INVESTING FROM A COUNTRY RISK PERSPECTIVE

Case Indonesia

Master’s Thesis
in Accounting and Finance

Author
Mika Koivisto 9653

Supervisors
Lic.Sc. Asta Manner
Lic.Sc. Ulla-Maarit Valve

27.11.2008
Turku
# CONTESTS

1  INTRODUCTION .................................................................................................................. 6
   1.1  Background ..................................................................................................................... 6
   1.2  Objectives ..................................................................................................................... 7
   1.3  Methodology and methods ............................................................................................ 8
   1.4  Structure ....................................................................................................................... 10

2  INVESTMENT DECISION-MAKING .................................................................................... 12
   2.1  Company investments .................................................................................................. 12
   2.2  Foreign direct investment ............................................................................................ 13
       2.2.1  Definition of and motives for foreign direct investment ......................................... 13
       2.2.2  Foreign direct investment as an entry mode ......................................................... 16
   2.3  Investment decision-making process ............................................................................ 17
   2.4  Eclectic theory on foreign direct investment choices .................................................. 21
       2.4.1  Dunning’s eclectic theory ....................................................................................... 21
       2.4.2  Ownership-specific advantages in eclectic theory ................................................. 23
       2.4.3  Location-specific advantages in eclectic theory ..................................................... 24
       2.4.4  Internalisation advantages in eclectic theory ......................................................... 26
   2.5  Location aspect framework of foreign direct investment ............................................. 27
       2.5.1  Tahir’s location aspect framework ....................................................................... 27
       2.5.2  Ownership-specific advantages in location aspect framework ............................ 28
       2.5.3  Location-specific advantages in location aspect framework ............................... 29
       2.5.4  Internalisation advantages in location aspect framework .................................... 31

3  RISKS IN INVESTING ABROAD ....................................................................................... 33
   3.1  Risk for companies ....................................................................................................... 33
       3.1.1  Definition of risk .................................................................................................... 33
       3.1.2  Risk determination and analysis ............................................................................. 34
   3.2  Definition of country risk and its varying categorisation ............................................. 37
   3.3  Classification of country risks .................................................................................... 39
       3.3.1  Economic risk ........................................................................................................ 39
       3.3.2  Transfer risk ........................................................................................................ 40
       3.3.3  Exchange rate risk ............................................................................................... 40
       3.3.4  Location risk ........................................................................................................ 41
       3.3.5  Sovereign risk ........................................................................................................ 42
       3.3.6  Political risk .......................................................................................................... 42
       3.3.7  Social aspect ......................................................................................................... 44
### 3.3.8 Corruption ................................................................. 45
### 3.3.9 Roundup of country risk relations ................................ 46
### 3.4 The effect of country risk for different types of investment .... 46
### 3.5 Country information and reducing risk ............................... 48
  - 3.5.1 Gathering country information ..................................... 48
  - 3.5.2 Reducing country risk .................................................. 48
### 3.6 Risk ratings .......................................................................... 50

### 4 INDONESIAN ECONOMY AND BUSINESS ENVIRONMENT .......... 52
### 4.1 Overview of Indonesia .......................................................... 52
### 4.2 Brief history of Indonesia in the modern times ...................... 53
### 4.3 Indonesian economy ............................................................. 54
  - 4.3.1 Past developments .......................................................... 54
  - 4.3.2 Recent developments ....................................................... 56
  - 4.3.3 Short-term prospects ....................................................... 59
### 4.4 The importance of a proper investment climate in attracting foreign direct investments .................................................. 60
  - 4.4.1 Investment climate defined .............................................. 60
  - 4.4.2 The importance of inward investments for countries .......... 61
  - 4.4.3 Developing countries attracting foreign direct investments .... 62
### 4.5 Indonesia’s investment environment ...................................... 63
  - 4.5.1 Background on Indonesia’s investment climate ................. 63
  - 4.5.2 Political aspect ............................................................... 65
  - 4.5.3 Corruption aspect ........................................................... 67
  - 4.5.4 Infrastructure aspect ....................................................... 68
  - 4.5.5 Workforce aspect ............................................................ 71
  - 4.5.6 Other aspects ................................................................. 72
  - 4.5.7 World Bank’s Doing Business 2009 survey ....................... 73

### 5 EMPIRICAL RESEARCH FINDINGS .......................................... 77
### 5.1 Background of the interviewees .......................................... 77
### 5.2 Decision-making process of companies operating in Indonesia ........ 79
### 5.3 Factors derived from OLI perspective affecting investments in Indonesia ............................................. 82
  - 5.3.1 Ownership-specific factors .............................................. 82
  - 5.3.2 Location-specific factors .................................................. 83
  - 5.3.3 Internalisation factors ..................................................... 86
### 5.4 Country risks faced by companies in Indonesia .................... 87
  - 5.4.1 Economic risk ............................................................... 87
  - 5.4.2 Transfer and exchange rate risks ...................................... 88
LIST OF FIGURES

Figure 1. Checkpoints in the foreign investment entry decision process (Root 1987, 127) ............................................................ 18

Figure 2. The eclectic framework (Tahir 2003, 53) ................................................................. 23

Figure 3. The framework related to location aspects (cf. Tahir 2003, 78) .................. 27

Figure 4. Decision-making (Hertz & Howard 1983, 14) ....................................................... 35

Figure 5. Linkages between the risks that comprise the notion of country risk ....... 46

Figure 6. Business involvement relative to risk (Poole-Robb & Bailey 2002, 34) .... 47

LIST OF TABLES

Table 1. Doing Business 2009 survey results (cf. World Bank 2008b, 2–4; cf. World Bank 2008c, 2–4). ................................................................. 73
1 INTRODUCTION

1.1 Background

Foreign direct investments have hit the world like a storm in the past 30 years. Two most important reasons behind this are, first, the costs of production in developed countries have risen rapidly. Second, market growth and thus demand for goods in the developing world have exploded. Moreover, companies often feel forced to follow competitors into unknown territories, leaving their own proper due diligence incomplete, which might turn out to be hazardous for their business. In international business, assessing risks faced by investments is vital in order to be prepared for different outcomes that new unpredictable environments may bring.

Companies’ investment decision-making process is typically very complex with several phases before leading to a decision. Furthermore, the process varies considerably between companies and different types of investments. Common objective is to make an optimal investment decision, but in reality a wide range of different factors affect the decisions made, for example competitors’ plans, company’s history, and on what its executives hold firsthand information on. Managers might even rule out some countries or areas from a closer examination simple because of a negative perception.

Country risk is something that makes investing in most parts of the world very risky. Country risk can originate from a wide range of sources, such as low transparency of government policies, corruption and economic environment. The probability for country risk related negative event to occur might be very small, nevertheless, all possible risks should be included in country risk assessments since possible downsides from most of the risks could be hazardous for investors.

Taking country risks into account, when undergoing an investment decision-making process, lay a foundation for successful long term investments. Gathering country information and being up-to-date on country risk issues does not stop after the initial investment decision is made but continuous analysis of different host country factors is vitally needed as environments tend to change fast when problems start to unravel. Assessment methods which aim to chart every risk imaginable and their consequences would be the best way forward since thorough analysis leaves less space for personal, often ill-informed, opinions. However, this method can be very time consuming and thus probably not worthwhile because of the costs involved. Luckily companies have the option of buying all the necessary data and analyses from cost-effective country risk rating agencies giving companies free hands to concentrate on their core businesses.
The case country in this study, Indonesia, is the fourth largest country in the world by population and by far the largest market in Southeast Asia. Regardless of the market size, abundance of natural resources and cheap labour, foreign direct investments into the country have been consistently lacking behind Indonesia’s neighbours, such as Malaysia, Thailand and Vietnam. This can be explained with several challenges that Indonesia’s business environment is facing, such as red tape, corruption, inflexible labour laws and uncertain policy making environment to name a few. On the other hand, Indonesian government is determined to make the country increasingly attractive to foreign investors, and it is implementing several changes in legislature, regulations and ways of doing business. These factors make this study on country risk-ridden Indonesia not only more interesting and actual but also more challenging.

At the present moment as the global economy is facing an inevitable downturn, companies are seeking markets that continue in a strong growth path despite deteriorating global environment. Indonesia could be one of these markets to invest in since fundamentals in the economy are sound and its economy has been experiencing strong and steady growth for the past few years. In addition, bulk of Indonesia’s economic growth derives from strong private consumption, which is not as vulnerable to global decline as, for example, export driven growth would be.

Previous studies on foreign direct investment seldom view country risk issues with the importance that they deserve. Some studies have introduced location issues that companies need to take into account but comprehensive analysis on how country risk affect investments is clearly needed, which is what this study is focusing on.

1.2 Objectives

The aim of this study is to explain how country risk affects companies’ investments. Both investment decision-making process and already established investments are studied from a country risk point of view. Dunning’s (1981; 1993) eclectic theory is used as a basis in this study for examining companies foreign direct investment (FDI) decision-making behaviour since the eclectic theory covers a range of different factors affecting FDI, and most importantly nation specific factors. Tahir (2003) has compiled several location theories together and formed a location aspect framework which complements Dunning’s eclectic theory in many ways. Together these two theories form a sound base for studying how country related risks affect investments.

The risks included in the notion of country risk and the notion itself are analysed in depth. The concept of risk and risk determination are also reviewed aiming at building a suitable background for discussing country risk and its effects. This theoretical background is put into a use in an Indonesian context. Thus, the Indonesian economic envi-
The environment is closely examined in this study. In addition, the concept of investment climate is introduced because of its strong linkage to companies’ foreign direct investment behaviour, and since various country risks affect the investment climate considerably. To shed light on how country risks and investment climate actually affect investments in Indonesia six focused interviews were conducted in Indonesia, five with company managers and one with a government official.

The purpose of this study can be narrowed down to three research questions, which are the following:

1. What country risk is?
2. How country risks are taken into account in investment decision-making?
3. How country risks and investment climate affect companies investing and operating in Indonesia?

The choice of mode of operation in abroad is a very important decision for companies. Nevertheless, this study focuses only on foreign direct investments may it be a joint or a sole venture type of investment. Moreover, the purpose of this study is not to offer a universal setting how company investments are affected by country risk. However, companies operating or planning to invest in Indonesia and, to some extent, in other developing countries, will get a more precise idea of country risks affecting investments, which could be then used for their own purposes.

1.3 Methodology and methods

The research methodology used in this study is action analytic approach, which lies in the field of qualitative research (see, for example, Lukka 1986; Lukka 1991: Kasanen, Lukka & Siltanen 1991). For qualitative research the objective is not to test theories or hypotheses but to examine the underlying data in a multifaceted and detail way. The empirical research target group is selected with an intention of getting the most fitting sample as possible, not with the aim of acquiring a random sample. Another aspect of qualitative research is that the shape of the research plan changes as the research process advances, making the research very adoptable to changing circumstances (Hirsjärvi, Remes & Sajavaara 2007, 160).

Action analytic approach is sort of a midpoint between nomothetic and constructive approaches since it also relies on empirical data. Action analytic approach is in essence more similar to descriptive methodology (how and why are things), but the transfer to the normative side (how things should be) is fairly uncomplicated since research often leads to the untangling of goals, situations and problems. In action analytic approach analysis is usually conducted with several parallel methods, where the contribution is mainly based on empirical data (Lukka 1986, 166–178; Lukka 1991, 135–146).
There are few problems associated with the action analytic approach. Firstly, action analytic approach provides one-off results, however, it is noted that the objective is not to acquire general results but to find answers to relevant research questions. Secondly, studies made with action analytic approach face two validity issues. As mentioned above, research results cannot necessarily be generalised since it is usually impossible that the research would be dealing with a statistical sample. Another validity issue is that objectivity of the studies is questionable since the researcher has an effect on the research subject, and the size of the effect is often difficult to measure (Lukka 1986, 166–178; Lukka 1991, 135–146).

The case in this study is Indonesia. The method used to collect empirical data was focused interview, and five director-level company representatives and one government official were interviewed. Focused interview was chosen as a method for this study since its form is very open, which does not restrict the interviewees in any unnecessary ways (Eskola & Suoranta 1998, 88).

The interview type used in this study is an intermediate form of standardised and open interview. Focused interview is suitable when research aims at explaining weakly recognised matters that the interviewees are not used to talk about frequently. For this study the focused interview was the most suitable form of interview since investment decisions and the effect of country risk to investments are hardly issues that managers need to address in their day-to-day business life. In addition, focused interview suits best a study with a somewhat limited number of interviews conducted (Hirsjärvi & Hurme 1995, 35–38).

Focused interview is a semi-structured interview since the themes of the interview are clear but the exact form and sequence of questions are missing. The name focused interview derives from the fact that during the interview the discussion will focus on a certain topic or topics but the exact structure is not predetermined. Focused interview has four salient attributes. First, the interviewees should be able to disclose all the matters that they are willing to. Second, the reactions of the interviewees should be as specific as possible. Third, the interview should work as a tool for the interviewees to describe the deeper meaning of the matter at hand. Fourth, the interview should take into account the characteristics and prior experiences that the interviewees have (Hirsjärvi & Hurme 1995, 35–38).

The companies, for which the managers interviewed in this study work, operate in fairly diversified business sectors with different aims in the future for the development of their businesses in Indonesia. These varied company backgrounds and goals lay a foundation for acquiring a more extensive picture of foreign business operations in the country. Mutual for all the companies is that they are expanding their businesses in Southeast Asia, but not necessarily in Indonesia due to the lacking investment environment in the country. In addition, an officer from the Indonesian Investment Coordinat-
ing Board – Indonesia’s investment promoting agency – was interviewed in order to get a view of a government official why Indonesia is lacking behind its neighbours in attracting investments and what are the government’s plans to improve the investment climate in the short term. The interviewees were both of local and foreign origin, which helps to balance possible biases hold by both of the groups about operating in the country. Furthermore, the interviewees’ companies originate from four different countries.

1.4 Structure

This study is organised in four main chapters which are set up by an introduction to the topic in chapter one. The main focus in the last chapter, chapter six, is to present the conclusions derived from empirical data analysis.

Second chapter in this study explains how investment decision-making process in companies works. Chapter begins with defining the importance of investments for companies and continues with an introduction of foreign direct investments (FDIs), and the features of FDI, such as motives for FDI and its suitability as an entry mode for foreign markets. The second chapter then discusses the investment decision-making process of a firm, which is followed by an introduction to Dunning’s eclectic theory. The eclectic theory combines existing theories of FDI into a single theory that also takes host nation specific factors into account. The chapter is concluded with Tahir’s location aspect framework which further clarifies Dunning’s eclectic theory.

Third chapter concentrates on country risk and starts with a definition of the concept of risk, and moves on to how risk is determined and analysed. Country risk is also defined and various methods of country risk classification are reviewed. This study builds on Meldrum’s definition for country risk and risks introduced by him – with two additional ones – which are analysed more closely. Chapter continues with a brief look how country risk affects different types of investment in a dissimilar way. Subsequently the chapter untangles the issue how country risk information can be acquired and how the risks can be reduced in companies. The chapter is concluded by an analysis of the role that country risk rating agencies play in providing information and analysis for companies.

Indonesian business environment is closely reviewed in chapter four. Firstly, a general overview of Indonesia is provided and a look to Indonesia’s history in post World War II period taken. Secondly, Indonesia’s economy, both past and recent developments, is analysed in closer detail. Third part commences with an analysis what is meant by investment climate and why governments aim to improve their investments climates in order to boost foreign direct investments. The chapter is then continued with a wide-ranging analysis of Indonesia’s investment climate focusing closely on country
risks and other problems affecting the investment climate, and the actions that the government has taken and what it aims to take in order to boost it.

In chapter five empirical data of company investment decision-making process and how Indonesia’s country risks affect investments are presented. This chapter aims at revealing typical country specific elements that affect investments made in Indonesia and also aims at generalising some factors that affect investment decisions in a wider array of markets.
2 INVESTMENT DECISION-MAKING

2.1 Company investments

A common characteristic for companies is that they pay expenses in order to achieve profits in the future. When a company expects to get returns in the long-term and usually also pays smaller expenses regularly, it is called investing. Defining feature of investing is also that it has a time dimension, meaning that the initial capital placement is expected to be covered perhaps after a substantial period of time (Honko 1979, 13).

Investment objects can vary between land area, buildings, factories and machinery. Furthermore, research and development (R&D), long-term advertising (e.g. branding), development of distribution network, and personnel training and development can all be classified as investments when future profits can be anticipated from these actions (Honko 1979, 13–14; Nickell 1978, 1).

The significance of investing for companies cannot be overestimated. For a company to thrive in competition it needs to improve the quality of its produce, cut its costs, enhance its productivity, be well-known among customers and have technological advantage in its sector. All of the above can be achieved by investing, particularly investing in cost-effective projects (Honko 1979, 15). Investing can shape companies future in either good or bad but investing is necessary for companies to succeed in the future. Technological change means that investments could become obsolete in a relative short period of time. Markets, both consumer and industrial, are very volatile, which poses challenges for companies to keep up. Moreover, competitors can also be somewhat unpredictable in their moves (Hull 1980, 2).

Investing also carries several risks. Predicted cash flows are merely estimates and these estimates can vary because of several factors out of company’s hands. These risks can be quantified in two ways by carrying out a sensitivity analysis by analysing each factor’s contribution to overall risk of the investment project or by risk simulation by trying to obtain directly the level of overall risk (Hull 1980, 16).

The probability of having a successful investment can be increased by building on experience gained through prior export to the target country. Investment decision is a complex process which requires evaluation of both the intended investment project and the investment climate of the target country (Root 1987, 123).

Companies interested in servicing foreign markets face a difficult choice in deciding what choice of an entry they should proceed with. Common choices are exporting, licensing, joint venture and sole venture. The choice of market entry is influenced by three factors which are ownership advantages, location advantages and internalisation
advantages of integrating transactions. Sole venture type of market entry is the most capital consuming and high on risk as well as on return. This mode also provides company with a high degree of control over its own business activities. Joint venture involves a relatively lower amount of risk, return and control which are commensurate on the equity participation of the investing company (Agarwal & Ramaswami 1992, 1–3). It should be noted that most advantages and risks raised in this study affect all foreign entry types, but as mentioned FDI will be the main focus.

2.2 Foreign direct investment

2.2.1 Definition of and motives for foreign direct investment

“...an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)” (United Nations Conference on Trade and Development 1999, 465).

Foreign direct investment (FDI) can be classified in a myriad of ways. Commonly FDI is said to be equity-based transfer of resources and rights, and it is unlimited in time. The definition of FDI specifies that investment location is outside the company’s home country but within the investing company. It could be further defined by adding that FDI is composed of a package which might include assets and intermediate products, such as management skills, technology, capital, entrepreneurship and access to markets. On the other hand, it should be noted that also plain sales subsidiaries are often regarded as FDI. As can be understood from the above definition, FDI does not necessarily stand for capital flows. Subsidiary may raise funds locally while the headquarters could be providing, for example, technical expertise and management support. Generally, investments exceeding ten percent of the total equity of a foreign entity are classified as FDIs, whereas investments below ten percent are viewed as portfolio investments. Re-invested earnings by a foreign company already operating in the country and the sale of non-financial assets by the parent company to its foreign subsidiary are also regarded as FDI (Tahir 2003, 11–12).

Company motives of FDI might change over time, but primarily companies invest outside their home market to gain access to new markets and resources. When compa-
nies become established and experienced in foreign activities they can use their overseas business network and expertise to raise their efficiency and to find new sources for competitive advantage in order to improve their global market position (Tahir 2003, 65–74). Companies are also found to be interested in acquiring manufactures at a lower cost when investing abroad (Root 1987, 123).

Dunning (1993, 56–61) describes four main type of motives for multinationals to engage in FDI.

- **Resource seeking**
  - Companies are prompted to invest abroad to acquire needed resources for lesser cost that would be available in their home country. Resource seeking comes in three different forms. First is the need for physical resources. Second is the seek for an abundance of cheap and well motivated labour. Third is the need to acquire management expertise, technological capability and organisational skills.

- **Market seeking**
  - Common for market seeking motives is that companies invest in a particular region to serve that region or its adjacent regions. There are five reasons for market seeking FDI motives. First, investments are carried out to protect or sustain existing markets, or to promote or exploit new markets. Second, products need to be adapted to local environment. Third, production and transaction costs are less than by supplying the market from distance. Fourth, it is often a part of a company strategy to have a physical presence in the leading markets served by competitors. Fifth and the single most important reason is that the host governments strongly encourage companies for such investments.

- **Efficiency seeking**
  - The aim for efficiency seeking FDI is to intensify the structure of market seeking or resource based investment in such a way that the company can gain from geographically dispersed operations. Efficiency seeking FDI is of two kinds. First, it is the type that is designed to take advantage of the differences in cost and availability of factor endowments in different countries. Second, it is the kind that takes place in countries with similar economic structures and income levels, and is designed to take advantage of economies of scope and scale, and of differences in consumer tastes.

- **Strategic asset seeking**
  - Companies also engage in FDI, by acquiring assets of foreign corporations, to promote their long-term strategic objectives – especially that of advancing their international competitiveness.
Dunning (1993, 61–62) concludes that besides these four main motives two additional motives could be added, which are escape and support investments. Escape investments take place when companies escape home government imposed restrictive legislation or macro-organisational policies. For instance, some sectors are highly regulated by the government, and green movement creates legal and political challenges for companies. Support investments are carried out to support the activities of the rest of the enterprise. This type of investing is designed to facilitate and promote the export of company goods and services.

Finnvera’s (2001, 18) study on Finnish companies suggests that six different factors are seen as underlying for companies engaging in foreign activities for the first time. These are partially the same as Dunning’s motives above:

- Nature of business requires expansion over national boundaries
  - Home market is inadequate for specialising thus the only option to acquire sufficient volume of business is to internationalise.
- Need for new markets
  - Going for new markets might be the only possibility to develop a company when home market is saturated. In addition, dissolution of former markets force companies to expand.
- Possibility for new activities
  - International markets possess endless opportunities for a company whose competitiveness is adequate. As has been seen in the recent past, borders are opening and new rapidly growing markets are developing.
- Responding to an outer stimulus
  - A suggestion from suppliers, partners, financiers etc. might catalyse internationalisation.
- Intensifying operations
  - Foreign activities can improve productivity and effectiveness, bring economies of scale, even out demand etc. International companies are generally more competitive and companies’ internationalisation is a way to prepare for foreign competition in their home markets.
- Personal motives
  - Internationalisation is an intriguing and vast challenge for managers. Personal motives and ambitions play an important role in engaging in such activities.

Tahir (2003, 74) argues from the base of the eclectic theory that current FDI decisions are a combination of four motives: ownership-specific, location-specific, internalisation and strategic. In addition, envisioned future strategies and historical background affect companies’ current FDI choices. Furthermore, the decision-making behaviour is
affected by differences in executives’ perceptions of the above advantages and also by diverse views on risk taking.

2.2.2 **Foreign direct investment as an entry mode**

Fundamentally, investment entry involves the transfer of an entire company (e.g. subsidiary) to a target country, whereas in other forms of entry the entry is less capital and time consuming. Furthermore, FDI entry is the most risky type of entry but possible returns are also the highest. Advantages of FDI entry, firstly, enable companies to exploit their competitive advantages more fully in the target market. Secondly, operating locally may lower the cost of supplying the local market compared with an export mode of entry. This is because of obtained savings in transportation and customs duties and possibly from lower manufacturing costs resulting from cheaper local inputs of raw materials, labour, energy etc. In addition, local production can increase the availability of supply if quotas are set up to limit exports or if company’s production plant in the home country is constrained by capacity. Fourthly, FDI entry may also create marketing advantages. Typically, local production provides a substantially better opportunity to adapt produces to local preferences and purchasing power. Moreover, FDI entry may enable companies to offer their produces quicker and more reliably to middlemen and customers, better provision of after-sales service, direct distribution by subsidiary’s own work force, and create a local company image (Root 1987, 124).

FDI entry mode has also its disadvantages. First of all, this type of entry requires vast resources, mainly capital and management skills, from the investing company. Higher commitment translates in to a higher exposure of risk; especially political risk has wider impact on FDI than on other modes of entry. The information needed for a well-informed FDI decision is far greater than for other types of entry, which increases the risk of poor investment decisions due to lack or misinterpretation of information. Other disadvantages include high start-up costs, long payback periods and difficulties in disinvestment if the company switches strategy or fails in its venture (Root 1987, 124–125).

Foreign direct investments have become an extremely important part of global business. FDIs have increased substantially in the last 25 years for a wide range of reasons, including technological and communication advancements, growth of financial markets, development and transition of free market economies around the world, and proliferation of regional integration between countries. The features of FDI make it highly desirable on one hand and remarkably controversial on the other. The baseline for FDI is that it is a long-term commitment. Compared with other forms of capital investments FDI offers greater stability and it holds up better in times of economic turbulence in host nations (Tahir 2003, 11–12).
2.3 Investment decision-making process

Investment decisions are one of the most important decisions that a company can make. Investments often require vast amounts of company’s resources and have a way of shaping company’s whole future. Investment decisions nearly always mean immediate outlays for exchange to anticipated future benefits. For the most part expenditures for investments are irreversible, which emphasises the role of planning prior to investment. Once the investment decision is made company should follow it through. Regardless of low returns in the beginning companies may find it a better option to continue with the project than to abandon it (Hull 1980, 2). When investing in emerging markets, options to abandon the investment or to change the scale of the investment proves out to be more valuable than in investments in developed economies. Executions of the above two options are closely related to country specific conditions, namely to country risks (Nordal 2001, 197–198).

Because of the widespread effects of investments, company management is usually making all final investment decisions related to medium and large scale investments, since they possess an overall vision of company’s future and the steps needed to be taken for the desired future conditions to be achieved. In addition, when company management is behind investment decisions they can make sure that different business units are developed equally and the type of investments are made that benefit the company overall not just one specific unit. Furthermore, centralising the final decision-making to be carried out by the company management ensures that the acceptance criteria for projects are the same, which enables the company to choose between the best projects. Management also becomes less attached to particular investment projects which make difficult choices of abandoning or changing the scale of projects easier (Honko 1979, 16–17, 205–206).

However, investment decision-making process may become inflexible and relevant information and ideas may be missed if management has the sole responsibility in choosing investment projects. Therefore, mid- and high-level company employees are often given a chance to contribute with inputs and ideas, which are often unique and differing from the management’s perspective. Planning and observing are some of the key areas in investment projects where company needs more inputs than the management has to offer (Honko 1979, 16–17, 206–207).

Poole-Robb and Bailey (2002, 37) add that it would be advantageous for companies if management understands all the reasons why the companies are becoming involved in overseas activities and how decisions relating to foreign markets come to be made. This knowledge would ensure that management’s decisions regarding foreign operations would be more informed, which is needed since business in foreign markets generally involves more risk and this risk is less understood than in the domestic environment.
The investment decision process is a lengthy process in which a number of sub-decisions are taken with multiple feedbacks that stimulate decision makers to reconsider earlier decisions. Root’s structure of decision-making process is introduced below (1987, 126–127).

![Decision Process Diagram](image)

**Figure 1. Checkpoints in the foreign investment entry decision process (Root 1987, 127)**

Investment decision-making process is highly complex and it goes through a sequence of checkpoints that must be passed if an investment proposal is to be accepted. The decision to start investigating a new foreign investment proposal is the first and most important checkpoint. Investigation process requires significant amount of management time and company resources. Investigation also tends to lead to a commitment
to the project by the managers carrying out the investigation. Therefore, the decision to investigate should be only taken after a thorough assessment of alternative entry modes and alternative forms of investment entry. This type of entry strategy review ensures that commitment to investment entry or particular form of investment entry is not premature. Generally, companies face the risk of setting up an investment investigating team too eagerly and the team is often only capable of thinking in the terms of the proposed investment, which leads to tunnel vision (Root 1987, 126–127).

Honko (1979, 185–187) suggests that some investment proposals should be set aside permanently and some for further development, which might later be transformed into executable proposals. Moreover, choosing between projects may be complicated since all planning and calculations concern the future, which makes information inaccurate. Discretionary factors also influence the decisions but cannot be included in the calculations.

After the decision has been made that a particular investment proposal should be investigated, the following step is to analyse both present and expected investment climates of the target country. Investment climate embraces all the environmental factors and forces – political, economic and socio-cultural – that may have an effect on the profitability and safety of the investment project. Information on the prevailing investment climate of the host country is available for company managers to be examined, but future investment climate can only be assessed in probability terms (Root 1987, 126–127).

According to Root (1987, 126) most dominant concern of future investment climate revolves around political environment, which can be defined as political risk. The investment climate analysis is simultaneously partly a risk analysis since assessing country specific risks is needed to get a clear picture of a country’s investment climate.

Finnvera (2001, 28) points out that acquiring sufficient information about a target country prior investment is crucial in order to avoid poor decisions. Background information could be about host country circumstances, policymaking, markets, and also about customers, competitors etc. Notable is that information is likely to be scarce and at the same time information is much more valuable than it would be in home market conditions. Information might also be fragmented and companies need to be able to combine all the pieces together, and both process and interpret the information in order to build a suitable basis for decision-making.

Poole-Robb and Bailey (2002, 36–37) argue that a lion’s share of decision makers will be driven by competitors in uncertain environments. It is common to look for peer groups for comforting signals to justify own actions. If a competitor moves into a particular country, then it is often a sufficient reason for a rival to make a similar move. This could lead the rival to not carrying out its own thorough due diligence, which is costly and time-consuming. The rival might assume that if others have moved into the
market, the market has to be relatively safe. Organisations are also known to engage in non-domestic markets simply to prevent the competition from dominating a specific market. More interestingly, companies also go into new markets in order to deprive their competitors from profits, even if it entails losses for themselves.

Äijö (2001, 18, 37) reports results from a study carried out by the Finnish Institute for International Trade (FINTRA). According to Äijö, 26% of Finnish small and medium-sized enterprises (SMEs) view that the lack of knowledge of international markets and countries is hindering their investing activities considerably. Finnish companies also believe that local companies have a significant advantage over foreign ones in market knowledge, and in both acquiring new and maintaining existing customer relationships. Surprisingly, the shortage of language proficient workers is also thought to be a significant obstacle constricting investments abroad.

After the investigation process has passed the investment climate checkpoints, managers begin with a full-scale economic analysis of the proposed project. The objective is to calculate will the project meet financial objectives when risks associated with the target country (obtained from the previous phase of the investigation process) are taken into account. If the project does not meet profitability and other objectives, it may be possible to redesign the project to increase profitability, say, by adapting new technologies or reducing plant size, or to lower risk, say, by switching from a sole venture to a joint venture (Root 1987, 126–127).

If the project passes the profitability and risk calculations, the final step to take are negotiations with the host government. It is possible that the host government will demand some changes to the project in the negotiations. In that case, management needs to evaluate the project with a new economic and risk analysis. If the results of the negotiations or the new analysis are satisfactory, the company proceeds with the investment entry (Root 1987, 126–127). Negotiating about the possible incentives for the investment with the government is also very important (Ollikainen, interview 18.4.2008).

The investment decision-making process need necessarily not to be such as the one Root (1987, 127–128) suggested in figure 1. The key steps are identified in Root’s model, however, in practise the process is likely to involve many twists and turns rather than being a direct process through the checkpoints. In the first phase managers are inclined to make crude judgements of the economic viability of the project and of the investment climate in order to decide should the investigation process be initiated. Later phases of the investigation process will either confirm or deny these prior assumptions of a profitable investment project. It also means that managers can turn down potentially profitable investment projects simple because of their misguided views. Kahra, Kanto and Kuusela (1998, 35–36) note that even if executives hold exactly the same information in hand of a specific investment project, it is still not certain that they will end up with a similar decision. This confirms the substantial influence that personal
views, preferences and work history have on managers. However, adequate information about a project is likely to reduce the use of subjective information and improve the decision made. Moreover, Wells and Ahmed (2007, 8–9) state that managers often do not even properly understand their own interests and limitations in decision-making. On the other hand, they continue that management’s prior experience proves out to be highly valuable in dealing with crisis. Responses to similar problem situations vary considerably between companies and the ones with the most experienced managers and better overall corporate strategy tend to outperform competitors.

2.4 Eclectic theory on foreign direct investment choices

2.4.1 Dunning’s eclectic theory

A well-published approach to FDI decision-making and its determinants is the eclectic theory. The father of the theory, John Dunning, combined competing theories together and formed a single theory, or a paradigm as it is also often referred. Dunning’s theory links together Hymer’s ownership advantages with the internalisation school, and adds a location dimension to the theory. Dunning also managed to add new considerations to the eclectic theory, such as the impact that different country and industry factors have on FDI (Jones & Wren 2006, 36).

The eclectic theory aims to explain which determinants influence company decisions to enter a foreign market. The eclectic theory as represented by Dunning (1981, 79; 1993, 79–80):

- Company controls ownership-specific (O) advantages compared with other companies operating a particular market. These advantages can usually be categorized as a possession of intangible assets, specific or exclusive to the company, and those which arise from common governance of cross-border value-added activities. These advantages and the use of them are expected to increase wealth creating capacity of the company.

- When the above condition is satisfied, it also needs to be more beneficial for the company to utilise the advantages itself by extending its own activities rather than externalising the advantages by selling or leasing these to other companies. These advantages are called internalisation (I) advantages. They may reflect great organisational efficiencies or the ability to exercise monopoly power over the assets under company’s governance.
When both above conditions are satisfied, it needs to be profitable for the company to combine these advantages with some factor inputs outside its home nation. If this would not be the case, foreign markets could be served only by exports. Countries possessing these resources or capabilities, over those who do not, have location-specific (L) advantages.

Taking into account the firm specific configuration of the ownership-specific, location-specific and internalisation (OLI) advantages, the company needs to analyse to what extent foreign operations are consistent with its long-term management strategy.

The initial eclectic theory of Dunning in 1981 argued that companies need to possess monopolistic intangible assets, or ownership-specific advantages, to be able to compete in an unfamiliar environment with foreign companies. Since then, Dunning’s eclectic theory has gone through modification and the nature of these intangible assets have been revised and expanded. Nevertheless, ownership-specific advantage can still probably be regarded as a necessary element for sustained profitability and growth (Tahir 2003, 51).

As shown above, Dunning’s newer and expanded version of the eclectic theory encompasses three determinants that affect the selection between FDIs at any given moment of time (Dunning 1993, 79–80). The determinants are ownership-specific advantage, location-specific advantage and internalisation advantage. Thus eclectic theory merges the traditional trade theory with the internalisation theory. The combination of these two theories allows eclectic theory more explanatory power than the theories it builds on, and it deals both with trade and foreign production operations. The relevance of these advantages and the composition between them varies among regions and countries, industries, and firms (Tahir 2003, 44–45, 50).

Ownership advantages are firm specific elements. These elements include firm size, firm’s international experience and the ability of the firm to develop differentiated products (Dunning 1993, 80–85). Ownership advantages are required to be not only unique but also sustainable in order to provide the firm a competitive advantage in FDIs (Brouthers et al. 1999). Location advantages represent how attractive a specific nation is, and that is measured mainly by market potential and investment risk (Root 1987, 33–41). Location advantages are also characterised by similarity in culture, market infrastructure and the availability of production at a lower cost. Whereas internalisation advantages are regarded as costs of choosing between a hierarchical mode of operation over an external mode (Dunning 1993, 80–85).
These three advantages affect company FDI choices by influencing company management’s conception of asset power (ownership-specific advantages), market attractiveness (location-specific advantages) and cost of integration (internalisation advantages) (Agarwal & Ramaswami 1992, 4–6). The eclectic theory suggests that when all the above three advantages are beneficial FDI will occur. It is also possible to construct determinants which predict companies’ FDI choices. The theory is considered to be extensive because of its richness (the several possible explanations it offers) and its creativity (constructing new determinants and combining them with existing determinants). The theory explains the determinants of FDI and how they vary between firms, industries and countries over time. New items can be brought to the theory as long as they fall under the three categories: ownership, location or internalisation advantages. Being such a flexible theory it can be used in the constantly evolving business environment in the long-term by both theorists and empiricists (Tahir 2003, 45–46, 49). Because of its extensive coverage of different FDI related factors, which affect FDI decision-making, especially nation specific factors, eclectic theory has been chosen as a base for this research and as a tool for closer examination of country related risks.

2.4.2 Ownership-specific advantages in eclectic theory

A company competing in a foreign nation with the nation’s local companies needs to possess certain advantages related to nationality or nature of their ownership. These advantages are called ownership-specific advantages, and three of them are recognised (Dunning 1988, 2):

- Those that originate from exclusive access to or possession of specific income generating assets
Those that are typically attained by established operations in a foreign country compared with a newly founded company

Those that stem from multinational activities or geographical diversification

The eclectic theory states that companies’ ability to engage in FDI is usually based on some competitive advantage possessed by companies. In producer goods industries the ownership-specific advantage is often related to the nature of products supplied. The competitive advantage could spring from company’s ability to produce its produce at a lower cost than competitors, or from the ability to utilise economies of large-scale production. On the other hand, in consumer goods sector ownership-specific advantages arise typically from the possession of branded products and trademarks together with the potential to offer reliable produce that is customised to the meet the demand of the local consumers (Dunning 1993, 142).

It should be noted that these ownership-specific advantages vary between companies and they are both industry and country specific. Divergence has been identified in previous studies between companies coming from different nations (Tahir 2003, 54). Ownership-specific advantages of US companies comprise mainly from their ability to innovate goods and services, their managerial and marketing skills, and their capability to exploit large and comparatively homogenous markets. Whereas the ownership-specific advantages of Japanese companies’ consist of their ability to produce differentiated, fault-free products at competitive prices (Dunning 1988, 9–11). UK based companies, on the other hand, have enjoyed comparative ownership-specific advantages in mature, relative low technology sectors and in consumer goods industries (Tahir 2003, 54).

Tahir (2003, 55) states that ownership-specific advantages can be underpinned by organisational and institutional capabilities. These capabilities have been identified to be more related to cultural and ownership factors rather than industry field factor. For example, the holistic approach of Japanese companies, such as the Keiretsu-type relationships and their special approach to human resource management have been a significant element in their ownership-specific advantage creation.

The degree of internationality of foreign investors is considered to be an additional base for ownership-specific advantage. Internationality could be measured by a combination of company age and experience of operating outside its home market. Moreover, it has been studied that the way companies organize their assets may be equally important as the assets themselves (Tahir 2003, 55).

2.4.3 Location-specific advantages in eclectic theory

The second strand of the eclectic theory deals with where should business activities be located. In eclectic theory the advantages or disadvantages of specific locations are con-
sidered separate from ownership-specific advantages of particular companies. Never-
theless, the ownership of assets, for example, a factory or an office is not irrelevant to
the location choice. Not only the ownership but also the route by which the assets or the
rights to these assets are transacted should be taken into consideration (Dunning 1998,
4).

Location-specific advantages are country specific factors which relate to the market
potential and market risk of a country under consideration, and are available to all com-
panies in that particular market. However, abilities to exploit these advantages differ
between companies. Well utilised location-specific advantages can mean increased
competitiveness in both the new market, by better coordination within country activi-
ties, and internationally, by lower cost of labour decreasing the cost of products in all
markets that they are sold (Tahir 2003, 56).

Tahir (2003, 56) presents two common factors for all location-specific advantages,
which are that they influence:

- The expected profitability of foreign operations in relation to export
- The expected profitability of having business activities in different countries

Location-specific advantages may favour either home country or a particular foreign
country as a future location for business activities. A company possessing ownership-
specific advantages should analyse where these advantages would be most profitable
and invest in that location (Kimura 1989, 299).

Investing companies may be inclined to undertake FDIs in a particular location to
protect and expand their ownership-specific advantages; they may also be investing in a
particular location simply for the purpose of acquiring new ownership-specific advant-
eges that are derived from operating in that location (Ekström 1998, 40). Nevertheless,
there exists a wide range of other location related reasons by which companies make
their location choices. Historically the imposition of trade barriers, reduction in trans-
port costs and the formation of economic unions or regional economic blocks have led
to an increase in foreign investment activity (Tahir 2003, 55–56). It has been found in
research that the more ownership-specific and location-specific advantages companies
possess the more likely they are to utilize in a more integrated mode (FDI versus export)
of entry into new markets, which supports Dunning’s eclectic theory (Brouthers,
Brouthers & Werner 1999, 833).

Location-specific advantages are regarded as factors that favour a specific location
and thus influence the decision-making process of FDI by increasing the propensity of
companies to engage in FDI and affecting the location chosen (Ekström 1998, 39). The
most commonly investigated location-specific advantages include market size and
growth, factor endowments (such as land, labour, capital, and entrepreneurship that a
country possesses and can be exploited), sources of supply, transportation costs, trade
barriers, and physical distance (Tahir 2003, 57).
Dunning (1993, 80–85) adds a few more advantages, namely cultural and market infrastructure similarity, and economic, legal, political and trade policies. As Dunning (1988, 17) explains, it should be noted that location-specific advantages are a much wider concept than merely factor endowments. In fact, companies FDI location decision has become less dependent on comparative advantage of factor endowments and more dependent on the strategies of internationally operating competitors, the desire to utilise in the economies of scale, the need to reduce market uncertainty and instability, and the incentive to profit by integrating related activities.

2.4.4 Internalisation advantages in eclectic theory

The third condition for FDI according to the eclectic theory is that foreign activities must be in the interest of companies that possess ownership-specific advantages. In addition, companies need to gain more from internalisation of these advantages than by selling them or transferring the rights to them (Dunning 1988, 2–6). When a company is operating internationally to internalise its ownership-specific advantages, the process of internalisation may generate new ownership advantages either by internal activities or by acquiring from competitors (Ekström, 1998, 41).

Companies utilise in foreign activities whenever the transaction cost of exchanging products or services between boarders exceeds the cost of establishing foreign market operations and doing the exchange within the national borders (Dunning & Kundu 1995). The need to reduce governmental, buyer and supplier uncertainty, the need to protect the quality of business produce, the need to maintain a high level of control, and increasingly the need to move to new independent markets speak in the favour of FDI rather than any other mode of doing business (Tahir 2003, 59).

Internalisation advantages are of intermediate type in the eclectic theory. Intermediate in the sense that internalisation advantages are determined by company’s ownership-specific advantages (Denekamp 1995, 495). In addition, intermediate in the sense that internalisation advantages are influenced by the expected profitability of operating in a particular location (Tahir 2003, 59). The eclectic theory suggests that companies circumvent or utilise the existence of transactional market failures in order to economise on transaction costs and capitalise more on its ownership-specific advantages (Ekström 1998, 42).
2.5 Location aspect framework of foreign direct investment

2.5.1 Tahir’s location aspect framework

There are several main theories analysing the way firms choose from different FDI alternatives. Location theories have faced criticism for only presenting a partial explanation of FDI. However, for this study they offer the most suitable framework as most of the other theories are mostly irrelevant since they concentrate on other issues than nation specific factors, whereas location theories aim at explaining the influence of host-country specific factors on companies FDI choices (Davidson & McFetridge 1985, 5–10; Tahir 2003, 26–27, 39). Tahir has grouped a few location theories together in order to provide a clear picture on a location aspect framework. Location theories attempt to define the influence of host country location-specific issues in companies’ FDI choices. These factors, can be categorized as environmental variables, which consist of political, cultural, infrastructural and legal factors in a host country. These variables have been identified to be crucial for companies since they affect the achievement of companies’ targets and success in foreign markets. Moreover, these four variables have been the most frequently studied environmental areas in location theories (Tahir 2003, 35–36).

Figure 3. The framework related to location aspects (cf. Tahir 2003, 78)
Tahir’s aspect framework proposes that there are three factors influencing companies FDI decisions which are based on the interpretations of the eclectic framework. These factors are ownership-specific, location-specific and internalisation as shown in the figure 3 above. These three advantages affect each other and the advantages combined form the FDI choice of a company to invest in a specific market. Each of these three advantages consists of different factors. Firstly, ownership-specific advantages comprise of R&D intensity, company size and company’s international experience. Secondy, location-specific advantages are composed of cultural distance between home and target country, market size, wage rate, corporate tax rates and inflation rates. Thirdly, internalisation advantages consist of country risks and exchange-rate fluctuations (Tahir 2003, 77–78). As explained in chapter three, in risk theory the notion of country risk is a broader concept than country risk in Tahir’s framework. In fact, the notion country risk includes factors from all of the three advantages listed here, making the eclectic theory and Tahir’s framework approaches to FDI decision-making very useful basis for this study as they examine both FDI decisions and country risks.

2.5.2 Ownership-specific advantages in location aspect framework

In order to stay competitive with host country companies in their home market, foreign companies must hold superior assets or skills that can counter the high costs of servicing these markets. Companies’ asset power is determined by their size, international experience and ability to develop differentiated products (Agarwal & Ramaswami 1992, 4).

FDI unlike exporting require vast financial and managerial resources. One important determinant in FDI choices is the ability to finance new projects by generating internal sources for financing. Larger companies are considered to be in a better position than small firms to make such commitments due to their substantial resource base. Company size and the amount of resources also influence the perceived risk of a project. Large company size and the availability of resources translate into a readiness to engage in FDI projects even in distant and unfamiliar markets, which signifies that the perceived risk is smaller with that kind of companies. It is considered to be much easier for large and resource rich companies to organize their production structure in a way that they can exploit benefits of economics of scale. Then it could also stand for higher efficiency gains, a lower marginal cost of production and a greater market share (Tahir 2003, 80–81).

Tahir (2003, 81–82) points out that company’s international experience can reduce the cost and uncertainty when conducting FDIs. It has been argued that company’s past experiences manifest themselves in organizational routines that form the basis of com-
pany’s future actions and function as a source of competitive advantage. Companies need to learn from prior experiences and transfer that knowledge into actions when similar circumstances prevail. Companies prefer using the same strategies as they have previously used, because these enhance company’s value by reducing planning and implementation costs, since the existing and approved routines can be used. Tallman (1992, 462) emphasises that past company decisions about FDI form a basis for future decisions. Companies can imitate their previously successful structures or follow competitors’ decisions when entering a new market.

Tahir (2003, 79) notes that FDI can be seen as a method to accumulate new technologies when old technologies become outdated. Rapid pace in technology development force companies to acquire new technologies and capabilities constantly by building them within the firm or by investing in companies and countries that possess these capabilities. It has been found that companies are interested in developing new technologies in countries that are among the leaders in product and process innovation. As Dunning (2000, 169) suggests, ownership-specific advantages do not rise only from possession of assets but also from a capability to acquire these assets. Thus companies intending to build advantages with FDI have incentive to invest in locations where their needed technologies are available. Serapio and Dalton (1999, 304–305) maintain that companies undertake in FDI to provide complementary assets to their core assets that are vital to the success of their foreign manufacturing or sales operations. When operating abroad, products and services need to be differentiated for the local taste and that requires adaptive development efforts such as redesigning and reengineering. To better respond to specific market conditions companies R&D should be conducted in a country where the subsidiary is located. Eventually these R&D capacities from all of the subsidiaries around the world accumulate into company’s knowledge base.

2.5.3 Location-specific advantages in location aspect framework

Companies interested in doing business outside their home market are expected to use a selective strategy and favour entry into more attractive markets, because chances of obtaining higher returns are better in such markets (Agarwal & Ramaswami 1992, 5). FDI theories suggest that investing companies prefer countries that offer greater location-specific advantages. Those location-specific advantages (or disadvantages) include cultural distance, market potential, wage rate, corporate tax rates and inflation. It is also known that both location-specific and ownership-specific advantages have a separate and combined effect on the choice of a target country for FDI (Tahir 2003, 82–88).

Hofstede (1980, 23) describes culture as “the collective programming of mind that differentiate the motives and behaviour of one social group to those of another”. Tahir
(2003, 83) maintains that cultural distance signifies challenges for companies how to deal with it, not only within individual markets but also across markets. There are two important aspects about cultural distance. Firstly, proper understanding of the cultural differences means that companies are more aware when adaptation may be necessary and when regional or global approaches are sufficient. Secondly, culture is inherently very conservative but through time interaction and borrowing between cultures have led to narrower differences between some cultures. Studies have identified that often companies make their first FDI into a market culturally closest to their home market. Moreover, company executives tend to undervalue FDIs into markets with a wide cultural distance to their home market due to executives own uncertainty.

Tahir (2003, 84) explains that domestic competition and market size of the host country are considered to be important determinants in FDI decision-making. Companies prefer large markets to invest in and usually they plan to capitalize on firm-specific assets by being the first to enter the market or by following leader companies in the new markets. In both of the above cases, the future market share in these new markets is the driving force behind company expansions into foreign countries. Large and prosperous markets are preferred because these markets offer higher returns on investment, although high entry barriers and competitive pressures make sure that high returns are not easily acquired. Culem (1988, 900) found in his study that host market size and the rate of growth have been key constituents for FDI decisions. Tahir (2003, 85) notes that this trend is most strongly seen with investments in developing countries, where market size has been a significant predictor of FDI. It has also been reported that established or newly acquired foreign subsidiaries continue the trend of locating business activities in countries with sizeable and prosperous markets, rather than in countries with low input and labour costs.

Tahir (2003, 85–86) states that location-specific advantage created by low wages raises the prospects of low production costs and might accelerate companies to invent new products and establish themselves in new markets. Classically it has been suggested that low wage rates increase the possibility to achieve plant-level scale and scope economies, higher efficiency in production and a greater market share. Several studies on FDI determinants have identified that labour cost differential has been a significant determinant of company FDI choices in developing countries. Austin (1990, 231–234) adds that these labour cost advantages are a primary reason for companies to integrate developing countries into their global strategy. Yoshitomo and Graham (1996, 38) suggest that labour costs are more likely to influence the decision-making when choosing between modes of servicing in the developing world rather than in developed markets. Caves (2007, 63–64) argues that wages are not a systematic influence but that unit labour costs are. Caves continues that human-capital resources clearly are an advantage
whereas labour market tightness is a major deterrent for companies. Moreover, sound infrastructure and low tax regime also affect the location choice of companies.

Tax rate is another market imperfection that can influence companies’ location choice. Theoretically, higher corporate tax rates reduce company profits and as a consequence discourage FDIs. Several wide ranging studies have proved this assumption true but some studies have also ended up in a different conclusion. For example a World Bank study claims that pro investment tax reductions are often unnecessary and sometimes even detrimental to inbound FDI (Tahir 2003, 86–87).

Host-country governments’ macroeconomic management is an important factor for FDI decision makers. Moreover, inflation is considered to be a good proxy for macroeconomic management. Changes in the relative prices of goods, labour and capital due to inflation have the potential of influencing the costs and benefits of operating internationally. Consequently low or high inflation rate in a specific country can push companies to expand or contract existing operations, as well as enter or exit the foreign country. Dependent on the risk tolerance of a company, rise in inflation may quickly lead to a reduction in FDIs in a foreign country in order to protect companies’ expected profits on investments. As long as uncertainty exists in the host country, investors will demand compensation for the extra risk they are taking which will lead to a decrease in the total amount of investment. Stable macroeconomic environment is often a very important factor when companies make their investment decisions (Tahir 2003, 88).

2.5.4 Internalisation advantages in location aspect framework

Internalisation advantages arise when potential profits from company specific assets are higher if they are transferred across boarders within company’s own organisation rather than sold outside the company. Internalisation advantages can be created if a company is able to reorganise and achieve internal transaction cost economies. This can be done through the introduction of new organisational structures, which would reduce internal contracting, search and monitoring costs. A number of internalisation factors have an effect on company’s location choices (Tahir 2003, 88–89). Of those factors country risk, exchange rate fluctuations and contractual risk are more closely examined here.

Butler and Joanquin (1998, 599) describe political instability as “the risk that a sovereign host government will change the rules under which business operate”. Tahir (2003, 89–90) notes that generally risks in foreign markets are viewed as deterrent to inward FDI. Recently, when economic structures of the developed nations have increasingly become integrated and more governments have adopted market-oriented approach to policies, the importance of political risk as a determinant of FDI decision-making has declined. On the other hand, studies on determinants of FDI in developing
countries have reached different conclusions. They show that political instability and political polarisation are significant determinants of FDI decision-making in developing countries. It is said that companies only invest in countries with highly volatile political and economic environment when their investment is fully reversible. If the investment is not reversible or modifiable, companies may try to delay or terminate the efforts on the investment altogether. It is suggested that companies might also execute FDIs that are designed to reduce the corporate risk that arises from political instability in the host country.

Tahir (2003, 90–91) points out that currency fluctuation between home and host country can have varying effects on different companies dependent on their objectives and strategies. Nevertheless, it is certain that volatile exchange rate of host country’s currency increases risks and uncertainty, thereby affecting investment activity negatively. Some studies have identified that exchange rate fluctuation is one of the most insignificant factor in FDI decision-making process. For example, wage differential and market size have been found to be more important in explaining the distribution of FDI. However, Grosse and Trevino (1996, 152) find that an increase in the value of home currency related to US dollar is a significant and positive determinant for FDIs in the United States. This is supported also by Grosse’s and Trevino’s (2002, 446) newer study with similar findings. They draw attention to the fact that these findings are in line with the usual hypothesis that companies from strong currency countries have an advantage in investing into weaker-currency countries. Tahir (2003, 91) argues that companies coming from countries with a strong currency benefit from it when they are seeking for low cost labour, efficiency for their operations, and market for their products. At the same time, if company’s foreign subsidiary has to import inputs for foreign production, then a low valued host country currency will discourage investments in that country. On the whole, Summary and Summary (1995, 88) state that exchange rate fluctuations show a significant and negative impact on FDI in developing countries.

Agarwal and Ramaswami (1992, 12, 23) point out that the measurement of internalisation advantage should be based on the relative risks (costs) of sharing assets and skills with a host country company opposed to integrating them within the company. Since such risks are difficult to measure are contractual risks associated with sharing the company’s assets and skills used as an estimate. Risks associated with using contracts include costs of making and enforcing contracts in a foreign country, and misuse or dissipation of company’s proprietary knowledge when operating a joint venture with a local company.
3 RISKS IN INVESTING ABROAD

3.1 Risk for companies

3.1.1 Definition of risk

Businesses face uncertainty nearly in all phases of their operations. Although some sources of uncertainty are sufficiently insignificant that companies can ignore them, other sources cannot be overlooked but to some extent they can be anticipated (Hertz & Howard 1983, 3, 8).

According to Hertz and Howard (1983, 3, 8) the term risk means both uncertainty, and the results of uncertainty. Thus risk refers to a lack of predictability in structure and outcomes of decisions and planning situations. Kuusela and Ollikainen (1998, 16–17), and Hamilton (1985, 10) define risk as an event which affects negatively the hoped or expected outcome of a project or target. Drottz-Sjöberg (1992, 4) observes that two components are always included in risk definitions. Firstly there is a probability for an event which, secondly, has negative consequences. Therefore risk could be described as a probability or an assessment for an event with negative consequences to occur. Kuusela and Ollikainen (2005, 30) add that even though managers realise the possibility of negative events, they cannot be sure when and on what scale the events will occur. This calls for a more specific analysis of risks which facilitates decision makers in their choices. Nordal (2001, 199) states that the wide-ranging use of risk includes both upside potential and downside risk.

Hertz and Howard (1983, 3, 8) note that most decisions, such as major investments or new product launches can be categorised as risky since their outcomes are not easily predicted, and consequently wrong decisions can often prove to be costly. The view of Poole-Robb and Bailey (2002, 7) is that all non-domestic investments are risky but opportunities make managers to take risks. Market pressure for improved returns has meant that more and more managers are daring to enter new markets without adequate due diligence or research which translates into increases in losses but also in profits dependent on the venture.

Companies can seek to reduce the riskiness arising from their activities in three alternative ways. Firstly, they can insure against some risks, including fires, accidents, theft etc. However in practise, companies would never consider to insure a major investment or a new product launch, since by doing so they would transfer rewards from the risk
taking almost entirely to the insurer. Secondly, companies might seek to share risks with some other companies perhaps because of extreme technological uncertainties, which would be too high for a single entity to bear. Thirdly, risk reduction can often be achieved through information and intelligence-gathering programs. Investments into new markets and product launches can possibly be improved by conducting market research. However, market research can be expensive and it may delay the planned business move for a period of time in which competitors may initiate a competing project. Regardless of the risk reducing actions and contingency plans, companies cannot get rid of risky consequences entirely (Hertz & Howard 1983, 8).

3.1.2 Risk determination and analysis

Risk is itself a broad concept and it has many dimensions in relation to projects within a firm. Firstly, risk needs to be identified by untangling the most critical variables of the project. Secondly, determining the expected future cash flows in which variability of cash flows and their probability to occur need to be assessed (Hertz & Howard 1983, 10, 12; Hamilton 1985, 64). Thirdly, it should be noted that risk varies with the level of the organisation. Companies engage in several different projects which create a risk spreading portfolio thus an extremely risky project at individual level becomes far less risky when viewed in a portfolio context. The purpose of risk determination and analysis is to understand better the risk clarification on a single project level (Hertz & Howard 1983, 10, 12).

Risk analysis can be viewed as having two major roles. Firstly, offering a broad perspective for structuring the decision-making process, and secondly, providing a set of techniques for evaluating the worth of competing decision options (Hertz & Howard 1983, 1). In attempting to deal with risk and uncertainty company managers can follow an analytical risk determination and analysis process which consists of three phases (Hertz and Howard 1983, 11–15):

- Risk identification
  - The problem is diagnosed and an understanding of its structure is developed and its possible impact on business
  - Given this gained level of understanding by company managers, they should be better able to determine the role of information gathering as a risk redactor and also finding possible solutions to the problem

- Risk measurement
  - All feasible alternatives are attempted to capture, and the nature of risks and uncertainties faced are specified
- Assessing and estimating project data and specifying the relationships between the key variables
- This screening process allows managers to identify whether the risks related to their project are more, less or the same as the average. However, it does not tell whether the project should be executed or not. That judgement must depend on company’s total risk and other strategic factors related to the company

Risk evaluation
- The investment project should be grouped into a single risk class according to the risks that it represents, and a risk-adjusted discount rate should be derived for the project. This way managers can define net present value figures which predict the likely effect of the project for the company
- At this stage managers can test the sensitivity of the net present value figure to the assumptions used in its calculation, such as an estimation of cash flows or correctness of the risk calculation and its effects on the selected discount rate
- Ultimately managers will balance each of these factors and take into account the information on intangibles, immeasurable factors, such as competitive factors, company strategies, organisational competencies, social factors etc. These intangibles presumably play an important role in managers’ decisions.

![Diagram of decision-making process](image)

Figure 4. Decision-making (Hertz & Howard 1983, 14)

The importance of intangibles is undoubtedly significant and managers’ project choices are influenced by (Hertz & Howard 1983, 15–17):

- The strategy and policy of the company
- Executive experience, and both managerial and technical resources
Resemblance to current projects
Managers tend to look for decision criteria with which they feel comfortable, they can understand and which also leave some room for managerial judgement. Research results also imply that (Hertz & Howard 1983, 15–17):

- Managerial time is often more scarce than access to finance
- Cost of additional information could come with a prohibitive price
- Therefore “gut feel” judgement is seen as valuable

Nevertheless, risk determination and analysis possess several benefits that managers can take advantage of. Firstly, risk determination and analysis assist managers in understanding the nature of cross-impacts between uncertain factors in their decision problems. Secondly, it enables managers to confront changes in the assumptions underlying the project’s viability with the help of sensitivity analysis. Thirdly, it develops an understanding of the risk inherent in the project, thus being more able to determine a risk classification for projects. Fourthly, it clarifies managers’ assumptions and improves communication and dialogue among managers (Hertz & Howard 1983, 1, 15–17). Risk analysis has the same effect as market research since both of them provide managers with sound information which leaves less room for uneducated guesses.

Poole-Robb and Bailey (2002, 8–9, 28–29) suggest that several executives suffer from an “intelligence gap” where what they perceive the risks to be about and what the risks really are form a wide gap which leads to unhealthy decisions. In addition, when carrying out risk analysis, managers tend to oversimplify complexity of the analysis environment by focusing on aspects that have been historically important or that confirm prior views and assumptions. Drottz-Sjöberg (1992, 5, 34) points out an example about managers weighing up risk. Drottz-Sjöberg has found evidence that managers who treat risk based on the consequences rather than the occurring probability perceive the risk associated with an event considerably higher. Thus manager’s risk valuation could depend heavily on the method of treating risk rather than on information and facts. Sillanpää (1998, 106) asserts that managers tend to overvalue security based risks since those risks have substantial media coverage.

Bekefi and Epstein (2008, 35) observe that personal biases often effect managers country risk related decision-making in social and political aspects. Moreover, managers also tend to assess higher risk premiums to projects in unfamiliar locations. Therefore managers’ attention is diverted from reducing country risk into wrong objectives. One reason behind this is the fact that social and political risks are thought to be immeasurable. Yet, as suggested earlier, adequate disclosures of risk assessment provide considerably more and better information for managers to base their decision on.
3.2 Definition of country risk and its varying categorisation

In the early and mid 1970s cross-border lending activity of commercial banks was very intense and country risk discussion concentrated mainly on analysing the credit worthiness of borrowing countries. Back then country risk was roughly defined as an exposure to a loss in cross-border lending caused by events which are, somewhat, under the control of the government of the borrowing country (Ciarrapico 1992, 4–7; Krayenbuehl 1985, viii–ix). More recently it has justly been found that multinational enterprises face different and greater risks than banks that are lending to foreign governments. A firm must consider a longer investment horizon, and analyse risks from a much broader spectrum of county characteristics. For example, a plant investment contains a much higher degree of risk simply because the firm remains exposed to risk for longer period of time (Meldrum 2000, 36).

Meldrum (2000, 33) and Nordal (2001, 197–199) have a 21st century view on country risk and note that all business transactions involve some degree of risk but when business transactions occur across international borders, they carry additional risks not present in domestic transactions. Meldrum (2000, 33) specifies that these additional risks, called country risks, typically arise from a variety of national differences in economic structures, policies, socio-political institutions, geography and currencies. Moosa (2002, 132) defines country risk as an exposure to a loss in cross-country transactions, caused by events in the host country that are partially under the control of the host government, but definitely not in the control of a private company. Nordal (2001, 197–199) adds that country risk should be included in the investment decision-making process and, if possible, it should be quantified. Nordal continues that country risk is most often measured only as a possibility although that is not the case always. Kuusela and Ollikainen (1998) remind that a notable feature of country risk is that the risk changes in time when economic conditions and legislation change in the host country.

The significance of country risk for foreign investors has become more substantial than it was in the past which can be partially explained by the rapid increase in the flow of capital between counties (Jones 2007, 145). The increased importance of country risk is no surprise, since country risk, like Jodice (1985, 5) notes, affects the most valuable assets a company possess: personnel, physical assets, and operations. Sillanpää (1998, 97) draws attention to several studies (such as Thunell 1977, 8; Banker 1983, 157) made in the US where country risk has been viewed as the single most influential factor affecting investment decision-making. However, country risk might still be difficult to conceptualise and it could be easily overlooked in the investment decision-making process. Poole-Robb & Bailey (2002, 9) agree with that and argue that country risk is like a gigantic iceberg with the most dangerous parts of it hidden in the waves of misconception, ignorance and naivety.
A wide range factors exist why investments are influenced by country specific issues. In general, country risk is distinguished for quite a few different sub-categories (Nordal 2001, 199). Many researchers view country risk merely as a synonym for political risk (see, for example, Jones 2007, 145). In this study that view is not supported, instead country risk is viewed as a much more comprehensive and more complex than the concept of political risk.

Nordal (2001, 199) divides country risk into three categories: economic risk, commercial risk and political risk. Macroeconomic situation translates into economic risk, such as the development of interest and exchange rates, which might have an effect on the profitability of an investment. Commercial risk relates to one investment specifically, such as the risk of local partners and private companies not fulfilling agreed contracts.

Sillanpää (1998, 100–101) defines country risk as being a sum of economic, political and cultural features of the host country. Exchange rate fluctuations, geographical factors, including catastrophes, and commercial risk, such as price wars with competitors, are not included in this definition.

Oetzel, Bettis and Zenner (2001, 129) also separate country risk into three categories and include economic and political risk among the three like Nordal and Sillanpää. The difference is that the third country risk in Oetzel et al. classification is social risk. Oetzel et al. add that these three risks are usually highly correlated and that differentiating between the risks is often difficult.

Poole-Robb and Bailey (2002, 8, 13–18) consider country risk from a much wider perspective than the researchers above. Their country risk classification includes political and economic factors, sovereign risk, benchmarks, security factors, partner/customer/acquisition appraisal, and Grey Area Dynamics (GADs). In this classification the Grey Area Dynamics is an interesting addition. It is a concept developed by Merchant International Group and it includes over a hundred different factors related to country risk. The ten key factors in GADs are corruption, bureaucracy, counterfeiting and theft, cultural issues, legal safeguards, organised crime, unfair trade, unfair competition, asset security, and extremism. However, Meldrum’s classification described below is more widely used and supported, while also accommodating the most noteworthy GADs in the model.

Meldrum (2000, 34) expresses the view of numerous other analysts in separating country risk into six main categories. This model of six classes of country risk is found in most of the risk rating services. Larger number of categories enables clearer categorisation of the factors and enables more factors to be taken into account in the model. The risks in Meldrum’s categorisation are: economic, transfer, exchange rate, location or neighbourhood, sovereign and political risk. Meldrum reminds that many of these categories overlap with each other given the interrelationship of the domestic economy with
the political system and with the international community. Therefore many individual variables might be placed in one or more categories dependent on the compiler of the country risk analysis. Meldrum classifies country risk in clear categories while taking the most important risks that affect foreign investors into account. That is why Meldrum’s classification is used as a basis for country risk analysis in this study with some minor additions to make sure all Indonesia specific factors are taken into account.

3.3 Classification of country risks

3.3.1 Economic risk

Economic risk derives from significant changes in host country’s economic structure or growth rate which would lead to a major change in the expected return of the investment. Economic risk arises from possible detrimental changes in fundamental economic policy goals (international, monetary, fiscal, or wealth distribution and creation) or from a considerable change in country’s comparative advantage (e.g. industry decline, democratic shift, resource depletion). Economic and political risks overlap with each other in some measurement classifications since both of them deal with policy issues (Meldrum 2000, 34). Inflation and unemployment are two examples that could arise from poor economic policies or conditions which affect the total country risk considerably (Oetzel et al. 2001, 130).

Poole-Robb and Bailey (2002, 28) have compiled a nearly comprehensive list of different economic risks. According to them economic risk stems from unfavourable changes in business cycles, GDP trends, inflation, interest rates, unemployment, trading barriers and alliances, disposable income levels, and exchange rates.

Meldrum (2000, 34) explains that economic risk is measured by traditional measures of fiscal and monetary policy, including the size and composition of government expenditures, the government’s debt situation, tax and monetary policies, and financial maturity. For longer-term investments the measures concentrate on long-run growth factors, the degree of openness of the economy and institutional factors that might affect company wealth creation. Bremmer (2005, 51) agrees that economic risk analysis is very important but basing investment decisions purely on economic data is foolish since understanding the surrounding political context is even more important.
3.3.2 Transfer risk

Transfer risk occurs when a foreign government decides to restrict overseas capital movements. Restrictions aim at making repatriating profits, dividends and capital more difficult. Governments can implement changes in capital movement legislation at any time leaving all investments types vulnerable. Transfer risk is most typically measured by government’s ability to earn foreign currency since difficulties in earning foreign currency increases the probability for the emergence of capital controls. Nonetheless, quantifying the risk remains troublesome or even impossible since the decision to impose restrictions on capital may purely be a political response to another problem. Therefore, quantitative methods typically used to assess transfer risk provide very little guidance, for example, when Malaysian government in the depths of the Asian Financial Crisis (AFC) made a political decision and imposed capital controls to fix the exchange-rate problem it was facing (Meldrum 2000, 34).

Transfer risk measures generally include the ratio of debt service payments to exports, ratio of foreign currency reserves to several different import categories, amount and structure of foreign debt relative to income, and measures related to the current account status. Following trends in these categories reveal potential imbalances that could lead a country to restrict certain types of capital flows. For example, a growing current account deficit as a percentage of GDP implies that host government is in a great need for foreign exchange to cover that deficit and it might resort to capital controls (Meldrum 2000, 34).

Restrictions for capital movement can usually be bypassed with several ways which depend on the host country legislation. Some commonly utilised methods include the transfer of loss-making activities to the host country and the usage of transfer pricing. Both of these methods are used to transfer profits to other countries and units which do not face prohibitions on repatriating profits. These methods could also be used for minimising taxes and transferring profits to units abroad whose tax burden is lower (Sillanpää 1998, 112).

3.3.3 Exchange rate risk

Exchange rate risk arises from unexpected adverse movements in host country currency exchange rate. The risk also includes an unexpected change in currency regime, for example, a change from a fixed to a floating exchange rate regime. Economic theory advises exchange risk analysis over longer time periods (more than a year). Short-term pressures tend to be driven by currency trading momentum while being reflected by economic fundamentals. In the shorter term, risk for various currencies can be substan-
tially reduced or even eliminated at an acceptable cost through various hedging mechanisms and futures arrangements. Currency hedging, however, becomes unpractical over the whole life cycle of a plant or similar direct investment. In which case, natural hedges should be developed, if it is possible, to reduce exchange rate risk (Meldrum 2000, 34–35). Natural hedges can be achieved by aligning revenues and costs in the same currency for example with agreements on the billing currency and by taking debt in the local currency (Sillanpää 1998, 112).

Oetzel et al. (2001, 130) point out the importance of exchange rate risk suggesting it is one of the most significant risks that companies face, and that both economic and political events can result in increased country risk through fluctuations in currency values. Such economic and political measures include major changes in country’s economic policies, terms of trade, political regime, attitude towards foreign direct investment and social stability.

Several quantitative measures used to identify transfer risk also identify exchange rate risk since abrupt depreciation of the currency can reduce imbalances that lead to climbed transfer risk. The level of exchange rate risk depends heavily on the country’s exchange rate policy. Managed floats are perceived to be riskier than fixed or currency board systems. Whereas, floating exchange rate systems have the lowest risk of producing an unexpected adverse movement in the exchange rate. In addition, considerable over- or under-valuation of a currency can help isolate exchange rate risk (Meldrum 2000, 35).

### 3.3.4 Location risk

Location, or neighbourhood, risk is caused by spillover effects of problems in the region, or faced by country’s trading partner. Similar country characteristics may also be susceptibility to contagion as seen in Latin America in the early 1980s and in Asia in the late 1990s. Thus location risk provides analysts with one more risk category to assess (Meldrum 2000, 35). The Economist article in 1986 entitled “Countries in Trouble” provided variables which work as predictors of future harm for foreign investors. Among the variables were two elements of location risk: the proximity to a trouble spot or to a super power (Coplin & O’Leary 1994, 6).

Geographic position is the basis for starting to measure location risk. Size, borders, trading partners, international trading alliances (e.g. NAFTA, EU, ASEAN), and distance from politically and economically important countries or regions help define location risk (Meldrum 2000, 35).
3.3.5 Sovereign risk

Sovereign risk stems when a government is unable or unwilling to honour its debt obligations, or when it reneges on loans it has guaranteed. Transfer risk may relate to sovereign risk in that a government may run out of foreign exchange due to adverse developments in its balance of payments. Sovereign risk also relates to political risk when a government decides not to honour its commitments for political reasons. One particular point to be taken into consideration when dealing with governments is that should the government not meet its obligations, private lenders find it nearly impossible to sue the foreign government without its consent (Meldrum 2000, 35). Sovereign risk is usually limited to transactions with a government of a sovereign country and it mainly deals with lending activities, but not necessarily (Moosa 2002, 132). Sovereign risk is also evident when a host government prevents companies or individuals residing in the country from fulfilling their overseas obligations (Hoti & McAleer 2005, 2).

Measures of sovereign risk are similar to those of transfer risk measures, concentrating on analysing government’s ability to pay by assessing the history of repayment performance and the potential cost for debt repudiation for the government. International setting complicates the measurement of sovereign risk even further. For example in the late 1990s, the International Monetary Fund (IMF) gave guarantees to Brazil in order to stop the spread of an international financial crisis. Had Brazil’s problems developed before the Asian and Russian financial crises, the level of support for Brazil would have been significantly lower and thus sovereign risk would have been higher (Meldrum 2000, 35).

3.3.6 Political risk

Political risk concerns risk of an adverse change in political institutions arising from a change in government controls, social fabric or other noneconomic factor. Political risk covers the potential for traditional political analysis, internal and external conflicts, and expropriation risk. Assessment of political risk requires analysis of a variety of factors, such as the relationships between various groups in the country, government’s decision-making process and the history of the country (Meldrum 2000, 35). Political risk can also be illustrated by politically caused losses, such as damage to property or actions against personnel, discriminatory taxation, and governmental interference with the terms of privately negotiated contracts (Haendel 1979, 71).

Poole-Robb and Bailey (2002, 28) have gathered a list of factors that might cause political risk to arise. These factors include changes in: government stability, industry
regulations, social legislation, tariff controls, taxation policy, employment law, and environmental protection.

Measuring political risk is done with various classification methods (including the type of political structure, civil or external strife incidents, range and diversity of ethnic structure), analyses and surveys by political experts. Most political risk assessments provide a rank or a grade based on multiple socio-political factors, and that value is accompanied by a written analysis. Little theoretical guidance exists that guide the quantifying process. Moreover, over time the importance of different socio-political events change in the view of individual analysts, so the consistence of many classifications is weak. Company analysts can also develop political risk analysis for their business through discussions with local country representatives or visits to other companies operating in the same sector in the target country (Meldrum 2000, 35).

Bremmer (2000, 52) draws attention to the importance of political risk for all companies with exposure in foreign markets. Bremmer lists four reasons why companies desperately need accurate information on political developments. First, international markets are more interconnected than they have been before. As an example of this is the Asian Financial Crisis in the later part of the 1990s which had effects around the world. At present, eyes are locked on China as domestic political decisions could have a wide impact on its economy and serious repercussions on the world economy. Second, the United States is making the world volatile with its new foreign affairs and security policy that has translated into the US military responding with an unprecedented capability to international shocks, and creating them. Third, the trend of offshoring is growing when companies move on to countries where labour is cheap but cheap labour comes with a price. Low wages and poor living conditions in offshoring countries increase the threat of social unrest. In addition, developing country governments are often not protecting intellectual property rights properly which offloads the responsibility onto the companies operating there. Fourth, the world is becoming more dependent upon energy of countries troubled by significant political risk – Russia, Saudi Arabia, Iran, Nigeria and Venezuela among them. These politically instable oil-producing states can easily produce worldwide shocks as the hunger for energy increases at a pace that supply can hardly match.

Bremmer (2005, 60) suggests that even though political instability translates into greater risk when investing in developing countries it is not necessarily a bad thing. This is because investing nearly always carries a hidden upside since many developing nations are somewhat unstable to begin with and adverse shocks cannot inflict much more damage in countries such as Afghanistan and Cambodia.

Constantly increasing and changing legislation might put companies in disadvantage compared with the situation that prevailed when the company made its initial investment. Stable legal environment is an important factor which encourages companies to
invest in specific counties, this is especially important for long-term and capital intensive type of investments. Legal risk stems from two different parties, from business partners and authorities, and their demands directed to the company. The risk materialises if those demands are found to be valid for example in court. Business partners might demand for compensation or a reduction in agreed prices. Where as authorities can demand a wider variety of things, including stricter safety norms or more taxes (Routamo 1998, 151–152).

3.3.7 Social aspect

Few researchers, like Meldrum (2000, 35), place social risk under the political risk category and many, like Jodice (1985, 4–6), regard it as an important individual group. Jodice continues that risks arising out of social changes (e.g. labour unionism, race relations, feminism) are usually not an output of the political system. Of course, some social factors might be the produce of political actions, such as laws governing collective bargaining, which makes social risk related to the political risk in many cases. Oetzel et al. (2001, 130) remind that social stability is almost always reflected in a country’s currency value which link the social aspect closely together with exchange rate risk.

Haendel (1979, 71–72) includes several sources of instability under the social risk category, including strong internal factions (religious, racial, language, tribal, or economic), social unrest and disorder, recent or impending independence, vested interest of local business groups, forthcoming elections, new international alliances or relations with neighbouring countries, and proximity to armed conflicts. Poole-Robb and Bailey (2002, 28) list a few more sources for social risk, such as population growth and shift, income distribution, social mobility, the quality of life, lifestyle changes, and public and media opinion. As can be seen from the social factors listed by Haendel, and Poole-Robb and Bailey, social risk is very closely related to host country’s culture and thus cultural aspect can be placed under the social risk being a narrower category of the two.

According to Sillanpää (1998, 109, 113) a substantial portion of country risk is derived from cultural differences which have a direct link to venture profitability. For example, venture preparation and tasks related to operating of the project are sometimes expected to go forward as they would in the home market. Also communication and supervision of work are problem spots as companies often lean on to traditional home market methods of personnel administration. Personnel training and reorganisation of work tasks reduce problems related to cultural differences. In addition, clear working guidelines and ownership arrangements added with rapid reporting help the subsidiary to maintain efficient working environment in challenging countries.
Äijö (2001, 18, 37) notes that over one-third of Finnish small and medium-sized enterprises view that the availability of qualified workforce is significantly lower for them than for local competitors. Moreover, one-third of Finnish SMEs also believe that the quality of overseas workforce is considerably lower than what they are used to.

### 3.3.8 Corruption

Corruption is the single most important factor contributing to political instability and economic decline in developing markets. Basically, corruption is a misallocation of capital, where economic resources are distributed for non-economic purposes (Gentile 1998). For any company, corruption costs are a direct loss. In some societies corruption costs, such as bribes and gifts, are expected to amount a total of 3% of all transaction costs at different levels of the transaction. A 3% decline in profit margin is a valid reason for numerous companies not to invest in many corruption-ridden markets where profit margin would be low either way (Coplin & O’Leary 1994, 5).

In the host country, corruption inevitably leads to political decline and might also be affecting social stability strongly. In countries commonly perceived as non-corrupt, citizens believe that riches and power have been honestly earned by the people possessing them. Whereas in corrupt countries rich people are perceived to have bought their way into power or bought political influence from political leaders. As a result, the rich and politicians are viewed as illegitimate, and this is a source for political and social instability (Gentile 1998).

As important as corruption is for understanding the overall country risk for developing markets, it is one key factor that is very difficult to measure. Thus countries are often grouped in categories of very corrupt, semi-corrupt, not-corrupt etc. Loose home country legislation towards corruption provides some companies an advantage over competitors coming from countries with stricter attitude towards corruption. This is evident, for example, between French and American companies. French companies have been able to make payoffs to win contracts in foreign countries as American and US listed companies are under the jurisdiction of the Foreign Corrupt Practises Act, which can mean heavy fines and prison time for executives involved in corruptive activities (Gentile 1998).
3.3.9 Roundup of country risk relations

Figure 5 acts as a roundup of all the different country risks analysed in chapter 3.3. As discussed before, most of the individual country risks are closely related to each other. First and foremost, political, social and economic risks can be seen as the most influential risks since they are deeply intervened with other risks and also between each other. Thus, it is often complicated to place a single factor exclusively under one of the eight risks categories discussed above. Moreover, eight different risk groups enable a more close examination of individual risks and their effects. These risks are presented again in chapter four in an Indonesian context.

In addition, figure 5 acts as a reminder that companies need to perform comprehensive risk analysis in order not to overlook any important factors. Noticeable on figure 5 is also the fact that location risk is not related to any other country risk since location risk arises from factors outside the control of the host government. The rest of the risks are somewhat under the control of the host government.

3.4 The effect of country risk for different types of investment

The effect of country risk for a company depends on the method of operating in foreign markets. This is illustrated in figure 6 below.
As already briefly discussed in chapter 2.1, different operating methods have different risk levels in foreign markets. Operating methods vary in their capital intensiveness, length of the investment and control of the investment. All of these factors could be described with the word involvement, and involvement in foreign ventures increases when moving from the left to right in the above figure. Often the first method of internationalisation for companies is exporting from where they gradually increase their activities if they are successful. Moving to the right in the figure towards foreign direct investment companies gain total control of their foreign venture with all the possible profits associated to it. At the same time, length of the involvement expands substantially and the possibility for adverse events rise, capital consuming increases with no or little chance for a quick escape if risks start to materialise. Therefore FDI is most risky of the foreign operating methods but offers also the most handsome profits and opportunities. Given the possibilities of FDI and its proneness to risk, country risk determination and analysis should be handled properly in order to avoid caveats and maximise on the potential (Sillanpää 1998, 99–100; Poole-Robb & Bailey 2002, 33–35).

Meldrum (2000, 36) emphasises that longer the investment is more impact will different country risk categories have. In particular economic, location and political risks will have a wide impact on an investment lasting twenty years or more. On the other hand, transfer risk most likely poses less of a risk for long-term investment since capital restrictions are unlikely to last for the whole investment period. Such restrictions are typically placed to help manage temporary foreign exchange shortages, while companies can reinvest profits locally and wait out the restrictions, usually without any negative impacts on the return of the investment in its full life.
3.5 Country information and reducing risk

3.5.1 Gathering country information

Extensive and current country information reduces risks in the host market in several different ways. Firstly, country information works as an instrument for organisational and managerial learning. Secondly, active enterprises can also get involved in processes that develop the whole host society (Sillanpää 1998, 111).

Companies can acquire country information in various ways. Usually country research done within the enterprise is substantially more expensive than buying the information from an external source. Information can sometimes be acquired with little or no cost since internet, publications, authorities, insurance companies etc. offer often comprehensive analyses on countries and specific industries. However, the more general the information is by nature the easier it is to acquire and the less it helps to solve often complicated problems companies face in foreign markets. The amount of free data and the fragmented nature of it might make analysis extremely difficult and country comparisons inaccurate (Sillanpää 1998, 104–109). Companies can combine all free information sources together and attain reasonably good estimates of the risks the company is facing (Nordal 2001, 200–201). Accuracy of these estimates can then be improved by buying some vital parts of information from external sources. If companies decide to do country risk analysis mainly within the company, they need to maintain continuous research in order to possess timely and accurate data, since when the underlying reasons for country risk in developing countries change they tend to change drastically (Sillanpää 1998, 104–109).

3.5.2 Reducing country risk

Bremmer (2005, 60) states that reducing country risk is essential for companies when they make the decision that a particular investment is worth taking on the risks that country related factors pose. In this chapter different ways how to reduce the effect of country risks are discussed. Reducing risks can be done in several ways, such as by collection and analysis of information, mitigating risks, getting export guarantees, and for example teaming up with a development bank in higher risk projects if possible. Haendel (1979, 78) finds four additional ways of minimising the effect of country risk: timing and entry strategies, altering the subsidiary’s activity, sourcing and movement of funds, and controlling the location of intangible assets.
Naturally, as stated earlier, collecting background information and performing proper analysis on all of the country risks is the best possible way to be prepared for different future developments, and above all, the only sustainable basis for making vital investment decisions. When decisions are based on as accurate analysis as possible, management can decide whether risks related to their investment are worth taking and if they are, management will be prepared for different scenarios and has formulated plans for different outcomes which can be executed promptly. Awareness of country risks and acting accordingly reduces risks and costs inflicted to the investment project substantially.

Companies can use traditional techniques to mitigate risks, such as recruiting local partners with extensive knowledge of the market or limiting R&D in countries with leaky intellectual property rights protection. Diversifying investments among several countries in a particular region as well as outside the main region is a good way to mitigate risks. Moreover, an ever-growing number of governmental and commercial organisations are offering insurances against risks, mainly political risks, such as political violence, expropriation of property, currency inconvertibility and breach of contract (Bremmer 2005, 60).

External parties offer export guarantees for foreign investors since most developing countries cannot make credible commitments to investors. As sovereign nations, they can renge on promises for example by insisting that investment terms be renegotiated or by nationalising projects. The external parties offering export guarantees are either home governments or multilateral organisations, and these guarantees generally cover against political risk in its wide definition (Wells & Ahmed 2007, 5–6). In addition, private insurers, like AIG, also offer political risk insurances for foreign investors (Coplin & O’Leary 1994, 5). All country risks cannot be covered by guarantees and insurances, and it is not even advisable since paying premiums to cover all risks would also eliminate the prospect of acquiring profits (Sillanpää 1998, 98–99).

State-authorised private justice has become an increasingly important part of the assurances for investors. This international arbitration for disputes has been in companies’ disposal since the 1990s when several treaties covering access, rules and enforcement were signed. Now companies can use arbitration when they believe that they have been mistreated by a host government, which has increased the number of cases on trial dramatically (Wells & Ahmed 2007, 5).

Luostarinen (1989, 206) states that one alternative way of reducing both actual and perceived risk is to reduce the amount of initial financial commitment to foreign markets. This can be done by a step by step penetration, gradual investment, or with a pilot based operation approach.

Teaming up with a development bank can offer valuable contributions for companies. Development banks cover project risks (mainly political and exchange rate risks) in
countries, sectors and companies where private sector would not invest alone. Mere presence of a development bank lessens the perceived risk for investors. In several developing countries government intervention has been the largest risk element for the success of specific projects. Development banks can use their connections and influence over local governments to restore a more suitable investment environment which substantially reduces risks for investors. Development banks do not offer cheaper financing to companies than the private financiers would, but they do offer various types of financing instruments under one roof which easily satisfies varying needs of different companies. Moreover, development banks can offer their wide influence on many local and regional players, and their unbeatable market experience and expertise (Asian Development Bank 2007, i–ii, 7).

Development banks are rapidly expanding their cooperation with companies, and financing from the banks to private companies has seen handsome double-digit growth annually for the past few years, which is expected to continue in the future. The banks’ activities are concentrated mainly on financial and infrastructure sectors but they are in the process of actively expanding to other sectors as well (African Development Bank 2006, 5–6; Inter-American Development Bank 2008, 2). For example, Asian Development Bank (2008c, 1–2) is concentrating, besides the financial and infrastructure sectors, on education and environment, and the Inter-American Development Bank (2008, 2) focuses increasingly on agribusiness, manufacturing and natural resources.

### 3.6 Risk ratings

Often the most cost effective and reliable way of acquiring information on country risk is to buy the information from a dedicated risk rating agency (Sillanpää 1998, 104–109). Literature reviews numerous risk rating agencies and their country risk valuation techniques (see, for example, Sillanpää 1998; Hoti & McAleer 2005; Krayenbuehl 1985; Coplin & O’Leary 1994; Erb, Harvey & Viskanta 1996; Oetzel et al. 2001). Eight of the most prominent risk rating agencies are: Economist Intelligence Unit (EIU), Euromoney, Institutional Investor, International Country Risk Guide (ICRG), Political Risk Services, Moody’s, Standard and Poor’s (S&P), and Business Environment Risk Intelligence (BERI) (Erb et al. 1996, 29–30; Hoti & McAleer 2005, 5). Common for all of the rating agencies is that they classify country risk by assigning a value, either a number or a letter, to each country in their ratings. This enables comparison between different countries in each agency’s ratings but not necessarily between the rating agencies since their methods and classifications differ from each other (Hoti & McAleer 2005, 105).

Risk rating agencies provide a consistent method of risk assessment and these methods can vary considerably between agencies. Generally agencies pool a range of quan-
itative and qualitative information on political, economic and financial risks together. The agencies themselves can be classified using seven criteria: definition of country risk ratings, number of countries analysed, frequency of risk ratings, type and number of ratings prepared, type and number of risk component variables used, weights assigned to risk components, and the range for risk ratings. Companies can use the above criteria in search of the most suitable rating agency for them. Ten most popular risk rating agencies differ substantially in several instances, such as in the number of countries covered (from 50 to 185 countries), by the frequency of ratings (from monthly to annual), and the number of risk component variables used (from 9 to 128). In addition, some agencies offer several different ratings for each individual country, for instance, Moody’s and Euromoney both have 10 ratings per country, one being a composite country risk rating comprising from the other nine component risk ratings. More specific information provided by the agencies enable companies to review country risk in more detail, and the continuous updating of the ratings help in adapting to changing environments (Hoti & McAleer 2005, 94–109).

Hoti and McAleer (2005, 95) suggest that risk rating agencies are of a special importance for investors investing in developing countries and for the countries themselves where publicly available information is often scarce. Oetzel et al. (2001, 128) emphasise that many managers fail to questions these country risk ratings and reports since they are assuming that country risk analysis is purely an objective fact-finding process. Erb et al. (1996, 30) state that the parameters taken into account are difficult to define exactly and that agencies’ recommendations will be based, to some extent, upon factors that the experts’ compiling the ratings believe are relevant.

The significance of risk rating agencies for companies, and trust that companies have for the agencies is illustrated perfectly in an article published in the midst of the Asian Financial Crisis. The Economist (1997, 70–71) reports that investors blame rating agencies for failing to warn them about the impending crisis in the Asian economies. The publication notes that it has been a case of too little, too late in country after country. Bad news tends to be reflected in country risk ratings over a longer period of time than good news. Downgrades happen gradually since they would also influence bond issuers, the valuable customers of rating agencies, negatively. Rating agencies also do not like their ratings get too far out of line with one another since it poses a risk of losing reputation relative to competitors by being wrong. When the AFC commenced at the end of the 1990s rating agencies failed to realise how difficult it would be for governments to do the things they promised to do, such as close frail banks, which once again proved the importance of political risk. Hoti and McAleer (2005, 96) maintain that the accuracy of risk rating agencies with their country risk measures is crucial. These rating systems have changed after the Southeast Asian, Russian and South American crises to better accommodate a wider range of factors that influence country risks in the present world.


4 INDONESIAN ECONOMY AND BUSINESS ENVIRONMENT

4.1 Overview of Indonesia

Indonesia, with 230 million people, is itself enormously diverse, being made up of 17,000 islands and a rainbow assortment of cultural and religious traditions (The Economist 2008a, 68).

Indonesia is the largest archipelago in the world, comprising of over 17,000 islands which spread out around the equator. The land area of Indonesia is approximately 2 million square kilometres, and the country measures about 5100 kilometres at its greatest east-west extent and about 1900 kilometres in north-south extent. Strongly related to the spread out nature of the country, Indonesia is culturally very diverse. There are 350 recognised ethnolinguistic groups in Indonesia, roughly half of them located in the island of Papua. In addition, 725 languages or dialects are spoken in the country, and 13 different languages have over one million speakers. Official national language Bahasa Indonesia, a slightly modified form of Malay (Malaysia’s and Brunei’s official tongue), is spoken by approximately 25 million Indonesian as a mother tongue and by 140 million people as a second language. Chinese is also among the thirteen languages with over one million speakers (The Investment Coordinating Board 2007, 1–4; Asian Development Bank 2008b; Library of Congress 2004, 4–7).

While being enormously vast and diverse country, Indonesia boast the fourth largest population in the world with from 225 to 250 million of inhabitants depending on the source cited. Population growth is around 1.3% annually, which adds three million new habitants to the population every year. Indonesia also has the largest Islamic population of any nation, as 88% of the population count themselves as Muslims (The Investment Coordinating Board 2007, 1–4; Asian Development Bank 2008b; Library of Congress 2004, 4–7).

Indonesia’s geographical location and form make the nation exposed to a range of natural forces, such as severe flooding and unpredictable droughts. In addition, Indonesia’s location in the area of several tectonic plates, often called as the Pacific “Ring of Fire”, makes the country vulnerable to volcanic activity and earthquakes, which can sometimes create tidal waves better known as tsunamis. In December 2004 the special territory of Aceh was left devastated after the Indian Ocean earthquake leaving approximately 170,000 people dead and area’s infrastructure wiped out. In May 2006 an earthquake in the island of Java, the most populated island in the country, nearby Indonesia’s former capital city Yogyakarta left 6,000 people dead. In addition, an industrial
4.2 Brief history of Indonesia in the modern times

The Dutch began to colonise Indonesia in the early 17th century, and in the Second World War Japan occupied the nation from 1942 to 1945. After the Japanese surrendered Indonesia declared itself independent, however, it took over four years before the Netherlands agreed to relinquish its colony. During these four years the country was filled with recurring hostilities and intermittent negotiations with the Dutch. Nationalist pride of Indonesians and their fierce determination for independence, added with United Nations as a mediator finally persuaded The Hague to recognise Indonesia’s sovereignty (Library of Congress 2004, 3; The World Factbook – Indonesia 2008).

Sukarno, the co-proclaimer of the independence in 1945, served as Indonesia’s first president between 1945 and 1965. First democratic presidential elections were held in 1955 with Sukarno re-elected, but in 1959 Sukarno announced a period of Guided Democracy and in 1963 proclaimed himself as president-for-life. In 1965 army general Soeharto came to power after a coup against the leading political party, and the New Order era begun. This new era started with the killings of an estimated 500 000 Indonesian communists and suspected communists (Nuutinen 2008, 4–5; Library of Congress 2004, 3).

The New Order era, which lasted over 30 years, has a very mixed record. The rule was authoritarian but it managed to bring stability to the country. The new rule also achieved tremendous economic growth and increased the well-being of the majority of Indonesians, and for example life expectancy rose from 46 to 65.5 years during that period. However, state’s heavy involvement in several business sectors worked against competition and laid a foundation for rampant corruption still visible in modern Indonesia. Strict political control and propagandising national ideology aided stability but did
not prepare the nation for a modern political existence. Soeharto provided strong political leadership but he did not make any preparations for a wise transition and in his last years he devotedly favoured his family and friends. When the Asian Financial Crisis hit in 1997–1998, the New Order lost the economic justification which had kept it in power for such a long period. Soeharto was forced to resign in May 1998 just after being elected for his seventh term as president (Nuutinen 2008, 4–5; Library of Congress 2004, 3–4).

The year 1999 saw the first freely contested parliamentary elections since 1955, and the nation saw three different presidents after Soeharto’s era before retired army general Susilo Bambang Yudhoyono was elected as president in 2004 in the first direct presidential elections in the history of Indonesia (Nuutinen 2008, 4–5; Library of Congress 2004, 3–4). Soeharto’s authoritarian rule has undermined the creation of formal institutions long after his downfall. The democratic reform has faced severe difficulties after the collapse of the old regime, such as institutional weakness, structural problems of resource dependence and distributional rivalries. The political system has switched from centralisation, rigidity, and hierarchically managed coalitions to dispersion, fluidity, and fragmented coalitions. Although a history of sound macroeconomic management and integration into global markets helps in confronting reform, the current political environment is turbulent with important obstacles to be tackled with (Lewis 2007, 236–237).

Other important events in the 21st century have been the peace agreement with armed separatists in Aceh and the independence of East Timor after 25 years of Indonesian occupation. Fighting terrorism has also been a primary target of the government after several fatal bombings in Jakarta and Bali. In addition, fighting rampant corruption, alleviating poverty, and implementing financial sector reforms are priorities of the current government (Nuutinen 2008, 4–5; The World Factbook – Indonesia 2008).

4.3 Indonesian economy

4.3.1 Past developments

The economy of newly independent Indonesia under Sukarno’s grasp developed poorly because of the poor policies implemented by the president and an overall difficult situation the country faced after the Dutch finally left. By the 1960s Indonesian economy was described as a “basket case” with annual inflation reaching 1 500 per cent and
yearly interest payments on debt exceeding country’s export revenues (Smith 2001, 1–2).

Soeharto’s ascension to power boosted Indonesian economy dramatically. Soeharto’s stabilisation program has been credited of being one of the most successful undertaken anywhere in the world in the modern history. Foreign trade and investment were seen to be of vital importance and the government lift several restrictions to boost them (Smith 2001, 2). During Soeharto’s New Order the economy developed from virtually no industry in 1965 to an exporter of industrialised products in the 1980s. The growth of total production exceeded the rates in neighbouring developing countries both in the 1980s and the beginning of the 1990s. The export industry was mainly driven by the influx of FDI in the beginning of the 1990s (Nuutinen 2008, 6; Library of Congress 2004, 7).

Development was spectacular during the 1970s and 1980s but the success did not resolve the underlying structural problems and, in fact, created new types of difficulties for the future. Soeharto favoured his family’s and friends’ businesses outrageously by implementing law changes and gifting lucrative sectors of the economy to them. The number of companies owned by Soeharto’s family mounted an immense 417 with a considerable proportion of the economy under their control. Corruption, collusion and nepotism were some of the sins of the authoritarian rule. These factors grew in importance and left the economy especially vulnerable to the financial crisis of 1997–1998 (Library of Congress 2004, 7).

After thirty years of the New Order rapid economic growth was believed to be self-sustained and natural. There were vested interests in the country to keep up the illusion of long-lasting economic growth as it justified the authoritarian rule, and rewarded both policy advisors and well-connected businessmen. Then suddenly in 1998 Indonesia fell into economic and political crisis. Only after the fell of the authoritarian government, experts started to criticise it for its authoritarianism and corruption. Alongside came also pessimism that sustained economic growth was unreachable, which reflected the prevailing moods, not well-grounded analysis (Dick 2001, 161–162).

The devaluation of Thai baht on 2 July 1997 catalysed a vast reversal of capital flows that initiated the Asian Financial Crisis. This sudden and tremendous reversal was largely due to the withdrawal of offshore commercial bank lending. This pushed the corporate sector towards insolvency and abruptly ended the economic growth period of three decades (Matsumoto 2007, 4). When the crisis begun to spread from Thailand, Indonesia’s economy seemed to be very healthy with strong and robust economic growth, in fact, most of the economic indicators looked at least comfortable pre-crisis. In the latter half of 1997 it looked like Indonesia would ride out the crisis relatively unscathed, however, the contagion effect stemmed surprisingly hard from depreciating neighbouring currencies and the withdrawal of short-term foreign investments (Smith 2001, 4; Hill 1999, 5–7).
In the year 1998 Indonesian economy contracted 13.1% and rupiah weakened from 2400 in 2007 to 14800 in 2008 against the US dollar, with inflation exceeding 60%. In addition, the amount of people living in absolute poverty increased to 25% in mid-1999 from 10% just five years earlier (Smith 2001, 4; Library of Congress 2004, 7; Matsumoto 2007, 5). These problems combined with the inability of the government to intervene effectively and to negotiate a deal with international financial authorities, and the evidence of unforeseen amount of corruption increased public frustration and ultimately led to the fall of the regime on 21 May 1998 (Matsumoto 2007, 4–5; Smith 2001, 5).

The consequences arising from the economic crisis were many, including significant depreciation of the rupiah, accelerating inflation, restricted access to finance due to reluctance by foreign lenders, and a near collapse of the domestic financial system (Basri & Van der Eng 2004, 1–2). The AFC set back economic development in the country but also forced the country to restructure the political and social systems established by Soeharto, systems that had deepened the impacts of the crisis (Matsumoto 2007, 4–5). The change of political regime and the conditions under which the International Monetary Fund (IMF) provided support to the troubled economy of Indonesia during 1998–2003 brought an era of both political and economic change and reform – called reformasi in Indonesian. A wide range of new policies were introduced aiming to cure problems plaguing Indonesia’s economy and generally sound macroeconomic policies were maintained (Basri & Van der Eng 2004, 1–2).

Indonesian economy recovered from the crisis in the coming years although the pace was somewhat slow compared with other countries that suffered severely from the AFC, such as Thailand and South Korea. In particular, the amount of foreign direct investment has lacked dismally behind the neighbouring economies. Even though Indonesia’s economic growth was relatively sluggish after the AFC, the country gained a new political reality offering greater degree of openness and plurality which work as a long-term enabler of economic welfare (Basri & Van der Eng 2004, 1–2).

4.3.2 Recent developments

*Indonesia’s economic growth prior the AFC accounted for an average of 7% between the years 1988 and 1997. For the ten years after the crisis, from 1998 to 2007, average GDP growth has been fairly sluggish at just over 4%, being a rate that has left Indonesia behind its neighbours, including Thailand, Philippines, Malaysia and Singapore (The Economist 2008a, 67).*
After the AFC presidents following Soeharto managed to stabilise the economy but structural problems, nepotism and corruption prevailed. Under president Yudhoyono’s term that begun in 2004 the nation has been undergoing significant economic reforms and the president himself has stood up to fight corruption. A lot has been done in terms of government’s economic policies, yet they still fail to satisfy public expectations (Nuutinen 2008, 6–7; The World Factbook – Indonesia 2008; Narjoko & Jotzo 2007, 143).

Indonesia’s economic growth in 2007 was 6.3 % which is the highest rate since 1996, and it clearly tops the five year average of 5.5%. The main drivers for the growth were private consumption, supported by private investment, and an expansion in net exports. This growth also reduced the amount of people living in absolute poverty from 17.8% in year 2006 to 16.6% in 2007. In addition, unemployment fell by 1.2% to 9.1%. The growth momentum has been maintained in the beginning of 2008 despite the deteriorating global environment, and both poverty and unemployment have fallen further. Growth for the year 2008 is expected to be at 6% or slightly more on favourable resource sector activity and increased investment. Indonesia’s economy is seen as better equipped for global slowdown then it was in the 1990s. Sound macroeconomic policies have improved fundamentals, such as lowered debt ratios and increased foreign exchange reserves. Liquidity has also been high in the financial sector and banks have a very low subprime mortgage risks. Nevertheless, possible changes in investor sentiments and increases in volatility in government bond market certainly pose risks for the overall economy (Asian Development Bank 2008a, 199; World Bank 2008a, 35; International monetary Fund 2008a, 3–4, 22).

Inflation in 2007 remained in the upper end of Bank of Indonesia’s (BI) target range and was 6.6% on average but it has accelerated since, and it reached 12.1% in September 2008. Rising inflation has been reflecting substantial increases in food and fuel prices, slightly weaker rupiah, as well as strong economic activity. Single most influential factor for growing inflation has been the increase of, heavily subsidised, domestic fuel prices by 29% in May 2008 to respond to the pressures of rising oil prices. Bank of Indonesia has responded with several interest rate increases to tighten monetary policy in 2008. The interest rate has been increased from 8.0% in December 2007 to 9.5% in October 2008. In the medium-term BI has set a target of 3% for inflation, and it is aiming to reach that goal in steps with inflation decreasing gradually every year (International monetary Fund 2008a, 3–4; World Bank 2008a, 35; Reichold, Ruiz-Arranz, Morales & Le Borgne 2008, 2; Investor Relation Unit 2008).

Bank of Indonesia’s official mandate is the stability of the rupiah and BI views that the inflation target is easiest to achieve with a floating currency. In practice, supporting economic growth is also one of BI’s aims. The set range for the rate of rupiah against US dollar is between 9000 and 9500. In 2007 the average rate was 9150 rupiah per US
dollar, and by the year end one US dollar was worth 9400 rupiahs. After strengthening in the beginning of 2008, the rupiah has fallen against the US dollar to 9785 by the 17th of October 2008. A new implemented policy of increased reselling of official foreign exchange receipts gained from oil exports should support the rupiah and help fight the inflation. At the moment rupiah is seen as moderately undervalued (Investor Relation Unit 2008; Reichold et al. 2008, 2; International monetary Fund 2008a, 3).

Indonesia’s international reserves have increased remarkably in the past fifteen years. In the early 1990s these reserves were less than $10 billion and in September 2008 they were $57.1 billion. With these reserves the economy is better prepared for sudden capital account reversals. Moreover, these reserves help in maintaining financial stability during the ongoing global credit crunch, when the possibility for capital outflows has increased substantially. Fundamentally international reserves are also held and used to avoid disruptive changes in the exchange rate, consumption and investments (Investor Relation Unit 2008; Reichold et al. 2008, 15).

A sign of sustainable economic growth has been an upgrade in the rating of Indonesia’s long-term foreign debt by Standard and Poor’s and Moody’s to BB- and Ba3, respectively, in 2007. These upgrades reflected the relatively moderate impact of US sub-prime crisis and an improved policy environment in Indonesia. Fitch continued the trend in February 2008 by upgrading Indonesia’s debt to BB, however, the global financial turmoil has raised international risk premiums significantly, up from 130 bps in mid-2007 to over 300 bps in 2008 (Asian Development Bank 2008a, 200; World Bank 2008a, 35).

Government budget has been suffering for years from oversized energy subsidies. Even with substantial fuel price rises in 2005 and 2008 energy subsidies are expected to be over 5% of GDP in 2008. Fixed domestics prices account for over two-thirds of total fuel sales, and with an estimated oil price of $95 per barrel subsidies will reach $14.3 trillion in 2008. At this level energy subsidies will be higher than central government’s social and capital spending combined. Evidence also exist that these subsidies have been poorly targeted, with minimal benefit to the poor. It is highly unlikely that further fuel price increases would take place before the 2009 elections, and in fact the government is figuring out options to limit the consumption of subsidised fuel as oversized subsidies considerably limit spending on priority areas. Moreover, recent fuel price increases have enabled the government to substantially reallocate spending to areas such as infrastructure, and this trend is likely to continue in the future (International monetary Fund 2008a, 3; International monetary Fund 2008b, 13; World Bank 2008a, 35; Asian Development Bank 2008a, 202–203).

In the budget for 2009 the government predicts that inflation will stabilise to 6.2% at year end, since commodity prices and oil prices have seen a decline amid fears of a global downturn. Rupiah is forecasted to strengthen against the US dollar to 9400 as a
yearly average, while 3-month interest rate is expected to be 7.5% at year end. GDP growth is forecasted to remain strong, despite the global turmoil, at 6%. Oil price for 2009 is set at $80 per barrel (Indonesia revises down 2009 budget inflation target; Details of Indonesia's revised '09 budget forecasts).

Government budgets in Indonesia are known to be often unrealistic. For 2008 budget it was clear beforehand that large increases in certain tax revenues and spending were unachievable. Oil price estimate in the state budget is particularly important as it has a wide effect on the economy. This has been a problem area, for example, the government estimated that oil price would average $60 per barrel for the year 2008 even when at the time of drafting the budget oil price was already at $70 per barrel. Moreover, also GDP growth prediction has previously been too optimistic, for example for the year 2008 analysts predicted a considerably lower growth than the government did and noted that government’s prediction was not based on prevailing circumstances. Budget for 2009 has faced similar criticism since inflation and interest rate expectations are viewed to be set too low. In addition, growth target for 2009 might be set too high as global demand for Indonesia’s key export commodities will most likely be hit by the global credit crisis (Kartika 2007, 230–231; Takii & Ramstetter 2007, 295; Indonesia revises down 2009 budget inflation target).

4.3.3 Short-term prospects

Predicting the future is always an unenviable task and the volatile global situation in the end of 2008 makes predicting Indonesia economic future accurately impossible and unreasonable. However, some general issues affecting the economy have been raised by research institutions. Indonesia’s preparedness to face a possible global downturn is also discussed.

Indonesia is better sheltered against a global slowdown than several other emerging market economies since exports are likely to remain strong as other emerging countries keep the demand for commodities relatively high. In addition, Indonesia’s diversified export base and relatively low trade exposure to the US allow Indonesia to remain on a moderately strong growth path. The economy is predicted to grow at least 6% in 2009. Growth will be driven mainly by continuously strong private consumption. Also private investments are likely to expand in response to an improving investment climate. Interest rates play an important role, and predicted lower interest rates would offer a significant boost for both private consumption and private investment. In addition, Indonesia’s balance of payments is forecasted to remain strong, which also has a positive impact on exchange rate stability (International monetary Fund 2008a, 10; International monetary Fund 2008b, 1–2; Asian Development Bank 2008a, 202–203).
Public investment cannot necessarily be boosted since subsidies will remain a major obstacle for an increase in spending, dependent on the development of oil and food prices. These price developments also have a direct and substantial effect on the inflation which in turn affects domestic demand. Although domestic demand is expected to remain sound, economic growth will be effected by weaker export growth owing to a slowdown in many economies. While Indonesia is relatively less vulnerable for a slowdown in the US economy, shifts in investor sentiment and increased global risk aversion could trigger capital outflows from more volatile emerging markets, including Indonesia. In addition, sharp price declines in commodity prices also pose risks to Indonesia’s growth since commodities account for more than half of Indonesia’s total exports. Drop in commodity prices thus affect export revenues but also valuations of many commodity producers on Jakarta Stock Exchange, which are heavily represented on the exchange. This could also trigger capital outflows, diminish interest in FDI on these sectors, and put pressures on the rupiah (Asian Development Bank 2008a, 203–204; International monetary Fund 2008a, 11).

4.4 The importance of a proper investment climate in attracting foreign direct investments

4.4.1 Investment climate defined

Thunell (1977, 5) defines the term investment climate as the regime for foreign direct investment. The risk for companies investing arises from possible changes in the rules for foreign investment, not necessarily the rules themselves. Therefore, a country can have a poor investment climate for two reasons: either because of the policies themselves, or because there is a great uncertainty about the stability of the policies regardless of whether the change would be good or bad.

Thunell (1977, 6) points out that a country’s investment climate consists from several different factors, including current economic situation and tendencies, institutional structure and infrastructure, social climate, administrative climate, and political climate. This classification of investment climate is nearly identical to Meldrum’s (2000) country risk categorisation, including economic, political, social, expropriation, exchange rate, corruption, cultural, infrastructure and legal aspects. This shows how closely related country risks are to investment climate and thus the investment decision-making of companies.
Caves (2007, 62–63) lists a few host country specific factors that have been identified to be boosting inward FDI in developing economies. Country’s openness for and government policy towards foreign investment are major elements in a favourable investment climate. In addition, sound economic structure, simple language, cultural similarities, human capital, and legal firmness of property rights are signs of an attractive investment environment.

4.4.2 The importance of inward investments for countries

Most countries see foreign direct investment as a way of promoting economic growth and development, and adding welfare to its citizens. Particularly many Southeast Asian countries are decisively promoting investments from abroad with numerous policy changes and incentives. They have adapted business and trade based strategies early in their development process and now their investment environment can be defined as export-enhancing and FDI-friendly, which many other countries are using as an example (Tahir 2003, 10–12).

Historically private sector investment has provided the bulk of external contribution in several economies (Organisation for Economic Co-operation and Development 1975, 9). Foreign direct investment can thus be crucial to the short- and long-term economic future in many countries (Nickell 1978, 1). Foreign direct investments constitute a resource flow to developing countries which has a wide and positive effect on their economic development. FDI provides a unique combination of long-term finance, training, technology, managerial expertise, know-how and marketing experience (Organisation for Economic Co-operation and Development 1983, 7). It is therefore natural for informed local governments to seek to encourage foreign direct investments in several different ways. Only the sectors which are perceived as central for different economies change over time. In 1975 the Organisation for Economic Co-operation and Development (OECD) emphasised the importance of natural resources, manufacturing and agriculture sectors in investing in developing countries (Organisation for Economic Co-operation and Development 1975, 9). Nowadays, natural resources and manufacturing are still vital for many developing economies, nevertheless, many governments emphasise the long-term effects of investments in technology and in other more advanced sectors (Fachruddin, interview 18.4.2008).

Ramstetter and Sjöholm (2006, 25–26) have identified in their study focusing on Indonesia that there are significant differences which effect foreign and local investors have on the economy. They found that foreign companies operating factories in Indonesia offer more competitive wages for workers and also enjoy from higher worker productivity than their local competitors. Both higher wages and better productivity have a
spillover effect to local plants and thus the whole economy. In addition, foreign companies have significantly higher export propensity which increases Indonesia’s exposure to export markets.

4.4.3 Developing countries attracting foreign direct investments

It is worth noting that the choice for a company that desires to establish a venture abroad is worldwide and in many cases, especially for smaller, less experienced enterprises, investment decision might not be in favour of location in the developing world. Therefore developing countries need to undertake different measures in order to attract foreign direct investment, such as provide an attractive investment environment and incentives. However, experience has shown that incentives affect investment choices only marginally since incentives can never substitute for the fundamentals, such as investment climate, political security and profit opportunities. Nevertheless, developing countries can often offer a number of genuine comparative advantages against developed countries, including natural resources, low-cost labour, domestic and export markets, a relatively weaker focus on social and environmental objectives, and lower taxes. These advantages can be outweighed by negative factors related most often to political and economic environments, such as lack of infrastructure and skilled labour, incoherent development policy, unpredictable decision-making and political risks (Organisation for Economic Co-operation and Development 1983, 7–8). While proper infrastructure truly attracts inward investments, it also facilitates outward investments which are vital for the growth of local companies (Toyne & Nigh 1997).

Jensen (2006, 1), and Brooks and Hill (2004, 73) provide full support for the OECD view above which was published already 25 years ago. They continue that the attractiveness of countries does not depend notably on low taxation levels or other fiscal incentives, and that fiscal competition between countries has been exaggerated. Instead of fiscal stimulus, the activities of the host government, and profitable and politically stable environments are viewed much more important by companies, and especially the predicted future state of these. Brooks and Hill (2004, 73–74) continue that a significant downside for fiscal incentives is that they are corruption-prone. Many governments treat these “rents” as bargaining tools for corruption. In addition, the rationale behind granting of the incentives could be ambiguous and they could also be used as an industry policy by agencies which do not have the analytical capacity to devise and implement such programs. However, fiscal incentives are not totally out of place, even though they are at best a secondary method in attracting investments, as they can also work as a useful signalling device in situations where host governments seek to press their reform credentials abroad.
Developing countries which have successfully attracted FDIs have a dynamic and outward looking economic stance supported by appropriate financial and economic policies, a disciplined labour force and a strong international credit standing. Developing countries that have aimed, at an early stage, to adapt liberal economic policies and to integrate their economies into the world economy have been most successful in attracting FDIs. Such enabling environments are even more attractive if accompanied by clear and stable investment conditions. In addition, investment security, including stability of investment conditions, non-discrimination of foreign enterprises, freedom of capital movements and satisfactory arrangements for the settlement of investment disputes are valued highly. When developing country governments choose to use FDI as an instrument to support development, they should try to maintain stable and mutually beneficial conditions for both local and foreign investors. In order to investment conditions remain sustainable adequate benefits need to be secured for the host country as well as legitimate interests of foreign investors need to be taken into account (Organisation for Economic Co-operation and Development 1983, 8).

4.5 Indonesia’s investment environment

4.5.1 Background on Indonesia’s investment climate

In the past there have been few examples of unpredictable actions of the Indonesian government against foreign investors. In the year 1980 Indonesia nationalised International Telephone & Telegraph’s Indonesian subsidiary, and in 1998 CalEnergy discovered that a presidential decree had suspended agreements for its geothermal power plants in Indonesia. These events need to be taken into account even today since foreign direct investment is not necessarily secure than it was in the past. Nevertheless, the international community has tried to construct systems that reduce the risk in investing abroad. These measures have included a broader coverage under official political risk insurance, greatly expanded role for arbitration of disputes, and more home government support for investors (Wells & Ahmed 2007, 3).

Despite negative events in the past investor confidence in Indonesia is gradually picking up. As a sign of this has been the numerous deals where foreign companies are buying stakes in Indonesian companies or getting rights to specific assets. FDIs soared by 73% in 2007, to $10.3 billion, a sum that is expected to increase in 2008 despite the credit crunch in international markets (The Economist 2008b, 72).
However, investments into Indonesia remain low by regional standards (International Monetary Fund 2008a, 4). Indonesia’s competitiveness in relation to its closest neighbours has been poor after the AFC, although, in the past few years FDI flows have started to increase again and in 2007 investments accounted for 24.8% of GDP, up by 5.4% in mere four years (Nuutinen 2008, 20–21; World Bank 2008a, 36; Asian Development Bank 2008, 199). In terms of FDI inflows in 2007 to South, East and Southeast Asia, Indonesia ranks as eight, behind substantially smaller economies such as Thailand, Malaysia and Singapore. It also seems like Vietnam will be leapfrogging Indonesia in FDI inflows in 2008. United Nations Conference on Trade and Development’s (UNCTAD) survey of most attractive locations for FDI in the next three years, 2008–2010, provides good news for Indonesia. By no surprise, China, India and the US are topping the list in UNCTAD’s survey as they have done in the past, but Indonesia is unexpectedly ranked as number eight among both develop and developing countries (United Nations Conference on Trade and Development 2008, 33–34, 48).

Revived interest of foreign investors in Indonesia does not mean that Indonesia’s problems with bureaucracy, corruption and legal uncertainty have evaporated (The Economist 2008b, 72). Investment climate remains relatively weak and governance issues exist, such as deficiencies in enforcement of contracts and weak regulatory framework. High taxes and lack of infrastructure are also seen as serious obstacles for investment growth (Moccero 2008, 15; International Monetary Fund 2008a, 4). In an attempt to improve the investment climate Indonesian government passed a new investment law and key tax law in 2007, as well as took several other measures to improve the investment climate. In spite of the passing of a few favourable laws, several pieces of new legislation are still needed, such as VAT and income tax laws. In addition, labour market reform is essential but it has faced political resistance and the process is unlikely to move forward before the 2009 general elections (International Monetary Fund 2008a, 4).

A high percentage of new investments in the country are in sectors and ventures where little capital is required and returns are rapid. Longer-term investments are much rarer, which reveals the state of the investment environment at the moment. Interesting aspect in recent investment growth into Indonesia is that the bulk of investments are coming from Asian companies while Western companies remain to be wary. Obvious reasons for this are that a few large multinational companies, including Mars and Intel, have recently suffered from curious court verdicts, and Exxon Mobil lost its rights to develop a major gas field in non-transparent circumstances. Many Western companies are rightfully waiting for the promised new mining, tax and labour laws to be passed before investing in Indonesia. However, Indonesia’s quirks are not stopping the Asian competitors of investing in the country, presumably since their home market conditions bear similarities with Indonesia. Thus, analysts are expecting that Western companies
will follow suit in investing to Indonesia before it is too late (The Economist 2008b, 72).

As discovered above, Indonesia’s growth potential, and large population with rapidly increasing wealth make investing in Indonesia highly desirable. Coface (2005, 225) adds that vast natural resources (energy, mineral, agriculture), added with financial and macroeconomic stability are strengths of the Indonesian investment climate. Moccero (2008, 15) notes that despite these natural resource advantages Indonesia only attracts 0.5% of world’s mining exploration investments compared with 5% prior the AFC.

The following subchapters concentrate on other specific aspects substantially effecting the Indonesian investment environment. Although very important, a closer examination of economic and currency aspects are omitted here since these have been analysed above. In addition, as political environment was already studied above, the following subchapters concentrate mostly on issues not previously discussed.

4.5.2 Political aspect

Even with a growth rate of 6.3% in 2007 growth remains lower than in pre-crisis years, and discussions about reinvigorating the economy are a commonplace. Thus, the government has been drawing up new legislation and introduced a policy package in June 2007, however, scrapping labour market reform from the package was a severe blow for the whole package (Takii & Ramstetter 2007, 295).

Some observers point out that slower growth after the crisis is related to less effective economic policy making. In fact, government’s capacity to dictate policies has been constrained by more powerful national parliament and local governments. Moreover, president Yudhoyono’s power base is relatively weak as he had to form a multi-party coalition, with diverse interest, in order to stay in power. Nevertheless, the introduction of new economic policies in the past few years has won him support. However little substantive change is visible in the business environment, which has raised critique that the government bureaucrats are better talking about reform than actually implementing it (Takii & Ramstetter 2007, 296).

The policy package introduced in 2007 included a new investment law which was aimed to strengthen country’s FDI regime. This new legislation simplifies regulations, provides tax incentives for investments, protects property rights, and for the first time guarantees equal treatment for domestic and foreign investors. In addition, a new negative list was published, which is a list that describes possible limitations in investing in different sectors. In the new negative list equity restrictions and foreign ownership barriers in several sectors are eased, however, some sectors have become more restricted in the name of national interest (Moccero 2008, 9). The new negative list is not exces-
sively protectionists, although it tightens restrictions on 11 sectors, 69 sectors will be more open for foreign investors. Even though the new investment law guarantees equal treatment for domestic and foreign investors in the economy, it does not allow equal opportunities to invest in all sectors (Takii & Ramstetter 2007, 315). Regardless, some negative developments in the new negative list, investors in general are satisfied with more transparent regulations which unify existing sectoral restrictions on foreign investment (Moccero 2008, 9).

Moreover, the policy package also improves investor protection, dispute resolution, immigration procedures and promises to cut red tape. Investor protection includes protection against expropriation by promising, in the case of seizure or nationalisation, owners that their assets are compensated at market value. It also guarantees foreigners the right to make international currency transfers to repatriate profits and dividends. Dispute resolution clause guarantees that disputes between the government and foreign investors can be settled by international arbitration. In addition, immigration procedures are eased to allow greater mobility of foreign professionals, and bureaucracy is also trying to be rooted out in several different ways (Moccero 2008, 9–10). Parliament passed also a tax administration law in 2007, which strengthened the rights of taxpayers while limiting the arbitrary decision-making by tax officials, and reduced the time for refunds of value-added tax (Asian Development Bank 2008a, 201).

The newest policy package differs from previously introduced packages in that now the specifications of what is expected from the package are clearer and evaluating methods are more transparent. The change in approach reflects government’s need to persuade the public and legislature to support such policy packages. Nevertheless, the policy package raise questions if it will have any more impact than its predecessors since the package lacks strong incentives for the bureaucracy to implement reforms which often are in conflict with its own interests (Takii & Ramstetter 2007, 297).

Following the implementation of the comprehensive economic policy package in 2007, business perceptions of the investment climate have shown some improvements, reflecting in stronger investment growth. Improving the investment climate continues to be a top priority of the government (International Monetary Fund 2008b, 4). Planned new round of reforms, to improve the investment climate, face a risk to encounter rigorous public opposition. Tariff changes and investment climate reforms related to labour market are generally opposed by the public. Therefore, awkward reforms are likely to slowdown in the lead-up to presidential and parliamentary elections in 2009 (Asian Development Bank 2008a, 204).

Moccero (2008, 9–10) points out that in addition to the wider perspective reforms smaller initiatives are under way. The Investment Coordinating Board has started coordinating between various government agencies involved in investment regulations with the aim of reducing the required time for approval of new investments. The intentions
are to cut the approval period from 105 days to one month. Moreover, local governments are setting up business licensing centres that try to reduce the uncertainty associated with the proliferation of local business regulations. Since Indonesia is a decentralised country the licensing procedures are dealt in many different government levels, which need to be made more streamlined. Coface (2005, 226) notes that despite the initiatives by the last few governments to boost the process of approving investments, it still remains finicky and troublesome.

4.5.3 Corruption aspect

Despite low wages, doing business in Indonesia is costly. This stems from the fact that transparency is low which means that confusion is high and it is often a sheer hassle to get anything done. Many in Indonesia have an interest in maintaining low transparency since it provides more opportunities for consultants and facilitators. In addition, the more red tape and forms there are to be filled, the more opportunities will numerous officials have to demand bribes at various hierarchy levels (Backman 2008, 126). To the corruption burden of Indonesia adds the fact that corrupt and unreliable judicial systems are making it difficult for companies to enforce contracts (The Economist 2008a, 68). A study conducted in 2001 by a country risk rating agency, called the Merchant International Group, found that Indonesia is the second most corrupt country in Asia after Pakistan (Poole-Robb & Bailey 2002, 67).

Corruption has gone so bad that almost any government service which is supposed to be provided free of charge will only take place if bribe money is provided. Ports are one prime example of this. A report conducted by the transport Ministry reveals that illegal fees levied at Indonesia’s ports exceed legal charges. Attitudes of regular Indonesians indicate that rooted corruption is very difficult to get rid of since Indonesians only regard taking substantial sums of money as corruption and that taking small amounts is generally acceptable, and often the norm (Backman 2008, 126–127).

Rooted corruption has been a problem all around the developing Asia but Indonesia is a prime example of corrupt members in the ruling elite. For example the Soeharto family used banks and international development money in business ventures, which were often financially unsound, for their own wealth creation activities. It is not uncommon in an Asian scale that national economies were, and are, controlled by corrupt officials, businessmen and military officers without public or parliamentary accountability. Many of the problems leading to the AFC related directly to issues such as transparency, corruption and cronyism (Poole-Robb & Bailey 2002, 11–12).

In spite of Soeharto’s downfall corruption has not disappeared, in fact, it has found new forms. Nowadays political power is much more decentralised than during Soe-
harto’s era which provides a wider range of people a chance to demand bribes (Backman 2008, 127, 130). The government is working hard on cutting down the amount of people that are slowing processes and demanding money. One of these measures has been the introduction of paperless licensing and approval of some of the processes. The idea is that when people do not meet face to face there is no opportunity to ask for bribes (Ismartono 2007, 5). In addition, after Soeharto’s time there exist much more political parties than before which need money from different sources to operate. For the facts stated above, many Western investors find it simply impossible to invest in Indonesia since they cannot do it in any meaningful way and still comply with the laws in their home countries (Backman 2008, 127, 130).

Indonesia has been enduring rampant corruption for years but recently there have been signs of progress. The government created the Corruption Eradication Commission (KPK) in 2002 and in 2008 KPK has initiated a spectacular series of busts, including the mayor of Medan (fourth largest city in the country), the former head of the central bank, and some members of the parliament. Even some ministers face allegations by the KPK. It seems that no institution is beyond KPK’s grasp which is unique in a country like Indonesia. KPK’s methods have also attained public support as the agency is calling for those convicted of bribes to be dressed in garish uniforms and thrown into the same jail where terrorists serve their time (The Economist 2008c, 63).

Other measures to take on the corruption have also been taken. In 1999 an anti-corruption law was enacted, and the new government launched a new high-profile anti-corruption campaign in 2004. More recently, efforts to curb corruption in the public sector have focused on increasing budgetary appropriations of several government agencies and by improving civil servants’ compensation. For example, the government budget for 2008 included a 20% increase in civil servants’ compensation (Moccero 2008, 11).

Transparency International’s (TI) 2008 Corruption Perception Index shows that Indonesia has made a leap up of 17 places in the ranking from the previous year. However, its ranking now is 126th among the 180 countries surveyed. Indonesia’s ranking has been rising ever since KPK was founded in 2002 and other measures were taken, and it is surveyed that corruption is being addressed more aggressively and effectively in the country, even though the problems are still vast. This time around at least the president, Susilo Bambang Yudhoyono, is thought to have clean hands (Transparency International 2008, 1–2; The Economist 2008c, 63).

4.5.4 Infrastructure aspect

The development of infrastructure was one of the authorities’ priorities in the 1970s and 1980s. Several projects were both financed and carried out by the public sector in areas
such as electricity, transport and telecommunications. At that time infrastructure related projects accounted for around 10% of GDP (Moccero 2008, 13). That rate has recovered strongly after the AFC, nevertheless, spending has been only around 3% of GDP in the 2000s. To maintain the current economic growth rate it is estimated that infrastructure spending should be around 5% of GDP. In fact, deteriorating infrastructure has been an important disincentive to investments as well as concerns over the legal and regulatory environment, which explains why private investments have not bounced back to pre-crisis levels (Narjoko & Jotzo 2007, 159; Moccero 2008, 13). The Global Competitiveness Report 2008–2009 from The World Economic Forum ranks Indonesia at 96th place of 134 countries surveyed in overall infrastructure quality (Schwab & Porter 2008, 14).

There are four major constraints for private sector involvement in infrastructure sector. First, Indonesia’s banking sector seems reluctant to finance infrastructure projects. Banks prefer short-term lending over long-term loans, and generally have limited experience in lending to the infrastructure sector. Second, implementing infrastructure related reforms is lacking. Third, infrastructure projects in many fields are forced to operate under non-market conditions, where infrastructure services are provided at regulated prices below costs and thus limiting chances for profits. Fourth, preparation and bidding process can reach 18–24 months and generally the supporting documentation prepared by the government agencies is poor. The result of these four constraints is that there is little incentive for private companies to invest in the infrastructure sector. Telecommunications sector has had a different kind of development path. It has been attracting a lot of post-crisis investment since policies regulating telecommunications sector are much more market-oriented than for other types of infrastructure (Narjoko & Jotzo 2007, 159–160).

Boosting the infrastructure sector on a public level will also be challenging. This is because local governments often lack the knowledge to implement infrastructure projects (Narjoko & Jotzo 2007, 160). In addition, local governments often do not have incentives to invest in infrastructure since many projects create externalities for neighbouring jurisdictions (Moccero 2008, 14–15). Thus the provincial governments should be assigned a greater share of total government infrastructure expenditures rather than giving them to the local governments. Furthermore, incentives to cooperate between districts should also be placed (Narjoko & Jotzo 2007, 161). Finally, government’s anti-corruption efforts have brought, surprisingly, negative development into the infrastructure sector. Evidence shows that local officials often fear of being charged of misconduct when committing budgetary resources to large infrastructure projects. This has been a consequence of the efforts to enhance accountability and may well be only a short-term problem (Moccero 2008, 15).
In developing countries the link between growth and infrastructure is stronger than in developed countries since infrastructure deficiencies are much more pressing in the developing world. In Indonesia there is significant potential for boosting growth by removing existing infrastructure bottlenecks. The government is trying to encourage private infrastructure development in many ways. It has held several high-profile infrastructure summits which aim to disseminate information on investment opportunities in areas such as electricity, transport, telecommunications, oil and gas. The authorities themselves focus on non-economically viable projects while encouraging private companies to invest in economically viable opportunities. The government also launched an Investment Policy Package in 2006 with an objective to increase institutional capacity and coordination between ministries in infrastructure development and regulation. The authorities have also supported a range of infrastructure projects with credit, and established a new working team which is to tackle with land acquisition problems. Government support can also be seen from its budget for 2008 where it increased budgetary appropriations for the ministries in charge of infrastructure (Moccero 2008, 15–16). The increase in fuel prices in May 2008 also provides government more fiscal space for priority spending in infrastructure and social programs (International Monetary Fund 2008b, 2).

Based on national surveys, bottlenecks in transport and energy are the most pressing infrastructure-related problems to general business development. Transportation infrastructure in Indonesia is poor, urban roads are congested and many important toll-road projects have been postponed. It is estimated that 43% of the roads in Java are congested and that figure is increasing rapidly. Overall, poor infrastructure has an adverse effect on the competitiveness of the manufacturing sector since it raises operating costs and increases travel time between plants and markets. Logistical costs may amount as much as 14% of total production costs in Indonesia, while in Japan these costs are close to 5% (Moccero 2008, 13–14).

Electricity consumption in Indonesia increased between 1998 and 2005 by over 7% per year and at the same time electricity generating capacity in the public sector increased merely by 1.4% per annum. Demand is expected to remain strong driven by both private and business consumption. Indonesia’s power sector would need a minimum of $2 billion in new investments annually to keep up with increasing demand (Narjoko & Jotzo 2007, 161–162). The likelihood for electricity shortages has increased significantly in recent years since demand has outpaced the extension of supply. Power outages are detrimental for all businesses but especially for companies in electricity intensive sectors, such as manufacturing. Some companies prepare themselves for outages with their own expensive generator energy. Costs of electricity production have also risen recently since 30% of electricity production is oil-based (Moccero 2008, 13–14).
In order to secure long-term electricity supply, market reform in the sector should be pushed through and a well-designed agenda for capacity expansion should be drawn. Unfortunately prospects for either of them do not look good. The 2002 electricity law was a major step forward as it, for example, laid a sound foundation for competition and encouraged private sector involvement. This law was, however, annulled by the constitutional court on the grounds of state control for critical economic sectors. In addition, the government spends vast sums of money for electricity subsidies, and as supply prices are regulated the state electricity company PLN is forced to sell electricity below cost for residential customers. This discourages energy saving by end-users, leads to extra supply capacity needs, and reduces the funds PLN has available for new investments and maintenance (Narjoko & Jotzo 2007, 162).

4.5.5 Workforce aspect

The labour force in Indonesia is about 110 million strong and every year 3 million new workers come into the labour market. Generally speaking, the labour force is young but not well-educated in comparison with other Asian countries. The Ministry of Labour has made some changes in the past few years in labour regulation for the benefit of the labour force, for example minimum wages have been increased. Indonesia used to have competitive wages for labour in an Asian scale but nowadays the situation has somewhat changed. Rises in minimum wages have reduced the competitiveness of labour intensive sectors, however, wages for low skilled labour differ considerably between industries and between different parts of the country. In addition, the lack of skilled labour has increased the wages of skilled professionals substantially. Several foreign companies operating in Indonesia find that middle management positions are especially difficult to fill in. That is why companies often recruit middle managers from abroad (Nuutinen 2008, 15).

The new government has been hesitant in pursuing important labour market policy reforms partly because of the strong opposition for such reforms. One prime example of this hesitation is the omission of competitiveness increasing labour market reforms from the policy package released in 2007. Revision of labour law was proposed to be a part of the investment policy package, and the proposed changes would have brought labour regulations in line with countries such as Thailand and Malaysia (Takii & Ramstetter 2007, 296; Asian Development Bank 2008a, 202). Most economists note that competition in the labour market is constrained by minimum wages, which prices low productivity labour out of the market, and also by severance pay and other regulations which protect existing employees heavily from new competitors (Takii & Ramstetter 2007, 296). Companies criticise the existing labour law, among other things, because it man-
dates severance payments that are much higher than elsewhere in the region, and thus limits the possibility of outsourcing work. Strict labour law also works as a disincentive to employment expansion since it is very inflexible when companies need to make redundancies (Asian Development Bank 2008a, 202). According to the labour law laid off workers get a 108 weeks salary as a severance pay if certain conditions are fulfilled, this is the highest in Asia after Sri Lanka (Ismartono 2007, 5).

4.5.6 Other aspects

Attitude towards foreign investors is one decisive factor in attracting investors. Indonesian government is thought to be extremely open to FDI. BKPM, the government investment promoting and coordinating agency, is carrying out its role vigorously albeit with limited powers. After the AFC the government has been trying to revive foreign investment since it views FDI to be essential to job creation and technology transfer (Coface 2005, 226).

Indonesia’s economic situation does not allow it to offer a wide variety of extremely attractive incentives, however, companies operating in special economic zones (SEZs) get tax exemptions (Coface 2005, 226). As stated in the new investment law, government intends to provide tax incentives to investments, although the amounts and modalities are yet to be confirmed. The plan is to target companies operating in priority areas, including remote regions and SEZs, and priority industries, such as infrastructure and R&D. Also labour intensive industries that are having partnerships with SMEs are supported. The main incentive instruments would be income tax breaks, reductions in land and building taxes as well as value added tax holidays and reductions in import duties for certain industries (Moccero 2008, 11).

Indonesian police have been effective in preventing terrorist attacks of radical Islamist groups which devastated the whole country in the early 2000s. The police have made some key arrests and the latest major attack in the country took place in 2005 (Takii & Ramstetter 2007, 296, 298). Reducing poverty and raising education level will be essential for the future development of the country as a whole but also important in decreasing the amount of favourable breeding ground for new recruits of radical Islamist groups (Coface 2005, 225). The role of religion is greatly debated in Indonesia. Some groups are demanding for establishment of a caliphate state on Islamic law while the mainstream view supports pluralism. Moderate groups that emphasise Indonesia’s diversity have been prevailing in the last decade, in fact, the government has also begun to adopt a role of a leading supporter of democratic values and human rights in Southeast Asia (Takii & Ramstetter 2007, 296, 298).
The image of a country is also important for investors. After a series of bombings in the beginning of 2000s the image of Indonesia has been gradually improving, and the government launched a major tourism campaign titled: “Visit Indonesia Year 2008” to increase tourism and to polish the image of the country. Unfortunately, this tourism campaign has been shadowed, as Kartika (2007, 233) notes, by a ban set by the European Commission preventing all 51 Indonesian airlines from flying to Europe due to their poor safety standards. This will affect the airline choices made by tourists and businessmen, as well as tarnish Indonesia’s image once more.

4.5.7 World Bank’s Doing Business 2009 survey

World Bank’s annual Doing Business survey is carried out in most of the countries in the world and it examines country specific regulations that enhance or constrain business. In Doing Business 2008 survey Indonesia improved its rank considerably from previous year to 123 of 178 countries evaluated (Ismartono 2007, 5). In 2009 survey Indonesia’s rank has declined to 129th place among 181 countries surveyed. Indonesia’s business environment, according to the Doing Business 2009 study, lacks remarkably behind its closest competitors Singapore, Thailand and Malaysia in terms of having an attractive environment for foreign investment. Among the toughest competition only Philippines’ investment environment is at a worse state than Indonesia’s (World Bank 2008b, 2). Table 1 below depicts Indonesia’s ranking in relevant categories in comparison with Thailand which has been considerably more successful in various recent business climate surveys.


<table>
<thead>
<tr>
<th>Category</th>
<th>Sub-categories</th>
<th>Value Indonesia</th>
<th>Value Thailand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ease of doing business</td>
<td>Rank Indonesia 129</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Rank Thailand 13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Starting a business</td>
<td>Procedures (number)</td>
<td>11</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>Duration (days)</td>
<td>76</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>Cost (% GNI per capita)</td>
<td>77.9</td>
<td>4.9</td>
</tr>
<tr>
<td></td>
<td>Paid in min. capital (% of GNI/cap.)</td>
<td>74.2</td>
<td>0</td>
</tr>
<tr>
<td>Employing workers</td>
<td>Difficulty of hiring index</td>
<td>61</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>Rigidity of hours index</td>
<td>0</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>Difficulty of firing index</td>
<td>60</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Rigidity of employment index</td>
<td>40</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>Firing costs (weeks of salary)</td>
<td>108</td>
<td>54</td>
</tr>
</tbody>
</table>
Before investors can legally start operating in a country they need to go through all the procedures required to incorporate and register the new firm. Usually developing countries have cumbersome entry procedures which are also often associated with corruption. Each procedure is a point of contact and thus a potential opportunity of corruption to extract a bride. Indonesia has suffered and still suffers from troublesome processes of setting up a business, however, progress has been made and both duration and cost of such procedures have declined in the past few years. Still, neighbouring countries like Thailand and Malaysia have substantially more straightforward business starting processes (World Bank 2008b, 5–9).

Governments face similar challenges all over the world on finding a balance between worker protection and labour market flexibility. Developing countries are known to err to one extreme. In Indonesia’s case, its rigid labour laws have been a major obstacle for businesses and any notable changes to improve the situation have not been taken, which has left the country in a disadvantage to its closest neighbours. The employing workers index values in Table 1 are from 0 to 100, higher value meaning stricter employment regulation (World Bank 2008b, 15–19).

Companies rate access to credit among the major barriers to their operations and growth. Doing Business ranking is based on how credit markets function, comprising of
two factors, credit registries and legal rights of borrowers and lenders. Credit registries that collect and distribute credit information on borrowers can significantly expand access to credit. By disseminating information these registries facilitate lenders assess risk and allocate credit more efficiently. Indonesia has improved its rank in getting credit index slightly in the past few years. On an Asian scale the country positions itself relatively well in getting credit index although Malaysia is ranked as number one on a global scale (World Bank 2008b, 24–27).

The presence of legal and regulatory protections is one decisive factor for most of the investors to invest in a specific country. Indonesia is ranked relatively high in investor protection index, however, its position dropped a few places from Doing Business 2008 survey. Despite Indonesia’s comparatively strong ranking in investor protection index, neighbouring countries such as Malaysia and Thailand are doing outstandingly well also in this category (World Bank 2008b, 28–31).

Taxes enable the host economy to offer public amenities, services, infrastructure etc. In order to enhance tax compliance governments need to simplify the process of paying taxes especially for SMEs that might opt out and choose to operate in the informal sector. In Indonesia’s case the time needed to pay taxes decreased significantly in 2006 but after that reforms have been nonexistent. Tax rate for companies in Indonesia is neither an obstacle nor an advantage in comparison between neighbouring countries but once again the whole process of paying taxes is generally more cumbersome than elsewhere in the region (World Bank 2008b, 32–35).

Benefits of trade are substantial but obstacles to trade, such as tariffs, quotas and distance from large markets, greatly increase the costs or completely prevent trading in some regions. Indonesia has successfully eliminated some of the bureaucracy affecting trading in the past few years. This has improved its ranking and its competitiveness in this category which is relatively strong even in comparison with its closest neighbours (World Bank 2008b, 36–39).

When contract enforcement is effective in a host country, companies are likely to engage with new customers and borrowers. Enforcing contracts index analyses the efficiency of the judicial system in resolving commercial disputes. Again, in this category Indonesia ranks well behind its neighbours and no improvements to the situation have been initiated in the past few years (World Bank 2008b, 40–43).

Bankruptcy system is essential for economies to help reorganize viable companies and close down unviable ones. Letting unviable businesses fail release human capital and assets that can be reallocated into more productive use. In Indonesia closing business is expensive and takes considerable amount of time which has a negative effect on its ranking and the country performs poorly also in comparison with other countries in the region (World Bank 2008b, 44–47).
Since the previous Doing Business survey in 2007 three reforms in Indonesia were undertaken in two different survey categories. First reform made getting credit easier by granting the right of borrowers to inspect their credit data at the Bank of Indonesia which helps to improve the accuracy and quality of the information financial institutions use when they assess the risk profiles of borrowers (World Bank 2008b, 48–50). Unfortunately, reforms in starting a business had overall a negative tone. Although business start-ups were sped up, minimum capital requirement was almost doubled when countries like Vietnam and India eliminated the requirement altogether (Ismartono 2007, 5; World Bank 2008b, 48–50).
5 EMPIRICAL RESEARCH FINDINGS

5.1 Background of the interviewees

First person interviewed was the Managing Director of FlexLink Indonesia Mr. Sakari Kuikka. In 2007 FlexLink had global revenue of $210 million from which 14% came from the Asia-Pacific region and $3 million in revenues came from Indonesia. FlexLink is originally a Swedish company but it has expanded around the world extensively and now it operates in 28 countries, including Indonesia, Singapore, China, India and Malaysia. FlexLink’s business is in conveyor systems solutions that they offer to various manufacturing industries. The company does not have any manufacturing in Indonesia. It imports its produce to Indonesia from China, Malaysia and Singapore, while operating as a trading company in Indonesia in order to keep their overall risk at a minimum level. FlexLink had been looking into the Indonesian market for five years before they eventually initiated their investment in 2006. They decided to wait because the AFC was too close. At the moment FlexLink is the largest company in its sector in Indonesia serving many industries such as foodstuff and tobacco (Kuikka, Interview 16.4.2008).

From Ahlström Indonesia President Director Mr. Andika Roemin was interviewed. Global revenue for Ahlström in 2007 was 1.8 billion Euros from which 130 million came from Asia, and the company operates in 26 countries globally. Ahlström is a global leader in manufacturing specialty papers and nonwovens that their customers turn into hundreds of different products, such as wipes, filters, flooring, labels and tapes. Ahlström started its registration process in Indonesia in October 2000 and was operational in January 2001. The company has both office and warehousing operations in Indonesia but not a mill. Ahlström’s business in Indonesia has expanded considerably and in 2007 annual revenue from Indonesia rose to $10 million (Roemin, interview 16.4.2008).

Third person interviewed was Chief Representative Mr. Sean Straton from Westpac Banking Corporation Indonesia. Westpac is the oldest company in Australia and it had its 191st birthday in 2008, and it employs 21 000 people. Westpac Banking Corporation offers a wide variety of banking services such as retail and institutional banking, and wealth management. Its net operating income for financial year 2008 was over AU$11 billion and only a rather small part of that income comes outside of Australia and New Zealand even though they operate in about fifteen countries. Westpac came to Indonesia already in 1972. It has had a representative office in the country ever since and it used to have a major share ownership of a local bank which was sold just before the AFC hit the country. For the consecutive ten years Westpac did not do much in the market and it
only had contractors working for them in Indonesia not Westpac people. In the end of 2006 the bank hired an experienced Australian banker to analyse the Indonesian market and see what the prospects would be for Westpac in the Indonesian market (Straton, interview 17.4.2008).

Fourth focused interview was with President Director Mr. Janne Juntunen from Pöyry Indonesia. At the moment 30% of Pöyry’s revenue comes outside of Europe, one third of that 30% comes from Asia. In 2007 Pöyry’s revenue amounted 720 million Euros. Pöyry has been operating in Indonesia for the past 25 years, the scale and concept has varied significantly and the amount of employees has been flexible between 5 to 25 persons during that time. At the moment Pöyry Indonesia’s employee count is on the lower end of the scale but the number of employees is on the rise. Pöyry is a global consulting and engineering company focusing on forest, infrastructure and environment sectors. Its main assets are in its employees which are easily transferable between different units according to demand in different markets (Juntunen, interview 18.4.2008).

From Metso Paper Indonesia, Country Manager Mr. Mika Ollikainen was interviewed. Metso is a global technology and engineering company and it comprises from three main businesses which are pulp and paper industry, rock and minerals processing and energy industry. In addition, it has business in a smaller scale in some other industries as well. Metso had a revenue of 7 billion Euros in 2007 with a workforce of 27 000 people. It has spread its operations in 50 countries all over the world. Approximately 35% of Metso’s revenue comes from Europe, while Asia accounts for a similar share. Moreover, revenues in Asia are growing at a very rapid pace. Metso came to Indonesia in the form of Metso Automation in 1988 and now Metso’s revenue from Indonesia is around 100 million Euros annually, which can change considerably year-on-year because of large one-off orders. In addition, 50% percent of paper and carton capacity in Indonesia originates from Metso Paper (Ollikainen, interview 18.4.2008).

Sixth person interviewed was a mid-ranking officer Mr. Hamid Fachruddin from the Investment Coordinating Board (BKPM). Moccero (2008, 9) states that BKPM was established in 1973 essentially as a screening and authorising agency for foreign investment. Now that the government has become increasingly committed to promoting investment opportunities it is converting BKPM into a fully-fledged investment promotion agency.

Furthermore, an email response was received from Mr. Thorolf Nyfors the President Director of United Fiber Systems which business is in paper and pulp related activities. United Fiber Systems originates from Singapore and its plan has been to set up a pulp mill in Indonesia but it has been facing severe difficulties on the way (Nyfors, e-mail response 27.3.2008).
5.2 Decision-making process of companies operating in Indonesia

Juntunen (Interview 18.4.2008) indicates that the main reason for coming to Indonesia was the enormous market potential but also that basic conditions for their business are there, such as plenty of space, suitable climate, excellent location near to large markets of India and China, but also a strong home market. These factors were already there 25 years ago when Pöyry initially invested in Indonesia. In fact, Indonesia was among the first countries where Pöyry invested in when the company started to expand its business abroad. Pöyry moved to Indonesia well before the competition and hoped that old customers would understand the market potential and follow them. Also, gaining new customers was among Pöyry’s objectives when they made their initial investment. However, Pöyry’s strategy differs between markets and countries since to some markets they do not move as fast and are likely to invest only to follow competitors, but again, Indonesia’s potential was seen too vast to be missed. According to Roemin (Interview 16.4.2008) when Ahlström’s invested in Indonesia very few customers existed in the country. Some competitors already had operations in Indonesia but Roemin insists that that was not a significant factor in making the investment decision but that Indonesia’s market potential was.

Kuikka (Interview 16.4.2008) tells that FlexLink was following its existing customers to Indonesian market but also wanted to acquire new customers after starting their operations in the country. He adds that getting new customers is comparatively simple if the offered product is of good quality although he admits that severe competition in some sectors might make acquiring new customers difficult. Straton (Interview 17.4.2008) sees following customers as well as competitors as very important reasons for their investment in Indonesia. However, Westpac is concentrating solely on Australian customers as their core expertise is on Australia. Westpac’s whole expansion strategy partially differs from most other banks because of their prominent status and long history. That is why the company is moving slowly in foreign markets and organic growth has been their strategy both in Australia and in Asia-Pacific. Ollikainen (Interview 18.4.2008) points out that Metso invested in Indonesia, before their main competitors entered, encouraged by the interest of some of their customers in the market. Ollikainen adds that in their business competitors are very likely to operate in same markets as Metso Paper since global market for the largest paper machines consists only of two or three companies. For Metso Minerals the decision to set up a service centre in Indonesia was clear, since the government has set up restrictions for operating services from abroad. The largest customer of Metso Minerals is also located in Indonesia.

Among the interviewed companies Indonesia was often very carefully analysed prior investment decision. Ahlström conducts thorough analysis of possible risks and expected profitability always when entering new markets. Mr. Roemin notes that sudden
policy changes are difficult to predict and pose serious threats in many markets. FlexLink’s growth strategy differs considerably from Westpac’s as FlexLink is growing very fast in different areas. Regardless of their differentiating growth strategies both companies value exhaustive market analysis. Kuikka adds that FlexLink has company wide procedures that the firm follows in analysing investment targets. As for Westpac, Mr. Straton was appointed to Indonesia to analyse the market to find out what are the risks, opportunities and what would Westpac gain from investing in Indonesia. Before appointing Mr. Straton to the task Westpac’s executives were aware of the market potential but needed thorough analysis of the market. Westpac has been preparing its investment in Indonesia for a considerable length of time, and it is obvious that Westpac’s strategy emphasises cautiousness in new investments. Both Mr. Roemin’s and Mr. Straton’s companies often use risk rating agencies’ services which are found to be reliable. Ahlström’s attitude towards country risks in Indonesia is interesting since the company has decided to insure all its assets. On one hand it is a very safe way of operating, on the other, insurance fees amount for 3% of Ahlström’s annual revenue in Indonesia (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008).

We have not invested less because of the country risk. If there would be an investment proposal, it would be accepted (Roemin, interview 16.4.2008).

The process leading to investment decision differs between the companies interviewed. All interviewees emphasise that investment decision is based on analysis and facts. However, for example in the case of Ahlström, Pöyry, FlexLink and Westpac management’s views are seen to have effects on the investment decision. In Pöyry, management’s bias is considered to be small as the management is very experienced to make decisions concerning foreign markets. In Ahlström few board members of the company have had a negative image of Indonesia and were worried about investing in Bali. This perceived higher risk in the case of Indonesia translated into a higher required return than in most other markets. Mr. Roemin continues that for Ahlström long-term growth potential is the most important aspect when making an investment decision and that tends to overweight all other aspects. In Australia Indonesia is generally viewed as a very dangerous country, and also Westpac’s management have had a cautious attitude towards investing in Indonesia. The bank is moving slowly forward with its investment in the country and gathering substantial amounts of information from various sources before committing themselves fully to Indonesia. Mr. Kuikka tells that FlexLink’s regional manager had a very important role in the decision to invest in Indonesia as he had experience on the country and knew the opportunities there. After combining re-
gional manager’s views and the results of market analysis, the company decided to go forward with their investment plan (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Ollikainen, interview 18.4.2008).

We would have warehousing operations and a workshop here, if we would trust the country (Kuikka, interview 16.4.2008).

Ahlström’s investment decision-making process starts with identifying and locating business opportunities. One important requirement is also that the country where investments are planned needs to have a sizable domestic market. The company conducts extensive due diligence on prospective host countries to minimise risks and maximise profits. Mr. Roemin continues that Ahlström is prepared to invest in any market if business opportunities exist. Country risk is not a decisive factory for the company but possibility to do profitable business is. In the case of Metso its investment decision-making process starts with a careful analysis how the sectors it operates in will evolve in the future. Then several managers ideate possible alternatives where the company could invest in. Metso focuses strongly in expansion in different markets, mostly in emerging markets, and also investing in possible future technologies is strategically important for them. After new investment targets are brought forth, the company initiates thorough feasibility studies. Consulting agencies are also hired to facilitate the process. Metso analyses many factors in house but consultants help in more market specific matters. Metso also aims to analyse how their investment will perform in the long-term, in a timeframe of ten years. After the investment decision is made, companies also need to be prepared for different outcomes. In the case of FlexLink, the company has analysed three different possible scenarios for its investment in Indonesia. In fact, FlexLink is prepared for the worst possible scenario as it has kept its commitment in the country at a minimal level. FlexLink’s objective is to invest as little capital in Indonesia as possible, refraining for example from buying office space or cars (Kuikka, interview 16.4.2008; Ollikainen, interview 18.4.2008; Roemin, interview 16.4.2008).

The slowness of new business registration has been a widely discussed issue in Indonesia. As mentioned above, in the case of Ahlström the process was fairly speedy. FlexLink hired a consultancy group to manage its registration process. The whole process took four months and according to Mr. Kuikka FlexLink was very satisfied for the duration. In addition, the costs associated with the registration were at a good level, for example in India FlexLink needed to pay double the amount than in Indonesia. Mr. Kuikka also adds that almost every company starting a business in Indonesia use the help of external consultants who know the ways and the procedures in the country (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008).
5.3 Factors derived from OLI perspective affecting investments in Indonesia

5.3.1 Ownership-specific factors

Earlier, in chapter two Tahir’s (2003) framework for location aspect was specified. In that framework the ownership-specific advantages comprise of firm size, firm’s R&D intensity and firm’s international experience.

In chapter 5.1 the interviewed companies were briefly introduced and firm sizes discussed. Clearly all of the companies are classified as large companies with all of them having extensive international experience, which supports the assumption that ownership-specific factors increase the propensity to invest abroad. Representatives of the interviewed firms all are confident that their companies have the capabilities – such as technological, managerial and financial – to handle international expansion. For example, FlexLink has expanded its business into ten new countries in just few years with the help of all the above mentioned capabilities. Mr. Juntunen emphasises that Pöyry was among the first Finnish companies to internationalise its business. Westpac is also focusing on recruiting experienced expats to acquire more knowledge for internationalisation. Moreover, all of the companies interviewed are financially strong which enable them to further expand their operations into new countries (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

All of the interviewees believe their companies are innovative, measured with R&D intensity or some other factor, or at least slightly more than their competitors. Mr. Kuikka states that FlexLink is truly an innovative company launching new product innovations constantly. FlexLink’s products are so good that competitors are often found copying them. He continues that products from a European manufacturer are also commonly highly valued and trusted in Indonesia. Mr. Roemin also emphasises that Ahlström is an innovative company with 1/3 of their revenue coming from products launched less than three years ago. Both Mr. Roemin and Mr. Straton accentuate that people is the driving force of their companies and the source for their success and innovation. Mr. Roemin adds that Ahlström strongly promotes the usage of local professionals and offers them a good path for career development within the company (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008).
5.3.2 Location-specific factors

Indonesia has always had the potential of being a good ground for business (Juntunen, interview 18.4.2008).

Tahir’s (2003) framework for location aspect describes that location-specific advantages stem from market size, cultural distance, wage rate, corporate tax rate and inflation. All five executives interviewed view that Indonesia is potential ground for business since market size is huge and economic growth is expected to remain strong. Market potential has been one of the key factors why the companies have invested in the country. Mr. Straton says that growth is massive in every industry and banking business will benefit from it substantially. Mr. Kuikka tells that potential for FlexLink’s business is vast and credible competitors are almost nonexistent. Mr. Kuikka goes on by stating that at the moment Indonesian competitors can only compete with price, which FlexLink can easily match if needed. Mr. Ollikainen expects that power business will be the strongest source of growth for Metso. Their new and cleaner technologies are needed when Indonesia starts to shift its energy production away from coal based power plants. Pöyry is also heavily involved in the energy sector and predicts substantial growth there. Mr. Juntunen points out that potential for business has always existed but still something in the market has been lacking. However, if market conditions change and more expertise is needed for example in Indonesia, Pöyry is very flexible in moving its workforce around (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

Government’s attitude towards investments is also thanked by many interviewees. The will to boost FDI is seen to be there but sometimes government’s methods are lacking. Particularly, large investments are cumbersome to carry out which is problematic since when investing substantial sums security would be needed because of the associated higher risks. Public attitude towards FDI is also positive, however, some companies face pressure from NGOs (non-governmental organisations). For example, several customers of Metso have been having problems with environmental NGOs, but Mr. Ollikainen remarks that most companies nowadays are much better than their reputation is. Metso benefits from growing environmental awareness in Indonesia as its product portfolio is full of products that are much more environmentally friendly than existing ones in the Indonesian market (Kuikka, interview 16.4.2008; Straton, interview 17.4.2008; Ollikainen, interview 18.4.2008).

All company representatives interviewed feel that cultural differences are not problematic when doing business in Indonesia. Naturally some differences exist but the interviewed companies are experienced in doing business around the world and they have staff that is capable of handling diverse situations. Notable cultural differences are evi-
dent in work ethics which might be problematic in some cases, especially with blue-collar workers. This increases the importance of qualified management and of recruiting suitable managers who can both demand results and motivate the workforce. Dutch influence can be seen in people’s thoughts in some level and also in the fact that people are relatively well educated. In addition, interpreting the thoughts of Indonesians is easier than other Asians in the region where the culture does not encourage direct communication (Kuikka, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

Wage rates depend on the industry you are in. Indonesia is not the most competitive when compared with Vietnam for example, but in Malaysia a sales assistant gets the same as an assistant manager does in Indonesia (Roemin, interview 16.4.2008).

The interviewed managers state that it is somewhat simple to recruit people but the availability of labour differs considerably between sectors and geographical locations, Java being the easiest area to recruit. Generally low skilled labour is rather easy to find but high skilled workers is more difficult. Mr. Juntunen says that recruiting problems might be a challenge for the economy overall even though Pöyry has not suffered from it. Only Ahlström has encountered problems in hiring highly skilled people but it has somewhat overcome that problem by starting to recruit graduates and training them the way the company wishes. Other companies have also initiated the same method as Ahlström but Mr. Roemin notes that hiring competent graduates is not simple either, and in fact in Malaysia the situation is better. Wage rates in Indonesia are perceived as competent among the managers interviewed. Mr. Fachruddin claims that many companies compensate their workforce more than the minimum required by law since the minimum level is quite low. Mr. Kuikka adds that top level managers are very expensive in Indonesia. The overall wage rate in Indonesia is lower than in neighbouring Malaysia, Thailand and Singapore. On the other hand, Vietnam is cheaper than Indonesia but skilled workforce is difficult to come by in Vietnam. In addition, relatively good language skills of Indonesian workers are seen as advantageous compared with other countries in the region (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

Reducing workforce is made difficult by law in Indonesia and most of the company representatives interviewed feel that laying off workers pose a problem. A 108 weeks salary must be paid for a laid off worker if certain conditions are fulfilled. This regulation forces companies sometimes to delay recruiting until it is absolutely necessary. In addition, companies need to think about the type of contracts that they are offering to
their employees. FlexLink employs its new employees with a fixed-term contract of one year, while Mr. Ollikainen explains that it would be tricky to avoid strict labour regulations with fixed-term contracts. Metso devotes a lot of resources for the training of its employees and wants to offer its employees best possible benefits and working conditions in order to keep the employees in the company. Thus it also offers all of its employees permanent work contracts always when it is possible (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Ollikainen, interview 18.4.2008).

Leaving workers might be a problem for investors in Indonesia. According to the interviewees such problems depend heavily on the sector in which firms are operating in. Mostly ethnic Chinese Indonesians are perceived to have very competitive mindsets which sometimes can lead them to leave their jobs and set up competing ventures. Leaving employees have not been a problem for Pöyry but the company is well aware of the possible threat, however, Pöyry’s business is not very vulnerable to the threat as few leaving employees could not set up all-inclusive competing businesses for large factory set up projects. FlexLink has seen few employees leave and set up competing firms. These rival companies have not been able to compete with FlexLink since its expertise remains unbeatable. Mr. Kuikka tells that work contracts including a clause that forbid using FlexLink specific knowledge in other companies is useless since enforcing contracts is very difficult. Mr. Ollikainen says that the threat of leaving employees is a serious one in their line of business since Indonesia is full of competing businesses where existing employees could move if they are offered an incentive, such as increase in salary. Mr. Ollikainen notes that a clear trend can be seen in Indonesia that employees are moving eagerly between companies. The situation is different for example in Thailand where competition in Metso’s sectors are not so intense and thus existing employees do not have many companies to switch to (Kuikka, interview 16.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

Corporate tax rate is at a fairly competitive level in Indonesia according to the managers interviewed. Tax rate is 30% at the moment but the government is planning to decrease the rate to 25% in the next two years. Mr. Roemin states that it is rather easy to adjust earnings in Indonesia in order to keep tax payments low. Interviewed managers note that the tax rate is not really affecting their investment eagerness since their business prospects in Indonesia look strong and that is what matters to them. For example, Singapore’s corporate tax rate is 22% but for the companies interviewed Singapore’s environment would not be viable for their businesses. On the other hand, Malaysian market could be a viable substitute for Indonesia in some cases but the tax rate there is not as competitive as in Indonesia. Mr. Ollikainen adds that lower corporate tax rate would be good to compensate for higher country risks associated with Indonesia (Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).
Incentives are offered for companies in Indonesia dependent on the type and the location of their investment. From the five companies interviewed Metso and Ahlström have been offered incentives as their planned investments are substantial in size. On the other hand, the size of Westpac’s, FlexLink’s and Pöyry’s operations mean that they are not eligible for any kind of incentives but they would be, if their investments in the country would grow. Mr. Straton suggests that despite not being eligible for incentives at the moment the company receives a lot of encouragement from the officials to expand their business in the country. Mr. Straton continues that the officials would like to see more foreign companies investing in the country since they would boost the economy and also for employ and train locals. Mr. Ollikainen says that the incentives offered for their planned investment have been slightly varying but mainly consist of tax incentives that depend heavily on the choice of location. The government is trying to develop certain areas of the country by promoting investments there. Mr. Roemin points out that the government is committed to offer competitive incentives, and that these incentives are also negotiable with the government (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

5.3.3 Internalisation factors

Tahir’s (2003) framework for location aspect explains that internalisation advantages arise from country risks and exchange-rate fluctuations. As specified in chapter two Agarwal and Ramaswami (1992) view contractual risk to be an important part of internalisation advantages as well.

Contract enforcement is seen as a minor problem in Indonesia among the company representatives. When contract enforcement with customers or partners is needed, problems arise since the whole process can be cumbersome. Ending up in court may easily take two or three years before a verdict is given. In addition, court rulings are often uncertain so companies do everything they can in order to keep themselves out of court. As Mr. Roemin and Mr. Ollikainen note, solving the issues with a business partner is preferred and it would be extremely rare to take someone to court, and neither of the companies has been in court in Indonesia. Companies can also compile contracts that define some important criteria which might prove to be useful later on, like Metso has done by defining that the company uses English law as a basis for its contracts and that possible disputes are settled in an arbitrary court in Singapore which decisions are binding for both parties (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).
Possible joint ventures with local partners are viewed with some scepticism among the interviewees. Mr. Kuikka states that FlexLink would probably not be willing to have a joint venture with a local company as the risks associated with it would be too high. Keeping all valuable business knowledge inside the company is vital for FlexLink. Mr. Juntunen says that reliable business partners exist in the Indonesian market, if Pöyry would ever need one. Mr. Straton points out that Westpac needs to have a controlling interest in its investments, and that knowledge stealing could be an issue in joint ventures as the laws and regulations are not watertight. However, Mr. Straton believes that finding a suitable business partner can be done after thorough due diligence and probably with the help of a consulting agency (Kuikka, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008).

5.4 Country risks faced by companies in Indonesia

5.4.1 Economic risk

All the company managers interviewed assume that Indonesian economic growth will remain strong and that no serious long-term threats to the economy are in sight. Growing population and vast natural resources are seen to be major contributors for the growth. Different sectors have different prospects according to the interviewees. Mr. Kuikka notes that it is already visible that electronics sector probably will not take off in the country, at least not in the short-term. Foodstuff and consumer goods sectors will remain very strong since population growth and greater disposable income increases the business of these sectors. Mr. Kuikka continues that also tobacco and car industry component manufacturers are looking to have a good future in the country. Mr. Straton says that emerging wealth and huge growing population mean extremely good opportunities for the banking sector. At the moment 3 million new potential banking customers come to the market every year. From a banking perspective strong economic fundamentals exist because of the strong growth and credit expansion added with sound banking regulations (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Ollikainen, interview 18.4.2008).

Macroeconomically Indonesia has been performing strongly in the past few years. Risks arise from shocks abroad and from high oil prices to which Indonesia is vulnerable to because of heavy subsidies. Interest rates are at a high level, which translates to the prices of foodstuff and oil. Mr. Straton suggests it will be interesting to see what the Bank of Indonesia will do with its policies in the near future. High inflation is not per-
ceived to have a significant effect on businesses of the interviewed companies. Mr. Kuikka and Mr. Ollikainen note that the only element inflation has a direct effect are salaries which are adjusted to inflation but salaries are a small part of their total costs. Larger part comes, for example, from price increases in natural resources. Mr. Ollikainen adds that inflation poses an indirect risk, if the growing inflation causes social instability in the country (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Straton, interview 17.4.2008; Ollikainen, interview 18.4.2008).

5.4.2 Transfer and exchange rate risks

All the managers interviewed agree that restrictions on capital movements are very unlikely to be imposed in Indonesia. Mr. Straton notes that Bank of Indonesia is very eager to see companies to invest back in to the country, but does not believe in any restrictions. However, Mr. Juntunen and Mr. Ollikainen add that transparency in Indonesia is a severe problem and law changes could be implemented almost overnight. Mr. Kuikka says that prior their investment, possibility for transfer risk among other country risks was analysed thoroughly. Most of the interviewees are confident that if restrictions are imposed those can be bypassed reasonably easy with accounting methods like transfer pricing. Indonesia’s attitude towards transfer pricing is much more open compared, for example, with Thailand where strict regulation exists. Mr. Roemin notes that money laundering act is related to capital movements by obliging companies to report repatriations bigger than $50 000 to the BI, but this regulation is not enacted to restrict capital movements (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

A few of the interviewees expressed their opinion how rupiah is likely to be performing in the future. They agree that Bank of Indonesia will do everything in their power to keep the currency rate fixed to US dollar. There is confidence among the interviewees that this can be done, especially since currency reserves are substantially larger now than they were before the AFC (Fachruddin, interview 18.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008).

Fluctuations in the rate of rupiah do not pose a threat for the companies interviewed since their sales are commonly in either US dollars or Euros. Moreover, companies try to keep rupiah transactions minimal to avoid any unnecessary risk. Thus changes in the exchange rate between Euro and US dollar are much more important for them. However, most of the companies interviewed have sales in both of those currencies which decreases their exchange rate risk. If the most dominant currency for a company develops unfavourably, the company faces a decision whether to decrease prices or keep their
current market share with a reduced profit margin. Mr. Juntunen states that Pöyry analyses currency changes continuously as their invoicing needs to be adjusted accordingly. Mr. Ollikainen points out that large decrease in the value of US dollar might affect their sales in Indonesia since the costs of Metso’s products would increase in the eyes of Indonesians. Nevertheless, this is not necessarily a problem since Metso’s major competitors are also European based so they will probably need to price their products similarly (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

5.4.3 Location and sovereign risks

Indonesia’s geographical position is viewed to be a potential risk for foreign companies operating there since shocks from neighbouring countries could easily spread to Indonesia. The interviewees feel that a lot has been done since the AFC, including reforms and improved economic structure, and increased currency reserves. Mr. Roemin is confident that a downturn in United States will only have limited effects on the Indonesian economy since United States is not an important trading partner for Indonesia. As a sign of regional integration, trade with neighbouring countries is starting to boom. Mr. Kuikka notes that Indonesia is also especially vulnerable for natural disasters, such as earthquakes, tsunamis and volcano eruptions. He continues that these do not, however, affect FlexLink’s operations in the country (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008).

Indonesia’s location is viewed mostly in a positive light by the companies operating there. Mr. Kuikka says that Indonesia is a remote country for many companies and this has meant less competition for FlexLink, and thus it has become the market leader in its sector in Indonesia. Mr. Straton views that for Australian companies Indonesia is a great market because of its vicinity and huge consumerism. In addition, Australia’s population and home market of 21 million people get a good add on from 230–240 million Indonesians (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008).

Sovereign risk is not something that companies are usually worried about. Despite the fact that a wide variety of more direct risks for companies exist, sovereign risk is a potential risk especially in the developing world. Mr. Roemin notes that Indonesia has historically been a good payer of foreign debt and recently it has been able to reduce its overall level of debt. Two factors lessening sovereign risk are that the government is getting more financial contribution from state-owned enterprises and it has been able to increase tax revenues. Mr. Kuikka reminds that since FlexLink has kept its fixed capital at a minimum level the company can simply leave the country if sovereign risk realises...
and other adverse events follow (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008).

5.4.4 Political risk and social stability

Policies have a big impact on the economy but I am not very optimistic about stable economic policies (Fachruddin, interview 18.4.2008).

Political risk is viewed as the largest risk for investors among the managers interviewed. Mr. Straton notes that Indonesia’s embracing of democracy has been a major step forward in stabilising the political environment since only ten years ago situation in Indonesia was completely different. The government is balancing between popular policy and trying to improve its international reputation. As a way of boosting international reputation the government is implementing competent economic and investment policies. This has been a significant step forward since previous governments were not able to create a basis for competitive business environment. Mr. Roemin states that competitive environment is a must for Indonesia since the country lacks capital resources and needs foreign capital to be invested there. Mr. Straton goes on that there will always be more regulation coming but remains optimistic that new regulations will improve the investment environment. The elections in 2009 are awaited with anticipation among the interviewees. Mr. Roemin asserts that the current government has done a lot of good for the economy and he predicts that the new government will keep on working on the economy and making new reforms. Surprisingly Mr. Fachruddin states that he is not very optimistic that the current and the forthcoming governments will be able to maintain stable economic policies (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

The largest risk probably lies in changing laws and regulations. Mr. Ollikainen points out that the most significant deterrent for FDI is the rapidly changing direction of business related laws and regulations. He continues that central government and local governments often have different views on how to proceed with economic regulations. Central government has been more transparent in the past few years but it keeps struggling with local authorities, and this poses serious risks for companies operating in Indonesia. In the past local governors were appointed by the central governments but now they are elected by popular vote causing further divergence between the central and local authorities. Mr. Roemin notes that the ruling government is not a single entity and that parliament has a major role in decision-making. Unfortunately, some parliament members work on issues of their own interest. For example, some officials want to
Mr. Straton explains few challenges that Westpac has encountered. First is the regulation for a specific ratio between expatriate and local workers. This regulation forces companies to hire mostly locals and also train them to take executive roles. Mr. Straton continues that also a regulation has been set that requires companies to illustrate succession planning for current executives to be replaced by Indonesians. The latter regulation is only effective in the banking sector. Mr. Straton adds that there is not enough qualified Indonesians to take these roles since their education and experience are lacking. He sees that the banks in Indonesia will have major problems with this piece of regulation. Second challenge is that the minimum capital requirement for a bank to get a banking license is $300 million. This regulation was set because BI does not want any more banks to be established in Indonesia. They want newcomers to buy existing banks in order to stabilise the amount of banks in the market. Another new regulation is the single presence policy which forces banks to divest their interest in other banks if their ownership reaches 25% or more in one bank. This regulation clearly directs how banks can do business in the country, and the banks are given until 2010 to divest their interest or conduct mergers. Single presence policy offers newcomers, such as Westpac, an excellent chance to get into the market. Even though above mentioned regulation provides challenges to Westpac Mr. Straton concludes that he fully understands the rationale behind these regulations. He also adds that private banks work closely together with the Bank of Indonesia, and that BI and the government have taken several measures which have improved the conditions of the banking industry (Straton, interview 17.4.2008).

Social stability has been a problem area in Indonesia and Mr. Ollikainen explains that by nature Indonesians are inclined to demonstrations. The company managers interviewed agree that Indonesia’s image has been tarnished by social unrest and also by several bombings. Despite Indonesia’s past the company managers are confident that
most drastic representations are history. Mr. Roemin states that Indonesians have learned from past conflicts. Mr. Ollikainen points out that if fuel and foodstuff prices increase considerably social stability is threatened. Both Mr. Roemin and Mr. Ollikainen note that elections in 2009 might spur people to participate in demonstrations, but both gentlemen think that it is highly unlikely that anything drastic will take place (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Ollikainen, interview 18.4.2008).

5.4.5 Corruption and infrastructure

All the company representatives interviewed see corruption as a severe problem in operating in Indonesia. The interviewees emphasise that they have not and will not be involved in any actions that could be interpreted as corruptive but bribes have been asked from them in several occasions. Companies have encountered corruption in dealings with government officials as well as with other companies. Mr. Ollikainen says that corruption is most evident in dealings with the authorities which can delay processes substantially if no bribe money is given. Mr. Ollikainen continues that during Soeharto’s era bribes were only demanded for Soeharto and his officials in one place whereas nowadays there are several different places where bribes would need to be paid, which has been a negative development. Mr. Ollikainen goes on by indicating that Indonesia has improved its ranking in corruption surveys in recent years and that development has only came from the private sector. For Metso as for many other companies, international regulations and laws that they follow are very strict and to be caught in giving bribes would be devastating for their reputation as well as would provide them severe sanctions. Mr. Kuikka and Mr. Ollikainen agree that customs is the most corrupted area of the authorities. They argue that without paying bribes importing goods takes an awful lot of time. Mr. Juntunen states that in Singapore it takes a day to offload a ship while in Indonesia it takes a week. Mr. Roemin says he has also noticed that customs procedures are taking longer now than they used to. One additional reason for lacklustre performance of customs is that infrastructure of seaports is lacking and they are heavily congested. Mr. Kuikka notes that corruption also exist when dealing with companies, and it is more likely to occur with smaller companies as large companies have usually adapted international ways of doing business. He continues that large companies are surprisingly clean but that in smaller companies low level employees often block the way up to serious negotiations with company managers, if bribes are not provided. Mr. Kuikka adds that luckily FlexLink does not have any dealings with state-owned enterprises which are the most corruption prone. Mr. Juntunen and Mr. Ollikainen state that declining to provide bribes makes their business more difficult in Indonesia but they are willing to pay
the price in order to have clean hands. Mr. Ollikainen continues that Metso loses a small portion of its business because of this but more substantial deals are always corrupt free. In the long run both Metso and Pöyry believe that being corrupt free provides better results than taking the easiest way out in problem situations (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).

Because of widespread corruption, companies often use consulting agencies to do the cumbersome processes for them. For example, starting up a business, getting work permits and other services are easier dealt with hiring a consultancy firm. Companies pay for specific procedures to be taken care of by a consulting firm. Hiring companies do not even want to know the methods that the consulting firms use as they only care about the results and do not wish to get involved in any way. Above mentioned importing problems with the customs can also be reduced by hiring a logistical company to help (Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Ollikainen, interview 18.4.2008).

The two Indonesians interviewed Mr. Roemin and Mr. Fachruddin have a different perception of corruption than the westerners interviewed. Mr. Roemin states that it is difficult to define what is corruption and what is not. He continues that Americans regard buying lunches to business partners as being corruption. He continues that in Indonesia when doing business one needs to take business partners out for dinners etc. to build and improve personal relationships which are very important in the country. Mr. Fachruddin says that corruption does not go by the name corruption in Indonesia since taking a small amount of bribes is usually not perceived to be very immoral. However, Mr. Fachruddin believes that the government will succeed in decreasing corruptive actions since it is very devoted to the matter and has started going after high level people (Fachruddin, interview 18.4.2008; Roemin, interview 16.4.2008).

If I would be the one investing, I would examine the neighbouring countries very closely before coming to Indonesia (Nyfors, e-mail response 27.3.2008).

Poor infrastructure is also a severe problem in Indonesia. Particularly in the provinces infrastructure is lacking, for example road and railroad networks are simply not there in many areas, and ports remain rather inefficient mainly because of corruption. Electricity supply is already a problem in Indonesia but the situation will probably worsen. The demand for electricity is growing 6–7% annually while the growth of new investments to electricity creation remains worryingly low at 1% annually. Mr. Juntunen notes that boosting electricity production requires difficult decisions which the current government has been unwilling to make. One major problem is that electricity
distributors cannot pay competitive market prices to electricity producers since electricity production is subsidised in the country. Mr. Ollikainen states that power cuts are too frequent in the capital Jakarta. He explains that power cuts are not acceptable for a company like Metso, once a year would be the absolute maximum for a business that depends heavily on electricity. For future investments Metso aims to calculate possible costs caused by the power cuts and notes that guaranteed access to electricity is one of the most important factors for them when they choose an area to operate in (Nywors, e-mail response 27.3.2008; Ollikainen, interview 18.4.2008; Juntunen, interview 18.4.2008).

5.5 Perceived investment climate

*If we want to invest in Asia, Indonesia is not notably worse than any other country here (Ollikainen, interview 18.4.2008).*

Previous chapters have been giving quite an exhaustive picture of Indonesia’s investment climate. However, this chapter provides views of the interviewees on, for example, which industries Indonesia would be the most suitable investing ground, and what are the most significant obstacles for investing as well as how they perceive the future.

Indonesia is viewed as a favourable breeding ground for several different sectors. Indonesia has a substantial amount of natural resources which have always attracted foreign investors. At the moment pulp, palm oil, oil, natural gas and coal are the resources that attract foreign businesses most. Forest industry has traditionally been strong but Mr. Nyfors states that the sector is slowly dying because illegal logging is decreasing, which has been the source for vast amounts of low priced timber. For manufacturing industries wage rates in the country are quite competitive but Indonesia lacks in many other important elements that encourage investments. Nevertheless, the country has its share of manufacturing industries but not nearly as much that its potential is. Textile and clothing industries have had significant production in Indonesia but recently countries like Vietnam have attracted most of the investments in these sectors. Indonesian government is working on revitalising these sectors and is hoping for the return of Japanese investors which during the Soeharto’s era where the biggest foreign investor group in the country. Electronics industry has not really set foot in Indonesia and the reason behind this is that Indonesia lacks engineering talent. Mr. Nyfors adds that agriculture would have a bright future, if landownership problems could finally be solved. Mr Fachruddin says that BKPM is eager to boost investments in sectors that promote job creation and technology transfer. Some of the sectors that BKPM is promoting at the moment are pharmaceuticals, chemicals, copper manufacturing, electronics and car
manufacturing. He adds that BKPM has been successful in promoting Indonesia abroad and letting potential investors know about opportunities in the country. In addition, existing foreign investors are coping well with the complex investment environment in Indonesia and they are commonly making new investments in the country. Mr. Fachruddin continues that market potential is the number one reason that attracts foreign investors but also consumerism is higher in Indonesia than in neighbouring countries. Mr. Juntunen adds that the basic elements in Indonesia are good, such as market potential and substantial home market. He notes that there exists a significant amount of authority approved private investment projects but for some reason many of these projects are never executed (Fachruddin, interview 18.4.2008; Roemin, interview 16.4.2008; Juntunen, interview 18.4.2008; Nyfors, e-mail response 27.3.2008).

The interviewees regard political instability as the largest deterrent for investments in Indonesia. Mr. Roemin notes that decision-making which is both centralised and regionalised is problematic since they often conflict with each other. He continues that bureaucracy is another problem since many companies have suffered from long legal procedures. Mr. Straton points out that the whole juridical system would need improvement and corruption should be tackled with. Mr. Roemin notes that borrowing money is very expensive in Indonesia and the spread between lending and savings rate is outrageously high which drives some companies to borrow from abroad, for example, from Singapore. Both Mr. Fachruddin and Mr. Straton agree that infrastructure is also among the biggest obstacles in investing in Indonesia. Mr. Straton says that banks are often unwilling to lend to infrastructure sector since Indonesia’s credit rating is not yet investment grade. The rating is expected to reach that rating in 2010 which would affect Westpac’s and other banks’ business in Indonesia substantially. Mr. Fachruddin lists that law enforcement is also a problem area added with a strict labour law. Mr. Juntunen notes that in Vietnam labour laws are more flexible and laying off employees is easier combined with lower wages. Mr. Fachruddin points out that BKPM is working basically alone to promote investments, and coordination between government agencies is almost nonexistent. He compares Indonesia with Vietnam where commitment to investment promotion can be found from top to bottom. Mr. Straton notes interestingly that the most significant challenge for him is to educate people inside Westpac that Indonesia is really worth investing in. He continues that finding a proper acquisition target to enter the market is challenge number two for them (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Straton, interview 17.4.2008; Juntunen, interview 18.4.2008).

*With a $100 million investment you cannot run off just like that (Kuikka, interview 16.4.2008)*.
Both Mr. Ollikainen and Mr. Roemin explained processes what their companies did when they prepared to invest in Asia. Ahlström made a list of countries in Asia where they could invest in and ranked the countries according to their business and growth opportunities. Mr. Roemin states that Indonesia was sixth on the list. Metso carries out comprehensive feasibility studies on countries where to invest in. Mr. Ollikainen says that when Metso made its decision where to place their service centre in 1996 it favoured Thailand over Indonesia because political risk was found to be too high in Indonesia. Metso’s investments are generally significant in size. The investment in Thailand was 10 to 15 million Euros, which is why Metso conducts thorough market research, and analyses future costs and revenues but also incentives given by governments. One decisive factor in favour of Thailand were greater tax concessions. Mr. Ollikainen notes that if that same investment decision would be made today, Indonesia would be chosen since political environment is much more stable now. At the moment Metso is planning a new investment in Southeast Asia and it is again analysing different markets. Indonesia is high on the list because Metso has several important customers in the country and its largest competitor has had a service centre in Indonesia for seven years already. Mr. Kuikka states that FlexLink is placing its major investments into neighbouring countries mainly because of the political risk in Indonesia. He reminds that FlexLink has kept its investment on a minimal level in Indonesia. He continues that it would be nearly impossible to run off from the country with larger and longer term investments (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Roemin, interview 16.4.2008; Ollikainen, interview 18.4.2008).

All the interviewees predict that Indonesia’s investment environment will improve in the future. The pace by which it is improving is however expected to be too slow. Company managers also agree that the government is committed to reforms which make the country more attractive to FDI, and also corruption is fought against. Huge problem still remains as the government is eager to talk about its plans and ideas but the actual implementation is lacking behind. Mr. Fachruddin states boldly that the new government to be elected in 2009 will not be any better. He feels that political parties are not seriously committed to improve the investment environment. Mr. Juntunen and Mr. Kuikka believe that the new government will make the difficult decisions that the existing government is not willing to make with the elections so close. They also think, controversially to Mr. Fachruddin’s view that progress in the investment environment will take place although they hope it would be faster than it has previously been. Mr. Kuikka notes that corruption problem will eventually improve as the government tries its best to change the mentality of Indonesians towards corruption, which will undoubtedly be a long process. It should be noted that even though Mr. Kuikka knows substantially about possible risks in Indonesia FlexLink has not had major problems with their investment in the country. One explanation could be that they have been very well prepared for the
market and have been able to minimise and avoid most of the caveats so far. Mr. Juntunen points out that the government has begun to realise that Indonesia is competing from investments in a global environment. Mr. Juntunen continues that many industries remain very competitive in Indonesia but legislation and transparency are inadequate. Mr. Ollikainen agrees with Mr. Juntunen and adds that clearer codes of conduct and legislation should be established as well as bureaucracy should be lessened (Fachruddin, interview 18.4.2008; Kuikka, interview 16.4.2008; Juntunen, interview 18.4.2008; Ollikainen, interview 18.4.2008).
6 CONCLUSIONS

The purpose of this study was to examine how country risk affects companies’ investments, particularly in Indonesian business environment. The relation between investment decisions of companies and different country risks has not been studied extensively in the past despite their close linkages. This study has sought to identify which nation-specific factors affect, and by what magnitude, investment decisions and existing investments in companies operating in Indonesia. Dunning’s (1981; 1993) eclectic theory and Tahir’s (2003) location aspect framework offered a suitable base for this research since they concentrate on issues which make companies engage in FDI. Nation-specific factors offered by Dunning and Tahir that encourage or discourage investments were accompanied with country risks from Meldrum’s (2000) classification, added with few other elements which are important in Indonesian investment environment. The above theoretical background was then analysed in an Indonesian context. This chapter presents the findings of the study, first the Indonesia specific findings of company investments and country risks, added with generalisations that apply to other environments as well at the end of the chapter.

Investing is an absolute must for all companies in order for them to stay competitive. FDI is often identified as a preferred way to invest since companies have full control of their investment and profits associated with it. This study found that companies have various company and industry specific reasons to engage in FDI. Above all, market potential was the number one reason for most of the companies to invest in Indonesia but also following customers and competitors was found to be important. If the new market has potential, companies tend to think that existing customers will soon follow suit, and while in the new market they also target to acquire new customers.

All of the interviewed companies have gone through substantial amount of market analysis prior to their investment. Their attitudes towards the Indonesian market may differ considerably but prior investment analysis was never neglected. Therefore companies have been well prepared for a range of negative occurrences, and thus have enabled the best possible basis for long-term investments. Moreover, the services of risk rating agencies were also found to be commonly used to help in assessing business environment of the host country. Furthermore, management’s perception of the market was seen to be influential in many companies. If management perceives a market as very risky, their opinions might be rather difficult to change. In addition, higher perceived risk translates into a higher required rate of return which in turn leads to discarding some viable investment projects. Positive perceived image and experience of the management was identified to accelerate the investment process significantly.

Dunning’s (1981; 1993) eclectic theory and Tahir’s (2003) location aspect framework were discussed in the study and ownership-specific, location-specific and inter-
nalisation advantages, and their subcategories were introduced. The theories suggest that possessing the above advantages is directly related to companies FDI propensity.

All the companies interviewed for this study possess strong ownership-specific advantages which were firm size, R&D intensity and firm’s international experience. Common for all of the companies was that they are substantial in size and operate in various countries around the world. R&D intensity is somewhat troublesome to analyse, but the managers interviewed suggested that innovation in their companies is on a par with competitors or above them.

Location-specific advantages – market size, cultural distance, wage rate, corporate tax rate and inflation – were viewed as being favourable or as having no negative effects on the businesses of the companies interviewed. Market potential was noted to be significant in Indonesia and that cultural differences were mostly unproblematic. The availability of labour has not been a major problem for the companies yet but it might pose problems in the future. However, labour laws were found to be too strict and leaving workers could be a headache dependent on the sector. Both wages and corporate tax rate were noted to be at a comparatively competitive level.

Internalisation advantages – country risks, exchange-rate fluctuations and contractual risk – pose serious challenges for the companies interviewed and might deter investing activity. Contract enforcement in the country remains a serious problem area since court processes are extremely slow and court rulings are uncertain. Poor contract enforcement also makes joint ventures with local partners problematic.

The companies interviewed for this study possess ownership advantages and view location and internalisation advantages as being somewhat positive in Indonesia. This is completely in line with Dunning’s eclectic theory and Tahir’s location aspect framework, which state that if OLI-factors exist for companies, they will engage in FDI. It is an expected outcome with this study sample since all of the companies have invested in the market. To further test these two theories also companies which have deterred from investing should be studied.

The term risk was defined as uncertainty or a result of uncertainty. Investments were discovered to be risky in essence since their outcomes are not easily predicted. Risk analysis was seen as a valuable method giving company management a broader perspective in decision-making and providing techniques to evaluate competing options. Country risk was specified as an exposure to a loss in cross-country transactions caused by events in the host country that are wholly or partially under the control of the host government. Country risk in this study was analysed based on Meldrum’s (2000) risk classification which includes economic, transfer, exchange rate, location, sovereign and political risks. In addition, infrastructure, social and corruption aspects were studied closely as they are significant factors in Indonesian environment.
Among the interviewees economic situation was not viewed to be risky, on the contrary, economic growth in the country is expected to remain strong and future looks relatively good despite a glooming global downturn. Both growing population and wealth, added with vast natural resources make Indonesia’s economic prospects look bright.

Companies were found to be prepared for possible restrictions on capital movements, for example, by using transfer pricing, however, the risk was perceived to be small even though the level of transparency on regulation is poor. In addition, exchange rate fluctuations were not seen to be threatening companies’ investments as companies have most of their revenues and costs in either US dollars or Euros. This has been a conscious choice by the companies to reduce exchange rate risk with a simple method. Nevertheless, adverse development of rupiah’s exchange rate may affect customers’ financial conditions therefore reducing orders from the companies interviewed.

The location of Indonesia was viewed mostly with a positive tone. For some of the companies Indonesia is located close to their other important markets and for some Indonesia is such a distant market that competitors are not interested in it. In addition, regional cooperation has increased Indonesia’s trade with its closest neighbours and thus lessened its vulnerability to the United States. Sovereign risk was found to be on the bottom of the list of risks to be analysed prior investment since it occurs very seldom. It could, however, be a significant risk particularly in the developing markets because of its indirect effects but the risk is very difficult to measure and predict.

Political risk was viewed as the most significant risk and deterrent for investments in Indonesia. Unpredictable policy environment has been plaguing investors, added with differing policy making between central and local governments. Nevertheless, the political environment has become more stable in the past ten years and transparency is expected to increase gradually in the future but nothing is certain. Social stability has increased along with political stability. However, there exists a possibility for social unrest which derives from adverse developments, for example, in political environment, exchange rate or economics factors, such as inflation and commodity prices.

Corruption has its roots deep in the Indonesians psyche. Indonesians, including the two Indonesian interviewed, have a very relaxed attitude towards corruption, and it will take years before this fundamental issue can change. Corruption was seen as one of the biggest problems that companies face in Indonesia, more precisely corruption occurring in dealings with the government officials. Corruption increases the costs of operating significantly since consulting agencies need to be hired and processes take a substantial amount of time to go through. Yet, for some companies investing in corruption ridden Indonesia might be impossible entirely since complying with strict home country legislation can make business operations in the country extremely problematic. It should be noted that all managers interviewed in this study may not have been able to share all
their knowledge on corruption because it a very sensitive issue for companies. This also has an effect on the reliability of this study in its corruption aspect.

Infrastructure in Indonesia was discovered to be lacking and most industries suffer from it. However, companies often find that they have no alternative investment locations, in terms of other countries, for their projects. Thus they are forced to invest in Indonesia, if they desire to penetrate into Indonesian market. What companies can do is to find the most suitable location in Indonesia since different regions within the country can vary substantially infrastructure-wise.

The importance of different risks for investors differs between countries and between industries. For example, corruption, risk of leaving workers, availability and wage rate of workers, and business prospects differ considerably between industries. Prior investing companies need to pinpoint the most important risks for their industry and the host country.

Proper investment climate was found to be important for developing governments that try to attract FDIs in order to develop their economies and gain expertise in various sectors. Government’s attitude towards FDI in Indonesia was found to be very positive. Indonesia’s investment climate and market could be described as promising, however, it should be noted that promising is something that Indonesia has been throughout the modern times but there has always been something lacking. Despite this, companies from a range of sectors driven by the market potential believe that the investment climate will improve in the future and that more and more sectors will become as successful as, for example, the natural resources sector has been. This believe is based on the fact that more transparency in decision-making and simple reforms, for example, to improve labour regulations and lessen bureaucracy would do wonders for the investment environment since many elements of it – such as wage rate, availability of labour, market size and growth – are already in a relatively good condition. It can be argued that the companies currently investing in Indonesia and braving country’s volatility are expected to profit from vast opportunities and market potential in the longer term that the more risk-averse companies forgo.

The objective of this study was to provide a general picture of the risks affecting investments in Indonesia regardless of the sector. However, based on this study it can be noted that there are several factors influencing companies’ investment decisions in a wider context, in an emerging markets context. Thus general conclusions from this study can be drawn which are presented below.

Market potential is the number one reason why companies engage in FDI. Economic environment need to be rather stable and offer potential for future growth. Political risk also affects investment decisions. Companies are found to invest in politically relative stable markets. Companies tend to wait for the political situation to stabilise in unstable host regions before they start investing. Politically unstable markets also somewhat at-
tract FDI but companies keep their investments on a low level to minimize their risks. Rampant corruption also deters investments since many companies find it impossible to operate in corruptive markets and at the same time comply with home market regulations. Moreover, corruption also increases the operating costs of companies which might lead to abandonment of investment projects whose rates of return are not especially high. Furthermore, managers perceived negative image of a specific market tend to affect the amount of projects initiated, or at least increase the required rates of return for projects.

Host country infrastructure is another important element in investment decision-making, particularly in emerging market conditions where infrastructure related problems can be relatively significant. The condition of existing infrastructure is essential when companies choose a location to operate in within the chosen country, but not as essential between countries since companies often need to operate in a particular country. In addition, location of the host country can be a factor in investment decision-making, if the location is close to other important markets or location is so remote that competition is scarce. Contagion risk is not on top of the list of risks to scrutinise since the possibility for contagion from neighbouring markets is present in almost every developing market. Sovereign, transfer and exchange rate risks are identified to be relatively less important in investment decisions making. These risks are either very improbable to occur or the risks can be lessened substantially with many cost-effective methods, such as natural hedges or transfer pricing.

If outstanding market opportunities exist, it can be argued that companies find innovative ways to operate in difficult market conditions. They adapt to new environments and find new ways to handle demanding situations. The better companies analyse new markets prior an investment decision, the better they are prepared for possible negative outcomes and can act accordingly which also translates into more profitable businesses.
REFERENCES


International Monetary Fund (2008a) *Indonesia: Staff report for the 2008 article IV consultation*. International Monetary Fund.


Interviews and E-mail response


Juntunen, Janne, President Director, Pöyry PLC. Interview 18.4.2008. Duration 1h 10min.

Kuikka, Sakari, Managing Director, FlexLink Systems AB. Interview 16.4.2008. Duration 1h 15min.

Nyfors, Thorolf, President Director, United Fiber System Ltd. E-mail response 27.3.2008.

Ollikainen, Mika, Country Manager, Metso Paper Inc. Interview 18.4.2008. Duration 1h 30min.

Roemin, Andika, President Director, Ahlström Corporation. Interview 16.4.2008. Duration 1h 40min.

Straton, Sean, Chief Representative, Westpac Banking Corporation. Interview 17.4.2008. Duration 1h 30min.
APPENDIX 1  COMPANY INTERVIEW QUESTIONS PART 1

*Investment decision-making*
How long have you been operating in Indonesia? How many different investments have you made there?

What are the main reasons for you to be operating in Indonesia?

Where you following competitors or customers to Indonesia?

How is the investment planning process in your company?

How much information do you gather prior to investment? Is the decision made purely on facts and figures? Does management perceived image of different markets influence the decision?

How was the investment decision-making process in your company in the case of investing in Indonesia? Initial / re-investment?

How much weight are you putting for investment climate vs. economic analysis?

*Country risk*
How the Indonesian market was analysed prior investment?

Was country risk analysed specifically or simply as a part of the market analysis? Did you quantify every risk imaginable? Did the results of quantifying seem reliable?

Did you use country risk rating agencies?

How were these country specific risks analysed and how much they can affect your business:

- **Political risk** (major changes in economic policies, political regime, terms of trade, attitude towards FDI)
- **Economic risk** (change in economic structure or growth rate, changes in fundamental economic policy goals [fiscal, monetary, international or wealth distribution/creation], or change in country’s comparative advantage [resource depletion, industry decline, demographic shift])
- **Sovereign risk** (government might be unable or unwilling to repay its loans, government may run out of foreign exchange due to unfavourable development in its balance of payments, government may decide not to repay for political reasons)
- **Transfer risk** (restrictions to capital movements (repatriate profits, dividends, capital)
- **Location risk** (geography [trading partners, trade alliances, size of the country, borders, distance from important markets] and neighbours [contagion effect])
- **Exchange rate** (hedging?)
- **Social stability**
- **Corruption**

Were you well prepared for the investment? What was the initial thought about preparedness? Do you feel now you succeeded in the pre work?

Have you cancelled any planned investments because of the country risk? Or invested less? Is it easy not to proceed with a project, which has been planned for long time?

**Investment climate in general**
What do you feel are the biggest obstacles in investing in Indonesia?

Have the law changes etc. improved the investment climate?

Why do you feel investments in Indonesia are lacking behind its neighbours?

How does the future look? Are government actions to the right direction? Is it enough? What should be done?

Did you initially consider some other markets instead of Indonesia? Has Indonesia lost some of your investments to other countries?

What were the incentives you were given? Have there been any changes to those?

How is the political environment? Complex / unpredictable / unstable / getting better?

How would you improve the investment climate?
APPENDIX 2  COMPANY INTERVIEW QUESTIONS PART 2

Ownership advantages

Firm size
1. What is the gross volume of business conducted by your firm in the preceding financial year?

Ability to develop differentiated products (R&D)
2. How do you rate your training program in terms of preparing your personnel to offer more added value to your customers than competitors?
3. How do you rate your firm’s potential to create new and creatively structured products/services for clients?

Multinational experience
4. Approximately, what percentage of your total earnings would you attribute to your foreign source income?
5. How multinational do you think your firm is, in terms of number of countries operated in?
6. How capable is your firm in terms of technological, managerial, and financial capabilities to handle international expansion?

Location advantages

Market potential/size
7. What do you think is the market potential of your business in Indonesia?
8. What do you think is the growth potential of your business in Indonesia?
9. What do you think is the general acceptability of your business in Indonesia?
10. What do you think about the attitude of government toward your business in Indonesia?
11. What do you think about the attitude of government toward foreign firms in general in Indonesia?

Cultural distance
12. How big is the cultural difference between company’s home country and Indonesia? What effects does it have in making investments and operating in the country?

Wage rate and labour market
13. How is the wage rate and the availability of qualified workforce?
14. How flexible is it to increase and reduce workforce? What effect do large compensations for employees when sacked have for you? Can you make contracts to avoid the compensation costs and make your workforce more flexible?

Corporation tax rate and incentives to invest
15. Is corporate tax rate favourable for investment? Are investment incentives increasing the attractiveness to invest in Indonesia?

Internalization advantages

Investment risk
16. What do you think about the general stability of the political, social, and economic conditions (growth, inflation, currency etc.) in Indonesia?
17. What do you think is the risk of converting and repatriating your income in Indonesia?
18. What do you think is the risk of expropriation of firms from Indonesia?

Contractual risk
19. Compared to that of the home country, how would you rate the costs of making and enforcing contracts in Indonesia?
20. How sure are you that your standards of quality of services/products will be maintained if you operated jointly with a local company in Indonesia?
21. What do you think is the risk of dissipation or misuse of your proprietary knowledge if you operated jointly with a local company in Indonesia?

Exchange-rate fluctuations
22. What effect the exchange-rate fluctuations of rupiah have to your investments and operations?
APPENDIX 3 INVESTMENT COORDINATING BOARD INTERVIEW QUESTIONS

*Investing in Indonesia*

What are the biggest elements that attract companies to invest in Indonesia? (natural resources, cheap labour, other?)

What refrain companies from investing in to Indonesia? What are the biggest obstacles for companies already executing their investments or operating in Indonesia?

Do companies overall have a low level of knowledge of the Indonesian market? Does low level of knowledge refrain companies from investing in to Indonesia? What’s the general image among companies of the Indonesian market?

Is the investment decision of companies influenced by something else than facts and figures?

Is thorough market analysis made prior to investment among companies? Are companies generally well prepared when investing?

*Country risk*

Is country risk taken into account?

Which risks have the biggest influence on investment decision-making process? What about after the investment has been made?

How would you rate the importance of the below risks for companies investing in Indonesia?

- Political risk
- Economic risk
- Sovereign risk
- Transfer risk
- Location risk
- Exchange rate

Have some companies cancelled investments or downsized investments because of the country risks involved? And maybe invested in some other country?
Investment climate in general
What are the incentives given for companies if they invest?

How is the investment climate?

Have the law changes etc. improved the investment climate? How would you improve the investment climate?

Why is investments to Indonesia lacking behind its neighbouring countries?

How does the future look? Are government actions to the right direction? Is it enough? What should be done?

How is the political environment? Complex / unpredictable / unstable / getting better?

Which industries are you promoting?

What are the hotspots (in terms of sectors) to invest in?