Centre for Strategic and International Studies
ERIA Economic Research Institute for ASEAN and East Asia
Review of Indonesian Economic Policies

A Perspective for Improving Indonesia's Competitiveness

- Shift the paradigm underneath Indonesia's competitiveness policy from inward-looking to outward-looking, for example, by increasing participation in global production network.
- Change the emphasis of government's role from regulator to facilitator, in order to improve competitiveness and export performance.
- Modify currently conventional export promotion strategy to become more modern and innovative.
- Become more active in initiating free trade agreements. Not being involved in any free trade block does not mean that Indonesia will not suffer any loss, as it will be further left behind from the competitors.

Indonesia's Issues of Competitiveness

At a glance, the Indonesian economy is still performing well in comparison to other countries. However, this performance has not been able to answer the challenges of the external environment that has already changed. This is partly due to weakening competitiveness of the Indonesian market.

What is the cause for this weakening competitiveness? First, Indonesia's terms of trade has experienced an increase, due to the appreciation of the Real Effective Exchange Rate (REER). The appreciation is because of the strengthening nominal exchange rate as well as the rise of domestic prices compared to other countries. Secondly, due to Indonesia's production technologies lagging behind several competitor countries. Thirdly, the failure to reform Indonesia's regulation after the 1997 Asian financial crisis.

Many of the competitiveness policies are based on approaches and paradigms which are no longer appropriate. First, many policies are too highly emphasized on value adding, e.g. the downstream policy. In fact, the value added in production more frequently comes from capital-intensive or skill-intensive activities, and not merely labor-intensive one, which is more needed for job creation. In addition, the increasing value added does not necessarily require a country to produce goods with higher value, like for example, producing aluminum instead of bauxite. Producing aluminum requires far more cost than producing bauxite. As a result, the added value may end up being negative, even though the value of aluminum is higher.

Second, many of the policies tend to be inward-looking and rely on import substitution. The rationale is that the provision to protect will provide an opportunity for domestic industries to learn and enjoy economies of scale before becoming efficient. However, the problem is that protection is often given without a clear limit of time or performance criterion. As a result, businesses prefer lobbying the government to obtain protection rather than becoming more efficient in production.

The various arguments made above are not in line with the current state of global production and trade, which is getting more vertically integrated, involving many different countries. For example, electronic items such as computers are produced across many different countries. This is often called the Global Production Network (GPN) or Global Value Chain (GVC). In GPN, fewer countries are producing goods from upstream all the way to downstream, and instead they are only producing goods that match with their comparative advantages.

Therefore, Indonesia needs to adjust its trade and industry policies in order to participate in GPN. Participating in GPN requires open trade and investment regimes, the availability of a wide range of excellent supporting services especially logistics, and lastly a competitive labor force.

Improving Competitiveness Through Exports

One of the main strategies to increase competitiveness is by improving export performance. Although Indonesia has a high population, Indonesia's market is only 1% of the world, which means that it needs to look for market elsewhere. In addition, export reflects the competitiveness of a country because the global market consists of more efficient and innovative companies. Indonesia's current exports are not enough diversified, both in terms of production and export destinations.

There are several problems facing Indonesia's exports. First of all, there are production bottlenecks (*supply-side constraints*) as described in the previous section. Secondly, there is a lack of information about the export destination's market characteristics and high "cost" of export. Thirdly, there are still barriers for exporters to access the market.

These high "costs" are making export activities more risky and less profitable for domestic players. The "cost" is taking into account the efforts needed to obtain information about the destination market, building networks, and meeting a variety of rules and regulations in the destination country.

Currently, the government seems more concerned about regulating rather than facilitating international trade. For example, the Trade Act of 2014 mandated the establishment of 9 Government Regulation, 14 Presidential Decree, and 20 Minister of Regulation. In 2014, for example, the Ministry of Trade published 368 trade-related regulations. The government must change its paradigm from regulator to facilitator.

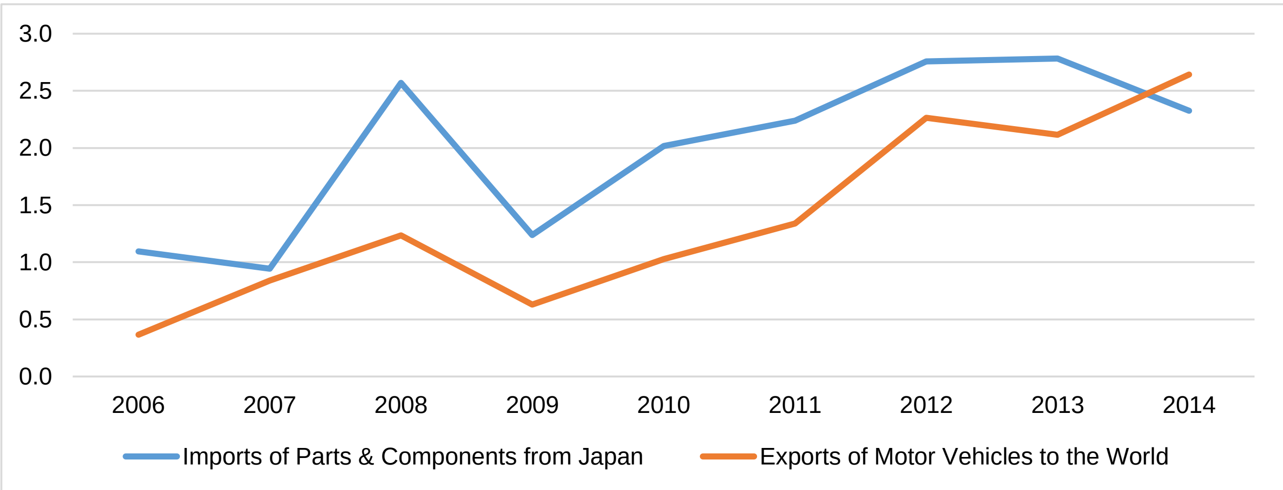
The Role of Trade Agreements and Increased Market Access

In addition to production constraints and export difficulties, market access also affects Indonesia's export competitiveness. Despite the success of the WTO in significantly lowering import duties, the level of duties is still affecting export competitiveness, especially coupled with non-tariff barriers. Currently, Indonesia has only a few trade agreements with partner countries, which means Indonesian products are suffering from high level of trade and non-trade barriers.

Unfortunately, in Indonesia's economic policy discussion, the free trade agreement is generally still perceived negatively. In a survey on the ASEAN Economic Community (AEC), only 45% of Indonesian companies see the AEC as an opportunity for them, which is far below other ASEAN countries. Trade agreements are often perceived as the reason for increasing imports.

After the establishment of the Indonesia-Japan Economic Partnership Agreement (IJEPA), the trade balance surplus is becoming smaller due to increased imports to Indonesia from Japan, which is higher than the increase in exports. This has led to the public opinion that IJEPA is detrimental to the Indonesian economy. However, we need to consider that imports are important in supporting domestic production, including those intended for exports. Indonesia's exports of auto products increased nearly by 5 times after joining the IJEPA, although not intended for the Japanese market, and thus making it not visible in the bilateral trade balance between Indonesia and Japan. This fact shows the importance of the GPN as discussed above.

Indonesia's Import and Export in the Automotive Sector after the IJEPA (in USD billion)



This publication is a result of the activity entitled "Economic Policymaking in Indonesia", that is jointly conducted by Centre for Strategic and International Studies (CSIS) and Economic Research Institute for ASEAN and East Asia (ERIA). This activity involves a number of competent researchers with expertises in specific areas of economic policy.