The Political Economy of Trade Policy in Indonesia

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ABSTRACT

This paper focuses on Indonesia's trade policies after the economic crisis. It examines the trend towards protection and addresses the issues of competitiveness. The concluding part briefly discusses Indonesia's policies on and involvement in free trade agreements (FTAs), which have recently proliferated in the Asia Pacific region.

Keywords: *Indonesia, political economy, trade policy, economic crisis, free trade agreement*

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Introduction

The performance of the Indonesian economy before the economic crisis was rather remarkable. Structural transformation had been taken place in agriculture, manufacturing and also the utilities and services sectors. The period from the mid 1960s to 1980s was a notable one in Indonesian economic history.

In the 1980s, the economy was faced with various problems. The weakened of oil prices in the early 1980s significantly reduced export earnings and budget revenues. The large decline in oil prices severely affected Indonesia's balance of payments. During the 1980-85 the economy grew by 3.7% p.a., which was much slower than the 7.5% during the period 1975-80. In response to this situation the Indonesian government undertook some adjustment programs to increase economic efficiency, altering its trade regime to become more outward looking, and accorded high priority to develop non-oil and gas (NOG) exports. No less than 24 packages of economic reforms were introduced from 1983 to 1995, aimed at increasing economic efficiency and encouraging investment as well as non-oil exports. Along with this change of orientation, the government changed its investment policy from one of control to one of promotion. In addition, various trade reforms were introduced to improve the trade and industrial policy regime. The Indonesian trade regime prior to the mid 1980s was relatively protected. However, from 1985 when trade reform was embarked upon, the levels of protection had declined and Indonesia entered an era of export orientation. These highlights accentuate the historical shift from import substitution to export orientation, particularly in the manufacturing sector. These various measures revived the economy, and during 1985-90 the annual rate growth of GDP was 6.3%.

In 1997 Indonesia was hit by the economic crisis. It forced the government to turn to the IMF and to adopt an economic recovery and reform program, including in trade. This paper focuses on Indonesia's trade policies after the economic crisis. It examines the trend towards protection and addresses the issues of competitiveness. The concluding part briefly discusses Indonesia's policies on and involvement in free trade agreements (FTAs), which have recently proliferated in the Asia Pacific region.

Indonesia's Pattern of Trade and Competitiveness

Pattern of trade

In 2001 the key markets for Indonesia's non oil exports were developing East Asia (accounting for 26%), Japan (15%) and NAFTA (16%), mainly the United States. It is worth noting that exports to East Asia increased significantly from 15% in 1990 to 26% in 2001. This was in large part due to an increase in exports to other ASEAN countries, whose share doubled to 16% of the total non oil exports. Brenton and Ikezuki (2003) shows that Indonesia's manufacturing exports to non-OECD countries in 1990 were 41% of those to OECD countries. This ratio has risen significantly to around 80% in 2001. This finding suggests that developing countries are becoming important markets for Indonesia. It is interesting to note that Indonesia has been quite successful in competing in developing countries. Its market share has been increasing throughout the last decade, thus making developing countries as important as OECD countries as destination of Indonesia's exports. This trend can be seen in Figure 1.[1]

This trend is in contrast to China's trade pattern, where developed countries are becoming more important as export destination. This could suggest that in the future Indonesia should consider targeting its exports to the developing economies. In this regard, it should be noted that in general developing countries have higher levels of tariff than

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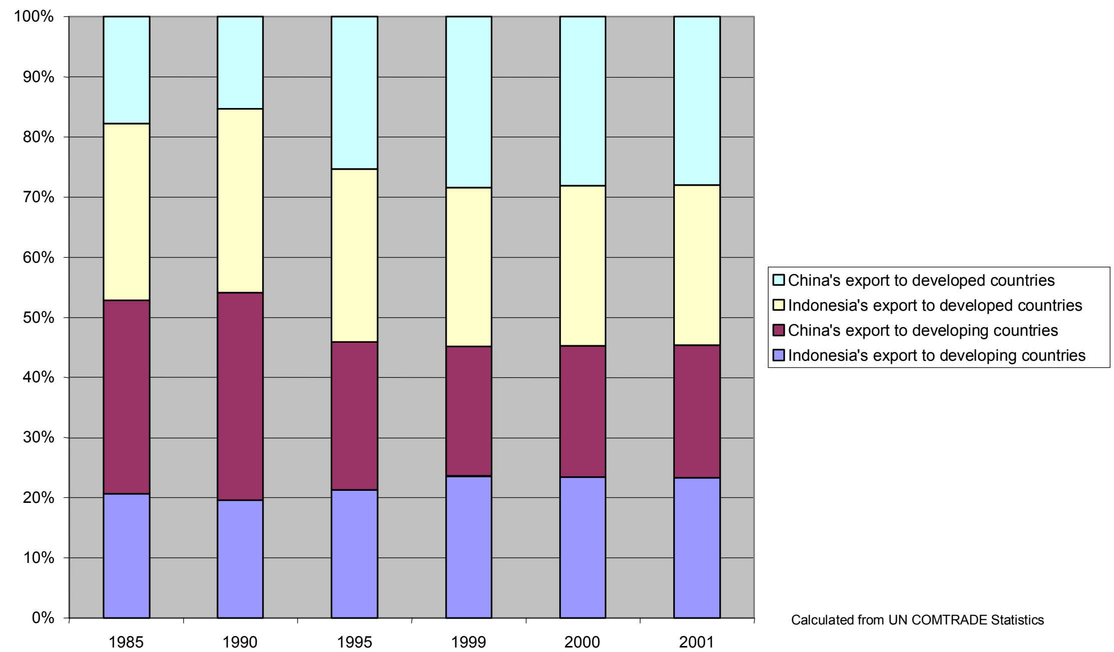
[1] Developing economies are defined as East Asia (excluding Japan), Latin America, Middle East and N. Africa, Other Europe and C. Asia, South Asia and Sub-Saharan Africa.

developed countries. Indonesia already has a much lower tariff than developing countries in general. This further suggests that it is in Indonesia's interest to see that tariffs in developing countries are being reduced.

Figure 1
The geographic destination of Indonesia and China exports



Export Performance and Competitiveness

Export growth remained sluggish since 2001. It is true that in 2001 and 2002 the slowdown of Indonesian exports could be attributed to weak global economic demand after September 11. However, the industrial production index has started to pick up in the 1st half of 2003: textile, leather and footwear products grew by 7.5%, whereas wood products grew by 6.9%. One of the possible explanations for this improvement was the shift of demand from some East Asian countries to Indonesia due to SARS. This was definitely the case for garments.[2] From January-July 2003 exports of textiles grew by more than 5%.

Nevertheless, serious problems persist and appear to be systemic. The slowdown of Indonesian exports can be attributed to supply problems, including the cost of doing business (high cost economy), weak industrial relations policy, minimum wage hikes and poor infrastructure conditions. These factors have become a major constraint to rapid growth of exports.

Table 2 shows that from 1985 to 2001 the growth of exports was driven by the increase of market share (competitiveness factor), but from 1995 to 2001 the source of growth was dominated by demand factors. In-depth observation shows that the majority of Indonesian exports experienced a decline in market share, except for palm oil, printing and writing paper and electronics. Table 3 shows the trends in Indonesian major manufacturing products' specialisation based on the Revealed Comparative Advantage (RCA).[3] From 1985 to 1995, all of these products experienced an increase in RCA (arrow from left to right). However, from 1995-2001 the RCA of some of these products, including plywood, textiles, footwear and garments, showed a declining trend (arrow from right to left). These figures reinforce the earlier suggestion that export growth was mainly driven by the supply side (competitiveness) rather than the demand side from 1985 to 1995, but this was no longer the case from 1995 to 2001. This suggests that the main obstacles to Indonesian export growth mainly stem from the supply side.

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[2] Based on an interview with Benny Soetrisno, the Chairman of the Indonesian Textile Association.

[3] RCA is calculated as: $(X_{ij}/X_j)/(X_{iw}/X_w)$. Where X_{ij} is export commodity i from country j, X_j is total export of country j, X_{iw} is export of commodity i in the world market and X_w is total world export.

Table 2: Decomposition of Indonesia's export changes

	Export Changes, 1995-2001 ($ mill)			Export Changes, 1985-2001 ($ mill)		
	Demand	Competitive	Diversi-	Demand	Competitive	Diversi-
Partner	Factor	Factor	fication	Factor	Factor	fication
China	43059	131306	271	53155	318560	200
Hong Kong, China	12601	-14747	-244	72668	-39096	-4700
Indonesia	7164	5460	461	19129	20828	333
Korea	21546	14179	1	74832	49337	363
Malaysia	18280	3601	342	43462	43146	796
Philippines	4649	17574	24	22844	12843	-71
Singapore	27809	-29677	-734	48574	15041	770
Taiwan, China	27963	-4814	117	112240	1096	-251
Thailand	8907	5811	414	14857	44655	232
Vietnam	520	7640	-18	403	13310	-74
All Above Countries	172498	136334	635	462164	479722	-2402
Japan	103104	-132464	-791	506926	-232044	-15647
European Union (15)	160661	-33740	-37	754854	-112113	-12225
NAFTA	116775	-97126	-5259	516344	-152427	-9313

Source: Calculated from UNCOMTRADE statistics

Table 3: Indonesia's Manufacturing Products' Revealed Comparative Advantage 1985-2001

SITC-4	Product (Revision 2)	1985	1995	2001
6342	Plywood consisting of sheets of woo	→	←	
6349	Wood,simply shaped,n.e.s.	→	←	
6597	Plaits and similar products of plaits	→	←	
6343	Improved wood and reconstituted woo	→	←	
6353	Builders' carpentry and joinery	→	←	
8421	Overcoats and other coats, men,s	→	→	
7511	Typewriters;cheque-writting machin	→	→	
6516	Yarn of discont.synth.fibres,contai	→	→	
8432	Suits & costumes,women's,of textile	→	→	
8510	Footwear	→	←	
6354	Manufactures of wood for domestic/d	→	→	
8443	Under garments,women,s,of textile f	→	←	
6423	Registers,exercise books,note books	→	→	
6531	Fabrics,woven of continuous synth.t	→	←	
8442	Under garments,excl.shirts,of texti	→	←	
8433	Dresses,women's,of textile fabrics	→	→	
7628	Other radio-broadcast receivers	→	←	
6521	Cotton fabrics,woven,unbleached,not	→	→	
5621	Mineral or chemical fertilizers,nit	→	←	
6581	Sacks and bags,of textile materials	→	→	

Calculated from UN COMTRADE statistics

To make things worse, this declining competitiveness was accompanied by creeping protectionism. Protectionism should not be the answer to the difficulties in making progress at the multilateral level (WTO), and does not provide a sustainable basis for growth. While there is no conclusive relationship between trade openness and growth in many countries, there is also no evidence that trade protection is systematically associated with high economic growth (Rodrik, 2002). This is particularly true for Indonesia. Protectionist policies will undermine the current open trade regime that has served Indonesia so well in the past (Aswicahyono, 1998; Basri 2001; Hill, 1996). The continuing signs of increasing protectionism imply that the Indonesian government has resorted to trade policy to overcome inefficiencies in the supply side. The government has not addressed the problem of lagging productivity through measures to increase efficiency. Instead, it tends to preserve the inefficient industries by increasing protectionism. The government has issued various *ad hoc* trade policies, including protectionist measures in a number of sectors. From 2001, protectionism has been on the rise, as evident in the increase in tariffs on wheat flour and trade regulations and licensing (*tata niaga*) on textiles, steel, sugar and clove. It is worth noting that the most common instrument of protection is non-tariff barriers, which fall directly under the authority of the Ministry of Trade and Industry (Ray, 2003). In contrast, the Ministry of Finance, which is responsible for tariffs, is less inclined to protectionism. Despite continuing signs of increased protectionism, the level of protection in Indonesia is still low compared to other Asian countries. including Thailand (Basri and Hill, 2004).

As for textiles and garments, the uncertainty of future prospects, particularly the post-Multi-Fiber Agreement (MFA), looms largely. While the integration of MFA into WTO and quota elimination provide new opportunities to the textile industry, the ability to capture these opportunities will depend heavily on the Indonesian textile industry's competitiveness. Entering the post-MFA era in 2005, competition will become more intense, and the development of high skilled expertise and know-how will be the key success factor for the industry. Unfortunately, some of Indonesia's manufacturing products, including textiles, are faced with various problems, particularly coming from the internal or supply side, including erosion of competitiveness in upstream industry and low labour productivity compared to other emerging Asian countries. In addition, the industry also suffers from the lack of new investments. In 1988-1992, for example, investment growth reached 14.41%, while in 1995-2001 it declined to 2.3% per annum.

With such low growth, the machinery and other equipment have rapidly become obsolete and thus contribute to the high production costs. On the external front, the emergence of strong textile and garment competitors in China and Vietnam and other low cost ASEAN countries have placed Indonesia in a difficult situation. As pointed out by Tanudjaja (2002), textiles and textile product exports from Indonesia to the US have continuously decreased since 1999. Compared to China, Korea and Taiwan, Indonesia's share in the US market is very small. A similar trend occurred in the European Union: in 1994 Indonesia ranked first with a 22.6 % share, but in 2001 Indonesia ranked number three after China and Thailand, with a share of 10.5 %.

Trade Reform during the Economic Crisis

In November 1997, the International Monetary Fund (IMF) entered the picture following various unsuccessful attempts by the Indonesian government to stabilize the rupiah. Unlike in Thailand and other pervious IMF packages, the Indonesian agreement includes trade reform which normally was beyond the mandate of the IMF (Soesastro and Basri, 1998). As pointed out by Soesastro and Basri (1998), in the structural adjustment program was to include a gradual reduction of import tariffs, including those on chemical products, iron and steel and fisheries products, to 5-10%. In addition, various commodities including wheat and wheat flour, soybean and garlic could be imported freely under a General Importer license. As for wheat flour the government imposed a 10% import tariff and would be reduced 5% in the year 2003. In fact, before 2003 the government has already reduced the tariff to 0% but reversed it back to 5% in 2002. In the structural reform program of 15 January 1998, domestic trade in agricultural products was fully deregulated. The clove marketing board was also being eliminated. In February 1998 all other marketing arrangements were abolished specifically for cement and paper, and the plywood cartels were dissolved. In the investment sector, formal and informal barriers to investment in palm oil plantation were removed in February 1998, and this was followed by removing all restrictions on investment in wholesale and retail trade. As for cement, internal and external trade restrictions were eliminated, allowing traders to buy and distribute all cement brands in all provinces and to export under the General

Exporter License. In addition, the government also discontinued special tax, customs and credit privileges to the National Car (Timor) project. Moreover, import restrictions on all new used ships were abolished. The significance of the IMF program lies perhaps in the boldness of the measures (Soesastro and Basri, 1998). The World Bank's proposals for further trade deregulation had been captured in these IMF packages. In fact, trade reform had stalled since the early 1990s. Thus the IMF trade reform program was obviously significant and has removed most of the non-tariff barriers.

Indonesia has become a relative open economy and deserves much credit for its unilateral liberalization. Figure 2 shows that average tariff has declined and in line with long-standing sectoral support, the highest tariffs apply mainly to alcoholic beverages and completely built-up motor vehicles. Figure 3 shows the average tariffs for some countries including Indonesia, illustrating the significant reduction from 1985 to 1999.[4] In fact, in 1999 the average tariff in Indonesia was lower than that in Thailand and China. [5] The overall average applied MFN tariff is currently 7.2 percent (2002), down from 9.5 percent in 1998. For industrial products, the average tariff is 7 percent, and for agricultural products it is 8.4 percent

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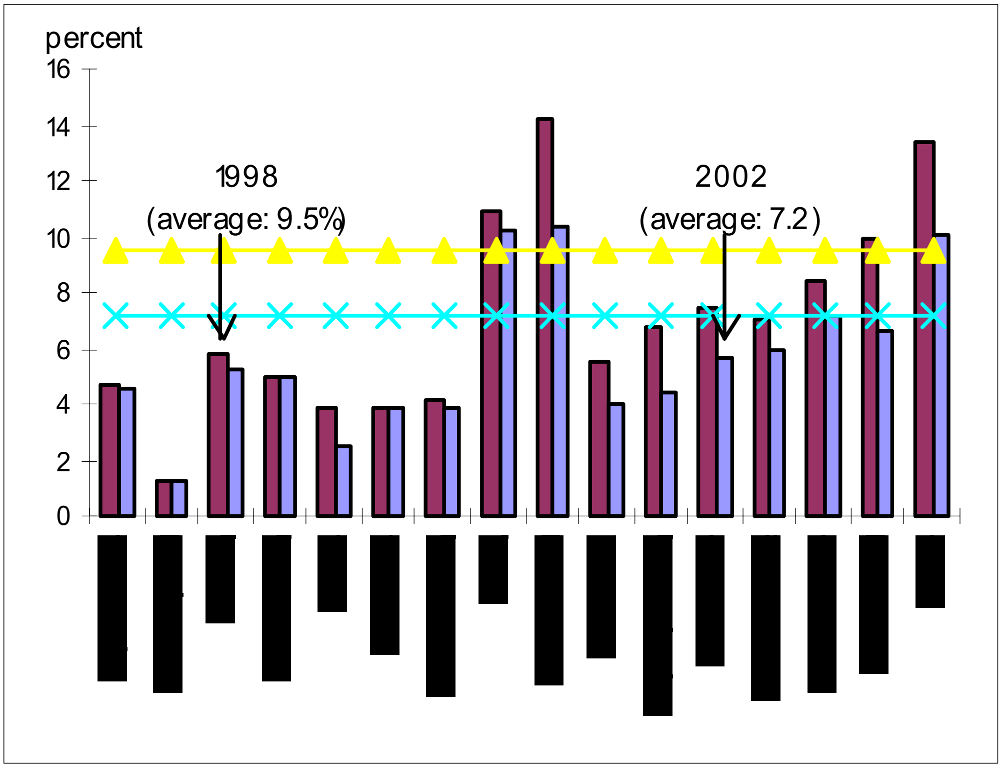
[4] This data is kindly provided by Shahid Yusuf of the World Bank

[5] However, China's tariff and NTB have come down further since WTO accession. Thus, after WTO accession China's level of protections are not high in comparison.

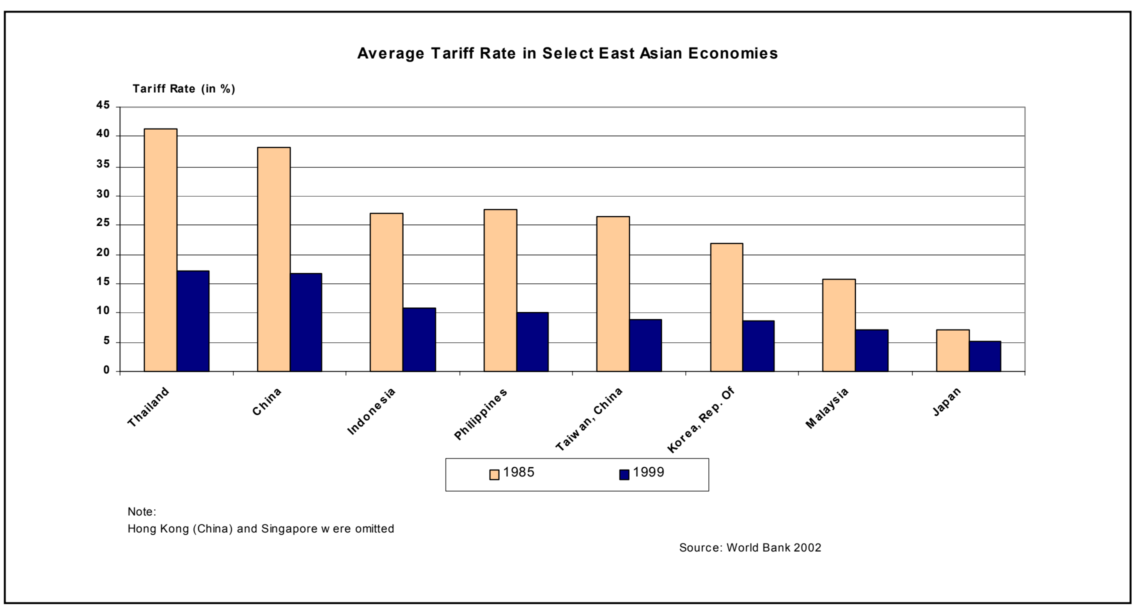
Figure 2: Tariffs have declined…

(tariff averages by 2-digit ISIC, 1998 and 2002)



Source: World Bank, 2004

Figure 3



The structure of trade protection post crisis

As shown below, the effective/nominal rate of protection (ERP/NRP) in the manufacturing sector was much higher than in the agriculture sector in 2000. Nominally, the average rate of protection in the manufacturing sector was 11.45%, while the average effective rate of protection could reach 25.72%. The rate of protection in this sector was also higher than the rate of protection in all IO sectors in 2000. Both nominal and effective rates of protection have standard deviations about double their average, 20.67% for NRP and 51.21% for ERP.

The average rates of protection (nominal and effective) in the agricultural sector were much lower than in the manufacturing sector. This shows that protection given to agricultural sector production is lower than in the manufacturing sector. The difference between the nominal and effective rate of protection in the agricultural sector in 2000 was not too significant: 5.03% for NRP and 5.81% for ERP (Table 4). They have standard deviations of about 4.54% and 5.27%, respectively.

Table 4
Average effective rate of protection (ERP) and nominal rate of protection (NRP) in the Indonesian Agriculture and Manufacturing Sectors, 2000

IO 2000	ERP		NRP	
	AVERAGE *	STANDARD DEVIATION	AVERAGE*	STANDARD DEVIATION
AGRICULTURE (SECTOR 1-34)	5.8	5.2	5.0	4.5
MANUFACTURE (SECTOR 49-141)	25.7	51.2	11.4	20.6
TOTAL	20.6	57.3	10.5	41.4

Note:
* Weight average based on sectors

Although the calculation of ERP shows that the manufacturing sector has a relatively higher protection rate than the agriculture sector, it is too early to state that those who gain most from protection are capital owners. This is because most non-tariff barriers in the manufacturing sector have been converted into tariff barriers since 1995. In the agriculture sector, non-tariff barriers still prevail, and these are not included in the calculation of the rate of protection in this study. For instance, trade liberalization as committed to in WTO or AFTA, gives priority to strengthening domestic sectors. Thus, local producers in the agriculture sector are still given protection in terms of non-tariff barriers like subsidies, import quotas, and other production improvements for certain commodities, like sugar and rice.

Creeping Protectionism

There is clear evidence that in the past crony capitalists and interest groups have been the major obstacles to trade liberalisation in Indonesia (Basri, 2001). In view of the importance of exports and their contribution to the Indonesian economy, and the huge depreciation of the real exchange rate after the economic crisis of 1997-98, it is less likely that Indonesia will return to high trade protection in the future. In addition, owing to the IMF agreement, following the economic crisis in 1997, much of the trade protection has been phased out. Furthermore, trade reforms of the last decade have successfully created many proponents, including exporters, academics, media and government officers, of an open trade regime for Indonesia.

Nevertheless, it would be imprudent to conclude that pressures for trade protection will subside. While it is true that the economic crisis has forced Indonesia to further liberalize its economy, it should also be remembered that liberalization has been blamed by some as the main cause of the crisis. In addition, resistance to market reform from protectionist groups cannot be underestimated. These groups are still prevalent and hold some key positions both in the government and in the business sector. They can create obstacles to further trade liberalization. Although the downfall of Soeharto in May 1998 has brought about a major change of the political setting towards a more democratic system, this does not mean patrimonialism or rent seeking activities have been eliminated. Patron-client relationships are still strong, and the increasing role of extra State actors has enabled various interest groups to organise lobbies for trade protection as shown in the case of wheat flour. The rhetoric of agricultural protectionism for example is to protect poor rural farmers, but in reality it protects politically powerful rent-seeking groups. Basri, Maddaremeng and Nuridzki (2004) shows that there is a statistical evidence that trade protection was mostly given to the sector with high capital intensive. This study also finds that there is no statistical evidence that trade protection has been given to protect the sector which has low wages and salaries. In other words there is no evidence that protection protect the poor. Contrary to the argument that protection help the poor or labour, this study shows that the capitalists are the one who are the benefited by trade protection in Indonesia.

The tug of war between pro and anti trade reform groups can be expected to continue and to involve extremely complex bargaining and coalition between rent-seekers, interest groups and the various government agencies. This is evident since 2001 as new protectionism began to creep in. Table 5 lists some trade policies that show this trend. In the case of lubricant oils, imports can be undertaken only by producer importers and not by general importers. The government also imposed anti dumping customs duty for imports of liquid sorbitol from Europe. This also applies to Black Carbon. Anti dumping has become an instrument of new protectionism. This creeping protectionism continued in 2002 as evident by increasing tariffs in catode and wheat flour and the introduction of trade regulations and licensing (*tata niaga*) on textile, steel, sugar and clove (Table 5).

Table 5: Lists of Regulations in year 2002 and 2003

Regulation	Principal Decision Makers	Status
Lists of Regulations in year 2003		
Increase in import tariff of Catode	Ministry of Finance	Increased by 5%
Increase in import tariff of Wheat Flour	Ministry of Finance	Increased by 5%

Suspension of Export of Sea Sand	Ministry of Trade and Industry	Preventing further environmental damage in the form of sinking of isle, particularly those around the outmost territory of Indonesia borders in Riau islands as result of sea sand mining and unsettled dispute over sea territory borders between Indonesia and Singapore
Lists of Regulations in year 2002		
Import Regulation (Tata Niaga Impor) on CFC Product	Ministry of Trade and Industry	Importir of CFC: PT. Dharma Niaga, PT. Pantja Niaga, and PT. Cipta Niaga. Importir of Metil Bromida: PT. Dharma Niaga, PT. Asomindo Raya, NV. Panca Ratna
Prohibition from Producing and Trading Ozone Depleting Substances and from Producing and Trading New Materials Using Ozone Depleting Substances	Ministry of Trade and Industry	
Pure Preliminary Quota to USA, European Economic Society, Canada, and Turkey in 2003	Directorate General of Foreign Trade, Ministry of Trade and Industry	
Import Regulation on Iron or rolled Steel	Ministry of Trade and Industry	Only Importer Producer
Import Regulation on Textile	Ministry of Trade and Industry	Only Importer Producer

Increase in import tariff of certain steels	Ministry of Finance	change to 20 or 25% from 5 or 10 or 15%
Import Regulation on Sugar	Ministry of Trade and Industry	Only Importer Producer
Cancel on Import Regulation on New and used cloth	Ministry of Trade and Industry	
Regulation on Clove Import	Ministry of Trade and Industry	Need approval from Ministry of Trade and Industry
Increase in import tariff of Sugar	Ministry of Finance	Sugar Cane Rp 550/kg; Bit Sugar Rp 700/kg; content of additional flavour Rp 700/kg; retail packaging Rp 700/kg; Sugar for industry Rp 700/kg; Etc. Rp 700/kg
Import Regulation on Raw Sugar	Ministry of Trade and Industry	Only Importer Producer
Custom Administration to Import Goods from Australia Nothern Terithory to Indonesia Custom Office except Jawa and Sumatera	Ministry of Finance	given an ease

Source: Ministry of Trade and Industry

Indonesia in the WTO and Doha Round: the importance of market access

On the market-access issue Indonesia emphasizes that multilateral negotiations should take fully into account the special needs and interests of developing and least-developed country participants.

Agriculture

Indonesia emphasizes the importance of food security and rural development. The Indonesian government is of the view that imposing trade protection in relation to those two issues is justifiable. In addition, Indonesia supports the elimination of agriculture subsidies in developed countries as well as tariff reduction in both developed and developing countries. There is a view that bound tariffs (40%) and average applied tariffs (8.4%) for Indonesian agricultural products are relatively low compared to other developing countries. Thus Indonesia has maintained its current tariff. Agriculture is the ndonesia's main defensive issue, especially on SP. Indonesia also chaired G33 on SP's at Cancun. On the special product (SP) issue, Indonesia agrees with the SP concept in the Derbez text and supports the idea to exclude SP from tariff reduction.

Non-agriculture: [6]

Market access issues still is an important issue in the multilateral trade negotiation and also for Indonesia. The Uruguay Round has produced some agreement in market access for manufacturing products (Bacchetta and Bora 2001), including the agreement to increase manufacturing products import both in developed and developing countries, whose tariff rates are bound. For developed countries the manufacturing tariff lines subject to bound tariffs increased from 78% to almost 100%, while for developing countries the coverage increased from 21% to 73%. In addition, the average tariff on developed countries' imports of manufacturing products was cut by 40% of imports from all sources and 37% on imports from developing countries, whereas, for developing countries, the reduction averaged 25% on manufacturing products from developed countries and 21% on manufacturing products imported from developing countries. Moreover, as for non tariff barriers, the Uruguay Round agreement prohibits the use of Voluntary Exports restraints (VERs) and will phase out Multifibre Arrangement by 2005. Despite this progress, developed countries' tariffs continue to show high dispersions in rates and significant peaks on products such as textile, clothing and leather products. In

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[6] This part is heavily drawn from World Bank (2004) " Making Indonesia Competitive: Promoting Exports, Managing Trade"

addition, developing countries are often either not bound or bound at relatively high levels.

As for Indonesia, around 93% tariff lines are subject to bound tariffs and the simple average bound rate is 39%. In fact, simple average for bound tariffs remains high for developing countries relative to developed countries. In manufacturing (non agricultural products), the market access to OECD countries is marked by low average tariffs both in the US and EU, but with relative high dispersion in tariffs. It is worth noting that the non agriculture products Indonesian exports to both the US and the EU are currently concentrated in above average duty products, making the weighted average of tariffs applied to Indonesia higher than the simple average in these markets. Average tariffs in developing countries are considerably higher, and average bound tariffs are still higher. It is important to note that 73% of Indonesian exports to Japan enter duty free, but only one-third of Indonesian exports to the EU and the US face zero MFN. In addition, almost all exports to developing countries are dutiable. More than 50% of the top 15 products exported to the EU are subject to zero MFN duties. These products account for around 20% of the total non agricultural products exports to the EU. However, it is worth noting that the main dutiable products of interest to Indonesia, including footwear and wood products, are excluded from the EU preferences (under GSP)

As for the US, seven of the main products exported to the US that are subject to zero duties account for around 20% of the total non-agricultural products exports to the US. Moreover, none of the main dutiable products exported by Indonesia to the US, such as wood products, clothing and footwear, are eligible for preferences and therefore pay the full MFN duties. These duties vary and can be very high, being over 16% for footwear and as much as 27.5% for certain clothing products. This suggests that the losses from the erosion of preferences will be very small relative to the gains from MFN tariff reductions on current exports since major Indonesia’s exports to the US and EU are excluded from preferences.

In the case of Japan, nine of the main NOG (non-oil and gas) products are subject to zero MFN. In fact, in Japan the main products that Indonesia currently exports have low tariffs, with most duties being less than 5%. It is interesting to note that clothing is not a main export product to Japan.

The un-weighted average tariffs are much higher in developing countries. Given that developing countries are now almost as important as developed countries for Indonesian manufacturing exports, the issue of the base tariffs from which tariff cuts by developing countries are made is of relevance to Indonesia both as an exporter and an importer. Since the average tariff in Indonesia is already relatively low, the further reduction of tariffs by using the Chairman's formula will reduce the tariffs by a smaller percentage compared to in other developing countries. Thus if Indonesia would like to gain market access in developing countries, Indonesia has to choose a formula which results in significant reduction of tariffs in other developing countries. For Indonesia, as for other developing countries, the key issue is whether tariff cuts should be made to bound or to applied rates. If the tariff cut is made to bound rates, it will give little impact on trade liberalization because the bound rates are substantially above the average of currently applied rates. However, if the tariff cut is made to applied tariff Indonesia will gain more.

In fact, the Indonesian government accepts tariff reduction so long as it is does not harm domestic industries. This argument is ambiguous and potentially reinforces protectionist tendencies. In addition, there is a strong view from the Ministry of Trade and Industry for the need to adopt a "picking winners" strategy. This view gives rise to creeping protectionism and rent seeking activities.

Services

There have been strong pressures on Indonesia to open up its services sector. Indonesia has not participated actively in the GATS of the WTO as well as within the AFAS (ASEAN Framework Agreement on Services). The challenge to Indonesia is to be able to come up with offers and requests concerning services liberalization. In order to be able to do this, Indonesia must first develop a clear vision of its services sectors.

Rules

Anti Dumping

Indonesia has established an anti-dumping committee. In line with other developing countries Indonesia urges the importance of discipline in the use of anti dumping as contingency protection. Nevertheless, it is worth noting that anti dumping measures are relatively new to Indonesia. It has applied anti dumping in the case of wheat flour. After an 18-month long investigation, the Indonesian Committee on Anti-Dumping (KADI) found that flour was being sold in Indonesia at lower prices than in the exporting country. KADI proposed that the government applied import duties, ranging from 5.96 per cent to 35.93 per cent on the offending companies.[7] Instead, the Minister of Finance rejected this proposal and imposed a 5% tariff on all wheat flour imports.

Safeguards

As reported in WTO (2004), due to pressures from local manufacturers, in 2002 Indonesia introduced a regulatory framework for safeguards measures, which take the form of higher import duties applied initially for a period of six months and can be extended to up to four years depending on the findings of investigation. The implementation was postponed in 2003 because the institutional framework had not yet been set. Indonesia is in favour of contingency measures, including safeguards, and supports the inclusion of safeguards issue in the negotiations on trade in services. However, implementing safeguards in services is a very complicated matter.

Subsidies

Indonesia also supports the agreement on subsidies and countervailing measures by including the members that are listed therein until their GNP per capita reach $1000 (in constant dollar 1990). In fact, for three consecutive years (1998-2001) Indonesia's GNP

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[7] *Australian Financial Review*, ' Dumping Allegations Dog Indonesia's Flour Market', 18 October 2001.

per capita had fallen to below $1000 due to the crisis, nevertheless, fiscal constraints made it difficulties for the Indonesian government to apply such measures.

TRIPS

On the TRIPs (Trade Related Intellectual Property) issue Indonesia and other developing countries wants to see that the negotiations on TRIPS and Public Health be completed soon. This is in line with their stand that TRIPS and Public Health will help developing countries provide affordable medicines for the people. In amending the TRIPS agreement Indonesia is sympathetic to the view of giving a fair chance to all members to review and convey their problems and objections against the existing temporary solution.

New Issues

In line with the progress in Cancun, Indonesia is of the view that competition policy, government procurement and investment should not be included in the WTO agenda and that trade facilitation should be discussed further. On trade facilitation Indonesia believes that its improvement will help increase trade flows. Indonesia also believes that this issue can best be implemented unilaterally and autonomously by way of commitment at the regional level, along with technical assistance provided through bilateral assistance and multilateral institutions.

Policy Implications and The Way Ahead

Basri and Hill (2004) argued that trade liberalization in the mid 1980s has been successful due to the adequate real exchange rate depreciation and thanks to the adverse terms of trade shocks in the collapse in the oil price. Both factors increased exports and indirectly protect domestic goods from imports, leading to less pressure for import protection. This situation has changed. The rupiah real exchange rate has appreciated by about 60% compared the 1998. In addition the government has raised the minimum wage in 1999. Corruption is pervasive and the high cost economy has reemerged. As discussed earlier, all of this has led to an erosion of Indonesia's manufacturing sector competitiveness. This will in turn increase the demand for protection. On the other hand, Indonesia's commitment to the WTO as well as to AFTA and the creation of an ASEAN Economic Community (AEC) could counterbalance those protectionist pressures. In this regard it is often asked whether Indonesia should actively engage in forming FTAs (free trade agreements) in order to maintain the momentum for trade and economic reform. This is indeed one powerful reason for countries to form FTAs or PTAs (preferential trading arrangements).

The World Trade Report of 2003 indicated that there has been a sharp increase in regional trading arrangement (RTAs) and PTAs over the past decade. It is concerned that the proliferation of PTAs will negatively affect the progress in the multilateral trade agenda. Many PTAs (preferential trading arrangements) involving East Asian economies are likely going to be negotiated in the years to come. The worry is that these activities may divert attention and energies away from the effort to strengthen existing regional arrangements (AFTA, AEC, APEC or even an East Asian Free Trade Area) and to strengthen the multilateral trading system. Moreover, the many bilateral and sub-regional FTAs being formed in the region may all be so different in scope and depth so as to make their future amalgamation a nightmare.

Indonesia is a newcomer in forming bilateral FTAs. Its agenda has been largely driven by the offers made by other countries to form FTAs with Indonesia. Unlike Singapore or Thailand, Indonesia does not pro-actively select countries as its potential FTA partner. During the Megawati government, Indonesia did not have an overall strategy guiding the formation of bilateral FTAs as a trade policy option.

The new government of Indonesia under President Yudhoyono seems to be moving ahead on forming bilateral free trade agreements (FTA). The push for the new government to engage in bilateral FTAs with Indonesia's major trading partners was given by the Indonesian Chamber of Commerce and Industry (KADIN). This was contained in their 12-point recommendations to the new government. The new Coordinating Minister for

Economic Affairs was the outgoing chairman of KADIN, and thus it was logical that the new government would adopt it as its policy.

The new Minister of Trade supports this policy because in her view Indonesia cannot afford not to do so as Indonesia's neighbors are already actively forming bilateral FTAs. However, the Minister of Trade clearly stated that Indonesia must not do so simply for the sake of following others. In fact, Indonesia should aim at producing high-quality (clean) FTAs, and should adopt some of the "best practices" that are being compiled and formulated by APEC.

Indonesia has a list of countries with which it will consider forming bilateral FTAs. Some originates from initiatives at the highest level, such as with Japan and the US. Others result from exchanges at the Ministerial level, such as with Pakistan and Iran. It can be expected that these two sets of agreements, if they are realized, will be of a different nature all together. The latter will be confined to reducing tariffs on goods. It will be a shallow free trade agreement. The former will be much broader in scope and deeper in its measures. It is immediately clear that a free trade agreement between Indonesia and a develop economy must have substantial coverage and cannot be a shallow one. In addition, Indonesia's economic and trade relations with such countries as Pakistan and Iran are very insignificant. It does appear that the government also does not put much of its attention and efforts towards the latter agreements.

In regard to agreement with Indonesia's major economic partner, Japan is first on the list. There are still obstacles to begin a process with the US because certain pre-conditions have been demanded by the US side. It seems that the US wants to see a resolution on some trade disputes (chicken legs, optical disks) before the negotiation can begin so that they cannot be used by Indonesia in making concessions.

The proposal to establish an Economic Partnership Agreement (EPA) between Indonesia and Japan was first aired in the Joint Announcement between President Megawati and

Prime Minister Koizumi on 24 June 2003 in Tokyo. A first preparatory meeting was held on 8-9 September 2003, followed by a second meeting on 19 December 2003.

At the first meeting both sides expressed interests in the broader concept of EPA rather than FTA. There was also an exchange of the economic conditions in both countries and on Indonesia's trade policy. They agreed to hold regular meetings until the time when a formal negotiation would take place. The Japan-Singapore EPA (JSEPA) was used a reference. There was also an exchange about the sensitive areas of each side.

The agenda of the second meeting involved the three components of an EPA: liberalization, facilitation, and cooperation. The scope of the discussion was extended to include such issues as customs procedure, MRAs, IPR, competition policy, business environment, SMEs, and human resources development.

In the meantime, Japan and ASEAN signed a Framework Agreement for Comprehensive Economic Partnership (CEP) on 8 October 2003 in Bali. It was suggested that this CEP provided another reference for the bilateral EPA. Indonesia raised the possibility of an Early Harvest program in the bilateral EPA, inspired by what developed in the ASEAN-China discussions. Instead, Japan preferred a single undertaking.

These two preparatory meetings were followed up by a Joint Study Group Meeting held on 31 January-1 February 2005 in Jakarta. The two sides presented analyses on the macro/micro economic impact of a Japan-Indonesia EPA. This was followed by exchanges of views on a number of areas of common interests. These include: (a) trade in goods; (b) services; (c) investment; (d) movement of natural persons; (e) improvement of business environment; (f) competition policy; (g) IPR; and (h) government procurement. Discussions in greater detail were held in working groups.

Some progress is evident in terms of coverage and attention. The Indonesian side in the meeting consisted of about 60 persons from various government departments, the Chamber of Commerce and Industry, and research institutes. This suggests the greater interest, but also the seriousness on the part of the government and its intention to involve wider stakeholders in the process.

What emanates from the meeting was the need on both sides to be able to clearly articulate how each sees the benefits (and costs) of the EPA. It became clear that investment and industrial restructuring were the main attractiveness. The benefits from tariff reductions for Japan were less than from an agreement with Thailand, for example, because Indonesia's tariffs have already become much lower than those in Thailand. Japan's FDI to Indonesia is likely to increase if the EPA enhances the business climate, and Indonesia will in turn benefit from industrial restructuring that results from reforms undertaken within the framework of the agreement (and beyond).

In addition, intensified exchanges on the above areas of common interest in fact amount to a "soft negotiation" already. While the exchanges are seen as non-binding, the help improve common understanding and narrow down disagreements. When the formal negotiations begin, both sides will already have a better feel for each other. This could result in a rather speedy negotiation.

The process that begins with preparatory meetings and Joint Study Group meetings is one that is useful and necessary for the Indonesian side. In particular, this is so because this process with Japan is the first for Indonesia. The major challenge for the Indonesian side is to coordinate amongst the different ministries and agencies, and to develop a common language, understanding and strategy. It may well be that before the end of the year an agreement could be reached to start with the official negotiations, and that by the end of 2006 both sides will be able to produce a draft EPA.

A main challenge for Indonesian negotiators is that they will begin this exercise by negotiating with the most important, but also the most difficult, countries -- Japan and the United States. If they can do this right the pay-offs will be substantial. But the risks are also very great. Indonesia can draw on some the agreements that have been concluded by Singapore and Thailand (with Japan, the US and Australia). It should be noted, however, that the Singapore-Japan agreement largely left out agriculture, which will be an important component in an agreement between Indonesia and Japan. The Singapore-US agreement largely deals with sectors and areas beyond goods trade that Indonesia may be least prepared to address.

Thus the learning process will be the most important aspect of the negotiations. In fact some kind of facilitation or technical assistance by Japan or the US should be built into the negotiating process itself.

As a member of ASEAN, Indonesia is also a party in the ASEAN-China FTA. Indonesia did not play an active role during the ASEAN-China negotiations. It also is not a leading party in ASEAN's negotiations with Japan, India, Korea, and the CER (Closer Economic Relations between Australia and New Zealand).

In the domestic arena, immediate efforts need to be made to come up with a clear understanding as to which sectors are likely to gain most from the FTAs and which sectors will be adversely affected by the FTAs. The former is necessary so that Indonesia can focus its efforts on those areas. The latter is important so that ways could be devised to lessen the likely negative impact. Domestic adjustments and reforms will have to be undertaken. As suggested before, bilateral or regional FTAs can help promote domestic reforms. Indeed, an agreement with the US is likely going to have the greatest effect on Indonesia's economic reform agenda. Demands for reforms made by the US side will be substantial. However, this should be done with great care as widespread impressions of bullying by the US will be counterproductive.

It does appear unavoidable that each bilateral agreement will be tailor-made. This is exactly why it may be difficult to amalgamate the many bilateral FTAs into a region-wide agreement at a later stage. Having this in mind, the PECC Trade Forum has proposed some kind of an "APEC Common Understanding on Regional Trading Arrangements" that lays out a set of guidelines for ensuring that FTAs in the APEC region do contribute to the achievements of APEC's objectives. APEC has recently issued a similar understanding on “best practices” in forming FTAs. East Asian countries, including Indonesia, should seriously take these guidelines into consideration when establishing bilateral or sub-regional FTAs. This has been the key message of Indonesia’s new Trade Minister. FTAs have become an element of Indonesia’s international economic diplomacy. Indonesia will negotiate FTAs only with a few major trading partners, and the policy is to aim at producing high quality agreements. This is a big challenge and can be overcome through systematic efforts to build capacity and to clearly formulate the strategy to actively engage in bilateral, regional, and multilateral trade agreements.

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