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From the Desk of...

James Castle
Indonesia Business Strategist

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**Will the real Indonesia please stand up?** Although Indonesia's stock market has been one of the region's best performing for the past three years and has seen over US$12billion in successful bond offerings – public and private – in the past two years, Indonesia cannot seem to shake its image as a difficult and sometimes dangerous place to do business. So, what's the real story?

Once a magnet for foreign capital in the boom days of the mid-1990's, Indonesia has been unable to regain its investment allure since the spectacular collapse of its government and economy in 1998. Indonesia's economy was clearly the hardest hit by the financial tsunami which swept through Asia's newly industrialised countries in 1997 and 1998, with its GDP dropping an incredible 14% in 1998. As a result, the thirty-year autocratic reign of the redoubtable Soeharto collapsed with many pundits expecting the country to do likewise in short order.

### FDI figures remain disappointingly low

Indonesia has clearly disappointed the pessimists who foresaw a Soviet Union-style political disintegration. It is now the world's third-largest democracy and one of its most dynamic and has regained its place among the fast growing South-east Asian economies. Nevertheless, it has been unable to regain the aura that attracted billions of dollars of foreign direct investment (FDI) in the 1990's. Foreign investment approvals, which averaged US$30bn per annum in the years leading up to the crisis, have averaged less than US$10 billion a year since 1997 according to data from the Indonesian Investment Board (BKPM). Overall investment is also down sharply, from a robust annual rate of 25-30% of GDP in the pre-crisis era to an anemic average of less than 20% since. Several sectors that attracted major amounts of foreign capital in Indonesia's boom years are now virtually dormant. For example, Indonesia used to attract over 5% of global expenditure on mining exploration annually but now receives less than 0.5%. The oil and gas story is only moderately better and crude oil production has dropped from a peak rate of 1.4 million barrels a day to fewer than 0.9 today and the country has become a net oil importer.

### … but the stock market and the bond markets soar

Meanwhile, however, the Jakarta Stock Exchange Index is up over 300% since January 2001 and 350% since its 2003 low of 392, and the Indonesian bond market remains very robust, despite a recent eccentric ruling by the Indonesian Supreme Court against holders of a $500mn 1994 Indah Kiat bond that is in default. Nevertheless the Indonesian government or government entities have successfully sold over US$5.4 bn of public debt this year, up 21% from the US$4.7 bn they sold in 2005. Meanwhile, Indonesian spreads are increasingly tight. The October issue of US$1 bn of debt by the State Electric Company (Perusahaan Listrik Negara) was six times over-subscribed at yields of 7.4% for the five-year portion (versus 7.75% guidance) and 7.9% for ten-year yield (versus 8.25% guidance). It is clear that although the risk premium for Indonesia is extremely low for Indonesia, financiers feel the macro cycle is on the upswing and portfolio investors are eager to participate.

### So why has FDI remained so low while portfolio investment is at a record high?

The simple answer; Indonesia's GDP growth is solid and its prospects are very good. Investors are more than willing to put their money into liquid bonds and listed equities and these investments can be sold in a heart-beat if the market turns sour. Conversely, investors are much more hesitant to put their capital into Indonesia for long term, illiquid projects, i.e. bricks and mortar for green-field manufacturing, infrastructure and natural resource exploration and development. Historically, investment in Indonesia has produced extremely high returns. These returns are once again being achieved today by companies already in the market and portfolio investors are quite willing to invest in the success of the government and the companies that have already taken the risks and done the heavy lifting necessary to succeed on the ground, but they will only do so in the form of liquid paper that can be sold at the first sign of trouble.

Direct investors, on the other hand, especially new-to-market investors with limited or no Indonesia experience, are unwilling to expose their capital and technology to Indonesia for the long term because of weak rule of law and the inability to enforce contracts and agreements via any transparent legal process. Even the new direct investors who have come recently are primarily interested in acquiring proven operating assets, for example, Phillip Morris' $5.2 bn March 2005 acquisition of domestic cigarette-maker, Sampoerna, rather than in building new capacity.

Despite macroeconomic stability, excellent growth prospects, low public debt, growing foreign exchange reserves, declining inflation, strong merchandise trade balance, growing exports and political stability provided by the popular and directly elected President, Susilo Bambang Yudhoyono – all conditions that should have investors lining up at the door! – investing in Indonesia remains an intimidating prospect for those who are not intimately familiar with its complex and often predatory regulatory environment.

### The SBY factor begins to kick-in …

There is cause for optimism that this will all change in the near future, if we remember that Susilo Bambang Yudhoyono, (popularly known as SBY), swept to an overwhelming electoral victory on a pro-business reform platform just two years ago in Indonesia's first ever direct election. Yudhoyono swamped the incumbent Megawati Soekarnoputri 61%-39% on an economic platform virtually identical to that proposed by the Indonesian Chamber of Commerce during the campaign.

The President's platform promised a simplified and more transparent regulatory environment for business, with clear proposals for reform of tax and labor regulations which are considered among the region's most restrictive and uncompetitive. SBY also indicated his strong desire to improve the investment law and prioritise the mobilisation of private investment in Indonesia's antiquated infrastructure sector, sharply reducing the corrupt and incompetent dominance of state-owned enterprises which have consistently failed to provide infrastructure adequate to support modern growth and keep pace with its better-managed ASEAN neighbours, Thailand, Malaysia and Singapore.

Even new 'tiger', socialist Vietnam, has proven more aggressive and efficient in upgrading its public services and is now growing more rapidly and attracting more private investment than Indonesia.
Since taking power in October 2004, the SBY administration has made significant progress in reducing corruption at the national level and improving order and discipline in a number of important institutions like the Police Force, the Investment Board (BKPM) and the Tax Department. On the other hand, it has not yet been successful in pushing its legislative agenda through the parliament. It has failed to revamp the government's cumbersome, anti-business procurement system and to produce transparent tender documents for infrastructure projects under conditions that are reasonable and bankable.

Despite these difficulties and delays, the government has not become dispirited nor defensive. The government remains fully and publicly committed to reform. It is highly likely that infrastructure investment will increase substantially over the next two years as the government increases public spending and some of its reforms-in-progress take hold and private investment starts to return. When this happens, growth will reach 7% and alert companies that are either already in the market or closely monitoring it, will be the ones best-positioned to participate and reap the rewards.

So the real Indonesia today is the one that offers high rewards for agile traders and is setting the stage for another wave of direct investment that could well spark a decade of 7% plus annual growth. To those who ask whether Indonesia is ready for major capital investment, the answer, frankly, is "not yet". When will it be? "Not long" … let's see - watch this space.


### About Jim Castle

Jim Castle is the Chief Executive of CastleAsia, a consultancy and research firm based in Jakarta. He is one of its most experienced business advisors on Indonesia with almost 30 years' experience working in, observing and analysing the Indonesian economy, its political developments and the business operating environment

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