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# RISKS TO WATCH

# INDONESIA

**Indonesia** is attracting **enormous emerging market investor interest**, partly due to President Susilo Bambang Yudhoyono's market-friendly reforms. Falling debt and market-friendly reforms could propel the country to achieve an investment grade credit rating within a couple of years, putting it on a par with BRIC nations such as China and enabling more institutional investment in its bonds. That trajectory, however, is imperilled by vested interests who stand to lose out if measures aimed at increasing transparency and creating a level playing field succeed. And **fund inflows could be reversed if policymakers fail to control inflation or impose controls to control capital**, as emerging markets struggle to deal with rising currencies.

## GOVERNMENT EFFECTIVENESS DRIVING REFORM

When Yudhoyono was re-elected with a strengthened mandate in 2009, many Indonesians hoped the ex-general would use his second and final term to shore up his legacy as a progressive reformer. Soon after his second term began, however, the government was distracted from policy making by a long and highly politicised enquiry into a bank bailout that led to the resignation of one of his top reformers, former Finance Minister Sri Mulyani Indrawati.

**Indrawati's resignation** was seen by some as a victory for her political enemies, chief among them Golkar party chief and tycoon Aburizal Bakrie. But **Agus Martowardojo**, who replaced her as finance minister, also has a track record of standing up to powerful interests and has sworn to continue Indrawati's reforms. Soon after Indrawati left, however, Yudhoyono gave Bakrie a new post as coalition manager, raising questions over his commitment to reform.

The rocky start to Yudhoyono's second term was a distraction to lawmaking and in the last year, parliament has only passed seven bills. Instead, lawmakers have busied themselves with expensive overseas study trips and plans for plush new parliamentary offices. The government's ineffectiveness at passing laws is emerging as a growing risk to reform.

Some positive signs have emerged. Respected economist Darmin Nasution was approved by parliament as the new central bank chief, a decision welcomed by economists. Analysts say Vice President Boediono and energetic technocrat Kuntoro Mangkusubroto have been busy behind the scenes designing a bureaucratic reform plan - a positive sign for foreign investors - but progress has been slow and civil service ineffectiveness remains a drag on growth.

### What to watch:

- The government has **drafted a new land acquisition bill that would set strict time limits on negotiations over land deemed as crucial to the public interest**. Weak land acquisition rules have held up vital infrastructure development. Despite the bill attracting broad parliamentary support, it is unlikely to be passed into law until next year and it may be as late as 2012 before it comes into effect.
- Whether the government can improve infrastructure by attracting investors into private-public partnerships. Yudhoyono has said he would boost infrastructure spending in 2011 by 28 percent from 2010 levels.



An Indonesian Muslim boy stands near police shields as his mother attends an anti-Israel protest in front of the U.S. embassy in Jakarta June 1, 2010. REUTERS/Beawiharta

- How much opponents of reform, including those within Yudhoyono's ruling coalition, manage to block other pro-investment policies such as **changes to the rigid labour laws** and cuts in energy subsidies.
- Progress with tax cases, since those involving Bakrie's companies such as Bumi Resources, appear to have stalled.

## CORRUPTION AND GOVERNANCE

Yudhoyono was elected on promises to tackle graft but by early in his second term, the Corruption Eradication Commission (KPK) was under attack, with attempts by senior law enforcement officials to frame two KPK leaders. Many felt Yudhoyono was slow to defend his top graft-busters.

His selection of a candidate to replace the outgoing police chief was seen as a test of Yudhoyono's commitment to reform of the notoriously corrupt force. When he picked Timur Pradopo, who is friendly with extremist religious groups and does not stand out as a reformist figure, he disappointed many.

Corruption investigations and convictions have continued, but focused mainly on mid-level officials or businessmen like Anggodo Widjojo, who was jailed in August after attempting to bribe and then frame anti-graft officials.

## RISK DATA

<b>Sovereign foreign currency:</b>	
S&P	BB (positive)
Moody's	Ba2 (positive)
Fitch	BB+ (stable)
<b>World Governance Indicators:</b>	
Voice & Accountability	48.3
Political Stability	24.1
Govt Effectiveness	46.7
Regulatory Quality	42.9
Rule of Law	34.4
Control of Corruption	28.1
<b>Eurasia Group</b>	
GPRI score	57
<b>IHS Global Insight</b>	
Country risk	2.76
Sovereign	BB+ (stable)
<b>Economist Intelligence Unit</b>	
Sovereign risk	BB
Political risk	B
Country risk	BB

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In late November the parliament chose soft-spoken academic Busjro Muqoddas to be the new head of the KPK, and while risk analysts said it was positive that the KPK now has a leader to drive the campaign to expose higher-level graft, the parliament chose the less aggressive of two final candidates. Yudhoyono followed up the KPK appointment by naming Basrief Arief to be a new attorney general, a position that is meant to work with the KPK to try graft suspects, but the choice of an internal candidate in a body widely seen as being corrupt disappointed anti-graft campaigners, who said this signalled Yudhoyono was not committed to reform.

Transparency International's latest Corruption Perception Index (CPI), released in October, put Indonesia's score at 2.8 out of 10, the same as last year, signalling a perception that there has been [no progress on corruption](#).

#### What to watch:

- How the new KPK chief performs and how the anti-graft body uses new powers to investigate unusual financial transactions.
- The effectiveness of the presidential delivery unit in tackling legal reform and other issues that deter investors.
- The pace of reform of Indonesia's civil service, police and courts. Yudhoyono's cautious response to the power struggle over the KPK suggests he will move much more slowly than markets had hoped. Investors betting on more decisive reform during Yudhoyono's second term have had to adjust expectations.

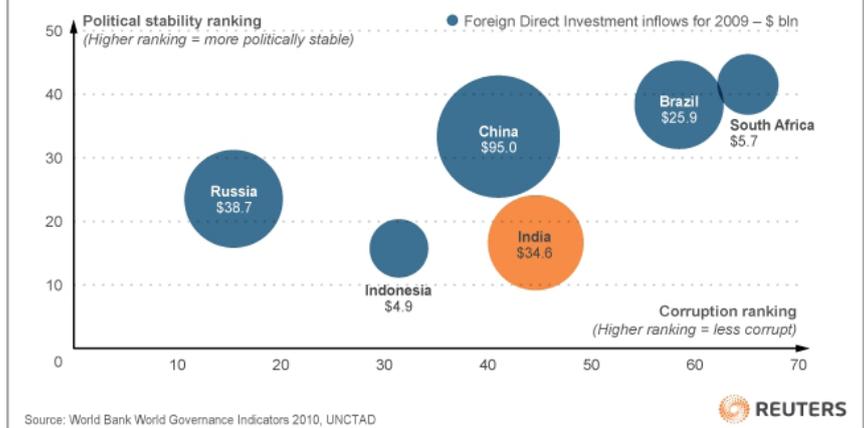
#### HOT MONEY AND CAPITAL CONTROLS

The central bank has said it has an arsenal of measures to deal with [volatile inflows of "hot money"](#), which it [worryes could hit the rupiah currency and financial stability if risk sentiment changes](#). Analysts say outright controls on capital are unlikely, given the government's desire to win an investment grade rating by next year to lower its borrowing costs. But officials are studying measures such as taxing capital inflows and extending a holding period for the central bank's popular short-term SBI debt, both moves that would worry investors. Bond traders have already completely shifted out of one-month SBI debt after a 28-day holding period was imposed earlier this year, and are now shifting out of three-month debt, as they worry liquidity would be hit by a longer holding period. The government is seeking to push investors towards even longer-dated investments, such as government bonds and foreign direct investment.

Capital inflows have boosted the rupiah 5 percent against the dollar this year, after it was Asia's best-performing currency in 2009 with a gain of 17 percent. But in a sign of what could happen if risk sentiment switched, the rupiah fell 0.5 percent in minutes in late November after news that North Korea had shelled a South Korean island, as investors moved into safe haven assets globally.

The central bank has not said it is defending a level for the rupiah but is trying to reduce volatility. Memories are still raw of the 1998 Asian crisis, which was widely blamed in Indonesia on foreign hot money being yanked from the country. The rupiah suffered its biggest one-day sell-off in nine months last November due to mixed signals on the potential for capital controls.

## Political stability vs corruption



#### What to watch:

- Policy changes or hints of moves by the central bank on SBI holding periods and bond auctions.
- The currency's strength, changes to the maturity of investors' bond and SBI holdings.

#### SECURITY

Suicide bombings at two luxury hotels in Jakarta last July were the first major terror attacks in Indonesia since 2005 and raised concerns that the threat from militants was again on the rise. Since then, the killings of Nordin Mohammad Top and, more recently, the [bomb-making expert Dulmatin](#), have significantly reduced that threat. But some risk persists.

Earlier this year, police discovered a new network of armed militants operating a secret training base in Aceh on Sumatra island. The group was plotting to assassinate Yudhoyono and government officials at an independence day celebration, and wanted to create an Islamic state, police said. In late June, [police captured preacher Abdullah Sonata](#) on suspicion of involvement in the Aceh group. Sonata had been jailed in the past but released early for good behaviour. His return to militancy raises questions about the effectiveness of Indonesia's efforts to rehabilitate captured militants.

Police also arrested firebrand cleric Abu Bakar Bashir in August for allegedly supporting and financing the Aceh group. Police have failed in the past to pin terrorism charges on Bashir; analysts say it is crucial they back up the charges this time.

Cooperation between the United States and Indonesia on security issues has also been [complicated by the poor human rights record of the police and military](#).

#### What to watch:

- [Ability of militants to regroup and launch more attacks](#). Particularly if remaining militants are able to establish firm enough links with al Qaeda or allies in Southeast Asia to secure sustained funding, expertise and recruits, the threat may be far from over. But [Indonesia's markets have proven highly resilient to militant attacks](#). Unless there is a significant and sustained deterioration in security, or militants reignite sectarian unrest, any sell-off would be limited and brief.

#### KEY DATES

- **December 3, 2010**  
Bank Indonesia monthly monetary policy meeting
- **December 14, 2010**  
Last government bond auction of 2010

#### RISK DATA

<b>JLT Group</b>	
Strikes, riots & civil unrest	5
Terrorism	5
War & civil war	3
Economic risk	6
Currency risk	5
Sovereign risk	6
Expropriation	5
Contract repudiation risk	6
Legal & regulatory risk	6
<b>Coface</b>	
Country rating	B
Business climate	C
<b>Transparency International</b>	
Corruption Perceptions Index Score	2.8
Rank (of 180)	111
<b>World Bank Doing Business</b>	
Rank (of 183)	122
<b>WEF Global Competitiveness</b>	
Score	4.43
Rank (of 133)	44
<b>Reporters Sans Frontières</b>	
World Press Freedom Index Score	35.83
Rank (of 175)	117