

## REVIEWING THE IMPORTANCE OF FREE TRADE AGREEMENTS FOR INDONESIA

**Yose Rizal Damuri**

This policy brief is the result of an activity entitled “Economic Policymaking in Indonesia” which is jointly conducted by Centre for Strategic and International Studies (CSIS) and Economic Research Institute for ASEAN and East Asia (ERIA). This activity is a contribution from research community that is expected to assist the government in formulating more effective economic policies in the future. In this activity, CSIS and ERIA invited 16 economists with specific fields of expertise from some leading research institutions to conduct in-depth discussions on seven strategic issues facing Indonesian economy (infrastructure development, competitiveness, investment climate, food policy, services sector policy, fiscal policy, and social protection policy), which is then summarized into policy briefs covering each of the topics.

Dissemination of the findings and recommendations produced by this activity is conducted through several channels. First, this activity has made efforts to engage the relevant government officials through some Focus Group Discussions (FGD), the publication of High Level Policy Notes, and hearings with some strategic policymakers with regard to each of the strategic issues mentioned above. Secondly, this activity also conducts widespread public disseminations through Public Seminars on each of the strategic issues, along with publications of the Policy Briefs and supporting multimedia that can be accessed online through [www.paradigmaekonomi.org](http://www.paradigmaekonomi.org).

## RECOMMENDATION AND MAIN INFORMATION

- 1. It takes a more holistic view to evaluate trade agreements, not just limited to market access. The impact of an agreement would be far beyond than just a bilateral balance of trade, including the industrial development and increasing competitiveness.*
- 2. Not joining a trade agreement does not necessarily mean that Indonesia will not suffer from losses. There are losses due to erosion of the competitiveness of Indonesian products while other countries are concluding various trade and investment agreements.*
- 3. A national strategy on the purpose and direction of trade agreements is absolutely required. The strategy needs to include various relevant aspects, and focuses not merely to increase exports, but also to deepen industries and increase competitiveness. The strategy should also consider that various new areas in the FTA could become supporting tools to achieve economic reforms that support the goals of economic development.*

**A** FREE TRADE agreement (Free Trade Area, FTA) is still a controversial topic within Indonesia's economic policy discourses. Trade agreement is still considered to be detrimental to the economy. Lots of resistance usually occurs whenever the government announces that Indonesia will follow or participate in a trade agreement.

According to a survey about the ASEAN Economic Community (AEC), only 45% of Indonesian companies see the AEC as an opportunity. It is far below than the other ASEAN countries, in which more than 70% of business actors see it as an opportunity. These negative perceptions emerge from a perspective that see trade agreements, as well as the accompanying process of economic openness, only threaten the domestic production sector, both in the agricultural and industrial area.

Domestic product placed in a position that unable to compete with imported products from trading partner countries, which led to an excess of imported goods in the domestic market. Meanwhile, the reduction in import duties and trade barriers in partner countries will not provide sufficient benefit because Indonesia's exported products are considered too uncompetitive and lacking in quality to take advantage of existing opportunities.

## THE IMPACT OF FTA

This negative perception also emerges from Indonesia's experiences of implementing several trade agreements, such as the Indonesia-Japan Economic Partnership Agreement (IJEPA) and the ASEAN-China Free Trade Agreement (ACFTA). Both of them, and several other agreements, are deemed to impose burdens on Indonesia's balance of trade.

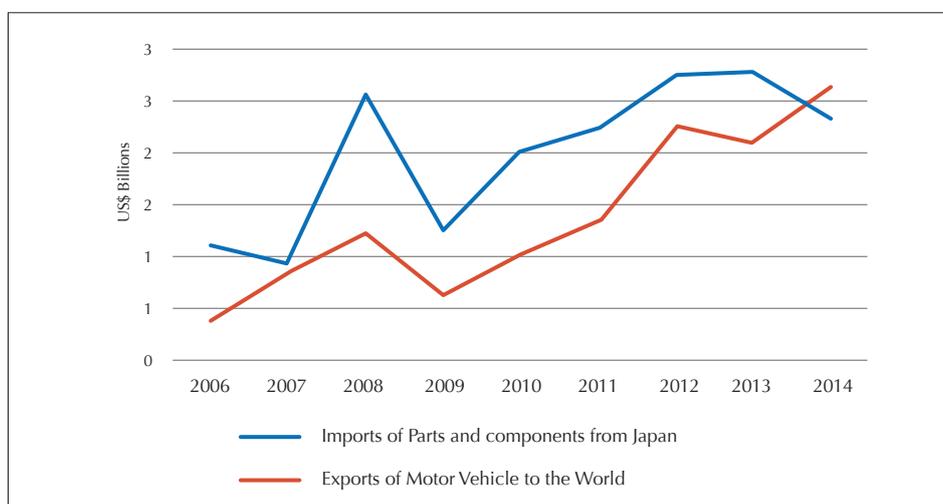
The Indonesia-Japan trade has continued to increase after IJEPA was concluded in 2007, and was fully implemented in 2012. The data shows that

the escalation of Indonesia's imports from Japan is higher than that of its exports. This led to the narrowing of Indonesia's trade surplus with Japan. Indonesia recorded a trade surplus of US \$ 16 billion in 2007, while the number was only about US \$ 8 billion in 2014.

Furthermore, the increase of imports from Japan was dominated by intermediate inputs for industrial uses, which increased by 18% annually, while imports of spare parts of vehicles grew by about 13% annually. Both products are important raw materials to support domestic production (including those for exports) and contribute to the industrial development in Indonesia.

Figure 1 below shows how the increase of imports of spare parts and motor vehicle components coincided with the rise of exports of motor vehicles from Indonesia. Unfortunately, these exports were not reflected in the bilateral balance of trade between Indonesia and Japan, as main destinations of exports were to the other countries, such as ASEAN and Middle Eastern countries.

**Figure 1. Indonesia's Import and Export in Automotive Sector**



Source: COMTRADE Database, arranged by the author

According to the illustration, two things need to be kept in mind while analyzing the results of an FTA. First, existence of international production network. It is not appropriate to look at balance of trade of just one particular country. Imports from a particular country might be the intermediate goods for production of final goods that will be exported to various other countries. Therefore, the results of an FTA cannot be based on the bilateral balance of trade only.

Secondly, the reduction of trade barriers could contribute positively to the development of the industry. This is especially the case when the intermediate input becomes cheaper, that in turn will also support exports. It could also attract investments as the investors would have no difficulty in obtaining raw materials and intermediate inputs for the production.

Japanese investment during 2008-2013 in the manufacturing sector, such as motor vehicles and electronics, amounted to almost US\$ 32 billion, much higher than the previous period. The increase of investment definitely encouraged imports of capital goods from Japan, which in turn reduced the bilateral balance of trade with Japan in the short run. However, it did provide more benefits in the longer run.

Furthermore, bear in mind that there might be other factors other than

FTA that are contributing to the increase of imports. In the case of ACFTA, only 65% of the total imports of Indonesia from China in 2014 were eligible for preferential import duties. Also note that not all eligible products would in fact receive preferential customs duties, due to the provisions of rules of origin/ROO. Besides, many products have very small differences between their MFN duties and the preferential duties (margin of preferences, MOP)<sup>1</sup>.

## **TRADE AGREEMENT, IS IT NECESSARY?**

When Indonesia decides not to join a particular trade agreement, it does not mean that Indonesia does not suffer from losses. Despite the success of WTO to significantly bring down customs duties, the current level of import duties still affect the competitiveness of exports. Moreover, given the tight global competition, a 1% difference in import duty could influence import decisions. Besides, trade agreements could also attract more investment.

One example can be found in the structure of customs duties in European Union countries, in which MFN import duties are still pretty high. The average import duty for agricultural products in 2012 was above 10%. Some manufacturing products, such as textiles and footwear products, were imposed an average import duty of 8%. Furthermore, many EU countries also apply specific duties, that are calculated not from the price of the products, but on their unit number and weight. This has more adversely impacted low-price products, such as those from Indonesia.

Fortunately, the EU also imposes preferential custom duties that are much lower than MFN customs duties. It is known as GSP. In 2012, almost half of Indonesia's exports to the EU obtained GSP facility. The use of GSP has ensured greater market access to these countries.

However, given that Indonesian economy is edging closer to be graduating to upper middle economy (upper-middle income), in a not too distant future Indonesian products may no longer be eligible for this GSP facility. The competitiveness of Indonesian products in the European Union would certainly suffer, especially compared to other (competitor) countries that are still enjoying this facility. According to a study by CSIS, the loss of access to GSP facility could reduce Indonesia's exports to the EU by more than 12% (Damuri et. al 2014).

To anticipate these issues, the Indonesian government must make an effort to improve market access to its main export destinations. Rival/competitor countries, such as neighbors in Southeast Asia, are now actively engaging in trade agreements with their export destination countries to gain greater market accesses. If Indonesia does not develop greater market access from trade agreements, its export competitiveness will suffer greatly. A CSIS study about Indonesia-EU CEPA also shows that Indonesian exports would fall by 8% if the EU successfully engages in trade agreements with its trading partners in ASEAN, while Indonesia missing out.

Note, however, that trade agreements do not only have an impact on trade, but also to the ability to attract foreign investment. Trade agreements could attract foreign investment through two different mechanisms. First, through the provision of investment openness and protection, which is usually stipulated in

<sup>1</sup> There is a 19% tariff items that receive MoP amounted to 0-5%, while 57% only obtain remission by 5-10%. The small differences between MFN and preferential lead to a lack of incentives for exporters from China or Indonesia importers to take advantage on the FTA.

the chapter on investment-related commitments. This entails improvements in investment climate, which will ultimately provide incentive for foreign investment.

The second mechanism comes from a more open regime of trade. Contemporary business models may require that a production process of goods to be carried out in various locations in different countries. For example, the production of electronic goods, such as smartphones, may require components that are produced in a number of different countries. This is also the case in the production of other goods such as clothing and food products. The trade agreement will facilitate smooth cross-border movement of goods. This is one of the main considerations in foreign investment decisions. Countries with trade agreements, and thus provide guarantee of easier cross-border movement of goods, are ultimately more attractive to foreign investment.

## INDONESIAN STRATEGY IN FTA

Table 1 provides a list of trade agreements between Indonesia and the trading partner countries. As illustrated, most of Indonesian FTA executed within the ASEAN networks along with nine other member states, plus six ASEAN partner countries. Indonesia only has two trade agreements, with Japan in the form of a comprehensive partnership agreement and with Pakistan which is a limited agreement. But there are 12 bilateral FTAs that are currently in the process of negotiation and preparation.

**Table 1. List of trade agreements of Indonesia**

	Ongoing	Ongoing Negotiation	Negotiation Preparation	Proses Joint Study Group
ASEAN	ASEAN, ASEAN+1 FTAs (Korea, China, India, Japan (not ratified yet) Australia, New Zealand)	Regional Comprehensive Economic Cooperation (RCEP)		
Bilateral	Japan, Pakistan (PTA)	Korea, EFTA, Iran, Chile, Australia	European Union, India, Turki	Egypt, Peru, Tunisia, Nigeria
Regional			TPP (?)	
Non-binding Cooperation	APEC			

Source: Compilations of many sources

It shows that on the one hand, Indonesia tends to not be able to reach a consensus to conclude trade negotiations that have already been started. FTA negotiation with EFTA, for example, was started since 2010, and only recently has it been restarted. Negotiations with South Korea are still suspended due to some considerably less-significant issues. This lack of progress is also palpable in several other negotiations. Difficulties often arise because there is no common perception among various policymakers about the direction and purpose of the negotiation.

But on the other hand, Indonesia seems very keen to start negotiations

even with countries that are not its major trading partners. This indicates the lack of appropriate strategy with regard to the selection of trading partners as potential FTA partners. Negotiation decisions are often started as a political and international diplomacy move that are not based on sound economic considerations<sup>2</sup>.

Furthermore, the content of one trade agreement could differ greatly with those in other agreements (CSIS, 2013). It indicates lack of clear strategy on what should be offered in or demanded from a negotiation. Indonesia needs to have a basic strategy on the direction and objectives of trade negotiations that provides clearer guidelines in choosing partner countries and in describing the main purpose of the FTA.

However, the purpose of the strategy should not be limited only to issues of trade in goods and market access, such as the increase of exports. The purpose of the FTA should also be aligned to the more fundamental development strategy.

One of the targets that can be addressed through trade agreements is the increasing participation in international production's net and global value chains. Better participation will make a positive contribution to the development of domestic industry and improve economic competitiveness. This strategy will probably not directly impact the export growth, and might even lead to a worsen condition of the balance of trade in the short term. But it will certainly prove to be beneficial in the long run.

## **DISCUSSION AREA IN TRADE AGREEMENT**

If the FTA strategy is based on a greater purpose than just increases in exports, the discussion in the FTA should also include various aspects which are beyond the scope of traditional FTAs. This includes a lot of things that are often called as behind-the-border-issues or WTO-plus such as investment liberalization and protection, intellectual property rights, competition policy and labor standards.

Those issues might stir some controversies because FTA deals are often perceived to reduce the sovereignty of the government to formulate economic policies as they have to conform to the agreed set of rules or regulations. One example is on the area of investment protection agreement that includes the investor-state dispute settlement, in which the government is perceived to be at a disadvantage.

However, the protection of investments will increase confidence in the investment climate that ensures the assets of the various actions which can be taken by the government such as compulsory divestment, or the expropriation and nationalization. It would also make the government more cautious in formulating policies that could harm investors.

Historically, the number of ISDS cases is relatively small compared to international investment. During 2003-2013, 461 cases entered international arbitration, 57 of which happened in 2013. Most of these cases involve countries with high risk of regulatory framework (Abbott, et. Al 2014). Around 17% of these cases involved Venezuela and Argentina, both of which score pretty low in the regulatory framework index of World Economic Forum's Global Competitiveness Report.

Most of these cases (about 40%) were found in the mining, extractive,

---

<sup>2</sup> Some negotiations preparations were started to mark the visit of the head of state trading partner, or vice versa, heads of state RI's visit to partner countries. This often causes joint-study which has been conducted difficult to be upgraded to a substantive negotiation.

and electricity sector, which are more vulnerable to the government actions. However, only a small number of the cases (about 18%) were won by the investors. As much as 37% of cases in the period between 2003 to 2013 were won by the government, while the rest were settled outside arbitration. These various facts may give a clear perspective on the position of the ISDS and investment protection.

Various issues of WTO-plus should be considered as an attempt to discipline the economic policymaking and to improve certainty in the business sector and the economy. The agreement in the FTA will provide a driving force for the improvement of Indonesia's economic policymaking, which in turn will upgrade competitiveness and economic performance.

## **REFERENCES**

- Damuri, Yose R., Raymond Atje, Audrey Soedjito (2014). Study on the Impact of an Indonesia-EU CEPA. CSIS Publication, published online [https://www.csis.or.id/research/page/study\\_on\\_the\\_impact\\_of\\_an\\_eu-indonesia\\_cepa.html](https://www.csis.or.id/research/page/study_on_the_impact_of_an_eu-indonesia_cepa.html)*
- CSIS (2013). An Assessment of Economic Impacts of FTAs in Indonesia. CSIS Publication, published online [https://www.csis.or.id/research/page/an\\_assessment\\_of\\_economic\\_impacts\\_of\\_ftas\\_in\\_indonesia.html](https://www.csis.or.id/research/page/an_assessment_of_economic_impacts_of_ftas_in_indonesia.html)*