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POLICY BRIEF

INDONESIA AND THE ESTABLISHMENT OF THE ASEAN ECONOMIC COMMUNITY IN 2015: ARE WE THERE YET?[1]

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KEY POINTS

- Indonesia has recorded positive economic growth for almost a decade. Gross domestic product (GDP) in purchasing power parity (PPP) terms surpassed US$1 trillion in 2011.
- Indonesia has yet to complete preparations for its commitments to the ASEAN Economic Community (AEC), which is to be established in 2015.
- Indonesia needs to fine-tune its trade and investment policies to ensure regional coherence.
- The existing domestic challenges that will affect how Indonesia fares in the AEC include low levels of capital endowment and value-added investment, counter-productive investment-related measures, and frequently being a target of the unfair trade practices of other states.
- Policies to improve the domestic business climate will better prepare Indonesia for the AEC.

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1. Introduction

Between 2005 and 2011, Indonesia maintained an average annual growth rate of more than 5.0%. By the end of 2011, its gross domestic product (GDP) in purchasing power parity (PPP) terms reached US$1,124 billion. As the largest economy in the regional grouping of the Association of Southeast Asian Nations (ASEAN), Indonesia can provide key support for regional integration via its participation in the ASEAN Economic Community (AEC).

A particular outcome of the proposed AEC that can benefit Indonesia is the formation of a single market and production base. Being the country with the largest population in the region, Indonesia's consumers are likely to be a target market for many regional exporters. Yet, according to the ASEAN Scorecard, regional progress on the implementation of measures to form a single market and production base from 2008-2011 has been slow and stood at only 65.9%, meanwhile the target for the AEC's establishment date is 31 December 2015.

[1] This policy brief is part of a series that highlights the competitiveness challenges that Asian countries face in the current economic environment where volatility has increased and trade is increasingly organized into regional value chains. It comes out of issues raised during the Asian International Economists Network (AIEN) Call for Papers Workshop, Trade Competitiveness in a World of Rapid Changes: Challenges and Opportunities for Asia, held at the Asian Development Bank (ADB), Manila on 22 March 2013.

This brief uses the context of the AEC to explore the current economic challenges Indonesia faces in capturing the benefits of integration. The brief also recommends strategies to overcome these challenges and help Indonesia better prepare for its commitment to the single market under the AEC.

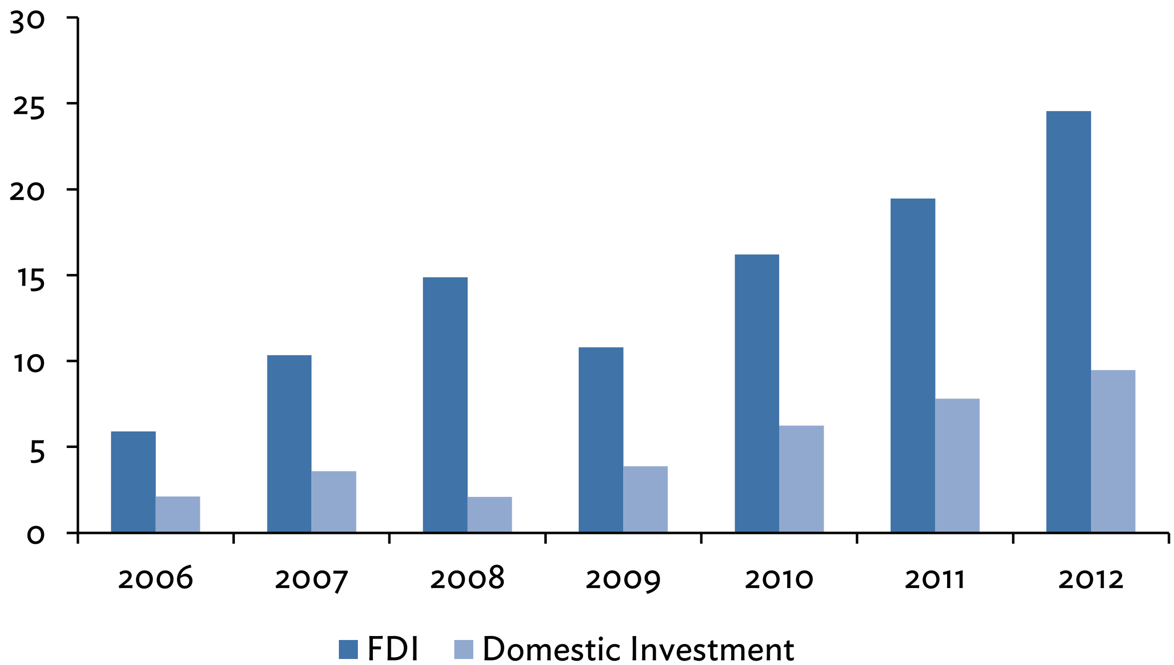
Table 1: Top 20 Commodity Imports and Exports of ASEAN Member States

Exports	Value ($ million)
Electronic integrated circuits and microassemblies	97,644
Petroleum oils, not crude	61,945
Automatic data processing machines; optical reader, etc.	40,779
Petroleum gases	34,107
Crude petroleum oils	28,699
Parts and accessories of computers and office machines	26,646
Palm oil and its fractions	26,057
Natural rubber, in primary form or plates	20,512
Coral, briquettes, ovoids and similar solid fuels manufactured from coal	19,852
Diodes, transistors, and similar semiconductor devices, etc.	17,109
Printing machinery, machines used ancillary to printing	12,926
Gold, unwrought or in semi-manufactured forms	11,468
Parts and accessories of motor vehicles	10,140
Electric appliance for line telephony (incl. current line system)	9,854
Television receivers (incl. video monitors and projectors)	8,613
Motor cars and vehicles for transporting persons (except public transport motor vehicles)	8,606
Copper ores and concentrates	
Rice	7,568
Prepared, unrecorded media (no film) for sound, etc.	6,679
Electrical appliance for electrical connection (e.g., fuse, switch)	6,593

Imports	Value ($ million)
Electronic integrated circuits and microassemblies	92,766
Petroleum oils, not crude	82,656
Crude petroleum oils	31,731
Automatic data processing machines; optical reader, etc.	20,605
Parts and accessories of computers and office machines	20,548
Electric appliance for line telephony (incl. current line system)	17,747
Gold, unwrought or in semi-manufactured forms	12,694
Motor cars and vehicles for transporting persons (except public transport motor vehicles)	12,202
Parts and accessories of motor vehicles	11,058
Diodes, transistors, and similar semiconductor devices, etc.	10,188
Printing machinery, machines used ancillary to printing	8,043
"Parts suitable for use soley or principally with televisions"	7,664
Motor vehicles for transport of goods	7,601
Natural rubber, in primary form or plates	7,403
Aircraft, powered; spacecraft and launch vehicles helicopters, satellites	7,105
Parts of machinery (for lifting, handling, loading, unloading, scraping, boring, extracting, leveling)	6,929
Electrical appliance for electrical connection (e.g., fuse, switch)	6,858
Rice	6,344
Turbo-jets. turbo-propellers and other gas turbines	6,198
Machines and mechanical appliances having individual functions, not specified or included elsewhere	5,477

Source: ASEAN Secretariat. 2012. ASEAN Community in Figures 2011. Jakarta.

Figure 2: Foreign and Domestic Investment in Indonesia, 2006–12 ($ billion)



FDI = foreign direct investment.

Source: Authors' compilation of data from the Indonesian Investment Coordination Board (BKPM Indonesia).

2. AEC by 2015: Opportunities and Challenges to Members

The overarching goal of the AEC is to further regional economic integration. It aims to accomplish this by freeing up the flow of goods, services, investment, and skilled labor, and by allowing the freer movement of capital. This will establish a single market and production base within ASEAN in which member states are expected to benefit from increased trade in goods and services, the efficient use of production factors, greater competitiveness among all member states based on their respective comparative advantages, and more opportunities for entrepreneurs in the region. These gains will improve economic welfare and support the further development of all member states.

While the AEC's goal of market integration is the most widely discussed, the main driving force behind ASEAN integration is production integration. Over the past decade, Asia as a whole has increasingly organized trade into regional production networks that tie neighbors together through a vertically integrated production process. Intra-ASEAN trade, which constituted 25.4% of total ASEAN trade in 2010, consists mostly of trade in component parts and raw materials (intermediate goods) for the manufacturing of consumer goods. Table 1 illustrates that intermediate goods top both export and import flows in the region. These flows have been supported by relatively low tariffs under the Common External Preferential Tariffs (CEPT)–ASEAN Trade in Goods (ATIGA) scheme.

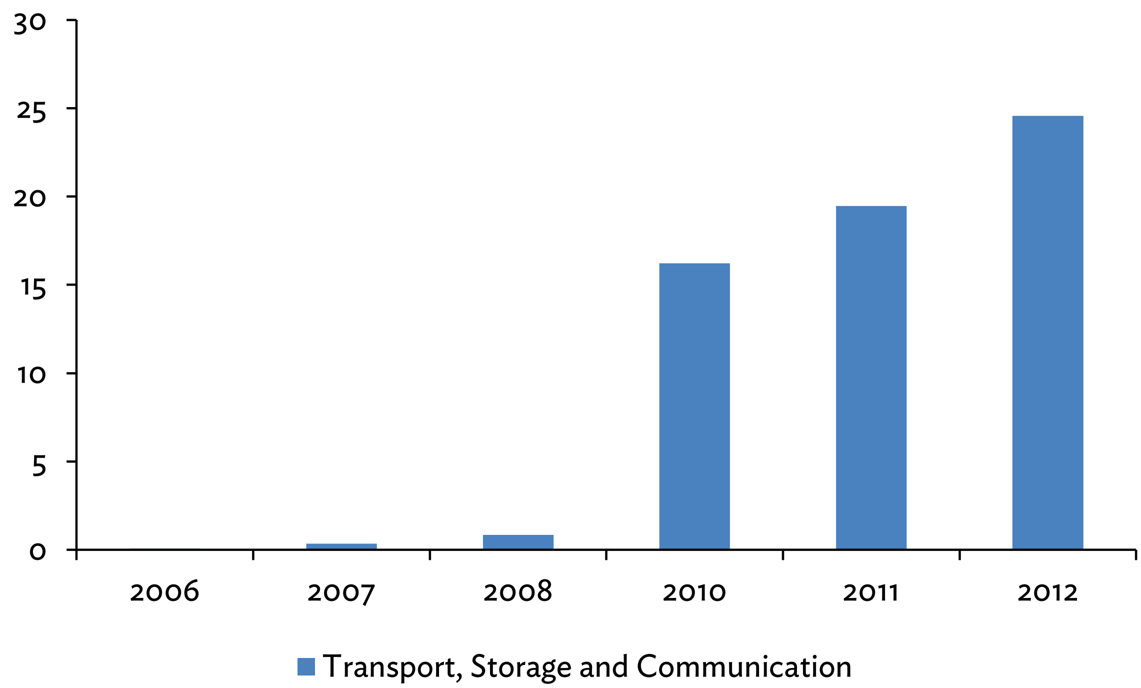
Though intra-regional trade has been an engine of growth in the region, challenges to the completion of a single market remain strong. These include non-tariff barriers and existing FTAs. Non-tariff barriers—standards, SPS requirement, and infrastructure—and carve-outs for protected sensitive industries will present negotiating challenges as each is usually supported by a domestic political constituency.

3. Indonesia's Challenges

For Indonesia to extract the maximum benefit from the AEC, it must address some elements of its current trade and investment policies that artificially limit trade flows. For example, the relaxation of non-tariff measures are needed to improve the flow of intermediate goods required for production activities in Indonesia. Pro-investment policies that ensure a stable and competitive investment regime will reduce the risk of investing in Indonesia, which can increase its attractiveness as an investment destination among ASEAN countries.

Indonesia has much to gain from a single ASEAN market. As a large country with favorable demographics, domestic demand drives GDP. Substantial natural endowments and relatively stable macroeconomic indicators can also serve to attract resource-seeking, market-seeking and platform foreign direct investment (FDI).

Figure 3: Infrastructure FDI Inflows in Indonesia ($ billion)



FDI = foreign direct investment.
Source: Authors' compilation of data from BKPM Indonesia

Yet, even with such opportunities, Indonesia still faces challenges in preparing to become a competitive player in the AEC. There are five challenges in particular that must be addressed in order for Indonesia to realize the full benefits of the AEC.

A. Low Capital Endowment

Figure 2 shows Indonesia's capital endowment sourced from FDI inflows from 2006 to 2012. A low relative capital endowment limits Indonesia's efforts to expand its production capacity and become a principal production hub in the region. For example, its mining sector requires substantial capital to finance exploration and extraction. This applies to other sectors as well, including manufacturing.

As a result of its low capital endowment, capital needs to be sourced from outside the country. Unfortunately, out of US$1,463 billion of global investment flows in 2011, only 1.3% went to Indonesia. Thus, there is significant capital available in the global market but it will only come to Indonesia if the country creates a conducive investment environment.

B. Limited Infrastructure

Infrastructure refers to both soft (policy) and hard (physical) infrastructure. Indonesia lacks adequate physical infrastructure—railways, airports, ports, and roads—to facilitate substantial trade flows. It is one of the countries in ASEAN with the highest costs for exporting goods.

Similarly, its regulatory framework restricts development in trade and investment. For example, restrictions on foreign investors exist in logistics services and maritime transportation in the form of joint-venture requirements and a maximum foreign ownership allowance of 49%. Although these restrictions are in compliance with Indonesia's obligations under the ASEAN Framework Agreement on Services (AFAS), they come with the price of limiting competition. This is being exacerbated by the plan for full implementation of a cabotage policy for domestic sea transportation that will ban foreign vessels from transporting goods or passengers between two points within the country by 2015, despite the shortage of Indonesian-flagged vessels. Effectively, with fewer vessels operators will have less competition and may possibly raise fees.

The introduction of a Master Plan for the Acceleration of the Expansion of Indonesia's Economic Development (MP3EI) is a good initial step being taken by the government. MP3EI creates a regulatory framework that enables public–private partnerships to finance physical infrastructure development. This appears to have yielded some results as shown in FDI in infrastructure, which has been increasing since 2010.

Table 2: Convicted Corruptors by Position, 2004–2013

Position	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Legislator	0	0	0	2	7	8	27	5	16	7	72
Ambassador	0	0	0	2	1	0	1	0	0	0	4
Governor	1	0	2	0	2	2	1	0	0	1	9
Mayor (Regent) and Deputy	0	0	3	7	5	5	4	4	4	2	34
Civil Servant (Echelon, I,II, and III)	2	9	15	10	22	14	12	15	8	7	114
Judge	0	0	0	0	0	0	1	2	2	3	8
Private	1	4	5	3	12	11	8	10	16	17	87
Others	0	6	1	2	4	4	9	3	3	9	41
Aggregate Total	4	23	29	27	55	45	65	39	50	48	385

Source: Data from Indonesian Corruption Eradication Commission (KPK) (updated on 31 August 2013).

C. Corruption and Decentralization

Corruption has long been recognized as an endemic problem in Indonesia, as exemplified by the establishment of the Indonesian Corruption Eradication Commission (KPK) a decade ago. In recent years, the fight against corruption has intensified as evidenced by the unprecedented number of judges, government officials, legislative members, and even police officials who have been brought to justice. However, this has not improved Indonesia's ranking in the Corruption Perception Index, which slipped 14 places in 2013 to 118th compared to its rank in 2011.

Corruption is not only the result of a lack of legal enforcement. The decentralization of the Indonesian government since 1999 has also contributed by creating new opportunities for corrupt activities. Excessive layers of bureaucracy also increase uncertainty for foreign investors due to overlapping or even contradictory regulations between the central and regional governments. Although petitions over conflicting regulatory practices can be brought to the Supreme Court, the process is time-consuming and resolution can take up to 6 years. Between 2006 and 2013, 186 cases of regulatory judicial review were decided by the Supreme Court.

D. Counter-Productive Investment Regulations

Indonesia is seeking to climb up the value-added ladder. One of the policies issued for this purpose is a restriction on the export of raw materials, set to be fully implemented by 1 January 2014. This restriction exemplifies the lack of full consideration given to certain policies that can result in counter-productive outcomes. For example, the bauxite ore extraction industry is at risk of being negatively affected. Indonesia has the sixth largest deposits of bauxite in the world and is currently the world's fourth largest producer. However, Indonesia's limited domestic capacity to process the ore into alumina, which is an intermediate material needed to produce aluminum, may lead to an existing natural resource being underutilized. This is not the only industry that may be affected by the potential ban as all other mineral extraction industries are at risk given the limited number of smelters in Indonesia. In addition, supporting infrastructure is insufficient—such as ports, transport links, and access to energy—in mineral-rich regions such as Kalimantan. This, in effect, has created confusion for businesses as well as government officials. These kinds of measures may backfire if investors' operations are significantly affected and they are motivated to move their operations elsewhere.

4. Strategies to Navigate Forward

As Indonesia progresses in meeting its commitments to the AEC, it simultaneously has the opportunity to implement complementary reforms to promote structural transformation and encourage FDI flows. Such reforms can also ensure that Indonesia is able to take advantage of its position as a large market within a dynamic region. There are four policies that Indonesia might consider in the short-run to maximize its gains from participation in the AEC.

First, Indonesia can consider better support for the existing legal framework. While the domestic legal framework may be weak and subject to corruption, there are alternative international legal structures where progress may be more direct. For example, Indonesia is subject to dispute settlement commitments under its Bilateral Investment Agreements (BITs), the ASEAN Comprehensive Investment Agreement

(ACIA), and the World Trade Organization (WTO). This may build support for broader domestic reform and strengthens the rule of law. Eventually, this may guide the government to remove contradictory laws that deter investment and to act in compliance with its international obligations.

Additionally, the government can increase opportunities for investors to participate in the formulation of trade policies and related activities. One way to do this is by ensuring the implementation of MP3EI, which incorporates the public–private partnership scheme to effectively finance the development of Indonesia's infrastructure.

A third consideration is that the government must also understand the type of FDI that it wants to attract. In this regard, Indonesia may want to attract FDI that can help enhance the competitiveness of existing industries. This can be done by taking global value chain (GVC) promotion measures, such as providing more incentives for the high-tech manufacturing industry and untangling the complicated bureaucracy. At the same time, the government should build its domestic productive capacity by supporting the development of the workforce. A final policy is to move away from protectionism as a trade instrument. While the country may be a target market for various products from the region, the government should be aware that in the context of GVC promotion measures it should not implement protectionist trade policies, especially for intermediate goods. With regard to final goods, by enhancing the competitiveness of domestic industries, they will be able to compete fairly with products from other ASEAN member states. At the same time, the government should establish strong enforcement institutions that can identify unfair trade practices against domestic industries and address them accordingly.

The above-mentioned strategies may not yield immediate results. In fact, it will take time to implement these strategies. However, if Indonesia seeks to be better prepared, it should start the implementation process now in advance of the full realization of the AEC.

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