ISSUES PAPER

INDONESIA - MUCH PROGRESS MADE, STILL MORE TO BE DONE

In recent years, Indonesia has done much to open up its economy to international trade and foreign investment, and has also begun to tackle the serious issue of corruption. However, more work still needs to be done in these areas, as well as in deepening the bilateral relationship between our two countries.

Improving the Australia-Indonesia bilateral relationship must remain central to Australia's foreign and trade policy priorities.

Key building blocks include strengthening personal relationships at the political leaders' level, realisation of the broadly based Association of South East Asian Nations (ASEAN) – Closer Economic Relations (Australia-New Zealand or CER) free trade agreement and potentially a discrete, bold and comprehensive Australia – Indonesia free trade agreement.

Taken as a whole, after a decade of political instability, Indonesia is generally headed in the right direction - politically, with the movement toward pluralist democracy (although decentralisation of authority to the regions has not been without problems) and economically, in the form of focusing on trade liberalisation, industry competitiveness and fiscal consolidation.

Policy reforms undertaken over the past two decades should provide Indonesia with more solid commercial and economic foundations, and are likely to reduce the risk of the 'crisis a decade' which typified the nation in the first fifty or so years after Independence.

However, absent further reforms, particularly in areas such as trade and industry policy, and in tackling corruption, Indonesia is likely to be locked into an economic development and growth path well below its potential.

TRADE POLICY

Trade policy in Indonesia has by and large followed the conventional track of many developing countries.

First, protectionism from Independence through to the early 1980s, when external pressures (notably the ending of the oil boom) compelled a pro-liberalisation agenda.

The latter part of the 1960s and into the 1970s in Indonesia saw trade policies framed by economic nationalism, interventionist industry and trade policies funded by revenues from the oil boom and expansive use of both tariff and non-tariff barriers to deliver protection to favoured industries and firms.

International trade and foreign investment policy shifted in the mid 1980s from import-substitution and control, respectively, to export-orientation and promotion, respectively.

Unilateralism

In the latter part of the 1980s, Indonesia engaged in a program of unilateral trade liberalisation, which saw the rationalisation and reduction of tariffs fairly much across-the-board, and the removal of certain non-tariff barriers (NTBs), in particular those relating to import licencing and import monopolies.

As a result, the average (unweighted) tariff declined from 27 per cent in 1986 to 20 per cent six years later, whilst NTBs as a percentage of tariff lines fell from 32 per cent in 1986 to 17 per cent in 1990 and 5 per cent in 1992 (NTBs as a percentage of imports dropped from 43 per cent in 1986 to 13 per cent in 1990).

By the early to mid 1990s, the momentum of unilateral trade liberalisation slowed in the face of growing political resistance to further reductions in protectionism, and opposition to removing NTBs in sensitive sectors, such as agriculture and parts of manufacturing (motor vehicles, plastics and cement).

Another wave of unilateral liberalisation occurred in 1994 (coinciding with the year Indonesia hosted the APEC Leaders Meeting), focusing mainly on easing restrictions on divestment requirements and on foreign investment.

A further trade liberalisation package in 1996 saw average (unweighted) tariffs cut from 20 per cent to 12 per cent, and NTBs down from 5 per cent to 3 per cent of tariff lines, and to 12 per cent of imports.

At the end of the 1990s, the Indonesian Government tackled some of the most protected sections of manufacturing industry, in particular motor vehicles, through the removal of local content requirements and simplification of import licencing.

The trade-weighted average tariff for manufacturing in Indonesia (excluding oil and gas processing) fell from around 59 per cent to 16 per cent over the 1987 – 1995 period, whilst the dispersion closed from 102 to 39 per cent.

Indonesia also undertook considerable tarification of its trade barriers converting subjective and opaque non-tariff barriers into more transparent and measurable tariffs.

Other initiatives included two substantial devaluations of the Indonesia rupiah, the implementation of pro-liberalisation investment rules and an effective duty drawback scheme for exporters, and the elimination of the highly corrupt customs service (and its replacement with a transparent foreign service provider).

During this period Indonesia had also expanded the breadth and depth of its international commitments to trade liberalisation.

By the mid to late 1980s, Indonesia had made pledges to the ASEAN Free Trade Agreement (AFTA) and the Asia Pacific Economic Co-operation (APEC) grouping, including its subsequent (1994) 'free and open trade and investment by 2010/2020' objective.

Both of these arrangements played a positive role within Indonesian trade policy, both acting as instruments for those within the policy processes committed to external liberalisation to resist demands for protectionist interventions and also to advance their own reform programs.

Protectionism

By the early to mid 1990s, before the Asian financial turmoil at least, the influence of the 'economic nationalists' (a polite euphemism for protectionists) was waning, whilst that of the pro-market technocrats was on the rise in the form of growing numbers, more important individuals in strategic positions, and greater sway with the then President Soeharto.

The successful pro-liberalisation policies and strategies of regional neighbours and key trade competitors (notably China) had a powerful demonstration effect within Indonesia, and played upon concerns within Indonesia about the country's relative economic weaknesses and implications if they did not follow suit.

The Ministry of Industry, traditionally a focal point, and advocate for intervention, protection and regulation in industry and trade policy within the Indonesian Government, swung around to embrace liberalisation, competition and efficiency.

By the mid 1990s, the domestic constituency for export-oriented, pro-liberalisation policies was reasonably well-formed, with an increasingly well-organised and vocal domestic exporting community, complemented by recently arrived foreign investors.

At the same time, the cohesiveness, voice and resolve of the losers from reform had weakened considerably, and thus acted as less of a barrier to change than they had in the past.

Since the late 1990s, and in particular following the period of IMF intervention, (1997 – 2003), Indonesia has largely avoided any recidivism to protectionism.

A number of factors have played a role in restraining protectionism in Indonesia.

These factors include:

- the sustained decline in the real exchange rate (making exports cheaper and imports more expensive);
- the legacy of IMF conditionality which disciplined protectionist elements within the Indonesian Government;
- that the balance of economic activity has shifted from domestic markets to export competitiveness; and
- that fiscal austerity has limited the capacity of economic nationalists and rent-seekers to obtain public funding for their favoured (self-interested) projects.

These changes in the dynamics and frameworks for trade and related policy in Indonesia have been reflected in the improved performance by Indonesian exporters in winning and holding markets in developing countries, where their market share has generally shown an upward trend.

Indeed, for much of the period 1985 to 1995, growth in Indonesian exports was driven by increased market share (that is, supply-side factors, such as Indonesian price competitiveness), but since that time the source of growth has shifted to demand side factors (that is, dynamics in the import markets).

The IMF in its assistance/intervention packages mandated a structural adjustment program which included progressive reduction in import tariffs toward a range of 5 to 10 per cent, deregulation of the then existing general import licencing system (which covered key food commodities), and the termination of restrictive marketing cartels (for products such as cement, paper and timber).

Regrettably, signs of protectionism have reasserted themselves in Indonesia over the past five years, and in particular following the ending of the IMF conditionality associated with its assistance and loans packages.

Such protectionism has taken the form of higher tariffs on key products (such as wheat flour), more onerous regulations and licencing arrangements (textiles, steel and sugar) and expanded use of non-tariff barriers (in an opaque and subjective manner). The increased use of anti-dumping complaints can also be regarded as an indicator of neo-protectionism.

Multilateralism

Indonesia's multilateral trade policy, and in particular its attitude toward the World Trade Organisation, has been mixed.

By and large, the Uruguay Round of trade liberalisation negotiations had relatively little impact on Indonesia's unilateral reforms of the 1980s and 1990s.

Indeed, Indonesia had, by 1994, largely implemented a tariff liberalisation program in excess of its commitments made under the Uruguay Round.

Other reform commitments in areas like agriculture, services, import licencing and investment were achieved with seemingly little stress either relatively early or by 2000 at the outside.

However, Indonesia's commitment to multilateralism appears to have waned over the past five years.

Its advocacy and negotiating approach to the WTO's Doha Round has on the surface been to support multilateral negotiations, on the basis they give full account to the special interests and needs of developing and least-developed countries.

In its WTO negotiations on agriculture, Indonesia has emphasised the importance of food security and rural development, and called for the elimination of agricultural subsidies in developed countries as well as tariff reductions in developed and developing countries.

On manufactures, Indonesia has accepted the utility of further reductions in tariffs, provided doing so does not cause damage to domestic industries.

On services, and despite considerable international pressure, Indonesia has shown little interest in services trade liberalisation at home or abroad, whether in the form of the WTO's General Agreement on the Trade in Services (GATS) or the ASEAN Framework Agreement for Services (AFAS).

Elsewhere, Indonesia regards anti-dumping and safeguards measures as forms of contingent protectionism, to be invoked when the effects of trade liberalisation become (politically) painful.

Nevertheless, the Yudhoyono Government has adopted, at minimum, an open mind to bilateral free trade agreements, in contrast to its predecessors which showed little interest in such initiatives.

Whilst not expressly, or pro-actively, seeking such agreements (in contrast to its ASEAN colleagues in Singapore, Thailand and to a lesser degree in Malaysia), the Yudhoyono administration is sensitive to being 'left out of the game' and has developed a list of priority countries.

This country list includes the United States of America and Japan (for economic reasons) and Pakistan and Iran (being prominent Muslim nations), although the expectations of substance, both in terms of breadth and depth, vary considerably.

The Australian Government has, to its credit, taken steps to build on this interest in enhanced bilateral arrangements by initiating a joint scoping study with Indonesian counterparts into a discrete Australia – Indonesia Free Trade Agreement.

Such an FTA could either be a stand-alone instrument, or better still build upon the foundations of an ASEAN – CER FTA, which by definition would include both Australia and Indonesia.

FURTHER LIBERALISATION

Indonesia would stand to gain from pressing ahead with trade liberalisation, whether unilateral, bilateral, regional or multilateral. It should embrace the opportunities which present themselves.

Research by the World Bank shows bold trade liberalisation would likely deliver a range of positive dividends to the Indonesian economy, including:

- stronger economic growth;
- higher per capita incomes (and concomitant reductions in the incidence of poverty;
- an improvement in terms of trade (the ratio of export to import prices); and
- generally higher real wages.

Similarly, econometric modelling has shown the country would see its overall welfare (a broad proxy for economic growth and development) rise in the short term by around 1.5 per cent if it were to implement its Uruguay Round obligations only.

However, additional benefits could be found if Indonesia were to press ahead with a 'WTO-plus' program of unilateral liberalisation (adding another 0.7 percentage points to overall welfare), while AFTA reforms would add 0.1 percentage points (largely reflecting the substantial range of exclusions and phase-ins), and APEC-style liberalisation would add 0.6 percentage points.

Most of these dividends are realised through improvements in allocative efficiency within the Indonesian economy – removing barriers to resources (labour and capital) moving to their most efficient uses.

Looked at another way, beyond honouring their WTO obligations, the Indonesian Government would be well advised, if necessary, to sequence trade policy reforms as unilateralism, followed by APEC, followed by AFTA, though there is nothing to stop it pursuing reforms on all fronts at the same time.

FOREIGN INVESTMENT

An allied issue is foreign investment policy, and Indonesia's relatively poor performance (when compared to other south-east Asian nations) in attracting and retaining foreign direct investment (FDI).

While Indonesia performed very well in the early 1990s through to 1996 (that is, before the Asian financial turmoil) in attracting sizeable net inflows of FDI, post-turmoil it experienced substantial net outflows which persisted until 2003.

The positive inflow after 2004 was somewhat clouded by the Indonesian Government's program of privatisation of certain state-owned enterprises, especially to foreigners, and bank restructuring (which included the sale of distressed banks to foreign investors).

Other useful initiatives and reforms in more recent times include the simplification of FDI entry requirements, with some 70 governmental agencies establishing 'one stop shop' services to facilitate the obtaining of necessary operating permits and business set-up.

At the same time, the Indonesian Government has signed investment protection agreements with more than 60 countries, key features of most of which are guarantees against nationalisation and avoidance of double taxation.

As to the future, the Indonesian Government needs to take concrete steps to improve the country's international competitiveness as a destination for FDI, particularly for 'greenfield' sites. It cannot afford to continue to carry the reputation of having an investment climate which ranks amongst the worst in south east Asia.

While there is no single 'magic bullet' approach to attracting and retaining FDI, a suite of attractive policy settings should include greater legal certainty and objective enforcement of the law, and business- and investor-friendly labour laws.

It should also include:

- greater clarity in the absolute and relative responsibilities of the central and provincial/local governments;
- the substantial wind-back, if not elimination, of corruption; and
- significant improvements in the quantity and quality of key economic infrastructure, especially major roads and seaports.

TRADE COMPLEMENTARITY

While both Australia and Indonesia may have embraced, albeit in different formats and to differing degrees, economic liberalisation policies, the bilateral trade relationship has exhibited a general deterioration since the late 1980s - a pattern which accelerated following the

Asian financial turmoil of the late 1990s.

Australia's relative share of Indonesia's import market, which benchmarks our export performance in Indonesia against those of our competitors, has fallen substantially over the past decade or so, reflecting an under-realisation of Australia's export potential in the Indonesian marketplace.

Our trade complementarity with Indonesia, which measures the market match between our two countries (we are selling what they want to buy), has also declined over the past decade or so, although there are early signs of a modest recovery in this indicator of trade performance.

Relative Degree of Trade Intensity

The Relative Degree of Trade Intensity (RDTI) is a measure of Australia's relative share of Indonesia's import market. Importantly, it implicitly benchmarks Australia's export performance in Indonesia, against those of our trade competitors.

In quantitative terms, the RDTI is the share of Australian exports destined for Indonesia, compared with that country's importance as a global import market.

An index number for the RDTI of 1.0 indicates Australia is doing relatively better than its trade competitors in the Indonesian market. An index number below 1.0 suggests our trade competitors are outperforming us in the Indonesian market.

Figure 1 shows a general trend decline in the relative intensity of Australia – Indonesian trade from the late 1980s and to the late 1990s, before stabilising in the early 2000s. By the mid 2000s, the indicator was at around one half of the level of 15 years earlier.

Across the 1989-2005 period as a whole, Australia's RDTI (our market share performance relative to our trade competitors) fell by an average of just over 6 per cent per annum in trend terms.

Relative Country Bias

The Relative Country Bias (RCB) of Australian exports to Indonesia (see Figure 2) measures how well actual Australian exports to Indonesia realise Australian export potential in Indonesia, as indicated by the complementarity of Australian exports and Indonesian imports.

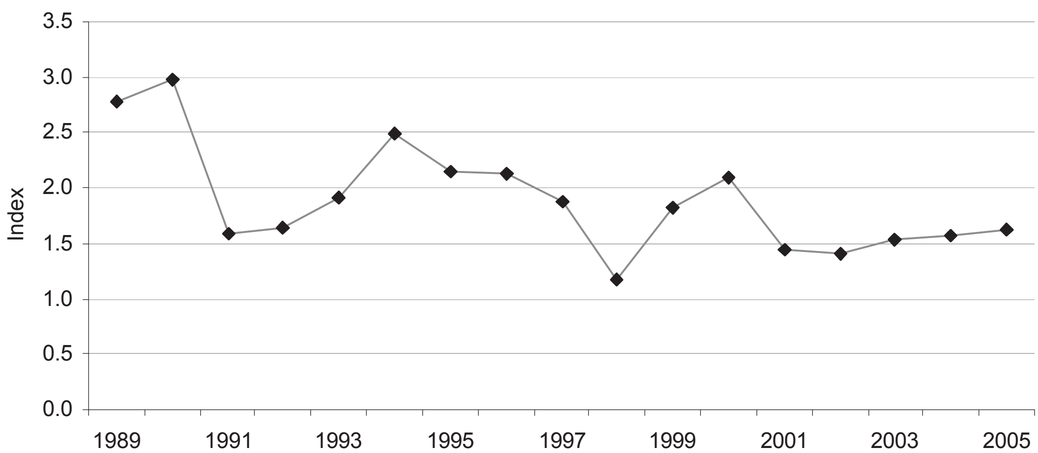
In quantitative terms, it is a weighted average of Australian market shares in Indonesia across a range of products and sectors to a similarly weighted average of Australia's global market shares.

An index number for the RCB of more than 1.0 indicates that Australian exporters are performing relatively better in the Indonesian market, for a given export profile, than they are in other export markets for a similar profile. An index number of less than 1.0 suggests a relatively inferior performance in the Indonesian market, compared to other export markets.

Figure 2 shows two distinct periods - the first from the late 1980s to the late 1990s when the indicator averaged around 1.4 and the second period following the Asian financial turmoil of the late 1990s when the indicator averaged just over 0.7, or around one half that of the previous period.

Looked at another way, the RCB declined by an annual average of around 5.3 percentage points over the 1989

Figure 1
Relative Degree of Trade Intensity



– 2005 period.

This pattern in Australia's RCB with Indonesia, suggests our exporters are doing relatively poorly in penetrating the Indonesian market than they are doing in other export markets. While the nascent upturn of the mid 2000s is welcome, there is still considerable distance to travel before we can return to the levels of a decade earlier.

Relative Degree of Trade Complementarity

The Relative Degree of Trade Complementarity (RDTC) is, in effect, a measure of market match between the Australian and the Indonesian economies – i.e. are we selling what they want to buy.

The RDTC compares the composition of Australian exports with that of Indonesia's imports, and measures Australian patterns of comparative advantage in export products/sectors to the shares of each product/sector in Indonesia's total imports.

An index number for the RDTC of more than 1.0 indicates a good market match (Australia is selling what Indonesia wants to buy, or they are buying what we want to sell). An index number below 1.0 points to the converse.

Figure 3 clearly shows a poor market match between Australia and Indonesia - we are not selling what they want to buy and they are not buying what we can sell.

This already weak market match has also deteriorated slightly since the late 1980s. After remaining fairly flat in the decade to the late 1990s, the RDTC dropped after 1997 (the year of the Asian financial turmoil). The RDTC post-turmoil was around 30 per cent below its pre-turmoil level.

KORUPSI, KOLUSI AND NEPOTISME

One of the greatest single problems besetting, and as such challenges confronting, Indonesia in realising its ambitions for robust and sustained real economic growth and development, is corruption and its close cousins collusion and nepotism.

These practices have undermined Indonesia's economic development and growth potential, and exacerbated the impact of, and the challenges in responding to, the Asian financial turmoil of the late 1990s.

Indonesia, as a nation, must, to the extent possible, eradicate the culture of korupsi, kolusi and nepotisme.

There have been improvements in the post-Soeharto era.

However to some extent, it would seem the centralised 'one stop shop' approach to corruption practiced during the Soeharto years has given way to a more fragmented, less organised system of bribe-eliciting involving substantially greater number of demandeurs from a broader spectrum.

Nevertheless, some useful steps are being taken from both outside and within Indonesia to wind back the scourge of corruption.

External initiatives include greater use of conditionality by international financial institutions such as the International Monetary Fund and the World Bank in their lending practices, demanding, in particular, commitments to, and tangible evidence of, decisive action to tackle corruption.

Bilateral aid donors are also increasingly insisting upon greater transparency in governmental operations before

Figure 2
Relative Country Bias

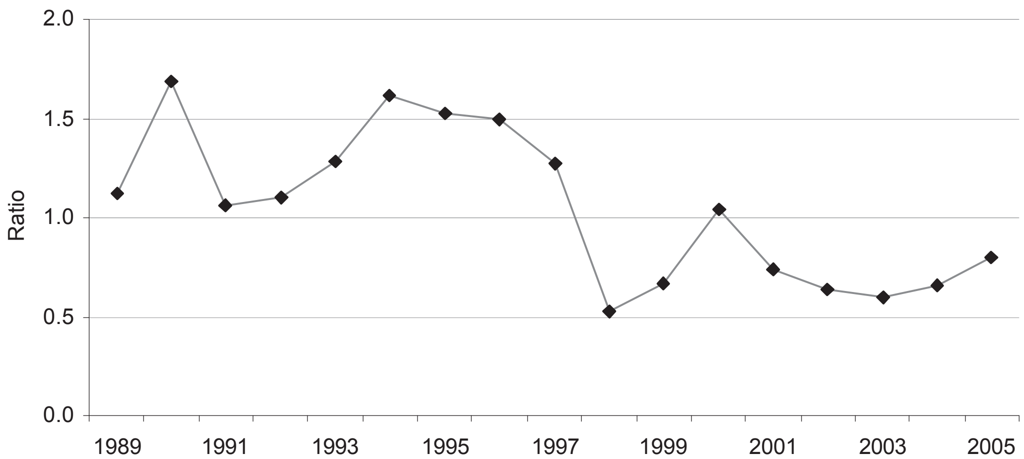
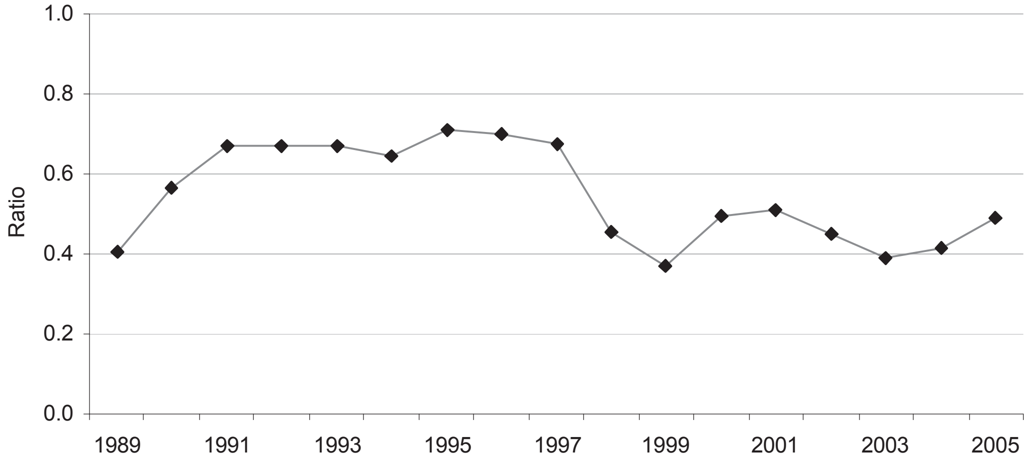


Figure 3
Relative Degree of Trade Complementarity



commitments will be made and delivered.

On the domestic front, President Yudhoyono issued Presidential Instruction No 5/2004, designed to accelerate the breadth and pace of corruption eradication by, inter alia, requiring government officials to make formal declarations of their wealth.

The Anti-Corruption Commission has made constructive proposals for civil service reform, the Supreme Audit Agency has undertaken some breakthrough audits of government agencies and public enterprises (and publishing the results thereof), and there have been a growing number of prosecutions (and convictions) for corruption.

Nevertheless, further measures are required. According to the World Bank, such steps include addressing discretionary and non-transparent FDI approval processes, tackling corruption amongst taxation and customs officials and reducing burdensome and intrusive 'site visits' by military and police agencies.

CONCLUSION

Indonesia is broadly headed in the right direction with its commercial, economic and political reform agenda.

The challenge now is to broaden and deepen these reform processes to consolidate the nation's future.

The transition to expansive democracy has taken place, most notably with the direct election of a President and the exit of the military from parliamentary representation.

The move toward greater economic and political decentralisation is underway, although some residual issues need to be dealt with, most notably the potential for the creation of intra-national barriers to trade and commerce.

Nevertheless, a number of important challenges remain, such as putting in place policy settings which seek to attract FDI, resisting nascent calls for interventionist and protectionist trade and industry policies, and decisive action to eradicate corruption, collusion and nepotism.

A mooted ASEAN-CER free trade agreement, or a bilateral free trade agreement with Australia, may help to address some of these issues.

The policy reforms undertaken to date provide Indonesia with a more solid commercial and economic foundation, and are likely to reduce the risk of the 'crisis a decade' which typified the nation in its first fifty years after Independence.

However, absent further reforms, Indonesia would appear to be locked into an economic development and growth path well below its potential.