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ICP MONTHLY ALERT

POLITICAL & POLICY ISSUES TO WATCH

October marks the end of the first year of Yudhoyono's second-term. Talk of a reshuffle was intense just a few weeks ago, but has since toned down considerably. The setgab (coalition secretariat) has so far proven to be an effective forum to satisfy the demands of SBY's coalition partners to have their views heard. After the stalemate over the Century bailout a few months ago, the coalition has been solid on a number of key issues, including the major components of the 2011 budget and the appointment of the new armed forces commander, Admiral Agus Suhartono. The coalition is fully expected to back the president's nominees for national police chief, attorney general and head of the anti-corruption commission (KPK), which he is expected to announce later this month. Overall, the setgab has created an underlying level of political stability that should hold over the medium-term.

With respect to the reshuffle, the government's internal inspectorate UKP4 headed by the well-respected Kuntoro Mangkusubroto will produce its evaluation of the cabinet by 20 October. Figures such as energy minister Darwin Saleh (PD) and transportation minister Freddy Numberi (PD) face personal scandals that could make them vulnerable. Public works minister Djoko Kirmanto (non-partisan) has already been in the spotlight for delays in several infrastructure projects. The recent collapse of newly built road arteries in Jakarta makes his position more precarious. Overall, some cabinet changes could certainly be made in the coming months based on performance alone. Nothing drastic is likely, however. Unless Yudhoyono can bring in PDIP or Gerindra into the coalition, party representation in the cabinet is unlikely to change despite some aggressive lobbying from SBY's own PD for an expanded presence.

Meanwhile, security is resurfacing as a major issue, as analysts increasingly see local terrorists focusing more on their "near enemy" of the police and Indonesian state and away from indiscriminate, Bali-style bombings. This has been highlighted, for example, by a recent string of violent bank robberies, a well-planned attack against a police station in Medan, and a suicide bomb attempt at a traffic police post in Bekasi. There is no doubt that Indonesia's counter-terrorism measures over the past several years have helped splinter and weaken the Jemaah Islamyiah network. However, the terrorists' tactical shift implying more crime and attacks on government officials, institutions and businesses could mean much more widespread, smaller-scale violence. While Indonesia is very far from the tense and volatile Pakistan or Middle East-type security situations, it remains a serious challenge to security forces and the broader public to adequately respond to this ongoing threat.

- Security situation deteriorates as police prove unable to adjust to terrorists' new tactics, creating social and political instability.

- **Reshuffle talks subside as coalition partners cozy up**

- **But cabinet changes still possible**

- **Shifting terrorist tactics threaten more widespread violence**

Key Risks



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MARKET OUTLOOK

The outlook for Indonesia's economy continues to improve. The Asian Development Bank (ADB) recently raised its 2010 growth forecast for Indonesia to 6.1% from 5.5% and to 6.3% from 6% for 2011. Similarly, the government and parliament have agreed to raise their 2011 growth forecast in next year's budget to 6.4% from 6.3%. Investment growth is seeing renewed momentum and is underpinning this optimism. The investment growth is reflected, for example, by rising construction levels, increased imports of machinery and transportation equipment, plus a host of deals, from a US\$6 billion steel mill venture between Posco and Krakatau Steel, a US\$5 billion railway project involving India's Reliance Power and Adani Group, and a US\$1.2 billion power plant expansion project by Paiton Energy and Tokyo Electric. Meanwhile, higher discretionary spending, as indicated by record sales of cars and motorcycles, foretells solid growth in private consumption. Along with higher investment levels, supported by rising income and improving credit availability, private consumption will continue to boost GDP.

On the negative side, exports, particularly manufacturing-related, may face headwinds with a stronger rupiah (now hovering near three-year highs of Rp8,900-8,950/US\$) and still relatively weak global demand. Furthermore, government spending continues to be hampered by inefficiencies. Inflation, meanwhile, continues to be a dark cloud on the horizon. Though it is pulling back somewhat, consumer inflation expectations remain high. A medium-term risk will be if surging energy prices force a major, 2005-style adjustment to administered prices. This would force a significant monetary tightening and a period of below-par growth. The administration is looking for a more gradual adjustment through limited curbs of subsidized fuel purchases and another electricity rate rise next year. Nonetheless, many are skeptical whether this can genuinely reduce the country's dependence on subsidies. Despite these potential pitfalls, however, the bullish story of Indonesia's secular growth path will likely continue.

Meanwhile, Indonesia appears to be fully on the radar screen of international portfolio investors. The Indonesian stock exchange (IDX) made successive highs in September with net foreign buying of nearly US\$700 million, making it the best performing market among Asia's top 15 economies this year. Yields for benchmark treasuries are also hitting record lows, as global funds continue to purchase Indonesian debt paper. Despite aggressive dollar purchases by Bank Indonesia that have boosted foreign reserves by 9% in the first three weeks of September alone to almost US\$90 billion, many expect the rupiah to strengthen further. A healthy correction in the stock and bond markets is due. Nevertheless, with renewed fear of sovereign defaults in parts of Europe plus an ultra-low yield environment in the U.S. and other developed nations, Indonesia's outperforming economy and prospects of a ratings upgrade should drive further appreciation of the country's capital assets.

- Rising terrorist threat and deteriorating security situation prompts delay of new investment projects and encourages portfolio investors to reduce holdings of Indonesian assets.

- **Renewal investment growth to boost economy**

- **Export headwinds, inflation creeping up**

..... but overall secular growth trend should continue

- **Strong growth prospects will keep Indonesia on investors' radar screens**

Capital asset appreciation likely to continue

Key Risks

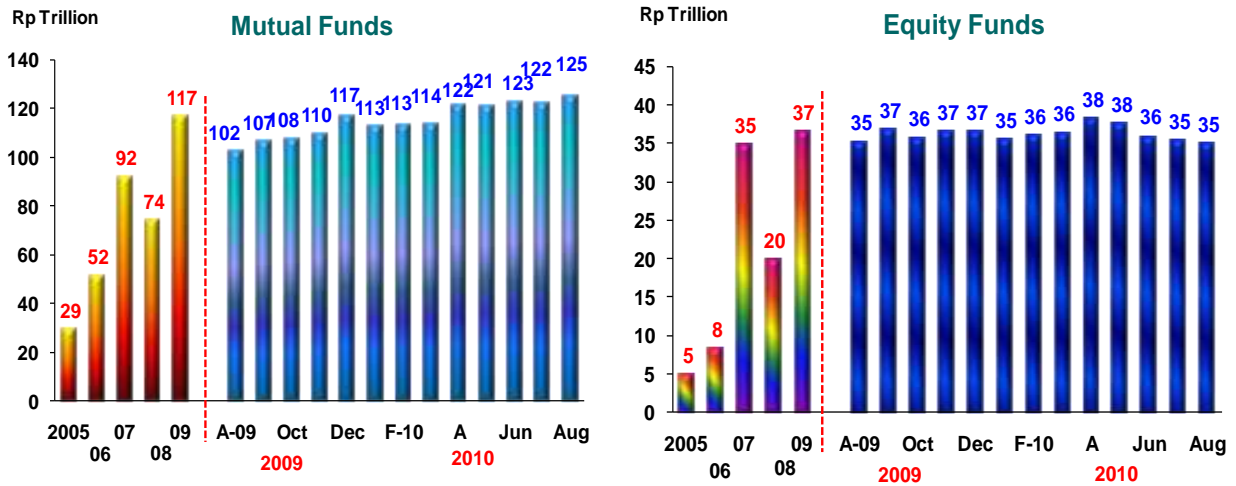
	2008	2009	2010*	2011*
GDP Growth (%)	6.1	4.5	6.2	7.0
CPI %, yoy	11.06	2.8	6.50	7.5
X-rate to US\$1, year end	10,950	9,400	9,000	8,750
SBI % (one-month), year end	9.25	6.50	6.50	7.50

Source: James Castle and Andri Manuwoto, CastleAsia, PT Jasa Cita, Jakarta, Indonesia



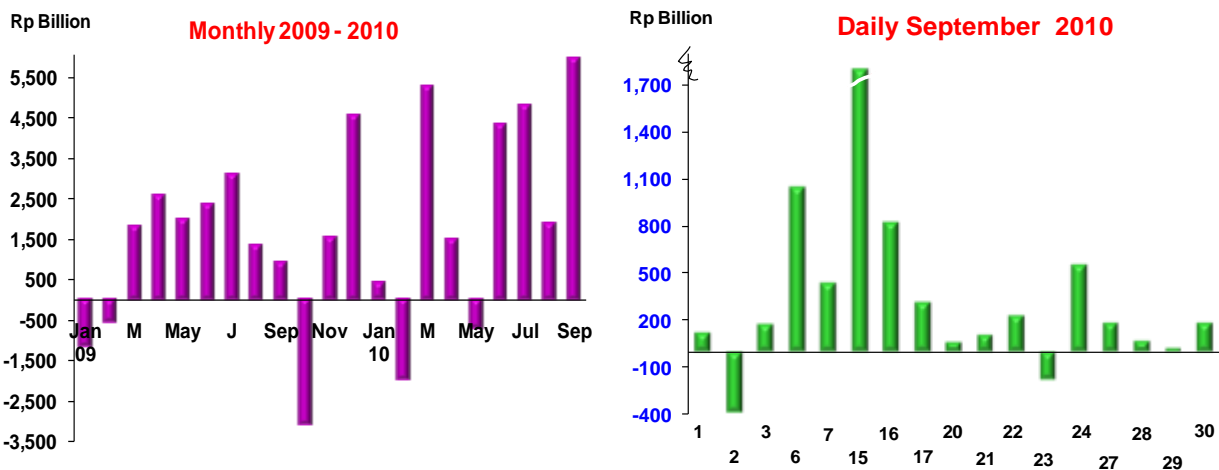
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Net Asset Value of Indonesian Investment Funds



Source: Capital Markets Supervisory Agency (Bapepam)

Indonesian Stock Exchange: Net Foreign Investment Flow



Source: Capital Markets Supervisory Agency (Bapepam)