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Vision Group enhancing EU-Indonesia Trade &
Investment Relations**

Synopsis report

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Document 1: Trade and Investment between EU – Indonesia Opportunities and Obstacles and Indonesian Trade with the EU: (IBM Belgium, July 2009)

Introduction to synopsis

Indonesia is South East Asia's largest economy and has the world's 4th largest population. Indonesia-EU trade and investment relations are strong and growing. This study and accompanying sector studies examined the reasons behind the relatively low level of EU trade and investment towards Indonesia, identifying drivers and constraints to expanded trade and investment.

The study also looks at the potential and opportunities offered by the Indonesian market, not only from the perspective of EU export interests, but also how EU goods, services, technology and investment could contribute to Indonesia's economic development and enhance the competitiveness of its industry.

The study says there are substantial opportunities to expand EU-Indonesia trade and investment. The size and growth on the Indonesian market are attractive to foreign exporters and investors. Leading EU exports to Indonesia have included capital goods, telecommunications equipment and different types of machinery and equipment.

Given fairly encouraging growth rates above 5 percent in Indonesia, the study predicts increased demand for capital investment for infrastructure and enterprises. Infrastructure needs in telecommunications and the roll-out of 3G, WIMAX and broadband internet access all represent expanding opportunities.

Investment in electricity generation is expanding including for large coal-fired power stations, geothermal energy and smaller back-up, community and SME generators. This is increasing demand for larger numbers of smaller power stations, including for renewable energy (solar, wind, biomass, mini-hydro) and for bio-fuel for power generation.

The report sees ASEAN development positively. It says increased investment by enterprises in capital equipment by enterprises is being stimulated by regional integration, which is expanding access to export markets and increasing competition in the domestic market. As Indonesia integrates into regional production networks both domestic and foreign enterprises will need to upgrade their capital equipment and enhance productivity to participate more actively in the dynamic growth of the region.

European manufacturers are exporting a broad range of machinery to Indonesia. Machinery and equipment for manufacturing and packaging food products and textiles have currently good prospects. The niche markets for European exporters of premium or branded consumer products are likely to experience strong growth.

International Context and Indonesian Development

During the global economic boom of 2002-2007, Indonesia returned to macroeconomic stability and experienced renewed economic growth. In the light of the severe international economic downturn which began in 2008, Indonesia showed that it was better positioned to face global financial uncertainties, maintaining positive growth rates of about 5 percent.

The report concludes that economic growth over the last 5 years has been good but not as high as that of China and India, due to relatively weak export growth, a declining world export market share, with FDI inflows lagging behind other ASEAN partner, [but the most recent FDI figures are encouraging with more than \$20 billion of FDI incoming in 2010]. The Report confirms Indonesia does have favourable factors supporting economic growth.

The EU is an important trading partner, but the level of EU trade and investment in Indonesia has been proportionally less than for other ASEAN countries relative to the size of the economy, primarily due to the relatively smaller role of FDI in the economy.

However the Report also confirms that there have been recent major increases in FDI into Indonesia, that the EU is the leading investment partners, and that the leading EU member states investing in Indonesia are the UK, the Netherlands, Germany and France.

Indonesia faced macroeconomic policy challenges to maintain growth and macroeconomic stability during the global downturn but emerged with a fairly robust performance including current account surplus.

Projections from World Bank and IMF indicate that Indonesia, like a number of key emerging markets, will return to higher growth (above the 5 percent growth it sustained throughout the crisis) more quickly and grow more rapidly than developed countries. Yet Indonesian economic growth is projected to lag somewhat behind China and India.

In the context of the 2009 global recession, Indonesia introduced temporary import controls on a range of products which could impede the achievement of better growth performance in the medium term. Indonesia is also increasingly using regulatory measures to boost local content in locally manufactured products.

Indonesia is engaged in international negotiations in the Doha Development Agenda (DDA) under WTO. It is also involved in ASEAN integration for trade in goods and services and in the implementation of ASEAN Plus FTAs with China, South Korea and Japan. FTA negotiations have been completed with Australia and New Zealand by ASEAN and are underway with India. The 14th ASEAN Summit made a number of significant initiatives to deepen ASEAN integration for trade in goods, services and investment and to expand the ASEAN Plus initiatives.

The report says that most of these FTAs focused primarily on trade in goods, with limited services components based on Indonesia's services commitments in the WTO.

Although the ASEAN and ASEAN Plus commitments represent progress, the report sees further scope for liberalization of services and investment.

Indonesia has retained non-tariff barriers on selected products, such as restrictions on rice and sugar. Some sectors such as automobiles remain highly protected. Indonesia has introduced import licensing requirements for a long list of products including electronics, apparel, food and beverage products and iron and steel, in response to the global downturn. There are also new technical regulations and mandatory standards, not always in line with international standards.

The changes in the Investment Law and Investment regulations in 2007 were intended to increase transparency but the negative list introduced some confusion and increased restrictions in certain sectors.

Indonesia has a low level of overall investment in the economy compared to other Asian economies, and the inflow of FDI lagged during the 2002-07 when FDI was booming globally. Increased FDI would make a significant contribution to overall capital formation and would enhance economic growth.

The Report says that the challenge for Indonesia is how to improve growth performance, and to expand exports of goods and services. Liberalisation of trade in services would require changes to investment regulations and opening up more of the economy FDI. The Report concludes that liberalisation of services and investment could make a significant contribution to economic growth in Indonesia.

Future Prospects and Challenges

Indonesia has good economic prospects and substantial development potential. The Indonesian economy is exhibiting some resilience in the global downturn and has good medium-term growth potential. It says that several factors have positive influences on Indonesia's economic development potential.

First, in the next decade Indonesia will experience a demographic dividend due to the falling birth rate and declining dependency rate, while the labour force will expand due to the large cohort of adolescents in the population who are entering the labour force. There is also potential for increase labour force participation by women. These demographic developments will expand the supply potential of the Indonesian economy.

Second, Indonesia has been on a reform path to tackle the many issues that is hampering its economic and social development: infrastructure, business and investment climate, SME development, corruption, education, etc. Until now, many of these reform efforts have only limited concrete results. In going forward, Indonesia would need to continue reform efforts in a more resolute manner and, in doing so, would also need to take a hard look at the economic nationalism that is taking stronger undertones.

Third, the initiatives taken by Indonesia with ASEAN partners to deepen integration with ASEAN and to negotiate FTAs with ASEAN Plus partners will stimulate growth in the

Indonesian and regional economies. Indonesia will integrate into regional production networks and supply chains as a result of these trade policy initiatives.

Fourth, East and Southeast Asia are likely to continue to be a dynamic region with relatively fast economic growth. The dynamism of the region and the integration of production networks will enhance economic potential in Indonesia.

There is considerable potential to build on the substantial trade and investment relationship between the EU and Indonesia. The EU-Indonesia trade and economic relationship is highly complementary with EU enterprises focusing on trade and investment in areas where they have technological or design capacities which provides a source of comparative advantage for Indonesia industry and exports. However, the Report says that this potential is under-exploited, largely due to the obstacles and constraints identified.

Yet if Indonesia were to undertake reforms to its business and investment climate and to deepen its integration process in the areas of trade in services and investment, the growth prospects of Indonesia would be enhanced significantly.

The study shows that increasing Indonesia's attractiveness to FDI would draw in technology, enhance skills development and expand capital formation that could create many employment opportunities for a young and expanding labour force. The overall conclusions are therefore positive and that the three sectors identified: telecommunications, consumer goods and the power sector offer particularly good opportunities for EU trade and investment.

The following obstacles and constraints have been identified by the study.

Tariffs

Indonesia has relatively low applied MFN tariffs, but the applied tariffs are well below the bound tariff levels in the WTO, which creates potential uncertainty in the tariff rates. Variability in customs rates and in the classification and valuation of imports can be a source of uncertainty for traders and create conditions conducive to corruption. In some industries the applied MFN tariffs have been increased in recent years.

Lack of Trade Facilitation and Poor Customs Administration

The Report prioritized the need to continue with customs reform to reduce the time and cost of clearing customs, to limit smuggling and corruption, and to better comply with WTO requirements. Indonesia has been active in the APEC trade facilitation framework with the aim of reducing transaction costs and is also participating in the ASEAN Single Window scheme. Computerized documentation requirements and customs clearance have facilitated both imports and exports. Registration of importers has remains a requirement.

Sanitary and Phyto Sanitary (SPS) Measure, Technical Regulations and Standards

Indonesia is increasingly imposing stricter technical regulations, not always in line with international standards. A number measures in recent years such as meat imports, registration and labelling requirements on processed food products, industrial standards for tyres, iron and steel have had negative impacts on EU exporters. Registration of imports of cosmetics and pharmaceuticals are burdensome and in the case of pharmaceuticals can severely restrict imports.

Import Licensing, State Trading and Related Non-Tariff Barriers

Import licenses have been progressively eliminated since the 1990s from affecting 1,192 tariff lines down to 141 products by 2008 still subject to import licenses, including alcoholic beverages, lubricants, textiles, explosives, and some dangerous chemicals.

Imports via State Enterprise monopolies are still prevailing, including rice, salt and sugar. There are de facto quantitative restrictions on the import of meat and chicken products by delivering to the importers a “Letter of Recommendation (Surat Rekomendasi Importir)” without which they are not allowed to import. Dairy imports are regulated and can only be imported by companies appointed by the Government. SOEs continue to play a large role in the economy, accounting for 45% of GDP, and are dominant in many sectors.

Some temporary” import controls were introduced by Indonesia on a wide range of products in response to the global slowdown in 2008.

Government Procurement

Government procurement lacks transparency in Indonesia, especially by regional and local governments. Incidents of corruption and collusion have been reported.

Lack of Effective Protection of Intellectual Property Rights

Despite clear improvements, the lack of effective protection for IPR is a major challenge for the business environment in Indonesia. The substantive legal framework for IPR needs to be elaborated or clarified in some areas, such as patent protection for pharmaceutical products not manufactured in Indonesia, as well as data exclusivity protection for pharmaceuticals and trade mark registration. The most important policy challenge is reinforcing the enforcement of IPR in many different areas including counterfeit goods and audio-visual products.

Business Climate and Governance

The need for transparency in government policy making, regulatory ambiguities created by decentralization, and a tendency to discretionary and overlapping administrative controls which can often be associated with corruption impede the business environment in Indonesia; Concerns about tax administration have also been identified.

Infrastructure Constraints

The Report confirms that lack of infrastructure, especially in the energy, telecommunications and transport sectors, is a major constraint on economic development of Indonesia. Private investment could contribute more to addressing infrastructure constraints. Significant improvements in the investment climate would facilitate private public partnerships and improve the prospects for investment in infrastructure.

Investment Restrictions and Treatment

The new Investment Law of 2007 provides for protection against expropriation, improves transparency and provides recourse to international arbitration. However, a large number of sectors have restrictions on foreign ownership and control. However in some sectors the restrictions on foreign ownership are below the level previously existing. Existing investments are also protected. The new law was intended to provide transparency and predictability for investment but some restrictions have caused confusion. This has been recognized by Government and proposals made to address the main legal uncertainties.

ASEAN Integration and FTAs

During the last ASEAN Summit a number of arrangements to strengthen and deepen ASEAN integration in trade of goods, in services and in investments were approved, as well as the intent of expanding ASEAN Plus FTAs. From the perspective of the Indonesia economy each of the ASEAN Plus FTAs bring advantages in the form of trade creation and potential losses in the form of trade diversion from lower cost third country suppliers.

The successful conclusion of the Doha negotiations and lower MFN trade barriers will serve to reduce potential trade diversion. Other FTAs such as with India will also serve to reduce trade diversion and increase potential trade and economic gains for Indonesia.

The implementation of ASEAN Plus FTAs with China, South Korea, Japan and recently with Australia and New Zealand, will eventually erode the relative competitive position of EU based exporters in the Indonesian market, unless negotiations are concluded for an EU ASEAN FTA. Even low MFN tariffs will affect negatively the market position of EU based exporters since non-ASEAN exporters will have preferred access under other FTAs.

Sectoral opportunities

The IBM Report includes a sectoral section with several chapters each on telecommunications, consumer goods and the power sector.

The telecommunications sector now accounts for about 10 percent of EU exports to Indonesia and this sector has been booming for several years. There is a trade in telephone handsets in both directions, with the EU exporting more high end mobile phones to Indonesia. EU exporters are relatively strong in the supply of GSM and 3 G Network equipment while European firms import cheaper Indonesian hand sets to help supply global supply chains.

The Report gives details on the evolution of the ICT sector (Information and Communications Technology) where mobile phones are increasingly used as a base for internet access. This is rapidly gaining importance and likely to expand significantly in Indonesia as infrastructure and regulations are improved.

In Indonesia, services are also rapidly moving from fixed lines to cellular services. Mobile phone subscribers rose from 32.8 million in 2004 to 92 million in 2007. Despite this there are substantial needs for new investment in fixed lines. The telecoms sector is likely to open up more as GATS commitments come into force in 2010, liberalizing landline distributors.

The sectoral report concludes that there are good opportunities for EU firms developing GSM and 3G telecom systems for Indonesia; even though the increase in market penetration rates is slowing down. Widespread use of 3G and 4 G systems will make up for this. However one of the main commercial risks is competition from lower cost CDMA technologies mostly from China.

The Report concludes that telecommunications is a sector where an EU-FTA (either ASEAN or bilateral with Indonesia) could and should advance beyond the Doha Development Agenda within the WTO.

The Report also produced a series of chapters on the consumer goods sector. This was done because the authors believed that there are niche markets available to EU firms in the areas of food and beverages, luxury products, cosmetics and retail distribution.

This sector has accounted for between 8 and 10 percent of Indonesian imports between about 2002 and 2007 with a bit of a downturn during the global financial crisis, but with every prospect of an upturn and strong growth going forward.

The main argument for prioritizing this sector is the size and growth in the market and the positive implications of Indonesian demographic data including the rise of a large middle class, estimated to reach 45 million people by 2010. The consumer goods sector is important for EU SMEs as well as MNCs. There would also be opportunities for EU SMEs to participate in joint ventures and invest in local manufacturing.

Indonesia imports a surprisingly large amount of fresh food for a country with a large agricultural sector. The country only supplies 35 percent of its milk and dairy produce and imports the rest from four countries – Australia, New Zealand, Denmark and the Netherlands. New Zealand, China, Australia and the USA supply most of the imported food to Indonesia (more than half) while the EU is also an important supplier.

There is a niche market for alcoholic beverages, especially for tourism. These are excluded from preferential trading arrangements like the ASEAN-Australia New Zealand FTA. There is also a potential niche market for high end of the market automobiles but AFTA and ASEAN Plus FTAs may erode this market.

The EU already supplies between 25 and 30 percent of the total Indonesian imports of cosmetics and this is an area where EU exports to Indonesia can be increased (as well as Indonesian exports to the EU).

The report spends some time looking at market prospects, VAT and tax, manufacturing opportunities, regulations, labelling and distribution networks for this sector.

The Report provides several chapters on the power generation sector because of the evident increase in demand as the production of electricity rises in line with demand. The EU was one of the most important suppliers of power generation equipment to Indonesia up to 2006, according to the Report, supplying in that year 56 percent of such products.

However the Report admits these figures could be faulty due to dollar-euro conversion rates and that the EU has been losing market share in this sector. In fact, the size of the sector is rapidly increasing and it may well be that the EU supply of goods into it is still decreasing, but it is also clear that there are now major opportunities in the sector.

The EU countries performing best in this area are reportedly Finland and the Netherlands, followed by Germany, the United Kingdom and Italy.

The IBM Report decided to include the power sector in the list of sectoral studies because power demand is rapidly increasing and several EU countries have established a track record showing that they can penetrate this market.

Interestingly, the top performance of Finland is based on supplying small and medium power stations using gas and biomass and a variety of renewable energy fuels, whereas Germany and the UK, and to a lesser extent France, have traditionally supplied rather larger power units.

The Report points out that the EU is a major provider of electricity generating technologies including nuclear, solar, wind and other renewable energies. The Report identifies some potential key players, in the form of the major EU utility-conglomerates including EDF and Gdf-Suez in France, EON in Germany and ENEL in Italy.

Italy has installed 52 geothermal plants and Indonesia is now expanding this sector. There is also geothermal technology in some other EU states (including Germany). The Report refers to opportunities in solar development, wind and biomass, as well as bio-fuel.

The Report describes how smaller power stations under 10 MW can only be owned up to 49 percent by foreign owners, but EU equipment can of course be sold to such plant and EU firms can participate as joint ventures.

The report supplies some information on the power sector including prospects for the different types of energy. The report concludes that the development of Independent Power Producers (IPPs) will be more important as PLN, the state power utility, cannot raise all the capital to finance the needed power stations.

The Sectoral Report on power concludes that there needs to be progress on energy policy and pricing to encourage investment. The Report raises the issue of tariffs applicable to electrical generation equipment (averaging 5 percent) while boilers and condensers have MFN tariffs of up to 10 percent. The Report concludes the ASEAN + FTAs will result in tariff advantages for Japan, Korea, China, India and later for Australia and New Zealand and that an ASEAN FTA or a bilateral FTA with Indonesia will be needed to redress this. The Report concludes that the power sector will present a major opportunity to EU firms.

Document 2: Indonesian Trade Access to the EU Opportunities & Challenges (Transtec 2010)

This report proved to have strong and helpful analyses of key sectors which it identified as offering good trade prospects for Indonesia. Its strength appeared to be based on adequate consultations on the ground in Indonesia as well as good analysis.

The study entitled *Indonesia's Trade Access to the European Union: Opportunities and Challenges* aimed to examine Indonesia's international competitiveness and export flows to the European Union (EU) and other markets, and to identify and prioritize key sectors and industries that would benefit from support given by initiatives like the EU-funded Trade Support Programme II (TSP-II).

It therefore identified positive sectors, at the same time identifying some of the cooperation instruments that would help Indonesia to accrue the actual benefits of trade opportunities. This is in line with the thinking emerging from early discussions in the Vision Group that cooperation instruments could be better integrated with trade opportunities.

1. *The EU as an Important Market*

There are extensive market opportunities for countries like Indonesia in the European Union. As a single entity, the European Union is the world's largest economic power, accounting for nearly 30 percent of total world output and outranking the total gross domestic product (GDP) of the United States, and of Japan and China combined. With the value of total trade equal to more than 40 percent of GDP, the European Union's openness to trade is more than three times greater than that of either the United States or Japan. The total value of its imports last year was US\$1.7 trillion, representing over 18 percent of total world trade. The ASEAN countries supply 5 percent of those EU imports and Indonesia contributes 18 percent of that share.

From Indonesia's perspective, there are two important differences among the 27 member countries of the European Union. The first is the large variations in the size of member countries in terms of their domestic markets and importance of external trade to their economies; the second is the considerable variation that occurs in consumer purchasing power across the countries. Under these conditions, Indonesian exporters have a wide range of market opportunities when looking for markets of different sizes, foreign trade and with consumer preferences for either high-end products or products that are more directed towards mass markets.

The European Union is also home for almost half of the world's largest transnational corporations. These companies depend on linkages with foreign-based producers in sectors that are of particular interest to Indonesia, for example, in chemicals, electrical equipment, food and beverage, motor vehicles and pharmaceuticals. By integrating their supplies into global value chains of these trans-nationals, local Indonesian producers are increasingly becoming part of networks of cooperating firms that are involved in the full cycle of activities that add value to the products that they supply to consumers, both in Europe and elsewhere.

2. Indonesia's Trade Flows with the European Union and Other Important Markets



Notwithstanding the size and importance of the European Union, the share of Indonesia's exports that are destined for that market has declined substantially, from 18 percent to 14 percent, over the last decade. This decline parallels similar reductions in the share of Indonesia's exports directed at the United States and Japan. As a result, the absorption of Indonesia's exports by these three markets has fallen from 55 percent in 2000 to 40 percent in 2009.

Most of the decline in Indonesia's exports to these developed markets has been redirected to the ASEAN regional market. This shift has increasingly allowed other ASEAN countries to use Indonesia's natural resources in their unprocessed forms to move up their value chains and produce greater quantities of processed and high-tech products. As a result, the fast-growing East Asian economies have been able to concentrate a growing proportion of their exports in manufactures and high value-added products, while Indonesia has remained entrenched in the production of raw materials and products having relatively small value-adding activities.

Indonesia could reverse this pattern by focusing its production activities on processing activities and other activities that add value to products. It has a relatively high degree of trade compatibility with EU imports. There are also a large number of products in which Indonesia has already succeeded in increasing its market shares in rapidly expanding markets in the European Union. Examples include electronic components, processed and prepared foods, and chemicals. In other products, however, Indonesia has not yet taken advantage of the fast growing EU markets for products like soaps and cosmetics, television parts, furniture, crustaceans, footwear and jewellery. Recognising these opportunities could stimulate the Indonesian private sector, with Government support, to find ways to overcome existing obstacles and develop products with potential for exports to fast-growing EU markets.

3. Selection of Focal Sub-Sectors and Industries for the Study

In order to provide lessons and guidelines for developing high-value added exports with dynamic growth markets in the European Union, the present study focuses on five industries or sub-sectors of importance to Indonesia. The selection process has invoked a number of criteria that can be grouped into three categories: (i) factors related to national development objective; (ii) factors related to foreign market determinants; and (iii) factors related to international competitiveness and internal factors. The results of the ranking and selection procedure the following focal industries:

-  *Fisheries and Agri-Foods:* These industries possess large opportunities for exporters to move into high value-adding downstream activities. Small and medium size enterprises (SMEs) tend to predominate in food industry clusters, and networking activities along the value chain provide large opportunities for knowledge and technology transfers to local producers. There are also important gains to be made in poverty alleviation by generating employment.
-  *Consumer Electronics:* The industry has considerable potential for value adding activities in the economy. There are extensive opportunities for Export Quality

Infrastructure (EQI) support directed at moving Indonesia from low to medium-tech products with favourable market prospects in the new EU member states of Eastern Europe to high-tech components in the high-income Western European economies. Trade compatibility between Indonesia's existing exports of these products and EU imports is the highest of any sector.

- ✚ *Furniture*: Development of this industry would offer large possibilities for SMEs and MSEs, employment generation, and poverty alleviation throughout Indonesia. The benefits from EQI activities could have a favourable environmental impact through improved quality management and control, standardisation, inspections and certification. Domestic business and trade associations are strong and could provide support to exporters intending to enter the EU market.
- ✚ *Natural Cosmetics*: The industry has the highest responsiveness of demand for imports to economic growth in the European Union. It therefore has the best EU market prospects among all sectors. Downstream activities involving the location of facilities for further processing are rapidly emerging in new manufacturing areas, where large research and development (R&D) inputs are also needed. Requirements for EQI improvements are therefore large in most Indonesian activities in this industry.

4. Focal Industries have a Huge Potential in the EU Market

Demand for imports of the focal products is projected to grow by nearly 7 percent a year over the medium term. This forecast is based on our econometric models that generated market estimates based on key assumptions about GDP growth, relative price changes for each of the traded products, and the exchange rate between the Euro and the US dollar. EU market outlook highlights are as follows:

- *Fisheries*: The European Union is by far the world's largest importer of fishery products, and its strong demand for fishery imports largely reflects its high responsiveness to changes in consumer incomes. Based on our estimates, and expectations about the medium-term prospects for economic growth in the European Union, fishery imports are projected to grow by a robust annual average of 8 percent. Above-average rates are expected to continue in processed fishery imports, which have in the past expanded twice as fast as all other types of fishery imports. The fastest growing product-level imports are likely to be fish and shellfish in their frozen form, including coalfish, eels, albacore, scallops, trout, mackerel, sardines and crabmeat. Imports of fresh and chilled yellow-fin tuna are also expected to show strong growth. Indonesia is in a particularly favourable position in that it has the world's largest catch of this species.
- *Agri-foods*: The EU demand for agri-food imports has been strong, particularly in its response to changes in consumer incomes. Demand for agri-food imports is projected to grow by 3.5 percent a year in the medium-term. Among individual product categories, fruit and vegetable juices are expected to continue as one of the largest processed agri-food imported into the European Union. It alone accounts for nearly one-fifth of all agri-food imports and it is expected to continue its robust growth, especially in tropical and exotic fruits

that are abundant in Indonesia. Other major imports showing strong demand prospects are prepared vegetables and fruits, and condiments and seasonings, where Indonesia has large varieties.

- *Consumer Electronics*: The size of the consumer electronics markets is by far the largest of all the focal sectors covered by this study. Demand is highly responsive to income changes, but year-to-year variations in EU imports are high. The medium-term forecast is for a 2 percent growth in imports. The top EU electronic product imports are fairly evenly distributed among the mass market applications in home appliances, data processing uses, audio and video.
- *Furniture*: The European Union is the largest market for furniture in the world. The medium-term outlook is for a 2 percent annual growth in imports, as foreign supplies become an increasingly larger proportion of the total furniture market in Europe. The top importing countries in the European Union are the United Kingdom, Germany, France and the Netherlands, which together account for two-thirds of all EU furniture imports.
- *Natural Cosmetics*: The cosmetic market of the European Union is nearly as large as the combined markets of the United States and Japan. Common growth patterns are occurring throughout the European Union in sun-care products. In addition, the aging population of Europe is generating growing demand for creams and skin care products. There is also a growing demand for natural and organic products across all age groups. Because of strong and rising consumption of cosmetic products in the European Union, cosmetic imports is projected to grow by 5-6 percent annually in 2010-2012, and thereafter accelerate to 7 percent a year.

5. Market Potential of Focal Sectors Needs to be Counter-Balanced with Compliance of Quality Requirements

While the EU market offers enormous growth opportunities for Indonesian exporters, its regulatory environment has strict controls that are largely aimed at protecting consumers and the environment. Requirements covering security, technical, sanitary, phyto-sanitary, environmental and other regulations are generally harmonised among EU member countries. General regulations cover food and feed safety, environmental protection, marketing standards, product safety, technical standardisation, packaging and labelling. Industry and product-specific requirements are also detailed in this study. This information is readily available and transparent to Indonesian exporters interested in selling their products in the EU market.

6. Indonesia is Well Positioned to Tackle Enormous Trade Potential with European Union

Indonesia has numerous advantages in the EU market that could help to reverse the under-representation of the EU market in its export portfolio. It has low labour costs and ready access to an abundance of resources. Its export prices to the EU market are generally competitive in local currency units, notwithstanding the undervalued currencies of many competitors have undermined Indonesia's price competitiveness in

some products. With the likely re-alignment of currencies in the coming year, Indonesia's stable currency will undoubtedly attract investors.

In the EU market, Indonesia is a beneficiary of trade preferences under the Generalized System of Preferences (GSP), which grants product imports into the European Union either duty-free access or tariff reductions. At present, almost 40 percent of Indonesia's 13 billion Euros exports to the EU market are eligible for preferential treatment. Yet only about 3 billion Euros of those products are actually covered under the scheme, and they are mainly concentrated in the areas of telecommunications instruments, television and audio equipment, garments and footwear. There is therefore considerable scope for greater use of the GSP facility by Indonesian exporters.

Both Government and business associations are facilitating private sector export growth, to the European Union and elsewhere. The Government's trade policy goals and priorities are to (i) improve its business climate and regional competitiveness; (ii) attract greater foreign and domestic investment, especially in infrastructure and export sectors; and (iii) generate high-quality job growth needed for sustained economic development. To this end, the Government has been promoting bilateral, regional, and multilateral trade, with the aim of expanding international markets in the European Union and in other markets.

Business associations have also provided extensive support to the private sector. However, for many small and medium size enterprises (SMEs) there remains a lack of awareness of EU market access requirements, product design needed for European customers, and available government support programs. Information dissemination by both Government and business associations is therefore an important means of ensuring that SMEs are able to successfully participate in value chains supplying the EU market.

7. *Most Challenges for Indonesia are in Supply-Side Aspects, Especially the EQI System*

Indonesia has suffered important losses in EU market shares in the last decade. Our estimates of the export relationships of these products from the focal industries suggest that those losses were largely due to non-price factors, including supply impediments from limitations in Export Quality Infrastructure (EQI). Export quality infrastructure is relevant for all export products that are required certain quality standards by the importers. For Indonesia's exports to the EU market, EQI issues centre on the system used to meet EU import standards and requirements, certification of products and management systems, competence of laboratories related to export, accreditation of laboratories, metrology and inspection.

- In *fisheries*, negative non-price effects on Indonesia's export competitiveness in the EU market more than offset improvements in the relative price of the products themselves, thereby producing an overall reduction in Indonesia's share of EU imports from third countries.
- In *agri-foods*, our estimates show that non-price factors in the last decade have reduced Indonesia's market share by 15 percent, while improvements in the industry's competitive export prices helped to increase market shares by an

average of 6 percent. The net relative price gains were therefore not sufficient to offset the negative effects from EQI and other supply-related factors affecting the industry's performance.

- In *consumer electronics*, our estimates suggest that there has been a large reduction in the earlier negative effects from non-price factors associated with supply impediments. The improvement in supply conditions is likely to be associated with the growing influence of multinational enterprises in the country, and improved EQI conditions in the components industry.
- In *furniture*, Indonesia's market share losses in the European Union have been largely due to non-price factors associated with non-price impediments on the supply side, although price movements and exchange rate pass-through effects have also contributed to the decline. Our estimates suggest these non-price factors were responsible for about one-third Indonesia's losses of shares in the EU furniture market during the past decade.
- In *natural cosmetics*, the industry experienced market share losses from non-price factors associated with supply impediments like EQI limitations. On average, the negative effect from non-price factors outweighed positive gains from price factors, causing a large net reduction in Indonesia's export market share of natural cosmetics and their ingredients in the EU market.

8. Main EQI Issues in Focal Sectors

There are some common EQI issues facing Indonesian industries that export to the EU market, but in general the issues tend to be industry-specific. Testing and accreditation difficulties are common, as are the inability of laboratories to perform all testing and analysis required by the European Union. As a result, accreditation by the large number of certification bodies in Indonesia is not always recognised internationally.

- For fisheries, quality and food safety improvements are needed in fish vessels, fishing ports and at landing sites, while in fish farming the presence of antibiotics in fishery products remains a major issue for Indonesia's exports to the European Union.
- For food products, the major impediment to bringing processing operations to the country is associated with SPS requirements in the EU market.
- In consumer electronics, EQI issues range from product design to components purchases, assembly and packaging.
- In furniture, EQI issues relate to the moisture content of woods to prevent cracking, standardisation of products, quality of the finished products, and safety testing.
- In natural cosmetics, the most important EQI issue is the ingredients used in products, where EU rules apply maximum concentration rates of allowable ingredients.

Apart from EQI limitations, major cross-sectoral obstacles remain in area like poor infrastructure, particularly road, electricity and logistics, as well as lack of marketing expertise and networking in extra-regional markets. SMEs confront great challenges in

meeting EU standards since they often lack information and face excessively high costs in providing those standards.

9. Tackling These Issues Could Result in an Enormous Increase in Export Revenues

The results of this study point to the enormous export revenue gains that Indonesia could achieve if it were to overcome EQI and supply-related constraints to placing products in the EU market. Our estimates indicate that in the last decade the average gain in revenue from the focal industries covered in this study would have been 28 percent if those supply-constraints had been overcome. Industry-specific findings are impressive:

- *Fisheries*: To the extent that Indonesia could have overcome its supply impediments on exports and maintained the same share of the EU fishery market that it reached in 2000, foreign exchange revenue from the industry during the last decade would have been nearly 20 percent higher in 2009 than was actually achieved.
- *Agri-Foods*: If Indonesia were to have overcome its supply impediments on exports and maintained its agri-foods market share at the beginning of the last decade, foreign exchange revenue from the industry would have been two-thirds higher than actual revenue for the industry.
- *Consumer Electronics*: Had Indonesia overcome its supply impediments on exports and maintained its share of the EU consumer electronics market that it reached at the beginning of the last decade, foreign exchange revenue from the industry would have been nearly 10 percent higher in 2009 than was actually achieved.
- *Furniture*: Had the industry overcome supply-side impediments and maintained its share of the EU furniture market in the middle of the last decade, the industry would have generated an additional 20 percent of foreign exchange revenue in 2005-2009 than was actually achieved.
- *Natural Cosmetics*: To the extent that Indonesia could have overcome its supply impediments on exports and maintained its cosmetics market share at the beginning of the decade, foreign exchange revenue from the industry would have been 40 percent higher in the first half of the decade and more than 10 percent larger in the second half.

10. Compliance with EU Quality Requirements also Helps Indonesian Exports to Other Developed Markets

Overcoming EQI and other supply-side obstacles will require considerable effort on the part of the industry. However, compliance with EU quality requirements would help Indonesian exporters not only gain greater access to the EU market, but also expand exports to other developed markets.

The benefits to the industry are considerable, as are the economy-wide effects that would be produced from additional employment and expenditures on downstream and supporting industries. These effects are particularly important for small and medium size enterprises (SMEs), which tend to predominate in upstream activities and have the greatest difficulties in getting their products to foreign markets.

Document 3: Trade Sustainability Impact Assessment (TSIA) of FTA between the EU and ASEAN - Final Report (Ecorys Research, May 2009).

Introduction

The Consultant Experts took the view that the importance of this Study was the way in which it approached FTA issues with suggested key points and methodologies, rather than simply a theoretical analysis of the benefits of an EU-ASEAN CEPA-FTA which is not being negotiated at present. The policy implications for a possible bilateral arrangement between EU and Indonesia are however of interest and in particular the "FTA flanking measures" remain valid and relevant also for a bilateral context.

It is noted that civil society is not yet involved in a systematic way in the trade policy making process in most ASEAN countries. In the EU there is a strong tradition in terms of social dialogue and civil society consultation. However progress is being made in ASEAN and the amount of attention now being paid to trade agreements in the Indonesian press and in civil society forums confirms the need to take this into account.

Overall Impact

Overall the FTA is expected to have substantial positive impacts (GDP, income, trade and employment) for ASEAN and small but positive effects for the EU. An alternative bilateral arrangement would clearly focus on benefits for Indonesia and the EU rather than at the regional level, although the regional integration backdrop would remain important.

National income effects from an EU-ASEAN FTA would be expected to amount to as much as 29.5 billion for the EU and between 725 million (rest of ASEAN) and 21.5 billion (Singapore) for ASEAN. In GDP percentage terms the most substantial increase expected from the Study would be achieved by Vietnam (with more than a 15% increase of GDP in the long run, and from the most ambitious scenario). {Add figures on Indonesia instead}

In an EU-ASEAN FTA context **Indonesia** would be expected to gain in electronic equipment, textiles and wearing apparel sectors, while motor vehicles and parts, gas production and businesses services would be expected to decline.[But it may be noted that foreign investment in the automotive sector has increased in Indonesia since 2008].

The expected impacts on wage levels are also a reflection of demand for certain skills, thus Thailand, the Philippines and Singapore in particular would see an increasing demand for skilled labour, as their economies shifted towards higher value-added and skilled activities.

The Transtec Study sees the same progression being possible in Indonesia. At sectoral level some real income decreases are expected in:

- the cereals and grains sector in parts of ASEAN in the short term, in the longer run, remaining producers may well find their real income increase as rationalization and investments in more efficient production systems yield higher returns;
- in the TCF sectors, EU regions dominated by clothing and particular footwear manufacturing, as short term unemployment levels in these regions may increase

Positive real income effects at sector level are expected for the TCF sectors in Indonesia (textiles)

The Study says that the extent to which investments within and from outside ASEAN will materialize depends on improvements to the investment and overall business climate.

As the cost of doing business, and trade and investment restrictiveness are still quite high in some ASEAN countries and for some sectors, further reforms in this area are likely to lead to substantial benefits to intellectual property rights, protection and competition policy and services liberalisation.

FDI will be encouraged further if intra-ASEAN integration and harmonization progress further. This will allow foreign investors to trade more easily within ASEAN, strengthening the region's role as a production base.

The Study concluded that in respect of an EU-ASEAN FTA Investment would not necessarily be expected to increase from outside ASEAN, in particular from EU investors, but improvement of the investment conditions, removal of NTBs and services liberalisation is also expected to increase investments from within ASEAN.

Overall, investments in the EU are expected to increase in services and non-production related activities (e.g. design and marketing in the TCF sectors), while investments in ASEAN will mostly be in productive capacity, and advanced technologies and products.

[The Indonesian context is somewhat different from the general ASEAN context in 2007, since there are signs of a boom in investment in infrastructure, power, manufacturing.]

The Study concludes that reduction of trade and investment barriers in the motor vehicles and parts sector could be expected to have a substantial positive impact on FDI flows, in which case investment interest might come from the EU as well, despite comments above that most investment shifts might come from inside ASEAN.

Similarly, the financial services potential for investment will improve with removal of ownership restrictions. This could eventually lead to greater direct involvement of EU financial services providers in the region.

The Study noted that the expected impact from lowering FDI restrictiveness would be a reduction in trade costs for services, by 6.3% in insurance services, 5.5% in communication services and 4.9% in both transport and other business services.

In terms of ***social impacts***, the FTA is expected to have an overall positive impact on poverty alleviation, albeit at the disaggregate level, while some groups may see an increase in poverty rates in the short run due to negative net price and income effects in the case of liberalisation beyond simple tariff reductions. In terms of the TSIA philosophy these downside effects should be identified and steps taken to adjust and mitigate the position.

The increased employment opportunities in the TCF sectors in the Rest of ASEAN, Indonesia and Vietnam is expected to facilitate the structural transformation processes taking place in these countries as agricultural workers could, without substantial retraining, be absorbed into these sectors, thus also contributing to poverty reduction.

In cereals and grains (particularly rice) and the fisheries sectors in ASEAN, some short-term poverty increases may occur as fisheries communities and rural areas see young people in particular move to urban areas to find employment in other sectors. This would require some adjustment measures in a bilateral or ASEAN context.

The expansion of the financial services sector may contribute to poverty reduction provided micro-credits will increase. Increased access to insurance will also provide social benefits.

Improvements in ***health and education*** levels in ASEAN are expected from the overall increases in welfare, wages and household income. The higher health, safety and hygiene standards achieved by ASEAN producers as a result of compliance with SPS would benefit public health in ASEAN, and the same would be true for Indonesia in a bilateral context.

Removal of investment barriers as a consequence of an FTA may open up some previously restricted social and environmental goods services sector to private and foreign investments, which could encourage efficiency gains and services improvements.

Employment of both skilled and unskilled labour would increase substantially across ASEAN as a consequence of an FTA. A bilateral agreement would have similar aims.

Due to efficiency gains and productivity increases, employment of both skilled and unskilled workers is expected to increase less than increases in output. Although this implies higher wages per worker, creating additional employment will continue to pose a major challenge for many ASEAN economies.

As a consequence of FTA, private Corporate Social Responsibility (CSR) and international initiatives will contribute to further addressing of labour issues in the region, provided commitments continue to be strong in a period of economic downturn and national legislation and standards are adequately enforced.

In terms of ***equality***, expected changes in wages indicate that in some countries high-skilled wages will increase more than low-skilled wages leading to increasing levels of relative inequality. Regional disparities may also increase in ASEAN as a consequence of inter-sectoral shifts and wage effects in favour of urban areas. This issue might also apply

to Indonesia as a very large and diverse archipelago, with very different levels of economic development between different areas, notably between Java and Eastern Indonesia.

The growth of the TCF sectors in ASEAN as a consequence of the FTA is expected to benefit female labour in particular, as the sectors tend to employ predominantly females.

In other, higher skilled sectors and activities, gender inequalities may in fact increase slightly, as high-skilled employment opportunities especially in specific segments of services sectors may exist, and these sectors tend to be relatively less open to females. The increased opportunities for skilled workers in the services and other sectors in ASEAN may benefit male workers relatively more than female workers. It would also be important to take note of this and address this issue in a bilateral context in the Indonesian case.

As a consequence of overall increased economic activity and trade, **environmental effects** are expected to be negative, with increased greenhouse gasses (GHG) emission and declining levels of air quality, mainly as a result of increased air, road and maritime transport, but also as a consequence of increased manufacturing output (emissions). This could prompt an EIA component to any bilateral FTA, including recommendations on how to deal with problems arising.

The FTA encourages further adoption of improved standards and cleaner technologies (facilitated by FDI), and this may help mitigate negative environmental impacts. Ensuring the FTA does not impact negatively on logging practices (taking into account existing illegal, unsustainable logging and land clearance problems,) means issues need to be seen in an integrated way. The Study recommends to include enhanced application of voluntary certification schemes and negotiation of FLEGT Voluntary Partnership Agreements.

Relatively limited effects on sectors with significant impacts on **land use** intensification are envisaged as a result of the FTA. This can be closely monitored as effects that do occur may have serious consequences for longer term sustainability. The special study on bio-fuels in the TSIA study and some of the sections in the Transtec Study address these issues.

Biodiversity issues are important in the fisheries sectors and possible negative impacts could be encountered in this sector in **Indonesia**, as catches and by-catches increase and could add to overfishing.

These issues arising from the fisheries sector are all the more important given that more Indonesian workers depend on fisheries than for any other country in ASEAN. By 2007 some 7.3 million Indonesians depended on fisheries, compared with 5.3 million Thais, 3.4 million Vietnamese and only 0.6 million Malaysians.

Effects of the FTA on **environmental quality** and **fresh and waste water** relate mostly to increased economic activity, urbanization and consumption following an FTA.

The impacts on environmental quality and fresh and waste water will differ per sector and will also depend on the extent to which investments in environmental goods and services

sectors will be enhanced (e.g. Waste Water Treatment Plant –WWTP- and water supply, recycling, waste management).

As the EU has substantial expertise in this area and is a world leader in environmental technologies, more investments in such sectors may allow for promoting trade and investment in innovative technologies and best practice implementation in the environmental goods sectors in ASEAN, improving environmental quality.

At sector level the main potential impacts of the FTA in terms of environmental quality, fresh and waste water will likely stem from fisheries (aquaculture) and TCF sectors.

Policy Context and Approach

The FTA is clearly part of a more general process of enhanced cooperation and dialogue between the two regions, that is increasingly built on mutual interests and reciprocity and as such has graduated from a purely assistance based form of cooperation.

The TSIA Study encourages, through its comprehensive nature, an innovative approach to a potential bilateral CEPA, including and in support of FTA provisions.

The mainstreaming of trade into these overall assistance programmes and cooperation agreements will enhance policy coherence and encourage further economic integration between the two regions and sustainable development in ASEAN.

The FTA and flanking measures should encourage convergence and cooperation through incentives and positive ongoing initiatives. In recent years many ASEAN countries (including **Indonesia**) and ASEAN as a whole have taken positive steps in lowering trade and investment barriers, adopting international agreements and conventions and addressing social and environmental issues through policy and legal reforms.

The bilateral implication is that capacity building and strengthened capacities to implement a CEPA-FTA agreement would be needed, as recommended by a TSIA approach.

Overall Policy Measures

FTA and Flanking Measures

Phasing of Tariff Reductions - The larger the envisaged tariff reduction in goods, tariff equivalent reduction in services, or NTB reduction, the more pronounced the specific short-term effects may be. For those sectors where potential short run negative impacts have been identified as a consequence of opening up, or where issues with relation to e.g. food security exist, the parties may consider a phased reduction of tariffs at a slower rate than what is foreseen in general, to allow for longer adjustment periods including through appropriate policy and legislative reforms and/or the building up of competitiveness. A condition to such a phased approach is that initiatives are undertaken to facilitate structural adjustments, a proper monitoring system could keep track of progress in this respect.

Inclusion of a Sustainable Development Chapter (SD) - The FTA should include a Sustainable Development Chapter that includes agreements and commitments on cooperation and progress towards specific social and environmental objectives.

Set up of Monitoring and Evaluation System - Continuous monitoring of implementation and enforcement of the FTA as well as periodic evaluations, which involve local stakeholders, so as to allow for awareness raising and capacity building among these stakeholders, should analyse the impact of the FTA between the EU and ASEAN. The aim should be to understand why, how and where sustainability impacts occur, and what can be done to ameliorate the sustainability impacts. The aim of monitoring and evaluation is thus both continuing analysis and policy prescription and should cover both the trade policy itself and the mitigating measures.

Continue to improve business and investment climate - Further improving the business and investment climate, including infrastructure development in ASEAN, reduction of red tape and other investment barriers and generally reducing the cost of doing business, is needed to achieve the longer term effects envisaged. Similarly continuing the progress towards removal of NTBs to trade and investments within ASEAN will enhance the attractiveness of the region as an investment location.

Encourage convergence and information exchange and provide assistance on technical trade issues such as SPS and RoO - Understanding and complying with rules and standards set within the national markets for public health and safety reasons or to avoid trade deflection is crucial for both parties to be able to actually benefit from the preferential access that the FTA would provide.

Measures to encourage understanding and compliance could include closer regulatory cooperation initiatives, TA programmes in standard setting, implementation and exchange of scientific testing methodologies, upgrading of laboratories, revising and alignment of SPS and other control systems (certification) and capacity building for relevant institutions.

Particularly in the agricultural sector, fisheries and food processing, SPS compliance issues have proven, at times, difficult. In addition, understanding RoO is important for preferential access in particularly the food processing, automotives and TCF sectors.

In addition, providing efficient information to the private sector on the implications and requirements of the FTA, particularly in relation to technical issues needs to be part of the FTA implementation process.

Information dissemination and exchange on the FTA (set up FTA Enquiry Points) - To enhance the understanding and support for the FTA and ensure economic actors are able to use the preferences accorded by it, active information dissemination and exchange on the exact agreement and what it means *de facto* for producers, especially for SME in EU and ASEAN, and sectors affected, should be an integral part of the FTA and its implementation. For this purpose the parties should consider the setting up of FTA Enquiry Points that may assist ASEAN producers in accessing EU markets, understanding RoO, complying with EU standard, provide information on investment conditions, etc.

Such centres and information exchange in general should also encourage improvement of compliance with SPS standards and concrete steps towards successful implementation and monitoring of commitments undertaken in the area of SPS beyond legal mutual recognition).

Promote trade and investment in innovative technologies - The objective of trade and investment in innovative technologies as a mitigating action is to provide the technical means to reduce various forms of pollution, health and safety threats on the work-floor and increase overall quality standards.

In addition, new technologies improve productivity levels and thus raise factor income. This could be encouraged through incentives for investments in and adoption of clean technologies, plant modernisation and health and safety measures.

The sectors where such an action could prove useful include fisheries and agriculture, textiles, clothing & footwear, food processing, chemicals, and automotives. Care will have to be taken to avoid giving unfair advantages to certain plants that are assisted with trade and investment in innovative technologies and to avoid market distortions.

At the level of the economy as a whole, a clear innovation and technology transfer strategy and the integration of external and domestic sectors is crucial to ensure a spreading of the gains from trade and investment liberalisation through an FTA.

Involvement of key stakeholders - Broad based involvement of the private sector and civil society in trade policy making and implementation is important for ensuring the agreements made truly reflect the interests of a society and takes into account sustainable development issues beyond narrow economic interest.

Through various existing forums and programmes, as well as through mechanisms that could be set-up as part of the FTA implementation process, the FTA could promote further involvement of civil society in the trade policy making process and in sustainable development issues related to implementation. In addition, incentives could be provided to encourage dialogue and partnership between public and private sector stakeholders, e.g. CSR initiatives.

Within ASEAN initiatives towards greater involvement of civil society – e.g. through tripartite dialogue between employer federations, labour unions and the government, the ASEAN Secretariat and various national forums that are being developed – should be further encouraged and integrated into the overall policy making process.

Continue process of policy and legislative reforms - To address specific geographically disparate effects and potential social exclusion effect of FTA, adjustment strategies should be aimed not just at national or sectoral levels, but may also need a regional policy focus.

One example of potential negative impacts is the reduction in tariff levels that will have a direct impact on government revenues. In many ASEAN countries the tax base is narrow, implying tariff incomes present an important source of revenues. To avoid over

dependence on excise tax and VAT, broadening the tax base (e.g. through income tax) could compensate for this loss in revenues, while it would in turn provide steady income base for the development of social policies, particularly social protection systems needed to cope with the short term adjustments due to FTA impacts on the production structures in ASEAN.

Further regional integration in ASEAN (ASEAN Customs Vision) and addressing NTB within ASEAN - This will enhance further the positive impacts of the FTA in terms of easier flows of goods, services and investments within and between the two regions. This in turn will enable foreign investors to use the region as a production or distribution base (regional production networks) and achieve economies of scale.

Addressing concerns of 'losers' and dealing with resistance - There are two types of losers that can be identified: on the one hand people working in those sectors or regions that are expected to experience declines, on the other hand people and organisations with vested interest that will likely resist changes that jeopardize their positions and income. The latter could be politically connected business tycoons heading monopolies, but also includes civil servants in e.g. customs who may see a loss of income from reduced opportunities to 'charge extra' for their services, due to improvements (automation) in customs procedures.

This resistance tends to be stronger than the support from those who benefit economically, mostly because these groups (e.g. consumers) are more dispersed and less organised. Resistance also comes from those in society that do not understand the implications of the FTA, thus eliminating the possibility of a fact-based and argued discussion on its risks and merits. Information dissemination and exchange on the FTA agreement and its implications is crucial, especially for SMEs and consumers.

It is important to address the concerns of people benefiting from the status quo for loss of their position, by considering ways to compensate for loss of income of some (e.g. customs officers) and by further improvement of competition policy and the rule of law to address and avoid abuse of dominant positions and corruption.

Cooperation with international organisations and initiatives - Where possible, the FTA parties should cooperate with international organisations such as ILO, UNEP, MEA Secretariats, WTO, as a means to address specific sustainability issues, establish closer convergence and find common ground between the two regions. The UN Partnership for Sustainable Development is a positive example in this respect. Already all EU and ASEAN countries are a signatory to this voluntary partnership organisation. Almost all ASEAN countries, with the exception of Laos, have developed or are in the process of developing national sustainable development plans. These should be further supported and developed.

Policy Measures related to the Economic Pillar

Whereas overall, both the EU and ASEAN are expected to benefit economically, the FTA will trigger or reinforce existing structural adjustment processes, which, at least in the short run, might cause some negative externalities. Economic policies can help minimize such negative externalities as well as help spin-off long term sustained economic growth. In

other words they may support the transitions from short to long run and accelerate the adjustment process.

Such a strategy should include improvement of the business and investment climate, SME development, integration of domestic and external sectors, encouragement of a level playing field and fair competition, and adjustment and compliance with technical issues.

Labour and social policies should be implemented in tandem, as these have been demonstrated to also contribute to productivity improvements (greater factor returns) and overall competitiveness.

FTA and Flanking Measures

Business climate improvement - An important constraint to investments, SME development and business development in general in ASEAN lies in the relatively high costs of doing business in several ASEAN countries. Lowering these costs will have positive impact not just on foreign activities, but also on domestic investments and entrepreneurship.

A key finding of the study has been that improvement of investment conditions through the addressing of a number of NTB greatly enhances longer term spin-off effects of the FTA, particularly for the services sectors, where most restrictions are still currently in place. But it also relates to a number of other cross-cutting areas such as IPR, competition policy and Rules of Origin considerations. Measures that can help this aim may include reduction of foreign ownership restrictions (e.g. in the financial services sector in ASEAN), competition policy and strengthening of market forces (e.g. phasing out state aid) and better regulation / convergence of regulation.

Measures that can contribute to an improved investment climate include promoting the 'practical' attractiveness of doing business, by lowering general costs of doing business and all the areas this may cover (e.g. reduction of red tape, removal of logistical restriction, improving transparency and the rule of law, reducing the cost and time for registration / setting up of a business, providing investment incentives).

Improvement of the business climate is already a high priority for most ASEAN member states as recent initiatives (**e.g. Investment Law in Indonesia**) have proven. Implementation and enforcement are now keys in ensuring the effectiveness of these initiatives.

Address Competition Policy issues - Anti-competitive behaviour by special interest groups and monopolies effectively close off entire sectors, not just to foreign investors, but to large parts of the domestic market as well, excluding investments and SME development and leading to higher prices and less variety for consumers. Resistance against reform of competition policy may be strong, but there is increasing recognition in ASEAN countries of the importance of having a competition policy and laws. Again, implementation and enforcement are still an issue and remain dependent on political will, capacity constraints and governance issues.

This policy measure can to some extent be taken up in the FTA proper, but also links closely to the overall policy measure of addressing concerns of loser and resistance to change as well as to the raising of awareness on benefits of the agreement conditional to the existence of a level playing field.

Stimulate entrepreneurship and competitiveness of the SME sector and integration of external and domestic sectors - SME are likely to be affected by ongoing economic liberalisation and structural reform of the economy. On the one hand, especially in the short run, some less efficient SME might face difficulties to operate in an increasingly competitive environment, favouring more efficient companies and driving less efficient ones out of the market. On the other hand, ongoing economic dynamic progress, improvement of the investment climate and the breaking up of monopolies / cartels through competition policy can create many new opportunities for SME and spur innovation and investment. This can create positive effects, e.g. for flexible companies in services sectors. Measures to enhance these positive chances for SME (and mitigate the negative ones) may include increase in business education (e.g. generally in entrepreneurship or specifically in content-wise knowledge) and retraining (facilitating displacement across sectors). Also, export promotion programmes for SME can be beneficial.

Economic policy should encourage integration of domestic and external sectors and development of linkages within the economy. As the example of the Philippines illustrates, an export-oriented strategy aimed at attracting FDI and promoting exports by creating 'enclaves' of foreign investors and exporters with limited linkages to the domestic economies, does little to include SME and the wider population in sharing the benefits from increased exports and growth. These links are crucial for poverty alleviation and encourage trade and investment in innovative technologies and a general upgrading of production and services. Industrial policy should thus focus on the so-called high road to development.

Promote trade and investment in innovative technologies and develop innovation and technology strategies - Trade and investment in innovative technologies – and more broadly speaking technological change – will greatly enhance the positive welfare effects of an FTA. In this respect both IPR protection as part of the FTA and a clear technology transfer strategy as a flanking measure are crucial measures. The link between protection of IPR and economic growth of developing countries has been studied extensively and the results suggest that developing countries can potentially benefit strongly, especially in the longer run from better IPR protection, as it induces local technology diffusion and increases local innovation. The extent to which this effect will materialise depends not just on IPR protection, but also on the existence of an IP and technology transfer strategy and system and the starting level of innovative capacity of each country.

Policy Measures related to the Social Pillar

Many of the social impacts are closely related to the expected acceleration of ongoing structural adjustment processes in the economy described above. Social and regional policies can help address issues related to reallocation of labour across regions and sectors, other potential inequality effects and changes in educational requirements.

FTA and Flanking Measures

Sustainable Development Chapter - It is likely that the FTA will include a sustainable development chapter. This chapter could include the following social issues:

- References to the requirement that both parties commit themselves to the effective implementation of core ILO labour standards and other basic decent work components.
- A requirement for both parties to submit regular reports on general progress.
- Engagement to respect the OECD Guidelines on Multinational Enterprises and the ILO Tripartite Declaration on Multinational Enterprises and Social Policy, and not to lower labour standards in order to attract foreign investment. A system where complaints about social problems should be subject to consideration by genuinely independent and well-qualified experts; possibility to establish a 'Trade and Sustainable Development Forum' providing for consultation with civil society, including workers' organisations, employers' organisations and NGOs, with a clearly defined, appropriate balance between those three groups of members.

Encourage convergence and provide information / assistance on technical trade issues such as SPS and RoO - Enhancement of approximation, implementation and monitoring of EU SPS standards may not only ensure protection of consumers in the EU, but could also have a positive impact on health and safety issues in ASEAN, as the generally higher health, safety, hygiene and quality standards of the EU are increasingly adopted. It must be noted that agreed harmonisation of SPS measures alone is not sufficient. A well functioning monitoring and control system on health and safety impacts is required to avoid long term negative impacts or adverse trade effects.

Improving the flexibility of EU and ASEAN labour markets and aid short-term adjustment needs - The more flexible the EU and ASEAN labour markets, the lower the short-run adjustment costs are expected to be. Preventative, mitigating and enhancing measures could include skills retraining in the short run and improving / increasing access to training and education system in the medium and longer run, as well as international cooperation on training and education (vocational, business and tertiary). Such cooperation may include cooperation between ASEAN and EU education institutions and training centres, promotion of educational exchanges – also leading to longer run achievement of similar levels of qualifications and cultural exchanges – increased emphasis on professional training and education (addition of curricula on entrepreneurship in higher education, vocational and professional training schools, business administration, etc.) to encourage entrepreneurship and facilitate modernisation of different sectors.

Already there is a strong focus in many ASEAN countries and in the EU on education. The challenge is to make this as responsive and flexible to changing labour market demands and requirements.

Analysis and monitoring of social protection systems - By making an assessment of the current social protection systems in place in the different countries party to the agreement and the extent to which they can cope with substantial structural adjustments in specific sectors and

areas in ASEAN and particular regions within the EU, will allow for the flagging of potential marginalisation of certain groups and the development of a monitoring and evaluation system that could identify needs for specific policy interventions at short and long term. Again, existing initiatives and policies in this area should be taken into account.

Develop adjustment strategies through regional and social policy - FTA impacts may be distributed unevenly across regions due to geographic concentration of certain affected sectors and/or general rural-urban migration. It is therefore important to develop adjustment policies and activities at the level of regions or even communities suffering from agricultural or industrial decline and migration. In the EU this is already possible through EU globalisation fund and structural funds. For the EU such regional impacts are expected to occur in the footwear and clothing industries, while in ASEAN particularly certain rural areas and communities (e.g. fishing villages) may be negatively affected in the short run and should be assisted with adjustment to the new equilibrium.

Social policy measures also are needed to ensure and strengthen the pro-poor effects and pro-gender equality effects of the FTA. Such measures could include technical assistance support with respect to SPS measures and productivity enhancement in rural and fisheries communities in ASEAN, coupled with policies aimed at deeper penetration of the banking sector into ASEAN rural areas (possible if regulatory burdens are reduced), micro-finance and micro-insurance development, as well as special attention for education and re-training for low-skilled female workers especially in services sectors.

Such social policies should be closely linked to economic policies supporting SMEs and the business environment, as development of the private sector remains the single most important driver of employment and poverty reduction.

Further develop tri-partite dialogue and encourage CSR agreements between employers and Unions - Support ongoing initiatives and programmes to include private sector and civil society in FTA implementation and monitoring, so as to promote social and civil society dialogue, CSR and ultimately productivity.

Cooperate with international organisations and build on ongoing initiatives with regard to decent work agenda - The study identified several ongoing and promising initiatives with regard to social dialogue and the decent work agenda. As many of the social and employment issues relate to a wider policy agenda (beyond the impacts of the FTA per se) cooperating and participating in existing initiatives of international organisations and support of private sector initiatives, such as CSR and corporate codes of conduct, agreements between employer federations and unions) is likely to be more effective in addressing wider sustainability issues than individual interventions in the narrow context of the FTA.

In this respect the EU may bring positive examples and experiences with regard to employment creation and improvement of labour conditions from EU accession countries, including successful adoption and implementation of labour standards, monitoring and evaluation of decent work indicators and capacity building, especially with respect to SME.

Policy Measures related to the Environmental Pillar

The study identified moderate effects of the FTA on environmental sustainability in the EU and ASEAN, although many of the impacted issues are existing issues related to the generally vulnerable environmental situation in ASEAN and pressures. Considering the ongoing nature of the pressures on natural resources in ASEAN stemming from population and economic growth trends and resource depletion, it is hard to attribute these impacts directly to the FTA, but the FTA could enhance or accelerate ongoing trends. At the same time, it could be used to help solve certain environmental problems, thus contributing in a positive way. As such, policy makers and civil society alike should look at the broader environmental agenda and issues of ASEAN and consider the leveraging opportunities that an FTA may provide in terms of addressing these.

Environmentally related policy measures can help prevent or mitigate some of the potential negative effects associated with the FTA resulting from the economic growth and may help create incentives for future environmental sustainable development.

FTA and Flanking Measures

Sustainable Development Chapter - It is likely that the FTA will include a sustainable development chapter on the following environmental issues:

- Commitment to multilateral / international environmental agreements and their effective implementation
- Commitment in terms of upholding domestic legislation and ensuring adequate enforcement
- Provisions to facilitate and promote trade in environmental friendly products and services
- Commitments related to specific concerns such as deforestation, biodiversity loss and fisheries resources
- Mechanisms to monitor implementation and impacts of the FTA including through, for instance, creation of a system of standards for objective measurement of pollution.

Incorporation of relevant environmental considerations and provisions in other chapters of the FTA - Relevant environmental considerations and provisions may be mainstreamed into other chapters of the FTA, for instance in relation to services, fisheries and agriculture.

Generally speaking, the Environmental Goods and Services (EGS) negotiations within the WTO are still facing some difficulties in terms of agreeing on the approach to liberalisation. The WTO framework relates to specific goods and services considered to contribute to environmental protection, abatement, and pollution control and resources management.

However, specific issues at sector level may not be included in this framework and should be addressed separately. Thus in relation to fisheries reference should be made to the signing and implementation of the UN Fish Stocks Agreement and to membership of

Regional Fisheries Management Organisations operating in the ASEAN, that have the legal responsibility and authority to manage the catches and fishing in the areas.

Linking National Interpretations of the Roundtable on Sustainable Palm Oil (RSPO) to FTA Negotiations - Given the importance of palm oil production in the region including for export purposes and the environmental concerns surrounding it, the role of the Roundtable on Sustainable Palm Oil (RSPO) and its proper implementation and monitoring is essential.

Having a set national interpretation of the recommendations issued by the RSPO that is subscribed to by all national RSPO parties is a first step in ensuring that environmental degradation caused by higher palm-oil production is adequately monitored and mitigated. Such an effort is currently being undertaken in Malaysia. A crucial point is establishing a systematic link between the national interpretation of the RSPO standards in Malaysia and the terms of the FTA between ASEAN and the EU. Indeed, making the EU ASEAN FTA contingent in some measure upon compliance with the national interpretation of the RSPO may bolster the visibility of sustainability issues in Malaysia in the oil palm sector.

Enhancement of environmental impact assessment and monitoring programs - In order to identify potential and ongoing environmental impacts so as to be able to devise appropriate preventive mitigating policies, strengthening or creating a system of standards for objective measurement and reporting of environmental variables (e.g. pollution, GHG emissions, deforestation rates, biodiversity loss etc) should be put in place, with reference to voluntary Environmental Management Systems. Besides providing a baseline for policy interventions, these measures will also promote environmental concerns in impact assessments and create awareness and disseminate information.

Create incentives for environmentally friendly production

The study demonstrated that increases in production and growth are likely to have a negative impact on various aspects of the environment. However, the FTA may directly and indirectly provide to encourage cleaner production. The World Bank (2008) states that “most countries that are more open to trade adopt cleaner technologies more quickly.”

In order to mitigate possible negative impacts and facilitate or accelerate the process of cleaner technologies adoption, policy options include creating incentives for environmentally friendly production in the form of tax incentives, but also by identifying and removing specific NTB for trade and investment in such technologies, through approximation of legislation within ASEAN and the EU. This is closely linked to the issue of promoting trade and investments in innovative technologies.

Link FLEGT/VPA process to FTA negotiations and implementation - The study illustrated the potentially positive impacts on illegal logging and timber trade of the FLEGT/VPA initiative and the proposed Due Diligence Regulation (DDR) for putting wood products onto the market in the EU. The FTA should clearly link to this initiative, as it relates closely to trade issues and has a strong regional dimension as well.

Measures to consider include:

- Investigating the possibility of granting tariff reductions for timber and timber products made of verified legal timber such as that derived from FLEGT Voluntary Partnership Agreements.
- Inclusion of FLEGT and, where applicable, the use of VPA or other legality verification mechanisms, in the Sustainable Development Chapter of the EUASEAN FTA. Although the VPA concerns bilateral negotiations, leveraging of the regional dimension of the FTA may provide for incentives to start and further encourage the FLEGT/VPA process in all ASEAN countries.
- A chapter on procurement that includes clauses for green procurement both in the EU and ASEAN. This would require the development of agreed criteria of legality of the goods covered in such clauses. As such criteria are being developed under the FLEGT/VPA with several countries already, within the context of government procurement within the FTA, a broad framework could be developed, based as much as possible on the FLEGT criteria.
- Further trade facilitation improvement, such as the development of electronic timber tracking systems; export licensing and customs clearance systems; the training of customs and enforcement officers to identify illegal wood and wood products and enforce trade related legislation; support to the harmonisation of customs systems within ASEAN so as to prevent deflection of illegal wood and wood products to third markets.
- Incentives for investments in legal and sustainable forestry, e.g. eco-labelling, products and processes and productivity improvements for legal timber and timber products, e.g. through technology and knowledge transfer.

Facilitate trade and investment in innovative technologies - Trade and investment in innovative technologies and technological development does not only promote greater factor returns and improved health and safety standards in the workplace, it also has potentially positive environmental impacts. One way to facilitate the uptake of environmentally friendly technologies could be the provision of tax incentives for such investments, in ASEAN in particular. Improvement of IPR protection could also encourage investments from EU environmental technology producers and providers in ASEAN. Further removal of intra-ASEAN NTB is also likely to facilitate investments and trade in environmental technology, as many of the companies producing these depend on economies of scale for competitiveness and thus would be encouraged by a larger market and production region.

Encourage participation of civil society - Overall, in both the EU and ASEAN, environmental civil society organisations are very actively involved in sustainability issues and participate in e.g. the FLEGT process and bio-fuels discussions. Their contributions to research and analysis in these areas are also notable.

Cooperate and coordinate with ongoing environmental initiatives and programmes - EU and ASEAN flanking measures should expand and cooperate in the context of international, regional and national policy initiatives in ASEAN, including the existing bilateral cooperation and assistance programmes between the EU and ASEAN but also support for the implementation of international agreements and programmes in ASEAN, for instance in relation to fisheries (United Nations Fish Stocks Agreement), support and cooperation to

the ASEAN Environment programmes and Sustainable Development Strategies in ASEAN countries.

Promote integrated approach to environmental impact issues - Although the broader environmental sustainability agenda of ASEAN cannot be addressed by an FTA, the ongoing dialogue and cooperation between the two regions of which the FTA is a part, could promote further integration of environmental issues into the policy making and cooperation process. This includes:

- Capacity building initiatives for green products and production processes in key sectors such as electronics, textiles and footwear.
- Encourage further understanding and incorporation of the links between social and environmental issues into negotiation and policy making processes.
- Strengthening property rights is policy measure that promotes sustainable development and introduces incentives for maintenance, land protection and adequate use.
- Monitoring land use change and implementing regulatory structures for mapping and establishing high conservation value areas. This has proven to be an important policy tool for reducing loss of biodiversity and illegal logging in particular.

Document 4: Indonesia's Expected Challenges in Pursuing an FTA with the EU – IISD 2009

Introduction

Indonesia and the EU took a major step recently to cement their economic relationship through the signing of a Partnership and Cooperation Agreement (PCA). The agreement, which was signed following the meeting between senior officials from both sides in Jogjakarta, on 14th July 2009, covers diverse areas of cooperation, such as trade, investment, human rights, climate change, migration, as well as efforts to address organised crime and communicable diseases.

As the PCA with Indonesia is the first such agreement to be signed by the EU with an Asian country, it reinforces Indonesia's diplomatic standing in the eyes of European policy-makers. The EU had recently concluded a Free Trade Agreement (FTA) with South Korea. However, it should be noted that FTA and PCA are somewhat different. While the former includes primarily trade and investment issues, the latter covers more comprehensive areas of cooperation, and can serve as the *umbrella* agreement for the former. It is not, however, necessary that the signing of a PCA precedes the signing of an FTA. Depending on the interests of its partners, the EU often considers signing an FTA prior to the signing of a PCA.

The signing of the PCA was also made possible following the recent decision by the EU to lift the 2007 ban on the four Indonesian airlines, including its national carrier Garuda Indonesia, from flying to Europe on safety grounds, a move that caused some resentment in Jakarta. With the lifting of the ban and the signing of the PCA, the trade relationship between Indonesia and the EU, which is valued at US\$ 28.4 billion a year, is expected to expand in the coming years.

Despite this encouraging progress in political relations between Jakarta and Brussels, the signing of the PCA is likely to present considerable challenges, particularly for Indonesia. Among other things, the agreement will pave the way for the negotiations on the long-awaited Free Trade Agreement (FTA), under the wider framework of the ASEAN-EU Free Trade Agreement (AEUFTA), to resume in the near future.

The discussion over the establishment of the AEUFTA have been suspended following, *inter alia*, the disagreement between the two sides over the political deadlock and human rights issues in Myanmar as well as the aforementioned ban imposed upon Indonesian airlines. Since then, Brussels has decided to pursue negotiations with individual ASEAN member countries with the hope of accelerating the signing of the PCAs and FTAs with them.

Despite the airlines ban, Indonesia appeared to be the most enthusiastic among the ASEAN countries in wanting to conclude the PCA agreement with the EU.

The discussions on the AEUFTA and the subsequent Indonesia-EU FTA (IEUFTA) began to emerge in 2005, at a time when global trade talks under the auspices of the World Trade Organization (WTO) came to be significantly challenged not only by the differences emerging amongst its member countries, but also by the rise of Bilateral Free Trade Agreements (BFTAs), concluded either between countries, between regional groupings, or between a regional grouping and a country. Frustrated by the deadlock in the multilateral-level negotiations, both the EU and ASEAN (and its individual member countries, including Indonesia) have in recent years taken a pro-active stance in pursuing a BFTA policy strategy.

For the EU in particular, its ability to secure market access to the ASEAN region, including that of Indonesia, has become even more critical in light of the economic slowdown resulting from the recent global financial crisis.

However, given the economic imbalance between the EU and Indonesia, economic relations between the two sides remain in favour of the EU. Today, the EU, as a regional bloc, has become an entity capable of exercising influence beyond that of other global economic superpowers.

The EU rules on labelling, content, manufacture, design and safety, for example, have become the rules that most global manufacturers follow. Within the EU there are many large multinational corporations (MNCs) with a global reach, many of which are already doing business in the Indonesian market. Indonesia and its ASEAN neighbours, on the other hand, have not yet evolved into a strong economic entity capable of competing with the EU at the global level.

Furthermore, Indonesia is still struggling to put into force domestic economic reforms, which are keys to stimulate the country's socio-economic development. It is thus likely that the adjustment costs to be paid by the Indonesian and the other Southeast Asian economic actors would be high, should an IEUFTA and AEUFTA be finally agreed upon and concluded.

In order to redress this imbalance, the proposed IEUFTA and the subsequent AEUFTA, must take into account the development interests of both Indonesia and ASEAN.

Key Issues in the EU-Indonesia FTA

There can be little doubt that the proposed Indonesia-EU FTA (IEUFTA) is likely to deepen the existing asymmetry in the economic relations between the two sides, particularly if short-term adjustment costs to be incurred by Indonesia are not addressed in the forthcoming FTA negotiations.

From an EU perspective, the agenda items central to the FTA negotiations will likely focus on elements such as the incorporation of a strict IPR regime, the promotion of service sector liberalization and so on. However these would be not only extremely difficult, but also costly to implement for Indonesia. The following are some of the main concerns to be expected in both the future negotiations and implementation of the FTA.

1. Policy Space

Policy space matters for Indonesia because it allows the GOI the sovereignty to determine the appropriate trade, investment and industrial policies that could help its own development amid the pursuit of economic liberalization.

In the multilateral setting, Indonesian trade policy-makers often argue for a list of *sensitive* products that should be excluded from liberalization initiatives (known as the Special Products or SP) and the Special Safeguard Mechanism (SSM) that allows the government to impose contingency restrictions on imports to deal with special circumstances, such as a sudden surge of imports.

These are seen as the components of policy space that Indonesia requires to cope with the adjustment costs generated from trade liberalization. The EU and other major developed countries, in contrary, consider these initiatives as a form of protectionist policy aimed at limiting their market access to the developing economies. However, given the different levels of development between the involved parties in this FTA, Indonesia feels that it should be accorded with the necessary concessions crucial to limiting the negative impacts of this trade liberalization.

2. Diverging Views on How to Achieve Economic Development

In relation to the issue of policy space above, *development* will likely prove another contentious issue under the IEUFTA. Although it would be important for the IEUFTA to prioritise the developmental objectives of Indonesia, the weaker side, EU and GOI seem to have different views on how economic *development* could be achieved through this trade agreement.

Past FTA negotiations between the EU and its Southern partners have shed light on the key elements deemed crucial by the EU to promoting sustainable economic development.

The EU favours extending technical assistance to its partners, places more emphasis on regional integration, and grants more flexible timeframes for the implementation of an FTA.

Indonesia, on the other hand, sees the achievement of economic *development* under the IEUFTA to include the freedom to use the above mentioned Special Products (SP) and Special Safeguard Mechanism (SSM), market access facilitation, allowing subsidies for small-scale production, and providing a firm commitment to investing in the country (as opposed to the *mere potential* of attracting investors).

3. The General System of Preferences (GSP) Scheme

The GSP scheme plays a significant part in the EU's external trade policy. The EU's GSP scheme offers either lower tariffs or completely duty-free access for imports from developing countries to the EU.

Although most ASEAN countries are beneficiaries of the EU's GSP scheme, the relative economic growth of the region has redefined the suitability of many ASEAN member countries to be accorded such status.

Indonesia is considered under the terms of the new EU-ASEAN GSP scheme that was adopted in June 2005, as now '*graduated from the EU's GSP scheme*'.

Thus since then, a number of Indonesian products, such as animal and vegetable fats, wood products, basket ware and so on, no longer enjoy GSP privileges. Given the limited ability of Indonesian economic actors, particularly small and medium-sized ones, to carry out operation beyond national borders, EU GSP policy *vis-à-vis* Indonesia should be reassessed.

4. Market access and subsidies

Market access and subsidies will also play key role in determining the conclusion of the IEUFTA.

For most producers and manufacturers in Indonesia, the EU's current policies concerning these two issues are contradictory. While low tariff rates for non-manufactured agricultural products may give the impression that the EU encourages the export of ASEAN produce to its markets, the stringent sanitary and phytosanitary (SPS) measures imposed at the EU borders can severely impede ASEAN exporters in further penetrating the EU market.

The EU, for example, has refused entry of Indonesian shrimp and other seafood products on the basis of health and sanitary reasons. The Union is concerned with the antibiotics used in Indonesian shrimp farming, also known as *chloramphenicol*, and requires Indonesian shrimp and other seafood products to go through the Rapid Alert System, which is normally used to inspect residual bacteria. Indonesian shrimp and seafood exporters, however, raised their objection to this regulation, pointing out that the substance is naturally produced in the soil and plankton which is eventually fed to the shrimps. A zero content of chloramphenicol in shrimp is, therefore, impossible.

At this point in the distribution chain, ASEAN producers find themselves in the disadvantageous situation of having already incurred transportation costs without eventually being able to sell their goods. Furthermore, assuming these produce do pass these EU's WTO-Plus SPS standards, which primarily refer to the arrangements in bilateral or regional trade arrangements, whose scope goes beyond those achieved at the WTO level.

ASEAN exporters are forced to compete with heavily subsidised domestic goods.

As regards to the manufactured products, these are usually hit by high tariff rates, a significant handicap which can often price any ASEAN product out of the EU market.

Indonesian manufacturers often speak of two key problems confronting them in relation to the EU: tariff peaks and tariff escalation. The EU maintains a number of high tariffs in limited positions of Common Commodity Nomenclature (CCN), and these cover

products, such as textiles, rubber, furniture, agriculture and food, all of which are relevant to Indonesia.

As far as tariff escalation is concerned, this means the EU imposes zero or very low tariff rates for unprocessed products, but very high tariffs on processed products. This has acted as a barrier to the development of some industrial sectors. Confronted with high tariffs for processed products and low tariffs for unprocessed ones, it is easy to imagine a developing country abandoning plans for industrialization and opting instead for agricultural production.

In relation to this, Indonesia and EU need to *clarify whether the IEUFTA aims to encourage Indonesia to remain as a low-level producer (e.g. exporting raw materials and agricultural products) or whether it aims to encourage the development of manufacturing industries in the Southeast Asian region. If the issue of tariff peaks remains unresolved, for example, one could forgive GOI for thinking that perhaps it is the trade policy of the EU to keep its partner as farmers and fishermen, rather than manufacturers.*

Furthermore, the issue of subsidies needs to be addressed in the IEUFTA. Whilst the continuous use of large agricultural subsidies in the EU remains a matter of concern amongst Indonesian agricultural exporters, the use of domestic subsidies for small-scale or grassroots producers might still be a useful tool to ensure the welfare of Indonesian farmers.

5. Foreign Direct Investment

With regard to foreign investment, the IEUFTA must do more than just create the *mere potential* for foreign investment. Most mainstream studies, such as Kettunen (2004) and one that was commissioned by the European Commission, promise that an FTA between the EU and ASEAN would increase the flows of European investment into ASEAN, including Indonesia.

However, there are non-economic factors, such as security, that may influence the flows of foreign investment into Southeast Asia. The IEUFTA, therefore, must secure a concrete commitment from both EU and Indonesia to invest in the two regions. Whilst foreign investment is acknowledged to be the prime mover of the development process, this promise remains a pipedream if no real capital investment flows into the regions, particularly into ASEAN.

Any conditions laid out by the EU which aim to liberalize foreign investment laws in the region must be met by a concomitant concrete undertaking that significant foreign investment ensues in the form of long-term capital flows from major European manufacturers. The EU, for instance, could assist and facilitate the promotion of Indonesian market opportunities to European investors and develop appropriate measures with Jakarta to determine how the 'right types' of investment could be expanded in Indonesia.

6. Extensive Liberalization at the Expense of the Poor and Marginalised

As with most BFTAs, the proposed IEUFTA and the AEUFTA need to be examined critically.

The EU, as mentioned earlier, favours the so-called *new age* FTAs, with commitments that go beyond those achieved at the multilateral level (or WTO-plus). The EU-led FTAs are normally comprehensive agreements, embracing not only the conventional trade in goods, but also areas such as service sector liberalization, investment, Intellectual Property Rights (IPRs), competition policy, public procurement (as opposed to the relatively more limited government procurement), and other issues.

As with many other developed countries, the members of the EU are growing increasingly frustrated at the slow progress of global trade talks. With its vast experience of carrying out an *enlargement process* in the Eastern European region, the EU is keen to strike up integration initiatives with countries or regional groupings in the Southern hemisphere for the purpose of penetrating new markets.

However, it has been generally observed that North-South BFTAs tend to generate more benefits for developed countries, and this could prove to be an issue of importance in the IEUFTA negotiations.

The incorporation of Trade-Related Intellectual Property Rights (TRIPs)-plus arrangement under the IEUFTA, for example, could further benefit large European pharmaceutical and agro-industrial companies at the expense of the Indonesian poor. According to one estimate, yearly profits of US\$ 32 billion have already been generated from drugs *discovered* by these companies as a result of their prior use in indigenous medicine. This is not to mention the loss of access and control that would be experienced by local farmers in Indonesia, such as access and control over seeds, etc., should a TRIPs Plus arrangement become a key component in IEUFTA negotiations.

7. The Participation of Civil Society and the Marginalised Sectors in the Process of FTA Negotiations

The importance of civil society and marginalised sectors in the IEUFTA policy-making process cannot be over-emphasised.

Civil society and marginalised sectors provide crucial and valuable alternative inputs to policy-makers seeking a mutually beneficial trade agreement. Although Indonesia counts as one of the largest democracies in the world, democratic governance in trade policy-making can still be improved, and the EU should in this respect use its leverage, as a leading democratic entity, to influence Indonesia so that the IEUFTA reflects the opinions and aspirations of not only large economic actors, but also of civil society. However, it has been observed that while big democracies such as the US and the EU promote global democracy, their own attitude towards public participation in trade decision-making processes has often been undemocratic. Trade negotiations, which are likely to affect many sectors of society, must be kept open, transparent and accountable to public scrutiny. It is

better to have lengthy consultations at national and regional levels than to ignore the possible impacts of trade on key development factors such as the society and the environment.

Policy Recommendations

The IEUFTA is likely to deepen the asymmetrical economic relations between Indonesia and the EU, particularly if the development objectives of the former are ignored in the forthcoming negotiations and implementation of this trade agreement. Precisely because of this, a number of factors need to be incorporated in the final text of the IEUFTA. These include taking into account and striking a balance between Indonesia's interpretation of the ways in which the IEUFTA should contribute to the development of Indonesia and EU's own interpretation of economic development.

1. Overall, Indonesia can certainly benefit from this trade agreement if the EU is willing to: allow the use of SP / SSM
2. Expand its existing GSP scheme
3. Improve market access facilitation for ASEAN's exports to the EU
4. Allow the use of subsidies for low-level agricultural producers
5. Provide concrete commitments for long-term capital investment into Indonesia
6. Agree to the use of flexible timeframes for the conclusion and implementation of IEUFTA
7. Ensure the participation of civil society groups in the IEUFTA policy-making processes. The use of SPs and SSM, in particular, must be justified in the IEUFTA as they can act as guarantees to ensure the sustainability of items or products deemed sensitive by Indonesian economic actors.

Document 5: Looking East: The European Union's New FTA Negotiations in Asia – ECIPE Nov. 2007

Introduction

In late 2006, the European Commission's *Global Europe* Communication announced a new EU policy on free trade agreements (FTAs). The core of this new chapter in EU trade policy was planned FTAs with three Asian partners, India, ASEAN and South Korea. The Commission secured a mandate for new negotiations from the EU Council in April 2007 and negotiations have already started.

The EU is not of course new to FTAs. Indeed, the EU has more Preferential Trade Agreements (PTAs) on the books than any other leading power. But it did put new FTAs in deep-freeze from the late 1990s, giving priority instead to the WTO and the Doha round. Others, meanwhile, launched themselves into FTAs. Before the EU's change of heart, it was the only leading power not to be engaged in FTAs in Asia.

What do the new EU-Asia FTA negotiations mean – for the EU, for its Asian partners, and for the international trading system?

The study addresses this question in four parts. 1. The state of EU-Asia trade relations. 2. The new negotiations in the context of overall EU FTA policy, also making some comparisons with the US approach to FTAs. 3. The *ex ante* state-of-play of FTAs in Asia, i.e. FTAs negotiated or underway in the region not involving the EU. 4. Assessment of prospects for EU negotiations with India, ASEAN and Korea. It also assesses the institutional framework for EU-China trade relations.

EU-Asia FTAs in EU Trade Policy Context

In *Global Europe*, the Commission stresses commercial criteria for its new FTAs. These are all about “stronger engagement with major emerging economies and regions; and a sharper focus on barriers to trade behind the border.” FTAs should strengthen EU competitiveness.

The commitment to the WTO and a successful Doha round is restated, but renewed priority is given to bilateral and region-to-region negotiations to achieve market-access objectives.

In terms of content, *Global Europe's* stated aim is to have strong, comprehensive, “WTO-plus” FTAs. Tariffs and quantitative restrictions should be eliminated. Presumably, this should apply to at least 90-95 per cent of tariff lines and trade volumes in order to comply safely with the “substantially-all-trade” criterion in Article XXIV GATT. There should be “far-reaching” liberalization of services and investment. Services provisions should

presumably be compatible with the “substantial sectoral-coverage” criterion in Article V GATS. A model EU investment agreement, developed in coordination with EU member-states, is envisaged. There should be provisions going beyond WTO disciplines on competition, government procurement, intellectual property rights (IPR) and trade facilitation. There should also be provisions on labour and environmental standards.

Rules of origin (ROO) should be simplified. More generally, there should be strong regulatory disciplines and regulatory cooperation, especially to tackle non-tariff barriers. This should involve improved transparency obligations, mutual recognition agreements, conformity with international standards, regulatory dialogues and technical assistance.

With the economic criteria of “market potential (economic size and growth) and the level of protection against EU export interests (tariffs and non-tariff barriers)” in mind, the EU has selected India, ASEAN and Korea as partners for new FTAs, but not yet China, which “meets many of these criteria, but requires special attention because of the opportunities and risks it presents.” Finally, *Global Europe* announces a review of EU trade defence instruments (anti-dumping duties, safeguards and countervailing duties). But the EU also wants “to make sure that others apply high standards in their use of trade defence instruments and international rules are fully respected.”

In contrast, the EU-Asian FTAs are intended to go wider and deeper, and contain more *reciprocal*, i.e. roughly equivalent, concessions.

The benchmarks for such FTAs would be the following:

- comprehensive coverage of trade in goods, with zero tariffs and quotas on at least 95 per cent of trade volumes (and without wholesale exemptions for “sensitive” agricultural products);
- strong coverage of services and investment, underpinned by solid disciplines on domestic regulation;
- reasonably strong coverage of competition rules, government procurement and trade facilitation; improved transparency obligations and better regulatory cooperation, especially on non-tariff barriers;
- avoidance of specific WTO-plus obligations on labour and environmental standards (which could harm developing-country trade prospects); and
- a serious effort to simplify ROO requirements. WTO-plus obligations on IPR could also be more of a burden than a benefit to low-income, less-advanced developing countries.

It would be better to stick to the implementation of the WTO’s TRIPS obligations and adoption of associated international standards.

Going beyond *Global Europe*, there are several features of EU existing trade policy, and of EU regulation generally, that raise doubts about the EU’s willingness and ability to conclude economically sensible FTAs.

First, the EU seeks increasingly to export its regulatory practices, and FTAs are a tempting vehicle. International organisations and multilateral, regional and bilateral agreements are all used to promote the adoption of EU standards on product safety, the environment,

corporate governance and a host of other issues. The EU always links its “non-trade” goals to its trade agreements, preferably by having non-trade provisions in such agreements. *Global Europe*, under the heading of “social justice”, seeks to “promote our values, including social and environmental standards and cultural diversity around the world”, hence, the commitment to include core labour and environmental standards in FTAs. The EU is also increasingly interested in linking trade policy to climate change. New FTAs will likely contain trade-and-sustainable-development chapters, which could house climate-change provisions in the future. Fairly general, declaratory language on climate change, democracy, human rights and other EU pet issues could well be inserted into FTAs and linked to other non-trade bilateral agreements. These could conceivably limit negotiating partners’ freedom of action down the line by tying them to EU-specific standards.

The EU’s approach to the regulation of risk in international trade is another issue that could be exported via FTAs. WTO itself has a science-based approach to risk assessment of product standards in international trade (covered by the WTO’s SPS and TBT agreements). The EU has a broader approach that takes non-scientific considerations into account, particularly in its interpretation of the “precautionary principle”, which can be used to restrict trade on public health-and-safety grounds. This allows for wider regulatory discretion than in science-based risk assessments and can be more exposed to protectionist abuse.

Promotion of regional integration elsewhere – obviously using the EU as the model – is another vehicle for regulatory export, hence the EU’s preference for region-to-region negotiations wherever possible, e.g. with the ACP countries, Mercosur, Central America, the Andean Community, and now ASEAN.

Second, the EU is more serious about commercially-relevant FTAs than most other players. The EU uses GATS-type positive listing for services and investment, it does not use investor state dispute settlement, it has weaker constraints on domestic regulatory discretion, and it has fairly general, non-binding, barely WTO-plus provisions on competition, government procurement and trade facilitation.

This could allow the EU and its negotiating partners, in a spirit of mutual defensiveness, to carve out sensitive services sectors (such as health care, education, the utilities and audiovisual services) and get away with weak regulatory disciplines in other areas.

The EU approach to IPR, as well as to labour and environmental standards in its FTAs, is to have general language to secure acceptance of international standards, rather than specific WTO-plus obligations. Geographical Indicators (GIs) is the one exceptional area of IPR where the EU will likely try to secure TRIPS-plus obligations.

The EU (like USA) concedes very little on the movement of temporary workers (covered by GATS Model Four), except for limited provisions on business personnel. Neither allows FTAs to impose disciplines on antidumping procedures or agricultural subsidies. Neither has been successful in concluding mutual recognition agreements in FTAs. And both have added considerably to the “spaghetti-bowl” complexity of ROOs.

To sum up what Asian partners can expect from the EU, using US FTAs for comparison: 1. Tariffs and quotas will be eliminated on 90 per cent or more of goods trade, but that will still allow for carve-outs for swathes of agricultural trade. 2. The EU approach to market access and rule discipline in services, investment, government procurement, competition and trade facilitation will not be as strong as in US FTAs. The EU is likely to concede very little on Mode Four, and is unlikely to relax its tough SPS and TBT measures for FTA partners. There will be little on anti-dumping and agricultural subsidies.

Finally, negotiating partners should be alert to EU stratagems to sneak in non-trade provisions on climate change, human rights and other issues into FTAs.

Third, why has the EU decided to negotiate FTAs with India, ASEAN and Korea but not with Japan and China? The latter two comprise 55 per cent of the EU's potential Asian market. An FTA with Korea could be considered a steppingstone to one with Japan. But excluding China from the FTA calculus is even less convincing, and diminishes the EU's "economic criteria" for new FTAs. Fear of Chinese competition is clearly the main reason why China is not on the list.

There are the dangers of efficiency losses from trade diversion, i.e. sourcing imports from high-cost countries in a preferential agreement and not from low-cost countries outside the agreement. This could be a problem when FTA partners have relatively high MFN tariffs and high regulatory barriers in goods, services and investment.

To sum up, the EU is more serious about commercially-relevant FTAs than most other players, i.e. Brazil, India, South Africa, ASEAN, Japan and China. But its "economic criteria" for new FTAs are compromised by 1. Non-trade goals and onerous regulations the EU tries to export via FTAs. 2. Weaker stance on market access and related rules compared with the USA. 3. Absence of Japan and China from its FTA wish-list; 4. Potential trade-diversion effects. 4. General mercantilist outlook that neglects unilateral liberalisation and internal-market reforms. The last two features are of course not confined to the EU.

FTAs in Asia

Unlike other regions, East Asia used to rely on non-discriminatory unilateral and multilateral liberalization rather than discriminatory FTAs. Now it is playing catch-up, with FTA initiatives spreading like wildfire in the past six years. The major Asian powers – China, India and Japan – are involved, as are Korea, Australia, New Zealand, Hong Kong, the Southeast-Asian countries, as well as other South-Asian countries. There are about 20 FTAs in force and 60 more in the pipeline in China, India and Southeast Asia.

China is the driving force for FTAs in Asia. It is considering or negotiating FTAs in East and South Asia, the Middle East, Latin America, Africa, and with Australia and New Zealand. By 2006, it had 9 FTAs on the books and was considering negotiations with up to 30 other countries.

The China-ASEAN set of negotiations, more than any other FTA initiative, is the one to watch in the region. The aim is to have an FTA in place by 2010. It would be the largest FTA ever negotiated, covering 11 diverse economies with a population of 1.7 billion and a GDP of US\$2 trillion. There has been reasonable progress in eliminating tariffs on trade in goods. Duties on 95 per cent of tariff lines will disappear by 2010; many remaining tariffs will go by 2012; and other tariffs will be reduced or be capped thereafter.

However, little progress to date has been made on non-tariff barriers in goods, services (where a relatively weak agreement has been reached), investment and other issues. China also has relatively strong WTO-plus FTAs with Hong Kong and Macau (both admittedly special cases); a comprehensive FTA on goods with Chile; and is negotiating FTAs with Australia, New Zealand and Singapore.

It is also thinking of negotiating rather weak FTAs elsewhere in the developing world. These are shallow, mostly preferential tariff reductions on a limited range of products. Even the China-ASEAN FTA is unlikely to create much extra trade and investment if it does not go substantially beyond tariff elimination in goods. Trading interests are placed in the context of foreign-policy “soft power”, i.e. diplomacy and relationship building.

Turning to ***Southeast Asia***, Singapore blazed the FTA trail, with Thailand next to follow, and now Malaysia, Indonesia, the Philippines and Vietnam trying to catch up. Singapore has agreements in force with Australia, New Zealand, Japan, USA, Korea, India and a host of other minor trading partners. Thailand has agreements in force with Australia, New Zealand, Bahrain, Japan, China and India. It was in negotiations with the USA and others, before the Thai political crisis and the subsequent military coup put all negotiations on hold. Malaysia has an agreement with Japan, and is negotiating with the USA, Australia, New Zealand, India, Pakistan, Korea and Chile. The Philippines has a new FTA with Japan; ***Indonesia*** is negotiating with Japan; and both are looking to start negotiations with others. Vietnam has a bilateral trade agreement with the USA, is negotiating with Japan and considering other negotiations. In addition, ASEAN collectively has negotiations with China, India, Japan, Australia-New Zealand CER and Korea.

Of the ASEAN countries, only ***Singapore*** has reasonably strong FTAs, with comprehensive coverage and strong rules for goods, services, investment and other issues. But Singapore, with its free-port economy, centralised city-state politics, efficient administration and world-class regulatory standards, is a misleading indicator for the region.

Many product areas, especially in agriculture, are likely to be excluded from goods liberalisation. Regulatory barriers are unlikely to be tackled with disciplines that go much deeper than existing WTO commitments.

Services commitments are unlikely to advance much beyond the WTO’s GATS agreement, let alone deliver meaningful net liberalisation or regulatory cooperation (e.g. on mutual recognition of standards and professional qualifications). Provisions on investment and the temporary movement of workers are also likely to be weak, with perhaps even weaker commitments on government procurement, competition rules and customs administration.

More important than all the above considerations, it is that agreements in force and those being negotiated are creating a “noodle bowl” of complex and restrictive rules of origin. A mess of differing general and product-specific ROO criteria is emerging. These differ between bilateral FTAs. Collective ASEAN FTAs with third countries will compound the problem, if they end up with yet another layer of differing ROO criteria. If this is indeed what emerges, administrative and other compliance costs could be too onerous for most exporters in the region. Many will find it cheaper to pay the MFN-tariff duty.

India is also newly active with FTAs, in its South-Asian backyard and in other developing-country regions, but severe political problems in the region (the Indo-Pakistani conflict over Kashmir, and the fact that India is completely surrounded by weak, failing or failed states) will make progress very difficult.

India’s approach to FTAs outside South Asia is mostly about foreign policy and is “trade light”, with little economic sense or strategy. An FTA with ASEAN is planned for completion by 2011; and bilateral FTAs are also in place with Thailand and Singapore.

In addition, India is part of the BIMSTEC group (the other members being Bangladesh, Sri Lanka, Nepal, Bhutan, Thailand and Myanmar) that plans an FTA by 2017.

Japan was the last major trading nation to hold out against discriminatory trade agreements, preferring the non-discriminatory WTO track instead. Japan’s biggest FTA initiative is the Japan-ASEAN Economic Partnership Agreement, which is supposed to be completed by 2012. It is comprehensive on paper, covering goods, services, investment, trade facilitation and several areas for economic cooperation. However, progress has been slow, much slower than in the China-ASEAN FTA. This is due to Japanese reluctance to reduce and then phase out agricultural tariffs, and to its insistence on restrictive and often product-specific rules of origin, especially for agricultural and manufactured products.

Another complicating factor is that Japan has given greater priority to bilateral FTA negotiations with individual ASEAN countries. Such bilateralism, especially with its noodle-bowl profusion of rules of origin, is going to make it very hard to achieve a clean, comprehensive Japan-ASEAN FTA.

Japan has several other FTA initiatives in train. It calls its FTAs “economic partnership agreements” (EPA), to indicate that they go beyond traditional FTAs in goods and have comprehensive coverage of trade and investment-related issues in goods and services.

South Korea, like Japan, it is defensive on agriculture. Unlike Japan, it seems to be more serious on other negotiating issues. It has made more progress than Japan in FTA negotiations with ASEAN.

In Southeast Asia, the **ASEAN Free Trade Area (AFTA)** has an accelerated timetable for intra-ASEAN tariff elimination, but has seen little progress on “AFTA-plus” items such as services, investment, non-tariff barriers, and mutual recognition and harmonisation of standards. An ASEAN Economic Community, a single market for goods, services, capital and the movement of skilled labour, is supposed to be achieved by 2015. So far, however,

ASEAN Vision Statements and other blueprints have largely failed to remove barriers to commerce in Southeast Asia. They seem rather distant from commercial ground realities.

An ***ASEAN Plus Three (APT) FTA*** (the “three” being Japan, South Korea and China) has been touted, as has an East-Asian FTA that might include Australia and New Zealand. There is talk of a pan-Asian FTA that would include India or SAFTA. Visions of an East Asian Economic Community and even an Asian Economic Community have appeared on the horizon. So far this talk is loose and empty – nothing more.

Regional players are speeding ahead with quick and weak bilateral FTAs, while little progress is being made with the larger ASEAN FTAs (beyond tariff elimination in goods trade). Such FTA activity distracts attention from further unilateral liberalisation and domestic reforms. That will probably hinder, not help, the cause of regional economic integration.

EU-Asia FTAs

EU-China Trade Relations - The Institutional Framework

China is now the EU’s largest trading partner in Asia and its second largest trading partner in the world. European multinational enterprises have big investments in China, much of it linked to trade: their China operations import machinery and other inputs from Europe and elsewhere, and export final goods back to Europe and the wider world. The EU says that “China is the single most important challenge for EU trade policy”. Yet the EU is avoiding an FTA with China, while it prioritises negotiations with less important Asian trading partners.

As things stand, a serious EU-China FTA is not achievable for either side. China is unlikely to get what it wants from the EU through an FTA: recognition of market-economy status; stronger disciplines on EU anti-dumping and safeguard measures; removal of peak tariffs on garments, leather goods and other manufactured exports; reduction of EU agricultural subsidies and tariffs to open markets for its expanding agricultural exports; and less trade-restrictive EU SPS and TBT measures.

All these measures restrict China’s labour intensive goods exports. FTA negotiations would put extra pressure on the EU to reduce or remove many of these barriers, which would expose inefficient EU producers to even greater Chinese competition. That is why the EU does not want an FTA with China.

What would EU exporters and investors gain from an FTA with China? China has already made very strong WTO commitments on tariffs and non-tariff barriers to goods trade, and on services liberalisation. But that still leaves significant gaps. A comprehensive, WTO-plus EU-China FTA would take over 90 per cent of Chinese tariffs down to zero (from a nominal MFN average of 9 per cent); deliver GATS-plus commitments on services liberalisation; remove foreign-ownership restrictions and secure better legal protection for EU investors; impose greater disciplines and transparency on all manner of domestic regulation (e.g. on administering subsidies, licenses, safety standards, IPR and customs

procedures); gain WTO-plus commitments on government procurement, competition rules and trade facilitation; and extract commitments on core labour and environmental standards. But, since the EU is unlikely to concede anything major to China, it is unlikely to get the above concessions from China. Furthermore, Chinese liberalising reforms do not have the strong tailwind they had in the run-up to WTO accession: the politics of further liberalisation in China is proving more difficult.

Given these realities, now is not the time to launch an EU-China FTA initiative. But now is the time to strengthen and strongly institutionalise bilateral trade cooperation. Present and envisaged arrangements are too soft. They should be hardened – without jumping onto the FTA bandwagon.

The EU and China agreed to a “strategic partnership” in 2003. In 2007, both sides agreed to start negotiations on a new Partnership and Cooperation Agreement (PCA). The EU intends the PCA to cover political and economic issues, including its non-trade objectives on democracy, human rights, the rule of law, sustainable development, climate change, and labour and environmental standards. Its trade-and-investment priorities for the PCA include: better enforcement of IPR; mutual recognition of geographical indicators; WTO-plus commitments on access for EU investors; and stronger regulatory cooperation on health-and-safety standards.

The EU envisages some institutional changes, such as an annual heads-of-government summit, stronger exchanges and dialogues at ministerial, senior-official and technical levels, and an independent EU-China Forum for non-governmental representatives.

The EU-Korea FTA

Korea is by far the EU’s best FTA prospect in Asia– for two reasons. First, Korea, next to Singapore, is the most credible FTA player in Asia. It has very high levels of agricultural protection and correspondingly defensive negotiating positions. But it has been more serious and forthcoming than Japan, China, ASEAN countries and India on non-agricultural issues in FTA negotiations.

Korea successfully concluded FTA negotiations with the toughest *demandeur* around, the USA, while US FTA negotiations with Thailand and Malaysia got stuck.

EU-Korea negotiations were recently successfully completed, with a relatively strong result, WTO-plus FTA, though with significant gaps. This FTA will deliver appreciable gains for Korea, but the net effect on the EU would be rather modest.

The EU-ASEAN FTA

EU-ASEAN trade is lower than EU bilateral trade with China and Japan, but it is higher than EU bilateral trade with Korea and India. EU FDI stock in ASEAN is higher than it is elsewhere in Asia except Japan. EU-ASEAN trade is overwhelmingly with Singapore, Malaysia and Thailand. EU FDI goes mostly to these three countries, and the bulk of it to Singapore.

Relatively big numbers for EU trade and FDI with ASEAN should not be taken at face value: ASEAN is neither a country nor an integrated economic region.

ASEAN countries vary widely in historical legacies, political systems, levels of economic development and institutional capacity. Singapore has high Western-style per-capita income; Malaysia is one of the wealthiest developing countries; Thailand is in the middle-income developing-country bracket; the Philippines and Indonesia have much lower, and Vietnam even lower, real incomes; and Cambodia, Laos and Myanmar are least developed countries. Tiny Brunei is rich solely due to oil revenues. Trade barriers between ASEAN countries, especially non-tariff and regulatory measures, are quite high. Regional economic integration exists more in ASEAN blueprints and “visions” than it does on the ground – a world away from the EU.

An EU-commissioned study on the potential impact of an EU-ASEAN FTA comes up with the following numbers.

An ambitious FTA (with zero tariffs on all goods trade and a 50 per-cent reduction in barriers to services trade) would increase EU GDP by 0.1 per cent and ASEAN GDP by 2.2 per cent.

A less ambitious FTA (with carve-outs for sensitive agricultural products) would hardly change these figures.

A third scenario (taking into account other existing FTAs) would increase the ASEAN gain to 2.6 per cent of GDP. A much more modest FTA (limited to goods liberalization) would increase EU GDP by 0.03 per cent and ASEAN GDP by 0.5 per cent.

Hence a substantial FTA would deliver appreciable gains for ASEAN but have a modest effect on the EU.

70% of the gains would accrue from services liberalization. Limited services liberalization would drastically reduce ASEAN gains, and reduce EU gains to virtually nil. These forecasts are similar to those for the EU-Korea FTA. The CGE model used covers non-tariff and regulatory measures only superficially, and is silent on rules of origin.

The EU and ASEAN have a Cooperation Agreement that dates back to 1980. Since 2004, they have the Trans Regional EU-ASEAN Trade Initiative (TREATI), which is now the framework for region-to-region regulatory cooperation on trade, investment and trade-facilitation issues.

The EU is also negotiating Partnership and Cooperation Agreements, covering a host of political and economic issues, with Singapore and Thailand, and will start PCA negotiations with Malaysia, Indonesia, the Philippines and Brunei. There are plans for a PCA with Vietnam as well. More broadly, the Asia-Europe Meeting (ASEM) is an annual summit involving the EU Commission, the EU member-states and the ten ASEAN members. It has an “economic pillar” for meetings of economic and finance ministers and senior

officials, as well as an Asia-Europe Business Forum. The EU has also expressed its wish to accede to the ASEAN Treaty of Amity and Cooperation.

The EU's mandate is to negotiate a collective FTA with the ASEAN members with which it has started or plans to start PCA negotiations. This leaves out Cambodia, Laos and Myanmar. The EU gives Cambodia and Laos duty-free access to its market already as part of its Everything but Arms package for LDCs. It will not include Myanmar on principle, given its human-rights record and the existence of EU sanctions on Myanmar.

Some ASEAN leaders, on the other hand, insist that the FTA must include all ASEAN members, in line with other ASEAN FTAs with third countries. These issues remain to be resolved. But compromise is likely: these should not be big negotiating road-blocks.

As for negotiating content, the EU wants a ten-year transition period for tariff elimination and commitments in services and investment, perhaps with longer transition periods for some sensitive agricultural products.

It is willing to give Special and Differential Treatment (SDT) to less-developed ASEAN countries in the form of longer transition periods. Interestingly, this differs from the EU's approach to the negotiations with Korea and India, for whom no SDT is envisaged. The EU's draft mandate for the ASEAN FTA negotiations contains softer language on government procurement and competition rules than in the draft mandate for the negotiations with Korea. With ASEAN, the EU wants compatibility with the WTO's GPA and regulatory cooperation on competition issues; there is no mention of GPA-plus market-access commitments, nor of binding commitments on competition enforcement. Finally, the EU aims to complete negotiations by mid 2009.

The bottom line is that an EU-ASEAN FTA only makes economic sense if it goes deep into non-tariff and regulatory barriers in ASEAN countries other than Singapore. This is highly unlikely.

First, the record of existing ASEAN FTAs – AFTA, FTAs between individual ASEAN countries and third countries, collective ASEAN FTAs with third countries – shows that they hardly go beyond tariff elimination on 90% or more of goods trade. Singapore's FTAs are exceptional. The USA is the only player that has attempted strong FTAs with ASEAN countries. It succeeded with Singapore, but has failed so far with Thailand and Malaysia, and considers Indonesia and the Philippines unlikely prospects.

Second, given intra-ASEAN differences and the lack of adequate common negotiating machinery, the EU will find it exceedingly difficult to negotiate with ASEAN collectively. ASEAN is big on summits, other meetings, Visions, Charters and sundry blueprints. Much of this is hot air. When it comes to concrete measures, ASEAN decision-making is very unwieldy and dilatory, and eventually- agreed positions tend to be low common denominators.

The easy way out for the EU and its ASEAN counterparts is to negotiate a relatively trade-light FTA that does not seriously tackle non-tariff and regulatory barriers, akin to other ASEAN FTAs. That would be politically symbolic but commercially nonsensical.

If this is indeed what transpires with ASEAN, the EU should change strategy, and the sooner the better. What should it do?

- The EU should give up on negotiating with ASEAN collectively (meaning ASEAN-10 or ASEAN-minus-3). Rather it should aim for a stronger TREATI framework for regulatory cooperation with ASEAN. This should be complemented with stronger trade-and-investment regulatory cooperation with individual ASEAN countries, perhaps within a PCA framework.
- The EU should go full speed ahead with an FTA with Singapore. This could be done in quick time and be relatively strong and clean. It would be at least as wide and deep as the US-Singapore FTA. Ideally, it would remedy some of the latter's faults, notably on complicated, product-specific rules of origin.
- The EU should *not* go full speed ahead with bilateral FTAs with other ASEAN countries. Serious FTAs with them are presently not deliverable. Malaysia and Thailand are the strongest candidates after Singapore. But Malaysia's vested interests are intimately bound up with its *Bumiputra* policies (that discriminate in favour of the Malay majority). This precludes sufficient opening of services markets and government procurement. Thailand has gone backwards after the military coup in 2006: economic-nationalist rhetoric has increased; anti-market NGOs are more influential; protectionist interests are more powerful; government is more incompetent; and economic illiteracy is all-pervasive.
- Indonesia, the Philippines and other ASEAN countries present even greater obstacles.

Conclusion

The EU says its new FTAs with Asian countries will be governed by commercial criteria, and that it is aiming for strong, comprehensive, WTO-plus FTAs. But, for the most part, this is unlikely to materialize.

The EU is not as ambitious on market access and rules as the USA in FTA negotiations. It has entrenched protectionist interests in agriculture as well as in some industrial-goods and services sectors. Its commercial criteria are severely compromised by its zeal to export the "EU regulatory model". This includes a range of non-trade objectives it sneaks into bilateral and regional trade agreements. Its two major Asian trading partners, China and Japan, are not on its FTA wish-list.

Over in Asia, the emerging patchwork of FTAs leaves much to be desired. Some FTAs are preferential-tariff agreements on a limited range of goods. Even the better ones are trade-light and barely WTO-plus: they cover tariff elimination on most goods trade, but do not seriously tackle non-tariff and regulatory barriers. They are unlikely to contribute to regional and global economic integration, but will cause extra complications through profusion of complicated and discriminatory deals. This is undermining comparatively simple, transparent, predictable and non-discriminatory multilateral trade rules.

Finally, the mercantilist outlook of all major FTA players, including the EU and its Asian partners, leads them to neglect unilateral liberalization and domestic structural reforms. The latter are far more important to building up firm-level competitiveness than crow-baring open export markets through FTA negotiations. As for the new FTA negotiations, the EU's best prospect is a relatively strong, WTO-plus FTA with Korea, building on the recently concluded US-Korea FTA.

But it will probably leave significant gaps, notably in agriculture and some services sectors. The EU has little hope of concluding a serious FTA with ASEAN collectively (or even with ASEAN minus Cambodia, Laos and Myanmar).

Rather it should focus on stronger EU-ASEAN trade-related regulatory-cooperation, and a strong, WTO-plus FTA with Singapore. Strong FTAs with other ASEAN countries are unlikely.

Document 6: Trade Policy at the Crossroads: The Indonesian Story – UNCTAD 2005

Following the recent crises and the subsequent slowdown in the world economy, many countries in the developed and developing world are at the crossroads in their trade strategy, uncertain whether to advance with trade reforms, to stand still or increase protection.

In this context, the purpose of this paper is to stimulate public policy debate on a future trade policy for Indonesia. This study offers an insight into the scope of the potential impacts of alternative trade policy scenarios, and helps assess the effects of Indonesia pursuing alternative trade policy paths.

Indonesia provides an interesting case study of the potential benefits and costs of alternative trade strategies that are under consideration in many developing countries. The ASEAN region has recently announced a deepening of its commitments and is considering widening the agreement to include countries such as China, Japan and the Republic of Korea. A bilateral agreement with the United States is also a possibility.

Against this background, Indonesia's options on trade policy range from increasing protection to actively pursuing bilateral, regional and multilateral initiatives.

The results of a general equilibrium analysis point to several interesting implications for policy makers. They show that increasing protection results in economic losses while a stand still and more liberalization produce economic gains.

Multilateral trade liberalization is a two-edged sword for many countries. The opening up of markets provides a welcome opportunity for the development of exports. On the other hand, it also brings increased competition, not only in export markets but also in domestic markets. To take advantage of market opportunities, resources need to flow from inefficient sectors to those where productivity is greater.

In the long run, developing countries have little choice but to continue down the liberalization road as the world becomes increasingly integrated. Liberalization is recognized as a desirable objective of economic policy for all economies and WTO members have committed themselves to moving towards this objective.

While openness is the end goal, the real question is how to get there, with the loudest voices – and many vested interests – calling for a *standstill* in current liberalization or an increase in protection. The various trade strategy options include increasing protection in selected industries.

While a competitive exchange rate, fiscal discipline, trade liberalization, a sound investment climate and secure property rights are considered necessary, they are no longer considered

sufficient. Other variables include good governance, low levels of corruption, flexible labour markets, inflation's targeting and social safety nets.

The slow progress in multilateral negotiations has inevitably led to a reinforcement of the trend since the 1990s towards the formation of regional trade and integration agreements. Bilateral and regional agreements seem to afford opportunities for faster, deeper liberalization with selected trading partners. It is much easier to get agreement with a few rather than many countries. The most obvious example of a successful agreement is the European Union.

Developing countries are queuing up to obtain access to developed country markets, both in Europe and the Americas. The difficulties with these agreements are the unequal bargaining power between the members, particularly for hub-and-spoke arrangements where one large economy essentially has bilateral arrangements with several smaller countries.

The danger is that the larger power excludes products of particular interest to its partners or exacts other policy changes that may be premature or costly for the smaller, developing partner. The Australia-US Free Trade Agreement is an example where sugar was excluded. The EU has mostly excluded agriculture from its network of agreements with the Euro-Mediterranean and Central and Eastern European countries.

Indonesia provides a useful case study of a country at the crossroads. It has undertaken substantial reforms, especially following the 1997 Asian financial crisis, but is yet to see the expected benefits. As a result, there is indecision about the way forward in its trade policy.

The paper examines the options for Indonesia and attempts to draw implications for developing countries more generally. An overview is provided of the evolution of Indonesia's trade regime since the 1960s, while the structure of the Indonesian economy in relation to existing trade flows and protection levels is also examined. The sectors enjoying or facing the largest protection rates and hence likely to be most affected by pending changes are agriculture, textiles and motor vehicles.

It discusses timing and sequencing issues for Indonesia in progressing with further liberalization and finally draws implications for policies that may also be of value to other countries facing a similar trade policy dilemma.

Indonesia still has room to move in its trade policy, but important questions arise about how to proceed – more liberalization or not and wider or deeper. However, as for other countries, there are some limitations on the options available to Indonesia: the scope for further trade reforms must be considered in the context of existing trade commitments, some of which are legally binding.

Indonesia's case depends on its commitments under ASEAN, APEC and the WTO. It can obviously accelerate liberalization at a faster pace without negative implications, but is likely to be more limited if it chooses to *standstill* or *go back*.

The scope under ASEAN, which covers about 20 per cent of Indonesia's trade, is limited as compared with other agreements. Indonesia has already locked into binding tariff reductions, with few exceptions, as part of AFTA. ASEAN has expressed its intention of achieving zero tariffs on all trade between founding members by 2015. There is more flexibility under APEC and the WTO. Indonesia has a number of non-binding commitments under APEC, which is seeking to achieve free and open trade and investment by 2020 for developing economies.

Under the WTO, Indonesia is progressively liberalizing, but for some products where the bound rates are significantly higher than the applied rates there is significant scope to increase the applied rates.

Much needs to be done for Indonesia to become internationally competitive *and* to be in a position to maximize the benefits from further trade liberalization. With so much to be done and Indonesia still recovering from an historic multi-dimensional crisis, a gradual rather than a "big bang" approach to further liberalization may be the most successful. Adjustment costs, especially in terms of unemployment, are likely to be reduced if reforms are phased in.

For such an approach to be sustainable and creditable, a clear agenda and timetable for further liberalization need to be set and adhered in order to send a clear signal that protection will be reduced and removed as industries affected by the changes will more likely respond to the changed set of incentives instead of undertaking inefficient lobbying to maintain protection.

Document 7: Country Note on Trade and Investment Policy Coordination Indonesia – Industrial Development Division, MOFA, UNESCAP, Bangkok July 2007

Introduction

Indonesia has experienced its transition to a democratic and decentralized country, and the current Government led by President Susilo Bambang Yudhoyono has continued its efforts to increase a broad-based political and economic program aimed at sustainable economic development.

In the beginning of his administration, President has set a goal of creating a more efficient economy through opening up market and liberalizing trade, protecting intellectual property rights, strengthening the rule of law and transparency, improving business climate and encouraging competition. In order to meet this goal, the Government has reviewed all rules and regulations related to imports and exports and business licensing. The intention of this review is to identify and rectify onerous bureaucracy and poorly conceived trade and investment policies.

In the context of the government's focus on improving Indonesia's business climate and competitiveness, two inter-agency teams were created with the overall aim of improving coordination of governmental strategies and positions in trade dialogues and negotiations and facilitating the development of strategic sectors. A presidential decree revitalized the National Team for Increasing Exports and Investment (originally established in 2003, with the President as Chair.

In October 2005, a further presidential decree established an interagency Indonesian National Trade Negotiation Team, with the Coordinating Minister for the Economy and the Minister of Trade as its chair and deputy chair respectively. In addition, the President has also assigned the Minister of Trade to coordinate the formulation of investment policies.

In regard to decentralization, the reform process emerged in a crisis situation because the significant shift in resources and responsibilities from the central and provincial to the district governments (440 local governments) occurred quite rapidly.

Trade Aspect

Consistent with broad-based approach to modernizing the economy, the Government is also progressing on trade policy. Tariffs, the main trade policy instrument, are in the process of being lowered and made more uniform in line with the ASEAN Tariff Harmonization Program. As a consequence of these changes and the deeper integration in the regional and the world, the overall import weighted applied MFN rate has come down

to a moderate 8.3 per cent in 2006, demonstrating the openness of the Indonesian economy. Moreover, non-tariff measures are continuing to be reduced and eliminated. Agriculture, critical to the livelihood of a large part of the Indonesian population, has started to benefit from a revitalization program providing support for infrastructure, financial services and institutional reform. Industrial policy is oriented to fostering cluster groups, with selective use of incentives to support the development of Indonesia's regions and deepen and diversify industrial production in the face of stiff international competition and a fast changing business environment.

In international trade relations, the Government has begun to follow a triple track strategy on the international trade negotiations: multilateral, under WTO auspices; regional, centred on ASEAN and ASEAN+3 agreements; and for the first time, Indonesia is also pursuing a bilateral trade agreement with Japan, with other possible bilateral agreements under study. In addition to WTO negotiations, Indonesia has been working together with other WTO members to achieve a balanced outcome, consistent with the development objectives that are central to the Doha Declaration.

In the bilateral level, Indonesia has finalised negotiations with Japan since mid 2005 to establish an Economic Partnership Agreement that covers goods, rules of origin, customs procedures, investment, services, movement of natural persons, competition policy, energy and mineral resources and cooperation. Indonesia is also in the process of negotiating FTA with Pakistan, and exploring the possibility with India and Iran.

For the last three years, Indonesia's trade balance has fluctuated, but registered a trade surplus of over US\$ 3 billion in 2006. Export grew at the robust rate of some 18 per cent in the period 2003-2006, reaching record levels. Much of this can be attributed to strong commodity prices, in particular oil and gas, but also rubber, palm oil, coal and metal ores, as well as the healthy growth of the world economy.

Oil and gas exports reached some US\$ 2.2 billion in 2006, an increase of 17.6 per cent over the previous year. In 2005 the increase was partially associated with the world price increase of crude oil, which also impact on an increase in the value oil and gas imports since Indonesia becomes a net importer of such products. Meanwhile, non-oil & gas exports reached US\$ 79.5 billion, nearly 20 per cent higher than in 2005. And for the year 2007, the government target for non-oil export growth is 14.5 per cent. Reaching this target requires special effort, in particular on trade-related infrastructure, but much depends on the external environment such as economic growth of major markets and commodities prices.

Investment Aspect

Besides the public investment done by the Government, the private sector investment, including foreign direct investment, is important for the modernization and efficiency of the economy. Therefore, investment policy has been an important component of the policy changes that have been introduced by the Government.

The investment reforms, intended to improve the country's investment climate, cover three policy reform packages launched in the first half of 2006. The investment policy package (February 2006) covers the following areas: i) general investment policies; ii) customs; iii) taxation; iv) labour market; and v) small & medium size enterprises.

The Infrastructure Development Package (March 2006) provides the policy framework for public private partnership and the risk sharing to enable acceleration of the building of infrastructure with private participation. And the Financial Sector Reform Package (July 2006) aims at improving coordination between the government and the central bank (Bank of Indonesia), and continuing steps to strengthen the banking industry, non bank financial institutions and the capital market.

A number of areas in each of these reform packages have been completed such as the risk sharing framework for infrastructure; the revised Customs Law; most recently the Investment Law, which was passed in Parliament on March 2007. At the same time there is an ongoing program of deregulation, administrative and bureaucratic reforms aimed at increasing the efficiency and good governance of the public service.

The government has also revised the Investment Negative List with a view to providing increased legal certainty. The negative list comprises of a number of areas that are closed for foreign investment and some areas, which are open to foreign investment, subject to certain conditions. The negative list is relatively short, comprising only 1 per cent of all economic activity, or precisely covering 25 industrial sectors. Inclusion of certain activities in the closed list is based on the criteria, such as health, safety, defence and security, environment, culture and national interest. The negative list is also to provide a more solid legal base, as well as greater clarity, transparency and simplicity for investors and clearer guidelines for sector inside the list.

Conclusion

The coordination is a very intricate problem for a government in implementing an efficient bureaucracy. And the GOI is very aware of this problem. In addressing this problem, in the beginning of his administration President Susilo Bambang Yudhoyono has created two inter-agency teams as mentioned above.

This strategic step has been followed by the encouraging progress. The Government has succeeded to finalize the new investment law and the investment negative list, as well as to introduce the new policy reform packages. It has also completed its negotiations with Japan on the Economic Partnership Agreement. And equally important, the trade and investment activities have improved positively. This has signalled that the process is in the right

direction. Although there have some progress showing that the coordination has functioned, the Government realizes that the coordination problem is not an easy task. The challenge is still very huge, in particular due to the decentralization process. Indeed, the coordination is an ideal which the Government hopes to achieve, but with this process of coordination in the right direction, gradually and surely, it will lead to the creation of a better trade and investment environment. In the international relations, Indonesia is a member of MIGA (multilateral investment guarantee agency), and has signed 61 Bilateral Investment Treaties/Investment Guarantee Agreements. However, current tendency Economic Partnership Agreement covers broader sectors including investment, services, labour, cooperation, capacity building, etc. In the last three years domestic investment has risen sharply, doubling between 2002 and 2005 (from Rp.26 trillion to Rp.56.6 trillion). In 2006, the realization of domestic investment until November amounted to Rp.153.9 trillion and the realization of foreign investment amounted to Rp.42.8 trillion (with Indonesia's currency assumption Rp.9.100 for 1 US\$). This has been concentrated in the food, chemicals and pharmaceutical industries as well as in electricity, gas and water supplies. Foreign direct investment tends to fluctuate considerably from year to year but has shown a moderate overall positive trend since 2003, reaching US\$ 8.9 billion in 2005. FDI is concentrated mainly in the large plantation, chemicals, automotive and pharmaceutical sectors, but there are significant levels also in transportation, warehousing, communications and construction.

Document 8: World Trade Organization Trade Policy Review Indonesia 2007

Introduction

Since 2003, Indonesia has continued a broad-based political and economic reform programme aimed at sustainable development and the alleviation of poverty. Under this programme, Indonesia achieved a sustained overall economic growth, a much lower inflation rate, falling debt and growing reserves. Indonesia is now able to pay increasing attention to addressing social problems.

In the last 10 years, Indonesia has undergone important democratic change, also devolving increased authority and responsibilities to the regions, aiming to help improve welfare across the country. It has made a major effort to address the issue of corruption, including in tax administration, customs and public procurement, by greater transparency and auditing in relation to both process and decision-making. It has sought to improve competition within the Indonesian economy, and hence also the competitiveness of business, through a new Investment Law. The law and its accompanying implementing regulations should further help to improve the climate for investment.

The Government has made some important advances in the implementation of protection of intellectual property rights.

Consistent with its broad approach to modernising the economy, the GOI is progressing on trade policy. Tariffs are in the process of being lowered and made more uniform in line with the ASEAN Tariff Harmonization Program. Non-tariff measures are continuing to be reduced and eliminated. Agriculture, critical to the livelihood of a large part of the Indonesian population, has started to benefit from a revitalization programme providing support for infrastructure, financial services, research and development and institutional reform.

Industrial policy is oriented to fostering cluster groups, with selective use of incentives to support the development of Indonesia's regions and deepen and diversify industrial production in the face of stiff international competition and a fast-changing business environment. Indonesia is seeking to develop a modern services sector that it regards as important through inter-sectoral linkages for the country's efforts to improve competitiveness in traditional and non-traditional exports.

In international trade relations, Indonesia is an active participant in the current WTO negotiations in order to achieve a balanced outcome, consistent with the development objectives that are central to the Doha Declaration. Indonesia's main concerns are to obtain improved access for its key agricultural and manufactured exports, while ensuring obtaining guarantees for its most sensitive sectors objectives and some flexibility to develop its industrial sector.

The Government is working to ensure that the benefits of the reforms - political, institutional, legal, social and economic reforms – are available to all the Indonesian people in a safe, just, democratic and prosperous Indonesia.

However, there are some constraints, internal and external, that need to be addressed. Implementation of many reforms already approved is underway but will take time. In a democracy, progress cannot be achieved overnight in implementing the comprehensive reform package set out by the President. Much also depends on economic conditions in world markets, affecting commodity prices and the flow of earnings to help to develop and modernize the economy.

Main Economic and Policy Developments

Since the previous Trade Policy Review of Indonesia, the Government carried out its own economic reform package.

The economic reforms have been implemented within the overall framework of the Agenda for National Development 2004-09, which had 3 main goals, namely a Safe and Peaceful Indonesia, a Just and Democratic Indonesia, a Prosperous Indonesia. With regards to the agenda for enhancing the prosperity of the people, the main target is to reduce total number of the poor population and lower unemployment. To attain these targets, the GOI created a "cut-through" strategy to accelerate economic growth (pro-growth); to create employment (pro-job) and reduce poverty (pro-poor); and to revitalize the agricultural sector.

In order to accelerate economic growth, in 2005 the Government announced several refinements of policy to impart great dynamism to the economy and to cope with external pressures, such as the oil price rises and the increase of interest rates. The specific measures taken covered: i) adjustment of the fuel price for the industry and mining sector with the market price, ii) economizing the use of fuels in government activities, iii) the adjustment of overall fuel prices; and iv) the accelerated reduction of fuel usage by electricity power plants. Cuts were also made in fuel subsidies, but these were offset by the unconditional cash transfer programme (UCT) to reduce the impact of the changes on the poor. Fiscal incentives were introduced to help industry, including by strengthening competitiveness, improving the business climate and compensating workers. The incentives package involved changing the value-added tax status of primary products to non-taxable products, and the waiver of customs duties for several industrial inputs.

These adjustments, together with interest rate increases, were intended to put fiscal and monetary policy on a solid footing. This was partly offset by export growth that reached 17.6% and by the growth rate of the economy to around 5.5%, and 6.3% in 2007, which contributed to growth in employment opportunities and poverty alleviation. Inflation, which had surged to 17% in 2005, was curtailed to 6.6% by the end of 2006.

Financial Sector Restructuring

Financial sector reforms are aimed at overcoming the problem of access to capital and finance needed as working capital and for growth.

The Government addressed weaknesses in the financial market by diversifying the sources of funding available to the real sector, both from financial institutions and capital markets. The Government took steps to strengthen financial sector stability to re-build public and market confidence in the Indonesian financial sector, decreasing the risk of any recurrence of the financial crisis. It also promoted competition between banks, other financial institutions and the capital market to improve the overall efficiency of the financial sector,

in order to drive down current inflated margins, and hence the cost of finance. The financial sector package, aimed at assisting in this process, is targeted mainly at regulatory and institutional reforms, directed at increasing access to finance and lowering the cost of finance.

Investment

While the Government plays a key role in the provision of public services, including health, education, infrastructure, etc., private sector investment, including inward foreign direct investment, is important for the modernisation and greater efficiency of the economy.

Therefore, investment policy has been an important component of the policy changes that were introduced in 2005. These reforms, intended to improve the country's investment climate cover are contained in three policy reform packages in 2006. The *Investment Policy Package* covered the following areas: i) general investment policies; ii) customs; iii) taxation; iv) the labour market; v) SME. The *Infrastructure Development Package* provided the policy framework for public private partnership and the risk sharing to enable acceleration of the building of infrastructure with private sector participation. The *Financial Sector Reform Package* aims at improving coordination between the Government and Bank Indonesia, and to continue reform steps to strengthen the banking industry, non-bank financial institutions and the capital market.

A number of areas in each of these reform packages, such as the risk sharing framework for infrastructure, the revised Customs Law, and the Investment Law was completed. At the same time a programme of deregulation, administrative and bureaucratic reforms aimed at increasing the efficiency and good governance of the public service was launched.

In the last three years domestic investment has risen sharply, concentrated in the food, chemicals and pharmaceuticals industries as well as in electricity, gas and water supplies. Foreign direct investment tends to fluctuate considerably from year to year but has shown a moderate overall positive secular trend since 2003. FDI is concentrated mainly in the large plantations, chemicals, automotive, and pharmaceutical sectors, but there are significant levels also in transportation, warehousing, communications and construction.

Infrastructure

Apart from the general objective of improving the investment climate, the reforms also targeted the challenges in improving infrastructure. GOI recognized that investment in infrastructure is necessary to improve the overall investment climate and to support economic growth, focussing on establishing an effective framework for policy, regulation and new institutions, sector specific reforms, facilitating the involvement of local government in the provision of infrastructure, and improved project preparation. It has also improved government procurement procedures to ensure value for money in public works and the elimination of corruption.

Despite improved public finances, the Government does not have the economic capacity to finance all necessary infrastructure development. It is estimated that around 60% of funding needed for infrastructure building will need to come from the private sector. To deal with this budget constraint, Government has adopted strategies such as promoting Public Private Partnerships (PPP). Under this strategy, a risk sharing framework was designed with the private sector, and funding allocated in the 2006 budget for the initial capital for an infrastructure fund expected to be supplemented by other investors to

increase the pool of funds accessible for infrastructure development by the private sector. This strategy enabled Government to focus its efforts to improve infrastructure development in lagging areas of the economy such as Eastern Indonesia.

Decentralisation and Special Economic Zones

The decentralisation process that started in 2001 is intended to extend economic progress to Indonesia's diverse regions where living standards range from levels comparable to those of the developed world to other areas that have very low incomes.

The Government took action to create a number of Special Economic Zones, aimed at creating the best practices in terms of policies, institutions and investor service in geographically defined zones, areas with existing clusters of industries or infrastructure where it is possible to create best practices in term of policy, in local government and quality of institutions. A single zone authority responsible for regulatory framework, licensing and dealing with investors was created to work closely with local government within the overall framework set by the central government.

Institutional Framework

Since 1998, Indonesia, which is a republic with a presidential system, has undertaken major reform of its political and governmental structures, with four amendments of the constitution in this period.

As a unitary state, a political power was highly concentrated at the national government. Through the decentralization process, however, the central government has devolved significant powers to regional government with a view to extend the regional government power and responsibility in fostering social and economic development. Between 2004 and 2009, all 480 provincial governors, heads of districts and mayors will be directly elected. This is intended to improve the political and economic accountability of the local public officials to their constituents.

One of implications of those democratic reforms is on the policy formulation process. Since a policy needs to be debated in order to achieve consensus across the country, policy formulation process may take a longer time. Nevertheless, the process has created a greater sense of ownership of all stakeholders on the importance of a policy.

Institutional and Legal Reform

Indonesia has taken a number of steps to modernize its economy and the functions of the state. Among the more important measures being implemented are those intended to improve the fairness, efficiency and transparency of its institutions and procedures. These include stringent measures to deal with corruption, new public procurement procedures, customs procedures, tax administration, investment procedures, manpower, transports.

A central element is the determination of the Government to stamp out *corruption*. To this end, the Corruption Eradication Commission (KPK), established under Law 30/ 2002, has extensive powers to deal with corruption.

In its efforts to create economic stability and a conducive investment climate, GOI recognizes that development and enforcement of the protection of IPR would encourage creativity and innovation. Therefore, the GOI created a special task force on Intellectual Property. Several significant efforts have been taken since the decree was issued. This

concerted effort resulted in the downgrading from Priority Watch List status to Watch List status imposed on Indonesia by USTR on IPR-related issues in early 2007.

In relation to *government procurement*, the GOI introduced new procedures to improve the transparency and efficiency of procedures and to foster competition in bidding for Government contract. The procedures relate to transparency, efficiency and effectiveness, fairness and accountability, including by simplifying bid procedures and acquirements and encouraging post qualification method for open tender. The President Decree obliged all government agencies to declare Government project plans and announce the tender invitations. Widespread procurement public notices are expected to increase the number of procurement participants, to enhance the quality of procurement process and to achieve more accountability and reliability of the process and simultaneously obtain government expenditure savings, as a result of more options to gain the best tender.

The Government developed an Electronic Government Procurement System (E-GP) to enhance transparency, accountability, and efficiency in the procurement system, and by reducing opportunities for corruption. In the future, the E-GP will be progressively implemented nation-wide.

The Government is modernizing *customs administration*, to facilitate trade. Under this programme the time for customs clearance has been greatly reduced. The customs administration has accelerated the restitution of duties on imported goods that are used in exports and established a priority channel for producer-importers as well as qualified general importers. The GOI intends to improve its business environment and strengthen business competition by enhancing *trade facilitation*. This includes improving the transparency and efficiency of export, import and customs procedures by establishing a National Single Window. On Line Certificate of Origin facility was also launched in January 2006 as an integral part of the National Single Window aimed at linking to the ASEAN Single Window (ASW) network.

In 2002, the Directorate General of Taxes (DGT) launched a modernization programme for *tax administration*. The essence of this programme is to implement the spirit of good governance through the application of a transparent and accountable tax administration system by utilizing the reliable and the modern information technology.

Concerning *income tax*, a draft law proposes, inter alia, the reduction of income tax rate for individual and corporate taxpayers. A Minister of Finance Regulation raised the amount of exempt income as deduction of net taxable income for calculation of Individual Income Tax as well as Withholding Income Tax.

The *investment reform* package cover key issues such as general policies, customs, tax rates, structure and administration, labour market reform and programmes to assist SME.

Competition policy is an important part of the Government reforms, intended to improve the functioning of the Indonesian economy. In recent years there has been considerable progress in deregulating international trade policy in Indonesia, with the reduction of import tariffs, licensing and export restraints. This should help provide competitive environment for local firms in both import and export markets.

Standards - The National Standardization Agency of Indonesia (BSN) has the responsibility for developing and promoting National Standardization in Indonesia, including through standards development, conformity assessment, and standard implementation. In recent

years there has been a restructuring of the institutional framework and procedures to foster openness, transparency, consensus, impartiality, coherence, and effectiveness, taking account of the development dimension and of international rules. The objective is to strengthen national competitiveness and improve the transparency and efficiency of trade transactions while assuring protection to consumer safety, public health, environment and security. Considering the importance of standards for trade facilitation, Indonesia has joined international standard forums such as International Organization for Standardization (ISO), International Electro-technical Commission (IEC), Codex Alimentarius Commission (CAC), and International Telecommunication Union (ITU).

In the context of WTO, BSN acts as a Notification Body and Enquiry Point for Indonesia. In the field of conformity assessment, Indonesia is continually improving its technical capabilities.

International Trade Relations - Indonesia's trade relations are principally governed by its membership of the WTO. In addition, Indonesia is also engaged in regional cooperation such as ASEAN, APEC, ASEM, Developing 8, as well as in bilateral cooperation. Indonesia considers that the above cooperation is consistent with Multilateral Trading System of WTO including the enabling clause and GATS which allow deepen its integration more rapidly with neighbouring countries. The economic integration of ASEAN region has been an important factor in the greater peace, stability and prosperity of the region. In this sense, Indonesia considers that its regional agreements are building blocks for longer term multilateral liberalisation.

Multilateral Cooperation

a. WTO and Doha Declaration

Indonesia has been an active participant in the WTO Doha Work Programme, in its own right and as a member of the G20 and the G33. The Doha Declaration put development at the centre of the current negotiations, but the delivery of the development promise depends to a large degree on faithful implementation of the Doha text. Indonesia considers that the essential technical work has been completed, but that political will and flexibility are urgently needed to move the negotiations toward a successful conclusion.

For Indonesia, the negotiations on agriculture and non-agricultural market access are critical. In *agriculture*, there is a need to concretise the solution to the problems faced by poor farmer in the developing countries through the Special Products (SPs) and Special Safeguard Mechanism (SSM) modalities. Regarding special products, there is a need to have verifiable indicators that can also be prioritized. Regarding the SSM, there is a need to be flexible in developing solutions based on the import volume and product price criteria (volume and price triggers). However, the key to a successful conclusion to the negotiations is agreement between the developed countries on reductions in tariffs and domestic support, as well as elimination of export subsidies and similar measures.

In *Non-Agricultural Market Access (NAMA)*, Indonesia supports the reduction and elimination of tariff peaks, high tariffs and tariff escalation, especially on products of export interest to the developing countries, as well as less than full reciprocity by developing countries. Nevertheless, Indonesia stands ready to make commitments to reduce

substantially its bound rates in the context of a balanced outcome of the overall negotiations, taking account of the Single Undertaking. However, Indonesia is also concerned to retain a degree of flexibility to develop its industrial sector that is so important for jobs (and hence poverty alleviation), especially in the light of the experience of the crisis of 1997/98 and the subsequent austerity programme. Indonesia believes that its moderate tariffs can help the development of outward-oriented industrial production that could become internationally competitive in the longer term.

In *services*, Indonesia emphasizes that agreement on this issue should not erode developing countries' flexibilities that were so carefully negotiated in the Uruguay Round. Negotiation in services must allow developing countries to liberalize sectors at the pace that correlate with their levels of development. In this context, sequencing and on-going requisite changes in domestic institutions and regulations are important in the services liberalization process. In the spirit of constructive engagement, Indonesia has made offers in 9 sectors: business services, communications, health and social services, transport, tourism and related services and energy services.

The protection of *intellectual property rights* is crucial for an environment that is conducive to innovation. However, it is important that this be seen in the context of the greater need to protect welfare, as in the case of access to affordable drugs and technologies, as well as providing some protection to traditional knowledge. There is a need in the WTO to resolve the issues of the relationship of the TRIPS to the Convention on Biodiversity and the extension of Geographical Indications to products other than Wines and Spirits. The objective of Indonesia on TRIPS is to work progressively towards full implementation of the TRIPS Agreement, and it has already taken a number of measures in this respect, among others the revision of related laws and regulations on IPR, institutional development of intellectual property related agencies as well as law enforcement.

On the issue of *TRIPS and Public Health*, Indonesia and other developing countries had made an effort to struggle for the opening of market access for the developing countries in acquiring cheap patented medicines in protecting the public health. The Doha Round had opened a way for developing countries to negotiate exemptions towards imported license on medicine goods/products.

The different needs and capacities of developing countries have been recognised in the GATT and WTO since 1955 as the basis for *special and differential treatment*. Addressing these development needs and capacities was rightly central to the Doha Ministerial Declaration, and Indonesia looks forward to full implementation of the promises of Doha in the post-Doha Work Programme of the WTO. Indonesia wishes to see Special & Differential Treatment being more precise, effective and operational. Equally important are the various issues related to implementation of the results of the Uruguay Round, where deadlines have repeatedly been missed and problems have only partially been resolved.

Trade Facilitation. Indonesia supports the negotiations to facilitate trade. In this respect, it would be useful to have further clarification of GATT Articles V (Freedom of Transit), VII (Valuation for Customs Purposes), and X (Publication and Administration of Trade Regulations). Indonesia considers that a successful outcome may need to be supported with the provision of technical assistance and capacity building for the developing countries.

Trade and Environment. Indonesia supports the negotiation to enhance mutual supportiveness between trade and environment. Indonesia is of the view that trade liberalization needs to be positive for trade, environment, and development.

Indonesia made 58 *notifications* in various areas, and has outstanding obligations to submit 36 notifications. However, because of the complexity of notification requirements, a lack of human capacity and the periodical staffing changes (tour-of-duty) of responsible officials, fulfilment of the notification obligation has not progressed well yet. In order to resolve this problem, Indonesia is trying to enhance the staff capacity and to improve coordination between domestic agencies in order to complete its outstanding notifications.

The GOI has adopted *trade remedy* policy in the form of anti-dumping, subsidy and countervailing duties, as well as safeguarding domestic industry against surges in the import of goods.

The GOI has taken serious steps to respond to allegations of dumping raised by foreign government against Indonesia exports. During the period under review, there were 61 dumping allegations on Indonesian products, where more than half (34 cases) of them imposed anti-dumping duties.

On safeguard measures, the Authority which conducts global safeguard investigations is KPPI (Indonesian Committee on Safeguards).

b. South-South Cooperation

Indonesia is currently participating in talks to expand the Global System of Trade Preferences (GSTP) which it regards as a valuable instrument for the expansion of South-South cooperation. Indonesia considers that South-South cooperation in trade in goods and services, as well as in investment, technology and other areas, can bring important benefits to developing countries.

As a member of *Developing 8*, Indonesia has signed the Preferential Trade Agreement (PTA) which aimed to expand trade among their members by reducing tariff on goods and other trade restrictions.

Indonesia has actively participated in the Organization of Islamic Conference (OIC) and has signed the protocol on the Preferential Tariff Scheme for TPS-OIC (PRETAS).

c. Regional Cooperation

With regard to ASEAN Economic Integration, 12 priority integration sectors were identified for accelerated economic integration (Agro based, wood based, Textile and Apparel, Automotive, Electronic, Healthcare, e-ASEAN, Tourism, Rubber based, Air Travel, Fisheries and Logistic Services). Steps towards policy integration include the 'horizontal' areas (e.g., customs, including the ASEAN Single Window); standards; rules of origin; non-tariff measures; and the liberalization of trade in services. Indonesia is country coordinator for the wood based and automotive sectors.

At the 12th ASEAN Summit, the Leaders affirmed their strong commitment to accelerate the establishment of an ASEAN Community by 2015 as envisioned in the ASEAN Vision 2020 and the ASEAN Concord II and signed the Cebu Declaration on the Establishment of ASEAN Community by 2015. In particular, the Leaders agreed to hasten the establishment of the ASEAN Economic Community by 2015 and to transform ASEAN into a region with free movement of goods, services, investment, skilled labour, and freer flow of capital. Each priority integration sector has a roadmap, which combines specific initiatives of the sector and the broad initiatives that cut across all sectors such as trade facilitation measures.

ASEAN is seeking to establish RTA with partners such as China, Japan, Korea, Australia, New Zealand, and India. At the ASEAN Summit in 2002, ASEAN members and China signed a framework agreement to begin negotiations in 2003 to create the world's largest FTA with a combined market of 1.7 billion people. In 2004, the ASEAN and Chinese Economic Ministers signed the Trade in Goods Agreement and Dispute Settlement Mechanism Agreement under ASEAN-China FTA (ACFTA). The gradual tariff elimination for products in Normal Track started in 2005 and will end in 2015. Finally, in January 2007, the ASEAN Economic Ministers and the Chinese Foreign Affairs Minister signed a Services Agreement.

The Framework Agreement between ASEAN and South Korea was signed by the Leaders on December 2006. At the same time, the ASEAN and Korea Economic Ministers signed the Dispute Settlement Mechanism Agreement of ASEAN-Korea FTA (AKFTA), and afterward, on August 2007, the Trade in Goods Agreement was also signed. The implementation of goods agreement started on June 2007 upon completion of domestic ratification from each party. The FTA negotiations CER (Australia and New Zealand), Japan and India were concluded at the end of 2007. Furthermore, ASEAN and the EU have launched ASEAN-EU FTA negotiations.

Other than FTA negotiations, ASEAN is also involved in cooperation under Trade and Investment Framework Arrangement (TIFA) with United States, Trade and Investment Framework (TIF) with Australia, and in the process of establishing ASEAN-Canada Trade and Investment Cooperation Arrangement (TICA). Indonesia plays an important role as the country coordinator for ASEAN countries in dealing with ASEAN consultations with United States and Canada.

Indonesia is committed to implementing APEC's voluntary target of open and free trade, as well as services and investment for developing country members by 2020, as set out in the Bogor Declaration of 1994. APEC economies are to achieve their targets on a voluntary and non-binding basis ("concerted unilateral liberalization").

In order to develop a high-quality RTA/FTA, Indonesia contributed in designing Model Measures of the minimum requirement for RTA/FTA on non-binding basis. Based on the Individual Action Plan (IAP) peer review process of 2005, it was noted that Indonesia was already over half way to achieving the Bogor Goals.

As a member of the Asian-Europe Meeting (ASEM), Indonesia take part in implementing the Leaders' vision of deepening the partnership to face future challenges, broadening the

perspective through marking out focussed areas for action, and reinforcing the institutional mechanism by forging a stronger partnership as outlined in the Helsinki Declaration.

d. Bilateral Cooperation

In line with its policy of establishing closer economic relations with countries in the Asian region, Indonesia has been negotiating with Japan since mid 2005 to establish a bilateral Economic Partnership Agreement that covers goods, rules of origin, customs procedures, investment, services, movement of persons, competition policy, energy and mineral resources and cooperation. Indonesia is also in the process of negotiating Preferential Trade Agreement with Pakistan, and exploring the possibility to negotiate PTA/FTA with India and Iran.

Talks and consultation on a range of trade and investment issues are also being held with major developed countries i.e. EU, United States and Australia.

e. Investment Treaties

Indonesia has signed 61 Bilateral Investment Treaties/Investment Guarantee Agreements. However, current tendency of negotiating Economic Partnership Agreements covers broader sectors including investment, services, labour, cooperation, capacity building, among others.

f. Others

Indonesia is determined to make best use of opportunities under the GSP. It considers that such preferences are a useful means of helping to diversify and expand its industrial sector and as such contribute to the overall economic developments of Indonesia, including job creation and the alleviation of poverty.

Considering the importance of human resources and infrastructure development, Indonesia is continuously assessing its needs and priorities to request to the donor countries for Technical Assistance and Capacity Building. In this regard, Indonesia appreciates to several donor countries and agencies, namely the European Union, JICA, USAID, AUSAID, KOICA, Switzerland, Sweden, WTO Secretariat, JETRO, New Zealand, India, China.

Trade and Related Policies

Overview of Policy and Development

Indonesia's trade and related policies are part of its overall social and economic development strategy, and not goals in themselves. While trade and related policies should contribute to the improved efficiency and overall growth of the economy that will increase the availability of resources for social purposes, policies - and their implementation - need to take account of short- to medium-term social consequences of change, particularly in the light of persistent unemployment and poverty, especially in some regions.

Because of the diversity of the levels of development across the archipelago, Indonesia considers that social justice requires the greater effort to spread the benefits of its economic achievements to all of its peoples, as in the decentralisation programme of recent years.

Indonesia is also of the view that the longer term development of the economy needs to be consistent with Indonesia's underlying comparative advantage. However, policy interventions may be needed to realize these goals in the presence of externalities associated with certain economic activities and in the light of important distortions on world markets, including barriers to exports. The pace of policy implementation also depends on the success in building supply capacities and social indicators. While Indonesia's own policies are obviously key, assistance from trading partners and donors can also be of considerable assistance.

With regard to the structure of the Indonesian economy, services make the largest contribution to GDP, around 40% in recent years. Manufacturing is second at some 28%, while the share of agriculture has fallen from 15.5% in 2002 to 12.9% in 2006, and mining and quarrying has grown from 8.8% to 10.6% in the same period. Construction has grown slightly to 7.5%, while the electricity, gas and water sector has remained stable at around 1%. Clearly, services and industry are now major employers, particularly in the urban areas, and any sectoral policy changes need to take account of the potential impact on employment. However, the agricultural sector is also critical for the poorest regions of the country. The sector has an important role in the provision of rice, the most basic food of the nation, but it also has a large element of subsistence farming, and, overall, the agricultural sector is a net consumer of rice.

Indonesia has considerable natural resources, renewable, such as its extensive tropical forests, fishing, etc., and non-renewable, such as oil and gas, and minerals. Managing these resources prudently for sustainable development is a major challenge for any government, and more so for Indonesia because of its many islands. To this end, various programmes are being implemented and being improved, including for example the management of its forestry and fishing resources.

Trade Developments and Policy Developments

Tariff policy

To fulfil its commitments in the Uruguay Round, Indonesia implemented significant changes in its bound MFN tariffs over the period 1996-2003. In addition, it has begun to implement further changes in its applied MFN rates under the ASEAN Tariff Harmonization Program for the period of 2005 to 2010, as well as reductions in AFTA preferential rates, consistent with its views on the importance of integration within the Asian region.

To accommodate national economic interests, however, some products have been excluded from the general schedule of tariff reduction programme. These are mainly in the agricultural, chemicals, plastics, metals, alcoholic beverages and automotive sectors, as well as products related to moral and security items.

The implementation of the tariff reduction programme has changed Indonesian tariff structure significantly. By the end of the programme (2003), the average rates had fallen to 7.2%, while rates lying in the 0-10% range increased to 83.4% of lines.

In 2004, one year after the tariff reduction programme ended, Indonesia adopted the new tariff classification under “ASEAN Harmonized Tariff Nomenclature” (AHTN) as part of Indonesian commitment under AFTA. The purpose of the programme is a gradual lowering and harmonisation of rates, intended to reduce inter-sectoral distortions, while preserving a moderate overall level of assistance to the productive sector on an MFN basis. The programme beyond 2010 has not been finalised yet.

With the new classification, the total tariff lines increased drastically from 7,540 in 2003 to 11,163 in 2004. As a consequence of the technical classification changes, tariff rates also changed, and the average tariff increased to 9.9%, with rates between 0 and 10 per cent covering 8,387 tariff lines (75% of the total tariff lines).

As a continuation of the tariff reduction programme, Indonesia introduced the Tariff Harmonization Programme for the period of 2005-2010. Under the programme, the average tariff reached 9.5% in 2006, with rates in the 0-10% range covering 8,365 tariff lines or 74.9% of the total.

Currently, Indonesia does not utilize tariff quotas.

Tariff Exemptions or Concessions and Duty Drawbacks

To increase the efficiency and the competitiveness of domestic industries, Indonesia provides certain tariff exemptions or concessions, in accordance with Indonesia Custom Law (Law 10/1995). The importation of raw materials, components, or machineries that are used by a certain industrial sectors can be exempted from import duties. Some of industries granted tariff exemptions or concessions include aircraft maintenance, public transportation, energy and telecommunications.

In addition, Indonesia is also implementing the Duty Drawback System on the re-export of imported inputs.

Non Tariff Measures

In order to improve the functioning of the economy in line with its dynamic comparative advantage and make it more responsive to long-term international price movements, Indonesia is progressively eliminating non-tariff measures, in particular the use of import licences which is currently limited to dangerous materials; explosives; ozone-depleting substances; alcoholic beverages; salt; propylene copolymers; lubricant; clove; textiles and textile products; nitrocellulose; machines and machinery; optical discs; and rough diamonds.

The most important measures still in place are: i) the regulation on the timing of the import of rice and sugar; ii) verification and other requirements for the export of tin and granite; and iii) the ban on the export of logs and sand.

The rice import regulation is intended to provide support for poor farmers in the face of distorted world prices as a result of subsidies by some rice-exporting countries, but it is

periodically relaxed at times of shortage, that is during non harvest periods, to stabilise prices.

The ban on the export of logs is used to support Indonesia's forestry and wildlife conservation policy while a broader forest management programme is being put in place. Because of the many islands and the rugged terrain, it is difficult and requires extensive resources to implement the forest management programme, which is also targeted at mining and to support forest or near-forest dwellers. The government is planning a compensation tax to be paid by mining and logging companies to compensate for environmental damage and finance re-forestation programme, to be implemented by local communities. Given the porous sea and land border, the export ban allows the immediate identification of illegal logs leaving the country. Cooperation is also being provided by a number of neighbouring countries as well as European countries in controlling the import of logs from Indonesia.

Incentives

Concerning central and local authorization of investments, to anticipate challenges that will be faced by Indonesia such as global competition and as mandated in Law No. 32 regarding Local Government, the Government issued a Government Regulation Bill (GRB) concerning the Guidance for Granting Incentives and Investment Facilitation in Local Area.

Sectoral Policies

Agriculture

Agriculture plays an important role in the Indonesian economy, providing employment for over 38 million people. There is also an important linkage to poverty, since the majority of Indonesia's poor live in rural communities and hence highly dependent on the agricultural sector

To further develop the sector, the Government launched the agricultural revitalization programme in 2005. Under the programme, the Government provides subsidies to increase production on food crops such as on fertilizers and hybrid seeds. Subsidized credit to smallholder farmers ("food security credit") is intended to motivate smallholder farmer to have more access to commercial banks, sharing risk between the Government, the commercial banks and the farmers.

Fisheries

Indonesia's Marine and Fisheries development plays an important role in providing employment, food sources, poverty alleviation and development, especially for the outer islands. The Fisheries Law aims at a new direction for fisheries management intended to improve of living condition of small-scale fishermen and fish farmers; to increase government revenues and foreign exchange earnings; to spur the expansion of job opportunities; to increase the supply and consumption of fish which is rich in protein sources; to optimize the management of fishery resources; to increase the productivity,

quality, added value and competitiveness; to increase the supply of raw materials for the fish processing industry; to achieve optimal utilization of fisheries resources, areas for fish culture and fish resources environment; and to ensure the conservation of fishery resources areas for fish culture and spatial management.

In order to improve fisheries management, the Government issued Government Decree number 17/2006 on Fisheries Management. The Government Decree applied new scheme of fisheries management which eliminates foreign vessels from operating in the Indonesian Economic Exclusive Zone.

However, productivity in the sea-fishing industry has remained low while over-fishing in some areas has threatened to deplete fish stocks. Illegal fishing, by both foreign and domestic operators, also has been a serious problem and causing environmental damage. In order to conserve fish stocks, the Minister of Marine Affairs and Fisheries has published a Ministerial Decree regarding the establishment of a coordination team on illegal fishing measures and fisheries processing industry revitalization.

Oil, gas and minerals

While Indonesia has important reserves of fossil fuels, it is still a net importer of crude oil, which had a negative effect on trade and on inflation. However, Indonesia is the world's leading exporter of liquefied natural gas, and the country has potential for further development of hydro-electric and geothermal energy (as well as coal), and other "green" sources of energy such as bio-fuels, solar power. Domestically, the lack of infrastructure has limited the use of alternative energy resources, and investment in the sector is needed. The increase in oil prices, if maintained, makes exploitation of these alternative sources of energy more viable, as well as being attractive from an environmental perspective.

Except for tin, commercial mining is relatively unimportant in Indonesia, although there is some potential for the production of coal, metallic and non-metallic minerals, and investment has been growing in this sector. Along with logging, mining has become an environmental issue that is now being subject to greater scrutiny and new regulations are being promulgated to address this issue.

Manufacturing

Since the industrial process was derailed by the crisis, the focus has shifted to ensuring the survival of the industry. Under the Industrial Revitalization Programme, the Government has used several measures to promote international competitiveness, such as the promotion of cluster groups and value-chain alliances that have recently started to be used to gain and sustain industrial competitiveness. The programme operates within the general context of the political, macroeconomic, institutional and legal reforms that are intended to improve the business environment. They are also being implemented within the context of moderate, harmonized tariffs and the progressive elimination of non-tariff measures. Incentives are principally used in relation to regional developments.

The focus is on strengthening and developing core clusters in the following areas: food and beverages, fishing, textiles and textile products, footwear, palm oil, timber (including rattan

and bamboo), rubber and rubber products, pulp and paper, electrical engineering, petro-chemical engineering.

The strategy involves strengthening linkages at all value chain levels in a cluster of related industries, improving value added along the value chain, improving resources employed by the industry, and developing small and medium-size industries

Services

Services account for around 40% of GDP, but exports of services only account for 7% of total exports of goods and services, a net deficit of around \$20 billion. This performance is less than satisfactory, and Indonesia recognizes that having access to efficient services is important to the good functioning of a modern economy, including as an important input into the production and trade of traditional exports of goods. Access to basic services is also important for human development. In this respect, the WTO framework on services should not erode the flexibilities that are characteristic of the GATS and should allow developing countries to open up their services sectors at a pace that is consistent with their level of development.

Indonesia does not at the moment provide any special incentive for the development of trade-related services.

Supervision of services monopolies is intended to ensure security, efficiency and quality of services at a fair price, which also provides for maintenance and a reasonable return to the service supplier.

Development of an efficient financial services sector is important as a source of finance for SME, which do not have easy access to international sources. Regulation of financial services is intended to ensure proper prudential supervision, security for account holders, and to help promote the real sector of the economy.

Other services that are particularly important for Indonesia are transport and communications – given the geographic diversity of the country –and tourist-related services which have started to recover after recent setbacks. Indonesia believes it has considerable potential for the development of labour services, e.g. in construction, for which a successful outcome of the Mode 4 negotiations in the WTO would be beneficial.

Future Directions

Economic Perspectives

The economic outlook for Indonesia has improved mainly as a result of the reforms that it has undertaken in recent years, and a healthy external environment.

The principal economic concerns of the Government relate to its ability to lift economic growth sufficiently to create jobs and address poverty. However, it is important for social justice, peace and stability to address a wider range of social and economic issues.

Moreover, it is essential also to help raise the development of the poorer regions of the country where the problems of poverty are more acute. However, further progress depends on the success of the Government's efforts in the ongoing implementation of the reforms

and rebuilding of much needed infrastructure, as well as external developments in the world economy.

The main source of growth in the next two years is expected to come from revival of investment which in turn will expand the capacity of exports, as well as consumption growth and to a lesser extent compared with previous years, government spending.

Government Programmes

Progress has been made in the Government's reform programme in terms of a number of new laws and regulations, as well as an ongoing process of changing legislation and regulations which are in different stages of implementation.

Further reforms, for example in the area of investment, are also under way or are being considered in the light of developments. As part of the effort to improve efficiency and public finances, further privatization of state-owned enterprises is being considered, but it will take time to prepare some of these businesses for privatization, and due account will need to be taken of the social consequences as well as the development implications, for example in the areas of public services such as transport and communications.

There is a need for further efforts to modernize and develop the real sector. Efforts are being made to revitalize the agriculture and industrial sectors, as the Government recognizes that an efficient services sector is also a key to the development of international competitiveness. From this perspective, its already open trade regime should be seen as a complement to other domestic policies, while the Government is moving carefully but progressively toward even greater opening up of the economy by reducing tariffs and non-tariff measures, facilitating trade and encouraging investment.

The Government is confident that the new Investment Law and the implementing regulations, as well as the other components of the investment package, will contribute in an important way towards improving the investment climate. Apart from its effort to improve the institutional and legal framework, the central Government needs to work more closely with the regional governments and the private sector in a number of areas, and to further develop an enabling environment for business, encouraging domestic as well as foreign direct investment.

Constraints, Challenges and Opportunities

The major internal challenges that are now faced by the Government of Indonesia are in implementing its reform programme to bring improvements to the quality of life for all its peoples. In this respect, some of the greatest needs are in the areas of health and social programmes, education, and physical infrastructure, and the challenge is to deliver improvements across its diverse regions.

Despite the improved economic performance, lower debt and an improved reserve position, Indonesia needs additional capital resources to carry forward these social and economic programmes. The new Investment Law will help in this respect, but the progress in the implementation of the reforms will be gradual, given the bottom-up nature of the

process, and the new legislative framework needs to be supported by short and medium term action plans to carry forward the momentum.

In some areas there is a need, especially in the poorer regions, to develop the administrative capacity to carry out reforms, even where funding has been provided.

In other areas, there is still a shortage of resources, human and capital, where Indonesia needs greater private sector involvement, and where foreign investment and aid could usefully assist.

The ongoing reforms also require the continuation of national dialogue to build a sense of consensus, ownership and common purpose in the new democratic framework. Such a process even though it will take time, will also mean that the reforms should “stick”.

Meanwhile, in the short term, the process of deregulation and bureaucratic reforms as well as creating islands of excellence and best practices within certain regions (Special Economic Zones) and within institutions, will be continued.

In terms of opportunities, the growth and increase in per capita incomes of the 220 million population of Indonesia offers opportunities for a robust market as well as a source of young and productive labour force. Indonesia also has a strong basis of natural resources on which to build on for its continued and sustained growth.

Externally, the constraints facing Indonesia include improved, secure access to overseas markets for its main exports, and increased competition. This can best be addressed in the multilateral framework of the WTO, and Indonesia stands ready to make substantive commitments consistent with its development needs. Indonesia looks forward to continue working closely with other WTO Members to achieve a speedy and successful conclusion to the current negotiations, taking account of the development dimension of the Doha Declaration.

Indonesia also looks forward to the continued deepening of its integration within the East Asia and Asia-Pacific region, which is consistent with the WTO and becomes the building block for the multilateral process.

Document 9: The Globalization Index 2009 : Indonesia

The Globalization Index 2009 shows the extent to which the world's largest countries by GDP are connecting to the global economy. The Index uses 20 separate indicators that capture the key aspects of cross-border integration of business.

These indicators fall into five broad categories:

1. Openness to trade
2. Capital movements
3. Labor movements
4. Exchange of technology and ideas
5. Cultural integration

These factors have been weighted (ranging from 17% to 22% for each) based on the significance placed upon each factor by 520 surveyed company executives doing international business.

The Index measures “relative” rather than “absolute” globalization. This means that a country’s trade, investment, labor, technology and cultural integration with other countries is measured relative to its GDP rather than by the absolute value of these elements being exchanged.

Redrawing the map: globalization and the changing world of business **Globalization Index 2009 Summary**

The Globalization Index was created to measure the extent to which the 60 largest countries (by GDP) are connecting to the rest of the world. This table provides a breakdown by country (or, where applicable, territory).

Overall	Country	2009 composite	1995 composite
1	Singapore	7.29	6.04
2	Hong Kong (SAR)	6.90	5.50
3	Ireland	6.87	5.08
4	Belgium	5.82	4.51
5	Sweden	5.77	4.00
6	Denmark	5.77	4.36
7	Switzerland	5.62	3.93
8	The Netherlands	5.45	4.62
9	Israel	5.16	4.67

10	Finland	5.14	3.76
11	Taiwan	4.90	3.90
12	Austria	4.88	4.38
13	Hungary	4.88	4.46
14	Canada	4.87	4.07
15	UK	4.76	4.11
16	Germany	4.71	3.83
17	Norway	4.59	3.57
18	Czech Republic	4.53	3.46
19	France	4.51	3.79
20	Australia	4.47	3.67
21	Spain	4.47	3.66
22	New Zealand	4.42	3.64
23	Slovakia	4.34	3.15
24	US	4.26	3.57
25	South Korea	4.17	2.76
26	Portugal	4.11	4.02
27	Chile	4.06	3.51
28	Bulgaria	4.03	3.52
29	Poland	4.02	2.96
30	Romania	4.00	2.65
31	Italy	3.96	3.50
32	Greece	3.90	3.64
33	Malaysia	3.89	3.93
34	Saudi Arabia	3.71	3.27
35	Philippines	3.67	3.00
36	Vietnam	3.62	2.73
37	Japan	3.57	2.65
38	Thailand	3.53	3.09
39	Mexico	3.50	2.98
40	China	3.41	2.69
41	Ukraine	3.41	2.42
42	Sri Lanka	3.35	3.27
43	Egypt	3.33	3.21
44	Colombia	3.33	2.96

45	Peru	3.24	2.88
46	India	3.14	2.50
47	Brazil	3.13	2.77
48	Argentina	3.08	3.15
49	Turkey	3.07	2.98
50	South Africa	3.04	2.69
51	Pakistan	3.02	2.55
52	Kazakhstan	2.97	2.39
53	Azerbaijan	2.86	3.03
54	Ecuador	2.79	2.64
55	Russia	2.77	2.51
56	Indonesia	2.70	2.85
57	Nigeria	2.65	2.63
58	Algeria	2.52	2.51
59	Venezuela	2.42	2.62
60	Iran	2.05	1.72

Country Details: INDONESIA

Index Listing: 56

Globalization Score 2009: 2.70

Commentary

- Indonesia has fallen 13 places in The Globalization Index since 1995, with its overall score decreasing slightly over this period.
- Movement of goods and services – its biggest contributor to globalization – has declined steadily since its peak of 1998. Although total trade as a percentage of GDP is low, the government does have policies in place to encourage a more open trading environment.
- A similar downward trend has impacted the movement of capital and finance, despite a largely positive government policy toward foreign investment, reasonable investment protection and a general lack of domestic favouritism.
- However, it's the exchange of technology and ideas that had the greatest impact on Indonesia's overall globalization score. Limited R&D trade and a relatively low number of broadband and internet subscribers resulted in an overall score of 1.1 for the category.
- The overall level of globalization is forecast to remain relatively stable until 2013, in the face of steady but limited increases in the movement of labor and the exchange of technology and ideas.

Category	Weighting	Score
Movement of goods and services (overall)	22%	3.92
Total trade (exports + imports) as %GDP	60%	1.37
Trade openness	10%	7.75
Tariff and non-tariff barriers	10%	7.75
Ease of trading (cross-border)	10%	7.75
Current-account restrictions	10%	7.75
Movement of capital and finance (overall)	21%	3.64
FDI flows (in and out as % of GDP)	50%	3.10
Portfolio capital flows (in and out as % of GDP)	10%	1.19
Government policy towards foreign investment	10%	5.50
Expropriation risk	10%	3.25
Investment protection schemes	10%	5.50
Domestic favouritism by government	10%	5.50
Movement of labor (overall)	19%	2.77
Net migration rate (per 1,000 population)	40%	2.52
Current transfers (in and out as % of GDP)	40%	1.89
Hiring of foreign nationals	20%	5.05
Exchange of technology and ideas (overall)	21%	1.15
R&D trade (in and out as % of GDP)	60%	1.08
Broadband subscriptions (per 100 people)	20%	1.10
Internet subscribers (per 100 people)	20%	1.38
Cultural integration (overall)	17%	1.78
Tourism (in and out per 1000 population)	33%	1.07
International outgoing fixed telephone traffic (minutes per capita)	33%	1.01
Openness of national culture to foreign influence	33%	3.25

Document 10: The Global Competitiveness Report 2009-2010 Indonesia

Assessment of Competitiveness of Indonesian Economy

The **2009-2010 Global Competitiveness Index (GCI)** ranks Indonesia 54th out of 133 countries. Moving up one place, the assessment is very much in line with that of the previous three years.

Three areas, among the most important given Indonesia's current stage of development, are of particular concern. First, infrastructure is in need of upgrading (84th), in particular with respect to ports (95th) and roads (94th). Second, several indicators reveal the poor level of public health: tuberculosis and malaria incidence are among the highest in the world, while infant mortality remains high. The third area of concern relates to technological readiness (88th). ICT penetration rates remain low by all measures.

The GCI classifies Indonesian economy as an economy in transition between being a factor-driven economy and becoming an efficiency-driven economy.

The country's competitiveness will therefore increasingly be driven by such efficiency enhancing factors, such as higher education and training; goods market efficiency, labour market efficiency, financial market sophistication, technological readiness, market size.

On a more positive note, similar to the situation in India, Indonesia ranks higher in more complex factors such as business sophistication (40th) and innovation (39th). This certainly bodes well for the future, but does not reduce the urgency of making improvements in other priority areas highlighted below.

According to the Index, **competitiveness is defined as the set of institutions, policies, and factors that determine the level of productivity of a country.** The level of productivity, in turn, sets the sustainable level of prosperity that can be earned by an economy. In other words, more-competitive economies tend to be able to produce higher levels of income for their citizens. The productivity level also determines the rates of return obtained by investments in an economy. Because the rates of return are the fundamental drivers of the growth rates of the economy, a more competitive economy is one that is likely to grow faster in the medium to long run.

The concept of competitiveness involves static and dynamic components: although the productivity of a country clearly determines its ability to sustain its level of income, it is also one of the central determinants of the returns to investment, which is one of the key factors explaining an economy's growth potential.

2.3.2 The 12 Pillars of Competitiveness

The determinants of competitiveness are many and complex. Economists have long tried to understand what determines the wealth of nations. Most recent theories focus on *investment in physical capital and infrastructure* as well as *other mechanisms such as education and training, technological progress, macroeconomic stability, good governance, the rule of law, transparent and well functioning institutions, firm sophistication, demand conditions, market size*, among others.

The central point, however, is that they are not mutually exclusive, two or more of them could be true at the same time.

The GCI provides a weighted average of many different components, each of which reflects one aspect of the complex concept called competitiveness. All these components are grouped into **12 pillars of competitiveness**, which are described below. Indonesia's position is shown at the bottom of each pillar's description.

It should be noted that, although the 12 pillars of competitiveness are described separately, they are not independent: not only are they related to each other, but they tend to reinforce each other.

For example, innovation (12th pillar) is not possible in a world without institutions (1st pillar) that guarantee intellectual property rights, cannot be performed in countries with a poorly educated and poorly trained labour force (5th pillar), and is more difficult in economies with inefficient markets (6th, 7th, and 8th pillars) or without extensive and efficient infrastructure (2nd pillar).

It is clear that different pillars affect different countries differently: the best way for Indonesia to improve its competitiveness is not the same as the best way for (i.e.) Switzerland. This is because Indonesia and Switzerland are in different stages of development, the first being an economy in transition between from a factor-driven economy to an efficiency-driven economy, the latter an innovation-driven economy.

Here below a description of the 12 pillars is presented. For each pillar and respective components, the rank of Indonesia is highlighted.

Basic Requirements - Rank of Indonesia: 70 out of 133

First pillar: Institutions

The institutional environment is determined by the legal and administrative framework within which individuals, firms, and governments interact to generate income and wealth in the economy.

The quality of institutions has a strong bearing on competitiveness and growth, given the increasingly direct role played by the state in the economy of many countries. It influences investment decisions and the organization of production, and plays a central role in the ways in which societies distribute the benefits and bear the costs of development strategies and policies. The role of institutions goes beyond the legal framework. Government

attitudes toward markets and freedoms, and the efficiency of its operations, are also very important: excessive bureaucracy and red tape, overregulation, corruption, lack of transparency and trustworthiness, and the political dependence of the judicial system impose significant economic costs to businesses and slow the process of economic development. Proper management of the public finances is also critical to ensuring trust in the national business environment. An economy is well served by businesses that are run honestly, where managers abide by strong ethical practices in their dealings with the government, other firms, and the public. Private sector transparency is indispensable to business, and can be brought about through the use of standards as well as auditing and accounting practices that ensure access to information in a timely manner.

1st Pillar - Institutions – *Rank of Indonesia: 58 out of 133*

1.01 Property rights	81
1.02 Intellectual property protection.....	67
1.03 Diversion of public funds	59
1.04 Public trust of politicians.....	52
1.05 Judicial independence	66
1.06 Favouritism in decisions of government officials	36
1.07 Wastefulness of government spending.....	28
1.08 Burden of government regulation.....	23
1.09 Efficiency of legal framework in settling disputes.....	59
1.10 Efficiency of legal framework in challenging regulations. ...	52
1.11 Transparency of government policymaking	87
1.12 Business costs of terrorism.....	82
1.13 Business costs of crime and violence	62
1.14 Organized crime.....	81
1.15 Reliability of police services.....	79
1.16 Ethical behaviour of firms	102
1.17 Strength of auditing and reporting standards	76
1.18 Efficacy of corporate boards.....	32
1.19 Protection of minority shareholders' interests	48

Second Pillar: Infrastructure

Extensive and efficient infrastructure is an essential driver of competitiveness. It is critical for ensuring the effective functioning of the economy, as it is an important factor determining the location of economic activity and the kinds of activities or sectors that can develop in a particular economy. In addition, the quality and extensiveness of infrastructure networks significantly impact economic growth and reduce income inequalities and poverty in a variety of ways. In this regard, a well-developed transport and communications infrastructure network is a prerequisite for the ability of less-developed communities to connect to core economic activities and basic services. Economies also depend on electricity supplies that are free of interruptions and shortages so that businesses and factories can work unimpeded. Finally, a solid and extensive telecommunications network allows for a rapid and free flow of information, which increases overall economic efficiency

by helping to ensure that businesses can communicate, and that decisions made by economic actors take into account all available relevant information.

2nd Pillar – Infrastructure - *Rank of Indonesia: 84 out of 133*

2.01 Quality of overall infrastructure.....	96
2.02 Quality of roads.....	94
2.03 Quality of railroad infrastructure	60
2.04 Quality of port infrastructure	95
2.05 Quality of air transport infrastructure.....	68
2.06 Available seat/km.....	21
2.07 Quality of electricity supply	96
2.08 Telephone lines.....	79

Third Pillar: Macroeconomic Stability

The stability of the macroeconomic environment is important for business and, therefore, is important for the overall competitiveness of a country. Although it is certainly true that macroeconomic stability alone cannot increase the productivity of a nation, it is also recognized that macroeconomic disarray harms the economy. The government cannot provide services efficiently if it has to make high-interest payments on its past debts. Running fiscal deficits limits the government's future ability to react to business cycles. Firms cannot operate efficiently when inflation rates are out of hand. In sum, the economy cannot grow in a sustainable manner unless the macro environment is stable. It is important to note that this pillar focuses only on macroeconomic stability, so it does not directly take into account the way in which public accounts are managed by the government.

3rd Pillar: - Macroeconomic Stability - *Rank of Indonesia: 52 out of 133*

3.01 Government surplus/deficit	74
3.02 National savings rate.....	40
3.03 Inflation	80
3.04 Interest rate spread.....	60
3.05 Government debt.....	56

Fourth Pillar: Health and Primary Education

A healthy workforce is vital to a country's competitiveness and productivity. Workers who are ill cannot function to their potential and will be less productive. Poor health leads to significant costs to business, as sick workers are often absent or operate at lower levels of efficiency. Investment in the provision of health services is thus critical for clear economic, as well as moral, considerations. In addition to health, this pillar takes into account the quantity and quality of basic education received by the population, which is increasingly important in today's economy. Basic education increases the efficiency of each individual worker. Moreover, workers who have received little formal education can carry out only simple manual work and find it much more difficult to adapt to more advanced production

processes and techniques. Lack of basic education can therefore become a constraint on business development, with firms finding it difficult to move up the value chain by producing more-sophisticated or value-intensive products. For the longer term, it will be essential to avoid significant reductions in resource allocation to these critical areas, given that government budgets in many countries will need to be cut to reduce public debt brought about by the present stimulus spending.

4th Pillar - Health and Primary Education - *Rank of Indonesia: 82 out of 133*

4.01 Business impact of malaria.....	97
4.02 Malaria incidence.....	105
4.03 Business impact of tuberculosis.....	92
4.04 Tuberculosis incidence.....	108
4.05 Business impact of HIV/AIDS	88
4.06 HIV prevalence.....	54
4.07 Infant mortality.....	85
4.08 Life expectancy.....	92
4.09 Quality of primary education.....	58
4.10 Primary enrolment.....	56
4.11 Education expenditure	127

INDICATOR RANK/133

Efficiency Enhancers: 50 out of 133

Fifth Pillar: Higher Education and Training

Quality higher education and training is crucial for economies that want to move up the value chain beyond simple production processes and products. In particular, today's globalizing economy requires economies to nurture pools of well-educated workers who are able to adapt rapidly to their changing environment. This pillar measures secondary and tertiary enrolment rates as well as the quality of education as assessed by the business community. The extent of staff training is also taken into consideration because of the importance of vocational and continuous on-the-job training, which is neglected in many economies, for ensuring a constant upgrading of workers' skills to the changing needs of the evolving economy.

5th Pillar - Higher Education and Training: *Rank of Indonesia: 69 out of 133*

5.01 Secondary enrolment.....	93
5.02 Tertiary enrolment.....	90
5.03 Quality of the educational system	44
5.04 Quality of math and science education	50
5.05 Quality of management schools.....	51
5.06 Internet access in schools	59
5.07 Local availability of research and training services	48
5.08 Extent of staff training	33

Sixth Pillar: Goods Market Efficiency

Countries with efficient goods markets are well positioned to produce the right mix of products and services given supply-and-demand conditions, as well as to ensure that these goods can be most effectively traded in the economy. *Healthy market competition, both domestic and foreign, is important in driving market efficiency and thus business productivity, by ensuring that the most efficient firms, producing goods demanded by the market, are those that thrive.* The best possible environment for the exchange of goods requires a minimum of impediments to business activity through government intervention. For example, competitiveness is hindered by burdensome taxes and by restrictive and discriminatory rules on foreign direct investment (FDI) limiting foreign ownership, as well as on international trade. The economic slowdown, with the consequent drop in trade and rise in unemployment, has increased the pressure on governments to adopt measures to protect domestic firms and jobs. Yet limiting global trade would not only amplify the current downturn, but in the longer term it would also reduce growth, in particular in developing countries. Market efficiency also depends on demand conditions such as customer orientation and buyer sophistication. For cultural reasons, customers in some countries may be more demanding than in others. This can create an important competitive advantage, as it forces companies to be more innovative and customer oriented and thus imposes the discipline necessary for efficiency to be achieved in the market.

6th Pillar - Goods Market Efficiency - *Rank of Indonesia: 41 out of 133*

6.01 Intensity of local competition	47
6.02 Extent of market dominance	34
6.03 Effectiveness of anti-monopoly policy.....	30
6.04 Extent and effect of taxation	22
6.05 Total tax rate	54
6.06 No. of procedures required to start a business.....	99
6.07 Time required starting a business.....	121
6.08 Agricultural policy costs	22
6.09 Prevalence of trade barriers.....	38
6.10 Tariff barriers	71
6.11 Prevalence of foreign ownership.....	41
6.12 Business impact of rules on FDI	41
6.13 Burden of customs procedures	83
6.14 Degree of customer orientation	54
6.15 Buyer sophistication	30

Seventh Pillar: Labour Market Efficiency

The efficiency and flexibility of the labour market are critical for ensuring that workers are allocated to their most efficient use in the economy and provided with incentives to give their best effort in their jobs. Labour markets must therefore have the flexibility to shift workers from one economic activity to another rapidly and at low cost, and to allow for wage fluctuations without much social disruption. Efficient labour markets must also ensure a clear relationship between worker

incentives and their efforts, as well as the best use of available talent, which includes equity in the business environment between women and men.

INDICATOR RANK/133

7th Pillar - Labour Market Efficiency: *Rank of Indonesia: 75 out of 133*

7.01 Cooperation in labour-employer relations	42
7.02 Flexibility of wage determination.....	92
7.03 Rigidity of employment.....	82
7.04 Hiring and firing practices	34
7.05 Firing costs	119
7.06 Pay and productivity.....	29
7.07 Reliance on professional management	55
7.08 Brain drain.....	25
7.09 Female participation in labour force.....	104

Eighth Pillar: Financial Market Sophistication

The present economic crisis has highlighted the central role of a sound and well-functioning financial sector for economic activity. *An efficient financial sector allocates the resources saved by citizens as well as those entering the economy from abroad to their most productive uses.* It channels resources to those entrepreneurial or investment projects with the highest expected rates of return, rather than to the politically connected. A thorough and proper assessment of risk is therefore a key ingredient. Business investment is critical to productivity. Therefore economies require sophisticated financial markets that can make capital available for private-sector investment from such sources as loans from a sound banking sector, well-regulated securities exchanges, venture capital, and other financial products. In order to fulfil all those functions, the banking sector needs to be trustworthy and transparent, and financial markets need appropriate regulation to protect investors and other actors in the economy at large.

8th Pillar - Financial Market Sophistication: *Rank of Indonesia 61 out of 133*

8.01 Financial market sophistication.....	56
8.02 Financing through local equity market.....	13
8.03 Ease of access to loans	21
8.04 Venture capital availability	15
8.05 Restriction on capital flows	33
8.06 Strength of investor protection.....	42
8.07 Soundness of banks	96
8.08 Regulation of securities exchanges.....	45
8.09 Legal rights index.....	98

Ninth Pillar: Technological Readiness

This pillar measures the agility with which an economy adopts existing technologies to enhance the productivity of its industries. Technology has increasingly become an important element for firms to compete and prosper. In particular, ICT have evolved into the “general purpose technology” of our time, given the critical spill-over to the other economic sectors and their role as efficient infrastructure for commercial transactions. Therefore, ICT access (including the presence of an ICT-friendly regulatory framework) and usage are included in the pillar as essential components of economies’ overall level of technological readiness. In this context, whether the technology used has or has not been developed within national borders is irrelevant for its effect on competitiveness. The central point is that the firms operating in the country have access to advanced products and blueprints and the ability to use them. In this context, the level of technology available to firms in a country needs to be distinguished from the country’s ability to innovate and expand the frontiers of knowledge.

9th Pillar - Technological Readiness: Rank of Indonesia: 88 out of 133

9.01 Availability of latest technologies.....	72
9.02 Firm-level technology absorption.....	65
9.03 Laws relating to ICT.....	65
9.04 FDI and technology transfer	49
9.05 Mobile telephone subscriptions.....	94
9.06 Internet users	87
9.07 Personal computers.....	103
9.08 Broadband Internet subscribers.....	101

Tenth Pillar: Market Size

The size of the market affects productivity because large markets allow firms to exploit economies of scale. In the era of globalization, international markets have become a substitute for domestic markets, especially for small countries. Trade openness is positively associated with growth. Trade has a positive effect on growth, especially for countries with small domestic markets. Thus, exports can be thought of as a substitute for domestic demand in determining the size of the market for the firms of a country. Further lowering barriers to trade would support this process.

10th Pillar - Market Size - Rank of Indonesia 16 out of 133

10.01 Domestic market size index.....	16
10.02 Foreign market size index.....	23

Innovation and Sophistication Factors: Rank of Indonesia 40 out of 133

Eleventh Pillar: Business Sophistication

Business sophistication is conducive to higher efficiency in the production of goods and services. This leads, in turn, to increased productivity, thus enhancing a nation’s competitiveness. Business sophistication concerns the quality of a country’s overall business networks as well as the

quality of individual firms' operations and strategies. The quality of a country's business networks and supporting industries is important for a variety of reasons. When companies and suppliers from a particular sector are interconnected in geographically proximate groups ("clusters"), efficiency is heightened, greater opportunities for innovation are created, and barriers to entry for new firms are reduced. Individual firms' operations and strategies (branding, marketing, the presence of a value chain, and the production of unique and sophisticated products) all lead to sophisticated and modern business processes.

11th Pillar - Business Sophistication: *Rank of Indonesia 40 out of 133*

11.01 Local supplier quantity	50
11.02 Local supplier quality	58
11.03 State of cluster development	24
11.04 Nature of competitive advantage.....	34
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Twelfth Pillar: Innovation

The final pillar of competitiveness is innovation. Although substantial gains can be obtained by improving institutions, building infrastructure, reducing macroeconomic instability, or improving human capital, all these factors eventually seem to run into diminishing returns. The same is true for the efficiency of the labour, financial, and goods markets. In the long run, standards of living can be expanded only with innovation. Although less-advanced countries can still improve their productivity by adopting existing technologies or making incremental improvements in other areas, for those that have reached the innovation-driven stage of development, this is no longer sufficient to increase productivity. *Firms in these countries must design and develop cutting-edge products and processes to maintain a competitive edge. This requires an environment that is conducive to innovative activity, supported by both the public and the private sectors.* In particular, this means sufficient investment in research and development (R&D) especially by the private sector, the presence of high-quality scientific research institutions, extensive collaboration in research between universities and industry, and the protection of intellectual property.

12th Pillar – Innovation - *Rank of Indonesia: 39 out of 133*

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12.03 Company spending on R&D.	28
12.04 University-industry collaboration in R&D	43
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Document 11: Doing Business Report 2010 Indonesia

Doing Business 2010: Reforming Through Difficult Times is the seventh in a series of annual reports investigating regulations that enhance business activity and those that constrain it. Doing Business presents quantitative indicators on business regulations and the protection of property rights that can be compared across 183 economies, from Afghanistan to Zimbabwe, over time.

A set of regulations affecting 10 stages of a business's life are measured: starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business. Data in *Doing Business 2010: Reforming Through Difficult Times* are current as of 1 June 1 2009. The indicators are used to analyze economic outcomes and identify what reforms have worked, where, and why.

According to the Doing Business Report 2010, **Indonesia ranks 122th out of 183 economies.**

Here below, a summary of Doing Business indicators for Indonesia can be found. The data used for this country profile come from the Doing Business database and in the full report are summarized in graphs. These graphs allow a comparison of the economies in each region not only with one another but also with the “good practice” economy for each indicator.

The good-practice economies are identified by their position in each indicator as well as their overall ranking and by their capacity to provide good examples of business regulation to other countries. These good-practice economies do not necessarily rank number 1 in the topic or indicator, but they are in the top 10.

Starting a Business	161
Dealing with Construction Permits	61
Employing Workers	149
Registering Property	95
Getting Credit	113
Protecting Investors	41
Paying Taxes	126
Trading Across Borders	45
Enforcing Contracts	146
Closing Business	142

In the year under investigation, Indonesia eased incorporation and post-incorporation processes for new business registration by introducing online services, eliminating certain licenses, making the registry more efficient, and cutting company deed legalization fees, publication fees, registration fees, and business license fees.

As a result, 2 procedures and 16 days were cut and the average company start-up cost was reduced by almost 52 percent of gross national income per capita.

Property registration also became easier because time limits were introduced for standard procedures at the land registry.

In addition, Indonesia increased investor protections by expanding disclosure requirements for related-party transactions.

The breakdown of the most problematic factors for doing business in Indonesia is shown here below:

The most problematic factors for doing business have been identified as follows:

	<u>%</u>
Inefficient government bureaucracy.....	20.2
Restrictive labour regulations.....	7.1
Inadequately educated workforce.....	4.7
Access to financing.....	7.3
Inadequate supply of infrastructure.....	14.8
Poor work ethic in national labour force	3.7
Corruption.....	8.7
Foreign currency regulations.....	5.2
Tax regulations	6.8
Inflation	6.1
Tax rates	1.9
Policy instability.....	9.0
Poor public health.....	0.5
Crime and theft	0.4
Government instability/coups	3.6
	100.0

Document 12: Economic Assessment of Indonesia OECD 2008, Policy Brief

This Policy Brief presents the Executive Summary of the 2008 Economic Assessment of Indonesia. A draft of this Economic Assessment was prepared by the Economics Department and discussed at a meeting of the Economic Development and Review Committee, which is made up of the 30 member countries and the European Commission, on 9 June 2008. The Economic Assessment is published under the responsibility of the Secretary-General of the OECD.

Indonesia's economic performance has improved markedly over the last few years. The economy has recovered in earnest from the 1997-98 financial crisis, and GDP growth has been around 5½ per cent per year since 2004. This rate is below that of some regional peers, but high enough to deliver broad-based improvements in living standards. The contribution of private consumption has trended up, especially since 2004, on the back of robust credit creation.

Investment also appears to be rebounding, although it remains lower than elsewhere in the region when measured in relation to GDP. Export growth has been supported by high commodity prices. The momentum of the current expansion is expected to be maintained in 2008-09, with GDP growth likely exceeding 6% per year. Yet, the current level of growth is insufficient to speed up the pace of reduction in poverty and unemployment.

Therefore, raising the economy's growth potential and sustaining it over the longer term is Indonesia's foremost policy challenge. To achieve this, concerted efforts are required in several areas, especially if the goals set out in Vision 2030 – a well thought-out initiative by a group of independent experts to achieve high growth – are to be fulfilled.

- **Should price subsidies be reduced further?**
- **How can monetary policy be strengthened?**
- **What can be done to improve the business environment?**
- **How to encourage investment?**
- **Would a more flexible labour code deliver lower unemployment?**
- **How to make social protection more effective?**

Against this background, the OECD Economic Assessment of Indonesia discusses a number of policy options for improving the business climate and making better use of labour inputs. Progress in these areas will contribute to enhancing economic efficiency further, so as to narrow the gap in relative living standards that currently exists between Indonesia and the more prosperous countries in the OECD area.

Should price subsidies be reduced further?

Responsible conduct of fiscal policy in an increasingly decentralised setting has delivered low budget deficits and falling public indebtedness in relation to GDP. The budget has therefore benefitted from an “interest dividend”, which has allowed the authorities to begin to reallocate scarce resources towards meritorious programmes in the social and infrastructure development areas.

Emphasis on human capital accumulation, and particularly on improvements in the quality of services, including labour training, would be particularly welcome, given that Indonesia’s educational attainment indicators fare particularly poorly in relation to some regional comparator countries and the OECD area. Efforts are also under way to strengthen tax administration, to alleviate the income tax burden on the business sector and to improve value-added taxation.

Decentralisation, which has put the local governments at the helm of service delivery since 2001, was implemented rapidly and yet without disruption. There is broad agreement that, based on its favourable public debt dynamics, Indonesia will in all likelihood continue to benefit from a relatively comfortable fiscal position in the years to come. Therefore, the time is now ripe for building on past achievements, which are commendable, and for strengthening the fiscal framework further.

Indonesia continues to subsidise fuel and electricity consumption by maintaining a sizeable gap between domestic and international oil prices. Subsidies are expected to make up about 20% of central government expenditure in 2008, with those on fuel taking up the lion’s share of the total. A few selected food items are also subsidised, but such outlays account for a small share of outlays on subsidies.

Efforts to eliminate fuel price subsidisation have yielded mixed results. For example, a mechanism introduced in 2001-02 for automatically adjusting domestic prices so as to reduce the gap between domestic and international fuel prices was abolished not long after.

These subsidies are an inefficient use of scarce budgetary resources at a time when resources are needed for human capital accumulation and infrastructure development, in addition to creating considerable fiscal stress when international fuel prices are high. First and foremost, a significant share of government spending on some subsidies (about two-thirds in the case of fuel, according to official estimates) accrue to individuals in the top two quintiles of the income distribution, rather than benefitting vulnerable social groups. These subsidies also make it difficult for the oil and electricity companies to pursue their commercial objectives independently of the government’s social policies.

Moreover, extensive subsidisation complicates the regulatory framework, because uncertainty in price setting discourages much needed private investment in these sectors. Finally, by keeping the price of fossil fuels artificially low, such price support encourages wasteful consumption and discourages a search for alternative sources of energy, with a detrimental impact on the environment. Therefore, the authorities’ efforts to gradually reduce the gap between domestic and international energy prices would be welcome, provided that targeted compensatory measures (discussed below) are taken to shield the needy from the attendant price rises. The increase in domestic fuel prices by nearly 30% in

mid-May was a step in the right direction, but the introduction of a formula-based mechanism for setting domestic fuel prices would have the advantage of making price changes transparent and removing them from the political arena.

How can monetary policy be strengthened?

Monetary policy has been conducted within a fully-fledged inflation-targeting regime since mid-2005, when monetary targeting was formally abandoned. Following an upsurge in 2005-06 as a result of fuel-price hikes, inflation was reduced and kept within the end-year target range of 5-7% in 2007. Increases in food and energy prices are nevertheless weighing on inflation outcomes yet again. Headline inflation and expectations have risen and are now well above the ceiling of the target range of 4-6% for 2008.

The effect of high food prices on inflation is particularly strong in emerging-market economies, where these items account for a comparatively high proportion of the consumer-price index. To strengthen credibility in the policy regime, the central bank is advised to react pre-emptively by tightening the monetary policy stance should the outlook for inflation and expectations deteriorate further.

International experience shows that resolute, forward-looking action is essential for anchoring expectations and enhancing policy credibility in countries that have a short track record with inflation targeting. Over the longer term, policy effort should also focus on lowering inflation towards the average of Indonesia's main trading partners. The announcement of gradually decreasing targets for the coming years, from 4-6% in 2008 to 3-5% over the medium term, is therefore a welcome signal of commitment to inflation convergence, which will require a sustained effort to achieve those targets.

The steps taken to strengthen the financial sector since the financial crisis of 1997-98, including the most recent biennial Structural Reform Programme, have largely paid off: the banking system is sound, capital-adequacy and liquidity indicators have improved over the years, and the quality of loan portfolios has been strengthened. Nevertheless, State-owned banks have a large presence in the sector, in part due to the rescue of failing banks after the crisis, and the non bank sector is relatively small. Credit-to-GDP ratios are lower than in regional peers and Indonesia's pre-crisis level, despite a robust expansion over the last few years.

As in other countries with a large informal sector, access to credit is particularly difficult for small and unregistered enterprises, which tend to rely on informal, costly sources of finance. Indonesia would therefore benefit from further financial deepening, including in particular the development of the non bank market segment and an expansion of credit to small businesses. Progress in this area could unleash opportunities for entrepreneurship, but policy action should continue to be guided by high standards of financial-sector supervision and prudential regulations.

What can be done to improve the business environment?

Pro-competition product-market regulations tend to be growth-enhancing, because the reallocation of inputs towards higher-productivity sectors is unencumbered. An assessment of Indonesia's regulatory environment on the basis of the OECD methodology for gauging competitive pressures in product markets suggests considerable scope for improvement.

In particular, despite recent deregulation efforts and reforms, Indonesia still fares particularly poorly in comparison with OECD countries in terms of the size and scope of government. For example, the government owns all or the majority of large firms in several sectors, including network industries. It is also involved in manufacturing and services, including banking and insurance.

Sector-specific restrictions on private-sector involvement also remain, including in transport and retail distribution, as well as foreign ownership ceilings, as discussed below. Options are being put forward by the authorities for liberalising State-owned monopolies in key network industries, which would contribute to opening up opportunities for the private sector.

The experience of several countries in the OECD area and beyond suggests that, with appropriately designed regulatory frameworks, the withdrawal of the State from network industries has been accompanied by an expansion of supply and a reduction in service prices, as well as increases in productivity.

There is near-consensual agreement that long-term growth is being held back more by supply- rather than demand-side constraints. The private sector can play a prominent role in the growth process, so long as the business climate can be improved considerably.

Economic and regulatory uncertainty, deficiencies in law enforcement and infrastructure bottlenecks are among the main barriers to entrepreneurship. Indonesia's ranking in international indicators of perceived corruption also suggests that there is significant room for improvement in that area too.

The authorities are aware of the need to take decisive action to tackle these deficiencies, and there has been unequivocal progress in some policy domains in recent years. In particular, enactment of the Investment Law in 2007 was a considerable step forward. The Law makes the investment regime more transparent to investors, and ensures equal treatment for domestic and foreign investment. Screening, notification and approval procedures have been simplified, but ownership ceilings remain in many sectors.

As a result, Indonesia's FDI legislation remains more restrictive than those of most OECD countries on the basis of the OECD methodology for assessing and comparing FDI regimes across countries. Further liberalisation of foreign ownership restrictions could therefore be envisaged in support of policy efforts to encourage investment and boost entrepreneurship. Policy effort in this area would therefore be welcome to nurture investor confidence in the new FDI regime.

How to encourage investment?

Indonesia's ratio of investment to GDP remains below those of regional comparator countries. This has raised concern among policymakers about the country's ability to lift and maintain potential growth over the longer term and to match the growth rates of the fastest-growing economies in the region, including China and India.

At the same time, Indonesia has some of the weakest infrastructure development indicators in Southeast Asia, suggesting ample pent-up demand for such investment. A strong fiscal position is creating room in the budget for increasing government spending on infrastructure. But greater private-sector involvement in infrastructure development and maintenance would be essential. For that, regulatory uncertainty must be reduced, especially with reference to the pricing of water/sanitation services, fuels and electricity.

Price subsidisation complicates investment decisions, because it makes it difficult for investors to assess the rates of return of projects. Existing restrictions on foreign ownership in these sectors also constrains private-sector involvement.

The design of a new, pro-investment regulatory framework, including price liberalisation, free entry into network industries and the setting up of independent regulators would obviously be a complex task but could create attractive opportunities for the private sector to participate in infrastructure development.

The decentralisation programme that was implemented in 2001 granted local governments considerable autonomy to issue business regulations, including licenses, and to levy fees and user charges for the provision of local services. Based on this prerogative, most jurisdictions have introduced several levies, often without the accord of the central government, as a means of raising revenue.

Central government efforts to tackle this problem have so far yielded mixed results. Initiatives have nevertheless been put in place, including by independent think-tanks, to raise awareness among district-level policymakers of the undesirable effects of a proliferation of local regulations on business activity.

These efforts seem to be bearing fruit. Several local governments are setting up one-stop shops as a means of facilitating business registration and the issuance of licenses. Also, legislation is under consideration by the central government to abolish local levies that are deemed in breach of nation wide regulations. Continued efforts to simplify business regulation procedures further and to make them more business-friendly would therefore be welcome. Steadfast progress in this area is crucial for rendering the regulatory framework more transparent and pro-investment.

Decentralisation has put the local governments at the forefront of service delivery, including in public investment programmes. But capacity constraints have resulted in a backlog of investment projects. At the same time, delays in approval of local government budgets by the Ministry of Home Affairs, which is required by law, have taken a toll on the implementation of investment projects.

In addition, a focus on short-term, calendar-year budgeting makes it difficult for local governments to carry out and finance multi year investment projects. Anecdotal evidence suggests that deficiencies in public procurement and tighter oversight in the context of the authorities' ongoing anti-corruption initiatives have made local government officials wary of executing budgetary commitments for fear of prosecution. This may be an unavoidable short-term cost of anti corruption efforts towards boosting accountability at the all levels of government over time.

The stock of unspent budgetary appropriations, especially those financed through revenue sharing with the natural resource-rich jurisdictions, has increased over time, taking a toll on the government's ability to implement investment projects. There is, therefore, considerable scope for reducing capacity constraints at the local level and for making budgetary processes, including central government approval of local government budgets, swifter and better equipped to deal with the multi-year nature of investment projects.

Would a more flexible labour code deliver lower unemployment?

Better utilisation of labour inputs is another pre requisite for putting growth on a higher, sustainable trajectory. A tightening of labour legislation, especially with enactment of the Manpower Law of 2003, has contributed to poor labour-market outcomes. These include unemployment, persistent informality and a loss of dynamism in labour-intensive manufacturing sectors, such as textiles, clothing and footwear, in which Indonesia has a comparative advantage.

Indonesia's labour legislation is rigid in relation to most countries in the OECD area, and particularly in comparison with regional peers.

On the basis of the OECD methodology for assessing the stringency of a country's Employment Protection Legislation (EPL), the Indonesian labour code is particularly restrictive on regular contracts, due essentially to bureaucratic dismissal procedures and costly severance-pay requirements.

There are also constraints on the use of temporary and fixed-term contractual arrangements, because of strict provisions on the duration and number of extensions of such contracts, as well as on the nature of the activities and occupations to which such arrangements apply. Alternative indicators, such as those featured in the World Bank's Doing Business reports, also underscore the stringency of Indonesia's EPL in comparison with regional peers and OECD countries.

Several options can be considered for making labour legislation more flexible. In particular, consideration could be given to simplifying procedures for dismissals in the case of regular contracts, relaxing restrictions on temporary work and fixed-term contracts, and reducing the burden of severance pay and long-term compensation on employers.

At about 65% of the median wage of salaried workers, the minimum wage is already relatively high in Indonesia in comparison with OECD countries. It has risen fast, especially after decentralisation in 2001, because the task of setting the value of the minimum wage is now under the local governments' purview.

This increase has had a deleterious impact on labour-market performance: increases in the minimum wage that are out of step with productivity gains are likely to displace lower-skilled workers. As in the case of EPL stringency, the loss of dynamism in labour-intensive sectors can be attributed to a large extent to the rising relative value of the minimum wage.

Therefore, further increases in the minimum wage could be capped so as not to exceed labour productivity gains. This, or, if it were possible, a gradual reduction over time would help to alleviate the adverse employment impact of such a high minimum wage (in relation to the median) on low-skilled workers and to facilitate formalisation in the labour market.

How to make social protection more effective?

Burdensome labour laws, including minimum-wage provisions, often penalise vulnerable workers, instead of protecting them. This is because legal provisions are not binding in the informal sector, where income is likely to be lower and job security more precarious. Also, increases in the minimum wage are most harmful to the workers at greatest risk of job losses in the formal sector.

Therefore, policy initiatives to build effective social protection while making the labour code more flexible could yield considerable dividends, including in terms of labour-market performance. To make tangible progress in this area, several policy options could be considered. For example, unemployment insurance could be introduced in lieu of onerous dismissal/severance compensation entitlements.

There are several options for designing an effective unemployment insurance scheme. But, as a general rule, it is important that such schemes be fiscally sound and affordable to workers and employers. At the same time, budget finances permitting, formal social insurance programmes could be developed. To this end, once credibility in the existing social insurance programme (Jamsostek) has been built, participation could be extended to the self-employed and employees in smaller enterprises on a voluntary basis, as envisaged by the 2004 Social Security Law (Jamsosnas).

Policy action in this area would be welcome to broaden the array of options for saving for retirement and to facilitate access to health care for those workers and their families who are currently uninsured. In any case, it should be acknowledged that the attractiveness of coverage, both by unemployment and social insurance, depends ultimately on the perceived benefits of social protection and the affordability of contributions, which may be a significant constraint for individuals on low incomes.

Indonesia already has a number of formal, government-financed safety nets. The authorities' efforts to strengthen these programmes since the 1997-98 financial crisis through community-based and targeted income transfers to vulnerable and poor individuals are commendable. These programmes are perceived to be working well, following efforts to improve targeting and governance in the delivery of benefits.

Emphasis is now shifting towards enhancing social assistance by equipping vulnerable individuals with the minimum skills needed to pull themselves out of poverty. This change is of course welcome.

To build on previous achievements, conditionality could be improved in the main existing income transfer programme (Program Keluarga Harapan) to strengthen the link between social protection and durable improvements in social outcomes.

International experience, especially in the Latin America countries that pioneered the design of conditional income transfers, suggests that the most effective eligibility requirements are related to school attendance and participation in preventive health care programmes.

Complementary initiatives can also be taken to improve the targeting of overall government social spending. A reduction in outlays on price subsidies for fuels and electricity, which are on balance poorly targeted, as mentioned above, would be a starting point. Budgetary resources could then be diverted to the financing of programmes that do reach the most vulnerable segments of society, improving the overall progressivity of social spending.

Document 13: FDI and Growth in East Asia: Lessons for Indonesia – 4.1(b), NBER and City University, New York, 4.1(b), RIIIE, Örebro University, Stockholm, 2010

Introduction

Foreign direct investment (FDI) has been a key aspect of increased globalization in recent decades. The growth in FDI has been higher than growth in international trade. Multinational firms have come to account for about 10% of world output and 30% of world exports, and a large share of new technologies is developed and controlled by these firms. Most studies find FDI to have been a source of the rapid growth of some Asian countries.

FDI often requires coordinating complicated operations over long distances: input goods and services need to be shipped between different branches of the multinational firm; and coordination and supervision requires visits by staff and a steady flow of information. It is clear that the complexities of operations across national borders put large requirements on the host country economic environment. Countries differ in their ability to attract FDI, depending on characteristics such as infrastructure, trade regimes, labor force skills, and institutional quality. It should therefore not come as a surprise that inflows of FDI differ substantially among countries in Asia.

However, Indonesia has been an outlier within the region, with lower inflows of FDI than other countries, especially in manufacturing, and with lower inflows than could be expected from its size and other country characteristics. The inflows of FDI that have taken place have benefited Indonesia and we use the Asian experience to provide some suggestions as to what measures would increase FDI. A relatively poor business environment with inefficient institutions seems to be an important explanation behind the low inflows of FDI.

Indonesia is a country where FDI inflows have been relatively modest, and lower than what would be expected from the size of the country. This paper tries to explain the low inflows of FDI by relating the situation in Indonesia to the experience of other countries in the region. Asia is a heterogeneous region and countries differ in many aspects. This provides a possibility to evaluate the determinants of FDI.

Indonesia as a recipient of FDI

FDI inflows have been large to most countries in East Asia but relatively modest to Indonesia. A way of describing Indonesia's record in attracting inward FDI is by comparing inward stocks over time with what might be predicted from equations relating the expected inward stock to several possible determinants of inflow of FDI.

The actual inward stock of FDI in Indonesia in 1985 as reported in the UNCTAD data base was 31% of the stock predicted by the equation and reached 40 percent of the predicted stock by 2005, when actual levels for four East Asian countries were higher than predicted levels and only the Philippines had a lower ratio of actual to predicted FDI stock

The data on aggregate stocks and flows of FDI to individual countries are subject to many problems of measurement and interpretation. For some countries, part of the FDI inflow does not add to the productive assets of the nominal destination country, but flows through to other countries, where the labor and physical capital financed by the flow end up. That is the case, for example for inflows to Hong Kong and Singapore. In other cases, the inflows never reach the supposed destination country, except as notations on accounting statements.

Inflows of FDI from countries where similar data on activities in foreign affiliates are available have been examined. The results above of lower inflows of FDI than what could be expected were largely confirmed. For instance, German FDI in Indonesia was lower than would be expected from a prediction based on FDI in all developing countries, whereas employment in Japanese-owned manufacturing plants in Indonesia was close to predicted levels.

The variables included in the predictions described above refer to Indonesia as a market for the investing firms and therefore capture mostly market seeking FDI. However, the results of the study were confirmed in other studies using broader sets of variables that reflect also Indonesia's attractiveness as a location for export-oriented production. For instance,

Indonesia exhibits underperformance in terms of FDI inflows, compared to what one would expect from country characteristics, according to UNCTAD (2010). They rank Indonesia as number 119 out of 141 countries in terms of FDI inflows. This figure could be compared to what UNCTAD refers to as the potential inflows of FDI, which is based on 12 different economic and policy variables, where Indonesia is ranked as number 85.

The history of FDI in Indonesia has thus been one of relatively low participation of foreign firms, as compared with their role in other countries in the region. Indonesia is not the country most closed to foreign firms, but it ranks low as a location for FDI in general and for participation in chains of production organized by foreign firms. The modest inflow of FDI to Indonesia stands in sharp contrast to the neighbouring countries which are all characterized by a heavy concentration of MNEs.

The effects of FDI on the Indonesian economy

It would be in Indonesia's interest to increase inflows of FDI only if such inflows benefits the country.

The empirical literature surveyed shows surprisingly consistent benefits of FDI to Indonesia. For instance, foreign firms bring in new production processes or start to produce new products benefits the country and will manifest itself in relatively high productivity in foreign firms. A number of studies show that this is indeed the case: foreign

firms have higher labor productivity and higher total factor productivity than local firms. Moreover, not only the level but also the growth of productivity is high in foreign firms. Finally, all of the listed studies find productivity to be high even after controlling for various firm characteristics, such as size and capital intensities.

Previous literature also shows a clear difference in export intensities: foreign firms are substantially more integrated in the international economy through exports. This is not surprising but a result found in most countries.

One interesting finding on Indonesia is that even foreign firms that start producing only for the Indonesian market are more able to switch to export than are local firms.

Foreign-owned establishments in Indonesia pay also higher wages than domestically owned establishments, even given the educational level of their labor forces. They also pay a higher premium the higher the level of education. Foreign firms' entry thus not only increases wages, but also increases the returns to education and encourages workers' investments in additional education. Accordingly, foreign acquisition of an Indonesian manufacturing plant results in higher wages for the plant's employees. Hence, foreign ownership and foreign acquisition increase wages relative to domestic ownership.

A similar story applies to growth in employment. Foreign firms have relatively high growth in employment and foreign acquisitions of domestic firms increase growth in employment, despite foreign-owned firms are relatively large and large firms tend to have relatively low growth rates in employment.

The study suggests that foreign firms have high productivity and export, pay high wages, and show a high growth in employment. If local firms benefit from FDI, it is clear that there are gains to the country from hosting foreign multinational firms, but the benefits are less clear if local firms are instead hurt by the presence of foreign firms. The effects of FDI on local firms are often expressed as spillovers.

Positive spillovers could for instance arise from transfer of technologies from foreign to domestic firms or from expanding markets for domestic suppliers of intermediate goods. Negative spillovers could result from increased competition which forces domestic firms out of business or forces them to operate at a lower scale of production.

Most studies focus on the effect on productivity but there almost all of the studies find evidence of positive spillovers: local firms benefit from the presence of foreign firms within the industry or region. For productivity, the positive effect is likely to come from technology spillovers, new technologies and knowledge that are made available for domestic firms, and from increased competition, a pressure to improve to secure market shares and survival. For wages, the positive effect of FDI is likely to be the result both of increased productivity through the discussed spillovers, and through an increased demand for labor. Since the foreign plants also have higher productivity and pay higher wages than local firms, the two factors together imply that higher foreign presence raises the general productivity and wage level in a province and industry.

Policy Discussion: how could Indonesia attract more FDI?

If faster growth is an important goal of economic policy, it would seem to be in Indonesia's interest to increase inflows of FDI considering the benefits FDI brings in terms of productivity growth, higher wages and strong employment growth. However, the Indonesian attitude towards FDI has always been rather ambivalent.

Indonesia's continuing ambivalence toward FDI is reflected in the fact that in each year's review of FDI policy in UNCTAD's World Investment Report in the last few years, some added restrictions in Indonesia are mentioned. For example, in the 2008 WIR "...Indonesia extended the list of business activities that are closed and partially restricted to foreign investment. In the 2009 WIR, "...in Indonesia...the Ministry of Communications issued a decree barring foreigners from investing in the construction and ownership of wireless communications towers, and in the 2010 WIR, "...some new restrictions to engage in certain activities were introduced (e.g. in India and Indonesia)". Indonesia was the only country mentioned as introducing new restrictions in all three years.

Fiscal incentives are often mentioned when policies to attract FDI are discussed in Indonesia. Such incentives have been used in other parts of East Asia, both in the form of favorable tax treatments and direct subsidies. Fiscal incentives can only be justified if the benefit to the host economy is larger than the cost of the fiscal incentives. Many authors argue that this is seldom the case. Moreover, most studies suggest that fiscal incentives are not important in MNE's localization decisions. One serious problem is that fiscal incentive schemes are difficult to administer and often lead to corruption. The past and present problems with the Indonesian Investment Promotion Agency (BKMP) suggest that such fiscal incentive policies run the risk of being relatively inefficient also in Indonesia.

It is therefore fruitful to address the general business climate in Indonesia. Previous discussions on determinants of FDI in East Asia suggested that high levels of education, good institutions, and openness to trade are all important factors in the location decision of multinational firms.

Education is very poor in Indonesia. The exception is enrolment in primary education which was substantially expanded in the 1970's with the use of public revenues from oil. However, enrolment in tertiary and secondary education has been lower than in most other countries in East Asia. Moreover, there are signs that the quality of education is relatively poor.

Improved education is important for attracting FDI but it will also affect Indonesia's absorptive capacity. The better the level of education the more Indonesia will benefit from foreign MNEs. The same can be said about the technological capacity in Indonesia. A higher technological capacity would encourage foreign MNEs to upgrade production to higher value added activities in Indonesia, rather than placing such production in other countries, and it would also increase spillovers by facilitating knowledge transfers from MNEs to local firms.

Technological capability is another area where there seems to be large potentials for improvements, which would be positive for attracting FDI. Indonesian technology policies before the Asian crisis were dominated by large high-tech projects in aircraft, shipbuilding, railroads, telecommunications, electronics, steel and machinery. Poor management and a weak scientific and engineering infrastructure made most of these projects fail. High-tech projects were mostly abandoned after the crisis but no new technology policy has emerged in its place. As a result, Indonesia remains at the bottom of the technology ladder in the region. One indication of the poor state of technology development and technology capability, or perhaps one of the causes, is the very low investment in research and development.

The same stark contrasts can be seen for R&D expenditures per employee, 5 or 6 thousand dollars per employee in the highest countries, Singapore and Taiwan, but only \$80 per employee in Indonesia.

Infrastructure is a related issue affecting the interest of foreign multinational firms to locate in Indonesia. The importance of infrastructure is clear from the East Asian experience where many countries have used improvements to infrastructure deliberately to attract foreign firms and to integrate in international production networks. It is also clear that many East Asian countries continue to invest heavily in infrastructure and that such investments increased further in for instance China after the outbreak of the global financial crisis in 2008.

Unfortunately, infrastructure is poor in Indonesia. A report on Indonesia in *The Economist* in 2009 quoted a Jakarta bank executive as saying that infrastructure had become the top obstacle to doing business in Indonesia among his banks' clients. "...roads, air- and seaports are inadequate...Electricity generation lags demand...Only 18% of the population have piped water and only 2.5% are connected to a sewer system...Export industries are hindered by a lack of ports...(The Economist, September 12, 2009, pp. 11-12)".

The crisis in the late 1990's had a negative effect on investments in infrastructure. However, investments remained very low even after the crisis was over. In 2010, *The Global Competitiveness Report* ranked Indonesia only as number 96 in terms of the quality of infrastructure, out of 133 included countries.

Some signs of an improvement came in 2009 when the government tried to balance a large drop in external demand by launching a program for major infrastructure investments. However, insufficient public funding is only one of many factors that restrain infrastructure development. Other problems that will be difficult to solve include a lack of technical capabilities at responsible local governments, poor coordination between central and local governments and between different regions, and large problems with land acquisitions.

FDI might be one way to improve infrastructure. Investments by foreign firms in infrastructure, and also in utilities, finance, construction and other non-tradable, are affected by various institutional factors such as competition and pricing policies. Complex regulations are often required to attract investments in these sectors.

Indonesia has a mixed history in dealing with inward investments in infrastructure projects. Lack of administrative capacity, poor regulatory structures and corruption are some of the main causes of failing investments in infrastructure. Wells (2007) suggest some policies to improve upon the investment regime: a closer look at international best practices, a ban on equity arrangements where importantly placed Indonesians get a share of foreign investments, and an institutional arrangement where only one government agency has the full responsibility to negotiate and make agreements with foreign investors in infrastructure projects.

The quality of institutions is perhaps the most important determinant to FDI. In a survey of Japanese firms that chose various countries as prospective sites for their foreign manufacturing locations, over 80% of those choosing Indonesia listed “Political and Social Environment” as a weak point, far more than for any other location. Indonesia has traditionally been seen as having some of the world’s most corrupt institutions. In a comment on corruption in Indonesia in 2008, Transparency International (2008) notes that Indonesia is plagued by rampant corruption, but with some signs of improvements during recent years. Despite this possible slight improvement, corruption remains a real problem and some recent reports indicate new setbacks when the police force, the parliament, and the Attorney General Office have been obstructing the work of the anti-corruption commission.

It is difficult to know exactly how negative corruption is for FDI inflows to Indonesia but there are ample of anecdotal stories of foreign firms who do not invest in Indonesia for fear that corruption will lead to bad-will or with problems with home country authorities.

There are also reasons why the changing nature of corruption might be negative. Corruption was high under the New Order regime but it was also highly institutionalized and predictable: once a standard contribution to the Suharto family or its closest allies had been made, the regime made sure that the foreign firms’ activities were not disturbed. Corruption after Suharto is mainly caused by local governments’ regulations. Corruption differs between provinces and districts, is highly arbitrarily, and therefore more difficult for foreign multinationals to deal with.

The business environment is generally seen to be poorer in Indonesia than in other East Asian countries. For instance, the Foreign Policy magazine Globalization Index is an indicator of investors’ perception of the investment climate in different countries and are often said to be closely watched by the international community. Indonesia was ranked as number 86 out of 156 countries and behind all included countries in East Asia except Cambodia and Vietnam.

The government has since 2006 tried to reform the investment climate for foreign firms. Some reforms of particular importance are the equal treatment of foreign and domestic investors and the streamlined application procedures for investment approvals. However, 25 sectors are closed to foreign firms. More importantly, Indonesia still uses ownership sharing requirements for foreign investments. Ownership sharing has been abandoned in many other countries, since they don’t provide any additional benefits to the host economy, and might deter inflows of FDI.

The problems for foreign firms are often caused by local authorities. With the decentralization of Indonesia in 2001, the quality of public policies and economic governance differ markedly across regions in Indonesia. Some local governments have been encouraging local and foreign firms, whereas many others have constrained firms by imprudent taxation, corruption and inefficient bureaucracy. Good local leadership seems to make a very big difference in fostering a good business environment.

Openness to trade is another important determinant of FDI, especially for multinational firms with vertically integrated production chains. The trade regime in Indonesia deteriorated after the crisis in 1997-98 with increased corruption at the customs services and with increased time and costs for clearing goods. In recent years, the situation seems to be improving.

One of the included criteria in the World Bank's Doing Business survey is trading across borders, which is defined as the documents, time and cost to export and import. Indonesia is ranked as number 45, hence substantially better than its average ranking of 122. It is also better than the ranking of many other countries in the region, and about the same ranking as China (rank 44). A slightly worrying sign, however, is that Indonesia dropped from rank 40 in 2007. Poor integration in the international economy is presumably one reason why Indonesia is not participating in international production networks to the same extent as many other East Asian countries.

Conclusion

FDI has been important in East Asia's economic development. Multinational firms have contributed to host country development by bringing in new technologies and providing access to foreign markets. The benefits have become increasingly obvious for policy makers over time and explain the changing attitude towards FDI in East Asia: from a negative view where most policies aimed at keeping foreign firms out, to a situation where substantial resources are spent on attracting foreign firms.

Multinational firms have responded to the policy changes and invested heavily in the region. Production networks, where different parts of multinationals' production chain are located in affiliates in different countries, seem to be particularly important in East Asia.

Indonesia has not fully participated in this development and attracts less FDI than what could be expected from its size and growth, particularly in the periods up to 1990 and in recent years. This coincides with a relative restrictive FDI regime and with later failures to continue with liberalizations. In the 1990's, when the FDI regime was substantially liberalized, FDI inflows were larger.

A survey of the literature shows that FDI has increased economic growth, wages, export, and employment in the Indonesian economy. What could be done if Indonesia wished to attract more FDI? As global and regional competition for FDI has increased, a FDI regime and an economic environment that were sufficient for attracting FDI some years ago are not sufficient today.

An analysis of determinants of FDI in East Asia gives some guidance: good institutions, a skilled workforce, and openness to trade. Some of these are factors where Indonesia has shown improvements in recent years. These improvements, if they are continued and intensified, will presumably make Indonesia more attractive for multinational firms, although it will take time before the improvements have more widespread impact on the economy.

It is important to recognize that the business environment is poorer than in many other East Asian countries. Indonesian institutions need to be improved further. Corruption is one area with some small signs of improvements, but where the situation remains worse than in most other countries in East Asia. Poor institutions and corruption increase the costs of production. Multinational firms that can choose between different locations will tend to stay out of Indonesia unless these issues are addressed.

On a positive note, there are some provinces that in recent years have been able to implement good policies and improve local institutions. To use these good examples for reforms and changes at a national level would increase inflows of FDI and thereby be fruitful for the continued development of Indonesia.

Document 14: Foreign Ownership and Employment Growth in Indonesia Manufacturing - 4.1(b), City University of New York, 4.1(b), RIIE, Örebro University, Stockholm, 2010

Introduction

Many developing countries would like to increase the share of modern or formal sectors in their employment. One way to accomplish this goal may be to encourage the entrance of foreign firms. They are typically relatively large, with high productivity and good access to foreign markets, and might therefore be better at creating jobs than domestic firms are. However, previous research on the issue has been limited by the paucity of long data sets for firm operations.

This study examined employment growth in Indonesia in a large panel of plants between 1975 and 2005, and especially in plants taken over by foreign owners from domestic ones. Employment growth is relatively high in foreign-owned establishments, although foreign firms own relatively large domestic plants, which in general grow more slowly than smaller plants. For plants that change the nationality of ownership during our period, we find a strong effect of shifts from domestic to foreign ownership in raising the growth rate of employment, but no significant effects of shifts from foreign to domestic ownership.

The faster growth of employment in the foreign-owned plants in general is concentrated in the takeovers, especially in the year of acquisition.

The study compared growth in foreign-owned and domestically owned, and examined employment growth after foreign acquisitions of domestically owned establishment and domestic acquisition of foreign-owned establishments. These observations hold constant the identity of the individual establishments. If foreign ownership provides superior technology or better access to world markets, establishments should tend to raise their employment after foreign takeover.

If these advantages require continued foreign ownership, there may be employment losses when a foreign-owned company is acquired by a domestic firm.

On the other hand, if the technological or other gains from foreign ownership are retained in the establishment, its level and growth of employment may continue after a domestic acquisition.

Foreign Plants in Indonesian Manufacturing

Indonesian manufacturing data were supplied by the Indonesian Statistical Office for the period 1975 to 2005. Employment in manufacturing plants with more than 20 employees

increased from fewer than 700 in 1975 to about 4 million in 1997 and later years. That growth was driven mainly by a strong increase in employment.

The industry sector and the ownership groups differed in some important aspects. One extreme difference was in size: government-owned plants were far larger than domestically-owned private plants, over 5 times as large in 2005. They were much larger also within the industry groups, with a few exceptions. Foreign-owned plants were also much larger, about three times, in every group. The size disparity may be an element in the frequency and success of takeovers.

To the extent the share of blue-collar workers in total employment can be associated with the average skill level in an establishment, it appears that foreign firms tended to use a slightly higher skill labour force than private domestic firms in the same industry. Government-owned plants operated with the lowest proportions of blue-collar workers consistently across almost all industries. Only government-owned plants employed work forces made up to the extent of 30 percent or more of white-collar workers, almost 40 percent in a few cases, while private domestic plants employed more than 20 percent white-collar workers in only one industry group in one year.

The changes in the share of Indonesian manufacturing employment in foreign-owned plants, discussed above, came about in several different ways. One was takeovers of domestically-owned plants by foreign firms, offset by takeovers of foreign-owned plants by Indonesian owners. Another was the establishment of new plants by foreign owners and the demise of existing plants. A third source of change was any differences in average rates of growth in employment between locally-owned and foreign-owned plants.

Foreign takeovers and employment growth

Regarding the effects of foreign takeovers from those of foreign ownership in general, the study estimates that the effect of foreign ownership aside from foreign acquisition effects is about 5% per year faster growth in employment. The effect of foreign acquisition is subsequent growth in employment at a rate 9% faster than in domestic plants.

The fixed effect approach looks at growth in employment within a firm before and after the acquisition and removes the time-constant unobserved plant characteristics that could confound the explanation of acquisition effects. Fixed effect estimates raise the foreign acquisition effect to 11%. The effect on blue-collar workers is about twice as large as the effect on white-collar workers.

The effect of FDI on employment might differ between trade regimes. FDI flows drawn to a developing country to take advantage of cheaper labor costs would respond to an export-oriented policy by expansion. By contrast, FDI induced by import substitution policy is limited by the size and income level of the host-country market. To test for the possible impact of differences in trade regimes, suggested above, we divide Indonesia's history since 1975 into three periods, which we think of as an import substitution period 1975-1985; a trade liberalization period 1986-1996; and the crisis and post-crisis period 1997-2005. The results support the idea that the effects of FDI on host countries are affected by trade

regimes. During the trade liberalization period 1986-1996, the employment growth rate effect of foreign acquisition was as high as 19 percent. In contrast, foreign takeovers had no significant effects on employment growth rates during the earlier, import substitution, period 1975-1985. Up through 1989, foreign takeovers accounted for a large part of total growth in employment in foreign-owned manufacturing establishments, but they were offset by declines in such employment from local takeovers of foreign-owned plants. After 1989, the foreign takeovers added more to the foreign-owned share than the domestic takeovers took away. The numbers of takeovers had been fairly similar in the two directions until the 1990s, but since then, foreign takeovers have been more numerous, except in 1997, during the Asian crisis. However, the net effect of foreign and domestic takeovers was less important as a source of employment growth in foreign-owned establishments than the combination of the establishment of new foreign-owned plants and their more rapid growth.

Matched comparisons of domestic and foreign takeovers

These results were tested for possible biases from the selectivity of acquisitions by using propensity score matching. Foreign takeovers raise the growth rate of employment by 10% on average during the acquisition and post-acquisition period, after correcting for the pre-acquisition differences between acquired and non-acquired plants. This is similar to the fixed effect estimate. Domestic takeovers, according to the matched comparison, do not affect employment growth rates.

While the employment growth rates in foreign takeovers do not differ significantly from those of plants remaining domestically-owned in the first and second years after the takeover, the impact of the foreign takeovers continues, because the acquired plants grow so much in the year of takeover that the same growth rate after takeover implies a considerably larger absolute growth in employment in the following years in the acquired plants, relative to domestic plants. There are no similar effects in absolute terms from domestic acquisitions of foreign plants.

One implication of this concentration in the year of acquisition is that the usual assumption that “Greenfield” investment adds resources to the recipient country, but acquisitions only change ownership is wrong. Acquisitions can be associated with very substantial additions to resources, quite apart from any gains that might arise from transfers from less-skilled to more-skilled management.

Conclusions

Most of the employment effects of foreign takeovers took place in the year of takeover. There was relatively little effect on growth rates in the following years, but the absolute additions to employment in the years after takeover were larger than they would have been under continued local ownership because the base was much larger. The negative or insignificant effect of domestic acquisition on foreign-owned plants, as in the fixed effects estimate and the difference-in-differences estimate from a matched sample, shows that the advantages of foreign-owned plants that accounted for more rapid growth required continued foreign ownership.

They are apparently lost if the plant returns to domestic ownership. One possible implication of the concentration of growth in the year of acquisition is that the distinction between “Greenfield investments” and acquisitions is not as sharp as is often assumed. Many of the acquisitions apparently involve major changes in the size and possibly other dimensions of the target firms.