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Indonesia's Trade Policy Regime amidst Global Challenges

Institute for International Trade

Policy challenges

The global trade environment is marked by geopolitical shifts, fragmenting globalization. This fragmentation poses substantial implications for emerging economies in Asia and ASEAN, including Indonesia. ASEAN economies have benefited immensely from globalization over the past four to five decades, with major progress driven by integration into the global economy. However, growing geopolitical tensions, from Ukraine through the Middle East to the South and East China seas, have disrupted supply chains and spiked commodity prices. This severely impacts developing economies like Indonesia, especially through imported commodities prices such as wheat and crude oil, causing rising costs. Additionally, post-pandemic high prices caused inflationary pressures, prompting advanced economies to rapidly hike interest rates and sustain them at higher levels.[01] This resulted in capital outflows from emerging markets, creating economic and budgetary pressures that require careful management, although these pressures appear to be easing as interest rates decline; however, a soft landing in developed countries and sustained macroeconomic stability remain uncertain.

Policy solutions

These multifaceted issues define the environment in which Indonesia operates, demanding resilient and adaptive policy measures to ensure sustained progress and stability. Should President Prabowo continue with President Joko Widodo's trade policies or tilt Indonesia in a different direction? This policy brief identifies the potential directions that the new Indonesian Government might take.

Indonesia's economic resilience amid global challenges

Under President Joko Widodo Indonesia has managed global risks well, maintaining stable gross domestic product (GDP) growth at around 5 percent, including during the pandemic when the economy only contracted by 2 percent before quickly recovering. This consistent growth amid high interest rates, geopolitical tensions, and commodity market fluctuations highlights Indonesia's resilience. In addition to maintaining economic growth, Indonesia has successfully reduced unemployment and poverty, ensuring inclusivity and equality. The country has also managed inflation effectively, keeping it below 3 percent for an extended period, which is commendable given the global struggle with food and energy inflation. Moreover, while global manufacturing activity is weak, with the global trade and manufacturing index close to contraction levels, Indonesia's Purchasing Managers' Index (PMI) consistently shows expansion, reflecting relative stability. Indonesia and India stand out in maintaining robust manufacturing activity, unlike many neighbouring Asian countries suffering from a weakened global economy.[02]

Indonesia's economic resilience can be attributed to a few key factors. The real strength lies in the synergy between fiscal and monetary policies. The close cooperation between the Central Bank and the Ministry of Finance helps Indonesia navigate significant challenges like pandemics, climate change, and structural transformations.

^The views expressed here are the author's alone and not those of the Institute for International Trade.

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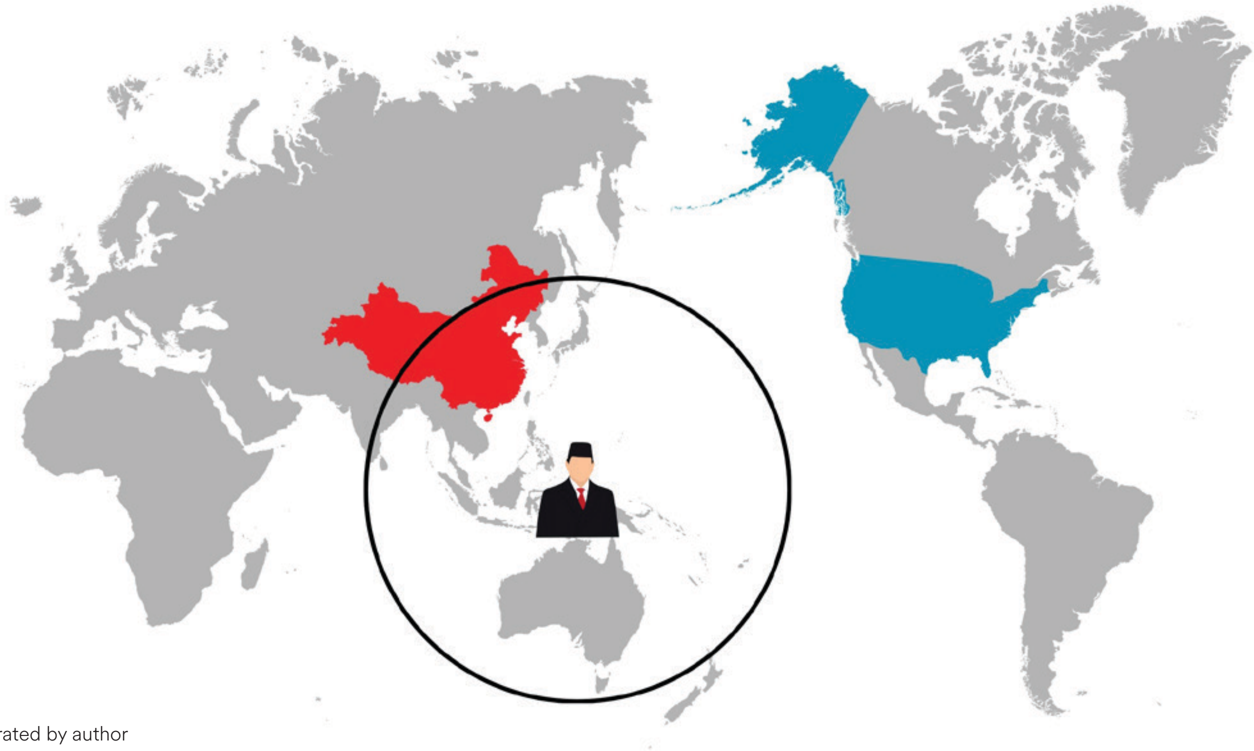
make history.



Illustrated by author

The external balance is another important factor. Historically, the current account has been a weak point for Indonesia, but it turned positive from 2020 to 2023. This trade balance surplus, driven by consistent manufacturing expansion and supported by a floating currency that enhances export competitiveness, has bolstered the country's ability to withstand critical macroeconomic stress periods.

Domestic demand also plays a significant role in economic stability. Balancing growth sources from both external and internal markets ensures continuous performance. Household consumption, which accounts for over 50 percent of the country's GDP, is a critical element. Post-pandemic low inflation and high growth have kept consumer confidence steady. The economy grew by 5.1 percent in the first quarter of this year, continuing the steady growth trend.[03]

Indonesia's ambitions and its geographic realities

Under President Joko Widodo since 2014, Indonesia has sought to elevate its economic standing, particularly through a focus on creating new infrastructure and advancing key sectors, despite facing the urgent challenge of sinking infrastructure and rising risk of flooding in its major capital city Jakarta, compelling a move to a new capital, Nusantara.[04] The ambitious plan aims to alleviate the pressing issues of congestion and environmental degradation in Jakarta while promoting growth in more underdeveloped regions like Kalimantan. Amidst its economic endeavours, Indonesia's reliance on natural resources remains strong, particularly in nickel production — holding the largest reserves globally, which is critical for modern battery manufacturing — along with significant coal and natural gas exports. The government has implemented protectionist policies intending to encourage local processing of minerals, leading to substantial foreign investment particularly in the nickel sector; however, the outcomes in other sectors have been mixed.

Indonesia's location enhances its strategic importance, placing it at the crossroads of the U.S.-China rivalry, which influences the nation's foreign policy. Historical non-alignment during the Cold War has resurfaced, as contemporary leadership endeavours to maintain neutrality while managing increasing pressure from both superpowers. The public supports this stance, reflecting a preference for remaining outside direct influence from either side, yet fears revolve around China's rising power against U.S. interests in the region. Indonesia's position in ASEAN serves both as a source of strength and a potential liability, as it navigates complex relationships with major powers while attempting to assert its own regional leadership.

Active participation in military exercises with the U.S. juxtaposes a growing dependence on Chinese investments, including involvement in initiatives that resonate with Indonesia's developmental goals. Critics argue that these close ties, particularly with China, may lead to vulnerabilities, especially with ongoing tensions between the superpowers that could destabilize Indonesia's aspiration for neutral diplomacy. The archipelago's critical waterways, essential for global trade, would likely draw attention during any potential military conflict, complicating Jakarta's strategy of neutrality. [05] As Indonesia's importance continues to rise in regional and global contexts, highlighted by its role in hosting significant summits and mediating international disputes, the country faces inherent tensions between its ambitions for independence and its geographic realities.

Despite growing opportunities, Indonesia's internal challenges such as economic inequality, fragile institutions, and uneven progress, pose risks to its trade policy ambitions. Success in reaching the "Golden Indonesia 2045" centennial vision of becoming a sovereign, advanced, fair, and prosperous nation will depend on addressing these internal issues while maintaining balanced foreign and trade relations.[06]

Effective trade policy will require Indonesia to navigate its strategic location adeptly and foster stronger institutions to support sustainable and inclusive growth. Strengthening domestic policies and ensuring consistent geopolitical strategies are crucial. This balanced approach may provide a foundation for Prabowo Subianto's incoming administration to articulate a clearer vision of national trade interests, enhancing Indonesia's position in global trade networks without compromising its neutral stance amidst international pressures.

Indonesia's bilateral and regional economic integration

During President Widodo's second term, Indonesia significantly ramped up its bilateral trade agreements, enhancing its global economic footprint.[07] The Chile-Indonesia FTA (effective August 2019) and the EFTA-Indonesia FTA (effective November 2021) exemplify Indonesia's strategic efforts to diversify trade partnerships. The Indonesia-Australia Comprehensive Economic Partnership Agreement (IA-CEPA), operational since July 2020, signifies a deepening of economic relations with Australia, a key player in the Indo-Pacific.

Additionally, Indonesia has forged important new agreements with the Republic of Korea, both through ASEAN and bilaterally, with the latest Indonesia-Korea FTA in effect since January 2023. Other notable bilateral agreements established during this period include the Indonesia-Pakistan PSA, active since September 2013, and the Mozambique-Indonesia FTA, which came into force in June 2022. The Japan-Indonesia FTA, operational since July 2008, also continues to play a vital role.

Indonesia's involvement in the Regional Comprehensive Economic Partnership (RCEP) is a significant milestone. RCEP is a large-scale trade agreement that includes all ten ASEAN member states plus five key trade partners: China, Japan, South Korea, Australia, and New Zealand. This agreement, which entered into force on January 1, 2022, aims to create a unified market by reducing tariffs, enhancing trade facilitation, and providing common rules on investment, intellectual property, and e-commerce. For Indonesia, RCEP offers an unparalleled opportunity to integrate more deeply into global value chains, attract foreign direct investment, and boost exports by leveraging preferential access to some of the world's largest and fastest-growing economies in the Indo-Pacific. The agreement is expected to significantly contribute to Indonesia's economic resilience and long-term growth by fostering a more competitive and dynamic business environment. Increased involvement in regional and global supply chains could grow Indonesia's trade by over 7 percent, and a 1 percent tariff reduction could boost trade by more than 2 percent on average.[08]

Furthermore, as of August 2024, Indonesia is still actively engaged in negotiation rounds for FTAs with several major economies, including the European Union (EU), India, Canada, Tunisia, Turkey, and the Eurasian Economic Union (EAEU). These ongoing negotiations reflect Indonesia's strategic initiative to expand its trade network, tapping into new markets and strengthening economic ties across different regions.

However, despite these ambitious strides towards greater integration, Indonesia continues to face significant international trade barriers. The country imposes an average import tariff of 8.1 percent, with higher rates for certain products. Taxes remain a significant concern for foreign companies due to arbitrary assessments and high fines. Additionally, luxury taxes, increased withholding tax rates, and income tax prepayment on imports complicate the business environment for importers. Complex licensing requirements, particularly for agricultural products, further challenge market access.

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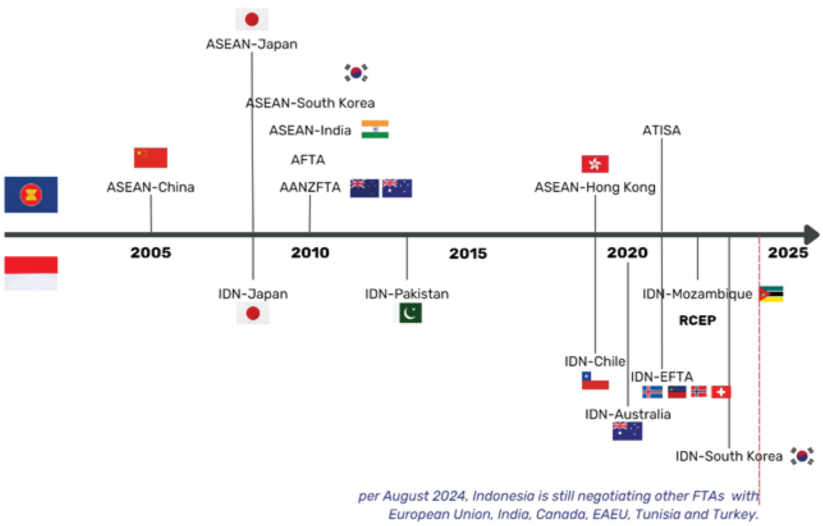
Non-tariff barriers exacerbate these issues through overlapping licensing requirements. The pharmaceutical industry faces specific hurdles related to pricing and reimbursement systems. Technical barriers such as stringent testing requirements impact products like toys, electronics, and medical devices. Sanitary and phytosanitary measures affect animal product facilities and fisheries, while government procurement preferences promote domestic sourcing, adding another layer of complexity. Intellectual property protection remains a concern due to ongoing issues of piracy and counterfeiting.

The services sector is restricted by barriers in audio visual, logistics, express delivery, and financial services. The Indonesian banking sector, regulated by the Indonesian Financial Services Authority (OJK) and Bank Indonesia (BI), allows up to 99 percent foreign ownership in commercial banks but limits it to 49 percent in private credit reporting firms. Peer-to-peer lending services have an 85 percent foreign ownership cap, and a moratorium on new licenses was issued in October 2021. Financial technology companies must register with OJK, and foreign ownership in payment companies is capped at 20 percent. Firms participating in the National

Figure 1: Timeline of Indonesia's Bilateral and ASEAN Free Trade Agreements



Payment Gateway (NPG) face a 20 percent foreign ownership limit and must partner with licensed Indonesian NPG switches.[09]

The transportation sector is impacted by regulations restricting foreign investment and ownership in essential goods transportation. Foreign ownership of vessels operating in Indonesian waters is limited to 49 percent under Law 17/2008 on shipping. The construction sector requires foreign companies to partner with local firms, particularly for high-risk projects. In franchising and retail distribution, Ministry of Trade (MOT) regulations prioritize the use of domestic goods, and MOT Regulation 50/2020 sets requirements for electronic commerce activities.

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While investment barriers have been reduced under Presidential Regulation 10/2021[10], opening various sectors for investment, local content requirements across sectors such as telecommunications, energy, mining, and textiles continue to pose challenges. Regulatory changes in the energy and mining sectors have raised concerns about contract sanctity and local content requirements, impacting the operations of foreign energy service companies.

Despite these tensions and the challenges posed by a faltering multilateral governance framework, Indonesia's industrial policy, particularly its nickel export ban, underscores its strategic importance. This policy, aimed at enhancing domestic processing capabilities and solidifying Indonesia's position in the global supply chain, reflects the country's ambition for economic autonomy. As Indonesia navigates these complexities, it must align its industrial policies with the realities of geopolitical tensions, particularly the ongoing U.S.-China rivalry, while maintaining its strategic influence in international commerce.

Overall, Indonesia's expanding network of bilateral and regional trade agreements over the past five years highlights its proactive stance in fostering economic growth, diversifying markets, and strengthening its position in the Indo-Pacific and the global economy under President Joko Widodo's leadership. Despite persistent trade barriers and the complex implications of policies like the nickel export ban, Indonesia continues to strive for greater integration and economic development through strategic international partnerships.

A future Indonesian trade policy

Moving forward, there are concerns about investor confidence under the new government led by Prabowo Subianto. Although he has pledged to continue current FTA negotiations and explore new trade opportunities, investors are wary of potential shifts in economic policy and regulatory practices. To maintain and enhance investor confidence, it is crucial for the new administration to focus on reducing trade barriers, enhancing regulatory transparency, and fostering a more favourable business environment. Effectively addressing these challenges is key to sustaining Indonesia's economic momentum and maintaining its attractiveness as a destination for foreign investment.

Considering the changing global economic landscape and emerging opportunities within the Indo-Pacific region, Indonesia should urgently develop a comprehensive Indo-Pacific strategy. This strategy should focus on enhancing trade relations, fostering economic growth, and maintaining investor confidence under Prabowo's leadership.

To solidify Indonesia's position in the Indo-Pacific region, the government must formulate a clear and cohesive national strategy that aligns with regional dynamics and leverages Indonesia's strategic position. Utilizing regional forums like ASEAN, Asia-Pacific Economic Cooperation (APEC), and the East Asia Summit will promote Indonesia's trade interests and foster collaboration with key partners. ASEAN remains a cornerstone of Indonesia's trade policy. Actively participating in ASEAN initiatives to further integrate regional economies and harmonize regulatory frameworks will deepen integration. Taking a leadership role in regional economic initiatives will ensure that Indonesia's interests are well-represented. Additionally, ensuring that economic policies are supported by measures that enhance regional security and stability will create a conducive environment for trade and investment. Beyond its region, Indonesia must continue the OECD accession process to expand its global outreach and integration.[11]

Boosting investor confidence requires transparent, consistent, and predictable regulatory frameworks. Streamlining the licensing process and reducing bureaucratic red tape, particularly for foreign investors, will be essential. Establishing clear and fair taxation policies to avoid arbitrary assessments and high fines will further attract foreign businesses. Additionally, ensuring that laws and regulations are applied uniformly across all sectors will contribute to a more stable business environment.

Recognizing India's pivotal role in the Indo-Pacific landscape, Indonesia should expedite FTA negotiations with India to capitalize on mutual economic interests and strengthen bilateral ties. Tapping into India's vast market potential, focusing on sectors such as technology, pharmaceuticals, and renewable energy, will be beneficial. Improving maritime and air connectivity with India will facilitate trade and enhance people-to-people exchanges.

> Addressing non-tariff barriers is crucial to improving market access and trade flows. Indonesia should harmonize and streamline overlapping licensing and regulatory requirements across different sectors

Furthermore, Indonesia should continue to build and strengthen its network of trade agreements. Finalizing FTA negotiations with major economies like the European Union (EU), Canada, Tunisia, Turkey, and the Eurasian Economic Union (EAEU) will expand trade opportunities. Proactively seeking new trade agreements with emerging markets and untapped regions will diversify Indonesia's trade relationships.

Kendari - Indonesia, June 1, 2022: Beautiful landscape view at the Nickel Mining Company (PT. Tiran Indonesia Site Lameruru, North Konawe, Southeast Sulawesi)

Addressing non-tariff barriers is crucial to improving market access and trade flows. Indonesia should harmonize and streamline overlapping licensing and regulatory requirements across different sectors. Relaxing stringent testing and certification requirements, especially in industries like pharmaceuticals, electronics, and medical devices, will simplify market entry. Harmonising sanitary and phytosanitary standards with international norms will facilitate smoother trade in animal products and fisheries.

Strengthening intellectual property protection is necessary to address ongoing issues of piracy and counterfeiting. Enhancing intellectual property laws and enforcing stricter penalties for violations will provide stronger legal frameworks. Empowering relevant agencies with the resources and authority needed to effectively combat intellectual property infringement is also crucial. With the launch of the Golden Visa program [12], which facilitates foreigners to invest and work in Indonesia and attracts high-quality talent, a strengthened digital trade ecosystem is essential to maximize the benefits. Expanding broadband access and digital infrastructure will support e-commerce and digital trade, further enhancing Indonesia's trade capabilities.[13]

To attract more foreign investment in service sectors, Indonesia should consider liberalizing services by leveraging existing FTAs more effectively through deeper commitments. Harmonizing regulations on foreign entry by streamlining visa and work permits, particularly for professions engaged in cross-border services, will make Indonesia a more attractive destination. Moreover, making regulations for service imports transparent and simple is vital. Implementing the WTO's Services Domestic Regulation Agreement, which emphasizes transparency in regulatory provisions related to market access, could serve as a guideline. Finally, ensuring closer integration of policies for the digital economy and services within FTAs will help Indonesia harness the full potential of its digital infrastructure and services sector.

Developing domestic processing industries is highlighted by the nickel export ban. However, it is important to recognize that what works for nickel does not necessarily apply to other commodities. Imposing similar bans could risk Indonesia's standing as an integrated global player in global value chains (GVCs). Instead, continuing to incentivize investment in smelting and other downstream industries while promoting research and development in key sectors like electric vehicle batteries will maintain Indonesia's competitiveness without jeopardizing its global trade relationships.

To address concerns about potential policy shifts under the new administration, it is vital to provide clear and consistent communication on policy directions to reassure investors. Upholding commitments made in existing trade agreements and honouring contractual obligations will preserve investor trust. Involving industry stakeholders, both domestic and international, in policy formulation will ensure that trade policies align with market realities and business needs.

By implementing these recommendations while exercising caution with commodity-specific policies, Indonesia can enhance its trade landscape, attract foreign investment, and sustain its economic growth trajectory in the global marketplace.

About the author

Dr Harry Wardana, Economist, Institute for International Trade, University of Adelaide.

Endnotes

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12. Read more on Reuters, "Indonesia launches 'Golden Visa' to lure foreign investors, boost economy", https://www.reuters.com/markets/asia/indonesia-launches-golden-visa-lure-foreign-investors-boost-economy-2024-07-25/

13. See, for example, IIT Working Paper on the impact of taxation on e-commerce on small business in Indonesia, and the reason to keep it open "The Value of Cross-border Digital Transmissions to MSMEs in Indonesia: Implications for Participation in the WTO E-commerce Moratorium", https://iit.adelaide.edu.au/news/list/2024/05/22/the-value-of-cross-border-digital-transmissions-to-msmes-in-indonesia

Further enquiries

The University of Adelaide SA 5005 Australia
enquiries iit01@adelaide.edu.au
phone +61 8 8313 6900
web iit.adelaide.edu.au