’s success demonstrates maintaining effective communication with all levels of government, as well as local community representatives, is invaluable.

Source: Carmichael and Corp, 1999.

SUPPORT NETWORKS FOR AUSTRALIAN MINERS

Austrade maintains a directory of Australian companies able to provide equipment and services to Indonesia’s mining, quarrying and construction industries. Australian export promotion groups, Austmine and Austenergy, support firms seeking to export mining equipment, related supplies and services to Indonesia.

Austrade assigns a high priority to assisting export companies, visiting major mines, identifying new opportunities, and promoting Australian companies and expertise in the mining sector. Austrade and a range of mining companies participate in Indonesia’s annual Mining Indonesia exhibition. The Australian Embassy in Jakarta also facilitates high level contact with relevant ministers and officials.

PROSPECTS

Mining is likely to remain an important sector in the Indonesian economy. New developments in governance and politics may promise a better environment for harnessing Indonesia’s substantial mineral wealth. However, the transition to political devolution raises taxation, legal and governance issues for miners, creating uncertainty, and illegal mining problems are increasing. Investors need to remain alert to local developments and the interests of stakeholders.
Appendix Table 9.1

Coal, Gold, Copper and Silver Dominate Output Advance
Production Growth and Volumes of Selected Minerals and Petroleum, ‘000s tons

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Petroleum</td>
<td>15992.9</td>
<td>15992.6</td>
<td>16179.5</td>
<td>15963.5</td>
<td>15843.8</td>
<td>14513.4</td>
</tr>
<tr>
<td>Tin ore concentrate</td>
<td>30.6</td>
<td>38.4</td>
<td>51.0</td>
<td>55.2</td>
<td>53.9</td>
<td>47.8</td>
</tr>
<tr>
<td>Copper ore concentrate</td>
<td>1095.8</td>
<td>1516.6</td>
<td>1758.9</td>
<td>1840.7</td>
<td>2640.0</td>
<td>2645.2</td>
</tr>
<tr>
<td>Nickel ore</td>
<td>2302.0</td>
<td>2513.3</td>
<td>3426.9</td>
<td>2829.9</td>
<td>2734.0</td>
<td>3245.3</td>
</tr>
<tr>
<td>Bauxite</td>
<td>1342.4</td>
<td>904.5</td>
<td>841.9</td>
<td>808.7</td>
<td>1055.6</td>
<td>1142.5</td>
</tr>
<tr>
<td>Coal</td>
<td>31238.5</td>
<td>41516.7</td>
<td>47338.6</td>
<td>52074.3</td>
<td>60320.8</td>
<td>69357.6</td>
</tr>
<tr>
<td>Iron sand concentrate</td>
<td>334.9</td>
<td>348.4</td>
<td>425.1</td>
<td>487.4</td>
<td>561.0</td>
<td>562.3</td>
</tr>
<tr>
<td>Gold</td>
<td>42.6</td>
<td>62.8</td>
<td>83.6</td>
<td>90.0</td>
<td>124.0</td>
<td>129.0</td>
</tr>
<tr>
<td>Silver</td>
<td>107.2</td>
<td>265.2</td>
<td>254.9</td>
<td>270.4</td>
<td>349.9</td>
<td>292.3</td>
</tr>
</tbody>
</table>

Note: a Thousands of barrels.
      b Thousands of kilograms.
REFERENCES


Austindo Resources Corporation, 2000, Information Provided to Brendan Millane on Company’s Operations in Indonesia, May, Jakarta.


Hamilton, M.S., 1998, Mining Environmental Policy in Indonesia: Program Evaluation of the Joint BLT-OSM Mining Environmental Project, Third Year of Effort, United States Department of Interior for Office of Surface Mining Reclamation and Enforcement, Washington DC.

Indonesian Constitution, 1947, Article 33, paragraph 3, Jakarta.


AGRICULTURE AND AGRIBUSINESS

KEY POINTS

• Since 1998, Indonesia has liberalised significantly its agricultural trade and investment regimes; this should promote more efficient use of agricultural land and resources, and rural income growth.

• Agriculture’s contribution to the economy is important but diminishing, generating under 20 per cent of GDP but over 40 per cent of employment.

• However, agricultural productivity in several sectors is below world averages; the Government’s new ten point plan prioritises raising agricultural productivity and farmers’ welfare, using programs to increase rural credit facilities and infrastructure.

• Since the crisis, Indonesian markets have opened for key agricultural commodities; this should benefit Australian exporters. More efficient agricultural policies also should generate opportunities for agricultural equipment and service exporters.

• Reforms liberalising foreign investor participation in plantations, freshwater fisheries, milk processing and agricultural product distribution offer good opportunities for agribusiness investment based on technology transfer. Foreign investment in the food sector markedly increased during 1999.
New reforms in agricultural trade and investment regimes should assist stronger and more efficient growth in Indonesia’s agricultural sector. Furthermore, Indonesian demand for agricultural produce will grow and diversify as incomes grow. Rising domestic demand, moderately low levels of agricultural productivity and recent reforms generate many opportunities for Australian businesses, including agricultural producers, agricultural and related equipment exporters, and agribusiness investors.

Agriculture is important to the Indonesian economy and society; it contributed around 19 per cent of output and 41 per cent of employment in 1999 (Table 10.1). The Government is removing monopoly importing and distribution mechanisms and high trade barriers that in the past hampered agricultural trade and productivity growth. This chapter identifies recent reforms and developments, and the opportunities for Australian agricultural product and equipment exporters and investors these reforms generate.

**AGRICULTURE IN THE ECONOMY**

Indonesia’s agricultural sector employs over 40 per cent of the population and is significant in world terms, despite its declining share of output and exports. Indonesia is the world’s largest producer of coconuts, second largest producer of copra, palm kernels, palm oil and natural rubber, and third largest rice producer. The country has 19 million hectares of arable land, with rice and corn farming representing almost 80 per cent of the total food crop area (Food and Agriculture Organisation, 1998).

Small scale subsistence farms account for about 87 per cent of total cultivated land; are labour intensive; and grow predominantly food crops. Concentrated in Java, Sumatra and Sulawesi, these farms produce 90 per cent of the country’s rice and corn. Large state owned and private estates account for the remaining 13 per cent of cultivated land; they use hired or contracted labour and engage in agribusiness and export cropping. Although estates account for a small share of total agricultural output, they dominate agricultural exports. Major producers of rubber, palm oil, coffee and cocoa are in Sumatra; rubber, cocoa and cashew nut plantations are in Sulawesi.

---

1 Until the mid 1970s, agriculture’s share of GDP exceeded that of other major sectors; however, this share fell as Indonesia’s industrial development advanced.

2 Java accounts for around 60 per cent, Sumatra 20 per cent and Sulawesi 10 per cent.
Table 10.1
Agriculture Provides Jobs, Rather than Exports
Agricultural Growth, Share of GDP, Employment and Exports

<table>
<thead>
<tr>
<th></th>
<th>Agriculture</th>
<th>Industry</th>
<th>Services</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Per cent of GDP</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1977</td>
<td>29.6</td>
<td>34.3</td>
<td>36.1</td>
</tr>
<tr>
<td>1987</td>
<td>23.4</td>
<td>36.3</td>
<td>40.3</td>
</tr>
<tr>
<td>1997</td>
<td>16.1</td>
<td>44.3</td>
<td>39.6</td>
</tr>
<tr>
<td>1999</td>
<td>19.5</td>
<td>45.3</td>
<td>35.2</td>
</tr>
<tr>
<td><strong>Average annual growth</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980-90</td>
<td>3.4</td>
<td>6.9</td>
<td>7.0</td>
</tr>
<tr>
<td>1990-98</td>
<td>2.8</td>
<td>9.9</td>
<td>7.2</td>
</tr>
<tr>
<td>1997</td>
<td>1.0</td>
<td>5.2</td>
<td>5.6</td>
</tr>
<tr>
<td>1998</td>
<td>0.8</td>
<td>-15.1</td>
<td>-16.2</td>
</tr>
<tr>
<td><strong>Per cent of employment</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>44.0</td>
<td>14.7</td>
<td>41.3</td>
</tr>
<tr>
<td>1997</td>
<td>41.1</td>
<td>14.0</td>
<td>44.9</td>
</tr>
<tr>
<td>1998</td>
<td>44.9</td>
<td>11.3</td>
<td>43.8</td>
</tr>
<tr>
<td>1999</td>
<td>41.0</td>
<td>14.1</td>
<td>44.9</td>
</tr>
<tr>
<td><strong>Per cent of total exports</strong></td>
<td></td>
<td>Oil/gas</td>
<td>Industry</td>
</tr>
<tr>
<td>1994</td>
<td>7.0</td>
<td>24.7</td>
<td>63.3</td>
</tr>
<tr>
<td>1995</td>
<td>6.1</td>
<td>22.1</td>
<td>66.7</td>
</tr>
<tr>
<td>1996</td>
<td>5.9</td>
<td>24.2</td>
<td>64.8</td>
</tr>
<tr>
<td>1997</td>
<td>5.6</td>
<td>20.8</td>
<td>66.8</td>
</tr>
<tr>
<td>1998</td>
<td>7.2</td>
<td>14.7</td>
<td>73.6</td>
</tr>
<tr>
<td>1999</td>
<td>5.8</td>
<td>20.0</td>
<td>68.2</td>
</tr>
</tbody>
</table>

Note: Industrial exports also include processed metals and minerals.

Given rural workers generally have small plots and low wages, dismantling agricultural trade barriers, along with improved rural credit and agricultural extension services should help rationalise agricultural production and raise productivity; this is generally low compared to other sectors and agricultural sectors elsewhere (Table 10.2). At the margin, land use could shift from low value, low return crops like rice and maize into more labour intensive, higher value added crops and activities including fruit and vegetable growing, chicken and livestock rearing, and fish farming.
Such rationalisation eventually would raise agricultural productivity and rural incomes, and probably consolidate some farms, providing economies of scale and boosting productivity. With fewer trade barriers, Australian exports to Indonesia, particularly of broad acre crops like rice, wheat, animal feed cereals and sugar, and capital intensive, cooler climate dairy products, should increase. However, the Government aims to maintain rice self sufficiency and rice farmers’ incomes; consequently, rice market liberalisation may occur more gradually than other agricultural product reforms.

**Output**

Although agricultural output grew more slowly than industry and services, growth was significant at around 3.4 per cent per year between 1980 and 1990, before slowing to 2.8 per cent per year between 1990 and 1998. Output is concentrated; five crops accounted for around 85 per cent of total output in the 1990s. Rice dominates production; annual production of around 30 million tonnes accounted for 35 to 40 per cent of total agricultural produce in the 1990s (Figure 10.1). Output of cassava and corn, the next most important crops, as well as palm oil, sugar, copra, sweet potatoes, soy beans and rubber grew steadily in the 1990s, but the 1997 El Nino drought cut recent output (Figure 10.2).

**Exports**

Although Indonesia is a leading exporter of several agricultural commodities, in 1999, agricultural commodities accounted for only 5.8 per cent of export revenues (Table 10.1). In US dollar terms, Indonesia’s agricultural exports grew on average by 5.4 per cent per year between 1988 and 1999, led by coffee, palm oil, rubber and tobacco. Estate crops, including rubber, palm oil and coffee, account for almost 50 per cent of Indonesia’s agricultural exports.

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3 Since 1994-95, commodities such as palm oil, other foodstuffs and copra cakes have been classed as manufactured products rather than agricultural products.
of agricultural exports (International Monetary Fund, 1999a). Rupiah devaluations helped boost agricultural exports, particularly during the post crisis period (Appendix Table 10.1) (United States Department of State, 2000). Despite this, except for the 1998 crisis year, the share of agricultural exports in total exports declined steadily throughout the 1990s, reflecting rapid growth in manufacturing and oil exports.

**Productivity**

The agricultural sector’s disproportionately large share of employment compared to output implies labour productivity is lower than in industry and services. Small scale subsistence farming dominates, with few economies of scale, reliance on labour intensive technologies, and poor access to credit and other key inputs.  

A rapidly growing population and slowly growing productivity cause periodic shortages of key foods including rice, and failure to achieve the government’s objective of rice self sufficiency. Rice productivity grew strongly during the 1980s owing to new high yield varieties, new irrigation schemes and state assistance through subsidised inputs and technical advice. Indonesian rice productivity now is above world average and significantly higher than that of Thailand and the Philippines, although below China and Australia (Table 10.2). However, productivity growth waned in the early 1990s, due mainly to lack of competition with imports and minimal consolidation of producers; hence the Government imported 5 million tonnes of rice between 1995 and 1997. With the 1997 drought, rice imports rose further to 5.9 million tonnes in 1998 and 3.6 million tonnes in 1999 (Table 10.4) (Economist Intelligence Unit, 2000).

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4 Typically, farms are less than 5 hectares, with the average size around 1 hectare.
INDONESIA'S RICE POLICY EVOLVING

Since the mid 1960s, the Indonesian Government has targeted self sufficiency particularly in rice, at stable and affordable prices. Government schemes provided price support for domestic producers, reduced agriculture taxes, erected extensive import barriers, provided irrigation infrastructure, subsidised credit, fertilisers and pesticides, and disseminated high yield seed varieties. By the mid 1980s, 85 per cent of rice farmers used high yield variety seeds, compared with 50 per cent in 1975, and Indonesia was self sufficient in rice.

The Government established Badan Urusan Logistik, BULOG, to control the domestic price of rice using a buffer stock arrangement. BULOG also monopolised the import of staples such as wheat, flour, sugar and garlic (Department of Foreign Affairs and Trade, 2000; and Library of Congress, 2000).

Rice shortages in the late 1990s and new reforms led authorities to restructure BULOG's role in the rice market. Now BULOG targets food security through subsidising rice, rather than stabilising retail prices or building up large, costly public stocks (International Monetary Fund, 1999b). Rice varieties only BULOG previously imported attract a transitional 30 per cent import duty of Rp. 430 per kilogram, to protect domestic producers against a fall in income (Cabalu, 2000). Following a critical state audit, BULOG also plans to adopt a more transparent accounting system and efficient operating structure.

Several key crops, including maize and soy beans which do not receive intensive public assistance, suffer from low productivity (Table 10.2).

Post crisis agricultural trade reform should assist Indonesia meet its food security objectives, even if Indonesia moves away from its rice self-sufficiency policy. This is because major food exporting countries like Australia and Thailand will increase capacity to meet Indonesian food production shortfalls, reducing variations in food prices due to local weather patterns.

AGRICULTURAL LIBERALISATION AND OPPORTUNITIES FOR AUSTRALIA

New reforms extended the Government’s mid 1990s trade liberalisation program into agricultural trade and marketing. Extensive agricultural trade and market reforms provide important opportunities for Australian exporters, and more relaxed foreign investment laws allow Australian investment in commercial plantations.
Table 10.2

Scope to Improve Agricultural Productivity
Average Yield of Selected Agricultural Crops for Selected Economies, 1999, kg/ha

<table>
<thead>
<tr>
<th>Economy</th>
<th>Paddy rice</th>
<th>Cassava</th>
<th>Maize</th>
<th>Ground nuts</th>
<th>Soy beans</th>
<th>Sweet potato</th>
<th>Garlic</th>
<th>Rubber</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>10 071</td>
<td>na</td>
<td>5 500</td>
<td>1 560</td>
<td>2 271</td>
<td>17 143</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>China</td>
<td>6 321</td>
<td>15 869</td>
<td>4 880</td>
<td>2 799</td>
<td>1 671</td>
<td>19 827</td>
<td>12 763</td>
<td>1 128</td>
</tr>
<tr>
<td>India</td>
<td>2 929</td>
<td>24 000</td>
<td>1 667</td>
<td>913</td>
<td>1 008</td>
<td>8 333</td>
<td>4 525</td>
<td>1 507</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4 261</td>
<td>12 795</td>
<td>2 646</td>
<td>1 523</td>
<td>1 186</td>
<td>9 610</td>
<td>3 599</td>
<td>690</td>
</tr>
<tr>
<td>Japan</td>
<td>6 414</td>
<td>na</td>
<td>2 400</td>
<td>2 336</td>
<td>1 730</td>
<td>22 652</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Philippines</td>
<td>2 863</td>
<td>8 508</td>
<td>1 719</td>
<td>1 012</td>
<td>1 154</td>
<td>4 370</td>
<td>2 507</td>
<td>687</td>
</tr>
<tr>
<td>Thailand</td>
<td>2 327</td>
<td>15 493</td>
<td>3 561</td>
<td>1 612</td>
<td>1 416</td>
<td>17 821</td>
<td>5 568</td>
<td>1 420</td>
</tr>
<tr>
<td>Mexico</td>
<td>4 816</td>
<td>11 705</td>
<td>2 536</td>
<td>1 405</td>
<td>1 616</td>
<td>18 750</td>
<td>7 321</td>
<td>1 833</td>
</tr>
<tr>
<td>United States</td>
<td>6 622</td>
<td>na</td>
<td>8 398</td>
<td>3 039</td>
<td>2 452</td>
<td>16 197</td>
<td>19 148</td>
<td>na</td>
</tr>
<tr>
<td>World</td>
<td>3 845</td>
<td>10 136</td>
<td>4 313</td>
<td>1 336</td>
<td>2 148</td>
<td>14 887</td>
<td>9 672</td>
<td>926</td>
</tr>
<tr>
<td>World max</td>
<td>10 071</td>
<td>27 333</td>
<td>23 000</td>
<td>6 075</td>
<td>3 571</td>
<td>34 091</td>
<td>27 500</td>
<td>1 981</td>
</tr>
<tr>
<td>Top producer</td>
<td>Australia</td>
<td>Barbados</td>
<td>Kuwait</td>
<td>Israel</td>
<td>Ethiopia</td>
<td>Israel</td>
<td>Haiti</td>
<td>Ivory Coast</td>
</tr>
</tbody>
</table>

Note: na Means not applicable or not available.
Source: Food and Agriculture Organisation, 1999.

**Agricultural Trade Reforms**

Post crisis reforms have lifted most restrictions on domestic and international trade in agriculture. In 1998, tariffs on most food items fell to a maximum of 5 per cent, and tariff rates on non-food agricultural products fell by 5 percentage points (Table 10.3). However, the 70 per cent depreciation of the rupiah in 1997-98 offset the removal of many of these trade barriers, making many Indonesian producers competitive at world prices. The Government’s removal of BULOG’s monopoly on a range of imports allows imports to compete with all commodities, in some cases replacing import bans with transitional tariffs. The Government also abolished import subsidies for wheat, sugar and soy beans by classifying them as ‘general imports’, and eliminated the Clove Marketing Board.

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5 In the early 1990s the Government started some agricultural trade reforms. For example, in 1991, the Government lowered non-tariff barriers so they affected only 30 per cent of agricultural production. In mid 1992, it abolished non-tariff barriers on rye, oats, barley and sorghum. Further reforms were pledged under the Uruguay Round.

6 BULOG’s involvement in wheat and soy beans ended in September 1998, and in December 1998 for sugar.
### Table 10.3

**Huge Tariff Reductions Open up Indonesian Agricultural Markets**

Tariff Rates of Selected Agricultural Commodities, 1995 and 1998, Per cent

<table>
<thead>
<tr>
<th>Commodity</th>
<th>1995</th>
<th>1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meat from cattle, sheep, goats, poultry and pigs</td>
<td>40-70</td>
<td>5</td>
</tr>
<tr>
<td>Fish, crustaceans (fresh, frozen, chilled)</td>
<td>100</td>
<td>5</td>
</tr>
<tr>
<td>Dairy products</td>
<td>50-238</td>
<td>5</td>
</tr>
<tr>
<td>Edible vegetables and certain roots and tubers</td>
<td>60-90</td>
<td>5</td>
</tr>
<tr>
<td>Edible fruit and nuts, citrus peel or melon peel</td>
<td>60-90</td>
<td>5</td>
</tr>
<tr>
<td>Coffee, tea and spices</td>
<td>100</td>
<td>5</td>
</tr>
<tr>
<td>Wheat/meslin</td>
<td>30</td>
<td>0/5</td>
</tr>
<tr>
<td>Rye</td>
<td>70</td>
<td>5</td>
</tr>
<tr>
<td>Barley</td>
<td>70</td>
<td>0</td>
</tr>
<tr>
<td>Oats</td>
<td>70</td>
<td>5</td>
</tr>
<tr>
<td>Maize</td>
<td>70</td>
<td>0</td>
</tr>
<tr>
<td>Rice</td>
<td>180</td>
<td>0</td>
</tr>
<tr>
<td>Grain sorghum</td>
<td>70</td>
<td>0</td>
</tr>
<tr>
<td>Other cereals</td>
<td>70</td>
<td>5</td>
</tr>
<tr>
<td>Wheat/meslin flour</td>
<td>30</td>
<td>5</td>
</tr>
<tr>
<td>Rye and corn flour</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Rice and other flour</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Other milling industry products, malt, starches, inulin and wheat gluten</td>
<td>70</td>
<td>5</td>
</tr>
<tr>
<td>Soy beans</td>
<td>30</td>
<td>20</td>
</tr>
<tr>
<td>Sugar</td>
<td>na</td>
<td>25</td>
</tr>
<tr>
<td>Ground nuts</td>
<td>45</td>
<td>5</td>
</tr>
<tr>
<td>Copra and palm kernels</td>
<td>45</td>
<td>5</td>
</tr>
<tr>
<td>Tobacco and tobacco substitutes</td>
<td>45-130</td>
<td>15</td>
</tr>
<tr>
<td>Bread, pastry, cakes and biscuits</td>
<td>80-100</td>
<td>5</td>
</tr>
<tr>
<td>Cotton, carded and combed</td>
<td>60</td>
<td>15</td>
</tr>
<tr>
<td>Hides</td>
<td>50-60</td>
<td>0</td>
</tr>
<tr>
<td>Natural rubber</td>
<td>50</td>
<td>15</td>
</tr>
</tbody>
</table>

Note: na Means not applicable as imports were banned.

AGRICULTURAL TRADE OPPORTUNITIES

Australia is a large, competitive, close and reliable supplier of many major Indonesian agricultural imports (Table 10.4). Reforms to key commodity markets have accentuated this natural complementarity of the two economies, generating many new opportunities for Australian producers.

Table 10.4
Australia a Big Exporter of Major Indonesian Agricultural Imports
Trade in Selected Agricultural Commodities, 1998

<table>
<thead>
<tr>
<th></th>
<th>Indonesia’s total imports</th>
<th>Australia’s total exports</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Quantity (’000 tonnes)</td>
<td>Value (US$ million)</td>
</tr>
<tr>
<td>Rice</td>
<td>1 895.0</td>
<td>861.1</td>
</tr>
<tr>
<td>Wheat</td>
<td>443.8</td>
<td>630.4</td>
</tr>
<tr>
<td>Wheat flour</td>
<td>23.9</td>
<td>4.9</td>
</tr>
<tr>
<td>Soy beans</td>
<td>343.1</td>
<td>98.7</td>
</tr>
<tr>
<td>Sugar</td>
<td>1 047.5</td>
<td>349.5</td>
</tr>
</tbody>
</table>

Note: Rice includes paddy, husked, milled paddy and broken rice.
Source: Food and Agriculture Organisation, 1999.

Rice

As Indonesia is the world’s third largest producer and consumer of rice, in the newly deregulated environment where trade in all qualities of rice is open to general importers and exporters, even small domestic shortfalls can offer exporters significant opportunities. 7 Rice varieties only BULOG previously imported, attract a transitional 30 per cent import duty of Rp. 430 per kilogram, to protect domestic producers. 8 The International Rice Research Institute forecasts Indonesia’s rice demand will rise by 38 per cent over the next 25 years. Australia leads the world in rice yields and production growth (Table 10.2). Its proximity to Indonesia indicates it would be a highly competitive supplier to the expanding Indonesian market (Food and Agriculture Organisation, 1999; and Economist Intelligence Unit, 2000).

7 Previously, private traders imported high grade, 5 per cent broken rice, and BULOG alone imported lower grades of rice, including the popular 25 per cent broken variety.
8 The import tariff level and BULOG’s procurement price for rice, which acts as a floor price, was reviewed and adjusted in August 2000, before the next crop. At the end of 1998, the procurement price was 12 per cent higher than BULOG’s open market selling price.
Wheat and Wheat Flour
Currently, Indonesia is Australia’s second largest wheat export market, consuming up to 4 million tonnes of wheat annually. Wheat is used primarily in noodles and bread. With all wheat import barriers recently removed, new opportunities should open for wheat exports, but the removal of subsidies on wheat flour imports may partially offset them.\(^9\) Liberalisation of flour milling has increased raw wheat imports as domestic flour now competes with imports. Six months after the market was liberalised, Indonesia imported a substantial 150,000 metric tonnes of flour and wheat based pre-mixes (Cabalu, 2000).

Soy Beans
Soy beans are an increasingly important and popular secondary source of protein in the Indonesian diet, primarily as tofu and tempe, with annual per capita consumption of over six kilograms. Most current soy bean imports come from the United States, Latin America and India. Since BULOG’s monopoly ended, private sector imports of soy beans have increased due to their significantly lower prices.\(^10\) Australia’s soy bean production is concentrated in the high quality market, for which demand is currently small. However, as incomes rise, so should consumption, boosting opportunities for Australian producers (Austrade, 2000).

Sugar
Current annual per capita consumption of sugar of 14 to 15 kilograms should grow rapidly with rising incomes, boosting imports. A transitional 25 per cent tariff replaced a sugar import ban, opening the market. Australia’s efficient sugar industry, with yields well above world average and a significant export capacity, is well placed to access these opportunities (Tables 10.2 and 10.4).\(^11\)

Fertilisers
New reforms have opened up the import and distribution of fertilisers, including urea, super phosphate, ammonium sulphate and potassium chloride, providing an opportunity for Australian exporters.\(^12\)

Processed Foods
Lower tariffs and a growing market boost export opportunities in the processed food industry (Table 10.3). Although the local processed food sector is relatively large, valued at US$5.94 billion in 1997, cooking oil and frozen seafood for export dominate and domestic per capita consumption is only US$30 per year.\(^13\) Hence, potential for market growth is considerable. The urban middle class, which comprise 20 per cent of the population, consume most processed food; the staple unprocessed village diet consists mainly of rice, vegetables, eggs, chicken and meat.

\(^9\) The pre-crisis subsidy on wheat flour imports reduced flour prices by about 40 per cent. However, without the subsidy, prices of wheat products are likely to rise, so wheat import demand probably will fall. Despite lower import demand, Australian wheat exports are more competitive than competing exports from the United States because of the weaker Australian dollar.

\(^10\) Domestic retail prices are about US$395 per tonne, over US$100 per tonne above world prices (United States Department of Agriculture, 1999).

\(^11\) Australia was the world’s sixth largest producer of sugar cane and second largest exporter in 1999.

\(^12\) PT Pusri, a state owned firm, previously was the monopoly distributor of all types of fertilisers, such as urea, super phosphate, ammonium sulphate and potassium chloride, for farmers. PT Pusri now is responsible only for procuring and distributing subsidised fertilisers, and maintaining buffer stocks.

\(^13\) The most recent year for which data are published.
Australian export opportunities exist in frozen and chilled meat, which is highly competitive and popular in the Indonesian market. In addition, fresh fruit, dairy products, snack foods, wine and niche products like frozen french fries and seasonings have gained good market acceptance. Demand for confectionery and baking ingredients for the biscuit and snack food industry, and whey products for the dairy and baking industry also is expanding.

**Agricultural Equipment**

Export opportunities for Australian suppliers also exist in food processing and packaging equipment. Palm oil and sugar industry liberalisation is increasing demand for sugar processing machinery, milling machinery, tractors, hydraulic excavators, motor graders, dryers for agricultural products, backhoe loaders, machinery to extract fats or oils, and water tube boilers. The Indonesian market for palm oil equipment has averaged 40 per cent growth per year since 1997. Total imports of palm oil equipment, worth US$397 million in 1997, should grow at a rate of 30 per cent per year over the next five years.

Development of Indonesia’s cold chain infrastructure also offers opportunities for the export of frozen produce and cold storage equipment. Gradually, supermarkets are replacing village wet markets, offering additional opportunities for exporters.

**Distribution of Fresh Produce**

Indonesian retailers vary greatly in their capacity and handling capabilities, constraining the distribution of fresh produce, but providing opportunities for exporters to the distribution sector. Forklifts are rare and only a few importers use pallets. Cold storage equipment is scarce. Although refrigerated truck
numbers are limited, trucking remains the preferred means to distribute fresh produce. Failure to maintain adequate temperatures, lack of humidity control, scarcity of ethylene oxidisers to prevent premature ripening and limited experience in implementing storage guidelines also hamper fresh produce distribution. These factors may constrain short term exports of fresh produce, but imply opportunities for Australian equipment exporters and logistics firms who could help overcome these difficulties.

**REFORMS TO INDONESIA'S RURAL CREDIT SCHEMES**

New reforms weaken the dominance of state banks in providing credit to the agricultural sector, and provide opportunities for the Australian finance sector. Before the crisis, a network of state owned regional development banks, village banks and cooperatives, and people’s credit banks distributed subsidised credit, primarily for rice production (Lapenu, 1998). With post crisis reforms, only commercial banks meet farmers’ credit requirements; they bear all risks of non-repayment of principal and are fully autonomous in credit decision making. The Government also will eliminate all lending quotas and targets for these institutions. Large commercial banks, possibly including some Australian operators, are better suited to managing risks in the sector.

Source: International Monetary Fund, 2000.

**FOREIGN INVESTMENT REFORM**

Reforms in mid 1998 liberalised foreign investment in plantations, including those producing palm oil and sugar and finished/semi-finished rattan products, and eliminated restrictions on foreign investment in the wholesale and retail trade, including distributing agricultural products. Foreign firms now can operate retail outlets in most major urban areas, although restrictions remain in the provinces (United States Department of Commerce, 1998; and Austrade, 1999).

In August 2000, the Government opened the freshwater fishery sector to foreign investment, including freshwater turtles, tilapia nilotica, anguila, bullfrogs, freshwater giant shrimp, milk fish and thillapya. Foreigners now can fish for demersal fish such as grouper, snapper and other varieties, except in the Malacca Strait and Arafura Sea exclusive economic zones. The Government also liberalised milk processing, in addition to repackaging powdered and sweetened condensed milk. Agricultural sectors totally closed to any form of investment include exploiting natural forests, lumbering, collecting and exploiting sponges, and producing alcoholic beverages such as spirits, wine and beer.\(^{14}\)

The agriculture and food sectors attracted significant foreign investment applications from 1995 to 1997; while these dipped sharply in 1998, domestic investment in some sectors started to recover in 1999 (Table 10.5). While foreign investment in plantations and food crops is still below pre-crisis peaks, food industry investment is recovering well.

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\(^{14}\) Indonesia’s New Negative Investment List can be retrieved electronically from www.usembassyjakarta.org/econ/investment0800.html.
Since the agricultural sector opened to foreign investment, some established plantation firms have sought foreign joint venture partners to boost expertise and capital investment. Some state agribusiness enterprises also are available for purchase under the privatisation program.

Table 10.5
Foreign and Domestic Investment down
Domestic and Foreign Investment Approvals, 1995-99

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Domestic</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Plantation and food crops</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Number of projects</td>
<td>55</td>
<td>123</td>
<td>127</td>
<td>33</td>
<td>16</td>
</tr>
<tr>
<td>Value of projects (US$ millions)</td>
<td>723.3</td>
<td>1,598.3</td>
<td>1,531.1</td>
<td>405.7</td>
<td>147.4</td>
</tr>
<tr>
<td><strong>Food industry</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of projects</td>
<td>72</td>
<td>53</td>
<td>53</td>
<td>32</td>
<td>28</td>
</tr>
<tr>
<td>Value of projects (US$ millions)</td>
<td>595.2</td>
<td>1,585.7</td>
<td>1,505.1</td>
<td>774.2</td>
<td>1,468.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of projects</td>
<td>775</td>
<td>810</td>
<td>718</td>
<td>324</td>
<td>237</td>
</tr>
<tr>
<td>Value of projects (US$ millions)</td>
<td>8,056.9</td>
<td>11,616.5</td>
<td>13,826.2</td>
<td>7,006.8</td>
<td>6,176.5</td>
</tr>
<tr>
<td><strong>Foreign</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Plantation and food crops</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of projects</td>
<td>61</td>
<td>18</td>
<td>3</td>
<td>32</td>
<td>27</td>
</tr>
<tr>
<td>Value of projects (US$ millions)</td>
<td>1,104</td>
<td>1,168</td>
<td>234</td>
<td>949</td>
<td>508</td>
</tr>
<tr>
<td><strong>Food industry</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of projects</td>
<td>38</td>
<td>37</td>
<td>26</td>
<td>32</td>
<td>48</td>
</tr>
<tr>
<td>Value of projects (US$ millions)</td>
<td>1,332</td>
<td>691</td>
<td>573</td>
<td>342</td>
<td>681</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of projects</td>
<td>799</td>
<td>959</td>
<td>790</td>
<td>1,035</td>
<td>1,164</td>
</tr>
<tr>
<td>Value of projects (US$ millions)</td>
<td>39,945</td>
<td>29,929</td>
<td>33,833</td>
<td>13,563</td>
<td>10,891</td>
</tr>
</tbody>
</table>

Strategically located on the world’s busiest shipping lane, Sumatra offers significant opportunities for Australia. Agriculture contributes 35 per cent of the total provincial GDP, with local firms profiting from rubber, palm oil, cocoa and coffee plantations, particularly since the crisis. These operators plan to diversify, especially into processing and downstream activities, providing considerable investment opportunities for Australia, including exporting agricultural automation and equipment (Cabalu, 2000).

Increasingly, food, beverages and fishery businesses are interested in joint ventures with foreigners. Australia’s success in the region’s agribusiness sector, including developing sugar farming and feedlots, means it is well placed to contribute. A new Austrade office and branch of the Indonesia-Australia Business Council, both in Medan, the capital, add to the support network for Australian firms in the area.

Source: Austrade, 1999.

Investment opportunities in agriculture are promising, especially in agri-industry. Although scattered, small scale farms can challenge foreign operators familiar with larger scale operations, rewards exist for investors seeking joint ventures with local operators and offering networks disseminating technology, credit, quality inputs and expertise.

**Downstream Processing**

Investment opportunities exist in producing and processing estate crops like sugar and palm oil milling; developing fisheries such as shrimp farming; capturing, producing and processing fish based on deep sea fisheries and aquaculture; and raising livestock such as sheep and cattle by integrated animal husbandry. Eastern Indonesia, Kawasan Timur Indonesia, including Kalimantan, Sulawesi, Nusa Tenggara Barat and Irian Jaya are the most promising provinces for these sectors. Kawasan Timur Indonesia offers relatively abundant underdeveloped natural resources, although infrastructure and skilled human resources are considerably less developed than in the western region, Kawasan Barat Indonesia.

Significant opportunities also exist in downstream processing of agricultural products. Investment in food processing, including sauces, drink concentrates, noodles, biscuits, infant formulas and snack foods, is increasing as local companies seek joint venture partners to inject much needed capital. Other opportunities include food and estate crops and their downstream industries, aquaculture, including inland and brackish water fisheries, marine fisheries and related processing industries. Palm oil plantation and related processing; wood processing, including pulp, paper mill and medium density fibres; furniture and handicrafts; and fruit processing, including pineapple canning and producing banana puree, all are promising sectors. Investment in these sectors is prominent in foreign investment inflows.  

Of the 94 foreign investment plans approved in July 2000, around half were for investments in export and import replacement sectors.
Sale of IBRA assets and privatisation of state enterprises also presents opportunities for Australian companies to acquire established agribusiness firms. Around 35 per cent of corporate assets held by IBRA are in the agribusiness sector, with some to be sold in early 2001, including Indomarket, Indomilk and Indomiwon. Thirty three state enterprises are in the agribusiness and consumer goods sector, accounting for close to 15 per cent of all state enterprises by turnover. (See Chapter 3 - Foreign Investment.)

**LINKING THROUGH INVESTMENT AND TECHNOLOGY TRANSFERS**

In August 2000, the Government opened the caged fish culture sector to foreign investment, providing opportunities for investment, technology transfer and research. Australian has expertise in caged fish culture and technology, with strong ties between the scientific community and fishing industry, such as with Southern Bluefin Tuna. Australia also has expertise in marketing live fish to markets in Asia and elsewhere.

Some Australian private companies accessing these opportunities include Western High Pty Ltd, which began its association with a fish farm in Seram Island in 1997. This linkage helped the original operators access Australian technologies, products and marketing networks. The new operation has a centralised hatchery producing fingerlings grown cheaply in local village waterways, with satellite aquaculture production based around the hatchery. Western High supplied fingerlings, constructed cages and distributes premium fish in established markets in western Indonesia, Hong Kong and Singapore.

This operation is part of a network of Australian and Indonesian expertise under the Australia Indonesia Investment Area, with breeding research underway at the University of Tasmania and Patimura University in Indonesia. (See box on Australia-Indonesia Development Area, Chapter 5 - Australian Opportunities.) A Tasmanian net manufacturer and an Australian feed provider, Pivot Nutrition, also are involved.

Source: Australia-Indonesia Development Area, 2000.

**PROSPECTS**

Recent reforms in Indonesia’s agricultural trade and foreign investment regimes promise more rapid and efficient growth in Indonesia’s agricultural sector. They also provide good prospects for Australia to contribute expertise and investment to assist the sector’s growth. Australia’s competitive agricultural exporters also are well placed to benefit from these reforms. Many bulk agricultural products like wheat, rice and sugar now are freed from monopoly import arrangements and high non-tariff barriers. The growth of Indonesia’s middle class suggests strong growth in demand for value added processed agricultural products.
### Appendix Table 10.1

**Rubber, Palm Oil and Shrimp Dominate Exports**


<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rubber</td>
<td>247</td>
<td>1,052</td>
<td>949</td>
<td>1,307</td>
<td>2,012</td>
<td>1,789</td>
<td>1,361</td>
<td>9.4</td>
</tr>
<tr>
<td>Palm oil&lt;sup&gt;a&lt;/sup&gt;</td>
<td>35</td>
<td>496</td>
<td>578</td>
<td>1,047</td>
<td>1,028</td>
<td>1,001</td>
<td>1,578</td>
<td>na</td>
</tr>
<tr>
<td>Coffee</td>
<td>69</td>
<td>264</td>
<td>340</td>
<td>946</td>
<td>643</td>
<td>602</td>
<td>597</td>
<td>33.6</td>
</tr>
<tr>
<td>Tea</td>
<td>18</td>
<td>144</td>
<td>149</td>
<td>106</td>
<td>93</td>
<td>115</td>
<td>172</td>
<td>7.1</td>
</tr>
<tr>
<td>Tobacco</td>
<td>21</td>
<td>80</td>
<td>73</td>
<td>60</td>
<td>81</td>
<td>80</td>
<td>140</td>
<td>16.4</td>
</tr>
<tr>
<td>Pepper</td>
<td>3</td>
<td>58</td>
<td>59</td>
<td>85</td>
<td>160</td>
<td>91</td>
<td>170</td>
<td>35.5</td>
</tr>
<tr>
<td>Shrimp</td>
<td>na</td>
<td>1,270</td>
<td>1,435</td>
<td>1,519</td>
<td>1,691</td>
<td>1,640</td>
<td>1,897</td>
<td>8.6</td>
</tr>
<tr>
<td>Tapioca</td>
<td>na</td>
<td>120</td>
<td>96</td>
<td>65</td>
<td>79</td>
<td>45</td>
<td>19</td>
<td>-26.3</td>
</tr>
<tr>
<td>Other foodstuffs&lt;sup&gt;a&lt;/sup&gt;</td>
<td>na</td>
<td>460</td>
<td>463</td>
<td>646</td>
<td>710</td>
<td>777</td>
<td>809</td>
<td>12.7</td>
</tr>
<tr>
<td>Copra cakes&lt;sup&gt;a&lt;/sup&gt;</td>
<td>30</td>
<td>63</td>
<td>65</td>
<td>79</td>
<td>78</td>
<td>106</td>
<td>80</td>
<td>7.0</td>
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<td>Hides</td>
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<td>43</td>
<td>43</td>
<td>53</td>
<td>43</td>
<td>37</td>
<td>57</td>
<td>8.9</td>
</tr>
<tr>
<td>Other</td>
<td>50</td>
<td>1,377</td>
<td>1,550</td>
<td>1,626</td>
<td>2,352</td>
<td>2,341</td>
<td>2,889</td>
<td>113.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>479</td>
<td>4,157</td>
<td>4,365</td>
<td>4,248</td>
<td>5,463</td>
<td>5,100</td>
<td>5,405</td>
<td>6.0</td>
</tr>
</tbody>
</table>

**Note:**
- <sup>a</sup> Since 1994-95, commodities such as palm oil, other foodstuffs, and copra cakes have been reclassified as manufactured goods. Their export values are indicated but not included in the total.
- na Means not available.

**Source:** International Monetary Fund, 1999b.
REFERENCES


Austrade, 2000, Information supplied to the East Asia Analytical Unit by Paul Martins and Timotius Wirawan, November, Jakarta.


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.

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\(^1\) 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.  

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.

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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
Implications

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.
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