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PERSPECTIVE

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Investment Trends and Industrial Prospects in Indonesia

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Technicians work on an assembly line of the BMW 7 series in Jakarta on 30 November 2016, as part of BMW announcement as they have started to assemble the luxurious series for the first time in Indonesia in that year. Photo: BAY ISMOYO / AFP.

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EXECUTIVE SUMMARY

- Investment trends in Indonesia in recent years present a mixed picture. Although total investments increased, much of this was driven by a rapid increase in domestic direct investment (DDI) while foreign direct investment (FDI) remained relatively stagnant. The DDI share of total investment rose from 35% in 2015 to 50% in 2021. In the manufacturing sector, however, FDI's share increased to 51% in 2021, while DDI's share declined, because domestic investment flowed mostly to the services sector.

- The overall increase in investments has been fuelled by the Jokowi government's active measures to facilitate business, streamline bureaucratic procedures and improve tax incentives, particularly after the Investment Coordinating Body (BKPM) was upgraded to Ministerial status in April 2021.

- However, more can be done to improve Indonesia's attractiveness to foreign investors vis-a-vis other investment destinations (such as Vietnam), and to encourage the growth of manufacturing activities in sectors which align with the national priorities to create jobs, move up the value chain and enhance knowledge and technology transfers. More policy support is needed to improve the capability of local firms to become reliable suppliers or partners with foreign clients, as well as to address lingering regulatory uncertainties arising from Indonesia's Job Creation Law and land acquisition issues.

- There is also the need to harmonise investment promotion and facilitation measures with suitable industrial policies such as downstream industry development and local content requirements. The latter must be implemented with caution as they violate WTO rules and may turn out to be counterproductive for the economy in the long run.

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INTRODUCTION

Last year, Indonesia's foreign and domestic direct investment realisation reached Rp 901 trillion (US$ 62 billion),[1] surpassing the official annual target of Rp 900 trillion. This is good news for the country, which is struggling to create employment opportunities and to bring its economic growth back to its pre-pandemic level. In 2022, the government has set a more ambitious investment target of Rp 1,200 trillion (US$ 83.8 billion).[2]

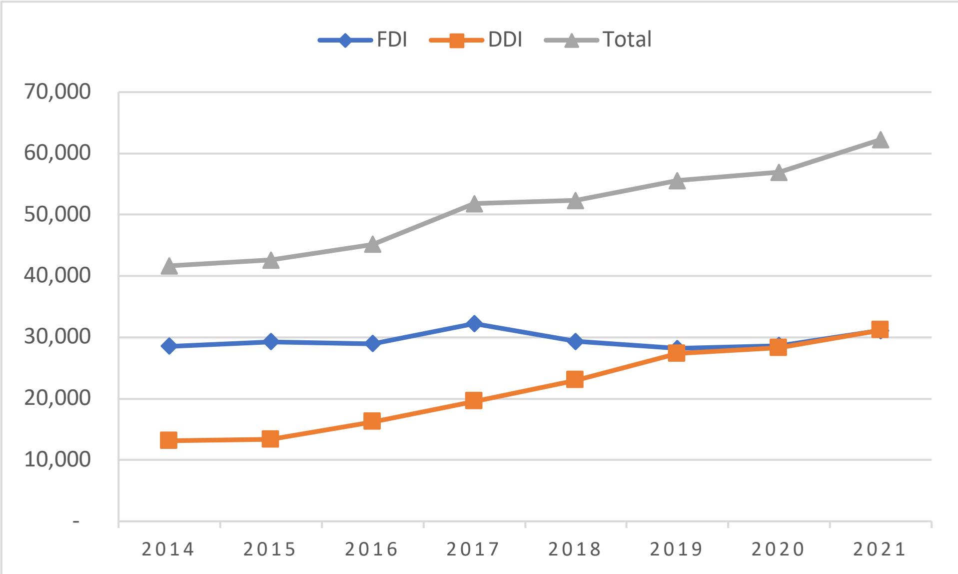
Several reasons underline the government's projection: First, the decline in Covid-19 cases and increase in vaccination rate;[3] second, political and macroeconomic stability remain strong, and; third, strong investor confidence in economic prospects in the country.[4] Yet, given rising geopolitical uncertainties, growing protectionism and increasing financial markets uncertainty due to US monetary policy, achieving the investment target for 2022 will not be easy.

This essay looks at investment trends in Indonesia with a particular focus on the industrial (manufacturing) sector.[5] The growth of this sector is critical to sustainable job creation for millions of workers in the country. The following section will give an update on investment trends in Indonesia, while the subsequent section discusses national investment policies and strategies, and follow that up with a discussion on key industrial policies that may affect investment trends. It concludes with some thoughts on future challenges.

INVESTMENT TRENDS

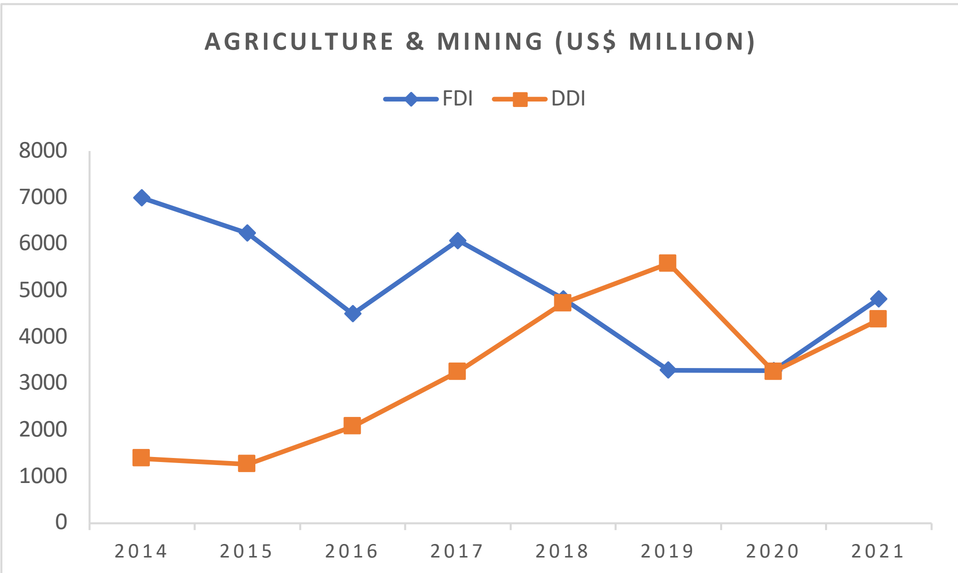
Since President Joko "Jokowi" Widodo took office, investment has been driven by a rapid increase in domestic direct investment (DDI) (Figure 1). Foreign direct investment (FDI), however, seems relatively stagnant. From 2014 to 2021, DDI grew by 16.4 per cent annually on average, while FDI grew by only 1.4 per cent annually. Indonesia's relative unattractiveness is partly to blame for causing the slow growth in FDI, compared with other investment destinations, especially Vietnam.[6] The DDI share in total investment increased from around 35 per cent in 2015 to 50 per cent in 2021.

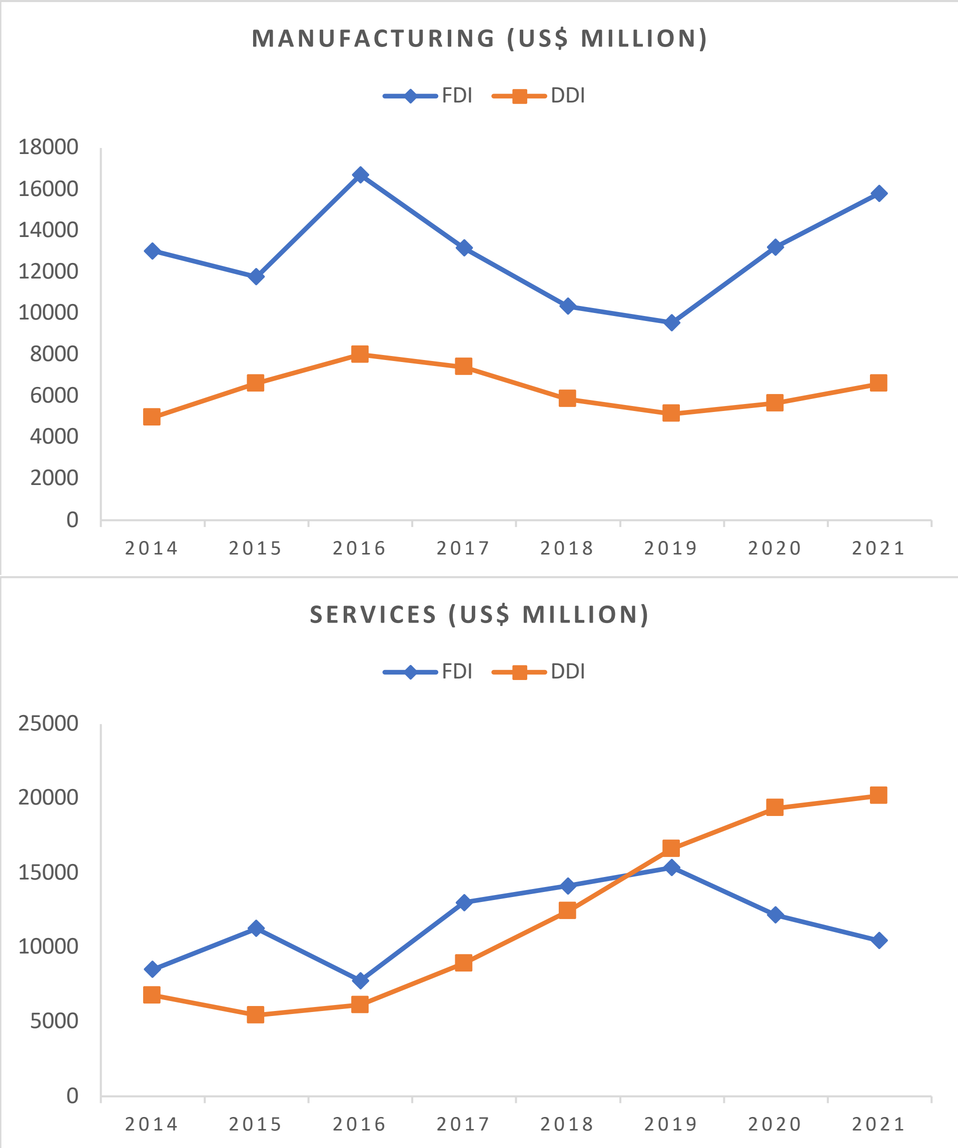
Figure 1: FDI and DDI realisation (US$ million), 2014-21



Source: BKPM

Figure 2: Investment realisation by sector, 2014-21





Source: BKPM

While DDI as a whole grew faster than FDI, in the manufacturing sector, domestic investment did not grow as fast as in the services sector. Figure 2 shows that DDI in the manufacturing sector has been relatively stagnant while in the services sector has been increasing since 2016.[7] Interestingly, the industry share of total FDI realisation has increased since 2020, reaching 51 per cent by 2021. This is driven by significant FDI in the base metal and metal goods sector (Table 1), with the government actively inviting FDI to promote downstream industries in mineral resources, especially nickel, bauxite, and copper.

Table 1: FDI realisation in the manufacturing sector (US$ million), 2015-21

	2015	2016	2017	2018	2019	2020	2021
Base metal & metal goods	2,421	3,068	2,969	2,219	3,559	5,969	6,974
Food	1,521	2,115	1,970	1,307	1,272	1,592	2,337
Chemical & pharmacy	1,956	2,889	2,578	1,938	1,486	1,743	1,657
Motor vehicle & transport equipment	1,757	2,370	1,271	971	754	942	1,502
Paper & printing	712	2,789	606	668	446	943	953
Machinery, E&E, medical equipment	678	838	817	1,341	500	601	679
Leather & footwear	162	144	369	244	188	214	486
Non-metal mineral	1,303	1,076	672	456	475	248	327
Textiles	433	321	372	305	239	280	312
Rubber & plastics	694	737	633	447	292	291	262
Wood & furniture	47	268	396	276	95	85	68
Others	83	75	504	174	245	294	246
Sum of Manufacturing	11,768	16,690	13,159	10,348	9,551	13,202	15,804
Total FDI	29,276	28,964	32,240	29,308	28,209	28,666	31,093
Share of total FDI	40%	58%	41%	35%	34%	46%	51%

Source: BKPM

Most of the investments in the metal industry are located outside Java, concentrated in mineral-rich provinces such as Central Sulawesi, Southeast Sulawesi, and North Maluku. The biggest investors in this sector come from China, Hong Kong and Singapore.

Meanwhile, investments in the food industry are primarily located in East and West Java, Riau and Banten provinces. The major investors in this sector come from Singapore, Malaysia and the United Kingdom. For the chemical industry, most investments come from Singapore, Japan and Malaysia, with central locations in Banten, Riau, and West and East Java provinces.

Table 2: DDI realisation in the manufacturing sector (Rp billion), 2015-21

	2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Food	24,534	32,029	38,540	39,088	36,603	27,873	20,427
Chemical & Pharmacy	20,712	30,054	13,734	13,338	9,484	22,526	12,240
Base metal & metal goods	7,082	10,128	11,345	10,468	8,183	8,858	10,399
Paper & printing	6,533	5,258	9,023	2,894	2,950	3,746	7,834
Rubber & plastics	3,696	3,577	4,823	3,415	3,069	4,429	7,803
Non metal mineral	20,502	15,405	7,641	4,523	3,573	5,862	6,522
Textiles	2,725	3,210	7,863	3,597	1,313	2,103	1,972
Motor vehicle & transport equipment	1,071	1,714	1,313	1,837	2,608	2,556	1,459
Wood & furniture	1,185	3,151	1,569	1,536	1,586	1,263	1,144
Leather & footwear	5	69	196	282	77	395	700
Machinery, E&E, medical equipment	856	1,446	2,464	1,950	1,152	1,156	535
Others	147	744	678	717	2,076	2,051	1,192
Sum of manufacturing	88,901	106,040	98,512	82,927	70,597	80,767	93,506
Total DDI	179,466	216,231	262,351	328,605	386,498	413,536	447,064
Share of total DDI	50%	49%	38%	25%	18%	20%	21%

Source: BKPM

Figure 3 shows that Singapore is the top source of FDI in Indonesia, accounting for around 30 per cent of total inward FDI. FDI from China has increased significantly since 2016, reaching 17 per cent of total FDI in 2019 and 2020, then falling to 10 per cent in 2021. The decline is mainly caused by the Covid-19 pandemic, which caused some investment delays. Interestingly, FDI from Hong Kong has increased during the pandemic, reaching 15 per cent of total FDI in 2021.[8]

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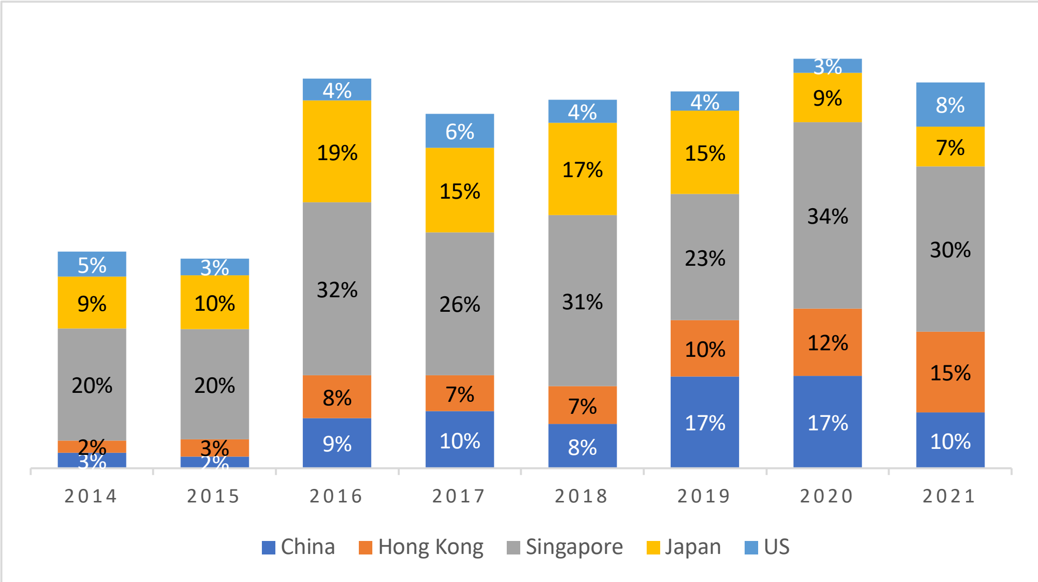
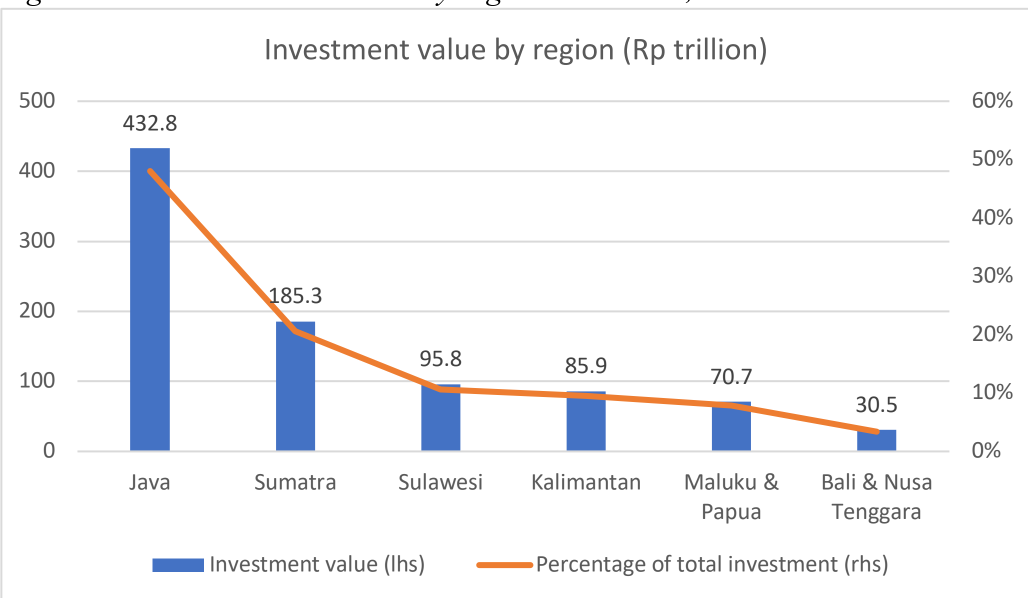
Figure 3: Share of FDI by country source (% of total FDI), 2014-21

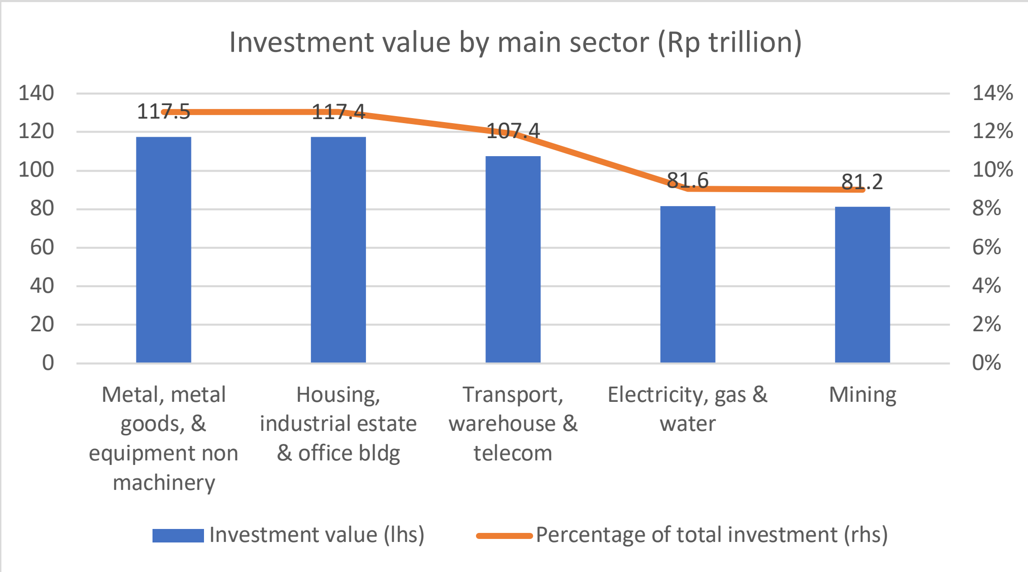


Source: BKPM

Figure 4 shows that most investment realisations are concentrated on Java island (48 per cent of total investment realisation). Resource-rich islands, Sumatera and Sulawesi, received about 21 per cent and 11 per cent of total investment realisation in 2021. Meanwhile, Kalimantan only received about 10 per cent of total investment. It is projected that investment in the island will further increase, boosted by the new capital relocation plan.

Figure 4: Investment realisation by region and sector, 2021





Source: BKPM

Regarding sectoral distribution, metal processing and construction, especially industrial estate and warehouse, received the largest investment realisation in 2021, at around 13 per cent each. This trend is related to the targeted sectors that are given special facilities by the government, especially for integrated industrial estate, special economic zones, and the smelter industry.

POLICY & STRATEGY TO PROMOTE INVESTMENT

The recent growth of investment realisation is partly related to new policy initiatives to facilitate investment realisation. Understanding these policy changes in greater detail is important as they will continue to drive future investments. The key change happened in April 2021, when President Jokowi decided to upgrade the Investment Coordinating Board (BKPM) to Ministry status. The Ministry, led by Bahlil Lahadalia, has a pivotal role in implementing regulatory reforms to promote a more business-friendly environment.

Investment Facilitation

Indonesia has taken several initiatives to improve investment facilitation. It passed Law No. 11/2020 on Job Creation (also known as Omnibus Law), to simplify investment regulations and licensing procedures. As part of the law's implementation, BKPM introduced a new risk-based investment licensing system, Online Single Submission (OSS), in August 2021. OSS is a web-based business licensing system for expediting business permits and integrating central government and regional administrative procedures. Under the new OSS system, low-risk businesses, especially small-medium enterprises (SMEs), only need a single licensing, i.e., Business Identification Number (NIB), to gain legal status.

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Furthermore, President Jokowi has established a task force headed by Minister Bahlil to help resolve investment delays and ensure that investment plans that have received permits can be realised immediately. The task force consists of representatives across ministries/agencies, the National Police, the Attorney General's Office, the entire Regional Police Chief, and the Regional Prosecutor.[9] At the point of writing, of the total of Rp 708 trillion associated with identified stalled investment projects, the Ministry has succeeded in facilitating Rp 558.7 trillion (78.9%).

The Ministry of Investment has also prepared pre-feasibility studies on some investment projects that will be offered (IPRO) to investors. These studies provide specific and comprehensive information about legal and technical aspects, economic feasibility, social and environmental impacts, business model schemes, and facilities from the government. As of time of writing, there have been 46 IPROs offered in various sectors, involving a total value of Rp 155.12 trillion.[10]

Tax Incentives

The government has also been providing several fiscal incentives to attract investors, especially in the so-called strategic sectors. For example, a tax holiday is provided for pioneer industries, defined as industries with broad linkages that offer added value and high externalities, introduce new technologies, and have strategic importance to the economy. Based on Finance Minister regulation no. 130/2020, there are 18 industrial sectors that fall within the scope of pioneer industries, including base metal, oil & gas, chemical, pharmacy, and infrastructure-related sectors.

To encourage job creation and absorption of local workers, the government offered incentives for labour-intensive sectors in the form of facilities to reduce net income tax by up to 60 per cent of specific tangible fixed assets values within a certain period.. In 2021, there were 45 labour-intensive industrial sectors employing an average of 300 workers who received the investment allowance. And to promote the knowledge and innovation ecosystem, the government has introduced a super tax deduction for industries engaging in vocational activities to provide knowledge and encourage knowledge and technology transfer; a maximum reduction of 200 per cent gross income from costs in the context of providing work practice, apprenticeship, and/or learning activities, and; an R&D super deduction to increase the role of industry in fostering innovation and the use of the latest technology in the production process. This incentive provides a maximum gross income deduction of 300 per cent over R&D costs carried out in Indonesia.

Special Economic Zones

The government has created several special economic zones (SEZs), free trade zones and industrial estate, with special regulations and incentives to lure investors. As of now, there are 18 SEZs covering a total area of more than 18 thousand hectares, and 122 industrial estates covering a total area of 47 thousand hectares. Two new SEZs are located in Batam, Riau Islands province. These SEZs focus on the digital economy (Nongsa Digital Park) and maintenance, repair and overhaul (MRO) services for aircraft (Batam Aero Technic), and

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are projected to create 26,476 jobs for local workers. The authority has set a target of attracting US$1.5 billion investment to the two SEZs in Batam by 2040. It remains to be seen how these SEZs can attract investments, but there is an indication of realisation challenge. In January, the government decided to remove the status of SEZ in Tanjung Api-Api, South Sumatra due to lack of progress in terms of land acquirement.[11]

Land Reallocation

One of the most challenging obstacles investors face is land acquisition. Yet, many companies have owned land rights for several years without realising their investment. To solve the 'idle land' problem, the government plans to revoke 2,078 mining business permits (IUP), 192 forest area use permits (IPPKH, *Izin Pinjam Pakai Kawasan Hutan*), and 34,448 Ha rights to cultivate (HGU)/right to build (HGB). After revoking the land rights from these companies, the government will offer them to new investors.

INDUSTRIAL POLICIES

The effectiveness of investment promotion and facilitation is tied to the national industrial policy. Historically, Indonesia's participation in the global supply chain has been limited to the low technology, labour-intensive, natural resources-based industries.[12] These industries have a comparative advantage in cheap labour and abundant raw materials, such as mineral products. Indonesia has been trying to change these trends to no longer rely on minerals or commodities exports but move up the manufacturing value chain. Given this, the government has been facilitating investment in the downstream mineral-processing industry.[13]

Mineral export ban to promoting downstream industry

To encourage downstream industry development, since 1 January 2020, the government has prohibited nickel ore exports.[14] In addition, it also regulates the Mineral Standard Price (HPM: Harga Patokan Mineral) for nickel ore; the HPM is set 30-40% below the international market to provide an incentive for the smelter (mineral processing) industry.[15]

These policies have in the last two to three years driven significant investment into nickel processing and nickel-based commodities. It has been reported that several prominent companies have shown interest in investing in the electric vehicle (EV) battery industry. For instance, Korea's LG Energy Solution signed an MoU with Indonesia Battery Corporation (IBC), a consortium of four state-owned companies consisting of PT Indonesia Asahan Aluminum, PT Aneka Tambang Tbk., PT Pertamina, and PT Perusahaan Listrik Negara, to develop a US$ 9.8 billion integrated EV battery factory in Batang, Central Java.[16,17] IBC has also approached China's CATL (Contemporary Amperex Technology) to develop a US$ 5 billion national EV battery industry ecosystem. [18] Finally, Taiwan's Foxconn is reported to invest US$ 8 billion EVs industry in Batang integrated industrial estate, Central Java.[19] Whether or not their investment will materialise depends on many factors, including the EV manufacturers' global strategies and Indonesia's trade and industrial policies.

Promoting Local Content

One policy that arguably can become a constraint for attracting FDI is local content requirements (TKDN or *Tingkat Komponen Dalam Negeri*) and imports restrictions in the respective sectors. TKDN is designed to spur the productivity and competitiveness of the national industry amid more restricted global trade conditions. This essentially goes against WTO rules on Trade-Related Investment Measures (TRIMs).[20] With TKDN, the government requires the use of local-made goods and services that have been certified by official surveyors. This requirement has been strongly applied to foreign companies that want to operate and sell their products in Indonesia, and there is a task force that reports to the President to supervise the implementation of this programme. Moreover, the government encourages big investors to partner with MSMEs to increase domestic companies' role. Recently, the Ministry of Investment initiated a new requirement for every company that obtains an investment incentive to submit a commitment to partner with MSMEs in the project's region. The local partner must also go through verification by the business association, local government, and the Ministry of Investment. This policy aims to encourage economic equity and promote the local economy.

Nevertheless, the effectiveness of the TKDN and partnership programme needs further evaluation. There is evidence around the region that local content requirement often fails to achieve the desired ends and imposes huge costs on the economy. Indonesia's and Malaysia's national car experiments are examples of such failure and of the costs.

CONCLUSION

While investment prospects in Indonesia remain promising, it is not easy to attract particular investments, especially those that will contribute to more inclusive and sustainable economic growth. The biggest challenge at this time is related to unpredictable business regulations. The Constitutional Court's order for the government to amend the Job Creation Law gives negative signals to investors about Indonesia's regulation uncertainties. The government should amend the law as soon as possible and ensure that it follows the proper mechanism, including public consultation. Then, the next step is to finalise the implementing regulations for the Job Creation Law in a consistent, reasonable and prudent manner to give business and legal certainty to investors. If the implementation regulations of the Job Creation Law are inconsistent, this will add to the challenge of attracting new investments.

Finally, it is important to harmonise investment promotion and facilitation measures with suitable industrial policies. In recent years, the latter have become more inward-looking and politically driven, making the FDI investment climate less attractive. Strict local content requirements put in place without domestic firms upgrading their capacity to be "linkage

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ready", i.e., having the standards that international investors expect from their suppliers, will not benefit the national economy and international investors.

ENDNOTES

[1] https://www5.bkpm.go.id/id/publikasi/siaran-pers/readmore/2450401/80401. Accessed 30 January 2022. This figure is implemented investment projects and not approved investments figure.
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