

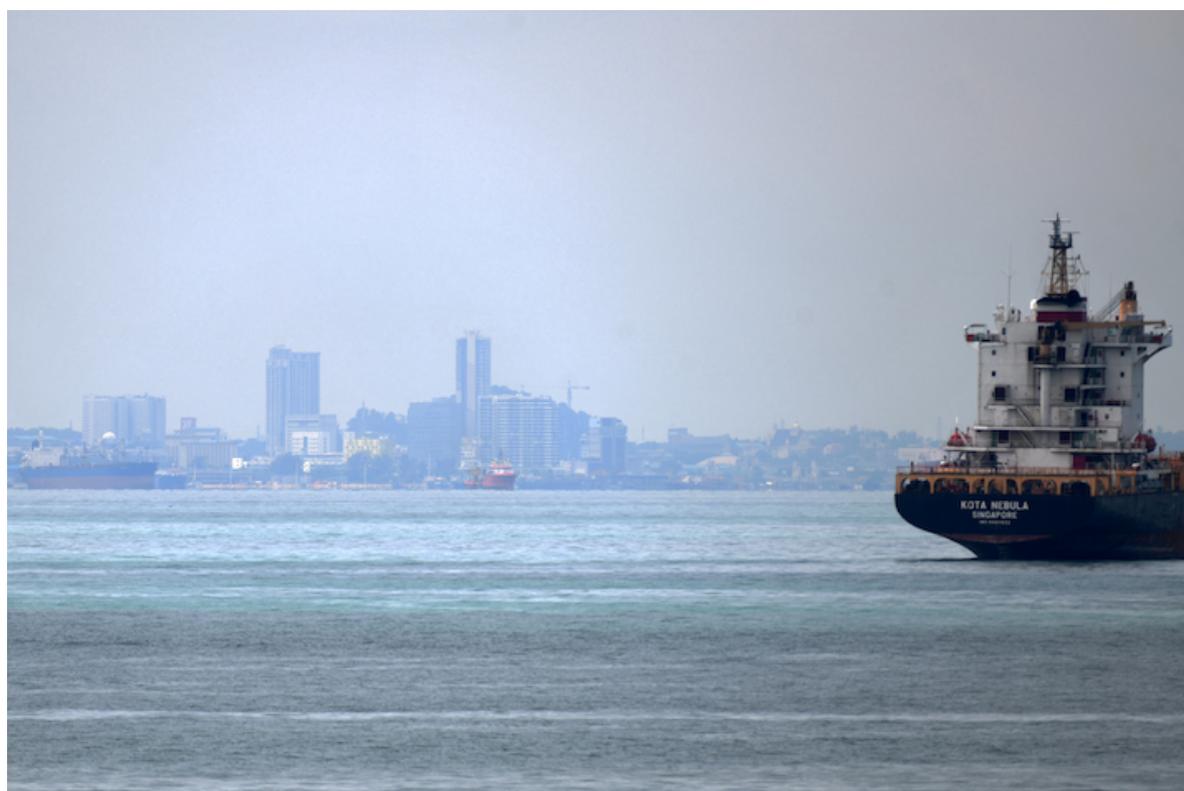
PERSPECTIVE

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The Riau Islands and its Battle with COVID: Down but not Out

*Francis E. Hutchinson and Siwage Dharma Negara**



As Batam's economic fortunes improved in 2018 and 2019, the province's economy began to recover but then, like everywhere else, was COVID-19 hit. A view of Indonesia's Batam Island (in the background) with a sea vessel on the side on May 2, 2020. Photo: Roslan RAHMAN, AFP

** Francis E. Hutchinson is Senior Fellow and Coordinator of the Malaysia Studies Programme, and Siwage Dharma Negara is Senior Fellow and Co-Coordinator of the Indonesia Studies Programme, at ISEAS – Yusof Ishak Institute. They are the editors of the upcoming ISEAS publication *The Riau Islands Province: Setting Sail*, which is the result of a three-year project analysing the province's establishment and development. They would like to thank Cassey Lee and Manggi Habir for their comments.*

EXECUTIVE SUMMARY

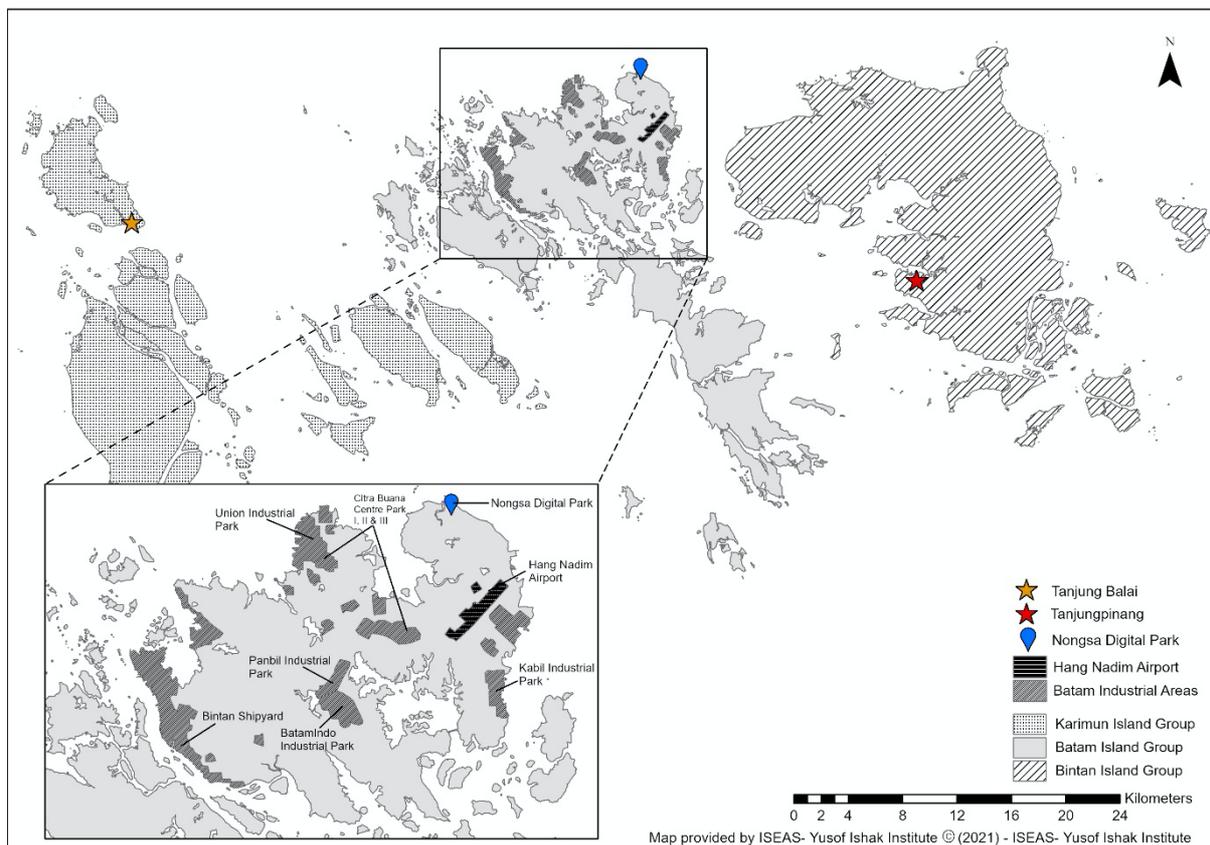
- Long a bright spot in the Indonesian economy, the Riau Islands have been through rough times of late. Used to stellar growth rates, the province's GDP growth slowed after 2015, dropping to an unprecedented low of 2 percent in 2017. The decline was caused by a growth slowdown in Batam, the Riau Islands' economic heartland.
- As Batam's economic fortunes improved in 2018 and 2019, the province's economy began to recover but then, like everywhere else, was COVID-19 hit.
- The Riau Islands are dependent on tourism and export-oriented manufacturing. International visitor arrivals are down 99 percent from one year ago, domestic visitors have halved, and hotels are not recovering costs. While overall manufacturing exports are not too badly affected, there are pockets of dismal performance.
- The effects have been drastic, with many economic sectors from professional services to higher education and from hotels and retail to logistics contracting. The pandemic has sent the province's economy into its first contraction since its birth, and unemployment has hit 10 percent.
- While times are tough, policy-makers are using this down time to clean house and deal with pending issues such as administrative overlap, upgrading key infrastructure, and rolling out new incentives.
- This is encouraging, but the 'to do' list is long, and includes upgrading port infrastructure, increasing connectivity between the Riau Islands and the rest of Indonesia, and addressing Batam's anomalous legal status.

INTRODUCTION

For the last 30 years, the Riau Islands have been an attractive destination for international investors. Lying immediately south of Singapore, the province has a population of 2.2 million scattered across 2,000 islands. These islands are clustered into six groups, the better-known of which are Batam, Bintan, and Karimun. While the provincial capital, Tanjungpinang, is on Bintan, the Riau Islands’ economic and demographic heartland is Batam, which accounts for roughly two-thirds of the province’s population and a similar proportion of its GDP (Figure 1).

Business friendly regulations, proximity to Singapore, and well-developed connections to the city-state have seen the province’s economy grow consistently. From the first investments in electrical and electronics production in the 1990s, over time the Riau Islands have come to host important tourism facilities, ship-building and repair yards, and more recently, activities such as digital animation and airplane maintenance, repair and overhaul.

Figure 1: Batam, Bintan, and Karimun

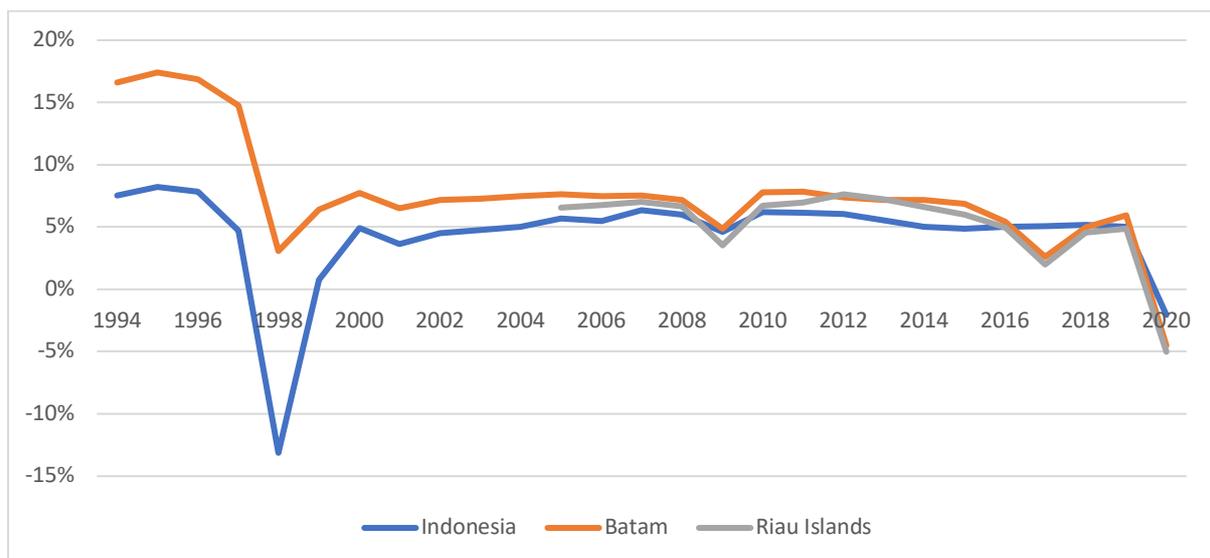


Enabled by Indonesia’s 2001 decentralisation measures, the Riau Islands opted to separate from the larger Riau Province in 2004. Riding on its newly-acquired autonomy, the Riau Islands Province looked set for a bright future. However, from 2010 onwards, the province faced economic headwinds. Foreign investment patterns changed, shifting to the more centrally-located and populated Java. Long enjoying steady levels of economic growth, the province’s wage levels had also climbed, undercutting its competitiveness.

The Province’s local context was also affected by policy dysfunctions. Local-level turf disputes between agencies based in Batam made investment approvals for establishing operations on the island long and arduous. Furthermore, plans to upgrade Batam’s status from a free trade zone (FTZ) to a special economic zone (SEZ) only raised more questions than answers for investors.¹

For these reasons, the province’s economic growth trajectory flattened, descending from vertiginous heights to average levels and then, most unexpectedly, to below the national mean in 2017 (Figure 2).

Figure 2: GDP Growth for Indonesia, the Riau Islands, and Batam (year on year, %)



Note: The Riau Islands became an independent province from Riau in 2004.

Source: BPS via CEIC

Nonetheless, the Riau Islands’ considerable advantages, along with steady tourism numbers, saw the Province’s growth levels pick up in 2018 and 2019 – until COVID-19 hit. The subsequent impact has sent the province’s economy into its first contraction since its birth.

COVID AND ITS EFFECTS

From its first reported COVID-19 case in March 20 last year, the number of cases in the Riau Islands increased consistently, reaching 8,149 cases as of February 1, 2021, with 202 deaths. The bulk of the cases are concentrated in Batam, which has registered 5,635 cases.² Unlike most of Java, which is currently under strict lockdown, pandemic management in the Riau Islands has been less restrictive. While schools are closed, factories are allowed to run and most businesses are operating as usual.

However, while daily operations have not been interrupted, the Riau Islands’ economy has fallen into recession, contracting by 7 percent in Q2, 6 percent in Q3, and a further 5 percent in Q4 2020 (Table 1). In annual terms, the province’s economy contracted by 5 percent in 2020. The most adversely affected sectors were: business services; transportation and storage; and

accommodation and food & beverages. All of these were hit in the first quarter of 2020 and experienced progressively worse performance over the subsequent two quarters, with contractions nearing 50 percent in Q3.

Table 1: The Riau Islands' GDP growth by sector (year on year, %)

Industry	Q4-2019	Q1-2020	Q2-2020	Q3-2020	Q4-2020
Agriculture, Forestry & Fisheries	-3%	2%	-6%	-7%	-4%
Mining & Quarrying	4%	-1%	-4%	-2%	-21%
Manufacturing Industry	4%	4%	1%	1%	10%
Electricity & Gas Supply	11%	2%	-5%	-7%	-8%
Water Supply, Waste Management	-10%	0%	-11%	-6%	6%
Construction	14%	5%	-11%	-9%	-10%
Wholesales & Retail, Repair of Motor Vehicles	1%	1%	-11%	-21%	-18%
Transportation & Storage	-2%	-7%	-63%	-46%	-45%
Accommodation & Food Beverages Activity	15%	-19%	-57%	-44%	-46%
Information & Communication	2%	6%	17%	20%	25%
Financial & Insurance Activity	1%	-1%	-5%	-5%	-3%
Real Estate	2%	3%	-10%	-11%	-16%
Business Services	-11%	-31%	-53%	-52%	-42%
Public Administration and Social Security	-8%	6%	10%	11%	11%
Education Services	4%	2%	-12%	-11%	-2%
Human Health & Social Work Activity	11%	1%	-9%	4%	-3%
Other Services	5%	-31%	-96%	-79%	-65%
Total GDP	5%	2%	-7%	-6%	-5%

Source: BPS via CEIC

While not registering downturns of the same magnitude, other areas of the economy such as vehicle trade and repair, real estate, and construction also slowed or shrank. The only bright sparks in 2020 were the manufacturing sector, ICT, public administration, and health and social work.

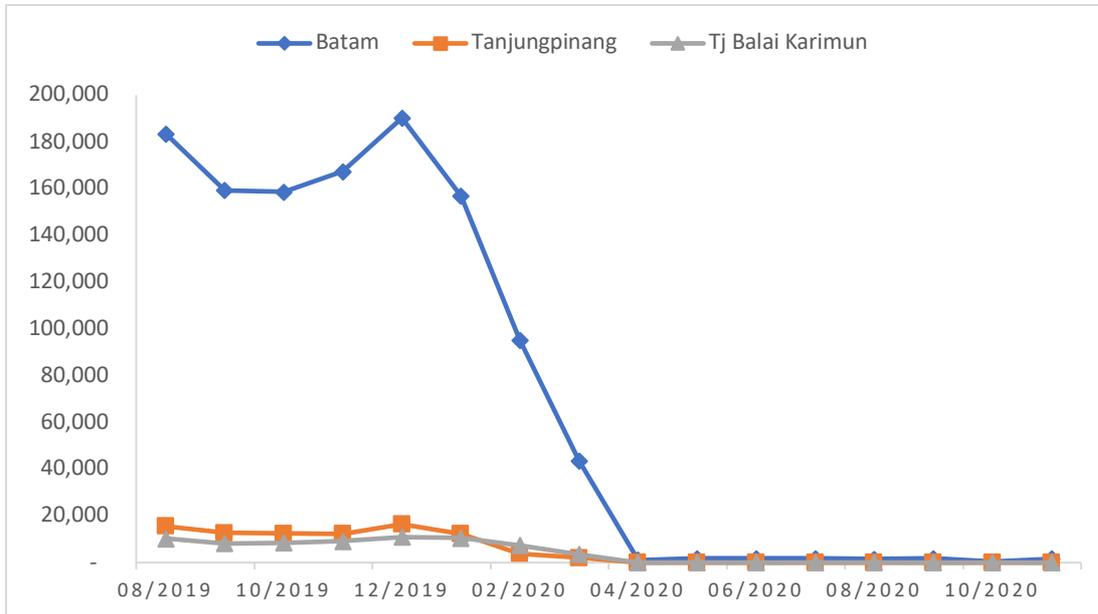
The overall economic situation facing the Riau Islands remains uncertain. The deep 2020 economic contraction has increased the open unemployment rate from 7 percent in 2019 to 10 percent in 2020.³

What accounts for this deep and far-reaching contraction? Long a destination for short holidays for Singaporeans and Malaysians, tourism is a key economic driver. Beyond accommodation, food, and beverage, the sector drives other activities such as real estate, construction, and finance. Mirroring policy responses elsewhere, Indonesia closed its borders to tourists and other short-term visitors. Thus, the number of foreign visitors to the island plummeted from around 190,000 in December 2019 to practically zero by April 2020.⁴

Batam has the distinction, along with Jakarta, of being the only port of entry into the country. However, compulsory PCR tests and safe travel pass requirements in Indonesia, as well as

source countries such as Malaysia and Singapore, have discouraged people from travelling to the island. A reciprocal green lane with Singapore was established, but is currently suspended.⁵

Figure 3: Number of International Visitors to the Riau Islands by Port

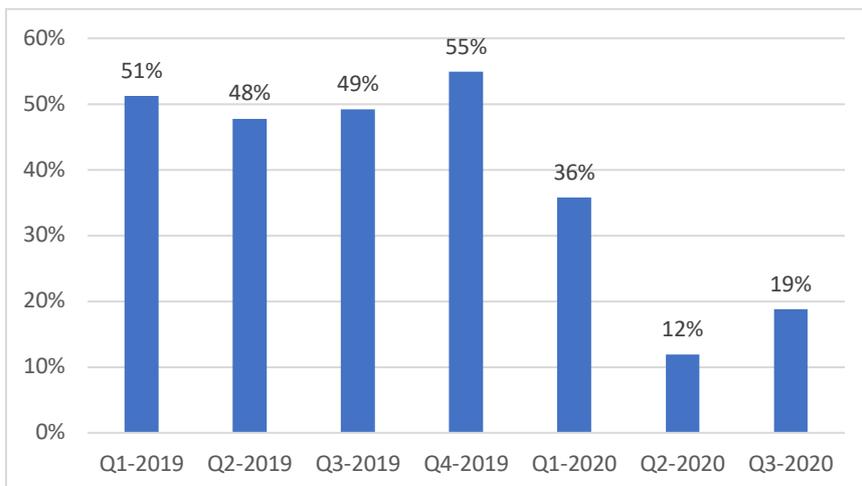


Source: BPS via CEIC

While the Riau Islands is also an attractive destination for domestic tourism, mobility restrictions and an aggressive testing regime have affected the number of local arrivals, which fell from almost 380,000 in November 2019 to 190,000 in November 2020.⁶

Consequently, hotel occupancy rates tumbled from 55 percent in Q4 2019 to only 12 percent in Q2 2020. In Q3 2020, this climbed slightly to 19 percent, but is still considerably lower than the break-even rate of 30 percent (Figure 4).⁷

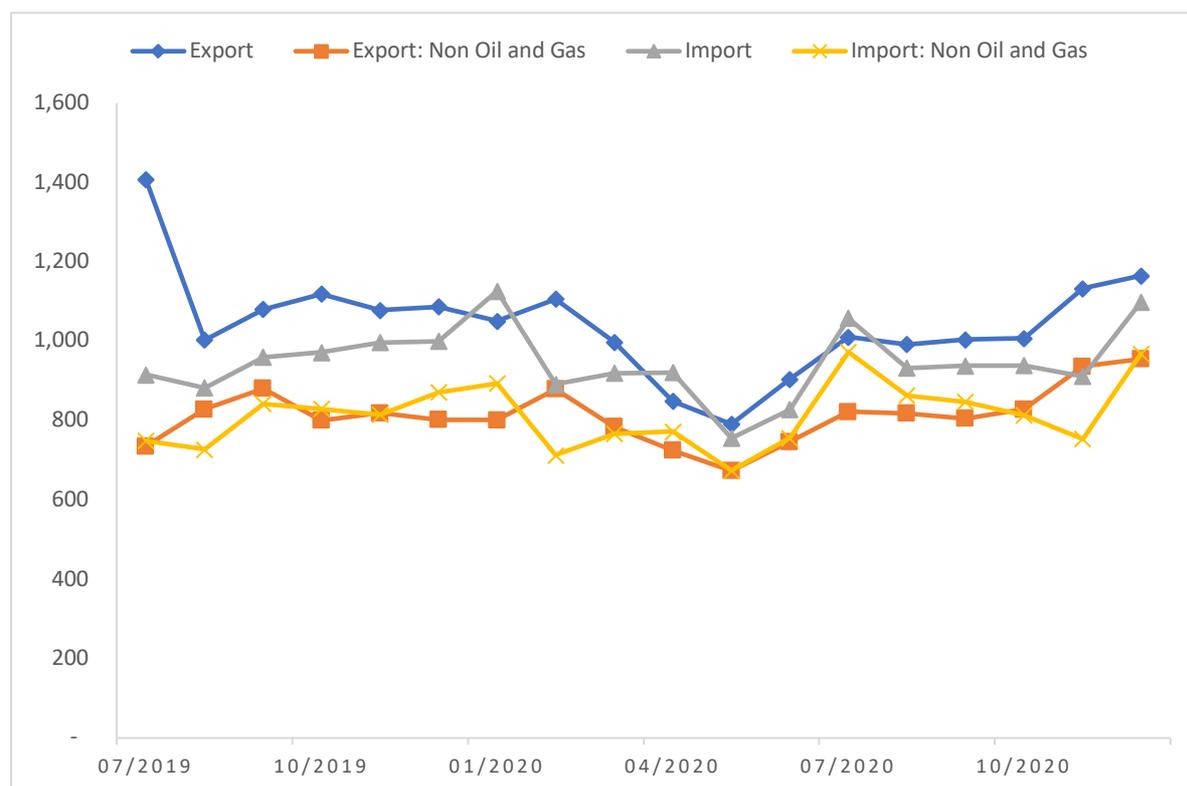
Figure 4: Hotel Occupancy in the Riau Islands Province (%)



Source: BPS via CEIC

Crucially for Batam and the Riau Islands more widely, the manufacturing sector recorded positive growth in 2020 (it has rebounded from 1 percent growth in Q3 to 10 percent in Q4). This resilient performance is mirrored in the Province’s exports, which only experienced a short-lived contraction. Exports started to decline in March 2020 and continued for a further two months before rebounding (Figure 5). As in the past, much of the province’s exports are bound for Singapore, which accounts for more than one-third of the total.⁸

Figure 5: The Riau Islands’ Export-Import Values (USD million)



Source: BPS via CEIC

Table 2 shows the province’s main exports and their recent performance. Certain sub-sectors such as electrical machinery and equipment, plastics, and chemical products have done well. However, steel production, cocoa processing, and the ship-building sector contracted. The last sector, in particular, was a very important employer in Batam, which houses approximately half of all of Indonesia’s shipyards.

Table 2: Top 10 Non-Oil and Gas Export Values (FOB, US million), the Riau Islands Province

	Goods	HS code	2020			Percentage change			Share
			Oct	Nov	Jan-Nov	m-o-m	y-o-y	Jan-Nov	
1	Electrical machinery and equipment	85	340.3	339.2	3,458.6	-0.3%	22.2%	19.8%	39.17
2	Machinery and mechanical appliances	84	81.1	88.5	956.6	9.1%	3.9%	1.1%	10.83
3	Animal or vegetable fats and oils	15	82.4	127.0	842.7	54.0%	18.6%	10.2%	9.54
4	Articles of iron or steel	73	28.1	37.9	519.1	34.8%	-37.0%	11.6%	5.88
5	Mineral fuels	27	52.9	72.1	500.9	36.4%			5.67
6	Miscellaneous chemical products	38	34.5	39.1	346.8	13.4%	111.7%	-34.2%	3.93
7	Cocoa	18	35.1	24.4	266.3	-30.7%	-8.7%	-3.6%	3.02
8	Plastics and articles thereof	39	25.5	28.8	229.1	13.0%	40.1%	6.4%	2.59
9	Optical instruments	90	20.6	21.2	213.8	2.9%	5.3%	-0.6%	2.42
10	Ships, boats and floating structures	89	0.8	46.1	189.9	5448.2%	-0.7%	-16.1%	2.15
	Total 10 goods classification		701.5	824.2	7523.6	17.5%	24.5%	15.4%	85.2

Source: BPS

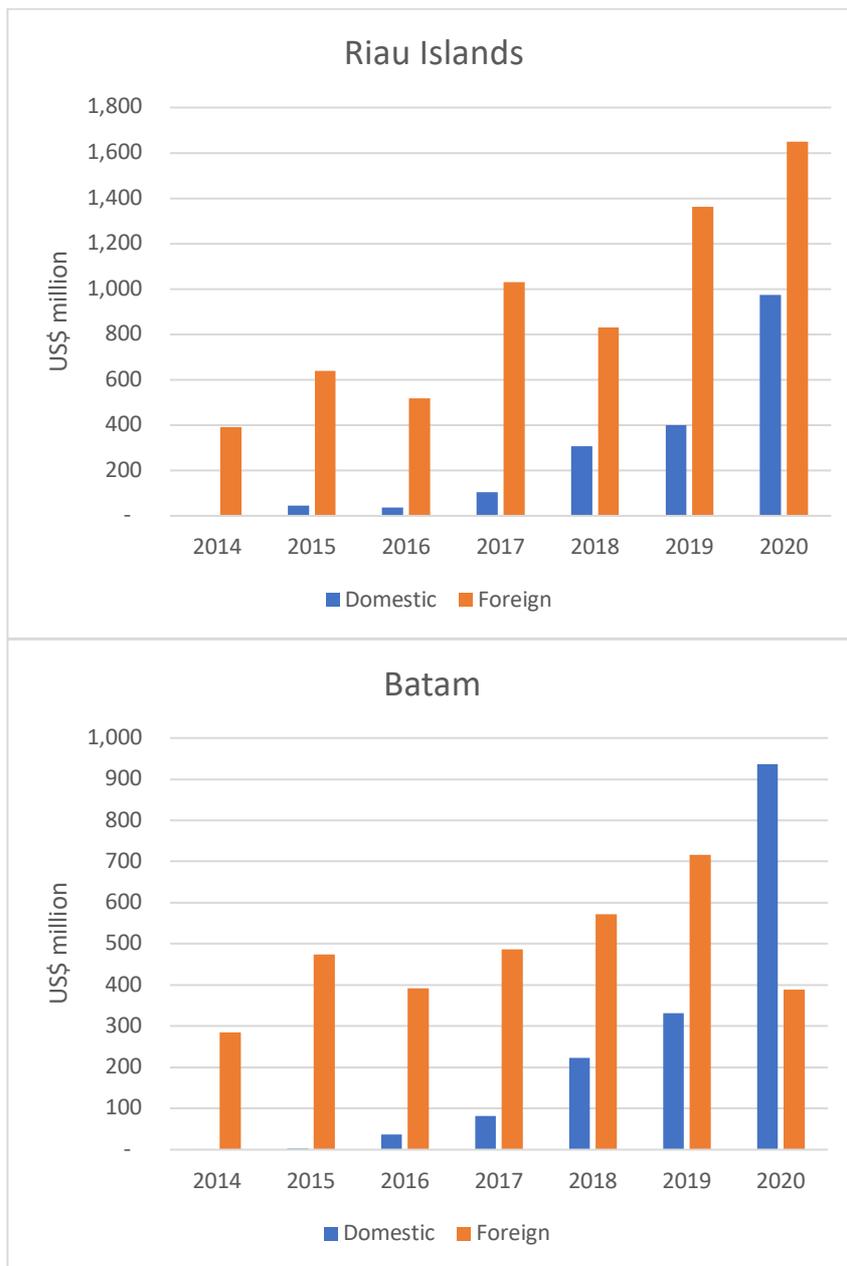
Despite fears that travel restrictions and the COVID-induced downturn would see an exodus of manufacturers from Batam, no significant relocations have taken place this year. Most companies do not want to lose their investments and are waiting out the downturn. In addition, because movement restrictions have not been rigorously applied, most manufacturing activities have continued uninterrupted. Local businesses are optimistic that operations can continue as long as imports from China are not interrupted.⁹

Nonetheless, the immediate future is not promising. Unemployment in the Riau Islands has increased significantly and is at 10 percent – significantly higher than the national average of seven percent.¹⁰

Furthermore, the pandemic has affected foreign investor confidence. Realised foreign direct investment (FDI) for Batam in 2020 is only half of 2019 levels, falling from USD 716 million to USD 389 million. On the upside, this is compensated for by substantially higher levels of domestic direct investment (DDI), which jumped from USD 311 million to USD 697 million. While FDI into Batam declined during the Covid-19 pandemic, total FDI into Riau Islands Province increased by 21 percent, from USD 1.36 billion in 2019 to 1.65 billion in 2020 (Figure 6).

Interestingly, Batam has received an unusually large amount of DDI. This was partly driven by the acceleration of several big infrastructure projects in Batam, improved road access to Batu Ampar port, re-construction of its south pier as well as an upgraded drainage system.¹¹ However, while this counter-cyclical expenditure is welcome, it is not in the form of job-generating investment.

Figure 6: Investment Realisation in the Riau Islands and Batam (USD million)



Source: BKPM

When the Going Gets Tough....

While the current situation is grim, and low investment levels portend challenges in the short term, central and local government officials have sought to address several pending issues.

First, following several decades of uncertainty, in late 2019 the Jokowi administration moved to address the administrative overlap between the main investor liaison agency in Batam, BP Batam, and the local municipal government.¹² In August 2019, President Jokowi clarified this, and brought the former under the control of the latter.¹³ The Mayor of Batam will now

concurrently serve as the Chairman of BP Batam, supervising the work of both the municipal government and Batam's investment promotion authority.

Second, the central government established two special economic zones in Batam last August. While the entirety of the island is already a free trade zone, these SEZs offer additional incentives targeting new, service-based activities. The first, Batam Aerocity SEZ, is based at Hang Nadim Airport and will provide maintenance and repair services for aircraft. Designed to boost the island's competitiveness in the logistics sector, the SEZ's operator has built two out of the six planned hangars for painting full-body aircraft. When all facilities are completed, the SEZ will be able to accommodate up to 56 aircraft.¹⁴

The other SEZ is based at Nongsa Digital Park (NDP), which consists of six office buildings housing some 100 companies employing 1,000 personnel. The majority of the tenants are Singapore-based firms and come from sectors such as: web design and development; marketing and data analytics; software development; insurance and e-learning¹⁵ NDP plans to complement this with an integrated data centre hub and tourism hub, and develop more land to accommodate up to 8,000 IT workers.¹⁶

However, beyond the establishment of these two specific SEZs, the key aspect is that they were set up without unravelling the existing free trade zone that governs the rest of the island. Originally established in 2007, the FTZ is meant to be in operation for 70 years and spans key parts of Batam's economy including its industrial heartland.¹⁷

Finally, one of the Province's highest profile and longest-running investor disputes looks likely to be resolved. In October 2012, PT West Point Terminal (WPT), a joint venture company with a subsidiary of the Chinese Sinopec Group (Sinomart) and the oil conglomerate PT Mas Capital Trust (MCT) started a USD 841 million oil depot project in Janda Berhias, a small island off Batam.

However, construction on the project has yet to kick off, due to disagreements between the joint venture partners over bidding arrangements.¹⁸ In December 2019, the Arbitration Court of the International Chamber of Commerce based in Singapore ruled in Sinomart's favour. The court decided that PT MCT was responsible for the project's delay.¹⁹ Following this, the Riau Islands Governor directly appealed to Sinopec to begin construction.²⁰ The case has been brought to Jakarta's attention, and it is likely that the central government will also push for timely progress.

PENDING ISSUES

Nonetheless, while the Riau Island's investment climate has undoubtedly benefited from these developments, policy-makers need to move on three additional fronts if the province is to be well-positioned for the global post-COVID recovery.

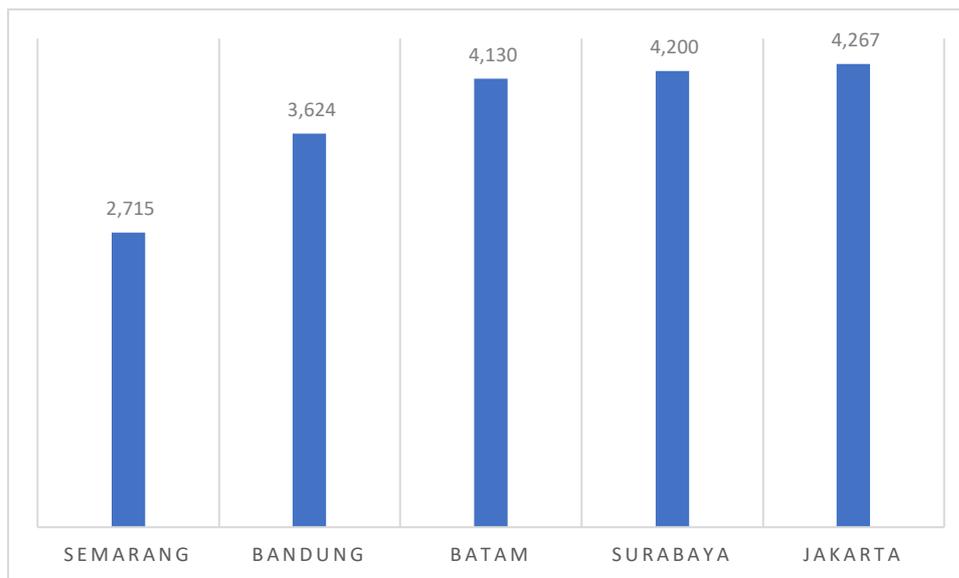
First, one of the most intractable problems faced by firms operating in the Riau Islands is the high logistics cost. For example, shipping a 20 feet container from Batam to Hong Kong via Singapore costs USD 800. Meanwhile, shipping the same size container from Jakarta to Hong Kong costs only USD 400.²¹

The key to reducing the logistics costs in the Riau Islands is through the revitalising of its dilapidated sea-port, Batu Ampar. At the moment, the Port’s capacity is only 200,000 TEU, which is too small for economies of scale.²² Indeed, at present, there are no gantry cranes at the port, and cargo is offloaded by barges.

There are long-standing plans for revitalising the port, but they have yet to come to fruition.²³ One of the key obstacles is the Indonesian National Shipowners’ Association (INSA) Batam and the local shipping association.²⁴ The proposal is to include local shippers in the new port operation under the management of Pelindo, the central government-owned state-owned enterprise. However, it has been rejected as the local shippers are afraid that the corporate giant’s monopoly power might reduce their market share.²⁵

The second area of concern pertains to wage levels on Batam. The island’s ranks of factory workers used to enjoy a range of formal sector opportunities in the electrical and electronics, chemical, and ship-building and repair subsectors. Consequently, wage levels have increased consistently over time, and for now are relatively high compared to other industrial locations in Indonesia (Figure 7). In particular, locations such as Semarang in Central Java and Bandung in West Java are significantly cheaper and more centrally-located.

Figure 7: Minimum wage in select industrial cities in Indonesia, 2020 (IDR 000)



Source: BPS

The final area of concern is Batam’s unusual customs status. The establishment of the island as a free trade zone facilitates the duty-free importation of many inputs for firms operating on the island. However, it also cuts Batam off from the domestic economy, and means that firms there must pay tax if they wish to sell their products on the local market. It also penalises imports to the island, including staples such as sugar, rice, and soy – which significantly increases the cost of living. Given existing and new regional agreements such as the ASEAN Economic Community and the Regional Comprehensive Economic Partnership, most imports to firms in Indonesia – not just those in Batam – are duty-free.

At present, the central government is trying to resolve this by allowing customs duties to be removed for goods that have undergone substantial processing in Batam. According to changes introduced in 2019, if companies based in Batam can show that the imported components have been processed in such a way that the final product is significantly different, they can apply for a tax reduction for sale on the domestic market.²⁶

CONCLUSION

While the downturn in tourism has hit the Riau Islands hard, it is fortunate that its economy is diversified, with firms producing a range of manufactures for exports. Although this sector has also been adversely affected, and formerly bustling shipyards are sitting idle, demand for other products, particularly electrical and electronics items has continued apace. Overall, the manufacturing sector has shown some resilience during the pandemic. In addition, the immediate downturn has been softened by counter-cyclical infrastructure spending by the central government.

Conscious of the need to rekindle investment and growth, policy-makers have turned their attention to resolving challenges in the local business environment. Long-standing issues pertaining to administrative overlaps and the establishment of special economic zones have been addressed, as has a blocked mega-project.

In the months ahead, policy-makers will need to improve connectivity between the Riau Islands and other parts of Indonesia, in particular Java. Given Indonesia's burgeoning domestic economy, the firewall separating firms on Batam from other parts of the country needs to be addressed, both as a way of attracting to and retaining investors on the island, as well as lowering the price of basic commodities. Furthermore, the local government and Batam's export promotion agency will need to learn to work together.

Should these issues be dealt with in any significant measure, the Riau Islands will very likely emerge from the pandemic with a stronger and more competitive business model.

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- ¹² Due to its history as a lynchpin of Indonesia's quest to attract technology-intensive manufacturing, Batam's policy environment differed from other parts of the country. In particular, BP Batam, a central government-established agency, carried out much of the work of investment promotion and liaison that would normally be the remit of the local government.
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- ²¹ <https://batampos.co.id/2020/08/28/baca-kabar-terbaru-pembangunan-pelabuhan-batu-ampar/>. Accessed 02/02/2021.
- ²² By comparison, Tanjung Priok, Indonesia's main port, has the capacity of 7 million TEU, while Belawan Port in North Sumatera, has the capacity of 1 million TEU.
- ²³ <https://batampos.co.id/2020/08/28/baca-kabar-terbaru-pembangunan-pelabuhan-batu-ampar/>. Accessed 02/02/2021.
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- ²⁵ *Ibid.*
- ²⁶ <https://bcbatam.beacukai.go.id/wp-content/uploads/2019/10/PMK-84-TAHUN-2019.pdf>. A politically more ambitious change would be to provide flexibility for selling export products produced in Batam to the domestic market. This will require some sort of flat fee charge to equalise treatment of duty-free imports of inputs enjoyed by Batam's SEZs or FTZs. But this would attract investment for those wanting flexibility to serve both Indonesia's substantial domestic market and the international market.

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