Building Bridges: Navigating Indonesia’s Infrastructure Choices

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Executive Summary

• Indonesia has large and distinctive I&C needs that are unlike any other Indo-Pacific country. This means the government will need to coordinate integrated infrastructure projects that solve its intra-island, inter-island, and international connectivity gaps.

• The number of new initiatives the Indonesian government can draw on for infrastructure support does not present either/or choices. Indonesia should be prepared to work with a range of I&C initiatives and match their corresponding strengths and specialisations with the appropriate projects.

• The State-Owned Enterprises (SOE) sector needs broader reforms to prevent loss of funds as infrastructure spending continues to increase. The Indonesian government should offer genuinely competitive tenders for I&C projects and encourage more private sector competition.

• Indonesia needs to solve the ‘bankability problem’ through capacity building in the Indonesian workforce for skills that contribute to better project design, implementation, and management.

• On the geopolitical front, Indonesia can manage the risk through avoiding pitting I&C initiatives in bidding wars.

• Indonesia is in a good position to reduce geopolitical tensions through building linkages between initiatives and encouraging national programs to disburse funds through established Multinational Development Banks (MDBs) that have strong governance processes.

• Government decentralisation policy presents a geopolitical risk of its own. Subnational governments are at risk of having poor projects designed for political purposes, and the national government should work closely with their subnational counterparts on their I&C needs and ensure bankable projects are developed.
The work of the Perth USAsia Centre focuses on the Indo-Pacific, a region containing most of the world’s leading and emerging economies. Strong economic relations between countries are crucial to the stability and prosperity of the region. In this report, Kyle Springer highlights that one of the region’s most important economies, Indonesia, faces serious connectivity issues with the rest of the Indo-Pacific resulting from infrastructure gaps.

Infrastructure and connectivity are critical for the future of our region. While the Indo-Pacific has a well-developed institutional architecture to promote trade and investment, the physical infrastructure linking its economies remains under-supplied. Governments are increasingly working to address this, by committing financial, political and diplomatic capital to a diverse range of connectivity initiatives. While these initiatives are a welcome development, there is a pressing need to ensure these efforts are effective, cooperative, and fit-for-purpose.

This report is the third in a Perth USAsia Centre series on Indo-Pacific connectivity. The first, Blueprints for the Indo-Pacific: Infrastructure and connectivity programs for regional integration surveys the contemporary landscape of infrastructure efforts. Here, Kyle Springer extends the analysis to Indonesia, where he evaluates the geopolitical risks the major Indo-Pacific I&C initiatives pose to the country. Indonesia Infrastructure Choices finds that Indonesia has domestic I&C challenges that are unlike most other Indo-Pacific countries and will require it to cooperate with each key initiative to some degree. However, Indonesia is in a position to use its vast I&C needs to build linkages between initiatives with competing geopolitical goals. This approach will help Indonesia manage geopolitical tension and risk, and could potentially set a precedent for how others in the region can manage great power competition as it plays out in the field of infrastructure investment.
Indonesia’s ‘infrastructure gap’ is a major barrier to its economic growth and regional integration. The World Bank estimates the country needs $500 billion of investment in infrastructure and connectivity (I&C) projects between 2017-22 to boost the efficiency of its economy enough to avoid the middle-income trap and continue its promising growth trajectory. Businesses and economic activity cannot achieve the country’s target growth rate without underlying infrastructure to support it and link it with international economic activity. Research shows that the more connectivity an Indonesian province has with the global economy through infrastructure, the better that province’s economy tends to perform overall.

Lack of infrastructure also compounds the existing challenge of connectivity between Indonesia’s islands. Consisting of thousands of islands and with rugged, mountainous terrain, Indonesia faces engineering and financing challenges in building and maintaining physical infrastructure. Economic development is uneven, with population and economic activity concentrated on and around the western islands of Sumatra and Java. On the eastern half of the archipelago, infrastructure gaps are more pronounced, which constrains growth and hinders local development efforts. Lack of infrastructure limits trade and economic integration within the country.

Infrastructure gaps are a barrier to international trade and investment. Indonesia is well-integrated into the regional trade architecture, which has lowered tariffs and other barriers to trade throughout the region. Indonesia is also strategically located in the geographic centre of the economically dynamic Indo-Pacific region. Several major shipping routes traverse the archipelago, which connects the Indian and Pacific Oceans. However, Indonesia’s infrastructure deficit means it is weakly connected to regional value chains, and has remained a transit area rather than...
becoming a major maritime hub. The economic flow-on effects include compounding an existing problem of rising food prices.

Indonesia’s I&C ‘vitals’ offers insight into how the lack of infrastructure has held it back from achieving its goal as a maritime fulcrum (see Figure 1 below). Indonesia suffers from higher non-tariff trade costs (which reflect transport and logistics costs) with the largest economy in the region, China, than its central location in Southeast Asia would suggest\(^3\). Despite its strategic location, Indonesia faces non-tariff trade costs at a similar level to South Asian countries like Bangladesh, which suffer from weak connectivity with Southeast and Northeast Asia\(^4\).

Despite its urbanisation and industrialisation, Indonesia’s non-tariff trade costs to China are on par with Lao PDR.

The size of infrastructure gaps requires the Indonesian government to seek investment from a diversity of sources. In reaction to the region-wide need for physical infrastructure, Indo-Pacific governments and intergovernmental organisations have established a number of new I&C initiatives with the aim of addressing the larger $1.5 trillion infrastructure gap facing the region.

At the same time, infrastructure has become a tool of great powers to exert influence and achieve diplomatic and strategic outcomes in the region. Each major Indo-Pacific I&C initiative presents different sets of economic benefits and geopolitical risks. The challenge for Indonesia is this: given the scale of its infrastructure needs, the Indonesian government will likely need to engage with each of these initiatives. The government will need to assess individual initiatives based on the types of infrastructure needed, the varying levels of development from province to province, and

**Figure 1 - Non-tariff trade costs to China, 2013**

<table>
<thead>
<tr>
<th>Country</th>
<th>% ad valorem equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>116.7</td>
</tr>
<tr>
<td>India</td>
<td>83.0</td>
</tr>
<tr>
<td>Cambodia</td>
<td>123.7</td>
</tr>
<tr>
<td>Indonesia</td>
<td>98.6</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>102.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>55.8</td>
</tr>
<tr>
<td>Philippines</td>
<td>97.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>66.9</td>
</tr>
<tr>
<td>Vietnam</td>
<td>40.6</td>
</tr>
</tbody>
</table>

Source: ESCAP-World Bank Trade Costs Database
the nature of its economic relations with other countries in the region.

Some initiatives pose little geopolitical risk for Indonesia. Regulatory dialogues like the MPAC and AFC do not finance projects; instead, they focus on coordinating policy and information sharing between member states. Multinational development banks (MDBs) are lower risk because financing schemes are accountable to governance structures and boards representing the broader interests of multiple member states. The national programs pose higher risks. While these initiatives offer similar types of cooperation, financing is structured differently from program to program. The way national programs deploy their resources often reflect the strategic interests of the sponsor country.

Some I&C initiatives are difficult to define. It is challenging to take stock of the breadth and impact of the Belt and Road Initiative (BRI) because no official list of its projects exists. Neither is there an official budget for the initiative. At its broadest, BRI constitutes a kind of brand for a wide variety of projects which involve Chinese state-owned banks and enterprises providing loans and technical assistance to countries in the region.

Because Indonesia faces challenges unlike many other countries in the region, Indonesia must develop its own framework for evaluating the political risks associated with each I&C initiative.

The new initiatives listed above provide much-needed resources to close Indonesia’s infrastructure gaps. They also pose risks in the current geopolitical context. This report finds that Indonesia has I&C challenges that are unlike most other Indo-Pacific countries and will require it to cooperate with each key initiative to some degree. Domestic characteristics are examined to the extent that they influence Indonesia’s vulnerability to geopolitical risk. Indonesia’s infrastructure gaps are a liability, but viewed from a different perspective they provide Indonesia with an opportunity to build linkages between seemingly competing I&C initiatives in the region.

Indonesia can use its vast I&C needs to build linkages between seemingly competing I&C initiatives

There are a number of other I&C initiatives available to Indonesia outside of the Indo-Pacific region that provide additional capital and assistance for its infrastructure drive. Its choices are not limited to those listed on Table 1 alone. This includes ongoing investment in projects from the World Bank, which pledged up to $11 billion in new financing to Indonesia, and from European development banks and others. While investment from outside the regional initiatives listed above will grow in significance, this paper focuses on how Indonesia can build linkages between Indo-Pacific initiatives and manage the geopolitical risks therein.
A brief overview of some of the major Indo-Pacific I&C initiatives available to Indonesia:

**Table 1. Non-exhaustive Overview of Major Indo-Pacific Infrastructure and Connectivity Initiatives Available to Indonesia**

<table>
<thead>
<tr>
<th>Initiative</th>
<th>Country</th>
<th>Type</th>
<th>Budget</th>
<th>Focus</th>
<th>Type of Cooperation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belt and Road Initiative (BRI)</td>
<td>China</td>
<td>National Program</td>
<td>No official budget [approx. $1 trillion]</td>
<td>Physical infrastructure, with a focus on road, rail, ports and energy.</td>
<td>Equity Finance, loan finance, increasingly technical assistance</td>
</tr>
<tr>
<td>Partnership for Quality Infrastructure (PQI)</td>
<td>Japan</td>
<td>National Program</td>
<td>Initially $110 billion, increased to $200 billion in 2016</td>
<td>'Quality' Infrastructure across a range of sectors, including transport, energy, telecommunications and natural resources</td>
<td>Equity finance, loan finance, standard-setting, technical assistance</td>
</tr>
<tr>
<td>International Development Finance Corporation (IDFC)</td>
<td>United States</td>
<td>National Program</td>
<td>$60 billion</td>
<td>Private sector involvement in development finance</td>
<td>Equity finance, loan finance, technical assistance</td>
</tr>
<tr>
<td>Infrastructure Asia</td>
<td>Singapore</td>
<td>Infrastructure agency</td>
<td>None, facilitating agency only</td>
<td>Power, transport, urban smart cities, water and sanitation</td>
<td>Specialises in services and finance advice for infrastructure projects</td>
</tr>
<tr>
<td>Asian Development Bank (ADB)</td>
<td>48 Member States</td>
<td>Multilateral development bank (MDB)</td>
<td>$147 billion subscribed capital; $80.6 billion of infrastructure loans (2008-17)</td>
<td>Poverty alleviation, gender equality, climate change resilience, and environmental sustainability; urban development; rural development and food security; governance and institutional capacity; regional cooperation and integration.</td>
<td>Loan finance, technical assistance, regulatory dialogue, standard-setting</td>
</tr>
<tr>
<td>Asian Infrastructure Investment Bank (AIIB)</td>
<td>44 Regional Members; 24 Non-Regional Members</td>
<td>MDB</td>
<td>$100 billion subscribed capital; $4.4 billion of loans [2014-18]</td>
<td>Rural infrastructure, energy and power, environmental protection, transportation and telecommunications, water supply sanitation and urban development and logistics</td>
<td>Loan finance, standard-setting</td>
</tr>
<tr>
<td>Master Plan on ASEAN Connectivity (MPAC)</td>
<td>Host Institution: Association of Southeast Asian Nations</td>
<td>Subregional process</td>
<td>None, dialogue only</td>
<td>Physical, institutional and people-to-people connectivity</td>
<td>Regulatory dialogue</td>
</tr>
<tr>
<td>APEC Framework on Connectivity (AFC)</td>
<td>Host Institution: Asia Pacific Economic Cooperation</td>
<td>Subregional process</td>
<td>None, dialogue only</td>
<td>Regulation of cross-border infrastructure to facilitate regional supply chains</td>
<td>Regulatory dialogue, standard-setting</td>
</tr>
</tbody>
</table>

Indonesia’s Infrastructure and Connectivity Challenges

Indonesia’s geography presents unique I&C challenges different from those in other countries in the Indo-Pacific. Geography naturally divides the country into over 17,000 islands across an archipelago spanning 5,000 kilometres. Many of its islands are mountainous and covered with dense, tropical rainforest. This topography presents engineering challenges and the sheer expanse of the archipelago presents its own connectivity problem. As a result, the types of infrastructure needed varies from island to island.

Different kinds of ‘infrastructure gaps’ exist on three levels: intra-island, inter-island, and international connectivity.

1. **Intra-island connectivity issues** exist between economic centres on the same island. In provinces in eastern Indonesia, there is a lack of basic infrastructure to start with. Large-scale projects are needed to address intra-island connectivity, and the Indonesian government has proposed plans to connect cities with railway networks on
Sulawesi and Kalimantan. Meanwhile, on the most populated island of Java, traffic congestion between the major cities of Jakarta and Surabaya delays the movement of goods by truck. Efforts to bypass traffic congestion include the construction of the Trans Java toll road and moving cargo onto ships. However, an alternative shipping route has been unsuccessful because of a lack of investment in the "roll on-roll off" facilities ports need to accommodate this mode of sea transport.

2. **Inter-island connectivity** refers to gaps between economic centres on different islands. The main mode of transport is shipping, and ports have become critical infrastructure on which the economies of some islands are dependent. Therefore, the agenda for improving connectivity between islands focusses on developing more efficient and better-quality port facilities, lowering shipping costs and increasing the reliability of shipping services. The 'backhaul' problem also increases the cost of shipping cargo throughout the archipelago. Ships returning to Java from eastern Indonesia haul small amounts of cargo back, often only 10 percent of their cargo capacity.

3. **International connectivity** is a yet more complex issue. Increasing connectivity with other markets involves improving pathways for both import and export. Efficient international connectivity gives Indonesian products access to an international market. As Indonesia advances its manufacturing exports, it will need to increase the efficiency of its supply chain so it is competitive with other countries. Well-designed infrastructure can help keep transport costs low, which in turn helps keep products at a globally competitive price. For imports, it is about giving Indonesian manufacturers and consumers more affordable access to international products, which is particularly important for technology products required by industry.

A mix of administrative policy and the poor quality of hard infrastructure contributes to connectivity gaps with the region.

Jakarta's port - Tanjung Priok - is the hub of international movement of goods to and from Indonesia, handling approximately 70 percent of international trade. Despite being Indonesia's largest and most advanced seaport, it suffers from congestion and administrative inefficiencies that make it a serious bottleneck. To alleviate pressure on Tanjung Priok, an additional terminal is under construction and facilities like the Jakarta International Containers Terminal (JICT) have been upgraded to handle larger ships. An alternative port is planned for development at Patimban, 100kms east of Jakarta. However, instead of relying solely on the construction of more port infrastructure, the Indonesian government can prompt a big efficiency leap by streamlining and speeding up customs and inspections processes.

The Indonesian government needs to make sure I&C initiatives pursuing projects across its islands understand these different connectivity issues, and that they are aligned to the type of projects needed to close gaps in a particular location. To be effective, projects must be able to integrate with other projects and existing infrastructure. For example, seaports need to be connected to hinterland areas with roads and rail.

Connecting such a large archipelago is a major task that will require new and innovative partnerships to solve the problems summarised above. Opportunities exist to initiate partnerships between business, government, and the state owned sector to deliver quality infrastructure projects in such a challenging geography. I&C needs are not limited to transport infrastructure either. Other sectors, notably the power sector under the 35 gigawatt plan, needs significant investment to bridge gaps in power supply. Partnerships will be key, because Indonesia cannot successfully rely on only one sector to develop I&C projects.
Map 1. Map of connectivity infrastructure projects in Indonesia
Building Bridges: Navigating Indonesia’s Infrastructure Choices

Source: Google Earth

- Road, Highway and Toll Road Projects
- Belt and Road Projects (Proposed and Active)
State owned enterprises (SOEs) currently dominate the construction and management of Indonesia’s I&C projects. One measure indicates SOEs are involved in 80 percent of the country’s infrastructure projects. Awarding infrastructure contracts to SOEs is a fast way to break ground on new projects because the government does not have adequate time to prepare a ‘bankable’ project proposal which requires going through a long, competitive tendering process to select a private partner and contractor. It is also attractive because in most cases the government has direct influence over the SOE. This gives them a political advantage. Politicians can apply pressure on SOEs to deliver projects within political term. For example, using finished projects as political capital and the promise of projects as leverage to help during re-election campaigns.

While using SOEs might offer short-term advantages, they present longer-term challenges for the overall development of high-quality infrastructure. Relying too much on SOEs crowds out much-needed private investment, undermines the benefits of competition among contractors, and limits the overall amount of resources available for I&C investment. Indonesian industry groups have expressed concern about the Indonesian government’s over-reliance on SOEs. Private companies are mostly engaged in infrastructure projects as sub-contractors under a state-owned primary contractor.

SOEs will continue to be important providers of infrastructure, especially in higher-risk domains where public investment is needed to address market failures. However, broader SOE reform is needed in Indonesia to create a more even playing field, and provide competitive contracts to private firms with a business interest in the development of I&C projects. Involving the private sector in investment, however, will require the Indonesian government to take steps to make sure projects are well-designed to draw the attention of private capital. It will also have to address investor concerns about sovereign risk and potential changes to regulatory regimes.

To attract private capital, diversify funding and encourage involvement of private enterprise in the construction of infrastructure, Indonesia needs to increase its technical capacity to identify, design and develop ‘bankable’, or investment-ready projects. A project is considered bankable if lenders are prepared to provide finance or if equity investors are satisfied enough with the project’s risk profile to take a stake in the project.

Indonesian infrastructure projects need to solve the ‘bankability’ problem to attract more investment.

A project’s ‘bankability’ is determined at the project development phase. A number of details go into a project proposal to make it investment-ready, for example:

- Clarity on the regulatory, legal, and institutional environment within which the project exists
- Accurate estimates for implementation cost and profitability
- Defining and estimating the potential engineering and financial challenges of the project
- Conducting feasibility studies that examine the project’s potential environmental and social impact
- Identifying community stakeholders and engaging them early in project design
- A clear definition of the desired outcomes of the project
- Assessing the suitable options for financing the project and the right mix of public and private partners.

An array of technical skills and professional expertise goes into designing investment-ready I&C projects: encompassing skill sets from knowledge of the trades to construction, engineering and business planning. A key
consideration for Indonesia moving forward is developing its capacity and a strong skills base for its workforce. Indonesia should select I&C initiatives that provide technical assistance at the design stage for the kinds of projects the country has less experience planning. The Indonesian government should particularly focus on receiving technical assistance for projects that have potential to be commercially viable.

The Asian Development Bank (ADB) has long provided technical assistance for infrastructure projects in Asia. Fortunately, other regional I&C initiatives have also begun to offer it, particularly the national programs BRI, IDFC, and PQI (See Table 1). Selecting the right initiative for technical assistance should be based on what successful projects the initiative has delivered in the past.

Building its capacity, Indonesia can then work towards expanding its pipeline of high-quality bankable projects for the private sector and I&C initiatives to assess as investment options. The government should ensure detailed project proposals are provided that help financiers determine risk.

While the Indonesian government has made progress in addressing corruption through the Corruption Eradication Commission (KPK) and court processes, corruption and inefficiency still present significant risks for I&C development. As infrastructure spending increases, the risk for misappropriation or misallocation of funds likewise grows. In 2017, an estimated Rp 1.5 trillion was lost from the infrastructure budget through bribes and misappropriation, more than twice the amount of losses in 2016. Indonesia’s Corruption Eradication Commission (KPK) and Indonesia Corruption Watch (ICW) found transportation infrastructure projects to be the most vulnerable to cash losses and exploitation.

SOEs pose higher risk for corruption and waste, and there are a number SOEs currently engulfed in graft investigations. One example is at the state-owned construction company PT Waskita Karya, whose employees lost up to Rp 186 billion of state funds by paying subcontractors to undertake fictitious work. Other SOEs in the oil and gas, power, telecommunications, agricultural and chemicals sectors have been embroiled in corruption cases. Solving this problem extends beyond the I&C policy domain, and requires addressing structural issues in the political economy of the Indonesian state-owned sector. However, SOE reform and the placement of safeguards in infrastructure projects can help manage risks.
Indonesia’s Infrastructure and Connectivity Policy Landscape

The Presidential Administration of Joko “Jokowi” Widodo has made I&C development a major policy focus. Jokowi’s enthusiastic and well-publicised support for infrastructure projects has contributed to his popular appeal as a national leader. According to one opinion poll, almost three-quarters of Indonesians approve of Jokowi’s efforts to deliver infrastructure projects, with approval stronger among rural Indonesians. Professional assessments of Jokowi’s progress on I&C projects are generally positive. Overall, Jokowi’s policies have stopped the infrastructure deficit from sliding back, but the government still needs much more investment to close infrastructure gaps.

In 2014, Jokowi articulated a national project for Indonesia to become a maritime hub under his concept of Poros Maritim Dunia, or ‘Global Maritime Fulcrum’. The project includes addressing inter-island connectivity and infrastructure gaps, strengthening Indonesia’s maritime economy. Proposed connectivity projects related to Jokowi’s maritime doctrine include the development of a string of ports connecting Java with eastern Indonesia.

In 2016, Jokowi rolled out the National Strategic Projects, a list of priority infrastructure projects identified as a foundation for future I&C development to accelerate Indonesia’s economic growth.

Attracting foreign investment in I&C is another prominent feature of Jokowi’s foreign policy agenda. The outcomes of his official visits to Indonesia’s main trading partners like South Korea often feature official pledges to increase investment in infrastructure. His administration has offered China options to invest in a range of 28 projects in four provinces under the banner of the Belt and Road Initiative (BRI).

The Jakarta Mass Rapid Transit (MRT) opened in March 2019
During his re-election campaign, the first presidential debate began with a discussion on infrastructure. Jokowi took the opportunity to highlight the advancement of infrastructure under his administration, including the numerous new highways, airports and seaports built under his watch. One of the most substantial projects completed during his tenure as president and previously as Governor of Jakarta is the much-needed Jakarta Metro Mass Rapid Transit (MRT). Phase 1 of the project is complete and opened for operation on 24 March 2019. Although more infrastructure is required, the MRT is considered a much-needed step in addressing congestion in the capital city of Jakarta, ranked the third-most traffic congested city in the world.

Jokowi has and successfully used his platform to promote the advancement of Indonesia’s I&C development, giving his government’s infrastructure drive national and international attention. However, as geopolitical tensions increase and governments continue to use infrastructure as a tool of influence, Indonesia will have to navigate risks associated with each I&C initiative. Indonesia’s interactions with the Belt and Road Initiative illustrates these challenges.

Of all Indonesia’s I&C projects, those connected with China’s BRI have been the most controversial. Head of Indonesia’s Investment Coordinating Board, Thomas Lembong, has been outspoken about the initiative’s shortcomings on one hand, but on the other acknowledges that his country needs BRI investment, among others, to close its infrastructure gaps. He points to one high-profile BRI project that has failed to deliver results as a prime example of the initiative’s flaws: the Jakarta-Bandung high-speed rail. The project has suffered delays stemming from land procurement problems. However, Indonesian officials are also frustrated by the lack of information and data available to them to monitor progress of the project, leading Lembong to characterise the management of the project as non-transparent.

The project has become so controversial that it emerged as a talking point during the 2019 elections. Presidential candidate Prabowo Subianto during a debate said he would review Chinese investment in Indonesia, particularly the Jakarta-Bandung rail project. Jokowi instead shied away from directly addressing the rail project in debates, instead pointing to the overall volume of infrastructure delivered during his tenure as president.

A common complaint often levied against BRI projects in other countries is that they bring in their own workers rather than employing locals. This reputation strikes a nationalist nerve in Indonesia, and compounds pre-existing anti-Chinese sentiment. Misinformation on social media about the presence of Chinese workers in the country is widespread. The reality is that Indonesia employs little foreign labour to begin with, making up less than one percent of Indonesia’s labour force. While BRI investors should seek to engage the local community and can take steps to manage its reputational problems, this will likely be an ongoing problem for the initiative in Indonesia.

Another of BRI’s reputational problems is that its financing may constitute ‘debt traps’, where a donor government lends unsustainable amounts of credit to smaller countries to give the creditor an influential advantage. In Indonesia’s case, it has maintained a cautious approach to foreign debt and is likely to resist pressure to take on high levels of foreign debt for I&C projects.
Indonesia has laid out general principles about the conditions under which it will accept finance for I&C projects, but it needs to clarify them further. In reaction to the reputational challenges of initiatives like BRI, Indonesia has spelled out the following guidelines for investors to:

1. Adhere to standards for environmentally-friendly operations
2. Employ Indonesian workers
3. Facilitate technology transfer to local partners
4. Offer economic benefit to Indonesia
5. Insistence on business-to-business (B2B) loans rather than government-to-government (G2G)

These guidelines may be a good foundation for an infrastructure investment policy, but the government needs to specify how they will be translated into concrete policies and administrative decisions. Some of the principles above do not appear to apply across the board. For example, Indonesia’s insistence on B2B loans rather than G2G seems not to apply in some cases. For example, the Cisumdawu toll road project in West Java is funded by two G2G loans from Chinese partners worth $469 million.

Indonesia has offered investment opportunities for BRI in four provinces with major I&C gaps. During a 2018 visit to Beijing for the Belt and Road Trade and Investment Forum, Indonesia’s Coordinating Maritime Affairs Minister Luhut Pandjaitan signed contracts and MOUs with China for future projects focussed on four provinces or ‘economic corridors’:

- North Sumatra
- North Kalimantan
- Bali
- North Sulawesi

However, BRI projects do not appear to be limited to these provinces. Other projects branded as BRI initiatives exist in West Java, like the Jakarta-Bandung rail project and other provinces like Central Java (See Map 2 on next page). Of the provinces where projects were offered, North Kalimantan and North Sulawesi are particularly isolated and in need of connectivity internationally and with other provinces.

The chief advantage of BRI to Indonesia is the volume of capital available to the initiative to channel into economically important I&C projects. If deployed correctly to well-designed projects, BRI investment has the opportunity to improve significantly Indonesia’s connectivity with China, lowering overall non-tariff trade costs between the two countries (see Figure 1). Risks involving BRI include limited transparency, security concerns regarding projects with a combination of military and civilian uses; and that through BRI, China could use its investment for geopolitical influence.

Even though BRI is controversial and its investment carries a number of risks, Indonesia will still need the resources it offers to address its infrastructure gaps. BRI investment comes with an advantage: it is willing to develop projects in high-risk provinces where there is little infrastructure to begin with, a pervasive problem in Indonesia particularly in the eastern archipelago. The question is, then, how can Indonesia manage geopolitical risks like those BRI poses?
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Map 2. Belt and Road Projects in Indonesia (Proposed and active)

- Belt and Road Projects (Proposed and Active)
- Economic corridors where BRI projects have been proposed
Building Bridges: Navigating Indonesia's Infrastructure Choices

Source: Google Earth
Geopolitical Risks for Indonesia

Infrastructure has arisen as a new stage for geopolitical competition. Major powers are using I&C initiatives for more than economic purposes alone. These initiatives also serve as a tool to achieve the diplomatic and strategic objectives of donor governments. They come with a number of geopolitical risks despite their utility for closing infrastructure gaps: they allow governments to make diplomatic side-payments, re-shape patterns of economic dependence and institutional architecture. The Indonesian government is aware that I&C initiatives can be and are used for diplomatic influence and leverage. Moreover, geopolitical tensions spilling over into I&C delivery can exacerbate the challenges Indonesia faces above, specifically the bankability problem.

Indonesia’s government, like other Indo-Pacific governments, will need to make decisions with a view to manage geopolitical risks tied to I&C initiatives.

Indonesia has a strategic location at the geographic core of the Indo-Pacific region. Indonesia’s maritime territory grants access to the Pacific and Indian Oceans. Important sea lines of communication, like the Strait of Malacca, between Sumatra and the Malaysian peninsula, is both a major trade route and a strategic ‘choke point.’ Practical alternative routes include the Sunda Strait between Java and Sumatra and the Lombok Strait, also lie within Indonesian maritime territory. The current geopolitical context has raised the value of control over access to the Indian Ocean. China’s so-called ‘Malacca Dilemma’, its vulnerable reliance on the Strait of Malacca for supply of energy, is an example of this.

Different I&C initiatives will seek different outcomes for their sponsored projects in the Indonesian archipelago. So far, BRI projects in Indonesia have focussed on applying Chinese industrial expertise to projects like smelters, power plants, and steel mills. In connectivity, Chinese finance has gone to toll roads rather than major seaport projects, as it has in South Asia.

China tends to see sea lines of communication passing through the Indonesian archipelago as risky. This has led to BRI investment in projects that develop alternative overland and sea routes, mostly to secure China’s energy supply and bypass the need to traverse the Malacca Strait or other chokepoints in the Indonesian archipelago. BRI projects have focussed on Indian Ocean ports in Myanmar, Pakistan, and Sri Lanka.

While BRI has had a high public profile, Japan’s national initiative, Partnership for Quality Infrastructure (PQI) has been a quiet achiever. Delivering infrastructure investment through the Japan International Cooperation Agency (JICA), Japan Bank for International Cooperation (JBIC) and additional contributions to the Asia Development Bank (ADB), research surveys show Japan is still outspending China in infrastructure in Indonesia. PQI’s orientation in Indonesia has been on advanced urban infrastructure, like mass transit and high-speed rail in densely populated areas like Jakarta and West Java, and power generation.

Newcomers to the landscape of I&C initiatives, like the recently-announced International Development Finance Corporation (IDFC) from the US, have yet to invest in projects or articulate a plan for the kinds of infrastructure it will seek to finance in Indonesia.

Indonesia’s political and economic position makes it a key partner for governments seeking to pursue an agenda in the Indo-Pacific region. Indonesia is the largest member of the Association of Southeast Asian Nations (ASEAN) and hosts the secretariat. Because of its standing, some countries view Indonesia as the de facto leader of the regional organisation. Through its ‘global maritime fulcrum’ concept, it seeks to position itself politically and diplomatically...
at the crossroads for the array of overlapping regional economic initiatives, like the Regional Comprehensive Economic Partnership (RCEP) and the Indian Ocean Rim Association (IORA)\(^42\).

Indonesia’s influential position at the core of the Indo-Pacific means any government seeking to pursue an agenda in the region needs to be able to collaborate with Indonesia to move its initiatives forward. At the same time, this puts Indonesia at risk of having its I&C needs become a ‘battleground’ for geopolitical influence in the region. In this scenario, competing initiatives attempt to outbid the other, leading to unrealistic proposals for the cost and completion time of a project. This kind of competition was witnessed in the bidding war between China and Japan for a contract to build the Jakarta-Bandung High Speed Rail project\(^43\).

**Case Study:**

**Jakarta-Bandung High Speed Rail**

This BRI-branded project is a joint venture between Indonesian and Chinese SOEs. China won the project contract after an aggressive bidding war with Japan. Indonesia signed an initial $4.5 billion loan agreement with the China Development Bank (CDB) in 2017. The project has faced a range of problems from its early stages, including doubts about the project’s financial viability and the accuracy of projected passenger usage when in operation\(^44\).

To undercut Japan’s offer, China’s bid offered extraordinary lending rates and unrealistic timelines for project completion\(^45\). It did not require a government guarantee to back the loan\(^44\). China also did not enforce its original insistence that all the land needed for the project had to be legally acquired before a loan agreement could be signed. CDB compromised by setting the deadline for land procurement for December 2017\(^44\). Land procurement has been an ongoing issue and is the main cause of delays. As of February 2019, 85 percent of the land for the project has been settled\(^44\).

Since ground breaking in 2016, a number of revisions have been made to the project’s original plan including details like the speed of the train, number of stations, and proposed expenditure. The construction company moved the target operation date from 2019 to 2020 and again to 2021. Cost estimates went up from $5.5 billion to $6 billion. Jokowi in 2017 reviewed the project’s financing and proposed changes in shareholding composition. To lower Indonesia’s exposure to risk the review proposed reducing its stake in the project to 10 percent while China would own the rest\(^44\).
Despite the problems with competition between initiatives, it is important to note that the range of I&C initiatives do not pose Indonesia with an either/or choice. There is not one initiative that on its own has the capability and resources to fill all of Indonesia's infrastructure gaps. To take advantage of the range of seemingly competing programs, Indonesia should choose an approach that identifies the individual strengths and capabilities of the initiatives and matches them to the right menu of projects. This will avoid the kind of counterproductive bidding wars that result in unrealistic proposals, which in turn undermine project bankability.

Indonesia's infrastructure choices are more about efficiently allocating the resources these initiatives have to offer, rather than picking winners project-to-project.

Avoiding an either/or approach and eschewing bidding wars is a part of the long-term management of geopolitical risk. The Indonesian government has an opportunity to shape how the I&C initiatives interact with each other as they address the infrastructure gap.

Indonesia is in a unique position to build linkages between the I&C initiatives. This extends from Indonesia's vast I&C needs and its status as a strategically and economically important country. Indonesia is in a flexible position, not being beholden politically or economically to any one major power, to push for joint projects. Its geography and need for multiple modes of transport infrastructure means the government will need to coordinate different projects delivered by different initiatives. For example, the proposed port at Patimban in West Java will need to connect to major rail or road projects if it is going to relieve congestion at Jakarta's Tanjung Priok port successfully.

Another opportunity exists to channel I&C finance through Multilateral Development Banks (MDBs) with strong governance frameworks. For one example, Indonesia can encourage BRI projects to disburse funds for I&C projects through the Asian Infrastructure Investment Bank (AIIB), where they will be subject to the approval of AIIB board members who represent its member countries. Indonesia is in a position of influence as a founding member of the AIIB. The advantage of this approach is that AIIB has modelled its governance structures on existing multilateral development banks like The World Bank and Asia Development Bank (ADB). While the bank’s governance structures have yet to be tested, this approach also presents an opportunity for Indonesia to work with other members of the bank to help ensure positive contributions to I&C needs in the region.
Using the AIIB as a mechanism for infrastructure financing will also help manage BRI’s reputational challenges in Indonesia.

Government decentralisation poses a geopolitical risk for Indonesia. Since Indonesia began its transition to democracy, it undertook a number of reforms known as ‘decentralisation’\(^59\). These reforms delegated authority and financial resources from the national to provincial and local governments. A wide range of decision-making and responsibility for service delivery in areas like transportation and public works became the remit of subnational governments.

While decentralisation gives subnational governments the authority to meet infrastructure needs at a grassroots level, this kind of discretion is also prone to misuse and inaction. Lacking capability to use infrastructure funds given to them from the national government, local authorities are unable to spend the cash on projects\(^51\). Decentralisation also makes it possible for local governments and politicians to seek out external support for their own infrastructure projects. In other countries, this has led to poorly designed projects and financing arrangements without supervision from a central government and existing outside of good-governance frameworks\(^52\).

Keeping subnational governments engaged and contributing to the project pipeline will be important in closing infrastructure gaps. Local and provincial governments are in a good position to take stock of the infrastructure needs in their own areas. However, Indonesia’s national government will need to take steps to build capability at the local level and to make sure their subnational counterparts are developing bankable I&C projects which fit within the national guidelines and goals.

### Table 2. AIIB Projects in Indonesia

<table>
<thead>
<tr>
<th>Project</th>
<th>Financing</th>
<th>Location</th>
<th>Partnership</th>
<th>Type of Cooperation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia National “Urban Renewal” Project</td>
<td>$216 million</td>
<td>Selected cities</td>
<td>The World Bank</td>
<td>Implementation support, technical assistance, and loan</td>
</tr>
<tr>
<td>Mandalika Urban and Tourism Infrastructure Project</td>
<td>$248.4 million</td>
<td>Mandalika, Lombok</td>
<td>Indonesia Tourism Development Corporation</td>
<td>Technical Assistance, Loan</td>
</tr>
<tr>
<td>Strategic Irrigation Modernization and Urgent Rehabilitation Project</td>
<td>$250 million</td>
<td>Selected regions</td>
<td>Water User Associations Federation</td>
<td>Loan</td>
</tr>
<tr>
<td>Dam Operational Improvement and Safety Project Phase II</td>
<td>$125 million</td>
<td>63 priority dams/reservoirs</td>
<td>Ministry of Public Works</td>
<td>Loan</td>
</tr>
<tr>
<td>Regional Infrastructure Development Fund Project</td>
<td>$250 million</td>
<td>Selected areas</td>
<td>PT Sarana Multi Infrastruktur (PT SMI)</td>
<td>Direct lending to subnational governments</td>
</tr>
</tbody>
</table>

Recommendations

Indonesia’s infrastructure gaps constrain its economic development and integration with the Indo-Pacific region. The scope of the problem is region-wide, and governments have responded with a range of I&C initiatives to provide capital, technical assistance, and regulatory dialogues to address these gaps. However, these I&C initiatives are increasingly used as diplomatic leverage by donor governments and as such carry certain geopolitical risks. As a result, Indonesia is faced with ‘infrastructure choices’, how to take advantage of these I&C initiatives while at the same time managing geopolitical risks associated with them.

There is no universal I&C strategy that can be applied to answer Indonesia’s diverse infrastructure needs. The cause and effect of infrastructure gaps are complex. The geopolitics of I&C initiatives add yet another layer of intricacy. As this paper has outlined, there are some general principles that will help Indonesia make informed infrastructure choices.

- Indonesia has large and distinctive infrastructure and connectivity needs that are unlike any other Indo-Pacific country. This means the government will need to coordinate integrated infrastructure projects that solve its intra-island, inter-island, and international connectivity challenges. Recognising that the number of new initiatives the Indonesian government can draw on for infrastructure support does not present either/or choices, it is important for Indonesia to match corresponding strengths and specialisations of the new I&C initiatives with the appropriate projects.

- The SOE sector needs broader reforms to level the playing field with the private sector and foreign companies and to prevent loss of funds as infrastructure spending continues to increase. The Indonesian government should offer competitive tenders for I&C projects and encourage more private sector competition. These tenders need to be genuine and encourage private sector participation.

- Indonesia needs to solve the ‘bankability problem’ through capacity building in the Indonesian workforce for skills that contribute to I&C project design and management. Improving project ‘bankability’ will attract more private investment and lead to high-quality infrastructure delivery. The government can seek technical assistance from new I&C initiatives that offer it for high-risk projects.

- On the geopolitical front, Indonesia can manage the risk through avoiding pitting I&C initiatives in bidding wars. Tensions can be reduced through Indonesia building linkages between initiatives and encouraging national programs to disburse funds through established MDBs. Finally, the government decentralisation policy has geopolitical implications. Subnational governments are at risk of having poor projects designed for political purposes, and the national government should work closely with their subnational counterparts on their I&C needs and ensure bankable projects are developed.

The fact that Indonesia is in such a good position to reduce geopolitical tensions and build linkages between I&C initiatives is a testament to the progress Indonesia has made in its economic and diplomatic spheres. Its strategic location makes it a linchpin for regional connectivity, and therefore a disconnected Indonesia is a disconnected region. If Indonesia can use its standing to promote cooperation between initiatives, it will set a precedent for I&C development in the rest of the Indo-Pacific region.
Endnotes


4 Ibid.

5 Ibid.


8 Ibid.

9 Ibid.

10 Ibid.


13 Ibid.

14 The Economist (2018), Indonesia’s leader, Jokowi, is splurging on infrastructure, 5 May. Available at https://www.economist.com/asia/2018/05/05/indonesia-lader-jokowi-is-splurging-on-infrastructure


16 Ibid.


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24 The Economist (2018), Indonesia’s leader, Jokowi, is splurging on infrastructure, 5 May. Available at https://www.economist.com/asia/2018/05/05/indonesia-lader-jokowi-is-splurging-on-infrastructure


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