

Political and Economic Risk Consultancy, Ltd.

A Compilation of Reports

REPORT 1

Batam Risk Report

Final Report

October 2003

REPORT 2

Batam: A Formula for Growth

Summary Paper of the Executive Investment Forum in Batam

June 2003

Prepared by:
Robert C. Broadfoot
Managing Director

Political and Economic Risk Consultancy, Ltd.

Batam Risk Report

Final Report

October 25, 2002

Batam Industrial Development Authority

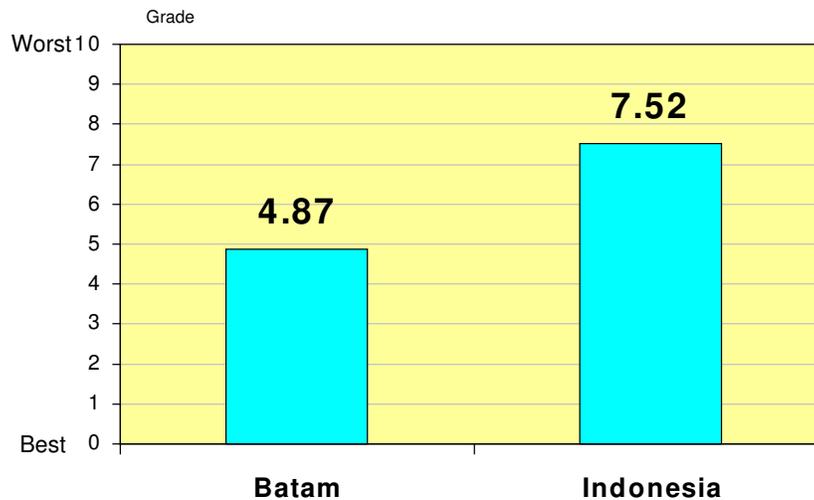
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1 Executive Summary

Comparing Batam Risks with overall Indonesian Risks



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

Foreign investors working in Batam consider the business environment to be less risky than overall Indonesian risks, especially from the perspective of labor-intensive companies manufacturing products for export to other countries in Asia, North America and Europe. Batam's physical infrastructure is superior. It is easier to import raw materials and equipment and to export finished product than it is from other places in Indonesia. Perhaps most importantly, Batam's close proximity to Singapore enables companies to take advantage of infrastructure, banks, and other supporting services that Singapore has to offer. This gives Batam an advantage not only to other places in Indonesia but also to other free trade zones in Southeast Asia. None have links with Singapore that are as close as Batam's.

Some expatriate perceptions toward Batam are worse than those toward all of Indonesia. The cost of labor is higher, for example. The problem of labor activism is rated more harshly. There are also growing concerns about personal security risks.

These problems notwithstanding, Batam's overall risk score is considerably better than Indonesia's. Expatriate perceptions toward Batam are also better than perceptions of expatriates in most other Southeast Asian countries toward their places of employment. Singapore and Malaysia are the two exceptions.

The graph above shows the comparison between perceptions toward Batam and those toward all of Indonesia when evaluated against the same set of variables (as presented in Appendix 1). The chart on the next page gives the overall scores of our survey and the scores of the major categories of variables for Batam, Indonesia, and a broad selection of other developing countries in the Asian region.

Batam Is Competitively Placed Within the Region

	Batam	China	India	Indonesia	Mal.	Phil.	Sing.	Thai.	Viet.
a) External variables	3.89	3.45	8.22	4.67	3.38	4.96	3.74	4.26	3.44
b) Foreign investor variables	4.06	5.88	6.51	6.93	4.20	5.16	2.26	5.46	5.16
c) Physical infrastructure	4.31	5.04	7.15	7.41	3.95	6.27	0.52	4.71	6.45
d) The ease of doing business	4.49	7.36	8.57	7.94	5.77	6.63	2.47	6.58	6.84
e) Domestic social environment	5.00	4.67	6.27	7.73	3.93	5.25	2.37	4.02	4.34
f) Quality of expatriate life	5.04	3.73	5.68	6.50	3.52	4.51	2.02	3.02	5.03
g) The political environment	5.49	6.58	7.81	8.49	5.53	7.05	1.63	6.45	6.36
h) Natural environment	5.27	7.93	8.43	9.12	4.69	8.07	2.32	7.51	6.97
i) Education and human resource variables	5.52	4.05	4.20	6.90	4.91	4.97	3.17	6.06	4.96
j) Institutional quality, accountability and standards	5.59	7.72	8.03	9.51	6.29	7.64	2.28	8.08	7.46
TOTAL SCORE	4.87	5.64	7.09	7.52	4.62	6.05	2.28	5.61	5.70

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

After discussing in Section 2 our methodology for arriving at these numbers, Section 3 this report examines in more detail the individual categories of variables that together form the total score.

2 Methodology

The data for this report comes from two different surveying exercises. The data that relates specifically to Batam comes from 61 face-to-face surveys that PERC conducted during September 2002. There were three main groups of business people. One was company managers residing in Singapore and Hong Kong who have investments in Batam. The nationality of these people was Singaporean, Hong Kong Chinese, Japanese, American, Australian, or European. None were Indonesian citizens. All had first-hand experience in dealing with their Batam operations. All also had experience in doing business in other parts of Asia.

A second group was managers of foreign direct investments in Batam. We interviewed 23 such people face-to-face during one week in Batam. Of the survey group, 21 were expatriates (mainly Singaporeans, but also Americans, Japanese, Germans and Australians). Two were Indonesian passport holders, both of whom were the resident managers of foreign direct investments in Batam.

The third groups of 15 were expatriate managers of foreign direct investments who were residing in Jakarta. We did not ask this group questions relating specifically to Batam. Instead, we asked them about business conditions in Jakarta (focusing mainly on infrastructure facilities there). This gave us data we used to compare against Batam in Section 3.3 of this report.

As can be seen in Appendix 1 of this report, most of the survey questions asked respondents to provide a grade of between zero to 10, with zero being the best grade possible and 10 the worst. The overall scores presented in this report are straight averages of these responses. A few questions asked for textual responses (like name Batam's three biggest strengths and its three biggest weaknesses). In these cases, we combined all the responses and then divided them into major categories.

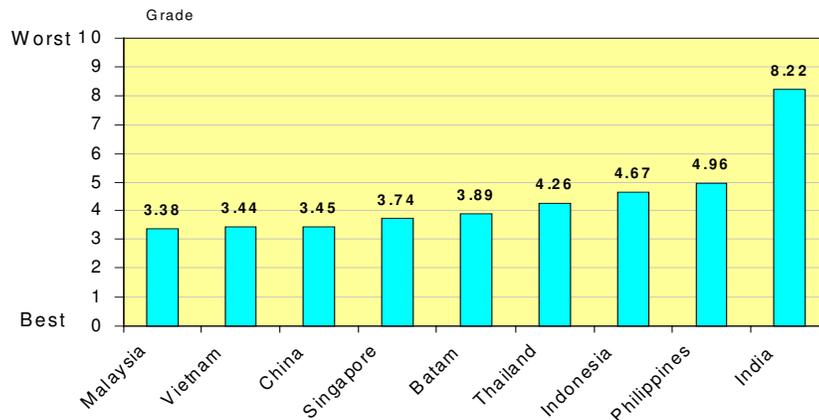
We used a different survey to arrive at the broader country grades used for comparison against Batam. PERC conducted this survey in the first half of 2002. In some cases, responses were in face-to-face interviews. In other cases, respondents replied to a direct mailout questionnaire. All respondents were expatriates working for foreign direct investments. Respondents provided grades only for the country in which they were working, not for other Asian countries. In each country, there were at least 50 responses, except for Vietnam, where the total grade was based on 35 responses.

Each major category grouping presented in Section 3 of this report shows the wording of the variable that related to Batam along with the comparable variable that was asked about the overall national conditions. In most cases, they are exactly the same, although in a few cases the wording was modified so that the respondent was directed to focus his or her answer specifically to conditions in Batam, not to all of Indonesia.

3 An Analysis of Major Categories of Risk That, Together, Define Overall Risks for Batam

3.1 External political risk variables

Vulnerability to External Variables



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

Batam is not perceived to be particularly vulnerable to or immune from external risks like the threat of international terrorism, developments within ASEAN or fallout from social instability elsewhere in the region or the world. In most cases, its grades mirror those of all of Indonesia. The significance of this is that it indicates the bias of our expatriate audience in Batam is not very different from the bias of expatriates living in Jakarta (who dominated the national-level grades).

However, there are a few reasons why Batam's grade is lower than Indonesia's overall grade. Most importantly, expatriate managers in Batam consider the island's relations with Singapore to be particularly strong. This is less on a diplomatic level than on the way the two economies interface with each other. The close proximity of Batam to Singapore – it is less than an hour's ferry ride away – means that foreign managers of investments in Batam can travel to and from Singapore much more easily and frequently than expatriates in other parts of Indonesia can physically interface with other countries. The variable in this section that reflects this most clearly is the one that asked about Batam's economic links with neighboring countries. It is much better than Indonesia's overall grade.

Expatriates in Batam also perceive that the island has better relations than overall Indonesian relations with trading partners lying further away, namely, Japan, Taiwan, the US and Europe, although its main commercial ties are directed toward Singapore and companies from other countries that have regional offices there. This is probably because Batam is much more focused on exports than is generally the case in Indonesia. Politics has not interfered with this business focus.

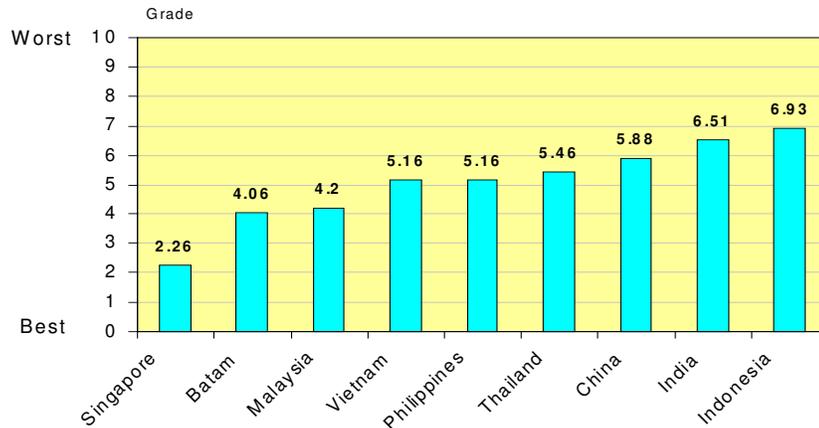
Our survey audience in Batam was just as sensitive to ASEAN security concerns as were expatriates residing elsewhere in the region – even more so, judging from Batam's higher grade. However, expatriates residing in Batam seemed to be more comfortable than their counterparts elsewhere in the region that Batam would not be upset by social instability in other countries, including outside the immediate ASEAN area. For example, Batam's population did not react strongly one way or another to the September 11, 2001 terrorist attacks on the US or the ensuing war in Afghanistan. At this point in time, the debate over the US position on Iraq is also not a major point of focus or concern in Batam the way it is in many other parts of Asia, including other parts of Indonesia. In this sense, Batam seems to be more apolitical toward such issues. This is contributing to a more stable social environment in which foreign investors in the Batam seem to find comforting. Batam's focus is much more on export-oriented manufacturing business than on regional or international politics, and foreign investors expect it to stay this way.

External political risk variables										
<i>Variable in Batam survey</i>	BATAM	<i>Variable in region-wide survey</i>	CH	INDIA	INDO	MA	PH	SI	TH	VN
Vulnerability of Batam to security concerns in ASEAN region	5.07	Regional security	2.67	8.33	4.67	4.29	6.33	4.3	4.44	3.88
Direct military threats to Batam	3.65	Direct military threats	2	7.67	3	2	4.92	3.71	2.33	2.38
Batam's relations with neighboring countries	3.30	Diplomatic relations with neighboring countries	1	9.5	5.67	2.43	3.83	4.43	4.78	3.5
Batam's economic links with neighboring countries	3.42	Economic links with neighboring countries	5	8	5	3.14	4.25	3.14	4.78	3.38
Fallout in Batam from social instability in other countries	3.70	Fallout from social instability in other countries	5	9.5	4	4.14	5.58	4.43	4.89	3.63
Batam's relations with major trading partners	4.21	Relations with major trading partners	5	6.33	5.67	4.29	4.83	2.43	4.33	3.88
AVERAGE GRADE	3.89		3.45	8.22	4.67	3.38	4.96	3.74	4.26	3.44

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

3.2 Foreign investor variables

Foreign Investor Variables



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

Foreign investors perceive that they are treated far better in Batam than is the case elsewhere in Indonesia and also compared with most other developing countries in Asia. The whole focus of Batam's industrial zone development has been to attract foreign investors in export-oriented manufacturing activities. Consequently, the authorities have made the investment approval and licensing process quite straightforward and have made it comparatively easy for expatriate staff to get employment visas.

The expatriates we interviewed were generally complimentary to the way the managers of the industrial zones where they were located played an interfacing role that helped to reduce bureaucratic problems and address other issues. The Batam Industrial Development Authority was also given high marks for its role in addressing the concerns of foreign investors.

Because Batam is so export-focused, investors do not normally encounter the types of discrimination that are frequently encountered in other parts of Indonesia, namely, by local special interest groups who are trying to protect their position in certain industries that generally cater to the domestic market. For much the same reason, new investors are generally welcome and existing investors are more positive about the levelness of the playing field than were investors in all other countries covered by this report except Singapore.

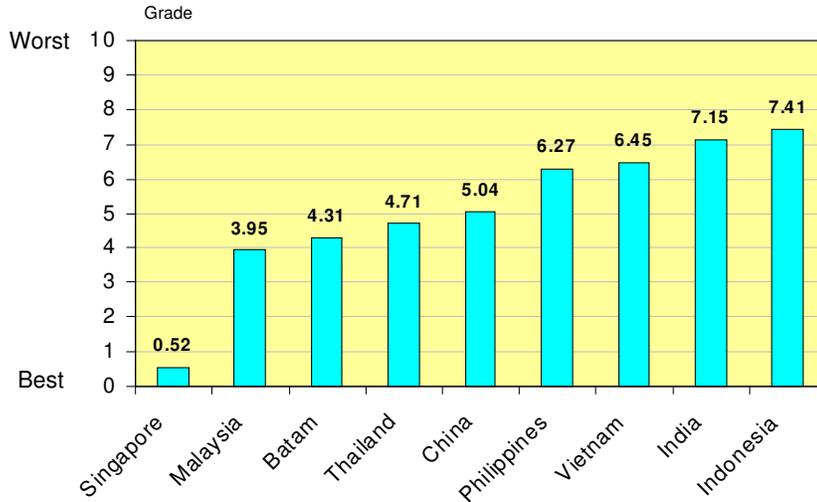
Many of the managers we interviewed were ethnic Chinese from Singapore. They did not think racism was a problem or feel that they had trouble interfacing with the local population. The other nationalities we interviewed were similarly positive. We felt the response of the ethnic Chinese was significant, however, because of the reputation of other parts of Indonesia for having serious strains between ethnic Chinese and indigenous Indonesians. This does not seem to be a problem at all in Batam.

Foreign investor variables										
Variable in Batam survey	BATAM	Variable in region-wide survey	CH	INDIA	INDO	MA	PH	SI	TH	VN
Discrimination against new foreign direct investment in Batam	3.40	Discrimination against new foreign direct investment	5	6.67	6.17	3	4.5	2.1	5.89	3
Levelness of local playing field for existing foreign investors	3.68	Levelness of local playing field for existing foreign investors	5	7.58	6	4.43	6.55	2.7	5.67	6.25
Transparency of investment approval and licensing process	3.80	Transparency of investment approval & licensing process	6	7.58	8.25	4.86	6.08	2.4	5.78	5.5
Ease with which indigenous population interfaces with expatriate population	3.86	Ease with which indigenous population interfaces with expatriate population	5	3.4	6.33	2.71	2.75	2.9	4.44	5.25
Immigration policy for expatriate staff and other talent	4.00	Immigration policy for expatriate staff and other talent	5	5	5	5.57	4.75	1.7	5.67	5.63
Extent that nationalism is an impediment to foreign investment	4.72	Extent that nationalism is an impediment to foreign investment	5	7.33	7.33	4.71	5.75	1.8	4.78	6.13
Mechanisms for foreign investors to communicate their concerns to the local Batam authorities	4.37	Mechanisms for foreign investors to communicate their concerns to the government	8	6.67	8.33	3.29	5.33	2	5.22	4.13
Responsiveness of the local Batam authorities to concerns expressed by foreign investors	4.66	Responsiveness of the government to concerns expressed by foreign investors	8	7.83	8	5	5.58	2.5	6.22	5.38
AVERAGE GRADE	4.06		5.88	6.51	6.93	4.20	5.16	2.26	5.46	5.16

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

3.3 Physical infrastructure

Physical Infrastructure



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

This section looks at how foreign investors perceive the quality of physical infrastructure that exists to support their operations. Batam's infrastructure is superior to that which exists elsewhere in Indonesia for purposes of supporting factories that need to import materials and export their finished products. The reasons for this are as follows:

- It is much easier to move materials and equipment into Batam through its port and airport from foreign supply sources than it is to other parts of Indonesia, including Jakarta.
- It is also easier to export finished product out of Batam's port and airport than it is to other parts of Indonesia, again including Jakarta.
- The basic infrastructure like electric power and water is comparable to what is available in Jakarta and superior to most other parts of the country, where investors frequently need to put in this type of infrastructure themselves. There are points that need improvement, but those using the facilities do not rate these as major obstacles.
- Batam benefits from its proximity to Singapore, which gives investors the ability to use infrastructure in Singapore when facilities are lacking in Batam. An example here is medical facilities.

Physical infrastructure										
<i>Variable in Batam survey</i>	BATAM	<i>Variable in region-wide survey</i>	CH	INDIA	INDO	MA	PH	SI	TH	VN
Telecommunications system	3.41	Telecommunications system	4.33	6.33	6.00	4.71	4.17	0.40	4.56	7.75
Internet and services supporting it	4.40	Internet and services supporting it	6.33	4.00	6.67	6.00	5.08	0.90	5.22	8.00
The local road system	5.69	The local road system	6.00	8.00	7.67	3.29	8.25	0.50	6.22	7.75
Container port facilities	4.73	Container port facilities	5.67	8.33	8.00	3.00	6.42	0.11	5.38	5.63
Freight forwarding facilities	4.11	Freight forwarding facilities	6.00	8.33	8.00	3.57	6.17	0.33	4.88	5.13
Airport facilities	3.32	Airport facilities	4.33	8.33	7.33	2.86	7.50	0.20	4.67	6.13
Access to airport	3.24	Access to airport	3.00	7.00	5.33	3.14	7.50	0.20	3.00	3.63
Electric power	4.96	Electric power	3.67	7.00	8.67	4.43	5.75	0.70	3.33	7.00
Water and other utilities	4.90	Water & other utilities	6.00	7.00	9.00	4.57	5.58	1.30	5.11	7.00
AVERAGE GRADE	4.31		5.04	7.15	7.41	3.95	6.27	0.52	4.71	6.45

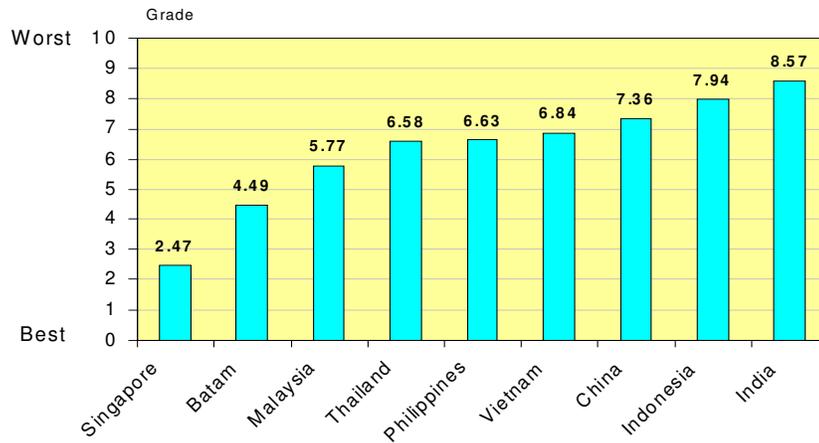
Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

Comparisons with Jakarta		
	Batam	Jakarta
The ease of importing capital goods and other necessary materials through the seaport	2.80	5.33
The ease of importing capital goods and other necessary materials through the airport	2.60	4.00
The ease of exporting finished product through the seaport	2.00	4.65
The ease of exporting finished product through the airport	1.50	4.50
Reliability of electricity supplies	4.20	5.27
The quality and reliability of water supplies	4.60	5.92
The quality of telecommunications facilities	4.60	4.19
Access to quality medical facilities	6.80	6.12

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

3.4 The ease of doing business

The Ease of Doing Business



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

The section looks at bureaucratic obstacles to doing business. It covers how the government interferes in business, either directly through such means as state-owned enterprises or indirectly through regulations. It also looks at how easily companies can use the system to protect such interests as intellectual property rights.

Because Batam's business environment is geared toward export-oriented manufacturing, it is not complicated by domestic monopolies and cartels that have affected the environment elsewhere in the country or in most other places in the ASEAN region. For the same reason, the local bureaucracy is easier to work with for such matters as licensing, obtaining the necessary trade permits, and protecting intellectual property.

It is easier to ship product out of Batam to foreign markets than it is to move product from Batam to other parts of Indonesia. Although this is not an altogether positive feature of the environment, it has greatly reduced the risk that technology and other intellectual property will be pirated. No one we interviewed cited this as a major problem. It is much less a concern in Batam than it is elsewhere in the region, with the single exception of in Singapore.

Batam remains very competitive compared with other Southeast Asian export-oriented production bases. China is a growing competitive alternative, however. The managers we interviewed all expressed this concern. They noted that they still have a competitive advantage in terms of costs when shipping to Singapore and most other parts of Southeast Asia. One problem, however, is that some of their customers are investing more in China and that they would prefer to be supplied by local sources than by more distant sources like Batam.

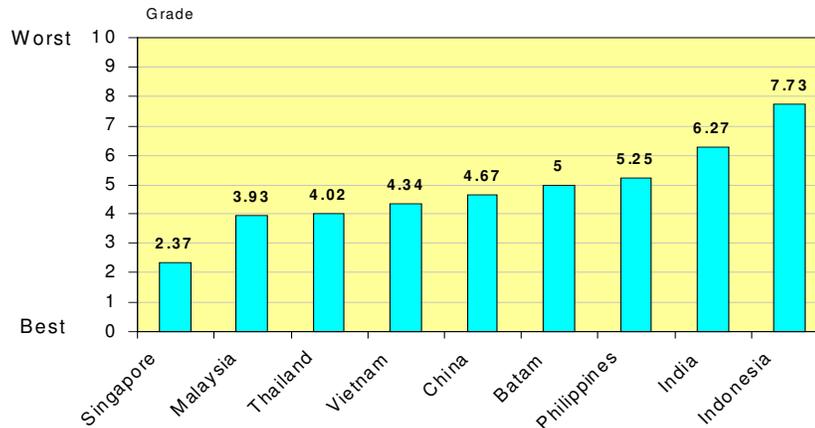
In this sense, Batam is facing a similar competitive challenge as other places in Southeast Asia, namely, how to compete against China and also to profit from the Mainland's growing importance as a market. Our survey indicates that Batam is better positioned than most other places in Southeast Asia since its labor costs are generally lower and companies there can take advantage of their proximity to Singapore's support facilities and services.

The ease of doing business										
<i>Variable in Batam survey</i>	BATAM	<i>Variable in region-wide survey</i>	CH	INDIA	INDO	MA	PH	SI	TH	VN
Existence of monopolies and cartels in Batam that close industries or distort market forces	3.94	Existence of monopolies & cartels that close industries or distort market forces	7.5	8.33	8.67	5.71	6.58	3.3	6.78	7
Level of competition between public and private sectors in Batam	4.38	Level of competition between public & private sectors	7.5	7.83	6.33	5.29	5.25	3.7	5.22	5.63
Bureaucracy / red tape in Batam	4.64	Bureaucracy/red tape	8.5	9.67	9.33	7	8.08	3.1	7.89	8.13
The ease of establishing a company in Batam	4.37	The ease of establishing a company	5	8.33	7.5	5.14	6	1.4	5.33	5.25
Official and unofficial barriers to imports of goods and services in Batam	3.94	Official & unofficial barriers to imports of goods & services	8	8.67	5.33	5.86	5.58	1.44	6.78	7
Existence of intellectual property rights pirates in Batam	5.31	Existence of intellectual property rights pirates	9.67	8.75	9.83	6.43	7.58	2.8	8.78	8.25
Degree to which local legal system can be relied on to defend against intellectual property rights abuses	5.34	Degree to which local legal system can be relied on to defend against intellectual property rights abuses	9	9	10	6.43	7.25	2.8	6.89	7.88
Competitiveness of Batam vs. rest of Indonesia and other ASEAN countries	3.99	Regional competitiveness	3.67	8	6.5	4.29	6.73	1.25	5	5.57
AVERAGE GRADE	4.49		7.36	8.57	7.94	5.77	6.63	2.47	6.58	6.84

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

3.5 The domestic social environment

Domestic Social Environment



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

The strongest point of Batam's domestic social environment is the comparative absence of religious and ethnic tensions that are evident in many other parts of Indonesia. There is little conflict between the indigenous population of Batam and those who have migrated to the island from other parts of Indonesia. The indigenous population is very small. Most Indonesians working there come from other parts of the country.

The managers we interviewed were critical about two aspects of Batam's social environment. First, they noted deterioration in the law-and-order situation, which they ascribed mainly to the rapid influx of people from other parts of Indonesia to the island. Many do not have jobs or the papers that give them the legal right to find one. Out of desperation, some of these people turn to robbery and other crimes.

This problem should be kept in perspective. It was not something that was prompting businessmen to flee the island. However, considering that many of the people we interviewed were Singaporeans who were comparing conditions in Batam with those that exist in Singapore, they were benchmarking against the place in Asia with the lowest crime rate. Perhaps the more significant point is that long-time expatriate residents of Batam had noted that the problem of crime has intensified since 1997. They thought this might be because the role of the military has diminished and the local police have not been as effective in fighting the problem.

The second problem that managers singled out for Batam was that of labor unrest. They blamed this on a regulatory environment that is tilted too much in favor of labor and encourages a confrontational situation between labor and management. In particular, they were critical of Ministry of Labor Decree No. 150/2000 that deals with the conditions for terminating employment. This decree gives longer-serving workers an added financial incentive to create a situation in which they are fired. Workers desiring to end their employment therefore frequently find it advantageous not to quit but to create problems that encourage employers to dismiss them.

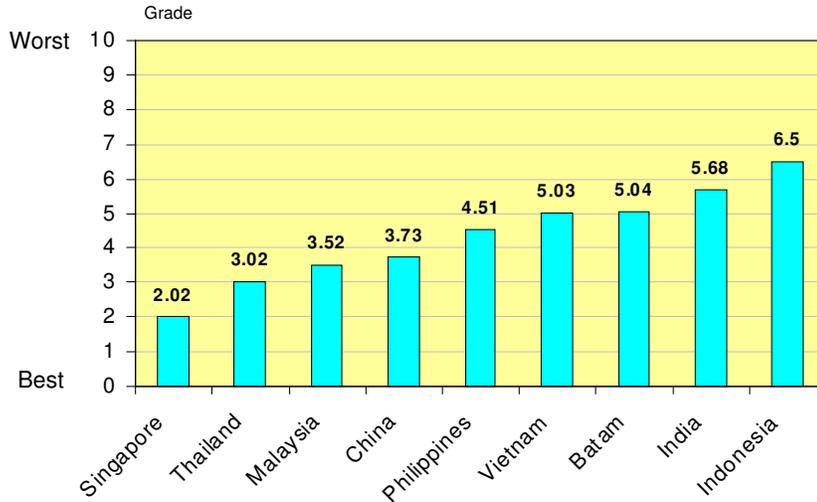
Batam is distinct from the rest of Indonesia from the perspective of being an easier base from which to manufacture for export. However, it is currently subject to the same labor laws that apply to the rest of Indonesia. In some ways, this works to Batam's disadvantage, as is reflected in the critical grade in our survey for variables relating to labor relations. Batam's labor problems do not lie in the fact that the cost of production labor is higher than elsewhere in Indonesia. None of the managers we interviewed were critical of the cost of labor. To the contrary, virtually all cited this as one of Batam's major drawing points. What they were critical of was a regulatory environment that was not conducive to smooth labor-management relations. They recognized that this was not the fault of the local authorities but a national-level problem. Still, it was one of the biggest detractors from the quality of the overall operating environment that we found in our interviews.

The domestic social environment										
Variable in Batam survey	BATAM	Variable in region-wide survey	CH	INDIA	INDO	MA	PH	SI	TH	VN
Public security and safety in Batam	6.51	Public security & safety	3.33	7	8	3.86	6.75	1.2	4.67	2.75
Information variables	4.08	Information variables	8.00	5.06	5.38	6.25	3.23	5.40	5.11	7.07
<i>i. Freedom of the press and other local media</i>	3.67	<i>i. Freedom of the press & other local media</i>	9.5	4.27	2.5	7	2.08	5.7	5.78	7.63
<i>ii. Quality of the press and other local media</i>	4.89	<i>ii. Quality of the press & other local media</i>	8.5	4.67	7	7	6	4.7	5.44	6.63
<i>iii. Degree that information flows freely</i>	4.49	<i>iii. Degree that information flows freely</i>	8.33	5.97	6	6.29	3.92	5.5	5.56	6.5
<i>iv. Freedom of speech</i>	3.29	<i>iv. Freedom of speech</i>	5.67	5.33	6	4.71	0.92	5.7	3.67	7.5
Religion	4.36	Religion	5.67	7.24	8.84	4.00	3.42	1.80	1.95	4.57
<i>i. Freedom of religion</i>	3.48	<i>i. Freedom of religion</i>	6.33	6.47	8	2.86	0.92	1.4	0.89	6.63
<i>ii. The threat of religious extremism</i>	5.23	<i>ii. Threat of religious extremism</i>	5	8	9.67	5.14	5.92	2.2	3	2.5
The threat of labor unrest	6.67	Threat of labor unrest	3.67	6.42	8	2.71	6.42	0.9	3.22	3.5
The extent that racism is a problem	4.77	Extent that racism is a problem	3.33	5.33	7	4.57	3	3.5	4	3.5
The extent that a rigid class system exists	3.75	Extent that a rigid class system exists	2.67	8.67	7.33	2.71	5.75	3	6.89	4.69
Regionalism	4.36	Regionalism	6	5.75	8	3.71	6.36	2.3	4.56	4.75
Insurrection risks	5.44	Insurrection risks	5	4.5	8.5	3.14	6.58	1.4	3.11	4.57
Overall social stability in Batam	5.01	Overall social stability	4.33	6.5	8.5	4.43	5.75	1.8	2.67	3.63
AVERAGE GRADE	5.00		4.67	6.27	7.73	3.93	5.25	2.37	4.02	4.34

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

3.6 The quality of life for expatriates

Quality of Expatriate Life



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

Batam offers comfortable living for expatriates. Costs are significantly lower than in Singapore for housing. There is basic health care. It is not as good as what is available in Jakarta, but considering that Batam is so close to Singapore, expatriates living on the island find it easy to use Singapore's superior health facilities if they have a more serious need. Sporting facilities include good and reasonably priced golf courses, tennis, and scuba diving. No one we interviewed complained about Batam in terms of its being a "hardship" posting.

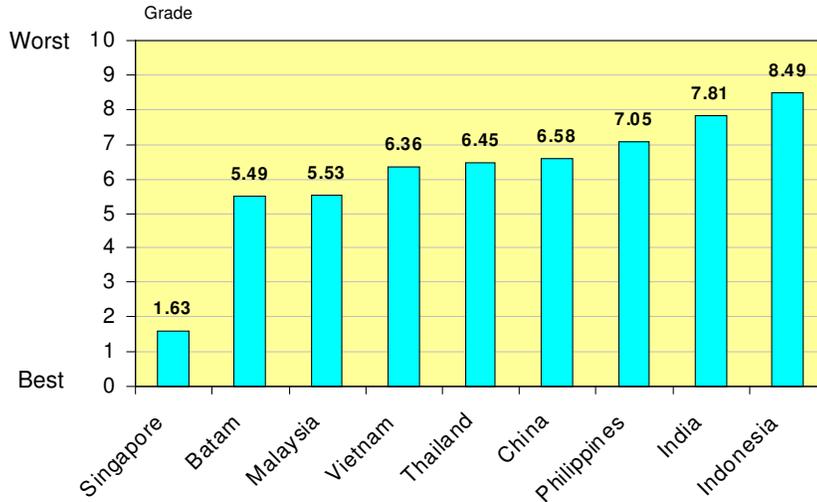
As is reflected elsewhere in this report, the biggest concern was personal security. None of the people we interviewed felt that they were discriminated against as foreigners. However, they are conscious of the need to take common sense security precautions, with the main concern being robbery. It is important to note that this was not a fear that deterred them from residing in Batam, since the problem is manageable. It was an aspect of the environment that stood in stark contrast to Singapore, however, where many of our survey respondents had resided previously.

Quality of life for expatriates										
Variable in Batam survey	BATAM	Variable in region-wide survey	CH	INDIA	INDO	MA	PH	SI	TH	VN
Housing	3.94	Housing	3.33	5.58	4.5	2.29	3.17	2.6	2.22	3.86
Health care	6.11	Health care	3.33	5.25	9	4.29	5.58	1.6	2.44	7.57
Sporting and other recreational facilities	4.65	Sporting & other recreational facilities	5.67	6.33	6.33	3.43	3.58	3.6	3.44	6
Personal security	5.51	Personal security	2	6.25	7.33	3.71	7.21	0.7	3.67	3.43
The extent that racism is a problem encountered by expatriates	4.97	The extent that racism is a problem encountered by expatriates	4.33	5	5.33	3.86	3	1.6	3.33	4.29
AVERAGE GRADE	5.04		3.73	5.68	6.50	3.52	4.51	2.02	3.02	5.03

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

3.7 The political environment

The Political Environment



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

Although Batam is subject to most of the same national-level political problems as the rest of Indonesia, there are some factors that help to shelter or protect the island. For example, expatriates in Batam hold the quality of the island's political leadership in higher regard than expatriates in Indonesia hold the national leadership. They also feel that the local political scene is more stable than the national political scene and that this helps to protect Batam from some of the national problems.

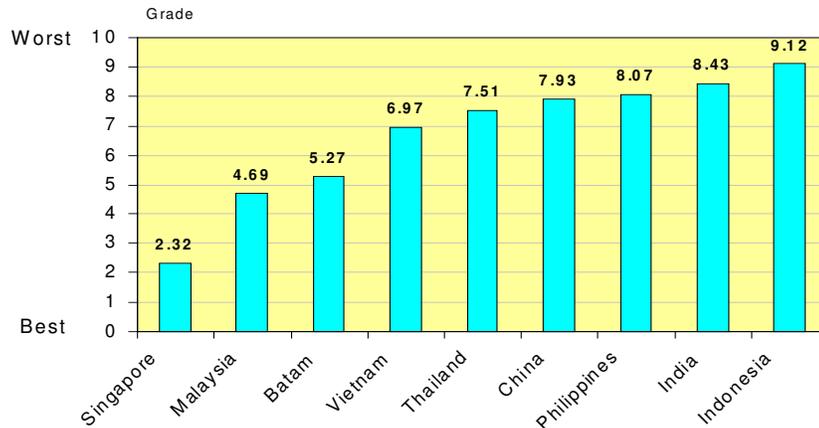
The quality of local policies, although not ideal, is still considerably better than national-level policies. Policies are also implemented more consistently on Batam than they are nationwide. This is a reflection of another variable rated more favorably for Batam than for all of Indonesia, namely, the quality of the local bureaucracy. It is perceived to operate more efficiently and in a less obstructionist manner than the bureaucracy elsewhere in Indonesia. In general, the government stays more out of the way of business in Batam than is the case elsewhere in Indonesia.

The political environment										
Variable in Batam survey	BATAM	Variable in region-wide survey	CH	INDIA	INDO	MA	PH	SI	TH	VN
Stability of government body responsible for administering Batam	5.18	Government stability	3.33	6	8.5	4	7.17	0.6	5.22	2.5
Quality of leadership of zone government	4.89	Quality of political leadership	3.33	7.5	8.5	5.29	6.83	1.5	7.67	6.13
The potential for disruptive political change at the national level to hurt Batam	6.11	The potential for disruptive political change	6.33	7.5	9	4.14	7.67	1.1	4.78	4
Political system risk	6.34	Political system risk	7	5.5	8.5	4.43	7.33	1.1	5.22	4.75
Efficiency of local civil service and zone bureaucrats	5.59	Civil service efficiency	7.67	7.83	8.33	6.86	8.25	1.7	7.56	7.88
Quality of the regulatory environment in Batam	5.75	Quality of the regulatory environment	8.33	7.33	8.5	6	7.58	1.7	6.78	7.5
Quality of government policies in Batam	5.19	Quality of government policies	6.33	7.5	9	5.14	6.25	1.8	7.11	6.75
Intrusiveness of the government into the affairs of companies and individuals in Batam	4.95	Intrusiveness of the government into the affairs of companies and individuals	8	9	6.5	6.29	5.83	3.3	5.56	7.63
Effectiveness of the government in implementing its economic policies in Batam	4.89	Effectiveness of the government in implementing its economic policies	6.33	9	8.5	5.29	6.75	0.7	6.67	7.38
Degree that business has to worry about inconsistencies in government policies and the way they are implemented in Batam	5.99	Degree that business has to worry about inconsistencies in government policies and the way they are implemented (either by the present or future governments)	7.67	9.5	9	5.43	6.92	1	7.67	8.13
Responsiveness of the local Batam authorities to business	5.18	Responsiveness of the government to business	6.33	8.5	8	6.43	7	1.7	5.33	6
Transparency of the regulatory and political decision-making processes in Batam	5.82	Transparency of the political decision-making process	8.33	8.5	9.5	7	7	3.3	7.78	7.63
AVERAGE GRADE	5.49		6.58	7.81	8.49	5.53	7.05	1.63	6.45	6.36

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

3.8 Natural environment

Quality of the Natural Environment



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

Batam has not been able to escape the environmental problems that have adversely affected expatriate perceptions elsewhere in Indonesia and in most other Asian countries. Batam's grades for most measures of pollution are considerably better than Indonesia's overall grades, but the relatively high scores indicate that expatriates living in Batam would like to see more attention to these issues.

Noise pollution is not a problem, and air quality is similar to Malaysia. Rapid economic growth has led to greater traffic congestion. The island's small size means the scale of the problem is much less than in places like Jakarta, but it is still a complaint. Traffic jams are a feature during certain periods of the day. Roads in the major industrial zones are of high quality, as is the main highway that links Batam to neighboring islands. However, secondary roads on Batam are frequently narrow and poorly maintained. This can make it difficult to move product by truck from one part of the island to another.

Water supplies are quite good, but the quality of the water could be higher. None of the managers we interviewed complained about water supply bottlenecks hurting their manufacturing capabilities. In part that is because the types of industries located on Batam do not usually require large supplies of water. Managers we interviewed did complain about the cost of water, as well as its quality. For example, few were willing to drink water out of the tap, which is something Singaporeans are accustomed to doing in Singapore. Most of these complaints were at the personal level – reflecting the quality of living – rather than at the production level.

The main contributing factor to the quality of Batam's physical environment is the rapid influx of new immigrants from other parts of Indonesia. This has put a strain on certain types of infrastructure, including housing, and also has placed a strain on the environment. The local authorities have found it difficult expanding basic housing and utilities fast enough to satisfy the demands of this growing population. The

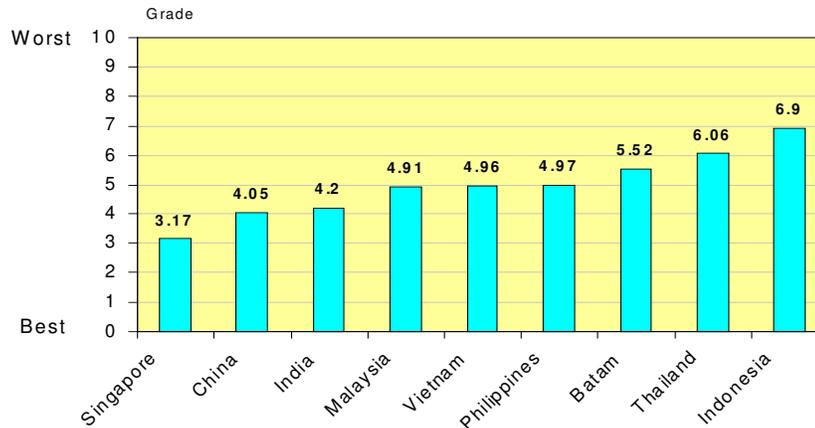
government has been good about minimizing any inconvenience to expatriates and foreign direct investments, but there has been some toll on the physical environment.

The quality of the natural environment										
<i>Variable in Batam survey</i>	BATAM	<i>Variable in region-wide survey</i>	CH	INDIA	INDO	MA	PH	SI	TH	VN
Quality of the government's environmental protection / enhancement policies	5.61	Quality of the government's environmental protection/enhancement policies	7.67	8.08	9.42	5.71	8.17	3.3	7.56	6.14
Air quality	5.01	Air quality	8.67	8.7	9	4.86	8.92	2	8.22	7.29
Water quality	4.96	Water quality	8.33	8.18	9	5.14	7	1.4	6.22	7.71
Noise pollution	4.84	Noise pollution	7.67	8.37	8.67	3.86	7.33	2.6	7.89	7.71
Traffic congestion	5.92	Traffic congestion	7.33	8.83	9.5	3.86	8.92	2.3	7.67	6
AVERAGE GRADE	5.27		7.93	8.43	9.12	4.69	8.07	2.32	7.51	6.97

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

3.9 The education and human resource environment

Education and Human Resource Variables



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

One of Batam's most attractive features for foreign direct investment is the low cost of its labor. To be sure, minimum wages rates in Batam are higher than in most other parts of Indonesia, in large part because the cost of living is also higher. However, wage rates are still low enough to make Batam competitive regionally.

Batam's local educational system is rated quite good by Indonesian standards. The local government has invested in local primary and secondary schools and in technical colleges. The most notable feature about Batam's labor force, however, is not how well educated the local labor force is but how easy it is for employers to import workers with the skills they need from other parts of Indonesia. Consequently, the overall skill level and productivity of Batam's labor force compares very favorably with Indonesia's overall grade. It is also in line with or better than most other countries in the region covered by our survey.

Where Batam has scored more poorly than other countries in the region are in variables relating to labor activism and work ethics. As noted elsewhere in this report, these problems have their roots in national labor regulations that, no matter what their original intention, have actually contributed to a more confrontational atmosphere between workers and managers. It is not simply that it is difficult and expensive to terminate workers. More importantly, longer-serving workers desiring to change jobs or to return to their home cities have a strong financial incentive to be disruptive in the work place, since they stand to benefit a lot more financially in the short term if they are fired than if they quit on their own.

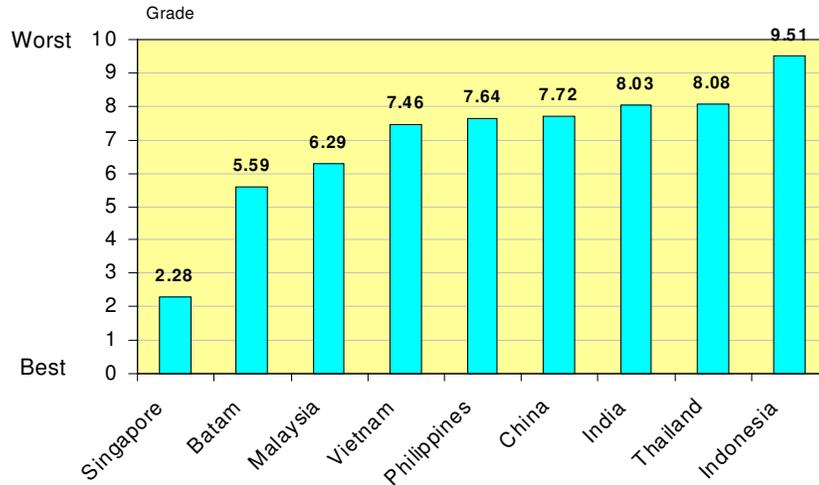
Although this is a national-level problem, it seems to be hurting Batam even more than other places in Indonesia, judging from our survey grades. While the low cost of labor was cited as one of Batam's biggest attractions, respondents to our survey were just as convinced that the termination and labor activism problems were the island's biggest shortcomings.

The education and human resource environment										
<i>Variable in Batam survey</i>	BATAM	<i>Variable in region-wide survey</i>	CH	INDIA	INDO	MA	PH	SI	TH	VN
Overall impression of the quality of the local educational system	5.11	Overall impression of the quality of the local educational system	4.33	5.33	8.67	6	6	3.4	7.89	6.29
Primary schooling for indigenous population	5.62	Primary schooling for indigenous population	2.33	5	8	4.43	5.83	3.2	7.33	4.14
Secondary schooling for indigenous population	5.12	Secondary schooling for indigenous population	3	4.93	8.67	5	6	3.3	7.89	4.71
University and post-graduate education for indigenous population	5.75	University & post-graduate education for indigenous population	4	3.3	8.67	6	5.58	3.8	7.67	5.86
Cost of production labor	5.68	Cost of production labor	1	1	3.67	2.57	4.08	3	3.11	2
Availability of high quality production labor	5.39	Availability of high quality production labor	3	3.67	6.67	4.71	3.75	3.2	6.78	6
Cost of clerical staff	4.26	Cost of clerical staff	1	2	3.33	1.86	3.25	2.8	2.56	1.86
Availability of high quality clerical staff	5.56	Availability of high quality clerical staff	3	5.33	7	5	3.75	4	5.89	6.14
Cost of management staff	4.53	Cost of management staff	2.67	2	4.67	3.14	3.08	3.4	4.33	3.86
Availability of high quality management staff	5.75	Availability of high quality management staff	4.5	3.67	7.67	6.71	4.17	4.5	5.89	7.14
Overall skill level of labor force	5.43	Overall skill level of labor force	6.33	4.83	7	6	4.67	3.6	6.67	6.43
Overall productivity of the labor force	5.24	Overall productivity of the labor force	5.67	6.33	7.67	6	6.08	3	6.33	5.14
Work ethic	6.13	Work ethic	4.33	6.5	7	6	5.67	2.9	5.22	3.57
English proficiency	6.05	English proficiency	7.33	3.45	8.5	5.86	3.58	2.6	7.89	6.43
Proficiency in other critical languages	6.41	Proficiency in other critical languages	8	5.33	9.33	4.43	7.33	2.2	7.89	5.83
Hi-tech proficiency	6.10	Hi-tech proficiency	5.67	2.33	7	6.86	5.33	2.7	7.22	6.67
Labor activism	7.04	Labor activism	2.67	6	6.67	2.71	6.58	1.1	3.33	3
Labor turnover	4.44	Labor turnover	4	4.67	4	5.14	4.75	4.4	5.11	4.14
AVERAGE GRADE	5.52		5.88	6.51	6.93	4.20	5.16	2.26	5.46	5.16

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

3.10 Institutional quality, accountability and standards

Institutional Quality, Accountability and Standards



Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

This is the section that received the most critical overall grade in our survey. That is because the variables measured here are also the most critically graded ones for all of Indonesia, and many of Batam's institutions and standards are influenced by the national government. The judicial system is a good example. Batam's laws are a close reflection of national laws. So are the institutions that police and enforce them. There are some important differences, however, that have contributed to a lower grade for Batam than for all of Indonesia.

The biggest difference between Batam and Indonesia as a whole is that the authorities that are in charge of running the zone are more hands-on and effective than the authorities that are running the country. The Batam authorities are not struggling with the problem of distressed assets; the national authorities are. Batam does not have the banking crisis that is a problem elsewhere in Indonesia; the island's industrial base is mainly foreign, and those companies have access to foreign financing.

Corruption exists, but it is more a feature of lower level interactions than something is a major problem from top to bottom in the system. Neither does Batam have the problem of state-owned enterprises or indigenous business groups competing in industries that foreign investors are trying to break into. This simplifies the situation greatly in Batam and means the island is not vulnerable to either the breadth or depth of problems that are evident at the national level.

Institutional quality, accountability and standards										
<i>Variable in Batam survey</i>	BATAM	<i>Variable in region-wide survey</i>	CH	INDIA	INDO	MA	PH	SI	TH	VN
Overall integrity of the legal system	5.28	Overall integrity of the legal system	8.33	7.00	9.83	5.86	7.75	1.70	7.78	7.00
Police	5.38	Police	6.67	7.67	9.83	6.43	8.08	1.40	8.89	7.00
Judiciary	5.50	Judiciary	8.33	7.33	9.83	6.57	7.50	2.00	7.22	7.25
Extent that state-owned enterprises are a problem	4.96	Extent that state-owned enterprises are a problem	9.00	8.00	8.33	6.00	6.33	3.90	7.00	7.75
Corruption	6.65	Corruption	7.00	9.17	9.92	5.71	8.00	0.90	8.89	8.25
Extent that cronyism, in particular, is a problem	5.78	Extent that cronyism, in particular, is a problem	7.00	9.00	9.33	7.14	8.18	3.80	8.67	7.50
AVERAGE GRADE	5.59		7.72	8.03	9.51	6.29	7.64	2.28	8.08	7.46

Grades range from zero to 10, with zero being the best grade possible and 10 the worst.

Political and Economic Risk Consultancy, Ltd.

Batam: A Formula for Growth

Summary paper of the Executive Investment forum in Batam

June, 2003

Batam Industrial Development Authority

Prepared by:

Robert C. Broadfoot

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1. Executive Summary

The Executive Investment Forum in Batam (EIFB) brought together nearly 30 senior executives from 16 of the world's leading multinational companies for two days on May 27 and 28, 2003 to discuss with senior Indonesian Government officials how Indonesia might be able to use Batam more effectively as a catalyst for greater economic development for all of Indonesia. The major recommendations of the participants of the EIFB were as follows:

First, the Government should protect what already works well in Batam so that it can keep the companies that have already invested on the island committed to the country. The Government should also remove some uncertainties that have arisen in recent years. In particular, investors want to know who is in control of what. They place a premium on regulatory certainty, and they need to work within a framework of reasonable labor laws.

Second, the Government should institutionalize or enshrine into law what already exists in practice in terms of Batam's status as a free-trade zone (FTZ) and the incentives it offers foreign direct investors. This is needed to remove uncertainties that might be deterring other foreign companies in export-oriented manufacturing industries from investing in Batam. Lacking the first-hand knowledge of existing investors in the island about the way the system works in practice, many foreign companies that are not actually in Batam have a different, more cautious perception of Indonesia. In order to increase their level of comfort with the investment environment, it is important to convince them that they can count on the rules of the game remaining unchanged in the medium-term.

These first two steps need to be addressed immediately, since Indonesia is already debating new laws relating to Batam's status. It is important to get these laws right and not have them result in greater uncertainty or negative changes to the existing environment that undermine features that companies already in Batam consider to be vital. Once what exists is adequately protected and promoted, the Government can then raise its sights and attempt to attract new investment in different industries other than export-oriented manufacturing. This brings the Government to the third step:

Third, enhance the environment beyond the current incentives being offered. Use Batam as a laboratory to develop policies and programs to attract Indonesian and foreign investors in industries that are currently not using Batam as a base but might consider doing so if certain changes came about. This will probably mean giving both indigenous and foreign investors in Batam better access to the Indonesian market and also permitting better integration with Singapore so that Batam can more fully benefit from Singapore's strengths while Singapore can more fully benefit from Batam's potential. The two systems are essentially complimentary, and this should be more fully exploited.

Timing is of the essence for any initiative. A variety of factors, from a strategic rethinking of Singapore's development plans to the impact of SARS on perceptions toward Mainland China, make this an ideal time to ask MNCs to take a hard look at Batam. However, if the Government does not move fast, events could overtake the island, jeopardizing the effort and investment the National Government has already put into the island to date.

2. Profile of the Executive Investment Forum in Batam

The Batam Industrial Development Authority retained Political & Economic Risk Consultancy, Ltd. (PERC) to organize a forum that would bring together senior executives of some of the world's most prominent multinational companies to discuss how the Indonesian Government might better use the Indonesian island of Batam as a catalyst for change for all of Indonesia. Although the companies were from a range of different industries, with different home countries, and there were also a number of different nationalities represented among the executives, the participants fell into two major categories of people: one was managers of existing foreign direct investments in Batam. The other included executives with regional responsibilities that covered Indonesia as well as other Asian countries. Many of the regional executives were also accompanied by their country heads for Indonesia. PERC's managing director, Robert Broadfoot, was responsible for facilitating the discussions at the Forum and also for writing this report presenting the Forum's main observations, conclusions and suggestions for action.

Outside experts were also invited to address the EIFB in order to provide independent perspectives on issues that shaped not only the investment environment for Indonesia and Batam, but also for the rest of Asia. In particular, Professor Michael J. Enright of the University of Hong Kong School of Business addressed the group on lessons Indonesia might draw from China as well as on changing MNC strategies for the region. In addition, Craig Foster and Matthew Quin of Hill and Associates addressed the group on security developments and risks in Indonesia and elsewhere in the region. In all these cases, the experts' function was to stimulate discussions among the participants in order to draw out the participants' concerns and help develop a deeper understanding of their priorities.

Senior Indonesian officials addressed the EIFB in a similar capacity to the outside experts. They also participated directly in the Forum's discussions, helping to convey the Indonesian perspective and giving the group a deeper understanding of the issues facing the Indonesian Government and how these issues are being prioritized. The Indonesia team was headed by Dr. Dorodjatun Kuntjoro-Jakti, the Coordinating Minister for Economic Affairs. Other leading members included Mr. Theo F. Tumeon, the Chairman of the Indonesian Investment Coordinating Board (BKPM); and Drs. Ismeth Abdullah, the Chairman of the Batam Industrial Development Authority (BIDA).

3. Timing Considerations

Participants were optimistic that the timing is right for the Indonesian Government to proactively promote Batam as an engine for economic growth for the country and as a catalyst for positive change. However, they issued a note of caution that such a favorable situation will not continue indefinitely and that if the Government does not take advantage of the opportunities that are available now, it could be much more difficult to do so at a later date. The reasons why MNCs might be more willing to look at investment opportunities in Batam today than they were a short while ago include the following:

- a. **Singapore is in transition.** The development formula that worked so well in the past for Singapore is not working so well today and it is likely to be even less appropriate in the future. The Singapore Government has said as much

and it is now encouraging government-owned companies as well as the private sector to rise to the challenge. Together, they have to decide where Singapore is going in the future, what industries or niches will be pushed, and how and where this push will take place. Due to land, labor and resource constraints, Singapore's economy will remain very externally focused. Cost considerations will also force it to develop strategic relationships with lower cost regions like Batam. This implies that Singapore will have to look to ways to strengthen existing trading and investment relationships as well as to nurture new ones. This is an immediate challenge. It is taking place now. It is in Batam's interest to position itself as an option for Singapore for certain manufacturing operations, logistical functions, and infrastructure support. If Batam does not raise the possibility of various partnering arrangements, the risk is high that Singapore will decide in favor of other options that exclude Batam, and these decisions, once made, will not be easily reversed or modified.

- b. **SARS has made foreign companies view China in a new light.** The Mainland will remain an attractive investment destination for many foreign companies. Its potential market is so large and its competitive capabilities as a production base for export are already recognized. However, it is a difficult place to do business. It is an easy place to put a lot of money, but it is a very difficult place to make handsome profits and to sustain good margins in the medium term. SARS has made businessmen aware of other vulnerabilities, ranging from the negative fallout that can happen in a society where there is a penchant for hiding certain facts when they might indicate problems to the ease with which the facilitation of business can be disrupted by such things as travel restrictions. Multinationals are reviewing their strategies with respect to their global investment locations and organizational structure for linking their operations together. Within Asia, they are still focusing on China but not so exclusively. Companies will not want to put all their eggs in one basket. They will continue to invest heavily in China, but they will also be looking at alternative locations to place a second or third facility. The attendants at the forum called this a "China plus One" or a "China plus Two" strategy. Batam will want to position itself as the plus one or one of the plus twos. In this sense, Batam's major competition for investment is less China than other locations in the region like India, Vietnam and the Philippines. This competition is really ramping up, however. Places like Subic, Johore and Ho Chi Minh City are becoming much more aggressive. Batam cannot afford to stand still in its policies and approach toward investment promotion if it is to compete effectively against these alternative sites.
- c. **International confidence in Indonesia's security situation is improving.** In addition to being free from SARS, Indonesia has also benefited from the way the Government has succeeded in cracking down on terrorism and in restoring social stability to the country. There had been fears that local Islamic extremists would take advantage of a strong grassroots reaction to the US war in Iraq to create more unrest in Indonesia and to ferment demonstrations against the US. These fears have not materialized, however. To the contrary, local sentiment seems to be strongly opposed to the type of violence that resulted in the Bali bombings last October. Extremist groups are having to adopt a lower profile, and the Government is trying to show the world through a high profile approach to the Bali bombing trials that it will take a hard-line to terrorism. All this is helping to restore international confidence in the security situation in Indonesia.

- d. Indonesia's international image is also being helped by recent economic developments.** The rupiah has been very stable in the foreign exchange market; in fact, it has been appreciating against the US dollar recently. The Central Bank has rebuilt its foreign exchange reserves, while the Government generally earns praise from the IMF and other foreign creditors for the way it has managed its fiscal accounts. The rate of real economic growth is matching or higher than most other countries in the region. Inflation is decelerating, yet the Government is still pushing ahead with such reforms as reducing subsidies on fuel and other basic commodities. It is also selling off distressed assets taken over by the Indonesian Bank Restructuring Agency in the wake of the 1997/98 financial crisis. The Government has strongly hinted that it is preparing to leave the IMF umbrella at the end of this year. All this is clearly improving the country's appeal among foreign fund managers and investors. So far this year, Indonesia's stock market is up about 18%, making it one of the best performing in Asia.
- e. Indonesia's domestic political reform process** is completely restructuring the way the Central Government and various regions of the country share political and economic power. Batam is well positioned to support this process of regionalization. It could be used to simulate development throughout Riau province and further into Sumatra. However, if this regionalization process is not well thought out but is allowed to evolve as an outcome of competing centers of power, the risk is high that Batam's attributes could be undermined by the process, jeopardizing all the effort and investment the Government has put into the island to date.

4. The Need to Preserve Batam's Achievements

Batam was originally set up as an experiment by the National Government of Indonesia. It is an experiment that has, by and large, worked – not just for Batam but for all of Indonesia. Evidence of this success includes the following:

- a. The National Government earns more than Rp 900 billion a year in tax revenues from Batam.
- b. The zone provides employment for more than 170,000 people in the formal sector and far more than that in the informal sector. Most of these workers come from other parts of Indonesia, with the majority coming from Java. These workers are some of the best paid in Indonesia and they transfer at least Rp 140 billion a year to their families via the National Postal Service to villages throughout Indonesia.
- c. Batam's exports amount to more than US\$5 billion a year, which is equal to about 10% of Indonesia's total exports.

That said, there has been some backsliding in recent years. Some of this is due to adverse external circumstances. Batam's exports, for example, have fallen from their peak of US\$6.7 billion hit in 2000, while last year's tax contribution to the National Government of Rp 907 billion was less than the Rp 947 billion contributed in 2001. Other complications with domestic roots have made many existing multinational investors in Batam feel less comfortable. Foremost among these complications are new laws relating to labor and pay that have interfered with smooth labor – management relations.

Still, the value of foreign direct investment has continued to grow. The cumulative value of FDI rose from US\$2.82 billion in 2000 to US\$3.1 billion in 2001 and to US\$3.62 billion last year. The participants at the EIFB who already have investments in Batam were very strong in their praise of the efficiency of the island's port and airport services. They claimed they can move their products into and out of Batam faster than any other manufacturing base in Asia. They were happy with the ease of obtaining employment visas for expatriate staff and they also like the liberal immigration policies for Indonesians from other parts of the archipelago. The enthusiasm caused the participants of the Forum to agree on what should be the Government's first priority, namely protect what already exists in Batam in order to keep existing investors committed. Participants said that protecting the attributes that already work strongly in Batam's favor means such things as:

- a. Maintaining the efficiency of the port and airport systems;
- b. Maintaining adequate infrastructure like power, water, telecommunications facilities and waste disposal systems;
- c. Keeping existing tax incentives;
- d. Keeping 100% ownership rights; and
- e. Keeping liberal immigration and employment rules.

When informed of the proposal that is currently under consideration to shrink the FTZ status to limited plots of ground on the island where factories are actually located instead of keeping the entire island a free-trade zone as is currently the case, participants of the Forum who already have investments in Batam felt strongly that this would be a bad idea. They argued that this would seriously upset existing logistical arrangements, increasing both inefficiency and costs and thereby detracting from Batam's attractiveness as an investment site for export-oriented manufacturers. For example, many investors currently store their raw materials in warehouses on the island that are not located directly on their production sites. Under the current system, it is very easy to move these goods from the warehouses to the production facilities when they are needed. However, if the system were to be changed to an "enclave" system, it would either substantially increase costs by forcing investors to build bonded warehouses on their production sites (which are frequently already fully occupied) or raise both costs and inefficiency by imposing a bureaucratic burden on moving the product from outside bonded warehouses through non-FTZ property on Batam to the actual factory location. For similar reasons, it could make it more difficult to move product from the factories to the ports and airport facilities for export. In other words, from the perspective of existing investors, absolutely nothing would be gained by tampering with the existing system in this manner, while the damage to the business environment – and therefore to Batam's attractiveness to foreign investors – could be considerable.

5. Making the Existing FTZ Formula More Successful

Indonesia has a public relations problem. Until very recently, coverage of Indonesia in the international media has been more negative than positive. It is frequently portrayed as a country where such problems as corruption, social unrest and political instability dominate the environment. Most existing investors in Batam have a different, more accurate view of the country. They know Indonesia and how

to navigate the system. Unfortunately, foreign companies not in Batam do not have this first-hand experience, and their impressions are shaped more by the exaggerated and lopsided media reports. Their perceptions are more negative. They are also less confident than existing investors that current tax and FTZ benefits will not be changed suddenly. Without this certainty, they are unwilling to commit their capital to the island.

Participants at the EIFB felt strongly that the Government should institutionalize what already exists in Batam. The Government should make permanent the features mentioned in Section 4 of this report and others that have defined the reality of the Batam zone. In order to do this, the Government should do the following:

- a. Make Batam's legal status as a free-trade zone more permanent. Make sure the new FTZ law is seen as a lasting or durable commitment by the Government.
- b. Do not just clarify but institutionalize who is in control of what. This cannot keep changing frequently.
- c. Provide greater regulatory certainty.
- d. Restore some of the certainty that has been lost during the past three or four years. Foreign investors understand and support the direction of political change that is taking place in Indonesia. They understand that it takes time for the country's leaders to reach a consensus on important issues. But as noted in Section 3 of this report, time is one thing that is not in infinite supply when it comes to Batam's future. Companies need to know what the Government views as the future for Batam. They would like the Government to explain clearly how it would like to see Batam evolve going forward. Foreign investors can work within a range of different parameters, but they need to know what those parameters are and have a fair degree of confidence that they will remain consistent over time.

Although there was some debate in the Forum over the value of various tax incentives, the consensus opinion was that, all else being equal, tax incentives can make a big difference. Some participants suggested specifically that income tax incentives would be BIDA's best chance of attracting serious MNC investment from places like Singapore in the near term. The competitive position of existing plants in Singapore has been eroded by high costs. Moreover, the incentives granted by the Singapore Government 10 and more years ago are now running out. Some of these plants have moved to Malaysia; others are in the process of moving to China (both of which offer tax incentives to encourage the moves). A Singapore-style investment program offering a 10-year tax holiday in Batam would pull very serious investment and jobs from Singapore to Batam.

6. Raising Batam's Potential to a Whole New Level

The points raised in the preceding two sections are needed to sustain the commitment of existing investors in Batam and to attract new ones in export-oriented manufacturing industries. This is the top, immediate priority. It needs to be addressed now through a more permanent codification of Batam's legal status. Looking further into the future, if the Government really wants to use Batam as a

catalyst for change for Indonesia, it will have to attract new investors in different fields than simply export processing. To do this, it will have to enhance the environment, not simply maintain it.

As appealing as export-oriented manufacturing investment might be today, there are some long-term challenges facing this type of development engine for Batam. As already noted in this report, other areas in the world are also trying to attract this type of investment. The environment is bound to be very competitive, therefore, and – over time – the net positive impact that Indonesia derives from this kind of business might start to diminish, particularly when the export markets being serviced are either developing comparable production capacities of their own (such as is happening in Mainland China) or are located in such far away geographic locations from Batam (such as the US or Europe) that they might be serviced just as conveniently by other low cost locations.

If Batam wants to distinguish itself from the competition, it needs to play on those features that are unique to Batam. Two stand out. One is its proximity to Singapore. The other is its proximity to other parts of Indonesia. These are features that other zones in Asia like Subic Bay, Shenzhen, and Ho Chi Minh City can never have. They will have to identify and play on their own unique attributes. To date, however, Indonesia has not come close to capitalizing on Batam's unique attributes to the fullest extent possible. Participants at the Forum identified three broad policy initiatives that the Indonesian Government could do that would be sure to generate considerable local and foreign investor interest in Batam in ways that could quickly turn the island into a catalyst for positive economic development for all of Indonesia. Those initiatives should include:

- a. Improving market access to Indonesia for companies with manufacturing and other operations in Batam;
- b. Making it an official policy to capitalize more fully on opportunities that exist with Singapore; and
- c. Encouraging Batam to integrate better with neighboring parts of Indonesia so the entire region benefits from the strengths of the respective parts.

The participants at the Forum recognize that as simple as this formula for success sounds, many obstacles stand in its way. Some are political at the national level; others are political at the local level. There are also financial considerations and the need to ensure that Batam is used in a way that is compatible with Indonesia's overall national aspirations, including the desire for greater regionalization and the various pressures and responsibilities this entails. Batam is not like other regions in Indonesia, however. Its population is largely imported from other parts of archipelago. It has a superior physical infrastructure and effective free-trade zone status mainly because the National Government had a vision 30 years ago and invested substantial amounts of money to realize that vision. If Batam is to progress on to the next level of its potential, participants at the Forum recommended that there be a champion at the National Government level for the new Batam initiative. Such a person is needed to help steer the island through the necessary political process.

7. Conclusion

Indonesia is going through some profound changes. Most are for the better. The transition has been unsettling, but that is only to be expected. Existing foreign investors and other major multinationals know that. The participants at the EIFB expressed a strong general sense of optimism in the country's future, and they agreed that the concept of using Batam as a catalyst for positive change is a very appealing one. As in so many things in life, there are a lot of routes to the same goal, and ultimately it is up to the Indonesian Government and the Indonesian people to decide on the path they want to set for their country. The participants at the Forum felt that there would be many multinational companies that would like to assist in this process if the Indonesian Government makes it known that such help would be welcomed and clearly outlines the ground rules for foreign participation. From their perspective on the central question around which the Batam Forum was organized, the participants suggested that the solution is to protect what is good and exists in Batam, to institutionalize or enshrine this so there is a greater degree of permanency and less uncertainty and then to take the steps needed to enhance the environment. Indeed, some of the participants of the EIFB said these steps might be the only way to accomplish this goal.

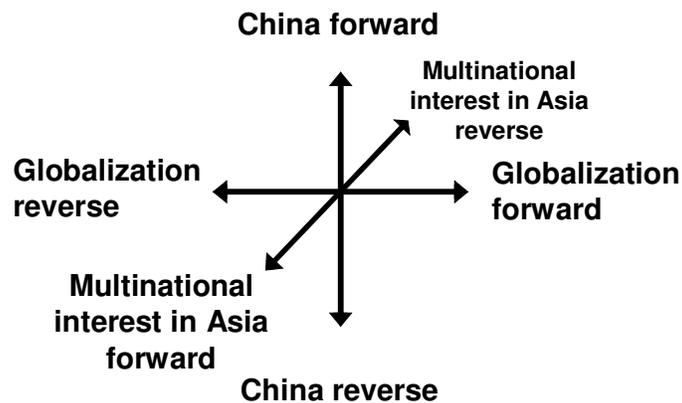
4 Appendix 1: Private Companies Attending the EIFB

1. Advanced Interconnect Technologies
2. Baker & McKenzie, Wong & Leow
3. Ciba Specialty Chemicals
4. Citra Agramasinti Nusantara (PT)
5. EM Holding
6. General Electric Inc.
7. Hill & Associates
8. International Finance Corporation
9. McDermott Far East Inc.
10. Motorola Inc.
11. P & O Nedloyd Ltd.
12. Pan United Shipyard Indonesia
13. Perkin Elmer Fluid Science Ltd.
14. Pegasus Capital Pte. Ltd.
15. Political & Economic Risk Consultancy, Ltd.
16. Scheineder Electric
17. Selectron

5 Appendix 2: External Drivers Shaping the Business Environment in Indonesia

A presentation by Robert Broadfoot, Managing Director of the Political & Economic Risk Consultancy, Ltd.

Scenario Grid for Indonesia



This forum might be focusing on Indonesia and Batam, but in order to do so, it is first important to look at the external world. What are the regional and global forces that are shaping the environment in which Indonesia will have to exist and to compete effectively? These forces are not so much “givens” as variables or critical uncertainties.

For the purpose of structuring this forum, we have identified three drivers. Much of our discussions will focus on fleshing out these drivers, developing an understanding of how this group perceives them and their implications for Indonesia. Indonesia has its unique strengths and weaknesses, its own idiosyncrasies. The temptation is to focus on these domestic factors exclusively. In reality, however, a strategy for development that is appropriate for Indonesia means viewing these domestic factors in the context of the external drivers.

China is a reality that Indonesia must live with. No matter whether China grows its economy rapidly and succeeds in transforming its system into one that is internationally competitive or China stumbles in these efforts and sees its reform program derailed by systemic deficiencies and political rigidities, China will have a profound impact on the competitive position of other Asian countries, including Indonesia. It will also affect the strategies that sub-regions like Batam need to adopt in order to develop.

Just because China might become a new economic Superpower in Asia, attract huge amounts of foreign direct investment, and develop into a formidable production base for exports does not mean Indonesia cannot also have a bright economic future and Batam cannot be a dynamic sub-region within Indonesia. If

China does succeed in such a manner, however, it will influence the kinds of opportunities that will exist for Indonesia, the kinds of threats it will face, and the kinds of strategies it needs to adopt in order to prosper in a world in which China's growing economic clout is a key feature.

By the same token, if China were to fail miserably in its reform efforts, causing its economy to stagnate and its political and social systems to become much more unstable, it does not mean that the spotlight of international attention will automatically shift to Indonesia and that the Republic's economy is predestined to prosper, or that foreign companies that had been drawn to zones in China like Shenzhen and Pudong will suddenly start flocking to Batam. If China ceases to be the center of economic attention the way it is today, Indonesia will face a different set of opportunities and risks, and the strategies it will have to adopt to best position the country for rapid economic development would probably be different than if China were still the center of attention. No matter whether China succeeds or fails, Indonesia would be better advised to take a proactive approach to managing its own future than a more passive or reactive approach.

Another key driver of the external environment in which Indonesia will have to exist is the extent that globalization moves forward or reverses. For decades now, the focus has been on how changes in technology like communications and transportation have been making the world "smaller," how the growth of trade and foreign direct investment is creating linkages between different countries even on opposite ends of the world, and how international banks and companies have been growing and merging their activities so that they have a truly global presence. Bodies like the World Trade Organization (WTO) have tried to push a common set of rules governing global trade, while bodies like the IMF and World Bank have gained influence over countries in ways that have encouraged the harmonization of certain fiscal and monetary policies according to norms these multilateral bodies consider appropriate.

In recent years, however, there has been a backlash against globalization. This was perhaps first really visible at the 1999 WTO Summit in Seattle, Washington. This meeting was disrupted by a disparate mob of activists from a number of countries who were protesting a range of perceived threats arising from what they interpreted to be globalization, including environmental degradation, new forms of "cultural imperialism" by the US and Western countries against poorer countries, labor abuses, and exploitation of multinationals from larger and wealthier countries of societies from smaller and poorer countries. No matter whether one agreed with these protestors or not, the fact remained that they succeeded in disrupting the Summit and raising the debate on whether globalization is a good or a bad thing. The word globalization itself has different meanings to different people, but other events since then have highlighted the fact that certain groups in the world feel strongly opposed to globalization. At their most extreme form, their acts of defiance led to the terrorist attacks on the World Trade Center (the target itself was highly symbolic for those opposed to what they see as US-inspired globalization). These attacks prompted the US to review its entire foreign policy and have directly led to two wars, one in Afghanistan and another in Iraq. It remains to be seen if this is the end of the matter or if the world is moving in a direction where even greater confrontation is the order of the day.

The possibility has to be raised, therefore, that the idea of globalization as it is being interpreted by such bodies as the WTO and many major multinationals and governments might not move forward. It is possible that those forces working against globalization will become so strong that the world actually becomes more fragmented

politically and economically. Trading blocs might proliferate that exclude non-members. Poor countries might refuse to adopt standards of intellectual property protection and corporate governance that they see being forced upon them by wealthier countries. Wealthier countries might disagree among themselves so much on certain policies like those relating to trade in agricultural products or to the treatment of major diplomatic issues like dealing with Iraq in the post-Saddam Hussein era that globalization ceases to be a viable concept and the world becomes factionalized along various economic, religious, and political fault-lines.

Anything that creates friction or increases the cost for a company to act globally is something that works against the whole concept of globalization. Terrorism and SARS, for example, work against globalization by increasing expenses and reducing efficiency for companies. Firms need to put in new screening systems for exports and imports in order to comply with security requirements by different countries like the US. Businessmen cannot travel from one country to another as easily as before. In addition to worrying about medical and security risks, they also have to worry about complying with quarantine requirements that differ from country to country. Insurance costs have risen. It is also getting more difficult to find people who will accept certain foreign postings due to security or health risk reasons.

Globalization might be a desirable concept in theory, but in practice it can collide directly with local forces that can subvert various kinds of cross-border business. In particular, there are huge differences between the legal systems of different countries both in terms of the way laws are written and the way they are enforced. There is talk of harmonization of different legal systems, but the results to date show that, at best, it is a slow and painful process. Often there is no progress at all. Special interest groups can frequently take advantage of local legal systems to protect themselves against the forces of globalization. This issue is therefore becoming increasingly important to multinational companies and banks that are trying to operate in a number of different countries.

A third driver external to Indonesia reflects multinationals' interest in Asia, with one extreme being high interest and the other extreme being low interest. Both of the other axes in the framework influence this variable directly. However, multinational interest in Asia is not simply a subset of globalization and China variables. Technological change, shareholder and home-country concerns about governance standards, legal system concerns, speed of market growth, and logistical cost considerations are just some of the factors that shape the enthusiasm of multinational companies for doing business in different parts of Asia and their strategies for structuring this business. Multinationals are very cost conscious. They also need certain infrastructure standards if they are to be able to conduct their business efficiently. They are drawn to systems that have more flexible labor laws rather than those with extremely rigid, onerous requirements. At the same time, they require certain skills to be able to perform certain functions, and they need to be able to interface or link their operations in one country with their global organization. Different companies have different needs, depending on their industry and organizational structure. Those needs change with time, which is one reason why companies sometimes need to restructure the way they operate.

6 Appendix 3: Investment Opportunities in Batam

Key points of a presentation by Ms. Riatna Jeo of BIDA

To give brief ideas what Batam has and what Batam can offer.

1. Strategic location of Batam, proximity to Singapore with close relation between Shenzhen and Hong Kong. Only 20 Km from Singapore and the area is 415 Km². Together with Rempang & Galang linked by 6 bridges, total area 715 Km².
2. Mission set for Batam, to be developed as :
 - Industrial Region
 - Trading
 - Transshipment
 - Tourism
 - Services, incl. Financial services
3. Basic modern infrastructure that investors would need
 - Sea Port : 3 Cargo Ports and 6 Ferry Terminals, including those serving the sea transportation to other major cities of Indonesia like Jakarta or Medan and other islands such as Bintan or places on the mainland of Sumatra. About 120 daily trips to Singapore & Malaysia from morning till midnight, make the place accessible.
 - International Airport. Not for international passenger but for International cargo. We have 8 daily regular flights to Jakarta despite other cities in Indonesia.
 - Source of water from 6 main water reservoirs with the capacity of almost 4000 liter per second which is capable to provide water for 1 million population.
 - Electricity supplied by the state owned as well as private owned, totaling the power supply for 350MW, and still expanding both for middle term and long term.
 - Road capacity, highway all the way to Rempang and Galang and expanding some of the major lanes.
 - Telecommunication, any facilities for data communication and fax is also available and that's linked to Batam Intelligence project that we have established the fiber optic backbone that would be able to supply for the information and the communication technology. This has been invested by PT Telkom Indonesia
4. Some statistical indicators of Batam
 - Population : 570K people living in Batam today with 175K are working as well as 70K people working in nonformal sectors, indicates a healthy dependency ratio.
 - About 2500 expatriates working and living in Batam.
 - Total investment is US\$ 9.2 billion which consists of government investment for about 22% mainly for the development of facilities and infrastructure.

- Comparable amount for domestic and foreign investment amounting to US\$ 7 billion.
5. World class industrial estate
- 16 industrial estates scattered throughout Batam, some are serving for certain type of industry, some are serving certain type of countries.
 - Total of 611 foreign companies as of last year.
 - Industries in Batam are all export oriented. Last year export figure was US\$ 5.9 billion, contributing to the non-oil & gas national export figure about 14%.
6. Tourism
- Hosting Some Cultural events on regular basis to Promote tourism as a taste of Indonesia to welcome you to Batam
 - We have hotels and resorts with 5 stars facility
 - We have 6 beautiful golf courses designed by world class golfers.
 - Altogether there were 1.1 million foreign visitors last year came to Batam
 - For the past 5 years we have managed to put Batam as the 2nd gateway for foreign visitors to Indonesia after Bali
7. Coming Infrastructure project and what Batam could be for the next 5 years
- Extension of Batu Ampar general cargo ports, to enable to supply for Batam needs and partially for transshipment to other part of Indonesia.
 - We are looking to develop gas generated Electricity.
 - International convention center located on southern tip of Batam
8. Education
- Batam Polytechnic is running on the 3rd years in corporation with Bandung Institute of Technologies (ITB) – the best engineering school in Indonesia.
 - It also gets technical assistance from Nanyang Polytechnic – Singapore
 - We are currently developing the permanent home for it in Batam center.
9. Waste water provision control
- We are working to integrate the whole system to provide a clean and healthy environment.
10. Batam Intelligence Island as the national pilot project.
- To integrate all the facilities in tourism, the government and the industry to be able to pass track all the activities and to provide efficient services.

- Public gas facility as the linking from Asam Merah – Jambi to Batam. The gas pipe is targeted to be completed on October 2003.

What Batam has to offer – concerning investment facilities:

- Allowing 100% Foreign Ownership
- Streamline processes for foreign investment, including the license, the immigration procedures and working permits for expatriates and export-import processes, because the whole area is bonded.
- TSP facility, investment allowance, and double taxation avoidance agreement
- Competitive investment and efficient operation cost

SUMMARY :

1. We are offering a strategic location coupled with modern facility.
2. We are supporting the facility with green and panoramic scenery and healthy environment by only developing half of the island and preserving the other half.
3. We still have vast spacious to expand
4. We offer attractive incentives and
5. We have full government support.

About Political & Economic Risk Consultancy, Ltd.

Robert Broadfoot researched and wrote this report. Mr. Broadfoot is the founder and Managing Director of Political & Economic Risk Consultancy, Ltd. (PERC). Established in 1976, PERC is headquartered in Hong Kong. From this base PERC manages a team of researchers and analysts in the ASEAN countries, the Greater China region and South Korea. Over 1,200 corporations and financial institutions worldwide currently use PERC's services to assess key trends and critical issues shaping the region, to identify growth opportunities, and to develop effective strategies for capitalizing on these opportunities.

PERC helps companies understand how politics and other subjective variables are shaping the business environment. Such variables may be difficult to quantify, but nevertheless can have a critical impact on investment performance and therefore have to be factored into the decision-making process, which is the function of PERC's services. PERC's value lies in the organization's experience, its Asian network of seasoned analysts, its emphasis on primary research, its complete independence from any vested interest groups, its pioneering work in the technical aspects of country risk research, its discretion, and its integrated, regional approach to analysis.

Surveying businessmen in all Southeast and East Asian countries is one of the main ways that PERC conducts primary research. Some of the indices PERC has developed over the years through its surveys have become the standard reference for monitoring such variables in Asia. For example, for over a decade now, PERC has also been surveying businessmen's perceptions of corruption in all major Asian countries.

Mr. Broadfoot is a regular lecturer at the Pacific Rim Banker's Program of the University of Washington in Seattle, where he teaches skills for analyzing country risk. For the past 14 years, Mr. Broadfoot has served as the economic adviser to the Swiss Business Council of Hong Kong Council. He is the publisher of PERC's *Asian Intelligence* newsletter and its annual *Business Environment Report*. The country data for this report was drawn from PERC's *Business Environment Report for 2002*.