Policy Paper

Indonesia for Global Justice

June 2019

Reforming Indonesia's Trade Policy Under the Threat of Prolonged Deficits

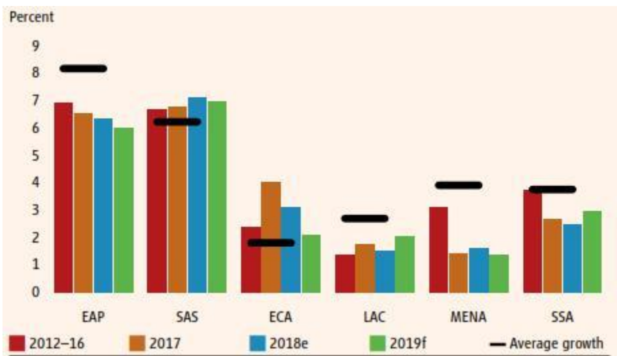
BPS(Statistics Indonesia) recorded Indonesia's trade balancein the first quarter of 2019, Indonesia had a deficit up to 2.5 billion USD while in 2018 it experienced deficit to 8.5 billion USD, and it is the worst in the history. According to that, will Indonesia experience a more severe trade deficit later this year? Especially in the middle of the current global situations nowadays that is exacerbated with the trade wars by the major players in global trade. Then what can Indonesia possibly do to overcome the trade deficit in the future? Will the government aggressiveness in conducting FTA (Free Trade Agreement) negotiations will be able to improve the balance significantly?

Introduction:

The Trade Balance Situation

Trade deficit that continues to swell seen as a result ofIndonesia trading performance in respond to global economic conditions are still relatively sluggish. The World Bank in its report predicts world economic growth in 2019 will still be held below 3%. While global trade only grew in the range of 4%. However, the World Bank is still optimistic that the growth of the East Asia and Pacific region (EAP) in the range of 6% which lost to South Asia's growth that reach 7%.

Regional Economic Growth 2012-2018



Source: World Bank[1]

[1] World_bank

The question arises, why does Indonesia continue to be overshadowed by the trade balance deficit which is predicted to worsen from year to year? This trade balance deficit is caused by two factors; **First,** in the non-oil and gas sector, throughout 2018 there was a significant increase in import value compare to the export value. The performance of non-oil and gas trade in 2018 depleted its surplus by 3.9 billion USD, recorded in 2019 from January-April (Q1) by 204 million USD only.

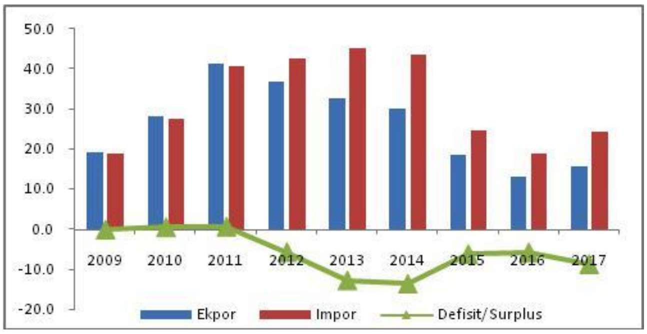
2014-2018 Non-Oil and Gas Exports (in Billion USD)

Source: Ministry of Internal Affairs

Second, in the oil and gas sector, the deficit has occurred since 2012 and has not returned to a positive position. This is due to the dominance of imported oil and gas products; BBM, LPG and condensate, where the latest data released by BPS in 2017 showed a deficit of 12.9 billion USD.

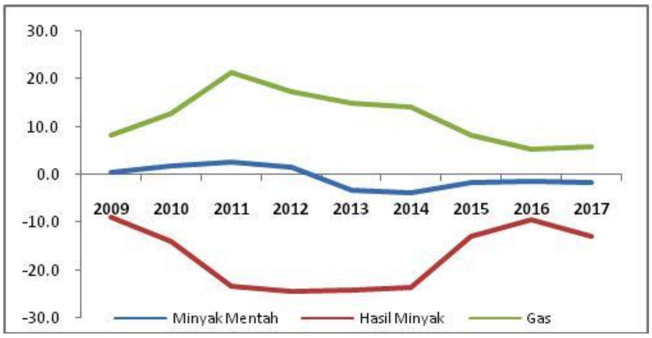
Meanwhile, exports only rely on gas exports where the surplus is up to 6 billion USD.The developments in Q1 2019 of oil and gas sector contributed a deficit of 2.7 billion USD[2]. The oil and gas sector contributed a significant deficit in line with fluctuations in world oil prices, in 2018 recorded a deficit of up to 12.46 billion USD.

Oil and Gas Exports-Imports in 2009-2018(in Billion USD)



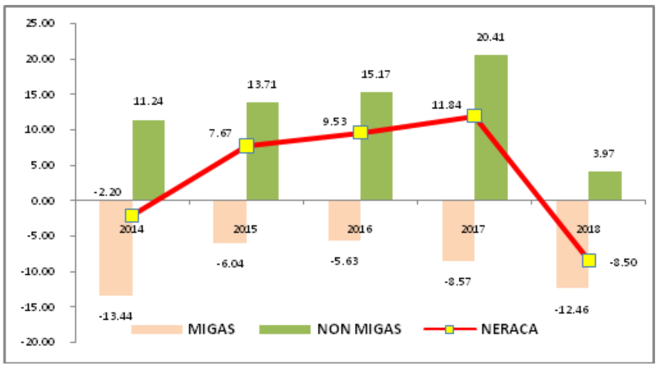
Source: Processed from BPS

2009-2018 Oil and Gas Balance Per Component (in Billion USD)



Source: Processed from BPS

Indonesia's Trade Balance in 2014-2018 (in Billion USD)



Source: Processed from Ministry of Trade

[2] BPS

FACTS

1 . Lower Value Added in Exports

Indonesia's exports recorded in 2018, when it seen from the performance per commodity if Indonesia's exports still rely on extractive commodities which approximately is around 24.05% with the composition: Coal 14.28%, Ore, crust and 3.53% metal ash, Iron and Steel 3.22%, copper 1.2% and tin 0.95%. While plantation and forest commodities which were semi-finished commodities reached 22.28% including; CPO is 12.50%, rubber is 3.92%, wood is 2.72% and pulp is 1.63%, tobacco is 0.74% and cocoa is 0.77%. As for raw goods such as fish and shrimp reaches 2:03% plus coffee, tea and spices 0.95%. In total, almost 50% of Indonesia's trade is a commodity with relatively low added value[3]

In terms of value, Indonesia's 10 (ten) largest export commodities in 2014 and 2018 are; Mineral fuel (coal) has increased dramatically in the range of 20.8 billion USD to 23.9 billion USD. CPO in the weak category and animal/vegetable oil declined slightly from USD 21 billion to USD 20.3 billion. Machinery and electrical equipment decreased considerably from 9.7 billion USD to 8.8 billion USD, on the contrary, vehicles and their parts rose significantly from 5.2 billion USD to 7.5 billion USD. Rubber and Mechanical Machinery each fell from 7 billion USD to 6.3 billion USD and 5.9 billion USD to 5.8 billion USD.

Value of 10 (ten) Indonesian Export Commodities in 2014 and 2018 (in USD)

Sectors	**2014**	**2018**
Mineral Fuels	20,884.0	23,982.4
Fats & Animal/Vegetable Oils	21,037.0	20,344.6
Electric machinery / equipment	9,745.7	8,854.0
vehicles and their parts	5,123.7	7,552.0
rubber and rubber goods	7,088.3	6,371.7
machinery / mechanical aircraft	5,969.1	5,865.9
Iron and Steel	1,148.1	5,751.4
jewelry and gems	4,619.4	5,557.4
Iron ore, crust, and metal	1,906.0	5,244.4
Footwear	4,108.4	5,113.3
Total Non-Oil	**145,961.2**	**162,810.2**

Source: Processed data from Ministry of Trade

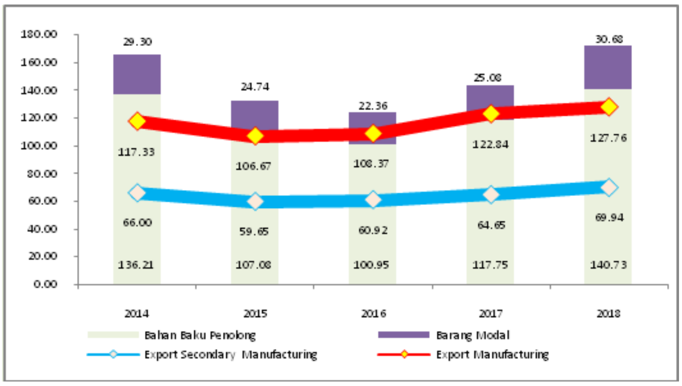
[3] Kemendag

Along with the relaxation policy, the ban on raw metal exports imposed since 2017, Iron and Steel rose very significantly from 1.1 billion USD to 5.7 billion USD, followed by Ore, Crust and Metal Ash also increased from 1.9 billion USD to 5.2 billion USD as well as jewelry and gems that increased from 4.6 billion USD to 5.5 billion USD. Meanwhile, the 10th largest commodity is footwear which increased from 4.1 billion USD to 5.1 billion USD.

2. The Greedy Industry of Imports

BPS records, the non-oil and gas in Indonesia dominated by the auxiliary raw materials in Q1 2019 stated to even reach 75.09%, while the export industry reach 74.03% portion. According to 2018 data, from 127.7 billion USD export value of processing industry only 69.9 billion USD or the 54.7% comes from secondary manufacture. Whereas in a simple logic, imported raw materials is a material that is more needed by secondary manufacture, while on agriculture and mining based industries processing more goods which produced from domestic raw materials.

The Comparison of Industrial Export Products and Imports of Industrial Supplies from 2014-2018 (in Billion USD)



Source: Processed from Ministry of Internal Affairs

This situation shows that the export of auxiliary raw materials whose value in 2018 reached 140.7 billion USD, half of this value was estimated went into industry with domestic-market orientation. This assumption is of course very rough calculation, it could be that the value is much greater considering the value of secondary manufacture export output should be much higher than the input value. Detailed data cannot be tracked given the limitations of data that can be accessed by the public, but this shows early indications that need to be studied jointly within the government which certainly has comprehensive data access from trade records at the Director General of Customs and Excise, Ministry of Finance, Ministry of Trade and Ministry of Industry.

ANALISYS

Aggressiveness of FTA is not a Solution to Increase Exports

On the other hand, the government of Indonesia is intensively proposing a Free Trade Agreement (FTA) with various partner countries on the grounds to boost the value of exports and encourage commodity re-exports to third countries. At least Indonesia is bound by 10 trade agreements[4] and 4 agreements that still underway the negotiation process plus 13 other negotiation initiatives[5].

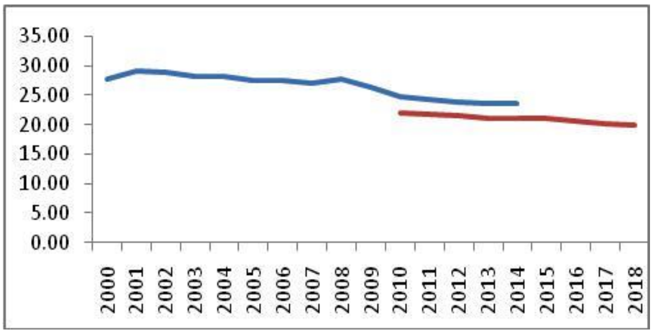
The opening of the market through FTA is indeed possible to open up greater export opportunities, but it does not mean that it is able to increase the value of exports by itself. To increase export value in utilizing FTA results, at least a comprehensive domestic policy is needed to spur significant growth in industrial capacity, especially industries which is needed in the markets of destination countries that have and will be bound in the FTA.FTA aggressiveness must be accompanied by three important things; **First,** increasing domestic production capacity, especially manufacturing-based ones. **Second,** Consideration of commodity competitiveness in the global market, and **Third,** Anticipatory scheme to manage the expansion of imports into the domestic market.

Judging from the first prerequisite, the actual conditions are precisely the opposite where industrial growth is only in the range of 4.27% in 2018 or slower than the economic growth which reached 5.17%. This is a symptom that has been going on for a long time where there is a decline in industrial contributions in GDP after the 1998 crisis and continues until now, or experts call it a

[4] WTO
[5] Kemendag

symptom of premature de-industrialization. This fact shows the need for the government's hard work to spur back the industrial growth.

Premature De-Industrialization Symptom



Source: processed from BPS

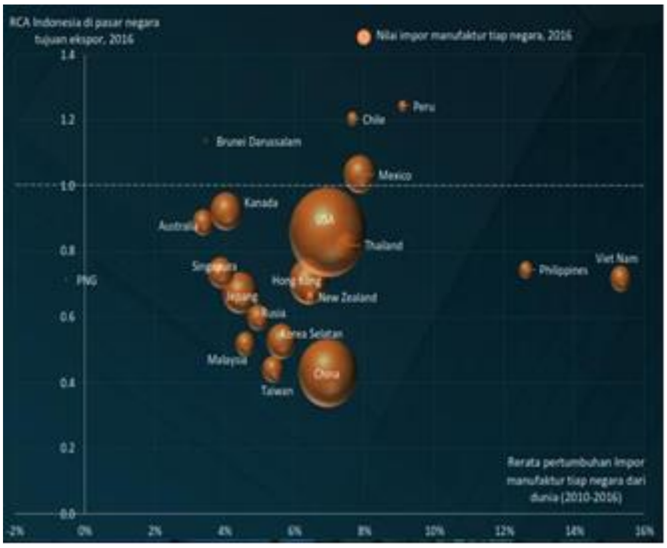
Without the development of industrial capacity, the FTA will not be able to lift an export performance which is only used 3 types of commodities only, namely; 1) Extractive industry products: Coal, Nickel, Iron, etc., 2) Intermediary commodities; CPO, Pulp, Rubber, etc., and 3) Raw Commodities, especially fisheries, timber and plantation products. All three are the industries with relatively low added value which is very dependent on global commodity price fluctuations.

Meanwhile, from the second prerequisite it can seen on how low commodity competitiveness, Revealed Comparative Advantage (RCA) Indonesia in the world's main market still less than 1 or below the global average, where to be a competitive market player at least the RCA value must be more than 1 and the higher the value, the better.

From the list of 19 Indonesian commodities that have RCA values above the world average (> 1) only 4 commodities, namely Palm Oil which in 2012 at 4.39 dropped to 3.97 in 2016, Footwear rose from 1.50 to 1.72, Coffee, tea and spices which fell from 1.49 to 1.32 and tin 5.66 to 6.66. While other commodities are far below 1 (<1), which means it is difficult to try to expand the market significantly. Even some experienced a downward trend including fuels, Chemical Products, Apparel, Furniture, Iron and Metal Raw Materials, Processed Wheat and Steel[6].

The government of Indonesia's efforts to shift trade to non-traditional markets but by capitalizing on non-competitive commodities will be difficult to change the performance of Indonesia's competitiveness. Exports to non-traditional markets certainly also have the same level of competition as traditional markets. The World Bank notes that the import value of several world market destinations in 2017 from Indonesia is still relatively small, the United States (21.15 billion USD), Australia (3.23 billion USD) and the European Union (16.7 billion Euros). This value is still lagging behind the import values of these countries from several other Asian industrial countries.

Indonesia's RCA in Several World Contries



Source: UNCTAD[7]

In addition, the FTA scheme is also feared to further increase the entry rate of raw materials auxiliary for domestic market-oriented industries so that in the long run there will be a higher level of industrial dependence on imported raw materials. The government needs to prepare an anticipation scheme by managing the traffic on industrial raw materials import to avoid the trade off with the potential of the domestic supply chain, especially those that shares the livelihoods of many people in the agriculture, fisheries, etc. Dependence on imported raw materials also has the potential to hinder national industrialization plans to encourage import substitution.

[6] Bhima Yudistira, INDEF, 2017

[7] Mohammad Faisal, Core Indonesia, April 2018.

The government needs to deal with the above matters by implementing a higher tax imposition scheme for non-export industries which consume imported raw materials auxiliary, especially in categories of goods that have the potential to be substituted domestically. On the other hand, the government needs to provide large incentives for local industries which further encourage the availability of domestic raw materials for export and import substitution. All of this certainly requires the seriousness of the government in the next 5 years to coordinate trade, industry policies and fiscal schemes.

Saving Oil and Gas Deficits

As for overcoming the oil and gas trade deficit, at least it will be resolved immediately if the 6 new Pertamina refineries targeted to be completed by 2023 can be realized or even accelerated. With this development, at least by increasing the optimal refinery capacity from 850 thousand barrel per day to 2.05 million barrel per day by 2025 so that it will reduce the import value of refined oil.

Even if this scenario has the potential to increase the value of crude oil imports but also has the potential to give rise to the export value of processed oil in the form of condensate or even be able to produce increased capacity of petrochemical industries derived from oil and gas processing, including other derivative industries such as; textiles, plastics, garments, plastic goods, etc. This increase in derivative industrial production capacity certainly allows market penetration given the increased availability of local raw materials.

However, in addition to enlarging the refinery, the government must also consider shifting to natural gas / Liquefied Natural Gas (LNG) for the power plants supply and local industries, given that there will be an additional gas supply around 7-9 MPTA (million cubic per year) in 2027 after the Masela Block operates. Now the total LNG production has reached 18 MPTA, at least there is a domestic quota of 6 MPTA, but it is still not utilized optimally and only absorbs around 2.8 MPTA. Meanwhile, imports have reached 12 MPTA.

RECOMMENDATIONS:

Projection and Steps Forward

At least in the next 5 years, the Indonesian government will continue to be faced with the threat of a trade deficit that continues to swell from year to year. Especially considering that globally there is still a phenomenon of trade war carried out by various countries to try to pursue domestic growth through export barriers.

Indonesia itself is threatened with this regulation, especially for palm oil and timber commodities that have trade restrictions to the European Union, palm oil derivative products are also subject to up to 50% import duty to India, and later the United States is discussing the imposition of higher import duties for countries that accused of playing the low exchange rate where Indonesia was considered as one of them.On the other hand, Indonesia has not been able to become a substitutive player on commodities from countries affected by rising import duties in trade wars, especially to the US market.

The deepened of trade deficit is a serious threat toward foreign exchange reserves which is clearly impossible to deal with by relying only on incentives to raise interest rates. This is because Indonesia's interest rates have been relatively high and if they continue to be increased it will threaten the resilience of the real sector. However, if it is not anticipated, the weakening of foreign exchange reserves will cause market panic whichcan be a trigger for the crisis.

So, it is absolutely necessary for the government's seriousness to overcome trade performance problems in the medium term (5-10 years ahead) with systematic policies in the industrial and trade sectors. To overcome this problem it cannot only rely on a quick win, for example the ban on importing 500 raw materials without being accompanied by the readiness of substitutive industrial capacity and adequate pre-conditions which will make the businesses frustrated.

Steps that must be immediately carried out by the government at least; **First, carefully arrange international trade cooperation policies and be more selective** and do not bind with the long-term commitments that harm the national economy.

Some things that should be of particular concern in the policy, namely: **(1)**Strengthen the position of negotiation to strengthen the reinforcement of local industry should be a negotiating positions which are not negotiable such as: *local content requirement policy (TKDN), limiting the export of raw materials, the obligation to transfer technology and ensuring the implementation of rules flexibility in the IPR, limiting the opening of market access for government procurement on goods and services, removing the rachet and standstill mechanism along with other mechanisms that limiting the state policy space, limiting the application of performance requirements, and remove the ISDS mechanisms*; **(2)** Comprehensive opening of market access needs to be reviewed and calculated by conducting a comprehensive impact analysis by the Government of Indonesia; **(3)** Non-Tariff Measures (NTMs) policy needs to be strengthened to become a strategy in dealing with the onslaught of imports in order to provide space for domestic products to be absorbed in various economic activities in Indonesia.

***Second,* developing import substitution-based industries by strengthening the supply chain based on local community products**, especially in the sector of Agro industry (agriculture, plantation, forestry, etc.) and Marine Industry (fisheries and marine). At least the government's initiative is needed to do two things; **(1)**Mapping potential links and matches the results of community production and its potential development on industrial scale, and, **(2)** Providing incentives to encourage collaboration between industry and small and medium enterprises in order to ensure the connection of the people's production chain. Both are to ensure that the plan of industrialization does not give birth to a trade off on the basis of people's livelihoods.

Industry is an intermediary factor that makes it possible to encourage more aggressive economic growth while allowing production capacity for exports to increase dramatically. If the government targets a 7% economic growth, it is inevitably necessary to encourage industrial growth of at least 10% so that it can contribute 2% of total economic growth. With adequate industrial growth it allows three things; 1. Reinforce the absorption of local commodities to be developed into commodities with higher value, 2.Increase absorption of better labors considering that the industry is a formal labor absorber which can be encouraged to create decent work conditions, and 3. Increased bigger tax revenue, considering that until now the industry is the biggest contributor to taxes reaching 30% in 2017 with a tax coefficient of 1.46 times of its contribution to GDP[8].

***Third,* Managing the Energy Sectors**, specifically accelerating the realization of the construction of 6 new Pertamina refineries with adequate incentives for investors and optimizing the use of LNG. Both must also be prepared to support derivative industrial raw materials in order to have better competitiveness.

All three are expected to be able to provide a solid foundation so that the Indonesian economy continues to grow sustainably amid the global economic turmoil. However, the government must ensure that plans to encourage investment should not degrade the rights of the livelihoods of local people or the quality of the environment so that they must be supported by careful planning involving the broadest participation of the people.***

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