

**“Capital Markets and
Institutional Investing in Indonesia”**

Panelists: Perry Warjiyo, Executive Director, International Monetary Fund;
Milan Zavadjil, Assistant Director, Asia Pacific Department, International Monetary Fund;
Edwin Soeryadjaya, Chairman, Saratoga Capital;
Kelley G. Howard and Neil M. Sitron, Crowell & Moring
Moderator: James McNaughton

**Wednesday, April 18, 2007
Washington, DC**

Sponsored by the Bank of America and Asia Investment Consultants

Note: Part II of the program on Capital Markets will be held in mid-May at the time of the visit to the United States of Bank Indonesia Deputy Governor Miranda Goeltom. USINDO will provide further information as soon as possible.

Kelly Howard and Neil Sitron of the Crowell & Moring law firm led off the program with a discussion of the Sarbanes-Oxley Act of 2002, which was passed by Congress in the wake of the Enron and Worldcom corporate scandals, and its impact on the international financial system. Howard and Sitron explained the main provisions of the Act which has created a high bar of corporate accountability, together with consternation about the costs involved. To summarize the main provisions:

- Sec. 302 and 906 – CEO/CFO certifications about the correctness of financial reports and internal financial controls
- Sec. 402 – Prohibition on loans to executives (more common outside the United States)
- Sec. 404 – Internal controls over financial reporting
- Sec. 406 – Code of ethics for senior financial officers
- Sec. 407(a) – Audit Committee financial expertise
- Title II – Auditor independence

They continued that there are exemptions for non-U.S. entities:

- Sec. 302 – No internal controls certification is required until Sec. 404 applies
- Sec. 404 – Delayed deadlines for management reporting on internal controls and auditor attestation
- Sec. 401(b)/Regulation G – Exemption from U.S. accounting standards if the securities issuance is targeted at non-U.S. investors
- Securities and Exchange Commission provides for exemptions based on compliance with local law (e.g., relating to audit committee independence); differences must be disclosed, however

Howard and Sitron cited the benefits of Sarbanes-Oxley compliance: access to capital in U.S. markets; visibility in financial markets; indication of liquidity; transparency; and sign of corporate strength.

Most complaints involve the cost of compliance of Sarbanes-Oxley, which could be several million dollars per company, and difficulty in exiting the U.S. market. Proposed rule changes could provide for easier de-registration if a securities issuer’s average daily U.S. trading volume is 5% or less of its worldwide volume or if the issuer’s securities are held by less than 300 U.S. residents. These and other new rules will become effective on June 4, 2007.

Important aspects of the Sarbanes-Oxley debate are the reconciliation of U.S. accounting standards with international financial regulations (the gap is narrowing) and the impending application of Sec. 404 provisions regarding internal controls beginning in July 2007. Consideration reportedly is being given to ease some requirements provided reasonable documentation is maintained. Consequences of Sarbanes-Oxley for foreign (and Indonesian) corporations are that they are reluctant to enter the U.S. securities market and those already here (Telkom and Indosat) feel “trapped” by the high standards and difficulty of exiting the market.

Milan Zavadjil of the IMF commented on recent macroeconomic trends and developments. He summed up the current situation by saying that Indonesia has achieved solid economic performance but less growth than hoped for. Per capita income is back to levels before the Asian financial crisis and fiscal consolidation has help to reduce public debt levels to slightly more than 3% of GDP. Higher reserves have contributed to lower vulnerability, resulting inconsiderably improved credit ratings by all major rating companies. GDP growth, after a dip in the middle of last year because of global oil price increases, reached 5.6% in 2006 but investment is still weak.

The first quarter of this year has seen a slowdown in foreign investment and domestic consumption but there has been strong export performance due to global demand and the current account surplus is increasing. Inflation has stabilized, allowing interest rates to decline to under 10%, but a pick-up in foreign direct investment (FDI) is needed if the economy is to grow more than the 6% in 2007 and to 7% in 3-5 years.

Foreign capital inflows remain moderate and investments in Indonesian portfolio assets continue to grow, mainly because of Bank Indonesia certificate (SBI) purchases. At the same time, Indonesia still lags behind regional countries, including Thailand and Vietnam in terms of net capital inflows as a percentage of GDP. In the banking sector, there have been some improvements with a reduction in the level of non-performing loans, the limited impact on Indonesia of the Shanghai financial market contraction, and a "remarkably stable" Rupiah.

Among the challenges described by Mr. Zavadjil were:

- --Growth is too low to deal with persistent unemployment. The official unemployment rate has increased despite the recovery of GDP growth and the poverty rate increased in 2006.
- --Contributing factors also are the low rate of investment and infrastructure inadequacies that retard foreign direct investment.
- --Regional FDI inflows to Thailand and Vietnam are higher than to Indonesia, thus Indonesian regional competitiveness is not what it should be.
- --There is slow progress in the economic reform agenda, although implementation has picked up recently.

Mr. Zavadjil concluded by commenting on the four areas needed to improve the investment climate: legal certainty, including judicial reform, tax administration, labor market flexibility and infrastructure. There has been recent progress in structural improvements with the passage by Parliament of a new investment law at the end of March, which among other things provides for equal treatment of domestic and foreign

investors and streamlining procedures for new investment and business operations. A new Customs Law was approved in October 2006 and a tax law on administrative procedures is expected to be approved in May.

Lastly, Indonesia maintains a policy dialogue with the IMF, although the Fund-supported lending program expired at the end of 2003 and Indonesia has repaid all of its loans from the IMF four years ahead of schedule. Article IV consultations will be held in May and the IMF is continuing to provide Indonesia with technical assistance in monetary operations, banking supervision and tax administration.

Incoming IMF Executive Director **Perry Warjiyo**, who until recently was director of policy of Bank Indonesia, added to Mr. Zavadzil's forecast.

He said that the main concern of Indonesian economic managers is to maintain stability but also provide for growth by increasing investment and exports while commodity prices remain high. Also, rising domestic consumption will help promote overall growth.

Continued price stability, strengthening the banking and financial system, maintaining low (1-2%) fiscal deficits, improving the investment climate and competitiveness, stimulating infrastructure development and improving bank intermediation are measures being pursued. On the banking side, further bank consolidation, improvements in central bank operations, and a deposit insurance system are needed, he concluded.

Investment banker **Edwin Soeryadjaya** provided the perspective from the Indonesian private sector standpoint. Noting the many factors that should make Indonesia an attractive locus for investment, he gave a positive appraisal of his country's political development and important decisions, such as the fuel price subsidy reduction, that have contributed to the growth of democracy and openness. On the economic side, some positives are:

- Increases in corporate earnings by 26% in 2006 over 2005 (among the highest rates in Asia). 2007 and 2008 earnings are expected to increase by more than 22% per year.
- Historically low interest rates with the SBI rate at about 9%, compared to 17.69% in 2001 and 11.4% a year ago. The rate is expected to drop further to 8.5%.
- Strengthening of the Rupiah from about 13,000 to about 9,000 to the US dollar since 1998.
- Inflation ranging between 5 -7% during the past six months, a historical low, and is expected to remain low.
- More easily obtainable capital from foreign and domestic banks, bond markets, and Singapore equity markets and hedge funds.

As mentioned earlier, however, high unemployment of 12.5% and under-employment of 40%, coupled with a loss of investment to China, Vietnam and Thailand, could ultimately lead to social instability. The government, moreover, is slow in implementing reform measures and infrastructure development, while decentralization in government has made doing business more difficult.

In this environment, the primary focal points for investment have been in distressed securities and companies stemming from the Asian financial crisis, natural resources development and infrastructure. PT Saratoga's primary investments in coal, fixed line telecommunications networks, telecommunication tower construction and leasing, and palm oil plantations have resulted in good growth and prospects. Concluding, Mr. Soeryadjaya described the main challenges to investment and growth as “management with skill and integrity,” social and labor conditions in the operating areas, local government capabilities, and locating investment partners with integrity.

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During the discussion, it was observed that some critics are promoting limits on foreign investment, for example, 40% ownership in telecommunications and the oil/gas sector, to be implemented under the new investment law. Additionally, the absence of an adequate mining law was cited as another inhibiting factor. Some observed that “Indonesia never performs up to its potential” because of investment obstacles, the focus on policy-making rather than implementation, long lead times to obtain government decisions and to reconcile differing policy views. These were summed up as “demo-crazy” or the difficulty of decision-making in a democratic environment.

However, strong countervailing arguments were offered. Critics tend to look at single factors, such as any of those cited above, for not making positive investment decisions, whereas financial market conditions make Indonesia an attractive location for capital investments, whether equity or portfolio. Looking at global risk, Russia defaulted and there are other examples where countries have performed worse than Indonesia but investor interest is still there. Concerning notable instances of Indonesian default as in the APP case, it is acknowledged that the legal environment needs improvement but the government inherited bad practices which SBY is trying to change. This is seen in the corruption prosecutions of high government officials and legislators, not private business people.

Commenting on the international impact of Sarbanes-Oxley, it was observed that there has been an overall improvement in corporate governance and the high cost and extraordinary efforts of compliance may be worth it in terms of cost-benefit analysis. In this regard, securities exchanges and financial markets tend to match each other and cross-territorial factors favor increasing implementation of Sarbanes-Oxley safeguards.

Lastly, Islamic bonds are becoming increasingly attractive instruments for infrastructure funding, not only from the Middle East but also from indigenous and western banks that have implemented syariah banking programs. The Indonesian Government is planning to issue its own Islamic bonds in competition with Malaysia and others, and there is an official desire to expand the market for Islamic financing.