IPA Backgrounder

Foreign Direct Investment and Recovery in Indonesia: Recent Events and Their Impact

by Malcolm Gray

Introduction and Summary

Some recent events in Indonesia have raised questions about the future role of foreign direct investment (FDI) in the Indonesian economy. This *Backgrounder* looks at those events and their implications.

FDI is important in the process of economic development, both as a desirable source of long-term finance and for the skill and technology transfer often associated with it. In the half century since independence, the Indonesian economy has had a range of drivers of economic development.

In the decade-or-so preceding the Asian crisis, FDI had assumed an important role and Indonesia had been reasonably successful in attracting it. The Asian crisis and subsequent events did more damage to the Indonesian economy than to any of the other crisis-affected economies (usually identified, for example, by the IMF, as Malaysia, the Republic of Korea, the Philippines and Thailand).

The impact on FDI in Indonesia was particularly marked. As a consequence of this and related developments, there are particular vulnerabilities in the economic situation in Indonesia that make the sharp fall-off in FDI especially damaging. Recent developments may significantly reduce the prospect of achieving an early turnaround in Indonesia's recent poor performance in attracting FDI and reduce the return to the Indonesian community from major elements of the previously accumulated stock of foreign investments. This *Backgrounder* looks at each of these topics in turn.

August 2002, Vol. 14/2, rrp $13.20

The Value of Foreign Direct Investment (FDI)

Value of foreign investment in the early stages economic development

In the early stages of economic development, a given increase in capital per worker can have a much more dramatic impact on output per worker than at later stages of development when the capital-per-worker ratio is higher. The restraint in consumption that is required to provide the funding for such investment from domestic sources, however, is typically more difficult because it implies sacrifices in current living standards that are already low. In these circumstances, foreign investment provides a way of securing the gains in output per worker, which are then shared with the foreign capital provider, without a corresponding sacrifice in current living standards.

FDI is generally less volatile

From the perspective of a developing country, FDI offers several advantages over alternative ways of providing such investment, such as foreign portfolio investment or foreign (typically bank) lending. FDI typically involves greater assumption of the risks of operating in the local environment by the foreign investor, through a longer-term commitment and because it is less easy to withdraw FDI than portfolio investment or a loan. It was noticeable during the Asian crisis that the typical pattern was that bank loans, many of which were short-term, were withdrawn very quickly, followed by portfolio investment, with FDI generally responding much less and more slowly. The lower volatility of FDI is reflected in a lower contribution to fluctuations in the external accounts of the host country and, consequently, fewer problems of economic management for the host government.

FDI often provides additional benefits

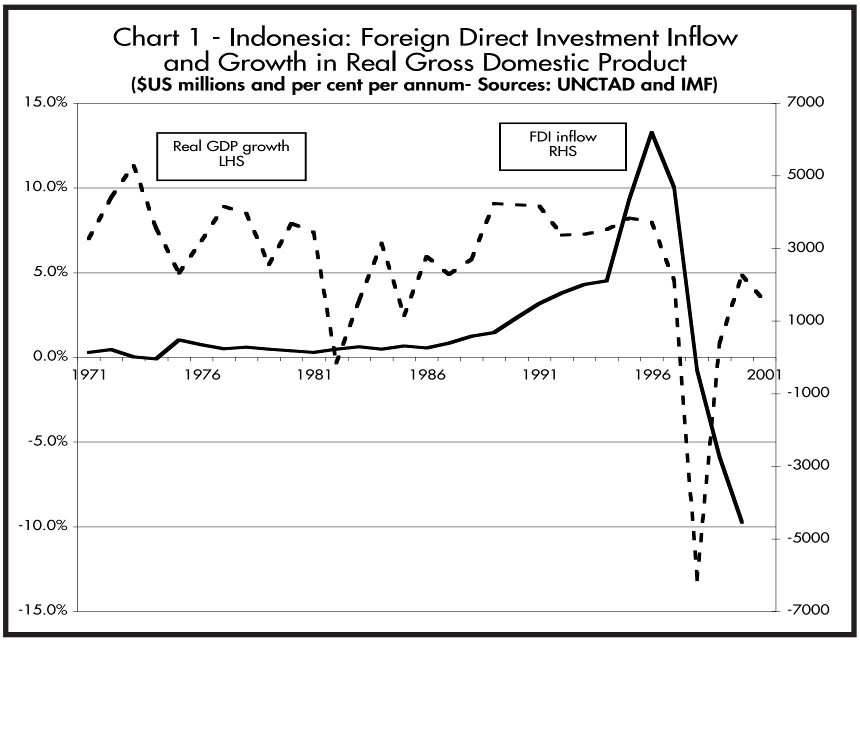
Direct investment links the project to the other operations of the direct investor, which can deliver a range of benefits to the host country. The physical facilities established by a foreign direct investor often embody technology new to the host country. Both during the construction and operation phases of such a plant, management skills may be channelled through the foreign investor of a kind either not available or in limited supply in the host country. The presence of a foreign direct investor can often facilitate obtaining loan capital for a project on terms that would not otherwise be available. In addition, a foreign direct investor may have access to product markets that would be difficult or expensive to access otherwise.

Drivers of Economic Growth in Indonesia

In looking at the principal drivers of economic development, the economic history of Indonesia since independence can be usefully divided into four phases: the period up until 1965, from 1965 to 1986, from 1986 to 1997 and the period since 1997.

From independence to 1965: the Sukarno presidency

Through the period of the Sukarno presidency, increasing reliance was placed on fiscal stimulus financed by money creation. This policy mix gave rise to accelerating inflation, a collapse in confidence and economic stagnation. Inflation peaked at 1,500



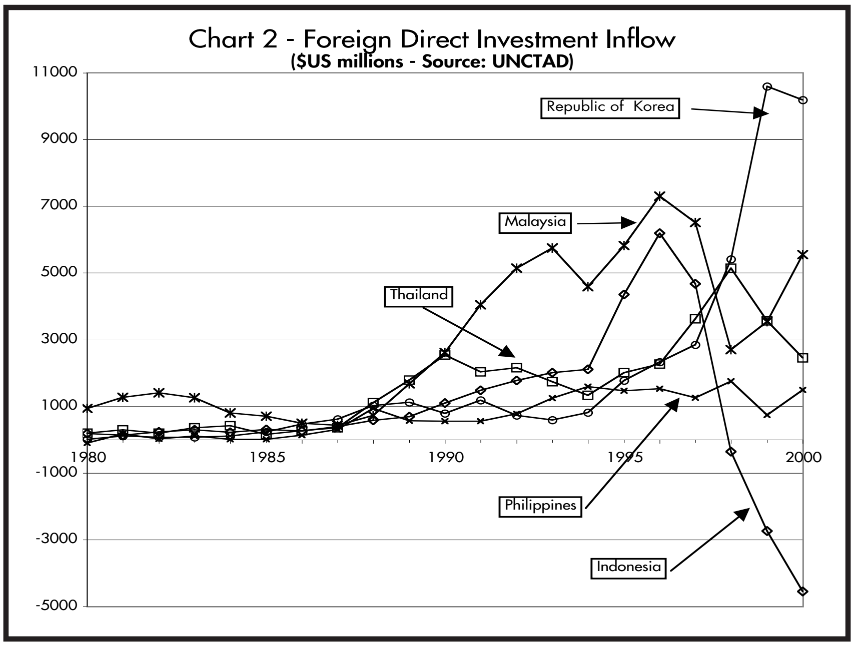
per cent in 1965, accompanied by food shortages and high unemployment.

From 1965 to 1986: reform through planning

The coming to power of President Soeharto in 1965 saw a sharp change in economic policy settings, with the introduction of multi-year economic plans to guide development. Oil revenues permitted government to play a major role in driving economic development while maintaining relatively conservative fiscal and monetary policies. The oil price rises of 1973 were important here. Initially this policy was very successful with economic growth averaging 8 per cent through the 1970s. As Chart 1 shows, however, the reliance on government as the principal driver of growth through increasingly bureaucratic processes saw growth falter in the early 1980s. The collapse of the oil market in 1986 made the growing pressure for a change in economic policy irresistible.

From 1986 to 1997: freeing markets

In response to the pressures of the early 1980s, economic policy became more market-oriented, with private sector investment assuming the role of the principal driver of economic growth. As Chart 1 shows, these policy changes stimulated FDI and saw it make a major contribution to restoring economic growth. In the late 1980s and early 1990s, economic growth returned to the levels of the 1970s. This period of strong growth ended in 1997 with the onset of the Asian crisis.



Indonesia Hard Hit by the Asian Crisis

Indonesia was hard hit by the Asian crisis of 1997–98 and, after a slow and limited recovery, is again experiencing slowing growth.

GDP contracted sharply

Although the Asian crisis affected a wide range of countries, its strongest effects were felt in Indonesia, Malaysia, the Republic of Korea, the Philippines and Thailand. The impact on Indonesia was markedly more severe and long-lasting than the impacts on the other crisis-affected economies. Real GDP declined by 13 per cent in Indonesia in 1998, more than any other crisis-affected economy, and was slower to recover, remaining below 1 per cent in 1999.

Particularly reflected in FDI inflows

All the affected countries suffered massive short-term capital outflows during the crisis. As depicted in Chart 2, Indonesia was unique among the crisis-affected economies in suffering substantial and sustained negative FDI inflow in the wake of the crisis. (FDI inflow is net direct investment by foreigners in Indonesia, with FDI outflow being net direct investment by Indonesians in the rest of the world.) According to the most recent figures available from UNCTAD, Indonesia has suffered net negative FDI inflow in every quarter since the third quarter of 1998. In Thailand, the crisis-affected economy most similar to Indonesia, FDI inflow actually increased in 1998 before falling back, but remained above pre-crisis-levels. In Malaysia, FDI inflow fell sharply during the crisis, but has subsequently recovered to a level close to the pre-crisis peak. The Republic of Korea seems to have become more attractive to foreign investors in the wake of the crisis, with FDI inflows climbing to more than four times their pre-crisis levels. FDI inflow to the Philippines, another country often compared to Indonesia, was not much affected by the crisis and has been broadly maintained at pre-crisis levels.

Growth slowing

The Indonesian economy finally began to recover in 2000, posting growth of 4.8 per cent, and it seemed to weather the global slowdown evident in 2001 better than its neighbours. Even so, growth slowed in 2001 to 3.3 per cent. With the fourth quarter showing an even bleaker picture, with GDP only 1.6 per cent above its level of the fourth quarter of 2000, growth is generally forecast to be a little over 3 per cent in 2002. Of particular concern in these figures are the recent poor performance and outlook for business investment and exports. Recent analysis has shown that, with growth at these levels, it will be six more years before per-capita GDP in Indonesia regains its level of 1997.

The Current Economic Situation

Against this background of restricted growth opportunities and the delay in restoring 1997 living standards, certain features of the current economic situation are of particular concern.

Financial restructuring proving difficult

The Indonesian financial system is struggling to overcome the legacy of the Asian crisis. The Government still controls more than three-quarters of the total assets of the commercial banks and much corporate debt remains unrestructured. Bank assets are dominated by government and central bank debt, with loans at only around one-third of deposits. About a quarter of distressed corporate debt is known to have been subject to restructuring arrangements. Even for that debt, recent World Bank analysis has raised doubts about whether most of these arrangements have succeeded in reducing debt to sustainable levels. Public sector debt is also substantial, with public debt interest payments budgeted to consume over 5 per cent of GDP in 2002, making it the largest single line item. Some progress is, however, being made. The Indonesian Bank Restructuring Agency (IBRA) disposed of 51 per cent of Bank Central Asia, Indonesia's largest retail bank, in March. The process for the sale of 51 per cent of Bank Niaga was, however, suspended in early June. IBRA is now making limited volumes of shares available on the Jakarta Stock Exchange with the avowed aim of testing the market price. The price of Bank Niaga shares has fallen by about 36 per cent in the six weeks to I July 2002.

Legal System Increasingly Unpredictable

A number of very high-profile cases have emerged where the Indonesian legal system has provided directions in the way commercial rules are applied that appear to undermine the confidence of international investors. The cases have all been very high profile, and have involved bankruptcy proceedings initiated against viable businesses, the attachment of assets to actors in closely contested commercial cases, and the abrupt seizure of assets on the basis of questionable outlines of events.

Privatisation programme behind schedule

The privatisation programme failed to meet its targets in each of the last three years. There were essentially no sales of state-owned enterprises in 1999 or 2000, and only a minority stake in PT Telcom was sold in 2001. Of particular concern is the role of regional government in preventing the sale of a controlling stake in PT Semen Gresik to Cemex, a Mexican company, discussed in more detail below. In both the privatisation programme and the IBRA's programmes, doubt has arisen about the preparedness of the Indonesian authorities to dispose of assets to foreign companies.

Problems emerging from decentralisation

In 1999, the Indonesian parliament passed laws 22 and 25 that mandated the introduction of a substantial programme of decentralisation beginning on 1 January 2001. Thus far, the programme has involved increasing the share of sub-national governments in total government expenditure from 13 per cent to 35 per cent and transferring more than two million people from national to sub-national government employment. Although the transition was, in many respects, remarkably successful, with minimal disruptions to service delivery or local government operations, some problems have begun to emerge. Mention has already been made of the role of sub-national governments in the attempted privatisation of Semen Gresik. In addition to increased grants from the national government, local governments were given broader taxation powers. Although new taxes and charges were to be subject to review by the national government, the principles established have proved vague and hard to administer. In spite of many reports of excessive charges and of disruptions to business from the new restrictions imposed, the national review body has not rescinded any of the new measures. Decentralisation has also seen the power to set minimum wages passed to the provincial governments. In a number of cases, most notably in Jakarta, excessive increases have been granted which have dissipated much of the competitiveness gained from the 40 per cent real depreciation of the rupiah.

A critical role for FDI

Growth in investment fell sharply in 2001 and is widely predicted to fall further in 2002. Re-establishing strong growth in investment is vital to increasing efficiency and securing a sustainable recovery. As discussed earlier, domestic private capital markets are currently in no condition to provide the level of funding required. The government is already under pressure from the IMF to reduce the budget deficit and is therefore poorly placed to provide further economic stimulus. Indeed, the task of bringing the burden of public debt interest under control is already substantial. Resistance to the sale of state-owned assets to interests likely to operate them more efficiently is doubly unhelpful. In these circumstances, foreign investment, and particularly FDI, is more valuable than ever.

Recent Developments and Their Impact

A number of recent developments have increased the level of uncertainty for investors in Indonesia. Although some of these—such as the increase in taxes, charges and restrictions on business, and the hikes in minimum wages—impact generally, others have raised particular questions about the future environment for FDI in Indonesia. Three cases arise from problems in relations between local and national governments: Semen Gresik, mentioned earlier, Kaltim Prima Coal (KPC) and the Caltex operation in Riau province. A fourth, Manulife Indonesia, raises fundamental questions about the administration of justice in Indonesia.

Caltex

In October 2001, the Indonesian parliament passed a new oil and gas law. This removed the monopoly over Indonesian oil and gas resources previously enjoyed by Pertamina, the state-owned oil company. Subsequently, the government of Riau province in north-east Sumatra secured a 50 per cent interest, effective from August 2002, in the large oil fields known as Coastal Plains Pekanbaru (CPP) in the province. The field is currently operated by US company Caltex Pacific Indonesia under an extension to its production-sharing contract which is due to expire in August 2002. This contract divides production from the field between Caltex, 15 per cent, and Pertamina, 85 per cent. The lack of an adequate return to the province in these arrangements has been a source of friction between the national and provincial governments. It has been reported that the provincial government and Pertamina propose to form a joint venture to take over operation of the oil field from Caltex. Other reports have identified interest in participating in the management of the oil field from a consortium of interests from South Africa, Great Britain, Saudi Arabia and Malaysia. In any event, this would seem to be the first time that a foreign operator has been replaced under a production-sharing contract, rather than an extension or renewal being worked out. Some fears have been expressed about whether the new operator will be able to manage the sophisticated recovery techniques that the field now requires or provide the additional investment needed. Caltex is Indonesia's largest foreign investor, employs 6,000 people and produces about half of Indonesia's oil output.

PT Semen Gresik

Cemex is a Mexico-based company with a 25.5 per cent interest in PT Semen Gresik, Indonesia's largest cement maker. The Indonesian Government owns the balance of the equity, but has a longstanding agreement with Cemex that would allow Cemex to buy it out. The provincial governments of West Sumatra and South Sulawesi recently combined to block the sale of further shares in Semen Gresik to Cemex by demanding that the operating units in their jurisdictions not be included in the sale.

KPC

KPC is a 50–50 joint venture between Rio Tinto and BP. It operates a large coalmine, widely regarded as the highest quality in Indonesia, in Kalimantan. Under its contract of work with the Indonesian Government, the joint venture was required to offer up 51 per cent of its interest in KPC to Indonesian parties by 2001. The joint venture had made various unsuccessful attempts to do this. On 18 March 2002, KPC reached an agreement with the Indonesian Government on the price of $US419m for offering 51 per cent of the company to Indonesian parties by 31 March. Before this offer could occur, the provincial government of East Kalimantan obtained an order in the South Jakarta District Court preventing any transfer of shares and freezing most other holdings of Rio Tinto and BP in Indonesia. The provincial government sued KPC for $US776 million in lost dividends (past and future), due to delays in the divestment and demanded that the shares be offered exclusively to it. This demand of exclusivity was inconsistent with KPC's contract of work with the Indonesian Government.

KPC subsequently reached agreement with the Indonesian Government to offer 51 per cent of its shares to the Indonesian Government for assignment to other Indonesian parties, including the provincial government, on 31 July 2002. The provincial government withdrew the legal action, but it continues to seek entitlement to the whole 51 per cent of shares on offer.

Manulife Indonesia

In 1999, the Canadian insurer Manulife, parent of one of Indonesia's largest life insurers, Manulife Indonesia, attempted to buy out its bankrupt local partner. In response, a series of bankruptcy claims were filed against Manulife Indonesia in the South Jakarta District Court culminating in a court-appointed administrator seizing the company. The move prompted the intervention of the Canadian Government, and led to IMF calls for the reform of Indonesia's commercial court, the revision of its bankruptcy law and the establishment of an anti-corruption commission. The Indonesian Supreme Court recently rejected the bankruptcy ruling of the lower court, but the strength of that rejection has been questioned by leading Indonesian lawyers and the plaintiff is reported to be considering the possibility of further legal action.

Impacts

A common element

The first three cases each involve a provincial government asserting new rights of ownership or control over enterprises located within its borders. Although friction between the national and provincial governments (for example, over the distribution of revenues form resource projects), is longstanding, these recent events seem to have been triggered by the decentralisation reforms put in place last year. Those reforms did not, however, grant the rights that are now being claimed. Rather, these claims are based on the political power of the provinces relative to the national government.

Caltex

In the case of Caltex, the national government has essentially gifted half of the rights over the CPP, previously held on its behalf by Pertamina, to the government of Riau. Although precedent suggests that Caltex could have a reasonable expectation that its production-sharing contract would be renewed, it had no formal legal rights. Nevertheless, the apparent arbitrariness and unpredictability of the unfolding events increase uncertainty for investors.

Cemex

In the case of Cemex, action by provincial governments is effectively preventing the company from exercising an option, which it obtained through an agreement with the national government, to purchase the balance of the equity in Semen Gresik. Cemex is losing the value of the option and the national government is losing the immediate revenue from disposal of the equity and casting doubt over its broader programme of privatisation. The avowed concerns of the provincial governments are the possibility that Cemex will lay off workers at plants located in their jurisdictions, but there is also a strong undercurrent of political dispute about the national government's right to exercise control over these plants. Cemex maintains that Semen Gresik needs US$100 million in fresh investment in the next five years to remain competitive in this region and reports suggest that there is significant scope for improving the efficiency of the overall operations. Neither the national nor the provincial government are well placed to meet these needs.

KPC

In the case of KPC, the provincial government has intervened and blocked an agreement between the national government and KPC that would have enabled KPC to discharge its obligation to offer shares. On the face of it, the demands of the provincial government seem ridiculous: exclusive rights to purchase the interest in KPC on behalf of a group of private investors and a claim for damages that seems to include future possible earnings but excludes the cost of buying the shares. Various reports have identified a range of private business interests alleged to be backing the provincial government, but the precise benefits to that government of achieving this outcome remain unclear. Perhaps of more concern is the longer-term management of KPC after divestment. The operation is large and has demanded substantial capital to establish and maintain it. In addition, getting the best returns from selling thermal coal in the volumes produced by the mine into relatively depressed global markets requires a high degree of marketing skill. Failure to continue adequately to meet these demands of the operation would clearly damage both the provincial and national economies.

Manulife Indonesia

The threatened bankruptcy of Manulife Indonesia would immediately deprive many Indonesians of the insurance cover for which they have paid, in spite of the fact that the company has a demonstrated capacity to continue to provide that cover. Although it has not provided a specific figure, Manulife has acknowledged that legal action to date has cost it 'millions of dollars'. Significantly, Manulife is one of the few large international companies to have made a substantial investment in Indonesia since the 1997 crisis. Its experiences are hardly likely to induce other companies to follow its lead.

Implications

These cases have clearly created considerable confusion about private property rights and about the rights and responsibilities of the different levels of government in Indonesia. Consequently, the uncertainty confronting investors, particularly foreign investors, has substantially increased, creating a significant deterrent to further investment. The potential loss of capital and managerial expertise in these four cases alone would impose significant costs on the national economy. The Cemex case has had an immediate and direct effect on the revenues of a government facing very significant fiscal challenges. The Manulife case has placed the operations of the Indonesian legal system under close international scrutiny. Overall, these events have called into serious question Indonesia's capacity to pursue urgently needed reform.

Conclusions

ADB's views clear

In its recent *Asian Development Outlook 2002*, the Asian Development Bank (ADB) had these things to say about Indonesia:

> Spurred by rising exports, increased investment was one of the factors that helped pull the economy out of recession in 2000 and early 2001. However, FDI inflows faded as global markets weakened in 2001. More important to longer-term prospects, there has been a widespread perception that the policy environment for investment in Indonesia has turned harsh and unsupportive. In the first 10 months of 2001, only $6 billion of FDI projects were approved, roughly equal to one third of the total approved during the comparable period in 2000. Because the fall in investment predates the September attacks on the US, it would seem to be part of the broader, longer-term problem of capital flight seen in Indonesia since the financial crisis. Continuing problems of financial governance, lack of credibility of the legal and judicial system, and political uncertainty have all discouraged investors from making longer-term commitments. The Capital Investment Board noted that only about 10 per cent of previously approved

projects—both domestic- and foreign-sponsored—were likely to be realized this year. The political problems hindering attempts to sell state-controlled assets are one of the symptoms of the broad negative investment sentiment.

Damage threatened as vulnerability is greatest

Indonesia is clearly wrestling with a number of economic and political problems. The relationship between the various levels of government is closely entwined in many of them. Decentralisation has long been called for, and many aspects of the reforms have been carried through successfully. It has become clear, however, that there are areas in which lack of clarity about rights and responsibilities or, perhaps, lack of appreciation of the consequences of certain policy actions is beginning to threaten serious damage to the national economy. The climate for investment in Indonesia was severely damaged by the Asian crisis and has suffered further from the continuing uncertainty about the policy environment. These latest events threaten to make an already difficult environment even less attractive.

All this is occurring precisely at a time when Indonesia desperately needs to encourage private capital inflow. Inflows of official assistance fell in 2001 and will fall further as policy adjustment loans tail off. The current account surplus is shrinking and the net foreign exchange reserve position deteriorated by over 6 per cent in 2001

Uncertainty must be resolved

According to the ADB, 'growth in the 7–10 per cent range is necessary to reduce poverty in a sustainable fashion and to meet the Government's long-term development goals'. Growth looks set to weaken in 2002 and, even factoring in some improvement in external markets in 2003, will still fall far short of this target range. The current state of Indonesian public finances means that economic growth cannot be driven from the public sector as it has been in the past. The private sector must play the dominant role. Given the parlous state of domestic financial markets, improving the environment for foreign investment is clearly a high policy priority. But that will not be achieved while the uncertainty engendered by recent events is allowed to remain.

About the Author

Malcolm Gray has worked in academia in the UK, US and Australia, occupied senior positions in the Commonwealth Public Service, including a period in the Prime Minister's Office, and was Group Economist at CRA Ltd, now Rio Tinto Ltd, for two years. He has been involved in teaching and research in economics, the development of a wide range of public policies, and the strategic management of a large, transnational public company.

Malcolm's teaching and research concentrated particularly on macroeconomic policy in an open economy with a particular emphasis on the role of financial markets. He has been closely involved in a range of important public policy initiatives, including in industry policy, science and technology, telecommunications, the Special Premiers Conferences and the reform of industrial relations. As Group Economist at CRA Ltd, he headed a small unit that provided analysis of broad developments in the world economy and conditions and outlook in the markets for specific mineral commodities, providing briefings that contributed to the company's strategic decision making.

This Backgrounder published by the Institute of Public Affairs Ltd (A.C.N. 008 627 727)
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