

CHAPTER 1, EXECUTIVE SUMMARY

As this Country Commercial Guide goes to press, the Indonesian Government, led by President Megawati Soekarnoputri, is facing significant challenges. The government is striving to combat terrorist elements in the country, to create effective democratic institutions, and to advance economic reforms. These are a tall order for a country that has witnessed repeated political and economic upheavals in recent years. Since the downfall of President Suharto in 1998, the country has had three Presidents. Little more than one year ago, Megawati Soekarnoputri, the daughter of Indonesia's first President was elected in a special session of the highest legislative body to become the fifth President of Indonesia, succeeding the troubled tenure of President Abdurrahman Wahid.

The terrorist activities during the last quarter of 2002, and in particular the October 12 bombings in Bali, took the country by surprise, and the impact on the economic and business environment is still being assessed. Given the resulting strong travel advisories by a number of Indonesia's trading partners, business and leisure travel to Indonesia and the entire region have declined significantly. Indonesian Government Ministers quickly reached out to the foreign business community in Indonesia and to their traditional partners overseas to assure them that the government is taking new measures to address the security situation. Nonetheless, the prolonged security threat resulted in an unpredictable commercial environment and dampened the early signs of recovery from the economic crisis that hit Asia in mid-1997.

The Megawati Administration made significant progress in stabilizing Indonesia's economy during its first year in office. It rejuvenated Indonesia's economic reform program and restored Indonesia's relationship with the IMF, which had deteriorated during the Presidency of former President Abdurrahman Wahid. In April 2002, the Paris Club of official creditors recognized the GOI's renewed commitment to economic reforms by agreeing to reschedule USD 5.5 billion in principal and interest payments falling due from April 1, 2002 to December 31, 2003. Indonesia maintained positive GDP growth through the world economic slowdown in 2001, GDP growth figures exhibiting signs of a strengthening economy. GDP grew 3.92 percent YoY in Q3 2002, improving on first quarter YoY growth of 2.87 percent.

Preliminary economic assessments following the October 2002 Bali bombings predict a modest economic slowdown. Current consensus is that Indonesia's GDP for 2003 could drop by a full percentage point to 3.0 percent. On November 1st, 2002, the Government of Indonesia and the House of Representatives formally agreed to slash the official economic forecast for next year a full percentage point from 5 to 4 percent. Tourism and related sectors such as transportation and restaurants are the most likely to be affected.

The economic impact of the Bali bombings blasts will likely be very serious for Bali but more manageable for the country as a whole. An estimated 4.3 million foreign tourists visited Bali in 2001, and tourism-related activities account for about half of Bali's economy. Occupancy rates at most Bali hotels, which were full before the blasts, are now at 20 percent or less. Although net bookings (cancellations minus new reservations) at some hotels have turned positive again, the World Bank estimates that tourist arrivals in Bali could fall by 20 percent in 2003 at a cost of approximately 350,000 jobs (Bali's total labor force is about 1.7 million). Handicraft producing areas in East Java will also be

hard hit by the slump in tourists. January 2003 will be a crucial month; if there are signs of an upswing by that time, most hotels and tourism-related businesses will likely refrain from laying off their workers in expectation of better days ahead.

The impact of the bombings on Indonesia's economy should be more manageable. Bali's economy is about 1.3 percent of the national economy, and tourism and related industries nationwide contribute an estimated 3.5 - 4.5 percent to GDP. Tourism contributed about USD 5.3 billion to Indonesia's balance of payments in 2001. If tourist arrivals decline 20 percent in 2003, most economists expect GDP growth to fall by a full percentage point from four percent to about three percent. Indonesia's current account surplus in 2003 could fall by USD 1 - 1.5 billion. The GOI has revised downward its official growth estimates, and submitted an updated budget to Parliament calling for an expanded fiscal stimulus to counter the effects of the bomb blasts. The key question for Indonesia's future growth prospects will be the indirect effect of the bombings on consumer and business confidence.

The U.S. and other donors expressed broad support for Indonesia's efforts to overcome the Bali bombings at a November 1 interim meeting of the Consultative Group on Indonesia (CGI). But there was also a strong consensus among donors that the GOI needs to boost security and improve the investment climate in order to spark a full recovery from the bombings. We recommend you follow a similar line in your private interactions with Minister Soewandi. While foreign donors will help mitigate the short-term economic effects of the bombings, a lasting recovery will require effective GOI action to combat domestic terrorism and improve the investment climate.

To date, no investment has left the country as a result of the Bali bombings. However, previously investors were already beginning to leave the country, moving their factories to other countries where the incentives are more attractive and the investment climate more favorable. New investment is not taking place, and according to economic experts this new investment is key to sustained recovery, since increased consumer and government spending are not enough on their own. The decline in foreign investment indicates that Indonesia is no longer seen as profitable investment destination. Investors point out to problems in the country to restore security, production capacity, employment and improved productivity.

Some new commercial opportunities have arisen out of the unfortunate security situation, including proposed procurement by the police and other government entities of security equipment and services at airports, ports and other tourist destinations. Attractive financing will be necessary to complete these transactions. Additional "best prospects" for American business in Indonesia, range from Industrial Chemicals, Water Resources Equipment and Services, Telecommunications Equipment and Services, Oil and Gas field machinery, Franchising, Medical Equipment, Educational Services, and Industrial Pumps. In the medium and long term there are enormous possibilities in a market of 220 million potential customers.

As a country in the early years of democracy, outbreaks of communal violence around the country are among the key political issues with economic implications. The implementation of decentralization, while offering democratic dividends, has been uneven and many issues including revenue-sharing between the central and local governments remain unresolved. Continuing reports of high-level corruption, especially in the judiciary, point to the need for comprehensive reform and implementation of good

governance practices. While the response to Megawati's administration has been hopeful, it is still unclear what impact her government finally will have on combatting the terrorism, advancing economic reform and enhancing general business conditions.