WOOD MARKETS ASIA

Trends, Issues and Market Opportunities 2005-2010

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INDONESIA: AN INDUSTRY IN CRISIS

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Background

Indonesia is a large and diverse country of some 17,500 islands, a population of 241 million, a workforce of 110 million, per capita GDP USD 3,500 (2004) and a GDP growth rate of 4.9% (2004).

Indonesia is known for its forest resources, which cover about 60% of land area, and the growth of its wood processing exports, particularly plywood and more recently pulp and paper. It is also known for the exploitation of this resource and the concerns expressed about long-term sustainability.

What is probably overlooked is that Indonesia is a significant market for wood products in its own right. Estimates from the late 1990’s had this at over 50 million m³ (roundwood equivalent – RWE), comprising mostly sawn timber for construction, remanufacturing, packaging, as well as plywood, paper and roundwood.

So what opportunities does this offer for the New Zealand forestry and forest products sector? First let us look more closely at the factors shaping the Indonesian forestry sector – resource availability, production and processing capacity, and the impact of illegal logging.

Resource

Indonesia’s forests covered some 162 million ha’s in 1950, reducing to 98 million ha’s in 2000 (40 million of which has been affected by some degree of logging). While the long-term average annual rate of deforestation is 1.3 million ha’s, the rate has been increasing over 10-15 years to reach 1.6-1.8 million ha’s during the 1990’s. By 2000 the rate had further increased to 2.1 million ha’s, with 2.4 million ha’s estimated for 2002.

With devolution of the authority to manage natural resources to the regions, the Ministry of Forestry has effectively lost control of forest resource allocation. “Illegal” licenses are granted by local authorities and Ministry of Forestry officials. Jakarta has been trying to reassert some authority, but local administrations in some regions are effectively ignoring orders and regulations made by the central government.

However, of greatest concern has been the decline in the protection forest estate – forest reserves are now seen as being one of the richest sources of quality logs, and are the target of extensive illegal logging activities. Data from the late 1990’s estimated that some 28 million ha’s of protection and reserve forests remained as at 1996, a decline of 11.5 million ha’s since 1984 (compared with a net decline in production and conversion forest of some 1.2 million ha’s over the same period). The rate of decline within these reserves will have increased with the increase in illegal logging since that time, as well as with increased population pressure on these resources.
In a country with a population of over 200 million there are many people seeking that extra bit of land on which to grow a crop and make a living. As an example, one forest park in South Sumatera with an area of 350,000 ha’s has some 15,600 squatter families living within it. Some of these families have obtained forest management rights, and the local Ministry of Forestry office has been accused of selling concession rights to logging companies. So in addition to illegal logging within the park, there has been land clearing for the planting of cassava, cocoa and coffee crops. Estimates of damage to the park range from 50-175,000 ha’s. Consequences from such destruction are not limited to the forest itself, but neighbouring farmers and communities often face water shortages in summer, and floods and landslides in winter.

The Government has implemented a number of programmes to try and reverse this decline of forest area (estimated at between 31-59 million ha’s of degraded forests). In addition to the industrial plantation programme (HTI – see below), funds have been set aside into what is known as the reforestation fund. This has grown to an estimated USD 1.17 billion and is intended to be used to help rehabilitate natural forests. However, concerns about the ability to manage these funds and effectively implement rehabilitation have limited their use to date. However, forest rehabilitation programmes are being implemented, with 251,000 of the planned 500,000 ha’s planted in 2004, and 750,000 ha’s planned for 2005. Community forestry programmes are also in place, and while there are numerous successes, the scale of planting (50,000 ha’s in the last 5 years) is insufficient to make up for the decline in natural forest area and production.

Concession Area and Log Production

This decline in forest area has had an impact on the number and area of forest concessions within the natural forest. These have declined from over 60 million ha’s in the early 1990’s when the sector was rapidly expanding, to a little over 20 million ha’s in 2003. This has seen a corresponding decline in the official log production statistics, with production peaking at over 30 million m³ in 1997, but dropping to approximately 10 million m³ in 2003 (note the natural forest allowable cut is approximately 5.5 million m³).
**Overcapacity**

This decline in resource availability has been set against spectacular growth in production capacity over the past 20 years. Since the late 1960s the Indonesian forestry sector has developed into one of the world’s largest exporters of forest products. Policies introduced in the 1980’s sought to shift Indonesia’s reliance on log exports to plywood, and as a consequence the plywood sector expanded rapidly to become the world’s largest exporter of plywood by the early 1990’s.

However the seeds for decline were sown during this period, with responsibility for the forest processing industry being transferred from the Forestry Department to the Department of Industry. The two Departments had essentially conflicting objectives, with the result that the Department of Industry issued licenses for the installation of new processing capacity without sufficient regard to the availability of adequate raw material. Furthermore, other government departments such as Agriculture, Mines and Energy were also pursuing policies for economic growth that often required large areas of forest to be cleared for plantation crops such as oil palm and rubber, and for mineral extraction.

Another key issue was that the industry was being developed almost entirely for the export sector, with little consideration to the rapidly expanding domestic market. This market in turn was served by a rapidly expanding domestic industry, often small mills which did not have their own concessions, and which were reliant on a supply of largely illegal logs, facilitated by access to selective logging concessions.

The Indonesian pulp sector also rapidly expanded during the 1990s, reliant initially on conversion forest with the intention of establishing plantation forests (HTI) on some of these cleared areas. There have been a number of notable successes, although overall the replanting of cleared conversion forest has been less than anticipated, with the result that demand is still high for logs from conversion forests.
Nevertheless, Indonesia is now set to become a significant exporter of hardwood woodchips from plantation forests. How has this come about? A number of the plantation forest developments were established without associated wood processing facilities, which were either to be established later, or which were planned but didn’t eventuate. These forest resources are now mature, and with no processing facilities nearby, Indonesian pulp and paper companies are buying these up, establishing export chip facilities and exporting the woodchips to their mills in China.

Consequently you have the situation where processing capacity has been developed over and above the ability of the existing forest resource to sustain it. Furthermore, while plantation forestry was intended to fill at least part of the long-term wood supply requirements, actual achievement of stocked area has been significantly behind targets.

This leaves the Indonesian forestry sector in an unenviable position of having processing capacity far in excess of legally available wood supply, and combined with a range of vested interests and enforcement problems, has lead to the explosion of illegal logging.
Illegal Logging – Indonesia’s Achilles Heel

Following the 1997/8 financial crisis, and in response to IMF requirements, log exports were reintroduced. While the official volumes were modest, significant volumes were illegally exported, particularly to Malaysia and China (shipments officially destined for mills in Java and Sumatera would somehow get “lost”, others would have the cooperation of officials, and some are smuggled). While the log export ban was reintroduced in 2003, and Indonesia has signed agreements with a number of countries to try and control the illegal trade, it still continues.

As an example, a recent report by EIA/Telapak (“The Final Frontier”) claims some 300,000 m³/month of merbau (kwila) logs are being exported illegally from Papua Province (Irian Jaya) to China alone. This is in addition to logs being supplied from other provinces and to other markets. While progress is being made with both China and Malaysia, agreement has stalled on the issue of illegal logging and the log trade, due to differences regarding the definition of illegal trade.

The industry is therefore facing very difficult times with declining markets, both in terms of volume and value, increased competition from lower cost producers (e.g. in China), overcapacity in the plywood sector, and illegal logs undercutting the cost of legal logs.

Nevertheless, steps are being taken to address the illegal logging problem, and the fact that the issue is publicly acknowledged and is being debated is a starting point.

The Ministry of Forestry has been canceling concession and plantation forest licenses, with the intention that these be on-sold to “more responsible” operators. They have also shut down processing plants involved with illegal log trade or exceeding production targets. Recent initiatives in Papua Province have confiscated logs, ships and machinery, and have resulted in the arrest of a number of businessmen and middle ranking officials from within the police, army, forestry, and customs.

The concession reform embarked on in 2002/3 sparked considerable debate within the private and public sectors in Indonesia. While many acknowledged the need for reforms, concern was expressed regarding the speed of change and appropriate motivation. The stated motivation for concession reform was that the government wants to cut the link between the processing industry and concessions, because profit is currently taken at the processing end. While they see potential benefits in being able to maximise earnings from the forests themselves for redistributing wealth, the desire to reduce the influence of the large corporations was also a factor. Nevertheless, some companies were concerned that concession reform could lead to supply constraints for existing industry, and an increase in illegal log trading.

More recently there have been reports that about 60% of the 115 plywood manufacturers in Indonesia have collapsed, and that more will close shortly unless the wood supply and illegal logging situation improves. Another source reported that in the last five years, 58 of 103 companies with forest concessions in east Kalimantan have gone bankrupt due the pressures of illegal logging.

These concerns appear to have been born out by recent events.

Unfortunately, while the problem of illegal logging is widely acknowledged, including the key causes, and steps are being taken to combat illegal logging, the issue remains that so many people are involved, and the consequences of significantly scaling back production will be felt by many involved legally and illegally within the sector.
**Indonesia’s Sustainable Forestry Future – does it have one?**

So where is the Indonesian forestry sector heading? While natural forest management will remain the backbone of the sector in the near term, it is likely over time that this will decline in size and significance. A number of companies are placing greater emphasis on the development of plantation forests, not only for pulp and paper, but also for solid wood end uses (plywood, saw timber, LVL, etc). They see the potential for a greater proportion of their industrial raw material requirements coming from plantation resources, with the natural forest supplying a smaller volume of higher value material for more decorative applications. However, at present they remain thwarted by the illegal log trade.

My view is that the plywood sector is slowly fading into the sunset, except for a minority of producers who have maintained their natural forest resource and/or are substituting other materials. However, whether they have the ability or opportunity to reinvent the sector remains to be seen. Sawn timber will remain important, at least for the domestic market and to supply raw material for value added processing. The pulp and paper industry looks set to continue dominating the sector, providing the plantation resource continues to expand, and is available for local processing and not exported as chip.

The main criticism has been that so long as the significant overcapacity in the sector is allowed to remain, and so long as there is rampant corruption and vested interests within the sector, then little real progress can be made. It would appear that the capacity issue is being addressed somewhat brutally in the plywood sector, the issue now remains to curtail the illegal export trade in logs and sawn timber to ensure ongoing resource availability.

**New Zealand Opportunities in Indonesia**

So what are the opportunities for New Zealand in Indonesia? Trade in 2004 between our two countries was approximately USD 330 million, with New Zealand exporting some USD 180 million of products to Indonesia – primarily forestry products including pulp, paper and furniture. Small volumes of radiata pine sawn timber and MDF are also being exported to Indonesia for furniture and moulding type products.

The two governments started discussing a Free Trade Agreement back in 2000/1, and while this has appeared to stall, it is back on the table for discussion in November of this year. Indonesia is particularly keen on trade in forest products, and with assistance in sustainable forest management.

So in terms of trade and investment, there are three potential spheres of opportunity:

1. New Zealand raw material supplies and manufactured products exported to Indonesia to replace dwindling local raw materials for re-export.

   Opportunities here might include plywood, although it is noted that the plywood manufacturing sector is not set up for radiata pine, and probably couldn’t compete with low cost suppliers such as China.
2. New Zealand raw materials and manufactured products exported to supply the Indonesian domestic market.

Indonesia does have a substantial domestic market, although it is well supplied at the lower end of that market. Opportunities here would include sawn timber and semi-processed products for manufacture, and higher end panel products. Note that while Indonesia is considered a comparatively poor country, like China and India it has a sizeable population, and the middle to upper classes have serious wealth.

3. Attract Indonesian manufacturers to NZ to relocate processing plants closer to sustainable supplies of raw material.

This was an option seriously considered by a number of companies over the past decade. The main issue now, apart from the sale of CHH, would be a lack of resource available in New Zealand for a world-scale plywood, MDF or pulp facility.

If all else fails, at least there will continue to be steady demand for New Zealand forestry consultants and expatriate management within Indonesia.

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