



Following January's successful Infrastructure Summit 2005 the government will soon be tendering specific infrastructure projects. In seeking to attract foreign investors, the government will need to address a fundamental obstacle: the lack of certainty in our legal system. Indonesia has suffered negative direct investment since 1999 (table I) in large part due to the breakdown in the rule of law in respect of commercial agreements. Locals and foreigners alike have seen too many unpredictable and inconsistent decisions in our Courts, whereby legitimate transactions are overturned. Not only must we urgently begin to reform our legal institutions, but we must be seen to be doing so.

Table 1 - Foreign Direct Investment (FDI) in Indonesia (1999-2003)

1999

US\$ 2,745 million

2000

US\$ 4,550 million

2001

US\$ 3,279 million

2002

US\$ 145 million

2003

-US\$596 million

Source: ASEAN Secretariat-ASEAN FDI Database, 2004

The government has set an economic growth target of 7.9% by 2009 through investment and domestic consumption. Such growth is deemed necessary to reduce the level of unemployment from 10.1% in 2003 to 5.1% in 2009. Domestic consumption alone will not be sufficient to create such job opportunities. Indonesia faces the daunting task of attracting foreign direct investment to develop its industries and infrastructure and facilitate annual economic growth of at least 6% with the aim to achieve a 7.9% growth by 2009.

We are competing with Thailand, China, India, Malaysia and Vietnam for FDI. Between 1995 and 2003, according to a report by the ASEAN Secretariat, Vietnam attracted US\$14.6 billion of

foreign direct investment compared to Indonesia with US\$3.84 billion, despite Indonesia having a much larger economy and only slightly higher labor costs. In 2003 and 2004, according to the Asian Development Bank, only about 25% of Indonesia's financing needs were met by equity investment (as opposed to bank and bond financing) versus 45% for Malaysia, 57% for Singapore and 73% for Hong Kong. Legal certainty, or the lack of it, is at the heart of this. The recent joint study by the Asian Development Bank, JBIC and the World Bank issued in March, "Connecting East Asia: A New Framework for Infrastructure", suggested that predictable government policies and regulations are necessary to attract direct investment for infrastructure. The report also stated that the lack of enforcement of contracts, inconsistencies in the regulations and in the Courts, as well as corruption hindered investment into infrastructure.

It is clear that FDI will rise if Indonesia establishes a sound and fair legal system. This requires transparent and accountable legal institutions to meet the demands of foreign and domestic investors, including local banks, all of whom require effective legal institutions to mitigate the risks of investment in the country. If it does not act soon, the government risks missing its own economic targets.

Failure to implement the reform measures will also mean that the government will need to provide additional guarantees (which will have implications for the state budget) in order to attract investor commitment to vital infrastructure projects. Given the increased demand for public spending on health, education, natural disaster management and other public initiatives, the government can little afford to set aside such funds.

Legal Certainty is Urgent

The issue of legal reform and certainty is not new. The government has issued numerous regulations as part of its legal reform process. What has been lacking is consistency in enforcing those regulations. Investors have faced difficulties resolving contractual or payment issues in the Indonesian court system. Court decisions are often inconsistent in dealing with the facts and the evidence.

In addition, Indonesian Courts, in particular District and High Courts, have often neglected the content of valid agreements between parties, even in cases where such transactions have been completed. In declining to respect the sanctity of commercial contracts, the Courts send strong, negative signals about Indonesia's commitment to legal reform and the rule of law. Cases involving Manulife, Prudential, PT Danareksa Jakarta and PT Tripolyta, for instance, illustrate

the Courts' disregard for legitimate transactions made under internationally accepted agreements. This has a significant impact on Indonesia's risk premium in the international capital markets ♦ and, of course, on FDI

Institutional Reform is Critical

Institutional reform will take time, but Indonesia cannot afford to wait. The legal risks of doing business in Indonesia are priced into all transactions whether by higher coupons on bonds or higher required returns on investment before equity is put at risk. Legal and compliance costs in Indonesia continue to increase due to the inefficiencies and uncertainty in the legal process. The fact that Indonesia was the only key member of ASEAN with negative FDI between 1999 and 2003 reinforces the urgency for immediate attention to reform the legal institutions as part of the overall policy to attract investment. During the January 2005 Summit, Coordinating Minister for Economy and Minister for Justice and Human Rights stated that the government would address legal reform as part of its infrastructure development initiative.

Indonesia must realise that the world is watching: The government has a clear mandate and must now demonstrate its willingness and commitment towards institutional reform.

The task ahead is immense, but setting up a clear step by step roadmap of reform with realistic and attainable goals, and then speedily starting along this process, will send a very strong signal to the investment community of the government's push for reform.