Regional Investment

The Chinese factor

The top echelons of government were all but vacated on April 18 as Jusuf Kalla headed off on a five-day visit to China accompanied by an astonishing array of Indonesia's political and economic elite. Three state ministers, three of the most powerful provincial governors, the CEO from the state-owned electricity company, and the owner of a major Indonesian bank joined the heads of Indonesia's Investment Coordinating Board (BKPM), Indonesia's Chamber of Commerce (Kadin), and some of the most influential members of the Indonesian House of Representatives (DPR). The composition of Kalla's entourage emphasises not only the growing importance of Indonesia-China ties, but also the combination of politics and economics that is fast defining the relationship between the two countries.

The *Report* gives a timely overview of the rise in Chinese investment in Indonesia, looking at the reasons behind its expansion, detailing its sectoral concentration and highlighting the political quid pro quo that lies behind many of the biggest business deals.

Expansion of Chinese overseas investment

Chinese investment overseas began at the end of the 1990s.

During the 1990s, as all eyes were on the massive flows of investment into China, Chinese companies began a remarkable expansion of investment out of the country in 1999. By reforming its overseas investment regulations, the Chinese government entreated its domestic companies to "go abroad."

It was driven by Chinese foreign exchange surpluses and a growing need for energy.

The main economic motivations for Chinese overseas investment is the country's appetite for energy to feed its growing domestic economy coupled with the need to channel its massive foreign exchange reserves out of the country. Standing at US$659 billion by 2005, the Chinese government is trying to avoid reinvesting this foreign exchange surplus in China, fearing that it would cause the domestic economy to overheat.

Total Chinese investment overseas amounts to around US$40 billion from 1982-2004.

Official data on Chinese investment abroad is notoriously inaccurate and widely divergent depending on its source. The Chinese Ministry of Commerce (MOFCOM) puts total cumulative investment abroad from 1982 to 2004 at roughly US$12 billion, whereas the country's State Administration of Foreign Exchange (SAFE) puts the number at approximately US$40 billion. MOFCOM's figures underestimate outward investment because they only include investments that have been officially approved, whereas SAFE measures actual outflows, testifying to the amount of "illegal" investment overseas as private companies seek to avoid government channels and their attending bureaucracy. Because of the bureaucratic hurdles, it should be noted that many overseas investments from the Chinese private sector are conducted through other countries, especially Hong Kong and Singapore.

This amount is still considerably less than total US investment overseas for the same period.

Already surpassing countries such as South Korea which have long been established in the international investment scene, this remarkable figure of US$40 billion nevertheless pales in comparison when compared to total cumulative US investment abroad from 1982 to 2004, which stands at over US$2 trillion.

TOTAL CHINESE INVESTMENT IN INDONESIA HAS BEEN UNDERESTIMATED BY OFFICIAL SOURCES.

Aggregate data on the levels of Chinese investment in Indonesia also vary widely depending on their source. Official statistics from MOFCOM put China's cumulative investment in Indonesia from 1979 to 2002 at just US$65 million. However, Indonesia's BKPM measures the realisation of Chinese investment in sectors outside of oil and gas, coal, banking, and insurance to be US$45 million from 2004 to 2005.

UNOFFICIAL STATISTICS PUT CHINESE INVESTMENT IN INDONESIA AT AROUND US$6 BILLION.

Unofficial statistics tell a very different story. Mohammad Toha, an executive on Kadin's Chinese Committee, which is intimately involved with mainland Chinese investment in Indonesia, suggests that cumulative investment from China for the past five years has reached some US$6 billion. Meanwhile, Indonesian Minister of Trade Mari Pangestu estimates total Chinese investment in the oil and gas sector alone to be US$1.2 billion, with another US$1 billion to US$2 billion mostly invested in agriculture and trading.

While MOFCOM's data is widely known to represent only a fraction of Chinese overseas investment, BKPM's statistics are also limited by their sectoral coverage and the fact that realised investment figures capture only those investments that have received permanent licenses to operate from the Indonesian government. In reality, the total amount of cumulative Chinese investment in Indonesia over the past few years is likely to be nearer the US$6 billion mark.

Economic sources of Chinese interest in Indonesia

CHINESE INTEREST IN THE INDONESIAN ECONOMY IS MOTIVATED BY INDONESIA'S WEALTH OF NATURAL RESOURCES AND DESIRE TO AVOID IMPORT QUOTAS AROUND THE WORLD.

Economically, Indonesia is a good match for Chinese investment needs because of its abundance of natural resources but lack of the capital and technology required for their exploitation. Indonesian timber has, for example, long been sought after in China to feed its domestic furniture manufacturing industry, but in recent months Chinese interest in Indonesian timber has risen exponentially. Officially, such a rise in demand is a response to the explosion of construction related to the 2008 Beijing Olympics, but some established China watchers question whether that is really true. The April 18 announcement of a proposal from a Chinese company to invest US$1 billion in a timber processing factory in Papua confirms this trend, much to the chagrin of environmentalists desperately trying to save the remainder of Indonesia's disappearing forests.

Another cause of China's interest in Indonesia is tension in relation to import quotas around the world, and with the US in particular. Re-locating Chinese manufacturing industries abroad in order to by-pass these import restrictions is becoming one of the dominant trends in Chinese investment abroad, although this process is only just beginning in Indonesia with factories opening up to produce electronic goods, garments, footwear, and furniture.

Coincidence of Indonesian and Chinese political interests

POLITICALLY, BOTH CHINA AND INDONESIA HAVE AN INTEREST IN OFFSETTING US POWER IN ASIA.

Politically, China and Indonesia have many important interests in common which serve to further cement their economic relationship. Both Indonesia and China have an interest in containing, or at least off-setting, the power of the United States within the region. Indonesia's relationship with the US has suffered in recent years due to the latter's invasion of Iraq, which many in Indonesia see as an attack on Islam. This leaves the Indonesian government vulnerable to criticism from opposition politicians whenever the government is seen to be dealing with US political or economic elites.

The US war on terror makes Indonesia-US relations uncomfortable given Indonesia's Muslim majority.

According to Marvin Ott, a professor at Washington's National War College, China sees Southeast Asia in the future as "roughly akin to Latin America to the United States." In other words, China's diplomacy within the region is aimed at securing a stable "backyard" and Indonesia's size, control over some of the most strategic seaways in Asia, and its central position in ASEAN all make it a key country for China to support within the region.

China is cultivating stability in its immediate geopolitical environment and sees Indonesia as a key ally.

Furthermore, ambivalence from both countries surrounding human rights stands in contrast to the political demands of the West. Seasoned Jakarta journalist Urip Hudiono suggests that China does not question alleged human rights violations perpetrated by the Indonesian military in its quest to contain separatist challenges from Aceh and Papua. In return, Indonesia holds a "one China" policy, in the past even refusing requests for official visits from Taiwan's head of state.

Both Indonesia and China do not question each others' human rights records.

A history of tense relations

China and Indonesia's relationship has strengthened considerably since the fall of Soeharto in 1998. Abdurrahman Wahid revived relations during his tenure as president from 1999 to 2001. He removed many of the cultural and social restrictions on Indonesia's ethnic Chinese community and also tried to set up an international axis between India, China, and Indonesia. Although Wahid's vision was cut short by his ouster as president in 2001, President Megawati, who replaced him, signed many military and economic cooperation deals with China and provided a memorable metaphor for the continued trend in warm relations when she danced with President Jiang Zemin on a state visit in 2002.

Since 1998, Indonesia-China relations have strengthened considerably under the successive governments of Wahid and Megawati.

Such a conflation of contemporary political interests stands in stark contrast to the tense history of Sino-Indonesian relations. The burgeoning relationship between the two countries in the immediate post-independence era was cut short in 1965 when Indonesia severed diplomatic relations with China in the aftermath of the October 1965 failed coup d'etat, which opened the door for General Soeharto's rise to power.

In contrast, political relations between the two countries have been historically tense, derived from suspected Chinese involvement in the 1965 failed coup d'etat.

At that time, the PKI's affiliation with the Communist Party in China gave General Soeharto ammunition to sever relations with China, claiming that China had shipped arms to the PKI to engineer the coup d'etat. Moreover, during the Cold War era the US government's support for Soeharto and Indonesia served to drive a wedge further between Indonesia and China.

Trade between the two countries continued throughout this period, but indirectly through Singapore and Hong Kong, until official trade was restored in 1985. With a full normalisation of diplomatic relations in 1990, political and economic relations continued to grow, but suffered again in 1998 when the ethnic Chinese community in Indonesia again became a scapegoat for Indonesia's internal political tensions.

President Yudhoyono has continued the trend of warm relations between the two countries with three state visits to China since his inauguration.

President Yudhoyono has continued to strengthen Sino-Indonesia political relations with three state visits to China since October 2004 and the signing of a "Strategic Partnership" document in 2005, encompassing a raft of economic and education projects and loan agreements.

The oil and gas sector

China's main economic interest in Indonesia is motivated by a thirst for oil in a region where an energy crisis is predicted for 2020.

However, the real story of Sino–Indonesia relations is in the economic sphere and relates to China's thirst for oil and its energy security policy more generally. Top US think-tanks, such as the Council on Foreign Relations and the Centre for Strategic and International Studies, predict that Asia will become the largest consumer of oil by 2010 because of both China's and India's unstoppable economic growth. This, they say, will create a world energy crisis that could begin by 2020.

Chinese oil consumption is still far below that of the US, but will grow quickly in the near future.

Chinese oil consumption is still far below US levels. In 2004, China consumed 6.5 million barrels per day (bpd), while the US consumed 20.4 million bpd; the US alone accounted for a quarter of the world's oil consumption. It is the continued growth of China's economy, however, that makes other countries nervous in a world of finite resources. It is predicted that by 2020 China's consumption of oil will reach 10.5 million bpd.

China is aiming to diversify its reliance on Middle Eastern oil.

China has so far relied on the Middle East for much of its oil imports. Firdaus Ibrahim, an oil analyst who has worked for Pertamina, said that in 2000 out of the 70 million tons of oil imported by China, 50 million tons came from the Middle East. However, in recent years the tandem of the US military presence and the political turmoil in the region has pushed China to find new sources of oil, particularly in Asia. Indeed, it was Unocal's interests in Central and Southeast Asian oil fields that drove the China National Offshore Oil Corporation's (CNOOC) failed bid to acquire Unocal in 2005. It is in this context that Indonesian oil is looking more and more attractive for China.

Most Chinese activities in Indonesia's oil sector centre around acquisitions of existing concessions rather than exploration or refining.

Out of China's three main state oil companies, CNOOC has been the most active in Indonesia. Its activities have focused on acquisitions of pre-existing concessions rather than refining or exploration. Dr. Kurtubi of the Centre for Petroleum and Energy Economics Studies in Jakarta told the *Report* that "this is because Chinese companies still do not have an appetite for exploration in Indonesia due to the high risks associated with oil exploration in Indonesia." Oil refining is not a large part of the Chinese oil companies' portfolio, as the Chinese government's policy is to import mostly crude oil. Oil analyst Sri Hartati Samhadi said that this is because crude oil is easier to store than refined oil, which degrades faster.

With CNOOC's acquisition of Repsol in 2002, a Chinese company is now the biggest offshore oil producer in Indonesia, although most of Indonesia's oil is produced onshore.

The biggest Indonesian CNOOC deal was made in 2002 when the company spent US$585 million to buy nine subsidiaries from the Spanish company Repsol, which operated in five oil and gas fields. This turned CNOOC into the biggest offshore oil producer in Indonesia with an output of 125,000 bpd. This was indeed a massive deal, and the tag that a Chinese company is now the biggest offshore oil producer in Indonesia made the headlines everywhere in 2002, but Dr. Kurtubi puts this into context by pointing out that most oil production in Indonesia is onshore.

Other major deals for Chinese oil companies have been the acquisition of Devon Energy, a US company, for US$262 million and production sharing contracts with Pertamina in Sukowati and Tuban, all in 2002. These Chinese purchases of oil concerns were not without their political undertones. In the case of Repsol, a *Report* source reveals, Pertamina had been preparing for years to take over this field, but after Megawati's 2002 trip to China it was agreed that a Chinese firm would be allowed control.

Anecdotal evidence also suggests that PetroChina was involved behind the scenes in the Cepu controversy. The dispute over Cepu centred on the question of whether Pertamina or the US company ExxonMobil would control the oil-rich field. It became something of a cause celebre for Indonesia's economic nationalists until it was resolved in favour of Exxon in March 2006. It has been reported that at one stage PetroChina was in the running for control of Cepu and that this served as a very useful bargaining chip for the Indonesian government in its negotiations with Exxon.

CHINESE OIL COMPANIES HAVE BEEN INVOLVED IN POLITICAL STRUGGLES FOR OWNERSHIP OF OIL FIELDS, INCLUDING CEPU.

Such stories are representative of one view that the entry of China into Indonesia's oil sector can only benefit Indonesia in the long run. The chairman of the Indonesian Construction Association, Sucipto, says "Chinese investment in oil and gas industries will help make investment climate in the sector more competitive, efficient, and effective," adding that "the growing investment by Chinese firms will reduce Indonesia's reliance on a few countries which so far have been controlling Indonesia's oil and gas resources."

SOME BELIEVE THAT CHINESE INVOLVEMENT IN INDONESIA'S OIL INDUSTRY HAS MADE THE INVESTMENT CLIMATE MORE COMPETITIVE, ULTIMATELY BENEFITING INDONESIA.

However, despite such stories that seem to suggest that other countries' oil interests in Indonesia are under threat from China, it is important to view China's involvement in the oil sector within context. In a data set obtained exclusively by the *Report*, Table 1 shows a steady increase in investment by Chinese companies in oil but still far below that invested by US firms. These statistics offer some interesting comparisons based on the levels of cumulative investment from 2000 to 2004. For example, China's investment is roughly a quarter of US investment, but it is almost the same size as France, over a third bigger than the UK and three times the size of Indonesian investment.

CHINESE INVESTMENT IN INDONESIA'S OIL SECTOR IS STILL ONLY A QUARTER OF US INVESTMENT.

Table 1:

Realisation of Investment Expenditure of Foreign Contractors
2000 – September 2005 (Thousands of US$)

	2000	2001	2002	2003	2004	2005
A/ Contracts in Production						
U.S.	2.333.1	2.251.5	2.737.8	2.818.7	2.450.6	1.744.6
China	519.3	499.4	490.1	632.9	731.9	527.4
U.K.	154.7	259.8	290.2	196.4	181.5	203.8
France	192.7	258.9	390.5	586.7	603.3	548.1
Indonesia	108.9	124.1	193.5	259.6	267.8	203.8
Other Countries	519.3	499.4	538.5	744.9	794.9	706.4
Total	3.605.2	3.782.8	4.640.5	5.239.3	5.030.0	3.934
B/ Contracts Not Yet in Production						
Total	325.8	419.2	735.4	432.3	527.9	730.4
TOTAL (A+B)	**3.931.0**	**4.201.9**	**5.375.9**	**5.671.6**	**5.557.9**	**4.664.5**

Source: Dirgen Migas

Table 2 shows the distance CNOOC has to go if it is to catch up with the production levels of the US firm Caltex.

Table 2:

Indonesian Crude Production by Company (Selected)
(1000 bpd)

Company	1974	1980	2001	2002	2003	2004
Caltex	909	760	643	577	507	507
CNOOC	54	82	126	115	95	81
Exspan	47	39	77	85	66	54
Total	2	199	90	80	81	82
ConocoPhilips	19	25	83	69	51	44
Unocal	101	109	59	56	54	56
BP	89	134	51	46	39	31
PetroChina	30	60	46	42	40	37
Pertamina	30	60	46	42	44	48
ExxonMobil	-	42	13	25	25	21

Primary Source: Migas Exploitation; Secondary Source: Petroleum Report Indonesia 2003 and 2005, American Embassy, Jakarta.

THE US OIL GIANT CALTEX ACCOUNTS FOR 50 PERCENT OF INDONESIA'S OIL PRODUCTION, CHINA'S CNOOC ACCOUNTS FOR 12 PERCENT.

Given that total Indonesian production is today hovering at around 1 million bpd, Caltex alone accounts for approximately 50 percent of Indonesia's total oil production, while CNOOC accounts for around 12 percent. With the potential 170,000 bpd from ExxonMobil's discoveries of oil in Cepu due to come on tap by 2008, the distance between production from Chinese and US companies is likely only to increase in the near future. However, as China steps up its acquisitions of oil fields, and perhaps moves into exploration, there is every chance that Chinese firms will catch up in the longer term.

Quid pro quo

INDONESIA PROVIDES CHINA WITH ACCESS TO HER OIL FIELDS IN RETURN FOR CHINESE INVESTMENT IN INFRASTRUCTURE.

In return for providing access to oil fields for Chinese companies, the Indonesian government asks for Chinese investment in infrastructure projects, which are generally unattractive to international investors because of their low profits and high risks. Over recent years the government has announced many "agreements" with Chinese companies to fund various infrastructure projects ranging from electricity plants to rail tracks and toll roads; many are worth billions of US dollars.

DESPITE MANY ANNOUNCEMENTS OF CHINESE-FUNDED INFRASTRUCTURE DEALS, MANY HAVE NOT ACTUALLY MATERIALISED.

However, all is not what it seems. One Western investment analyst in Jakarta has recently been involved in the negotiations between Chinese companies and the Indonesian government over infrastructure deals. He told the *Report* that "last year many Chinese businessmen came to the Indonesian government's infrastructure summit, spent a lot of money travelling around and inspecting potential sites, but in the end they didn't do any investing."

While confirming that much of the Chinese interest in Indonesia's infrastructure arose as a result of the 2005 meeting between President Yudhoyono and President Hu Jintao, his own experience is that "there seems to have been a different point of view about what was agreed between the two sides and they are both still trying to work that out."

The sticking points seem to be centred on two main issues. First, the Chinese want to bring their own blue-collar labour to Indonesia to staff their investments, which is anathema to the Indonesian government, as it faces increasing unemployment. The second problem is the issue of ownership. Whereas the Chinese want complete ownership of investments, such as coal and power stations, the Indonesian government is only able to offer operating contracts because of the constitutional clause that outlaws direct foreign ownership of resources.

DIFFICULTIES SURROUNDING THE IMPORTATION OF CHINESE LABOUR AND FULL OWNERSHIP OF NATURAL RESOURCES NEED TO BE RESOLVED BEFORE INFRASTRUCTURE DEALS PROCEED.

If the government announcements of agreed Chinese investment in infrastructure projects are anything to go by, Chinese companies will have an even stronger presence in the Indonesian economy. Until then, however, investment which has actually materialised in this sector remains minimal.

Environmental concerns

Returning to the natural resource sector, environmentalists are increasingly concerned that the Indonesian government's desire for Chinese involvement in infrastructure is at a very great cost for the natural environment.

It has been alleged, for example, that an offshore oil facility run by CNOOC and BP Indonesia created a massive oil spill around the Thousand Islands, just off the coast of Jakarta, in 2003. Backed by forensic data proving that the oil spill came from the CNOOC facility, environmental groups are adamant that there is more than enough evidence to prosecute the two companies. However, sources report that the involvement of CNOOC makes it politically unfeasible for the prosecution to continue. This stands in contrast to the recent Newmont case where a US mining firm was taken to court for alleged environmental violations despite a total lack of evidence.

SUSPICIONS THAT AN ALLEGED OIL SPILL FROM A CNOOC/ BP INDONESIA OFFSHORE FACILITY HAS NOT BEEN PURSUED BECAUSE OF CHINA'S POLITICAL INFLUENCE IN INDONESIA.

Another example of Chinese companies' preparedness to use their political clout to the detriment of the natural environment is the case of the Satui pulp mill in South Kalimantan. Owned by the Singapore-based company UFS, plans for the construction of the mill were put on hold in 2002 because the forest concessions, which the company had bought to feed the mill, were the subject of a dispute with the Indonesian government. The dispute centred on the non-payment of reforestation funds by the previous owner of the concession to the Indonesian government. When UFS's partner, a Dutch firm, withdrew its involvement in 2002 under pressure from international environmental NGOs, UFS searched for another.

ADDITIONAL ALLEGATIONS THAT THE INVOLVEMENT OF ANOTHER CHINESE STATE-OWNED COMPANY HAS FACILITATED AN ENVIRONMENTALLY DESTRUCTIVE PULP MILL, AGAIN DUE TO CHINA'S POLITICAL INFLUENCE.

The new partner that UFS found was state-owned Chinese company China National Machinery & Equipment Import & Export Corporation (CMEC). In 2002, observers predicted that CMEC's involvement in the pulp mill would aid UFS's case with the Indonesian government over the forest concessions. An analyst stated that "Indonesia and China have good ties and the market will be expecting the concessions issue to be resolved positively." This prediction did indeed come true in 2005 when the Supreme Court ruled in favour of UFS and the Satui mill is now expected to begin production by 2007.

More recently, this pattern was again confirmed by the announcement in

Environmentalists question the validity of Chinese-funded plans to build a massive oil palm plantation in Kalimantan, suspecting that the land will just be harvested for timber and then left empty.

February 2006 of a Chinese-funded plan to build and operate a 2000km-long, 5km-wide oil palm plantation in Kalimantan, which slices through three national parks. Environmentalists have questioned the plan, pointing to the fact that much of the land under consideration is not even suitable for growing oil palm and voicing their suspicions that it is a subterfuge for the Chinese company to harvest the timber on the land. Economist Faisal Basri has openly accused the Indonesian government of "offering timber in exchange for Chinese investment in infrastructure projects."

China's own domestic environmental record is one of the worst in the world. Logging of domestic timber has reached such a degree that the Chinese government has been forced to impose a moratorium on it and China has 10 of the most polluted cities in the world. With such a track record of disregard for its own natural environment, countries which host Chinese investment need to be especially on guard.

Conclusion

Chinese executives have advantages over their Western counterparts in Indonesia due to their experience of doing business in developing country environments and their international connections.

Some analysts have suggested that, compared with Western business executives, Chinese executives possess important assets when investing in developing countries like Indonesia. Connections with overseas Chinese networks is one asset which is often mentioned, especially in the Indonesian context. Although there is no real data to support the idea that Chinese-Indonesian businessmen have particular connections to mainland Chinese businesses, the abundance of anecdotal evidence on the flows of Chinese-Indonesian money out of Indonesia and into China immediately after the onset of the Asian Economic Crisis seem to at least partly confirm this idea. It should also be remembered, however, that Indonesia's ethnic Chinese community has long been established in Indonesia, to the extent that many no longer even speak Chinese.

An enabling political environment is also a major bonus.

Another important asset that Chinese businesses are thought to possess is their experience in doing business in developing countries. It has been suggested by some that a flexibility in business practices, related to a certain freedom from thinking in terms of contracts and rules, is a good match for the Indonesian business environment. To be sure, drawbacks for the Chinese also exist; a lack of corporate management skills and a poor technological base are just two. Nevertheless, if some of the propositions presented here are at least partly accepted then it seems that the already solid position of Chinese investors in Indonesia is strengthened immeasurably by the support of a favourable political environment.❐