

# MIZUHO RESEARCH PAPER

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*The Indonesian Economy  
under the Yudhoyono  
Administration – a crucial  
stage in its efforts to improve  
the investment climate*

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## Summary

1. Winning Indonesia's first-ever direct presidential election in 2004, Susilo Bambang Yudhoyono succeeded in building Indonesia's most stable government since the fall of the Suharto administration. President Yudhoyono rapidly gained support in the House of Representatives as a strong leader backed by legitimacy based upon his overwhelming support among the public. Given the rise of expectations toward the stabilization of Indonesia's political and social conditions and the progress of policy steps, foreign direct investment has started to show signs of recovery.
2. The basic policy targets of the Yudhoyono administration are the eradication of corruption, restoration of public security and the stimulation of economic growth. Looking back upon its first year in power, the Yudhoyono administration has made unprecedented achievements in the eradication of bribery and corruption such as the exposure of a major bribery scandal at the national and local levels of government and investigations on corrupt practices in the judiciary. The administration has also made considerable progress in terms of public security by drafting a roadmap toward solution of the 29-year conflict in the province of Aceh – the Free Aceh Movement (*Gerakan Aceh Merdeka*, GAM).
3. Despite the Yudhoyono administration's priority task to improve Indonesia's ill-reputed investment climate, the administration lacks definite achievements in this area in its first year. For example, the government is making slow progress in the improvement of the legal system, which has a deep correlation with the investment climate. The legislative process is behind schedule, given the time necessary for the coordination of interests. As for infrastructure development which lags other Asian countries, despite the administration's decision to promote the utilization of private-sector capital due to budget limitations, only 15 of the 91 infrastructure projects drawing on private capital set forth in early 2005, have resulted in successful bids. This stems

from uncertainties regarding profitability and guarantee of risks due to inadequacies in the government guarantee system. The improvement of the legal system is indispensable to facilitate the use of private capital.

4. In the year 2005, the surge of crude oil prices led to the rise of inflation pressures, which in turn caused a sharp rise of fuel subsidies paid by the government to curb the rise of domestic fuel prices. The slow response of the government to provide appropriate policy initiatives such as the adoption of a tighter monetary policy stance and the reduction of fuel subsidies led to the loss of confidence among investors, resulting in the plunge of both the stock market and the Indonesian currency in the summer of 2005. To make up for its initial delay, the central bank decided upon a sharp interest rate hike and the government more than doubled (on average) the price of fuel to curb the rise of fuel subsidies. The market regained stability as a result of these policy measures, leading to the recovery of stock prices and the rupiah.
5. The quick policy response in the face of market disruption turned out to highlight the Yudhoyono administration's keen awareness and ability to respond to risks and crises. Despite the delay in initiatives toward the improvement of the investment climate, expectations among businesses and investors have not yet soured, pushing the administration into its second year. In 2006, the government unveiled the *Policy Package for Improvement of the Investment Climate*, setting forth the course of action and time target for each of the pending issues. The belated improvement of the legal system is finally starting to move forward with some of the related bills being submitted to parliament. For investment in Indonesia to pick up, improvements of the investment climate are necessary in ways that are tangible for businesses and investors. The Yudhoyono administration faces numerous tasks, and, in the absence of solid results in its second year, will lose not only the public's trust but also the confidence among businesses and investors, making it all the more difficult to achieve a full-fledged recovery of investment. The Yudhoyono administration stands at a

crucial stage in its efforts to improve the investment climate.

## **1. Introduction**

Indonesia is the largest country in Southeast Asia and the fourth most populous country in the world ranking after China, India and the United States of America (US) with a population of more than 220 million. It has abundant natural resources such as minerals and agricultural commodities. Until the mid-1990s when the country was hit by economic crisis, Indonesia attracted widespread attention among foreign corporations in terms of investment and market entry. Despite the sharp drop triggered by the economic crisis, Indonesia surpassed China as the largest destination of Japan's foreign direct investment up to FY2003 according to the aggregate value of investments since FY1951. However, foreign direct investment has been slumping, drawing less attention in comparison with the BRICs (Brazil, Russia, India and China). Attention is gathering around the outcome of Indonesia's efforts to improve its investment climate in a bid to revive foreign investment.

Winning Indonesia's first direct presidential election backed by strong popular support in 2004, President Susilo Bambang Yudhoyono places the improvement of the investment climate high upon the administration's policy agenda. There have been high expectations that the Indonesia's political and social conditions would stabilize and that initiatives for the improvement of the investment climate would progress under the strong leadership of President Yudhoyono who was elected as a result of strong support by the people as a clean and strong leader. Despite nascent signs of recovery of direct investment in Indonesia, the stirrings still fall short of a full-fledged upswing.

The purpose of this report is to provide an overview of the Yudhoyono administration's achievements in its first year in terms of

its policy targets – public security, eradication of bribery and corruption and national prosperity – and economic conditions, and to comment upon its future tasks to regain its former high economic growth.

## **2. The Yudhoyono administration and its policy vision**

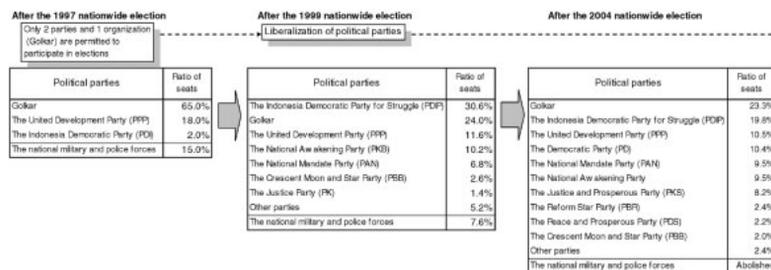
### **(1) Inauguration in the midst of prolonged political unrest in Indonesia**

During the 32-year rule of the Suharto regime up to 1998, Indonesia's social order was maintained under an authoritarian system of governance. President Suharto was granted enormous powers under the Constitution enacted in 1945 (Note 1). Even though the president was elected indirectly by a vote in the People's Consultative Assembly, the highest organ of state power, a democratic election system was unable to function properly under circumstances where the majority of seats were dominated by President Suharto's own Golkar party through limitations upon political parties in the electoral process and presidential rights to appoint half the members of the People's Consultative Assembly.

Since the collapse of the Suharto administration, political reforms have been carried out, liberalizing the establishment of political parties and enabling their participation in elections. This has led to a rapid increase of political parties in the House of Representatives (**Figure 1**). Furthermore, state power which was concentrated upon the president under the Suharto regime, was slashed by a constitutional amendment and the president lost his supremacy over the House of Representatives by the abolishment of the president's right to appoint members of the People's Consultative Assembly. Despite the progress of democratization due to the political reforms, the president is compelled to act as coordinator in partisan politics

under a multi-party coalition where the House of Representatives possesses supremacy. In contrast to the long 32-year rule of the Suharto administration, the subsequent Habibie (Bacharuddin Jusuf Habibie), Wahid (Abdurrahman Wahid) and Megawati (Megawati Sukarnoputri) administrations all were short-lived, hampering the continuity of policies.

**Figure 1: Seats in the House of Representatives – ratio of seats by political party**



Note: The national military and police forces are appointed by the president.

Golkar was officially registered as a political party on March 1999.

Source: Internet website of the Ministry of Foreign Affairs of Japan.

Under these circumstances, Indonesia held its first presidential election in 2004 under a system of direct election of the president and vice president established by the fourth constitutional amendment in August 2002. Subsequent to the first round of the elections among five candidates held in July, Yudhoyono won the second round of the elections, defeating incumbent President Megawati with 60.9% of the popular vote. Despite the lack of strong partisan support, Yudhoyono maintained a sharp lead ahead of Wiranto (former top commander of the armed forces) backed by the Golkar party (the largest party in Indonesia) and Megawati backed by the second largest party – the Indonesia Democratic Party for Struggle (PDI-P). The results reflected the voters' focus upon the candidates' personal attributes and expectations and revealed the public's distrust and disappointment in partisan politics which failed

to maintain political stability and social order.

## **(2) Success in building a stable political base**

Winning Indonesia's first-ever direct presidential election, President Yudhoyono gained support as a leader with strong powers and legitimacy based upon his overwhelming support among the public. Possessing only 57 seats in the 550-seat House of Representatives (10.4% of the total seats), the weakness of the Indonesia Democratic Party (PDI) was an initial source of concern for President Yudhoyono who drew his direct support from the PDI. However, with the cooperation of Vice President Jusuf Kalla, the Yudhoyono administration gradually gained support within the major parties and built a more stable power base. Apart from the Indonesia Democratic Party (PDI), the Crescent Moon and Star Party (PBB) and the Justice Party (PK) were the only parties expressing clear support for the Yudhoyono administration at the time of the first round of the presidential elections. Even though the three parties combined only totaled a paltry 69 seats (seat distribution ratio of 12.5%), other parties (mainly Islamic political parties) joined the ruling bloc in the course of the runoff election to the formation of the new cabinet, raising the total number of seats to 285 (seat distribution ratio of 51.8%) at the start of the Yudhoyono administration.

Although the Golkar party and the Indonesia Democratic Party for Struggle (the two major political parties) were united in an anti-Yudhoyono coalition at this point in time, Vice President Jusuf Kalla's victory in the election for party leadership against the incumbent Akbar Tanjung at the Golkar party convention in December led to the Golkar party's participation in the ruling bloc. In contrast, solidarity started to fray in the opposition camp. Even though former President Megawati was reelected as party leader of the Indonesia Democratic Party for Struggle, a dissident group calling for renovation broke off and formed the "Renewed Democratic Party". Forming a majority party on the back of his legitimacy and unifying force as a leader elected directly by the

people, President Yudhohono succeeded in forming the most stable government since the collapse of the Suharto regime.

### **(3) The Yudhoyono administration's agenda**

President Yudhoyono's threefold pledge in his election campaign are (1) the achievement of a society respecting law, equality and human rights, (2) the achievement of public order, and (3) the promotion of economic growth for the reduction of poverty and the increase of jobs. These also comprise the basis of the administrative policies revealed by President Yudhoyono upon assumption of office and the cabinet members' policy positions. A brief explanation of each of the policies are as follows.

Firstly, the targets set forth to "achieve a society respecting law, equality and human rights", are (i) the accomplishment and guarantee of the rule of law, and (ii) the eradication of corruption. Even though corruption is Indonesia's pending issue since the days of the Suharto administration, corruption remained unresolved even after the collapse of the regime. The situation has been aggravated because the dispersion of powers amid lingering problems regarding governance has increased the opportunities to acquire concessions. According to the 2005 global ranking in terms of cleanliness of governance based upon the Corruption Perception Index *(Note 2)* published every year by Transparency International, a German non-government organization (NGO), Indonesia ranks 137<sup>th</sup> place among 157 countries of the world. Indonesia's rampant corruption is considered the most serious not only in the developed countries but also among the countries of Asia **(Figure 2)**.

**Figure 2: The Corruption Perception Index**

Country rank	Index			Country or region
	2005	2002	2000	
1	9.7	9.4	9.2	Iceland
2	9.6	9.7	9.8	Finland
3	9.6	9.5	9.4	New Zealand
4	9.5	9.5	10	Denmark
5	9.4	9.3	9.1	Singapore
17	7.6	7.7	7.5	United States
21	7.3	7.1	6.1	Japan
32	5.9	5.6	5.6	Taiwan
39	5.1	4.9	5.1	Malaysia
40	5	4.5	3.8	South Korea
59	3.8	3.2	3.2	Thailand
78	3.2	3.5	3.4	China
88	2.9	2.7	2.9	India
107	2.6	2.4	2.6	Vietnam
117	2.5	2.6	3.6	Philippines
137	2.2	1.9	1.7	Indonesia

Note: The lower the index, the higher the degree of corruption perceived.  
Source: Transparency International.

The spread of corruption in society leads to the rise of unpredictable costs for companies in connection with licenses, tax collection, customs clearance, breach of contract and protection of property rights. In Indonesia, officials often require exorbitant fees in the course of customs clearance, tax payment and licensing procedures. In an annual questionnaire survey on overseas direct investment conducted toward Japanese manufacturers by the Japan Bank for International Cooperation (JBIC), many companies cited the lack of transparency in administrative procedures and operations of systems as a problem in Indonesia's investment climate (**Figure 3**). Furthermore, a ten-point proposal for improvement of the investment climate presented by the Jakarta Japan Club (JJC) to former President Megawati in September 2001, listed items related to the rule of law and corruption such as (i) establishment of law and order, (ii) improvement of taxation and the taxation process, (iii) the facilitation of customs clearance procedures, and (iv) the compulsory disclosure of public information, on the same level as targets such as the improvement and development of tax breaks and measures to facilitate investment, the improvement of infrastructure and

resolution of labor issues. Since corruption is one of the major impediments to corporate business activities, the Yudhoyono administration is committed to the eradication of corruption from the perspective of economic growth.

**Figure 3: Indonesia's challenges to attract investment by Japanese manufacturers**

		FY2005 Survey		FY2004 Survey	
		Companies	Ratio (%)	Companies	Ratio (%)
(Number of respondents)		39	100	38	100
Legal and tax system	Underdeveloped legal system	9	23.1	4	10.5
	Lack of transparency in implementation of laws	13	33.3	8	21.1
	Complicated tax collection system	7	17.9	7	18.4
	Lack of transparency in tax system operation	9	23.1	9	23.7
	Tax rise	2	5.1	4	10.5
Overall administration	Regulation of foreign enterprises	6	15.4	4	10.5
	Cumbersome and opaque investment license/approval procedures	6	15.4	4	10.5
	Difficulties in obtaining entry and work visas	3	7.7	1	2.6
	Inadequate protection of intellectual property rights	7	17.9	4	10.5
	Regulation of foreign exchange and remittances	3	7.7	1	2.6
	Import regulations and customs procedures	5	12.8	-	-

Source: JBIC Institute.

We shall turn now to public security. In addition to strengthening measures toward terrorism by Muslim extremists, the Yudhoyono administration places priority upon resolving regional conflicts in Aceh and Papua and quelling riots in Maluku and Sulawesi Tengah.

Numerous deaths and injuries have been inflicted by major terrorist attacks by Muslim extremists such as the sporadic bombings in Bali and Jakarta, serving as a blow upon businesses and tourism. Having roots in the military and past experience of overseeing the anti-terrorism campaign as Minister for Security and Political Affairs under both the Wahid and Megawati administrations, President Yudhoyono expressed his firm resolve to prevent and eradicate terrorism.

Even though there are no simple solutions for the regional conflicts and riots, given deep-rooted issues such as the long-suppressed demands for cessation and independence, human

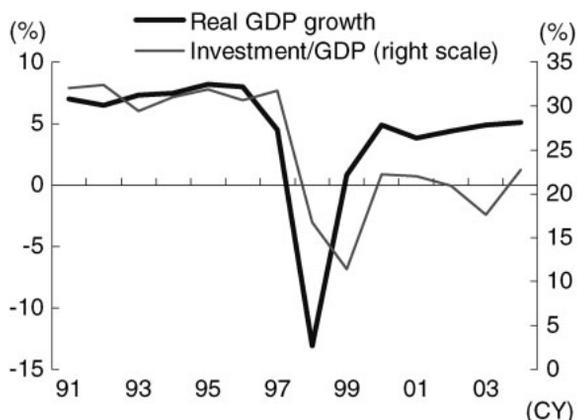
rights violations and religious conflicts, the Yudhoyono administration emphasized that it would keep a close eye upon regional conflicts and riots, based upon its fundamental stance to maintain national unity. With respect to the clashes between the Indonesian military and the Gerakan Aceh Merdeka (Free Aceh Movement, “GAM”) – armed anti-government rebels seeking inquiries into human rights abuses during the Suharto administration and Aceh’s cessation and independence from Indonesia – the devastation of Aceh province due to the massive earthquake and tsunami two months after the establishment of the Yudhoyono administration has made the resolution of the conflicts an urgent issue also from the perspective of post-disaster aid and recovery.

#### **(4) The improvement of the investment climate**

As for “the promotion of economic growth for the reduction of poverty and the rise of employment”, its basic policy stance regarding the economy, the Yudhoyono administration placed the improvement of Indonesia’s investment climate at the top of its economic agenda. President Yudhoyono promised in his electoral pledge that he would lower the rate of unemployment (currently around 10%) to 5.1% and reduce the poverty ratio (currently approximately 16%) to 8%. In order to lower the unemployment rate by absorbing the newly entering labor force (approximately 2.5 million people every year) as well as the existing jobless workers (slightly over 10 million), the rate of economic growth in real terms would have to be at least 7% per annum.

Even though the Indonesian economy is recovering from negative growth after the Asian currency crisis in the second half of the 1990s, the rate of real GDP growth averaged only 4.6% during the period from 2000 to 2004. Even when economic growth was highest in 2004, the rate of real GDP growth was only 5.1%. Compared to the first half of the 1990s when the economy grew at a pace above 7% per annum, the slow recovery of investment is hampering Indonesia’s economic rebound (**Figure 4**).

**Figure 4: Investments (as a percentage of GDP)**



Source: Asian Development Bank, *Key Indicators*.

Comprising one of the components of demand, the stagnation of investment (fixed capital formation) would slow down the absorption of technology and knowhow embodied by production capacity and production facilities from a supply-side perspective, and may well serve as a drag upon the rise of productivity. Based upon its conviction that the rise of investment is indispensable for economic growth, the Yudhoyono administration pledged that it would raise the incentive for investment among business corporations through the improvement of the investment climate.

The Yudhoyono administration's basic program on economic measures centering around measures to improve the investment climate are set forth in (i) the *Midterm Development Program* (January 2005) for the first five years of the administration (2004 – 2009) formulated by the State Ministry of National Development Planning on the basis of President Yudhoyono's policy vision in his electoral pledge, and (ii) the *100 Day Agenda* (October 2004) compiling the policy agenda to be addressed during the Yudhoyono administration's the first 100 days in power (**Figure 5**). In addition to the JCC's aforementioned policy proposal, issues raised by

research organs and business circles such as the Indonesian Chamber of Commerce and Industry and the American Indonesian Chamber of Commerce are included in the policy measures on improvement of the investment climate. While the contents cover a wide range of issues, the key measures include the improvement of the investment climate involving the legal system and its operation, labor market flexibility and infrastructure development.

**Chart 5: The Yudhoyono administration’s basic policy agenda**

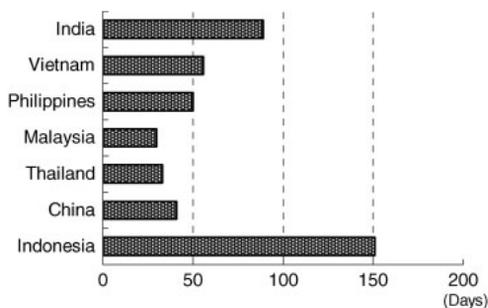
- |  |
|--|
| <ul style="list-style-type: none"> <li>○ Creation of a safe and peaceful Indonesia</li> <li>○ Creation of a fair and democratic Indonesia</li> <li>○ Creation of a prosperous Indonesia               <ol style="list-style-type: none"> <li>1. Improvement of the investment climate                   <ul style="list-style-type: none"> <li>• Improvement and creation of job opportunities</li> <li>• Improvement of investment climate and guarantee of businesses</li> <li>• Acceleration of infrastructure development through private sector participation</li> </ul> </li> <li>2. Macroeconomic stabilization</li> <li>3. Eradication of poverty and improvement of social welfare</li> </ol> </li> </ul> |
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Sources: local press coverage

Source: Local press coverage.

In addition to corruption, (i) the cumbersome and complicated process regarding taxes, customs clearance and licenses, and (ii) local ordinances hampering corporate activity (Note 3) are some of the investment climate issues which have been cited regarding the legal system and its operation. Take for example the cumbersome investment licensing procedure. A World Bank survey revealed that the average number of days necessary from application to granting of a license in Indonesia is 151 days, which is considerably longer than other Asian countries such as China (41 days) and Thailand (33 days) (**Figure 6**). In addition, tax breaks for investment, tax cuts on dividends and the reduction in scope of objects taxable as luxurious items have been included in the policy agenda in order to boost corporate investment incentive.

**Figure 6: Number of days necessary for business licenses in Asia**



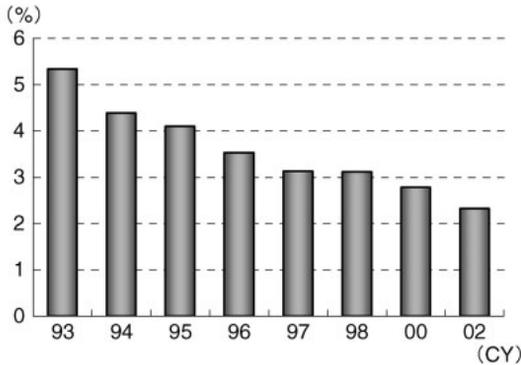
Note: Average number of days necessary to obtain licenses/approvals in each of the countries.

Source: World Bank, *Doing Business in 2005*.

Even though the fall of the Suharto regime triggered a significant improvement of workers' rights which were suppressed under the regime, the fall also led to adverse effects such as the frequent occurrence of labor disputes, rise of wages and significant limitations upon dismissal rights. Since these issues may well lead not only to the deterioration of the investment climate but also the decrease of job opportunities, the Yudhoyono administration is slated to rectify the situation by reviewing and improving Indonesia's labor laws and the conciliation system for labor-management disputes.

In much the same way as private investment and foreign direct investment, infrastructure investment has dropped sharply since the mid-1990s (**Figure 7**). The drop stems from budget spending cuts for infrastructure development as a result of (i) restraints upon overall expenditures reflecting the deterioration of the fiscal balance after the Asian currency crisis, and (ii) the expansion of rigid expenditures such as debt servicing costs, fuel subsidies (Note 4) and budget transfers to local governments based upon the law to balance the budget between the central and local governments.

**Figure 7: Infrastructure investment (as a percentage of GDP)**



Source: State Ministry of National Development Planning of Indonesia

Restraints upon infrastructure investment have led not only to a freeze upon new infrastructure development projects but also the deterioration of existing infrastructure. According to the 2005 annual ranking of world competitiveness by the IMD (a Swiss business school), the overall competitiveness of Indonesia's infrastructure is the lowest among the 60 countries and regions of the world. Even in terms of basic infrastructure such as geographic conditions, roads, airports, electricity & energy, Indonesia ranks 54<sup>th</sup> place. This indicates that the competitiveness of Indonesia's infrastructure is inferior even in comparison to China and other ASEAN nations.

Even local Indonesian companies express deep discontent regarding Indonesia's infrastructure mainly regarding physical distribution such as roads, ports and harbors. For example, some of the problems cited are, (i) traffic congestion due to the severance of Jakarta's orbital motorway, (ii) the inadequacy of the road network connecting urban areas, airports, ports and harbors, (iii) the cramped waterways of the Port of Tanjung Priok, and (iv) the inadequacy of terminals for motor vehicles. Problems regarding electrical power are also surfacing such as supply shortages and power outages stemming from PLN's (Indonesia's state-owned electrical power company) financial difficulties and inadequacies of

electrical power lines.

In view of these conditions, the Yudhoyono administration has set a target to raise the annual value of infrastructure investment from the current 2% of GDP to 5% of GDP, which would bring the cumulative value of investment during the period from 2005 to 2009 to approximately US\$145 billion (Note 5). Although the administration wishes to finance 55% of overall costs or US\$80 billion, by domestic and foreign private investment given the budget constraints mentioned before, the majority would be dependent upon foreign capital. Given these circumstances, the Yudhoyono administration's economic policy program places emphasis upon the amendment and improvement of the legal system to stimulate private sector participation in infrastructure development works.

While the Yudhoyono administration regards the stimulation of growth as its primary target in terms of the economy, it also stresses economic stability such as inflation control and the maintenance of fiscal discipline. The *Medium Term Development Plan* (2004 to 2009) sets forth numerical targets regarding macroeconomic indicators during the period (**Figure 8**), underscoring President Yudhoyono's election pledge of economic growth over 7%. With respect to economic stabilization, the *Medium Term Development Plan* sets forth a target to balance the budget in 2009. In view of Indonesia's past experience during the Asian currency crisis, the underlying reason of the Yudhoyono administration's policy agenda to stabilize macroeconomic conditions stems from its awareness on the importance of macroeconomic stability to maintain foreign investor confidence in order to facilitate foreign investment necessary to stimulate the growth of the economy. Turning to the maintenance of fiscal discipline, from the perspective to secure budget allocations for infrastructure investment, it would be necessary to seek ways to increase budget revenues through the reform of the tax system and a more efficient system of tax collection, while simultaneously, reducing budget expenditures other than infrastructure investment. In particular, a major target for budget cuts would be fuel subsidies which are rising sharply due to the recent surge of crude oil prices.

In fact, from the point of maintaining fiscal discipline and securing funds necessary for economic development, the reduction/abolishment of fuel subsidies has been a long-term policy agenda of the Suharto administration since its inauguration.

**Figure 8: Macroeconomic targets in the *Medium Term Development Plan***

Item	Unit	2004	2005	2006	2007	2008	2009
GDP (real)	(%)	5.1	5.5	6.1	6.7	7.2	7.6
CPI	(%)	6.1	7.0	5.5	5.0	4.0	3.0
Unemployment rate	(%)	9.7	9.5	8.9	7.9	6.6	5.1
Trade balance	US\$ 100 million	251.0	238.0	210.0	200.0	192.0	178.0
Foreign reserves	US\$ 100 million	363.0	368.0	360.0	356.0	352.0	359.0
Fiscal balance (% of GDP)	(%)	-1.1	-0.7	-0.6	-0.3	0.0	0.3
Outstanding public debt (% of GDP)	(%)	53.9	48.0	43.9	39.5	35.4	31.8
Outstanding external debt	US\$ 100 million	1349.0	1309.0	1292.0	1287.0	1297.0	1331.0

Source: State Ministry of National Development Planning.

### **3. The Yudhoyono administration's accomplishments in its first year**

#### **(1) Eradication of corruption and recovery of public security**

Looking back at the Yudhoyono administration's first year in power, a certain level of success has been achieved in terms of eradicating corruption and regaining public security.

In Indonesia, the Corruption Eradication Commission of Indonesia (*Komisi Pemberantasan Korupsi*, KPK), formed in December 2002, possesses legal authority to uncover, investigate and prosecute corruption cases. Despite the lack of significant accomplishments during the former Megawati administration, President Yudhoyono's strong resolve on anticorruption has driven the KPK to uncover major cases of corruption at the central and local government levels, such as the exposure of systematic bribery in the General Elections Commission (KPU) (leading members of the KPU

were arrested) and the arrest of the Aceh province governor for embezzlement involving the purchase of a Russian helicopter. In collaboration with the KPK, the President's Anti-corruption Team (formed in May 2005), arrested the former Minister of Religion for embezzling funds designated for Mecca pilgrimages in June. An investigation on a bribery scandal involving former president Suharto's half-brother led to the arrest of several supreme court officials and a lawyer in September and a subsequent questioning of the supreme court judge in November, thus delving into corrupt practices in the judiciary. In August 2005, President Yudhoyono revealed in the FY2006 Budget Message that 233 cases of graft were prosecuted during the first ten months of the administration.

Turning to public security, significant progress has been made in resolving the conflict in Aceh province which ranks high in terms of urgency. Hit hard by the massive earthquake and tsunami at the end of 2004, The Free Aceh Movement (*Gerakan Aceh Merdeka*, GAM) and the Indonesian government held a series of peace talks moderated by former Finnish president Martti Ahtisaari from early 2005. At the seventh round of the talks in July 2005, the Indonesian government and GAM reached a basic agreement to sign a peace agreement set out in a Memorandum of Understanding (MoU). The MoU was officially signed in August in Helsinki, Finland. Under the terms of the MoU, GAM withdrew its claims toward independence of Aceh province and began its disarmament process, while the Indonesian Government agreed to the following terms: (i) GAM's political participation, (ii) amnesty for GAM members, (iii) self autonomy (with the exception of diplomacy, national defense, security, finance, budget matters, judiciary and freedom of religion), (iv) allocation of 70% of income from local natural resource to Aceh province, and (v) withdrawal of government troops from Aceh province.

The MoU provides a roadmap for settlement of the 29-year dispute in Aceh province, leading to expectations toward Aceh's recovery and reconstruction. The Aceh Monitoring Mission (AMM) consisting of monitors from the European Union (EU) and five

ASEAN countries (Brunei, Malaysia, Philippines, Singapore and Thailand) has been established to monitor the implementation of the MoU. In a press statement on December 19<sup>th</sup>, the AMM confirmed that GAM has fulfilled its obligations under the MoU to hand over all its weapons and government troops have also started to withdraw from Aceh province. The pending task of the Indonesian government is to facilitate the legislative process of laws necessary for the implementation of its obligations under the MoU such as GAM's political participation and the allocation of natural resource income to Aceh province.

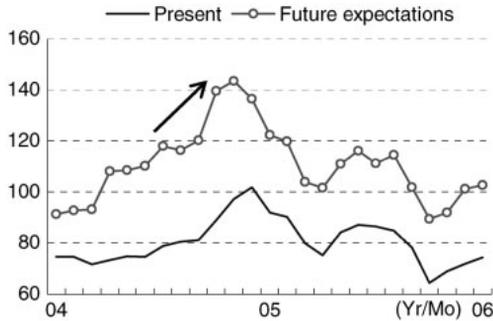
While the Yudhoyono administration has made progress since its first day in power, it is still woefully short of a complete eradication of bribery and corruption. In terms of public security, conflicts still continue in areas other than Aceh province. Furthermore, the second terrorist bombing in Bali in October 2005 indicates that concerns regarding terrorism have not subsided either. Even so, the progress is commendable for achieving unprecedented tasks never accomplished by previous administrations. According to a public opinion poll in April 2006 conducted by the Indonesian Survey Institute (Lingkaran Survei Indonesia, LSI), a leading Indonesian private public opinion research firm, 59% of the respondents feel satisfied with President Yudhoyono's efforts regarding corruption and that 56% are satisfied with the progress made in Aceh, revealing the public's high evaluation of President Yudhoyono compared with his predecessors.

## **(2) Progress on measures to facilitate growth fall below expectations**

President Yudhoyono's leadership and expectations toward the implementation of the economic policy program have had a positive impact upon confidence among businesses and investors. The consumer confidence index, compiled by the central bank on the basis of consumer surveys, rose sharply from the summer to the end of 2004 which corresponds to the period when the probability of Yudhoyono's victory in the presidential election rose sharply to just

after the inauguration of the Yudhoyono administration (**Figure 9**).

**Figure 9: The consumer confidence index**

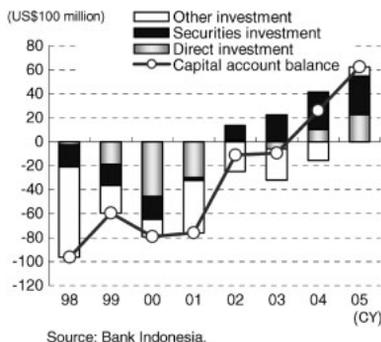


Note: The consumer confidence index is based upon surveys of consumers regarding the present and future (6 to 12 months forward) living conditions. A reading above 100 indicates that more respondents feel that conditions are improving than those that feel that conditions are worsening.

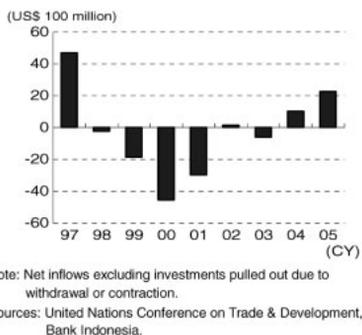
Source: Bank Indonesia

Foreign investment flows also increased. The deficit in the capital account persisting since the Asian currency crisis finally rose into a surplus in 2004 reflecting the rise of inward securities investment flows and the recovery of inward direct investment (**Figures 10, 11**). The recovery of inward direct investment stems from the improvement of business investment confidence stimulated by the stabilization of Indonesia's sociopolitical landscape under the Yudhoyono administration and progress of its policy measures, as well as the rise of consumer spending in Indonesia.

**Figure 10: Capital account balance**



**Figure 11: Inward direct investment flows**



Being the largest country in the ASEAN with a population of over 200 million, Indonesia drew attention among investors for its potential consumer market until the Asian currency crisis in the second half of the 1990s. Despite the sharp drop of consumer spending after the currency crisis, Indonesia's per-capita GDP which had dropped to as low as the US\$500-level at one point in time recovered to the US\$1,000-level in 2003. The rise of purchasing power and the spread of consumer loans spurred by low interest rates have boosted the sales of durable consumer goods such as motorcycles, automobiles and household electrical appliances during the past few years. Reflecting these trends, Japanese manufacturers including major motorcycle makers such as Honda and Yamaha, automobile and household electrical appliance makers and manufacturers of related parts are starting to invest in a bid to augment capacity.

The stock market is also rallying. After climbing to a historical high for the first time in 78 months in January 9, 2004, the Jakarta Composite Index surged in the second half of the year, rising 44.6% in annual terms.

Despite high initial expectations, the Yudhoyono administration has not achieved significant results in terms of economic policy.

Despite measures such as the identification of local ordinances hindering corporate business activity and the introduction of tax incentives in a bid to improve the investment environment, amendments of the legal system closely linked to the investment environment such as investment laws, labor laws and tax laws are making slow progress. This is due to the slow legislative process stemming from the cumbersome and time-consuming nature of adjusting the interests of relevant parties.

Turning to infrastructure development, calls for private-sector participation (including foreign corporations) were made for 91 projects (in transportation, communications, gas pipelines and water supply facilities) totaling US\$22.5 billion at the First Infrastructure Summit (Note 6) held in January 2005. However, successful contracts have been made for only 15 of the 91 projects during 2005 because of inadequacies regarding government guarantees and uncertainties regarding profitability and risk guarantees. Given these results, the Second Infrastructure Summit scheduled originally in November 2005 was postponed twice, and should be held sometime toward the end of 2006.

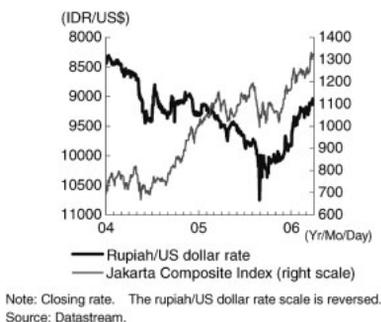
Amid the slow progress of the policy measures to stimulate growth, Indonesia's unemployment rate reached 10.8% as of October 2005, revealing a rocky road toward the Yudhoyono's ultimate goal in economic policy which is the creation of more jobs and the reduction of poverty. On the contrary, given an unexpected surge of crude oil prices in its first year in power, the Yudhoyono administration was faced with economic turmoil, albeit on a temporary basis as explained in more detail below. According to a public opinion poll as of April 2006 conducted by LSI, 74% responded that the Yudhoyono administration had failed to tackle the chronic problem of unemployment and 70% of respondents felt there had been no improvement in their household incomes, revealing the public's bleak assessment of the Yudhoyono administration's achievements regarding the economy in comparison to the accomplishments regarding corruption and public security.

## 4. Policy measures regarding the currency and stock market turmoil

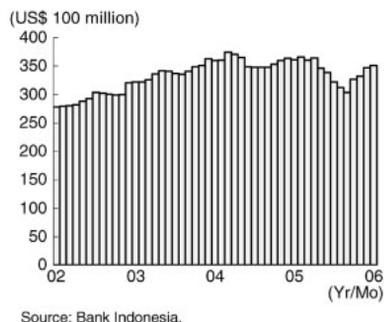
### (1) Loss of market confidence due to slow policy response

The rupiah and Indonesian stock prices dropped sharply in August 2005. (Figure 12). On August 19<sup>th</sup>, the rupiah's value to the US dollar dropped to US\$1 = IDR10,000 for the first time in approximately 42 months and continued to lose further ground, momentarily falling close to US\$1 = 12,000 during midday trading on August 30<sup>th</sup>. As a result of the central bank's (Bank Indonesia) market intervention to support the rupiah, Indonesia's foreign currency reserves fell (Figure 13). Meanwhile, even though the Jakarta Composite Index started to climb from mid-2004 at the time of the presidential election and reached a historical high (1,192.2) on August 3, 2005, reflecting the high expectations among investors toward the Yudhoyono administration, the stock market dropped sharply in mid-August.

**Figure 12: The rupiah and the Jakarta Composite Index**



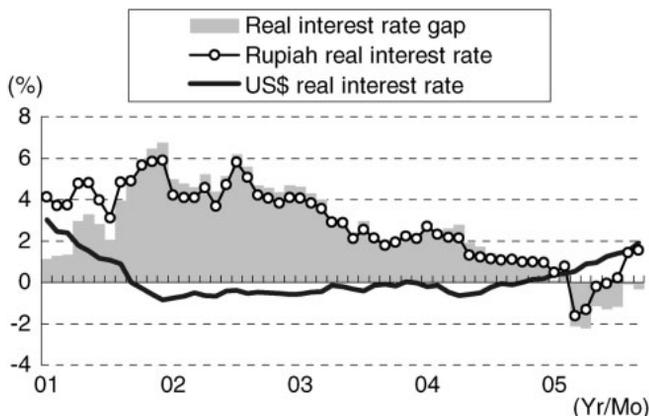
**Figure 13: Indonesia's foreign currency reserves**



To start out with, the rupiah had been following a mild depreciation to the US dollar since mid-2004 due to: (i) US dollar funding for the repayment of external debt and the settlement of petroleum import costs by Pertamina, Indonesia's state-owned petroleum company (Note 7), and (ii) the interest rate gap (rupiah interest rate minus US dollar interest rate) accompanying US interest rate hikes. Even so, in view of the fact that the rupiah's plunge in August 2005 was accompanied with the sharp fall of the Jakarta Composite Index, the depreciation of the Indonesian currency stems most likely from the loss of investor confidence and the acceleration of capital outflows. A sense of misgiving toward monetary policy and the government's policy response toward various problems such as the ballooning fuel subsidies accompanying the surge of crude oil prices are the main reasons for the loss of investor confidence.

Looking first at monetary policy trends, Bank Indonesia has continued to cut interest rates, reflecting the decline of the inflation rate since the peak in the spring of 2002. Since Bank Indonesia continued to take a low interest rate policy despite a mild rise of the inflation rate after bottoming in the spring of 2004, real-term interest rates fell and dipped into negative territory in 2005. Meanwhile in the US, successive rate hikes since June 2004 led to the contraction of the real interest rate gap between the rupiah and the US dollar (rupiah interest rate minus US dollar interest rate) (**Figure 14**).

**Figure 14: The interest rate gap in real terms between the US and Indonesia**



Note: The US dollar real interest rate = US\$ 1-month SIBOR minus core CPI.  
 The rupiah real interest rate = 1-month SBI minus CPI (ex food and energy).  
 The real interest rate gap = rupiah interest rate minus US\$ interest rate.  
 Source: Bloomberg.

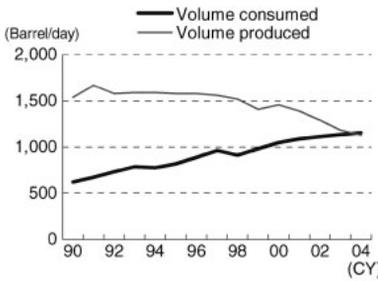
Under these circumstances, Bank Indonesia raised the BI Rate (the reference rate to ensure that the 1-month SBI remains at around the level of the BI Rate) by 25 basis points (8.50%→8.75%) on August 9<sup>th</sup> and the Fasilitas Bank Indonesia deposit facility rate (the FASBI rate) also by 25 bps (7.25%→7.59%). Even so, since the rate hike turned out modest compared to the inflation rate and US interest rates, the rate hike only served to highlight the central bank’s reluctance to tighten, leading to the acceleration of the rupiah’s fall toward the end of the month.

Even though the rise of fuel subsidies was temporarily suppressed by an average 29% hike of petroleum & fuel prices in March 2005, the subsequent rise of crude oil prices led to the further increase of fuel subsidies. The initial budget for FY2005 (from January to December of 2005) originally estimated that the amount of fuel subsidy expenditures would be IDR19 trillion on the assumption that the price of crude oil would be US\$24 per barrel.

Even though fuel subsidy expenditures were increased to IDR76.5 trillion, by raising the underlying price of crude oil to US\$ 45 in the first budget supplementation in June, there is a greater possibility that fuel subsidy expenditures would have to be increased further by a large degree reflecting the surge of crude oil prices.

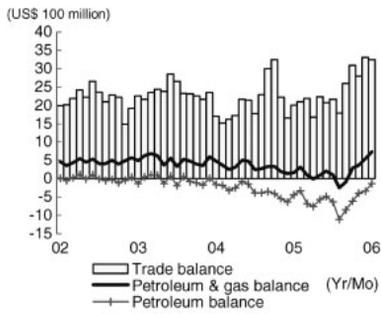
Higher crude oil prices alone are not to be blamed for undermining Indonesia’s economic fundamentals. Although Indonesia is an oil-producing country with oil reserves to last another 10 to 20 years, it became a net importer of petroleum from 2004 onward as a result of (i) the rise of petroleum consumption along with economic recovery, (ii) the sharp decline of oil production due to its aging existing oil fields and the stagnation of petroleum exploration activities (**Figure 15**). Net petroleum imports continued to increase in 2005. Even so, Indonesia still has an overall trade surplus given the rise of exports of industrial products and primary commodities other than crude oil (**Figure 16**), presenting a very different situation compared to Thailand which has fallen into a trade deficit due to the increase of petroleum imports. It would be premature to conclude that the rise of crude oil prices is the direct cause of the rupiah’s fall.

**Figure 15: Petroleum production and consumption**



Source: British Petroleum, *Statistics Review of World Energy 2005*.

**Figure 16: Indonesia’s trade balance**



Source: Statistics Indonesia.

By the same token, the increase of fuel subsidies alone would not lead to a sharp deterioration of Indonesia's fiscal balance. Looking at both the expenditures and revenues side of the fiscal balance, spending for subsidies and local transfers of petroleum-related revenues would increase, while tax revenues and non-tax revenues related to petroleum would increase. Turning to the net impact upon the fiscal balance (petroleum-related expenditures minus petroleum-related revenues) in the FY2005 first supplementary budget, the rise of fuel subsidies only served to increase the fiscal deficit by IDR325 billion (0.12% of GDP) from the initial budget.

Even so, it is undeniable that the increase of rigid expenditures such as fuel subsidies is serving as restraints upon discretionary spending regarding infrastructure. Moreover, measures to maintain low domestic fuel prices are dampening the incentive to conserve energy and resulting in the rise of petroleum consumption. As mentioned earlier, the reduction of fuel subsidies from the perspective of fiscal discipline is one of the Yudhoyono administration's basic policy commitments. Procrastination in this area would only serve to create doubts regarding the administration's stance on policy implementation. Thus, we are inclined to believe that the sharp fall of the rupiah stems in part from the loss of confidence among investors.

## **(2) Markets regain stability due to interest rate and fuel price hikes**

Despite the initial slow response, the Yudhoyono administration was quick to act in the face of market instability. To start out with, Bank Indonesia raised the BI rate by 75 bps and the FASBI by 100 bps on August 30<sup>th</sup> and subsequently took steps to raise interest rates on four occasions (totaling 325 bps), raising the BI rate to 12.75%.

Reflecting President Yudhoyono's announcement on August 31<sup>st</sup> that petroleum fuel prices would be raised again sometime after October, fuel prices were raised by an average of 2.26 times on October 1<sup>st</sup>. In addition to fuel for automobiles and ships, heating

fuel widely used among households as fuel for cooking purposes was also subject to the price hike. Considering its impact upon households, the government decided to provide a compensation of IDR100,000/month to poor households with incomes under IDR175,000/month. The government also unveiled an incentive package for industries, due to concerns that higher fuel prices might have a negative impact such as the rise of distribution costs (**Figure 17**).

**Figure 17: Incentive package for industries**

<p><b>Taxation</b></p> <ul style="list-style-type: none"> <li>• Exemption of primary commodities from VAT</li> <li>• Exemption of parts and raw materials for heavy machinery makers from import tariffs</li> <li>• Reduction of import tariffs on sugar</li> <li>• Exemption of engine parts for public transportation from import tariffs</li> <li>• Reduction of automobile taxes for public vehicles</li> <li>• Early abolishment of local decrees regarding taxes and surcharges which hamper corporate business activity</li> </ul>
<p><b>Customs clearance</b></p> <ul style="list-style-type: none"> <li>• Exemption of technical inspection of imports of medical-purpose salt, tire cord, filter cloth, canvas &amp; jute bags</li> <li>• Relaxation of inspections regarding imports by manufacturers</li> <li>• Reinforcement of oversight on smuggling</li> </ul>
<p><b>Transportation</b></p> <ul style="list-style-type: none"> <li>• Restraints upon container handling charges</li> <li>• Reduction of vehicle weight and abolishment of Article 36 regarding excess loading</li> </ul>

The Office of the Coordinating Minister for Economic Affairs.

Fuel subsidy expenditures have been curbed, given the government's decision to raise domestic fuel prices. In contrast to initial forecasts that fuel subsidy expenditures in FY2005 would rise to IDR139 trillion along with the rise of crude oil prices, fuel subsidy expenditures in the second supplementary budget, factoring in the fuel price hike on October 1<sup>st</sup>, stood at IDR89 trillion (up 16% from the first supplementary budget). FY2006 fuel subsidy expenditures are projected to stand at IDR54 trillion, based upon crude oil price forecasts of IDR54 trillion. The government has announced that it will phase out and eventually abolish the fuel subsidies.

The market has regained stability, and confidence among investors is no longer falling, reflecting Bank Indonesia's acceleration of interest rate hikes since the end of August and the

government's reduction of fuel subsidies. The rupiah's value to the US dollar, which had fallen to nearly IDR12,000/dollar in August, has been trading around IDR10,000/dollar since the end of August, recovering to the IDR9,000-level since the year-end. The Jakarta Composite Index is also rebounding from the bottom at 994.77 on August 29<sup>th</sup>, rising to the 1,300-level (**Figure 12**).

### **(3) The after effects of the fuel price hike**

Even so, higher fuel prices will lead to a harsher environment for the economy and corporate profits in the short-term.

To start out with, Indonesia's has a very low energy efficiency level, with unit energy input surpassing Japan and larger even in comparison with other countries of Asia. Furthermore, Indonesia's high dependence upon petroleum as a source of energy makes it vulnerable to the rise of petroleum fuel prices. For companies, the rise of petroleum prices would lead to (i) the rise of distribution costs due to higher fuel prices for automobiles and ships and (ii) the rise of electrical power costs because of a relatively high dependence upon petroleum (approximately 20%) for electrical power generation (Note 8).

The impact of the rise of petroleum prices is also spreading to wages. In Indonesia, minimum wages are determined annually in each of the provinces. Since October 1<sup>st</sup> when the government implemented a major petroleum price hike, minimum wages for 2006 have been decided by each of the provinces. Minimum wages in Jakarta (a special capital city district) rose 15.1% y-o-y to IDR819,100, rising at a double-digit rate for the first time in four years. Other provinces have also followed by sharply raising minimum wages (**Figure 18**). Generally, the rise of minimum wages would lead to an inevitable rise of labor costs because overall wages of all workers would also rise in accordance with their years of continuous employment. Furthermore, according to M.S. Hidayat, chairman of the Indonesian Chamber of Commerce and Industry, some companies appear to be implementing layoffs to cope with the sharp rise of petroleum fuel prices and the rise of operational costs,

with other companies likely following suit.

**Figure 18: Minimum wages in major provinces (2006)**

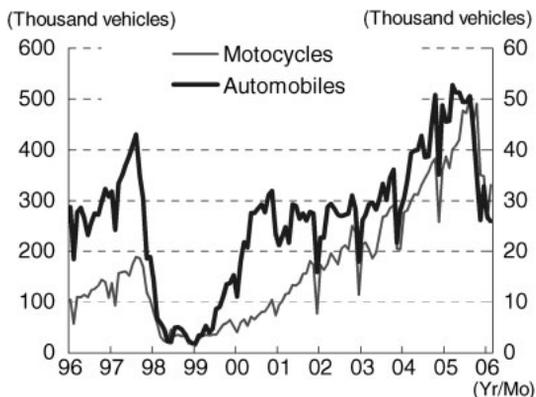
Province	Minimum wage		(Y-o-y% change)
	(Rupiah)	(Yen)	
Jakarta	819,100	9,826	15.1
North Sumatra	737,794	8,851	23.0
South Sumatra	604,000	7,246	19.9
Riau	637,000	7,642	15.5
Riau Islands	670,000	9,117	36.5
West Java	447,654	5,370	9.7
Banten	661,613	7,937	13.1
Bali	510,000	6,118	14.0

Note: Exchange rate as of the end of 2005 (0.012 yen/rupiah).

Source: Indonesia, Ministry of Manpower and Transmigration.

Consumer spending will most likely slow down reflecting the sluggish rise of real income due to the rise of inflation, the deterioration of labor market conditions and the rise of interest rates. In particular, the rise of interest rates on bank loans should serve as a drag upon the sales of high-end durable consumer goods such as cars. Automobile sales, which had been driven by the spread of consumer loans under a low interest rate environment during the past few years, has fallen over the year-end in 2005 (**Figure 19**). For the time being, companies will be faced with the rise of operational costs, the slowdown of consumer spending and its negative impact upon sales.

**Figure 19: Sales of motorcycles and automobiles**



Source: Astra International.

## **5. Future tasks: tangible results regarding the improvement of the investment climate**

### **(1) Expectations are carried on to the second year**

Demonstrations broke out across the country including the capital city of Jakarta since October 1<sup>st</sup> when the government implemented a sharp petroleum fuel price hike. Nevertheless, the demonstrations did not develop into riots and were quelled within a few days. Even though the fuel & energy price hike in May 1998 under the Suharto administration triggered riots and led to the collapse of the regime and the announcement of a major fuel price hike in January 2003 by the Megawati administration led to large scale protest demonstrations which resulted in the rescission of the hike, the recent protests were relatively benign despite the magnitude of the price hike which was the largest ever in history.

President Yudhoyono's success in reducing fuel subsidies – a

longstanding challenge in Indonesia – underscores the stability and executive ability of the Yudhoyono administration. Despite an undeniable delay in decision making in the initial stage of the market turmoil in August, the administration deserves commendation for its awareness and quick response to the crisis in the ensuing stages which led to its success in quelling the market turmoil.

The Yudhoyono administration is not responsible for any definite errors in policy decisions regarding Indonesia's economic instability in its first year in power, which stems partially from unexpected contingencies such as the massive earthquake off the Sumatra coast and Indian Ocean tsunami and the surge of crude oil prices.

President Yudhoyono conducted a cabinet reshuffle, mainly targeting the cabinet's economic team with poor performance, on the basis of performance evaluations of all cabinet members during the first year of the administration. To lead the cabinet's economic team, former Finance Minister Boediono was appointed as the Coordinating Minister for Economy, given his achievements in macroeconomic helmsmanship under the Megawati administration. Sri Mulyani, executive director of the International Monetary Fund (IMF) and former Minister of National Development Planning, was appointed as the Minister of Finance. It appears that President Yudhoyono is preparing to improve the administration's performance in economic policy in the second year by appointing technocrats with proven records to key economic cabinet positions. Investor response to the cabinet reshuffle appears to be more or less favorable, judging from the rise of both the rupiah and the stock market since December 8<sup>th</sup> when the cabinet lineup was announced.

## **(2) Maneuvering the economy in the face of mounting issues**

Looking at the external environment surrounding Indonesia's economy, despite the solid growth of overseas economies such as the developed countries and China, crude oil prices are pinned at a high level due to persistent supply-side concerns. Domestically, the major petroleum fuel price hike in October 2005 is driving up inflationary pressures, providing reasons to believe that monetary

policy authorities will continue to take a tight monetary policy stance for the time being. Indonesia's rate of real GDP growth has been slowing from the peak (6.7% o-y-a) just after the inauguration of the Yudhoyono administration in the Oct-Dec quarter of 2004. The economic slowdown has been intensifying since October 2005, along with the emerging impact of the fuel price hike and rise of interest rates. In the Oct-Dec quarter, the rate of economic growth fell to 4.9% o-y-a.

Despite the government's economic growth target of 6.2% in 2006, the achievement of the target would be difficult, because high energy prices and high interest rates continue to dampen consumer spending and private sector investment even after the turn of the year. Rather than being bound by the 6.2% target, the Yudhoyono administration in its second year is expected to concentrate on achieving steady results regarding the improvement of the investment climate, which are measures to regain high economic growth in the medium term, the expansion of employment and reduction of poverty, while maintaining macroeconomic stability such as keeping inflation in check.

On March 2<sup>nd</sup>, The Office of the Coordinating Minister for Economic Affairs announced the *Policy Package for Improvement of the Investment Climate*. Signed by President Yudhoyono as of February 27<sup>th</sup> as "Presidential Decree No. 3/2006", the package includes a total of 19 basic policies covering five main areas (general, customs & excises, taxes, manpower and small & medium enterprises and cooperatives) (**Figure 20**). Specific programs, measures and time targets have been established for each policy area and deadlines have been set for belated legislative procedures for the amendment of related laws such as the revision of the investment law, the revision of the law on manpower and the revision of tax laws. By introducing the non-discrimination principle between foreign and domestic entities, simplifying and promoting the transparency of investment license procedures and tax collection and improving the rigid labor market, these legal improvements are deemed important from the perspective of deregulating/abolishing regulations and

systems which serve as impediments toward corporate activity, Legislative procedures regarding these legal amendments are progressing, paving the way to for the improvement of the legal framework for investment.

**Figure 20: The Policy Package for Improvement of the Investment Climate, 2006**

Area	Basic policy	Action program
General	Strengthening investment service institutions	Revision of investment law Revision of regulations related to investment Revitalization of the National Team for the Enhancement of Exports and Investment (TEPI) Acceleration of business licensing and investment and the establishment of companies
	Synchronizing Central Regulations and Regional Regulations	Review of Regional Regulations that obstruct investment
	Clarify regulations concerning the requirement for an Environmental Impact (AMDAL)	Amendment of degree of the State Minister of the Environment on the Types of Business Plans and/or the activities for which an AMDAL is mandatory
Customs & Excises	Acceleration of the flow of goods	Acceleration of the customs examination process Faster cargo processing and lower costs at the Ports of Tanjung Priok and Soekarno Hatta
	Expansion of the role of Bonded Zones	Extension of the function of Bonded warehouse (TFB) and changes in some concepts of Bonded Zones to attract investors to invest Improvement of TFB regulations Automation of activities at TFB
	Radicalization of smuggling Debureaucratization in the Excises Sector	Enhanced customs facilities in the bonded zone Increase activities to eradicate smuggling Accelerate the registration and application process for excises facilities
Taxes	Tax incentives for investment	Improve the Law's on General Provisions and Procedures of Tax, Income Tax and Value Added Tax on Goods & Services and Sales Tax on Luxury Goods Income tax facilities for certain business sectors Reduce regional taxes that have the potential to push up prices/service
	Carrying out the "self-assessment" system consistently	Review Income Tax rate Review regulations regarding monthly tax payments (prepayment/installment) Improvement of tax services to increase the people's awareness of the importance of paying tax
	Revised Value Added Tax (VAT) to promote exports	Cancel the VAT penalty Increase the competitiveness of service exports Increase the competitiveness of (primary) agricultural products
	Protecting the rights of taxpayers	Apply the Code of Ethics for Tax Officers/Tax Officials Reform the Tax Payment System
	Promoting transparency and disclosure	Disclosure of Tax Audits and investigations Increasing the knowledge of the community regarding Taxes
Manpower	Creating an Industrial Relations climate that supports the expansion of employment	Review Law No. 13/2003 on Manpower Amending the implementation regulations of Law No. 13/2003 on Manpower
	Protection and Placement of Indonesian Manpower (TKI) overseas	Review Law No. 39/2004 on the Placement and Protection of Indonesian Manpower Overseas
	Settlement of various industrial relations disputes quickly, cheaply and fairly	Implementation of Law No. 2/2004 on the Settlement of Industrial Relations Disputes
	Accelerating the process of issuing Manpower licenses	Review the related Law's/Regulations/Decrees/Circular Letters
	Creation of a flexible and productive manpower market	Development of Employment Exchange and Employment Market Information
Small and Medium Enterprises and Cooperatives/UKMK	Broadthrough of transmigration development paradigms in the framework of expanding employment	Amend Law No. 15/1997 on Transmigration
	Empowerment of Small and Medium Enterprises and Cooperatives/UKMK	Improvement of regulations related to licensing Development of Consultancy Services for Small and Medium Industries (KM) Enhanced access for UKMK to financial resources and other productive resources Strengthening of Partnership between big Enterprises and UKMK

Source: The Office of the Coordinating Minister for Economic Affairs, *Policy Package for Improvement of the Investment Climate*.

However, these legal developments only comprise the first step toward the improvement of the investment environment. In addition to legal improvements, it is essential to upgrade the investment climate in ways that are tangible for companies and investors such as reviewing the related regulations and local ordinances and simplifying and facilitating the procedures for approvals and licenses.

Take, for example, the improvement of infrastructure. Even

though the facilitation of private–sector participation is indispensable, a necessary precondition would be the development of a legal framework for government guarantees for business profitability and risks and ensuring its implementation. For the time being, the government should improve the relevant legal systems while focusing upon the implementation of high priority projects within its limited fiscal resources.

Despite a certain level of success during the first year of the Yudhoyono administration, further progress is still necessary regarding the eradication of corruption and bribery, regional disputes and terrorism, given its strong connection with business risks. In particular, it is necessary to correct the situation in which companies face exorbitant fees in customs, tax, approval and license procedures in daily operations.

The Yudhoyono administration is also strongly urged to continue its efforts to promote the government–industry dialog starting from the days of the former Megawati administration in the course of improving the investment climate. Opportunities for dialog such as *The High Level Government/Private–Sector Joint Forum on Investment* (Note 10) based upon the Japan–Indonesia Summit Meeting (November 2004) and periodic meetings between the president, cabinet members in charge of the economy and the industrial world are continuing even after the inauguration of the Yudhoyono administration. By reflecting those wishes voiced in these meetings in future government policies, the administration would be able to gain the industrial world’s confidence, leading in turn to a greater incentive to invest among companies over the medium and long–term.

Ranking on par in terms of potential with the BRICs (Brazil, Russia, India and China), Indonesia’s resurgence depends upon the Yudhoyono administration’s future efforts. Admittedly, it would be difficult for the Yudhoyono administration to achieve all its goals in the second year, given the numerous challenges it faces. Even so, unless it succeeds in reaping steady achievements surpassing those in its first year, expectations among businesses and investors would

sour, serving as a detriment to all hopes of a full-fledged recovery of investment and high economic growth. The Yudhoyono administration is approaching a critical stage in economic policy management.

\* \* \* \* \*

Notes:

1. Constitution of 1945, as amended (four amendments since 1999).
2. The Corruption Perception Index is a composite index based upon surveys of research institutions, private businesses and individuals, grading the countries of the world by a score of one to ten, according to the degree to which corruption is perceived to exist. The lower the score, the higher the degree of corruption.
3. Given the reinforcement of the powers of local governments by the enactment of legislation on decentralization in 1999 (Law No. 22/1999 on Regional Governance and Law No. 25/1999 on Fiscal Balance Between the Centre and the Regions), the local governments took steps to increase their revenues by issuing a spate of ordinances on fiscal resources such as local taxes, surcharges and third party donations, leading to the increase of burdens upon companies, serving as a negative impact upon corporate activities.
4. Subsidies paid by the government to Pertamina in the event of a surge of crude oil prices in order to suppress the rise of domestic fuel prices.
5. Excluding the US\$4 billion relief funds for the Sumatra earthquake and Indian Ocean tsunami.
6. Summit meeting hosted by the Indonesian government and the Indonesian Chamber of Commerce and Industry, where members of government, international organizations and foreign investors discuss the development of Indonesia's infrastructure.
7. While Pertamina exports crude oil, it also imports refined petroleum products. Since (i) foreign currency proceeds out of Pertamina's crude oil exports are first incorporated into foreign reserves and (ii) rupiah-denominated fuel subsidies paid by the government are exchanged for US dollars for the settlement of import payments, the transaction leads to massive US dollar purchases.
8. PLN, Indonesia's state-owned electricity company, raised electrical utility rates for industrial usage during peak periods from rates charged from October 2005. Given a large number of companies that resort to in-house electrical power generation to cope with the unreliable supply of electrical power, the rise of industrial fuel prices will lead to the rise of in-house electrical power generation costs.
9. Jakarta Post (December 28, 2005).
10. The *High Level Government/Private-Sector Joint Forum on Investment ("Joint Forum")* was established as a framework for dialog for the promotion of investment

from Japan to Indonesia. Participants include representatives of the government and private sectors of both Japan and Indonesia. Through discussions in the four working groups including (1) Tax/Custom WG, (2) Labor WG, (3) Infrastructure WG, and (4) Competitiveness/Small and Medium Enterprises (SME) WG, the *Joint Forum* drew up a Strategic Investment Action Plan (SIAP, announced in June 2005) and monitors the progress of the SIAP.



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