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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND TO THE  
EUROPEAN PARLIAMENT**

**"DEVELOPING CLOSER RELATIONS  
BETWEEN INDONESIA AND THE EUROPEAN UNION"**

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## **1. INTRODUCTION**

Relations between the EU and Indonesia are now three decades old. As an ASEAN founding member, Indonesia was involved in the ASEAN-EU dialogue launched at the first ministerial meeting between the two sides in 1978 and was a signatory to the EC-ASEAN Co-operation Agreement of 1980. Indonesia has been a major player in the ASEAN context, but the East Timor issue has put a strain on the EU's relationship with Indonesia, and, by extension, with ASEAN, for several years. However, Indonesia's renunciation of its territorial claim to East Timor has now created a new situation that enables the EU to take a fresh and more comprehensive look at Indonesia and its relationship with the Union.

Indonesia has also recently embarked on the most far-reaching change in its history post-independence, with the holding of free and fair elections leading to a democratic government.

It is now time to establish the EU as a partner of substance for Indonesia, which is the world's fourth most populous country, has its biggest Muslim population and plays a key strategic role in the region. Indonesia's stability is important to the region and it has the potential to play a major role in promoting peace, stability and democratic values in Asia. In past decades, and until the recent economic crisis, it had achieved impressive progress in economic development, reduction of poverty and improvement of social conditions. Europe's economic ties with Indonesia are already considerable in terms of trade, investment and business presence, but they could still be improved. Indonesia will represent even greater opportunities in the future.

This Communication identifies ways in which the EU can help the Indonesian government and people face up to their immediate political, social, economic, developmental and environmental challenges and build a renewed, intensified and multi-faceted relationship with a democratising Indonesia.

In taking advantage of these opportunities, the EU will need to give appropriate attention to promoting improvements in human rights, which are a prerequisite both for a democratic society and for sustainable development.

## **2. POLITICAL DIALOGUE**

### **2.1. Indonesia's Role in the Region**

#### *2.1.1. A Key Player in the Asia Pacific Region*

Indonesia is a key player in the Asia-Pacific region. Europe should seek to strengthen both bilateral consultation and regional cooperation. Indonesia also has a decisive role in the ASEAN process, not only because it is the largest member, but also because of traditional respect for Indonesia's international stance, in particular in the Non-Aligned Movement. Its relations with Japan, China and Australia also have an impact on ASEAN's relationship with these countries.

The EU's relationship with Indonesia has been framed by the EU-ASEAN partnership. Indonesia has also been an important partner in ASEM. The ASEAN Regional Forum (ARF) of which the EU is a member, provides a framework to discuss security issues.

In the past, EU's dialogue with Indonesia to promote common interests in these fora has been rather limited when compared to that with other ASEAN members such as Thailand and the Philippines. The change in Indonesian leadership opens new avenues for dialogue on:

- Promotion of security in the region, e.g. South China Sea, strengthening the ARF, small arms;
- Enhancement of the EU-ASEAN Dialogue: the resumption of the EU-ASEAN political dialogue will need positive support from all ASEAN members to ensure that it leads to substantial discussions on major issues,
- Promotion of concepts of democracy and human rights in the region: Indonesia is one of the ASEAN members contributing to the current evolution towards democracy and concern for human rights. The EU should support the impetus such members can give to creating a more open political dialogue within ASEAN. Given that Indonesia has in the past been seen as a role model for Burma, positive developments in Indonesia should be used to encourage increased democracy and respect for human rights there.

### *2.1.2 Future Relationship with East Timor*

One of the most pressing issues for EU consideration should be the establishment of a peaceful and consensual partnership between Indonesia and East Timor. Open borders and free trade between East and West Timor will be important for the future development of both parts of the island. There are promising signs: the visit of Xanana Gusmao to Jakarta and conciliatory language on both sides. However, slow progress on the repatriation of East Timorese refugees from West Timor and the enquiry on human rights violations in East Timor are less encouraging. On the former, co-operation with the Indonesian authorities is improving and it is hoped that this difficult situation will be resolved soon, as promised by the Indonesian Government. The success of the latter will depend very much on the co-operation between the UN Commission of Enquiry and the Indonesian Human Rights Commission (KomNasHAM).

## **2.2. Human Rights**

The transitional Habibie government had already launched reforms to overcome the severe shortcomings of the past. Since May 1998, these have included steps towards freedom of the media<sup>1</sup>, the release of most political prisoners and a partial investigation of past human rights violations, including those in East Timor. The government has ratified several international human rights instruments. The National Commission for Human Rights, KomNasHAM (Komisi Nasional Hak Asasi Manusia), has become a more effective instrument for investigating human rights violations, including land and labour disputes, allegations of killings, disappearances and torture. Some of its published findings have identified responsibility for human rights violations, including those in the province of Aceh, where the involvement of the armed forces has been established. A similar test case for the credibility of KomNasHAM will be the final conclusions it draws from the acts of violence that occurred in East Timor and the follow-up of its findings by the authorities.

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<sup>1</sup>The Law on Freedom of Public Expression, passed by the Parliament in August 1999, but not yet enacted into law, is still challenged as a constraint, as one could arguably maintain that no such regulation is needed at all.

Violations of human rights also remain of concern in those provinces where the government – while being responsible for maintaining security – is faced with aspirations for some kind of regional autonomy or independence.

Nevertheless, the clear commitment of the present government to develop a culture of respect for human rights and break with past abuses is evident, inter alia, in the appointment of a state minister for human rights and the release of the last remaining political prisoners by parliamentary and presidential pardon.

Equally important, questions of the environment, respect for human rights of local stakeholders in forested areas and the rights of indigenous people must be addressed.

The EU understands that Indonesia's human rights policies and practices need to be considered in a long-term perspective. Experience shows that establishment of respect for human rights, democratic principles, the rule of law and good governance in the institutions and structures of state and society is a gradual process. Community support therefore needs to be based on a long-term programme-based rather than a project-based strategy.

Possible approaches could include a permanent dialogue with the government, regular contacts with the National Human Rights Commission and with NGOs, as well as programmes to raise the awareness of human rights and the institutional capacities of civil society. In a country the size of Indonesia, overall improvements will not occur overnight and need to take into account the socio-economic situation and culture of the country.

### **2.3. Anchoring Democracy, the Rule of Law and Good Governance**

Indonesia is currently undergoing a process of fundamental change and democratic reform of the state and its relationship with civil society. This transitional phase, together with the economic and social impact of the economic crisis, have created a fragile and volatile situation.

The EU acknowledges that reforms to establish democratic principles, the rule of law and good governance are of course a demanding task for any country. Such reforms are a long-term project, because they require not only legal acts but also changes in the institutional set-up and management of public affairs to ensure their application. In this context, the EU welcomes Indonesia's ratification of ILO-Conventions covering freedom of association, collective bargaining, non-discrimination and the elimination of forced and child labour and trusts that the Indonesian authorities will ensure effective implementation of these Conventions.

The parliamentary elections of 7<sup>th</sup> June 1999, which were held freely and to international standards, demonstrated Indonesia's commitment to democracy. The result of the elections expressed clearly and credibly the will of the electorate to change course. Indonesians had a chance, for the first time in their history, to change their government peacefully. Many newly founded political parties were able to compete. Another milestone in democratic development were the presidential elections of 20<sup>th</sup> and 22<sup>nd</sup> October 1999. The broad-based composition of the new government reflects the desire to break with the past.

Formal elements of a democratic and responsible government are now in place. But the leadership's good intentions are being met with resistance from the supporters of the old structures within the bureaucracy and the army. The main challenge for Indonesia now

consists in giving substance to the new democratic structures and strengthening their institutional capacities, without risking functional and regional clashes.

### *2.3.1. Constitutional Reform*

One of the most pressing questions is the future division of power between central government and the provinces. Unrest in some regions is a challenge to Indonesia's stability and the preservation of its national territorial integrity. Indonesia must find a balance between demands for equity and recognition of cultural differences at local and regional levels and the need for coherent national policies and a co-ordinated and fair transfer and allocation of resources between the regions and the central government.

### *2.3.2. Role of the Armed Forces*

Even after constitutional amendment, the Armed Forces still occupy non-elected seats in Parliament. Under the previous regime, a fundamental tenet was the dual function (“dwi-fungsi”) of the military, given responsibility for both defence and national security. The latter gave the army a decisive political role. Formally, the dual-function concept has not been abandoned. But attempts are being made to convert the Armed Forces into a professional defence organisation. Tensions between the newly elected government and the armed forces have increased. A start to re-position the military domestically has been made recently by separating them from the police. The EU welcomes this. In the recent past, other Southeast Asian countries have successfully demonstrated how to disengage the armed forces both from civil administration and from politics.

In the EU's view, all partners should support this process, which needs to consider the will of the electorate rather than old sensitivities.

### *2.3.3. Rule of Law, Legal & Institutional Reforms and Access to Justice*

The primacy of law is a fundamental principle of any democratic system, as it allows the protection and promotion of human rights and provides a more secure environment for private-sector trade and investment. It places limitations on the power of the State, implies a clear and transparent legal and regulatory framework for governmental action and requires effective means of enforcement and of recourse for citizens to defend their rights.

The Habibie administration began a reform process, but fell short of implementing many of these initiatives. The new government has expressed the clear intention to continue on the path of legal reforms. It has not yet set out all elements of comprehensive policy. This might take some time given the complexity of the Indonesian legal and political system<sup>2</sup>.

The government's treatment of allegations against former President Soeharto will be significant because of their symbolism.

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<sup>2</sup>In public and private law (including commercial law, the Dutch system of civil law predominates. During the last two decades other influences have affected legislative initiatives. For example, in matters of commercial law, the Indonesian government has sought assistance from various common law jurisdictions, particularly the US and Australia. In matters of family law and family property, traditional systems, including Islamic law, are often present.

#### *2.3.4. The Judicial System and the Legal and Regulatory Framework*

Delivering justice requires the existence of an independent judicial system that, in turn, creates confidence. There is a lot of domestic pressure to tackle the issue. The envisaged creation of a single independent Bar Association, with a clear Code of Conduct for practising lawyers, and the power to dismiss lawyers perpetrating corrupt practices or other infringements, would be another important initiative.

The EU should support, through close collaboration with the government, the establishment of a fully independent judiciary and offer support for institutional capacity strengthening. A review of the legal framework - in particular, of economic laws - seems essential. At present, the basic structure and content of commercial legislation in Indonesia is very incomplete and there is a serious lack of expertise and trained personnel to reform, upgrade and implement legislation in these fields. The IMF's new letter of intent on Indonesia apparently stresses the need to upgrade the commercial legal structure (bankruptcy, competition, finance, etc.) and on the role of the Attorney General's Office in that respect. The Attorney General is developing a proactive programme of legal reform, in addition to his role as investigator and prosecutor. So far, this has included the proposal for the creation of a new Human Rights Tribunal. Support for the Attorney General and his office is a priority.

#### *2.3.5. Good Governance*

The EU is encouraged that good governance, including the fight against corruption, particularly in government procurement, is a top priority for the new government, especially in the area of public procurement. Almost all of the problems faced by Indonesia at present can be linked to the absence of a system of good governance and the rule of law. Overall, a political environment with efficient, transparent, and accountable institutions is needed to anchor democracy, raise confidence in public decision-making and bring about economic recovery.

One of the great difficulties facing the new administration will be the reform of the civil service, since almost all branches have problems of overstaffing and lack of skills. Lack of resources and the reluctance of civil servants to accept change are likely to hamper the government's reforms. In this context, the importance of well-founded decision-making, based on scientific evidence and research, should be underscored.

Over the past decade, the EU has developed a clear policy and expertise for promoting good governance and co-operates closely with its international co-operation partners. Given the Indonesian Government's determination to progress in this area, the EU could offer technical assistance. This should be co-ordinated with other international donors and achieved through mechanisms set up, chaired and driven by the Indonesian Government. The programme should be accompanied by actions designed to strengthen the monitoring capacity of civil society organisations.

To make participatory democracy sustainable, actors from civil society have to be effectively organised. Indonesia has a large number of social organisations at grass root level. Within the limits of the previous political system, their work concentrated mostly on social aid. Some of these organisations are already delivering valuable contributions to the strengthening of civil society. To complement its government-level dialogue with Indonesia, the EU should build the capacity of these organisations and could act as a catalyst for contacts between effectively-run NGOs, business associations, trade unions and academic and research institutions.

## 2.4. Stability and Cohesion of Indonesia

Throughout its history, Indonesia has always had to cope with ethnic, religious and regional tensions<sup>3</sup>, but they have considerably intensified in the last two years. They represent one of the major challenges the new government has to address in the short-term. In particular calls for independence in Aceh and, to a lesser extent in Irian Jaya pose an immediate and explosive problem. Fears are widespread that, after the East Timor experience, any new cases of devolution may signal the break-up of Indonesia.

### 2.4.1 *Preserving Indonesia's cohesion*

Indonesia seeks support from the international community for its territorial integrity. This call has already received a positive answer from the USA, ASEAN and East Asian partners who backed non-violent efforts to end Aceh's separatist unrest, and supported President Wahid's view that Aceh should not be offered independence.

Equally, the current EU position is to support Indonesia's territorial integrity (see Presidency Declaration 25.11.99), and to call for a peaceful settlement of the current Aceh crisis. Indonesia's cultural diversity within a sole entity can be an asset: the European experience is a good example. ASEAN efforts to deepen regional integration should also be taken into account. In order better to respond to the devolutionary aspirations of its member countries' regions, ASEAN may wish to develop a stronger regional dimension, as the Union has done.

An important step forward will be the setting up of a comprehensive and balanced framework for a degree of autonomy for provinces. Discussion of decentralisation and/or genuinely federal elements has been far from conclusive, given the diverging points of interest at national level (need for co-ordination of the transfer of resources, national cohesion) and at provincial level (provinces rich or poor in natural resources but with aspirations towards regional autonomy, etc).

### 2.4.2 *A Society of Tolerance*

Ethnic and religious unrest is another crucial issue. Despite shortcomings in the past, it was able to achieve the coexistence of the Islamic majority with many other religions. Recently, political instability has heightened religious tensions, in particular in Ambon and other parts of the Mollucas where the decades-old policy of transmigration, intended to alleviate the demographic pressure from overpopulated areas, has contributed to ethnic and religious tension. Ethnic problems are also of particular importance for the Chinese minority, which is regularly targeted by rioters during periods of civil unrest because of its economic success. Ethnic unrest has in the past even caused refugee problems for neighbouring Papua New Guinea.

These are matters of grave concern, and the Union has on a number of occasions called on the Indonesian Government to resolve these problems peacefully and to work out conciliatory approaches. The appointment of a minister of settlement and territorial development indicates a shift with regard to internal resettlement policy.

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<sup>3</sup>Indonesia, the fourth most populous country in the world, has a population estimated at 210 million people and a territory composed of 17,506 islands, stretching over one tenth of the equator. The population is mainly Malay/Indonesian with Melanesians in Irian Jaya and the eastern islands and with a 3% ethnic Chinese minority. Indonesia is 87% Muslim, 10% Christian and 3% Hindu/Buddhist

Special responsibility for Ambon has been given to Vice President Megawati Soekarnoputri, who visited the region, together with the President. Their joint statement on reconciliation deserves the full support of the EU. The Commission (ECHO) is resuming humanitarian aid to displaced people in the Mollucas.

Fundamental rights including the rights of minorities should be an essential part of any future political dialogue with Indonesia with a view to supporting a constructive approach to this problem.

### 3. ECONOMIC AND TRADE RELATIONS

#### 3.1. Trade

Indonesian trade remained sluggish in 1998-99, even with the stimulus of currency depreciation. Indonesian sources show that, after a decline of 9% in 1998, **exports** were down 3.5% year-on-year in January-October 1999, even though oil and gas have been selling at record prices. **Imports** declined by 7.1% year-on-year in January-October 1999, after a large fall in 1998. This stagnation of imports is related to the fall in investment and the weakness of the domestic supply of credits to the industrial sector.

##### *3.1.1. Multilateral trade*

Indonesia is an influential member of the WTO and plays a key role within ASEAN on multilateral trade issues. Since the conclusion of the Uruguay Round, Indonesia appears to have faithfully implemented its commitments. A discriminatory regime on cars was successfully challenged by the EU and other WTO<sup>4</sup> and has been amended. Indonesia was able to play a constructive role in the run-up to the Seattle ministerial conference and was among those developing countries with which the EU worked in order to secure a balanced and broad-based package of results. Priorities for Indonesia in the WTO include better market access for textiles and clothing products, the review and tightening of anti-dumping rules, and additional flexibility for developing countries in a number of areas. The EU has an interest in furthering the discussions with Indonesia on matters of common interest in the WTO, and in more intensive cooperation, both bilaterally and in EC-ASEAN and ASEM for a, to facilitate the launch of a new WTO trade round designed to meet the interests of both sides.

##### *3.1.2. Bilateral Trade*

The EU is a prime trading partner for Indonesia. It is the largest destination for Indonesia's exports other than oil/gas<sup>5</sup> and it is the number one supplier of goods to Indonesia. The booming Indonesian economy in the 80's and 90's had a particularly great impact on EC-Indonesia trade with total two-way trade exceeding € 16.5 bn in 1997 (€ 8.27bn v. € 8.29bn) - a more than eight-fold increase since 1980.

However, the financial crisis provoked a sharp decline in EC exports to Indonesia (53% in 1998 and 23% year-on-year in the 1<sup>st</sup> semester of 1999). There was an increase in value of EC imports from Indonesia (7% in 1998) but a decline (-11% year-on-year) in the first semester of 1999. The EC registered a bilateral € 5 bn trade deficit in 1998. This trade deficit is an essential EU contribution to the recovery process and the EU has acted fully in line with the

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<sup>4</sup>report of the panel on Indonesia: certain measures affecting the automobile industry, 2.7.99 ref. WT/DS64/R

<sup>5</sup>Japan buys most oil/gas

April 1998 ASEM trade pledge. A “new trade pledge” towards Indonesia would be a strong political signal of support to the Indonesian Government's efforts to deal with its country's economic problems.

There is significant potential to expand trade, in both goods and services, which can be developed through a continuous focus on the opening of markets. Meanwhile, discussions should start on current market access issues between both partners with a view to stimulating two-way trade flows. Such discussions are foreseen in the EC-ASEAN framework and could be developed in a bilateral Senior Officials' Meeting (SOM) framework.

### *3.1.3. General System of Preferences (GSP)*

In 1997, Indonesia ranked as the third biggest beneficiary of EC GSP overall and the biggest ASEAN beneficiary. Around 55% of its trade with EU received GSP status at that time. However, the total graduation of Indonesia, for three crucial product sectors - wood, footwear and animal fats and oils - in January 1998, had a significant impact on its potential market access to the EU. This unfortunately coincided with the peak of the economic crisis in the region. This graduation was based on 1992 figures for the development index and 1993 figures for trade data and it does not, therefore, reflect the impact of the crisis on Indonesia exports. Furthermore, a revision of the graduation mechanism, which was foreseen for 1999, was postponed to 2000. This would take account of the 1999 figures which would more accurately reflect the adverse effects of the economic crisis than those which would have been used in the 1999 review. As regards wood, Indonesia could examine the possibility of using the incentive schemes introduced in 1998<sup>6</sup>, which offer additional benefits to countries that respect standards relating to the sustainable management of tropical forests (ITTO). To date, Indonesia has failed to indicate interest in these schemes. However, assistance to help Indonesia progressively apply these standards could be envisaged in the framework of the EU forestry programme.

## **3.2 Recovery from the crisis**

Prior to the crisis, the Indonesian economy had made remarkable progress. From the sixties to the nineties, Indonesia was one of only three economies in the world to move from the bottom of the world's economic growth tables to the top. This brought with it a substantial reduction in poverty and significant social progress, particularly in the fields of education and health.

This growth was, however, partly based on weak banking and financial systems which were also, together with cronyism and corruption, root causes of the financial crisis throughout the region. In the case of Indonesia, the poorest of the affected countries, the economic and political systems were yet more fragile and untransparent. The change provoked by the crisis in the political system was also more dramatic than in the other countries of the region and, as a result, Indonesia was the worst hit of all. It is also the country whose recovery has been the most difficult and the slowest.

### *3.2.1 The Challenges of Economic Recovery*

The main challenge is the establishment of a new democratic political regime to provide the country with renewed stability. The holding of free and fair elections and the designation of a government that should respond to the widely expressed desire for change have created the fundamental conditions for recovery. But there is still a long way to go.

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<sup>6</sup>Council Regulation (EC) N° 1154/98 of 25 May 1998.

The government needs to address macroeconomic challenges swiftly and rigorously, in particular, the following:

- reforming and recapitalising the financial system,
- containing the levels of sovereign and foreign debt, particularly foreign sovereign debt,
- eradicating corruption and cronyism and replacing them with the rule of the law.

The new Indonesian Government seems decided to focus its economic policy on these challenges. It will need the help of international partners, in particular IFI's, to push forward the necessary reforms.

### *3.2.2 The Role of International Financial Institutions (IFIs)*

The current state of Indonesia's public finances is serious. Containment of the country's national debt is a major challenge. The need for fiscal stimulus to support the economy and the escalating cost of bank clean-ups put further pressure on public funds. The World Bank has warned that public debt could rise to about 100% of GDP in 2000, up from only 24% in mid-97. IFI support is therefore needed more than ever. Furthermore, IFI will play a decisive role in advising the Indonesian Government in economic, social and administrative reforms. The Union, with its Member States being major contributors to the IFIs, and itself an important donor, has a role to play in order to ensure that the right support is given under the right conditions. The IMF has been holding discussions with the Indonesian Government on these points, and a letter of intent was signed on 20 January, setting out a clear reform programme. It is understood that due attention has been given to the social cost of such reforms. This is an important factor, as an earlier reform plan combined with political frustration triggered social unrest in May 1998.

In this context, the EU should strengthen its co-ordination with the IFIs and in particular, the World Bank and Asian Development Bank. A regular co-ordination mechanism in Jakarta for Heads of Mission (HOMs) and IFIs would bring substantial benefits for both sides.

### *3.2.3 Future Investment Policy*

New investments in the private sector are badly needed to revitalise the economy. But available data up to the third quarter of 1999 suggest that investment has not yet started rising from the subdued level of 1998. This is reflected in EU exports of machinery and capital goods to Indonesia, which continued to fall throughout the first half of 1999.

EU direct investment in Indonesia was significant prior to the crisis, reaching an average of € 550 Mio in the years 1995-1997. According to the Indonesian Investment Coordinating Board, the EU has been the largest investor in Indonesia since the recording of FDI data started in 1967.

In terms of investment policy, the current administration have shown a clear commitment and has given top priority to attracting new foreign capital. That said, previously closed sectors (e.g. transportation, warehousing, tele-communications) have gradually opened up to foreign investment since mid-1999 while other sectors have become more friendly towards FDI. A further opening-up of the financial services area to foreign services suppliers, notably in the banking and insurance fields, may help the Indonesian government reshape a stronger financial sector and provide it with the requested diversity, liquidity and stability. Lastly, efforts should be made in terms to improve current accountability practice.

Several sectors still remain restricted or closed to FDI, but the new administration is expected to continue the drive towards more openness to FDI.

Given the Government's commitment and the prominence of the EU as an investor in Indonesia, the exchange of views between Europe and Indonesia on these policies should be enhanced, in particular at the level of senior officials (SOM). Fora for dialogue with Indonesia on investment are also available within ASEM (the Investment Experts Group) and in the EC-ASEAN framework.

Member States are stepping up their efforts to build investment links with Indonesia. There is a need to co-ordinate the EU business presence. Support for the recently created Europe-Indonesia Association (EIA) will help to achieve this.

### **3.3 Restructuring the Economy**

Overall, the government's major task will be to restore domestic and international confidence in the Indonesian economy by establishing new and effective policies that break with the past in most fields. The Union can bring a lot of experience to this process and assistance could be envisaged where needed. Some areas for particular attention would be:

#### *3.3.1 Good Governance*

One of the most important means to attract more investment, achieve sound economic development and ensure best value for taxpayers money, is to implement good governance. See section 2.3.5.

#### *3.3.2 Banking System Reform*

Indonesia's Bank Restructuring programme is proceeding. Many reforms have been carried out, but the challenges that remain are still daunting. The IMF and World Bank have successfully used their influence on several occasions to keep the process on track. The Bank Bali scandal tarnished the Indonesian Bank Restructuring Agency's (IBRA) image. A recent shift of control over IBRA from the Finance Ministry to the President himself is designed to increase the agency's independence. The estimated cost of recapitalisation is enormous with the eventual total cost in the region of 60% of GDP. EU support to banking restructuring has been given through the IFIs, ASEM Trust Fund, EFEX, and Member States' assistance.

#### *3.3.3 Economic Regulations*

The framework of economic law in Indonesia is very weak, and needs extensive reform and upgrading. The lack of an operational system, together with widespread corruption within the judiciary has led to disrespect for the legal system. General recourse to irresponsible lending has seriously restricted credit for valid business operations. While business activity should be pursued by the private sector, the government needs urgently to put in place a strong legal framework for economy, providing for accountability and encouraging good business practices. This should be accompanied by an immediate start to the privatisation of the assets held by IBRA, which have a face value of about 80% of Indonesia's GDP. Particular areas of the law which required attention are bankruptcy (together with settlement provisions these are needed to return to a healthy corporate society), competition law and financial regulation and intellectual property rights. Improvements in enterprise monitoring and accounting practices are also required. In these areas, Europe has considerable experience which could be usefully exploited in co-operation initiatives with Indonesia.

## 4. SUSTAINABLE DEVELOPMENT

### 4.1 Social Development Background

The Soeharto administration (1965-1998) deliberately focused on development and made impressive social and educational advances. Poverty was reduced in absolute and relative terms. Urbanisation advanced, with a high standard of housing and public infrastructure. Population growth was steadily reduced to a rate of 1.7 % p.a., a remarkably low figure that was achieved without any coercive measures. From the ranks of the world's poorest nations in the 1950s and early 1960s, Indonesia entered the middle-income range, with per-capita GDP exceeding 1.100 \$ by the mid 1990s. Other significant achievements included health care, life expectancy and literacy. This progress in social development was halted or even reversed as a result of the crisis and was aggravated by a severe drought. In 1998, the economy contracted by 13.6%, in comparison with the average annual economic growth of 6.5% that Indonesia experienced in the period from 1967 to 1997. It seems that the urban lower and middle classes were most affected by the decreasing demand for labour and shrinking real wage levels. Given its initially less favourable position, the rural population fared relatively better. Of great concern is the increase in unemployment and its detrimental effect on conditions of employment. The Indonesian government has addressed this problem and succeeded in creating additional jobs, but it is obvious that annual economic growth rates below 5 % will be insufficient to ease the unemployment/underemployment problem.

To counter these negative effects, social safety net programmes were introduced in 1998 with the help of the World Bank. The value of these is uncontested by all political parties, given the millions below the poverty line, the large number of school children in danger of leaving education for good<sup>7</sup> as well as their importance for subsidising food and medical care. The implementation of these programmes has been controversial and criticised because of financial leakage diversion and inadequate monitoring.

Pending the resolution of the Bank Bali problem, international financing institutions have put on hold all fast-disbursing budget support. This included loans to the Social Safety Net Programme. As the Indonesian government has agreed to disclose the audit-report of the incident, IFIs are in a position to resume their support, although valuable time has been lost.

The EU should give increased support to the social sector. To avoid the shortcomings of the past, dialogue among the various groups concerned must be improved as must the administration at national and provincial level. In the long term, a comprehensive system of social security could be envisaged.

In the longer term and to avoid economic downturns having such a negative social impact, the EU should help Indonesia to set up some independent basic social insurance schemes, to provide, for virtually all workers minimum unemployment and/or pension benefits as well as basic medical insurance. This would avoid the massive move into poverty of laid-off people in the case of economic crisis. Such schemes will also contribute to poverty alleviation by reducing vulnerability of people who are close to the poverty line. Such schemes must be placed outside the enterprise to ensure that in case of bankruptcy, they do not disappear with the enterprise itself. Europe has a long and diverse experience in this field which could be of great interest for Indonesia.

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<sup>7</sup>Primary school enrolment appears to be stable at approx. 95 %, secondary enrolment dropped slightly from 54.4 to 53.2 %, although public expenditure on education decreased sharply between 1996 and 1998.

## 4.2 Poverty Alleviation

The crisis and the severe drought in 1998 increased the poverty rate from 11% in 1996 to 14-20% in 1998<sup>8</sup>. In urban areas, the poverty level roughly doubled (from 3.8%). In rural areas it increased significantly in absolute numbers to around 17.6%. Overall economic inequality seems to have changed little, but a detailed assessment shows very different regional and social patterns. Poverty increased more in urban than in rural areas. Java was more affected than the other islands. The agriculture and construction sectors, which employ poorer segments of the population, were more vulnerable. Surprisingly, the urban middle class was also strongly affected. It remains however unclear to what extent the severe recession Indonesia had a differential impact on men and women - information on this will be important for optimal targeting of poverty alleviation.

The Government of Indonesia helped to cushion some of the negative effects by providing subsidised food.

The ASEM Trust Fund that was set up specifically to address financial and social reform problems stemming from the crisis has also been a valuable tool for Indonesia. It has permitted rapid implementation of a series of advisory actions relating to key social policy issues. The EU has contributed substantially to the Fund<sup>9</sup>. The € 4.5 million so far allocated to Indonesia has included projects in areas such as school grants, rapid poverty assessments, medical assistance and utilities.

Given the proven effectiveness of the expertise provided via the ASEM Trust Fund, the EU should consider providing additional resources, including possibly through an extension of the ASEM Trust Fund. In general, prospects for a social dialogue between the EU, the government and NGOs on both sides, should be explored.

## 4.3 Promoting better environmental performance

During decades of very high economic growth, little attention was paid to environmental issues. As a consequence, pollution levels are high in many areas. These damage health and induce excess mortality, especially in urban areas. Poor people, who in general depend more on natural resources are particularly affected by a degraded environment. The planned reforms for better governance could offer an opportunity to reform fiscal policy and remove some environmentally harmful subsidies (on certain very polluting fuels for example).

Moreover, the economic recovery and new investments flows could offer an opportunity to introduce more environment friendly (or cleaner) technologies and to improve fuel-use efficiency. The EU has a very rich experience in this field and could provide very valuable technical assistance to Indonesia.

The financial crisis in Indonesia has exacerbated and created new environmental problems; there is a real risk that environmental considerations will be relegated to a low priority in the name of economic recovery. A basic assumption of the Union should be that Indonesia cannot wait to address environmental problems until the financial situation gets better. The risk of environmental degradation becoming the cause of the next crisis is too great.

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<sup>8</sup>Data according to the most methodologically reliable sources (World Bank studies, 1998).

<sup>9</sup>The Commission's pledge of € 15 million was complemented by commitments by Member States, totalling € 28 million (Denmark, France, Italy, Luxemburg, the Netherlands, Finland, Sweden and the United Kingdom).

Over recent years, the forest fires and subsequent 'haze' problems (see 4.4 below) have focused attention on the adequacy of Indonesian environment policy in general, including that related to industrial production, coastal zone management, mining, urban environment, etc.

Indonesia should be encouraged to integrate environmental considerations into all other policy areas. Specific areas should include industrial policy (e.g. by encouraging the implementation of a sound Environmental Impact Assessment regime, notably directed at all investment in new industrial enterprises); in education, by promoting environmental education at all levels; in urban development and city planning policy; in transport policy and in rural development policy. Indonesia should be offered assistance in identifying environmental priorities and directing resources towards them. Where applicable, relevant EU environmental technologies will be incorporated into the economic and development co-operation programmes.

Given Indonesia's size and potential environmental impact over the coming decades as expected economic growth gathers pace, specific global environmental priorities, such as the mitigation of greenhouse gas emissions, should feature among joint co-operation activities attracting EU assistance.

#### **4.4 Forests and the Environment**

The forests of Indonesia represent 10 % of the world's remaining tropical forests and are considered to be amongst the richest in biodiversity being home to a great number of species found nowhere else in the world. Forests play an important economic, social and environmental role in Indonesia. Their atmospheric carbon sequestration and biodiversity are globally important.

The threat to the country's forests predates the economic crisis. Pre-existing problems were excess processing capacity by the industrial timber industry, over-commitment to production at the expense of conservation, insufficient forest access rights at the local level, lack of biodiversity protection and rampant illegal felling of trees. The economic crisis and political transition aggravated these deficiencies, accelerated illegal logging and weakened the economic position of local stakeholders.

Besides illegal logging, fires are the most pressing problem. Forest fires are the manifestation, in a particular climatic context, of trends in land use practices. The national policy on industrial plantations is one of the driving forces in the use of forested land. The government maintains a policy of extending oil palm plantations at the expense of the forested areas. While this sector is known for its financial performance, its poor adherence to sustainable land management practices and the encouragement to investments is established. Alternatives to burning ("slash and burn") still have to be researched and developed.

Indonesia's fires in 1997 were estimated to have caused more emissions of CO<sub>2</sub> than man-made sources from North America. Fires burning out of control have caused severe damage (haze, loss of timber, decline in tourism, etc.). They are also a symptom of deficiencies in forest management and in the implementation of policies. Already in 1995 the use of fire to clear agricultural land was outlawed, but because of a lack of political commitment and budgetary resources the ban was not effectively implemented.

Indonesia's forests are being felled at a rapid rate, both "legally" in designated forest conversion areas and illegally in many other areas, even in national parks. The long term climatic and ecological impact is a cause of serious concern for the global community. However, the losers in this process are also the many marginalised groups who depend to a

greater or lesser extent on forests for their livelihoods and whose interests have often not been considered.

#### *4.4.1 Forestry and EU action*

The new Indonesian government has stated its commitment to reform. A genuine change of approach in the forestry sector would provide an opportunity for the Commission to contribute substantially. The EU has chosen forest sector development as one of its top priorities for support. About 60 % of development assistance to the country's forest sector are presently being provided through Commission projects. The present EC forestry programme (about 106 mio €) consists of a series of six coherent projects that address major issues<sup>10</sup> : forest fires, forest management, sustainable harvesting and the preservation of an ecological balance. The area-based forestry projects are already engaged in actions to assist the resolution of conflicts between stakeholders, which can now be more easily achieved at national and provincial level.

Although Commission funded work in the sector is already substantial, additional actions may need to be considered. A number of problems should be addressed in the near future in co-operation with other donors (notably the Member States). Among them is the inadequate provision of counterpart staff to the projects, the sometimes limited involvement of the beneficiary side, the relatively low sense of ownership and the lack of political follow-through. The EC should be able to intensify its actions, in particular proceeding as soon as possible to set up a full Fire Prevention and Control Programme. The problem of Indonesian logging companies outside their own country - sometimes involved in unsustainable logging operations abroad - could be usefully included in the dialogue with the Indonesian authorities, and also in the framework of the ASEAN-EU dialogue.

These problems are largely related to the specific socio-political reality of Indonesia. Solving these problems will necessitate changes in the way policy decisions are taken and implemented. Civil society in its various forms will have to play an active role. This process has already started. It could be accelerated if resources were more effectively channelled and the extensive experience at the disposal of the Commission and the Member States were better exploited by the government. A start in this direction has been made by the government sponsored forest seminar in January 2000.

## **5. FUTURE APPROACH**

The above considerations lead to the conclusion that the European Union should update and strengthen its relationship with Indonesia. This should be achieved through a step-by-step approach taking into account the progress realised by the Indonesian Government in solving internal conflicts peacefully, reforming the economy and in strengthening the country's democratic institutions.

In setting out key strategic objectives for a closer relationship with Indonesia, the EU should focus on a dialogue specific to Indonesia but within the ASEAN-EU partnership. This would

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<sup>10</sup>1. Leuser Development Programme (Gunung Leuser National Park, covering 2 mio. ha in North Sumatra and Aceh), 2. Forest Fire Prevention and Control Project (South Sumatra), 3. Berau Forest Management Programme (East Kalimantan), 4. Forest Inventory and Monitoring Project (updating national forest resource data and establishing an integrated information system), 5. South and Central Kalimantan Production Forest Project, 6. Forest Liaison Bureau (Jakarta).

involve a bilateral political and economic dialogue for the advancement of mutual interests, taking into account the respective regional importance of both partners.

## **5.1 Political And Security Matters**

The EU contribution to the elections<sup>11</sup> proved extremely successful and it was very well received by the Indonesian people. EU support to the democratic process should not stop there.

(1) The Union should develop a political dialogue with Indonesia, on an equal footing. Its main purpose would be:

- to share views on regional political and security developments and identify possible co-operation,
- to support governmental efforts to bring forward necessary reforms and to encourage further steps towards anchoring democracy in Indonesia,
- to develop a dialogue with Indonesia on human rights.

(2) The Union should pay special attention to promoting good governance and application of the rule of law, a priority for the Indonesian Government. European assistance could focus on:

- co-operation in the establishment and training of an independent judicial system, including promotion of respect for human rights and strengthening the Office of the Attorney General;
- support to the reform of the civil service, concentrating on one or two key sectors, of which one could be forestry, taking into account the EU's leading role as a donor in this area;
- development of contacts between European and Indonesian defence officials;
- strengthening civil society.

(3) Actions designed to reduce cultural and religious tensions should concentrate on:

- humanitarian aid for displaced people or those at risk,
- efforts to promote dialogue and reconciliation taking into account governmental actions, as well as international and regional endeavours. Special attention should be given to the involvement of civil society,
- sharing with Indonesia the wide and diverse experience of EU Member States in dealing with decentralisation and regional change. Exchange of know-how and information on existing federal systems in Europe could prove a valuable contribution.

(4) For regions seeking devolution, the Union should develop a dialogue with Indonesia and other international partners to help seek viable solutions that respond both to these regions' aspirations and to the objective of avoiding the disintegration of Indonesia. Although this question is an internal policy matter, it has strong potential effects internationally.

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<sup>11</sup> For the parliamentary elections, significant financial support was given and a large election observation unit, comprising 136 long and short-term observers, was dispatched to the country. The team's close co-operation with the administration was appreciated as a substantive contribution to strengthening democracy.

## 5.2 Economic and Trade Relations

Enhancing trade relations should be a key objective of the strategy. In particular:

- The EC has an interest in furthering the discussions with Indonesia on matters of common interest in the WTO, and should develop more intensive cooperation, both bilaterally and through the ASEAN and ASEM fora, to facilitate the launch of a new WTO trade round designed to meet the interests of both sides.
- A “new trade pledge” towards Indonesia, reiterating the ASEM trade pledge would be a strong political signal of support to the Indonesian Government's efforts to deal with its country's economic problems.
- Discussions should start on current market access issues for trade in goods and services between both partners to stimulate two-way trade flows.
- Support for economic recovery should be a priority in the EU's short-term strategy for Indonesia.
- The EU should strengthen its co-ordination with IFIs<sup>12</sup>, in particular the World Bank and the Asian Development Bank. A regular co-ordination mechanism in Jakarta for HOMs and IFIs would bring substantial benefits for both sides. For the EU, it would ensure better knowledge of the evolution of the situation and would allow a co-ordinated approach to projects which correspond to the policies adopted. For the IFIs, it would be an opportunity to integrate EU contributions more effectively into the overall effort.
- Given the prominence of the EU as an investor in Indonesia, the exchange of views between Europe and Indonesia on investment policies should be intensified, in particular at SOM<sup>13</sup> level in the ASEM Investment Experts Group and in the EC-ASEAN framework.
- European instruments designed to promote investment, such as AsiaInvest, could be useful for the promotion of European SME investment in Indonesia. Various EC-ASEAN economic co-operation programmes also exist to improve the business environment and investor confidence. The Commission will consider the possibility of stimulating an increased utilisation of these instruments and programmes in Indonesia through seminars or business events.
- Given the importance of Community transport legislation, the EU should explore with the Indonesian authorities the possibility of co-operation on issues such as satellite navigation (GNSS), air transport economics (e.g. public service obligations and regional air services), air safety, maritime piracy and other matters of common interest.

## 5.3 Raising the EU's Profile in Indonesia

Indonesia does not perceive the European Union as such as a major partner and it receives only limited attention compared with the United States or Japan. The EU is viewed primarily as a trading bloc and there is little awareness of its supranational nature.

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<sup>12</sup> Clearly, the consequences of the 3-year reform programme that the government has agreed with the IMF on 20<sup>th</sup> January 2000, has to be considered. This plan includes far-reaching reforms in the banking sector (privatisation), in the energy sector, and in the areas of taxation and commercial policies. A detailed evaluation of this ambitious reform programme and of its repercussions for EU trade and investment should follow.

<sup>13</sup> Senior Officials Meeting

### *5.3.1 Developing a dialogue with the authorities*

The development of an EU-Indonesia bilateral dialogue would enhance substantially the Indonesian government's perception of Europe and its interest in Indonesia's future. This could help to position the Union as a major dialogue partner. As with the other original members of ASEAN, there is no bilateral agreement between the EU and Indonesia. The 1980 EC-ASEAN agreement serves as a framework for economic relations, while the EU-ASEAN Ministerial Meeting is a platform for political dialogue. The Commission has responded positively to the Indonesian request to hold regular Senior Official Meetings in the future, as is already the case with Thailand and Philippines. The question of a bilateral co-operation agreement with Indonesia, in addition to the existing EC-ASEAN co-operation agreement, could be considered. The advantages for the EU of engaging in a comprehensive dialogue with a reform-oriented Indonesian government are obvious. Such a dialogue could even give an impetus to the EU-ASEAN dialogue.

### *5.3.2 Promoting EU visibility in Indonesia*

The “new strategy towards Asia” already stressed the need to promote a greater knowledge of Europe in Asia, and vice versa. This makes it necessary for individual Union actors to join forces in areas such as information, higher education and culture. The Commission and the Member States could endeavour to develop further common activities "on the ground" in order to promote this objective. Within the current EC strategy for co-operation in higher education, various programmes have been launched or are in the process of preparation. They offer a good basis for enhanced co-operation with Indonesia, but require adequate promotion in Indonesia to be fully effective.

## **5.4 Focusing Support for Development**

Indonesia's development assistance needs are enormous. The current level of EC financial commitments for Indonesia is a great deal less than those of other donors. But total aid provided by the EU, taking account of bilateral aid provided by Member States and contributions to the IFIs, is substantial. The first step should be to maximise the impact of the total EU contribution by strengthening the Union's global approach to development cooperation with Indonesia.

The changes occurring in Indonesia are attracting the attention of all the major players who share an interest in seeing reforms being undertaken as swiftly as possible. Co-ordination is required in order to ensure that future EU co-operation complements other donors' contributions.

An EU approach to supporting sustainable development in Indonesia could focus on a number of targets:

(1) In order to address the needs of target groups suffering from the impact of the crisis, social safety net programmes such as family planning, support to maintain children in school, mother and child health/nutrition, and support to the NGO network<sup>14</sup> should be prioritised in future actions.

(2) The Union should also pay special attention to the question of poverty alleviation, in particular in problem areas such as the Mollucas and West Timor. This could involve small-

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<sup>14</sup>i.e. the Community recovery Programme of the World Bank

scale rural development projects, small enterprise and agri-business development, water & sanitation for rural communities, and community health and education. The Cairo conclusions should be taken into consideration in particular as regards women's role in social and economic development.

(3) A key priority for the EU will remain sustainable natural resources management, in particular with regard to forestry, where the EC and Member States have already established a solid background of co-operation in Indonesia. This applies to effective conservation of areas with significant bio-diversity and measures to improve the sustainability of forest production management. In that context, but not exclusively focusing on forest research, the development of the scientific research capacities of Indonesia should be strengthened. It is well demonstrated that sustainable development requires investment in clean technologies, best practices and improved natural resource management capabilities.

It is obvious that the Commission's limited financial resources allotted to Asia put constraints on its future actions in clearly defined priority areas. However, an additional effort should be made in order to upgrade its co-operation to a level consistent with Indonesia's needs.

The political situation would now appear to allow the establishment of a proper programming dialogue between the Commission and the government, in particular on sustainable development.

The Council is invited to adopt this approach and to invite the Commission, Member States, business and other actors to co-operate in pursuing it.

## **FINANCIAL STATEMENT**

### **1. TITLE OF OPERATION**

Communication from the Commission: "A Strategy for closer relations between Indonesia and the European Union".

### **2. BUDGET HEADING(S) INVOLVED**

- B7-20 Food aid and support operations
- B7-21 Humanitarian aid
- B7-30 Co-operation with Asian developing countries
- B7-60 Community measures to support NGOs
- B7-61 Training and promotion of awareness of development issues
- B7-62 Environment, health and the fight against drugs in the developing countries
- B7-63 Population and demography in the developing countries
- B7-64 Specific aid schemes in the field of development
- B7-65 Measures to combat fraud in the co-operation sector and management and assessment of Community aid
- B7-70 European initiative for democracy and human rights
- B7-87 Promotion of commercial relations
- B8-01 PESC

### **3. LEGAL BASIS**

PVD/ALA Regulation, Democracy and Human Rights Regulation, etc.

### **4. DESCRIPTION OF OPERATION**

#### **4.1 General objective**

Communication from the Commission to the Council and the European Parliament which outlines the key elements of a strategy for the development of closer relations between the EU and Indonesia into the new millennium.

#### 4.2 Period covered and arrangements for renewal

### 5. CLASSIFICATION OF EXPENDITURE OR REVENUE

#### 5.1 Non-compulsory expenditure

#### 5.2 Differentiated appropriations

#### 5.3 Type of revenue involved

The projects launched under the Communication will not engender any specific revenue.

### 6. TYPE OF EXPENDITURE OR REVENUE

– 100% subsidy

### 7. FINANCIAL IMPACT

The present document, in itself, has no direct financial impact. The cost of individual action for most of the credit lines possibly concerned will be decided and calculated on a case by case basis.

#### 7.1 Method of calculating total cost of operation (relation between individual and total costs)

#### 7.2 Itemised breakdown of cost

Commitment appropriations EURO million (at current prices)

Breakdown	year n	n+1	N+2	n+3	n+4	n+5 and subs. yrs	
Total							

#### 7.3 OPERATIONAL EXPENDITURE FOR STUDIES, EXPERTS ETC. INCLUDED IN PART B OF THE BUDGET

Commitment appropriations EURO million (at current prices)

	year n	n+1	N+2	n+3	n+4	n+5 and subs. yrs	Total
– Studies							
–Meetings of experts <sup>15</sup>							
– Information and publications							
Total							

#### **7.4 Schedule of commitment and payment appropriations**

On request, following appraisal of the project by the Commission departments and up to an amount not exceeding the appropriations to be entered under the relevant budget headings, in each annual budgetary procedure.

#### **8. FRAUD PREVENTION MEASURES**

- Specific control measures envisaged
- The Indonesian authorities and the Commission will apply the normal control measures in the implementation of projects, as foreseen by each financing agreement and contract.

#### **9. ELEMENTS OF COST-EFFECTIVENESS ANALYSIS**

##### **9.1 Specific and quantified objectives; target population**

- Specific objectives: links with general objective
- To be defined on a case by case basis.
- Target population: distinguish for any individual objectives; indicate the end-beneficiaries of the Community's financial contribution and the intermediaries involved.
- To be defined on a case by case basis.

##### **9.2 Grounds for the operation**

- Need for Community financial aid, with particular regard for the principle of subsidiarity

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<sup>15</sup>Costs satisfying the criteria in the Commission communication of 22.4.1992 (SEC (92)769)

- To be defined on a case by case basis.

### 9.3 Monitoring and evaluation of the operation

- Performance indicators selected

To be defined on a case by case basis, and included in each financing agreement and contract.

## 10. ADMINISTRATIVE EXPENDITURE (SECTION III, PART A OF THE BUDGET)

This section of the financial statement must be sent to DGs Personnel and Administration and Budget; DG Personnel and Administration will then forward it to DG Budget with its opinion.

Actual mobilization of the necessary administrative resources will depend on the Commission's annual decision on the allocation of resources, taking into account the number of staff and additional amounts authorized by the budgetary authority.

### 10.1 Effect on the number of posts

Type of post		Staff to be assigned to managing the operation		Source		Duration
				Existing resources in the DG or department concerned	Additional resources	
Officials or temporary staff	A					
	B					
	C					
Other resources						
Total						

If additional resources are required, indicate the pace at which they will have to be made available.

## 10.2 Overall financial impact of additional human resources

EURO

	Amounts	Method of calculation
Officials		
Temporary staff		
Other resources (indicate budget heading)		
Total		

The amounts given must express the total cost of additional posts for the entire duration of the operation, if this duration is predetermined, or for 12 months if it is indefinite.

## 10.3 Increase in other administrative expenditure as a result of the operation

EURO

Budget heading	Amounts	Method of calculation
A-701 (missions)		
Total		

The amounts given must correspond to total expenditure arising from the operation if its duration is predetermined or expenditure for 12 months if it is indefinite.

The costs will be covered by existing resources.