# Economic Report

# The First Half
**Of**
# Year 2006

**Issued by Indonesia Kadin Secretariat**
**under**
**Cooperation between KADIN Indonesia and JETRO**

# ECONOMIC INDICATORS

| Indicator | | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| 1. | GDP with constant price of year 2000 (Trillion Rp | 1,506.10 | 1,579.60 | 1,660.60 | 1,749.60 | 1,842.3(1) |
| 2. | GDP Growth (%) | 4.38 | 4.88 | 5.13 | 5.6 | 5.30 (1) |
| 3. | Inflation (%) | 10.03 | 5.06 | 6.4 | 17.11 | 2.87 (2) |
| 4. | Total Export (Billion US$) | 57.0 | 55.6 | 69.7 | 85.57 | 38.39 (3) |
| 5. | Non Oil and Gas Export (Billion US$) | 44.9 | 43.1 | 54.1 | 66.32 | 29.78 (3) |
| 6. | Total Import (US$ Billion) | 31.2 | 29.5 | 46.2 | 57.55 | 23.14 (3) |
| '7. | Non Oil and Gas Import (Billion US$) | 24.8 | 22.6 | 34.6 | 40.16 | 16.34 (3) |
| 8. | Trade Balance (Billion US$) | 25.8 | 26.1 | 23.5 | 28.02 | 15.25 (3) |
| 9. | Current Account (Billion US$) | 4.7 | 4.0 | 2.9 | 0.93 | - |
| 10. | Foreign Reserves (Billion US$, year end) | 32.0 | 36.3 | 35.93 | 34.72 | 40.11 (7) |
| 11. | Foreign Debt Position (Billion US$ | 131.3 | 135.4 | 136.1 | 133.5 | 131.8 (8) |
| 12. | Rupiah/US$ (Bank Indonesia Middle Rate) | 8,940 | 8,330 | 9,355 | 9,830 | 9,300 (7) |
| 13. | Total Government Revenue (Trillion Rp) | 299.0 | 341.1 | 380.4 | 516.2 | 539.4 (*) |
| 14. | Total Government Expenditure (Trillion Rp) | 322.2 | 378.8 | 397.8 | 542.4 | 559.3 (*) |
| 15. | Balance of Finance (Trillion Rp.) | -23.2 | -37.7 | -17.4 | -26.2 | -19.8 |
| 16. | Base Money (Trillion Rp) | 138.3 | 136.5 | 199.7 | 239.8 | 239.3 (4) |
| 17. | Money Supply (Trillion Rp) | | | | | |
| | a. M1 | 191.9 | 207.6 | 253.8 | 281.9 | 282.4 (4) |
| | b. M2 | 883.9 | 911.2 | 1,033.50 | 1,203.20 | 1,198.0 (4) |
| 18. | Banking Third Party Fund (Trillion Rp) | 845.0 | 866.3 | 965.1 | 1,134.10 | 1,133.5 (5) |
| 19. | Banking Credits (Trillion Rp) | 365.4 | 411.7 | 553.6 | 689.7 | 687.4 (5) |
| 20. | Interest Rates (%, annualy) | | | | | |
| | a. 1 month SBI | 12.9 | 8.1 | 7.4 | 12.75 | 12.50 (6) |
| | b. 1 month Time Deposit | 12.8 | 7.7 | 6.4 | 11.98 | 11.70 (5) |
| | c. Working Capital Credit | 18.3 | 15.8 | 13.4 | 15.92 | 16.29 (5) |
| | d. Investment Credit | 17.8 | 16.3 | 14.1 | 15.43 | 15.90 (5) |
| 21. | Investment Approval | | | | | |
| | - Domestic (Trillion Rp) | 25.3 | 16.0 | 36.80 | 50.58 | 56.80 (3) |
| | - Foreign (Billion US$) | 9.7 | 6.2 | 10.3 | 13.58 | 3.66 (3) |
| 22. | JSX Composite Index | 424.9 | 742.5 | 1,000.20 | 1,162.60 | 1,310.3 (7) |
| 23. | JSX Market Capitalization | 268.4 | 411.7 | 679.9 | 758.4 | 914.90 (4) |

Source: BPS, BI and JSX

1) Projection
2) January - June 2006
3) January - May 2006
4) Position at the end of May 2006
*) in State Budget

5) Position at the end of April 2006
6) Position on 28 of June 2006
7) Position at the end of June 2006
8) Position at the end of first quarter

## The Growth of Macro Economic

The Leading variables of Indonesia's macro economic that is gross domestic product (GDP) experienced an unfortunate development. The GDP value based on constant price of 2000 is estimated only on Rp. 1,842.3 trillion in the year of 2006. So that, the growth of GDP is projected to reach a merely 5.3% in 2006 compare to 5.6% in 2005. This estimation is lower that those measured by several institution in the world. For example, Citigroup, which conducting an analysis on Indonesia's economy periodically, predicted that Indonesia will enjoy an economy growth by almost 6% in 2006. World Bank, International Monetary Fund (IMF) and Asian Development Bank (ADB) share a similar estimated figure.

Prediction on a declining trend in 2006 compare to 2005, as mentioned above, is actually short term growth estimation. The short term economic growth is determined by several factors different from the long term growth. Primary factors behind lower growth of GDP in 2006 is mainly due to the aggregate demand side, particularly declining household consumptions as a result of public weakening purchasing power due to the increased inflation rate following the rise of Oil (BBM) price. Data from year 2003 to 2005 showed a significant jump of consumer price index, though estimated inflation for the period of January-May 2006 was only around 2.03%.

Nevertheless, other prominent factor to be taken into consideration is the long term growth, since the growth on yearly basis may differ, and whether the growth is moving toward a positive trend. Long term growth is mainly determined by aggregate supply side that is the availability and quality of production inputs such as, labor, capital, technology, raw materials, infrastructures, and energy and by the long term development strategy consisting numbers of consistent and interrelated policies.

Based on a deliberate observation since the crisis in 1997/98 until today, it can be concluded that there were some significant factors, both on the demand side (output market) and offering side (production), to be the main cause of Indonesia's lower economic growth relatively compared to other countries hit by similar crisis in 1998 such as South Korean and Thailand. As illustrated in Figure 1, there are at least 6 primary factors such as follows;

1. Government policies were not consistent and sufficient enough to support a high economic growth. It can be seen from the unavailable comprehensive policy of national industry to determine priorities of industries to lead with definite steps, both in short term and long term that must be carried out to support the growth of industries identified as key industries. These steps must also cover the development strategy of supporting industries. Further, the failure of government policy to support the growth of economic was also reflected from a number of regulations set by Department of Trade and Industry which were sometimes temporary in nature, inconsistent and often in conflict with previous policies and/or policy from other sectors such as agriculture sector. Many cases relating to the lack of raw materials

experienced by domestic industry, taxation case in Batam, and interrupted supply of gas to manure industry (in Aceh) and the rise of BBM (Oil) price, were among other obvious cases as a result of unavailable national policy to support the growth of national economy.

2. Limited Infrastructures. It was mainly due to unavailable government policy to support the development of infrastructures facilities as a crucial factor to improve competitiveness and national economy growth. The delay of organizing Infrastructure Summit II for several times indicated government unaccountability to manage domestic infrastructure sector. The infrastructure condition in Indonesia has become worst in the past two years caused by many natural disasters starting from Tsunami in Aceh to earthquake in Sunda Straits/Indian Sea, in July 2006 adding up the number of damaged infrastructures.

3. Increasing production cost due to the rise of energy price and increasingly number of official and unofficial collection. This increasing number of collection closely related to the great influence of bureaucracy as well as regional regulations ever since the implementation of regional autonomy. Besides, the increase in production cost was also driven by the increased of yearly regional minimum wage (RMW or UMR in Indonesian term). The increase of RMW that was not followed with advance productivity and not compensated with the elimination of other production costs, directly or indirectly, would in turn dismissed the comparative competitiveness factors owned by Indonesia all these years, that is abundant labor with low wages compare to other countries, then resulting in a negative impact to the growth itself.

4. Low productivity level. Three main factors are the following, low quality of labor/ human resources (most of today's Indonesian labors' are merely from elementary school, which was also reflected from worst Human Development Index (HDI) in Indonesia compared to ASEAN countries), low production capacity that limits the capability of domestic industries to improve production volume, and poor technology skills and development. Limitation of production capacity mostly attributed to the insignificant number of banking loan, low level of investment, either foreign investment as well as domestic investment. Meanwhile, poor technology skill in Indonesia is mainly due to a low quality of human resources and lack of support from government (may be concluded from the insignificant contribution to the development of science and technology from APBN/ *State Budget)*, and private sector (may be observed from a week coordination between national business world with universities or domestic research and development institution).

5. Low level of national entrepreneurship. It is shown from inferior innovation applied by national businessmen both in terms of products, applied production process, promotion and marketing activities

conducted all these years. Low level of entrepreneurship was also related to the poor quality of human resources and poor technology skill and development in Indonesia.

6. Low level of investment growth, particularly from foreign direct investment (FDI). It was closely related to the unfavorable business environment, security, and law certainty as well as basic problems such as poor infrastructure, inconsistent economic policy and worsened labor condition.

By definition, economic growth or GDP is the growth of total output of all economic sectors, whereas the output growth of certain sector may be defined as total output growth of all companies within the sector. Based on this premises, one can say that the slow trend of economic growth in Indonesia since the crisis is strongly related to slower growth in domestic business activities, especially from private sectors as the economy leading sector. As it is applied in any countries in the world, business activities of all business scale (micro, small, middle and big) evolved within a very dynamic and complex environment. Therefore, company's performance is strongly influenced by its environment. Government efforts in promoting or supporting certain type of business act will be in vain without considering the environment of that business, and a broader context of economic development to create "rule of play" of all business activities that affect how to do the business and how the market works. Environment in which certain business may be operated can be divided into two types, direct environment and broader environment (Figure 2). Broader environment is an environment that is indirectly affected business activities consisting of the following components; macro economic (such as trade policy, industrial policy, financial policy, and monetary and fiscal policies), government and politic at local and national level (such as legislative and the process of making certain policy, judiciary and security and stability), services rendered by government.

**Figure 1: Six (6) Main Factors to the Low Growth of Indonesia's Economy**

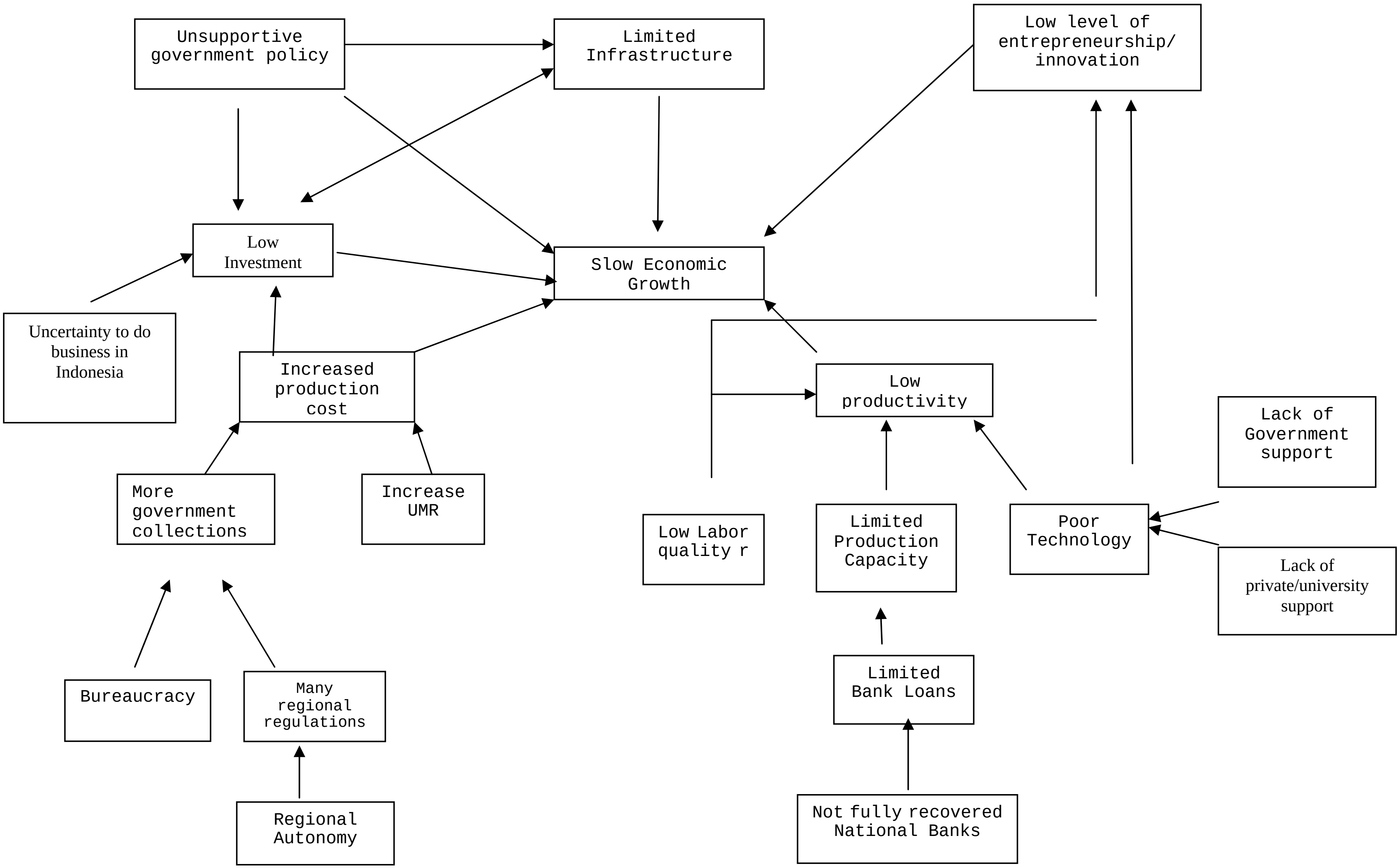
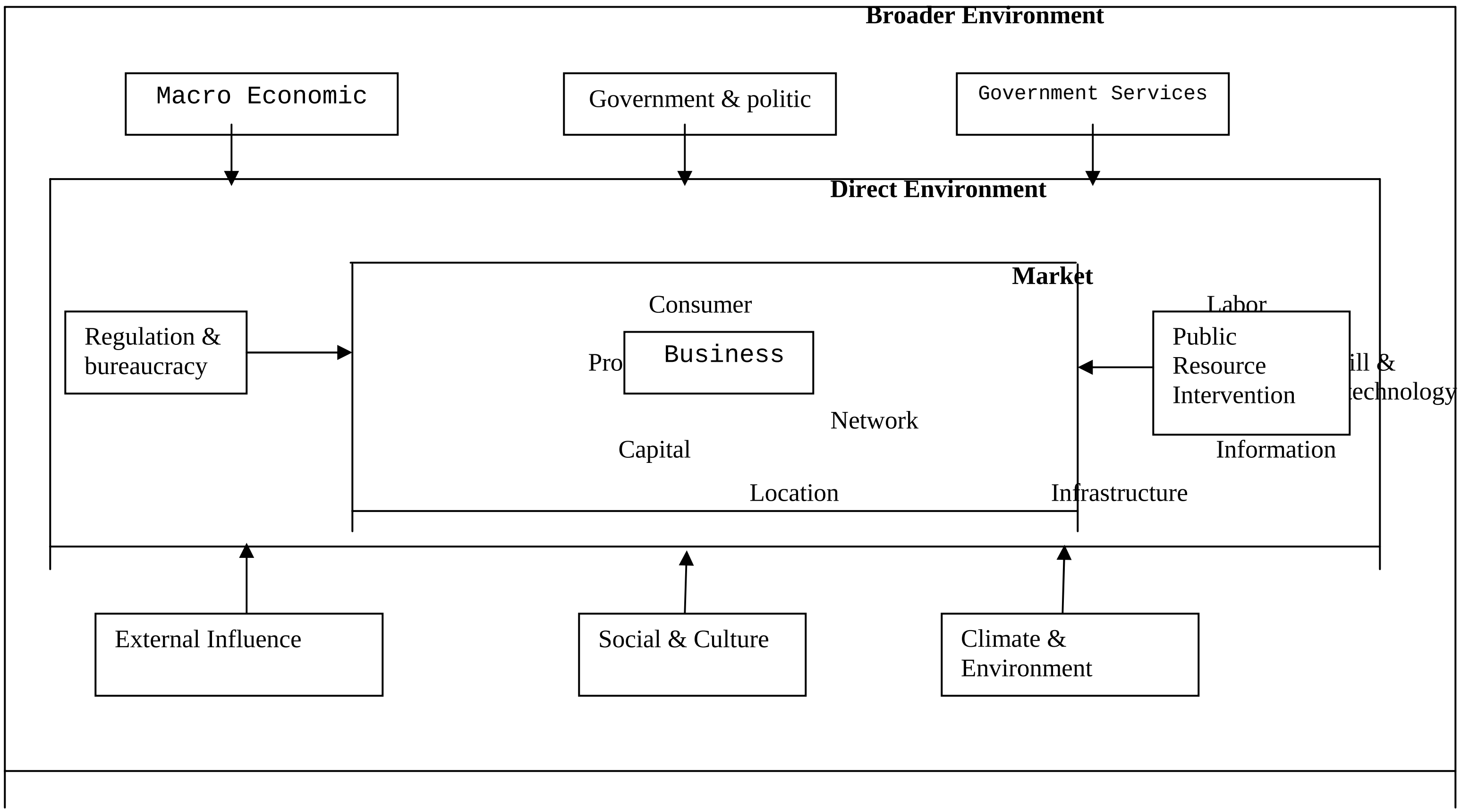


**Figure 2: Business World in Direct and Broader Environment**



(such as health service and education, infrastructure, utilities and security service), external influence (global trading, foreign aid, trend and need of global community, technology and information), social and culture (such as demography, consumer need, and attitude toward business), and climate as well as natural environment (such as natural resources, weather and agriculture cycle).

Meanwhile, direct environment can be defined as environment directly influenced toward all business activities, that is market (consumer, labor, skill and technology, production tools and materials, location, infrastructure, capital and network), regulation and bureaucracy (such as constitutions, regulation, tax tariff, and taxation system, license and permit, product standard and process, and consumer and environment protection), and interventions funded by public fund (such financial service for business activities).

## The Growth of Export and Import

BPS data indicated that export value in January 2006 including oil/gas and non-oil/gas was 7.56 billion US$ and 5.73 billion US$ respectively, while import value each amounted to 4.39 billion and 3.18 billion US$. As a result, Indonesia's net foreign trade balance for the period of January 2006 for oil/gas and non-oil/gas enjoyed a surplus of 3.17 billion and 2.55 billion US$ subsequently. Compared to the export in January 2005, the value reached by oil/gas and non oil/gas were up to 23.26% and 16.63% respectively. The prominent factors of the increasing export values were the increase of export of mining production sector from 0.44 billion to 0.97 billion US$. Meanwhile, imports value including oil/gas and non-oil/gas sectors during January 2006 each improved up to 6.49% and 3.89% compared to the same period of the previous year. Imports in January 2006 were still dominated by imports of raw materials valued 3.23 billion US$ or increased by 1.41%. compared to import of similar product in the same period back in January 2005 valued 3.18 billion US$.

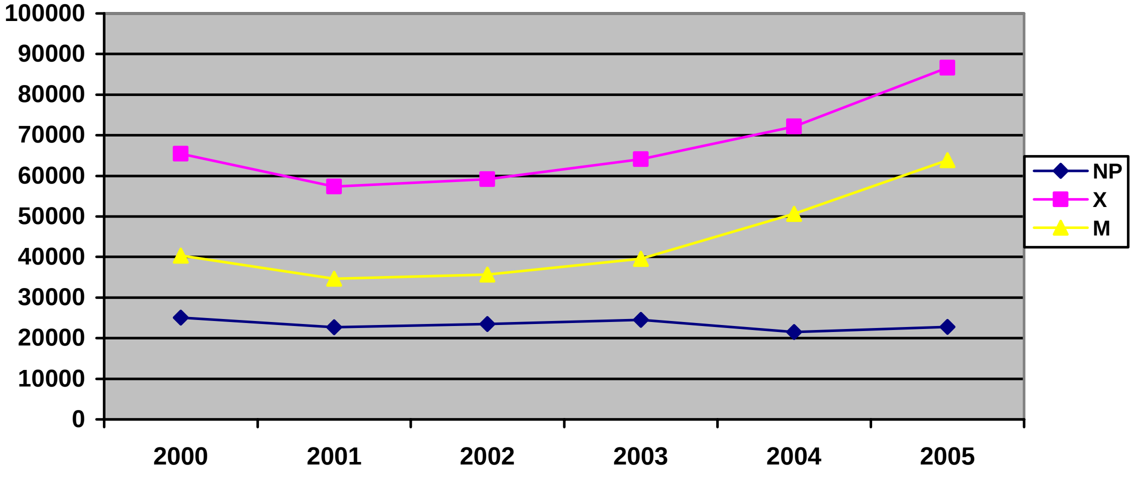
Hence, the last data of BPS stated that exports value in May 2006 recorded as the highest number in the history. The exports value in that particular month reached up to 8.34 billion US$ or improved 9.79% compared to value in April 2006. The cumulative exports during the months of January – May set at 38.39 billion US$ or increased by 13.40% from the same period in 2005. Based on that figure, export value of non-oil/gas increased by 10.52% and oil/gas export up by 7.22% from April. According to BPS (Kompas, Tuesday, July 4, 2006, p.17), the improvement of export value in May mainly attributed to the increased of export from mining sector particularly grains, crust and metal dust. The export value of those products jumped to 113 billion US$ compared to the value in April.

In general, high exports value recorded in May 2006 mostly due to the price increase of several commodities such as crude palm oil (CPO), rubber and coal as well as the high price of crude oil in the world market. During the last five months, rubber exports amounted to 776 million US$, CPO up to 360 million US$, and coal reached 800 million US$. Based on these facts, BPS predicted that the total exports of Indonesia during the year of 2006 could reach up to 100 million US$ assuming the favorable world economic condition and high world demand toward Indonesian export products (Kompas, Tuesday, July 4, 2006, p.17).

On the import side, it was recorded in May 2005 that the value reached 5.96 billion US$ or up by almost 6.50% compared to the value in April 2006. During the period of January-May 2006, imports value reached a high of 23.14 billion US$ or dropped by 2.12% from the same period in 2005.

Judging the development from the year 2000, total exports value (oil/gas and non-oil/gas) has slightly declined from 65.4million US$ in 2000 to 57.4million US$ in 2001, and yet finally maintain its growth until today. Thus, the surplus in foreign trade balance also experienced a slight declined from 25million US$ to 22.7million US$ during the same period (Figure 1). Assuming that the prediction of BPS is achieved and the growth of imports is relatively stable then we may expect an increase value in Indonesia's trade balance at the end of 2006.

**Figure 3: Trend of Indonesia's Foreign Trade Balance (NP), Export (X) and Import (M), during 2000-2005 (million US$).**




Source: BPS.

Meanwhile, import sector also down from 23.7% in 2005 to 6.2% in 2006. The estimation of declining import was in line with the estimation declining of economic growth since most of the domestic economy activities were strongly depended on processed raw materials, capital goods and services. However, since primary sector especially oil/gas sector still played a significant role in Indonesia's economy, then it is safe to conclude that the trade balance could enjoy a relatively high growth.

All these years, the government has done numerous efforts to boost export competitiveness of Indonesia, including recent decision to accelerate the process to establish Indonesian Export Import Association, as the derivative of Indonesian Export Bank (BEI). However, the effectiveness of every step implemented by the government in an attempt to boost export value is heavily depend on whether those steps is working hand in hand with the matters dealt by Indonesian exporters today. Based on the research conducted by World Bank (2004), slow export growth basically caused by the following four factors.

First, declining cost competitiveness due to higher appreciation of rupiah's and inflation rate in comparison with inflation rate in the counter trade partner. Besides, IMF suggested that labor cost/unit in Indonesia nowadays is 35% higher than prior to the crisis. Low cost competitiveness of Indonesia's manufacturing industry also a result of a high domestic transaction costs in Indonesia. During the year of 2001-2002, general price level in Indonesia grew by 24% mainly due to the rise of electricity tariff (102%), diesel oil (159%), water (27%) and transportation (32%) (James, Ray, & Minor, 2003). Meanwhile, the sharp increased of BBM/Oil price during the second semester in 2005 resulting in rapid increase in inflation rate by 2 digits (Thee, 2006). All of those factors made up to high production costs of Indonesia's export products compare to other countries. With a relatively low productivity level which not compensating the increase in production cost, price competitiveness of Indonesia's products in the global market tend to decline compare to the price of similar products from other countries.

Second, declining trend of investment. Poor business condition in Indonesia is also considered to be another main problem in preventing export growth due to the inability to attract foreign investments which was the prominent player in boosting non-oil/gas exports, including industrial products. The absent of foreign investment also means that new investment required to product upgrading is poorly performed. Indonesia's experience during the new governance era particularly in the growth of non-oil/gas industry stated that foreign direct investment was crucial to improve Indonesia's export of industrial products which increased a great deal during the 80's the crisis hit. An astonishing export leap came from China where most of its export oriented activities originated from foreign investment. It's Textile Industry and textile products (TPT) might be an actual example. According to Aswicahyono and Hill (2004), textile industry by foreign investment in Indonesia was discontinued in the past few years, and worsened the export performance of TPT industry compared to those in the new governance era. Even, dominant Japanese foreign investment in TPT industry during the new governance era was sharply declined after the crisis. For example, four years ahead of the crisis, Japanese TPT companies invested an average 119 million US$ a year in those of Indonesian. However, during 2003 and 2004, Japanese investment was merely an average of 7 million US$ a year.

Third, fierce international competition. China and Vietnam has been the biggest competitors for Indonesia since they are competing in the exports of product from labor intensive industry similar to those in Indonesia, such as textile, garment and footwear, and rapidly growing compared to Indonesia's exports. As a result, Indonesia lost its market share in 30 non-oil/gas export to China and Vietnam, including industrial products such as textile, footwear and other labor intensive products (Pangestu, 2005). If poor national industry condition today remain unchanged then Indonesia will most likely to loose its global market share of leading industrial products such as textile and finish clothing (TPT), shoes and wood products. For example, compare to those in the new governance era, Indonesia's export of TPT started to narrow since the economy crisis in 1998. A constant analysis of market share by Aswicahyono & friends (2005) revealed that Indonesia has started to loose its competitiveness in TPT industry, particularly garment, although the labor cost/unit that is cost of wage in accordance with work productivity remain competitive. Thus, Indonesia's TPT industry becomes more difficult to compete particularly with China.

Several studies predicted that following the elimination of Multi-Fiber Agreement (MFA) at the end of 2004, China's TPT imports share will surge and hence dominating domestic markets of USA and EU while Indonesia's TPT import share will move downward or being the least in the world market. It also means that Indonesia faced a stiff competition from China's TPT both in domestic and global market. However, the anxiety over potential loss toward elimination of MFA related to the share of Indonesia's TPT industry in USA and EU markets caused by stiff competition with China, is not yet realized. This was due to the introduction of quota limitation over China's TPT by USA and EU following the elimination of MFA. Hence, it provides breakthrough for Indonesia's TPT to maintain its market share in USA and EU. Yet, there is still some degree of alarmed position of Indonesia's TPT that the opportunity might not be fully implemented due to the existing problems and obstacles faced by both industries in terms of reserved condition, particularly rapid growth in production costs of both industries compared to other countries (Thee, 2006).

Other cases related to Indonesia's export of wood products. Based on the news released on Wednesday, June 28, 2006 (p.17), stated that wood industry and forest products in Indonesia have gone worst. Cited from BPS data, wood and forest products during the past three years experienced a negative growth. In 2004, this industry recorded a negative 2.1% and a negative 1.3% in 2005, and even worst during the first quarter of 2006 down to a negative 5.8%. According to Indonesian Wood Panel Association (Apkindo), production of wood panel in Indonesia had one time reached around 7 million meter cubic during 1999-2000 and sharply declined to 3.5 million meter cubic in 2005. And yet, Malaysia is estimated to produce wood panel up to 4 million meter cubic (Kompas, Wednesday, June 28, 2006, p.17). Of 120 wood panel factories in Indonesia, those remain in production and exporting it products was only 52 factories. However, the average production with used capacity of these factories was 50% less than normal capacity. (Kompas, Wednesday, June 28, 2006, p.17)

Ironically, wood industry and forest products were rapidly grow on competitor countries such as China, Malaysia and Vietnam despite the fact that those countries do not have their own raw materials. Indonesia's furniture export amounting to 1.79 billion US$ or average growth of 0.088 billion US$ per year during the last 8 years. Within the same period, furniture export from China grow in an average 1.1 billion US$ in 2005. Yet, many believes that Indonesia's wood industry will survive due to its ability to fit in with market condition by improving quality control, better design, ability to fulfill the standard of international environment, and advance marketing effort in international market (Aswicahyono & Hill, 2004).

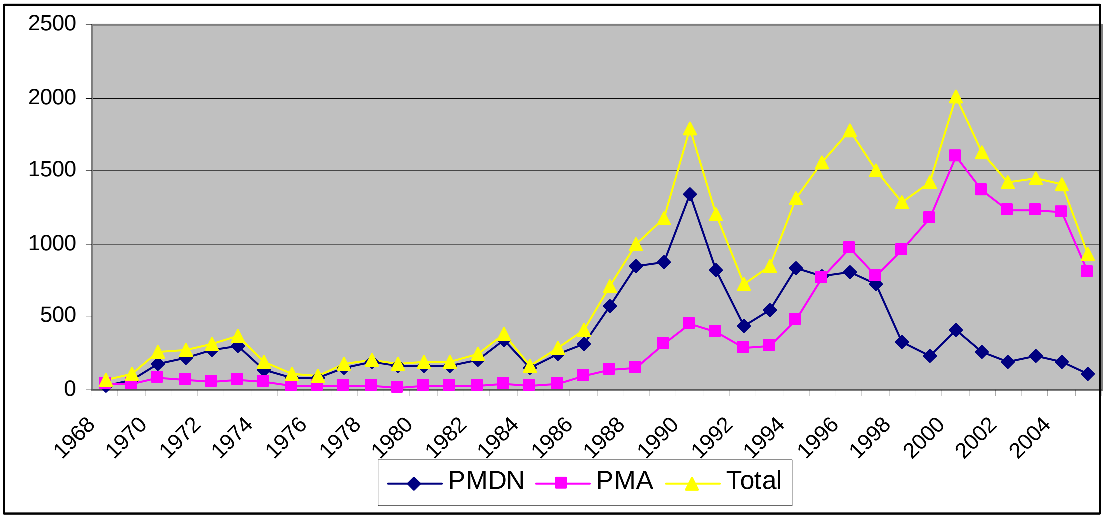
Fourth, poor trade facility. Numerous restrictions in harbor and physical facility have been one of the main factors to enlarge the costs of exported products. Although the tariff of using Indonesian harbor/port is relatively low but almost all exports from Indonesia transshipped through Singapore or Malaysia due to lack of efficiency in Indonesia's harbor/port. According to the analysis related to the efficiency of Indonesia's harbor, namely Jakarta International Container Terminal, JICT), as the main terminal in Tanjung Priok which is the biggest terminal throughout Indonesia is in fact the most inefficient terminal in the South East Asia. Judging from the productivity side (as in total container to be loaded in one hour) and the cost/unit side (cost to lift a container measuring 40 foot high in an hour) then JICT in Tanjung Priok is again the most inefficient terminal comparing to other harbor in South East Asian, such as Singapore and Port Klang in Malaysia (Ray, 2003).

## The Development of Direct Investment

Data from Investment Coordinating Board (BKPM) indicated that since 2004 the direct investment, either foreign or domestic investment, tend to increase with a relatively slow rate. Based on data approved investment, the value of domestic direct investment (DDI or PMDN in Indonesian) recorded at Rp. 36.80 trillion and increase to Rp. 50.58 trillion in 2005. Whereas, foreign direct investment (FDI or PMA in Indonesian) recorded at 10.30 billion US$ and up to 13.58 billion US$ during the same period.

Following the crisis in 1998, the number of new FDI projects has actually improved, at least according to the approved data from BKPM. However, after the year 2000, the number returned to its low position. (Figure 4). But, an interesting matter was that after the crisis, the number of new FDI projects annually is bigger than the new projects of DDI. It shows that following the crisis, the role of FDI has become far more significant than DDI in the growth of domestic direct investment as well as the development of national economy.

**Figure 4: The growth in number of approved FDI and DDI, 1967-2005**




Source: BKPM

Will FDI or DDI able to move higher compare to 2005, and continue to grow in future? The answer lies in many factors. One of them is business climate. All these years, the business climate in Indonesia is not favorable, and this, undoubtedly, has become the main factor to delay the investment growth in Indonesia. It can be easily stated that business climate reflecting several factors related to certain location and creating opportunity and incentive for investor to invest productively. In other word, favorable business climate is a certain climate to push a businessman to make an investment with the lowest cost and risk on one side, and gain long term profit on the other side (Stern, 2002). As an example, several studies pointed out that as a result of investment climate improvement during the 80's and 90's followed by a sharp decline in terms of investment cost and risk, then private investment as a part of GDP has jump to a high 200% in China and India (Tambunan,2006)

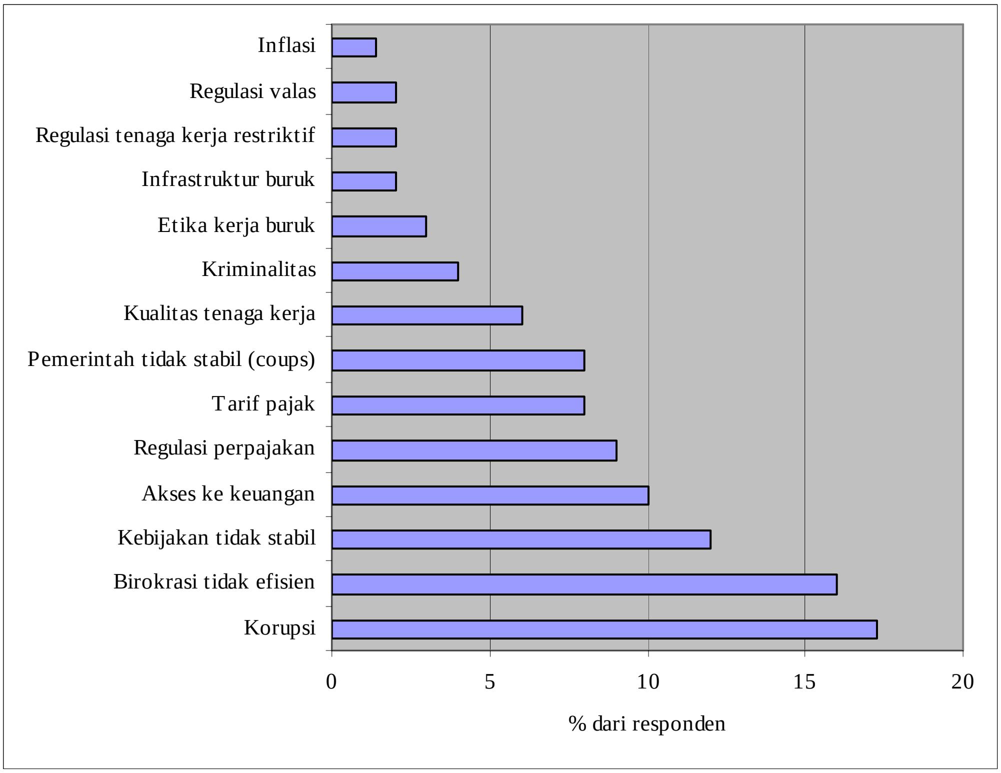
In the report by World Bank concerning investment climate (World Bank, 2005a), it is said that many factors should be taken into consideration in an effort to improve investment climate, among other things the macro economic stability and low rate of corruption. This report, which is based on a survey conducted toward over 26,000 companies in 53 countries, including Indonesia stated that even though the obstacles varied across countries and even among companies/sectors within the countries, the result in general reveal the importance of obstacles related to policy, including policy uncertainty and macro economic stability that must be considered in making a business/investment decision.

The result of survey conducted by World Bank was supported by annual survey result concerning the country's competitiveness done by The World Economic Forum (WEF) toward companies in over 100 countries in the world (included 250 businessmen in Indonesia). As can be seen in Figure 5, based on percentage of respondent, it turned out that three business obstacles ranked at the highest position is corruption, followed by bureaucracy and unstable policy. Most of the respondent argues that corruption is the most disturbing factor to their business. Corruption influence toward business may occur through several channel such as permit settlement, tax payment, goods loading from port, land purchase/selling, or in the operation of development projects.

Most of the other respondents believed that bureaucracy is the most inefficient practice to delay the growth of business in Indonesia (Table 1). Inefficient bureaucracy increase business costs, either in real form that is the amount of cost to be spent by businessman, or in term of alternative cost that is the time wasted in managing business permit which means loosing the chance to gain profit.

The third biggest group of businessman included in the survey argued that policy, particularly unstable economic macro policy, is the most damaging factor to their business. Unstable policy will enlarge uncertainty or risk in doing business and charge some extra costs for businessman/investor. Even in some media, that issue is considered to be the main obstacle, besides law uncertainty, for FDI to enter Indonesia. Survey result from World Bank (World Bank, 2005a) regarding investment climate stated that the percentage of Indonesian companies included in the sample considering that interpretation on government regulations that is unpredictable reached over 50%.

**Figure 5 : Factors to Hamper Business Growth in Indonesia in *The Global Competitiveness Report 2004-2005.***




Source: WEF (2004)

*Note: from above; inflation, foreign exchange regulation, restriction to labor regulation, poor infrastructure, poor working ethic, criminal rate, unstable government, tax tariff, tax regulation, access to financial, unstable policy, inefficient bureaucracy, corruption.*

**Table 1: Indonesia's relative position for Bureaucracy Level and Its Costs in *the Global Competitiveness Report 2004-2005.***

| Indicators | Ranking (total of 104 countries) |
|---|---|
| Burden from central government | 15 |
| Burden of regulations from regional government | 29 |
| Bureaucracy Level | 85 |
| Irregular/illegal payment in export and import | 75 |
| Irregular/illegal payment in using public utilities | 70 |
| Irregular/illegal payment in tax payment | 76 |
| Irregular/illegal payment in public contract | 46 |
| Irregular payment in credit application | 80 |
| Irregular/illegal payment in judicial decision | 69 |
| Business costs from irregular/illegal payment | 81 |

Source: WEF (2004).

According to the report of World Bank, as mentioned above, in order to create more favorable investment climate the government must deal with 3 issues; cost, risk and limitation in competition. As pointed out in Table 2, the report clearly explained the aspects of costs, risks and limitation of competition in which government hold a powerful influence. If government influence through its policy and attitude toward that aspect turned negative, for instance business cost becomes expensive, then those policies have dismissed the opportunity to increase new investment or business, or to expand the production capacity of existing businesses, meaning eliminating the possibility to improve investment.

As can be observed, government policies and attitude that could directly or indirectly affected the investment costs ranging from corruption, unfavorable tariff and taxation system, public services, trading policy regarding import duties, bureaucracy in settling permits, monetary policy influencing interest and inflation rate, until government spending to developing or improving infrastructure. That last matter has become crucial issue in the past few years to be discussed in Indonesia that is poor domestic infrastructure condition. A study by World Bank (World Bank, 2004) related to a number of serious problems including high cost in conducting business in many countries in the world stated that in developing countries such as Indonesia, to get a telephone line, loading goods from custom-house, and registering new business, required far more time with greater costs compared to developed industrial countries.

**Table 2. Government Policy and Attitude Influencing Investment Decision**

| Three significant factors affecting investment decision | Factors creating opportunity and incentive to make investment | |
|---|---|---|
| | Strong government influence | Weak government influence |
| Cost | Corruption<br>Tax tariff and system<br>Import duties & export tariff<br>Subsidy<br>Regulation & bureaucracy burden<br>Infrastructure<br>Public services,<br>Finance sector performance<br>Interest rate<br>Regulation of labor | Price of materials set by market,<br>Distance over input & output market<br>Related scale & scope of economy related to certain technology |
| Risk | Anticipated policy direction & its credibility,<br>Macro economic stability,<br>Property rights ,<br>Enforcing obedient over contract/ agreement,<br>To revoke property rights for public interest | Reaction of consumer & competitor<br>External surprises,<br>Natural Disasters<br>Supplier skill , |
| Limitation for competition | Limitation regulation to enter & exit,<br>Competition law & policy,<br>Functioning financial sector market,<br>Infrastructure | Market scale & distance to input & output market,<br>Economy scale certain activities |

Source: from Table 1.1 in World Bank (2005a) with slight modification

Until today, other factors to hamper investment growth (particularly FDI) in Indonesia is poor infrastructure. Two reports pointed out how poor the infrastructure in Indonesia in relative compared to other countries. First, report from World Bank (2005b). As can be seen in Table 3, though Indonesia is the biggest country in ASEAN, its rank to all significant indicators related to infrastructure is extremely poor. For instance, in terms of main road network, Indonesia is positioned in number 8 out of 12 ASEAN members, whereas in terms of fix telephone network, Indonesia is worst country in that group.

Second report came from WEF (2004), where the survey result concerning infrastructure quality Indonesia might be seen in Table 4. For the overall quality of infrastructure, Indonesia ranked in number 44 out of 144 countries included in the sample. For the infrastructure quality based on its types, Indonesia’s condition is poor, even worst for example in terms of quality of telephone/fax and total telephone network per 1000 citizens.

**Table 3: Infrastructure Performance in ASEAN**

| Indicators | Indonesia (2000) | Ranking in ASEAN |
|---|---|---|
| Electrification rate (%) | 53 | 11 of 12 countries |
| Fix telephone network (%) | 4 | 12 of 12 countries |
| Total request of *mobile phone* (%) | 6 | 9 of 12 countries |
| Access to better sanitation (%) | 55 | 7 of 11 countries |
| Access to clean water (%) | 78 | 7 of 11 countries |
| Main road network (km per 1000citizens) | 1,7 | 8 of 12 countries |

Source: World Bank (2005b).

One of the serious problems rose during the after crisis period in 1997/1998 was rights of land and other type of property. Since the year 1999 until today, number of companies suffered from serious problem, including FDI, where a group of people unexpectedly appeared and requesting back the land that has been bought and resided by those companies and claiming that they have not been given adequate compensation of selling their land during the Suharto era. These facts are obviously very uncomfortable for companies located in the land that suddenly becomes disputes with local people, and it can be a threat not only to the continuity of production activities but also property security of those companies. Therefore, granting more certainty over rights of land and other form of properties becomes very important for government to boost domestic investment, not only to bring secure feeling for investor but also easing the access to funding.

**Table 4. Relative Position of Indonesia for Infrastructure Quality in *the Global Competitiveness Report 2004-2005.***

| Indicator | Ranking (total 104 countries) |
|---|---|
| Overall quality | 44 |
| Main road development | 28 |
| Port quality | 40 |
| Air transportation quality | 61 |
| Electricity supply | 68 |
| Post office efficiency | 57 |
| Fax/telephone quality | 85 |
| Telephone network per 1000 citizens (data, 2003) | 86 |

Source: WEF (2005).

Many evidences supported the idea that certainty of property rights is strongly affected the investment activities. For example, a case study in East Europe and Former Soviet Union from Johnson & friends (2002) concluded that more companies believed the security of their property rights and reinvested the profit by as much as 145 to 40% compared to those companies whose remain in doubt regarding their property rights. A study across country from Kauffmann & friends (2003) revealed that ownership rights of property are crucial and one of the most determinant factors for investment growth. Other issues considered poor in Indonesia yet influencing the business risk is court system. Survey result regarding business climate by World Bank (2005a) stated that this issue has become serious problems in many developing countries where companies, FDI to be exact, has little confidence toward court ability to handle problems related to business world, including to stand by their property rights. Therefore, one effort that has to be implemented by government in increasing investment is to improve court system and need to get the highest priority.

Other factor often neglected but played an important role in influencing Indonesia's competitiveness level in inviting FDI is quality of education and technology development domestically. Report from WEF (2004) indicating that out of 104 countries included in the sample, Indonesia's rank related to education and technology development is very low. Table 5 shows that Indonesia is positioned at number 35 for education quality (whether the applied education system sufficient enough to meet country's requirement), and at number 48 in terms of quality of public school (whether the quality in one country similar to the best quality in the world). The most interesting issue in this report is related to the total of children attending primary school enrollment, whereas the situation in Indonesia was not that bad. It has to be admitted that as a result of government policy regarding basic education obligation, Indonesia succeeding improved the number the number of children attending elementary school. However, in a higher level of education, Indonesia considered to be poor. Ironic, since one determinants of country's competitiveness, even become the comparative advantage to attract FDI is higher education of human resources. Today, with an advance technology to lower transportation costs, and the emerging of more footloose industries using synthetic raw materials, particularly FDI, by granting variety of incentives will be in vain if Indonesia could not produce high education quality of human resources.

**Table 5: Relative Position of Indonesia to Education & Technology Development in *the Global Competitiveness Report 2004-2005.***

| Indicator | Ranking (total 104 countries) |
|---|---|
| Quality of education system | 35 |
| Quality of public schools | 48 |
| Quality of science and math education | 57 |
| Distribution of a quality health services | 36 |
| Level (based on secondary data in 2001, or recent years available); | |
| -*primary enrollment* | 23 |
| -*secondary enrollment*) | 81 |
| -*tertiary enrollment* | 74 |
| Technology readiness | 57 |

Source: WEF (2004).