

PART ONE: THE INDONESIAN INVESTMENT ENVIRONMENT

THE INDONESIAN ECONOMY

Despite the tragedy of the 26 December 2004 tsunami, Indonesia entered 2005 with improved macroeconomic indicators. The Indonesian economy was positioned to move to a more sustainable growth rate following the election in October 2004 that brought to office a government with renewed resolve for fiscal discipline and a clear desire to lift foreign direct investment. Indonesia's recovery from the severe economic crisis of 1997/98 had earlier lagged that of its neighbours, and was largely fueled by private consumption rather than investment. GDP grew by 3.8% in 2002 and 4.1% in 2003. The 2004 figure of 5.1%¹ was a sound result and preliminary data for the GDP growth in the first quarter of 2005 at 6.4% was surprisingly strong, given the aftermath of the tsunami as well as expectations of interest rate and fuel price increases.

TABLE 1: INDONESIAN ANNUAL GROWTH FORECASTS 2005 AND BEYOND

AGENCY	2005 FORECAST	BEYOND 2005
Economist Intelligence Unit (EIU)	5.4%*	5.2% from 2006-2009
Dow Jones poll of 6 economists	5.1%	n.a.
Reuters poll of 10 research houses	5.3%	n.a.
World Bank	5.4%	Over 6% 2006-2009
International Monetary Fund (IMF)	5.5%	6% in 2006 and 2007
Indonesian Government	5.5%	7.6% by 2009
IMA Asia (incl. Castle Asia)	6%	7% in 2006

* Downgraded from 5.7% after the December 2004 tsunami.

THE GOOD NEWS:

- Indonesia has maintained a stable currency and has experienced strong international support following the December 2004 tsunami. The economic impact of the tsunami on a national basis is thought unlikely to be severe – although clearly devastating for the provinces of Aceh and North Sumatra.
- Debt management improved with the external debt to GDP ratio declining from 56% in 2003 to 51% in late 2004. The current level of short-term debt to international reserves is comparable to that of Malaysia and Korea. Debt mitigation from the Paris Club and other lenders, spurred by the tsunami disaster, will also help the fiscal picture.
- Improved market sentiment has seen local equities markets touching record highs. The Jakarta Stock Exchange composite index reached an all-time high in January 2005. The index has increased by a factor of 2.5 in just 2 years.²

¹ Indonesian BPS, data released 16 February 2005.

² World Bank, *Raising Investment in Indonesia*, 15 December 2004.

- Domestic investment activity is increasing and this trend is expected to continue, largely as a result of Indonesian industry's positive attitude to the election of President Susilo Bambang Yudhoyono and the expectation of political stability and effective government.

'Political stability is settling in. The recent elections cap what has been in essence a genuine political revolution over the last 5 years and demonstrate that legitimate and effective democracy is taking hold in Indonesia.'

WORLD BANK, DECEMBER 2004

- Credit upgrades by Standard & Poor's and Fitch.

In December 2004 Standard & Poor's (S&P) raised Indonesia's sovereign credit ratings, commenting that the outlook for Indonesia's ratings was positive, suggesting that future upgrades were likely. S&P cited 'ongoing progress in Indonesia's macroeconomic stability, steadfast fiscal management, a declining debt and debt-service burden, and favourable external liquidity' as the primary reasons for the lift in rating.

Those fundamentals put Indonesia 'in good stead to achieve faster and more broad-based growth than the average 4.1% of the past 5 years.'

Fitch Ratings in January 2005 also raised Indonesia's debt rating one step, following the government efforts to cut the budget deficit, amid signs of accelerating economic growth.

Fitch commented that the upgrade came as the economy was forecast by the government to grow 5.5 percent in 2005 - the fastest in nine years.³ 'Investment from abroad supports growth that will probably quicken to 5 percent this year from 4.5 percent in 2004', Fitch said. The ratings reflect 'stronger economic growth and continued improvements in the nation's public and external finances.'

'Private consumption, a noticeable pickup in domestic investment activities and improving foreign investor interest in key sectors such as oil and gas should become more supportive of economic growth,' the Fitch statement said.

- An 11.5% improvement in export revenues.
- High capacity utilisation and increased company profitability.
- Declining interest rates and improved credit availability. Consumer credit has been on a steady upwards climb since 2000 and continues to support growing demand. Credit expansion in 2004 was fuelled by consumer demand, which grew by 35%.⁴ Credit outstanding for private consumption has now returned to pre-crisis levels.

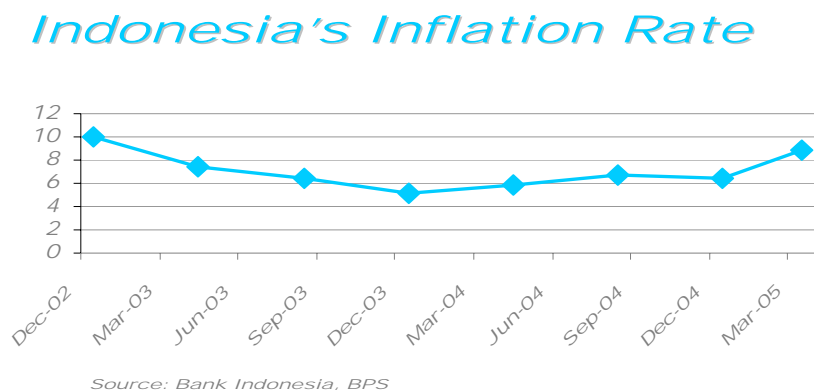
³ Preliminary data for GDP growth in the first quarter of 2005 was 6.4% on a year-on-year basis.

⁴ Bank Indonesia, 4 February, 2005.

Indonesian companies interviewed during December 2004 were generally positive about the cost and availability of funds to finance business expansion.

- Improved foreign portfolio capital inflows.
- Poverty index improved to pre-crisis levels.
- Consumer price inflation soared to a year-on-year rate of 8.8% in March 2005 (after averaging 6.1% in 2004) as a result of the 29% increase in average fuel prices implemented on 1 March 2005. The inflation rate reduced slightly to 8.1% in April due to the weakness of the rupiah and the increase in fuel prices filtering through the economy.

FIGURE 1: INDONESIA'S INFLATION RATE DECEMBER 2002 – MARCH 2005



- Food prices, which make up about 25% of the index, and inflationary pressures for the food component, fell during the second half of 2004. This positive performance was, however, followed by a higher than expected lift in CPI in January 2005, resulting in a year-on-year figure of 7.3%.
- Indonesia's tourist arrivals have risen steadily since the beginning of 2004. In calendar year (CY) 2004, the number of foreign tourists rose by around 23% to 4.54 million.⁵

Tourists were not discouraged from visiting Indonesia despite the unprecedented series of legislative and presidential elections during last year. Nor did the bomb blast outside the Australian Embassy in September 2004 have a significant impact on tourist arrivals as it was generally not viewed as targeting tourists.

The tsunami did not cause any damage to Indonesia's major tourist centres of Bali and Lombok, and some suggest that Indonesia may even benefit from a diversion of tourists from Phuket in Thailand during the reconstruction there.

⁵ There are various reports providing different numbers – but the figure of 4.54 million tourists is most frequently quoted.

- Price regulation has improved. The mandated reforms of the International Monetary Fund (IMF) in 1998 that required the dismantling of various monopolies (e.g. those in the clove and plywood industries), as well as the removal of price controls, have resulted in more open competition. Some significant price control mechanisms still exist, however, notably in the agriculture sector.

ISSUES TO WATCH SHORT-TERM:

Indonesian interest rates have been steady through 2004 and credit availability is good. Analysts do however expect higher interest rates, particularly if fuel prices are increased. Observers consider the current interest rate of 7.4% could rise 1 percentage point during 2005 to curb inflationary trends.⁶

2005 will be a crucial year for Indonesia to achieve higher export revenues, particularly in oil and gas, to offset import demand for consumer goods. A sustained increase in imports of capital goods will confirm that Indonesia's economic recovery is truly on track.

INDONESIA'S FUEL PRICE MINEFIELD

Indonesia's fuel prices were pegged to a weighted average oil price of US\$22-24 per barrel in January 2003. In the interim world oil prices soared, with Europe's benchmark, dated Brent crude⁷, averaging over US\$45 per barrel.

To sustain artificially low domestic prices, Indonesia's fuel subsidies have climbed to around US\$6 billion per annum (p.a.), and are estimated to exceed the total development expenditure in the national budget. It is recognised that these levels of subsidy are unsustainable – but any move to reduce them is expected to meet with heavy resistance.

The Indonesian Government has foreshadowed fuel price adjustments in March 2005, with an increase in prices averaging 30%. The government is likely to maintain the subsidy for kerosene in view of its importance to those at or below the poverty line, and attempts to direct increases towards higher income groups better able to afford them – most especially private vehicle owners.

- This could result in a monthly increase in the CPI index of 0.3%, and would exacerbate the January inflation rate figure of 7.3%, which is of concern.⁸

Any reduction of the fuel subsidy will require adroit political management and some sort of convincing message that the savings realised would be redirected towards other areas of more enduring public good.

⁶ Michael Chambers, CLSA Indonesia, 15 February 2005.

⁷ Brent crude is the benchmark contract of the London-based International Petroleum Exchange for crude oil futures trading. Contracts are dated for specific periods. Dated Brent crude is the European counterpart of West Texas Intermediate (WTI) crude benchmark.

⁸ Michael Spencer, Asia Chief Economist, Deutsche Bank Singapore, 14 February 2005.

It is estimated that a 20% increase in oil prices would free up US\$2 billion (1% of GDP) and increase the rate of inflation by 0.5-1%.⁹ The World Bank estimates that if fuel prices were raised by 20% per year from 2005 to 2007, fuel subsidies would be reduced to almost zero.

Fuel subsidies, however, are a highly charged political issue that will test the resolve of the SBY administration to its core. Fuel price increases were attempted in the last days of President Soeharto's New Order government and played a part in that government's downfall. Attempts to raise fuel prices during the administration of President Megawati Sukarnoputri also failed amidst strident public protests.

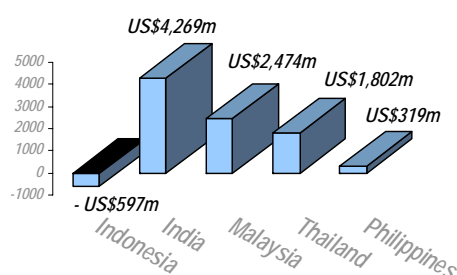
Fuel price subsidies are perhaps the major short-term issue weighing on the investment climate. The international investment community is watching this issue as a test of the new government's resolve.

LONGER TERM CONCERNS:

The key factors that impact investor confidence are:

- Policy and regulatory uncertainty
- Corruption
- Taxation administration
- Regulatory bottlenecks
- Legal and judicial processes and administration
- Labour regulations.

Indonesia's main competitors for foreign direct investment (FDI) in East Asia, notably China, India, Thailand and Malaysia, although also influenced to a greater or lesser degree by these concerns, have nevertheless continued to attract significant foreign direct investment. Indonesia on the other hand has seen a net outflow.



Source: UNCTAD World Investment Report 2004

FIGURE 2: FOREIGN DIRECT INVESTMENT BY COUNTRY – 2003

Increased investment – domestic and foreign – is a primary policy objective for the Susilo Bambang Yudhoyono government. Indonesia must compete against its Asian neighbours to attract that investment. China is not included on this graph – as its FDI inflow for 2003 was US\$53.5 billion – more than twelve times that of India.

The October 2004 election victory of President Susilo Bambang Yudhoyono is seen by many investors as the harbinger of change.

⁹ World Bank, *New Directions paper*, January 2005.

It is widely believed that if the new Indonesian Government demonstrates the political will to implement the structural changes it has promised, a substantial turnaround in investment inflows is possible within the next 12 months.

THE KADIN ROADMAP

To promote economic recovery, KADIN (Kamar Dagang dan Industri), the Indonesian Chamber of Commerce and Industry, identified specific concerns and in October 2004 released 'The Roadmap for the Revitalisation of Industry and Investment.'

This document identifies 5 broad preconditions and 6 critical success factors considered necessary to improve Indonesia's investment standing and economic performance.

KADIN'S PRE-CONDITIONS ARE:

- macroeconomic stability
- security and political stability
- positive work ethics, national discipline, and providing services and care to improve performance
- trust and a spirit of togetherness
- clean, transparent & effective administration (good public governance).

KADIN'S CRITICAL SUCCESS FACTORS:

KADIN also drew upon a survey conducted by the International Chamber in August 2004, to point to areas of particular concern. Table 2 lists the issues that were noted.

TABLE 2: IDENTIFICATION OF ISSUES FACED BY THE INDONESIAN BUSINESS COMMUNITY
(% OF RESPONDENTS WITH NEGATIVE EXPERIENCES)

ISSUES	NEGATIVE EXPERIENCE
Law enforcement	91%
Corruption	88%
Tax	84%
Inconsistency in policy/regulations	82%
Manpower	64%
Crime and security	58%
Infrastructure	51%
Regional autonomy	51%

Source: Indonesia – New Directions – CGI meeting, 19-20 January 2005¹⁰

¹⁰ The CGI is the Consultative Group on Indonesia, which consists of Indonesia's chief donor countries. Australia is a member of the CGI.

The Roadmap highlighted five key sectors that KADIN considers essential for reform to ensure Indonesia's return to strong economic growth. They are:

- Law
- Taxes
- Manpower
- Infrastructure
- Regional Autonomy.

On the basis of these studies KADIN has provided the Indonesian Government with a series of proposed Action Plans to improve Indonesia's economic competitiveness and revitalise investment.

The exercise is an important contribution to high level business dialogue in Indonesia and emphasises the quality of interactions that are now taking place between the Indonesian Government and industry leaders.

Supporting the KADIN measures, the Investment Climate Working Group (comprising international donors and businesses) also recently noted that improving the investment climate requires substantial change in the medium-term and stressed three primary elements in the process:

- Safeguards for the key accomplishments achieved to date
- Early, decisive action by the incoming government to deliver on its promises
- A comprehensive, medium-term road map to address the structural issues impeding investment.

President Susilo Bambang Yudhoyono noted:



'My government is adopting what I call the triple track strategy: first, to promote growth through export and investment; secondly, to promote employment by stimulating the real [industrial] sector and thirdly, to reduce poverty by promoting agriculture and rural development.'

PRESIDENT SUSILO BAMBANG YUDHOYONO WANTS TO SEE AN AVERAGE OF 6.6% REAL GDP GROWTH OVER THE NEXT 5 YEARS.

THE INDONESIAN INVESTMENT CLIMATE:

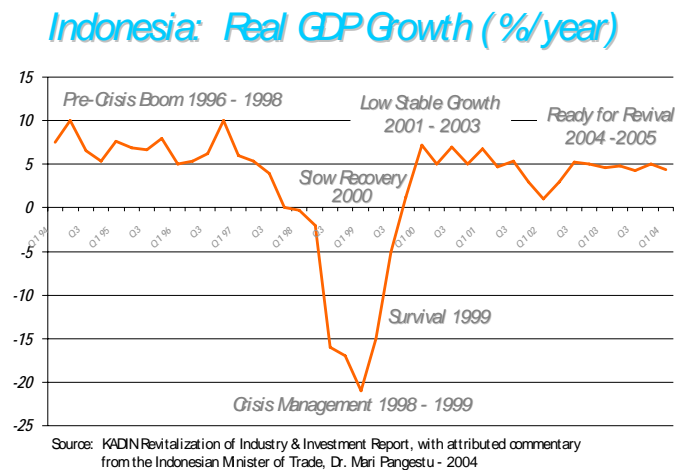
Structural issues, such as corruption and judicial reform, cannot be resolved overnight. But the investment market is awaiting the actual implementation of a reform agenda that will remove the obstacles to a recovery in foreign investment.

The international investment community believes that executive intervention in stalled projects, particularly in the oil and gas sector, will send a strong message to all that Indonesia is firmly committed to the reform process.

CRISIS AND RECOVERY

The following graph demonstrates how severely the 1997/98 Asian financial crisis affected Indonesia. The country's recovery has been slow relative to its regional competitors, but positive signs of that recovery are emerging.

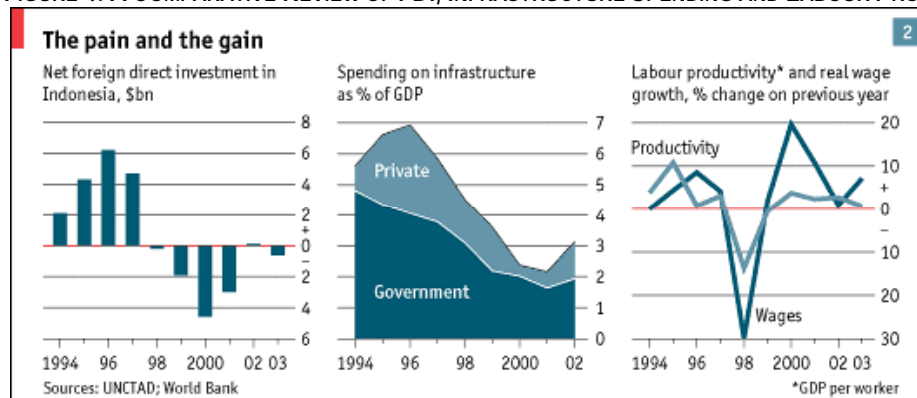
FIGURE 3: INDONESIA'S REAL GROWTH IN GDP, 1996-2005



Before the 1997/98 economic crisis ('Krismon') investment was about 30% of GDP but in 2003 the figure was 18%, the lowest since the early 1970's.¹¹

¹¹ *The Economist* survey, December 2004.

FIGURE 4: A COMPARATIVE REVIEW OF FDI, INFRASTRUCTURE SPENDING AND LABOUR PRODUCTIVITY



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In 2004, investment in Indonesia grew by 16% and its contribution to GDP rose to 20.1%.¹² This has been the highest growth in total investment (both domestic and foreign) since 1997/98, according to Bank Internasional Indonesia (BII).

- *Realised foreign* investment (FDI) in calendar year 2004 reached US\$4.6 billion, down from US\$5.4 billion in 2003, according to the latest data from Indonesia's Investment Coordinating Board (BKPM).
- *Realised domestic* investment increased to Rp15.2 trillion (about US\$1.6 billion) in 2004 from Rp11.5 trillion (about US\$1.25 billion) in 2003.¹³
- Foreign investment *approvals* in 2004 were, however, US\$10.28 billion – down from US\$14 billion in 2003.
- The latest figures for investment approvals suggest an improved investment outlook, as after falling more than one-third, to US\$10.28 billion in 2004, approvals for FDI more than tripled in January 2005 to US\$872.1 million.

The food sector has been of interest – but essentially for the domestic investor. In 2003, the agrifood sector accounted for 9% of total domestic investment. Their limited drawing power for foreign investment, however, is of concern, with FDI in the agrifood sector 4% of total FDI in 2002 and less in 2003.

¹² BPS Indonesia, media release, 16 February 2005.

¹³ PT Danareksa, February 2005.

FOREIGN INVESTMENT – DRIVERS AND BENEFITS

THE GLOBAL PERSPECTIVE:

In principle companies invest internationally to increase their output and/or profit margin. They look to maximise the yield from available resources and achieve a more advantageous market position. The relative attractiveness of particular markets is of course a prime consideration, and benchmarking markets against each other is generally a key part of the exercise.

- In the period from 1980 to 2000, global FDI flows grew briskly. This was particularly so during the 1986-1990 period, when many countries relaxed their regulatory barriers. Until 1997/98 Indonesia was a major participant in this FDI growth.
- Following the Asian financial crisis of 1997/98, FDI growth was strong again as many companies in the region collapsed. This collapse initiated a frenzy of merger and acquisition activity. In Indonesia bargain hunters moved in to pick up assets at very low Rupiah/USD valuations.
- Since 2000, however, global investment flows have fallen and remained relatively flat¹⁴ – with the primary exception of China.

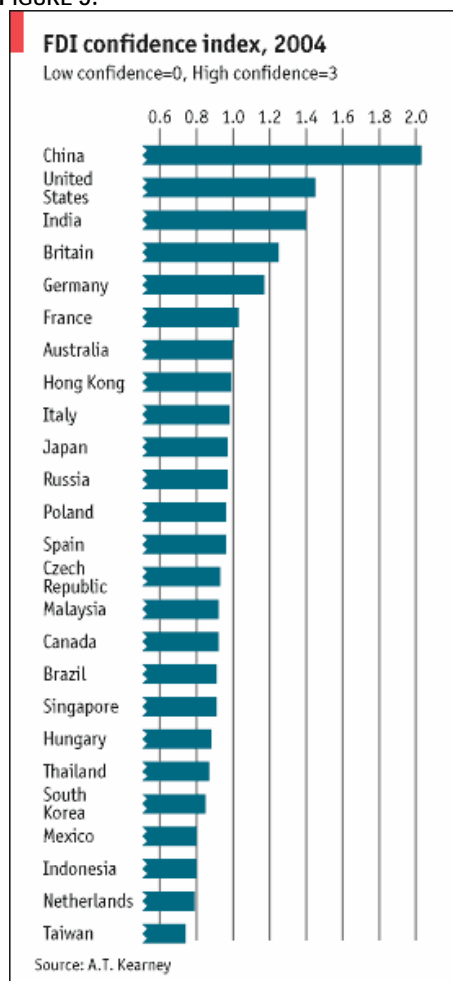
Indonesia has not yet regained its investment momentum. It was a strong performer in the early 1990s, but whilst overall economic recovery has been slow and relatively steady, investment as a share of GDP has fallen precipitously from 30% pre-crisis to about 18% in 2004.

THE CHINA FACTOR:

While Indonesia has been experiencing an investment drought, China has had an investment flood. China dominates all global FDI rankings, despite the fact that FDI is only a relatively small component of its GDP. It is very hard for countries like Indonesia to compete for the investment dollar when their economic fundamentals and manufacturing capabilities are currently matched against those of China.

¹⁴ Douglas Brooks and Hal Hill, *Asian Development Review*, Vol 21, No 1, 2004.

FIGURE 5:



According to the *A.T. Kearney Confidence Index Survey*, of the top 1,000 companies accounting for 70% of global FDI flows – across all regions and sectors – China remains by far the most preferred destination for global foreign investment.

The USA comes in second, followed by India, which has risen from 6th place in 2003. India now ranks second to China as a location for foreign investment in manufacturing. Indonesia is substantially down the list.

THE IMPERATIVE FOR INDONESIA TO IMPROVE ITS INVESTMENT STANDING WAS STATED BY *THE ECONOMIST* IN ITS DECEMBER 2004 SURVEY OF INDONESIA:

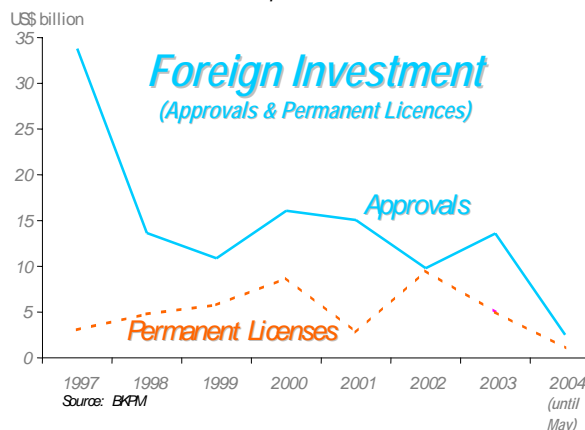
*'Most foreigners regard Indonesia as more of a cautionary tale than a model. That is a judgement Mr Yudhoyono must reverse. For the fate of his presidency rests on the economy, and the fate of the economy rests on attracting foreign investment.'*¹⁵

© The Economist Newspaper Limited, London, 20 January 2005

2005, however, has started well for Indonesian investment. In January US\$872 million in investment approvals were recorded. Nevertheless, three projects in the chemicals/petrochemicals sector accounted for more than 60% of this total – valued at US\$553 million.

¹⁵ *The Economist*, 11 December 2004.

FIGURE 6: TOTAL FOREIGN INVESTMENT IN INDONESIA, 1997-2004



INDONESIAN AGRICULTURE

Agriculture is a major element of the Indonesian economy, accounting for 15% of GDP¹⁶ and employing approximately 42 million of the country's total population of 215 million – almost 20% of the labour force. Agriculture accounts for 12% of Indonesia's exports and 17% of imports.¹⁷

Indonesia is endowed with plentiful resources of arable land – the basic building blocks of competitive agriculture and of food processing industries.¹⁸ A large and rapidly growing domestic market offers considerable opportunities for both food production and processing. The rapid urbanisation of a country of this size makes consumers within reach of the mass media. They have become more attracted to Western food styles that also complement their traditional cuisine. Indonesian consumers seek quality ingredients and improved processing in their own cuisine, and Australian food producers and processors are well-positioned to meet these needs.

The Indonesian agrifood industry has proved remarkably resilient to the 1997/98 financial crisis, and consumption across all sectors has returned to, or exceeded, pre-crisis levels. Middle class consumers, who were severely disadvantaged by the 1997/98 crisis, are recovering their purchasing power and seeking better quality food products.

Despite a sizeable market and available arable land, Indonesia's agrifood companies do suffer from wide variations in production efficiency, limited infrastructure, as well as high cost and inefficient distribution networks. These impediments have compromised international competitiveness in general farm production – and in plantation crops, such as palm oil, cocoa, rubber and coffee, have tested management capability and inhibited export performance.

Nevertheless Indonesia is the world's second largest producer of palm oil after Malaysia, and has experienced strong growth in production – especially in Sumatra. Indonesia accounts for 34% of

¹⁶ EIU estimate.

¹⁷ Thomas and Orden, International Food Policy Research Institute, November 2004.

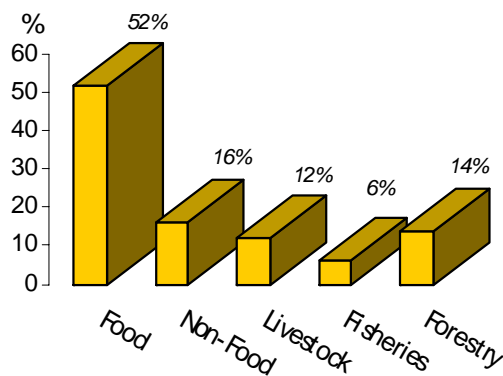
¹⁸ With a total land area of some 1.8 million sq km, 11.3% of that land, or over 200,000 sq km is arable. It is estimated that some 7.23% of Indonesia's land is under permanent crops. <http://www.cia.gov/cia/publications/factbook/geos/id.html>.

world production of palm oil, and is expected soon to overtake Malaysia as the world's leading palm oil producer.

Indonesian agricultural policy has traditionally been based on national self-sufficiency in basic commodities, with volume exports limited to plantation crops – and of course spices.

- Production is largely concentrated on the islands of Java, Sumatra and Sulawesi.
- Smallholder farms (often less than one hectare in size) occupy the largest share of cultivated land and grow mainly food crops (maize and rice being the major crops).
- Large scale farms, state or privately-owned, account for a small share of agricultural output, but a higher proportion of agricultural exports, such as palm oil, cocoa, rubber and coffee.

FIGURE 7: RELATIVE SHARES OF AGRICULTURAL GDP - INDONESIA: 1999-2002



Rice is Indonesia's primary crop, accounting for 40% of Indonesia's agricultural production by value between 1999 and 2002.¹⁹

During this period major gains were registered by the palm oil and fisheries sectors.

Source: Thomas and Orden, International Food Policy Research Institute, November 2004

The SBY Government has demonstrated its willingness to listen to industry and to foster new investments to lift efficiencies in the agrifood industries. In keeping with this renewed openness, there is also increased international pressure for changes and modifications to policy settings – both at the centre and regional government levels.

POLICIES OF SELF-SUFFICIENCY

From 1965 until the Asian economic crisis in 1997/98, the Indonesian agriculture sector grew quite strongly.²⁰ Programs directed towards self-sufficiency, particularly in rice – Indonesia's most important staple food – played a major role in agricultural policy. Rice self-sufficiency was largely achieved by 1985, however imports were necessary for the period 1997 to 2002. Since then imports have fallen to minimal amounts, although the Indonesian logistics agency Badan Urusan Logistik (BULOG), recently announced it would import rice in 2005 as a 'buffer' or 'standby' stock.

¹⁹ Thomas and Orden, International Food Policy Research Institute, November 2004.

²⁰ Growth in the Indonesian agriculture sector during the period 1965-98 was generally in the range of 3-4% p.a.

A range of highly complex programs have heavily influenced the Indonesian agriculture sector. They include subsidised inputs such as fertiliser and pesticides, as well as protection from imports and price stabilisation programs managed by BULOG.

Under Indonesia's agreements with the IMF, following on from the Asian economic crisis of 1997/98, many of these programs were removed or rationalised. BULOG's trading monopolies started to be phased out, except for rice, and a number of other structural reforms were made, including, for a period, the removal or reduction of various subsidies and the general lowering of tariffs on agricultural produce. However, some reversal of these reforms has occurred in the past couple of years, including the re-raising of certain agrifood tariffs.

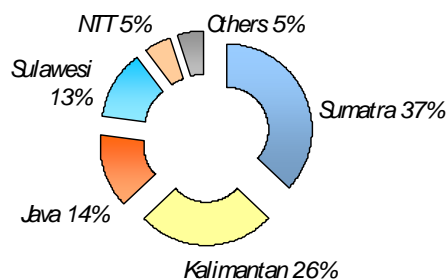
Self-sufficiency appears to be still a major element in the Indonesian Government's food security agenda. It is a keenly debated policy, as it competes with other government programs for funding, including poverty alleviation, decentralisation and diversification of the agriculture sector towards higher value crops.²¹

The Indonesian approach contrasts with, for example, that of China, which has embarked on reforms of its formerly highly-protected and centrally-controlled agriculture sector, which have seen China become a significant exporter of higher-value horticulture and other produce (e.g. apples, shallots, garlic and mushrooms etc.). This has been accompanied by some easing of its formerly strong adherence to total self-sufficiency in more basic commodities, such as grains. China has recognised the economic advantages of allowing more imports of a range of agricultural and food commodities to supplement domestic production.

AGRIBUSINESS CAPABILITY²²

There are extensive land areas available for growing plantation crops, including tropical tree crops and crops suited to mechanised production, particularly on the islands of Sumatra, Sulawesi and Kalimantan. On Java, where land is scarce, the soil is extremely fertile and high-density vegetable crops, such as mushrooms, beans and other vegetables, grow well. These crops are labour-intensive, economical with land and lend themselves well to small holder production.

FIGURE 8: LOCATION OF INDONESIA'S AGRICULTURAL LAND



Source: BPS Indonesia (data does not include land surrounding houses)

²¹ Thomas and Orden, International Food Policy Research Institute, November 2004.

²² Reference is made to 'Prospects for Indonesia's exports of Agro-industrial products' by Stephen Magiera, Harvard Institute for International Development, March 1995.

TABLE 3: LOCATION OF INDONESIA'S AGRICULTURAL LAND BY PROVINCE

	<i>(millions of hectares)²³</i>
West Kalimantan	4.48
Central Kalimantan	3.69
North Sumatra	3.71
South Sumatra	3.29
Riau	3.07
Nusa Tenggara Timur	2.57
East Java	2.52
North Kalimantan	2.51
East Kalimantan	2.51
South Sulawesi	2.50
Jambi	2.17
South Kalimantan	2.15
Aceh	2.14
West Java	2.08
Central Sulawesi	2.05
Lampung	1.85
Other provinces	6.07
TOTAL	49.36

Commercial food processing depends on a number of factors for success. To be internationally viable, cost competitiveness in the final stages of manufacture is essential. The first stage of processing generally occurs near the point of production, as the raw material is bulky and/or deteriorates quickly. Final processing, on the other hand, is generally capital-intensive and frequently involves the addition of other raw materials such as sugar, salt, flour and oils. Access to these other inputs, especially through good port facilities, generally influences the choice of location for the processing plant.

At the final production stage low-cost labour tends not to be such a critical factor, except for labour-intensive industries, such as meat and fish processing. The high capital cost of a plant involved in the final processing generally mandates that such plants operate on a continuous basis, with regular and reliable delivery of raw materials and other inputs.

In many instances in Indonesia, regular and consistent supply of raw materials at farm level have proved problematic. Various methods of sourcing have been employed, with varying degrees of success. These include:

- Spot market purchasing: this is always a risky technique if there are the requirements of a high capital processing plant to feed. Spot purchasing tends to be more successful when the basic inputs are widely traded, but even then volume and quality inconsistencies frequently occur.
- Vertically-integrated projects: these have been quite successful in Indonesia, notably in the poultry, dairy and beef processing sectors. Success often depends on the

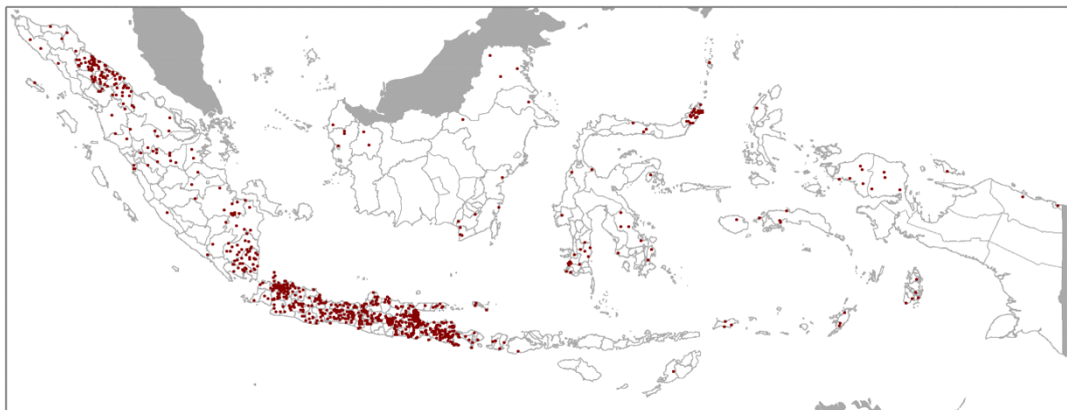
²³ BPS figures, 2000.

amount of land required. If the raw material can be produced intensively (e.g. beef feed lotting or poultry batteries) the success rate has tended to be higher.

- Contract farming: this is most successful when the processor deals direct with farmers and provides assistance with inputs such as planting materials, fertilisers, pesticides and provides technical and financial support. Evidence of a long-term commitment from the processor obviously hastens the farmers' 'buy in' to the project.

The following diagram graphically illustrates the high concentration of food processing on Java, and in selective regions of Sumatra and Sulawesi. Each dot on the map represents a food processing establishment that has more than 500 employees.

FIGURE 9: THE GEOGRAPHICAL SPREAD OF FOOD PROCESSING FACILITIES IN INDONESIA



Source: World Bank, December 2004

The Australian Council for International Agricultural Research (ACIAR) is engaged in a range of agricultural development projects throughout Indonesia, notably in the Eastern Islands. ACIAR publications and data provide useful insights into a range of agricultural production and processing projects.²⁴

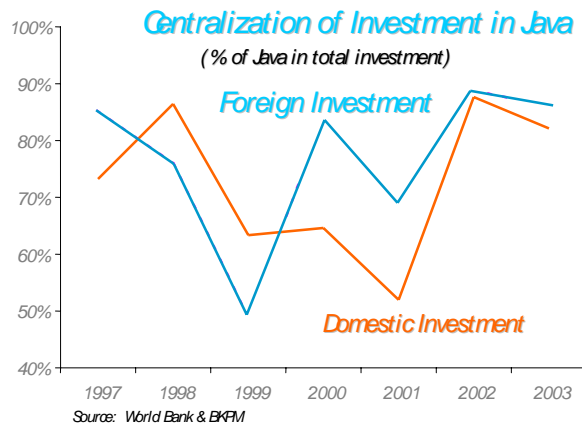
TRANSPORT & DISTRIBUTION

In Indonesia, with more than 17,000 islands extending over 5,000 km East to West and 1,700 km North to South, transport is a critical factor in market competitiveness. In particular, transport costs between islands are high and bulk transport capacity is limited.

Although the islands away from Java offer larger and cheaper agricultural development sites, there has only been limited interest by foreign food companies (other than plantation operators) in investing away from the major centres of population. Major international logistics groups, such as Linfox, Exel, TNT and GAC (the latter in joint venture with Samudera Indonesia Group) have made substantial investments in distribution, although their focus has been primarily on Java.

²⁴ Refer to <http://www.aciar.gov.au>.

FIGURE 10: CENTRALISATION OF INVESTMENT IN JAVA (% OF JAVA AS PART OF TOTAL INVESTMENT)



Java remains the dominant region for investment. In domestic investment, Java accounted for 70% of total values in 1997-2004 followed by Sumatra (15%) and Kalimantan (11%) among 7 regions (islands). In foreign investment, Java accounted for 75% followed by Sumatra (17%). For both domestic and foreign investment, the share for Java was high in 2002/3 while that of Riau declined sharply in 2002/3.²⁵

LABOUR PRODUCTIVITY

Indonesian labour costs are low, and while labour productivity has risen over time, it is still below that of most other countries in the region. Moreover wage increases have often negated productivity improvements. The Manufacturing Census of 2001 indicates that labour costs in the food processing sector rose by 27% while growth in value added terms per employee rose by only 9%.

Labour regulations are a major concern for many companies and much of this concern relates to the Labour Protection Law passed in 2003. The provisions of this law (particularly its severance and long service pay terms) are regarded as considerably more generous than those of its regional competitors. A 40-hour working week (China and Vietnam have 48-hour weeks), the right to be paid while striking and strict limits on temporary and contract labour also add to the cost of hiring labour, and are assessed on relative terms with those in other parts of Asia. Minimum wages are also set by provincial governments, based on concept of a 'fitting' standard of living which is generally not well-defined.²⁶

Surveys conducted by the World Bank and Asian Development Bank have indicated that the major area of concern for companies is the law with regard to layoffs. Other causes of concern expressed are absenteeism/days lost on strikes as well as shortages of skilled staff.

POLICIES OF REGIONAL AUTONOMY

The Government of Indonesia has embarked upon a major policy of decentralisation of responsibilities and revenues to the regions. These changes were enacted in two decentralisation laws in 1999, which came into effect in January 2001. Since independence, and particularly during the period of the New Order Government of President Soeharto, power had been strongly

²⁵ World Bank, 'Raising Investment in Indonesia', 15 December 2004..

²⁶ World Bank, 'Raising Investment in Indonesia', 15 December 2004..

centralised, with decision-making and control of the country's resources overwhelmingly in the hands of the central government in Jakarta.

Pressures for decentralisation reached a high point in 1998 following the fall of the New Order Government. At issue was the return of an increased proportion of revenue generated in a region to that particular region, in addition to conferring responsibility for delivering services, such as public works, health, education, agriculture and communications.

The move created a major shift in power and responsibility within Indonesia's bureaucracy. Nearly two million civil servants were transferred to the regions and by 2002 approximately one third of total public expenditure was being administered by regional governments within Indonesia.²⁷

Such a rapid devolution of power and responsibility was bound to cause concern. The greatest issue has been the differing views of central and regional authorities on the delivery of particular services.

A number of these early problems has since been solved with amending legislation introduced in 2004. The new legislation has provided a clearer definition of issues such as revenue allocation, expenditure and borrowings. The new legislation has provided for the direct election of sub-national government executives, with the aim of increasing their accountability.

One of the negative outcomes of the decentralisation policy has been the introduction of what have been termed 'nuisance taxes' in a number of the regions. The 2004 legislation addressed this issue, and attempted to curtail taxes that lead to a 'high cost economy.' There is still, however, some way to go in the implementation of this legislation.

The Indonesian Government announced on 15 February 2005 that it has embarked on a review of 60 laws issued by regional administrations that are impeding trade and discouraging investment. It was announced at the same time that the central government might rescind some of the powers of local authorities to issue by-laws and return certain powers to the central government. These deliberations are expected to take some time.



Indonesia's Trade Minister, Dr. Mari Pangestu (pictured left) has noted that 'The government will identify by-laws that need to be synchronised to improve foreign investor confidence in this country.'

Minister Pangestu has also highlighted the need to facilitate business permit renewals at central and regional level. She could see no problem in these permits being of 5 years' duration.

²⁷ World Bank, *Indonesia – New Directions*, CGI report, January 2005.

Comments such as these are encouraging signs that Indonesia's central government is aware of the problems that regional autonomy can cause for foreign investment, and that the government is taking steps to address them.

IMPLICATIONS OF DECENTRALISATION FOR INVESTMENT

While there have clearly been problems and misunderstandings in the early stages of decentralisation, many Indonesian companies have also welcomed the decentralisation moves, finding that dealing locally on regulatory issues to be more convenient and efficient than in Jakarta. On the other hand, some companies have found that decentralisation has added further layers of bureaucracy and ambiguity to their business processes, and have experienced additional problems in obtaining approvals and licences.

It is clear that as the decentralisation policy evolves, some regions will develop more efficient mechanisms to attract investment, while others will be less effective. Discussions with food processing companies in Indonesia who have recently made investments in the regions, suggest that those who have established a solid presence on the ground, have managed the new regional processes reasonably well. 'Nuisance taxes' levied by regions, are an annoyance to many, but hopefully the 2004 legislative amendments will go a fair way to resolving problems.

It is pertinent to note in this context that the KADIN 2004 survey²⁸ ranks regional autonomy as less of an issue for Indonesian business than many others.

The decentralisation policy is relatively new. It is a major and ambitious change to an entrenched system of strong and tightly held central control. The policy is widely believed to be sensible and equitable, and investors can expect benefits from local autonomy over time.

THE INDONESIAN REGULATORY ENVIRONMENT

THE INDONESIAN INVESTMENT PROCESS

The Capital Investment Board, BKPM (Badan Koordinasi Penanaman Modal) has the responsibility to administer and grant investment applications. BKPM issues licences for both domestic and foreign investment. Established in 1973, it is a non-departmental government agency reporting direct to the President of the Republic of Indonesia. Key considerations in the implementation of BKPM policy are:

²⁸ KADIN, "The Roadmap for the Revitalisation of Industry and Investment", October 2004, page 32.

- investment in Indonesia is categorised as either being domestic (PMDN) or foreign (PMA)
- an investment with any degree of direct foreign ownership is defined as a PMA investment
- Investment approvals in oil and gas, as well as banking and insurance, are managed directly by the appropriate Ministry.

Since 1997/98 under restructuring programs initiated under the IMF, most sectors of general commercial activity have been open to foreign investment. In some areas there is a requirement for joint venture with a local partner. Those sectors are limited, and include basic infrastructure such as port operations, electricity generation, shipping, treatment and distribution of public drinking water, rail transport and medical services. A number of sectors have been removed from this so-called negative list and the pathway for foreign investment has been substantially improved. Major developments have included:

- 100% foreign ownership of companies in most sectors
- foreign involvement in the retail sector
- foreign involvement in the distribution of locally made products
- increasing foreign engagement in the medical and telecommunications sectors.

In agribusiness, investment in fresh water aquaculture requires approval on a national interest basis, and cooperation with local communities is also usually a pre-condition to operate. This is also the case with a number of other fisheries activities.

ESTABLISHING A PMA COMPANY

While the foreign investment approval process is easier today than it was before 1997, it still remains complex, and requires familiarity with the procedures and ministries involved in the process. Any company seeking to establish an Indonesian PMA company is strongly recommended to retain good professional advice.

THE FOLLOWING PRECIS DRAWS UPON ADVICE PROVIDED BY KEN ALLAN OF PT KUNCI, AN EXPERIENCED TAX ADVISER IN INDONESIA. IT PROVIDES A BRIEF OUTLINE OF THE PROCEDURES ASSOCIATED WITH ESTABLISHING A PMA COMPANY.²⁹

FDI most often referred to by its Indonesian abbreviation PMA, is governed primarily by the Foreign Capital Investment Law No. 1 of 1967, amended by Law No. 11 of 1970. As a legal basis, the law is fairly accommodative to various deregulatory policies and measures to date, and those that will be taken by the government in the foreseeable future.

In addition to Investment Law No. 1/1967, PMA companies as well as other companies, in

²⁹ Further information is provided by Kunci Consulting on their website <http://www.kunciconsulting.com>. Full information is also available on the BKPM website <http://www.bkpm.go.id/en/>. There are a number of skilled financial advisors, based in Indonesia, who can assist with the PMA process. Further information is provided in the companion Investment Guide which is also available on this website.

their business operations are still subject to sector/industrial policies as required by corresponding ministries.

Incorporation of a PMA Company

The Investment Coordinating Board (BKPM), the government body which processes and handles FDI applications, issued an important deregulation package on PMA in May 1994 referred to as PP-20/1994. It was seen as a very significant step toward a much more conducive and attractive investment environment in Indonesia. The regulation:

- *allows 100% FDI in selected areas of business*
- *limits FDI to 95%, with a minimum of 5% ownership by an Indonesian*
- *allows FDI investment with certain conditions*
- *stipulates the sectors which are closed to FDI investment.*

For those companies choosing to make a 100% foreign investment, there is a requirement that 15 years from the commencement of commercial operations, the 100% foreign shareholder must sell at least 5% of the firm to an Indonesian entity. A company that is initially 95% foreign-owned is not subject to any divestment requirement.

The amount of capital to be invested in a foreign-owned company is decided by the investing parties themselves, and the BKPM approval is based on the economics and scale of the project. Foreign investment companies are basically free to choose where in Indonesia they will set up operations, with the proviso that factories must be in areas zoned for industry or in an industrial estate.

The life of foreign investment companies has been extended by allowing the renewal of the fixed operating license (IUT) for an additional 30 years. In other words, the initial licenses (SPPP BKPM) are valid for 3 years, plus 2 x 30 years, for a total of 63 years.

The process of incorporation of a new foreign direct investment company:

Initial License (valid for 3 years)

1. *Prepare and send the application with required documentation, compiled according to the investment plan. Set up a joint venture agreement if you are making the investment with Indonesian partners.*
2. *Obtain the Initial License (SPPP BKPM), valid for 3 years.*
3. *Incorporation:*
 - a. *Establish Articles of Association with a Public Notary detailing proof of capital investment and send it to the Ministry of Justice for approval and issuance of State Gazette*
 - b. *Registration of company address with local council (domicile)*
 - c. *Tax registration*
 - d. *Company registration with the Department of Industry and Trade.*

4. Key expatriate positions (work permits).

Fixed Operating License (30 years)

5. Prepare and send the 6-month report to the provincial BKPM office.

6. Incorporate facilities – Master list/APIT or property ownership.

7. Provincial approval for Fixed Licenses (BAP).

8. Fixed License (IUT) for 30 years is issued.

A Limited Liability company is established either under foreign shareholders or through a joint venture with Indonesians or wholly owned by Indonesian shareholders and must be approved by the Ministry of Justice. It does not matter who is the owner of an Indonesian Limited Liability company, but they must comply with Indonesian law and are considered an Indonesian company. The company can subsequently be changed or sold to the shareholders, either foreign or Indonesian.

THE DISTRIBUTION PROVISIONS

It should be noted when planning investment in the agrifood sector that under current regulations, foreign companies manufacturing in Indonesia may distribute their locally produced goods at the wholesale level, and may also apply for permits to import and distribute other products as well.

Companies engaging in wholesale distribution may not, however, conduct retail operations directly. To engage in retail operations, they must establish a separate retail company.

It is important to note that licensing processes may be affected by regional government regulation. These regulations should be carefully checked before selecting a manufacturing location.

REGIONAL INVESTMENT AUTHORITIES - BKPM

There are regional BKPM offices, known as BKPM (Badan Koordinasi Penanaman Modal Daerah)³⁰ which now have a high degree of decision-making power. They operate in association with other regional government agencies who may also have responsibility for issuing licences and approvals.

³⁰ Daerah is 'region' in Bahasa Indonesia.

Regional governments compete for investment, and this can enable the foreign investor to negotiate more attractive arrangements. Nevertheless the processes are only recently established, and procedures are still in a stage of evolution.

PROPOSED NEW LEGISLATION:

The Indonesian Government is currently drafting a unified law on investment that will replace the existing Domestic Capital Investment Law and the Foreign Investment Law and regulate investment in all sectors. The first draft was prepared in November 2001. The intention of the legislation is to incorporate market-oriented principles of investment policy and establish basic guarantees such as equal treatment of foreign and domestic investors, whenever possible and protection against expropriation of investment. There has been some suggestions that Indonesia will move from an 'approval' to a 'registration' process with new FDI projects or applications.

The SBY government has indicated that it will take action to introduce this new legislation in 2005. It is one of the election promises of the incoming government that is being watched very closely by the foreign investment community.

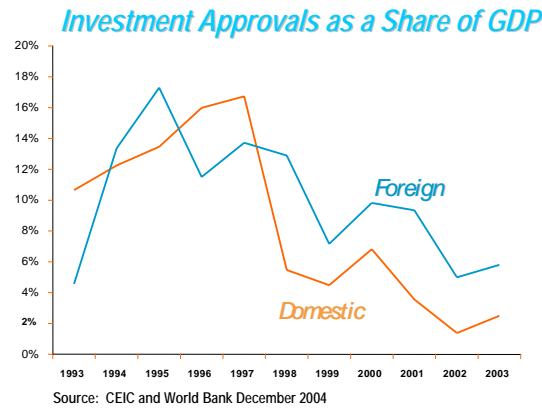
While the new legislation will undoubtedly stimulate new international interest in investment in Indonesia, the existing investment legislation facilitates most investments reasonably well. Obstacles tend to appear more at the project execution stage when dealing with implementing agencies and local governments.

THE CURRENT LEVEL OF INVESTMENT ACTIVITY

Although there has been considerable streamlining of BKPM processes, there is still a general gap between investment approvals and actual project implementation. About half of the approvals recorded appear to result in project realisation.³¹ There is, naturally, a time lag between approval and implementation of an investment, and this makes short-term comparisons difficult.

³¹ World Bank report – 15 December 2004

FIGURE 11: INVESTMENT APPROVALS AS A SHARE OF GDP, 1993-2003



In 2004, there were 177 domestic investment projects approved, compared with 202 in 2003, a fall of 12%. Looking behind the fall in aggregate figures, there was a drop in new (green field) projects from 171 to 155 but an increase in business expansion projects from 84 to 104 or 24%. This indicates increasing confidence by domestic companies to expand their operations.

TABLE 4: FOREIGN INVESTMENT APPROVALS FOR 2004

INDONESIA FOREIGN INVESTMENT APPROVALS	CY 2003		CY 2004	
	# projects	Value USD mn	# projects	Value USD mn
New projects	1,025	5,312	1,038	5,390
Project expansion	275	3,609	276	3,039
Change of status	150	5,126	149	1,847
TOTAL	1,175	14,047	1,187	10,277

Source: BKPM, December 2004

Indonesia counts three categories for investment:

- new investment
- expansions
- changes in status (which tends to inflate investment approval figures).

Changes in status occur when a foreign investor purchases a domestic company – partially or wholly – in which case the *entire* equity of the Indonesian company is added to the investment approval totals. Privatisation sales have tended to increase the amounts recorded in the *change in status* category of new investments significantly – and this has tended to inflate investment figures. This was particularly the case in the 2002 calendar year (see Figure 12).

In terms of investment activity in the food industry during 2004, there was a fairly wide range of activity (see Table 5).

TABLE 5: INDONESIA FOOD INVESTMENT ACTIVITY IN 2004, BY PROJECT VALUE.

	DOMESTIC INVESTMENT (PMDN)	FOREIGN INVESTMENT (PMA)
Food industry	28%	7%
Food crops & plantations	5%	1.5%

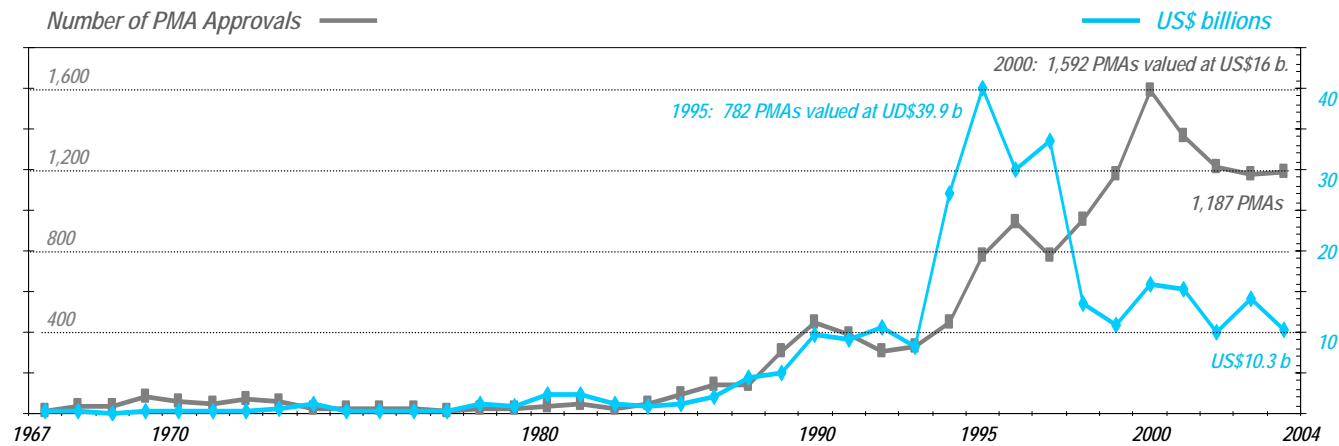
Source: BKPM

- In the domestic investment area, food industry projects represented 28% of approvals by value in 2004.
- For foreign investment, food industry projects were 7% by value of investments approved in 2004. These were valued at US\$4.2 million.

In both the domestic and foreign investment sectors, Indonesia is at something of a 'crossroads' where trends in the market place are yet to be manifested in official statistics. A combination of analytical and anecdotal data, however, does suggest positive trends in investment inflows.

Figure 12:

Trends in Indonesian Foreign Investment Approvals



Source: BKPM December 31 2004

Note: The above graph does not factor in the substantial devaluation of the Rupiah over the period 1995 to 2004.
The following are average Rupiah / Australian dollar exchange rates over the period 1996 – 2004 (Rupiah per A\$1.00)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Rupiah/AUD	1,786.2	2,048.0	5,010.8	4,210.1	4,904.0	5,311.0	5,064.4	5,584.5	6,578.0

Sources: RBA, except for the years 2000, 2001, 2002 – which are calculated from IMF/IFS cross rates.

THE INDONESIAN LEGAL SYSTEM³²

THE STRUCTURE OF THE LEGAL SYSTEM

The Indonesian legal system is complex. It is based on three distinctly different legal codes. Prior to the arrival of Dutch traders and colonists in the late 16th century, there were well-developed regional kingdoms, operating under sophisticated systems of *adat* (customary) law. Vestiges of these *adat* principles can still be deduced in various determinations today.

Dutch colonisation, over 350 years, left a legacy of Dutch law, and a number of colonial laws still have application today. After independence on 17th August 1945, the Indonesian authorities began to create a national legal system based on contemporary Indonesian precepts of law and justice, but also drawing upon Dutch systems and on customary practice. These three strands: *adat* law, Dutch colonial law and national law co-exist in modern Indonesian jurisprudence.

Indonesian commercial law is grounded in the *Commercial Code of 1847* - a relic of the colonial period – but has been extensively supplemented by a large number of laws enacted since independence. These include:

- the Banking Law 1992 (amended in 1998)
- Company Law 1995
- Capital Market Law 1995
- Antimonopoly Law 1999
- the Oil & Natural Gas Law 2001.

Adat law is not always obvious, although some *adat* principles such as '*consensus through decision making*' appear in current Indonesian legislation.

The Indonesian judicial system is composed of several types of courts under the oversight of the Supreme Court. Following the civil law tradition of the Netherlands, Indonesian courts do not apply the principle of precedent that is so familiar in common law jurisdictions. Similarly civil law systems in Indonesia do not use juries. Rather verdicts of guilt or innocence are decided by panels, composed of three judges. One of these judges is the Chair and is usually more senior than the other two judges.

Most disputes appear before the courts of general jurisdiction, with the court of first instance being the State Court. There are about 250 State Courts throughout Indonesia, each with its own territorial jurisdiction. Appeals from the State Court are heard before the High Court, of which there are around 20 throughout Indonesia. The High Court is a district court of appeal. Appeals from the High Court and, in some instances from the State Court, may be made to the Supreme Court located in Jakarta.

In 1998, the Indonesian authorities established the Commercial Court. Initially to handle bankruptcy and insolvency applications, its jurisdiction now can be extended to other commercial matters. Appeals from the Commercial Court proceed direct to the Supreme Court.

³² Information was provided by Dr. Benny S. Tabalujan from the National University of Singapore.

HOW THE LEGAL SYSTEM WORKS

Modern Indonesian legislation comes in a number of forms and understanding them is not straightforward. To assist with clarification, the Indonesian Parliament has issued the following official hierarchy of legislation:

- 1945 Constitution
- MPR (Parliamentary) Resolution
- Law
- Government Regulation Substituting a Law
- Government Regulation
- Presidential Decree
- Regional Regulation

A 2003 Asian Development Bank/World Bank study indicated that about 25% of companies surveyed rated the Indonesian legal and judiciary system as a 'major or severe constraint' to doing business. Survey data indicated that the process of enforcing contracts takes longer, and is more costly and complicated than in other countries in the region.

The practical effect of this is that most companies avoid the Indonesian legal system. About 10% of the disputes companies have with their clients are resolved in the courts, compared with 20% in Malaysia. Most companies work at resolving their disputes by negotiation.

There are also cultural factors at work, with negotiated settlements being generally preferred to adversarial litigation, along with the disadvantages of high court costs, length of proceedings and uncertain outcomes.

INTELLECTUAL PROPERTY ISSUES³³

Indonesian laws for the protection of intellectual property (IP) have been inadequate and a cause of concern for many foreign investors. The Indonesian Government has endeavored to reform its IP laws. In July 2001 it passed a revised Patent Law and amended the 1992 *Trademark Law*. In July 2002 it promulgated a new *Copyright Law*.

PATENTS

As noted above, Indonesia passed a revised Patent Law in July 2001, which increased fines for patent infringements and established an independent Patent Commission to rule on disputes and appeals. Products and manufacturing processes are patentable for up to 20 years. The law includes compulsory licensing provisions and limits patent protection to products that are 'implemented' in Indonesia – i.e. the inventor must produce a product or utilise a value-added process in Indonesia to obtain patent protection for the product or process.

The legislation does specifically exclude foods and beverages from protection, but it does cover foreign pharmaceutical patents.

³³ Data sourced from EIU and US Department of Commerce

TRADEMARKS

An amendment to the Trademark Law of 1992 was also passed in July 2001, and carries the following stipulations:

- the 'first-to-file' principle remains a prerequisite for establishing trademark rights
- the registration process takes 14 months – assuming no opposition from a third party
- registration of a licence with the Directorate-General is mandatory
- protection lasts 10 or 20 years, depending on the type of mark
- infringement cases are heard in a commercial court, rather than the general district court, with a limit on the length of time any one case can take.

As enforcement mechanisms are still developing, companies tend to initiate legal action to resolve their dispute.

Among other considerations, the law recognises that a joint venture has as much right to a trademark as its parent and that the intention of the law is to protect the public against counterfeits of brand-name products. However, the law affords protection only to those who have registered a trademark (in Indonesia or elsewhere), rather than to the bona fide first user of a mark.

The Directorate of Trademarks still has a large backlog of application registrations. The process now takes more than two years. Moreover, applicants report that, even after registration of a trademark has been granted, the Directorate can take up to 12 months to issue a certificate of registration, which is needed to commence enforcement proceedings.

INDONESIAN FOOD STANDARDS AND LABELLING REGULATIONS³⁴

The *Indonesian Food Act of 1996* is the primary legislation regulating national food standards. This legislation has been supplemented by a number of implementing regulations and decrees. For example, the *Consumer Protection Act of 1999* contains general provisions applicable to food labelling.

- Indonesia's *Food and Drug Control Authority* (BPOM) is responsible for food labelling and registration approvals.
- One of the key requirements for processed food manufacturers is obtaining a registration – for either an ML (imported product) or MD (domestic product).
- The labelling regime is covered by the Consumer Protection Law of 1999.

³⁴ The US Department of Agriculture issued a comprehensive Country Report in March 2004 on Indonesian Food Regulations and Standards. The reference is GAIN Report ID4009 which can be downloaded from the USDA web site at www.usda.gov.

Packaged food products must be labelled using the Indonesian language, Arabic numbers and Roman text. The key points of the current labelling legislation under the *Food Act 1996* include the requirements that the label of the product contain:

- the name of the product
- a list of ingredients
- net weight or volume in metric units
- name and address of the manufacturer
- advice on whether the product is 'halal' (processed to Islamic standards), and
- date of expiry.

Specific labelling is required for milk products, baby food, alcoholic beverages and particular halal food. There are also requirements for products containing GMO ingredients or products that have been irradiated.

Nutritional labelling is not mandatory, but is subject to regulation if claims are provided. Regulation in this area is variable, although the principles are clear in relation to therapeutic or health claims. These are outlined in detail in the USDA document referenced earlier, and are similar to international practice, in that any health claims must be substantiated. Functional claims that are not misleading are permitted.

Hence, such claims as 'fibre aids digestion' are acceptable, but ones such as 'vegetable protein prevents ulcers' are not. The use by or expiry date must also be shown on the package.

The experiences of food producers in obtaining approvals for their products are variable. There is some suggestion that the process is more complex and delays more common for the ML registration system for imported products than it is for MD or Indonesian-produced goods.

It is worthwhile spending time to understand the system and not leaving the process of registration entirely to a local agent, as they may seek to claim ownership of the registration documentation – although the registration is for the product and can be transferred with changes in agency representation. Austrade and other market advisors can provide valuable insights into the necessary procedures.

Most Indonesian manufacturers interviewed for this report did not regard the MD process as particularly onerous, although they often experienced difficulty with the level of detail required regarding ingredient composition. Delays in issuing registrations are not uncommon.

Most Indonesian companies have administrative staff who ensure their registrations are up to date and know how to expedite approvals for new products. It is useful to take time to understand these processes, and to be able to display that knowledge appropriately.

SEEKING GOOD ADVICE

Australian companies, large or small, do require sound advice from local practitioners and are well-served by a variety of Australian legal firms as well as accounting and financial advisory groups.

Many Australian lawyers and financial advisers are well-versed in investing in Indonesia. The global accounting firms in Jakarta virtually all have Australian partners and staff, as well as accumulated Indonesian experience within their Australian operations.

Given the nature of the investment process, there are inevitably many other agencies, in addition to BKPM, and other advisers involved in the investment process. The following 'road map' attempts to provide more of a visual guide to the steps required to establish an operation in Indonesia – and who to contact in the process.

ASSESSING THE INDONESIAN MARKET – FOR COMPANIES NEW TO THE MARKET

Investment requires a far deeper understanding of the nature of a market – its structure and characteristics – than does general merchandise trade. A company that has been trading successfully in Indonesia for many years, no matter how familiar they consider they are with the way business is done, requires still specialist advice before investing.

This following check list addresses some of the basic business issues that need to be considered when developing a strategy for investment in Indonesia. The following advice assumes some prior familiarity with the Indonesian market. Individuals who have limited knowledge of the Indonesian trading environment are recommended first to read the publication *Food Exporters' Guide to Indonesia*.³⁵

TABLE 6: A CHECK LIST OF ISSUES IMPACTING INVESTMENT DECISIONS.

ISSUE	How To Do It	RESULTS
<i>What is the advantage of manufacturing my product, or delivering my service in-market rather than direct from Australia?</i>	Seek out free/low cost market information from public domain sources (e.g. DFAT, DAFF, Austrade, State Government publications, USDA, IMF, World Bank and academic papers etc.).	Freely available information on the internet gets you across a range of issues quickly. Federal and State Government organisations also have useful information in-house, and can provide advice on where to access other current data available internationally.
	Assess how your prime foreign competitors are positioning themselves in market. Use Austrade and/or a local business consultant and talk to other companies that have a presence in Indonesia.	This will help to equip you formulate the right sort of questions to be asked for a more detailed market analysis.
	Attend networking functions held by AIBC, Chambers of Commerce, Department of Foreign Affairs & Trade, Austrade and State Governments. Learn from others' experiences.	Better able to assess what your local associates, business partners, clients and customers are proposing with regard to local establishment – and enables you to begin to calculate the costs and benefits of direct investment.

³⁵ Available on the Department of Agriculture, Fisheries and Forestry website: <http://www.daff.gov.au>

<i>A SWOT analysis</i>	Price surveys from buyers and Austrade. Identify and analyse offshore and onshore competition.	Time spent on researching competition may save many expensive visits and negotiations.
<i>Assess the nature and scale of the business engagement required – from representative office to a more complex business arrangement?</i>	Deeper discussions with Indonesian end-users, intermediaries and consultants. Rigorous analysis of establishment costs.	Decide whether your company needs a 'bricks and mortar' type presence or whether the market is best serviced by direct exports.
<i>Identify the 'big issues'</i>	Talk to companies that are successful in the market. Try to determine why they succeeded and seek anecdotal data on why others failed. The lessons of failure are often as important as the lessons of success.	Focus on and prioritise the major factors needed for success – and their cost to acquire. Provides clearer vision for overall business planning and cost analysis.
<i>What type of business structure is best suited to developing the Indonesian market for my product/service?</i>	Approach legal and accounting firms as well as business consultants and advisers who have the best track record in your market sector. Endeavour to ensure their advice is impartial.	Assess consultants' advice against your objectives, and benchmark against costs/benefits of similar scale investment in home market and alternative offshore locations.
<i>Create a business plan</i>	Develop realistic timelines, validating them with the advice of those familiar with the process, rather than promoters of investment who will present an optimistic view.	Calculate return on investment parameters and identify project milestones in the business establishment process.
<i>Contingency Planning</i>	Approximate or model possible changes in key variables (e.g. exchange rate movements, political risk, commercial risk, left field factors [e.g. bird flu outbreak]), and consider possible impacts and responses to minimise negative effects.	Minimise the number of 'nasty surprises'/shocks.

FINDING THE RIGHT LOCAL INVESTMENT PARTNER

Partner searches are usually the most critical – and most difficult – aspect of establishing an offshore business. There are no guaranteed rules.

Some companies have been successful in identifying their local partners or associates on first meeting. Long-term experience indicates that a carefully planned, analytical process substantially reduces the risks associated with partner selection. As with

marriage – the golden rule is *don't rush into it*. Table 7 provides some suggested guidelines:

TABLE 7: PARTNER SEARCH GUIDELINES

<i>HOW TO DO IT</i>	<i>THE PROCESS</i>
Develop a profile for the ideal partner. Leave the 'chemistry' till later.	Assess needs for financial resources, manufacturing capability, distribution reach and technical resources.
Conduct extensive desk research before setting foot in the market. The internet delivers huge productivity gains.	Buy market research reports on your industry sector. Many companies sell reports by segment to reduce costs.
Assemble a list of prospective partners using Austrade, business consultants & networking.	First hand referrals from Australian companies in related fields are valuable.
Plan a structured business visit with as many confirmed meetings as possible.	Take a vertical 'slice' of the market and meet contacts from government, chambers, industry associations, end-users, manufacturers, wholesalers, agents, advisers and consultants.
Blend advice from a variety of sources to gain a 'whole of market' view, not just the perspective from a distributor or agent.	
Keep a broad perspective and avoid premature commitments.	Use Austrade, State Governments or consultants to fix meetings. Arrange meetings directly wherever possible for maximum impact.
Develop a short list of potential business partners, with high weighting on industry referrals and evidence of track record.	Undertake credit and other background checks on prospective partners, and contact other foreign companies they are associated with.
Consider inviting potential partners to Australia to judge their 'fit' with your operations, your associates and business advisers.	Austrade's EMDG scheme may assist with the costs of these visits.

Foreign companies that have been successful in Indonesia overwhelmingly attest to the importance of an effective local partner or associate. Even companies that are wholly owned subsidiaries of major foreign companies have agreements with distributors and other forms of commercial alliances. These can prove invaluable in negotiating one's way through an often opaque trading environment.

Time spent at the identification and selection stage pays huge dividends. The costs of an inappropriate or failed partnership are incalculable and will compromise the success of the venture. The Indonesian legal process does tend to favour the local company and litigation can be expensive, time-consuming and often inconclusive.

FORMING A BUSINESS ENTITY IN INDONESIA

There is an increasing range of choices for establishing a business structure in Indonesia, and many of these are not as expensive as a traditional joint venture (JV) operation.

Some of these options are listed in the following table, along with comments on their suitability for various business models.

TABLE 8: BUSINESS STRUCTURE OPTIONS.

<i>BUSINESS STRUCTURE</i>	<i>FEATURES & BENEFITS</i>	<i>COMMENTARY</i>
Joint Venture Company	The most commonly used model for South East Asian investment – principally because of various controls on the degree of foreign ownership. Like other successful business models, it relies on the quality and ‘cultural fit’ with the local partner. Advantages are many, notably navigating the local bureaucracy and ‘getting things done.’ Access to the partner’s distribution network is often the critical factor in JVs.	Will continue to be the favoured business model for many major manufacturing operations. It is generally the format encouraged by host government regulatory systems. Identification and selection of partner is naturally critical and should be undertaken in a well-considered fashion, although in some industries a ‘natural partner’ is evident. Partner selection is the most critical step for successful JVs.
100% Foreign-owned Company	An option that has become more widely available in recent years with following varying degrees of deregulation and one that has been successfully used by many companies. It has the advantage of independence in decision-making – but without the local insights of a JV partner. Corporate structure is simple and offers agility in adapting to market conditions.	Sound models include non-equity alliances with local companies who have a strategic stake in the business (e.g. contract manufacture, distribution and marketing) providing ‘insider’ advice a JV partner would normally deliver.
Acquisitions	Indonesia’s mergers and acquisition (M&A) boom of 1998-2001, many foreign companies participated in ‘bargain basement’ purchases of Indonesian assets – that had been severely discounted by the financial crisis. Prices and asset	As the Indonesian economy increasingly opens to global forces, sound M&A prospects continue to appear – and exchange differentials make acquisitions attractive. In the food sector, there are

values are now, however, some excellent Indonesian recovering. Access to international brands and technology, as well as the opportunity to move into export markets, continues to encourage Indonesian firms to seek out well-positioned, foreign equity partners.³⁶

Licences & Technical Associations

The deregulated Indonesian environment now offers many more opportunities for non-equity business alliances, notably in the retail and distribution sectors, as well as franchises. Financial risks are low but strong attention must be paid to brand protection and product or service quality assurance.

Choice of business partner is critical as these arrangements rely heavily on a high degree of trust in view of imperfect legal and policy settings. There is now considerable legal and financial advisory experience to develop business structures of this nature.

Commercial Agreements

This category covers a wide range of business associations which do not involve equity, but which bind the companies in commercial agreements that are outside the traditional 'agent/principal' model of export/import trade.

Australian legal and financial advisory firms can suggest a range of business models tailored to specific commercial circumstances.

Third Country Associations

Investment engagement in Indonesia from Singapore and Malaysia is high. Locating Singaporean and Malaysian (and other Asian) companies whose interests are complementary can provide a highly effective market entry model, which builds on the experience of the other parties. Time spent in searching out potential business associates in South East Asia can prove highly profitable.

A range of engagements is possible, from a buy-in to a technical or commercial association. Most importantly, Australian companies should seek out alliances of this nature, rather than taking an Indonesia-only approach. South East Asian companies are well-embedded in Indonesia and are increasing their investment presence.

³⁶ The series of DFAT publications *Subsistence to Supermarket II Series, Volume I: Agrifood Multinational Corporations in Asia*, December 2001, Appendices 2 and 4, provide an extensive listing of FDI in the agrifood sector in Indonesia and the rest of Asia during the Asian financial crisis.

Australian Associations

There is nothing new about 'piggy back' arrangements with other Australian companies where the experience of the partners is complementary. These types of associations are more prevalent in remote and 'difficult' markets in the Middle East and Africa but the model is equally valid in Indonesia.

Finding the right partner and the correct 'fit' is never easy but Australian companies often 'go it alone' without researching potential alliances with other Australian companies – even competitors – but where business interests can be complementary. These types of arrangements can also deliver huge cost savings, particularly at start-up.

EXPATRIATE REPRESENTATION:

A question that generally looms large in the mind of a potential investor is whether to appoint expatriate management or not. Expatriate packages are an expensive option, and there are often alternatives, such as contracting the services of a locally based consultant to oversee the company's interests and provide an on the ground presence, particularly during the establishment phase. Regular visits from Australian executives are naturally necessary, taking care to avoid prolonged stays, which may have taxation implications.

If expatriate representation is essential to establish a company's presence and ensure that work practices and standards reflect those of the parent company, there is a range of options to consider. Through judicious attention to the structuring of salary packages, as well as arrangements for accommodation and transport etc., reasonable and effective provisions can be made. The major accounting firms are well-experienced in providing detailed advice on the various options available.

LICENSING:

As an alternative to the above, many companies license their products and services in Indonesia to avoid the cost and time to establish a local operation and to avoid the complexities of operating in a foreign tax regime. This mode of entry often has appeal to small and medium size enterprises (SMEs) where both financial and human resources are limited.

While this option has many attractions, it requires particular care in the selection of a local associate. There are many examples of highly successful licensing structures, and the food franchise sector is one area where a number of Australian companies have followed this route.

Sound local legal advice is necessary in the establishment of agreements and contracts. Fortunately, there is a great deal of experience to call on when framing these arrangements.

Protection of intellectual property in Indonesia can be both difficult and expensive, and establishing high levels of trust with an Indonesian business partner is critical in arrangements of this nature. As noted previously in other areas of litigation, bringing IP disputes before the local courts is both costly and time-consuming.